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DC *flows into* REAL ESTATE SOLUTIONS

Daily valued real estate funds that include private real estate offer greater diversification and lower volatility than REITs alone, delivering bricks-and-mortar real estate benefits to defined contribution plans. Market volatility in 2022, combined with private real estate's strong post-Covid performance, resulted in enhanced rebalancing needs due to the denominator effect. Managers of daily valued real estate funds experienced rebalancing outflows in 1H 2022 but are again seeing positive flows. However, investor prioritization may be an issue for new cash flows.

NAREIM spoke with **Clarion Partners, JPMorgan Asset Management, PGIM Real Estate** *and* **Principal Real Estate Investors** *to get a real-time pulse of the DC market, as well as to understand DC real estate appetite in times of market stress and manager considerations surrounding liquidity and rebalancing.*

By Zoe Hughes

PARTICIPANTS

Tripp Braillard
SVP, Head of Defined Contribution Distribution, **Clarion Partners**
In his role, Tripp is focused on the distribution of Clarion's products within the US institutional defined contribution channel. He joined Clarion Partners in 2022 and began working in the industry in 1993. He is a member of the Defined Contribution Real Estate Council (DCREC), Defined Contribution Alternatives Association (DCALTA) and Defined Contribution Institutional Investment Association (DCIIA).

Jani Venter
Executive Director, **JPMorgan Asset Management**
Jani is a member of the Funds Management Team and leads JPMorgan's Defined Contribution (DC) Real Estate Solutions. She serves as Co-president for the Defined Contribution Real Estate Council (DCREC), and actively contributes to the Defined Contribution Alternatives Association (DCALTA) and Defined Contribution Institutional Investment Association (DCIIA).

Sara Shean
Managing Director, **PGIM Real Estate**
Sara is a portfolio manager for the PGIM Retirement Real Estate fund series. She has over 20 years of defined contribution experience and is actively involved in the Defined Contribution Real Estate Council (DCREC), Defined Contribution Institutional Investment Association (DCIIA), Defined Contribution Alternatives Association (DCALTA) and Defined Contribution Investment Forum (DCIF) in the UK.

Diane Smola
Managing Director, **Principal Real Estate Investors**
Diane joined Principal in June 2021. Prior to her current role, Diane led consulting relationships with advisory and delegated corporate, public and higher education defined contribution plans at Aon. She is actively involved in the Defined Contribution Real Estate Council (DCREC), Defined Contribution Alternatives Association (DCALTA), Defined Contribution Institutional Investment Association (DCIIA) and IIDC Institute.

Participants' DC offerings

Clarion Partners: One DC product with $170 million AUM.

JPMorgan Asset Management: $4.5 billion in DC real estate AUM across a number of direct private and blended private/public solutions.

PGIM Real Estate: Two products in the daily valued DC space with $3.5 billion combined AUM.

Principal Real Estate Investors: Daily valued and daily liquidity ODCE fund since 1982 with $13.3 billion AUM.

The market was volatile in 2022. How was it for real estate DC flows?

Tripp Braillard, Clarion Partners: DC capital raising slowed a bit in 2022 as the year progressed, mainly due to the so-called denominator effect. Private real estate performance was relatively strong for most of the year compared to the downdraft in the public equity markets. This led some institutional DC plan sponsors and trustees needing to rebalance away from strong performing assets like private real estate to stay within their target allocations.

Despite the slowdown in inbound capital flows, plan sponsor interest in DC real estate strategies weren't affected. The investment case spoke for itself during 2022: private real estate acted differently, helping buoy portfolios, which is the diversification effect that plan managers are looking for.

Sara Shean, PGIM Real Estate: From the DC perspective, 2022 was really a tale of two halves. In the first half of the year, we experienced a negative cash flow environment as real estate outperformed equities and bonds. The rebalancing moved away given the denominator effect that Tripp mentioned. As real estate values began to come down in the second half of the year, we saw the flows reverse and ended up in a positive cash flow mode. This trend has continued into 2023 to date.

For the full year of 2022, we ended just in negative territory across our two funds in terms of cash flows. But if we include the first quarter year to date, then we're slightly positive, even ahead of where we were in 2022; I would say the previous 12 months were neutralized.

Despite negative rebalancing activity in the first half of last year, we were fortunate that our second product was buoyed by new cash flows coming in. That kept that product in positive cash flow territory in each quarter of 2022. As we look at our pipeline for the first half of this year, we have about $150 million expected to fund by mid-2023. However, committed capital is going to be tricky this year, because it's a matter of when that capital will be freed up to be reallocated.

