WHAT'S NEW IN ASSET ALLOCATION?

by Susan Hudson-Wilson

The use of asset allocation tools in the risk management and return enhancement of real estate portfolios has, at long last, come into its own. Investment advisory and real estate research and strategy firms provide institutional investors with rigorous quantitative methodologies to analyze the structure of a portfolio and assess the likelihood its returns are achieved with the least amount of risk possible. Sophisticated institutional investors apply the tools now and others will follow over time.

While the adoption of this approach to portfolio construction and management is laudable, there is never a spare moment to savor the accomplishment. A major complication to the portfolio design problem has been introduced called the "quadrants" approach to real estate. The quadrants approach seeks to broaden the traditional definition of real estate to include all the ways real estate is expressed in the investment arena. This article will explain the sense of the quadrants and discuss how the concept both complicates and enriches our thinking. In recent papers I have explained the concept of the quadrants approach to investing.[1] The intuition is recounted here.

The Sense Of The Quadrants

Traditionally real estate has, at least in the institutional investment community, been narrowly defined as assets traded in the private markets. Insurance companies allowed for the notion that both private debt and private equity could be accommodated within that definition. However, pension funds held that real estate equaled private equity. This traditional idea is now being challenged and explored for two primary reasons.

The first reason to broaden the definition of real estate is because the market where real estate assets trade does not determine the ultimate value of the investment. The ultimate value is determined by the real estate itself. For example, if a REIT was to liquidate, the value of the shares would instantly revert to the value of the underlying real estate. The management premium or discount and the impact of the stock market would evaporate as an influence on the share value. Thus, real estate is really what you are buying when you buy a REIT. A further example is a CMBS issue. If push comes to shove, particularly for the BB and lower tranches, and the real estate underlying the mortgages becomes distressed, the value of the position would be fully dependent upon the value of the real estate.

Susan Hudson-Wilson, CFA, is president and founder of Property & Portfolio Research, Inc., an independent real estate research and portfolio strategy firm. The firm services large institutional investors in the development of investment strategies suitable for their real estate portfolios.

Thus, the trading market and the structure of the investment layered on top of the asset serve to alter the timing of cash flows and perhaps to recut the riskiness of cash flows. This does not alter the importance of the underlying real estate. The trading market creates temporal shifts in the performance of the asset and adds influence to its valuation. Consequently, the trading market where an asset is priced and transacted should not cause us to overlook that real estate continues to drive the asset's ultimate performance.

The second reason to broaden real estate's definition is that all real estate is, to a greater or a lesser degree, comprised of both debt-like and equity-like behaviors.[2] The leases represent the cash flows most synonymous with the debt market as leases are contractual cash flows derived from differing credits. This is precisely analogous to a bond. The unleased portion of a building, and/or the space in the building at the end of the lease term is characterized as pure residual equity. The value has no contractual obligations attached to it; this part of the value is 100 percent exposed to the conditions in the market. A speculative multitenant office or industrial building is a good example of an entire property which is characterized as pure equity.

Every building, with the exception of one with a AAA credit tenant on a triple net lease, is exposed to both these behaviors in differing degrees. All real estate is a hybrid. Until now real estate investors have not paid appropriate attention to this extremely important reality. Debt and equity behave very differently in terms of their expected returns, riskiness and correlations with other assets. It is important to be specific about the desired mix of these two behaviors within the real estate portfolio.

The quadrants approach, which looks to debt and equity and to public and private markets, makes sense intuitively and from the all-important portfolio perspective. Given our acceptance of this premise, what are the implications? Some enormous complications to portfolio management and planning arise immediately. The first is the appropriate definition of core[3] and the second is the setting of performance norms for mixed asset allocation. Enormous benefits arise including a greatly enhanced access to the tools of active portfolio management and the expanded ability to take advantage of arbitrage opportunities across the real estate markets.

The Definition Of Core

Institutional investors require a fairly specific definition of a core investment strategy as a starting place to set investment policy. They need to know where to find the middle of the road to decide whether to perform in line with or to deliberately deviate from that standard. Pension fund boards are accustomed to this type of reference point in other asset classes, and they desire it in real estate.

The traditional definition of real estate included a definition of core based on performance norms rather than on the contents of the private equity quadrant. In other words, the definition included assets that exhibited stabilized performance and did not necessarily reflect the majority of assets in the market. This approach flies in the face of the most fundamental finance theory and really was not the proper way to think about core. A more appropriate and consistent approach would be to use the words core and index somewhat synonymously. Core should be defined as the behavior of the investable universe within each quadrant. This universe would not necessarily exhibit stabilized behavior at all times, but it would accurately capture the relevant available universe.

