Securitized and Direct Real Estate in a Portfolio under Different Market Conditions

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Overview

Although securitized (SRE) and direct real estate (DRE) have common economic drivers, prior research suggests that the benefits of adding SRE to a portfolio that already includes DRE may be limited. We investigate whether and how adding SRE to U.S. portfolios of stocks, bonds, and direct real estate affects portfolio performance and allocations. Our main focus is on whether the results change under different market conditions. Using data for the last 25 years, we first detect SRE volatility episodes, particularly those related to specific events, and examine whether the responses to shocks vary across sectors. We then estimate the impacts of GDP- and VIX-based regime-switching strategies on the performance and composition of mixed-asset portfolios. We first show that SRE sectors respond differently to shocks. In a portfolio context, we find that including SRE, particularly at the sector level, improves risk-adjusted performance, and that the average allocation to SRE ranges from 3% to 28%. We also show that the regime-switching framework generally outperforms static strategies, with performance depending on the effectiveness of constraints in limiting concentration risk. Our findings highlight the value of sectoral diversification as well as of a dynamic approach to securitized real estate investments.

What This Study Asks

- Do securitized real estate sectors respond differently to shocks?
- How does adding securitized real estate to a mixed-asset portfolio of stocks, bonds, and direct real estate affect its performance and asset allocation?
- Do the benefits of holding securitized real estate in a mixed-asset portfolio vary across market conditions and property sectors?
- Do sector-level diversification and dynamic securitized real estate allocation strategies benefit investors?

Data and Approach

We use monthly index-level U.S. data for the period 2000-2024, covering stocks, bonds, direct real estate, and nine securitized real estate sectors, including alternative sectors and mortgage REITs. We first examine how SRE volatility changes over time and across sectors. We then assess how GDP- and VIX-based regime-switching strategies affect the performance and composition of mixed-asset portfolios. Our dynamic framework seeks to maximize risk-adjusted returns in lower-risk periods, while shifting toward minimizing portfolio risk in higher-risk periods.

We construct portfolios of stocks, bonds, and a fixed 10% allocation to direct real estate, and then examine how results change when SRE is added. Liquid assets are rebalanced quarterly under the GDP-based framework and monthly under the VIX-based framework, while the direct real estate allocation is rebalanced back to 10% every three years to reflect its low liquidity and high transaction costs. We consider each of three ways of allocating to the SRE market: (1) by treating SRE as a broad market allocation, (2) by treating SRE as a set of individual sectors, and (3) by using sector-level data with a 10% cap on each sector to prevent any one sector from dominating the allocation at a given point in time.

Key Findings

- SRE sectors respond differently to shocks, underscoring the value of sector-level exposure: self-storage, apartment, and healthcare properties proved most resilient during crises, while office, retail and hotel sectors experienced more severe drawdowns
- The Global Financial Crisis produced the most persistent high-volatility regime, consistent with its more systemic nature
- Adding SRE, particularly at the sector level, improves risk-adjusted portfolio performance, though managing concentration risk is important
- The dynamic regime-switching framework generally outperforms static strategies, with results depending on how effectively portfolio constraints limit concentration risk
- GDP-based strategies perform slightly better than VIX-based strategies, likely reflecting the more stable nature of GDP-based regimes
- A dynamic approach leads to more balanced portfolios across stocks, bonds, and SRE
- Average SRE allocations range from 3% to 16% in capped portfolios (3%-28% when uncapped)

Implications for Practice

- For investors and portfolio managers:
    - Securitized real estate should be viewed as a complement to, rather than a substitute for, direct real estate, adding access to sectoral diversification, and greater flexibility for portfolio rebalancing
    - Sector-level SRE diversification matters, as sector dynamics can be markedly different under various market conditions
    - GDP-based regimes may be more suitable for investors seeking a more stable dynamic allocation framework, while VIX-based regimes may appeal to investors who are more responsive to shorter-term changes in market sentiment and information flow
- For risk managers: a dynamic approach can help SRE investors to shift between return-seeking and risk-reduction goals, provided concentration risk is carefully managed