Although the near-term outlook for private real estate may be challenging, we are hearing from a number of plan sponsors who are now, after experiencing the volatility of the last 12 months, interested in having a discussion about more portfolio diversifiers. So, I do think that some of that dislocation and pain will lead eventually to opportunity in this space.

Jani Venter, JPMorgan Asset Management: I echo Sara's comments on renewed positive momentum. Market trends continue to drive positive new flows into the asset class. We are seeing new investors allocating to real estate and existing investors increasing their allocations as a result of the strong benefits they recognized across time periods, but especially since Covid.

If you think back to the exceptional returns that core real estate delivered in 2021, the rebalancing that occurred in the first half of 2022 year was not surprising. It was more the magnitude of the rebalancing requests that stressed real estate liquidity, largely driven by volatility in the stock and bond markets. You don't have to look further than 2022 for proof that DC plan participants benefit from the inclusion of private real estate. Not only was 2022 among the worst years for a 60/40 portfolio since the mid-1970s, bond performance actually amplified the pain felt in stocks. It is times like these when exposure to private markets can result in meaningful improvements to retirement outcomes.

Over the short term, aggressive interest rate hikes and fears of recession have resulted in shifts in real estate pricing. Real estate continues to be a strategic long-term allocation, demonstrating its net of fee benefit and ability to strengthen participant retirement outcomes across market cycles.

Diane Smola, Principal Real Estate Investors: In the first quarter of 2022, we anticipated more rebalancing than we actually received, but the second quarter was much more active for us in terms of DC plan rebalancing requests.

Looking forward, I think there is some hesitation on timing by investors, as many expect some continued weakening in the market as the Fed rates move higher. We have demand from new clients of our DC OCIO [outsourced chief investment officer] investors. Since onboarding takes some planning, we look forward to matching the timing of those new investments with what may be a very favorable vintage year for investing in core private equity real estate.

We're still looking at a market where there's some capitulation expected on both sides of the transaction in terms of pricing, both from sellers and buyers. We see more opportunities in the market in terms of investment looking forward, especially versus the last quarter of 2022 when there was a fair amount of transactions brought to market, but also those removed from the market and not closed.

“Market trends continue to drive positive new flows into the asset class. We are seeing new investors allocating to real estate and existing investors increasing their allocations as a result of the strong benefits they recognized across time periods, but especially since Covid.”

TB: It was a very similar story for us. Rebalancing in the third quarter was negative for us, but overall we were positive for 2022.

Do you expect this trend to continue in 2023?

SS: As a whole, we should be expecting to see positive cash flows for 2023, given where we are in terms of real estate values compared to equities and fixed income.

The interesting quandary for us is, we're first movers. The flows in the DC space and the DB [defined benefit] space tend to move in opposite directions; I would say DC tends to move earlier. Because DC plans are rebalancing so much more frequently than DB, we see the flows start to move away more quickly and we also see the flows start to come back more quickly.

JV: DC investors and consultants are increasingly recognizing the value proposition of including private real estate in retirement portfolios. We have included private real estate in DC plans for over 15 years and have successfully managed portfolios through prior periods of market inflections. Looking ahead, DC plans with existing exposure could support positive flows if equities continue to recover. For new investors, the current pricing dynamics in real estate may present a unique entry point in late 2023, which could drive flows into the asset class.

DS: We are anticipating positive cash flows from DC investors in 2023. Conversations are ongoing as more plans are looking to increase allocations to inflation-sensitive assets, not only within their target date funds, but also within real asset/inflation-sensitive white label funds.

