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Principal Asset Management℠

Investment education

Real Estate in Modern Portfolios: A Wealth Advisor's Guide

HIGHLIGHTS

- **Like institutional investors, private wealth clients can use the full spectrum of real estate investment alternatives to meet portfolio goals.**
- **The real estate investment market can be divided into four quadrants: private equity, private debt, public equity, and public debt.**
- **Each quadrant offers accessible investments with a wide range of risk/return profiles.**
- **Diversification, capital appreciation, and income generation are important potential benefits of including real estate in your portfolio.**

While many high-net-worth investors have experience with residential property ownership and may own commercial real estate properties directly, the investment landscape offers a more diverse opportunity set of investment vehicles - private real estate funds that offer different return profiles across the risk spectrum (core, core-plus, value-add and opportunistic), publicly traded real estate investment trusts (known as REITs) and real estate debt including loans as well as public Commercial Mortgage-Backed Securities (CMBS). Additionally, there are specialized and alternative property types like data centers, cell towers, senior housing and single-family rentals that may be more difficult for many investors to access directly.

Commercial real estate (CRE) is already a core holding in the institutional space with many institutional investors allocating an average of approximately 10% of the portfolio to the asset class. They recognize its potential to deliver multiple portfolio benefits, including steady income generation, potential capital appreciation, inflation hedging characteristics, and portfolio diversification through its typically low correlation with traditional assets like stocks and bonds. We believe that wealth managers can take inspiration from institutional approaches to help individual clients consider real estate as part of their own portfolio strategy.

The best starting point for clients interested in exploring the asset class is to understand the four quadrants of the real estate sector.

What are the four quadrants of real estate investing?

There are four main areas that make up the the real estate market – private equity, private debt, public equity, and public debt. This breakdown is useful because each of these quadrants has unique characteristics that investment managers must account for when selecting options for clients.

Private equity

Investing in private equity real estate involves the acquisition and ownership of property or properties either directly or via an investment fund.

Private debt

Private debt real estate investments allow non-bank lenders, like funds, to provide capital to real estate developers or owners, usually in the form of loans secured by the property.

Public equity

Includes publicly traded companies, such as real estate investment trusts (REITs), that own and operate income-producing real estate, allowing investors to gain exposure to real estate without directly owning physical properties.

Public debt

The public debt market trades debt instruments, such as commercial mortgage-backed securities (CMBS), that are issued to finance real estate projects or infrastructure.

Within each quadrant, there are different risk profiles and there are investments in numerous property sectors. In our view, one of the best ways to make sense of the options is to focus on risk levels. In addition to liquidity considerations, accurately gauging return relative to risk is key when investing in real estate.

Overview of real estate equity vehicle types

Each of the quadrants has unique characteristics, but within real estate equity there are four common segments. Ranging from lower to higher risk, there are core, core-plus, value-added, and opportunistic strategies. These segments are defined by risk and return profile, as well as the strategy to drive results. Investors can select investment products that focus on specific strategies to tailor their return objectives.

Key questions	Core	Core-plus	Value-add	Opportunistic
What is the strategy to drive results?	Buy and maintain an already performing asset	Enhance the asset through light renovation and lease-up	Rehabilitate or redevelop the asset and lease-up	Develop the asset from the ground up, redeveloping existing properties into a different use, or purchasing distressed properties in need of significant rehabilitation
What is the expected return profile?	7-10% primarily driven by income returns	9-13% driven by a combination of real income and capital appreciation	13-15% Real income and greater capital appreciation	15-20% primarily driven by capital appreciation
What is the risk of capital loss?	Lower	Low	Medium	Higher

Source: Principal Real Estate, June 2025. Any forecasted returns, yields or other forward-looking performance shown in this material are not meant to predict the returns of any portfolio or strategy and do not guarantee future results. The forecasted returns are shown for Illustrative, informational purposes only and subject to change without notice. These forecasted returns do not reflect any deductions for investment management fees or expenses that would reduce the actual returns realized by investors and there is no guarantee that the forecasted returns will be realized or achieved or that any investment strategy will be successful. The information concerning the real estate market outlook is based on current market conditions and general assumptions which will fluctuate and may be superseded by subsequent market events or for other reasons.

