REAL ESTATE

Bringing Modern Portfolio Theory To Investment Real Estate

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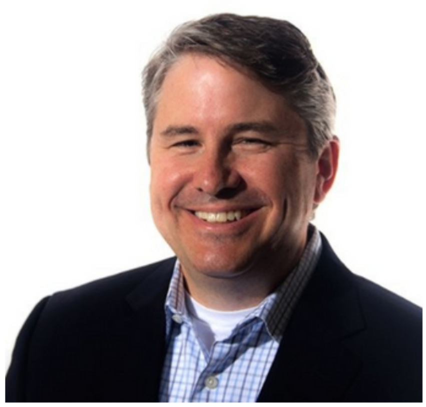
The author argues that advisors should grasp the benefits that Modern Portfolio Theory should bring to commercial real estate investments – and give their businesses an edge.



Here's another guest article that comments on the real estate market from David Wieland, founder and CEO of Realized. (See his previous article here.) He applies what is called "modern portfolio theory" (in fact, it is now quite old) to the bricks-and-mortar world. It's an example of how we try to get deep into the details of investment stories and get beyond the superficialities.

The usual editorial disclaimers apply to guest articles. The editors are very pleased to share these insights and invite replies. Email tom.burroughes@wealthbriefing.com

Nobel prize winner Harry Markowitz once said that becoming an economist was not a childhood dream of his. But in 1952, he introduced a ground-breaking strategy that revolutionized the way we invest – modern portfolio theory (MPT).

As a result of his research and forward thinking, Markowitz deduced that the performance of an individual stock was not as vital as the composition and success of an investor's overall portfolio. And even though MPT didn't take off until the 1960s, the concept is now the gold standard for financial advisors. Nobel laureate Paul Samuelson said of the investment strategy and its developer: "Wall Street stands on the shoulders of Harry Markowitz."

Yet oddly enough, MPT isn't something investors typically apply to real estate investment the way they do stocks and bonds. Doing so, however, could reduce investment risk in real estate while also building a more diversified portfolio.

The risks of traditional CRE investment

Conventional wisdom holds that real estate is typically a less volatile investment than stocks. That's because real estate investment has different types of returns and risk profiles than traditional asset classes. And while alternative investments aren't a good fit for clients seeking short-term rewards since they don't offer easy liquidity, an investor with a five- to 10-year investment horizon will find commercial real estate (CRE) has the potential to provide solid returns.

Investing in CRE helps investors increase the diversity of their portfolios. And financial advisors can help clients take this diversification even further by applying MPT to real estate investments, expanding an investor's CRE portfolio to help manage risk in a similar way to traditional portfolios.

Let's say an investor owns one retail property that houses one tenant. Should the tenant decide to close his business, the property could be vacant for quite some time before the owner-investor secures a new lessee. However, if a client invested those same assets in multiple properties or property types, they could spread the risk, and that's one of the key potential benefits of MPT.

But many investors don't have the funds to invest in multiple properties, so it's hard for them to apply MPT to real estate investments. Instead of investing in multiple types of properties, say, a combination of student housing and retail, CRE investors may often only be able to invest in one property type. This can leave them vulnerable.

Applying MPT in CRE

If a client only has $500,000 to invest, how can they diversify and purchase several commercial properties? One option is through a Delaware Statutory Trust (DST), which is a legal entity that allows multiple investors to pool their resources, so they can own a fractional interest in several commercial property types, such as multifamily residential, hospitality, or retail, as well as in several geographic locations.

DSTs also allow for 1031 exchange transactions and their pass-through advantages, such as capital gains tax deferment, for passive investments. Owning a share in a DST allows investors to apply the ideas of MPT to property ownership, diversifying their CRE assets.

DSTs also provide an Umbrella Partnership Real Estate Investment Trust (UPREIT) option, which is especially attractive if your client already owns a property but wants to reduce or eliminate the management of it. An UPREIT is a partnership between the owner of an appreciated property and a Real Estate Investment Trust (REIT). The REIT is a company that owns, finances, or invests in real estate or real-estate-related assets, providing individual investors the opportunity to invest in a portfolio of larger properties. In exchange for transferring their property to the trust, the property owner receives operating partnership units through a tax-deferred exchange comparable to a 1031. Property owners can continue to defer those capital gains until they sell their shares or convert their units to REIT shares.

DSTs and DSTs with an UPREIT option are vehicles to help investors diversify their CRE portfolio and potentially decrease their tax obligations.