RESEARCH INSIGHTS

Can Investors Afford to Ignore Affordability? The Investment Characteristics of Affordable Housing

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There is an affordability crisis in housing. While higher interest rates and rising home values have put homeownership out of the reach of many people, the crisis extends to the rental market as well. The Joint Center for Housing Studies of Harvard University notes that 22.4 million renter households in the US were defined as cost burdened as of 2022, meaning they spent more than 30% of income on housing and utilities.[1] This is the highest number on record going back to 2001. Further, 12.1 million of those households were classified as severely cost burdened, spending more than 50% of income on shelter. Although lack of affordable housing affects the least economically advantaged segment of society the most (one study estimates the gap between the number of extremely low-income households and the number of units affordable to them at 7.3 million units[2]), the effects extend into the middle class, and even households with average incomes have increasing difficulty finding reasonable accommodations that fit within their budgets. A recent Gallup Poll found that housing affordability was the second-most-important financial issue cited by Americans, after inflation.[3] But this is not just a US issue; similar discussions and concerns about affordability can be heard in Canada, Australia, Europe, and elsewhere.

The crisis has implications not only for the individuals and households directly affected by it but also for the broader economy. Households burdened by housing costs have less disposable income to spend on other goods and services. Lack of affordable housing decreases mobility, leaving people less able to move for better jobs, opportunities, schools, or an improved lifestyle. Many urban centers are out of reach, so individuals cannot access the economic benefits that agglomeration provides. Competitiveness of specific cities with acute affordability issues can be impacted as workers take their talents elsewhere. Lack of affordability has significant implications for the long-term health of both local and national economies, even beyond the obvious social issues it creates.

The long-term solution to a lack of affordable housing is actually fairly simple—more units, both for single-family ownership and for rent, of all types but especially those with rents targeted at people with average and below-average incomes.

What role can the private sector, and specifically institutional capital, play in helping solve the affordability crisis? Many institutional investors, quite rightly, are often suspicious of this type of question. They are keenly aware of their fiduciary duty—they must invest for the good of their beneficiaries and cannot take a haircut on financial performance to attempt to solve a social problem. Further, many investors, such as pension funds, believe they already have a social mission—to fund the retirements of teachers, firefighters, municipal employees, and the like—and this mission takes precedence.

In this article, I compare the historical investment performance of more- and less-affordable multifamily properties. The question is, Should real estate investors consider an affordable housing allocation based purely on the investment characteristics, with no consideration for any type of social good that may come from it (or, alternatively, with any social good viewed as simply a happy side effect of the investment thesis)? To give away my punch line, the answer is yes. Affordable multifamily has performed well as an investment and by many measures better than properties that are less affordable. Allocations to affordable housing are not investments that sacrifice performance to pursue a social goal but, in fact, are investments that can help maximize overall portfolio performance.

I am not the first to look at the investment characteristics of affordable housing. The most recent PREA-sponsored special real estate issue of the *Journal of Portfolio Management* features an excellent article on the topic by Mark Roberts of Southern Methodist University and Crow Holdings Capital

1. *The State of the Nation's Housing 2024*, Joint Center for Housing Studies of Harvard University, 2024.
2. *The Gap: A Shortage of Affordable Homes*, National Low Income Housing Coalition, March 2024.
3. Jeffrey M. Jones, "Americans Continue to Name Inflation as Top Financial Problem," Gallup, May 2, 2024.

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and Jake Wegmann from the University of Texas at Austin.[4] I highly encouraged readers interested in the topic to read their article, available to members on the PREA website. My short article takes only a cursory look at the issues, and Roberts and Wegmann conducted a much more detailed and robust examination.

Defining Affordability … or Not

In my analysis of the investment performance of affordable housing, I use data from NCREIF. NCREIF recently added area median income (AMI) by core-based statistical area (CBSA) to its database, allowing categorization of institutionally owned properties by average metro income. But comparing multifamily properties by whether or not they are affordable requires some definition of what affordability means.

