



## **Kyle Bass on Inflation and How to Protect Against It**

By Mark Quam  
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Kyle Bass, the founder of Hayman Capital, foresaw the collapse of the sub-prime mortgage bond market in 2008 and the foreign sovereign debt crisis in Greece, and he now predicts that Japan will be the next to fall. Bass' latest warning is about looming Inflation – and he advises how to protect against it.

On February 1 at the Tiger 21 conference in Palm Beach, Florida, Bass was interviewed by CNBC's Gary Kaminsky. Kaminsky began by pointing out that the Dow Jones Industrial Average has reached 14,000 for the first time since 2007 and asked pointedly, "Does this make sense to you, and is the stock market the place you have to be?"

Bass replied, "Look, if the monetary base is going to continue to grow at the rate it is growing and the Fed is going to hold rates where they are today, we've lost the correlation between stocks and bonds. And the fed is buying \$85 billion a month, about as much as our fiscal deficit. I think stocks continue to go higher."

Bass elaborated on what sounded like good news for equities. "I think you kind of lose sight of what's important, in my opinion, if you are so focused on nominal pricing and equities when the monetary base is growing as fast as it is," he said. "The analogy I drew inside was simply: One of the best-performing equity markets in the last decades has been Zimbabwe. But your entire equity portfolio now buys you three eggs? You have to really focus on the insidious nature of what inflation is and how real returns might be negative in both equities and bonds."

Kaminsky quickly asked the key question: "How do you protect yourself from the inflation ahead?"

"I think to protect yourself, you need to own productive assets," Bass said. "You need to own anything — like an apartment complex or an oil well or a global business — that is a productive business that sells things in various different currencies. And if you really want to protect yourself, you put long-term fixed-rate debt on these businesses. Just don't put too much debt on these businesses. Own some sort of asset that generates cash flow, and finance it with these low interest rates Bernanke is giving us, fixed."



Before we dive in, I must admit I know very little about the ownership of oil wells, and I can't define what Bass means by a global, productive, multi-currency business.

But I will focus on the third asset class he mentioned and the one I know best – real estate.

### **Breaking down real estate**

When Bass recommended buying apartment complexes that generate cash flow using low leverage and financing them with low interest rates, he was referring to buy-and-hold core real estate.

