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Consider Real Estate in Your Allocation?

SEPTEMBER 2024

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KEY TAKEAWAYS

- **Two birds with one stone:** Real estate as an asset class has generated very good long-term returns usually paired with cash flows.
- **Merits of private real estate:** It's generally not subject to emotional whims of investors and operators often can be more patient in having a long-term focus.
- **Election impact:** No matter who controls Washington, real estate generally has been a rewarding portion of an overall asset allocation.

We recently hosted a webinar with our partners at Origin Investments. John Buckingham was joined by Origin co-founder and co-CEO, Michael Episcope. The duo discussed Real Estate's place in an asset allocation, explored market dynamics and highlighted potential Value-oriented opportunities. Michael offered insight into Origin's "secret sauce" and explained why he thinks headlines do not necessarily reflect activity that Origin is seeing on the ground.

We believe the webinar is worth watching in its entirety (click here), but there are some important highlights that we think are worth calling out. The questions and answers have been lightly edited. If you are Accredited Investor or Qualified Partner, please contact us so we can send you the full presentation, which includes discussion about Origin's specific products that may be available to you.

THE BIG PICTURE

John Buckingham [JB]: I'll begin with a big picture, higher-level question. Most folks have some experience with real estate, even if it's just as a homeowner, but most of the followers of our newsletter are more focused on the equity markets. Can you talk a little bit about why real estate beyond owning your own home should be part of an overall asset allocation mix for an investor?

Michael Episcope [ME]: When it when it comes to real estate, I think you have to look at it like any other asset and why do you want to add any asset to a portfolio? Well, at least for one of two reasons and hopefully both. You either want to lower volatility and/or increase returns. With most assets, you're going to get one or the other. Real estate is a bit of an anomaly, where you get both. You actually get lower volatility and you increase the returns, and when you look at the historic returns over real estate over the last 40 years, it certainly kept up with the S&P 500 index.

[ME] It's an interesting asset class because, when you think about it, it's both a bond and an equity in a single wrapper. You have bond-like returns because you have leases that act like many bonds - these contractual payments provide stable cash flow. Then you have a hard asset that grows over time because those lease payments increase in value as well. So as an asset class, I think it's not a matter of if you go into real estate but how much you go into real estate and how you go into real estate. Do you go into the public side do you go into the private side? Do you go into multifamily, office, ground-up development, et cetera. There are so many different ways to access real estate.

OFFICE SPACE

[JB] The New York Times recently had a story about the office market and what a disaster that's been. Should folks worry about real estate investments?

[ME] Office is totally different animal. It's extremely difficult to make money in the office space, even pre-COVID. Brokers and property managers make the money and the reason for that is because office requires so much in terms of tenant improvements and it's almost a binomial investment return. If you have a big office building and suddenly you lose one of your largest tenants, you could see your equity wiped out completely in that because the cost of a tenant can sometimes be $200, $300, or $400 in that space and when you're talking about spaces that are 100,000 square feet, 200,000+ square feet, that adds up to a lot of money.

[ME] I think when you're talking about apartments, there's a certain amount of turnover that you expect that's already baked into the numbers, you have diversification on that and self-storage is exactly the opposite, too. There's no real capital spending (capex), there's not a lot of turnover, there's not a lot of cost in the turnover. I was with my son last week moving him into his apartment. We had to stop by his self-storage facility and I kind of had real estate envy looking at this because here's a building that has metal walls and it has concrete floors and you go inside and the storage sheds are metal as well and they have steel beams and there's virtually nothing in terms of capex or anything like that.

INTEREST RATE IMPACT

[JB] Interest rates have risen rapidly over the last few years and lately have come back down. Could you explain how that might be affecting your multifamily market? Are you seeing opportunities in other areas?

[ME] If we would have had this conversation six months ago, it would have been very different. Today, we really see the light at the end of the tunnel. Just to put this in perspective, the last two years, real estate has been in a recession. We've seen record supply coming to market, we've seen interest rates rise, we've seen cap rates expand (cap rate is the inverse of the multiple on earnings), so two years ago your cap rate was about 3.5%, which would equate to about a 30x multiple on earnings. Today, cap rates are 5%. As cap rates go up, valuations come down. You had valuation and multiples on earnings come down, earnings have decreased because expenses went up, NOI (net operating income) went down and rents came down because of a supply issue.

[ME] Are we seeing distress? The answer is no, not today. Especially not in the category of property that we deal with, which tends to be more a Class A type multi-family property. We are seeing stress in the system and to me this is why there's opportunity today, but when we think about the fundamentals of real estate the healing process, it stops when you stop putting shovels in the ground. Real estate and all other asset classes are cyclical. It's a supply-demand imbalance. When you stop adding new supply to the equation, you're setting yourself up for a lower supply. That's what we see right now.

