THE EVOLUTION OF PENSION FUND REAL ESTATE PORTFOLIO DIVERSIFICATION STRATEGIES

by Barbara R. Cambon, CRE

Pension funds began investing in real estate in the early 1970s. During the last 25 years they have accumulated approximately $120 billion in property of various types through a number of investment formats. During the last five years pension fund portfolios have been impacted dramatically by the worst market downturn since the real estate asset class was added to their overall portfolio asset allocation. This article reviews the historical development of diversification strategies within the real estate sector in order to identify and discuss the factors most likely to influence the further evolution of pension funds' investment strategies for real estate.

Pension funds initially began investing in real estate through large open-end commingled funds, many of which were sponsored by insurance companies. The fund manager was responsible for all decisions regarding the diversification of the portfolio. Most funds had a broad charter in terms of the stated investment strategy and, consequently, were invested in most commercial property types throughout the United States. Early in the life of these funds, the predominant property types were office, retail and industrial. All were income-producing properties that generally were unleveraged.

By the early 1980s, the investor market began to question the validity of appraisal-based pricing and the liquidity promised by the open-end funds. In response, fund managers developed a product structured to meet these concerns—the closed-end fund. Early closed-end funds still had a fairly broad property type charter, including office, retail and industrial, but generally were smaller capital pools and thus acquired a smaller number of properties. The first generation of closed-end funds added little to the diversification of investors' portfolios.

As the capital market demand for the asset class from all sources increased in the late 1980s, pension funds grew increasingly selective in their investment acquisition strategies. While their asset allocation studies continued to dictate target funding levels in excess of the value of their current property holdings, the pricing of new acquisitions had shifted. Lower initial cash yields were accepted in exchange for the prospects of greater future growth. Real estate acquisition strategies became increasingly focused not only on certain property

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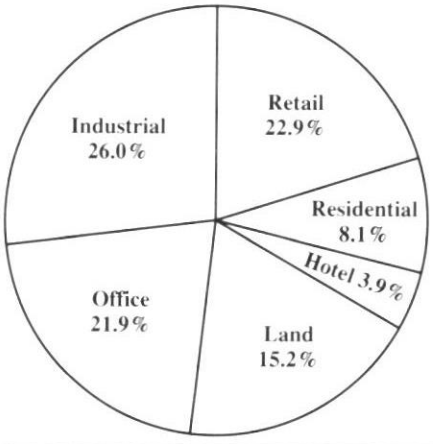
types and regions, but on specific properties. Investors increasingly looked to direct property acquisitions, or fully or partially-specified pooled funds, as the preferred investment mode. In 1988, office acquisitions (in terms of dollars invested) hit an all time high. By the end of the decade, the bottom fell out of not only that strategy, but the property market in general.

FIGURE 1

Portfolio Index Composition by Property Type
(Quarter 4, 1979)

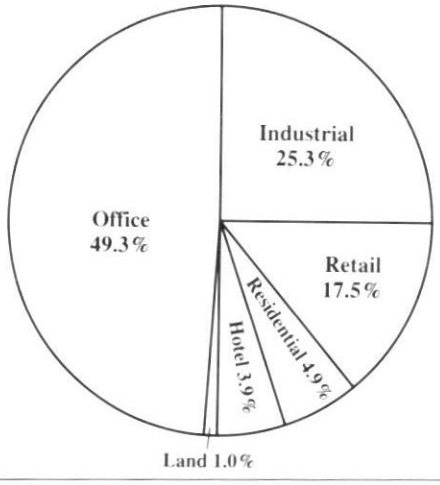


Source: Institutional Property Consultants, Inc.

By the early 1990s pension funds were looking in two fairly narrow directions: specified property types that were expected to generate steady income and positive growth (primarily retail), and new categories of non traditional or non core investments

FIGURE 2

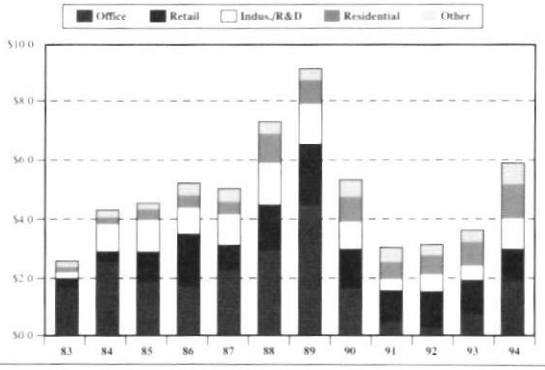
Portfolio Index Composition by Property Type
(Quarter 4, 1984)



Source: Institutional Property Consultants, Inc.

