Principal℠

Private real estate:
Accessing diversification, stable income, and inflation protection

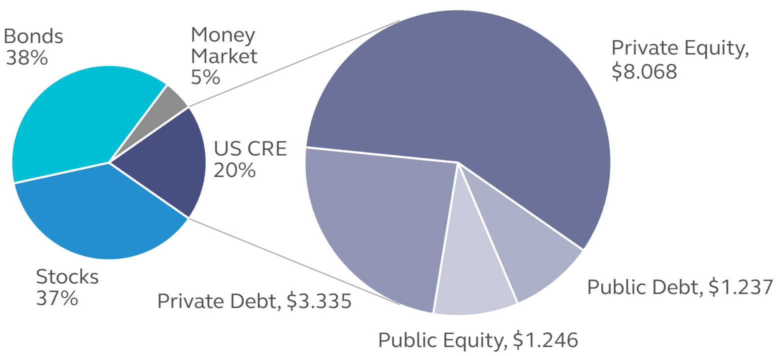
Today's global investment landscape is flush with economic uncertainty and the unprecedented monetary and fiscal stimulus triggered by the pandemic. Investor need for asset classes that dampen volatility and lower correlation to global markets has increased. One large asset class is private real estate, which can provide stable income and diversification, while also protecting against rising inflation.

As COVID-19 vaccines are distributed and the economy recovers, we believe U.S. private real estate can help investors enhance their investment strategies. Real estate is becoming an increasingly attractive component in diverse and resilient portfolios and we believe investors should consider this asset class to meet their long-term goals.

Private real estate characteristics

Private debt and private equity commercial real estate is a $11.4 trillion market in the U.S. (Exhibit 1). At its most basic, private equity real estate is an ownership interest in commercial properties. In a fund structure, these investments are diversified across regions and spread across real estate sectors—such as apartments, student housing, or data centers—and are often categorized based on the risk-return profile of the underlying investment strategy.

Exihibit 1: Commercial real estate universe in the U.S.
(in $ trillions)



Source: Federal Reserve, NAREIT, Preqin, CoStar Portfolio Strategy, Barclays. As of 4Q 2019

Why private real estate?

- **Diversification:**
  In addition to low correlations to other asset classes, regional and industrial differences offer diverse performance drivers.
- **Low volatility:**
  Compared to stocks, commercial real estate can offer better risk-adjusted returns.
- **Stable income:**
  The asset class has the potential to provide stable and consistent income returns to investors, regardless of the business cycle.
- **Inflation protection:**
  Private real estate makes portfolios more efficient by allowing investors to grow income during periods of inflation concern.
- **Proven track record:**
  Since 1980, private real estate has delivered total annual absolute returns of 8.8%. (Source: NCREIF as of Q4 2020)

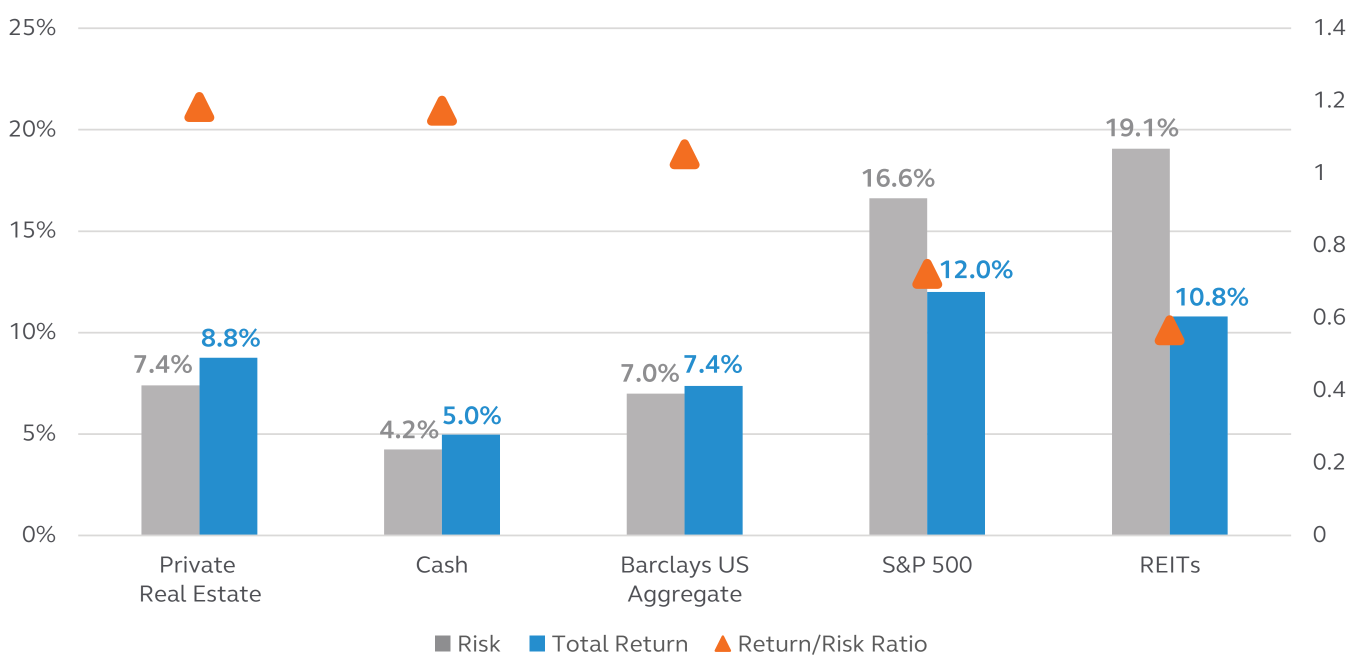
Core strategies typically target the lowest risk-adjusted returns, while value-add approaches tend to take on more risk and generate higher returns through more leverage to generate greater capital gains. Opportunistic strategies are those with the highest risk and potential for returns, generated mostly from capital gains and higher use of leverage.

