The Institutional Real Estate Clearinghouse: Implications for Institutional Investment in Real Estate

by

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1988

Submitted to the Department of Urban Studies and Planning in Partial Fulfillment of the Requirements for the Degree of

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Abstract

The real estate recession of the late 1980's and early 1990's resulted in a significant drop in real estate values. Institutional investors who participated in equity real estate investment experienced tremendous losses. This was especially true for investors who held interest in commingled real estate funds offered by real estate investment managers. As values dropped, many investors lashed out at real estate investment managers and consultants, blaming them for the heavy losses. The experience caused investors to demand changes in the management of their equity real estate investments.

A group of industry participants seeks to meet these investor demands by providing investors more control over their real estate investments. Their goal is to place in to operation a private, non-profit real estate clearinghouse. This secondary market, known as the Institutional Real Estate Clearinghouse (Clearinghouse), will allow investors to anonymously trade shares in commingled real estate funds. Clearinghouse creators believe the Clearinghouse will allow investors to more easily adjust their real estate portfolio allocation, provide a greater level of information disclosure, and enable investors to discover prices based on actual transactions rather than appraised values. Their idea is not unique, but it is untested on commingled real estate funds. As a result, their is a diversity of opinions regarding the need for the Clearinghouse and its prospects for success.

This thesis begins by examining commercial real estate as an investment. A detailed description of how institutional investors access the real estate asset class is also included. The body of the thesis focuses on the organizational and legal structure of the Clearinghouse. It explains how Clearinghouse creators believe the Clearinghouse will lead to changes in the current private real estate investment system. Interviews with investors, investment managers, and consultants reveal the views of current industry participants regarding the need for the Clearinghouse and its probability for success. The thesis concludes by considering potential future outcomes of the current trends in institutional investment in real estate and possible scenarios for the success of the Clearinghouse.

Thesis Supervisor: Blake Eagle
Title: Chairman, MIT Center for Real Estate
To my beautiful wife Joanna, without whose love and support I would not have completed this thesis.
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Introduction

Institutional investment in real estate commingled funds has declined in recent years. Most large institutional investors, made up primarily of pension funds, have moved away from commingled funds in favor of separate accounts and direct in-house investment. Many medium-sized pension funds cannot invest in real estate through separate accounts and maintain a level of diversification, and are unsatisfied with the investment characteristics of commingled funds. Small funds rarely participate in real estate investment because even a ten percent allocation of their investment portfolio to real estate is too small to access commingled funds or separate accounts. Institutional investors of all sizes have cited problems with the real estate commingled funds, which include: lack of control, conflicts of interests with investment managers, unreliable valuation, limited liquidity, and limited tradability of commingled fund units.

This institutional uneasiness with private real estate investment has brought about a call for leadership and new direction by some pension fund investors active in the real estate asset class. Many industry participants are debating how the real estate industry should proceed to best meet the investment needs of institutional real estate investors. Some believe industry leaders should be proactive and work toward large scale, market-wide solutions to the problems at hand; others believe that market forces independently should determine the fate of institutional investment in the private real estate market.

Those industry leaders who believe that decisive action is necessary advocate the creation of a private, non-profit real estate clearinghouse through which institutional investors can trade shares in private real estate securities, commonly known as "commingled funds." This secondary market would be known as the Institutional Real Estate Clearinghouse, or "Clearinghouse." The Clearinghouse is designed to reduce the problems associated with investment in commingled funds. This idea is controversial. Not
all industry participants believe the Clearinghouse is a good idea and more have questions as to whether it will be successful.

This thesis examines the real estate investment process and explores the Clearinghouse concept. It identifies what many believe are the elements of success for the Clearinghouse and examines the implications to institutional real estate investment should it be successful.

Chapter 1 provides an overview of equity real estate capital markets. Topics examined include: types of real estate investment, such as free and clear equity and real estate mortgages; real estate investment vehicles, such as the real estate investment trust (REIT) and real estate partnerships; and markets in which real estate properties and property linked securities trade, such as the private property market, the private security market, and the public security market.

Chapter 2 focuses on the private securities market and how institutional investors access this market. A general description is provided for the two traditional private securities: the open-end commingled fund and the closed-end commingled fund, as well as a discussion of in-house and separate account direct investment.

Chapter 3 describes the Clearinghouse organizational structure. It outlines the operation of the Clearinghouse trading market, plans for information standardization, and relevant legal issues. The chapter also explains how the Clearinghouse approach seeks to address some of the weaknesses presently associated with investment in commingled funds.

Chapter 4 summarizes the results of interviews with plan sponsors, endowments, investment managers, and real estate consultants. From the perspective of the interviewees, the chapter examines: whether the Clearinghouse is a good idea, the keys to success for the Clearinghouse, and summarizes the Clearinghouse impact on investors, investment managers and service agents.
Chapter 5 discusses possible scenarios for future institutional investment in real estate, describes the Clearinghouse impact on industry participants, and examines potential scenarios for success of the Clearinghouse. The chapter also draws conclusions from the information contained within the thesis.
Chapter One
Real Estate Capital Markets

The productive capacity of a society is a function of the real assets of its economy: the land, buildings, knowledge, and machines used to produce goods and workers whose skills are necessary to use those resources. In contrast to real assets, financial assets indirectly contribute to the productive capacity of an economy by allowing for separation of ownership and management of a firm and facilitating the transfer of funds to enterprises with attractive investment opportunities.¹

Securities, Investments and Markets

Financial assets, or "securities", can be classified as money market instruments or capital market instruments. The money market includes short-term, marketable, liquid, low-risk debt securities such as treasury bills, certificates of deposit, commercial paper, banker's acceptances, eurodollars, and repurchase agreements.² The capital market, which includes longer term and riskier securities, is much more diverse than the money market. It is divided into four segments: (1) fixed income securities, such as treasury notes, various types of bonds, mortgages and mortgage backed securities; (2) equity securities, including common and preferred stock; (3) stock and bond market indexes, such as the Dow Jones Industrial Average, Standard & Poor's Composite 500 Stock Index, Value Line index, and bond market indicators produced by various investment banks; and (4) derivatives, which include options, futures, and other security, currency, or asset-based derivatives.³

Securities are traded in financial markets that arise as a natural response to investor needs. There are four distinct types of markets: direct search markets, brokered markets,

³ Bodie, Zvi, Alex Kane, Alan Markus.
dealer markets, and auction markets. Direct search markets are the least organized. Buyers and sellers must seek each other out directly. In brokered markets, intermediaries profit by offering search services to buyers and sellers. New issues of securities are brokered in the primary market, while existing securities trade among investors in the secondary market. Dealer markets arise when trading activity in a particular type of asset increases. Dealers differ from brokers in that they trade assets for their own account. The most integrated market is the auction market, in which buyers and sellers converge at one place to bid or offer on an asset. One advantage of an auction market is one need not search extensively to find the best price for an asset. If all participants converge, they can mutually agree to prices and minimize the bid/ask spread.

Real Estate Investments and Markets

As of September 1990, the combined total of commercial real estate debt and equity was $4.5 trillion. Despite its large size, real estate receives little attention from the investment community. Two reasons explain why. First, corporations own approximately 2/3 of the existing stock of commercial real estate assets for use in their business operations. This limits the amount of the commercial real estate available to be traded. Second, the commercial real estate transactions that do occur are mostly private, which hides the normal information flow from investors.

Real estate held for investment is owned in different investment structures, including: free and clear equity, leveraged equity, mortgages, hybrid debt, senior ground leases, and options. For each investment structure the underlying assets are buildings that produce the cash flows. Real estate investments are accessible to investors through direct

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4 Ibid.
5 Block transactions are another brokered market in which buyers and sellers exchange large blocks of securities.
7 Ibid.
8 Ibid.
ownership or through ownership vehicles such as REITs, partnerships, corporations, and vehicles designed for collective institutional investment. Real estate investment vehicles are legal claims on the future cash flows of an asset or group of assets. Each vehicle is structured to offer investment characteristics in a specific format preferred by certain investors. Real estate investments trade in one of three markets: the direct property or land and building market, the private security market, and the public security market.

**Commercial Real Estate Investment Structures**

The focus of this thesis is on institutional investment in real estate, most of which has been undertaken by United States pension funds. Pension funds have elected to participate in operating, multi-tenant buildings. They typically own free and clear interest in office, retail, industrial, and apartment buildings. Other pension fund investments in real estate include convertible and participating mortgages, which are essentially "disguised" equity investments. The following is a brief description of real estate investment structures in order of preference by institutional investors.9

**Free and Clear Equity** One of the most common forms of real estate investment. It simply means ownership without debt. Cash flows from free and clear ownership come from monthly rental payments.

**Leveraged Equity** Allows investors to use less capital to purchase a property by utilizing debt financing. An investors can purchase property with approximately 75% less capital than would be required to purchase free and clear equity in the same property.

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Real Estate Mortgage  Considered the most stable portion of a property's cash flow because it is usually senior to all other payments except taxes. Mortgage cash flows are predictable because investors have senior contractual claims to a defined dollar amount of the property's cash flow.

Hybrid Debt  A mortgage with an option on future property appreciation. Cash flow from hybrid debt is similar to that of a mortgage except the interest rate is usually lower.

Senior Ground Lease  Created when a property's ownership is divided into two pieces: a finite leasehold on a building and the permanent ownership of the land and improvements on the land. Upon termination of the ground lease, the landowner takes possession of building as well as the land. If rent is not paid during the term of the ground lease, the land owner can take possession of the entire property, giving the land owner a senior position in the property. Cash flow comes from ground lease payments which are senior to all other payments.

Real Estate Options  The right to future increase in the value of property. They are the riskiest of real estate investments. Usually written on buildings, options are rarely the target of institutional real estate investors.

Real Estate Investment Vehicles and Legal Structures

There are two types of investment vehicles: finite-life or closed-end and infinite-life or open-end. These vehicles have many different legal structures, including: 501(c)(25) Title Holding Corporations, REITs, limited liability companies, insurance company separate accounts, partnerships, Revenue Ruling 81-100 Group Trusts, and Bank-584 Trust Funds. Each legal structure offers unique features which are taken into account when
Investment Structures

<table>
<thead>
<tr>
<th>Senior ground lease</th>
<th>Mortgage</th>
<th>Hybrid debt</th>
<th>Free and clear equity</th>
<th>Leveraged equity</th>
<th>Option</th>
</tr>
</thead>
</table>

**RELATIVE RISK**

Lowest to Highest

Source: Managing Real Estate Portfolios

<table>
<thead>
<tr>
<th>Option</th>
<th>Senior ground lease</th>
<th>Hybrid debt</th>
<th>Mortgage</th>
<th>Leveraged equity</th>
<th>Free and clear equity</th>
</tr>
</thead>
</table>

**RELATIVE LIQUIDITY**

Lowest to Highest

<table>
<thead>
<tr>
<th>Option</th>
<th>Senior ground lease</th>
<th>Hybrid debt</th>
<th>Mortgage</th>
<th>Leveraged equity</th>
<th>Free and clear equity</th>
</tr>
</thead>
</table>

**PARTICIPATION BY PENSION FUNDS**

Lowest to Highest
### Investment Structures

<table>
<thead>
<tr>
<th>Senior ground lease</th>
<th>Mortgage</th>
<th>Hybrid debt</th>
<th>Free and clear equity</th>
<th>Leveraged equity</th>
<th>Option</th>
</tr>
</thead>
</table>

**RELATIVE RISK**

- Lowest
- Highest

*Source: Managing Real Estate Portfolios*

<table>
<thead>
<tr>
<th>Option</th>
<th>Senior ground lease</th>
<th>Hybrid debt</th>
<th>Mortgage</th>
<th>Leveraged equity</th>
<th>Free and clear equity</th>
</tr>
</thead>
</table>

**RELATIVE LIQUIDITY**

- Lowest
- Highest

<table>
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<th>Option</th>
<th>Senior ground lease</th>
<th>Hybrid debt</th>
<th>Mortgage</th>
<th>Leveraged equity</th>
<th>Free and clear equity</th>
</tr>
</thead>
</table>

**PARTICIPATION BY PENSION FUNDS**

- Lowest
- Highest
a legal structure is chosen for an investment vehicle. Features of investment vehicle legal structures include: class of investors permitted to invest in the fund, payment of unrelated business taxable income (UBTI), UBTI debt-financed exemption, investor liability, free transferability of interest, and other considerations.

REITs, title holding corporations, and partnerships are preferred by many investors because they limit investor liability, provide tax-conduit efficiency, and provide for the free transferability of interest. Separate accounts, 584 Trust Funds, limited liability companies, and group trusts provide for tax-conduit efficiency, but lack features such as transferability and liquidity that are increasingly important to investors seeking active portfolio management.\textsuperscript{10}

**Real Estate Markets**

Real estate investments can be traded in one of three markets: (1) the private property market; (2) the private security market; and (3) the public security market. Cash flows from different types of real property investments are paid through different ownership vehicles in each of these markets. Investors in the private property market, the largest of the three real estate investment markets, purchase the various types of real estate investments in whole. They are assisted in their acquisition and disposition efforts by intermediaries such as commercial real estate brokers, who provide sales and leasing services to property investors and owners. Property managers employed by investors in private property markets often assist with building maintenance and rent collection.

