Diversification Matters

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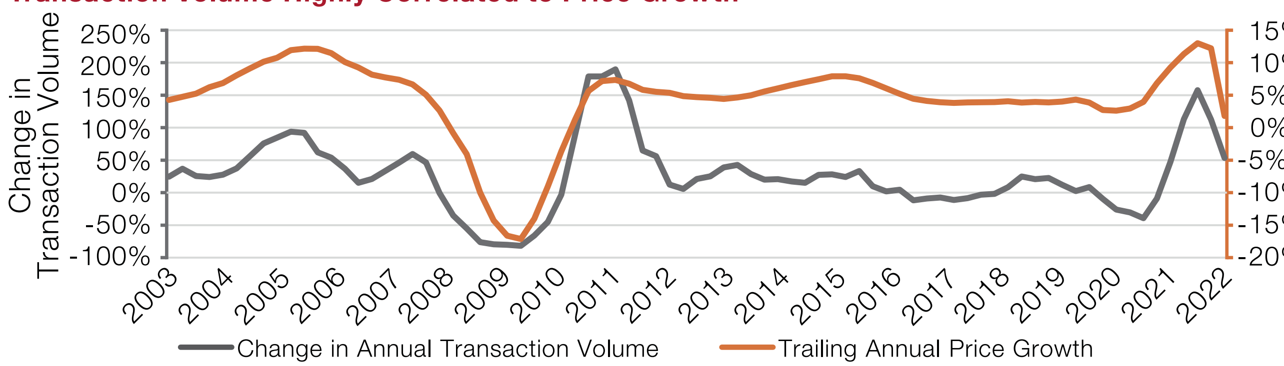
Why consider a diversified real estate portfolio today?

After six decades in the real estate business, Hines views diversification as of similar importance to cash flow, lease performance, and location, location, location because it is still not possible to reliably call market tops or bottoms. Without diversification, investors may increase their risk of being overweight in a poorly performing region, sector, or asset class.

Decades of Data Don't Lie.

Decades of data show portfolio diversification reducing risk,[1] but there are many ways to implement this strategy (by region, sector, market cap, style box, issuer, industry, credit quality, geography, asset type, etc.). Real estate is a complex system with thousands of variables capable of influencing outcomes. For us, true diversification must be regional, across sectors and asset classes, particularly given the risks inherent in the U.S. market – take a look:

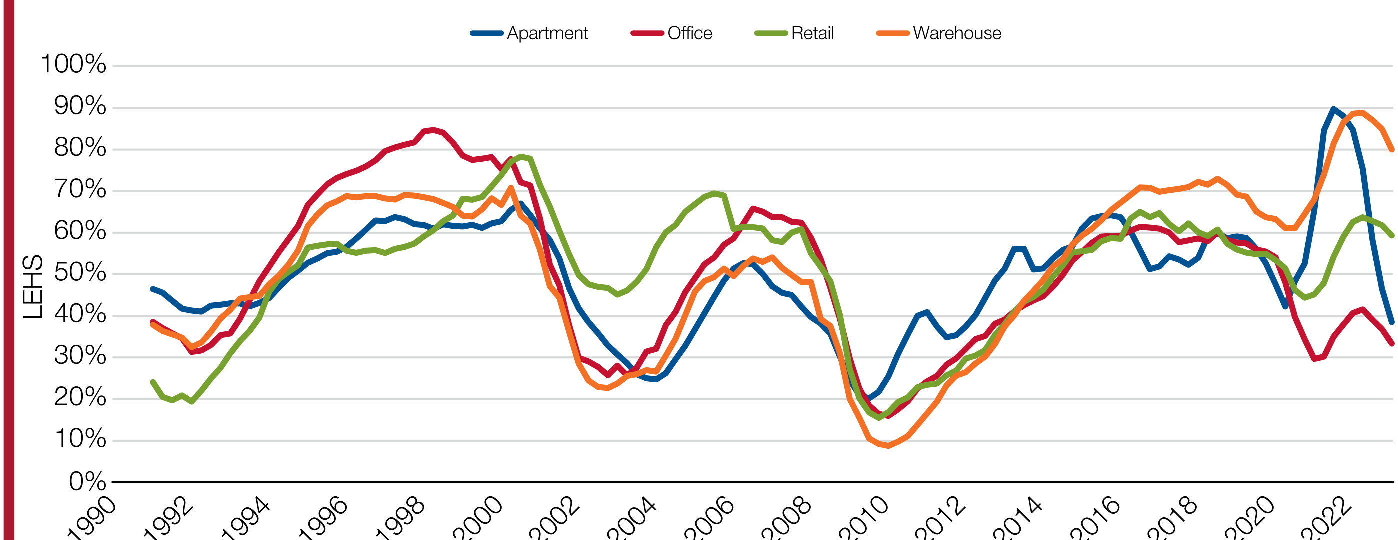
Transaction Volume Highly Correlated to Price Growth



Sources: NCREIF, Real Capital Analytics, Hines Research. As of 2022Q4.