Regardless of where a private real estate investment strategy falls on this risk-return spectrum, each strategy has the potential to provide three key benefits for investors:

1. **Diversification:** Private real estate as a market can access nearly every corner of the U.S. economy. The regional and industrial differences nationwide—from West Coast tech hubs to the metropolitan areas with outsized demographic growth in the Southeast—offer diverse industrial and commercial real estate demand drivers across property types. From a portfolio perspective, private equity and debt tend to have more stable valuations and present less volatility because of less frequent trading and longer holding periods.

Typically, volatility levels for the NCREIF Property Index (NPI)—the benchmark for real estate performance—remain under 3%. Compared to other asset classes, as shown in Exhibit 2, private real estate can offer diversification with less volatility and a risk-adjusted return higher than stocks and bonds.

Exhibit 2: Returns and volatility across asset classes (1978-2020)



Source: NCREIF, NAREIT, Barclays, Federal Reserve. As of Q4 2020

Private real estate markets also tend to exhibit lower—sometimes negative—correlations to other asset classes as shown in Exhibit 3. The potential for lower correlations across certain markets, particularly those that may not be as closely tied to broader macroeconomic cyclical events, offers investors further diversification benefits. This is welcome in the current environment, as investors are finding it increasingly more challenging to diversify portfolios with uncorrelated assets.

Exhibit 3: Correlations (annual returns)

	Large Cap Equities	Mid Cap Equities	Small Cap Equities	Treasuries	Investment Grade Corporate Bonds	High Yield Corporate Bonds	Hedge Funds
NCREIF Property Index (appraisal-based index)	0.11	0.05	0.05	-0.03	-0.25	-0.37	0.15

Sources: PREA Research, NCREIF, Refinitiv Datastream. As of Q4 2020

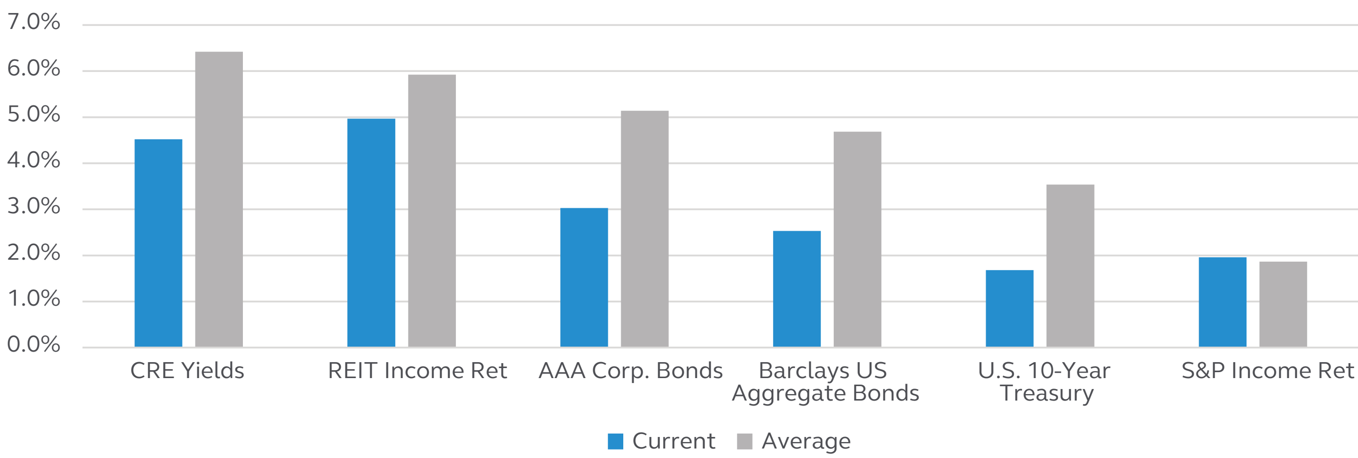
Based on annual returns to: NCREIF Property Index, RCA CPPI, Russell Top 200 Index, Russell Midcap Index, Russell 2000, Barclays US Treasury Index, Barclays US Corp. Investment Grade Index, Barclays US Corp. High Yield Index, Dow Jones-Credit Suisse Hedge Fund Index.

