LAKELAND CAPITAL

Multifamily Investments Find a Home in Any Market Environment

Multifamily real estate can be a portfolio building block given strong track record and underlying physical assets

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Key Insights

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An allocation to multifamily has historically generated attractive returns while also providing diversification benefits and downside protection.

Unlike traditional asset classes, multifamily is a good inflation hedge and can offset rising prices through rent increases and capital improvements.

Investing in underlying physical assets through individual deals can help investors align their portfolios with unique goals.

Investors have been on a rollercoaster ride in recent years as markets plunged following the onset of the Covid-19 pandemic before surging upward almost just as rapidly. They can be forgiven for straining to see whether a new dip lies ahead or if the current rally still has more track left to run.

Unlike at a theme park though, investors can walk their own path simply by adjusting their portfolios. And now is an opportune moment to pressure-test investment decisions, with one-third of economists forecasting that the US economy is headed toward a recession in 2025.[1] The crucial question then becomes—*what is the optimal portfolio?*

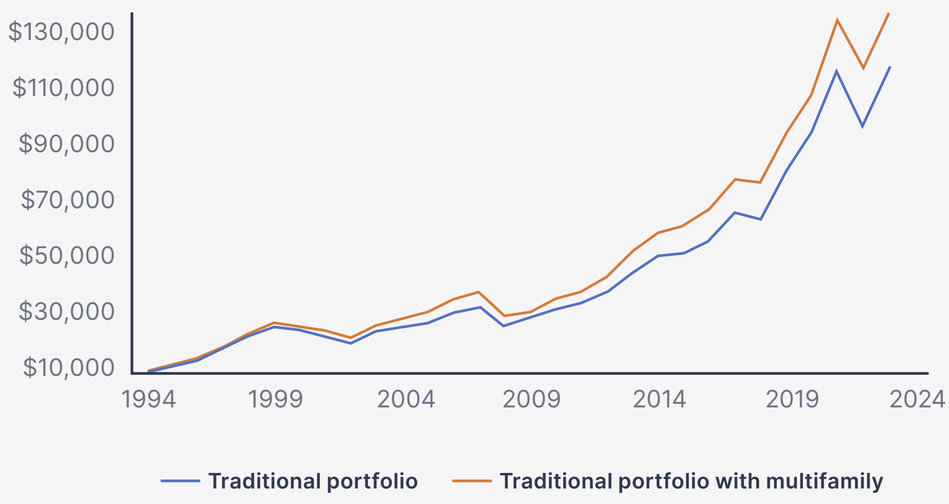
We believe the best mix of investments includes an allocation to multifamily real estate. It has a lengthy track record of delivering strong returns, even during times of elevated inflation, and provides critical diversification benefits versus traditional asset classes. Importantly for investors with a longer-term time horizon, multifamily investments in select locations with proven managers have also demonstrated the capacity to generate significant added value.

Multifamily Allocation Can Prop Up the Portfolio

The traditional investment wisdom is that a balanced portfolio consisting of 60% stocks and 40% bonds (60/40 portfolio) should be primed for long-term success. But that strategy seemed to fizzle out in recent years as government bonds lagged behind other asset classes amid an extended period of low interest rates followed by a spike in inflation. As a result, investors have been left to consider whether they should make allocations to additional asset classes.

Multifamily real estate could certainly provide a meaningful boost to portfolio performance, especially if history is any guide. Over the past 30 years, a 60/40 portfolio that added 20% multifamily and cut the bonds allocation down to 20% generated higher returns than its traditional counterpart. Multifamily delivered an annualized return of 8.4% during that span, nearly double that of US 10-year Treasuries. It also outperformed US investment-grade corporate bonds as well as gold and the broader commodities market on a risk-return basis.

Figure 1 — Portfolio returns boosted by multifamily allocation



Source: Y-axis displays value of portfolio starting at $10,000. Data is calculated on an annual basis from 1994-2023. Hypothetical asset allocations are as follows—traditional portfolio (60% S&P 500, 40% 10-year US Treasuries), traditional portfolio with multifamily (60% S&P 500, 20% 10-year US Treasuries and 20% multifamily). Data sourced from National Multifamily Housing Council and Federal Reserve of St. Louis (FRED).

1. Bankrate. Q2 Economic Indicator Survey. July, 2024.

The diversification qualities of multifamily are another reason why we believe it merits consideration as a core component in most portfolios. During the past 30 years, multifamily real estate had a correlation of just 0.09 to the S&P 500 and 0.10 to US 10-year Treasuries on a scale of 1 to -1, where 1 indicates values moving in tandem and -1 shows them moving inversely. By contrast, the lowest tier of investment-grade corporate bonds had a 0.47 correlation to the S&P 500, which would have resulted in increased volatility for investors who added it as an allocation to a portfolio with a high concentration of stocks.