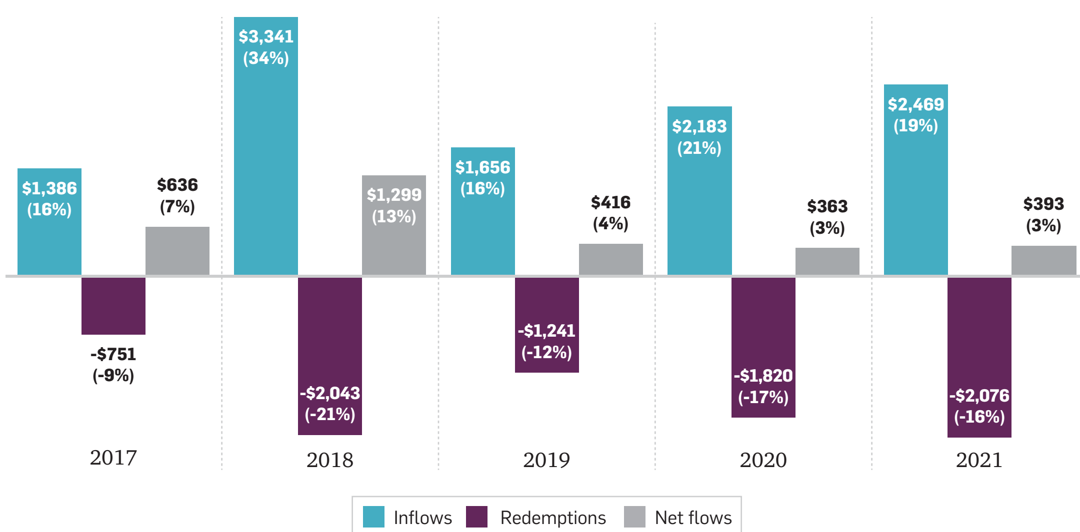
TB: I think the downward rebalancing trend that we saw in 2022 will not continue for two reasons. First, the markets have stabilized and I don't believe we're going to see a dramatic divergence between public and private markets like we did last year. Second, there's optimism in conversations with potential prospects. We're having more frequent and better conversations with plan sponsors and consultants, and generally seeing a lot more interest.

CHALLENGES WITH REBALANCING

Rebalancing was the issue of 2022. What is the best approach to rebalancing in times of market stress?

DS: As I mentioned earlier, we saw fewer rebalancing requests in the first quarter of 2022 than we had anticipated. We did see an increase in them in the second quarter of 2022 as the market started to reconcile a higher interest rate regime and likely downward pressure on real estate pricing. I do think that there are lots of conversations about the size of that

1. Total private real estate DC capital net inflows fell in 2022 but are recovering in 2023



Note: % represents total capital flows as a % of AUM for a sample set of respondents.

Source: The Defined Contribution Survey 2022.

rebalancing range, and investors are moving from a very tight rebalancing range to a lot more flexibility in that range than perhaps they had a few years ago. In a time of significant market dislocation, that flexibility can be helpful for investors.

TB: At Clarion, we serve a broad array of institutional clients and see organizations take different approaches to rebalancing. We see three primary types of rebalancing approaches among our investors. The first is very strict, with no flexibility relative to their target portfolio allocations. These tend to be plans that require rebalancing by statute; public plans tend to fall into this bucket. The second is multi-asset programs that have bands which give the fiduciary some flexibility. Typically, the fiduciary would let real estate run to the upper levels of those bands to avoid unnecessary transactions. Finally, there's full discretion. These firms allowed their real estate allocations to run high in late 2022, because they expected the pendulum to swing back and the market to come back to equilibrium.

JV: There are investors and consultants that are of the opinion that systematic rebalancing isn't always in their clients' best interest, especially during a period such as the first half of 2022. They are willing to step back and take a light touch on rebalancing to ensure the diversification and downside protection is recognized, and not rebalanced away into underperforming asset classes.

To Tripp's point, there are also clients that, from a fiduciary standpoint, have strict guidelines in their documentation to systematically rebalance and there is limited flexibility around that.

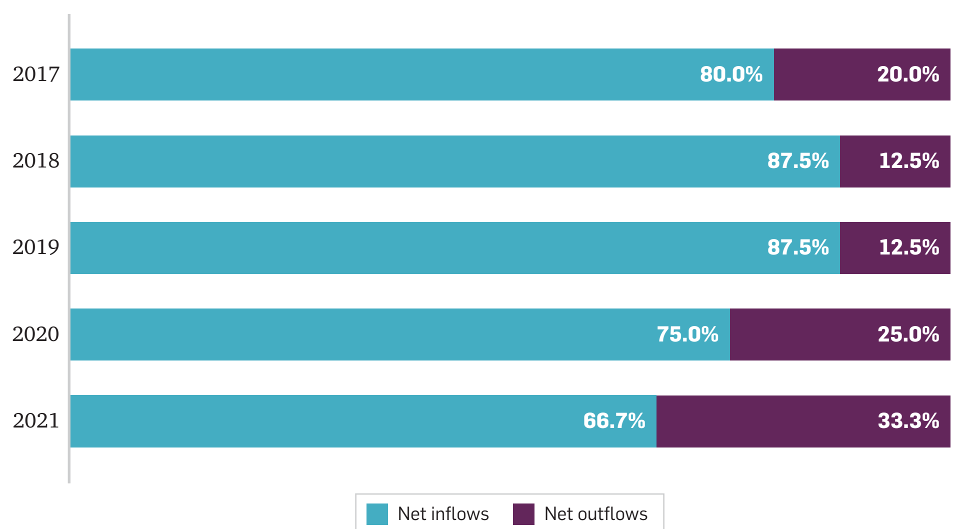
SS: In the DC space, we see a spectrum, from systematic to fully customized rebalancing, and it can be daily, monthly or quarterly. I agree that fiduciaries and glidepath managers are currently evaluating the optimal level of flexibility within their rebalancing guidelines.

