Investing in Real Estate as a Hedge Against Inflation

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Amidst the backdrop of a strong post-pandemic recovery during which global economies experienced unprecedented stimulus to stave off a severe economic downturn, there is no question prices for goods are rising. Whether it's the cost of food, travel, materials, cars or other consumer goods, we have all experienced a sudden and sharp increase in prices.

While the debate continues as to whether these increases are temporary or not, some investors have been positioning their portfolios for the risk that monetary and fiscal policy are going to drive inflationary pressures for the foreseeable future. It is difficult to directly invest in inflation, but one can invest in asset classes that are generally positively correlated with inflation to help protect their portfolios. One such asset class, commercial real estate, has empirically been one of the most effective in this regard.[1]

THE EFFECTIVENESS OF COMMERCIAL REAL ESTATE AS A HEDGE AGAINST INFLATION

The effectiveness of any hedge is measured by the strategy's ability to offset whatever risk an investor seeks to hedge against. The best investment to hedge against inflation is one that is most positively correlated with inflation. When looking at the three largest investable asset classes, fixed income, equities and real estate, real estate has historically demonstrated the most positive relative correlation to inflation. Quarterly real estate returns from 2000 through 2020 exhibited 1.5x the correlation with inflation compared to equities, whereas bond returns exhibited negative correlation.[1]

Correlation to Personal Consumption Expenditures Price Index[2]

(Q4 2000 – Q4 2020)

National Council of Real Estate Investment Fiduciaries Property Index[3]	0.36
S&P 500[3]	0.24
Bloomberg Barclays U.S. Aggregate Bond Index[3]	-0.31

1. **Past performance is no guarantee of future results.** There is no guarantee that commercial real estate will be an effective investment hedge against inflation.
2. PCE Price Index Source: U.S. Bureau of Economic Analysis, Personal Consumption Expenditures: Chain-type Price Index [PCEPI], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/PCEPI, August 15, 2021
3. Source: Bloomberg

THE LINK BETWEEN COMMERCIAL REAL ESTATE PERFORMANCE AND INFLATION

Why has commercial real estate historically exhibited such a positive correlation with inflation, and why would an investor expect the same going forward? The answer is that commercial real estate can provide investors with both hard asset exposure and dynamic cash flows, both of which can respond directly to inflationary pressures. In addition, many commercial real estate properties are important to the tenant's businesses and livelihoods. Therefore, as inflationary pressures increase, landlords can be better positioned to pass through these pressures in the form of higher rents while still maintaining strong occupancy.

Real Estate is a Hard Asset

The link between inflation and real estate is easiest to understand given the sector's classification as a hard asset, which at its core is a compilation of various components (e.g. land, steel, lumber and concrete). As purchasing power erodes, prices of those underlying components increase. If the cost required to build a new property increases, then it follows that the value of an existing asset would likely increase as well.

> *As inflationary pressures increase, landlords are better positioned to pass through these pressures in the form of higher rent while still maintaining strong occupancy.*

Dynamic Cash Flows

When looking at financial assets that derive the majority of their returns from cash flow, real estate can be analogous to fixed income. Assuming a property is leased, there is a contractual rent obligation from the tenant (lessee) to the real estate owner (landlord), which can be similar to a coupon payment owed by an issuer to a bondholder.[4]

In order to maintain value when faced with inflation, bond yields need to rise to offset the deterioration in purchasing power. During inflationary periods, investors of fixed-rate bonds will see the value of their holdings decline. The extent of such declines will largely depend on the remaining time until maturity. Long-dated bonds are more susceptible to value declines than short-dated bonds because a short-dated bond matures sooner, thereby allowing the bondholder to reinvest the proceeds into a new bond at current market rates.

As an asset class that has historically derived a large portion of its returns from income, real estate landlords/owners can typically increase rents to offset inflation. The ability to increase rents most often depends on the supply and demand for the real estate in question in a given market, and the length and/or the contractual terms of the lease. The shorter the lease term, the sooner an owner can raise rents and thus grow the property-level cash flow. The longer the lease term, the longer it will take to raise rents, which will have a more pronounced negative impact on the property value. However, even long-duration leases can provide a hedge against inflation, as they often include contractual rent bumps that are either fixed or indexed to an inflation benchmark, such as the Consumer Price Index ("CPI").