The private real estate security market is the creation of real estate money managers who raise money from passive investors, such as pension funds, and invest the money in the private property market. Investors in the private security market own shares or units in pools of real estate called "commingled funds"\textsuperscript{11}. In return for their investment, private


\textsuperscript{11} Chapter 2 contains a detailed discussion of commingled funds.
## Investment Structure Comparison for Multiple Plan Investments

<table>
<thead>
<tr>
<th>Features</th>
<th>501(c)(3)</th>
<th>Limited Liability Company</th>
<th>REIT</th>
<th>Insurance Company Separate Accounts</th>
<th>Partnership</th>
<th>New Rev. Rul. 81-100</th>
<th>Trust Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restrictions on Class of Investors</td>
<td>Limited to 35 shareholders, all of which are 401(a) plans (including union plans), governmental plans of 501(c)(3) entities</td>
<td>No restrictions, but need at least 100 investors</td>
<td>No restrictions</td>
<td>Generally limited to plans</td>
<td>No restrictions</td>
<td>Restricted to 401(a) plans (including union plans), governmental plans and IRA’s</td>
<td>Accounts for which a bank already serves as fiduciary</td>
</tr>
<tr>
<td>Unrelated Business Taxable Income (UBTI)</td>
<td>Paid by corporation</td>
<td>Generally no UBTI, but see special considerations</td>
<td>Paid at investor level</td>
<td>Generally no UBTI</td>
<td>Paid at investor level</td>
<td>Paid by group trust</td>
<td>Paid at investor level</td>
</tr>
<tr>
<td>UBTI Debt-Financed Exemption</td>
<td>Available</td>
<td>Generally no UBTI, but see special considerations</td>
<td>Available</td>
<td>Generally no UBTI</td>
<td>Available</td>
<td>Available</td>
<td>Probably</td>
</tr>
<tr>
<td>ERISA Status</td>
<td>May be a Real Estate Operating Company (REOC) and may also qualify for publicly-traded exemption</td>
<td>May be a REOC</td>
<td>Always subject to ERISA, and insurance company is always an ERISA fiduciary</td>
<td>May be a REOC</td>
<td>Always subject to ERISA, and bank is an ERISA fiduciary</td>
<td>Always subject to ERISA, and bank is an ERISA fiduciary</td>
<td>Always subject to ERISA, and bank is an ERISA fiduciary</td>
</tr>
<tr>
<td>Investor Liability</td>
<td>Limited to contributions</td>
<td>Limited to contributions, but see special consideration</td>
<td>Limited to contributions</td>
<td>Limited to contributions</td>
<td>If limited partner, limited to contributions</td>
<td>Intended to be limited to contributions, but uncertain</td>
<td>Limited to contributions</td>
</tr>
<tr>
<td>Free Transferability of Interest</td>
<td>Yes</td>
<td>Yes</td>
<td>Restricted</td>
<td>No, but redemptions permitted</td>
<td>Generally yes</td>
<td>No, but redemptions permitted</td>
<td>No, but redemptions possible</td>
</tr>
<tr>
<td>Special Considerations</td>
<td>Must distribute all income currently (other than limited expense reserves)</td>
<td>If a REIT is formed as a trust rather than a corporation, limited liability may vary based on state laws</td>
<td>Not authorized in all states</td>
<td>Since not a separate entity, insurance company receivership may delay distributions and other investor rights</td>
<td>A partnership that relies on the lack of free transferability for a partnership status under the tax law will impose limitations on transferability</td>
<td>If maintained by a bank, unitholder must be redeemed within 12 months of request</td>
<td>Unitholder must be redeemed within 12 months of request</td>
</tr>
<tr>
<td></td>
<td>Engaging in any active trade or business will generally result in loss of tax-exempt status, but de minimis amounts of UBTI incidental to the ownership of real estate permitted</td>
<td>Certain restrictions under REIT rules on activities, assets, and the nature of income received</td>
<td>Uncertainty as to whether limited liability will be respected by states other than state of formation</td>
<td>Tax exempt under sections 401(a) of the Internal Revenue Code</td>
<td>Tax exempt under section of the Internal Revenue Code</td>
<td>Not commonly used because of the investor restrictions that apply to 584 trust but not bank sponsored 81-100 trusts</td>
<td>Tax-exempt under section of the Internal Revenue Code</td>
</tr>
</tbody>
</table>

Source: Mayer, Brown & Platt
security investors receive cash flow from fund properties and a pro-rata share of revenue form property sales. At present there is no formal secondary market for this investment vehicle. Sales of previously issued private securities are sold in the direct search market or brokered by the management firm that issued the security.

The public equity real estate security market consists of two vehicles - corporations and REITs. Each vehicle issues shares to the market through an initial public offering. These shares then trade in a secondary auction market such as the New York Stock Exchange. Financial intermediaries in the public security market include investment banks that structure initial public offerings and facilitate the sale of securities to the public.

**Investment Characteristics**

Real estate offers certain investment characteristics. They include among others, return, risk, liquidity, and management control. These characteristics vary according to the structure of the investment, the type of investment vehicle, and the market in which the investment trades. For example, an investor can purchase 100% interest in a building in the property market. To defer risk, the investor can sell partial interest in the investment by placing the building in a vehicle such as a REIT. In the process, the investor will lose some managerial control over the investment. To make the investment more liquid, the REIT can be sold to the public and traded on a public exchange. This action will change the risk and return characteristics of the investment. Throughout this process, the investment characteristics, not the investment structure, changed.

**Pension Fund Investment in Real Estate**

Pension funds began to seriously consider investment in the real estate asset class in the mid 1970's. Until then, pension funds allocated most of their funds to stocks and bonds. They avoided investment in real estate for a number of reasons. A primary and

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12 The Clearinghouse is an attempt to create a secondary market for comminflled funds.
important reason stemmed from federal tax law, which historically provided incentives for investors to maximize leverage and make use of sizable tax shelter benefits. As tax-exempt institutions, pension funds invested based on pre-tax returns and were outbid for properties by tax shelter investors who bought property based on after-tax returns. Furthermore, as all cash investors, pensions funds were unable to enjoy the effects of positive leverage used by other investors when making real estate decisions.\(^{13}\)

Pension funds gave several reasons for avoiding leveraged investments. They had plenty of cash and did not need to use debt financing in order to meet their real estate portfolio targets. As risk averse investors, pension funds feared leverage would place their real estate investment at risk and have a negative affect on portfolio performance. Moreover, income generated by leveraged investments was taxed under Section 514 of the Internal Revenue Code.\(^{14}\) Leverage also offered no advantages to investors during periods when interest rates were greater than the free and clear rate of return.

Another reason pension funds avoided investment in real estate was the perception that real estate was a high risk investment not suitable for the trustee-beneficiary characteristic of pension funds. Pension funds viewed real estate as a largely unregulated industry dominated by entrepreneurs. The approaches used for real estate investment were unfamiliar to many pension fund managers, who were accustomed to a traditional trustee-fiduciary relationship.\(^{15}\)

Pension funds also avoided the real estate asset class for management reasons. Investment in real properties required an intensive management effort, and pension funds were primarily passive investors. Managers and advisors to pension funds were trained in equity security and fixed income analysis, not in the details of real estate investment, which appeared to be more complex than securities investment.\(^{16}\)

\(^{14}\) Ibid, p. 689.
\(^{15}\) Ibid, p. 688.
\(^{16}\) Ibid.
A final reason why pension funds avoided investment in real estate was due to a lack of information needed to perform comprehensive investment analysis. Detailed information needed in various market areas to measure the expected return and risk characteristics of real estate investments was not available. Without data, the quantitative financial analysis developed to analyze stock and bond performances could not be performed on real estate investments. Pension fund managers and advisors relied on accepted investment analysis and measurement technology to better position themselves against charges of violating the prudent man rules and guidelines established by the Employee Retirement Income Security Act (ERISA).\(^\text{17}\)

Throughout the 1970's and 1980's, many of the issues that caused pension funds to avoid investment in real estate were no longer present. The passage of the ERISA in 1974 validated the principle of diversification and opened the door for the introduction of real estate as an important diversifier in a mixed asset portfolio.\(^\text{18}\) As a result of the ERISA, pension fund advisors began to offer expert real estate advice to their pension fund clients. The Frank Russell Company, a pension fund consultant, and the National Association of Real Estate Investment Fiduciaries created a real estate return index, known as the Russell-NCREIF Property Index (RNPI) in 1978.\(^\text{19}\) This index allowed for levels of quantitative analysis of the real estate asset class previously not undertaken due to a lack of good information. Use of the RN-Index by academics and industry researchers showed that real estate was not as risky as once believed and could improve the risk return performance of a mixed asset portfolio.\(^\text{20}\) Tax law changes in 1980 eliminated the unrelated business income tax on income generated by pension funds on leveraged investments, thereby removing the disincentive for pension fund investors to use leverage.\(^\text{21}\) The Tax Reform Act of 1986 greatly reduced the tax shelter benefits associated

\(^{17}\) Ibid.

\(^{18}\) Hudson-Wilson, Susan, Charles H. Wartzebach, p. xii.

\(^{19}\) Interview with Blake Eagle.


\(^{21}\) Brueggeman, William B., Jeffrey D. Fisher, p. 689.
with real estate investment, reducing the role of tax considerations in the determination of real estate investment by pension funds.\(^22\)

As a result of the changes stated above, real estate began to be included in mixed asset portfolios because portfolio managers believed it offered four significant investment characteristics: inflation hedge, competitive total return, return stability, and portfolio diversification. For the year ending 1987, returns from properties included in the RNPI outpaced inflation for the previous one, three, five, seven, and ten-year periods. During this same time, ten-year returns on the RNPI compared favorably with the S&P 500 and the Lehman Government/Corporate Bond Index, making real estate returns competitive with those of stock and bond. These returns also experienced low volatility. The standard deviation of real estate returns was much lower than those for stocks and bonds, indicating a higher degree of stability. Finally, real estate returns had generally increased during periods when financial assets had declined, making real estate negatively correlated with stocks and bonds. This meant that real estate, as an asset class, could provide diversification if included in a mixed asset portfolio. Taken together, these four performance characteristics provided justification for institutional investors to increase significantly their allocations to real estate.\(^23\)

\(^{22}\) Ibid, p.688.

Chapter 2

Institutional Investment in Real Estate:
Fund Structures and Direct Investment

To increase investment in the real estate asset class, pension funds and other institutional investors had to determine how to best access the property markets. They had one or more of four possible alternatives: (1) open-end commingled funds; (2) closed-end commingled funds; (3) direct purchase of real estate assets through an in-house real estate organization; or (4) direct purchase of real estate assets through an investment manager either on a discretionary basis or on a fee basis.

As pension funds entered the market for real estate investments, institutional money managers from all sectors recommended that pension funds "pool up" their capital to achieve a level of diversification unattainable through direct investment by a fund acting alone.\(^1\) The private investment security chosen for diversified investment in real estate is known as a "real estate commingled fund" (commingled fund).

Commingled funds are created from the investment capital contributions of pension funds and other institutional investors. The money is held in trust and managed by an investment manager or general partner. The manager of the fund is always a fiduciary under the general law of trusts, but may or may not be subject to the fiduciary standards of the ERISA. The pension plans are usually passive investors and have minimal or no control over how the money is invested.\(^2\) Today there are more than 190 real estate commingled funds.\(^3\) These funds are structured as either open-end or closed-end funds.

\(^1\) Eagle, Blake, "Open-end funds Versus Closed-end funds", Frank Russell Company, 1984.
\(^2\) McKelvy, Pension Fund Investments in Real Estate, 1984.
\(^3\) Institutional Property Consultants, 1994.
Strategic Considerations

Yes

Real Estate

$ 

Indirect Pooled Funds 

Direct 

Internal 

Advisor 

Combination 

Insurance Co 

Bank 

Advisor 

Other 

Open End 

Closed End 

REIT 

Limited Partnership 

Securities 

Portfolio 

No

Financial Market 

Capital Allocation 

Direct vs. Indirect 

Investment Vehicle 

Investment Manager 

Portfolio 

Source: Frank Russell Company
**The Open-end Fund**

First Wachovia Bank established the first open-end commingled pension real estate investment fund in 1968. It was soon followed by the Prudential Property Separate Account (PRISA) in 1970. Open-end commingled funds were among the first private real estate equity securities to be offered to institutional investors. Their organizational structure is similar to that of publicly owned mutual funds. The sponsoring manager, acting as the management company, has sole responsibility for the investment selection process, as well as the ongoing management of the fund and its assets. The participating investors are passive "shareholders". They rely completely on the sponsoring manager for investment structuring, decisions, and performance.

Open-end commingled funds are continuously open for investment. This structure allows investors to purchase fund units on a regular basis. The purchase price for new units is the appraised net asset value for the most recent quarter divided by the number of units outstanding. The investor's account is expressed as the number of fund units or shares owned, adjusted each quarter by the amount of the total return or loss.

Open-end funds have an "in perpetuity" life characteristic. This enables managers to time local property markets and determine when it is advantageous to buy, sell, or hold. Income generated from open-end fund assets is typically retained for reinvestment. Investors may have the option of withdrawing this income under certain circumstances. The retention of income builds into the fund a mechanism for internal expansion which allows the fund manager to diversify the portfolio by property type and geographic region.

In theory, the organizational structure of an open-end fund permits it to continually expand. This enables the fund to purchase properties of considerable value. Very large

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6 McKelvy, p. 221, 1984.
open-end funds can consider properties valued over $100 million without creating portfolio imbalances. Size can provide large open-end equity funds the advantage of being part of a small group of potential buyers for high yielding properties priced out of the reach of most investors. The increasing size of the open-end fund also allows management to consider a broader range of real estate investments, including diverse investments in property such as hotels and farmland, properties typically not considered as appropriate investments for smaller commingled funds.

