

**THE EVOLUTION OF PENSION FUND INVESTMENT
IN REAL ESTATE**

by

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Abstract

This thesis traces the evolution of U.S. pension fund investment in real estate, examining the economic and regulatory factors that have contributed to the acceptance of real estate as a core portfolio asset.

Prior to 1952, pension funds invested the majority of their assets in long-term bonds. Over the next 20 years, stock investments gradually grew until, by 1972, they comprised nearly 75% of total pension fund assets. Though real estate allocations will never reach 75%, the gradual 20-year assimilation of real estate as an asset class is similar to that experienced by the equity markets.

The first real estate commingled fund was offered in 1968 but it was not until the latter part of the 1970's that pension funds began to seriously consider realty allocations. Several motivating factors converged at that time, prompting the shift into real estate: the passage of ERISA in 1974 mandated diversification across asset classes; the geometric growth in pension fund contributions necessitated investments capable of absorbing large amounts of long-term capital; high realty returns were being posted in the late 1970's and early 1980's due to double-digit inflation and the demand for space in an expanding economy.

The increasing demand for institutional investment grade properties stimulated the growth of independent advisory firms. These firms provided professional real estate products and services to clients who had no prior experience in real estate investment. While there were maybe 15 such advisory firms operating in the mid-1970's, by 1983 there were nearly 70 such firms actively managing pension funds' real estate assets.

Over the years, as pension funds gained experience in real estate, investment strategies were modified. Initially, open-ended commingled funds were the favored means of investment; later, sponsors progressed to more specialized closed-end commingled funds. Currently, the trend is towards direct investment administered by in-house real estate personnel or separate accounts managed by an advisory firm. The pension fund/advisory firm relationship also evolved from being discretionary, the advisory firm making all critical decisions, to being completely non-discretionary. Today, the advisory firm serves more as an operating company, overseeing the management of properties. Asset management has replaced acquisition expertise as the primary criterion for choosing an advisory firm.

The advisory industry is contracting due to the slowdown in the national economy, the low level of activity in the real estate market, and the demand by pension funds for increased service and lower fees. To survive this period of downsizing, advisory firms will have to have a substantial base of assets under management -- a minimum of \$500 million to \$1 billion -- in order to stay in business. Research will play an increasingly important role in advisory firms to provide quantifiable, economically justified, investment decisions.

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Methodology

To trace the evolution of pension fund investment in real estate the author conducted a literature search covering institutional investment periodicals from 1975 to the present. Reviewing such periodicals as *Pensions & Investments*, *Institutional Investor*, the *AREUEA Journal*, *Real Estate Finance*, and a variety of other industry and academic periodicals, provided insights into the forces influencing pension funds' investment practices.

Once the subject was framed within an historical context, industry representatives were interviewed to gain insights into current trends within the industry. Of particular interest was the changing role of the real estate advisory firm in today's market. Interviews were conducted with five public and three private pension plans having, substantial real estate assets, to determine the current and future status of real estate as a core portfolio asset. Would they remain committed to real estate in light of today's soft market? How were they restructuring their real estate portfolios and what were their strategies for future investment? What investment vehicles were they using and what was the character of their current relationship with advisory firms?

To gain an understanding of the role of advisory firms, five of the nation's top advisory firms were questioned. How were they adapting to changing market conditions and increased demands from clients? What products and services are they offering? What role will advisory firms play in the future?

Chapter One provides an historical overview of real estate investment from 1968, when the first commingled fund was offered, to the stock market crash in 1987. The various types of pension plans are described, as are their real estate investment practices. Forces which contributed to the boom in real estate investment are also investigated.

Chapter Two looks at the growth of the real estate advisory firms, examining the changing nature of their products and services over time. The evolution of investment

vehicles is traced to understand why pension funds have moved from commingled investments to separate accounts.

Chapter Three provides a briefing of current economic conditions in the United States and the health of the real estate market. Traditional reasons for pension fund investment in real estate are re-examined to ascertain their validity in light of today's market.

Chapter Four draws upon information gained in the interviews to establish the nature of the pension fund/advisory firm relationship today. Pension fund demands, advisor responses, and current strategies for real estate investment are included in this chapter. Lastly, the trend towards consolidation within the real estate industry is discussed.

Chapter Five presents a summary of the findings of this thesis.

Chapter One

An Historical Overview

Pension Fund Investment in Real Estate

Pension fund assets, valued at approximately \$2.3 trillion in 1990, constitute the largest single pool of capital in the United States.¹ This figure represents an 151% increase over 1980's total asset value of approximately \$916 billion.²

Pension funds are growing faster than any other sources of real estate capital. If 10% of the current pool of assets were allocated to real estate, this would represent \$230 billion in investable funds. Current allocations fall short of that mark. Of the top 200 pension funds, corporate plans hold approximately 5.3% in real estate equity and public funds 4.6%.³

In 1968 the first real estate commingled fund was offered to U.S. institutional investors by the First Wachovia Bank in North Carolina.⁴ Over the next 20 years real estate was slowly accepted as a legitimate institutional investment. Not until the late 1980's did real estate join stocks and bonds as a core portfolio asset.

Pensions funds' changing attitudes towards real estate during this 20-year time span reflect investor response to shifts in the U.S. economic cycles and reactions to imposed regulatory measures. This chapter provides an historical overview of pension fund investment in real estate, examining the underlying economic and regulatory forces which influenced pension funds' acceptance of real estate as a core portfolio asset.

¹Flow of Funds Account, Board of Governors of the Federal Reserve System.

²ibid.

³"Top 1000 Pension Plans," *Pensions and Investments*, January 1991.

⁴Melnikoff, Meyer. "A Note on the Dawn of Property Investment by American Pension Funds" *AREUEA Journal*, Vol.12, No.3, 1984.

The Business of Pension Funds

Total pension fund assets are split approximately 50-50 between public and private funds. According to the 1990 Greenwich Associates annual survey of the 2,000 largest pension funds, corporate sponsors represented 49% of total pension assets. Public pension funds, sponsored by state and local governments, represented 45%, while endowments and foundations accounted for 6%.⁵

Pension fund administrators are charged with the task of administering pension contributions to insure that funds will be available for disbursement when vested employees reach retirement age. Their investment strategies depend upon the maturity of their parent industry and the expected demand of benefit payments. Pension plans for maturing industries, with many beneficiaries near retirement, look to those investments providing cash flow and liquidity. Growing industries, with few beneficiaries near retirement, will have a relatively lower interest in cash flow and liquidity.

Defined Contribution Plans

Under defined contribution plans, each employee has a separate account. Plan sponsors are required to provide employees with investment options, usually three, which must meet the investment criteria established by ERISA. Unlike defined benefit plans, the plan sponsor has no obligation to ensure the performance of the plan's investments. Retirees receive only what they, or their employers, have contributed to the fund, plus the proceeds from the investment of those funds.

Defined contribution plans may be either employer-sponsored or employee-directed. Employer-sponsored plans relieve employees of having to manage their own

⁵Greenwich Associates, annual study of the investment management practices of U.S. tax-exempt funds, Greenwich CT, 1991.

retirement plan. The employer maintains control of the fund and investment strategies resemble those used by defined benefit plans. As with the defined benefit plans, liability remains an issue with the employer-directed plans

Over 90% of the defined contribution plans are employee-directed. The employer is not liable for the performance of the plan, he only offers investment options to choose from. Part of the reason for the popularity of these plans, such as the 401(k), is that they allow employers and employees to defer taxes on that portion invested in the plan.

Defined Benefit Plans

Defined benefit plans pay retirees a fixed, monthly sum when they retire, regardless of what they have contributed to the fund. Under the conditions set by the Employment Retirement Security Act of 1974 (ERISA) plan sponsors are required to ensure that the promised benefits will be available to the future beneficiaries. If corporations are unable to meet their fiduciary responsibility to their vested beneficiaries, up to 30% of the corporations net worth can be attached by a federal tax lien.⁶ Defined benefit plans are difficult to administer due to increasingly complicated accounting standards imposed on them. These costly administrative requirements, plus the liability issue, have prompted employers to terminate defined benefit plans and switch to defined contribution plans.⁷

⁶ERISA, Act. 3, par. 1002.

⁷Doran, Pietro. "Real Estate Investment for Defined Contribution Plans: An Analysis," master's thesis, M.I.T, Center for Real Estate Development, 1990.

Exhibit 1
Asset Distribution of Private Trusteed Pension Plan
by Plan Type: 1982-1990
 (billions)

Year End	Single Employer		Multi-Employer	Total Assets
	DB	DC		
1982	\$399	\$196	\$61	\$655
1983	449	239	72	760
1984	460	256	79	795
1985	545	325	98	967
1986	588	359	114	1,061
1987	598	386	117	1,102
1988	680	427	130	1,237
1989	752	463	147	1,362
1990	757	437	144	1,338

Source: Employee Benefit Research Institute

While defined benefit plans have increased 89% between 1982 and 1990, defined contribution plans have grown by 136%. The increasing use of defined contribution plans, at the expense of defined benefit plans, will impact the growth of pension fund investment in real estate.

Effect of Plan Type on Real Estate Investment

Because of their long-term orientation and emphasis on maximizing portfolio returns, defined benefit plans are more receptive to including real estate in their investment strategies.⁸ Defined contribution plans, having a shorter vestment period, are more concerned with the liquidity of their assets. Since vestment can occur within 0 to 5 years, the fund must be able to accomodate employee withdrawals. Liquidity is accomplished by either maintaining a portion of the plan in cash reserves or by relying on the incoming

⁸Doran, p.25.

funds to maintain withdrawal demands.⁹ Typically, the funds are conservatively invested in low-risk, capital-preserving instruments, such as mutual funds. The use of equity real estate is very limited among all types of defined contribution plans.

Pensions and Investments 1990 survey of the top 1000 pension funds revealed that defined benefit plans had \$20.8 billion invested in real estate compared to \$4.6 billion for defined contribution plans. While 123 defined benefit sponsors used real estate in 1990, only 11 defined contribution sponsors did so .

It is estimated that in 1991 investment returns for pensions plans, as a group, will be below actuarial assumptions.¹⁰ Net cash flow, contributions minus distributions, was a negative \$7 million in 1990, compared to \$-1 billion in 1989. As a result, pension plans will have to look to investment gains, not contributions, to keep their assets growing. In the corporate sector, cash flow is strongly negative. Expected 1990 distributions of \$51 billion exceed the expected contribution of \$38 billion, a difference of \$13 billion. The public sector shows a positive cash flow of \$6 billion, \$45 in contributions, \$38 billion in distributions. However, positive cash flow in the public sector has fallen from \$16 billion in 1988 to \$12 billion in 1989, to its current \$6 billion.¹¹

Public Plans

Public plans are not subject to ERISA but are constrained in their investment practices by the municipal or state statutes that govern them. Historically, public fund investment strategies tended to be more conservative than corporate strategies, with their portfolios more heavily weighted toward bonds and other fixed-income securities.¹² Many

⁹Doran, p. 33

¹⁰Greenwich Associates, annual study, 1991.

¹¹Greenwich Associates, annual study, 1991.

¹²Ramseyer, William. "Public Pension Funds: A New, but Cautious, Participant in Real Estate Finance" *Real Estate Finance*, Summer 1984.

public funds were forbidden to invest in real estate. Residential mortgages were the preferred alternative, less risky than equity ventures and without the management hassle. By the mid-1980's many funds' legislative constraints had been loosened, allowing public plans to invest a portion of their considerable assets in real estate. Public plans now represent 45% of total pension fund assets.¹³

Early Investment in Real Estate

Real estate equity funds were first provided by bank trust departments and insurance companies, historical providers of investment opportunities for pension funds. The first investment vehicles to be offered were open-ended, commingled real estate equity funds. The first such fund was established by the First Wachovia Bank in 1968 and was soon followed by the Prudential Property Separate Account (PRISA), activated in July of 1970.¹⁴

These investments were specifically marketed to pension funds. They appealed to this new group of real estate investors because they offered a pool of diversified real estate assets that could be immediately invested in, without plan sponsors having to learn the nuances of real estate investment. A featured selling point was the funds' liquidity, allowing investors, regardless of their cash flow and liquidity requirements, to invest. Plans representing mature industries could conceivably partake in what was normally considered a long-term investment.

Despite the presence of these early real estate equity funds, pension funds did not begin to seriously consider real estate as an asset allocation until mid-1970. Stocks and bonds prevailed in pension fund allocation.

¹³Greenwich Associates, annual study, 1991.

¹⁴Melnikoff, Meyer, "A Note on the Dawn of Property Investment by American Pension Funds" AREUEA Journal, Vol.12, No.3, 1984.

Pension Funds and the Stock Market

Until 1952, pension funds held little stock, preferring the safety of high-grade corporate bonds for their investments.¹⁵ Worried about the effect of inflation on pension liabilities, administrators slowly began shifting assets into the stock market. Twenty years later, in 1972, stocks represented nearly three-quarters of total pension fund assets. The increasing presence of pension assets changed the nature of the stock market. Due to the sheer size of their collective pool, pension funds brought about "block" trading: trades of 10,000 shares or more.

Exhibit 2 Block Trades/Day on the New York Stock Exchange

	<u>Avg.No.</u>	<u>% of Total NYSE Volume</u>
1965	9	3%
1970	68	15%
1975	136	17%
1980	528	29%
1984	1,713	50%

Source: Reilly, Frank. Investments. Dryden Press: 1986.

In 1965, 3% of all trades on the New York Stock Exchange were block trades. Increasing pension fund participation brought the block trading percentage up to 50% by 1984.¹⁶ It is estimated that as of the first quarter, 1991, U.S. institutional investors own 39% of the market value of the stock market.¹⁷

¹⁵McKelvey, p 14.

¹⁶Reilly, Frank. Investments, p. 101, Dryden Press: 1986.

¹⁷Tobin, NYSE

By 1972, 74% of pension fund assets were in common stocks. When the stock market plummeted in 1973 and 1974 pension funds were faced with the fact that their stocks were worth 55 cents on the dollar.¹⁸ This loss of value left investment managers in the 1970's bewildered: "Remember," says one, "we came through a generation of money managers in the 1960's where any idiot who was throwing darts at the wall would make money in the stock market."¹⁹ Real estate at that time was not a consideration: "If someone were to come to a manager and tell him that he could make 7% in a real estate commingled fund, he'd tell him he was crazy. The manager was making 30% in the stock market."²⁰

Real Estate Investment in the Early 1970's

Real estate had been riding the crest of demand generated during the 1960's. It too boomed until it peaked in 1973, laid low by inflation and recession. With interest rates and construction costs at historic highs, demand for new space evaporated. Millions of square feet of vacant office space lay fallow on the market, new construction came to a halt. The 1974 collapse of the REITs brought more properties onto the market. From 1974 to 1976 the market was awash with properties that developers and investors were desperate to unload at bargain prices.²¹

Commingled real estate funds could purchase these properties for less than replacement cost. When the real estate market began to tighten in 1977 and the economy floated towards double-digit inflation, these commingled funds were able to post returns

¹⁸McKelvey, p 18.

¹⁹McKelvey, p.14.

²⁰McKelvey, p.18.

²¹McKelvey, p.213.

that out-performed the equity and bond markets.²² As a result of this performance, pension funds began to seriously consider real estate as an asset allocation.

Two other conditions compelled pension funds to consider real estate investment: the passage of the Employee Retirement Income Security Act (ERISA) and the geometric increase of investable contributions to pension fund coffers.

The Impact of ERISA

Prior to 1974, corporate pension funds were subject to few regulations. With the passage of ERISA in 1974, private pension fund administrators were legally bound, as fiduciaries, to insure the performance of the fund. Should a corporation's pension plan not meet its fiduciary responsibility to vested beneficiaries, a federal tax lien could be placed on up to 30% of the corporations net worth.²³

The application of the "prudent man" rule, later interpreted as the "prudent expert" rule, in pension fund investment is found in Section 404 of ERISA. Under this section a fiduciary is defined as anyone with discretionary authority in the administration of a plan, or anyone who provides advice to a plan for compensation, or who has authority or responsibility to do so.²⁴

Section 404 prescribes that the fiduciary shall:

"discharge his or her duties solely in the interest of plan participants or beneficiaries, and A) for the sole purpose of providing plan benefits to them; B) with care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use; C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it would

²²McKelvey, p.213.

