LIQUIDITY ISSUES IN
DOMESTIC PENSION FUND
REAL ESTATE INVESTMENTS

by
Lynn A. Fitzpatrick

B.A., Tufts University

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Signature of the author ________________________________
Lynn A. Fitzpatrick
Department of Urban Studies and Planning
September 1991

Certified by ________________________________
Marc A. Léouargand
Lecturer in Urban Studies and Planning
Thesis Advisor

Accepted by ________________________________
Gloria Schuck
Chairperson
Interdepartmental Degree Program
in Real Estate Development

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LYNN A. FITZPATRICK

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Abstract

This paper examines liquidity issues encountered by domestic pension funds during their history of involvement in equity real estate investment. It examines allocation, compensation, appraisal based return and transactions cost issues as they relate to liquidity in closed-end and open-end commingled fund investment and direct separate account investment. Past and present strategies for disposing of real estate assets are reviewed, followed by the introduction of portfolio management and dispositions matrix.

During the 1970's and 1980's pension funds concentrated their efforts on growing their portfolios through the acquisition of properties. It was not until this recent real estate downcycle that portfolio managers, consultants and advisors started to focus their attention on liquidity issues in this asset class. Having amassed significant holdings, pension funds should examine the contribution of individual assets to meeting portfolio goals rather than make dispositions decisions exclusively on a property specific basis.

Thesis Supervisor: Marc A. Louargand
Title: Lecturer
Department of Urban Studies and Planning
Introduction

During the decade of the 1980's domestic pension funds' investment in real estate surged from roughly $3 billion to slightly over $100 billion.[15] With relatively little experience in this asset class, they became the predominant owners of what has become known as "institutional quality" real estate. Consultants and investment advisory services have thrived on assisting pension funds in determining and implementing investment strategies. Historically, the pension funds, consultants and advisors have concentrated their efforts on acquiring properties. Once real estate portfolios grew to the point where annual acquisitions represented a small portion of the overall investment in real estate, pension plan sponsors, consultants and advisors started to pay more attention to portfolio goals. Their efforts were still concentrated on transactions, primarily acquisitions, but with portfolio returns tapering off and declining starting in the late 1980's, asset management and liquidity issues became of paramount concern.

This thesis examines trends in the involvement of pension funds in real estate, emphasizing motivations for the disposition of assets from portfolios, whether they be commingled funds managed by advisors of pension fund portfolios created through direct separate account investment. Because only a small body of literature exists regarding dispositions strategies and processes, the analysis relies on interviews with plan sponsors and advisors.
Chapter 1 provides an historical overview of domestic pension plan sponsors' early foray into real estate investment through open-end and closed-end commingled real estate funds. Following a brief discussion of ERISA, allocation and compensation issues are addressed.

Chapter 2 studies allocation issues as they relate to pension fund involvement in commingled funds during the late 1980's. Citing particular funds as examples. The chapter includes an examination of larger plan sponsors' quest for control over their investments by the move from commingled funds toward direct separate account investment.

Chapter 3 discusses some of the qualities that separate real estate investment from other forms of investment by considering the vagaries of appraisal based returns and transactions costs.

Chapter 4 addresses portfolio managers' past and present dispositions strategies by reviewing the findings of a study completed in 1988 and by recounting and analyzing excerpts from advisors' responses to a 1990 public pension fund RFP. The chapter concludes with a framework for establishing a portfolio dispositions strategy by taking property specific and market factors into consideration.

Chapter 5 contains a discussion of how liquidity issues have been handled in the past and offers suggestions as to how to confront current liquidity issues.
Chapter I

U.S. Pension Fund Investment in Real Estate - An Overview

1.1 The Beginnings

Domestic pension funds, with assets valued at over $2.8 trillion in 1990, represent the largest source of long-term capital in the United States. [1] Pension fund investments have shifted over the years from a concentration in bonds during the 1950's to a heavy weighting in stocks during the early 1970's. [6] Pension funds have a history of involvement in commingled funds. Commingled funds, whether they be managed by banks, insurance companies or independent investment advisors, pool contributions from pension plans who believe that the fund manager's investment goals match their objectives. With contributions exclusively from pension funds, these commingled accounts are tax exempt. This vehicle was often used as a means for plan sponsors, particularly smaller ones, to invest their monies and diversify their portfolios. Initially, pension funds participated in stock and bond commingled funds. As plan contributions grew, investment advisors created a wide variety of special interest commingled funds. The commingled real estate fund business evolved in a manner similar to that of the securities fund business, with the initial commingled funds such as those managed by Prudential Insurance Company and Equitable Life Assurance Company, having broad diversification strategies. Gradually specialized funds that would invest in a particular property type or geographic area were offered. Commingled real estate funds could be structured as limited partnerships, tax-
exempt corporations, private real estate investment trusts or group trusts.

Both public and private pension fund managers are subject to the scrutiny of their annuitants. On the public side their performance may be addressed in the political arena, while on the private side they must operate under ERISA, the Employee Retirement Income Security Act of 1974. ERISA established the guidelines for pension fund fiduciaries. A fiduciary is personally liable for the money given to him to invest; is subject to the prudent man rule; is limited to investment decisions by ERISA's prohibited transactions rules (designed to prevent self-dealing and conflicts of interest by fiduciaries); and is constrained as to how he charges a plan for his services. As a "prudent man" he must diversify risks so as to minimize the risks of large losses." With ERISA, many funds looked to real estate as an additional class into which to diversify. It provided a long-term income stream with potential for appreciation. To achieve the effects of diversification many pension funds targeted a ten to fifteen percent allocation of their entire pension fund toward investment in real estate. While a fiduciary has discretion over the investment of funds, he often distances his responsibility by hiring investment consultants and advisors. Because many pension funds were inexperienced in real estate investment and active property management, they sought the assistance of real estate advisors who usually initiated them into real estate investing through the participation in a commingled fund first, and later through direct investments. Pension funds
expect their advisors to adhere to the "prudent expert" standard, embracing the prudent decision making process typically employed by experts in the areas of real estate acquisition, operation, disposition and portfolio management.[2]

Pension fund involvement in equity real estate began in the late 1960's with a commingled fund started by Wachovia Bank and Trust Co. in 1968. During the late 1960's and early 1970's other banks and insurance companies followed suit; finally in 1975 an independent investment manager, Rosenberg Capital Management offered a commingled equity real estate fund, the Rosenberg Real Estate Equity Fund (RREEF). With stocks and bonds outperforming commingled real estate fund returns and with the collapse of the REITs in 1974, there was little interest in real estate equities until the late 1970's when Prudential Property Investment Separate Account (PRISA) and other commingled equity real estate funds' returns surged well into the double digits, outperforming other investment returns and inflation. Equity real estate investment managers and pension fund managers perceived real estate to be the ultimate portfolio hedge against inflation and pressed for greater involvement in this asset class. PRISA, the largest and most successfully marketed commingled equity real estate fund, represented the most broadly diversified basket of equity real estate investments and, therefore was used by many pension fund managers to make their initial foray into real estate investing. Prudential, Equitable, Aetna and RREEF dominated the commingled business, yet well over one hundred other managers had swarmed into
the business by 1982.[29]

Managers and pension funds alike could not satisfy their appetite for real estate investments. Both earned high returns in this fledgling business. Real estate investment advisory fees were among the most lucrative in the money management field. Like kids in a candy store, neither party could get enough.

These commingled equity real estate funds were structured as open-end or closed-end. Open-end fund managers allow participants to join at any point during the fund's operating history and allow flexibility in exiting a fund so long as there is adequate liquidity to redeem units through the sale of properties or from operating cash flows. A closed-end fund will invest only those funds committed in its initial offering and is designed to be liquidated after a finite period. As pension plan sponsors and real estate managers became more sophisticated and comfortable in making real estate investments they began to make direct, rather than commingled, investments in real estate.

Whether these commingled funds are run by banks, insurance companies or independent advisors, most commingled real estate funds have the same investment strategy. "They buy complete ownership in the highest quality and most prestigious property they can find and rarely sell it. Most would never consider buying a property with the intention of selling it in two years and making a profit... few properties, once parked in a commingled fund portfolio, ever find the exit."[29]

"Institutional quality" real estate, that is sought by pension
fund investment advisors for unleveraged equity purchases includes the "best properties", almost exclusively including well-leased industrial, office and retail developments in "top-tier" cities throughout the United States. As advisors chase the same product from one demographically sound market to another, prices rise for finished product and the development market gets overheated. Although there are some advisors who do add value by aggressively managing properties, or by purchasing them to rehabilitate or expand them, only a limited number of commingled funds and advisors take on developmental risk.

Regardless of the method of investment, properties purchased by institutional real estate investors rarely are ever sold. The data base used by Miles, Guilkey and Cole for research reported in "The Motivation for Institutional Real Estate Sales and Implications for Asset Class Returns", includes a total of 277 investment-grade properties that had been sold out of the 1,001 property Russell-NCREIF index from its inception in January 1978 through December 1986. At March 1991 the Russell-NCREIF Index includes 1,506 properties valued at $22.18 billion. An updated comparable data set, currently being analyzed by Brian Webb, David Guilkey and Mike Miles, reveals that 569 properties have been sold out of the Russell-NCREIF index through 1990. Only one third of the the

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*In the course of the data collection process, it was determined that 70 properties from a sample of 347 properties were unsuitable for study, resulting in a sample set of 277.

A total number of 726 properties were sold out of the index through 1990, some of these did not qualify for the study because they did not represent arms lengths transactions or they became
properties in the index had been traded over the past thirteen years, equating to a 3 percent turnover per year. This transaction rate pales in comparison the activity reported in the other portfolios held by domestic pension funds. As reported in a July 29, 1991 *Fortune* article, The Council of Institutional Investors calculates that its members keep their stocks an average of more than four years. CalPERS, an anomaly, holds their for an average of eight years.[31] The turnover rates in these portfolios is 25 percent and 12.5 percent, respectively; significantly higher than the turnover behavior in tax-exempt real estate portfolios. While this affirms the widely held view that real estate assets are sold infrequently, it begs the question as to why they are not sold and if they are, what are the advisors' and sponsors' motivations for selling.