Listed REITs can serve as a complement to private equity CRE portfolios for a variety of reasons. First, they are more liquid since they are traded on national stock exchanges allowing investors the opportunity to buy and sell the stocks every minute of every trading day. Second, while listed REIT returns are more volatile than private CRE equity over the near term, they are also leading indicators for the private CRE equity. As a result, adding an allocation of public real estate to a private portfolio can smooth returns at certain allocations. Third, they offer investors access to alternative CRE property types as nearly 70% of market capitalization is in sectors that we consider to be next generation like data centers. The property types owned by real estate are typically core in nature, but listed REITs may also offer value-add opportunities through acquisitions and redevelopment.

CRE debt is often overlooked, but it's an important part of the CRE capital structure and offers compelling risk-adjusted returns in the current market. Like equity, debt may be structured as public or private.

Within private debt, there are various risk return profiles: (1) Senior debt that offers the lowest risk and lowest return (2) Mezzanine debt that is subordinate to senior debt, but above the equity and (3) Preferred equity that technically is equity but structured with fixed returns and senior to common equity. Longer term fixed rate loans can typically be encumbered by stabilized properties while bridge loans are usually floating rate and can be collateralized by a range of assets in different phases of the investment life cycle, including light transitional, transitional (more in depth business plans), or even stabilized assets where the seller is bridging to sell. Finally, construction loans fund ground-up development or major redevelopment.

Public debt most often comes in the form of Commercial Mortgage-Backed Securities (CMBS) - a type of bond backed by a single CRE loan or a pool of loans. The loans are then bundled together in a securitization and bonds (tranches) are issued with different levels of risk and return. The most senior tranche is typically rated AAA; it's paid first and therefore has the lowest risk, but also the lowest yield. There are also mezzanine tranches (typically rated AA to BBB) with moderate risk and return while subordinate / junior tranches (typically rated BB, B, and unrated) that absorb losses first if loans default and therefore have higher risk, but higher yields. CMBS is more liquid than private CRE debt, but not as liquid as publicly listed REITs.

Investors can tailor their portfolios across the four quadrants based on their risk tolerance, yield requirements and liquidity preferences. Within the public quadrants, REITs and CMBS are often used and well understood in traditional portfolios, but private equity and private debt should not be overlooked. They offer similar long-term fundamentals as their public counterparts but are often less volatile albeit more illiquid. We think there is a home in portfolios for all four quadrants – it's not an either-or proposition.

REAL ESTATE INVESTMENT STRATEGY RISK AND RETURN PROFILES

Core: Low-risk, income-focused, stable assets; buying and maintaining an already performing asset.

Core-plus: Slightly riskier, with some potential for value appreciation; enhancing the asset through light renovation and lease-up.

Value-add: Moderate risk, often involving renovations or operational improvements; rehabilitate or redevelop the asset and lease-up.

Opportunistic: High-risk, high-return projects, or developing assets from the ground up; redeveloping existing properties into a different use, or purchasing distressed properties in need of significant rehabilitation.

How do real estate investments impact portfolio construction?

Real estate investments have some key features that may enhance your clients' portfolios. Chief among these is diversification. There are relatively low correlations between stocks and bonds and real estate, particularly for private real estate, as shown in the correlation data compiled by Principal Asset Management below comparing real estate indices with global stock and bonds over the past 10 years. This correlation profile suggests that including both public and private real estate in a portfolio may provide compelling diversification benefits when combined with traditional assets like stocks and bonds.

Correlation levels over the past 10-year period

	Global stock[(1)]	Global investment grade[(2)]	Global REITs[(3)]	Investment grade CMBS[(4)]	Private equity real estate[(5)]	Private debt real estate[(6)]
Global stock	1.00	0.47	0.82	0.43	-0.34	-0.03
Global investment grade	0.47	1.00	0.61	0.86	-0.38	0.24
Global REITs	0.82	0.61	1.00	0.58	-0.13	0.33
Investment grade CMBS	0.43	0.86	0.58	1.00	-0.40	0.27
Private equity real estate	-0.34	-0.38	-0.13	-0.40	1.00	0.52
Private debt real estate	-0.03	0.24	0.33	0.27	0.52	1.00

Source: Bloomberg, Preqin, NAREIT, NCREIF, Principal Asset Management. Quarterly returns 1Q 2014 to 4Q 2024. No investment strategy, such as asset allocation or diversification, can guarantee a profit or protect against loss in periods of declining values. Past performance does not guarantee future index returns. It is not possible to invest directly in an index.