²³ERISA, Act. 3, par. 1002

²⁴Gray, Hillary. "New Directions in the Investment and Control of Pension Funds," Investor Responsibility Research Center, Washington, D.C. 1983.

be prudent not to do so, and D) in accordance with plan documents and instruments."(ERISA, Section 404(a))

The prudence regulations and the clause governing investment policies, 404(c), did not specifically tell a manager how to invest.²⁵ Unsure of how the new law would subsequently be interpreted in court, pension funds invested in conservative, "prudent" investments. The Department of Labor (DOL) later clarified that the "prudence" rule did not rule out risky investments nor investment in non-traditional assets.²⁶ And that non-traditional investment could, "improve diversification if it includes new investment opportunities in such areas as small business and real estate."²⁷

Nor did ERISA define any specific percentage of assets to allocated to non-traditional investments, such as 10% to real estate. This has been attributed to a misinterpretation of section 404(a) which limits the inclusion of a sponsor's own assets within the fund to "10% of the sponsor's securities or real property."²⁸

The Growth of Investable Funds

Motivated by ERISA, pension funds were in need of new forms of investment in which to place their ever-growing pool of funds.

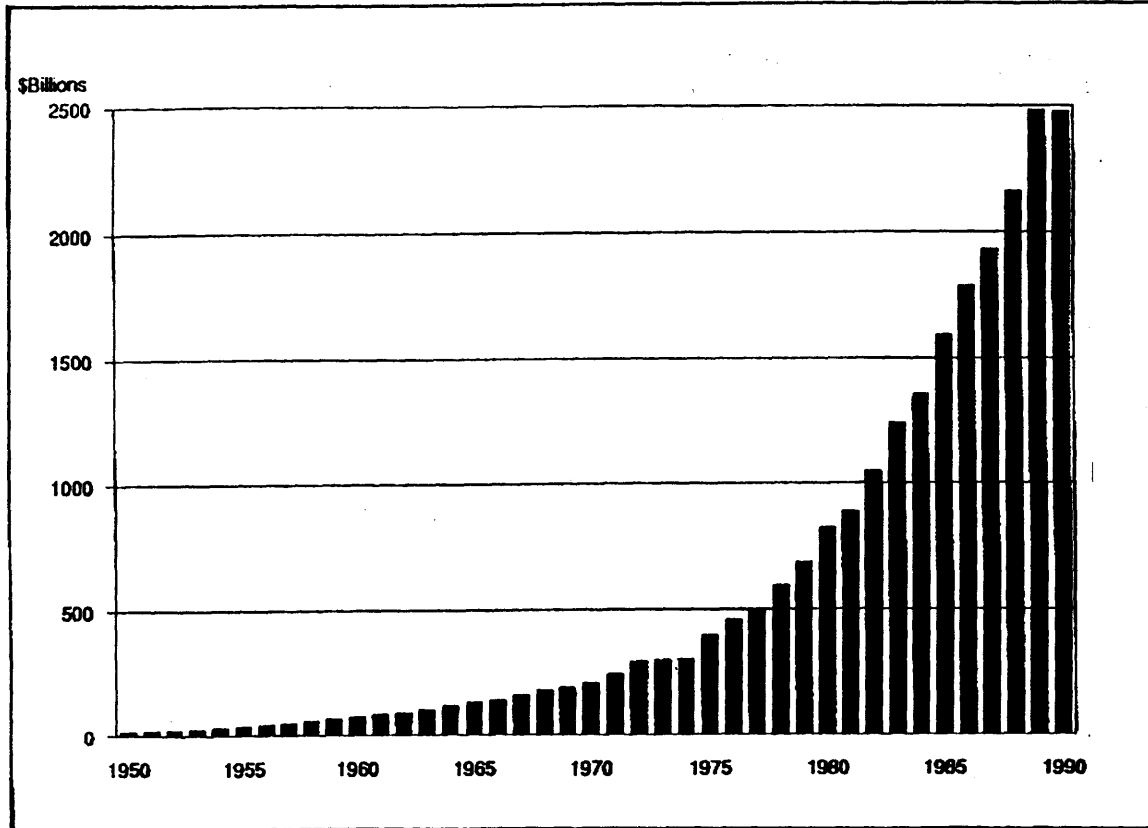
²⁵It could be argued that these regulations gave rise to the allegation that pensions funds operate under a "herd" instinct. That is, if the majority of funds are invested in equities, it must be "prudent" to do so. This "herd" instinct would be seen to prevail in the decision-making process pension funds would exercise over real estate investment.

²⁶ERISA Committee Reports, par. 5035

²⁷Gray, Hillary, p.55.

²⁸Merkle, Ned; "The Do's and Don'ts of Pension Management," AMACON, New York, 1981.

Exhibit 3
Total Pension Fund Financial Assets
and Rate of Growth, 1950-1990



Source: Employee Benefit Research Institute

The above figure graphically portrays the geometric increase of pension assets from 1950 to 1990, increasing rapidly from the mid-1970's. Vast supplies of capital could be absorbed the the U.S. realty market which was deep enough not to be dominated by any one fund. Additionally, by conveniently placing enormous sums in long-term real estate investments, some of the administrative headaches were relieved. This growth in assets needing placement happily coincided with an expanding economy and an increasing demand for space.

The Building Boom

Two distinct sources fueled the building boom of the early 1980's. One was the growth in the actual demand for space due to demographics and structural changes in the nation's economy. The second source was a change in the capital markets and the demand for real estate as an investment asset.²⁹

Three sources have been identified as contributing to the demand for space: 1. The baby boomers came of age, entered the work force and formed their own households. 2. Women entered the labor force in unprecedented numbers, increasing their participation rate from 50% to 70%. 3. There was a structural shift in the economy as the U.S. shifted from being a manufacturing-based economy to a service-based economy.³⁰

These events gave economic credence to the boom in office construction but it was investment demand, the need by institutions to place large sums of capital in investments, that caused the market to overshoot.

The Shift to Real Estate

Meyer Melnikoff, the godfather of institutional real estate investment, described 1980 as the "threshold year" for real estate.³¹ *Pensions and Investments* 1980 survey of the pension fund community found that 22% of the sponsors were invested in real estate, compared to 15% the previous year.³² Most notably, over half of the large funds were invested in real estate. Large corporate plans, with their more aggressive investment policies, had pioneered pension investment in realty. Lagging the corporations, large

²⁹Bacow, Larry, "A Look at the Real Estate Cycle," M.I.T., C.R.E.D. Newsletter, Spring 1991.

³⁰Sagalyn, Lynne & Louargand, Marc. "Real Estate in the Next Recession," M.I.T, Center for Real Estate Development, 1989.

³¹Melnikoff, Meyer, "A Note on the Dawn of Property Investment by American Pension Funds" AREUEA Journal, Vol.12, No.3, 1984.

³²*Pensions & Investments*, Dec. 20, 1980.

public pension plans began their initial forays into real estate investment. Continued high inflation, combined with incipient recession and poor stock market performance, fueled the trend toward "alternative" non-stock and bond investments.

Pension funds were not the only players in the real estate investment game; they were joined by syndicators and private investors, foreign institutions and the banks.

New Sources of Real Estate Capital

The Economic Recovery Tax Act of 1981 (ERTA) provided additional incentive for real estate investment. Though it had no direct effect on the tax-exempt pension plans, it did fuel increasing real estate investment by non-tax-exempt investors. ERTA was, in short, a direct federal subsidy to the real estate market.

Syndicators took advantage of the shortened 15-year depreciation schedules and interest write-offs, selling those benefits to wealthy individuals who needed to shelter their high personal incomes. The underlying economics of a project, concerns such as marketability and cash flow generation, were given only secondary consideration by the syndicators. Combined public and private syndication investments jumped from \$1.9 billion in 1980 to \$8.3 billion in 1983.³³

Adding to the competition were foreign individuals and institutions looking to invest in U.S. real estate. Lacking large-scale investment opportunities in their own countries, off-shore investors viewed the U.S. as a safe harbor for their long-term investments. Unlike their U.S. compatriots, foreign funds had always considered property a core asset class. As discussed below, these funds would be active players in the late 1980's market.

With tremendous amounts of capital, from a variety of sources, chasing too few properties, capitalization rates were driven lower and projected yields began to diminish.

³³Robert A. Stranger & Co.

U.S. pension funds began to reconsider the wisdom of investing in real estate. Still initiates to the real estate game, they were not convinced of real estates' lauded benefits.

In April of 1982 *Pensions and Investments* reported that the, "Bloom is off the real estate rose."³⁴ As inflation drifted downward, pension funds shuffled their assets into the bond market to capture the high rates of interest. With the stock market also rebounding, financial assets offered better value compared to real estate.

Reallocation strategies such as this are a typical reflex for institutional investors. Changing market conditions demand a realignment of asset allocation so as to take advantage of inefficiencies in the market. Real estate, the new asset class, was not treated any differently than its stock and bond brethren. Real estate had been sold as an inflationary hedge and expectations about inflation were changing. If the economy was entering a period of disinflation, why hold real estate assets?

This reasoning prompted PRISA investors to liquidate their holdings. Responding to the change in direction of the herd, pension funds lined up outside of Prudential's doors to redeem their shares. Though the fund had been sold as a "liquid" real estate investment, plan sponsors found themselves waiting to recover their investments. To protect the integrity of the fund, Prudential refused to sell assets at below appraised value just to meet redemption requirements.³⁵ This well-publicized event sent a shock-wave through the pension fund community, causing those already invested in real estate to reconsider their proportional allocation, and those not already invested to rethink their commitment.

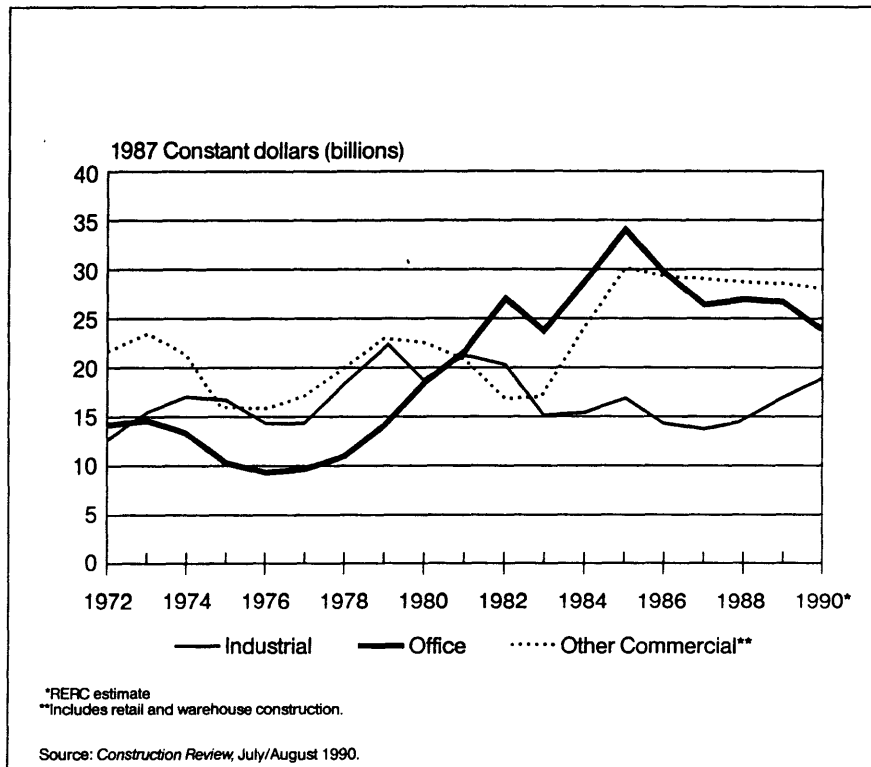
³⁴"Realty Interest Slows for Sponsors,"*Pensions & Investments*, April 1982.

³⁵ "PRISA Sticks to its Gunds in Dealing with Withdrawals,"*Pensions & Investments*, March, 7, 1983.

Excess Supply

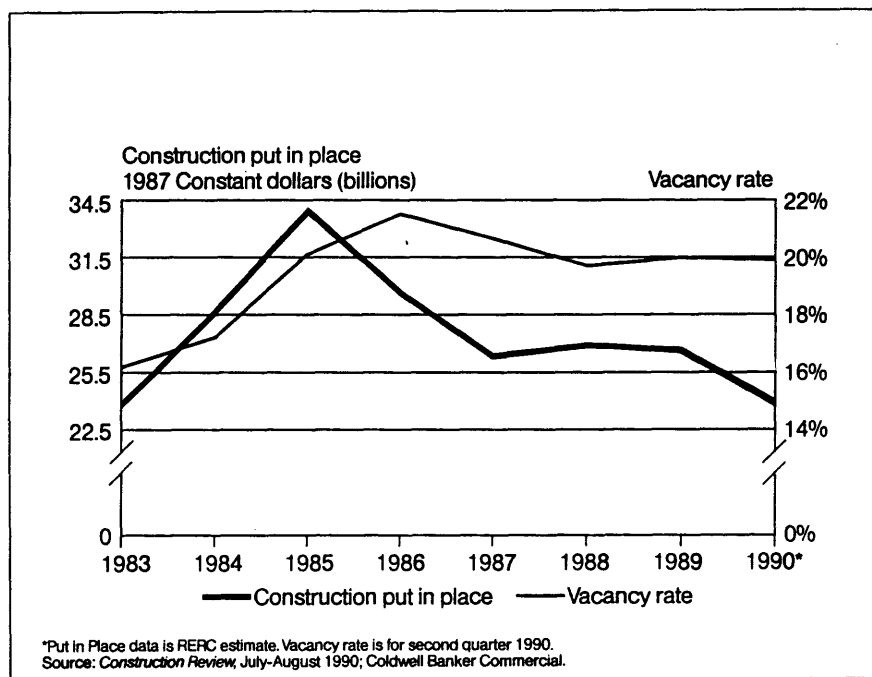
By September of 1984 articles heralding Armageddon due to overbuilding began to appear in the pension fund and real estate press.³⁶ As Exhibits 4 and 5 show, vacancy rates increased along with construction, giving every indication of an oversupplied market. Returns on real estate investments began their downward slide.

Exhibit 4
New Construction Put in Place



³⁶Hemmerick, S. "Glut of Office Buildings Flattens Rental Income," *Pensions & Investments*, Sept. 3, 1984.

Exhibit 5
Construction Put in Place vs. Vacancy Rate



The continuation of building, despite the warning signs, reflects the institutionalization of the real estate market that began in the early 1970's.³⁷ No longer was development a local phenomenon, held in check by local knowledge. Previously, banks, with their intrinsic knowledge of the local market, would refuse to lend construction funds if a take-out commitment was not in place. Locally-based developers understood the vagaries of their particular markets. With the nationalization of the development and lending industries the focus shifted. A development company from Boston could build in Houston with financing from a New York Bank.

Banks were eager to finance construction projects.³⁸ Corporations, historically one of their best customers, had no incentive to borrow due to an excess of their own funds.

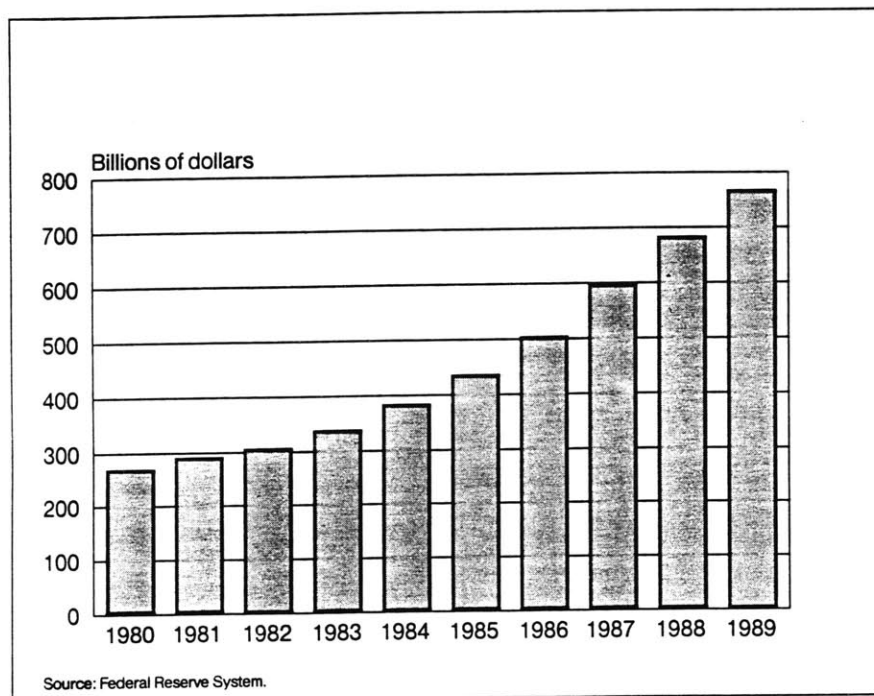
³⁷Westerbeck, M. "Pension Funds Cautious about Realty," *Pensions & Investments*, Oct.31, 1983.