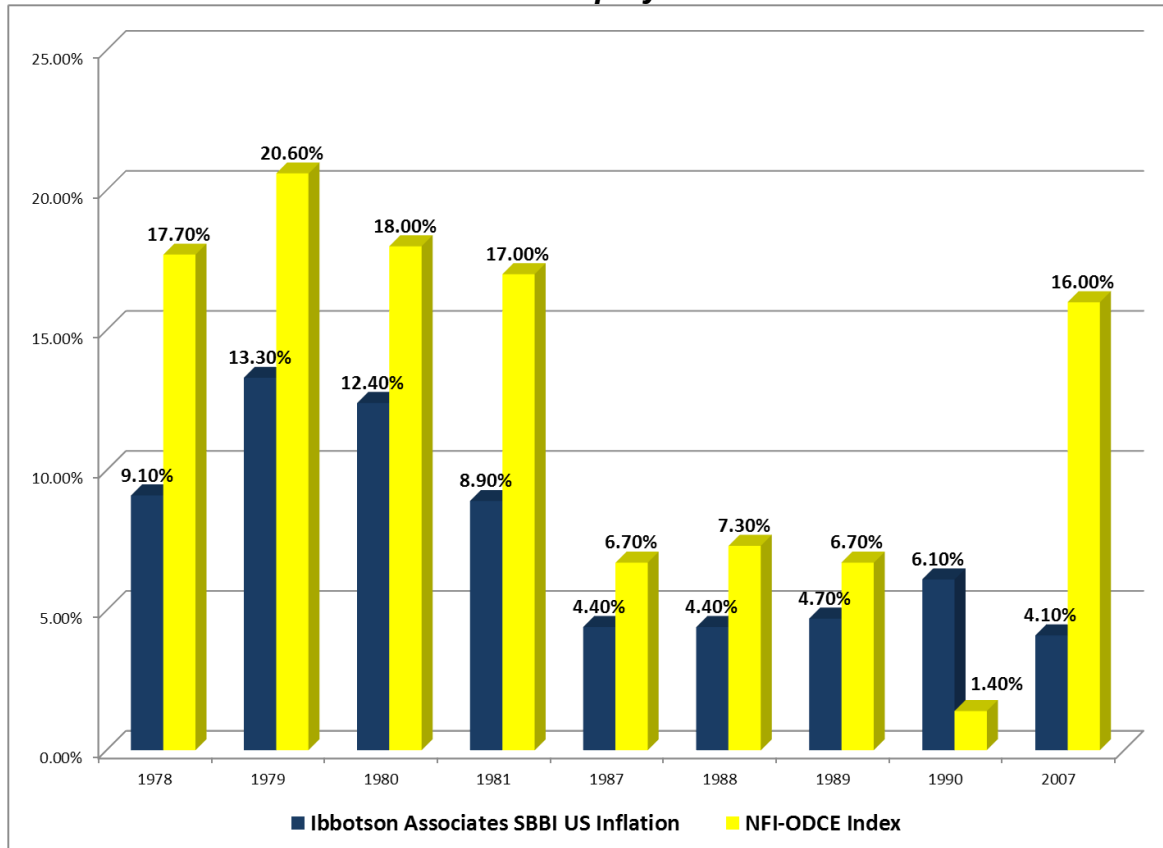
A full 93% of pension funds and other institutions invest in real-estate private-equity funds. These funds can generally be categorized into one of four buckets: core, core plus, value-add and opportunistic. I will provide a brief description of each to demonstrate that Bass was talking about core.

- **Core:** High-quality real estate assets, leveraged between 0% – 30%, with a stable tenant base and conservative, income-focused return targets.
- **Core Plus:** Leverage up to 50%, with substantial share of expected total return to be derived from income.
- **Value Added:** More aggressive active asset management often employs more leverage and involves buying property, improving it and selling for a gain.
- **Opportunistic:** Includes investing in emerging markets, development projects, distressed assets and nonperforming loans.

### **Core real estate performance in inflation**

First, let's look back at the times when where inflation was greater than 4% in the last 35 years. To evaluate how core real estate fared in these times, we will look at the NCREIF Open End Diversified Core Fund Index (NFI-ODCE). The NFI-ODCE reports on both a historical and current basis the results of 30 open-end commingled real-estate private-equity funds pursuing a core investment strategy.