Simmering unresolved issues (like stubborn inflation and rising interest rates) could still result in a prolonged recession. Given that both trailing transaction volume and price growth have fallen, investors may wish to carefully consider these indicators, along with other potential portfolio risks.

U.S. Leasing Enviroment Health Score (LEHS)[2]

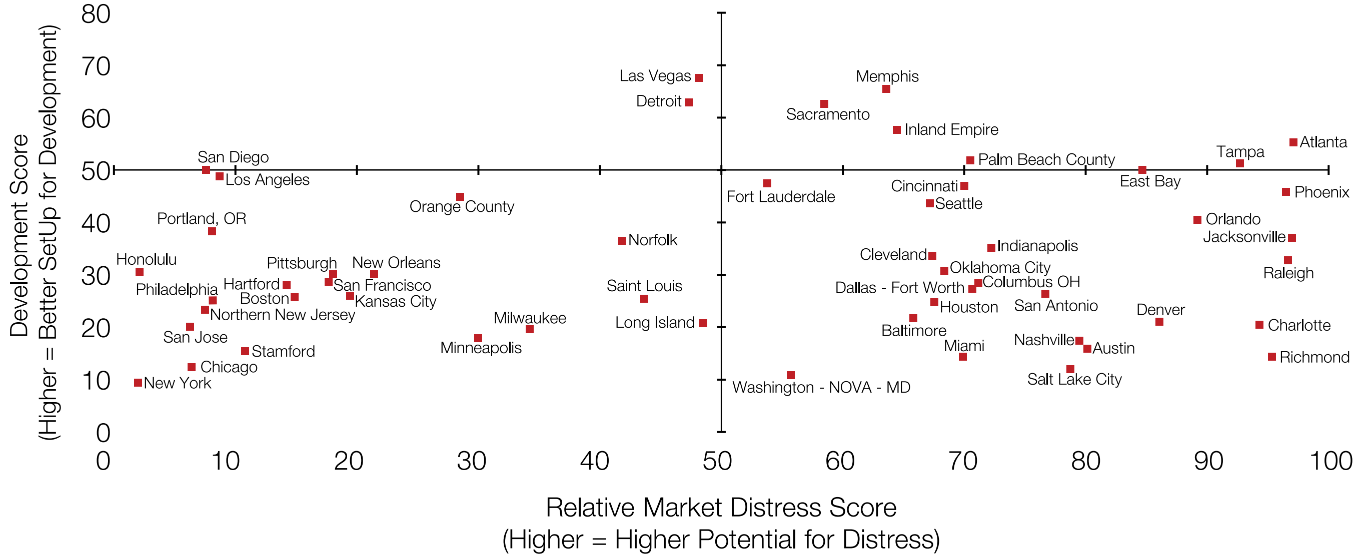


Sources: CoStar, Hines Research, prelim 2023Q1 data as of February 13

1. *NCREIF and Hines Research, January 1, 1984 through December 31, 2022. As measured by the Sharpe Ratio – a financial calculation describing how much excess return is received for the extra volatility of holding a riskier asset.*
2. *The Leasing Environment Health Score measures the relative health of a market's current Leasing Environment. It combines Vacancy rates, trailing annual rent growth and trailing annual demand growth into a composite score.*

Overall, fundamentals are in a downtrend, but let's get granular. The health of all four major sectors have headed down, but only Multifamily has been in a steep, sustained decline.