³⁸Reirer, S. "The Office Market Time Bomb," *Institutional Investor*, June 1985.

Real estate was viewed as the most attractive alternative investment. Before, commercial banks had served as short-term construction lenders only, making construction loans on projects with long-term financing commitments from insurance companies in place. As life companies retreated from the take-out market, commercial banks filled the void with mini-perm loans which financed construction and operations for a year or two beyond the lease-up stage. Typically, miniperms, or "bullet loans," provided for a specified maximum construction loan amount and interest-only debt service. The full loan balance was due from 5 to 7 years after the initial loan closing.³⁹

Exhibit 6

Estimated Real Estate Loans Held by Commercial Banks



³⁹ Wm. Brueggeman, Jeffery Fisher, Leo Stone. 1989. Real Estate Finance. Boston: Irwin.

Exhibit 6 graphically portrays the increased real estate involvement of the banking industry. For commercial banks, real estate loans, as a proportion of total assets, went from 29% in 1980, to 38% in 1989.

Savings and loan institutions had historically served the residential market, providing fixed-rate, long-term mortgages to home buyers. By the time deregulation brought S&Ls into the commercial market, they were already in a weakened financial condition. The practice of borrowing short and lending long had dissipated earnings during high inflation, and savers' preference for the new money market funds was further eroding their earnings. In the rush to generate fees and interest payments to bolster their bottom lines, these inexperienced commercial lenders did not carefully analyze the underlying economics of their real estate ventures. Deals were struck to generate fees and interest payments. Even though pension funds were looking to place funds, many of these projects were considered second-tier, below the acquisition standards of the institutions.

Academic Approval

The passage of ERISA, and increasing interest in the comparative performance of real estate to other asset classes, prompted a wave of research activity. Academic research on real estate performance during the 1970's was limited by the lack of available data bases. Compared to the established securities markets, real estate had long been criticized for its peculiarities which stymied efforts to standardize it as an asset class: it was not traded on an open market; no two transactions were alike; transactions were private, not open to public inspection; and it was an illiquid asset, usually held for long durations.

By the mid-1980's several of the commingled real estate funds had been in existence for a decade or more. These funds supplied the necessary data for a number of studies, several of which were published in the fall 1984, *American Real Estate and Urban Economics Association (AREUEA) Journal*.

In this issue, authors Ibbotson and Siegel stated that real estate could improve the risk-adjusted portfolio in one of two ways. First, market inefficiencies could be taken advantage of to produce a "good buy." Secondly, that the addition of real estate may reduce overall portfolio risk, even if it is not a "good buy."⁴⁰

Brueggeman, Chen and Thibodeau published the results of a study which pointed to the diversification benefits to be derived from real estate, showing that it was negatively correlated to stocks and bonds. Furthermore, since real estate returns were positively correlated to the Consumer Price Index, inflation protection could also exist in a portfolio containing real estate assets. Portfolios containing only stock and bond investments were shown to exhibit no inflation protection. From their examination of the data bases they also concluded that real estate generally outperformed stocks and bonds.⁴¹

Concurrently, Zerbst and Cambon's study published in the *Journal of Portfolio Management*, concluded that real estate returns generally equaled or exceeded stock returns and that real estate consistently outperformed bonds, Treasury bills, and the rate of inflation. As their colleagues discovered, real estate was shown to be negatively correlated to stocks and bonds, recommending it as a diversification strategy.⁴²

Later, these early studies would be criticized for their use of unreliable data bases, but for now, they helped to change real estate's image as an exotic, or alternative, investment class, pushing it towards acceptance as a legitimate asset class.

⁴⁰Ibbotson and Siegel, "Real Estate Investment Funds: Performance and Portfolio Considerations," AREUEA Journal, Vol.12, No.3, 1984.

⁴¹ibid.

⁴²Zerbst and Cambon, "Real Estate: Historical Returns and Risks," *The Journal of Portfolio Management*, Spring 1984.

The Tax Reform Act of 1986

The explosive growth of the stock market in the mid-1980's resulted in the real estate component of overall portfolios dropping as much as five percentage points. Corporate plans, pessimistic of the health of the over-built real estate market and disenchanted by falling returns, were not so willing to increase their real estate allocation.

Fears about the real estate market were somewhat alleviated by the passage of the Tax Reform Act of 1986 (TRA). This act placed stringent statutory limitations on the utilization of tax shelters, shutting off the flow of funds from tax-driven syndicators.⁴³ Depreciation schedules were lengthened from 15 years to 27.5 years for residential rental and 31 years for nonresidential. Both classes had to be depreciated by straight-line methods. Distinctions were made between active and passive income and their respective tax deductions. No longer could passive losses from real estate investments be written off from active income received from wages.

When TRA was enacted, popular opinion held that the exclusion of tax-driven deals would exert a downward pressure on prices. Not so. Prices remained high, despite the surplus of space, due to steadily growing investment demand from public pension funds and a sharp increase in foreign investment.⁴⁴

Many of the public plans, recently freed from legislative investment constraints, were anxious to invest in real estate. Likewise, small and mid-sized corporate pension plans were looking to emulate their bigger corporate brothers and sisters.

⁴³Schwartz, Sheldon, "Real Estate and the Tax Reform Act of 1986," *Real Estate Review*, Winter 1987.

⁴⁴Chernoff, Joel. "Real Estate Prices Stay High," *Pensions & Investments*, Oct. 27, 1986.

Exhibit 7
Public Plan Investment in Real Estate
as a Portion of the Top 200 Aggregate* Plans
(in billions)

1985	\$8.6
1986	10.0
1987	12.9
1988	12.8
1989	24.2
1990	30.3

* Top 200 includes both private and public plans

Source: Pensions & Investments, top 200 funds invested in real estate & Ellen Brown

According to *Pensions & Investment's* survey of the top 200 pension funds, public funds increased their commitment from \$8.6 billion in 1985 to \$12.9 in 1987, a 67% increase. Foreign investor presences steadily grew throughout the 1980's, increasing by more than \$8 billion between 1987 and 1988.⁴⁵

Exhibit 8
Total Cummulative Real Estate Capital
from Foreign Investors

	(Billions)
1980	\$7.3
1981	10.7
1982	13.5
1983	17.2
1984	20.7
1985	22.8
1986	26.2
1987	31.8
1988	40.0
1989	45.9

Source: The Roulac Group of Deloitte & Touche

⁴⁵"Real Estate Capital Flows 1989" Equitable Real Estate Investment Management and the Roulac Consulting Group.

Foreign investors, with a long history of real estate investment, viewed the U.S. market as a safe market for long-term investment of their considerable assets.⁴⁶ The 40% drop in the dollar, relative to the yen, deutchmark and pound, made U.S. realty seem inexpensive by comparison. Japanese institutions and individuals were particularly keen on U.S. markets. Due to the high rate of savings in Japan, institutional investors possessed more capital than they could invest domestically. Added to that was the favorable balance of payments situation which produced the liquidity to fund U.S. acquisitions. Even more an impetus were the 8% - 10% yields, a bonanza compared to Japanese domestic returns of 2% - 4%.

Pension Fund Reaction to the Market

From 1980 to 1987, the pension fund press reported the industry's wavering commitment to real estate. Though pension fund investments had increased from \$19 billion in 1980 to \$87.8 billion in 1987, real estate was still considered an alternative asset, not on par with stocks and bonds.⁴⁷

Turmoil and unrest characterized the real estate markets of the mid-1980's. The recovery anticipated in 1986 was delayed due to unusually low oil prices, the implications of tax reform, an overbuilt market and a generally slow economy. Returns for commingled funds continued to slide due to a depreciation of assets. PRISA lost \$1 Billion in assets in 1986 as a result of client withdrawals.⁴⁸ The recession in oil-producing states forced the writedown of properties in those areas. Pension fund administrators began to get edgy, questioning the fiduciary wisdom of investing in such an apparently risky asset class.

⁴⁶Bacow, Larry, "Understanding Foreign Investment in Real Estate," M.I.T., Center for Real Estate Development, 1987.

⁴⁷"Real Estate Capital Flows 1989"

⁴⁸Hermmerick, S. "Plagued by Withdrawals," *Pensions & Investments*, July 21, 1986.

On October 19, 1987, the stock market plummeted. In that same year, unleveraged pension fund real estate investments on the Russell/NCREIF index posted a record low total return of 5.4%, with office properties returning a miserable 0.6%. Some within the industry wondered if the same fate awaited real estate; that a drastic correction was needed to deal with over-valuation in the market.⁴⁹

After the Crash

The October crash induced a temporary state of paralysis. In the aftermath, investors took another look at the diversification benefits attributed to real estate. Many of those already invested saw that their real estate holdings, as a percentage of assets, had increased due to the relative devaluation of equities. This being the case, many of these investors delayed any new allocations to real estate. Other investors, those who had shirked real estate investment during the bull market, became born-again real estate investors.

The crash had a sobering effect, but within a year's time the pension fund press was reporting that sponsors were, "Ready for a real estate buying spree."⁵⁰ However, one thing had changed since the early 1980's: this was an increasingly sophisticated group of investors who had progressed significantly up the real estate learning curve over the past decade.

The stock market crash brought home the fact that real estate would have to become a core portfolio asset in order to more completely diversify the overall portfolio and lower its volatility. At the same time, pension fund administrators were faced with a fundamentally unstable real estate market characterized by oversupply, increasing vacancy

⁴⁹Reinbach, A. "Values to Drop as Realty Prices Rise," *Pensions and Investments*, Nov. 14, 1988.

⁵⁰Hemmerick, S. "Funds Ready for a Buying Spree," *Pensions & Investments*, September 1988.

and declining returns. This being the case, fund administrators began to reassess their real estate investment strategies and redefine their relationship with advisory firms.

Chapter Two

The Growth of the Real Estate Advisory Industry

The growth of the real estate advisory sector parallels that of pension fund investment in real estate; products and services evolving in response to changing demands by pension fund clients. Passage of ERISA, and the growth of pension assets seeking real estate investment opportunities, spawned the advisory industry.

Prior to 1980, there were few independent advisory firms. In the mid-1970's maybe 15 such firms were in existence, by 1981 that number had risen to 40, and two years later 65 independent firms were polled for *Pensions and Investments* annual survey.¹

The genealogy of real estate investment vehicles begins with the large, open-ended funds offered by bank trust departments and insurance companies. Placing funds with an established insurance company would, in the pension funds' opinion, be considered a "prudent" investment. Before the diversification clause of ERISA was clarified by the Dept. of Labor, there was some doubt as to how the D.O.L. might subsequently rule on the inclusion of real estate assets. The liquidity of the open-ended, commingled funds appealed to investors: should the D.O.L. rule that real estate was not a fiduciarily responsible investment, investors could readily liquidate their holdings -- or so they thought.

Another feature which recommended the large open-ended funds was their experienced real estate staff. Pension fund administrators were well-versed in the securities markets. Real estate, however, was a dissimilar asset classification requiring specialized skills and knowledge for prudent investment decision-making. Insurance companies, with their history of long-term mortgage financing and their experience as equity investors for

¹McKelvey, p.214.

their own general accounts, were deemed to possess the requisite skills for institutional real estate investment.

Closed-End Commingled Funds

After the open-ended funds, closed-end funds represent the next generation of real estate investment vehicles. This commingled fund closes its doors to additional investment once it has reached its target allocation. Once the subscribed funds are in hand, properties are purchased and held for a pre-determined period, typically 10 years. When the due date arrives, the fund is liquidated and proceeds are distributed to the investors. Should poor market conditions exist, the fund is typically provided with an option to hold the properties until favorable conditions exist.

Closed-end funds are generally smaller in scope than the large, open-ended funds.² Fewer properties are contained in the portfolio, and they are generally smaller in scale, due to the need to provide diversification within the capped amount of funds. For example, an open-ended fund such as PRISA could invest in \$100 million properties, while closed-end funds acquired properties in the \$5 - \$20 million range. Other than that, their early investment strategies were essentially the same: target the most prestigious, well-located properties and purchase them, 100%, with cash up-front.³

From 1979 to 1982, the number of commingled funds more than doubled, from 60 to 135.⁴ Open-ended funds led the tally, both in the number of funds offered and the amount of money invested but closed-end funds were more innovative in their approach. This was due to the corporate structure of the managers: open-ended funds were managed by insurance companies and bank trust departments, whereas closed-end funds were the

²Rohrer, J. "How Pension Funds are Making Their Great Leap into Real Estate," *Institutional Investor*, June 1981.

³McKelvey, p.218.

⁴McKelvey, p.211.

domain of the advisory firms. More entrepreneurial by nature, they served as a bell-weather to the economy and the real estate market, shifting their investment strategies to meet new market demands.

Due to their inexperience in real estate, few of the pension funds showed any interest in developing in-house real estate departments during the early part of the decade. Only large funds, with pension assets in excess of \$750 million could consider building in-house real estate expertise.⁵ This was a fortuitous decision for many of the independent advisory firms which were born during this early part of the decade.

Professional organizations representing pension funds and their real estate staffs, consultants, real estate advisors, appraisers, and other affiliated professionals, were born during this time. These professional organizations, such as the National Council of Real Estate Investment Fiduciaries (NCREIF), provided research, helped with the standardization of procedures, and served as a forum for institutional real estate investment.

Wall Street Enters the Race

Wall Street firms, lured by the smell of fees, began their move into real estate advisory service in 1982.⁶ Their reputation as investment bankers, coupled with their long-term client relationships, seemed a sure formula for success. Goldman, Sachs & Co., Salomon Bros., Shearson/American Express, E.F. Hutton and Dean Witter Reynolds began their real estate subsidiaries during this time period. Acknowledging their lack of experience in real estate, Wall St. firms planned to lure experienced real estate professionals with high salaries. Some of these firms saw themselves in an enviable position: able to redeploy corporate assets by creating sale/lease-backs that would provide financing for corporate clients and investment opportunities for pension fund clients. Others questioned

⁵Gropper, D. "Real Estate: Going Direct," *Institutional Investor*, June 1984.

⁶Sandler, S. "Wall St. Enters the Pension Fray," *Institutional Investor*, November 1982.

this incestuous relationship. Might these advisory firms be tempted to "borrow" from pension clients to "help out" corporate clients?⁷ As discussed below, it soon became evident that Wall Street's fast-paced, deal-driven, methods did not lend themselves to advisory services.⁸

The conflict of interest argument has been raised since pension funds first started investing with insurance companies and advisory firms. With insurance companies, the question asked was, which account would get the purchased property? The insurance company's general account or the commingled fund? If an advisory firm is administering more than one commingled fund, or also handles separate accounts, how are the properties judiciously allocated?⁹

Retrenchment Strategies

After a decade of steadily rising returns, the real estate market began to crack in 1982. Open- and closed-end funds began producing lower yields than in previous years.¹⁰ As the securities market took off, plan administrators looked to redeploy funds from real estate to the stock market. PRISA's earlier claim to liquidity was challenged as investors sought to redeem their shares.

Due to the pension community's eroding confidence in the performance of real estate, advisory firms had a more difficult time marketing their products. To prop up investor interest during a period of disinflation, advisors embarked upon a number of new sales strategies:¹¹

⁷ *ibid.*

⁸ Westerbeck, S. "Firms Fade From the Field," *Pensions and Investments*, Sept. 17, 1984.

⁹ McKelvey, p. 234.

¹⁰ Rohrer, J. "Real Estate Managers Tough it Out," *Institutional Investor*, June 1983.

¹¹ *ibid.*

1) Clients were persuaded to look at real estate as part of their fixed-income portfolio. Rather than stressing the appreciation aspect, and inflation-hedging qualities of real estate, favorable lease structures and cash flow were highlighted.

2) Advisory firms stressed the strength of their respective research departments, emphasizing the critical need for research, both to satisfy ERISA regulations and to insure maximum performance of the investment. Diversification strategies, which informed the selection criteria utilized by acquisition departments, was another selling point.