Are the challenges of rebalancing causing existing investors to increase their allocations?

SS: The primary theme we hear over and over again is downside protection. While the outsized returns in private real estate were enjoyed in 2021, investors really value the smoothed volatility and downside protection they receive from the asset class. Many clients said: "When I look at what was in positive territory over the last 18 months, it was my private allocations (versus the public allocations)."

JV: It's the diversification and downside protection. Real estate is not going to deliver 20%-plus returns annually as it did in 2021. It's the stability and more consistent positive returns that offer the potential to support stronger outcomes for participants over multiple market cycles.

2. After experiencing net outflows due to the denominator effect, managers say that capital flows of DC capital into private real estate strategies are again positive in 2023



Source: The Defined Contribution Survey 2022.

MANAGING LIQUIDITY

In the Defined Contribution Survey 2022, participants told us that the average liquidity sleeve was 13%, while the median was 10%. As we look to 2023, what do we think that liquidity sleeve is going to be? Do investors need more liquidity?

SS: What I think the Survey shows is, as we see additional investments into products that don't have a built-in liquidity sleeve, that average will come down. It was 15% for a pretty long time and it recently decreased to 13%. We may see the level continue to tick down over time.

I don't foresee a big change in the existing liquidity sleeves. We have one product with a 25% sleeve and one with 15% as a sleeve, and that's a strategic allocation for us that we manage fairly tightly. For products with a built-in liquidity sleeve, that level is determined by the manager rather than the client.

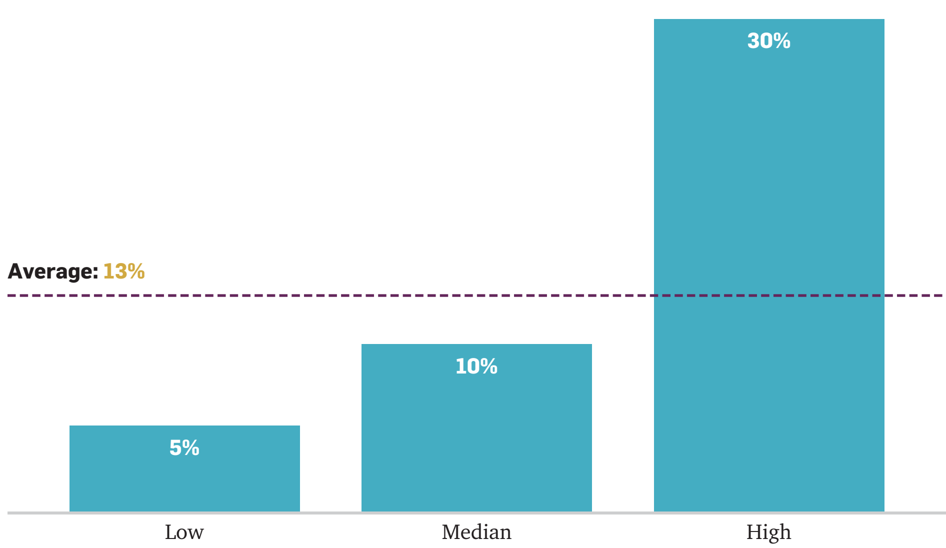
It has been interesting to us that, even though any one of our clients could utilize the 25% liquidity sleeve product, very few in the last 10 years have taken us up on that. The vast majority of our asset growth has come in the 15% liquidity sleeve product. I think this points to investors wanting as much direct real estate exposure as possible if they make the decision to invest in it. They want that liquidity sleeve to be as small as needed to accomplish the job.

DS: Our daily valued private equity real estate (ODCE) product does not include an allocation to REITs. It is a pure-play investment, so the liquidity is accessed via cash and other liquidity mechanisms in the portfolio. Our DC clients manage liquidity primarily through the other sleeves in their multi-asset portfolio, either from REITs or other liquid asset classes. As a result, they may choose to access liquidity from a source other than their REIT allocation when REIT returns have been under pressure. Because the private real estate allocation within a target date fund typically averages 10% or less, the multi-asset portfolio manager has an abundance of liquid investments from which to source their distribution needs.