Other stated advantages of open-end funds include limited investor redemption and dollar cost averaging over various market cycles. Limited investor redemption provides investors with an element of liquidity. The sources of cash for investor redemption include fund investment income, net proceeds from resale of fund assets and other investors awaiting entry into the fund. Dollar cost averaging of the open-end fund occurs when fund investment income and proceeds from the sale of fund assets are reinvested over different market cycles.

The Closed-End Fund

Introduced in the early 1970's, closed-end commingled funds became the next generation of private real estate investment vehicles. Initial sponsors of closed-end funds were operators in the real estate industry, such as LaSalle Partners and Coldwell Banker. Today, most financial institutions that offer open-end funds also offer closed-end funds. The closed-end fund terminates the subscription process once it has reached a certain level of assets under management. The fund manager then invests the money in real estate with the intention of selling the entire portfolio in ten or more years and distributing the proceeds

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8 Ibid.
9 Ibid.
10 Ibid.
to the original investors. Investors can vote to extend the life of the fund or sell only a portion of fund assets.\textsuperscript{11}

Closed-end funds are generally smaller in capitalization than open-end funds. With a fixed capital base, the closed-end fund typically acquires properties in the $5 to $20 million range. This is done to achieve some diversification within the fund. Similar to an open-end fund, a closed-end fund targets the most prestigious, well located properties for all cash acquisition.\textsuperscript{12}

An established closed-end fund is invested in an identifiable group of properties. This provides investors the opportunity to monitor specific portfolio assets. Most closed-end funds are initially "blind funds" that invest based on an acquisition strategy that is defined prior to the purchase of the real estate assets. The strategy remains unaltered during the life of the fund.\textsuperscript{13}

Appraisals are used to benchmark the value of a closed-end fund, but are not used as the basis for fund investment participation. Investors enter the fund on an identical cash basis. An investor choosing to exit the fund must identify a willing purchaser and negotiate a sales price with that party. Income generated from closed-end fund assets is regularly distributed to fund investors. Net proceeds from the sale of fund assets are distributed to investors on a pro rata basis after an initial period during which the closed-end fund manager can reinvest the money.\textsuperscript{14}

\textbf{Weaknesses of the Commingled Fund Investment}

Real estate commingled funds serve a worthwhile purpose. They allow investors to invest a few million dollars and own a share of a multi-billion dollar diversified real estate

\textsuperscript{11} McKelvy, 1984.
\textsuperscript{12} Ibid.
\textsuperscript{13} Eagle, Blake, "Open-end funds Versus Closed-end funds", Frank Russell Company, 1984.
\textsuperscript{14} Ibid.
Comminged Real Estate Funds (CREFS)
(Private Real Estate Securities)
Jun-94

### Open-end Funds

<table>
<thead>
<tr>
<th>Vehicle</th>
<th>No. Funds</th>
<th>No. Assets</th>
<th>Net Asset Value ($ Millions)</th>
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<tr>
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<td>Limited Partnership</td>
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</tr>
<tr>
<td>501(c)25</td>
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<td>0</td>
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<tr>
<td>Other</td>
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### Closed-end Funds

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<th>No. Assets</th>
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<td><strong>1596</strong></td>
<td><strong>$22,013.05</strong></td>
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</table>

Sources: Institutional Property Consultants
Institutional Real Estate Clearinghouse
portfolio run by an experienced real estate company. The investor does not have to worry about managing, buying, selling or leasing the properties. Commingled funds do have drawbacks, however, including fund manager conflict of interest, limited liquidity, and non-standardized information.\textsuperscript{15}

**Conflict of Interest**

Most open-end and closed-end commingled fund managers control how their portfolio is valued. They select an appraiser who values the properties in the fund. The appraiser determines property value by capitalizing operating income from fund properties. The amount fund property values have increased or decreased since the last valuation is the unrealized appreciation or depreciation for that period. Since management fees are directly tied to the portfolio’s value, fund managers can be tempted to make subtle judgments about the property’s values that have a positive affect on their fee income. When fund values go up, so does management fee income.\textsuperscript{16}

Another conflict between fund managers and investors involves the calculation of rate of return. The rate of return on all commingled funds is computed from appraised values. The total return calculation consists of cash flow from properties in a fund plus unrealized property appreciation. The cash flow portion of the total return is the sum of actual cash generated from the properties within the fund. Unrealized property appreciation is an estimate from a third party appraiser or a member of the fund manager’s appraisal staff. This results in a large portion of reported return based on appraisal assumptions about property values. Fund managers then quote these appraisal based returns to fund investors to the hundredth of a percent, giving legitimacy to the number. Through the appraisal process, real estate commingled fund managers can disguise a bad year caused by a down market. This does not mean that they will deliberately mislead their investors, only

\textsuperscript{15} McKelvy, 1984.
\textsuperscript{16} Ibid.
that they have a strong motivation to do so. With positive performance, open-end fund managers can attract additional investment capital into their fund. This also leads to higher management fees.\textsuperscript{17}

Further potential manager and investor conflict of interest involves allocation of acquired properties. Many commingled fund managers run more than one real estate fund. When a high quality asset is purchased, the manager must decide in which fund the property will be placed. Investors with whom the management company does a great deal of business may receive preferential treatment. This problem is most obvious for insurance companies that both manage funds in separate accounts and invest in equity real estate on their own behalf through their general accounts. Although insurance companies and other real estate managers have devised ways to try to avoid conflict among different accounts, the problem of divided loyalties remains.

Insurance company separate accounts create a unique conflict of interest problem. The prohibited transactions provision of the ERISA forbids managers from purchasing or selling property on which their general accounts hold a mortgage.\textsuperscript{18} The only way a separate account can purchase a property mortgaged by its parent is if the account receives a special exemption from the department of labor, which can take six months to a year to process. This conflict causes separate account managers to do business with their competitors. Historically, insurance company's general accounts have been one of the nations leading real estate investors. They have invested billions of dollars in mortgages and have strong relationships with developers. The mortgaged properties and their developers are precisely the properties and people an insurance company would want to do business with for its separate account, but they cannot because of the ERISA constraints.

\textsuperscript{17} Ibid.
The success of the insurance company's real estate investments collides with the interests of their pension clients.\textsuperscript{19}

\textbf{Liquidity}

Open-end commingled fund managers send a mixed message to their pension clients on the issue of liquidity. On one hand, fund managers insist that real estate is an illiquid investment from which investors should not intend on cashing out for many years. On the other hand, the manager will buy back fund shares from investors seeking to withdraw, as long as sufficient cash is available for which the fund manager has no other plans. The fund manager sends a message that an investment in an open-end commingled fund is illiquid until the manager decides it can be made liquid. This is a dangerous position to take considering that pension funds tend to move as a herd.\textsuperscript{20} If all investors in an open-end commingled fund simultaneously request redemption, not enough money will be available to meet investor demands and the system will fail to produce liquidity.

Closed-end fund liquidity problems arise when funds are scheduled for liquidation at a time when property market conditions are poor. Investors are faced with the decision of selling assets at depressed values or leaving their money in the fund until property values improve. Closed-end fund investors achieve liquidity only if property markets happen to be strong when the fund is scheduled for liquidation.

\textbf{Information}

No standard information reporting practices are used throughout the institutional real estate investment industry. Investors are forced to spend significant amount of time translating and comparing commingled fund information received from different fund managers. "For many years, effectively since its inception, the institutional real estate

\textsuperscript{19} McKelvy, 1984.
\textsuperscript{20} Ibid.
industry has operated with accounting, performance reporting and appraisal standards that
at times are perceived as less than consistent. Much of this perception can be traced to
differences in accounting practices, inconsistencies in the calculation and disclosure of
performance returns and the distinctions among the various appraisal methodologies."\(^{21}\)
Most commingled fund managers do not clearly disclose all of their fees or explain how
their rate-of-return is derived. Some also refuse to give clients details about the properties
held in the fund, identifying properties in fund reports, not by name and what they cost but
by property type, square footage and location.\(^{22}\) "No one can make reasonable and
prudent investment decisions without adequate information. The lack of such information
is, without a doubt, the biggest single shortcoming of the commingled fund industry
today."\(^{23}\)

**Direct Investment**

Direct investment in real property provides similar risk, return, and diversification
characteristics to investment in real estate commingled funds. Pension funds that chose to
invest directly in real estate must decide whether to hire a firm to manage their accounts or to
handle their property investments in-house.\(^{24}\) Due to the cost necessary to set up an in-
house staff and the investment capital required to acquire an individual portfolio, direct
investment through an in-house staff is limited to large pension funds. To operate
effectively, an in-house staff must possess the real estate skills needed to operate a real estate
portfolio. Necessary skills include: quality property acquisition, real estate investment
analysis, property performance measurement, risk assessment, property management,
reporting techniques, appraisal procedures, and property disposition.

\(^{21}\) Morris and Ramseyer, 1993.
\(^{22}\) McKelvy, p. 236, 1984.
\(^{24}\) McKelvy, 1984.
Direct Investment: In-house Management

In-house real estate investment has many advantages. If managed correctly, a pension plan can earn higher returns on an in-house property portfolio than it could earn on a portfolio run by an investment advisor or on a commingle fund because the pension plan can control property level decisions. In-house real estate investment also eliminates many of the conflicts of interest associated with real estate investment managers. An in-house real estate staff works only on its own account. Accordingly, there is no motivation to maximize appraised values and assets under management, and all acquisitions go directly to one account. With an in-house real estate investment staff, detailed information on the cost of management verses the amount actually invested in property can be used to identify cost overruns and make necessary adjustments. Pension funds with an in-house real estate staff may also receive the first opportunity to purchase quality properties because they can assure those who bring them deals that no one else will be shown the opportunity. The internally managed pension fund can also devise a specific strategy for real estate investment. It can invest in high credit, low management deals or high management deals that offer a higher return and/or diversification benefits. To further enhance real estate investment returns, pension funds can hire top real estate investment personnel to work specifically on their account.25

Direct real estate investment through an in-house staff also has distinct disadvantages. Unless a pension fund operates a large, multi-property, in-house portfolio, its real estate allocation may be undiversified. A small, in-house portfolio could suffer a significant loss should one of the fund properties depreciate in value due to either market conditions or a natural disaster. In-house real estate investment also involves the fund more with their tenant's needs. Big problems with properties must be dealt with directly by the pension plan and may require the plan's trustees to get involved. Direct investment is also illiquid, which can become a problem if the pension fund decides it no longer wants to

25 Ibid.
invest in real estate. In-house investment also requires the plan trustees to be more involved with the real estate investments by overseeing the process. Some trustees may be inclined to influence the plan's real estate investments to the benefit of personal connections or may be persistent with their uninformed opinions about real estate investment strategy. Direct in-house investment also lacks a window to the real estate marketplace. Without interaction with other investment professionals, in-house managers can lose perspective on market trends and conditions.

**Direct Investment - Advisory Management**

An alternative way for pension funds to invest directly in real estate is to engage the services of an investment advisor.\(^{26}\) Pension funds hire an investment manager to try and achieve higher returns than they do on commingled funds or to diversify their holdings in commingled funds. Investment advisors traditionally establish separate accounts for each separate account client. The amount of discretion the manager has with regard to pension fund dollars varies according to the agreement between the pension plan sponsor and the separate account manager. Separate accounts set up for large pension plans usually involve a large allocation of funds and limited discretion on the part of the manager. Smaller pension funds may allocate money to an investment manager who picks the investments, and after a review by the pension fund's board of trustees, buys them. The investment manager then manages the properties, decides when to buy and sell, and reports the results back to the pension plan. The investment manager is paid a fee for advisory services that is usually based on the amount of assets managed for the pension fund.\(^{27}\)

Advisory fees are typically based on the number of assets bought or sold and the amount of assets managed as well as the scope of services provided by the advisor. Separate account advisory fees are usually based on the book value of property bought or

\(^{26}\) Ibid.  
\(^{27}\) Ibid.
sold plus out of pocket expenses. Some separate account managers charge fees based on appraised value since it has been acceptable to pension funds that invest in commingled funds.\textsuperscript{28}

The desire by pension fund trustees to protect themselves from fiduciary responsibility is the main reason advisory firms are hired.\textsuperscript{29} The separate account investment manager protects pension fund board of trustee members by taking fiduciary responsibility for the investments made on behalf of the pension fund. If the fund is sued for imprudent investing, the investment manager, not the board of trustees, is more likely liable. Generally, to avoid liability, a board must only show that it prudently selected and oversaw the advisory firm, not the investments made on its behalf.

Another advantage to real estate investment through an investment advisor is certain levels of pension fund control over the properties in which they invest. Pension funds can instruct their investment manager to invest only in certain properties and can maintain approval on every transaction. This provides the pension fund with better control over the portfolio composition than does investment in commingled funds. Direct investment through an advisor also allows the fund to avoid buying into commingled funds at inflated appraised values. They have the ability to buy properties at actual cost. Hiring an advisor can also be as convenient as investing in a commingled fund. The advisor can handle all aspects of the investment should that be the boards' desire.

There are also many disadvantages to real estate investment through an investment advisor. Some of these problems are similar to those associated with commingled fund investment, while others are unique to investment through an advisor. Similar to commingled funds, separate account managers have fixed fees for services. These fees can be higher than fees for investment in a commingled fund. The pension plan must pay the investment management fee before it collects any cash flow from its real estate investments.

\textsuperscript{28} Ibid.  
\textsuperscript{29} Ibid, p. 251.
Furthermore, some separate account advisors compute their fees based on appraised values, exposing the pension fund to a significant conflict similar to that associated with commingled fund investment. Advisors may also have multiple clients. This results in potential conflicts among various accounts.\textsuperscript{30}

Other disadvantages include the time it can take for an advisor to find deals and put together a real estate portfolio. By buying into a commingled fund, the pension fund can be instantly invested and diversified. Furthermore, the control gained by investment in a separate account may backfire. The advisor's investment strategy can be negatively impacted by the opinions of the pension plan's trustees who know little about real estate. This can result in a mediocre performance that leaves the pension fund better off investing in a commingled fund.

