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TRANSCRIPT

Real Estate from a Multi-Asset Class perspective

*Featuring: **Peter Shepard**, Head of Fixed Income, Multi-Asset Class and Private Assets Research*

Will Robson: Hi there and welcome to the sixth in our Real Estate Conversations series. I'm joined here today by Peter Shepard, who is here to talk to us about real estate, but from a multi asset class perspective. Welcome, Peter, could you just start off by telling us a little bit about the perspective that you bring to the asset class and the kind of conversations that you have with your clients?

Peter Shepard: Hi, Will. I lead the research group for multi-asset class, fixed income and private assets. So we're looking at private assets, including private real estate, private equity, private infrastructure, but also looking at these in the context of the multi-asset class portfolio, so thinking about the asset owner, looking at real estate but trying to understand how does real estate fit in with everything else? To what extent is it providing diversification? To what extent is it providing exposure to the systematic risks driving the rest of the portfolio?

Will Robson: Okay. I think it would be a really interesting perspective to bring to the current crisis around the Coronavirus, not just for those assets and the clients, but also for our asset manager clients to understand the perspective of their clients and how they're viewing this situation. So, if you had spending a lot of time with those asset owner clients, what are the big questions they have on their minds at the moment?

Peter Shepard: Yeah, I think that a lot of them are really struggling to understand what is the impact of the crisis on the private asset portfolio in particular. I think that a lot of people in the public markets are trying to understand where this is going, but in the private markets the question is what's already happened? And people largely don't know yet. Valuations are often really lagged and so they're just waiting to get a mark. But even on that, we know that valuations typically are pretty smooth, and so when they do get a number they don't know, does that reflect everything that's happened or does that reflect just the first chapter of it? And so today a lot of them are looking at marks from actually in private equity or typically just getting in now Q4 2019 valuations, which looked great. And so, the private assets look good according to that, some of them are wondering are they now significantly overweight private assets, the denominator effect. We think probably that a lot of private assets have had behaved somewhat similarly to public and may not be a great time to dramatically change your allocation, go to the secondary market to try to down weight or halt allocations or ongoing commitment, et cetera.

Will Robson: Okay. So there's this appreciation of the valuation smoothing and lags and the information in private assets, in the way that they're going to kind of deal with the situation. Are you able to offer insights from the research that you do to help them understand what could be the marks? It's not a definitive answer, but just helping them through that problem.

Peter Shepard: Yeah. We're not trying to provide the answer. We're trying to provide as many different perspectives as possible. So we're looking from a fundamentals basis, a cash flow approach thinking in terms of, "what could be the fundamental drivers here?" "What does that look like?" Take a different perspective based on what we call now casting, saying "okay, let's use our models to understand how public and private over the long run tend to be related to each other, and then what we can observe in the public markets. What does that suggest may have happened in the private markets?" And that suggestion is that private markets are different, but they're not this magical, safe haven. Ultimately, private real estate, other private assets, they're exposed to the same economy, and it gets reflected quickly in the public markets and maybe the public markets overreact. So some of the public market volatility could be panic selling and the like, which doesn't happen in private markets, cause you can't to the same extent. But we think that over the long run, economically, if this drawdown is more L-shaped or W-shaped or pick your letter rather than a V-shape, it gets harder and harder for private assets to just ride it out and keep those smooth valuations high.

Will Robson: Yeah. It's interesting that you talk about the different shapes of a potential recovery, looking at the real estate data that I spend most of my time with. It's interesting that the nature of the impact through the Covid crisis on cash flows immediately, so whether it's through clients or tenants not being able to pay the rent or just looking for a holiday for three or six months, typically you see an impact on the NOI in a lagged way because of the lease structures and the way that market movements flow through to cash flows. But this time around it's been much more immediate and in some ways the pricing movement, in terms of the yields, hasn't been seen yet. It's a backwards way around. Is that distinction between this crisis and the GFC, for example, come through in the discussions that you're having with the clients.

Peter Shepard: Yeah. So a lot of asset owners are just trying to make sense of, how is this crisis similar to that one? How is it different? Clearly the fact that it seems to originate in the real economy rather than in the financial markets, real estate though plays a lesser role in this crisis, or so far, particularly the residential real estate was central to it the last crisis.

Generally, it seems that people are more caught off guard by this crisis that came like an asteroid out of the sky, whereas actually when we look back at the GFC, it actually played out as sudden as that scene at the time, it actually was in slow motion compared to this one. But a lot of what we see or our clients are seeing, in terms of just overall magnitude, so far quite similar to the GFC, and I think the real question though, is what happens next? So, after the GFC we saw certainly hard times persisting for years after, but the economy got back and largely took the same shape that it had before.

I think what we're seeing now is the potential for this crisis to really accelerate changes, maybe changes that were already happening, but to have them change now and really never come back. So, certainly in real estate, retail has been suffering, but you could imagine that this will rapidly accelerate the pain that the retail segment maybe would have experienced over the next five years. Maybe a lot of that is happening all at once and will be not just slow to come back, but potentially fundamentally altered.

Will Robson: Okay. From the perspective of real estate asset managers, they're at the coalface and, especially in the early stages of the crisis, it was all about "let's make sure we can collect the rent and actually get the income coming through." It's very near term issues and problems to face. When you talk with the asset owner clients, are there any much higher level, bigger problems that are keeping them up at night in terms of things that might change their attitude to real estate allocations going forward, that may impact the real estate asset management industry in a broader sense rather than sector by sector.

Peter Shepard: Yeah. I think the biggest question for a lot of them is- well, some of them have viewed real estate as an income source and it is. But I think with low bond yields, many of them have said "I don't like the yields I'm getting on my treasuries, let me move some of that into real estate." And they've thought of it as a similar asset. I think some are waking up to the realization that real estate is a much more cyclical growth-sensitive asset.

We've for a while seen it that way in terms of the capital value in real estate. But now we're even realizing that the income side as well has a lot of that in the near term. And so I think the question may be "will real estate be perceived differently?" Real estate no longer can be seen simply as income, core real estate, in particular, in the income bucket and the asset owner's portfolio, but will the asset owner see it more as a risk asset? A growth-sensitive asset? Et cetera.

Will Robson: And maybe the answer to that question isn't yes or no, it'll be more specific about what kinds of real estate are more like the income play and which are more growth-sensitive and getting a lot more detailed analysis on understanding what exposure you have.

Peter Shepard: Yeah. I think the question isn't "is real estate a bond, or is it an equity?" I think the question is "what kinds of real estate have?" "What kinds of characteristics in common with each of those?" And it's different depending on where you are on the risk curve, certainly.

Will Robson: After crises, you tend to find increased demand for risk analytics and transparency, but it seems this particular question about really understanding the nature of the returns that you're getting from real estate and what it is providing coming out of this crisis, maybe a bigger demand for that kind of analysis.

Peter Shepard: Yeah. I think there will surely be, or almost surely be, requirements for more risk management and kind of a governance perspective. But I think, maybe as importantly or more importantly, is the risk management from the perspective of the portfolio, the asset allocation decision-making. I'm realizing, "wait a minute, this might be a bit of a different asset class than we thought it was.

Will Robson: Okay. Well, I think that's a really interesting perspective to bring to our clients, kind of top down view., so thanks for your time, Peter, and thanks everyone for joining. We'll catch you next time. On the seventh episode.

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