### ***Inflation vs. Core Real Estate Private Equity***

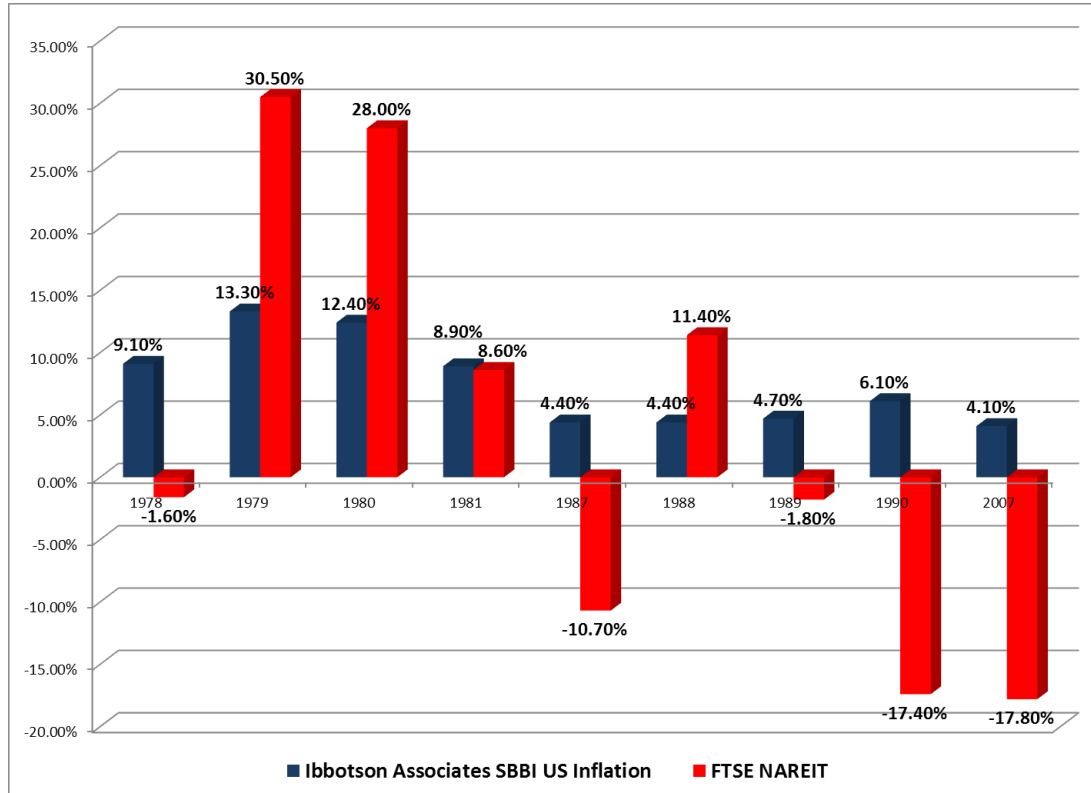


As you can see, there were nine years in the past 35 when inflation was over 4%, and a four-year period between 1978-1981 when inflation stayed above 8.9%. In every year except 1990, core real-estate private-equity funds outperformed the rate of inflation.

### **Do public REITs provide the same protection?**

Many investors use public real estate investment trusts (REITs), REIT mutual funds or REIT exchange-traded funds as their investments of choice when allocating to real estate. Before you invest in public REITs – regardless of the structure – let’s take a look at the same periods and see how the REIT market fared. To evaluate the REIT market, I will use the FTSE NAREIT Composite Index, a free-float adjusted market-capitalization-weighted index that includes all tax-qualified REITs listed in the NYSE, AMEX and NASDAQ National Market.

### *Inflation vs. Public REITs*



As you can see, the public REIT market did not provide the same consistent hedge against inflation as the open-end commingled real-estate private-equity market. In fact, there were four years of negative returns and only three in which REITs outpaced inflation.

### **Why the difference between core real estate private equity and public REITs?**

A building does not change in value if it is owned by a public REIT instead of a private fund. One explanation of why core private funds have performed better as an inflation hedge during these periods is public market volatility. Shares of a public REIT are priced by the public trading market, which causes the REIT's stock price to fluctuate based on the number of sellers and the number of buyers of its shares. As a result, there are periods of dislocation between the value of the real estate owned by a REIT and the value of the REIT's stock price.

This dislocation is one of the key reasons why the public REIT market did not provide the same hedge as core private funds. For example, research by [Green Street Advisors](#), a real-estate research and consulting firm, shows that real estate values were up during recent periods of high inflation in 1990 and 2007, but REIT stocks were trading at discounts of more than 20% to the value of the real estate assets they owned.

