USAA REAL ESTATE

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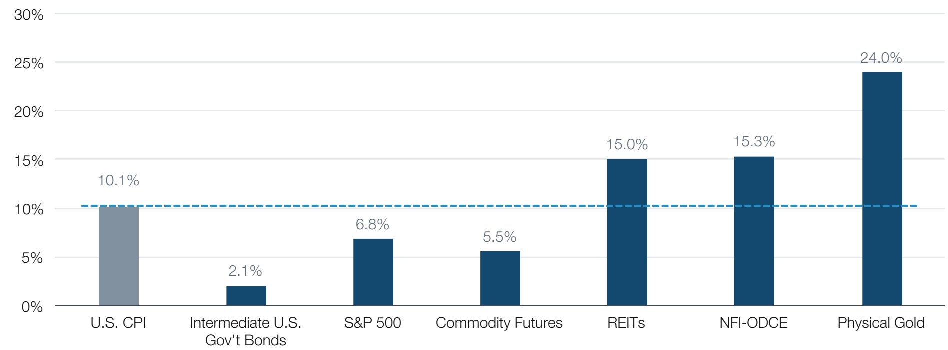
Direct real estate and inflation

While the United States has not experienced a period of high, sustained inflation in almost 40 years, headline inflation soared to a 13-year high of 5.4 percent in June, due to the rapid reopening of the economy (Exhibit 1). Further, core inflation rose to 4.5 percent, the largest increase since 1991. Given that a key objective of many investors is maintaining the purchasing power of their portfolios in real terms, the perceived prominence of inflation risk has intensified. Despite the Federal Reserve's assertion of a temporary spike, investors are becoming increasingly concerned, as evidenced by the rise in U.S. interest rates in the first half of 2021 and the University of Michigan Survey of Consumers anticipating a more than 4 percent jump in prices in the coming year.[1] Further evidence can be seen in the recent 10-year TIPS Breakeven Inflation Rate reaching 2.57 percent — its highest level since early 2013.[2]

Real estate as an effective inflation hedge

In addition to the risk, return and diversification benefits that direct real estate provides to a comprehensive portfolio, it can also offer investors a hedge against inflation. Fundamentally, real estate provides a hedge against inflation because rental and lease payments — varying by property type and associated lease structure — are adjusted regularly for inflation. Additionally, price appreciation can occur as a result of the capital rotation out of stocks and bonds and into direct real estate in times of inflation. This is assuming a tight, functioning market.

Exhibit 2. Asset class performance during an inflationary environment
(March 1978 – September 1981)

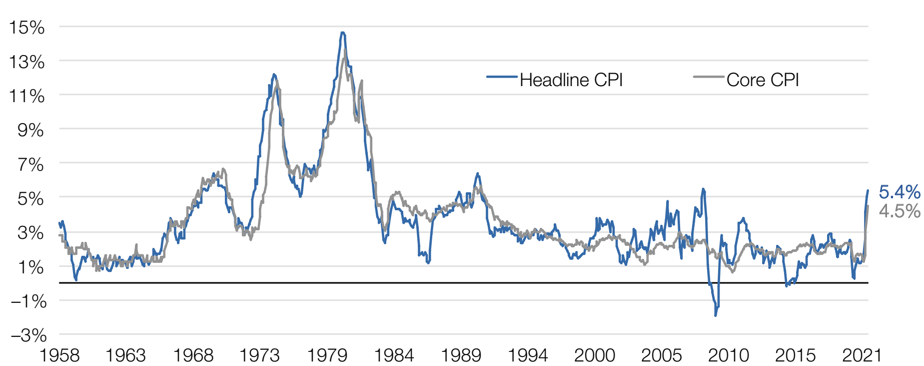


Sources: Bloomberg LP, USAA Real Estate

When examining the inflation-hedging abilities of an asset class, investors can use several different approaches. These include, but are not limited to: correlation to headline inflation, correlation to expected vs. unexpected inflation, beta to inflation, and performance during different inflationary regimes (high, low, accelerating, decelerating). Our analysis focuses on the last period of high, accelerating, and persistent inflation in the United States — the Great Inflation — spanning from the late 1970s to early 1980s. As shown in Exhibit 2, core real estate (as measured by the NCREIF NFI-ODCE Index) and REITs more than kept pace with inflation during this time, whereas both stocks and nominal bonds failed to do so.