3) New markets, such as endowments and public pension funds, were sought out. Many public funds had recently been given the go-ahead by their legislatures to invest in real estate. Smaller plans, without the required assets for direct investment, were targeted for closed-end funds. Some managers of pooled funds added direct investment counseling services to attract the larger funds.

4) Specialized closed-end funds were created, segmented by such aspects as property type, geographic location, and development risk. Investors could then pick from a menu of funds, matching the inherent risk and return benefits of each fund to their overall portfolio.

5) Tougher acquisition standards were set. Only top-quality buildings, 90% leased, with 10% minimum cash-on-cash returns were considered. Creative financing strategies, to share equity risk were also introduced.

6) Rather than concentrating efforts on acquiring new properties, closer management attention was given to those properties already in the portfolio in order to increase their returns. Existing properties were also examined for upgrading and expansion.

It's interesting to note how these 1982 marketing strategies are being resurrected in today's declining market. The difference being that in 1982 the market was only experiencing a temporary lull in activity. As will be discussed in Chapter 3, today's market has undergone a significant structural change. Though still used as marketing tools,

research, asset management, current cash flow and specialized funds are now a very real part of real estate investment.

By 1984 many of the small advisory firms began to fall by the wayside. Even Wall Street retreated from the advisory business. Salomon Bros. had aimed for a very select group of clients from the public pension funds -- a pool with which Salomon had established a relationship selling mortgage-backed securities. Salomon faded from the advisory scene due to personnel changes, a common complaint within the industry at this time. Key experienced real estate people left the firm for better offers, and, because they felt Salomon Bros. lacked the proper "advisory" mind-set.¹²

The firm conceded that advisory work was contrary to the nature of the investment banking business: "Salomon's interest is in things that move faster. It's a trading firm." "It's difficult for Salomon to get involved in an advisory capacity when they're used to making the decisions and trading."¹³

Investment Vehicles

In an effort to differentiate themselves, advisory firms devised a number of investment vehicles. Hybrid debt arrangements such as convertible and participating mortgages were especially popular during capital-starved times.¹⁴ Rather than competing with one another, some pension funds and syndicators joined forces, devising accrued interest arrangements whereby a higher interest rate was stated but a lower interest was actually paid. The difference between the stated and paid interest accrued, anted up by the syndicator as a balloon payment at the end. This scheme allowed the syndicators to get

¹²"Firms Fade From the Field," *Pensions and Investments*, Sept.17, 1984.

¹³ibid.

¹⁴Rohrer, J. "Real Estate Managers Tough it Out"

higher tax write-offs for interest deductions, which were unusable by the tax-exempt pension funds.

Prior to 1981, pension funds had to carefully structure any real estate debt so as not to incur any unrelated business tax. Tax-exempt status was only allowed on the equity portion of a deal; pension funds incurred a tax liability on the mortgaged portion of the income stream. When the tax code was amended, pension funds were allowed to invest tax-free in levered real estate provided the transaction met a number of conditions.¹⁵ This opened a new range of investment opportunities in levered properties.¹⁶

The use of leverage to acquire real estate was debated in the pension fund press. Those advocating the use of leverage pointed to its diversification benefits: more properties, with a wider geographic and property type mix, could be acquired. Also, within a favorable market, the difference between the cost of capital and the return on the property could heighten the overall rate of return.¹⁷

More cautious investors, however, thought 100% equity investment was the only "prudent" course of action.¹⁸ What if a downturn in the market lowered cash flows below that needed to cover the debt service? Sponsors would then have to provide an infusion of cash to buoy their investment.

Other investment strategies included joint ventures with development partners and other "value creation" schemes. Since the competition for investment grade properties was so keen, and investors were faced with increasing prices and falling yields, development deals and rehab schemes offered the only means to out-perform the market. Though higher returns were posted, the inherent risk of development kept many from participating in this

¹⁵U.S., Senate, "Legislative History of Miscellaneous Revenue Act of 1980, P.L.-605," Report #96-1036 Section 109 (December 13, 1980)p.11612

¹⁶Deals still have to be structured to avoid Unrelated Business Tax. Pension funds were not given carte blanche and the deals must meet a number of subjective tests to qualify. From an interview with Michael Ervolini, A.E.W., Boston, July 25, 1991.

¹⁷Martin, N. "Weighing Leverage," *Institutional Investor*, June 1977.

¹⁸Rohrer, J. "Why RREEF Keeps RROLLING Along," *Institutional Investor*, June 1983.

market. *Pensions and Investments* 1986 poll indicated that while 7% of real estate assets were dedicated to development projects, the lion's share, 93% went toward the purchase of existing buildings.¹⁹

Advisory Firms Fall from the Race

Despite the range of products marketed, it was clear by the mid-1980's that the well-established firms, with a record of sustained performance, would dominate the real estate advisory field. Real estate investment continued to grow at a positive rate, but the rate of growth, as can be seen in Exhibit 9, had slowed considerably by 1984, directly effecting the growth of the advisory sector.

Exhibit 9
Percent Change from Previous Year
in Total Real Estate Capital

1980	29.3%
1981	58.9%
1982	32.8%
1983	23.4%
1984	13.3%
1985	13.5%
1986	15.1%
1987	19.8%
1988	2.3%
1989	10.9%

Source: Roulac Real Estate Consulting Group

¹⁹Hemmerick, S. "Investors Place \$5.6 Billion of New Business in Direct Accounts," *Pensions & Investments*, Sept 1986.

This slowdown was a result of the decreasing growth rate of contributions to pension plans. Contributions fell off for a number of reasons. More defined benefit plans were being terminated and defined contributions plans, with no allocation to real estate, continued to increase. Pension fund administrators were spooked by the underlying economics of the market: continued building without regard to supply and demand, lower returns in the face of decreasing capitalization rates, and the prospect of low inflation. Under such soft market conditions pension administrators looked to experienced firms, with proven track records, for their real estate investment advice.

One of the winners was the Rosenberg Real Estate Equity Fund (RREEF). Established in 1975, RREEF built their reputation on specialized, closed-end funds. Typically, five to ten-year-old properties were purchased, free and clear, with RREEF having complete discretion over transactions. No development deals were done as it was the company's philosophy that taking such risk was fiduciarily irresponsible. All property management was handled in-house so as to insure the optimal operating performance of the property.

Not only did RREEF's investment strategy and track record appeal to the pension funds, but their entrepreneurial organizational structure set them apart from the advisory services run by behemoth insurance companies.²⁰ The experienced principals had an ownership stake in the business, which investors felt made the firm more aggressive in managing their assets. Principals would personally scout for properties, making deals on the spot -- an advantage in a highly competitive marketplace.

²⁰Rohrer, J. "Why RREEF Keeps RROLLING Along," *Institutional Investor*, June 1983.

Going Direct

By 1986 it was evident that the prevailing trend was away from open-end accounts, toward specialized, closed-end funds, separate accounts, or direct investment.²¹ Increasingly, pension funds were moving away from a diversified "core" portfolio approach to more specialized investing which would enhance portfolio returns.

Exhibit 10 Changing Commingled Fund Characteristics

	<u>1983</u>	<u>1988</u>
Open-End Funds	80%	62%
Closed-End Funds	20%	38%
Diversified	87%	76%
Specialized	13%	24%

Source: Evaluation Associates and Roulac Real Estate Consulting Group.

The reasons typically cited for disinvestment in open-ended accounts include pension plan terminations; reallocation of real estate dollars to other other securities; a decline in inflation, which neutralized real estate's inflation-hedging aspects; and, a shift to other real estate investment vehicles.

Many of the large pension funds began investing in real estate directly, either through separate accounts managed by an advisor or through their own real estate departments. Several reasons are given for this move towards independence.²²

²¹Hemmerick, S. "Investors Place \$5.6 Billion of New Business in Direct Accounts."

²²Rohrer, J. "Real Estate Managers Tough it Out," *Institutional Investor*, June 1983.

1. Direct investment was viewed as a natural progression from commingled funds. Since many of the large funds had been involved with real estate since the mid-1970's, they felt more comfortable accepting real estate as a valid asset class. Having progressed along the learning curve, they were now ready to take a more active role in the decision-making process. More aggressive stances to increasing yields were taken, such as joint venture partnerships and value-added approaches.

2. There was a general disenchantment with commingled funds. The open-ended funds were not as liquid as originally thought and there were complaints regarding the valuation process when an investor wished to leave the fund. Entering and exiting share values were based on appraised value, not market value, and there was widespread skepticism within the pension fund community regarding this valuation process. Fees were linked to appraised value, commonly priced at 1 - 1.25% of assets under management.

3. By having more control over the asset, it was felt there would be more opportunity for greater returns. Pension funds would have more financial flexibility in structuring deals and they would have more of an opportunity to take advantage of current market conditions. Real estate portfolios could be custom-tailored to derive the most benefit from diversification by risk, property, lease roll, and location. Properties could be more closely monitored to optimize performance and high asset management fees could be eradicated.

Exhibit 11
Direct vs. Commingled Real Estate
Investments -- Corporate Plans Only

	<u>1983</u>	<u>1988</u>
Direct	33%	62.5%
Commingled	66.7%	37.5%

Source: Evaluation Associates and Roulac Real Estate Consulting Group.

Between 1983 and 1988, the percentage of pension funds using direct, separate accounts increased from 33.3% to 62.5%. The shift to direct accounts became apparent in 1986-87, during which time considerable press was being given to advisory firm performance.²³ Fee structures were being challenged, as was the process of using appraisals for determining fund valuation. With the movement toward separate accounts, investors were in a better position to negotiate fees with advisory firms. Traditional fixed fees began to be replaced with lower base fees or performance-based fees.

Heitman Advisory in Chicago, was one firm that used a modified fee structure.²⁴ Their sliding fee scale was no doubt one of the reasons Heitman Advisory became the largest real estate manager in 1987, with \$3.6 billion under management. For the first \$10 million invested, 4% was charged, 3% on the next \$10 million, 2% on the next \$20 million, and 1% when the assets exceeded \$40 million. At disposition, 2% of the first \$10 million returned to the client was charged, 1.5% of the next \$10 million, and 1% of any amount over \$20 million. An annual fee of 25 basis points times the original amount of cash invested was charged, as well as 5% of the operating income being siphoned off for leasing and management fees.

Commingled Funds and the Appraisal Process

The debate surrounding the use of appraisals to value real estate portfolios had been haunting the industry since the inception of commingled funds. The debate approached crisis proportions in the mid 1980's, when pension funds began demanding more accurate performance data in order to assess real estate's viability as an asset class. Fund sponsors'

²³From *Pensions & Investments* annual survey of advisory firms, it was estimated that separate accounts increased from 32% in 1986 to 45.4% in 1987.

²⁴*Institutional Investor*, October 1987.

complaints now had to be reconciled, as it was a buyer's market for real estate advisory services.

The requirement to value real estate portfolios is rooted in U.S. banking law which requires that commingled funds must be valued and reported quarterly.²⁵ Under the strictures of ERISA, an annual valuation must be placed on the portfolio so that plan sponsors can determine their annual contribution to the plan.

Two components constitute return on real estate: cash flow from operations and appreciation of the asset. Though cash flow seems a readily discernible number, individual bookkeeping and operational practices can mask the true return. For instance, are the numbers inflated because maintenance has been deferred? Are replacement reserves included in the returns? Problems such as these are not insurmountable. They can be taken care of quite easily by standardizing accounting and operation procedures. However, assessing the appreciation of the property is, at best, an estimate.

Commingled funds are typically appraised on a quarterly basis. Annual appraisals are conducted by an outside appraiser, hired by the manager, while intervening appraisals are conducted in-house. Closed-end funds, because of their longer holding periods, considered annual appraisals to be sufficient. Quarterly appraisals were more important to the open-end funds as they were the key in determining going-in and going-out share values. With the exodus from open-end funds in the early 1980's, this practice came under increasing fire.

Some in the industry felt that unfair arbitrage opportunities existed within the open-ended funds.²⁶ Redemptions were initially given on a first-come, first-serve basis, prompting investors to "abandon ship." Investors with long-term investment horizons felt that they were at the mercy of those who treated the fund as a short-term investment,

²⁵McKelvey, p. 218.

²⁶Westerbeck, M. "Open-end fund drops may flag arbitraging," *Pensions & Investments*, March 17, 1983.

exiting whenever returns started to slide. Pulling out large blocks of shares threatened the stability of the fund as managers sought means to redeem claims against the fund due to the cash demands having to be met. Hancock was able to alleviate some of this problem by redeeming requests on a pro-rata basis.²⁷

A chief criticism of the appraisal process was that it was controlled by the managers, not the sponsors. Since the appraiser was in the manager's employ, might he be persuaded to err on his employer's side? Appraiser impartiality was a critical question because manager's fees were tied to the value of the portfolio.

When real estate started to be written down in value in 1986, many of the pension funds wondered if the appraised value of their investments truly reflected current market conditions. A one year lag in appraisals could represent a significant amount in fees. The writedown of RREEF oil-patch properties in 1987, spurred the fee debate.²⁸

One Main Place, a Dallas office tower, dropped almost \$43 million in value in the six-month period between appraisals, December 1986 - June 1987. This precipitous decline in value was taken as proof of the inexactness of the appraisal process. Other writedowns in RREEF's USA II fund included a \$21 million depreciation of a Houston office building, and the nearly \$17 million writedown of a Denver building.

Some investors questioned whether the writedowns should not have come sooner. Yearly appraisals lagged the market and it was suspected that appraisers were being talked into incremental writedowns so that the funds, and the managers' fees, would not have to take such a big hit.²⁹

To stem the tide of discontent and bolster pension fund executives' confidence in real estate investing, NCREIF proposed guidelines for how real estate managers should

²⁷Covaleski, J. "Hancock Fund Faces Pressure," *Pensions & Investments*, Oct. 5, 1987.

²⁸Hemmerick & Covaleski, "RREEF Writedown Spurs Fee Debate," *Pensions & Investments*, Sept. 10, 1987.

²⁹ibid.

contract with appraisers and direct their work.³⁰ The "Guideline for Preparation of an Appraisal Engagement Letter" sought to standardize the appraisal process by prescribing the methods and procedures to be used in the appraisal process.

More Complaints About Fees

Asset management fees were also questioned. Yearly asset management fees could be substantial: \$1 million to \$1.25 million on a \$100 million fund. Since the majority of the funds targeted prime, institutional grade properties, sponsors wondered if the management burden warranted such high fees. How much work was involved in managing a fully-tenanted, top-quality, CBD office building? In addition to the asset management fee, some managers were netting five percent of annual cash flow for day-to-day management of each building.

Sponsors were also concerned that fees were not linked to performance. Why would a manager be inclined to sell a property at the top of the market, and realize appreciated earnings for the fund, if their fees were tied to the amount of assets under management? In another vein, why would a manager undertake a substantial renovation project if it would decrease operating cash flow during the construction period?

Pig in a Poke

Another criticism leveled at commingled funds was that the managers exercised complete discretionary control over the funds. One pension fund executive compared commingled funds to buying, "Real estate futures."³¹ The future value of the fund determined by the manager's ability to pick properties in growth areas that would appreciate significantly over the long term.

³⁰Covaleski, J. "Appraisal Guidelines Eyed," *Pensions & Investments*, Mar. 9, 1987.

³¹Hemmerick, S. "1989's Realty Deals Try to Reduce Risk," *Pensions & Investments*, Jan. 8, 1990.

When buying into a closed-end fund, investors were not buying an identified set of properties. Properties were not purchased until the fund was closed. Certain parameters would define the focus of the fund; for instance, only certain types of property, such as industrial or multi-family, would be contained within the fund. Or, funds might target a specific geographic area or invest only in development ventures. These specified funds were first introduced in the early 1980's as advisory firms sought to create products that would appeal to sponsors' acquisition demands.

Purchase of the properties provided little enlightenment to the investors. They were only given the most general of descriptions, "250,000 sq.ft. office building in San Francisco." Managers were reluctant to divulge any more information, such as purchase price or cash flow, for fear that it could jeopardize the subsequent sale price of the property.³²

Comparison Across Real Estate Funds

Comparison of performance across funds was hindered by the lack of standardized reporting requirements. How was the rate of return of each fund calculated? On the gross assets of the fund, before asset management fees had been deducted, or after fees had been deducted? Were all of the contributions to the fund actually invested in real estate or was a portion held in some other form, waiting to be invested? Further compounding the problem of comparison was that each fund had its own fiscal year, depending on the month in which it was activated.³³

³²McKelvey, p.237.