1.2 Allocations

Although real estate represents over half of the total wealth portfolio of the United States, many of the larger plans determined that to achieve any of the benefits of diversification they needed to allocate a minimum of 10 to 15 percent of their total pool of funds to real estate.[28] Once the larger plans had made a commitment to real estate investment their allocation goal generally remained static, and not being able to reinvest dispositions dollars in real estate was of minor consequence to many plan sponsors. Recently, as real estate returns have levered transactions.
declined, sponsors, advisors and consultants have conducted extensive studies to plead the case for investing in real estate. Some funds whose targets used to be approximately ten percent of total invested funds, now have instructions not to exceed ten percent. Of the funds interviewed, most were at or near their targeted allocation. The time it took them to reach that target partially reflects on their attitude toward dispositions. Those that had reached their target early were more likely to have considered turning away from commingled investment toward separate account investment; and, as their portfolios grew, traded up to into investments in larger properties to accomplish their diversification objectives. Those that had not attained their allocation targets were more concerned with how to place dollars than how to get the highest returns. Many of these funds, with the help of their advisors, clearly missed a window of opportunity during the late 1980's to realize good returns rather than to concentrate on acquisitions. One plan sponsor remarked that his plan would have been light years ahead had they timed the market correctly. We may be too early in the real estate investment cycle to determine what the foregone opportunity costs of not selling in the late 1980's and holding through the current down market are versus selling at the peak and purchasing in a rising cap rate environment.

Commingled fund and many separate account returns have declined over the past three years. As returns for open-ended funds' returns plummeted from a median return of 8.6% in 1989 to an
estimated return of between 5.0% and 6.0% for 1990, pension fund managers have been implementing more stringent reporting requirements while at the same time placing downward pressure on advisory fees.[14] This is especially true of the separate account business where negotiations are among fewer parties. Currently, the average fee charged by most commingled funds is 1.25% of assets under management and separate account fees are about .80%.[12] The more creative sponsors and more aggressive advisory firms have led the march toward incentive compensation fees. Arrangements whereby the sponsor awards ten percent of the profits above a five percent real rate of return or where the advisor is awarded a portion of the residual amount after obtaining a hurdle rate of return for the investor, are being negotiated with more frequency. Investors are shifting toward compensating for realized appreciation, not for unrealized appreciation as reported in appraisals. As these arrangements become more commonplace, advisors are taking on more of an entrepreneurial mindset and the gap between the institutional pension fund business and the income property business is narrowing.

1.3 Early Compensation

Owner and manager compensation in the income property business is typically tied to the performance of the properties purchased. However, traditionally, in the pension fund business, real estate advisors have been paid on a fixed fee based on the amount of money, or the asset value, under management. This traditional fee
arrangement discourages advisors from selling and encourages the acquisition of assets; the larger the acquisitions volume and the greater the asset value the greater the compensation. The advisors' motivations were not fully in synch with those of the sponsors. Advisors were trying to grow portfolios while the sponsors had the added responsibility of diversifying their overall investment portfolios into assets that generated good returns. As more than one large plan sponsor recalls, "there was no attempt at income averaging, and little regard for market timing, the dollars went in fast." Some individual sponsors acquired upwards of one billion dollars a year during the early to mid 1980's, some reached their targeted allocations within as little as two years. While funds were occupied with trying to achieve their targeted allocation the emphasis was on acquiring properties and little regard was given to selling. To dispose of a property was to take a step backwards from reaching the goal. Unless a property was dragging the overall fund's rate of return down significantly, the manager had no motivation whatsoever to sell, so properties remained parked in funds indefinitely.

Compensation of real estate investment advisors, whether it be for the management of commingled account or separate account business has been lucrative, particularly when compared to the fees earned on managing stock and bond portfolios. Whereas stock and bond managers often earn less than 50 basis points on their assets under management, through the end of the 1980's real estate advisory fee structures were significantly higher. In addition to
charging a 50 to 100 basis point fee on invested dollars or the value of assets under management, advisors would often charge transactions fees.[11] A one percent acquisitions and a one percent dispositions fee was not uncommon. Initially, sponsors complained about these fees, yet they could not support their arguments because they had very little expertise in real estate investment and management. Sponsors were persuaded that the management of real estate assets is much more intensive than that of securities portfolios. While the prospectus would outline acquisitions, management and dispositions fees it often did not detail other fees. These administrative and on-site management fees were often buried in the operating expenses of the properties. In any event, a significant percentage of annual investment income could easily be eaten up by fees charged by managers, even when annual returns to real estate were in the double digits.

These arrangements prevailed throughout the inflationary period of the 1980's. During the late 1980's, when property returns fell below those of treasury bills and with the effects of the Tax Reform Act of 1986 and the overbuilding of the United States' real property markets, sponsors began to question the returns they were receiving on their real estate investments. Compensation, asset quality, management and liquidity issues began to arise. While advisors have been called upon to make research material available to their sponsors, they have also had a more demanding reporting requirement place upon them. Pension funds that used to be silent investors are asking questions and expecting accountability. Funds
are requiring advisors to present annual investment plans in which the advisor discusses the outlook on real estate investing and makes recommendations on property types, investment structures and markets. Properties managed on behalf of a pension plan are reviewed in detail annually while returns are calculated quarterly.

California Public Employees Retirement System (CalPERS), with a net asset value of their 96 property portfolio at approximately $5 billion, paid $13.3 million in asset management fees in 1989, not to mention consulting, accounting and staff overhead. CalPERS and other pension funds have begun to scrutinize the fees charged by their existing and perspective real estate advisors. Formerly, when responding to CalPERS' RFP's, separate account advisors did not give much consideration to asset management fees. Advisors kept themselves in the running for the business with responses such as, "we are willing to entertain fixed or incentive fees". Of late, they are required to bid for the business and CalPERS emphasizes fee structure in evaluating advisors. In 1990 CalPERS announced a cap of $500,000 per year per building plus an additional 20 basis points on the amount that the property exceeds $100 million. History has given these pension funds a greater understanding of the actual costs of managing a building and the cost of the overlay of advisory services. One public plan sponsor maintains that as a plan sponsor he has no desire not to see the asset manager make money, but he objects to the spreads that they have been making.

With high margins, advisors could afford to grow their staffs.
Recently, as developers and advisory firms are struggling to stay alive, staffs have been reduced. Those with the leanest, most efficient staffs and those most in need of the business fanned the flames of competitive pricing. In response to a large pension fund's recent RFP, managers quoted acquisitions fees ranging from 75 basis points to 150 basis points on a $20 million asset and 25 to 100 basis points on a $200 million project. Asset management fees on a $200 million and a $600 million portfolio ranged from 60 to 125 basis points and 35 to 125 basis points, respectively.[21] Consider dispositions fees based on a 1 to 1.25 percent of the residual value of the building. Are the asset manager's motivations similar to those of the owner? When dispositions fees were in the same range as asset management fees and legal, engineering and other closing costs were netted out of the sponsor's returns upon liquidation, there was not much incentive to sell. The asset manager could retain the building a part of his routine and continue to collect a management fee. The asset manager, if he were to sell a property could go without acquiring a property for an equivalent amount for approximately one year.

Plan sponsors have placed more downward pressure on asset management and acquisitions fees than they have on dispositions fees, to the point where in some cases the dispositions fee may be twice as much as the ongoing asset management fee. When the asset manager can earn on one transaction what he would normally make in two years of property maintenance and reporting, it probably does make sense to encourage a sale. In this market, however, it may
take an asset manager or dispositions professional as long a two
years to sell the property.

Advisors are wary of being accused of churning accounts. If you
consider the transactions in the Russell-NCREIF property index,
they could hardly be accused of this. They did not have to churn
accounts, because in the past, provided the advisor's performance
stacked up with others in the field, there was always money to be
invested in real estate. Now, if a property is sold, an advisor
often has to work hard to get a pension fund investor to come off
of the side lines and put his money into real estate. Many funds
have placed a ceiling on their real estate allocations. A survey
conducted by Greenwich Associates reported new pension fund
investment in real estate increased by $1.6 billion from 1989 to
1990, with private pension fund investment in real estate declining
by $1.6 billion from $51 billion to $49.4 billion and public fund
investment increasing by $3.2 billion from $34.9 billion to $38.1
billion.[32]

Turnover in portfolios has been low, so too have returns to
sponsors. In fact, CalPERS reported that "fourth quarter, 1990
returns were almost categorically negative. The nominal after fee
return on the total portfolio was -4.5%", with only one of its
direct separate account advisor portfolios showing positive returns
both before and after fees.[35] Short of an instantaneous
turnaround in the domestic real estate market, how can CalPERS and
others caught with negative returns start to use their funds to pay
their annuitants rather than their advisors?
As portfolios are transferred from one manager to another, some sponsors are paying only for value added. Arrangements may be struck whereby the advisor is awarded a specified percentage of any growth in cash flow in addition to a portion of the difference between the net sales price and the value agreed upon the at assumption of the management contract. This does not give the advisor much of a chance to hedge his downside. He must weigh the cost of his management services with those of the incremental gains that can be made on the property and the portfolio. In trying to align asset managers' and property managers' objectives with those of pension fund portfolio managers', some portfolio managers are agreeing to provide base compensation relating to leasing status and cash flow and an incentive arrangement above and beyond the floor.

Another step in the evolution of pension fund investment may be to take the investment and management function in house. This alternative is being considered by larger plans who have been involved with this asset class for some time and whose fiduciaries are seasoned in real estate. Employing an in-house investment staff allows the plan to be aware of all of its costs, including property management and administration. It allows the staff to concentrate on its own properties and the acquisition and disposition of properties to meet specific needs within the portfolio. While these plans may not be paying consulting and advisory fees, they run the risk of not being able to attract additional knowledgeable real estate professionals because of the
compensation guidelines which are in place for the rest of the organization. Institutional real estate compensation is higher than that of the public sector and many corporate salary structures. Another alternative would be to devise a way whereby investments in institutional quality real estate could be made more liquid, i.e. securitization by way of real estate investment trusts (REIT's) or the securitization of individual assets such as has been done on the Rockefeller Plaza Complex in New York. The topic of securitization will be discussed in Chapter III.
Chapter II
Illiqidity and the Quest for Control

2.1 The mounting withdrawal requests of the late 1980's

Some pension fund managers sought methods by which they could gain more control over their real estate portfolios and the fees they were being charged. After having tested the waters and confirmed real estate as an asset class, funds such as OhioPERS and IBM made a conscious decision in the late 1980's to end their involvement in commingled real estate funds and to pursue direct investments through advisors. While they went to the window early and were able to withdraw from some open-ended funds ahead of other participants, they remain in the queue in other less liquid funds. Whereas some funds have devised and have done their best to honor liquidation schedules, other commingled funds have been less successful in meeting withdrawal requests, particularly as fund participants have lined up in the queue as a defensive strategy, regardless of their overall real estate portfolio objectives. Some funds may be queuing up at the advice of their counsel while others may be doing it out of necessity, making it difficult to guage "true" liquidity demand. "Some managers have (slowed the liquidation process) by refusing to sell properties at bargain basement prices in a buyers' market. Others are switching to pro-rata instead of first-come first-served, systems for meeting withdrawal requests."