[(1)] MSCI World Total Return; [(2)] Bloomberg Global-Aggregate Total Return Index Value Unhedged USD; [(3)] FTSE EPRA NAREIT DEVELOPED Total Return Index USD; [(4)] BB/BC Inv Grade CMBS Index (Total Return Unhedged); [(5)] NFI ODCE Total Return Index, Gross USD; [(6)] NCREIF/CREFC Debt Agg Total Return Index. See index descriptions in Important Information section

OTHER ADVANTAGES INCLUDE:

- **Income generation.** The real estate quadrants have the potential to add income from numerous sources to client portfolios, which may help to ensure that client liabilities can be met.
- **Inflation hedging.** Real estate values and rental income typically rise with inflation, making it a natural hedge. Investment in properties with long-term leases and built-in rent escalations can also create certainty and protect purchasing power.
- **Tax efficiency.** Depreciation deductions on real estate holdings reduce taxable income. In addition, some structures (such as REITs or investments in qualified opportunity zones) receive preferential tax treatment.
- **Estate planning benefits.** Real estate assets can be used to transfer wealth efficiently through a variety of estate planning strategies. In some cases, such as with grantor retained annuity trusts (GRATs), clients can reduce the taxable value of their estate while retaining the income from the asset.

Historical performance during inflationary periods

Asset class	Typical behavior during high inflation periods	Reason
Private real estate/REITs	Generally, will rise	Rental income and property values will generally increase with inflation
Equities	Varies	Earnings may grow but higher interest rates can compress valuations
Fixed income	Declines	Inflation erodes purchasing power of fixed payments
Cash	Declines	Value erodes quickly in real terms

Source: Principal Asset Management, June 2025

From a portfolio construction perspective, the four quadrants tend to react differently to prevailing market or economic trends. One example is their reaction to interest rates. Private market investments are generally less immediately affected by interest rate changes due to their long-term, illiquid nature and less frequent valuation adjustments given their long-term investment time horizons. Meanwhile public market investments react more quickly as interest rates influence market sentiment, valuations, and liquidity. In other words, public markets tend to be leading indicators in both downturns and recoveries.

A review of the annual results for the four quadrants from 2007 to 2024 shows just how dispersed results can be. For this reason, the quadrants often function best when used together. A dynamic allocation approach may provide investors with the best possible outcomes by maximizing the opportunity set in any given market environment and through considering the asset allocation mix that is most suited to their objectives.

Average performance spread across quadrants since 2007: 21.03%

Performance gross total return

Percentages in last row show the difference between the highest performing sub-asset class and the lowest for the relvant year.

REITs | Investment-grade CMBS | Private debt real estate | Private equity real estate

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
16.0%	-4.1%	37.1%	20.8%	16.0%	27.7%	13.9%	15.0%	15.0%	8.8%	10.4%	8.3%	21.9%	7.6%	26.1%	7.5%	9.7%	5.0%
5.7%	-10.0%	28.1%	19.6%	6.9%	10.9%	3.7%	12.5%	2.7%	4.1%	7.6%	2.6%	8.3%	6.3%	22.2%	-9.0%	5.6%	5.0%
4.6%	-22.7%	14.7%	16.4%	6.5%	10.0%	2.9%	7.4%	0.9%	3.5%	5.7%	1.0%	8.1%	1.2%	1.9%	-10.9%	5.3%	0.9%
-7.4%	-48.2%	-29.8%	10.2%	-6.5%	4.7%	0.2%	4.2%	-0.8%	2.9%	3.5%	-5.6%	5.3%	-9.0%	-0.9%	-25.1%	-12.0%	-1.4%
23.4%	44.1%	66.9%	10.6%	22.4%	23.1%	13.8%	10.8%	15.8%	5.9%	6.8%	14.0%	16.6%	16.6%	27.0%	32.6%	21.7%	6.4%

Source: Principal Asset Management, as of 31 December 2024. Indices: US REITs: U.S. REIT Linked Index; IG CMBS: Bloomberg US CMBS Investment Grade Index; Private RE Debt: Giliberto- Levy Index; Private RE Equity: ODCE value weighted index. Past performance is not indicative of future performance. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index.