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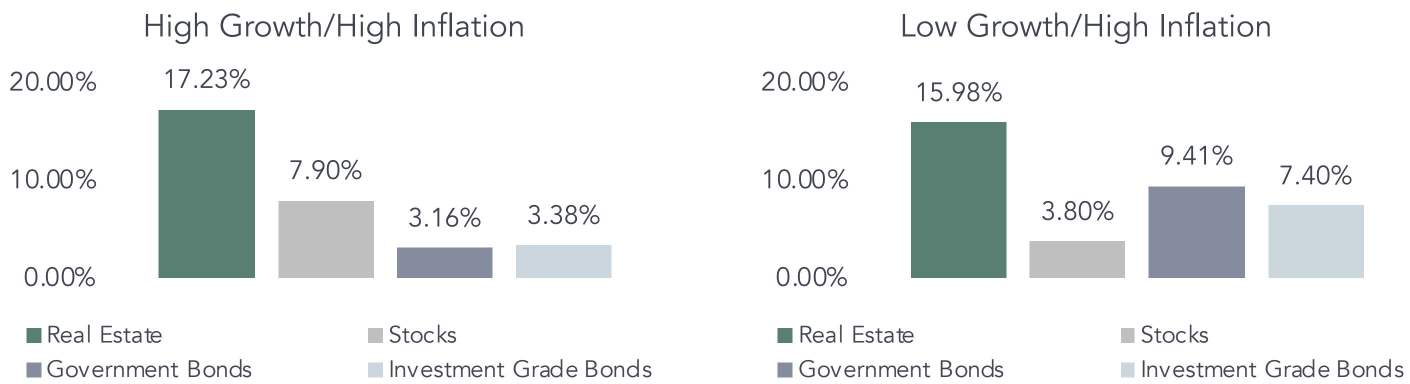
4. **The risks associated with an investment in real estate may materially differ from an investment in bonds or other fixed-income instruments. Such differences include different types of expenses associated with real estate (i.e., mortgage interest, property insurance, property management, acquisition/disposition/leasing fees, etc.), the risks that a tenant defaults on their rent obligation, risks of tenant vacancies, risks associated with market fluctuations and much more. Further, a direct investment in real estate is typically less liquid than investments in bonds. One should carefully assess all applicable risk factors before making an investment in real estate.**

Essential Nature of Real Estate

The extent to which inflation affects current and future tenants' willingness and ability to pay rent is an important factor when analyzing if a property will be a good inflation hedge. When inflation is occurring because of strong economic growth caused by increased demand (demand-pull inflation), the prospects for most businesses and consumers are strong, therefore the detrimental effect of inflation may be muted. However, when inflation is accompanied by low economic growth (cost-push inflation), it can be highly detrimental to overall levels of prosperity. The relative difference in the performance of financial assets in these low-growth and high-growth inflationary environments is illustrated below. In both environments, commercial real estate performance has been significantly stronger than that of both equities and traditional fixed income because of its essential nature to the underlying tenant.

Asset Class Performance During Periods of High Inflation



Past performance is not indicative of future results. High growth and high inflation are defined as periods where the gross domestic product and the consumer price index each rise at least 2.5% annually. Data sources: BlackRock, National Council of Real Estate Investment Fiduciaries (NCREIF), Bloomberg and S&P 500. Data from December 31, 2000 to December 31, 2020. Real Estate is represented by the NFI-ODCE Index, Stocks are represented by the S&P 500 Index, Government Bonds are represented by the Bloomberg Barclays U.S. Government Aggregate Index, Investment Grade Bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index. An investment cannot be made in an index, which is unmanaged and has returns that do not reflect any trading, management or other costs.

