Real Estate as an Alternative Investment and an "Alternative" to Hedge Funds

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I've found that, sometimes, the best wisdom is delivered via silly, off-the-cuff remarks. In fact, Yogi Berra, the legendary New York Yankees 1950s-era catcher, was so adept at delivering such wisdom that his quotes have taken on a life of their own. They're known as "Yogisms."

Who could have possibly known, though, that one of his most famous one-liners would perfectly describe the hedge fund industry some 60 years later? When asked about a trendy restaurant on the New York scene, Yogi replied, "Nobody goes there anymore. It's too crowded."

The Rise of Alternatives

Hedge funds are the big kids on the block when it comes to alternative investments.

Investopedia defines an alternative investment as "an asset that is not one of the conventional investment types, such as stocks, bonds, and cash… [and] include private equity, hedge funds, managed futures, real estate, commodities, and derivatives contracts."

In the wake of the dot-com stock market crash in 2000, alternative investments gained increased notoriety. After the economic crisis of 2008, the alternative investment train took off.

The popularity was fueled by the desire to obtain exposure to asset classes or strategies that do not have a strong correlation to various equity classes.

Hedge funds, not surprisingly, became the big winner in terms of attracting new assets in the alternative investment space. During the late 1980s and into the 1990s, many hedge funds made a lot of money. Top managers attained rock-star status, including Paul Tudor Jones, Julian Robertson, and Steve Cohen. Even into the early 2000s, hedge fund performance was strong on a relative basis.

Hedge Funds as a Victim of Their Own Success

Of late, however, hedge funds have taken a beating on the public relations front due to lackluster performance and high-profile defections from the industry by large institutional investors. Much of the blame has been placed on the excessive fees and a debate on the merits of active versus passive investment management. Both the fee and performance issues have been cited as reasons for big investors, such as the California Public Employee's Retirement System, American International Group, and the Illinois State Board of Investments, to pull money from hedge funds.

But for all the talk about fees and the effectiveness of active management, a more logical explanation might simply be that there are just too many funds with too many assets chasing too few opportunities. In the early-to-mid 1990s, hedge funds managed about $250 billion in assets. Today that number is estimated to be $2.8 *trillion*. As Yogi might say, no one wants to invest in hedge funds anymore because there is too much invested in hedge funds.

That poses a question: Where does an investor looking for the benefits of alternative investing turn now?

Private Real Estate as an Alternative Investment

One potential alternative may be commercial real estate. In terms of the benefits of alternative investing, real estate checks several boxes.

For starters, private investment (not real estate investment trusts) provides returns that are not directly correlated with stock market returns. While there are fluctuations tied to economic conditions, real estate investment is not as dependent on the whims of other investors.

Investors in hedge funds (or any mutual fund) can be adversely affected by another member of a pooled investment deciding to cash out during a downturn. In such a situation, the fund manager may be forced to liquidate positions in unfavorable conditions to meet other investor's withdrawal requests. While hedge funds do have some limitations on withdrawals, by nature, real estate has a longer-term focus.

Another advantage real estate has as an alternative investment is that it is a tangible asset and provides a real return in terms of cash flow. The returns are generally ideal in inflationary environments because lease renewals provide the investor the ability to increase rents and not be locked into specific coupon rates.

Real estate investment can also bring significant tax benefits. Income produced can be reduced or "sheltered" by depreciation expense, which is not a cash outlay and directly increases after-tax income. In addition, a 1031 exchange can defer capital gains (and depreciation recapture) on the sale of real estate when a new like-kind property is purchased. It may be possible to defer the capital gains throughout the lifetime of an investor so that heirs end up receiving a stepped-up cost basis (link to “Understanding Basis” post when live) and avoid paying capital gains taxes (link to “Estate Planning with 1031 Exchange” post when live) altogether.

In recent years, the popularity of alternative investments has waned (due mostly to the issues surrounding hedge funds). The case for alternatives and the increased diversification they bring, however, remains relevant, particularly after several years of strong stock market returns. As Yogi Berra also said, “A nickel ain’t worth a dime anymore,” so it is important to stay invested.

Private real estate investment provides a number of benefits and opportunities that other “alternatives” do not, but they don’t come without risk. A skilled and experienced manager can help seek out these opportunities while assessing and managing risk from a professional perspective.