There are as many specific approaches to affordable housing investment as there are investors; each strategy is unique in some way, and often the specific definition of *affordability* varies. Some investors concentrate on housing defined as affordable under some regulatory regime, while others aim not to meet any regulatory definition but to keep rents at an accessible level for a specific target segment. That segment is often defined in terms of household income relative to AMI—a unit should be affordable to a household at a certain percentage of AMI. Different strategies may target different segments, with some affordable housing strategies targeting, for instance, renters at less than 60% of AMI, others targeting less than 80%, and some targeting between 80% and 120% of AMI to provide housing options for average middle-class households in the area. Even basic terminology can differ across strategies and investors, with some referring to affordable housing and others preferring terminology such as attainable, essential, or workforce housing. Each term may mean the same thing or entirely different things, making comparisons difficult because of a lack of standardization in the sector.

Given that the industry has no standard definition of affordable housing, I avoid the issue in this article by not defining the term. I compare properties that have differing levels of affordability for tenants, and I use the term *affordable* as a shorthand for the category with the lowest rents. I make no claim that this is an appropriate definition of affordable housing for the industry. Readers can look at the results based on the categories I chose and decide for themselves how they relate to their own definitions of affordable housing.

To implement my examination of the investment performance of affordable housing, I begin with all multifamily properties in the NCREIF database. Because NCREIF tracks data for entire properties and not individual units within a property, I cannot track the affordability of specific units and whether a property contains a mix of affordable and market-rate units. The affordability classification is therefore based on the average rent per unit across the entire property, calculated as rent income for the property divided by the number of occupied units. For each quarter from 1Q2008 to 1Q2024 (the start date being determined by the start date of AMI data in the NCREIF data), I classify each property into one of three categories:

1. Most Affordable: Average rent per unit is less than 30% of income for someone making 80% of AMI in the CBSA in which the property is located.

2. Mid-Market: Average rent per unit is less than 30% of income for someone making 120% or less of AMI in the CBSA in which the property is located but more than 30% of income for someone making 80% or less of AMI.

3. Least Affordable: Average rent per unit is less than 30% of income for only someone making more than 120% of AMI in the CBSA in which the property is located.

As noted above, I do not imply that these categories are the correct way to classify affordable housing; they are just a simple way to classify multifamily properties to compare across different levels of affordability. Any specific numbers could be used to define the categories and any number of categories could be defined, but for my purposes here, this approach is a simple and straightforward way of breaking up properties into affordability categories.

One caveat is that properties are broken into the three categories each quarter, and there is no way to

4. Mark G. Roberts and Jake Wegmann. "ESG Investing: Moderate-Income Rental Housing as a Viable Real Estate Asset Class," *Journal of Portfolio Management*, PREA-sponsored special real estate issue, 2023.

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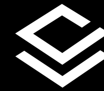