[13] Additionally, some funds have lengthened
the period in which they have to honor the withdrawal requests. These measures have combined to reduce withdrawal requests.

Commingled fund managers have had difficulty providing liquidity because certain property types and markets that have been heavily invested in by institutions such as central business district and suburban office have been overbuilt, resulting in lower rents and higher vacancies and lower than projected sales prices. Pension fund trustees and executives have sought to withdraw before writedowns would deflate appraised values.

In attempting to create liquidity, commingled fund managers face many conflicts. Remaining clients do not want to face writedowns on the value of their assets nor do they want to see cash flows from the remaining properties being earmarked strictly to honor withdrawal requests. They want to see the value of their interests protected by reinvesting cashflows as needed for leasing commissions, tenant improvements and capital repairs and maintenance. As one pension fund executive actively seeking to get out of commingled funds remarked during an interview, "If the commingled fund managers want you to remain in, they can keep you."

At August of 1990 investors had put in withdrawal requests totalling more than $1.9 billion from open-ended commingled funds. [13] This amount is equal to 10 percent of the total value of the thirty open-end funds in the Piper universe followed by Rogers and Casey Associates of Greenwich, Connecticut. While some requests have initiated sales of individual properties from funds, others have prompted the liquidation of entire funds. One such
fund was the John Hancock Equity Real Estate Account, with an appraised asset value of approximately $600 million in January of 1988, the fund was liquidated over a two year period from the first quarter of 1988 through the fourth quarter of 1990. During that period Hancock sold a total of 60 properties at 88% of their 1988 appraised value, after netting out the cost of brokerage, engineering, legal, environmental surveys, environmental remediation, and other transactions costs. Some of the properties were reappraised between 1988 and their disposition, taking these same fees into account, the properties in the portfolio netted 92% of their most recent appraisal prior to disposition. Timing played a crucial role in achieving these results. Hancock's early determination to liquidate was fortuitous given the collapse of the commercial real estate markets at the turn of the decade.

The closed-end commingled funds created in the early 1980's that were designed to be liquidated over a specified time frame have run into great difficulties in the highly illiquid markets of 1990 and 1991. Piedmont Realty Advisors, for example, the current manager of Pension Realty Trust A, initially a portfolio of eleven participating mortgages, is being liquidated following foreclosure on eight of its mortgages.[44] With little investor demand for southwestern suburban office product, the advisor's expectations for the fund have been lowered from a four percent real rate of return to one percent. Having disposed of one property, the advisor is "working to implement a liquidation that will allow investors to receive a return on their capital and a real return to
their investment, albeit it will be modest."[44] Its deep pocket investors can expect liquidation only to the extent that Piedmont can market the properties at a fair price. If they can not, they will continue to hold the properties.

The initial subscriptions of RREEF's West III, West IV and Midamerica I funds closed in the six-month period between July 1979 and January 1980 with a net asset value of the three funds of $255 million.[17] Each of the funds was designed to be liquidated after a ten-year period. Some of the eighteen tax-exempt limited partners and RREEF principals feel that it would be unwise to sell the assets in the recently depressed real estate markets and have tried to devise a mechanism by which those wishing to exit the funds would sell their interests in specific properties to other pension funds. The selected properties would be rolled into a new fund which would be managed by RREEF for up to another ten years. Properties would be sold as markets became stronger. The complications of working with clients who had different interests and the Department of Labor who would rule on ERISA-related issues, caused RREEF to withdraw its proposed plan.[18]

Advisors have experienced little consensus in the history of these funds other than the initial purchase decision. As Paul Sack, a RREEF principal commented, "It was easy to get all the clients together on their preferences and concerns because the people who had the same strategies and concerns went into the funds and the others didn't."[18] Another RREEF principal echoed this sentiment, commenting that the legal structure these group trust
documents did not anticipate all of the issues involved in liquidating a fund.

Investment managers have had some success in creating liquidity for their commingled fund participants. In addition to providing liquidity through the sale of individual properties held in portfolios, advisors such as RREEF have created a secondary market in which clients can trade fund units. By these strategies, RREEF executives estimate that they have created nearly $1 billion in liquidity; approximately $400 million in property sales and $600 million through the trading of units.

While both of these methods provide ways for pension funds to move in and out of real estate investments, the current state of evolution is not nearly as efficient as those of other security markets. Information and transactions costs and the time associated with a real estate transaction make this market less efficient and less liquid than other markets.

Liquidity is a stumbling block to closed-end, commingled investment as can be demonstrated through a discussion of a particular closed-end fund structure employed by at least one firm. Should a pension fund wish to get out of this closed-end fund, it would be the duty of the pension fund or the commingled fund sponsor to find a qualified investor to replace the one seeking to leave. In the institutional investment area, there are a limited number of qualified investors in terms of size and desire to invest. Not only that, it would be difficult to arrive at a "market" value for the commingled fund units to be traded. As
originally structured, a plan, within the particular closed-end fund under consideration, could offer its shares up to other pension plans for a period of 60 days and negotiate a price for them. Failing that, the units could be offered to subscribers of the manager's other funds for an additional 60 day period. If no buyers were found in this universe, the fund manager could buy back the shares, provided that by doing so he would not jeopardize the fund's other unit holders. The manager could buy the units back with available cash or he could sell properties. (Selling property prior to the liquidation date violates the basic concept of a closed-end fund.) If the manager did repurchase the units, it would be at 90 percent of the market value of the shares, with the remaining 10 percent to be paid out upon liquidation of the entire fund. In effect, the inefficiency of this investment vehicle and market could render the investment completely illiquid for six months or more, at which time its value is only 90 percent of market value which is based on appraisals.[29]

In attempting to provide liquidity to open-end commingled investors, managers can face similar delays when forced to sell a property. Not only does the manager have a grace period in which he can use his best efforts in honoring a withdrawal request, but it can take the manager months to sell a property, especially during a down market with little capital available for financing a purchaser.

Whether working with a commingled or a separate account portfolio, the manager of the fund should consider each
investment's contribution to portfolio goals, status within the investment lifecycle and marketability. A dispositions strategy as it relates to these issues should be considered regularly. The remainder of this paper will examine property specific dispositions issues, advisors' and plan sponsors' professed policies toward dispositions, a framework for reviewing dispositions decisions and a means of providing additional liquidity to the institutional real estate market.

2.2 The move toward Separate Accounts

Many of the pension funds that have large real estate holdings have had moderate success in getting out of commingled accounts and have gone to direct separate account investment. As their allocation to real estate grows in absolute dollar terms, there has been talk of taking the investment, management and dispositions responsibilities in-house rather than leaving them at the discretion of advisors.

For those tax-exempt investors who do use advisors for their commingled and separate account investments, there are some general themes that can be seen across these relationships. Once an advisor is approved by a plan, he will make acquisitions recommendations to the pension fund real estate professionals. Some pension funds, particularly the private ones, give their professionals discretion to approve deals, with authority resting in senior investment staff or with an investment committee. On the public side there are examples where investment authority resides
with real estate professionals and individuals within the treasury department of the governmental jurisdiction or civil servant body, but frequently the final investment decision rests with a lay board of directors. These types of boards are subject to the political objectives of their members and emotional decisions rather than an understanding of the underlying real estate fundamentals of the proposed transaction. Those public plans which require board approval for the acquisition of property often require the same type of procedure for the approval or disposition of a property over a specified dollar amount. One can imagine the difficulties one would encounter in trying to persuade a board to sell a property which its collective membership they had given the approval to purchase in the first place. In a down market, with appraisals lagging market values these boards are suspicious about selling a property for less than appraised value. They also question why a purchaser would see more value in a property than they do.

Few properties have been sold from the portfolios of public pension plans that are managed in such a fashion. These funds have viewed real estate as a long-term investment vehicle to be held indefinitely. Advisors rarely make the recommendation to sell unless they receive an unsolicited offer that is well above the appraised value of the property.

There are some public plans that take a much more aggressive approach to the management of their real estate portfolios. One such plan is the State of Connecticut Trust Funds where discretion
rests with the real estate staff, who are not civil servants; the plan's chief investment officer and the State Treasurer. This fund has sold out of all of its commingled accounts and does direct separate account investment, believing that it can increase its yield and gain control over its assets and advisors' fees.

A 1990 Pensions & Investments survey reported that tax-exempt investors, primarily the larger pension funds, held 50.4% of their real estate assets in separate accounts. For the year ended June 30, 1990, "Tax-exempt assets in separate real estate accounts jumped 28.8%...to $65.064 billion from $50.5 billion a year earlier. Tax-exempt assets in commingled funds, on the other hand, increased only 2.3%, to $64.357 billion from $62.9 billion during the same period."[19]

In a report based on data collected from its consulting client base, with assets totalling approximately $14 billion in 1990, Callan Associates suggests that "investors routinely might expect returns over 300 to 400 basis points higher over time from direct separate accounts invested in core real estate than from commingled fund(s) invested in core real estate."[12] While some of the improved performance may be accounted for by reduced fees; close monitoring and clear directions given by the sponsor, play an important role.

In reviewing and reunderwriting their advisors' work, The State of Connecticut Trust Funds always considers dispositions as part of its acquisitions strategy. This has allowed the plan to purchase an office building with substantial lease up risk and achieve high
return by selling a property within a two year time frame and to take a piece of a participating mortgage with a pre-sale commitment and realize a gain on sale before funding. Some may argue that these types of transactions reflect higher risks, while others would contend that by working under a policy that includes a dispositions strategy, this fund has managed and mitigated its risk.