Core must be redefined for the private equity quadrant and the index notion must be applied to the other quadrants. This implies that the definition of core within and across the quadrants will shift over time and that the definitions will not be identical.

The Setting Of Performance Norms

We are currently conducting mixed asset, asset allocation exercises without the benefit of an appropriate input for the real estate asset class. The data set presently used by allocators reflects yesterday's understanding of core measurement. The allocations which use the traditional definition of real estate are far smaller than the allocations which use a more inclusive definition. This is not of trivial importance to the chief investment officers of pension funds and insurance companies, since they are judged on their performance relative to these norms. For the real estate portfolio manager, as well, there are implications. They are putting one set of behaviors into the asset allocation model and delivering a different and unrelated set of behaviors to the aggregate portfolio. This disconnect will eventually wreak havoc in the planning and evaluation processes. The real estate portfolio manager's job would become far more interesting if the size of the allocation and the scope of the permissible investment options would increase. We do not know what performance numbers should go into the asset allocation model. We are driving without a map.

Access To The Tools Of Portfolio Management

If the definition were expanded to cover all the quadrants, the real estate portfolio manager, now restricted in shuffling the mix of the real estate portfolio, would have vastly improved flexibility in portfolio management. Allocations to property types and geographies could be more flexibly and more cost effectively shifted to reflect changing markets and portfolio return requirements and tolerances for risk. The portfolio manager could establish a base of private market holdings which over time could use the public and more divisible markets to execute incremental portfolio restructurings. The benefits of reducing the cost of portfolio repositioning would permit the portfolio to be more efficiently structured for longer times. In the private equity quadrant the cost of restructuring is so high that frequently the benefits of a redeployment are overwhelmed by the costs.

Arbitrage Opportunities

A final benefit associated with broadening the definition of real estate to cover all the ways real estate expresses itself, is that the investor would be in a position to exploit arbitrage opportunities across the quadrants. It is frequently the case that one market or another is essentially mispricing the assets within the market. For example, currently the private market is pricing a shopping mall at a far lower cap rate than the public market. If an investor is interested in an allocation to retail, the availability of a choice in the market of execution would surely draw the investor to the public market. Some very enhanced returns can be earned by exercising the spreads caused by the inefficient pricing in markets over time. At any rate, it makes no sense to overpay for something which is available at a greatly reduced price in a related market.

Conclusion

What's new in asset allocation? Too much! The simple world of private equity is being challenged with an intuitively plausible expanded definition of real estate. Real estate is more appropriately described as investments in which the driving or ultimate performance determinant is the underlying real estate and not the trading and pricing market. Also real estate has been misdefined as private *equity* when, in fact, virtually all real estate is comprised of both debt and equity behaviors.

The new definition brings great challenges. We must redefine core across the quadrants and will probably end up with a concept that is based on the notion of indexation. We need to capture the true behavior of each quadrant, not the behavior of a sub-set of stabilized assets. We must also recalculate the performance norms of real estate in order to think properly about the issue of allocation to real estate in the mixed asset portfolio. Since we are not properly specifying the performance, we are probably underallocating to the real estate class.

Good things come from the shift in definitions as portfolio managers gain access to a far wider set of portfolio management tools. The tools will be more flexible and cost effective to execute shifts in the real estate portfolio which are desired by the investors. In addition, the portfolio manager will be in a greatly enhanced position to exploit arbitrage opportunities across the quadrants. Investors will be able to seek the lowest cost fashion to execute the allocations within the real estate portfolio. This will save execution cost and will add return to the portfolio. As with most important sea changes, this one has its challenges and its benefits. However, overall, this change is sensible and useful.

NOTES

1. Elbaum, Bernard and Susan Hudson-Wilson: "Diversification Benefits for Investors in Real Estate", *Journal of Portfolio Management*, Volume 21, Number 3, Spring 1995, pp. 92-99.
   Guenther Daniel and Susan Hudson-Wilson: "The Four Quadrants: Diversification Benefits for Investors in Real Estate—A Second Look", *Real Estate Finance*, Volume 12, Number 2, Summer 1995, pp. 82-99.
2. Cashdan Daniel, Jeffrey Fisher and R. Brian Webb: "LOBs and RAREs: The Decomposition of Commercial Real Estate Returns," Working Paper, Indiana Center for Real Estate Studies, 1991.
3. Hudson-Wilson, Susan: "A Note: Defining 'Core' Real Estate—What's the (   ) Quadrants Got To Do, Got To Do With It?", *Real Estate Finance*, Fall 1995.