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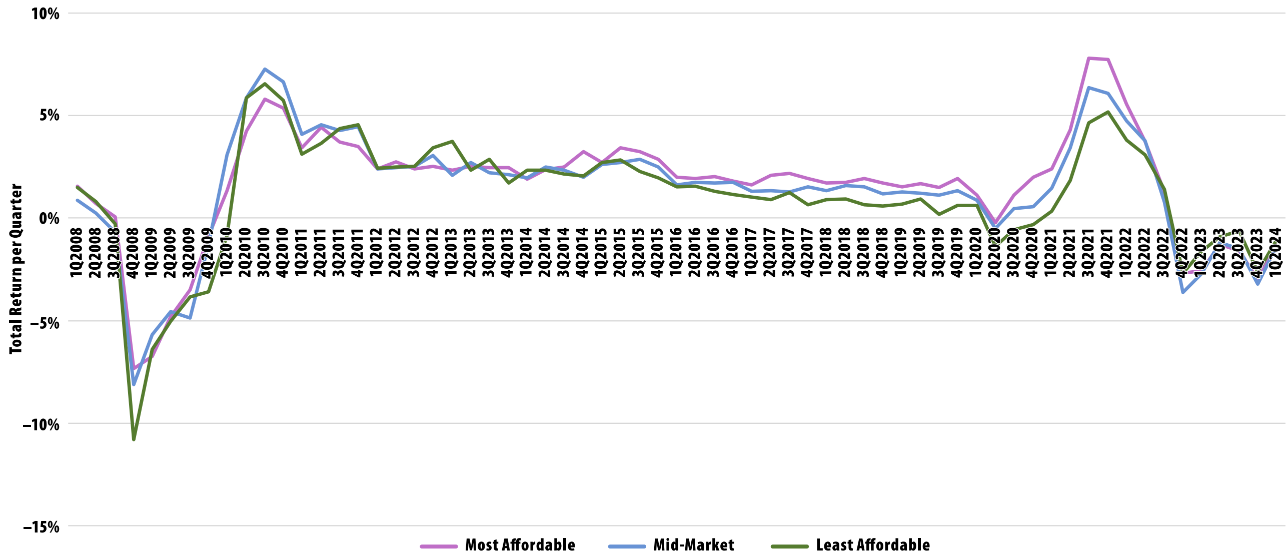
Exhibit 1: Multifamily Returns by Affordability



Source: PREA Research based on NCREIF data

determine if a particular property that is classified as most affordable in one quarter has, in fact, been purchased as part of a value-added strategy with a plan to drive up rents and make the property less affordable in the future. To mitigate this effect, I also compare rents two years ago with AMI. To be in the final sample, a multifamily property must have been purchased at least two years ago and the average rent two years in the past would put it in the same category as this quarter's average rent.[5] Limiting the sample to properties that have not changed their affordability category for the past two years should reduce the chance that properties labeled most affordable now are value-added plays that will become substantially less affordable in the future.

Note also that the definition of *affordability* used here is based on rent only and does not include the cost of utilities. In their article, Roberts and Wegmann carefully incorporated estimated utility costs into the analysis, and I point interested readers there. In this article, I compare properties based on only differing rent levels (compared with local AMI). In addition, while many affordable housing investment strategies devote significant energy to amenities and programs of value to tenants with the goal of having a stickier tenant base and reduced vacancy and turnover costs, I do not explicitly look at such things in this article.

Returns to Investors by Affordability Category

Exhibit 1 plots the total returns each quarter from 1Q2008 to 1Q2024 for multifamily properties in different affordability categories. Notice first that in the downswing of 2009 and the subsequent rebound, the most-affordable properties lost the least in the downturn but did not gain as much in the upswing. This is consistent with the typical argument that affordable housing is less exposed to the economic cycle. As I noted earlier, there is significant unmet demand for affordable housing, and the supply-demand gap means less vacancy variation for affordable housing over the cycle. People always need someplace to live, no matter the state of the economy; in fact, demand for more-affordable space may even increase in recessionary times as people look for more-affordable places to live.

Despite that, during the most recent peak in returns (second half of 2021), more-affordable multifamily actually outperformed less affordable. In fact, the most-affordable category outperformed the least affordable consistently every quarter from 2Q2014 to 2Q2022. Since that eight-year stretch of consistent outperformance, affordable has lagged more-expensive multifamily slightly during

5. Unfortunately, I am not able to compare rent two years ago with AMI two years in the past, so past rent is compared with current AMI (i.e., the same AMI with which current rent is being compared).

Exhibit 2: Summary Investment Performance

	Most Affordable	Mid-Market	Least Affordable
Average Return/ Quarter	1.64%	1.42%	1.06%
Volatility of Quarterly Returns	2.78%	2.87%	2.89%
Compound Average Annual Return, 1Q2008 to 1Q2024	6.54%	5.62%	4.15%

Source: PREA Research based on NCREIF data

Exhibit 3: Correlations

	Most Affordable	Mid-Market
Mid-Market	0.97	
Least Affordable	0.93	0.95

Source: PREA Research based on NCREIF data
Note: Based on quarterly total returns 1Q2008 to 1Q2024.