FIGURE 3

Pension Fund Real Estate Acquisitions by Property Type
($ Billions)



Source: Institutional Property Consultants, Inc.

which included timber and farmland. Improved supply/demand relationships in the apartment sector contributed to the acceptance of multi-family apartment investments as part of the real estate portfolio strategy. During this time frame, investment strategies for new commingled fund products were becoming increasingly focused regarding property type and geographic location. The drop in office property values, combined with increased acquisition volume in the retail sector, had altered the real estate portfolio mix. The market research needed to assist in identifying future growth prospects by property type and region was addressed by the emergence of senior researchers in several of the top traditional real estate advisory firms.

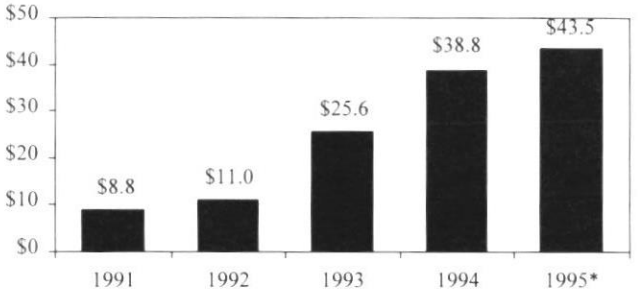
During the same period of time, the capital markets were beginning to respond to the shifting capital demands of the real estate sector. Just as changing regulatory conditions led the traditional sources of real estate finance to withdraw from new investment in real estate, Wall Street was seeking ways to capitalize on the resulting capital void. During 1992-1994, the market capitalization of the Real Estate Investment Trust (REIT) sector grew from less than $10 billion to over $40 billion. These new public companies had management and assets in place, capital to grow and a recent record of attractive dividend yields.

How have these factors influenced pension funds' real estate diversification strategies? New pension fund investment capital is slowly returning to the real estate sector, but investors are much more introspective. The last five years of returns have had a significant impact on how pension funds approach the strategic planning process for the real estate sector. This has led to critical reexamination of the real estate advisor's role in the investment planning and implementation process.

At the same time, the market recovery has brought a whole new array of investment formats and investment strategies many of which are being offered by new investment firms. The real estate capital market matrix is a topic of discussion at many pension real estate conferences. These changes are influencing these investors' real estate investment strategies in a number of ways.

FIGURE 4

Total Market Equity REIT Capitalization
($ Billions)



Source: NAREIT ***As of June 30, 1995**

Core And Non Core

The mix of core and non core strategies has shifted with non core strategies now comprising up to 50 percent of the total real estate allocation. Core strategies are defined as completed, substantially leased properties with stable operating income in major metropolitan markets with anticipated total returns of 200 basis points over ten year Treasuries. Core properties may be apartments, industrial, retail and office. Non core strategies are properties with a higher risk profile than core and/or require specialized management and expertise with anticipated total returns of 300 basis points over core expected returns (i.e., 500 basis points over ten year Treasuries). This shift is the result of pension funds' re-examination of real estate's role in their overall investment strategy. Many of these large capital pools appear to be moving increasingly toward substantial indexation of their domestic equity portfolios. As this takes place, these funds will increasingly look to their private investments, including real estate, to provide better than market total returns. Thus, private investments are being increasingly viewed as the yield-enhancing sector of the portfolio. This view argues for a portfolio strategy with a larger percentage of non core investments with higher expected total returns.

Property Type Mix

Property type mix in the portfolio is likely to be rebalanced more frequently through investor-driven portfolio decisions. The advent of property type-specific investment programs has provided the pension investor with better mechanisms for changing the portfolio's property type mix over time. The emergence of market mechanisms, such as the Institutional Real Estate Clearinghouse designed to facilitate the transfer of the investors' investment interests, also will provide investors with greater flexibility over their portfolio mix and their ability to change that mix over time.

