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What's the Best Method to Broadly Access Real Estate? Interval Funds Might Have Cracked the Code

Many investors are aware of the attractive benefits of investing in real estate such as income, capital appreciation, and potential tax advantages. However, investors struggle with the myriad of vehicle types to access real estate, all with their pros and cons. Direct ownership in real estate is tangible, can be controlled by investors, and valued at fair market value. But direct ownership also requires significant oversight and maintenance and accomplishing broad exposure and meaningful diversification can be challenging or impossible for individuals without millions of investible capital. Publicly traded REITs are passive investments that can be diversified (although many are single sector focused), but their significant pricing volatility and periodic large value declines create undue stress in portfolios given that REITs tend to be highly correlated to equity markets. Furthermore, REITs are not always reflective of the true value of the underlying real estate and have the potential to trade below net asset value (NAV).

The interval fund structure, still relatively new for real estate investing, may provide the right balance of passive investing in real estate and can more accurately reflect the underlying real estate's fair market value. Because interval funds price daily based on net asset value, their values aren't subject to the daily whims and sentiment of stock market traders like publicly traded REITs and, instead, mark to the actual value of the underlying real estate. But, they have almost all of the benefits of public REITs including ease of investing with ticker symbols, daily pricing, passive ownership, and attractive income returns. They also balance liquidity by offering periodic liquidity (typically quarterly), and are an enhancement to direct-held real estate in terms of reliable liquidity without the unpredictability of public REIT pricing. Despite their attractiveness, misconceptions remain around interval funds. We seek to address those here.

MISCONCEPTION: Interval fund net asset values lag the pricing of public REIT markets

REALITY: Interval funds strike their NAV using current real estate values whereas public REITs fluctuate significantly in an attempt to assess where real estate will be priced in the future. This can often create frequent pricing mismatches of public REIT stock prices with actual real estate values (i.e., premiums and discounts). From 2000-2022 for example, the public REIT index experienced 11 drawdowns of 10% or more. If interval fund NAV values did consistently lag public REIT values, we could expect a similar number of drawdowns occurring in private real estate 1-2 quarters after their public counterparts. However, in only one instance during this same period did private real estate values decline over 4%. This comparison shows that public REITs have questionable predictive ability.

MISCONCEPTION: Interval funds lack liquidity

REALITY: Interval funds invest in private real estate by acquiring shares in underlying private REITs or funds and offer periodic liquidity through quarterly repurchase offers, which is mandated given they are 1940 Act structured funds. Although less liquid than public REITs, with a bit of planning interval funds can meet most investors' liquidity needs and their investment objectives. Interval funds should not be investors' first source of liquidity for unexpected needs, but investors should be cautious of using public REITs as a liquidity source given their significant volatility and their potential to trade below NAV. In reality, most investors don't need daily or intraday liquidity and research has suggested that illiquidity premiums await patient investors.

MISCONCEPTION: **Interval funds are inefficient because they have multiple fee layers**

REALITY: Interval funds' underlying real estate investments are typically privately offered REITs, which are geared towards institutional investors, and generally just as efficient as public REITs. Underlying management fees are generally similar or less than a typical public REIT's general & administrative expenses and executive compensation structures. Given that interval funds invest in private REITs, they can be viewed similar to mutual funds that invest in public REITs.

MISCONCEPTION: **Interval funds indirect real estate access is inferior to direct access**

REALITY: Indirect real estate access (i.e., owning shares in real estate interval funds) not only affords truly passive ownership with similar tax advantages as public REITs, but it can also provide up to hundreds of billions of dollars in underlying real estate exposure for even a small individual investment size, greatly enhancing diversification.

Further, direct real estate ownership is much less flexible in structuring and managing a real estate portfolio. For example, direct real estate ownership tends to be the most illiquid of all options and has high transactions costs because individual properties must be purchased and sold. Re-allocating sector and geographic exposure becomes extremely difficult, potentially costly, and time prohibitive. Alternatively, interval funds can sell in and out of ownership positions in underlying funds relatively easily, thus more easily pivoting their portfolios to capture opportunities in the market.

Real estate interval funds solve for many of the challenges individual real estate investors face, thus it is not surprising that they are proliferating. Real estate interval funds' assets under management have grown to over $22 billion in just 11 years of existence. We expect this trend to continue as investors value access and exposure, diversification, and pricing transparency over control and daily liquidity.

Private Real Estate: as measured by the NCREIF Property Index.

Public REITs: as measured by the MSCI U.S. REIT Index.