Correlations based on data to 2020, beginning in 1978 (NPI), 1979 (equity indices), 1978 (Treasury and investment grade), 1984 (high yield), and 1994 (hedge funds).

2. Stable income: One of private real estate's most attractive features is its ability to potentially provide stable and consistent income for investors, regardless of the business cycle. Similar to coupon payments from a bond, the majority of commercial real estate's return is generated by rental payments on long-term leases. As a result, real estate has not only outperformed many other assets classes' returns but has done so with much less volatility (as noted above). This relatively stable and regular return can provide bedrock reassurance to investors seeking income.

The income component of real estate is arguably only more important in today's environment. Yields on fixed-income investments have been compressed to historic lows because of accommodative policies from global central banks and more investor demand for low-risk assets. However, yields on commercial real estate have remained one of the more attractive among asset classes in the current economic cycle. While some of commercial real estate's income yield compared to other asset classes can be attributed to its illiquidity premium, a large portion is driven by rent growth, occupancy levels, and long-term leasing agreements that help lock in stable income returns—even through periods of negative economic growth.

Exhibit 4: Yields (Q3 1998 – Q4 2020)



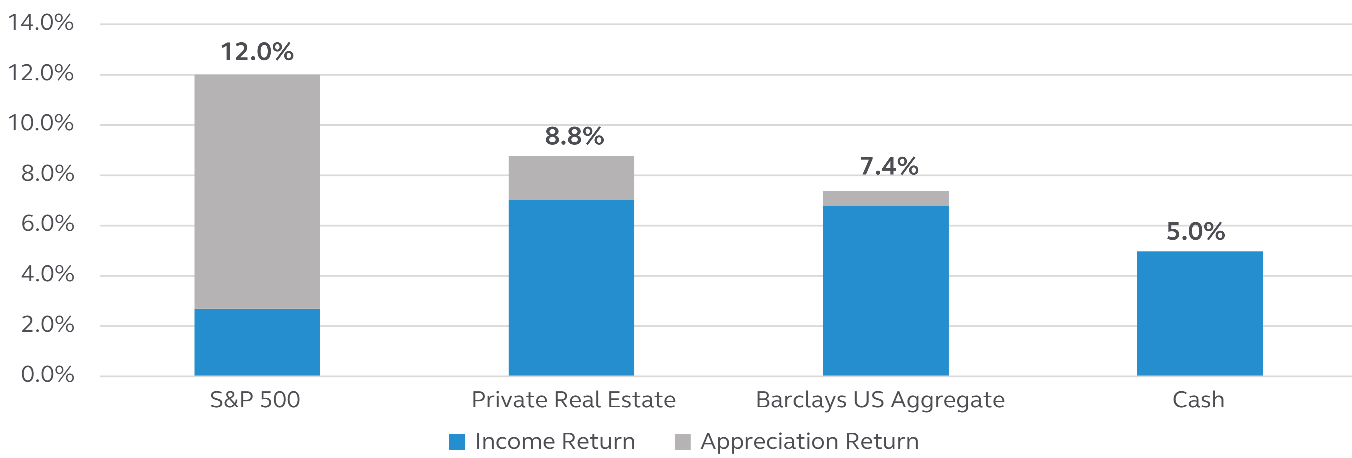
Source: NCREIF, Barclays, Bloomberg (As of Q4 2020)

3. Inflation protection: Because commercial real estate's income-generating potential and yields are not fixed and can move in response to inflation, the asset class is unique in its ability to mitigate inflation risk. This is particularly true for property types with shorter leases such as apartments and hotels which reset more often. Other property types such as office, industrial, and retail tend to have some indexation to inflation in their lease contracts, also providing protection. So private real estate can provide an element of inflation protection, allowing investors to grow their income during periods of heightened inflation concerns.