Publicly Traded Real Estate Securities

The publicly traded real estate companies will play an increasingly significant role in the investors' portfolios. Pension funds will continue to seek out quality management and assets at attractive pricing which may be available through public companies. Many of the new REITs are highly focused in their strategy, particularly by property type, which will contribute to the investors' control over portfolio mix.

Private Real Estate Securities

The new generation of private real estate securities (commingled funds) has incorporated a number of structural and governance changes. These changes have increased their attractiveness as investment formats. Many of these funds are infinite life funds with the expectation that over time they will perform like real estate operating companies. Investors desiring liquidity in their private securities will have new mechanisms available, such as the Clearinghouse. The Clearinghouse is an industry-sponsored facility designed to disseminate information and list bids and asks for the nearly $40 billion of existing commingled funds as well as all newly formed funds. Investors will be able to sell their shares, or units, in private real estate securities through a screen-based electronic trading system designed to serve the needs of the private institutional real estate marketplace.

Opportunity Funds

Following the lead of the RTC, banks and insurance companies developed programs to reduce, over a short period of time,their real estate portfolio holdings. Forming up on the buy side was entrepreneurial capital willing to take the risks of early stage property market recovery. As the magnitude of the portfolio disposition process became better understood, and as the sponsors of these early investment pools began to generate exceptional returns to participants, a next round of funds, the opportunity funds, was offered to pension funds. These non core strategies have substantially higher risk-return criteria, but, to date, have been successful in attracting nearly $10 billion from pension funds. Opportunity fund strategies continue to evolve today, seeking out those areas of investment most affected by changing capital market participants or overlooked by the marketplace. For

example, some opportunity funds are evaluating opportunities to acquire ownership stakes in public limited partnerships.

International

Pension funds now hold a significant percentage of their total portfolio investments in non-U.S. stocks and bonds. Increasing allocations to international investment reflect the differential economic growth rates projected around the globe and the demand for capital to fuel that growth. The same rationale for international investments in general can be applied to real estate investing as well. As investors evaluate the projected growth in property current yields and value available in the U.S. market, they will eventually turn their attention to non-U.S. property markets. Indeed, institutional investors today are seeing a growing array of international real estate investment programs with strategies ranging from stable investment markets (i.e., the UK market, with a long history of property investment by global investors) to emerging markets with their demand for development of new modern properties. As the opportunistic phase of the U.S. property market cycle begins to wind down, it is expected that investors' attention may shift to international markets which offer the potential for returns higher than projected for the U.S. market.

Conclusion

The real estate market in which pension funds invest during the rest of this decade will be very different from that of the 1980s. Continuing institutionalization of the $3 trillion U.S. property investment market will ultimately shift the ownership of the sector from the individual entrepreneur to large institutions. Second, the securitization of real estate investments certainly will experience another wave or influx of investment capital, converting what once were private real estate development companies into publicly owned real estate operating companies. Information technologies will spur the depth and breadth of this market as greater access to information on both public and private real estate companies is achieved at a lower cost.

By the end of this decade, pension portfolios will have expanded beyond the private market pooled fund and direct investment strategies primarily employed during the last real estate market cycle. Portfolios will include investments in real estate companies, private and public, with both U.S. and non-U.S. property holdings. The expertise that will be tapped to run these portfolios will come not only from the traditional real estate advisory community, but also from the ranks of real estate operators whose business activities once centered around development and property management. Securities firms will, with the growth in the market capitalization for publicly traded real estate companies, seek to develop specialists in the sector. Already the number of management firms specializing in this area has grown. Real estate pricing will become more significantly influenced by transaction pricing of investor interests as contrasted with the current market mechanism for private market investments of appraisals of property interests. While real estate is likely to continue to be viewed as a long term hold asset, investors will have the increased flexibility to change their minds over the holding period.

The changed structure of today's real estate arena has created a new playing field for pension fund investors. Illiquid private market investments will comprise only one component of institutional investors' total real estate holdings. High quality real estate investments combined with the right management and ownership structures will continue to be the key ingredients. Successful real estate strategies will access the sector through a broad array of private and public market options.