There are two schools of thought on liquidity. Some managers of multi-asset portfolios want to manage that liquidity on their own, in which case they're attracted to the pure play; others want to delegate liquidity management and access the REIT sleeve within a packaged private real estate product.

JV: The fact that there is a range of daily valued real estate solutions available today demonstrates the evolution of the market over time to address investor needs. Our view is that a blend of public and private real estate best addresses DC plan needs. Investors have generally favored blended solutions that offer investor diversification while delivering the characteristics of private real estate and daily liquidity through public real estate markets.

3. The average quarterly liquidity sleeve for dedicated DC real estate strategies is 13%



Note: Liquidity sleeve allocation may include REITs, cash and other liquidity holdings.

Source: The Defined Contribution Survey 2022.

I don't believe the enhanced rebalancing needs during 2022 will increase liquidity allocations, but they highlight the importance of actively managing liquidity allocations with appropriate daily guidelines. To Sara's point, if the universe brings in more 100% private solutions, that industry average measurement will decline.

TB: I think 15% feels about right for products that offer structural liquidity, but I think it's important to offer choice — one with liquidity and a product without. The key reasons why a plan sponsor would opt into a product with liquidity include structure and flexibility. It's not an investment decision; it's not uncertainty about the private markets versus public markets, or a market timing decision at all.

The other factor is timing around rebalancing. In products with no liquidity, you're limited to very specific windows when you can rebalance. Certain plans aren't on that schedule and may have a mismatch in timing, in which case they may need a strategy with a liquidity buffer to accommodate that plan's particular timing need to push through a rebalance.

DS: Although we do not have a liquidity sleeve within our daily valued real estate product, absent a withdrawal limitation, investors can rebalance as of any date, not just during specific windows.

To Tripp's point, in our product, you're not restricted to entry and exit on a monthly or a quarterly basis. It's daily for cash flows.

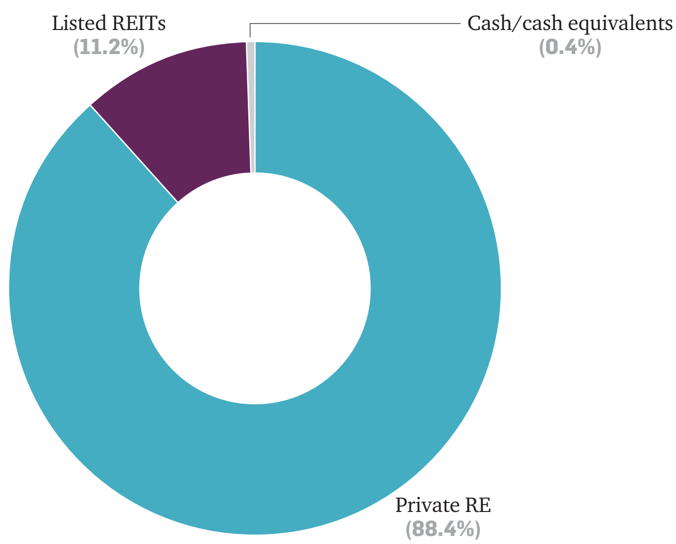
" The key reasons why a plan sponsor would opt into a product with liquidity include structure and flexibility. It's not an investment decision; it's not uncertainty about the private markets versus public markets, or a market timing decision at all. "

REIT EXPOSURE

As public market returns are increasing, so will REIT returns. As you look to structuring your own products, will you increase your REIT exposure to capture some of those returns?

JV: We do not take tactical views on public versus private real estate and we implement strategic long-term allocation targets within blended real estate solutions. We recognize that there are changing dynamics between private and public real estate, but REITs serve a liquidity purpose within these solutions. We believe this approach delivers the strongest portfolio outcomes.

4. The average target allocation to liquid REITs and cash or cash equivalents is 11.6% on average



Source: The Defined Contribution Survey 2022.

Key lessons

During your time on the DC side, what has been your biggest takeaway or lesson learned that you would give your younger version joining the industry now?

Sara Shean: Despite short-term periods of stress in the markets, the daily valued products continue to do what they're designed to do — provide access to the benefits of private real estate in a structure that works for DC plans.