Pension fund real estate executives who aggressively manage their portfolios expect advisors to make recommendations to sell properties. In the past advisors were reluctant to make such a recommendation not only because they were intent on growing the assets under management and preferred to make an acquisitions recommendation, but also because they were afraid that they would not have the authority to reinvest those funds. Most pension funds do not allocate funds among advisors, rather they review and invest on a deal by deal basis and do not compensate advisors for managing cash. While they would prefer the advisors to be proactive in making sell recommendations, in the past they have found that the impetus to sell has come on the part of the plan sponsor.
Chapter III

Appraisal and Transaction Illiquidity Issues

3.1 Appraisal Based Returns

At the heart of the compensation and liquidity conflicts that persist in this asset class is the convention of evaluating property, advisor and portfolio performance based on appraisals. The most common form of compensation has been to pay advisors based on the value of the assets which they have under management. The value is established by the appraisal process which has been administered and controlled by the asset manager. This arrangement allows for a conflict in that while both the sponsor and the advisor want to see the asset value appreciate, the advisor's rewards grow based on appraised values rather than actual market transactions. Some managers actually conduct the appraisal of their client's properties. Pennsylvania Public School Employees Retirement System recently disclosed a $26 million discrepancy in the value reported by the asset manager and that reported by an outside appraiser.[40]

Appraisal based return reporting is not directly comparable to the transactions based returns generated in the stock, bond and paper markets. Real estate returns are subject to smoothing and inaccuracies in addition to marketability problems. An appraiser uses market based transactions to determine the appropriate capitalization rate at which to value the property's income stream.
What happens in a disorderly market where transaction data is scarce because the information is kept private and transactions are practically non-existent because of a liquidity and credibility crisis? In the current regulatory environment, forced liquidations and REO sales violate the Uniform Standards of Professional Appraisal Practice standard definition of "market value" which is:

"The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeable, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of the sale as of a specified date and the passing of title from seller to buyer under conditions whereby: 1) buyer and seller are typically motivated; 2) both parties are well informed or well advised, and acting in what they consider their own best interests; 3) a reasonable time is allowed for exposure in the open market; 4) payment is made in terms of cash in United States dollars or in terms of financial arrangements comparable thereto; and 5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale."

The buying spree of the 1980's sent the prices on institutional quality real estate skyrocketing. Transactions prices and appraised values were bid up to unprecedented levels. "With few transactions to provide comparisons, the resulting distortions translated into unrealistically high valuations, and correspondingly, unrealistically high owner and seller expectations."[39] The spread between the bid and the ask has widened and persisted at between 15 and 25 percent. Some owners have been forced to liquidate properties, but most institutional investors with long term staying power have opted out of the market hoping that the underlying market value of their investments will
adjust upwards over time to reflect the value at which they are carrying the asset on their books.

Both the managers and the advisors have been reluctant to write down the value of their real estate holdings. The advisors believe that to do such a thing would impact negatively on their performance which might run them the risk of losing business. The sponsors do not want to admit that they have overpriced assets on their books. By not facing the facts, we now have an investment class and community that has become the subject of intense scrutiny. As Scott Westphal, real estate investment manager for IBM's pension fund commented in a recent interview,

"...carrying portfolios at unrealistically high levels causes more trouble than writing them down. Current carrying values, for example are viewed with a lot of skepticism by our investment communities....the current income that the investments generate based on inflated carrying values is unrealistically low....When you invest in Treasuries at 8% or higher, it's difficult to justify having investments in real estate that are generating a 6-7% cash yield- especially where there's a possibility that you will be writing them down even further. We would rather get them down to realistic levels as soon as possible, so that there is some sort of reasonable spread between real estate yields and fixed income yields."[41]

Many of our money center banks were faced with a similar predicament in the LDC debt crisis of the 1980's and their recent high exposure to the underperforming energy and real estate sectors. Loans to Latin American countries remained on watch list and non-accrual status for years until Citicorp finally faced the music with its second quarter 1987 decision to reserve for loan losses totaling $3 billion to Latin American debtors. Other banks followed suit and were able to reduce the human and financial
resources consumed with justifying the carrying values of these loans. By writing down the value of their equity real estate holdings, pension fund managers would be better able to balance their investment portfolios and to predict the contribution of these assets toward future payouts to annuitants. Will the pension funds behave in a similar fashion to their institutional brethren with one fund taking the plunge and reporting improved returns, only to be followed by everyone else? If pension funds did write down the value of their assets, would they not be more willing to subsequently trade properties to meet their portfolio objectives? Nearly five years had passed between the time that RREEF took a substantial writedown on the value of its portfolios until the fourth quarter of 1990 when Aetna took a 10 percent writedown across the board on its properties under management. While Aetna has regained credibility, some wonder if a writedown of this size is adequate for not only Aetna but for the industry as a whole.

Those funds that truly believe in the value of real estate as diversification tool may even call for an increase in real estate investment to bring their investment to targeted allocation goals. CalPERS expects its fund to grow to $90 billion by 1995. It anticipates nearly doubling its real estate holdings. By keeping the allocation steady at 10 percent, it plans to grow its real estate portfolio by approximately $4 billion from a $5 billion base to $9 billion. Both the fund's 1990 net investment value and gross investment value have declined from 1989 levels due to writedowns.

Flush with cash, in a rising cap rate environment, both plan
sponsors and advisors agree that now is the time to be purchasing real estate. The problem is that these are the very owners of real estate that do not want to put their properties up for sale because they know that they will not achieve the unrealized appreciation they have already reported on their books. On the very same page of its annual evaluation for CalPERS, Roulac lists the following as two of the current real estate investment implications due to today's economic environment:

"CalPERS should consider taking advantage of the lack of capital availability to purchase premier properties at yields above those seen in recent years. As prices begin to reflect the new realities of the market, returns will bring pensions and other investors back into the market place.

CalPERS should avoid selling real estate during the next one to three years as prices decline and then stabilize. Rather, CalPERS should hold onto properties and wait for market prices to begin moving upward in the mid to late 1990's."[35]

An August 1990 research report published by Alex. Brown & Sons Incorporated argues that direct real estate investments owned by pension funds may be highly overvalued. Researchers compared the implied growth rate for properties held within the Russell-NCREIF Index for the 1983-1990 period with the actual growth rate demonstrated by the properties. The overstated growth rate is reflected in the appraised values reported to the Index. Assuming a fifth year terminal value based on year-six NOI capped at 50 to 100 basis points above the initial cap rate and applying it to the actual income stream they concluded that these assets may be overvalued by between 13 and 19%. This study and others also concluded that transaction-based real estate returns are more
volatile than the pension and investment community has heretofore believed.

Until recently it was generally believed that real estate has provided higher risk adjusted returns than stocks or bonds, showed low or negative correlations to these other investments and has been highly correlated to anticipated and unanticipated inflation. Despite these favorable qualities, direct real estate investment comprised only 3 to 4 percent of tax-exempt portfolios. Part of the reason for this is the insecurity that managers have with the appraisal process. Real estate is considered an illiquid asset. The value of most other assets held in manager's portfolios are reported daily in the newspapers while those of real estate may be restated as frequently as annually through a less than perfect process that can be manipulated by information supply, timing and relationships.

Attempting to bring more consistency and understanding to the process CalPERS led the way by providing a software package to its advisors and by reserving the right to approve of the outside appraiser used. Advisors and sponsors may find that they will receive appraised values that are more reflective of market values if they provide the appraiser with detailed property information and instructions to price the asset as if it were to be marketed for sale immediately. Some consideration should be given to the length of time it takes to package and market the property. What is a reasonable marketing period? When investors were outbidding each other to lay claim to another trophy property, as few as three
months may have elapsed from the time it was decided to sell a property to the delivery of a letter of intent. As the spread between the bid and the ask began to widen so too did the marketing period. Properties that normally would have good market reception are being marketed two and three times because purchasers are unable to find financing.
3.2 Transactions Costs

Not only is the marketing of a property time consuming, it is expensive. Even in a good market there are generally few prospective buyers for a property. These large assets usually are not sold in small pieces so a market price established by continuous bidding is rare. Even publicly traded REITs can be listed as inactive for long stretches of time. In the commercial real estate arena, the cost of information is high and the transactions costs based on that information are higher than for other asset classes.

Real estate is not a commodity. Properties are heterogeneous bundles of rights, varying by location, investment vehicle, current use and regulations governing that use. Each of these facets must be thoroughly investigated when considering purchasing a property. This information is difficult to obtain because most of it is kept private. When investigating a property, a purchaser benefits by having a willing seller who will reveal historical information. Some sellers will offer to let purchasers speak with lawyers, brokers, property managers and even tenants that have been involved with the property. Real estate is the only of the major asset classes held by pension funds, where trades based on insider information are allowed and it is difficult to collect good quality, reliable information. Should a seller make this information available, the purchaser or advisor acting on behalf of the purchaser will seek other sources of information, either
confirming or disputing that used by the seller to support his valuation of the property.

Having been fortunate enough to find a property which meets his investment parameters, an investor will enter the information gathering and due diligence process. During this investigative period he may arrive at the conclusion that the property, in fact, is not a suitable investment; or another prospective buyer may be granted the exclusive right to pursue its purchase. In seeking real estate investments, purchasers may have to go through the information gathering process in many markets and for several buildings before they actually acquire one that satisfies their portfolio objectives.

The hierarchy involved in institutional investing adds layers of approval costs to property transactions. Not only does an advisor's acquisition staff spend and enormous amount of time gathering and analyzing information, but in many shops, before a recommendation is made to a separate account, the property is brought before an investment committee for approval. After having met their approval it is then recommended to the fund sponsor, if it is a non-discretionary relationship. The sponsor will then spend time studying and questioning information. Once the sponsor is comfortable with it, the investment is then taken through the sponsor's investment committee approval process. A CalPERS investment officer comments,"...with real estate by it very nature, trustees feel it's necessary for them to be involved in the decisions. If real estate takes 5 to 10 percent of your portfolio,
it takes 40 percent of your decision making time". [42]

Ibbotson and Siegel [24] discussed factors influencing real estate returns and suggested that non-risk factors such as control, taxes, marketability costs and information costs must be taken into account, and may be more important than risks in pricing these assets. Each transaction, whether it be a purchase or a sale must bear the cost of fees paid to advisors, lawyers, structural and environmental engineers, title companies, governments, surveyors, brokers and financiers when leverage is used. These costs may run as high a 10 percent of the disposition value of some properties in locales where transfer taxes are high. Once a property is sold, the funds must be reinvested. They may be reinvested temporarily in another asset class while one goes through the process of searching for a property that is desirable to the portfolio in terms of risk and returns.