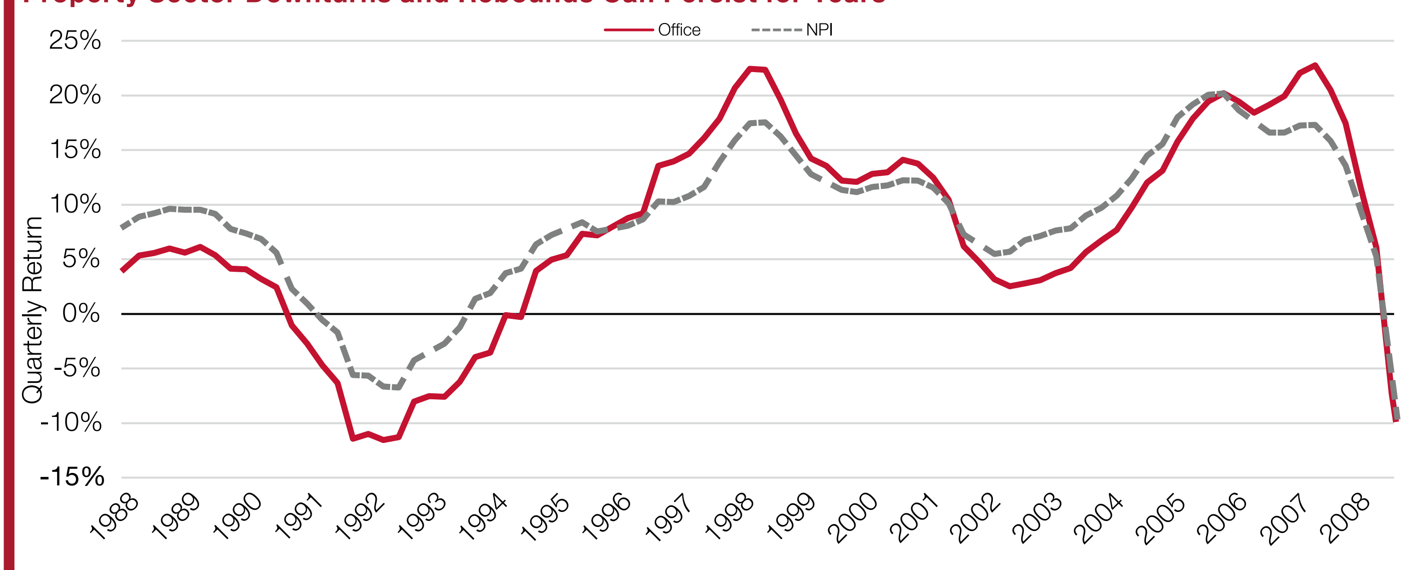
U.S. Apartment Potential Distress Versus Development Prospects



Sources: Moody's, CoStar, NCREIF, Hines Research. As of 4Q2022. The Relative Market Distress Score is a 0-100 cross-market (relative) score where higher = higher potential for market distress. The factors are used, including Hines Research proprietary scores for fundamental health and pricing, and each market's peak trailing annual inflation over 2021 and 2022. The Development Score...

However, taking a deeper dive into U.S. Multifamily, our research shows some markets have been in reasonably good health (the left half of the plot above), which is completely at odds with the earlier graph. Still, downtrends can persist for years. One glaring example is the Office sector within the NCREIF Property Index, which (beginning with Q4 of 1990) fell every quarter for almost four years. The rebound, however, was equally dramatic, with Office delivering positive returns until running into the GFC in 2008Q4.

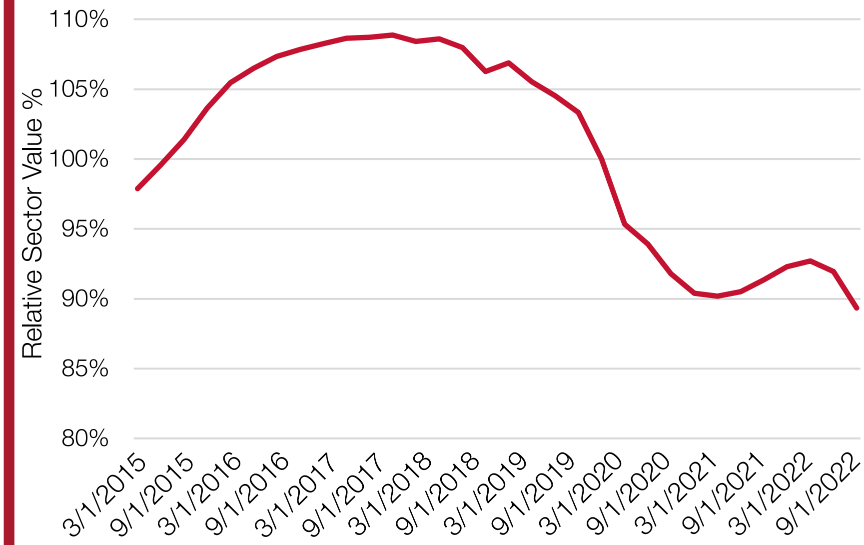
Property Sector Downturns and Rebounds Can Persist for Years



Sources: NCREIF, Real Capital Analytics, Hines Research. As of 2022Q4

Another more recent example is how Retail fared in the early days of COVID. The NCREIF Retail subsector lost more than 15% of its value in just two years (2019Q2 through 2021Q1). Combining the precise capabilities of Hines Research with the insights of our local experts may reduce the risk of our investors getting caught on the wrong side of an unexpected trend.