³³McKelvey, p. 233.

Comparison with other Asset Allocations

The mystery surrounding real estate fund performance caused even more frustration when trying to compare it to other asset classes. Inefficiencies in the real estate market, the lack of transactions, and the diverse characteristics of the underlying properties making up each fund, made it difficult to quantitatively compare them to the well-established securities markets.

No shroud of mystery veiled the stock and bond markets: transactions and values were posted daily in an open market. Money managers could not smooth out their losses over quarterly or annual appraisals, nor could they influence the valuation process.³⁴ At any time they were accountable for their performance.

Real Estate Investment in the Late 1980's

Institutional Investor's 1989 "Pension Olympics" placed real estate advisory firms at the top of the list of successful management firms.³⁵ Never before, in *Institutional Investor's* 16-year history had real estate advisory firms so dominated the list. What made it even more of an anomaly was the fact that the U.S. real estate market was in such a weakened condition. Vacancy rates continued in their upward trend, an indication of increasing surplus space on the market. Regional recessions were prompting continued writedowns of properties. Curiously though, high-profile, fully tenanted properties were still commanding a high price. What was happening?

Following the 1987 stock market crash, there was a burst of euphoria for real estate as funds sought to meet the magical 10% allocation target. The old imbalance, however,

³⁴McKelvey, p. 230.

³⁵"The Pension Olympics," *Institutional Investor*, February 1989.

still persisted: domestic and foreign institutions still clamored after the top 2% of the market, the "institutional investment grade" properties.

Portfolio Strategy

Competition for trophy properties increased during the late 1980's as a result of growing foreign investment. Japanese investment grew eight-fold between 1983 and 1988.³⁶ Though foreign investors accounted for less than 1% of the total real estate market, their propensity to buy high profile CBD properties produced scare headlines in the press.³⁷ Overall, their holdings were a miniscule portion of total U.S. real estate assets, but their capitalization rates were so low that domestic funds could not compete.

Falling retail and office returns, especially in distressed markets, compelled investors to examine other forms of property investment. Development deals, once eschewed as being too risky a venture, increased from 7% in 1986 to 11% in 1987.³⁸

Other property classes, other than fully tenanted, CBD, office buildings and regional malls, were considered, such as multi-family housing, hotels, and mixed-use developments.

Exhibit 12 Real Estate Portfolio Asset Mix

	<u>1983</u>	<u>1989</u>
Office/Commercial	50%	38%
Retail	20%	27%
Industrial*	19%	19%
Hotels	6%	2%
Multi-family	3%	9%
Land	2%	5%

Source: Evaluation Associates & Roulac Real Estate Consulting Group

³⁶"Real Estate Capital Flows 1989," Equitable Real Estate Investment Management and the Roulac Consulting Group.

³⁷Bacow, Larry, "Understanding Foreign Investment in Real Estate," M.I.T., Center for Real Estate Development, 1987.

³⁸*Pensions & Investments*, September 1987.

Non-traditional markets were expropriated; such as, apartments, timberland, farmland, storage facilities and trailer parks. Contrarian approaches were taken: buying in secondary markets, traditionally a taboo, or buying discounted properties in weakened markets. Poorly performing assets were targeted, the idea being that with the application of superior management, the project could be turned around. So-called "vulture funds" were established to pick off properties from distressed owners. Existing whole portfolios of real estate assets were also purchased, with an eye toward restructuring them; selling and exchanging properties within the portfolio to enhance yields.

As a result of the stock market crash financial accounting procedures were amended, requiring corporations to list the debts of their subsidiaries. To beef up their bottom lines, corporations began to unload real estate holdings, leading to a resurgence of sale/leasebacks.

Exhibit 13
Russell/NCREIF Returns by Property Type

<u>Year</u>	<u>Office</u>	<u>Retail</u>	<u>Warehouse/Indust.</u>	<u>Total</u>
1978	21.2	10.7	14.2	16.0
1979	19.6	12.3	20.4	20.7
1980	26.0	12.8	16.2	18.1
1981	20.9	11.0	15.2	16.8
1982	9.9	7.0	9.0	9.4
1983	12.3	15.1	10.8	13.3
1984	12.1	16.2	12.3	13.0
1985	8.8	11.9	12.5	10.1
1986	4.2	11.4	8.5	6.5
1987	0.6	11.4	11.4	5.4
1988	2.9	13.4	10.3	7.0
1989	3.2	10.3	10.2	5.8
1990	-2.8	6.2	2.2	1.2

Source: Russell/NCREIF Index

Despite all this activity, the 1989 Russell-NCREIF index posted the lowest annual return in the history of the index. Real estate did not even keep pace with inflation and it underperformed equities, bonds and Treasury bills.

Such poor performance gave pension funds cause to reflect: relationships with advisory firms were redefined, real estate allocation targets were adjusted, and, in light of the continued strangulation of traditional credit sources, pension funds revised their investment strategies.

Chapter Three

Pension Investment in Today's Real Estate Market

Before examining the current relationship between pension funds and real estate advisory firms, consideration should be given to the current role of real estate in the overall investment portfolio. Do historical arguments for the inclusion of real estate still apply and what benefits are to be derived from real estate investment?

Traditional Reasons for Real Estate Investment

Five reasons are traditionally given as to why pension funds should invest in real estate.¹

1. For its negative correlation with stock and bond portfolios.
2. As a means of reducing the volatility of the overall portfolio.
3. For its historic ability to hedge inflation.
4. To meet the diversification requirements of ERISA.
5. It is an investment vehicle capable of absorbing large sums of money without dominating the marketplace.

Do these five traditional reasons still apply to real estate investment in the 1990's?

Asset Allocation

Greenwich Associates' 1990 survey reveals that asset allocation is the primary concern of pension fund managers and their investment committees.² Of the 2,000 plans surveyed, asset allocation was judged *the* most important issue facing administrators today. Pension funds are shifting the balance between equities and bonds, increasing equities from

¹ "Real Estate Slump Burns Pension Funds, Offers Opportunities," *Corporate Cashflow*, April 1991.

² Greenwich Associates, annual study of the investment management practices of U.S. tax-exempt funds, Greenwich CT, 1991

Pension funds are shifting the balance between equities and bonds, increasing equities from 47% to 51%, decreasing bonds from 35% to 32%. Though the report makes no mention of the expected percentage to be allocated to real estate, the study concluded that the percentage of funds *planning* to invest in real estate had dropped from 9% in 1988, to 6% in the following year, and to 4% in 1990.

There is concern that the current turnaround in real estate will motivate some pension funds to withdraw and deter others from investing in the first place.³ Real estate professionals have countered by pointing out the long-term benefits of real estate. Pulling out when the the market softens is short-sighted, reactive and will abort any future gains to be made when the market inevitably tightens up.

As funds prepare to pay out more than they take in contributions, they will have to rely on investment returns to make up the difference. It is estimated that as funds reach their mature state they will be paying out approximately 2-4% of their investments.⁴ Real estate, with its relatively steady cash return and long-term growth pattern, matches "fairly well" with those requirements.⁵ Seven and eight percent cash-on-cash returns, with a growth rate that approaches the inflation rate, would be well-suited to future cash flow demand for pensions.⁶

Modern Portfolio Theory and Real Estate

Real estate was elevated to core asset status in the late 1980's. The pension fund community has (generally) accepted that real estate assets will help to diversify the overall portfolio. How much real estate is necessary, in order to realize diversification benefits, is still being debated.

³ibid

⁴Williams, T. "Property Fills Cash Need," *Pensions & Investments*, Sept. 17, 1990.

⁵ibid.

⁶ibid.

Recent academic research has focused on fine-tuning the mix of assets in the real estate portfolio to optimize diversification benefits.⁷ Diversifying the portfolio solely on the basis of property type and geographic location, so-called “naive” diversification, has been shown to be an inefficient means of achieving diversification.⁸

The collapse of oil-state realty markets led pension funds to agitate for more precise methods of portfolio assembly. Simultaneously, rising national office vacancy rates alerted investors to the bias in their portfolios towards office buildings. Advisory firms were criticized for using a deal-oriented approach that resulted in random portfolios, only vaguely diversified by geography and property type.⁹

Currently, the industry trend is toward more exacting methods of portfolio assembly. Sponsors want to know that they are diversified not only by city and property type, but by such other means as financial structure, leasing structure and maturity, the tenant mix of their buildings and the creditworthiness of their tenants.¹⁰ Properties are grouped by "economic location" in which underlying economic drivers, such as employment base, projected employment growth, and demographic trends are analyzed to determine current and future market conditions. Supply constraints, such as growth moratoria and height restrictions, are also examined for their effect on future supply and demand.¹¹ As discussed further in the next chapter, research capabilities, both for pension funds and advisory firms, will gain in importance as investors carefully weigh their investment decisions.

⁷see Cole, Guilkey, Miles & Webb (1989); Hartzell, Shulman & Wurtzebach (1987)

⁸ Cole, Guilkey, Miles & Webb, "More Scientific Diversification Strategies for Commercial Real Estate," *Real Estate Review*, Spring 1989.

⁹ Lewis, J. "MPT Comes to Real Estate," *Institutional Investor*, February 1990, p 153.

¹⁰ Hudson-Wilson, Susan; lecture delivered at M.I.T., Center for Real Estate Development, Spring 1991.

¹¹ Wheaton, William; lecture delivered at M.I.T. Center for Real Estate Development, Spring 1991.

Is Real Estate Still an Inflation Hedge?

Another of the traditional reasons given for real estate investment is its ability to hedge inflation. Research during the 1980's demonstrated the positive correlation between real estate values and the rate of inflation.¹² Given today's economic conditions, compounded by structural oversupply, investors have begun to wonder if real estate will maintain its historical relationship with inflation.

Mike Miles, professor at the University of North Carolina, Chapel Hill, contends that the real estate market today is so out of balance, that it has lost its inflation hedging characteristics.¹³ Because of excess supply, real estate will no longer respond to unexpected inflation as it did in the past. Blake Eagle elaborates on this thesis, pointing out that the market today is characterized as a "tenant market," not a landlord market.¹⁴ Landlords can not automatically pass along the increased cost of utilities, janitorial services, real estate taxes, insurance, and other costs, as they did in the past when real estate supply and demand were in balance. What happened in the late 1970's and early 1980's was that there was a real demand for space, accompanied by a high rate of inflation, which allowed these costs to be passed through. With supply, today, outstripping demand, tenants are able to choose from a number of options in the market. Under such competitive conditions, it is not as easy for building managers to automatically pass through increases to their tenants.

Mortgage terms have crippled real estate's inflation hedging capabilities.¹⁵ The mortgages used to finance real estate in the 1960's and 1970's were typically long-term,

¹² see Brueggeman, Chen & Thibodeau (1984), Zerbst & Cambon (1984), Hartzell, Hekman & Miles

¹³ Gorman, B. "Is Real Estate Still an Inflationary Hedge?" interviews with Mike Miles and Blake Eagle, *Journal of Property Management*, Jan/Feb 1991.

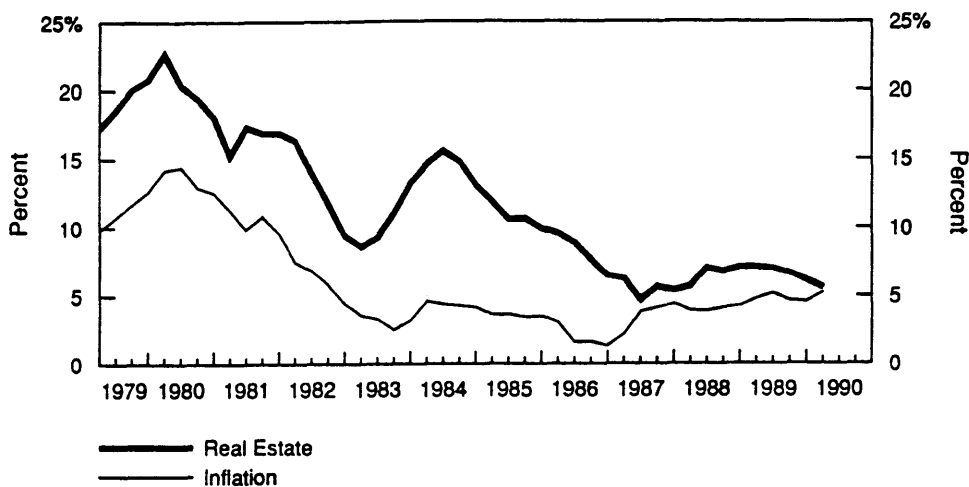
¹⁴ *ibid.*

¹⁵ *ibid.*

fixed-rate mortgages. Nominal interest rates are composed of two elements, the real rate of interest plus expectations about inflation. During the double-digit inflationary period of the late 1970's, lending institutions took a beating on their fixed-rate loans that had not anticipated high inflation rates. Unexpected inflation reduced the real interest rates on loans.¹⁶ Mortgaged property owners not only paid a negative real rate of interest, they could write off that interest and enjoy increasing property appreciation from demand pressures.

Lenders, however, learned their lesson. During the 1980's shorter-term, high-rate mortgages were written that would protect lenders from unexpected inflation. Real estate would not be the beneficiary to high inflation as it had been earlier. Exhibits 14 and 15 characterize the relationship between real estate returns and inflation.

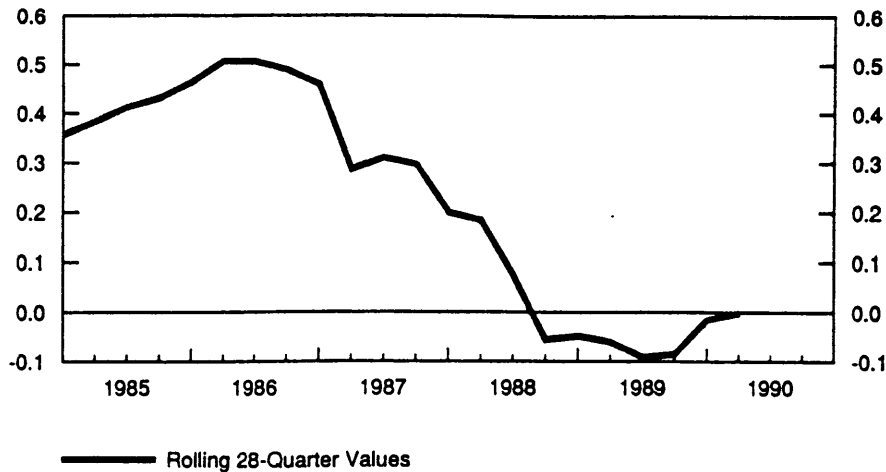
Exhibit 14
Real Estate Returns vs. Inflation
1979-1st Quarter 1990



Sources: U.S. Bureau of Labor Statistics and Russell-NCREIF.

¹⁶Downs, Anthony & S. Michael Gilberto, "How Inflation Erodes the Income of Fixed-Rate Lenders" *Real Estate Review*, Spring 1981.

Exhibit 15
Correlation Between Real Estate
Returns and Inflation
1985-1st Quarter 1990



Sources: U.S. Bureau of Labor Statistics, Russell-NCREIF and Salomon Brothers Inc.

The Real Estate Investment Pool

The enormity of the real estate marketplace contributed to initial investor appeal. This still holds true; in fact, the market has expanded due to restricted capital flows from other sources and off-shore investment opportunities.

Current market conditions present U.S. pension plans with both new acquisition opportunities as well as the potential to provide capital for transactions that, before, might have been provided by commercial banks, insurance companies, and foreign investors.¹⁷

¹⁷"Real Estate Capital Flows 1989," Equitable Real Estate Investment Management and the Roulac Consulting Group.

The recent tightening of the real estate capital markets will give pension funds more leverage in negotiating favorable terms. Additionally, lower property prices are expected as the market adjusts to reflect diminished expectations about future performance.

Though still in its infancy, international realty has the potential to broaden the investment pool considerably. The implications of off-shore investing are discussed in the next chapter.

Chapter Four The Pension Fund/Advisory Firm Relationship Today

Demands on Advisory Firms

Unequivocally, all pension funds interviewed stated that they are demanding more today from their real estate advisors: more stringent reporting procedures, higher performance standards, nondiscretionary accounts and lower fees. Advisory firm managers generally concur.