Closing settlement sheets provided by various advisors were used to attempt to estimate the transactions costs associated with the disposition of a property. A sample of forty-two properties was analyzed. The settlement sheets provided information on closing costs such as recording fees, title policy costs, conveyance fees, survey, transfer taxes, lender fees and in some instances mortgage recordation fees. The burden of these costs to the seller varied from representing 0.0% of the sales price of the property to approximately 7.0% of the sales price. On average these costs represented 2.4% of the sales price. There are a number of reasons for this range. The primary one being that transactions are
heavily negotiated and consequently the responsibility for paying these fees is also negotiated.

For the majority of the transactions, sellers paid brokerage commissions associated with the sale. These commissions represented 1.4% of the sales price of the properties. Below, are graphs tracking both sellers' costs and purchasers' costs. Graph A compares dispositions transactions costs as a percentage of sales price and Graph B tracks transactions costs on an absolute dollar basis.

Graph A - Seller's Cost vs. Price

Graph A reveals that transactions costs on smaller institutional properties can be as high as 5.0%. As property values increase, fees associated with the sale decline as a percentage of value. The two outliers, with transactions costs in excess of 6.0%, were buildings located in New York City where the seller was responsible for paying New York State Real Property Transfer Gains Tax and New York State and City Reap Property Transfer Taxes. Looking beyond, to Graphs C and E, the combined transactions costs on these properties were nearly 7.0% and 10.0%, respectively.
Graph B - Seller's Cost vs. Price

Graph B indicates that sellers' transactions costs in absolute dollar terms trend upward as the value of the property grows. Excluding the relatively unnegotiable transfer taxes, sellers' costs peaked at slightly below $350,000.

Graph C - Purchaser's Cost vs. Price

Graph C reveals purchasers' fees to be more modest than those of sellers'. Although the average costs to the purchaser was .2%
across these transactions, if you were to eliminate the outlying New York City transaction where the purchaser was responsible for payment of the brokerage fees, the average would have been .1% of the purchase price.

Graph D - Total Cost vs. Price

Graph D indicates that total transactions prices can be as high as 10.0%, while on average, the combined costs of the seller and purchaser is 2.6%. Total transactions fees follow a trend line similar to that of the sellers' costs; decreasing as a percentage of sales as the property value increases.

The transactions costs analyzed above do not include what advisors refer to as reimburseables; legal fees, and other third party services such as additional financial feasibility studies, and structural and environmental survey costs. A separate group of fifteen purchases was used to estimate these costs as a percentage of property values. Properties ranged in value from $5 million to $345 million. Combined these fees averaged .3% of the property value, or $162,000. Legal fees comprised the bulk of these fees,
averaging $139,000.

Graph E - Consulting Fees vs. Price

Although these fees were borne by a purchaser, it is fair to say that a seller would have the burden of comparable third party consulting fees. Legal costs will vary depending on whose lawyer drafts the Purchase and Sale Agreement, how many parties are involved and how complicated the transaction is. Structural and environmental costs may be higher for the seller than they are for the buyer because the seller will probably conduct a Phase I environmental study, a structural engineering survey and an appraisal in preparation for a sale. As a result of these reports the seller will weigh the costs of remedying problems that would make the property less saleable or result in a large reduction in the sales price.

Understanding that the same properties were not used for both studies, the following is an estimate of the costs associated with
selling and subsequently purchasing a replacement property for a portfolio.

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<tbody>
<tr>
<td>Seller's Expenses</td>
<td>2.4%</td>
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<td>Seller's Consulting Fees</td>
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<td></td>
<td>2.7%</td>
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<tr>
<td>Purchaser's Expenses</td>
<td>.2%</td>
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<tr>
<td>Purchaser's Consulting Fees</td>
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<tr>
<td>Advisor's Disposition Fee((^c))</td>
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<td>Advisor's Acquisition Fee</td>
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The total average transactions cost of 5.2% does not factor in the cost of the interim investment of the sales proceeds while searching for another property in which to reinvest the proceeds of the sale. The costs associated with selling and reinvesting the sales proceeds are significant. So significant that owners who do not think that they can generate a profit after overcoming transactions costs are likely to hold on to the property. If an owner thinks that property values were going to fall in excess of 5.2%, selling may be a wise decision. By the same token, if a property owner were to receive an unsolicited bid that would allow the owner to make a profit after transactions costs, selling may also be advisable.

At this point in time, with infrequent transactions, it is not uncommon to have properties put under contract more than once, an owner, whether he be working through an advisor or investing on his

\(^c\) Advisory fees are negotiable.
own, is well-advised to take transactions costs into account when making a dispositions decision. Owners may also want to consider investing in securitized forms of real estate such as REIT's in which the underlying assets do not change hands.

As volatility in real estate transactions is recognized to be more highly correlated with that of stocks and bonds there are moves afoot to devise a ways whereby investments in institutional quality real estate could be made more liquid, ie. securitization by way of real estate investment trusts (REIT's) or the securitization of individual assets such as has been done on the Rockefeller Plaza Complex in New York. This would allow investors to trade in and out of real estate while the underlying assets remain held in the same form of ownership. Transactions costs for the unit holder would be reduced.

The creation of an informal secondary market for individual funds has been tried with mixed success before. International Property Consultants and Frank Russell Co. are leading discussions with the Department of Labor and pension fund managers in support of establishing such a market. This would allow those pension funds that want to withdraw from commingled funds the opportunity to get out and have greater control of their own destiny. Funds wishing to enter the real estate market or to participate in a particular commingled fund may do so with greater ease than they had previously.

Some skeptics, namely those with large real estate holdings are resistant to securitization because they are afraid that should
their holdings be securitized, they would trade at a discount to what it is held at on their books. One way or another, whether it be through securitization, reappraisal or a forced sale, pension funds will have to address the inflated values on their books.
4.1 Past Sales Motivations

Guilkey, Miles and Cole [8] tested potential sales motivations by conducting regression analyses on investment grade properties held and sold as part of the Russell-NCREIF index; hypothesizing the following:

The manager/seller may simply, have a less optimistic forecast of the property's future value than the potential buyer. In a market characterized by informational assymetries, both the buyer and the seller may believe that they have superior information justifying the transaction.

The fund manager may sell one or several properties to meet his liquidity needs.

Managerial efficiencies. Asset management is relatively more expensive for small than large properties, so that managers may sell off the smaller properties in their portfolios to purchase larger ones, thus reducing their internal operating expenses.

Operational logistics may also dictate that a manager should sell off a property that is geographically located far away from the bulk of the properties that are in a manager's portfolio.

The authors concluded that managers did tend to sell those properties that were least rewarding in terms of compensation. They also sold properties in markets with strong current demand, but where the surge in supply had not yet hit the market. Although this study suggests that managers behave as sophisticated investors who are concerned with fine-tuning their portfolios, it is essential to note that this study bases its conclusions on sales information prior to 1987 where managers who had an outlying
property in a location that was pleasant to visit at opportune times of the year could still hide them. Properties have been held because they photograph well and are used for annual reports and brochures. Managers do not want to give up the property as part of their routine. A sales decision may expose an environmental or structural defect which may lead to complex and costly remediation measures, which would drag down immediate returns. Another concern is that the market value may not approximate the value at which the asset has been carried on the books. An updated study being conducted by Miles, Guilkey and Webb, with a sample set of 569 properties sold, is to be published within the year. Its findings suggest that many of the sales that have taken place during the 1987 through 1990 are the result of forced liquidations, typically of commingled funds.

4.2 Professed Dispositions Strategies

As pension funds have begun to focus on return and liquidity issues, they have begun to look beyond investment strategies and have begun to consider asset management and dispositions strategies when choosing advisors. While in the past it was uncommon to fire an advisor, it is no longer uncommon for sponsors to reallocate their properties among advisors. An advisor who purchased a building may not manage it throughout its investment lifetime. An advisor's past performance as well as his response to client interviews and RFP's are often used by consultants and plan sponsors when determining who will be awarded investment and
management responsibility. As part of its most recent RFP, conducted in 1990, a large public pension fund asked respondents to comment on their approach to asset management and the dispositions of properties. The following are excerpts referring to the criterion used by different advisors to determine whether it is appropriate to sell a property.\textsuperscript{d}

* In general, we would recommend disposing of an asset when its value, based on property performance, market conditions, and appraisals to determine if the property is at or close to maximization.

* Assess capital, local market (supply/demand), historical performance, projected future returns and the relative completion of the asset management plan. Also consider economic, demographic, social or political factors which would impact the yield on the property and long-term growth.

* Conduct ongoing market research, if the market prospects are not positive, the regional asset managers flag the property for sale. In preparation for sale they try to achieve the highest face rent and take care of deferred maintenance.

* Consider revised investment objectives of the owner, try to maximize property values and sell when they believe the ROI would start to deteriorate in the future.

* Timing- there is no property we manage which is not for sale at the proper price. If we find a buyer willing to pay a premium over

\textsuperscript{d}Please note that these are not all of the responses nor are they the complete responses. These excerpts are taken from a sample of 16 advisors.
what we feel is the appropriate market value, even a well-performing property will be sold.
* Consider selling a property when appreciation potential is slowing or when value has peaked.
* Consider selling with market changes or property obsolescence.
* Portfolio considerations such as diversification into alternative property types or economic location, or the need for investor to liquidate to raise cash for other uses.
* The advisor must liquidate assets when incremental values have been created and prevailing market conditions favor a sale.
* The advisor must recognize deterioration in market conditions and reduced return expectations.
* The advisor should consider instances that require rebalancing the portfolio geographically and identification of superior investment alternatives in other regions.
* Consider lease expiration, expected market conditions, changes in physical competitiveness and physical condition. Look at comparable. Put through acquisitions disciplines to ascertain whether, at the currently available selling price, the property should be held or sold. Supply good quality properties available for sale.
* Sell if the property is showing poor performance relative to the portfolio.
* Consider selling when there are attractive reinvestment opportunities and poor forecasted performance due to change in market such as amount and quality of competition which would affect
future occupancy and rental rates.
* Consider current level of investor and tenant demand.
* Consider capital markets, changes in credit availability, fiscal changes, changes in attitudes toward real estate. Take an opportunistic, counter cyclical attitude toward real estate investment.
* Consider hold/sell/improve decisions. If market value has reached the point where future economic benefits and appreciation of property will not beat targeted level, sell.
* Sell at top of investment cycle to achieve planned results. Maintain original hold period strategies unless prevailing market conditions or property performance are other than anticipated when the property was purchased.
* Upgrade portfolio.
* Avoid exposure to capital improvements.
* Consider age of property and cost to maintain. Sell if it requires excessive asset management resources beyond the value of the property.
* Pose the question "Why not sell?". Consider market conditions, lease schedules, metropolitan economic factors and the capital market. Believe that twenty-five percent of value is created in timing of sale.
* Consider selling when the growth curve has begun to flatten and market conditions are favorable. Sell regardless of past performance.
* Sell when the property's performance exhibits dramatic variation
from projections.

