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Rethinking strategy

In today's uncertain environment, investors can still enjoy the best of both worlds.

The phrase 'street cred' is often used to refer to artists or brands that have established their authority or credibility (hence the word 'cred') in their line of expertise.

In the world of investing, CRED is the acronym for a little understood but established fixed income asset class called 'commercial real estate debt'.

Fund manager MaxCap has been looking after CRED investors since 2007 and makes a case for why the returns from this asset class is worth considering above all others with a similar volatility profile.

MaxCap collaborated with University of Technology Sydney (UTS) to look behind CRED's appeal. Find out more in this issue.

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The combination of healthy returns and reduced risk has long been the holy grail for investors. The traditional response has been to build a diverse portfolio. But as today's investors grapple with heightened risk and compressed returns, many are rethinking traditional asset allocations.

An alternative in the fixed income asset class is Commercial Real Estate Debt (CRED), which is delivering the solution investors are looking for. New research conducted by the University of Technology Sydney (UTS) in collaboration with MaxCap Group, a leading commercial real estate debt specialist, confirms that CRED provides an attractive return-for-risk combination while significantly reducing portfolio volatility.

How CRED works

CRED is a fixed income loan secured by commercial property. The underlying asset is commercial real estate ranging across the full spectrum of property sectors from industrial warehouses to office buildings to low and high-density residential assets etc.

CRED investors earn a fixed rate, and as the loan is generally held to maturity, this provides a predictable return for the duration of the loan most often structured with a strong cash yield. Unlike a direct investment in commercial real estate, CRED investors are typically protected from property market downturns by the equity buffer of the loan to valuation ratio and a diverse and robust security suite.

Strong returns, low volatility

As a fixed income investment, CRED investors are particularly drawn to the low level of volatility of this asset class, especially compared to other high-return investments. This attractive risk/return dynamic has significant implications for investors. The UTS/MaxCap study revealed that CRED delivered higher historic returns than cash, bonds, equities and property, but had a very low volatility rate at 1.1% p.a. compared to bonds at 3.3% p.a. CRED is highly defensive in nature and its volatility is most comparable to cash which had a volatility rate of 0.9% p.a.

As mentioned, CRED has the potential to deliver impressive returns that outpace equities and even the underlying commercial property market itself. A key factor driving these robust returns, is the withdrawal of the major banks from the CRED market – largely in response to regulatory intervention. This has led to a large funding gap for specialists likes MaxCap. Another key driver is the heterogenous nature of the underlying commercial property itself. Each real estate asset is different from the next and requires a deep and broad level of skill and expertise to manage the CRED investments effectively.

Importantly, investors need to be discerning when selecting CRED investments. Strong risk-adjusted returns can be delivered consistently, but only when the following three essential ingredients are correctly factored in:

1. The quality of the underlying commercial real estate;
2. The experience, financial strength, conduct & capability of the borrower; and
3. The investment managers ability to source the highest quality lending opportunities and then their experience and capability to identify risk and effectively mitigate the risks prior to commencing the investment or lending program.

A compelling reduction in risk

The MaxCap/UTS study found CRED reduces portfolio risk through low or negative correlation to other major asset classes. The benefit to investors is that CRED returns improve relative to other asset classes during periods of crisis and sustained economic uncertainty, acting as a stabilising force in an investment portfolio.

The study examined the impact on a typical diversified portfolio following a 10% allocation to CRED. Returns rise from 8.05% to 8.76% – an increase of 0.71%. At the same time, volatility drops from 8.07% to 7.16%, a decline of 0.91%.

These findings offer a compelling case for investors to add CRED to a portfolio. The result is enhanced returns, downside protection, and a reduction in volatility leading to an increase in risk-adjusted returns.

As Wayne Lasky, MaxCap's managing director notes, "There are very few asset classes that can lay claim to such impressive performance." Moreover, he says CRED has demonstrated resilience throughout market cycles including the current COVID-19 environment. He adds, "Our collaborative study with UTS confirms CRED presents a strategic allocation for investors focused on capital preservation through stable, defensive and asset-backed income."

Appeal for Australian investors

The characteristics that make CRED such a powerful tool for enhancing portfolio returns coupled with downside protection from volatility apply globally but vary from region to region. However, the conditions for CRED are particularly favourable in the Australian market.

Macro-economic fundamentals, banking sector structures and regulatory intervention all combine to create conditions in which CRED investors can achieve outsized returns relative to the risk undertaken.

That said, the decision to invest in CRED should be carefully considered, and ideally be informed by CRED investment specialists. This is largely because the strong risk-adjusted returns on offer need to be accessed in private markets. As noted earlier, CRED positions are generally held to maturity. Investors cannot typically redeem their investment in response to real or perceived downswings in the commercial property market, although MaxCap has developed products that offer some liquidity.

A well-structured loan will be designed with a hold-to-maturity mindset capable of weathering current and future conditions. But this calls for expertise. As Lasky explains, "The MaxCap team understands the way in which CRED reacts to market stress. This has enabled us to address risk through structure, selectivity and pricing, demonstrating that risk-adjusted return premiums can endure throughout economic cycles, including periods of market volatility and stress."

A new strategic approach

According to Lasky, MaxCap has experienced a marked increase in capital inflows from investors into commercial real estate debt in 2020 and throughout the Covid-19 pandemic. Nonetheless, CRED allocations remain relatively small in comparison to many other asset classes. Lasky believes this will change in the years ahead as CRED takes on increased strategic value for investment portfolios.

"As investors and their advisers look for ways to navigate the COVID crisis, CRED presents a highly relevant allocation opportunity," says Lasky. "Faced with uncertainty, there is no doubt that defensive investments with the capability to lower risk and increase returns will become increasingly sought after by investors over the next decade." **FS**

The quote

Our collaborative study with UTS confirms CRED presents a strategic allocation for investors focused on capital preservation through stable, defensive and asset-backed income.

Watch the video on www.fsitv.com