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REAL ESTATE INVESTMENT MANAGEMENT

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Introduction

Pension funds are now an established part of the real estate industry and, if U.S. Department of Labor Estimates of future pension growth are accurate,[1] they promise to be even more influential in the future. This promised future influence has spawned a vast spectrum of investment managers and pension funds can now invest their reserves with everything from good old boys to three piece suits.[2] Traditional real estate analysis, capital asset pricing model adaptations, and all manner of combinations and permutations are available.

For some, the selection of an investment manager appears quite simple. As James A. Kujaca so succinctly put it in Pension World:[3]

> A pension fund will want to select a real estate investment manager who has an impeccable reputation, an excellent performance record, a thorough knowledge of property evaluation and property management, organizational depth, reasonable fees, no conflict of interests, and who is financially sound and able to locate prime, profitable properties on a sustained basis.

Unfortunately, the Hershel Walker of real estate investment managers has not yet appeared from the playing fields of American business schools. In fact, the selection process is sufficiently difficult that a number of consulting firms

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[1]The U.S. Department of Labor estimates that total pension fund assets will grow to nearly $3 trillion by 1995. This growth, from $8,000 in reserves per working American to $30,000 per working American, is certainly substantial in relation to the magnitude of the nation's tangible wealth. On the other hand, $30,000 still isn't much to retire on and that says something about the need to maintain the work ethics as the population ages.

[2]A recent Greenwich Research Associates study showed 71% of Fortune 100 pension funds hold equity real estate, but only 36% of the Fortune 1,000 do so. The median percentage allocation of those that do invest was around 6%, and for all pension funds surveyed, the amount devoted to property was less than 3%.

[3]Pension World, April 1981.

are now selling "search" services which assist the pension fund in choosing an investment advisor.

We believe that the search process contains within it a combination of financial and motivational factors which not only influence the search but suggest trends toward structural changes in the organizational form of real estate asset managers. This essay develops these financial and motivational factors from several viewpoints which all converge on similar implications about future formats for real estate asset management.

Background

Real estate investment management for pension funds starts with a stock and bond mentality since the client (the pension fund) is today primarily a stock and bond investor. Pension funds are familiar with the pioneering work by Fischer, Williams, Markowitz, Tobin and Sharpe; and, to a lesser extent, with subsequent refinements of the capital asset pricing paradigm and extensions into arbitrage pricing theory.[4] The bottom line is that they have dealt in a rather efficient market, understand the theory that supports a "Fair Game Assumption" in return behavior, and are familiar with the traditional measures used to rank the risk adjusted performance of investment managers.[5]

Real estate is different: the asset is definitionally heterogeneous due to its unique location. Real estate markets are characterized by local orientation, infrequent trades, private transactions, expensive, often non-public information, illiquidity, imperfect divisibility and property specific financing. These

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[4]See Roll [1977] and Roll and Ross [1980].

[5]See Sharpe [1975], Jensen [1969], Treynor [1965], and Fama [1972].

differences suggest a less efficient market where comparative advantage is possible. In such markets, investment management is more important and it costs more.

Still, since pension portfolio management involves allocations between stocks, bonds, and real estate, real estate investment must involve a blend of capital market logic with traditional real estate analysis. In other words, the admitted difficulties with application of modern portfolio theory do not justify ignoring the portfolio attributes of real estate.

The pension funds want better risk adjusted returns and the risk adjustment should be in portfolio terms. This means simply that the pension fund wants to invest in properties that improve the return or reduce the risk of their overall portfolios. The investment manager can help the pension fund achieve this result, i.e., garner the benefits from real estate investment, in two ways:

1. The investment manager can buy (or make) properties which are individually a better investment than the market average. This is the natural implication of a less efficient market.[6]

2. By choosing real estate investments that have low or negative correlations with the pension fund's existing stock and bond portfolios, the investment manager can create new combined portfolios that have less risk for any given level of return.[7]

The difficult issue for the pension fund is deciding which of the investment managers is most likely to be able to actualize these two potential benefits.

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[6]It should be noted that the other natural implication is that the investment manager might buy a "dog" if he turned out to have a comparative disadvantage.

[7]The mathematics of this result are clearly and simply stated by Fogler [1983].

A Brief History of Real Estate Returns

While the academic and professional literature on real estate returns is limited and suspect in many respects, certain general conclusions emerge.[8] Real estate (except when purchased through an REITS) appear to offer higher absolute and higher risk adjusted returns than stocks or bonds.[9] Equally important, real estate returns appear to have a low correlation with stock and bond returns and a high correlation with inflation.[10] Thus, real estate offers both of the opportunities suggested in the section above as well as inflation protection. Clearly, the possible benefits from real estate appear attractive; but the question of which investment manager remains.