Exhibit 4: Average Income and Appreciation Returns

	Most Affordable	Mid-Market	Least Affordable
Average Income Return/Quarter	1.25%	1.16%	1.03%
Average Appreciation Return/Quarter	0.38%	0.26%	0.03%

Source: PREA Research based on NCREIF data
Note: Based on quarterly total returns 1Q2008 to 1Q2024.

the current downturn in values. The reason there is a difference between this cycle and 2009–2010 is unknown, but it may be because the current cycle is a downswing in property markets while the underlying economy remains relatively robust versus general recessionary conditions that also affect properties.

Exhibit 2 provides a summary of investment performance of the different categories of multifamily. The most-affordable properties had the highest return per quarter on average, followed by mid-market properties, with the least affordable having the lowest average returns.[6] Volatility of quarterly returns is slightly lower for the most-affordable properties but quite similar to volatility of the other categories. Most important, the difference in average returns each quarter works out to a large difference in the long-run returns—over the 26-year time period, the most-affordable properties outperformed the least affordable by 239 basis points per year.

The historical record shows that, far from giving up investment performance to allocate to affordable housing, investors would have actually left money on the table by not investing in affordable housing. The most-affordable multifamily has outperformed by a significant margin over the past 26 years.

But are more- and less-affordable properties entirely different beasts that are not good substitutes for each other? Exhibit 3 shows the correlations between returns across the different categories. The most-affordable properties have a correlation of 0.97 with mid-market properties and 0.93 with the least affordable. These very high correlations indicate that all three affordability categories are driven, at least on a quarter-to-quarter basis, by similar factors. All categories seem to react in a similar fashion to market changes but in way that produces higher average returns to the most-affordable properties.

What Has Driven Affordable's Outperformance?

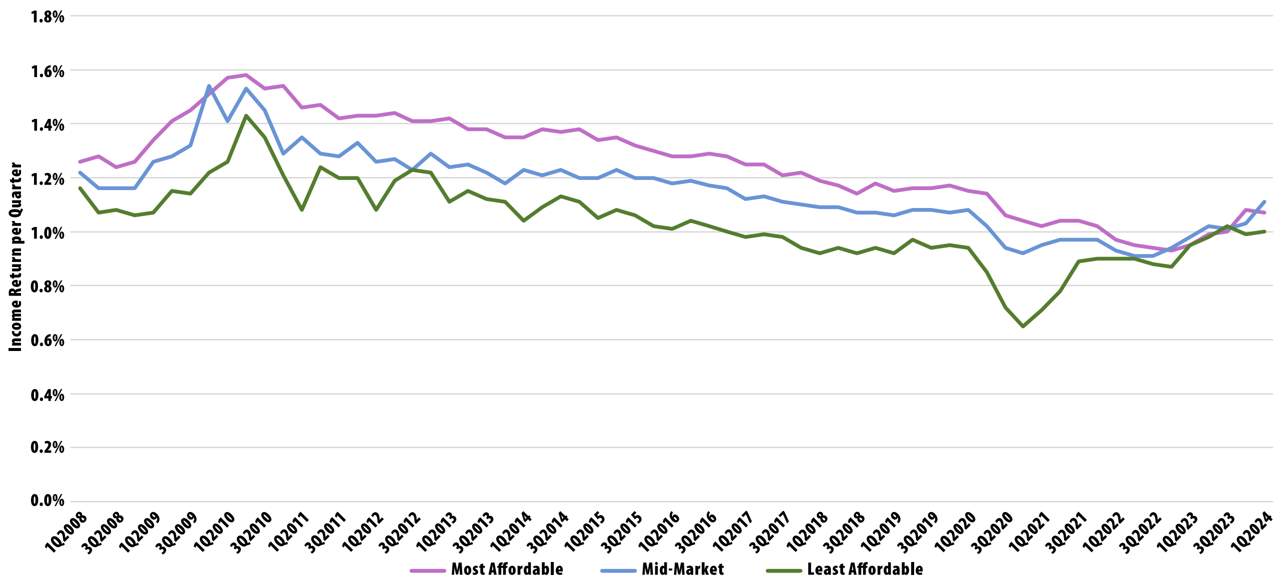
To get a better idea of what drove the outperformance by the most-affordable multifamily properties, I first look at the breakdown of returns into income and capital appreciation. As shown in Exhibit 4, the most-affordable category produced both higher average income and higher appreciation.[7]

