The Great Real Estate Debate: Public vs. Private

Stocks and bonds often get the spotlight among investors, but real estate can also play a valuable role in long-term asset allocations.

For example, real estate and rental income may help provide a long-term hedge to running inflation. Income derived from real estate investments may help investors fund spending needs over time or contribute to long-term growth objectives in combination with property value appreciation.

Real estate can also provide diversification benefits in a total portfolio as it can behave differently, exhibiting different return patterns than stocks and bonds.

What Are REITs?

Real estate investment trusts (REITs) are a common way to gain exposure to real estate investments. First established in 1960 under the Eisenhower administration, REITs are companies that own or finance income-producing real estate but act as passthrough vehicles that distribute income to shareholders.

Companies operating as REITs don't pay taxes on the earnings they distribute to shareholders, like mutual funds and ETFs. For a company to enjoy the benefits of the REIT structure, U.S. regulations set certain requirements that include:

- 75% of assets in real estate assets or cash-like securities.
- 75% of taxable income from real estate-related income like rent on a property, mortgage interest, gains on the sale of property and dividends/gains from other REITs.
- 90% or more of ordinary income and 95% of net capital gains delivered to shareholders.

Accessing Diversified Real Estate Exposure

REITs expand opportunities for everyday investors to pursue broadly diversified real estate investments. While many investors may own property through their primary residences, REITs can provide exposure to many different property types in various locales, such as single-family rentals, hotels and resorts, office buildings, storage facilities, retail shopping malls and industrial facilities.

As of the end of 2020, some 250 U.S. REITs collectively owned more than 500,000 properties totaling $2 trillion in value.[1]

[1] Source: National Association of Real Estate Investment Trusts (Nareit).

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Figure 1 | Global REITs Offer Exposure to Properties in Over 50 Countries

The U.S. approach to REITs has also served as a model for many other countries to create similar securities. Hundreds of public REIT-like companies operate outside the U.S., offering exposure to properties in more than 50 countries worldwide.

Source: Bloomberg, Avantis Investors.

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How Do Public and Private REITs Differ?

Most REITs are publicly traded on stock exchanges. Investors can purchase shares of individual REITs or invest through commingled funds like ETFs and mutual funds that invest in REITs. Mutual fund and ETF investors do not own shares of REITs directly.

REITs can also operate as private companies that don't register with the U.S. Securities and Exchange Commission (SEC) or trade on stock exchanges. Private REITs are typically available only to institutional or accredited investors.

Figure 2 lays out other similarities and differences. To start, to operate as either a public or private REIT, a company must meet the criteria required to qualify as a REIT. For both public and private REITs, this means the majority of total assets must be invested in real estate, and the bulk of income must be passed through to shareholders as dividends. In other words, the underlying exposure may be similar.

Figure 2 | Comparing Key Attributes of Public and Private REITs

	PUBLIC REITS	PRIVATE REITS
75% of Total Assets in Real Estate	Yes	Yes
75% of Taxable Income From Real Estate-Related Income	Yes	Yes
Distributes at Least 90% of Taxable Income Through Shareholder Dividends	Yes	Yes
Traded on National Stock Exchanges	Yes	No
Daily Liquidity Generally Available	Yes	No
Daily Market Pricing	Yes	No
Fees and Expenses Reflected in Net Asset Value (NAV)	Yes	No

Source: Avantis Investors.

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Beyond these required features of REITs, we see two clear differences between public and private REITs.

- Liquidity: Because private REITs aren't traded in a public market, they offer no guarantee of daily liquidity to shareholders. They are often considered illiquid investments. In contrast, public REITs can generally be bought and sold daily in the public market.
- Pricing: Public REITs are priced each day as buyers and sellers transact in the market, reflecting the market's current expectations of the underlying properties' valuations, expected cash flows from rental income, and costs from expenses and management fees. Private REITs rely on appraisal-based pricing, meaning a REIT's net asset value (NAV) is based on underlying property values that are often estimated quarterly or sometimes less frequently, and unlike public REITs do not reflect management fees and expenses.

One risk for investors to consider when evaluating private REITs is that appraisal-based pricing may mean private REIT prices are stale or, in other words, don't reflect current information that could affect prices. Another risk comes from the price of private REITs not reflecting fees and expenses.

Let's consider an example to compare market pricing versus appraisal-based pricing. Imagine two REITs (REIT 1 and REIT 2) that share the same properties at an even 50/50 split. REIT 1 has a lower, flat management fee (e.g., 0.50% of assets), and REIT 2 has a higher, flat management fee (e.g., 1% of assets) plus a performance participation fee (e.g., 15% of any appreciation).

If both REITs were priced in the market, REIT 2 should have a lower price than REIT 1. Investors would likely pay less for REIT 2, given that they would also receive less because of the higher fees. If both REITs were priced only by appraisal values, as is the case for private REITs, each would have the same price since the NAV for each REIT is based on the same underlying properties and management fees are not part of the value of the properties.

So, if we paid full price for the properties based on the appraisal-based NAV but only received 85% of the appreciation (as in the case of REIT 2), then this would be like paying full price for only 85% of the properties.

Given these differences in liquidity and transparency in pricing, investors may wonder what drives the appeal of private real estate. It may come from a belief that private real estate can offer higher returns.

However, that may not always be the case. As noted previously, private REITs are priced differently than public REITs, and they typically charge higher fees. This means private REITs may have a higher hurdle to surpass in order to outperform their public counterparts.

What's important is that investors understand the potential benefits, risks and tradeoffs between investment options and make decisions they believe best meet their unique investment goals.

But if the objective is gaining broadly diversified real estate exposure, public REITs, or funds that invest in public REITs, can be an efficient way to get it and one we believe may meet the mark for many investors.