The biggest disadvantage of an individually run separate account is that it is not as diversified as a commingled fund, making the separate account more risky. To compensate for the higher risk, the pension fund should earn higher returns on average than it would in a commingled fund. It is also questionable as to whether or not the separate managers can provide new or better investment strategies than can a commingled fund. Moreover, separate account managers and commingled fund managers are often the same firm. It is possible for a pension fund to invest in both a separate account and a commingled fund and experience worse returns than just investing in a commingled fund if the pension fund is not compensated for the risk associated with separate account investing.

\textbf{The Need for New Direction}

In addition to the numerous conflicts of interest, poor liquidity, and insufficient information associated with commingled funds, pension investors are concerned with the overall performance of real estate commingled fund managers. A recent survey commissioned by the National Association of Real Estate Investment Managers (NAREIM)\textsuperscript{30}

\textsuperscript{30} McKevey, 1984.
revealed many of these concerns. According to survey results, real estate investment managers need to better comprehend the pension funds' business and culture and make a stronger effort to understand, and fit in with, overall portfolio strategy. This sentiment is articulated well by one plan sponsor: "We're like elephants being led around by investment managers with hooks in our noses." Another plan sponsor expressed concern over a perceived deal-driven mentality on the part of investment managers by saying, "There are a lot of managers out here that will do anything to put businesses on the books. I think it detracts from making a dispassionate evaluation of the asset itself."

Plan sponsors were especially pointed about conflicts of interest and investment manager compensation and fees, as evidenced by the following plan sponsor quote: "All I've seen is basic greed, the desire to put as many dollars under management as possible, the desire to generate as much fee income as possible. I think it has finally come back to haunt them." Plan sponsors were especially opposed to paying investment management fees above the level of management expenses while they were losing money on their investments.

Concern was also expressed about the fund managers level of fiduciary responsibility and reluctance to sell portfolio assets. Some plan sponsors think managers should have taken greater care when investing pension money because they were acting on the behalf of plan beneficiaries. Others were of the opinion that with their extensive research capabilities and access to individual market level data, investment managers should have been more accurate in timing property dispositions. According to one plan sponsor, "It has taken a lot of prodding on our part to get sale recommendations. There's just a real reluctance to even consider the idea. This is tied in with the idea that if a manager recommends a sale, then it reduces their assets under management and income."

33 Ibid, p. 7.
Final issues of concern about plan sponsors include communication and standardization and long-term vision for the industry. Plan sponsors want to be regularly informed of their investment's performance, not suddenly told that there has been a significant reduction in the plan's portfolio value. Complaints about the communication and standardization process included appraisal standards that vary widely by appraisal firm, and accounting standards that differ in terminology, language and form. A concern about a lack of long-term vision for the institutional real estate investment industry seems to be the challenge investment managers must address in order to preserve institutional investment in private real estate securities. While still committed to the real estate asset class, plan sponsors have specific concerns about manager education and ethics, deal-driven mentality, compensation and fees, viable sell discipline, fiduciary responsibility, communication and standardization and a long-term vision for the real estate investment industry. According to plan sponsors, the real estate investment industry must re-invent itself.34

34 Ibid.
Chapter 3
The Clearinghouse

On February 3, 1994, a group of senior-level decision-makers representing twenty-six major real estate investment businesses voted to form, capitalize and place into operation a not for profit facility to be known as the Institutional Real Estate Clearinghouse, or Clearinghouse.\(^1\) Simply stated, the Clearinghouse is an industry group effort to create a central trading market for private real estate securities, primarily consisting of commingled real estate funds. The goal of the Clearinghouse is the free flow of real estate information and the exchange of private securities based on buyer and seller negotiated prices, rather than third party appraised value. The operation of an active secondary market will serve to increase the level of efficiency of the private real estate market by providing investors with the option to buy and sell commingled fund units at competitive prices in the secondary market.\(^2\)

The Institutional Real Estate Clearinghouse Concept

As stated in chapter one, there is at present no formal secondary market for privately placed real estate securities. There is no established market in which buyers and sellers can meet to engage in the bid/ask process. Units that do trade, do so in the direct search or brokered markets, rather than in the most integrated market, the auction market. The Clearinghouse is a secondary market for real estate private placement securities.

The Institutional Real Estate Clearinghouse is designed to further develop the capital market structures for private real estate investment vehicles by addressing the needs and requirements of institutional investors for information, transferability of investment interests (liquidity), and the means to enable price discovery.\(^3\) The Clearinghouse is

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2 Ibid.
### All Funds

<table>
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<th>Vehicle</th>
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Sources: Institutional Property Consultants  
Institutional Real Estate Clearinghouse
designed to solve two important problems in the commercial real estate property market: 1) a lack of ability to discover and transact at prices other than appraised values, and 2) a restricted universe of market participants. The Clearinghouse concept is not unique. Its application to private real estate markets is, however, untested. The Clearinghouse concepts will be applied first to real estate commingled funds owned by primarily US pension funds. The concepts may later be applied to other private Real Estate Investment Trusts, unregistered mortgaged backed securities, and private securities backed by pools of international real estate assets.

**Organization**

The Clearinghouse will be organized as a non-profit corporation. It will be financed by "members" who will consist of pension real estate investment managers, investment consultants, portfolio managers, and plan sponsors. Founding members will pay a membership fee for an opportunity to participate directly in fulfilling the mission of the corporation.

The objective of the Clearinghouse is the creation of a secondary market trading facility for privately securitized pools of commercial real estate assets. The Clearinghouse will be used primarily by United States and foreign retirement plans, other categories of tax exempt institutional investors such as charitable foundations and endowment funds of colleges, universities, and hospitals, and taxable institutional investors. It is designed to combine the private transaction characteristics of real estate with the systems and disciplines of the organized financial markets. Important Clearinghouse characteristics will include: a trading market facility; standards for trading; information standardization; information storage, retrieval, and dissemination; and qualifying institutional investor participants.

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7 Ibid, p. 6.
## Clearinghouse Characteristics

<table>
<thead>
<tr>
<th>Trading Market Facility</th>
<th>Eligible Investment Trusts</th>
<th>Information Standards</th>
<th>Info. Storage, Retrieval, and Dissemination</th>
<th>Qualified Institutional Investor Participants</th>
<th>Revenue Sources</th>
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</thead>
<tbody>
<tr>
<td>As a non-profit corporation, the Clearinghouse will facilitate secondary trading of private securities qualified for ownership by tax-exempt investors.</td>
<td>Initially, investment interests transferred through the exchange will be unregistered shares or units of pooled real estate funds owned primarily by qualified pension and profit sharing trusts and other types of institutional investors. These shares or units will include: insurance company separate accounts, bank collective trust funds, 81-100 group trusts, REITs, unregistered limited partnerships, and private corporations.</td>
<td>Clearinghouse is working with industry participants such as investors, investment managers, investment consultants, and other interested parties to establish base-line standards of an acceptable information set and to ensure that all parties deliver information that is reliable, timely, and accurate for decision making purposes. Using the recent success of REIT IPO's as an example, the Clearinghouse corporation believes that adequate information can be assembled in a manner acceptable to the investment community.</td>
<td>The Clearinghouse will facilitate the electronic retrieval of detailed real estate and financial information in a standardized format that will be regularly updated. The standardized detail of information will allow qualified investors to make analysis and comparative evaluations of reliable data from which to make bid/ask pricing judgments and buy/sell/hold decisions.</td>
<td>Prospective buyers and sellers will be required to meet suitability standards established by the Clearinghouse, with proper attention to legal requirements as established by government regulatory agencies, to ensure that trading activities are conducted between qualified institutional investors.</td>
<td>Financial feasibility and operating budgets of the Clearinghouse will be continuously reviewed in connection with implementation alternatives. Clearinghouse revenues may be shared with external service providers. Potential revenue sources include the following: 1) Listing or registration fees. 2) Completed transaction fees. 3) Access fees charged to users to obtain information about available investments. 4) Annual membership fees if expenses are greater than other fee revenue.</td>
</tr>
</tbody>
</table>

Source: Clearinghouse Business Plan
Legal Issues

An important element to the operational success of the Clearinghouse is overcoming potential legal and regulatory issues. These include: the application of the Securities Exchange Act to the operation of the Clearinghouse; the application of securities laws to pension owned commingled funds; restrictions or limitations imposed upon various categories of securities interests or different types of fund structures; the ERISA; and antitrust.\(^8\)

Legal Issues: Exchange

To avoid costs and government regulations, it is preferable that the Clearinghouse not be subject to registration as a national securities exchange, a clearing agency, or a securities information processor under the Securities and Exchange Act of 1934. To be exempted from SEC requirements, the Clearinghouse must obtain a "no action letter" exempting its proposed private market securities trading system from SEC registration. To obtain a "no action letter", the Clearinghouse must show that it does not have participants or members who act as "specialists" or "market makers" to ensure a liquid marketplace. Approval from the SEC would exempt Clearinghouse operators and brokers effecting transactions through the system from registration as a clearing agency or securities information processor.\(^9\)

Legal Issues: Securities

Commingled real estate fund interests are securities. State and federal securities laws need to be reviewed from the perspective of commingled funds, commingled fund managers, and pension plans and foundations which may sell units through the Clearinghouse. The Securities Act of 1933 (the Securities Act) requires that every offer or


\(^9\) Ibid.
sale of a security must be registered with the SEC unless an exemption applies. This would include any re-offer or resale by an institutional holder of commingled fund units. Securities traded through the Clearinghouse can avoid SEC registration provided they qualify as exempted securities under SEC Rule 144A. Enacted in 1990, Rule 144A exempts resale of "non fungible" securities to a buyer which the seller reasonably believes to be a qualified institutional buyer. Entities such as ERISA plans, governmental plans, and foundations which own and invest on a discretionary basis at least $100 million in securities of unaffiliated issuers are considered qualified institutional buyers. Certain basic information regarding the security issuer (i.e. commingled fund) must be available to both the buyer and seller, in order for a seller to rely on Rule 144A. This information would include a brief statement of the issuing funds nature of business, the products or services it offers, and the fund's balance sheet, including profit and loss and retained earnings statements for the three most recent fiscal years. Such statements should be audited to the extent reasonably available.¹⁰

Exemption Clauses Used By Commingled Funds

Banks and Insurance Companies:

To avoid registration with the SEC in connection with the initial offering of commingled funds, banks and insurance companies usually rely on section 3(a)(2) of the Securities Act. Section 3(a)(2) generally exempts from registration interests in bank collective trust funds and insurance company contracts issued in connection with tax-qualified retirement plans or governmental plans. The exemption applies to the fund interests themselves, not just the initial issuance. Banks and insurance companies can avoid registration with the SEC in order to trade interests in commingled funds through the

¹⁰ Ibid.
Clearinghouse as long as adequate safeguards, such as insuring that the purchaser is a tax qualified retirement plan or government plan, are followed.\footnote{11}

Other Commingled Funds:

Private REITs, non-bank group trusts and non-publicly traded partnerships generally rely on section 4(2) of the Securities Act to exempt issuance of securities not involving a public offering. Exemption is usually effected through compliance with Regulation D of the Securities Act, which prohibits sales through any form of general solicitation. Regulation D does not impose any limit on the number of accredited investors that may purchase through a private offering or the dollar amount of an offering. Accredited investors include any ERISA plan or governmental plan or tax-exempt foundation which has total assets in excess of $5,000,000. Private REITs, non-bank group trusts and non-publicly traded securities should be able to rely on regulation D to use the Clearinghouse for re-sale of securities, as long as initial private security issuances are not made through the Clearinghouse.\footnote{12}

\textbf{State Blue Sky Laws, Anti-Fraud Rules, and Other Securities Laws}

Other state and securities laws may affect the trades that occur through the Clearinghouse.\footnote{13} Designed to protect investors from sellers of highly speculative stock, state security laws known as "Blue Sky" laws must be surveyed in each state potentially involved in future Clearinghouse transactions. Each of the states have securities laws that affect the offer and sale of securities within their jurisdiction. These laws differ by state, but typically provide institutional investor exemptions. State Blue Sky laws are not anticipated to affect the trading of private shares through the Clearinghouse.