High real estate income returns for affordable housing may not be a surprise to some—this type of property often trades at a higher capitalization rate. However, a closer look at income returns reveals that affordable housing, like any investment, is not without risk. Exhibit 5 plots quarterly income returns

6. A statistical test (a paired t-test for the statistical nerds in the readership) of the difference in average return between the most- and the least-affordable categories indicates that the difference in average return is too large to have been caused by chance.

7. The difference between average income and appreciation returns to the most and least affordable is statistically significant, i.e., it is extremely unlikely to have occurred simply by chance.

Exhibit 5: Income Returns



Source: PREA Research based on NCREIF data

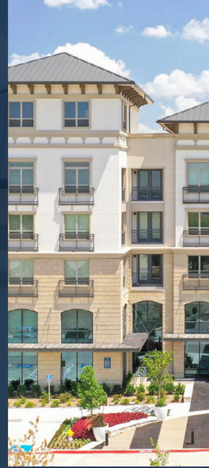
over time. Affordable properties have typically been valued to produce an income return spread over the least affordable. Up to 2020, that spread typically ran about 25 basis points. However, in the most recent period, that spread seems to have largely disappeared, as all categories of multifamily have undergone cap rate expansion, with the least-affordable segment expanding the most. Going forward in the current cycle, multifamily investors should be cognizant of this—if income return spreads go back to their historical norms, it could involve a relative repricing of affordable versus less-affordable properties in favor of the less affordable.

Slow and Steady Wins the Race

Although income return spreads currently appear less favorable for affordable housing than they have in the past, how much should long-term investors worry about shorter-term cyclical fluctuations in the relative values of less-affordable properties? Every investor will have a different answer to this question. But in formulating an answer, it may be useful to consider the factors underlying the higher average rate of property appreciation shown in Exhibit 4.

Higher average appreciation returns for more-affordable multifamily may seem puzzling at first. After all, a key characteristic of an affordable housing strategy is to not grow rents at the highest rate possible but rather to have them grow at a reasonable pace that allows the property to stay affordable. If rents grow slowly, how can property values increase more than in properties where they are allowed to rise quickly?

An important part of the answer is shown in Exhibit 6, which plots average net operating income (NOI) per unit (total units, not just occupied) each quarter for the three affordability categories. The least-affordable properties had the highest NOI per unit, and the most affordable, the lowest—entirely as expected given the difference in rent levels. Extremely important, however, is that the NOI per unit was far more volatile for the least-affordable properties. NOI per unit for the most-affordable properties is much less volatile over time and tends to rise at a slow, steady pace. There are certainly times when growth in NOI per unit in the least-affordable segment far outstrips that in the most affordable—2010 to 2012 and 2021 to the start of 2023 are prime examples. But while less-affordable properties had periods of rapid growth and performance in NOI per unit, they were also prone to pullbacks, such as during 2008, 2020, and the most recent four quarters. This gave the least-affordable properties periods of both



