LAKELAND CAPITAL

Multifamily Leads the Way in Real Estate

Historic outperformance and powerful tailwinds make multifamily the sub-sector to watch within the asset class

Key Insights

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Real estate has historically supported investment portfolios with diversification benefits and steady returns, especially during periods of high inflation and economic uncertainty.

Multifamily occupies a sweet spot in the asset class and should deliver more downside protection while also capturing additional upside opportunities.

Overwhelming demand for affordable housing should provide a powerful tailwind that soaks up new supply and generates further returns.

Interest in real estate investing has grown considerably since the onset of the global pandemic triggered historic volatility in traditional asset classes. Once thought of as a safe-haven, bonds, in particular, have weathered heavy losses that spurred investors to divest portions of their portfolio in search of steady returns. The question that many are now asking is: How would an allocation to real estate bolster their portfolios?

While real estate investments deserve consideration in every market environment, we feel that they can play an especially vital role in the current climate of economic uncertainty. This is because history has shown that real estate offers meaningful diversification benefits versus traditional asset classes while also performing well during periods of high inflation. Within real estate, we feel that the multifamily sub-sector is uniquely positioned to deliver additional upside with powerful tailwinds driving an increased demand for affordable housing.

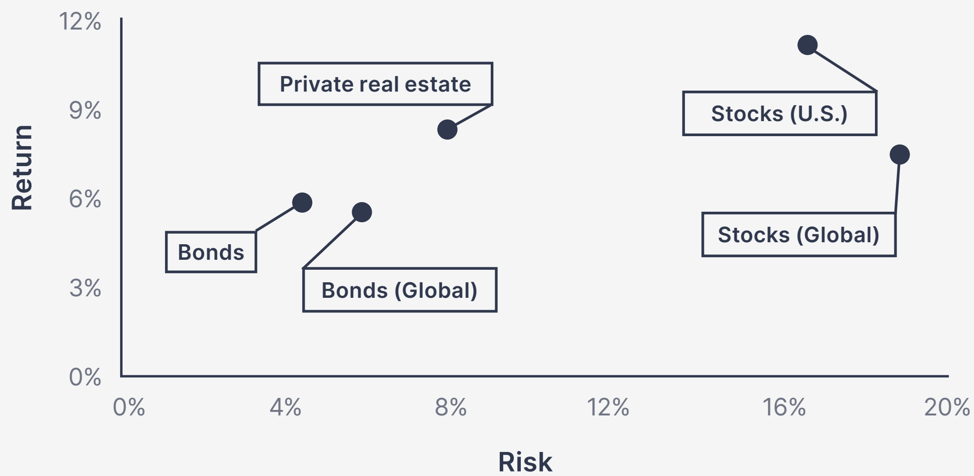
How Real Estate Bolsters Investment Portfolios

Investors who relied on the old adage of building a blended portfolio solely around stocks and bonds found their patience sorely tested in the past few years. While major U.S. and global equity benchmarks have recovered from sharp losses at the start of 2020, they still trade off recent highs and remain weighed down by high valuations. Meanwhile, the U.S. 10-year treasury yield topped 4.2% in 2022 for the first time in nearly 15 years.

Adding an allocation to real estate could help investors to bolster their battered portfolios. Importantly, private real estate has demonstrated very little correlation to either stocks or bonds[1]. That diversification benefit together with a relatively low level of risk, as measured by standard deviation, makes real estate a useful defensive component.

Real estate is also an inflation hedge. Since property is a physical asset, rising costs can be passed on through a reset in rents. This is in part why private U.S. real estate has outperformed stocks and bonds over the past four decades during periods when inflation was higher than normal[2]. In fact, real estate has also delivered positive returns during each of the past five periods of extended monetary tightening. This is perhaps most relevant to investors going forward because the Federal Reserve (Fed) launched its latest round of rate hikes in 2022 and has cautioned the market to expect higher lending rates in the face of stubbornly high inflation.

Figure 1 — Real estate delivers downside protection with upside opportunities



Source: Nuveen. Y-axis displays average annual returns; X-axis displays standard deviation. Data are based on rolling one-year total returns, calculated on a quarterly basis for periods ending March 31, 1992 through December 31, 2020. Data sourced from NCREIF, FactSet, Nuveen, LLC.