NCREIF U.S. Retail Sector (100%=Q1 2020)



Sources: NCREIF, Hines Research. As of 2022Q4.

Avoid Gray Swans

True Black Swan events are rare, but judging by the headlines, a new category may have emerged. Anyone betting exclusively on strong U.S. Office and Retail performance during the periods described earlier will attest to the value of diversification, as will anyone currently overweighted in (for example) the greater Phoenix Multifamily market. These investors are at increased risk of severe portfolio underperformance, but our data again proves the value of diversification. Since 1985, a custom sector composite (20% Retail, 30% Apartment, 20% Industrial, 25% Office and 5% Hotel) has outperformed the NPI with less risk. Risk-adjusted profitability was also superior.

Period - 1985 through 2022	NPI	Custom Composite
Annualized Return	8.5%	8.8%
Risk[3]	7.4%	7.2%
Sharpe Ratio	1.16	1.22

In another example, a 100% Office portfolio created in 1991 and held through 2022 would have underperformed our custom composite by nearly two percentage points while subjecting investors to 21% more volatility.[4]

3. Risk is measured by standard deviation. This measures the average amount by which the value of an investment may swing above or below its historical average.
4. NCREIF and Hines Research, January 1, 1991 through December 31, 2022

Why Consider a Diversified U.S. Real Estate Portfolio?

1 **Reduced Exposure Risk:** Diversified real estate funds typically provide a broader range of assets than sector funds, reducing the risk of exposure to a single market or asset class.

2 **Stability and Lower Volatility:** Diversified funds tend to be less volatile and more stable than sector funds due to their broad diversification across asset classes and markets.

3 **Professional Management and Innovation:** With greater flexibility to manage the overall portfolio, professional managers can take advantage of emerging opportunities for improved diversification across regions, sectors, and asset classes. This also helps diversify income streams.

4 **Scalability:** It is much easier (and less expensive) for Portfolio Manager (“PM”) to scale diversified funds. Trying to buy (for example) sufficient Industrial assets may require acquisitions in areas (and/or prices) that otherwise wouldn’t be considered.

5 **Increased Competition:** There has been a proliferation of real estate funds launched in the last five or so years. According to Preqin, over 5,600 real estate funds were launched in the past decade (2013-2022), about twice the total for the previous 10 years. We believe it is essential for long-term success to purchase assets based on value, not popularity.

Professional Management Assures Effective Diversification and Can Cushion Downside

Hines proprietary research data shows diversification across U.S. regions, sectors, and asset classes is best when combined. Real estate investing can be complex, but we believe professional management can provide smart diversification and downside protection. By capturing and analyzing all sectors in major regional markets, we can often tilt toward assets in a specific metro area, more closely examine opportunities in specific sectors or find those occasional “diamonds in the rough.” We believe smart diversification holds up well in all business cycles, including corrections.

About the Indexes and Sources

The NFI-ODCE, short for NCREIF Fund Index - Open End Diversified Core Equity, is a capitalization weighted, gross of fee, time weighted return index with an inception date of December 31, 1977. Other supplemental data such as equal-weight and net of fee returns are also provided by NCREIF for information purposes and additional analysis. To be eligible for NFI-ODCE membership, each member fund must be marketed as an open-end fund with a diversified core investment strategy primarily investing in private equity real estate. All member funds must adhere to the following index inclusion criteria:

(1) At least 80% of the market value of net assets must be invested in real estate with no more than 20% invested in cash or equivalents;

(2) at least 80% of the market value of real estate net assets must be invested in private equity real estate properties. No more than 20% of such assets may be invested in, but not limited to, property debt, public company, equity/debt or private company (operating business) equity/debt;

(3) At least 95% of market value of real estate net assets must be invested in U.S. markets;

(4) At least 80% of market value of real estate net assets must be invested in office, industrial, apartment and retail property types;

(5) No more than 65% (± for market forces) of market value of real estate net assets may be invested in one property type or one region as defined by the NPI;

(6) No more than 35% leverage. Leverage is defined as the ratio of total debt, grossed-up for ownership share of off-balance sheet debt, to the fund's total assets, also which are grossed-up for such offbalance sheet debt.

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