\footnote{11} Ibid. \footnote{12} Ibid. \footnote{13} Ibid.
The Clearinghouse is not anticipated to have an adverse affect on the exemptions from the Securities Exchange Act of 1934 and the Investment Company Act currently relied on by commingled funds, and should have no implication with regard to the Investment Advisers Act.¹⁴

**Issues Specific To Commingled Funds**

The documents governing a commingled real estate fund may affect the fund units' tradability on the Clearinghouse. Many commingled funds contain provisions that prohibit transfers or impose conditions on transfers such as consent of the fund manager, consent of other fund unit holders, rights of first refusal, or opinion letters. Transfers that redeem seller's units and re-issue units to a buyer must be reviewed to determine whether the transfer will violate fund provisions, such as: 1) the priority of honoring redemption requests; 2) any prohibition on issuing new units; 3) prohibition on issuing units at other than net asset value; or 4) provisions relating to the use of cash received for new units. Some third party contracts may be affected by a unit transfer if the transfer causes a material change in the control of the fund. In other cases, the transfer of an interest that does not cause a material change might require consent of a third party, where a third party has made a loan to a fund which holds ERISA assets and has imposed restrictions to assure compliance with ERISA's prohibited transaction rules. Some transfers of a material interest (or multiple transfers within a stated period of time) may also result in local real estate transfer taxes.¹⁵

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¹⁴ Ibid.
¹⁵ Ibid.
### Transferability of Commingled Funds

<table>
<thead>
<tr>
<th>Insuritancy Company Separate Accounts</th>
<th>Group Trusts</th>
<th>Bank Trust Company Collective Funds</th>
<th>Partnerships</th>
<th>REITs</th>
<th>Limited Liability Company</th>
<th>Title Holding Corp.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Qualified Buyers:</strong></td>
<td><strong>Eligible Unit Holders:</strong></td>
<td></td>
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<tr>
<td>Buyer must qualify for purposes of the Securities Act (Rule 144A).</td>
<td>Group trusts are tax exempt under IRC Section 501(a) if they form part of a 401(a) plan. IRS Rev. Rul. 81-100 allows pools of several 501(a) trusts to qualify under 501(a). 501(a) provided: 1) the group trust is part of each plan, 2) only tax-qualified retirement plan participate, 3) diversion of part of corpus or income is prohibited, and 4) assignment of group trust interests is prohibited. Group trusts may also include government plans.</td>
<td>Typically structured as group trusts under Rev. Rul. 81-100, therefore subject to same concerns as group trusts. If sponsor is a national bank, fund may also be subject to Reg. 9 issued by the OCC. State bank and trust companies are sometimes subject to state regulations similar to OCC regulations. Reg. 9 requires redemption requests to be met within one year. Redemption value must be at fair value as determined by the trustee in good faith. Exchanges other than NAV could be viewed by the OCC as inconsistent with the purpose of collective funds or as a method to avoid the 12 month rule of Reg. 9. A buyer of units would probably have to enter into an agency agreement with the bank in order to invest in the collective fund. An advantage of bank collective funds over other group trusts is that the bank typically reserves the right to amend without unitholder consent, subject to ERISA obligations and to bank regulations.</td>
<td>Transfer of p-ships may be subject to limitations for the following tax reasons:</td>
<td>Trading of REITs should not raise significant additional issues, although procedures may be required to ensure that the REIT does not fall below 100 shareholders (for IRS purposes) and that the modified 5/50 rule is not violated for REITs seeking to avoid UBIT for their shareholders.</td>
<td></td>
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<tr>
<td><strong>Value:</strong></td>
<td>Possible to avoid value issues by assigning new contract to new unitholder and cancelation of old contract, with no money transferred to or from the insurance company.</td>
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<tr>
<td>If units trade at value different than NAV, state laws and Internal Revenue Code Section 817(d)(3) must be reviewed.</td>
<td>Also, if no withdraw queues, seller can withdraw at NAV, buyer can purchase at NAV and buyer and seller can negotiate side payment.</td>
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<tr>
<td><strong>Form of Contract:</strong></td>
<td><strong>Non-Assignment:</strong></td>
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<tr>
<td>Transfers to other states will require approval of buyer's state's department of insurance if fund contract is not already approved in that state.</td>
<td>Group trust units are not transferable, but simultaneous redemption and reissuance of units at a price other than NAV may be permitted for some group trusts.</td>
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<tr>
<td><strong>Documentation:</strong></td>
<td>Due to Rev. Rul. 81-100, all group trusts will contain a provison against assignmet. To simultaneously redeem and reissue units, the assignment provision would have to be amended, which would require consent of a majority or supermajority of unitholders.</td>
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</table>

**Source:** Mayer, Brown & Platt
ERISA Issues

ERISA's fiduciary rules will apply to any transaction made by ERISA plans, including Clearinghouse transactions. None of the rules are anticipated to present significant issues as long as buy and sell decisions are made by fiduciaries who are independent of each other. Issues specific to ERISA plans who trade through the Clearinghouse include: prohibited transaction exemptions, plan asset status, and valuation. Prohibited transaction issues stem from plans that hold an interest in separate accounts or bank collective funds for which certain transactions are prohibited by the ERISA. The Clearinghouse will need to implement procedures to assure ERISA funds of compliance with exemption rules that allow for certain transactions.16

Some REITs and partnerships restrict ERISA and governmental plans to less than 25% of each class of equity security in order to prevent fund assets from being characterized as an ERISA assets. These funds may restrict transfers to ensure continued compliance with limits on ERISA investors. Valuation of plan assets is important to pension plan and commingled fund managers because valuation has an impact on whether a plan is adequately funded. The ERISA requires that plan assets be valued at fair value as determined in good faith by a trustee or named fiduciary. Plans generally carry real estate assets at net asset value and view isolated transaction as having limited impact on the funds value. To the extent that trades through the Clearinghouse represent a true market value for the units, that value, which may vary from net asset value, would have to be taken into account by plan sponsors and fiduciaries.17

Antitrust Issues

The Clearinghouse should not raise significant antitrust issues because it is designed to foster competition. There would be antitrust concerns if standards and

16 Ibid.
conditions imposed by the Clearinghouse were used for the purpose of limiting the access of others to the market; if the procedures established for admission or expulsion did not provide appropriate due process to the affected entities; or if the collection and exchange of data were used as a subterfuge for price fixing.18

**Operation of the Trading Market**

Though nothing has been finalized at the time of this writing, the Clearinghouse proprietary trading system (PTS) will most likely be managed by an independent service provider. Once selected, the PTS manager will act as a centralized broker through which purchase and sale activity of existing commingled fund shares and future shares of previously issued commingled funds and other private real estate securities will occur. Proprietary trading services will include receipt and listing of orders to buy and sell commingled real estate funds, logging of orders into the service providers' internal system, execution of orders, credit, and buy side market development.

Buy/sell orders will be made for a specific number of units at a specific price, a bid or offer wanted, a best price over a certain amount, or an order at the current market. When an order is received, it will be entered into the PTS database, assigned a number, and become part of an internal tracking system. An order will be executed when the buying and selling parties come to terms on price and quantity. When an order is executed, the PTS manager will notify the parties by phone and follow with a hard copy confirmation. Parties will have a specific period of time to object to (DK) the trade. The service provider will settle the trade on a specific settlement date. The service provider will also settle the trade by clearing the funds between the buyer and seller and notify the parties that the trade has occurred and title has transferred. The service provider, along with the Clearinghouse will develop credit policies to ensure compliance with the trading policies.19

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18 Krueger, Bert, p. 9.
19 Clearinghouse Business Plan Outline (Draft), 1993.
Development of a buy side market is key to the success of the Clearinghouse's goal of developing a more liquid secondary market for commingled real estate fund shares. The service provider selected to manage the trading market will assist in the development of a buy side market by marketing the Clearinghouse and specific commingled funds being traded and to educate potential buyers as to how the Clearinghouse works. Marketing efforts will include seminars, appearances by management level personnel at conferences, preparation of written materials, advertising, issuance of press releases, mailings to qualified firms, and telemarketing by the PTS manager's personnel.²⁰

Trades will occur in an off-exchange electronic trading system. Similar to existing off-exchange trading systems such as the Arizona Stock Exchange (AZX) and Portfolio Systems for Institutional Trading (POSIT), the Clearinghouse trading system will be designed to accommodate use by institutional investors. Off-exchange electronic trading offers many advantages to institutional traders. They allow trades to occur after the public exchanges are closed, offer anonymity to participants, and the trading costs are usually less than those of public exchanges.²¹ By offering anonymity, the Clearinghouse will enable institutions to avoid letting the market know they want to acquire or sell a commingled fund holding. Another benefit to the electronic systems is a way to circumvent the built-in conflicts of interest of the broker dealer system, in which firms act both as agents, representing the client, and as dealers, trading for their own account against the client.²² Off-exchange electronic trading also allows traders to avoid front running. Front running occurs when a broker-dealer learns that a customer wants a security that the broker-dealer does not have, has a trader buy it from another party and turns around and sells it to the customer as a dealer, not as an agent or broker at an inflated price. Broker-dealers are able to do this because they can use their screens to access the prices at which other broker-

²¹ Winninghoff, Ellie, "Off-Exchange Trading Is Hot", Global Finance, Date unknown.
²² Ibid.
dealers are willing to sell or buy. Institutions do not have access to that information. On an electronic trading system, all participants have access to the same information.\footnote{Ibid.}

**Legal Requirements for Customers**

The service provider selected will require that investors who trade through the Clearinghouse will be provided access to sufficient information as required under the Securities Act of 1933, including amendments, to enable them to make informed decisions regarding trades.

**Standardization of Information**

Standardization of information can be broken into two categories - information standardization and availability, distribution and disclosure of information. It has been standard practice for commingled fund and separate account managers to make information available only to their investment clients and their investor's consultants, in a unique format. As a general rule, they have not made the information available to the broad institutional investor market. Many plan sponsors have complained about lack of consistency and standardization of information reporting among fund managers. Most fund managers insist that the information reported is proprietary and that it should be restricted in order to maintain competitive advantages. Some investment managers have even cited provisions of the ERISA to support a claim that it is their fiduciary responsibility to maintain information confidentiality.\footnote{Clearinghouse Business Plan Outline (Draft), 1993.}

In an effort to resolve the conflict over information disclosure and standardization, a task force of real estate industry associations was set up to find a solution. The task force consists of the National Council of Real Estate Investment Fiduciaries (NCREIF), the Pension Real Estate Association (PREA), and the National Association of Real Estate
Investment Managers. Their objective is to describe a program that will lead to information standardization about investment activities for pooled real estate investment entities and separate accounts. Their purpose consists of three tasks: problem definition, work program definition, and a request for services. Definition of the problem should reconcile the current information disclosure practices in the real estate investment industry and the un-met needs of information users. The work program design seeks to identify: 1) the anticipated process and the preferred timetable to develop information standards, 2) the required deliverables including expected level of details and documentation, 3) the characterization of the deliverables and ownership and publication rights associated with all deliverables, 4) the previous industry efforts and resources that should be reconciled during the course of the work program, and 5) various organizations and people that should be involved in the process for rendering information and review. A request for services and qualification should be prepared and distributed to candidate service providers to perform the work program.25

No information standards for the Clearinghouse have been set at the writing of this thesis. Many Clearinghouse organizers view the operation of the Clearinghouse as the best way to achieve information standardization and uniformity of reporting, which will result in lower information costs. Many also believe that the ideas put forth by the trade groups are a good benchmark for the standardization process and are best implemented through the Clearinghouse. One specific idea for information standardization is to use the Clearinghouse to make portfolio level data packages available to the institutional investor market via computer based electronic delivery systems. The Clearinghouse, as part of its role as a central facility, could become the primary data base for pension owned private, real estate securitized investments. The portfolio information would be readily delivered

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over existing electronic networks of established vendors such as Telerate, Reuters, and
Bloomberg, which reach approximately 200,000 screens.\textsuperscript{26}

Final discussions with regard to information disclosure will be a highly contested
issue by Clearinghouse members. Many industry participants acknowledge a problem with
the current amount and quality of private market real estate information, but have different
opinions on the standards for information disclosure and dissemination that should be set
going forward. Many investment managers and consultants believe that the amount of
information presently disclosed is sufficient, more information disclosure is not needed.
Some even believe that there is too much real estate data disclosed, much of it is not useful.
With a few exceptions, the investment managers and consultants interviewed believe that
the central issue regarding information is the need for more standardization, information
that is more understandable, easier to access and more comparable.\textsuperscript{27}

There is less agreement about the overall level of disclosure that should be made
available within the institutional real estate investment community. At present, there is no
consensus among investment managers on how information should be standardized and
distributed. Even though investment managers disclose varying levels of information,
almost all of the investment managers interviewed believe that the level of information
disclosure by their firms is an acceptable level for the entire industry. They also differed on
whether the information disclosed by public REITs should be the standard set for the entire
industry. Some believe that REIT disclosure levels are a good place to start the information
standardization process, while others believe that the private market already supplies more,
better quality information than do public REITs.\textsuperscript{28}

Many plan sponsors interviewed are not interested in information on funds in which
they are not invested, unless they plan to purchase into a new fund or plan to buy existing
fund units from another plan sponsor. Some are not interested because they do not plan to

\textsuperscript{26} Ibid.
\textsuperscript{27} Interviews with Investment Managers and Consultants, July 1994.
\textsuperscript{28} Interviews with Investment Managers, July 1994.
invest in commingled funds in the future and therefore see no need to track the market. Others do not have the time to use the information unless it is easy to access and quick to understand and compare. A few said that it would be nice to have the industry provide good information in a simple format to allow investors to compare information on all funds. Most of the fund managers interviewed are generally pleased with the amount and quality of information they receive from investment managers of commingled funds in which they are invested. They did indicate that their level of satisfaction depends upon the investment manager who provides the information, some are better than others.29

Clearinghouse Solutions to Commingled Fund Weaknesses

As discussed in chapter 2, a recent NAREIM study provided insight into the problems associated with institutional investment in real estate commingled funds. Issues of concern, as expressed by plan sponsors who were interviewed for the NAREIM study include: poor returns, conflict of interest between plan sponsors and investment managers, lack of liquidity, information weaknesses, and an overall concern with the performance of real estate fund managers. Organizers and supporters of the Clearinghouse believe that the Clearinghouse can play a significant roll to bring about improvement in those areas.30

Poor Returns

While the Clearinghouse will have no direct effect on real estate returns, its sponsors believe that information provided by Clearinghouse users combined with information from actual share trades will provided investors with more tools to use in the investment decision process. The Clearinghouse could lead to lower volatility in the private markets, which for most institutional investors would be a positive step forward.