The prevailing trend toward separate accounts has given pension funds the upper hand. Pension fund administrators have historically been loath to dismiss real estate managers. It was common enough in the industry to dismiss stock or bond managers because the liquidity and market efficiency of those asset classes facilitated the move.¹ The structure of the realty commingled funds made it virtually impossible to remove managers despite their poor performance. Getting other investors in the fund to go along with the removal could be troublesome. Those with fewer assets in the fund would not consider the trouble worth it, compared to those firms with a larger stake.² With the move toward separate accounts, investors can more readily switch their real estate managers.

More control is also being exercised by the pension plans in terms of acquisitions, dispositions, and day-to-day management. More pensions are developing their own in-house real estate expertise and research capabilities. Investment strategies are formulated in-house, guided by investment policies which establish acceptable levels of risk and return and quantify diversification measures. Advisory firms are told what to buy and where, reversing the historical relationship between pension funds and advisory firms.

¹Hemmerick, S. "Client Loyalty Fading in Bumpy Realty Market" *Pensions & Investment*, Feb. 19, 1990.

²ibid

Advisory firms are tailoring their new commingled funds to accommodate client demand for more control. Earlier commingled funds were legally structured as group trusts, an inflexible vehicle which locked in the maturation date and delineated the rights and obligations of participants and managers.³ Today, this format is considered too rigid to allow the proactive management of a fund nor is it acceptable to the control-conscious sponsors.

RREEF's new commingled fund uses a more flexible format which allows for investor discretion.⁴ A board of directors, comprised of investors, has the final decision on whether to buy or sell; RREEF assumes the roll of an operating company. Rather than holding properties for a specified duration, properties are actively bought and sold and funds reinvested to take advantage of the market. The fund will have a longer, and extendable, maturation date in order to provide more flexibility in the future disposition of assets.

CalPERS has been very aggressive in redefining their advisory firm relationships. The voluminous RFP⁵ procedure for procuring advisory firms explicitly defines CalPERS's expectations. Upper limits are set on annual asset management fees, appraisal procedures for valuing the properties are detailed, as are strict reporting standards. In short, instead of the advisory firms' marketing their skills to the pension fund, CalPERS says, "This is what we want, these are the procedures we want you to follow, give us a price." (Could "change orders" be too far behind?)

The movement toward nondiscretionary accounts is another aspect of the increased control being exerted by pension funds. Using CalPERS as an example, account managers operate on a completely nondiscretionary basis when it comes to acquisition or disposition.

³Interview with Wiley Greig, RREEF, San Francisco, July 1991.

⁴ibid

⁵Request for Proposals initiates the bidding process in government-let contracts for goods or services. The RFP states the products and services to be provided, the requirements for contractor qualifications, and any other parameters which define the contract.

All major decisions must be made by the pension fund, though the advisory firm bears fiduciary responsibility. More latitude is shown in terms of the day-to-day operation of the property. CalPERS will examine such key documents as lease agreements, but managers exercise discretionary control over the management of the property. Reporting is standardized, managers reporting quarterly by means of an in-house computerized system which allows CalPERS to track asset performance and, concomitantly, manager performance.⁶

Asset Performance

Closely linked with the issue of increased control is pension fund demand for improved asset performance. Cash-on-cash returns have replaced projected appreciation as the primary deal criterion.⁷ Perceived risk in the current market place, as well as pessimism about future performance, has prompted investors to demand cash-on-cash returns which exceed the the risk-free rate of five or ten-year Treasury bills.⁸ Income streams are expected to remain flat over the next two to three years, with a slight improvement after that. At the same time, expenses are expected to increase 4-5% annually, in sync with a projected five-year inflation rate of 5% annually.⁹

Cap rates have increased nationwide, an indication of investor pessimism in the market. Properties in need of renovation, or purchased from distressed sellers, are registering cap rates in the 10%-12% range.¹⁰

⁶Interview w/ Roger Franz, CalPERS, Sacramento, July 1991.

⁷Interview w/ Kevin Comer, Ohio Public Employees Retirement System, July 1991.

⁸ Ibid.

⁹"Investors' Higher Yield Expectations Aren't Being Met," *Pensions & Investments*, May 31, 1991.

¹⁰Interview w/ Mary Ann Hoffman, Trammell Crow, July 1991.

Exhibit 16

Real Estate Investment Criteria by Property Type 1st quarter, 1991

Property Type	<u>Retail</u>					
	<u>Indust.</u>	<u>Regional Center</u>	<u>Comm./ Nbrhood. Center</u>	<u>CBD</u>	<u>Office Suburb.</u>	<u>Apt.</u>
Pre-Tax Yield						
IRR (%)						
Range*	11-12	11-13	11-12.5	11.5-13	11-13	10.5-13
Average	12.0	11.6	9.0	8.6	9.4	8.6
Going in						
Cap Rate (%)	9.1	7.4	9.0	8.6	9.4	8.6
Terminal						
Cap Rate (%)	9.5	7.7	8.9	9.5	9.5	9.0

*Ranges and other data reflect the central tendencies of respondents; high and low responses have generally been eliminated.

Source: Real Estate Research Corp., Chicago.

A Comparison: Pension Funds and Money Managers

Securities managers, those who manage pension funds stock and bond portfolios are experiencing similar changes in their relationship with pension fund clients. Track record and long-term performance are the prime determinants for choosing a management firm. As the money management business becomes more competitive, consolidation is inevitable.¹¹

Money managers complain that consultants are forcing them to specialize.¹² To placate the consultants, a management firm must have a definable investment focus; for example, specializing in growth-oriented stocks or mutual funds. If an advisor does not have a clearly defined specialty it is unlikely that they will appear on a consultant's list. This process can constrain investments: If you are a "growth firm" then you must show continued outstanding performance and this may preclude you from buying a company that

¹¹Interview w/Laurie Ann Kloppenburg, Loomis-Sayles, Boston, July 1991.

¹²ibid.

is nearing the bottom of its business cycle. Buying the property at this time would increase future earnings but, during the early stages of ownership, the lower returns would drag down the overall performance ratings of the advisory firm.¹³

After the October 1987 crash, prices for acquiring money management firms fell dramatically. In 1986, acquisition prices were approximated at four times revenue. After October, those values dropped to approximately two times revenue.¹⁴ As a result of the downturn in the market, money management fees remained flat in 1988 and managers were more willing to negotiate on fees.¹⁵

The switch to defined contribution plans is also effecting the money management industry. Risk-averse employee plans, such as 401(k)'s, have a tendency to choose the safest investment vehicles. Guaranteed Investment Contracts (GIC's) and mutual funds offered by large established managers are the prime investment vehicles which tends to concentrate money management in the hands of a few firms.¹⁶

Contrary to expectations, the number of pension funds solely using internal management has shrunk. *Pensions and Investments* 1990 survey of the top 200 funds disclosed that the number of funds managed entirely in-house had fallen from 30 in 1980 to 10.¹⁷ Passive investment strategies, such as indexed portfolios, are managed in-house but when diversifying into asset classes that require special skills, outside managers are contracted.

Unlike what's happening in the real estate advisory sector, there is no downward pressure on fees at this time nor is there a movement toward non-discretionary accounts. The annual fee paid by the total funds to their outside managers is 38.8 basis points, an

¹³ibid.

¹⁴Prices Fall for Advisory Firms,"*Pensions & Investments*, March 7, 1988.

¹⁵ibid.

¹⁶Kalson, G. "Make Room for New Managers," *Pensions & Investments*, Feb. 4, 1991.

¹⁷Williams, T. "The Dawn of a New Age for Internal Portfolios." *Pensions & Investments*, June 10, 1991.

increase from 1988's total of 35.7 basis points.¹⁸ Corporations and foundations pay an average of 44 basis points, while public funds pay 32.2.¹⁹ There is a trend toward performance-based fees: 15% of total funds now have performance-based fees, 8% expect to implement them, bringing the expected total to 22%.²⁰

Most notably, public plans display more of a propensity for developing in-house expertise as compared to private plans. Two reasons are cited for this phenomenon.²¹ With their faster growing pool of funds, public plans can justify the increased expenditure of developing a full-time staff. Secondly, public plan trustees are more actively involved in administering the fund and more willing to build in-house management operations. In contrast, the senior management of the private sector does not want to add fiduciary risk to their business risk. Pension administration is a different culture, removed from the sponsor's core business.

Real Estate Advisors' Response to Changing Market Conditions

Increased Service

Real estate professionals are dubbing the 1990's the "decade of service" or the "decade of performance." Whatever title is bestowed, it is certain that advisory firms will not enjoy the same relationship with pension funds that they did in the 1980's: pension funds will be calling the shots this time around.

Advisory firms have had to reassess their business strategies in order to carve out a place in today's more competitive market. "Asset management" has become the catch-word

¹⁸ibid.

¹⁹ibid.

²⁰ibid.

²¹Williams, T. "The Dawn of a New Age for Internal Portfolios." *Pensions & Investments*, June 10, 1991.

of the 1990's as investors seek to maintain the quality and competitiveness of the assets already in their portfolios.

Whether in-house management capabilities will be a criteria for advisory firm selection is unclear. Wiley Greig, at RREEF, submits that pension fund administrators are not convinced that in-house management improves investment performance. RREEF's philosophy is that superior performance can only be obtained when the assets are managed in-house. Unless pension fund can be shown, *quantitatively*, that this is true, they will question management fees which include this service.²²

The demand for higher reporting standards in conjunction with a downward pressure on fees will shrink the profit margin for advisory firms.²³ Copley Real Estate Advisors reports that five years ago clients were content with aggregate information which pertained to the entire portfolio. Now, they want property specific information; clients want to monitor the performance of the properties to avoid the possibility of any "surprises."²⁴

Some firms, relatively new to the business, are marketing their skills obtained from working in other segments of the realty industry such as development or brokerage. Trammell Crow, a name long synonymous with development, is flexing their property management muscles as Trammell Crow Realty Advisors, established in 1985. Another marketing ploy, one designed to appeal to property owners in today's overbuilt market, is Trammell Crow's nation-wide leasing network. Not willing to shed their developer's skin entirely, they also look to purchase for their clients properties in need of renovation. To reduce development risk, minimum 10% caps, based on existing rents, are used, and

²²Interview with Wiley Greig, RREEF, San Francisco, July 1991.

²³Interview with Linda Stoller, Copley Real Estate Advisors, Boston, July 1991..

²⁴ibid.

nothing less than a 15% IRR is considered. Cash-strapped sellers, in need of an infusion of capital are targeted.²⁵

Specialization

Other firms are establishing themselves as specialists in specific property types or geographic locations. When the dust of the 1980's started to settle, many funds found that their portfolios were heavily weighted toward office buildings. In an attempt to balance their portfolio mix, other property types were sought for their diversification benefits and as a means to boost portfolio performance.

Some newcomers to the management field feel that they have to specialize in a particular property type or geographic region that pension funds may not have in their portfolios; otherwise, they would never get their foot in the door.²⁶

Of the eight public and private pension plans queried, all stated that they were looking to fill out their existing real estate portfolios with specific properties. Advisory firms are accommodating that need by strategically positioning themselves as "experts" in particular property types.²⁷ Broad-based service approaches may be fine for huge firms, such as J.M.B., but will swamp the capabilities of smaller firms in an ever-competitive market. Besides, fund administrators note that advisory firms' reputations, their areas of expertise, are common knowledge within the industry. For example, the Alaska Permanent Fund is careful in selecting just those services that fit their particular needs. Central Real Estate Advisors and Metric Institutional Realty are hired to manage their multi-family holdings specifically because of their in-house management staff. Lehndorff-Babson is not

²⁵Interview with Mary Ann Hoffman, Trammell Crow Realty Advisors, July 1991.

²⁶Retkwa, R. "Pension Funds: Financiers of the '90's?" *National Real Estate Investor*, June 1990.

²⁷Interview with Linda Stoller, Copley Real Estate Advisors, Boston, July 1991.

used because they do not have in-house apartment management capabilities; however, they receive accolades for their management of Alaska's shopping center properties.²⁸

Targeting a niche and promoting it is the predominant strategic plan for survival amongst independent advisory firms. Firms such as Copley, who stress their "value-added" approach,²⁹ and A.E.W., known for their financial structuring of deals,³⁰ will focus on their well-known capabilities, as well as introduce new, specialized, product lines that are not currently held in portfolios.

New products include well-located single family developments, health care facilities, undeveloped commercially zoned land that exhibits a likelihood for development in the near future, timber properties and farm land. To entice wary, risk-adverse pension funds, single-tenant, net leased buildings, with ten years remaining on current leases are marketed. Retail and industrial properties in need of revitalization are also popular, though acquisition prices are determined solely by current cash flow. As can be seen from the variety of new products offered, the trend is away from core portfolio acquisitions, toward specialized property types that offer unique diversification benefits and higher potential returns.

Expanding Research Capabilities

The collapse of the property markets in oil-producing states spurred renewed interest in real estate research.³¹ Prior to interviewing industry representatives, the author was of the opinion that in-house research capabilities would be the factor determining which which advisory firms would flourish or fail in the 1990's. Research was found to be important, but not the fulcrum of future success.

²⁸Interview with Pete Jeans, Alaska Permanent Fund, July 1991.

²⁹Interview with Linda Stoller, Copley Real Estate Advisors, Boston, July 1991.

³⁰Interview with Michael Ervolini, A.E.W., Boston, July 1991.

³¹Interview with Wiley Greig, RREEF, San Francisco, July 1991

On the quantitative side, performance is what matters most to pension funds; if expanded research capabilities actually contribute to improved performance, so be it. But fund administrators will not chose a advisory firm by research capabilities alone.³² Of more concern to administrators was the qualitative side of the coin: trust in their advisors.³³ Trust in the capabilities of the advisory firm to perform their duties in the best interest of the pension client; faith in their reporting, that the numbers they are shown truthfully and accurately portray the performance of the property; and, comfort in inter-personal dealings with their managers. Real estate has, by its very nature, been a people-centered, relationship-oriented business, and that has not changed.

Having said this, does not negate the fact that new quantitative demands will be placed on advisory firms. The current ill health of the marketplace and concerns about the the future growth of the U.S. economy, will demand a more rigorous analytical approach to real estate investment.

An Emphasis on Information

The decision-making procedures utilized by successful real estate investors in the past, relied upon insights, either implicit or explicit, into the changing forces that effect market demand.³⁴ This was a function of a real estate professional's experience, network of contacts, and "gut instinct." Qualitative judgements will still be made, such is human nature, but pension funds will demand that decisions be backed up by quantitative support.

Because of increased client demand for improved reporting, accountability and asset performance, advisory firms will have to access and analyze data from a variety of sources.

³²Interviews with CalPERS, Alaska Permanent Fund, Ohio Public Employees and Illinois Municipal Retirement Fund, July 1991.

³³ibid.

³⁴Roulac, S. & Lynford, L. "Real Estate Decision Making in an Information Era" *Real Estate Finance Journal*, Summer 1990.

Demographic changes and employment growth will be monitored to determine the supply and demand dynamics of individual markets. Changes in business and industry will be tracked to determine their resultant effect on demand: corporate down-sizing, consolidations and mergers will shrink demand for space in some areas, while other areas, particularly those with a lower paid qualified workforce, will see an increase in demand.³⁵ Space usage will be effected by revolutions in communication and information technology, some properties becoming less valuable due to technological obsolescence

Successful domestic real estate investment in the near term will hinge upon accurate information for a number of reasons.³⁶

1. Excess supply of nearly every property type indicates that it will be several years until vacancy rates return to 'normal.'
2. Demand for space will not increase at the rate it did in the past. Slow growth in the economy and the downsizing of industries, will prompt tenants to economize on space.
3. Uncertainty, brought about by structural changes in the economy, will lead to more risk-adverse decision-making behaviors.
4. Real estate will not bring the record returns it did in the past, nor will it perform as well against other financial investments. Investors will be more conservative in their investments and more critical of their performance.
5. The demand for properties from institutional investors is greater than the demand by tenants to occupy that space.
6. Pension funds and other consumers of investment management services will demand higher standards of performance and accountability.

Due to client demands for quantified decision-making procedures, advisory firms are adding research departments or embellishing their existing ones.

³⁵“Capital Flow 1990: Real Estate Alternatives for Institutional Investors,” a report prepared for Equitable Real Estate Management Inc., by the The Roulac Group of Deloitte and Touche, 1990.

³⁶Roulac & Lynford, 1990.