While the RFP process has forced respondents to address the issue of dispositions in writing, some of these responses cause one to wonder how much thought and attention has been given to the dispositions process. Those sponsors who do not use the RFP process but require interviews with prospective and existing advisors are also asking them about dispositions strategies. Although the handling of this topic may not be the primary determinant of who gets the business, it would behoove all advisors not to be caught off guard when the question is posed.

It should not surprise advisors that many plan sponsors do not have a clearly defined dispositions strategy either. They may be posing the question because others have posed it of them or they have acquired so many properties that they now have a portfolio and need to treat investment decisions on a portfolio basis rather than exclusively on the property level.

It is not my intention to analyze each of the above responses, but rather to categorize them to see whose interests they are serving and at what level: property, market or portfolio.

Of the 16 advisors whose responses were reviewed:

12 mentioned that they addressed dispositions on a regular basis
12 would sell based on market conditions (present and forecast)
9 responded that they would sell given an opportunistic situation
8 would sell when estimates of future incremental gains in value had peaked
7 would consider portfolio objectives
7 would sell when the property has shown signs of obsolescence and
3 were thoughtful enough to consider changes in the owner's objectives.

1 openly supported the Guilkey, Miles and Cole theory, choosing to sell when it was no longer rewarding to the manager.

Many advisors tried to cover their bases and responded by reflecting on what might have prompted them to sell in the past. Needless to say they covered all of the bases, but it is amazing that only three of them considered the investment objectives and portfolio requirements of the sponsor.

Advisors, like salespersons should know the interests and objectives of their potential clients. This means that they should have an idea, particularly with a public fund, of what its stated investment goals are and what type of properties it possesses. This will enable the advisor to determine how its investment niche fits and benefits the fund's strategy. Some funds do not publish a lot of material, while others provide policy statements on every facet of their plan. CalPERS, for instance, has a Statement of Investment Objectives and Policies for the Real Estate Portfolio dating back to 1987. Among the first points it touches on is the portfolio investment performance objectives; desiring a minimum long-term portfolio real rate of return of 5 percent. Each asset that has been purchased should have had projections that have met or exceeded this criterion. Should any investment managers have doubts that a property will not perform to these expectations, they should consider disposing of it unless it more than compensates in meeting other portfolio objectives.
The advisor should also be aware of the diversification goals of the sponsor. As risk managers, sponsors spread their capital among a variety of asset types, markets, managers and even financial structures with the goal of reducing portfolio risk. Typically a plan will have a core portfolio. The definition of core has evolved over the years. Depending on the portfolio manager and the time frame, it can mean industrial buildings, office buildings, shopping centers and apartments which are substantially leased and generate market rate current yields or it can be defined as

"existing propert(ies) with quality construction and design features, predictable cash flows, located in a reasonably diverse metropolitan area, assurances to a broad pool of potential purchasers upon disposition, requiring quality asset and property management which is not overly specialized, with an all cash or limited leverage structure."[8]

Given the current state of capital markets and the divergence in owners' and buyer's expectations, the pool of potential purchasers has diminished. What is important, however, is that investment advisors and sponsors go beyond property level and market considerations and take into account portfolio implications when deciding to hold or sell a property.

Of those sponsors interviewed, only one had formerly committed its dispositions policies and objectives to writing. This policy statement was prepared more recently than that of its policy statement regarding investment objectives; in March of 1990. To quote from it:

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*This policy statement is attached as Exhibit I.*
"The primary purpose of selling properties will be to reinvest the proceeds in investments that offer higher return levels for a given level of risk. In general, if current real estate market conditions indicate that new investments can be made that will outperform certain properties in the portfolio, or if certain properties are not expected to perform up to the System's rate of return objective over a reasonable holding period, those properties should be sold.

In order to reduce risk in portfolio, certain levels of diversification are to be maintained. Sale decisions should take into account the impact on portfolio diversification as well as rate of return."

CalPERS encourages its advisors to pay close attention to property cash flow projections, and is considering having its advisors provide 3, 5, 7 and 10 year cash flow projections. These projections will be compared to the original projections to see if the property is meeting original expectations.

Many of the situations that are of special consideration to CalPERS are identical to those mentioned in the RFP responses above (although the responses were not to a CalPERS RFP). A response that was not among those of the RFP but was mentioned by an advisor in an interview, is to consider selling the property once it has been held for five years. The rationale is that signs of deferred maintenance and property obsolescence will start to show and either capital improvements, maturing leases or large redeductions in the sales price will erode the owner's returns.

CalPERS, like other investment managers and analysts, is sensitive to the source of a property's income stream. By determining how much of the property's returns are derived from ongoing cash flow versus residual value upon sale, the fund is better prepared to meet its future obligations and can assess the
volatility of that asset. While fixed income and other equities are classified as income, balanced and growth it seems that the domestic institutional real estate world did not view their investments in that light until markets were overbuilt and rents and sales prices started to retreat.
4.3 Methodology for Dispositions

While those involved in the tax-exempt real estate investment arena devote a considerable amount of time to generating investment proforma and considering investment decisions, many have begun to realize that the management and dispositions of properties are equally as important as the acquisitions. One investment advisor suggests that 25 percent of the real estate value can be achieved in the sell, and another supports the theory that 50 percent of the sell is in the buy. As an owner or advisor, the motivation to sell a property should come from one of three places: the portfolio, the market and the property.

Many advisors claim to put their properties through a hold versus sell analysis. This discipline may be performed solely by the asset manager, or in larger shops, it will involve not only the asset manager but the research, portfolio management and even a separately-functioning dispositions team.

The hold versus sell analysis evaluates the internal rates of return to the property as if it were to be sold within one year, three years and five years of the analysis. This analysis estimates the achievable sales price of the property and subtracts any remaining debt and costs associated with sales.

In the case of a sale in the future, rental growth factors and terminal capitalization rates may be adjusted to reflect the asset manager's estimation of property and market conditions. While remaining debt and sales costs are subtracted in the same manner as
they are with the near term sale, capital improvement costs including tenant improvements, leasing commissions and structural and cosmetic repairs are deducted before arriving at a net sales proceeds figure.

Example:

**Assumptions:**
- Going in Cap Rate:
- Terminal Cap Rate:
- Growth Factor:
- Holding Period:

**Cash Returns:**
- NPV of Cash Flow to Sale:
- Sales Price:

**Less:**
- Debt Remaining:
- Sales Costs:
- Capital Additions:
- Other Costs:

=================================================================
Net Sales Proceeds

This framework for comparison of the timing of a property disposition may be adequate for some managers, but it gives rise to numerous questions, some of which are solved by relying on the expertise of the asset manager and others which are solved by the introduction of other disciplines and consideration of the appraisal process.

Should the near-term sales IRR, and perhaps, the net sales proceeds exceed future returns, should the property be sold? How does the valuation from this exercise compare with that of the appraised value? Is the estimated sales price achievable? What is the most efficient way to market and sell the property? What are

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' Framework as used by AMB Institutional Realty Advisors, Inc.
the actual transactions costs? What will the actual returns after fees be to the investor? How will the net sales proceeds be reinvested?

To assist in answering some of these questions, some advisory firms call on the assistance of their in-house research, acquisitions and dispositions staffs. Research utilizes market and economic data to determine market conditions, economic (supply/demand) trends and the potential of the specific property type with a market area (MSA or SMSA). The advisor's assessment of the marketability of the property is then compared with an appraisal of the property prepared by an independent appraiser. Discrepancies are discussed and valuations are adjusted and ultimately a sales price is established. The acquisitions staff is then asked if they would buy at the derived price, and the dispositions staff is asked whether they feel a sale is feasible at the derived price.

Taking all of the above information into account, a portfolio manager will then determine whether the property should be sold from the portfolio. If the property is being managed as a direct separate account a recommendation will be made to the owner of the property. Any one involved in this lengthy decision-making and reporting process may choose from a myriad of reasons to discourage a sales recommendation. One interviewee with extensive dispositions experience stressed the importance of creating a specialized dispositions team to evaluate and conduct the dispositions of all properties under management, having found that
dispositions is time consuming and when delegated to the asset management or the acquisitions staff, dispositions often takes a low priority.

In a commingled fund, an advisor's results are often compared directly with those of other advisors working with an investor or against an index such as the Russell-NCREIF. Where the goal is to show returns, a contradiction often arises in that the properties that might be best poised for sale are often those that are providing the highest current yields and are therefore carrying the portfolio returns. Rather than jeopardize the portfolio performance, both the advisor and the owner grow attached to them and cull those properties that pull the portfolio returns down instead. Greed overcomes common sense, the property is held beyond it's and the market's peak, capital improvements are needed to keep pace with the competition and the terminal capitalization rate rises.

Among the earliest of the scant literature regarding institutional property sales was a 1985 article written by William M. Russell, then senior vice president of Aetna Realty Investors, Inc. Aetna's Real Estate Separate Account (RESA) was valued at $1.5 billion in 1984 and included 107 properties. As part of a conscious effort to reassure clients that appraised values approximate sales prices, and that investors can take comfort in the fact that the unrealized appreciation component of real estate returns is attainable, Aetna sold off 10 percent of the total number of properties in the RESA portfolio. Russell admits that
"many of these were our weaker properties." Despite this active dispositions policy, the portfolio continued to grow. In 1985 RESA included 126 properties. Aetna voluntarily followed this practice from 1984 through 1989; selling between nine and fourteen properties valued at between $70 million to $80 million per year. In 1989 Aetna disposed of $352 million in assets, partially in keeping with its stated dispositions policies and, in the later part of the year, to meet the rising tide of withdrawal requests. Playing the Sunday quarterback, one Aetna executive commented that "in reality the 10 percent should have been 100 percent". As Aetna tried to satisfy investors' withdrawal requests, the weaker properties were not the only ones sold. Much controversy arose when the suggestion was made to sell one of the fund's strongest performers, a New England mall which was purchased before the New England real estate market and investors' demand for retail was strong. After weeks of heated debate the Investment Committee was persuaded to sell. The sale represented roughly one third of the dispositions revenues for the year and was later recognized as being one of the best examples of market timing that Aetna has exhibited in RESA.