1. Nuveen. Resiliency and diversification from uncorrelated market exposure. May 2021.
2. Brookfield Real Estate. Real estate investing: An effective solution amid rising inflation. 2021.

Multifamily Leads the Way

Within real estate, we feel that the multifamily sub-sector occupies a sweet spot that can deliver downside protection while also capturing even more upside potential than the broader asset class.

Multifamily compares favorably on a historical basis against other real estate sub-sectors like hotel, industrial, retail and office. It delivered the highest average annual return during the 25-year period ending in 2017 and notably boasted a significantly lower risk level than the office and industrial sub-sectors[3].

Helping to drive the steady performance, multifamily is less susceptible to cyclical downturns since affordable housing is an ever-present need. To use the Global Financial Crisis (GFC) as an example, it took multifamily 8 quarters to recover its value, while the office sub-sector required 12 and hotel needed 15. As for rent prices, multifamily recouped its losses even faster, in just 7 quarters[4].

Not all geographic regions are equal though when it comes to multifamily investment. For instance, metro areas in the Northeast and Mid-Atlantic regions bounced back from the GFC faster than the national average, whereas it took Atlanta and Phoenix more than three years apiece. This makes it imperative for investors to develop an informed, on-the-ground view of the nuances and specific factors that could impact local markets.

3. CBRE. U.S. multifamily housing: A primer for offshore investors. 2017.
4. CBRE. Which multifamily markets held up the best in the last downturn. 2019.

Long-Term Support for Multifamily

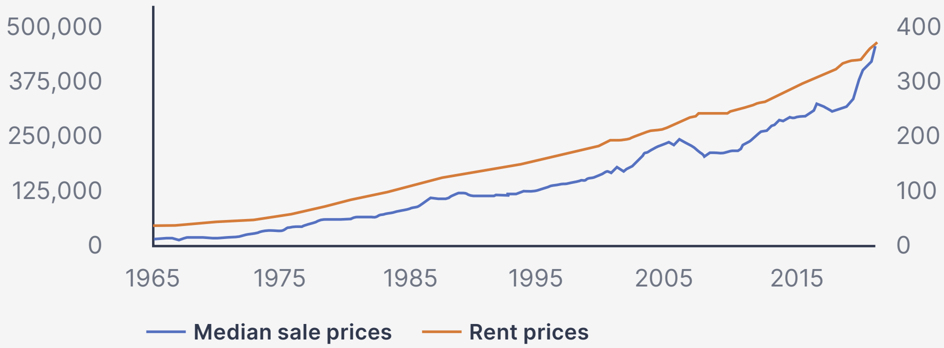
Multifamily has been a cornerstone of the real estate asset class in large part because of the core demand for affordable housing. We expect that this will not only persist but actually intensify, creating a powerful tailwind that will drive further returns.

The historic unaffordability of home ownership is one of the key factors supporting increased demand for multifamily residential properties. Median sale prices of U.S. homes doubled over the past decade, while rents increased about 46% during that span. It is not just housing costs that are higher either. After a prolonged period of near-zero interest rates, the Fed has raised its key lending rate to a 15-year high, increasing the running expense of a mortgage. In fact, Freddie Mac estimates that 15 million mortgage-ready households now find themselves unable to afford a home[5]. It is no surprise then that census data going back to 1965 shows a record percentage of Americans households are now opting to rent, with upticks even across older demographics[6].

This environment has spurred more demand for rental housing, which in turn supports higher multifamily rent prices. Although not rising at the same blistering pace as sale prices, rents hit a record high in 2022 on the back of two straight years of double-digit percentage increases. While rent growth will no doubt moderate as landlords look to avoid tenant relocations amid an economic slowdown, we still see room for further gains. Meanwhile, Freddie Mac is projecting a 3.9% increase in 2023, which it states is above an annual range of 3.6%-6.1% set between the GFC and pandemic. CBRE expects rent growth for the year to top 4%[7].

Certain metro regions should also be able to support even higher rent growth. In the third quarter of 2022, for example, Boston recorded a 6% increase in multifamily rents versus a 4% uptick in the national average[8]. Richmond also beat the benchmark with a 7% rise[9].

Figure 2 — Home prices close historic gap with rents



Source: Federal Reserve Bank of St. Louis. Left Y-axis displays Median Sales Price of Houses Sold for the United States (dollars, quarterly, not seasonally adjusted); Right Y-axis displays Consumer Price Index for All Urban Consumers: Rent of Primary Residence in U.S. City Average (Index 1982-1984=100; quarterly, not seasonally adjusted).