A Few Complications

We will argue that an application of risk management principles is possible in real estate investment management and that it has no parallel in stock and bond investment management. However, this possibility is at the root of several serious problems involved with the ex post performance evaluation of real estate investment managers.

1. Accounting and appraisal inconsistencies can easily be of sufficient magnitude to materially distort performance evaluation.[11] The National Council of Real Estate Investment Fiduciary (NCREIF) is working a standard appraisal engagement letter and fuller disclosure of accounting differences, but the possibility exists today for investment managers

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[8]See Zerbst and Gambon [1983] and McCue [1983] for summaries of the literature.

[9]This counter intuitive result (higher risk adjusted returns) is probably due to the faulty definition of risk (variance of returns) which neglects liquidity risk, skewness (real estate returns appear non-normal) and/or agency problems (the human decision maker has a different perception of risk than the institution).

[10]See Miles and McCue [1983] for a more rigorous treatment of these issues.

[11]See Miles [1983] for example calculations.

to trade off IRR for reported earnings in maintenance policy, leasing strategy and other areas.

2. The turnover of investment managers between firms is quite high. Since most of the real estate management firms (or functions within larger institutions) involve a small number of key people, high turnover makes historic comparisons very difficult.

   Turnover is a particularly difficult problem since real estate investment managers are typically compensated based on the volume of assets under management not directly on performance. Thus, strong past performance encourages growth in the volume of assets under management and there are clear operational economies of scale in investing in larger properties. The result is a "second order" form of incentive compensation which may well be paid after the key people have moved to another firm.

3. Billions of dollars of investments and multiple leases on most properties create a paper mountain for anyone trying to ascertain how a particular investment manager's portfolio will perform under different economic scenarios. While many consulting firms doing searches claim such forward looking financial analysis (as contrasted with historic performance evaluation), the amount of work involved in rigorously modeling lease expectations leads one to conclude that most are simply asking the investment managers about leasing strategy, a far simpler and less reliable approach, than auditing leases to infer strategy.

4. While many pension funds are actively seeking "inflation protection," few are certain whether they mean actual inflation, anticipated inflation or unanticipated inflation. Since protection against anticipated inflation can be purchased in the capital markets, one presumes the answer is unanticipated inflation but, if so, much of the literature uses the wrong measures.[12]

5. Ownership structuring and special allocations of tax benefits, like alternative leasing strategies, offer a way for investment managers to alter the risk/return characteristics of the underlying bricks and mortar. While there are potential benefits from this flexibility (which does not have a stock market parallel), the reader of investment managers' annual reports will find little related disclosure.[13]

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[12]See Fogler [1983] and McCue [1983] for a fuller explanation.

[13]The evolution of special allocations of tax benefits and related "convertible mortgages" has raised serious tax questions. If these instruments are interpreted as partnerships then it would be logical to apply the Treasury's March 4, 1983 interpretation of Section 704(b), i.e., substantial economic effect.

On another related tax front, Senator Dole's attack on leasing by tax-exempt entities may lead to legislation which will impact on permissible ownership structures.

6. Most of the investment managers advertise the benefits of diversification across property types and geographic regions. However, the classifications in both cases are so gross that research to date shows insufficient benefits from such diversifications to justify the related costs (primarily collection of market information and property management).[14]

With All These Problems, How Are the Search Firms Searching?

While the problems cited above present very real problems, the potential benefits from real estate investments seem to dominate and pension funds must decide on which investment manager to use (or occasionally to do the investing "in house"). As previously noted, several national firms now offer to do searches for pension clients with some efforts being largely qualitative while others are more quantitative following stock market traditions with certain adjustments to fit the real estate asset. In almost all cases, the search service involves some education of the pension fund client. On the qualitative side, the people and the investment strategy are examined. On the quantitative side, returns are analyzed with one search firm claiming to find nearly a 1,000 basis points difference between high and low performers; and, more remarkably, that the same firms stay at the top and at the bottom year after year.[15]

In addition to such rankings which relate to the first of the two ways an investment manager can serve a pension client, the investment managers are also striving to achieve better portfolio balance for their pension clients. Again, the search firms are checking up on them but with a slightly different motive.

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[14]NCREIF is working on more exacting classifications. See McCue [1983] for problems with the current categories.

[15]This large spread, if generally accepted, would be both good and bad news to the investment managers. Clearly, it shows a very inefficient market and the comparative advantage of the winners is worth a great deal. On the other hand, the low performers should probably be shot for stealing from the working class.