Average annual income returns: Q4 2004 through Q4 2024

Asset class	Average income return
U.S. private debt real estate*	7.51%
U.S. private equity real estate	5.25%
U.S. public equity real estate (REITs)	4.60%
U.S. public debt real estate (CMBS)	4.46%
U.S. fixed income	3.69%
Global equities	3.11%
U.S. equities	1.94%

Source: Principal Asset Management as of 31 December 2024. Indices: Private debt real estate - NCREIF/CREFC Debt Agg Income; Private equity real estate - NPI Income return; U.S. public equity real estate - NAREIT (All REITS, Income return); U.S. public debt real estate - Bloomberg Investment Grade CMBS; U.S. fixed income - Bloomberg Barclays US Aggregate (Income); Global equities - MSCI ACWI Ex US Income Return; U.S. equities - S&P Inc Return Index. Past performance is not indicative of future performance. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index.
*U.S. private debt real estate is from Q4 2013 through Q4 2024

THREE QUESTIONS TO ASK YOUR CLIENTS ABOUT INVESTING IN REAL ESTATE:

1. What role do you think real estate could play in your asset allocation strategy?
2. Are you familiar with how real estate investments can provide income that may be protected from inflation?
3. What questions do you have about the risks of investing in real estate?

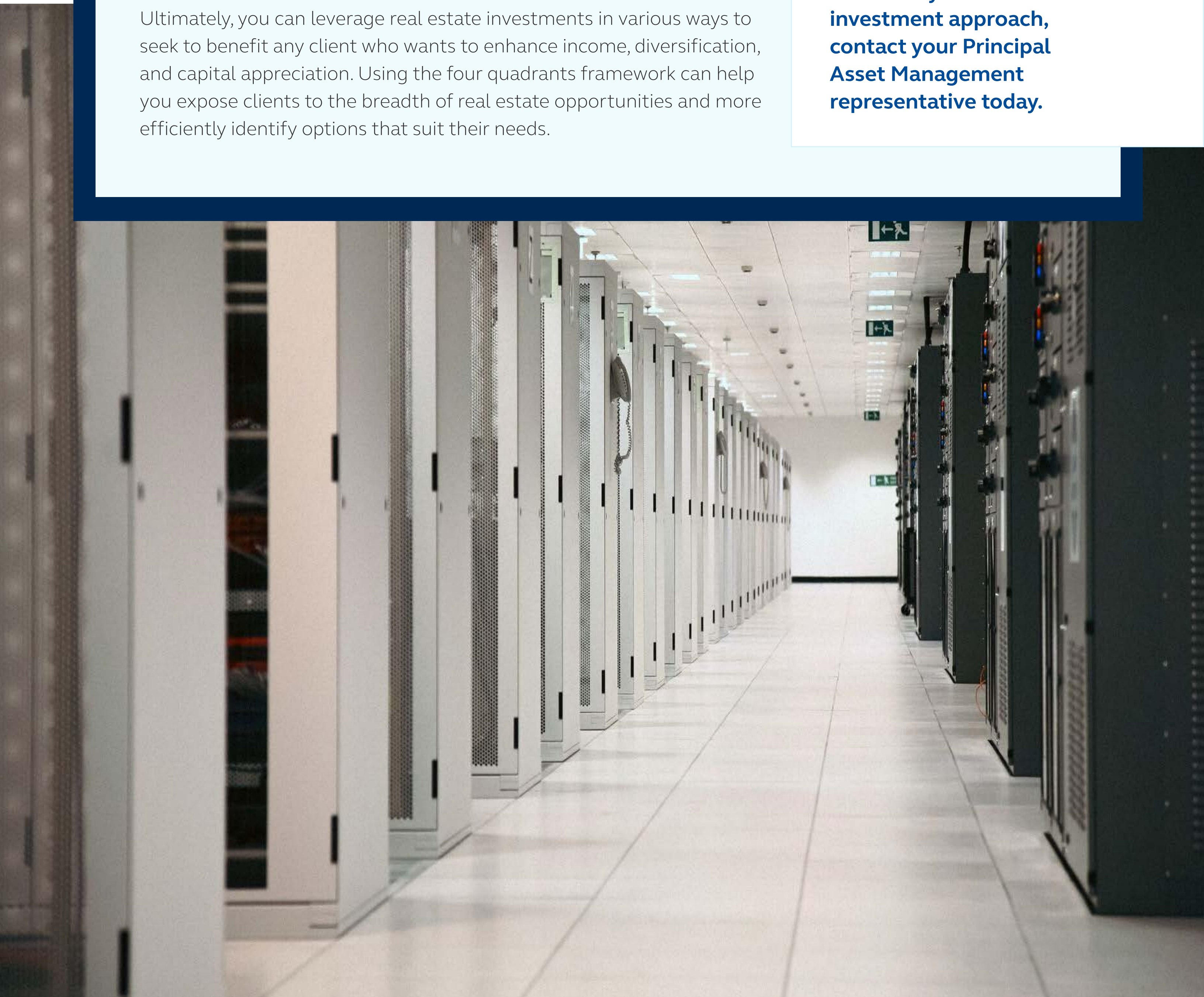
Discussing real estate with clients

Real estate investments often create tangible, meaningful impact that resonates with investors beyond pure financial returns. These investments can drive significant societal transformations – for example, developing affordable housing, building senior living facilities, or funding sustainable building improvements. This combination of social purpose and environmental stewardship, alongside potential financial returns, makes real estate particularly appealing to investors seeking to align their portfolios with their values.

As part of your discussions with clients, it can be beneficial to ask your investment provider to offer photos of funded projects, or case studies of projects that were financed by specific real estate investments. Sharing these resources with your clients can help them get a better picture the tangible advantages of real estate developments in society as well as in their portfolios.

Ultimately, you can leverage real estate investments in various ways to seek to benefit any client who wants to enhance income, diversification, and capital appreciation. Using the four quadrants framework can help you expose clients to the breadth of real estate opportunities and more efficiently identify options that suit their needs.

If you have questions on how leveraging the four quadrants framework will influence your clients' investment approach, contact your Principal Asset Management representative today.