29 Interviews with plan sponsors, July 1994.
Conflicts of Interest

The Clearinghouse will not directly resolve any of the conflicts of interest between investors and fund managers. However, it will allow investors to avoid conflicts of interests with fund managers by selling their commingled fund shares. Over time, the sale of commingled fund shares at prices that convey a clear dissatisfaction of the management structure of the fund could eventually lead managers to change management agreements to a structure that is more acceptable to institutional real estate investors.

Liquidity

The main goal of the Clearinghouse is not to provide liquidity, but to allow investors to price liquidity at the share level. However, by creating a central facility for the exchange of commingled fund information and a place where prospective buyers and sellers can find each other in confidence, Clearinghouse creators expect the current level of liquidity in the private real estate securities market to improve. The level of liquidity will be based on the number of investors that are exposed to seller desires to dispose of commingled fund shares. Clearinghouse creators believe that a central trading facility is a vast improvement over the current process of seeking buyers in the direct search or brokered markets because sellers can be assured of the best execution for their shares trades. Over time, as more investors begin to access the private real estate securities market, greater liquidity will be achieved.

Information Weaknesses

Clearinghouse creators expect the Clearinghouse to play the key role in achieving information standardization and distribution within the real estate investment industry in several ways. First, the quality of information regarding commingled funds will improve. Second, information will become more widely disseminated through delivery across electronic networks to a much broader audience of qualified buyers and sellers. Third,
managers will no longer be able to hold back information that could be better used to
determine the value of commingled fund units. Fourth, much information about
commingled fund values will be communicated to the marketplace from actual trades that
occur. Using available fund and property level information combined with the prices at
which trades occur, investors will be able to value investment components such as
management and liquidity. Prices will be set by buyers and sellers based on discount rates
specific to their fund, not based on a discount rate determined by an outside appraiser. It is
reasonable to assume that commingled funds that are perceived to be well managed and
responsive to investors will trade at prices higher than those that are not. Also, shares in
funds that trade more easily than other fund shares may receive a price premium for the
higher level of liquidity.

Management Performance

According to its creators, the Clearinghouse provides a simple way for investors to
send a message to managers that they are not satisfied with management performance.
Investors can sell their interests in the fund. In essence, the Clearinghouse will allow
market forces to be used to communicate the level of management that is acceptable to
investors.
Chapter Four
The Clearinghouse: A Perspective from Industry Participants

To determine whether the real estate industry is ready to accept a clearinghouse for commingled funds, interviews were conducted with real estate investment managers, real estate consultants, and pension fund plan sponsors and sponsors of endowments. Those interviewed discussed Clearinghouse advantages and disadvantages, the probability for success, the key factors for success, and implications for participants in the institutional real estate business.¹

Is the Clearinghouse a Good Idea?

Most industry participants either favor or are neutral to the Clearinghouse concept. Some do not think that a private trading market for institutional real estate investors, created by investment managers and consultants, is good for the long-term viability of the industry. Clearinghouse creators and supporters believe that the Clearinghouse effort is a necessary and positive response to a call for leadership by investors in the real estate asset class. They have designed the Clearinghouse to address many of the issues that have been cited by investors as problems or deficiencies within the private real estate investment market. Creators envision that the Clearinghouse can improve or resolve these issues to the betterment of the asset class as a whole.²

Those who disagree with the Clearinghouse concept would prefer to allow the present situation in the real estate market to run its course. They contend that what is occurring in the market is not new. Problems similar to those facing the real estate industry have occurred in other markets, such as venture capital. If left alone, the problems will be resolved by independent market forces. One opponent to the Clearinghouse asserts that

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¹ The industry participants interviewed are listed in the bibliography of this thesis.
some harm may even come out of creation of the Clearinghouse. This person is fearful that the Clearinghouse will create a market in which large, well-intentioned investors will "dump" their unwanted shares on small, uniformed investors and take advantage of their inexperience and limited information to the detriment of the long term viability of the industry. Clearinghouse supporters believe that institutional investors, with the assistance of investment managers and real estate consultants, are capable of making informed investment decisions regarding private real estate securities. They believe that engaging in the trading of these securities will enhance the long-term success of the real estate industry.3

Advantages of the Clearinghouse

Liquidity

The most often cited advantage of the Clearinghouse is that it will enhance the liquidity of commingled fund shares and other private real estate securities. While various industry participants have different viewpoints on the level of liquidity the Clearinghouse would create, most believe some level of improved liquidity is an advantage.4 One interviewee believes improved liquidity is essential in order to maintain and grow the level of investment in the real estate asset class going forward.5 Another concludes that liquidity is especially important to plan sponsors whose company needs to sell its real estate assets quickly, because of a corporate merger, bankruptcy, or other situation that would cause a pension plan to terminate. This interviewee holds the view that the real estate industry must work to rectify this problem in order to maintain real estate as a viable asset class in the future.6 More than one interviewee maintains that liquidity will provide flexibility to investors by allowing them to manage their own investments from a portfolio allocation

3 Interviews with Consultants, July 1994.
6 Ibid.
standpoint and alter investment allocation during the life of a private real estate investment fund.\textsuperscript{7} Other interviewees state that greater liquidity will bring new capital to the private real estate market. Some believe a greater amount of capital, caused by greater liquidity, will ultimately enhance the value of private security shares.\textsuperscript{8} Still another interviewee holds the view that the liquidity created by the Clearinghouse will provide an opportunity for investment managers to successfully offer more real estate products to the institutional real estate community.\textsuperscript{9}

**Pricing and Valuation**

Another advantage of the Clearinghouse cited by those interviewed is the creation of a pricing mechanism for shares or units in commingled funds and other private real estate securities. This pricing mechanism will lead to a valuation of real estate assets that more accurately represents the true worth of the market.\textsuperscript{11} They hold the view that a valuation of a private real estate fund based on transacted share prices between buyers and sellers in an auction market is an improvement over the existing practice of appraisal-based values.\textsuperscript{12}

**Standardization of Information**

The interviewees cite the standardization of information as another Clearinghouse advantage.\textsuperscript{13} Though they do not all agree on the amount and quality of information that should be provided by the Clearinghouse, they all acknowledge a need for an improvement of the current system. Before private real estate security markets can grow and move forward, some interviewees believe assessable standardized information is necessary.

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\textsuperscript{7} Ibid.
\textsuperscript{8} Interviews with Investment Managers and Plan Sponsors, July 1994.
\textsuperscript{9} Ibid.
\textsuperscript{11} Ibid.
\textsuperscript{12} Ibid.
\textsuperscript{13} Interviews with Plan Sponsors, Investment Managers, and Consultants, July 1994.
Greater Efficiency in the Private Real Estate Investment Market

According to some interviewees, the Clearinghouse will lead to a more efficient real estate investment market. It will do so on several fronts. First, it will allow investors to adjust portfolio allocations at the investment share level. Secondly, with pricing information resulting from actual trades and standardized information, investors will be able to engage in better apples-to-apples comparative analysis. Third, it will allow investors to price marginal liquidity. Some also contend that a more efficient market will eventually lead to greater participation by institutional investors.14

Disadvantages of the Clearinghouse

Most interviewees believe there are few disadvantages associated with the Institutional Real Estate Clearinghouse. It is an improvement over the present system.15 Of the disadvantages mentioned, two are considered by some to be advantages: valuation and a more efficient private real estate market. Some industry participants fear the trades that will occur through the Clearinghouse will potentially cause fund values to be based on the lowest share trade comparable, made by the most desperate seller in a particular fund. Thus, those who hold their shares will have their investments valued by a share price set by those who decide to sell at a great discount. Other interviewees cite the possible creation of a more efficient private real estate market as a disadvantage because they contend arbitrage profits can be made by investing in the private market using privileged or inside information.16 Another item mentioned by interviewees is the lack of a market maker. Some interviewees hold the view that a market maker is necessary to complete trades when buyers cannot find sellers and sellers cannot find buyers. Without a market maker, some believe the Clearinghouse will not succeed. Other interviewees do not believe the lack of a market maker should be considered a disadvantage of the Clearinghouse because there is no

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14 Ibid.
15 Ibid.
16 Interviews with Plan Sponsors and Investment managers, July 1994.
market maker in the present private market system. The Clearinghouse may be at a
disadvantage when compared to other markets because it does not have a market maker, but
it is not a disadvantage "of" the Clearinghouse. Other disadvantages cited include the cost
to create, access and operate the market and the time and effort that will be required to
provide information.17

Probability for Success

There is more uncertainty about whether the Clearinghouse will succeed than there
is about whether the concept should be tried. While not opposing the creation of the
Clearinghouse, some industry participants cite a number of reasons why the Clearinghouse
may not succeed.18 Those who doubt the viability of the Clearinghouse base their
skepticism on the lack of sellers at the probable bid level. One interviewee said that the
actual motivation to sell is not great enough to result in trades at prices that will attract
buyers. The interviewee said that pension funds invest for the long term and are not
willing to "take the hit" necessary to make trades at the prices required to attract buyers.
Investors would rather hold on to shares that they really do not want than approach their
board to seek approval to sell at a discount from net asset value. For example, this
interviewee's pension fund offered to purchase units in commingled funds from other plan
sponsor who had indicated a willingness to sell, but the other plan decided not to sell at a
price much less than net asset value. The fund would only sell at or near the par value of
the fund units. If this is the mentality of the private real estate security market, the
interviewee wondered why investors would be willing to pay fees to trade through the
Clearinghouse, if only to trade at or near net asset value.19

Another interviewee does not believe the Clearinghouse will generate enough trades
to be successful because investors can go directly to the market and obtain all information

required to execute a direct trade. According to this interviewee, there are a number of
buyers who are ready to purchase shares, but sellers are not willing to sell at prices
acceptable to the buyers. The problem with the market is pricing, not liquidity. The
Clearinghouse will not provide anything not already available to buyers in the private real
estate market. The interviewee stated that if sellers want to sell they can expose their
intentions to the entire industry by taking out an ad in an industry journal or magazine and
reach the universe of potential buyers just as easily as could the Clearinghouse. The
interviewee added that because the Clearinghouse does not provide a market maker, it is
essentially no different than the brokered or direct search markets already available to
investors.20

Other industry participants believe the Clearinghouse will succeed. They cite trades
at or near net asset value as evidence of the need for the Clearinghouse. According to these
interviewees, sellers are reluctant to go to their boards for approval to sell below net asset
value because they cannot be sure that they have exposed their desire to sell to the entire
industry. If they are forced to sell below net asset value, sellers can support the price
received to those they are accountable to by citing the sale exposure received through the
Clearinghouse. These interviewees also contend that the ability of investors to transact
anonymously through the Clearinghouse will push reluctant sellers to sell. Additionally, if
the Clearinghouse is successful in creating a more liquid market place, with better and more
widely disseminated and standardized information, some trades may occur at higher than
net asset value based on the viewpoint that those shares are undervalued and growth
opportunities lie ahead.21

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21 Ibid.
Key Factors for Success

The majority of interviewees indicated execution of trades, overcoming regulations, and quick formation and operation as key factors for the success of the Clearinghouse. The overwhelming element necessary for success mentioned was the need for people to actually trade through the Clearinghouse in sufficient volume to cover the cost of Clearinghouse operations. An active trading market was mentioned most often because of its affect on other issues key to the Clearinghouse's success, such as achieving a fair value for units traded.

Standardization of information was noted as a key to success because sufficient quantity and quality of information is seen as fundamental to the actual execution of trades. Some interviewees believe that investment managers and plan sponsors must be willing to provide needed information for dissemination throughout the industry to make an active trading market viable.

Legal and regulatory issues were also mentioned as key factors for the success of the Clearinghouse. Specifically mentioned were the legal issues surrounding the operation of the exchange outside the regulatory controls of the Securities and Exchange Commission (SEC) and legal issues involving the trading of commingled fund shares or units. Concern was also expressed about potential seller liability for sellers who provide information relied upon to complete a trade.

Broader support by consultants was mentioned by one interviewee as a key to success. This interviewee expressed concern that not all consultants were supportive of the Clearinghouse, which could harm the Clearinghouse effort by creating a division among investment managers and plan sponsors.

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23 Interviews with Investment Managers, July 1994.
24 Ibid.
Implications for Industry Participants

Formation and successful operation of the Clearinghouse could have significant implications for the following participants in the institutional investment business: institutional investors, investment consultants, investment broker-traders-dealers, investment analysts, and real estate managers. Those most affected will be the existing industry participants: plan sponsors, investment managers, and consultants.