PUBLIC VS. PRIVATE

[JB] As equity investors, what we've seen is that private or public real estate investment trusts (REITs) as an asset class have struggled mightily in the interest rate environment. I am wondering if you can talk a little bit about how private valuations have held up versus public.

[ME] I never say public or private. Public and private are going to mirror each other over long periods of time. The reason why you want to be in the private markets is for alpha. You can get into deals that you're not going to see in the public market. You can take more risk in the private markets. You can do different kinds of deals than public REITs are set up for as well, but they are going to somewhat mirror each other. In fact, what's really interesting—I've been studying this for years— the public markets almost always lead the private markets, and they tend to lead them by 6, 12 or 18 months. You can go back and you can see this back in 2022 with the public REITs (and I'm talking strictly multifamily). I look at these every day, keep an eye on them, and the public markets started to lead the way down and the private markets were still very robust there was a lot of capital and then ultimately the private markets caught up to the public markets. Valuations started to come down and capital started to flee the system. It's categorically the opposite today public markets have come off their bottoms. They've

come down significantly over the last few years, bottoming out last November, when we saw the 10-year Treasury hit 5% and they're up anywhere between 20% and 35% in the multifamily space.

[ME] Yet, we haven't really seen the private markets recover and it takes a while before capital starts flowing into that market and we see asset prices getting bid up again and that's really when the capital markets recover.

HEADING TO THE POLLS

[JB] We're in election campaign season. There have been a lot of policies floated out there. Do you have any thoughts on what you're hearing from the candidates and how that might impact real estate in general?

[ME] The reality is the fundamentals aren't going to change depending on who gets into the White House. I do think if Trump gets elected, you will see an extension of the 2017 Tax Cuts, which a lot of those do benefit real estate. There is a 20% deduction on REIT [taxes]. You also have QOZ law that will likely get extended. You have some tax laws that are favorable for corporations. I think in the short run that will most likely give real estate a boost or help give it some tailwind. On the Harris side, I don't see anything so concrete that I can say today it's going to help. I know she came out with a policy that talked about building 3 million new homes across for sale and rental. I'll be honest, we have a housing shortage in this country, and we do need that and I'm always going to default for what's good for this country and what's good for the consumer and we're long-term investors and I think if the U.S. consumers win, then we do also.

ORIGIN INVESTMENTS

[JB] Let's transition to specifics about Origin and your focus, your philosophy and strategies. The area that you operate in multifamily. Could you expand on Origin Investments?

[ME] We have three strategies: we build, we buy, and we lend. There's a lot of advantages to having three strategies in a single asset class is that we see every deal. Our team wakes up thinking about one asset only. There's just an inherent advantage of really understanding every nuance to the asset class, then being able to solve problems and putting capital out in those different structures.

[ME] I would also say that within even our multifamily class, there are two areas that we focus on. One is traditional, which is more garden and wrap (those are construction styles). We're looking to provide what I will characterize as the most affordable option to a demographic we define as a renter by choice. These are people who make $80k, $90k or $100k+ per year. They could buy but they choose to rent for the flexibility. Build-to-rent is an important choice. When we think about Millennials, they want the convenience of a single-family home they generally don't want to be in a three-story walk-up apartment building carrying their groceries up and their kids, things like that. What a build-to-rent community is, you can think about it as single-family homes that are purpose-built. There's a leasing office. There's a gym. There's a dog park. There's a kid park. There are all of these amenities that you would typically have in a traditional vertical apartment building but in a horizontal development and you need more acres for this you can't do this on two or three acres you need 15, 20, 25+ acres to be able to put one of these build-to-rent communities in. We really cater to that demographic.

[ME] On the on the equity side, I would say one of the biggest advantages in deal flow is just having those boots on the ground, having five offices in the market, having deal officers who wake up every day knowing their data set, knowing the owners, the brokers, everything about that market. Honestly, there's nothing we don't see. Every now and then I'll get a deal sent directly to me and I'll send it to our team. Whether you're in venture capital, private equity or real estate it's important to see your available data set. It's impossible to gauge the quality of a deal without looking at hundreds of them and comparing them to one another? Volume itself is a huge advantage for us.

A QUANTITATIVE FRAMEWORK FOR REAL ESTATE

[JB] Could you explain Origin's Multilytics tool?

[ME] Multilytics is a rent forecasting tool. We used to use third-party forecasters, we would pay a lot of money and they were just garbage. Absolute garbage. We put people together who know data science and computer programming and

real estate professionals and created a model. It produced something quite amazing and we think it's the most accurate predictor of rent growth in the market. It points us to markets where there is still value and steers us away from markets where there's no longer value. You can't forecast things like COVID and there's always exogenous effects, but when we can go to a market like Colorado Springs, which is a smaller market kind of a sub-market that drafts off Denver. You want to be there first and we were there when ground was $25 per square foot and three years later it was $150. We did the same thing in Jacksonville and Tampa. And there's a lot of markets even today where there is value where Multilytics is flashing green that we're excited about, but being a Value investor you have to get there first.