A.E.W. recently sold a minority interest in their firm to United Asset Management. The \$15 million purchase price will reportedly be used to to expand the firm's research capabilities.³⁷ A.E.W. has a committed research staff which takes a technical, "top-down" research approach, using cluster analysis to determine in which areas properties should be purchased to obtain optimal diversification benefits.³⁸ By comparison, RREEF has adopted a "bottom-up" approach, examining the underlying economics on a deal-specific basis.³⁹ Copley Real Estate Advisors works in the same vein, as they feel a "top-down" approach does not explain why one building may be fully leased, while a similar building across the street lies vacant.⁴⁰

What is interesting to note is that A.E.W. feels that the pressure to develop research capabilities is not coming so much from the pension funds as it is from the consultants.⁴¹ Large pension funds, especially the public ones with in-house expertise, do not demand that their managers have extensive research departments.⁴² Information sharing between the client and the advisor, plus the discretionary nature of the accounts, are seen to make up for any research shortcomings.

Since the large plans employ several advisory firms, it makes sense that portfolio allocation strategies should be made at the pension fund or consultant level. Real estate advisors have been critical of the consultants' lack of leadership in this area, criticizing them for not taking a more proactive approach towards current real estate holdings and for not devising comprehensive strategies for real estate investment.⁴³

³⁷Williams, T. "A.E.W. Sells Stake in Firm," *Pensions & Investments*, April 1, 1991.

³⁸Lecture by Susan Hudson-Wilson, M.I.T., Center for Real Estate Development, Spring 1991.

³⁹Interview with Wiley Greig.

⁴⁰Interview with Linda Stoller.

⁴¹Interview with Michael Ervolini.

⁴²Interviews with CalPERS, Ohio Public Employees, & Illinois Municipal Retirement Fund, July 1991.

⁴³Interview with Mary Briggs, Mellon-McMahan Real Estate Advisors, San Francisco, July 1991.

Current Strategies for Real Estate Investment

Adjusting the Mix

The current lull in real estate activity is providing investors and advisors with the opportunity to reassess their real estate investment strategies. Compared to the fast-paced flurry of transactions that characterized the 1980's, the early 1990's will be a period of retrenchment, in which investors examine their holdings and plot their course for the future.

As pension funds look to reshuffle their portfolios, it is evident that office buildings, which once topped every funds' shopping list, will fall from grace.⁴⁴ Instead, investors will be looking to diversify their portfolios with industrial properties, community and neighborhood shopping centers, apartment buildings, and other "non-traditional" property types.

Industrial Properties

In the initial rush to diversify portfolios, industrial properties were targeted because of their steady performance over time. Unlike office buildings, which were prone to overbuilding due to speculation, industrial space closely followed the dictates of supply and demand.⁴⁵

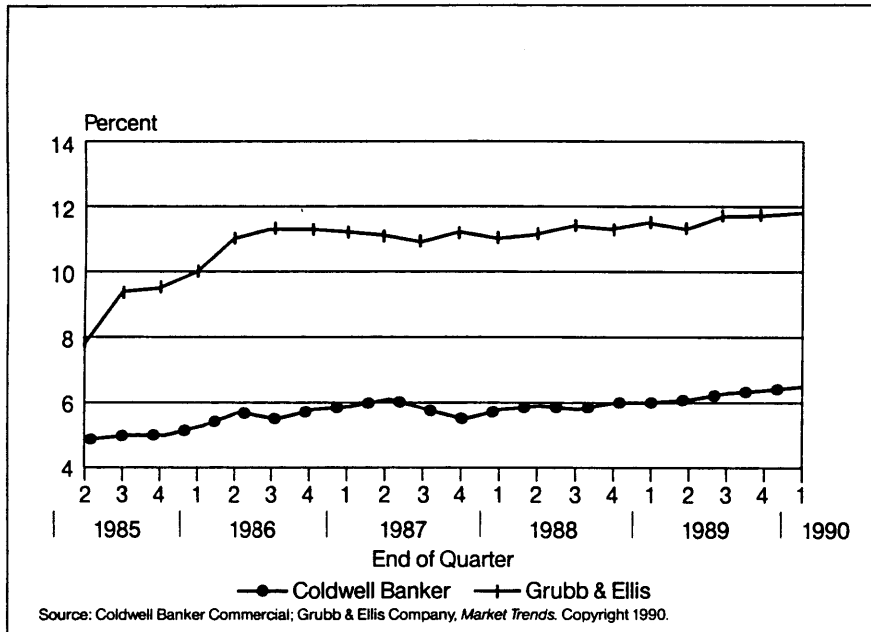
Currently, demand from institutional investors has decreased returns due to increasing prices. Whereas in 1989, 64% of the those institutions surveyed by the Real Estate Research Corporation (RERC) placed industrial properties at the top of their

⁴⁴RREEF doesn't even look at office buildings any more. Heitman will consider only exceptional deals. Crittenden Report, 9/17/90.

⁴⁵Lynne B. Sagalyn & Marc A. Louargand, "Real Estate and the Next Recession," M.I.T., Center for Real Estate Development, 1989

acquisition list, by 1990 it had fallen to 55%.⁴⁶ Reasons behind this decline include falling returns, increasing prices and slowing U.S. economic growth.

Exhibit 17
National Industrial Vacancy Rates



No boom in industrial space is expected due to several reasons:⁴⁷

1. Over 50% of industrial space is owner-occupied.
2. Of the rental market, 25% is single-tenanted, typically build-to-suit arrangements, while the remaining 25% of the market is multi-tenant. Merchant builders concentrate on this last quarter of the marketplace making it susceptible to overbuilding. Since these developments are easy to replicate, management sensitive

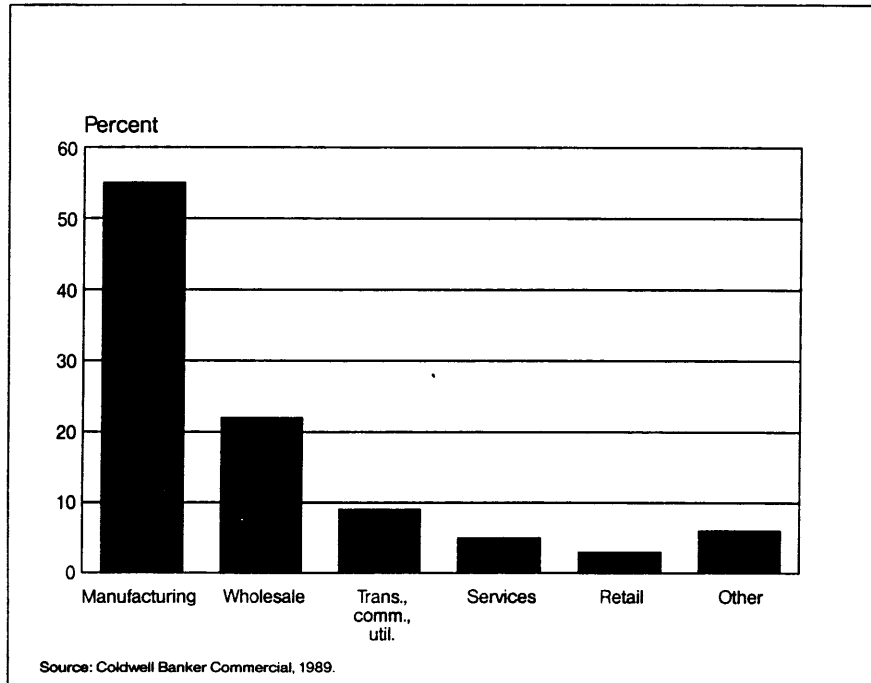
⁴⁶“Emerging Trends in Real Estate: 1991,” prepared for Equitable Real Estate Investment Management, Inc., by the Real Estate Research Corp, 1991.

⁴⁷Lecture by William Wheaton, M.I.T., Center for Real Estate Development, Spring 1991, and “Emerging Trends in Real Estate: 1991,” p. 27.

and highly vulnerable to economic downturn, it is debatable whether they are “investment grade.”

3. Overall, there is a downward trend in industrial space demand as the U.S. switches to a service-based economy. Manufacturing and wholesale trade employment, the biggest users of industrial space, has flattened. Manufacturing capacity utilization peaked in early 1989 and has fallen steadily.

Exhibit 18
Who Uses Industrial Space?



The fundamentals of the industrial marketplace suggest that advisory firms, especially those lacking proven performance in this field, will not see a significant increase in business. There will be no demand for new supply until wholesale employment growth stimulates new construction.⁴⁸

⁴⁸Sagalyn & Louargand, p. 11.

Community and Neighborhood Shopping Centers

Community and neighborhood shopping centers are receiving attention for two reasons. Pension funds need to diversify into retail but prices on regional malls are astronomical. Secondly, promoters of these smaller malls predict that as baby boomers age, regional malls will not be as appealing.⁴⁹ Many have made their major purchases, are entering their saving years and are more concerned with time-saving transactions. Local malls offer convenient parking close to the stores as well as a mix of tenants that can be specifically tailored to each neighborhood's needs.

In comparison to regional centers, these smaller centers do not have the same proportion of credit tenants, nor do they capture as large a market share as a well-placed regional mall.⁵⁰ As such, more cautious investors have been adverse to investing in these ventures. Their fears, however, are not born out by the data. In their analysis of returns from community centers Sagalyn and Louargand found returns to be less volatile than those exhibited by regional malls.⁵¹

Despite these findings, naysayers are not willing to embrace these smaller retail properties: there's too much of the product available, small malls must compete against neighboring retail establishments, and their tenants are vulnerable to economic downturns.⁵² Generally, these are pension funds who have their allocation of retail property invested in regional malls.⁵³ For those funds looking to add retail to their

⁴⁹ibid., p.43.

⁵⁰ibid., p.13.

⁵¹ibid., p.17.

⁵²"Emerging Trends in Real Estate: 1991," prepared for Equitable Real Estate Investment Management, Inc., by the Real Estate Research Corp, 1991.

⁵³Interview with Pete Jeans, July 1991.

portfolios, the unavailability and steep prices of regional malls has persuaded them to consider smaller malls, as well as "super stores"⁵⁴ and "power centers."⁵⁵

Due to the downturn in the economy and pessimism surrounding the future growth of the retail sector, plan sponsors are very cautious of retail acquisitions. The slowdown in new mall construction may provide opportunities to upgrade older centers to institutional quality investments but new projects will meet with investor reticence.⁵⁶ Though these alternative retail products are a current trend in the industry, it is unlikely that advisory firms new to this product type will capture much of the market. Only firms with an established "value-added" track records will be sought out by investors, and, even then may be required to invest along side the institutions in order to spread the risk. To market alternative retail schemes to pension plans, managers will have to arm themselves with a battery of supporting documentation attesting to the economic feasibility of the project.

Multifamily Residential

Pressures from investors have successively increased the prices on office, retail and then industrial properties. Apartment buildings will be next: pension funds pumped \$300 million into multifamily housing commingled funds in 1989, a 240% increase from 1988.⁵⁷ This does not include separate accounts or direct investments.

One factor contributing to interest in apartment buildings is that cash-conscious investors are realizing income, in the form of rent payments, from their investments. Appreciation at the back-end is not driving the deals, current cash flow is.

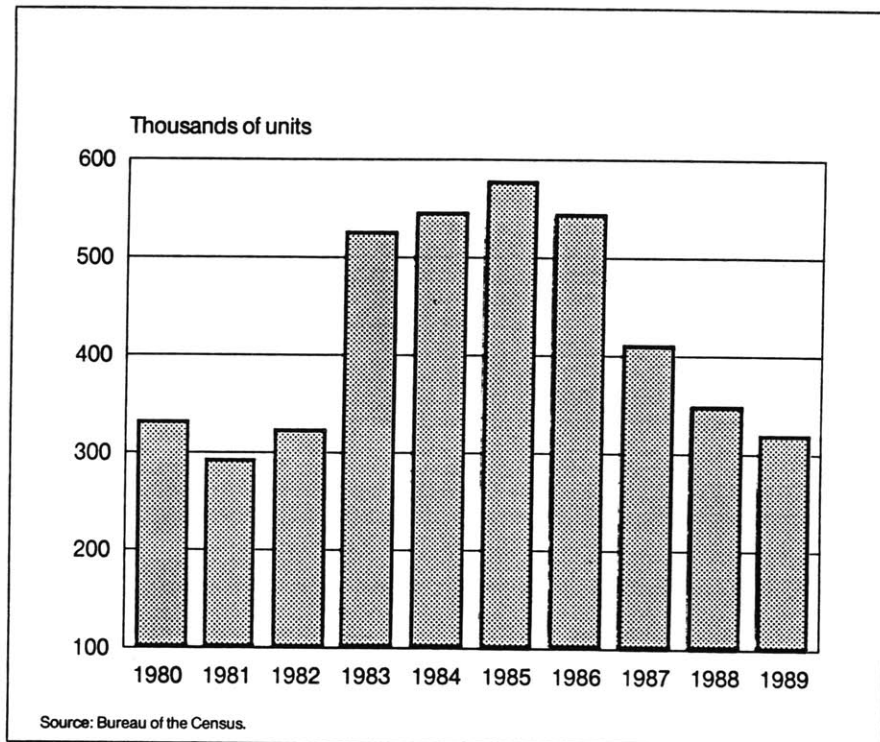
⁵⁴Super stores are large grocery stores which include bakeries, delicatessens, spirit shops and other specialties.

⁵⁵Power centers are shopping centers that do not contain a department store anchor, opting instead for a grocery store or large variety store.

⁵⁶ibid.

⁵⁷Hemmerick, S. "Apartment Hunt" *Pensions & Investments*, April 30, 1990.

Exhibit 19
Multifamily Housing Starts in
Buildings with 5 or More Units



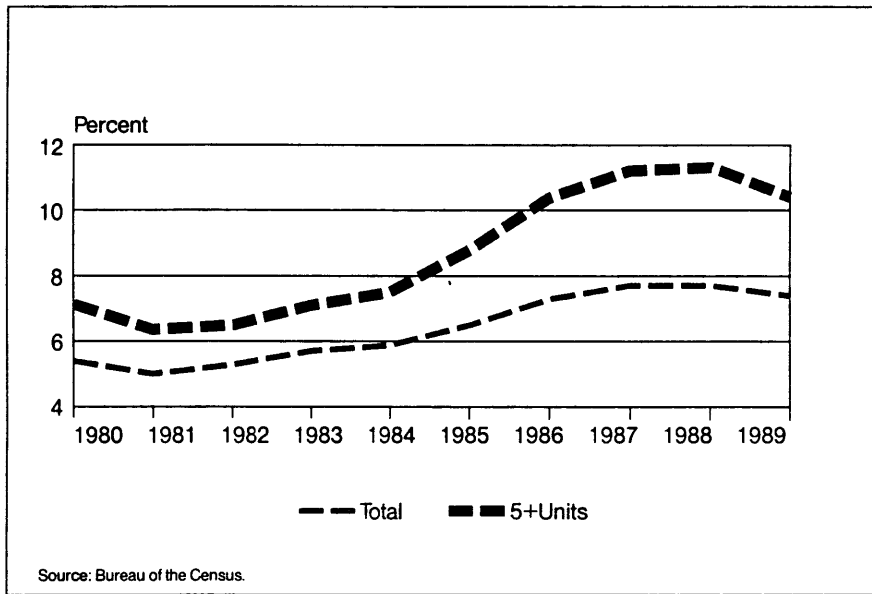
The economics of apartments support investor interest.⁵⁸ Supply and demand are, generally, in balance, with demand outstripping supply in some areas. Following the Tax Reform Act of 1986, apartment starts plummeted, individual investors having been stripped of their write-offs. Supply was further constrained by the financial troubles of the S & L's which made it difficult for developers to finance projects.

Institutional investors had little interest in this property type until the late 1980's: they had bigger fish to fry and did not want to be bothered with the management headaches. As traditional investment opportunities dwindled, the problems associated with multifamily projects no longer seemed insurmountable. Investors began to target supply-

⁵⁸ibid.

constrained areas and cities where the cost of owning a home had accelerated beyond the reach of its residents. Management risk could be reduced by the application of superior management skills.

Exhibit 20
Multifamily Rental Vacancy Rates



From a diversification standpoint, multifamily properties make sense: rents are not particularly sensitive to changes in the national business cycle and have been shown to be a relatively good hedge against inflation.⁵⁹ The ability of apartment rents to hedge inflation comes from three sources:⁶⁰

1. Short lease terms and renter expectations of rent increases during inflationary periods.
2. Inflation pushes interest rates higher, making it difficult for potential homeowners to qualify.

⁵⁹L. Sagalyn & Louargand, p.20.

⁶⁰ibid.