Plan Sponsors

If successful, the Clearinghouse will offer plan sponsors the option of acquiring and disposing of existing commingled fund units with greater efficiency than is now available. Additionally, plan sponsors could offer new issues of private debt and equity securities backed by direct property holdings already owned by institutional investors in a separate account that once issued, would be tradable through the Clearinghouse. The Clearinghouse could also lead to manager and investment portfolio reviews based on independent information provided through the Clearinghouse information system.\(^{26}\)

Most plan sponsors do not believe that the Clearinghouse will affect their allocations to the real estate asset class, through either commingled funds or direct investment. Most said the percent of their plans' assets invested in real estate is a factor of the macro economic outlook, the expected real returns from the real estate asset class, and the expected real returns from other asset classes such as stocks and bonds. Plan sponsors interviewed that achieve diversification through direct investment (managed in-house or through investment managers) plan to continue their allocation to real estate investments regardless of the success or failure of the Clearinghouse. Their real estate investment strategy consists primarily of direct investments in real estate with occasional participation in commingled funds to "fill holes in their real estate portfolio" or achieve what they believe

\(^{26}\) Interviews with Consultants, July 1994.
to be excess returns from the purchase of existing commingled fund units at a discount. Generally, these plan sponsors plan to use the Clearinghouse to divest commingled fund units and re-invest in direct real estate investments.\textsuperscript{27}

Those plan sponsors interviewed who cannot achieve diversification through direct investment, are uncertain about their future level of investment in the real estate asset class. One plan sponsor interviewed commented that there is too much effort required to access the real estate asset class for the resulting return. "Real estate is too detailed and takes too much time for the reward. It takes 25\% of our investment staff's time to manage 10\% of our investment portfolio." If liquidity in the private markets were to improve, this plan sponsor may stay with the real estate class, but at the current level of liquidity, he does not believe investment in real estate is compelling. For this particular pension fund to return to investment in the real estate class, greater commingled fund liquidity would have to be present for secondary market units to ensure an exit strategy that does not require a huge discount from net asset value.\textsuperscript{28}

\textbf{Real Estate Investment Consultants}

New roles for real estate investment consultants originating from successful operation of the Clearinghouse include portfolio analysis regarding commingled fund buy-sell-hold strategies and search services for primary and intermediary buyers and sellers for their clients' investment interests in commingled fund shares. Not all consultants believe that the Clearinghouse will impact how their firms conduct business, however, most agree that some business opportunities will result because "any change brings some opportunity." Some consultants believe their services will become more valuable because a successful Clearinghouse will allow them to access information and become closer to actual transactions. Other consultants see many opportunities for their business as a result of the

\textsuperscript{27} Interviews with Plan Sponsors, July 1994.
\textsuperscript{28} Ibid.
Clearinghouse. One consultant is creating a rating scheme for commingled funds and plans to consult on new investment strategies on both the asset and share level with information generated on trades through the Clearinghouse.29

Investment Managers

The implications of the Clearinghouse for investment managers mentioned by interviewees are many.30 With the Clearinghouse in operation, some investment managers believe they will be better able to handle investors' demands for redemption, sale, or acquisition of interests in existing commingled funds and other pooled investment vehicles. If the Clearinghouse is successful in increasing participation in pooled real estate investments, the investment managers would be in a position to issue additional securities and expand the capitalization of the market for commingled funds. They may also be able to issue securities in connection with new commingled funds, convert clients' direct property holdings to collective investment vehicles, and merge or restructure existing commingled funds. Investment managers could also provide the service of acquisition and portfolio management of new issue or existing private real estate securities on behalf of clients. They may be able to better monitor financial, valuation and pricing trends of comparable funds that trade in the secondary market. Finally, they may be able to disseminate information on all commingled funds to existing and potential investors.31

Other investment managers do not anticipate much change as a result of Clearinghouse operations. Some cite the fact that they exclusively manage separate accounts and since the Clearinghouse is designed for commingled funds, its operation will not affect them. Other separate accounts managers may consider forming commingled funds should the Clearinghouse be successful. One interviewee foresees an opportunity to

29 Interviews with Consultants, July 1994.
31 Ibid.
consult on potential share acquisition, but believes that it would constitute a very small portion of their business.\(^{32}\)

**Service Providers and Other industry Participants**

Successful operation of the Clearinghouse could expand the number of services offered to Clearinghouse participants. Potential opportunities exist for: investment intermediaries, who would execute buy-sell orders of private security shares, facilitate the issuance of new private securities, and design and offer innovative financial instruments such as futures and options based on private real estate security prices; portfolio managers, who would implement portfolio strategies and perform risk-return analysis on private real estate securities with information made available through the Clearinghouse; and investment analysts who would analyze commingled funds on behalf of institutional investors for buy-hold-sell advisory and research services.\(^{33}\)

**Additional Clearinghouse Issues**

Although no immediate change is expected, many investment managers believe that if successful, the operation of the Clearinghouse will eventually lead to participation in the real estate private placement market by investors who have not participated in the past. According to some investment managers, the key to participation by investors who have avoided investment because of their investment portfolio's small size is sufficient liquidity and proof that the Clearinghouse can be used as an exit strategy.\(^{34}\)

In an effort to increase their investment management business, some investment managers are working individually to resolve issues important to institutional real estate investors. The focus of most of their efforts involves the creation of an investment vehicle designed to satisfy the concerns of investors. The private REIT is the vehicle being chosen

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\(^{32}\) Interviews with Investment Managers, July, 1994.

\(^{33}\) Interviews with Consultants, July, 1994.

\(^{34}\) Ibid.
by most investment managers for current commingled fund offerings. The private REIT is designed for: better governance, which includes an independent board of directors; improved transferability; alignment of manager and investor interests through innovative management compensation structures; improved information reporting; and greater liquidity, to be achieved by having a broader universe of potential investors (i.e. non institutional investors).

A final issue relevant to the Clearinghouse is the advantages of the private capital markets vis a vis the public capital markets, if any. This issue is important because the private real estate capital markets must offer some advantage over the public markets to maintain investment in the private markets in the future. Many people interviewed believe that both markets are viable, and at times each market offers pricing advantages over the other (as exemplified by pricing of regional malls and outlet malls by each market). Some believe there are times when investors should be in the public markets to a greater extent and vice versa. Other interviewees believe that the private markets offer better pricing, better management, and better expected returns, but know of no data confirming which market offers better returns. Other common responses emphasizing the benefits of the private markets include better information and greater control and discretion with regard to asset level decisions and lower security issuance costs (no investment banking fees).

Some consultants interviewed believe that the public markets are more efficient than the private markets, which allows for return enhancement in the private markets. Another mentioned benefit of the private real estate investment markets is the ability to exploit inside information. Others mentioned the focus on quarterly earnings performance in the public

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35 Ibid.
38 Ibid.
markets as a benefit to the private markets, which is also a good place for long term investors to earn higher expected returns.\textsuperscript{39}

Many plan sponsor decisions to invest in public real estate securities, such as REITs, are based on state law and investment policy more than market characteristics. Investment in REIT stocks are usually made by small cap stock managers as part of an equity security investment strategy. Some real estate investment managers at public funds do not invest in REITs because only 50\% of their entire portfolio is permitted by state law to be invested in public equity securities. The managers of the equity security portfolio are always at the 50\% level, leaving no option for investment in REITs by real estate managers.\textsuperscript{40}

\textsuperscript{39} Interviews with Consultants, July 1994.
\textsuperscript{40} Interviews with Plan Sponsors, July 1994.
Chapter Five
The Clearinghouse and the Future of the Private Real Estate Investment Markets

The concept of an organized trading market for privately placed, unregistered securities is nothing new. Since the adoption of Rule 144A by the SEC in April of 1990, an active secondary market has existed for a variety of privately placed equity and debt securities. Clearinghouse founders seek to bring the advantages associated with Rule 144A to the market for privately placed real estate securities (commingled funds). The goal of Clearinghouse organizers is to sponsor the secondary market for real estate commingled fund shares as an auction market to allow for best execution of traded shares and a more efficient transfer of information than presently exists.

The Clearinghouse is controversial because it represents significant change in institutional real estate investment practices. Some industry participants express concerns that the Clearinghouse changes will lessen the need for their services. They are also concerned that new opportunities created by active share trading could alter the traditional roles played by investment managers and consultants, opening the real estate advisory business to new competition.

While these concerns are valid, it is important to remember that significant change will occur in the private real estate investment market with or without the Clearinghouse. Clearinghouse effects on participants in institutional real estate investment should be compared with the future state of the institutional real estate investment market without the Clearinghouse, not its current state. Uncertainty exists concerning whether institutional investors will return to commingled funds as a way to access the real estate asset class. There is reason to believe that they will not return, unless significant changes occur.

To understand the risks and benefits associated with the Clearinghouse, one must consider the future of private institutional real estate investment market. The following five
scenarios address potential future outcomes for the present commingled fund investment market.

**Future Private Market Scenarios**

**Scenario 1: Wind Down**

Attracted to the high degree of control over their real estate investments and intent on exploiting private market inefficiencies, large pension funds and endowments will continue to invest directly in real estate or will own individual portfolios managed by a separate account manager. They will not participate in future commingled fund offerings and will insist that planned liquidation of closed-end funds occur as scheduled.

Unable to diversify through direct or separate account investing, medium sized funds will continue to avoid both direct investment and separate account investment. Concerned about asset based fees, limited exit strategies and general uncertainty about the commingled fund market, medium sized funds will eliminate investment in commingled funds and re-invest proceeds from the sale of closed-end fund assets in other investments, including public REITs.

Small funds, not large enough to access the commingled fund market and concerned about the same issues effecting medium sized funds, will remain out of the private real estate markets. They too will turn to the public REIT market to make real estate investments, providing real estate offers a compelling investment story. They will likely use security managers as part of a total portfolio strategy rather than real estate management specialists.

Over time, commingled fund managers will be forced to sell assets in closed-end funds. More money will exit the private security market than will enter. To maintain the level of investment management fees, commingled fund managers will manage portfolios of pubic REIT stocks or sponsor the creation and public offering of REITs. They will also
begin to increase their services to large pension funds and institutions which will increase competition with other established separate accounts managers.

Separate account managers will continue to increase the number and value of assets under management as large institutional investors grow in size and maintain the same percentage commitment to the real estate asset class. Faced with increased competition from commingled fund investment managers, separate account managers will lower fees and/or offer a performance based fee structure. They too will begin to manage portfolios of public REITs as investment moves from private to public vehicles.

The public REIT market will increase in size as public REITs encounter less competition to purchase quality real estate assets. Looking to grow in order to increase earnings and market capitalization, public REITs will be one of a few potential purchasers of assets sold from closed-end commingled funds in liquidation.

Scenario 2: Zero Sum Game

Similar to the wind down scenario, in the zero sum game scenario large pension funds and endowments will invest in real estate through direct investment or through separate account managers. Unlike the wind down scenario, medium sized institutional investors will invest in commingle funds, but only at the level of their current commitment. They will not increase the level of their participation in commingled funds. Small institutional investors will continue to be absent from private commingled funds.

Commingled fund managers will maintain their current level of business, by reinvesting money from commingled funds in liquidation or rolling over closed-end funds for a new fixed term. Growth in the value of assets under management will be limited to increases in the value of fund assets. Separate account managers will expand their business as large funds maintain their same percent commitment to the real estate asset class. In order to maintain the same volume of investment, fees will be restructured according to performance or be reduced outright for both commingled fund managers and separate
account managers. New assets under management will replace old assets at a new, lower fee structure. Lower fees will cause high cost service managers to either merge with other investment managers or exit the business.

The public REIT market will grow as medium and small institutional investors increase their participation in public REIT securities.

**Scenario Three: New Players**

Under the new player scenario, investment in commingled funds will be maintained or increased as new investment managers such as GE Capital, Fidelity, Koll/Bren, Sam Zell/Merrill Lynch, and others create new private market investment strategies attractive to all institutional investors, especially medium and small sized funds. Unsaddled by problems from the previous markets and structured to operate under new, performance based fee structures, these new investment managers will attract investment dollars away from managers who were active in the 1970's and 1980's. These new players in the private real estate markets will force existing managers to re-invent themselves, lose market share, or possibly discontinue operations.

**Scenario Four: Business As Usual**

Investment in real estate commingled funds will return to levels seen prior to the real estate slump of the late 1980's and early 1990's. The same investment managers will manage most of the new funds committed to the private commingled fund market. Attractive expected returns will be sufficient to attract institutional investors to commingled funds. No significant industry changes will be needed to increase institutional investment in commingled funds.
Scenario Five: Increased Investment in Commingled Funds

Through a change in the structure of the commingled fund market, such as that proposed by the members of the Institutional Real Estate Clearinghouse, investment in private real estate securities of all types will greatly increase. With proven tradability at prices acceptable to most investors and the expanding availability of cost effective, standardized information, institutional investors of all sizes will increase their allocation to real estate commingled funds. The market will expand to make room for new players. Investment managers will compete for a share of an "expanding pie".

The above mentioned scenarios are oversimplified, but the future of the institutional real estate investment markets will likely contain elements of some or all of the scenarios. Without some change in market structure, increased investment in commingled funds is unlikely to occur.

Investment managers have begun to make progress in solving some of the problems associated with investment in real estate commingled funds. Some investment managers have attempted to provide more investor control to enhance share tradability by structuring funds as REITs. Some of these private REITs contain provisions for an outside Board of Directors and even allow for termination of the investment manager with a vote of a simple majority of shareholders. Many investment managers have also restructured their fee schedules to include equity participation upon fund termination in an attempt to better align their interests with those of their investors.

These changes are an improvement over the previous commingled fund generation, but may not be sufficient to increase investor participation in commingled funds. The changes are minor compared to those proposed by the Clearinghouse founders. They merely represent alternatives to the existing system. The Clearinghouse represents a new system in the interface between investors and managers.
<table>
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<th>Scenario</th>
<th>Market for Commingled Funds: Future Scenarios</th>
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<td>Large institutions participate in real estate asset class through in-house or separate account direct investment.</td>
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<td><strong>Scenario 2</strong></td>
<td>Medium-sized institutions maintain current commitment to commingled funds.</td>
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<td><strong>Scenario 3</strong></td>
<td>Small institutions continue to avoid commingled funds.</td>
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<td><strong>Scenario 4</strong></td>
<td>Commingled fund managers forced to sell assets in closed-end funds. Begin to manage portfolios of public REIT stocks.</td>
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<td><strong>Scenario 5</strong></td>
<td>Separate account managers continue to sell assets in liquidation. Also begin to manage portfolios of public REIT stocks.</td>
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- **Increased investment**: A structural change in the commingled fund market, such as that proposed by The Clearinghouse, leads to increased participation in the commingled fund market by investors of all sizes.