Diane Smola: Patience, not panic. We can get through market dislocations because markets recover, and real estate will continue to serve as stabilizer in multi-asset portfolios. Also, patience is paramount when speaking to potential new investors as few DC plans want to be early movers.

Tripp Braillard: Conversations with investors potentially take place over a span of months and years, so patience is important. I remember something that Sara said a few years ago that stuck with me: "When you hear no, it may not mean no, it just means not today." Plans change, investment needs evolve, and private real estate is now much more of a mainstream asset class in multi-asset investment portfolios. It has been a key component of defined benefit retirement portfolios for many decades. It's just a matter of time that it becomes incorporated into more and more diversified and personalized DC portfolio strategies.

Jani Venter: I think it is important to remember that many DC investors are newer to investing in private real estate. This means education, communication and transparency are critical. For example, it is important to communicate with clients and consultants during periods of market stress so they know what they are going to experience. By establishing mutual expectations around private market dynamics, strong client relationships can be formed.

SS: The REITs are there structurally to provide liquidity. We are not making bets tactically, trying to move between public and private real estate. In almost every meeting, we are asked: "Are you trying to use the REIT sleeve to accomplish an investment goal?" And the answer is, from our perspective, we're using them to provide liquidity, nothing more.

ONWARD AND UPWARD

In 2022, DC Survey participants said that 42% of all inflows came from new investors or new mandates. Do you expect this to continue, and, if so, what does the new investor or mandate look like?

JV: We would expect 50% of inflows from existing plans, and the remaining 50% from new investors looking to access private market benefits.

SS: We're hoping that we see more or less an even split of flows from new and existing investors. Given where values are likely to be in 2023 versus traditional equities and bonds, we expect positive cash flows in this environment.

TB: As our business is newer, I think we will probably see more flows from new investors than existing. If our business were more mature, it would probably be 50/50 as well.

DS: We're hoping for the same thing. We're also hearing more about white label inflation-sensitive funds being created and the place for real estate in those funds. These are investors who want more customized product with an individual manager rather than a single multi-asset solution.

Where's the biggest concern?

TB: The conversations that we have with both plan sponsors and consultants are generally very constructive. They understand the investment case for adding private real estate to the DC plan. The conversations really come down to prioritization by plan sponsors. Plan sponsors today are faced with many competing priorities, including overhauling a custom target date series to adding a retirement income solution. The launch of SECURE 2.0 [Act of 2022 aimed to strengthen the retirement system] introduces an additional suite of potential priorities for plan sponsors around plan design changes.

What's the next frontier for real estate in DC plans?

Diane Smola: Will we see the adoption of private real estate debt? I believe that is next.

Tripp Braillard: I think so. Fixed income is a large component of DC assets. At $5 trillion in total assets, the market size for debt is much bigger than just real estate. Fixed income is 50% of DC assets right now.

Sara Shean: When real estate debt actually begins to be adopted, I think it has the potential to grow even more quickly than the equity side has over the last 10 to 15 years.

DS: And what will its place be? Will its place be in the fixed income white label option in the plan, or will it also be included in custom target date funds? I think it has a place in both.

Jani Venter: I agree. It's just a matter of time.

When will private real estate debt come through?

SS: We've been discussing the asset class for two-plus years. Interest remains fairly strong, but as discussed earlier, patience is key in DC.

JV: Two years, potentially three years or more. It's a market evolution where we need sufficient adoption on the equity side that supports investors and consultants looking beyond equity at the benefits of investing in real estate debt.

Plan sponsors think about what will make the most impact for their participants. It may not be changing the investment lineup; it may be implementing other structural changes like emergency savings, college loan repayment accounts and other plan design changes. We want to get mindshare, and that, for me, is the biggest challenge.

SS: Well said. We also continue to see concerns around litigation risk, and I believe that fees tie into the litigation concerns.

DS: I think part of the issue is whether or not the investment committee members already have experience with private real estate from their DB plan oversight. If so, they well understand the benefits of adding it to their multi-asset DC plan options. If not, more education on the benefits of the asset class is in order. As mentioned earlier, investment committees may now prioritize implementing new provisions of SECURE 2.0 over making changes to their investment lineup.

We can't get away from the litigation concern, but I want to reframe that discussion. It's all about what's going to improve investment outcomes for participants, and, I hope, less about explicit fees and the fear of being sued.

JV: I agree with the point shared by the others — implementation priority and litigation fears are holding investors back today. We have conversations where plans recognize the value of adding real estate, but it's not at the top of their priority list at this point in time. ◆

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