It is also worth taking a closer look at the defensive qualities multifamily can provide in a portfolio. Multifamily properties themselves are intended to satisfy the fundamental need for affordable housing and cannot be easily replaced. That is in large part why we view this real estate sub-sector as an all-weather investment and why it managed to record gains in 27 of the past 30 years versus 24 for the S&P 500 and 23 for US 10-year Treasuries. Notably, the return profile of multifamily was even more stable than the supposed safe haven of Treasuries, as measured by standard deviation.

Inflation Hedge That Outperforms Broader Real Estate Market

An extended period of low interest rates may have lulled investors into a false sense of calm before inflation suddenly spiked to a 30-year high in 2022. The Federal Reserve (Fed) raised interest rates 11 times over the course of just 16 months to counter the rapid rise in prices, triggering sharp swings across most asset classes. Inflation has since eased but is still expected to remain above the Fed's key 2% target in the long term, underscoring the imperative for investors to account for it in their portfolios.[2]

Inflation can significantly weigh on traditional asset classes. A 60/40 portfolio would have recorded negative returns in four of the past seven periods dating back to 1941 when inflation exceeded 10%. Also concerning, the correlation between stocks and bonds turned positive in five of those periods, climbing as high as 0.57 between June 2021 and February 2023.[3] That indicates investors not only had to contend with disappointing performance but also a breakdown in diversification.

Multifamily is considered a strong inflation hedge, on the other hand. Rising prices can be offset by increasing rents, which have gone up in 16 of the past 18 years. Fannie Mae expects the trend to continue too, forecasting rent growth of 1.3% in the first half of 2024.[4] Also, just as importantly, the value of properties themselves can be improved through apartment renovations and other capital improvements.

More broadly, real estate has demonstrated positive performance during periods of inflation. Yet, multifamily has outpaced the other segments when inflation tops 5%.[5] This is intuitive when considering that apartment leases are more flexible and typically made on a yearly basis, whereas rental periods for offices and retail locations may be locked in for periods lasting 10 years or more. Overwhelming demand for affordable housing coupled with a shortage of ready supply has been another factor driving multifamily returns.[6]

2. Federal Reserve Bank of Philadelphia. Short-Term and Long-Term Inflation Forecasts: Survey of Professional Forecasters. August, 2024.
3. Morningstar. What Higher Inflation Means for Stock and Bond Correlations. May, 2024.
4. Fannie Mae. Multifamily Economic and Market Commentary. August, 2024.
5. HLC Equity. A Historical Look at Multifamily Performance in Inflationary Environments. May, 2022.
6. For more on our views about the long-term tailwinds driving multifamily returns, please read our recent research "Multifamily Leads the Way in Real Estate." https://lakelandcapital.com/wp-content/uploads/2023/09/lakeland_multifamily.pdf

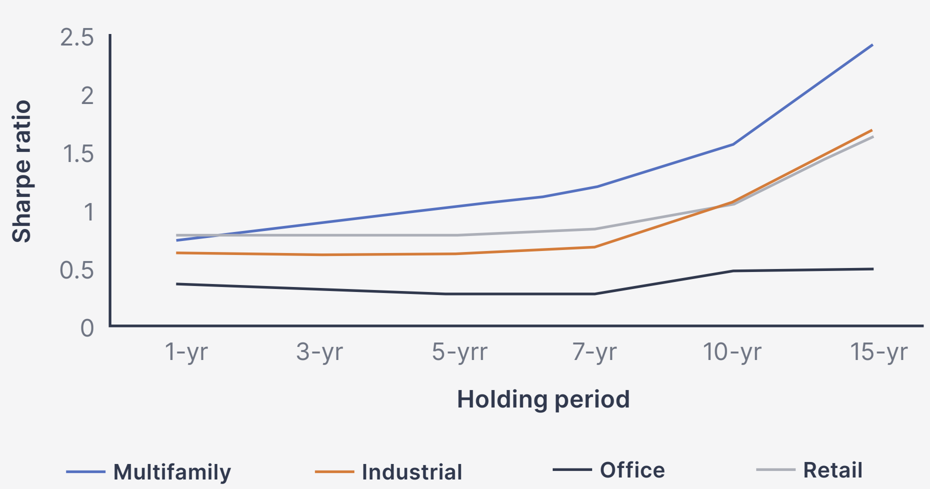
Experienced Managers Generate Additional Long-Term Value

Real estate is especially suited for investors who have a longer-term focus, given how the underlying physical assets can increase in value over time while paying out steady income along the way. Within the asset class, multifamily appears best positioned to deliver additional value. A recent study showed how it recorded higher levels of the Sharpe ratio–which effectively measures return potential while also accounting for potential risk–versus other real estate sub-sectors as holding periods extend over time.

We believe that this outperformance in multifamily over time can partly be explained through improvements to the value of apartments through renovations and other capital improvements. Since leases are typically made on a year-to-year basis, any upgrades can be priced into future rents without significant delay. That is not the case for other real estate segments, however, which have much longer lease periods and where changes to the property might be time-consuming and cost prohibitive.