Private real estate's proven track record

Despite these important diversity, stability, and inflation protection arguments, the ultimate goal for asset managers is to deliver attractive returns to their clients. On both a risk-adjusted and absolute basis, U.S. private real estate has an impressive track record. Since its inception more than 40 years ago, the NCREIF NPI Index shows U.S. commercial real estate to be one of the better performing asset classes. While U.S. stocks have delivered the best absolute performance since 1980, private real estate has delivered total annual returns of 8.8% finishing second. We believe this proven track record, along with the market's combination of diversification, income, and inflation protection, has set private real estate up to be one of the more compelling investments today.

Exhibit 5: Commercial real estate performance holds its own as an asset class
Cumulative average annual total returns (Q1 1978 – Q4 2020)



Source: NCREIF, Barclays, Federal Reserve. As of Q4 2020.

Principal Real Estate Investors: Industry leaders in real estate

As a top-10 global real estate manager[1] shaped by more than 60 years of real estate experience[2], Principal Real Estate Investors is the dedicated real estate investment group within Principal Global Investors. Our capabilities span the spectrum of public, private, equity and debt investment alternatives offering innovative solutions and investment opportunities across all four quadrants of commercial real estate. With over 275 real estate investment professionals, our goal is to deliver consistent, risk-adjusted performance and high-quality service. Our market reach and research are vital to achieving this goal-and so is our commitment to innovation.

Our investment process combines top-down economic and industry analysis with bottom-up asset fundamentals focused on individual investments. This integrated process is driven by our proprietary research of both the real estate market and the overall economy. We use a team-oriented, research-based, multi-disciplined approach. And our investment capabilities are distinguished by coverage of approximately 45 U.S. markets, long-standing relationships, and a large pipeline that provides access to a high volume of off-market transactions unavailable to most other funds of this type.

[1] Managers ranked by total worldwide assets (net of leverage), as of 30 June 2020. "Largest Real Estate Managers," Pensions & Investments, 5 October 2020

[2] Principal Real Estate Investors became registered with the SEC in November 1999. Activities noted prior to this date were conducted beginning with the real estate investment management area of Principal Life Insurance Company and later Principal Capital Real Estate Investors, LLC, the predecessor firm to Principal Real Estate Investors.

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Risk Considerations

Investment involves risk including possible loss of principal. Past performance is no guarantee of future results. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk.

Important information

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Exhibits 2, 3, 4, and 5: The S&P 500 is a market-capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market; The NCREIF Property Index (NPI) is a quarterly, unleveraged composite total return for private commercial real estate properties held for investment purposes only. All properties in the NPI have been acquired, at least in part, on behalf of tax-exempt institutional investors and held in a fiduciary environment; The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency). (Future Ticker: I00001US); Cash: LIBOR 1-Month Rates: U.S. Dollar Denominated Deposits- The ICE LIBOR is the primary benchmark for short-term interest rates globally, used for mortgages, loans, for interest rate contracts on futures and options exchanges, and as a general gauge of the health of financial monetary markets; REITS: FTSE NAREIT All REITs (FNAR)- The FTSE NAREIT All REITs Index is a market capitalization-weighted index that and includes all tax-qualified real estate investment trusts (REITs) that are listed on the New York Stock Exchange, the American Stock Exchange or the NASDAQ National Market List. The FTSE NAREIT All REITs Index is not free float adjusted, and constituents are not required to meet minimum size and liquidity criteria.

CRE Cap Rates: The capitalization rate calculated from the NCREIF Property Index (NPI)

REIT Income Ret: Income Return from the FTSE NAREIT All REITs index

AAA Corp. Bonds: Moody's Not Seasonally Adjusted AAA Corporate Bond Yield [AAA], retrieved from FRED, Federal Reserve Bank of St. Louis Barclays U.S.

Aggregate Bonds: Income return from the Bloomberg Barclays US Aggregate Total Return Value Unhedged USD

U.S. 10-Year Treasury: US Department of Treasury, closing market bid yields on the 10 year US Treasury security.

S&P Income Ret: Income return from the S&P 500 Total Return Index (Internal Calculation). To note, every index in the paper is on end of period quarterly basis.

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