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Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. Real estate investment options, such as real estate investment trusts (REITs) and commercial mortgage backed securities (CMBS), are subject to risks associated with credit, liquidity, interest rate fluctuation, adverse general and local economic conditions, and decreases in real estate values and occupancy rates. Direct investments in real estate are highly illiquid and subject to industry or economic cycles resulting in downturns in demand. Accordingly, there can be no assurance that investments in real estate will be able to be sold in a timely manner and/or on favorable terms. Private market investments, unlike publicly traded stocks, involve various risks due to illiquidity, lack of transparency, and higher minimum investment requirements. These risks include liquidity risk, market risk, capital risk, and regulatory risk. Additionally, private market investments often involve higher fees and expenses and may have longer investment horizons. Investment risk may be magnified with alternative investment strategies due to their use of arbitrage, leverage, and derivatives. Asset allocation and diversification do not ensure a profit or protect against a loss.

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Indices used: MSCI World - a global equity index that represents the performance of large and mid-cap stocks across developed market countries; Bloomberg Global-Aggregate Total Return Index Value Unhedged USD - a broad, multi-currency benchmark that tracks the performance of investment-grade, fixed-rate bonds across both developed and emerging markets, without currency hedging; FTSE EPRA NAREIT Developed Total Return Index USD - a globally recognized benchmark that tracks the performance of publicly traded real estate companies and REITs in developed markets; BB/BC Inv Grade CMBS Index (TR Unhedged) - tracks the performance of investment-grade Commercial Mortgage-Backed Securities (CMBS) within a specific rating range, typically those rated between BBB- and BBB+, and provides a total return (TR) calculation without any currency hedging (Unhedged); NFI ODCE Index - performance of open-end private real estate funds that invest in core properties; NCREIF/CREFC Debt Agg total return - a fund-level aggregate that tracks the performance of open-end funds providing credit and financing for commercial real estate. Giliberto Levy Index - tracks investment results produced by private-market debt investments in commercial real estate within the United States; The MSCI ACWI Ex US Income Return Index - tracks the performance of large and mid-cap stocks in developed and emerging markets outside the United States, with a focus on companies exhibiting higher dividend yields and quality characteristics; S&P 500 Index - tracks the performance of 500 of the largest publicly traded companies in the United States; Bloomberg Barclays U.S. Aggregate Bond Index - tracks the performance of a wide range of publicly offered, fixed-rate, taxable, dollar-denominated bonds, including U.S. Treasuries, government-related securities, corporate bonds, and mortgage-backed securities.

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