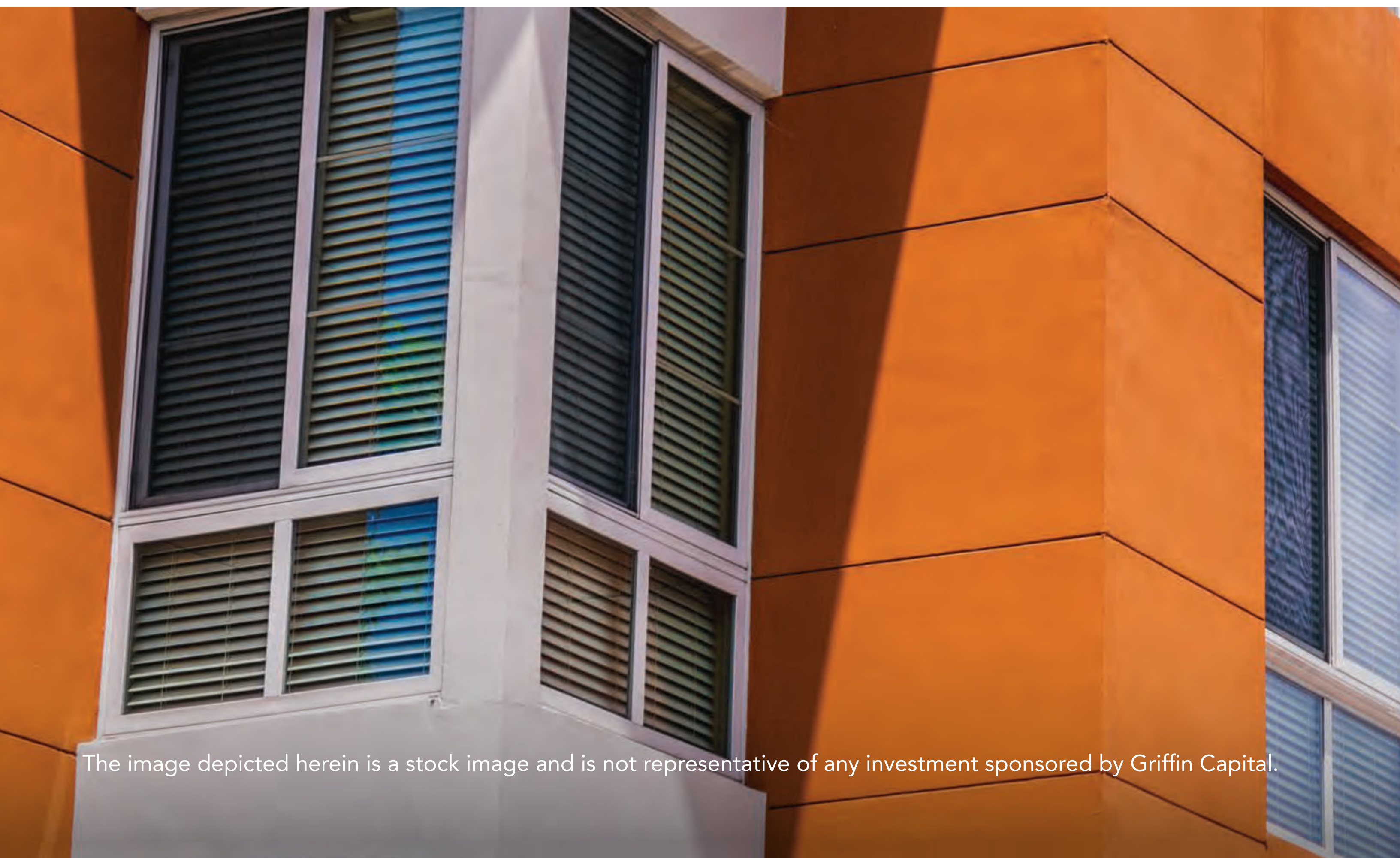
What would a manufacturing company do without the industrial property where it develops and/or stores its products? What would a restaurant be without the location where it makes food and serves customers? A business's profitability may suffer from inflation; however, they may have little choice but to keep paying rent if they want to stay in business.

THE OPTIMAL REAL ESTATE STRATEGY IN AN INFLATIONARY ENVIRONMENT

While all real estate is a hard asset, not all sectors perform similarly in varying parts of a market cycle. Like other asset classes, there are various subsectors in the property markets, and each will have variable ability to maintain occupancy and adjust cash flows in the face of inflation. Properties that are more likely to exhibit the strongest performance in periods of inflation maintain the following characteristics: shorter-term leases, inflation-linked leases and strong underlying demand drivers.

Long-term leases (like long duration bonds) provide cash flow stability, but when inflation drives interest rates and/or market rents higher, their value suffers. Conversely, short-term leases allow the landlord to more frequently adjust rents to market and thus increase cash flow. Hotels have the shortest "leases" as a guest generally rents a room for a day; as such, a hotel operator can reprice the cost of that room daily. Multifamily follows closely behind with leases that are predominately one year in duration. Next, retail (shopping centers), office buildings and industrial warehouses follow with generally medium- to long-term lease structures. It is worth noting that many long duration leases have contractual increases or may be indexed to the CPI or some other inflation benchmark, thus providing the owner with a measure of inflation protection.

Typical Lease Duration by Property Type



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Necessity-Based Real Estate

The more essential a property is to tenants, the more likely it is that they will keep paying rent in the face of inflation. Therefore, it is important to assess the degree by which the tenant relies on the property. Hospitality properties may thrive if inflation is spurred by strong economic growth, but if the opposite occurs, then individuals and businesses are likely to offset their business slowdown and weaker purchasing power by foregoing travel and leisure spending. For other property types, such as office and industrial, the degree to which a tenant relies on its real estate footprint will vary from industry to industry, and therefore must be considered on a case-by-case basis. But of all real estate, multifamily is perhaps most essential to tenants as it provides shelter. In addition to its essential nature, in periods of inflation, the affordability gap between owning and renting may widen. This gap may in turn place home ownership out of reach for a larger portion of the population, and thus fuel even greater demand for multifamily.

CONCLUSION

Real estate has always been an essential asset class in a well-diversified asset allocation model. In the face of a challenging traditional fixed income market and looming inflationary pressures, capital flows into the real estate sector continue to be robust. Though investors are attracted to the relative return characteristics the asset class has to offer, it is important to be cognizant that not all real estate is similar. Performance drivers vary by sector, market and tenant; therefore, it is imperative investors evaluate a multitude of factors when risk adjusting their real estate allocation. In periods of inflation, real estate investors are more keenly focused on sectors that have shorter duration leases with demand drivers underpinned by strong secular growth trends. The dynamic nature of these cash flows and the strength of the demand drivers are particularly evident in the multifamily sector.

Griffin Capital Plaza
1520 E. Grand Avenue
El Segundo, CA 90245

310.469.6100
www.griffincapital.com

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