Direct core real estate exhibited the strongest correlation (0.29) to headline inflation across major asset classes during this short, but important, time period. Further, direct real estate represented the most optimal risk-adjusted return profile (Sharpe ratio of 2.48 — see Exhibit 3). Conversely, both U.S. stocks and intermediate government bonds failed to keep pace with inflation, as shown by the light blue dotted line in Exhibit 2 representing the cumulative inflation hurdle. Intermediate U.S. Government bonds and U.S. equities were negatively correlated with high, sustained inflation and also generated negative risk-adjusted returns. While fixed income normally represents a portfolio's lowest-risk asset, or safe haven, traditional active fixed-income strategies (e.g., buy-and-hold, yield curve positioning)

Exhibit 1. U.S. Consumer Price Indices (year-over-year)
Figures are not seasonally adjusted. Data as of June 30, 2021



Source: U.S. Bureau of Labor Statistics become vulnerable during times of high inflation and can drive negative portfolio performance through an erosion of inflation-adjusted value. Listed REITs displayed a competitive total return profile, but they did so with a negative correlation to inflation. Although physical gold prices exhibited the other positive correlation to inflation, they saw the highest overall volatility (Exhibit 3) and can serve as a drag on portfolio performance if high inflation fails to materialize.

Listed REITs or direct core real estate

In addition to the finite time period presented above, leading academic research has shown that listed REITs provide suboptimal protection from general inflation for investors.[3] Much like stocks, listed REITs historically have failed to offer effective protection from inflation, and analysis of their dividend yields and inflation rates also show negative correlations.[4] As investors adjust their expectations due to a rising price level and the resulting possibility of a deteriorating macroeconomic environment, the actual returns of listed REITs become adversely affected. On the contrary, empirical evidence shows that direct real estate has provided an effective hedge against expected inflation (Exhibit 3) and at least a partial hedge against unexpected inflation, another important threat to maintaining a portfolio's purchasing power, but for the sake of brevity, it will not be discussed here.[5]

Exhibit 3. Asset class characteristics vs. U.S. inflation
(March 1978 – September 1981)

	Correlation	Return	Risk	Sharpe Ratio
Intermediate U.S. Gov't Bonds	–0.03	2.1%	11.5%	–0.75
S&P 500	–0.20	6.8%	14.4%	–0.27
Commodity Futures	–0.20	5.5%	17.7%	–0.29
REITs	–0.19	15.0%	15.8%	0.27
NFI-ODCE	**0.29**	**15.3%**	**1.9%**	**2.48**
Physical Gold	0.25	24.0%	39.0%	0.34
NFI-ODCE (2x risk)				1.24
NFI-ODCE (3x risk)				0.83
NFI-ODCE (Bonds/Stock Blended Risk)				0.36

Sources: Bloomberg LP, USAA Real Estate

Conclusion

Direct real estate exposure has historically provided a hedge against inflation. Empirically, other traditional, long-only investments such as stocks, nominal bonds and even listed REITs tend to be negatively impacted during inflationary environments in the United States or represent a suboptimal asset allocation decision given today's enhanced investment landscape. In contrast, direct real estate is positioned to be a superior hedge against rising inflation because of the various market fundamentals and dynamics explained herein. As well, a potential added benefit of direct real estate exposure is the strong total return profile, whereas other alternative investments may exhibit solid inflation-hedging characteristics (e.g., physical gold) but can come at a cost to the portfolio if significant inflation is not realized. Direct real estate features a compelling combination of inflation-hedging properties and strong absolute and risk-adjusted returns for investors.

Notes:

[1] Board of Governors of the Federal Reserve System (U.S.). (2021). June 2021 FOMC Meeting Minutes Press Release. Retrieved June 24, 2021, from https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

[2] Federal Reserve Bank of St. Louis. FRED Economic Data: 10-Year Breakeven Inflation Rate. Retrieved June 3, 2021, from http://fred.stlouisfed.org/series/T10YIE

[3] Benjamin, J.D., Sirmans, G.S., Zietz, E.N. (2001). "Returns and Risk on Real Estate and Other Investments: More Evidence." *Journal of Portfolio Management.* 7:3, 183-214.

[4] Ibid.

[5] Ibid.

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CORPORATE OVERVIEW

With approximately $26 billion in assets under management and 11 global offices, **USAA Real Estate** is an industry leader in acquiring, developing, financing and managing the highest quality real estate assets in North America and Europe. The mission of USAA Real Estate is to serve the financial interests of its investor clients by strengthening the profitability and diversity of the USAA investment portfolio, which includes multifamily, industrial, office and hotel properties, as well as ecommerce logistics and distribution centers, media production facilities and data centers. For more information, visit usrealco.com.

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