Real Estate Facilitates Portfolio Diversification and May Temper Volatility

A long-term investment in commercial real estate may help diversify a portfolio, reduce volatility and hedge against inflation. In addition, leases on commercial properties offer the opportunity for rental income and capital appreciation.

### Commercial Properties Offer Many Potential Advantages

| **Inflation Hedge** | The law of supply and demand states that with high demand, prices rise.\(^1\) As the demand for real estate rises, owners may benefit from rising rents and property values. The converse can also be true. In an attempt to keep pace with inflation, the Consumer Price Index (CPI), an index that measures the prices paid for goods and services, is commonly used to adjust rents.\(^2\) |
| **Help Navigate Interest Rate Risk** | Historical data show that property performance has often remained resilient in the face of rising interest rates. With several factors that may provide protection in a rising interest rate environment, the most important is that rate hikes reflect expected strengthening of economic and employment conditions. Even with modest wage growth and tepid GDP growth, property performance can benefit from job growth and constrained construction activity.\(^3\) There are, however, potential concerns such as tenants not being able to pay increased rent. |
| **Lower Correlation** | Correlation is a measure of how one asset moves in tandem with another asset. By combining uncorrelated assets, the movements of one asset can be expected to at least partially mitigate the movements of the second asset, reducing the average volatility of a portfolio. Diversification can be achieved when assets do not move by the same amount, even when they move in the same direction.\(^4\) Correlation between assets may change over time and in particular circumstances, such as economic stress, or differ over short-term and long-term periods. |
| **Long-Term Return Potential** | Investors tend to be drawn to real estate because it offers the opportunity for rental income and capital appreciation over the long-term. Generally, investors are willing to forgo some liquidity for the prospect of higher income potential over the long-term. |

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\(^1\) Investopedia. How does the law of supply and demand affect the housing market? April 2, 2015.


Role of Correlation in Portfolio Construction

Many investors rely on correlation as an essential ingredient in portfolio construction. Uncorrelated assets are expected to behave independently from each other through changing market environments. By combining imperfectly correlated assets, a portfolio's expected volatility may be reduced, often without a significant effect on returns.4

Investors have traditionally used bonds to diversify their stock allocations because of their relatively low volatility and low average correlation to stocks.5 Modern portfolio theory, however, emphasizes that investors can construct portfolios to optimize expected returns based on a given level of risk by including a variety of investments – real estate being one that has drawn investors’ attention in recent years. Research and historical performance suggest that diversifying an investment portfolio with real estate may provide higher returns.

Real Estate Has the Potential to Increase Returns - 2006 to 2016 (10 Years)

When an investor diversifies across stocks, bonds and commercial real estate, the result may be a more resilient and less volatile portfolio. Investors should consider an allocation in real estate a long-term investment, in which they do not require immediate liquidity. Over the long term, commercial real estate may generate income and capital appreciation, and has shown to reduce overall volatility.

Past performance is not a guarantee of future results. Charts for illustrative purposes only. Investing 10 or 20 percent in direct real estate both increased the portfolio’s total return and lowered the portfolio’s overall standard deviation.

The charts above compare the returns of the S&P 500 Index, Barclays U.S. Aggregate Bond Index and the NCREIF (National Council of Real Estate Investment Fiduciaries) Index, with and without an asset allocation to direct real estate, over a 10-year time period. Standard deviation is a measurement of the variability of an investment, derived from its historical returns. A higher standard deviation indicates a greater variability of an investment. The S&P 500 Index is a market capitalization weighted index of 500 widely held equity securities, designed to measure broad U.S. equity performance. The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, adjustable rate mortgage pass-through asset backed securities, and commercial mortgage backed securities. NCREIF Property Index (NPI) is the accepted index created to provide an instrument to gauge the investment performance of the commercial real estate market. NPI is an index that reflects the returns of a large pool of individual commercial real estate properties, is leverage free with no fees and includes a blended pool of institutional quality properties.

Each index provides a broad representation of a particular asset class and is not indicative of any investment. Asset allocation does not ensure a profit or protect against a loss. The rates of returns shown do not reflect the deduction of fees and expenses inherent in investing. An investment cannot be made directly in an index.

Disclosure

The views expressed herein are subject to change based upon economic, real estate and other market conditions. These views should not be relied upon for investment advice. Any forward-looking statements are based on information currently available to us and are subject to a number of known and unknown risks, uncertainties and factors which may cause actual results, performance or achievements expressed or implied by these forward-looking statements.

Important Risk Factors to Consider

Investments in real estate assets are subject to varying degrees of risk and are relatively illiquid. Several factors may adversely affect the financial condition, operating results and value of real estate assets. These factors include, but are not limited to:

- changes in national, regional and local economic conditions, such as inflation and interest rate fluctuations;
- local property supply and demand conditions;
- ability to collect rent from tenants;
- vacancies or ability to lease on favorable terms;
- increases in operating costs, including insurance premiums, utilities and real estate taxes;
- federal, state or local laws and regulations;
- acts of nature, such as hurricanes, earthquakes, tornadoes or floods.

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