4.4 Portfolio Considerations

Domestic pension funds' involvement in real estate exhibits a history of naive diversification by property type and geographic area. In an attempt to hold the market, the herd would go on a buying spree where the forecast was optimistic. Aside from opportune sales, dispositions were often motivated by managerial
efficiencies. As portfolio sizes grew, diversification could be accomplished with fewer transactions and fewer asset managers by investing in larger, more expensive properties than in several smaller ones.

Owners and managers have begun to monitor portfolio exposure to industries, tenants, lease rollovers, financial structure..... Balancing a portfolio as it relates to these issues should not be accomplished exclusively by acquiring properties. Portfolio exposure issues may be handled equally as effectively by disposing of a property.

It is never too late to ask the question, "What is the job of a pension fund?". Pensions exist to invest on behalf of their participants, dollars which are to be returned at some point in the future to their pensioners. The goal by all involved, is to receive not only a return on capital, but also a return of capital. Once real estate was viewed as a diversification tool, pension funds began to invest in it. But they need a community to sell them on it. For the longest time that community sold real estate to pension funds on a deal by deal basis. Yes, the pension funds bought into large commingled funds, but for the most part the people that were acquiring for the commingled fund were making purchases on a deal by deal basis. Both the pension funds and the advisors disregarded some of the basic tenets of the existing pension fund investment strategy that had been upheld prior to the inclusion of real estate as a recognized asset class.

All of the products a mutual fund salesperson has to offer can be
categorized in one of three ways: income, balanced and growth. Pension funds themselves can be characterized that way and as part of a mixed asset portfolio, so too should real estate portfolios and the individual assets within the portfolio.

Individual investor and a pension fund sponsors, should design portfolios to meet anticipated future demands. Individuals consider their personal retirement needs and the needs of their posterity. Pension plans look at benefits to be paid out to those enrolled in the plan, current benefit recipients and all those presently contributing and vested to determine what will be owed to them in the future. Their goal is to be able to match the fund plans at any point in the future.

Each pool of annuitants varies. Some plans have high current demands, while others may not be as mature and require more distant payouts. Still other pension funds may call for virtually even payout over the predictable future. Individuals as well as plans have different profiles.

Consider where real estate rests within most institutional portfolios. Short-term funding liabilities are matched with cash and marketable securities. More distant funding liabilities are hedged with less liquid instruments and distant funding needs are matched with relatively illiquid investments such as real estate. Only occasionally, most likely in distress situations should real estate be called upon to meet the immediate cash needs of a fund.

The composition of a fund's real estate portfolio should mirror the expressed goals of the entire plan. If the plan has a steady
stream of demands, then it should be investing in properties for their dividend effect. The returns expected from the portfolio, and hence, from the individual assets should be derived from a continuous, reliable income stream.

Most funds, while professing to taking a balanced approach to their real estate investments, have in fact, been lured into using the growth approach. They have taken the deal by deal approach and used growth rates in excess of four percent, a high tenant retention ratio and low terminal cap rates, relying on appreciation to meet their overall return objectives. These assumptions have been applied to established CBD office buildings in top tier cities as well as to suburban industrial buildings. Like equities, real estate growth funds can be expected to have higher risk that income funds. These investments may be inappropriate vehicles for some plans.

Consideration of the entire investment portfolio should be taken into account. The first priority in determining a portfolio dispositions strategy is to consider how your real estate portfolio compares with your entire portfolio. A framework that may assist in determining which properties to cull while at the same time keeps portfolio considerations in the foreground but addresses property level and market level concerns expressed in the advisors' responses to the RFP, takes a form similar to The Boston Consulting Group's (BCG) product growth/share matrix. The BCG matrix assumes that cash flow is a measure of business success, cash use is a function of market growth and cash generation is a function of a
product's market share. Properties within their respective markets may be regarded as businesses or products. Each quadrant within the BCG model represents a different type of product at a different cash flow position, which, in turn, requires a different type of management strategy.

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Each quadrant is described as follows:

**Cash Cows** - products which possess high market share and generate more cash than is required by the low growth market in which they operate. The additional cash generated can be used to fund other product development.

**Stars** - products which generate a considerable amount of cash flow, much of which is used to support its growth. As growth slows, stars become cash cows. These products represent the company's future and require aggressive marketing.

**Problem Children/ ?'s** - generate little cash flow as a result of low
market share, but require large amounts of cash to support their high growth rate. Strategically a company should support the product in achieving high market share or it should abandon it.

Dogs- are products which neither generate or require much cash. Because of low market share and low growth, these products offer little opportunity for future profits. To maximize cash generation the product is often abandoned.

A pension fund's portfolios of properties can be treated as a similar portfolio whereby those funds seeking to maximize income may cull their portfolios and retain only cash cows. Those taking a balanced approach may use the excess cash generated from their cash cows to make problem children into stars. Portfolio managers wishing to create a growth portfolio may find their portfolio to be heavily concentrated in stars.

While this analogy may hold for real estate, it is important to establish a relationship between the property's cashflow position and the stage at which it is in its life cycle. Again, equating properties to products, each goes through a life cycle. As discussed by Onkvisit, Shaw[33] and Wasson[43], generally speaking the life cycle of a product follows a pattern of introduction, growth, maturation and decline. The duration of each of these stages varies by product, market and marketing efforts, yet the characteristics of each stage are similar.

Development and the introduction of a property is characterized
by indirect competition in which the property will be competing for tenants from other locations or grades of commercial properties. In any event, the properties are not identical. The profits generated by the property are low because most income is applied to promotion or leasing activities. During development and leaseup the owners are sensitive to how the property is perceived, and are more apt to make modifications to make the property more attractive and to enhance its leaseup.

The growth phase is recognized by market acceptance and earlier promotional deficits are turned into operating profits. Others will recognize the success of the property and attempt to develop competing properties. Accompanying this competition is market segmentation. Marketing efforts focus on the property's market niche.

During the maturation phase growth slows and properties within their various market segments experience stable profits. New developments slows as barriers to entry such as the permitting process, infrastructure development or number, size and type of tenants in the market for additional space decline.

Usually market maturity uncovers some degree of overcapacity, bringing with it a permanent battle for market position. As operating proceeds are spent on marketing cosmetic and capital improvements to maintain rent roll stability, profits start to diminish.

Following maturation the building will eventually meet its period of decline. Profits are thin, capital improvements and
rehabilitation alternatives are analyzed closely in order to stave off property obsolescence.

Mapping these property lifecycle characteristics onto the BCG matrix may shed some light as to portfolio mix and objectives.

**Portfolio Mix**

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<th>CASH COW</th>
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<td>Maturation</td>
<td>Decline or Misconceived</td>
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**Property Descriptions**

**Cash Cow- (Maturation)**
Properties purchased at a low basis
Well-Leased properties in markets with restrictions on development
Properties in strong markets with low tenant turnover

**Star- (Growth)**
Properties in fringe locations
New in-fill properties in lease-up

**?- (Growth)**
Class B or C properties which rely on tenant overflow from higher identity buildings or developments

**Dog- (Decline or Misconceived)**
Physically obsolete properties
Misconceived properties
Out of favor properties due to poor access, infrastructure, municipal security or other market factors

The goal in managing a portfolio of properties would be to avoid dogs and stay out of the lower right hand quadrant. Properties in
this category should never have been purchased in the first place. They exhibit poor performance relative to the rest of the portfolio. These may be new properties that were misconceived and acquired as the result of a precommitment agreement; a foreclosure; or poor design, market, or financial analysis. These assets should be priced so that users and local market players can rehabilitate, remediate and/or demolish and rebuild; they should not be priced at an exit cap several hundred basis points below that at which they were purchased with the hope of achieving the original acquisition proforma.

The remaining quadrants; problem children, stars and cash cows, reflect the portfolio's posture on income and appreciation. The tendency would be to try to move your portfolio to the lower left hand corner if you were to take an income approach and toward the upper left hand quadrant if you were to take an growth approach. Those properties falling within the dog or problem children categories require astute management, constantly monitoring for the appropriate time to dispose of a property once it becomes apparent that it its potential for cash generation will never exceed its cash needs.

While stars and problem children both represent growth phases. The profits generated during these growth phases determine the property status. This status may be largely dependent on the overall local property market conditions and the demand for services at a location rather than exclusively the building characteristics. Those properties developed in fringe locations
may never meet with financial success because despite costly marketing campaigns, it may perform well below projections in terms of leaseup and rent. Stars, on the other hand, may also be at fringe locations but may be developed and marketed precisely at the right time, and are on their way to becoming stars.

Portfolio managers must be aware of the interdependencies of the properties which they hold. With the current and future demands of annuitants in mind, managers should cull their portfolios. This does not mean that only the dogs and the problem children should be sold. If modest cashflow is acceptable in the near term, a portfolio manager may elect to keep the dogs and stars and wait for the appropriate time in the capital and user markets, to sell. Timing of the sale of a cash cow is also important. Constant monitoring of cash flows may indicate at which stage of maturation the property is and whether it is headed toward dogdom.

Systematic evaluation of portfolio goals and property mix will provide insight as to which properties should be removed from the portfolio. A property should be disposed of when its anticipated performance is no longer consistent with portfolio objectives in terms of diversification and profitability issues, when resources may be better deployed, when cash flow contributions are below the goals established for the portfolio and when the market share of the property declines to the point where it does not meet profitability objectives.
5.1 Conclusion

The third decade of domestic pension fund investment in equity real estate was ushered in with dramatically overbuilt markets and a capital crisis. The performance of equity real estate portfolios has been negatively impacted forcing pension funds, consultants and advisors to rethink their methods and strategies. The traditional arguments for the inclusion of real estate in tax-exempt investors' portfolios; diversification, inflationary hedging and superior returns are being questioned. The turn of events since the mid 1980's has been dramatic. Pension funds' ravenous appetite for acquisitions during the 1980's has been followed by 1990's style heartburn. With a focus on near term performance, the industry has shifted its disposition toward real estate to respond to liquidity issues.