5. Freddie Mac. 2023 Multifamily Outlook. December 2022.
6. Pew Research Center. More U.S. households are renting than at any point in 50 years. July 2017.
7. CBRE. U.S. real estate market outlook 2023. December 2022.
8. Colliers. 22Q3 Boston multifamily market report. November 2022.
9. Colliers. 22Q3 Richmond multifamily market report. November 2022.

Demand Will Still Outpace New Supply Glut

The overwhelming need for affordable housing has certainly not gone unnoticed by property developers who are preparing a record amount of new supply set to come on the market. CBRE forecasts 450,000 new units will be added in 2023, with a total of 3.5 million needed by 2035. We still expect that demand will significantly exceed supply in the near term, however, given that vacancy rates continue to sit below historical averages and employment opportunities within most metro regions remain abundant.

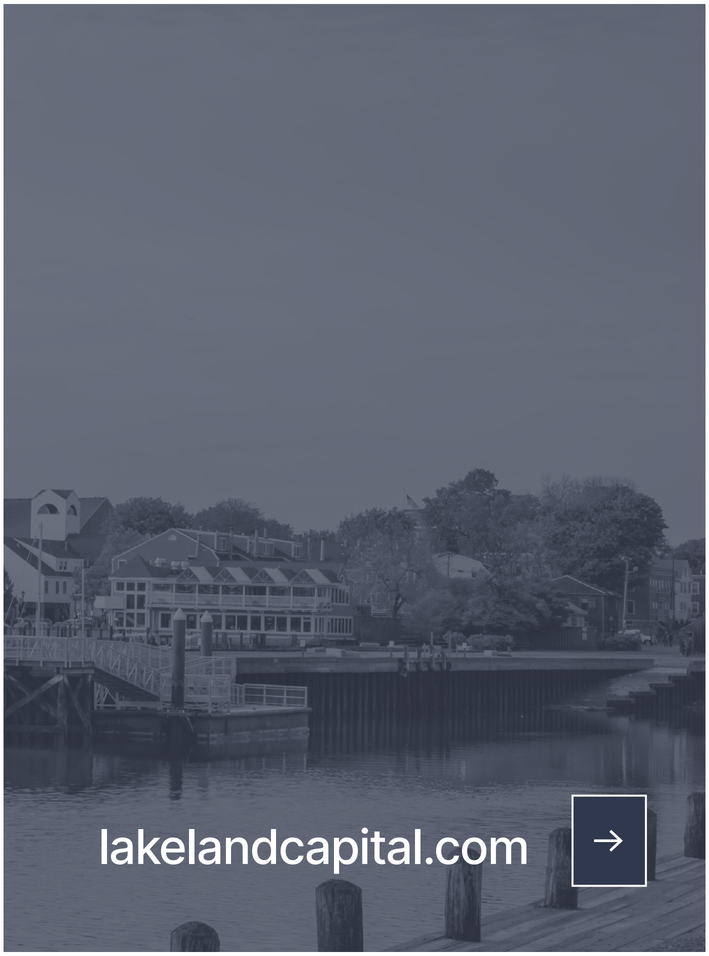
The coming supply glut is even more pronounced in specific metro regions where demand is most high. In Boston, there were 18,000 units under construction towards the end of 2022, which represented 8% of total inventory. While that certainly bears close observation, we remain confident that the strength of the local economy will support a robust level of demand able to soak up excess supply. It is worth noting that more than 12,000 jobs in biotech alone were created in Massachusetts in 2021[10].

10. Boston Globe. Despite industry-wide stock slump, Mass. Biotech startups raised $5.1 billion in the first half of 2022. August 2022.

What We're Watching Next

The real estate asset class has demonstrated a capacity to deliver not just downside protection but also upside opportunities when paired in a portfolio with stocks and bonds. We believe the multifamily sub-sector, in particular, will occupy increasing market interest, given its attractive risk adjusted return profile along with the unique tailwinds set to drive further positive performance.

Over time, we expect the opportunity set within this asset class will continue to grow, favoring strategic investors who can make effective allocation decisions based on an informed understanding of specific geographic markets that offer the most upside.



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