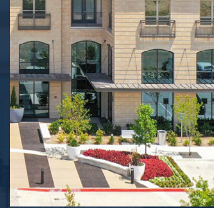


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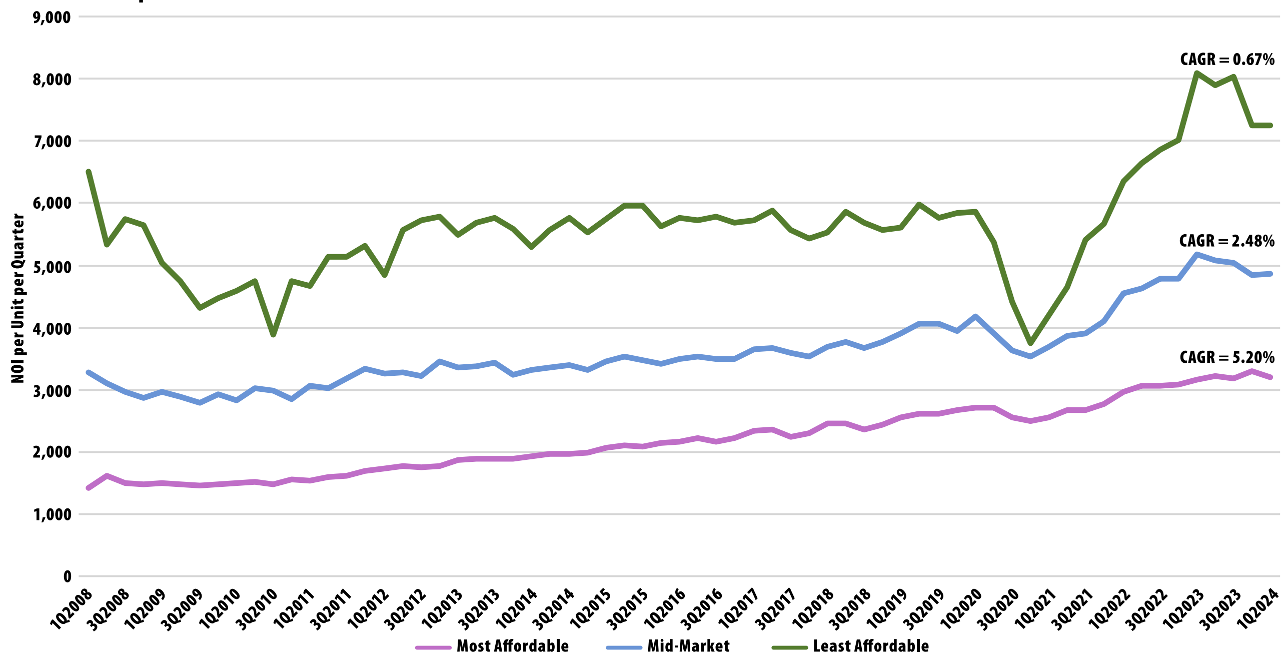
Exhibit 6: NOI per Unit



Source: PREA Research based on NCREIF data

large outperformance and large underperformance in NOI per unit growth over time compared with more-affordable properties. During this entire period, NOI per unit growth for affordable properties chugged along at a slow and steady pace.

Over the entire period, the steady, slow growth in affordable housing resulted in average long-term growth rates that were dramatically higher. The compound annual growth rate (CAGR) in NOI per unit for the most-affordable multifamily was 5.20% annually, versus only 0.67% annually for the least affordable. The higher long-term growth in more-affordable housing helps explain the segment's higher long-term appreciation returns.

Conclusion

NOI growth of higher-priced, less-affordable properties has outperformed at certain times, and rotating a multifamily portfolio toward less-affordable properties to take advantage of these occurrences may be tempting. But predicting the timing of the real estate market is difficult at best. Predicting turning points and then implementing a real estate investment strategy in a timely way to take advantage of them is exceedingly difficult. Over time, the lower susceptibility of affordable housing to the cycle means that, while it showed no periods of particularly rapid growth, it produced higher average growth in the long term along with higher average returns to investors. The NOI per unit growth rate for affordable housing may be boring, but it has been very effective for long-term investors over the past quarter century. ■

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