Being able to upgrade properties also underscores the imperative of partnering with a trusted multifamily investment manager. Inexperienced operators simply renovating apartments in hopes they get leased risk incurring unnecessary construction costs and seeing rental income dry up in the event of prolonged vacancies. Seasoned managers, on the other hand, know renovation decisions must be informed by a rigorous cross-check of demographic data–like population changes and job growth–against local market conditions. And just as importantly, they can draw upon experience and deep local connections to utilize an active management approach that generates additional value over time once a significant improvement plan is implemented.

Figure 2 — Multifamily paces risk-return improvement over longer holding periods



Source: National Council of Real Estate Investment Fiduciaries (NCREIF). Data is compiled between 1987-2016.

Individual Deals for Physical Assets Better Aligned with Individual Preferences

Multifamily investments differentiate themselves from traditional asset classes not only by having a unique impact on the portfolio but also because they are physical assets. Investors can choose to invest directly in individual properties through a professional investment manager. While this individual deal approach is inherently capacity constrained, it also offers an option for investors to pick and choose opportunities closely aligned with their unique preferences.

The location of the investment is a key area where the individual deal approach allows more tailoring. Investing directly in an individual property ensures that investors can choose their preferred market or exclude an undesired location, whichever the case may be.[7]

This should be a critical consideration for any investor considering a multifamily allocation because market conditions vary widely by location. For instance, in Boston, asking rents rose more than 2% in July from the previous year, versus a national average of 0.8%. By contrast, rents dropped nearly 4% in Atlanta.[8] Meanwhile, the vacancy rate in Boston was 5.7%, comfortably below the national average of 7.8%.[9] In our view, this underscores how cities like Boston, which have a diversified economy and an entrenched housing market with barriers to entry, can expect to see steady rent growth.

7. For more on our views about how individual deals can align with investor preferences, please read our recent research "Individual Deals Over Funds Makes a Difference in Real Estate." https://lakelandcapital.com/wp-content/uploads/2023/09/lakeland_investments.pdf

8. Multi-Housing News. 2024 Rent Growth. August, 2024.

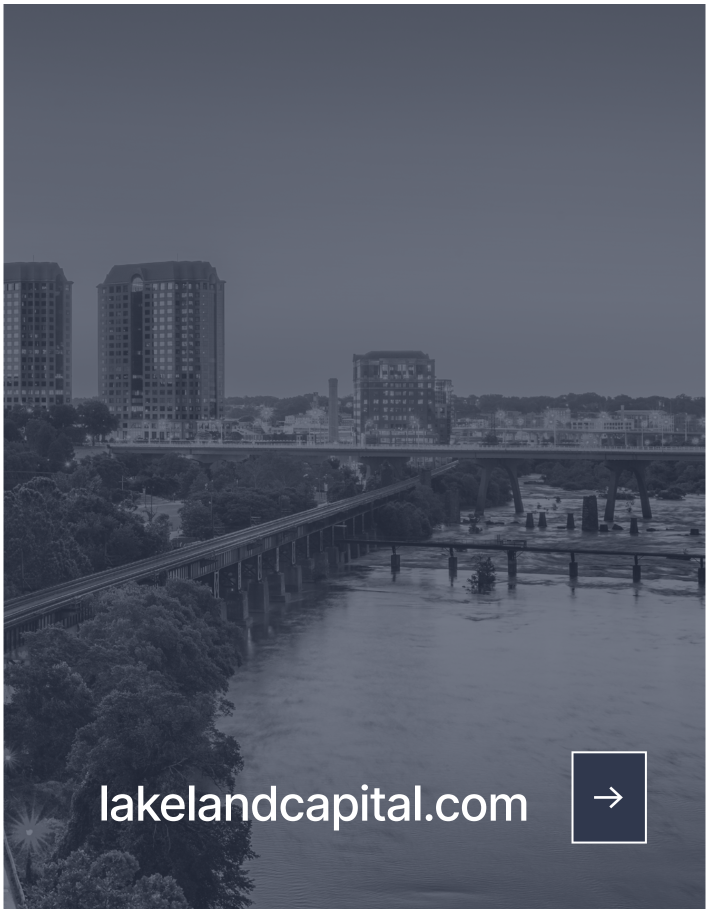
9. Colliers. 24Q2 Greater Boston Multifamily Report. August, 2024.

What We're Watching Next

Balanced portfolios have traditionally been made up of stocks and bonds. We believe an allocation to multifamily real estate deserves serious consideration as well, not just because of its strong track record and differentiating qualities but also because the nature of investing in the underlying physical assets can help investors align portfolios with their individual goals.

Over time, we expect the opportunity set within multifamily real estate will continue to grow. Competition for assets also stands to increase, however, as the Fed provides further clarity on interest rate easing and the broader market searches for ways to deploy a vast amount of dry powder that reportedly topped $400 billion in October 2023.[10]

In this environment, experienced managers must utilize on-the-ground capabilities and local connections to canvas a wide pipeline of investment opportunities and then get the right properties under contract at the right prices.



10. JLL. Dry powder for investment. January 2024.

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