Throughout the 1970's and much of the 1980's, pension fund investment in real estate was through commingled investment. The popularity of the closed-end and open-end commingled funds diminished as the larger pension plans approached their allocation targets and realized that they could accomplish their diversification strategies while at the same time gain control over property selection and management through investment in specialized commingled funds or direct separate investment in larger properties. Those who attempted to withdraw from open-end
commingled funds in the mid-1980's encountered some resistance but generally were able to accomplish their mission.

As real estate returns started to decline in the late 1980's, pension funds took a different view toward real estate. Raced with declining returns, investors applied increasing pressure on the real estate fund managers. This pressure came in the form of mounting withdrawal requests and measures to change fee structures.

It was not until the turn of the decade that pension fund investors become cognizant that real estate is truly an illiquid investment. Overbuilt markets and declining rents, regulations in the banking industry and a change in the global capital markets have culminated in a disorderly real estate market. The valuation of individual buildings has become difficult. Fair market transactions have ground to a halt while forced liquidations have risen, making it difficult for appraisers to value properties particularly when pension fund and professional real estate portfolio managers reluctantly face the specter of writedown.

As real estate returns and the frequency of transactions have declined, the industry has begun to concentrate its efforts on its existing possessions. Research, portfolio management and asset management have emerged as essential disciplines to be employed by all those involved in institutional real estate. Whereas acquisitions was given much attention in the past, dispositions will start to play a major role as a means of maximizing property values and addressing portfolio objectives.

As indicated through RFP responses and interviews there are a
myriad of reasons to sell a property. Motivations for disposition of a property vary with the stage at which properties and real estate markets are within their life cycles. It will behoove portfolio managers to apply some of the techniques used by corporate and product managers, and examine their real estate portfolios within the context of their entire pension fund holdings in determining which properties suit their needs. Income, balanced and growth portfolios, or variations on them, can be created and adjusted by culling portfolios and disposing of those properties which are not apt to contribute to future goals.

As pension fund allocations to real estate stabilize at between 3 and 4 percent of all pension fund assets, liquidity issues are of dominant concern. Advisors continue to have difficulty meeting withdrawal requests, fund managers are reluctant to write down the value of their portfolios, and few "market" transactions are taking place. Underlying this current malaise is the issue of illiquidity. As some struggle to create liquidity in the market through encouraging reappraisals of properties and the securitization of assets and portfolios, others are grappling with how to make the best of what they have through aggressive management. Due to unique pricing factors, such as segmented markets; high transactions costs; inelastic supply in the short run and not short sales, except with REIT's; real estate may never perform as other securities do. By keeping these factors in mind and by addressing them on an industry-wide, portfolio and property level, institutional real estate owners and their advisors can
better manage their real estate portfolios and the liquidity issues associated with them.
CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Statement of Investment Objectives and Policies
for Property Sales

March, 1990

I. OBJECTIVE

The California Public Employees' Retirement System (the System) has determined that it is appropriate to sell properties and other real estate interests from time to time in order to maximize its returns (for a given level of risk) from this investment sector. While the System intends to be a long-term holder of most of its real estate investments, it recognizes that changing the portfolio to control diversification and to emphasize those sectors or individual properties that are expected to perform best at times requires the sale of past investments.

II. SALE CONSIDERATIONS

The primary purpose of selling properties will be to reinvest the proceeds in investments that offer higher return expectations for a given level of risk. In general, if current real estate market conditions indicate that new investments can be made that will outperform certain properties in the portfolio, or if certain properties are not expected to perform up to the System's rate of return objective over a reasonable holding period, those properties should be sold.

In order to reduce risk in the portfolio, certain levels of diversification are to be maintained. Sale decisions should take into account the impact on portfolio diversification as well as rate of return.

Transaction costs for real estate sales and purchases are high, including brokerage fees, investment advisor fees, legal fees, and due diligence costs, as well as considerable staff time. Comparison of returns from an existing investment to a new investment should take into account these transaction costs.

III. PROPERTY REVIEW PROCESS

Advisors shall review each property for which they perform asset management services with the Staff annually. This review shall include discussion of the property value based on the most recent independent appraisal, the market in which the property is located, and the future outlook for property performance.

The most critical determinant in considering sale of the property is the projection of future cash flow. The preparation of the projection requires consideration of market supply and demand factors, property specific factors, and investor demand factors.
The advisor should provide a current ten year cash flow projection to the staff, along with a hold or sell recommendation, as a part of the annual review package. For each property, the advisor shall provide a brief written summary of assumptions, the projection, and its conclusions and recommendation. If the advisor agrees substantially with the independent appraisal report, the cash flow projection prepared by the appraiser may be utilized for the annual review.

In the discussion concerning the cash flow projection, the following types of considerations should be reviewed:

- The cash flow projection should be compared to the original projection of the property, to analyze how the property has performed and is expected to perform relative to the original expectations.

- The cash flow projection should be compared to the prior year's cash flow projection, to analyze how the property has performed and is expected to perform relative to the prior year's expectation.

- Property activity should be compared to any specific indications of sale that may have been identified either in the original asset management plan or prior year's asset management plans. For example, it may have been indicated that sale would occur after releasing space formerly occupied by a major tenant, or following completion of a major renovation project.

- Components of future anticipated return should be analyzed relative to current investment opportunities, to determine whether future return is primarily dependent on price appreciation relative to income, or vice versa.

The following additional situations indicate that sale should be specifically considered:

- The advisor does not believe that the future performance of the property, based on the advisor's projection and the anticipated proceeds from sale, will meet the System's minimum real return objectives.

- The appraised value exceeds the advisor's current estimate of value, indicating that the advisor's knowledge of the property and the market leads the advisor to expect poorer performance in the future than the market perception according to the appraiser.

- Some properties of the same property type in the market area are selling for prices above the advisor's estimate of their value, indicating that some buyers are overvaluing the properties and paying premium prices. This may occur when a property is performing especially well, and buyers may be seeking properties with little vacancy, strong cash flow, and relatively low risk.

- The advisor expects the market to soften, based on demand factors (such as changing demographics or loss of major businesses from the community) or supply factors (such as anticipated competition from new development).

- The property is on the Watch List.

- The property has been held for more than 5 years.
IV. UNSOLICITED EXPRESSIONS OF INTEREST

From time to time, the staff and investment advisors receive unsolicited expressions of interest from potential buyers of the System's properties. As the System invests in each property for long-term appreciation, it will generally not be responsive to expressions of interest in properties that are not currently on the market. No financial or operating information is to be made available to any outside party concerning any property which may be the basis for an offer to purchase without the approval of the staff.

In the event the expression of interest is received by the staff, it should be referred to the appropriate advisor, following up with the advisor on the situation as appropriate.

Expressions of interest received should be reviewed by the advisors, considering such factors as:

• Is the property one that the System should consider selling?

• Is the buyer qualified and reputable?

• Does the expression of interest imply a selling price that will meet or exceed the current estimated value of the property, so that the final sales price will exceed the price that the System would be willing to pay for the property?

Expressions of interest that pass this review should be considered serious offers. The real estate staff should be informed by the advisor of all serious offers, along with the advisor's recommendation as to whether the offer should be pursued, and why.

V. DECISION PROCESS FOR SALES

Property sales recommendations may result from the review process or an unsolicited offer. The recommendation may be initiated by the advisor or by the real estate staff. The staff may initiate an independent market study to assist its understanding of conditions that will affect future property performance.

The staff and advisor should discuss the proposed sale terms and reach an agreement on the pricing and other key terms of sale. In the event that the proposed asking price does not exceed the maximum investment amount delegated to the Staff Policy Committee in the Delegation and Approval Guidelines, the Staff Policy Committee shall approve or disapprove the proposed transaction, based on their decision-making process. In the event that the proposed asking price exceeds the maximum investment amount delegated to the Staff Policy Committee, the sale proposal shall be placed on the agenda of the Investment Committee for approval.

In the event that the real estate staff and the advisor cannot agree on whether to sell a property or on the terms of the sale, the real estate staff and the advisor shall discuss the proposal(s) before the Staff Policy Committee. The Staff Policy Committee shall determine whether to sell the property and on what terms, subject to Investment Committee approval if the proposed asking price exceeds the maximum investment amount delegated to the Staff Policy Committee.
The sale proposal to be approved by the Staff Policy Committee or the Investment Committee shall include the target price and major terms and conditions to be sought, as well as the minimum price and terms that will be acceptable to the System without further approval. In the event the advisor is able to negotiate the sale within those terms, it shall communicate the sale terms to the staff, and work with the staff to close the transaction.

In the event the advisor is unable to negotiate the sale within those terms, and wishes to recommend a sale at a reduced price or less advantageous terms, the advisor shall present to the System its proposal to sell the property for the negotiated terms. In the event that the proposed sale price does not exceed the maximum investment amount delegated to the Staff Policy Committee in the Delegation and Approval Guidelines, the Staff Policy Committee shall approve or disapprove the proposed transaction, based on their decision-making process. In the event that the proposed sale price exceeds the maximum investment amount delegated to the Staff Policy Committee, the sale proposal shall be placed on the agenda of the Investment Committee for approval.

VI. SALE PROCESS

If the System decides to sell the property, the advisor is responsible for pursuing the most advantageous means to achieve the highest possible price from a qualified buyer. Sale of the property will include development of a marketing plan and marketing materials by the advisor, subject to the approval of the staff. The marketing plan may involve recommendations to delay the sale in order to maximize proceeds. Activities that may result in recommending a delay include:

- consummating leases that are expected to be signed in the near future
- completing renovations or cosmetic improvements that will increase the sale price by more than the cost of the improvement
- completing an environmental and hazardous waste study on the property

Communication between the advisor and the staff should be maintained during the process.

VII. SALE TERMS

Terms of each sale will be negotiated based on the market, the specific property attributes, and the needs of the seller. In general, the System will prefer all cash sales of the entire property, rather than a situation in which a reduced interest in the property is retained. However, if providing a mortgage on the property after sale will result in obtaining the highest price, and the buyer requesting such a provision would be considered a qualified borrower under the System's mortgage lending guidelines, a mortgage may be considered.

Obtaining new mortgage debt on a property that is being considered for sale in order to leverage the investment will generally not be considered. In a situation in which the System and its advisors feel that property and market conditions indicate that a sale is appropriate, it is the intent of the System to remove the property from its portfolio.
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