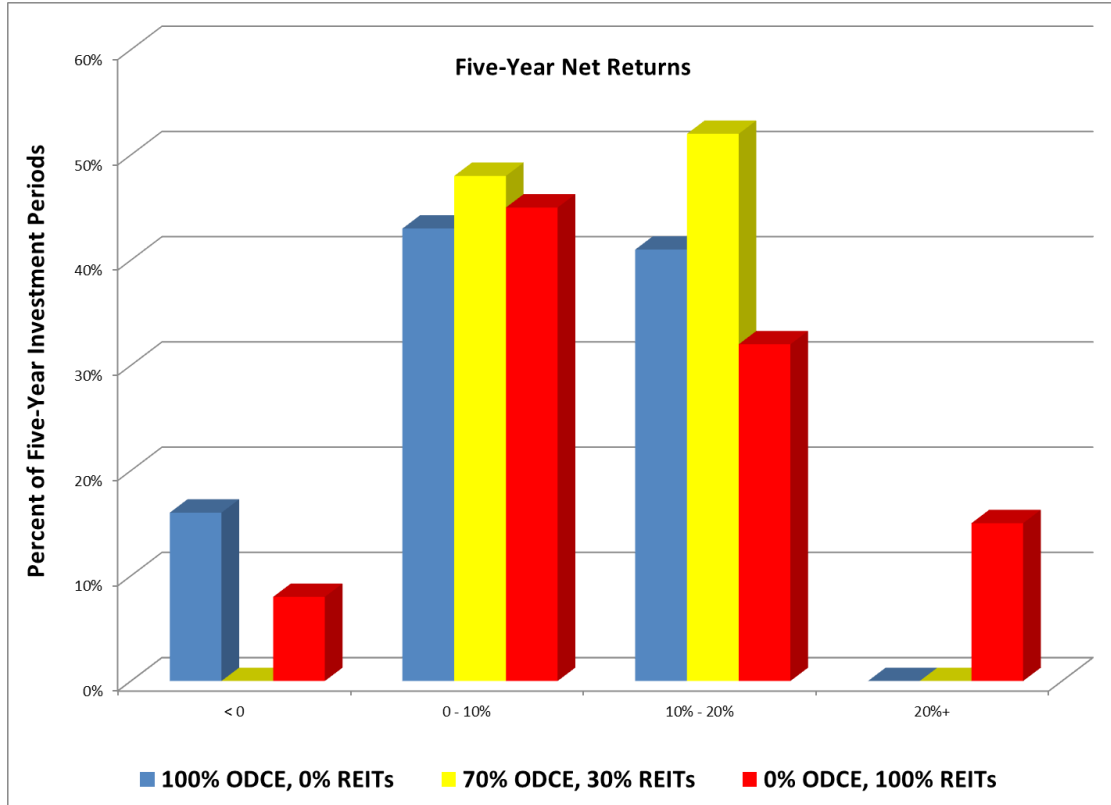


I am not saying owning public REITs is a bad strategy. In fact there are many benefits to owning public REITs and core private funds beyond inflation protection. However, it is impossible to determine if a dislocation in REIT stocks will exist during the next inflationary period. Therefore, it is important to ask if there is a happy medium in a total real estate allocation.

### Core real estate private equity and public REITs are complementary

Core private funds and REITs have different long-term investment characteristics. A diversified portfolio with investments in both can earn higher returns, hedge against inflation and see a lower potential for negative returns.

The National Association of Real Estate Investment Trusts (NAREIT) recently studied an optimally blended portfolio of two-thirds core real estate private equity and about one-third publicly traded REIT investments. The hypothetical portfolio produced positive double-digit or single-digit average annual returns for all rolling five-year periods since 1978 without a single period of negative returns – even during the most recent real estate market crisis.





## **Conclusion – get your real estate flu shot**

If Kyle Bass is right, and I believe he is, we could be in for a number of years of inflation like we experienced between 1978 and 1981. Direct ownership of core real estate in normal market conditions is healthy for any portfolio because it provides durable income, low correlation to the broader markets, low volatility and potential for capital appreciation. But in times of inflation, investing in core real estate is more than healthy — it is preventative medicine. We never know what kind of flu season we are going to have, but in my family, we all get our flu shots.

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*Mark Quam is the CEO of [Versus Capital](#), an asset manager, exclusively focused on real estate investment platforms that seek to have low correlation to the broader equity and debt indices. Versus Capital is the advisor to the first mutual fund that invests in core real-estate private-equity funds (VCMIX).*

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