Several search firms are looking for smaller investment managers with specialized operations (e.g., only new retail properties in the Sunbelt) and doing their own "homemade" diversification for the pension client. They examine the existing pension portfolio and then try to find a collection of real estate investments whose returns show low correlation with the existing stock and bond returns. Note that when the search firm does this, it is offering the pension fund diversification of the pension portfolio. Again, several investment managers are advertising a diversified real estate portfolio; the two are quite different.

Looking to the future, it appears logical to expect the search firms to become more quantitative as the data improves. Because of previously noted differences in real estate, they will probably continue to do more financial analysis than traditional performance evaluation. Since the pension fund's goal is overall portfolio performance, it makes sense to expect either the pension fund directly, or the search firms acting for the pension funds, to look for opportunities for homemade diversification. In other words, to try and accomplish the second potential benefit by using an appropriate combination of specialized investment managers.[16] Since the pension funds must deal with the allocation decision between stocks, bonds, and real estate, the additional step of allocating between real estate investment advisors is a small one.

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[16] Note that a certain amount of specialization occurs due to regulatory differences, i.e., D.O.L., S.E.C., etc. Consequently, financial institutions already have different funds for different clients though they may use the same personnel for several funds.

What About the People Perspective?

If there is more room for comparative advantage in real estate, then it follows that the pension funds will want to look at the internal operations of the investment managers and ascertain what type of organization is most likely to perform best in the rather entrepreneurial world of real estate investment.

To be able to achieve benefit number one, i.e., to exploit the market's inefficiency, a real estate investment manager needs a certain kind of internal environment. Specifically, the following characteristics are important:

1. Incentive Reward for Performance — The investment manager is operating in many ways like an entrepreneur or he shouldn't be in an inefficient market. Structuring the incentive is not easy since pension funds will make honest men millionaires while flirting with ERISA restrictions regarding risk avoidance and conflict of interest.[17]

2. Creative Innovation — The investment manager must be able to "see" deals. The ideal environment not only fosters such innovation, but also protects the innovator from hasty condemnation during the periodic downside outcome which is inevitable with such endeavors.

3. Deal Making — The investment manager must be able to negotiate, and quickly, either purchases or sales.

4. Administration — The investment manager must have plan and budget discipline. He should be in a small enough organization to have close contact with his ultimate customers and the high level of informal communication often associated with success in such ventures.

Since it seems unlikely that one individual would possess all of the last three qualities, there is need for some form of the team approach. On the other hand, few large bureaucracies are known for traits 1, 2 or 3. (The exceptions are those noted by Peters and Waterman in In Search of Excellence and they are directly on point with the comments above.) The conclusion is that a small entrepreneurial team with defined spans of control would be most likely to exhibit the three traits above

[17]The pension funds do have one big advantage. Even after they make the investment manager a millionaire, he or she will still need the pension fund to be able to do the larger projects.

and consequently be able to exploit market inefficiencies. Note that smaller teams are consistent with the specialized fund concept which has already been shown to be best suited for homemade diversification.

Concluding Comments About Evolution of the Industry

There are two potential types of benefits to pension funds from real estate investment. The type of investment manager best able to provide both benefits in the small (but not one man) specialized entrepreneurial firm. Search firms are tending in this direction and so are several of their pension clients. It thus is logical to expect a trend toward such firms in the real estate investment management industry.

This does not argue that the giants will fade away. Prudential and Equitable could quite easily establish a series of specialized smaller funds from their existing inventories and stables of trained managers. Thus, a pension fund could start down the learning curve with a large "diversified in real state" investment manager and then move to specialization without ever leaving the one institution.[18]

Who will provide the service but is an unanswered question, but there is substantial reason to believe that one kind of operation offers the best change

[18] The giants' ability to offer pension funds and a whole array of funds is an advantage offset possibly by their problems with internal compensation limits.

to provide the two basic benefits from real estate investment and that consequently the industry will move toward that format.[19,20]

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[19]As a first experiment in real estate, pension funds may opt for the larger, diversified in real estate, investment managers. However, as they gain experience, they can be expected to move in the direction cited above. Eventually, when real estate achieves a substantial place in the aggregate pension fund portfolio, large "diversified in real estate" investment managers may again be the answer (as Index Funds are the stock market's answer) if institutional investment serves to make real estate markets more efficient.

[20]One of the authors believes that the natural result of increased pension fund investment in real estate will be institutional collusion and pressure to restrict entry (through zoning, building codes, etc.) to assure that the supply they create will not outstrip demand. It will be done in the name of safety and the environment, but will have the same effect as any cartel on price.

The other author, admittedly of lesser scope, doesn't ascribe to all the economics of this argument.

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