PLANS A & B

[JB] What happens if a deal goes bad?

[ME] We've never lost money on a multifamily deal. We used to do other asset classes and we did lose money on...an office deal that we purchased pre-COVID and sold post-COVID. I think about it like this, and you bring up stocks and it's very diversification is key and if you think about the S&P 500 in any one year and even this year when the stock market is up considerably, there's going to be a lot of companies in your portfolio that have lost money. Real estate is no different. It's about the choices you make beforehand, and I think about decisions and outcomes and our job is to make good decisions and if you make a series of good decisions all the time, you are going to have more great outcomes than bad outcomes in that situation.

[ME] I'll give you an example, when COVID first hit we went out to our investors in April 2020, and we were talking to the investor relations team and I said we need to communicate with investors and they said what are we going to say? We don't know what's going on. I said that's exactly what we're going to say, but what we said is "look we don't know where the world is. The global markets just shut down. We made some really good decisions. We're in the right market. We leverage correctly. Our business plans are solid. We have a lot of cash on hand and we're invested with you. We're going to do everything we can to get to the other side."

[ME] It's different in a publicly traded world, where if you make a decision and you can just get out. In real estate, you have to see it through to the other side. You have to think about being a long-term holder three, four, five, ten years and yes, we just went through a real estate recession, but as a longtime investor I know that I'm going to go through a lot more in the future. Setting yourself up for success to go through those recessions which means the right assets, the right cities, the proper amount of leverage is really important.

LEARN MORE

If you'd like additional information about Origin Investment's real estate offerings and how they might fit into your asset allocation, please contact Jason Clark, CFA (jclark@kovitz.com or 949.424.1013).

For additional information about subscribing to the *The Prudent Speculator* newsletter, please call Phil Edwards at 800.258.7786 or email pedwards@kovitz.com.

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The description of products, services, and performance results contained herein is not an offering or a solicitation of any kind. Past performance is not an indication of future results. Securities investments are subject to risk and may lose value.

All returns are geometric average unless otherwise stated. The geometric average is calculated using the mean of a set of products that takes into account the effects of compounding.

The Standard & Poor's 500 index (S&P 500) is a broad stock market index based on the market capitalizations of the largest 500 companies listed in the U.S. Small company stocks, via Ibbotson Associates, are the bottom twenty percent of the New York Stock Exchange. Large company stocks, via Ibbotson Associates, are represented by the S&P 500 index. The S&P 500 Growth Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Growth Index. The S&P 500 Value Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Value Index.

The factor-based (book value-to-price) portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into four groups: large value, large growth, small value and small growth. The aggregate Value and Growth portfolios are monthly averages of the two returns.

Growth stocks = 50% Fama-French small growth and 50% Fama-French large growth returns rebalanced monthly. Value stocks = 50% Fama-French small value and 50% Fama-French large value returns rebalanced monthly. The portfolios are formed on Book Equity/Market Equity at the end of each June using NYSE breakpoints via Eugene F. Fama and Kenneth R. French. Dividend payers = 30% top of Fama-French dividend payers, 40% of middle Fama-French dividend payers, and 30% bottom of Fama-French dividend payers rebalanced monthly. Non-dividend payers = Fama-French stocks that do not pay a dividend. Long term corporate bonds represented by the Ibbotson Associates SBBI US LT Corp Total Return index. Long term government bonds represented by the Ibbotson Associates SBBI US LT Govt Total Return index. Intermediate term government bonds represented by the Ibbotson Associates SBBI US IT Govt Total Return index. Treasury bills represented by the Ibbotson Associates SBBI US 30 Day TBill Total Return index. Inflation represented by the Ibbotson Associates SBBI US Inflation index.

The Russell 3000 Index is composed of 3000 large U.S. companies, as determined by market capitalization. This portfolio of Securities represents approximately 98% of the investable U.S. equity market. The Russell 3000 Index is comprised of stocks within the Russell 1000 and the Russell 2000 Indices. Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI ACWI Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31 1987. It includes both emerging and developed world markets. The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. The DJ US Real Estate Index represents REITs & other companies that invest directly or indirectly in real estate through development, management or ownership, including property agencies. The index is a subset of the Dow Jones U.S. Index, which covers 95% of U.S. securities based on float-adjusted market capitalization. The S&P GSCI Total Return Index in USD is widely recognized as the leading measure of general commodity price movements and inflation in the world economy. Index is calculated primarily on a world production weighted basis, comprised of the principal physical commodities futures contracts.

From 1927 to present, we utilized the dividend-weighted portfolio data from Eugene F. Fama and Kenneth R. French. The dataset is broken into five groups: non-dividend paying, top 30% of dividend payers, middle 40% of dividend payers, bottom 30% of dividend payers and all dividend payers (weighted 30% of top dividend payers, 40% of middle dividend payers and 30% of low dividend payers).

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