- **New players in the market**: New participants in institutional real estate investment management竞争 with established managers.

- **High expected returns from real estate investments**: High expected returns from real estate investments are sufficient to bring investors back.
When considering the Clearinghouse, the two questions that industry participants must answer are: Should the Clearinghouse be put into operation? Does it have a reasonable prospect for success?

**Should the Clearinghouse be Put into Operation?**

**Investment Manager Perspective**

For those who want to see continued growth in commingled funds, which for obvious reasons includes every real estate investment manager, the Clearinghouse offers some good prospects to achieve that objective. The question each manager must ask is: Are the promised results of the Clearinghouse worth the potential risks to their business?

There is much uncertainty concerning whether institutional investors will use commingled funds to access the real estate asset class. Some evidence suggests they may not. Many large pension funds (approximately the largest 100 pension funds) will continue to invest in real estate. They will do so through direct investment, either in-house or through a separate account manager, not through commingled funds.

Medium and small sized pension funds cannot invest directly in real estate and achieve an acceptable level of diversification. This limits their participation in private real estate investment to collective investment vehicles such as commingled funds. Medium and small sized funds will likely avoid investment in commingled funds at levels in which they previously participated unless they can be assured of an exit strategy that does not require a substantial devaluation of their economic interest. They also have the ability to invest in a growing public REIT market, which was not as attractive an investment during the 1980's as it appears to be today.

There is also a growing need for liquidity due to the increase in defined contribution plans. This is true more for small and medium sized funds than it is for large funds. Large funds operating defined benefit plans can better afford a portion of their portfolio to be illiquid because they can rely on other portions of their portfolio to meet the liquidity needs.
of the pension fund. Additionally, large funds primarily invest directly in real estate, which gives them the ability to sell assets in order to gain liquidity. Commingled fund investors do not share this advantage. The investment manager controls the asset disposition decision and entity wind-down process. Medium and small sized investors are also more susceptible to the risks associated with illiquid investments because of the smaller size of their portfolios. Additionally, without the economies of scale enjoyed by large funds, most medium and small sized funds cannot justify the additional management time required to manage the real estate portion of their portfolio.

Without a realistic exit strategy many medium sized pension funds will not return to investment in commingled funds at the same levels they once invested. New pension funds will probably not enter the commingled fund market. They will not be able to justify the illiquidity risks, management time, and costs associated with commingled fund investment. This creates a problem for investment managers and those pension funds that do invest in commingled funds in the future. Fewer commingled participants will compound the illiquidity problems because even fewer buyers will exist for those investors who desire to exit the fund.

Some investment managers suggest that liquidity can be achieved by structuring commingled funds as private REITs and taking the private REIT public. While this would serve to expand the market of buyers for fund shares, it is not accomplished without cost and risk. First, significant consensus among fund participants would be needed to agree to take the REIT public. Second, the cost of accessing the public markets can be very expensive - up to 8% of the value of the REIT. Third, the pricing in the public markets may not be as attractive as in the private markets. Fourth, public REITs that are not self managed with substantial equity in the company have not been as well accepted by the public investment community. Fifth, while liquidity may be achieved, diversification and other private market benefits could be lost. Sixth, this idea is yet to be proven to actually work. It may be an improvement to the existing system, but it does not solve liquidity and
 informational problems. Seventh, the investment manager is essentially replacing its institutional investors with new investors. Substantial time and effort is required to effect this transaction.

Other investment managers point to the recent success of certain firms that have raised money for new commingled funds as evidence that investors will return to the commingled fund investment. The success of these firms may have more to do with investor confidence in the manager sponsoring the fund than in commingled funds in general. These recent successes are firm specific. The Clearinghouse is about the entire private real estate securities market. Firms that are successful under current market conditions will be even more successful once the Clearinghouse is in operation. They will be able to use their reputation in the industry to provide more services to clients.

There are some claims that some investment managers are privately scared to death that the Clearinghouse may actually go into operation. They cite concerns that commingled fund units would trade at a discount to net asset value, casting doubt on the validity of appraisals of fund properties - limiting fees and limiting jobs.¹ Will fees and jobs be maintained without the Clearinghouse? Once again, investment managers must compare the impact of the Clearinghouse to the impact of no change at all.

Many investors will invest in the private real estate markets, including commingled funds, if the structure of the market can be changed to better meet their investment needs. The problem is structural. Investors need a more cost effective and efficient way to enter and exit the market. Investment managers have the ability to re-structure the commingled fund market, but it will require significant change. Of all the ideas put forward to improve investment conditions for commingle:¹ funds, only the Institutional Real Estate Clearinghouse involves changing the system of investment. It attempts to provide investors best execution for share trades, allows for easier market entry and exit, and seeks to create an environment that could lead to greater investor participation and market

expansion. New investor participation could lead to increased liquidity and investor control. It could also lead to increases in the number of assets managed by investment managers, which would increase investment management fees and jobs. All things considered, investment managers should support the Clearinghouse.

Before addressing the institutional investors' perspective regarding the Clearinghouse, the reader should be reminded of the role of pension funds. Pension funds exist to provide retirement income for the beneficiaries of the pension plan. Pension fund investment goals are not to earn high returns at high risk levels. They seek to preserve capital and hedge against the negative effects of inflation. To achieve these goals pension funds must earn a real rate of return sufficient to cover the operating expenses of the fund, assuming capital contributions are adequate to provide for a fully funded retirement plan. Considering the role pension funds play, there is no reason for a fund to take risks to earn any more than a moderate rate of return. IRS rules even provide a disincentive for pension funds to earn high returns by reclassifying income deemed to be excessive as UBTI and taxing it accordingly. Consistent with pension fund goals, most managers target real rates of return in a range of 6% - 9%. Given their investment goals, it seems logical that pension funds would favor a more efficient, less volatile real estate investment market. The Clearinghouse could make private real estate investment more consistent with pension fund investment goals.

The Clearinghouse will not solve short term problems associated with commingled fund investment. It is a proposed long term solution to the inefficiencies in the commingled fund market. If commingled fund investors want to preserve the investment characteristics of the private market and also desire a more efficient market that offers liquidity negotiated between principals, the Clearinghouse provides a possible solution.
The Large Pension Fund Perspective

Large pension plans, which consist of approximately the largest 100 pension funds, can afford to invest directly in real estate through either in-house management or through the services of a separate account manager. They do not presently have to worry about the liquidity limitations of their investments. The other portions of their mixed asset portfolio will provide sufficient liquidity to meet the liability demands of the fund. Someday, however, the large plans will need to sell their real estate investments, whether to time local market conditions and maximize returns or to re-allocate a portion of their portfolio to a better performing asset class. At these times, large pension plans would benefit from the existence of a private security secondary market. Without a viable commingled fund market, large pension funds will be limited to sell at the asset level. They will face high transaction costs and will be subject to local property market conditions. It can be argued that even large funds have a vested interest in the market for commingled funds. An active commingled fund market would provide another viable venue into which large pension plans could sell their real estate assets. It would also provide an alternative way to restructure real estate investment portfolios.

Some industry participants argue that large pension plans can benefit from the inefficiencies that currently exist in the private real estate markets. They can use proprietary information and superior investment expertise to increase returns without increasing risk. If this is true, the Clearinghouse may actually be a disadvantage to large fund real estate investors. It will lessen their ability to earn arbitrage profits in the private real estate market. In practice, however, arbitrage profits have rarely occurred. They are also not consistent with the pension funds' goal to earn moderate returns in order to provide retirement benefits for plan beneficiaries. If arbitrage profits do not exist, and an efficient market is consistent with pension fund investment goals, should not large pension fund investors welcome the anticipated effects of the Clearinghouse? If the Clearinghouse

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works, would not all pension funds have access to a less risky private real estate investment market? Would not a less risky investment market combined with continued access to real estate class through the private market, with its diversification and inflation hedge benefits, outweigh the potential possibility for large funds to earn arbitrage profits on what is effectively 10% of their portfolio? If so, large pension funds should logically support the Clearinghouse because they have more to gain from its successful operation than they would gain if the current real estate private market structure remains unchanged.

Medium and Small Pension Fund Perspective

Generally speaking, medium and small sized funds cannot invest directly in real estate properties because they cannot achieve an acceptable level of diversification. They are limited to collective investment vehicles such as commingled funds. Medium and small sized pension funds will continue to hesitate before investing in commingled funds until they can be assured of an exit strategy that does not require a significant devaluation of their commingled fund interests.

Additionally, medium and small sized pension funds do not have the economies of scale enjoyed by large pension funds. Most cannot justify the additional management time and costs required to manage the real estate portion of their portfolio. These funds would greatly benefit from a more efficient and cost effective private real estate investment market that could occur as a result of the Clearinghouse.

Liquidity is more important to medium and small pension funds than it is to large pension funds because liquidity is needed to effectively manage their funds in the best interests of their beneficiaries. This is especially true of the growing defined contribution portion of retirement funds. When employees desire distributions from their retirement plan, such as during times of unemployment, managers of their money must have a viable means to provide liquidity without significantly reducing the investors return. Investors do not have time to wait for real estate market conditions to improve before they can access
their money. Nor can they afford to sacrifice a portion of their retirement benefits to pay for the lack of liquidity historically associated with commingled real estate funds.

Medium and small sized pension funds would benefit most from the successful operation of the Clearinghouse. They would be able to begin or continue investment in the real estate private markets, gaining the diversification and inflation hedge advantages of such investments, without subjecting the fund to the risks associated with limited exit strategies. They should support the Clearinghouse.

Does the Clearinghouse Have a Reasonable Prospect for Success?

As stated by many industry participants interviewed for this thesis, sufficient trading activity to cover operating costs is key to the success of the Clearinghouse\(^3\). The following three scenarios consider the potential trading levels and their effects on the Clearinghouse.

Clearinghouse Success Scenarios

**Scenario One: Light Trading**

Trading through the Clearinghouse is light. Fees from trades that do occur are insufficient to cover the costs of operation. Clearinghouse members are not willing to subsidize costs of operation. After an initial trial period, the Clearinghouse closes as a trading facility. Information standardization and disclosure efforts furthered by the Clearinghouse are continued through other industry groups. Commingled fund owners become aware of the established industry players that are prepared to trade shares. Trading growth continues in the brokered and direct search markets.

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\(^3\) Interviews with Plan Sponsors, Investment Managers, and Consultants, July 1994.
Scenario Two: Moderate Trading

Investors trade through the Clearinghouse in moderate amounts. Enough fees are generated to cover costs of basic operation. Information standardization and dissemination helps to make markets more efficient. Investors begin to use Clearinghouse trade information to price real estate private market investments. Investors begin to include secondary market commingled fund shares in their real estate portfolio strategy.

Scenario Three: Heavy Trading

Significant trading occurs through the Clearinghouse. Trading fees exceed the costs of operation and surplus revenues are distributed to the original investors. New players such as investment banks begin to use the Clearinghouse as a way to introduce financial services to customers. Private commingled fund shares become more liquid. New classes of investors begin to access real estate investments through the Clearinghouse. New types of private real estate securities (private mortgage backed securities) begin to trade through the Clearinghouse.

Institutional real estate investors will determine which of the above mentioned scenarios occur. If investors trade commingled fund shares, the Clearinghouse will be successful. If they do not trade, it will fail as a trading market. Indirectly, managers and consultants will have an impact on the Clearinghouse's relative success. They will influence their clients by recommending buy, sell, and hold strategies. If they strongly recommend trading, investors will likely trade. If managers and consultants do not recommend or discourage trading, investors will likely not trade.

Another key factor for the success of the Clearinghouse is the exposure it receives in the investment community. At present, institutional real estate investors are not completely informed about the Clearinghouse. Clearinghouse founders must educate the industry about Clearinghouse benefits over the long term. They must also teach investors
how to trade their commingled fund shares. Investors understanding of the Clearinghouse and their knowledge of how to use it is a key to success.

**Conclusion**

Institutional investment in private real estate is positioned for tremendous growth. Most property markets are at the bottom of a cycle while the pool of institutional money available for investment continues to expand. Stock and bond markets are showing signs of increased volatility and many investors are expressing concerns about inflation. Now is an excellent time for institutional investors to increase their allocation to private real estate investments. This presents an opportunity for real estate investment managers.

To increase institutional investment in the private real estate market, the present investment system must be changed. Today's institutional investors require a greater level of control over their investments. The growing pool of defined contribution plans require greater liquidity. All investors want more flexibility to implement dynamic portfolio strategies. The present system does not offer these investors the investment control and flexibility they require.

This thesis has discussed the real estate investment process and the real estate investment opportunities presently available to institutional investors. It has also explained investor dissatisfaction with the current structure of the private real estate investment market. Much of the paper has focused on one proposed solution to the problems associated with the private real estate investment market - The Institutional Real Estate Clearinghouse.

The Clearinghouse attempts to create a new system or process for institutional investment in real estate. It is designed to address investor concerns about the present system, while maintaining the integrity of the private market. It represents a new way of thinking about investment in real estate. The Clearinghouse seeks to create a more efficient and cost effective system for the distribution of capital.
The Clearinghouse may not be a perfect solution to private market problems, but it is the best solution available to the industry today. It addresses investor concerns with the present system and provides an intelligent argument for investors to increase investment in private real estate. To be successful, the Clearinghouse must receive support from current industry participants - institutional investors, managers, and consultants. Investors must be educated about Clearinghouse benefits. Investment managers and consultants must support the Clearinghouse by actively encouraging investors to use it with appropriate discipline in pursuit of investment goals. The success of the Clearinghouse depends on the industry's ability to realize that the Clearinghouse represents positive change and new opportunity.
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