COMMERCIAL REAL ESTATE DEBT (CRED) AS A CATALYST FOR PORTFOLIO SUCCESS

The current economic landscape, with higher US interest rates and escalating international tensions, we observe a growing correlation between stocks and bonds (as shown in Figure 2), marking a pivotal shift in asset allocation strategies. Conventional fixed-income investments can no longer effectively serve as a buffer against portfolio shocks. Consequently, we advocate the inclusion of Commercial Real Estate Debt Strategies (CRED) with collateral-backed cash flows as a potential alternative to conventional fixed-income assets. In addition to the potentially appealing returns, we also highlight the diversification advantages that CRED can offer to a more traditional investment portfolio.

While CRED's ability to adapt to various economic conditions is impressive, and can boost returns in a typical 60/40 portfolio, offering higher yields and better protection against inflation. Our main idea is that government bond portfolios, which used to act as shock absorbers and diversifiers, can no longer serve this role. Recent events in the bond market in 2022 and 2023, driven by persistent inflation and the downgrade of U.S. debt, support this perspective.

ENHANCING THE PROSPECTS OF GENUINE INFLATION PROTECTION

Senior Mortgages in the commercial real estate sector have delivered strong yields and attractive total returns, even during a period of rapidly rising interest rates and inflation, not seen in 50 years.

Additionally, senior mortgages possess valuable collateral that can act as a safeguard if financial conditions tighten further and are a solid defense against inflation, safeguarding returns during volatile economic times. Assets like TIPS, Gold, Public REITs, and Commodities, traditionally seen as inflation hedges, have recently underperformed due to various factors.

TIPS, in particular, may not always align with current inflation due to their longer-term focus.

Public REITs are influenced by stock market fluctuations, diluting their inflation-hedging strength.

Commodities are historically reliable but inherently volatile.

A prudent strategy involves diversifying among investments with a strong fundamental link to inflation, including Commercial Real Estate Debt, to enhance the chances of genuine inflation protection in a portfolio.

CRED can provide valuable diversification to a portfolio, reducing overall risk. Diversification is often referred to as the only 'free lunch' in investment because it can stabilize returns and enhance performance predictability. Real Asset investments, such as CRED, with their link to inflation and the security of tangible assets, tend to perform differently across economic conditions compared to traditional Public Equity and Debt investments.

These variations are reflected in low-to-moderate correlations between CRED and conventional assets, such as Global Investment-Grade and High-Yield Corporate Bonds over the last two decades.

The diversification benefits mean that CRED, with attractive risk-adjusted returns and low correlation with stocks and bonds, can expand the efficient frontier. In other words, adding CRED to a portfolio, especially in respect of a long-term 'All Weather' allocation, can potentially increase returns without absorbing any additional risk. This is particularly pertinent in light of the poor performance of the bond component of the traditional 60/40 portfolio in recent years.

Peformance in rising interest rates **(1.3.22 – 31.10.23)**

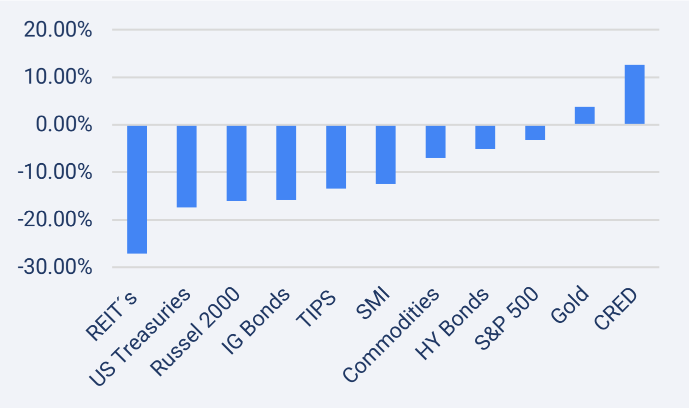

Figure 1. Source: Gold (XAUUSD), Commodities (UBS Bloomberg Commodity Index), HY Bonds (iShares iBoxx High Yield Corp BD ETF), TIPS (iShares IE00B1FZSC47), Russel 2000 (iShares ETF), US Treasuries (iShares 7-10y), IG Bonds (iShares iboxx IG Corp Bd ETF), REIT's (iShares Global REIT), CRED (Valvest Steady Income Fund USD-I) – Performance March 1st, 2022 until October 31st, 2023.

Realized Correlation S&P500 and US-Treasuries

Figure 2: Source: Bloomberg; Macrobond; Refinitiv

Fixed Income Volatility: CRED as a Stable Alternative

The counterargument to increasing allocations in Private Markets such as CRED revolves around liquidity concerns. The suitability of illiquid investments varies among investor classifications. Institutional investors, such as endowments and foundations, with long-term horizons and lower short-term liquidity requirements, can allocate more to illiquid Alternatives.

Similarly, pension funds, due to the long-term nature of their liabilities, can diversify into less liquid investments without significant financial compromise. With highly liquid U.S. Treasury Bills currently offering attractive running yields following the recent hiking cycle, there appears to be less need to invest in illiquid assets. However, the past two years in particular have shown that bond investments are subject to high volatility, partly due to interest rates sensitivity, reflecting both credit spreads and potential defaults.

Financial market forces will drive supply, demand and therefore the price discovery of a fixed income instrument. The overall environment has not changed, and we expect bonds to remain subject to increased volatility and therefore vulnerable to valuation losses.
Conversely, CRED is less interest rate sensitive and is therefore a suitable alternative for income-oriented investors who do not want their returns to be subject to the whims of unpredictable market forces.

THE IMPORTANCE OF PRUDENT AND IN-DEPTH SELECTION

At Valvest, we are focused on facilitating access to CRED through carefully crafted investment vehicles that seek to mitigate dependence on market movements. Our range of investment solutions, which are subject to European regulatory standards, includes liquid evergreen funds and a selection of investment opportunities with fixed maturities.

In our investment approach, which is centered around specific transactions, we don't seek the potential for upward market movements (Beta). Instead, we emphasize assets that provide us with the highest level of protection. Our lending activities are exclusively directed towards properties in prime locations within 25 metropolitan areas in the US. We prioritize flexibility, offering short-term loans that can be readily adjusted to adapt to market conditions while securing our position at the top of the capital structure with first lien senior mortgages. Our borrower selection process focuses on strong financial profiles, ensuring lower Loan-to-Value (LTV) ratios, and establishing interest reserves for added security. Furthermore, our investments are safeguarded through a comprehensive pledge that includes an interest in the borrowing entity and meticulous documentation, encompassing construction plans and lease agreements. To fortify financial stability, we implement a Carry-Guarantee, wherein a private individual personally, guarantees interest payments with their own wealth. Lastly, we emphasize the importance of having "skin in the game" by having the originator hold a 5% subordinated interest in each loan to align all interests and provide additional security. As we act as a financing partner to the borrower, we follow a disciplined due diligence procedure to fully understand the stabilization process of an asset and the risks involved. This not only provides interesting returns but also protects the capital invested and prevents losses. Importantly, this approach allows us to achieve these returns without owning the building, reducing the exposure to operational and maintenance risks. By carefully selecting borrowers with pricing power, inflation risks can be mitigated, while rising interest rates can enhance income-based returns. The ongoing rise in interest rates has led to a notable shift in income distribution, favoring debt investors over real estate equity holders. As mortgage rates increase, debt investors can capture a larger portion of property income. While the potential for substantial gains may not be as pronounced as that of real estate owners, being positioned at the top of the capital structure significantly mitigates downside risk.

And historically, CRED has delivered positive returns even during recessions, underscoring its reliability and resilience in challenging economic environments.