3. Rising interest rates will dampen construction starts for both rental and homeowner housing.

All of the pension funds interviewed expressed an interest in multifamily housing. Advisory firms have accommodated this demand with no fewer than 16 specialty apartment funds being offered as of mid-1990.⁶¹ Considering the interest shown by institutional investors, caution should be exercised to insure that supply and demand fundamentals are not forsaken in the rush to invest.

Research will play an important role in marketing multifamily properties to pension funds. Existing supply, potential supply, employment growth and demographic analysis will have to be carefully analyzed to justify investment, especially for new construction. Also, those advisory firms which offer in-house management will have the advantage over firms which contract out this service.

Going International

The advent of the European Economic Community has focused a considerable amount of interest on Europe. Declining performance of U.S. investments has prompted some investors to look abroad for opportunities -- looking is all they seem to be doing.

According to Greenwich Associates, Greenwich, CT, only 2% of 1,016 corporate pension funds and 3% of 310 public funds had any international real estate investment at the beginning of 1991. The prospects for future development are no brighter: only another 2% of corporate funds and 4% of public funds indicated they were planning to start investing in international real estate.⁶² Total U.S. pension fund cash investment in real

⁶¹Emerging Trends in Real Estate: 1991," p20.

⁶²Greenwich Associates, annual study of the investment management practices of U.S. tax-exempt funds, Greenwich CT, 1991

estate is estimated to be about \$3 billion, of which Canada accounts for approximately \$2 billion.⁶³

Several reasons contribute to investor wariness in international realty.⁶⁴

1. Pension funds have only recently progressed up the real estate learning curve in domestic markets. Having just gotten their sea legs in the U.S. market, and knowing full well what it took them to get there, they feel as though they do not have the expertise to invest internationally.

2. They've got enough problems at home. Funds are wrestling with poorly performing domestic portfolios and many are cutting back on their real estate allocations.

3. European property prices are higher than U.S. prices, a deterrent considering the poor performance of domestic markets.

4. American investors are unfamiliar with foreign business practices, regulatory and tax constraints, legal procedures, and the underlying economic drivers of supply and demand. A considerable amount of expense would be involved in acquiring just the rudiments of the market. Also, there is a concern about political stability and currency risk.

5. Investors complain about the lack of data and information pertaining to U.S. markets and find that most foreign countries are a "black hole" by comparison.

Despite the skepticism (this may echo the arguments given in the early 1970's for not investing in U.S. real estate) there are sound reasons for considering foreign investment.⁶⁵

1. The continued trend toward globalization of the world's economy necessitates the inclusion of foreign holdings to diversify the portfolio.

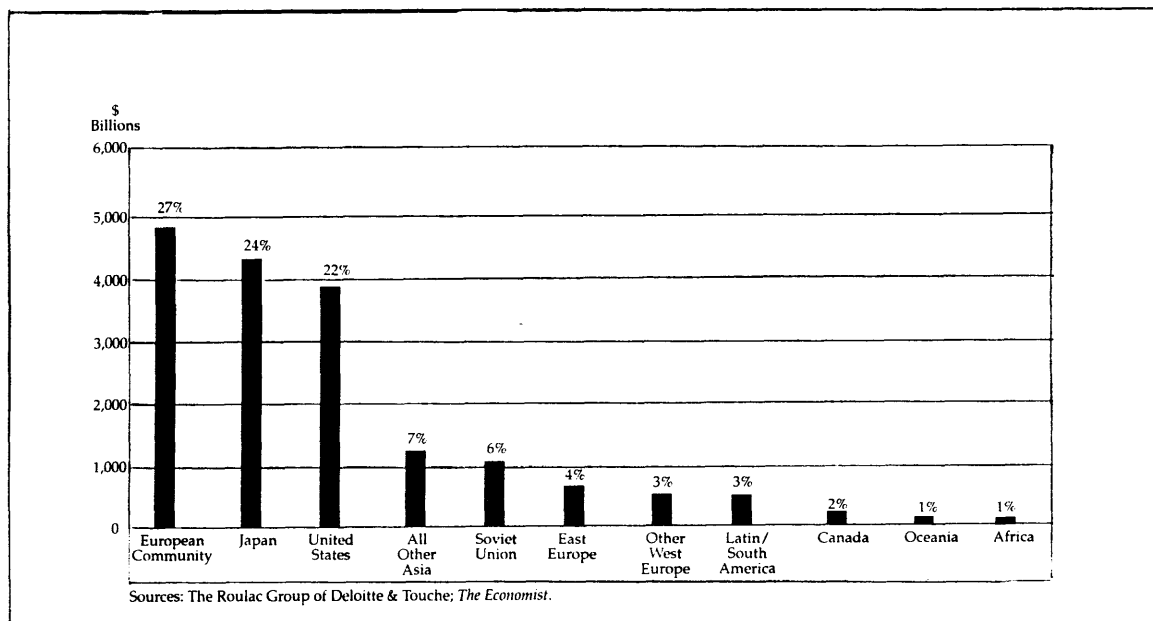
⁶³Hemmerick, S. "US Funds Wary of Overseas Realty Pitch" *Pensions & Investments*, April 29, 1991.

⁶⁴ibid.

⁶⁵ibid.

2. The U.S. market represents only a fraction of the global real estate market. The U.S. constitutes only 6% of the world's physical real estate, 5% of the world populations and 5% of cities with a population of 1 million or more.⁶⁶ With the significant amount investable funds controlled by U.S. pension funds, new investment opportunities may be found in foreign countries.

Exhibit 21
Global Real Estate Value
(1989 estimate)



The aggregation of real estate wealth in Europe, Japan and the United States is highlighted in Exhibit 21. Though other areas of the world may contain large populations and substantial real estate, those real estate values consist mainly of agricultural, residential and small retail uses. For this reason, institutional investors will concentrate their

⁶⁶Capital Flow 1990: Real Estate Alternatives for Institutional Investors,” a report prepared for Equitable Real Estate Management Inc., by the The Roulac Group of Deolotte and Touche, 1990.

investments in the top three areas. In the long-term, other select pockets within the Pacific Rim and Eastern Europe will be considered for investment.⁶⁷

Some of the U.S. pension funds interviewed expressed an interest in foreign real estate investment. CalPERS has taken the initial step by commissioning the Roulac Investment Group to study international real estate investing. Not everyone, however, on the CalPERS investment committee was convinced of the wisdom of international investment. In a split vote, they decided to adopt a policy that would allow the board to at least look at international investment.⁶⁸ CalPERS's Roger Franz, stated that they might consider creating a co-investment fund, spreading the risk with several other pension funds. They would adopt a similar strategy as that used in their RFP process: a detailed set of requirements would be established and prospective managers would bid accordingly. CalPERS would want to engage the services of an advisory firm that has had a long-term presence in the European community.⁶⁹

Many public pension funds will not play in the international real estate game unless freed from their legislative constraints.⁷⁰

Several advisory firms have offered commingled funds specializing in European properties, but have had little success in their marketing efforts.⁷¹ Jones Lang Wootton's limited partnership fund is seeking a \$500 million initial capitalization, with a target of \$1 billion. The minimum investment is only \$5 million, but as of April 1991 they had no takers. Prudential is marketing their Global Real Estate Investment Fund which has received money from Prudential's own general account and foreign pension funds, but no

⁶⁷ibid.

⁶⁸Hemmerick, "US Funds Wary of Overseas Realty Pitch."

⁶⁹Interview with Roger Franz, CalPERS, July 1991.

⁷⁰Interview with Kevin Comer, Ohio Public Employees Retirement System, July 1991.

⁷¹Hemmerick, "US Funds Wary of Overseas Realty Pitch"

American pension funds. JMB was considering marketing a commingled fund for European real estate but has shelved its plans due to lack of investor interest.

All of the pension plans and advisory firms interviewed expressed reluctance regarding international real estate investment. Responses from pension plans were all in the lukewarm range: “no interest at all,” “not now, maybe later,” “we’re considering it.” One respondent, who requested anonymity, replied that they had been burned in their initial European ventures and would therefore seek only the most conservative investment paths.

What was clear, in talking to these pension plans, is that they would not be inclined to use U.S. advisors for international investment. Instead, they would seek out established foreign advisory firms, with proven performance records and impeccable references in the host country. When asked if they would consider a U.S. advisory firm who was linked with a foreign firm, the general response was, “Why pay double the fees, why not deal directly with the off-shore expert?”

Though foreign investment will no doubt be the next wave in real estate investment, it is doubtful that U.S. advisory firms will play a significant role. To successfully position themselves to take advantage of foreign investment opportunities, domestic firms will have to clearly, quantifiably, demonstrate where they will add value. As stated earlier, it is unlikely that firms who have no previous experience in this field will be able to successfully market their international products. Investors are too wary to entrust any sizeable investments to a novice firm.

Consolidation of the Industry

The recent downturn in real estate activity, due to overbuilding, constricted capital flows, and record-low performance of real estate assets, will lead to consolidation within the real estate industry. Downsizing will effect every segment of the industry, from developers, to bankers, to builders, to brokers. Anyone offering real estate services will struggle to adapt in an industry that's no longer growing. Exhibit 22 indicates how the

volume of transactions has slowed by more than one-half. Though this data includes only insurance company activity, it is indicative of the slowdown that has pervaded the industry.

Exhibit 22
Survey of Mortgage Commitments on Commercial Properties
Made by 20 Life Insurance Companies

	<u>1st Quarter 1986</u>		<u>1st Quarter 1991</u>	
	<u># of Loans</u>	<u>(000) \$ Committed</u>	<u># of Loans</u>	<u>(000) \$ Committed</u>
Apartment	103	860,841	39	302,204
Office	231	3,003,686	39	459,739
Retail	93	1,050,039	43	703,343
Industrial	85	323,225	46	232,683
Total	512	5,237,791	167	1,697,969

Source: American Council of Life Insurance

The continued trend toward defined contribution plans will also hurt the real estate industry. Traditionally these plans have chosen highly conservative, capital preserving investments that are easier to administer than real estate investments. In the near-term, it is unlikely that there will be a detectable shift toward real estate investment (Exhibit 23.)

Exhibit 23
Defined Contribution Plan
Percent Allocation to Equity Real Estate

	<u>1988</u>	<u>1989</u>	<u>1990</u>
Change in 401(k) Plan	0.1%	0.5%	0.3%
Change in Profit-Sharing Plan	2.4	1.3	1.1
Change in Savings and Thrift Plan	0.4	0.0	0.1
All Defined Contribution Plans		1.0	0.6

Source: Greenwich Associates

Interviews with industry representatives indicate that as pension funds keep pushing to lower fees and demand more service, marginal advisory firms will be forced out of the business. Currently, fees are figured on 60 basis points of assets under management, down approximately 100% from 100-125 basis points several years ago.⁷²

To remain in business, it is estimated that advisors will need to have \$500 million to \$1 billion of assets under management.⁷³ Those firms with less than \$500 million will have to merge, relinquish their portfolios, or quit. The movement toward consolidation is already much in evidence: RREEF absorbed Piedmont Realty, Sentinel is buying Meyer Real Estate Advisors, McMahan merged with the Mellon Bank 18 months ago, and A.E.W. acquired Security Portfolios in Los Angeles. Adding to the pressure is the fact that pension funds are shifting whole portfolios from one manager to another in the hopes of improving portfolio performance. Aggregation is also indicated by the increasing number of advisory firms seeking to purchase whole portfolios from distressed investors, banks and insurance companies.

Consolidation implies that the large firms will get larger; vertically integrating to provide more services to clients, a "one-stop shopping" approach. This does not mean that small firms are doomed to extinction. Small firms that are able to establish a reputation as specialists in a particular property type, geographical area, or service, will find themselves in demand. Several of the pension funds interviewed, especially the public plans, expressed a penchant for boutique firms: "Performance is the determining factor, not scale."⁷⁴ Having developed their own in-house expertise, public funds look to the boutique firms to fill out their existing portfolios with specified properties.

⁷²Interview with Mary Briggs, Mellon-McMahan, San Francisco, July 26, 1991.

⁷³Interviews with Mary Briggs, and Wiley Greig, July 1991.

⁷⁴Interview with Kevin Comer, July 1991.

Chapter Five Conclusions

Real estate is not just experiencing "another downcycle" as has been true in the past. What we are witnessing is a major evolutionary change in the real estate industry due to a number of factors: a shifting of the U.S. economic base from manufacturing to service; changing demographics which decrease the growth in demand for most property types; structural oversupply of nearly every property type; the restructuring of the real estate capital markets; and, diminished expectations about future economic growth. Throughout the 1970's and early 1980's the U.S. was in an expansive stage of development, now it has plateaued. Concurrently, the growth of total pension fund assets is leveling off, in sync with slowing economic growth.

Aggregate demand for space has slowed since its peak in 1984 yet buildings continued to be built through the late 1980's. The amount of square footage added in the last decade is staggering. It is estimated that 38% of all shopping centers, 33% of all existing office buildings and 25% of industrial space, was added to the U.S. inventory of stock.¹ Currently, national office vacancy rates hover at 20%. Salomon Bros. research department predicts that national vacancy rates will not drop below 15% until the year 2022 as a result of the slowdown in office employment.² Operating returns for 1991 will range between 5% and 6% but the negative appreciation component will drag overall returns to an all-time low of -4%³

In light of this economic climate, the following general trends regarding pension fund investment in real estate have been identified:

¹Evans, M. "Real Estate 1991--The Party's Over," *Journal of Property Management*, January 1991.

²"No Quick Fix for Office Vacancies," *Pensions & Investments*, April 1, 1991

³Hemmerick, S. "Dismal Performance Imperils Realty Firms," *Pensions & Investments*, March 18, 1991.

- Despite the gloomy economic outlook, pension funds will remain committed to real estate. Real estate is now considered a core portfolio asset, in the same league as stocks and bonds. Though the overall industry allocation to real estate is low, less than 5%, all of the pension funds interviewed expressed a 10% target commitment, with two sponsors seeking a 15% allocation.⁴

- During the past decade pension funds have gained a better understanding of what real estate is, what it is not, and what benefits can realistically be derived from holding property. They have come to understand that real estate should not be treated as a bond, passively held until its maturation date. Instead, it is viewed more as an operating business, an investment that requires proactive management and administration in order to optimize returns.

- Modern portfolio theory will be applied at the pension fund/consultant level to achieve overall portfolio diversification benefits. Within-real estate diversification techniques will also be promulgated at the pension fund/consultant level since many of the large funds employ several advisory firms. Increasingly, consultants will be called upon to assist in developing overall real estate investment strategies. No longer can investors simply say they "buy the best priced properties in premier locations." A defined policy, with clearly stated objectives and a course of action will be required.

- Transactions will take place at a slower pace due to increased due diligence demands.

The Effect on Advisory Firms

- The trend toward separate accounts will continue as pension funds seek more control over their realty assets. Advisors will operate in a non-discretionary capacity, with fund administrators exercising control over all important decisions.

⁴Anonymous and Illinois Municipal Retirement Fund.

- The move toward separate accounts will allow clients to change advisors more readily than they did in the past. Within the industry, 30-day cancellation notices are becoming standard.

- Commingled funds will be difficult, if not impossible, to market due to sponsor demand for more control. Commingled funds which allow investors more discretion will likely be the only funds to survive in the current market. Separate accounts will be the primary growth area.

- Pension funds will not be seeking core portfolio acquisitions, the trend will continue to be towards peripheral properties that will provide superior diversification and income benefits.

- Acquisitions will no longer be product-driven but research-driven. Sponsors will demand quantifiable proof of the future performance of the asset. Advisors will have to verify that the underlying economics of supply and demand justify acquisition.

- Asset management will play an increasingly important role. In today's soft market asset management is the only way to add value. Acquisition capabilities will not be as important to clients as a management capabilities. Advisory firms will tend to act more like operating companies as compared to their "deal-driven" acquisitions persona of the previous decade.

- Consolidation within the advisory industry will continue. New firms will find it virtually impossible to survive unless they can quickly acquire a critical mass of assets to manage. Two types of firms will exist; either very large firms offering multi-faceted service capabilities or boutique firms which specialize in certain types of properties or services.

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Joan Fallon, TIAA

Roger Franz, California Public Employees Retirement System

Wiley Greig, RREEF, San Francisco

Mary Ann Hoffman, Trammell Crow Real Estate Advisors

Steven Hoover, General Electric

Pete Jeans, Alaska Permanent Fund

Laurie Ann Kloppenbug, Loomis-Sayles, Boston

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