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SPOTLIGHT
Real Estate Debt

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Six reasons institutional investors should consider adding debt to their portfolios

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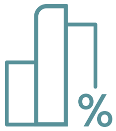

1. Attractive risk-adjusted returns: In today's environment, the combination of elevated interest rates and attractive credit spreads mean that real estate debt offers compelling returns relative to other fixed income alternatives. The potential for achieving these higher yields, while maintaining a relatively conservative risk profile, is appealing to institutional investors looking to mitigate risk.

Real estate debt can offer different opportunities through the market cycle, with the ability to adjust advance rates during market downturns to minimize risk, while benefiting from cyclical recoveries.

2. Stable and predictable income: An allocation to real estate debt may allow investors to enhance their portfolio income returns. The coupon-like nature of interest payments from borrowers can provide consistent and stable cash flows for investors, with a significant portion of the total return being achieved through income returns.

3. Downside protection and capital preservation: Real estate debt offers the ability for investors to gain exposure to the same underlying real estate, but via a protected position in the capital structure, offering an often-significant equity cushion to buffer against potential value fluctuations.

Careful structuring can further enhance downside protections; these investments are typically collateralized by the physical underlying property, providing security that differs to some other forms of fixed income investments. In a default event, active asset management is critical, and managers who have the expertise to step in and manage the underlying asset can further protect against potential losses and in some instances create upside value.

Senior or unlevered whole loan lenders sit in the last-loss position, allowing investors to consider more actively managed business plans than they might be comfortable investing in via an equity commitment.

4. Diversification benefits: Real estate debt provides exposure to one of the largest segments of the real estate market, typically with lower volatility than real estate equity. And adding real estate debt to an institutional portfolio can enhance diversification, as it often has low correlation with traditional asset classes like stocks and bonds, which can help to improve overall risk-adjusted returns.

5. Regulatory efficiency and opportunity: For insurance companies, real estate debt is treated favorably under Solvency II and other similar regimes, making it a capital-efficient way to deploy assets and capture attractive relative returns. Additionally, enhanced regulation has led to retrenchment by traditional bank lenders, creating opportunities for investors working with non-bank alternative lenders, such as institutionally managed debt funds.

6. Inflation hedge: As inflation rises, so too do the interest rates central banks often use to combat it. Real estate debt investments, particularly those with floating-rate loans linked to central bank rates, can therefore offer some protection against inflation.

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