Bank Trust Department Operation of Commingled Real Estate Funds

by Mike Miles and Janelle Langford

INTRODUCTION

Commingled real estate funds are becoming an important vehicle through which money managers offer their clients participation in the real estate market. These commingled funds offer the advantages of real property investment while minimizing certain diversification, liquidity, financing, and transaction cost problems. With the growth in pension and profit-sharing dollars and ERISA's diversification requirements, several commercial banks have initiated such funds. The client commits a portion of his total dollars to real estate and receives these benefits:

1) Higher returns than the stock market.[1]
2) Greater income stability.
3) Specialized personnel to make and manage the investment.
4) Greater investment liquidity than would be individually possible in the real estate area.
5) Participation in large scale projects with minimum investment.
6) Diversification both geographically and by type of property.
7) Inflation protection.[2]
8) Lower overall portfolio risk.[3]

Based on the enumerated advantages and the growth of trust and pension funds generally, these funds should continue to grow and become an integral part of a commercial bank's offerings to pension and profit-sharing clients. Correspondingly, an understanding of the investment perspective of bank trust departments will become increasingly important to all real estate professionals.

Despite rapid growth in the past few years, bank-operated commingled real estate funds are still a relatively new phenomenon. Several major banks are just completing logistical plans for the implementation of such funds with an

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even larger group still in the feasibility stage. Of the nation's 50 largest banks, only these twelve[4] currently have operating commingled real estate funds:

Bank of America
Bankers Trust Co.
Chemical Bank
Citizens and Southern
Continental Illinois National Bank and Trust Company
Crocker National Bank
First National Bank of Boston
First National Bank of Chicago
Morgan Guaranty[5]
North Carolina National Bank
Wachovia Bank and Trust
Wells Fargo Bank

Essentially, commercial banks are a subset of one of five alternatives for pension funds seeking to include real estate investments in their portfolios. The pension funds can:

1) Individually own and manage real estate assets.
2) Individually own and hire outside management for real estate assets.
3) Use group ownership and management of real estate assets.
4) Purchase shares in limited partnerships involved in real estate.
5) Invest in undivided pools managed by banks or insurance companies.

Recent interest in the last alternative stems from the facility with which this vehicle can overcome problems typically associated with real estate investment (as compared to investment in stocks and bonds):

1) Initial investment research in an inefficient market is both difficult and time consuming. At the same time, such a market creates comparative advantage opportunities in valuation which point out a need for "expert" investment advisors.
2) Management of real property assets is messy and costly, yet tremendously important.
3) The scale of real estate investment opportunities often requires investor groups and/or substantial debt financing. The large investment scale further complicates diversification efforts.
4) The investment term is typically rather long and the investment relatively illiquid during the term.

Given the advantages and attendant problems of including real estate investments, option five looks particularly attractive. The interesting questions involve the investment strategy, operation, ideal size, and structure of such pools.

Structurally, commingled pools have several investment alternatives ranging *from* low loan-to-value first mortgage loans on completed, well-located, fully-occupied projects having net leases to Triple A tenants *to* equity positions in heavily leveraged development projects.[6] In between lie numerous intermediate positions paralleling the unfortunate REIT legacy. Essentially, the structure decision involves packing the investment asset to fit the project's riskiness and to meet client objectives. The use of mortgage financing can be viewed as a way to divide a project's cash flow into different risk categories. The well-managed fund will seek an asset structure which will maximize returns consistent with a desired risk exposure.[7] (For example, Chemical Bank has two commingled real estate funds, Mortgage Leaseback and Equity, with each designed to meet a certain set of client needs.)

THE SURVEY

This study deals exclusively with bank trust department sponsored commingled real estate funds.[8] Following a search of the literature,[9] the questionnaire shown in *Exhibit I* was prepared and mailed to the 50 largest U.S. banks as reported in *Fortune* (July, 1977). A draft of this paper with detailed responses was then sent to all 50 banks as an added assurance of accuracy.

EXHIBIT I

COMMINGLED REAL ESTATE FUND QUESTIONNAIRE

Note: If you have more than one fund, please complete a separate questionnaire for each fund.

1. Is the Trust/Investment area of your bank currently managing a commingled real estate fund?
   ______ Yes. In what year was it begun? ____________ *Skip to question 4*
   ______ No. *Answer question 2 or 3.*

2. If the Trust/Investment area previously managed a commingled real estate fund but has discontinued it, please give the dates it was operative and explain briefly why the fund was discontinued. Then complete questions 4 through 23 based on your experiences with that fund.

3. If the Trust/Investment area has *never managed* a commingled real estate fund, when would you expect to initiate such a pool? (Please check one answer.)
   ______ 1978-1979 ______ Uncertain
   ______ 1980-1985 ______ Never
   Please complete this questionnaire hypothetically on the basis of your current beliefs about commingled real estate funds.

4. Please check the type of clients that participate in your commingled fund and the percentage that each comprises of the total dollar investment of the fund.

	100%	99-75%	74-50%	49-25%	24-1%
______ Pension	______	______	______	______	______
______ Endowment	______	______	______	______	______
______ Personal Trust	______	______	______	______	______
______ Other (Please explain)	______	______	______	______	______

5. Check the type of properties in which your fund invests and check the percentage of the total dollar investment of the commingled fund which each property type comprises.

	100%	99-75%	74-50%	49-25%	24-1%
______ Office	______	______	______	______	______
______ Commercial Retail	______	______	______	______	______
______ Industrial	______	______	______	______	______
______ Residential	______	______	______	______	______
______ Raw Land	______	______	______	______	______
______ Farm Land	______	______	______	______	______
______ Hotel/Motel	______	______	______	______	______
______ Other (Please explain)	______	______	______	______	______

6. Does your Fund have minimum and/or maximum amount which it will invest in one property?

Minimum	*Maximum*
______ No minimum	______ Less than 500,000
______ 0-$200,000	______ 500,000 to 1,000,000
______ $200,000-499,000	______ 1,000,000 to 5,000,000
______ $500,000-1,000,000	______ 5,000,000 to 10,000,000
______ $1,000,000 or over (Please give limit ________)	______ Greater than 10,000,000
	______ No maximum

7. In regard to geographical diversity, would you characterize your fund's investments as previously

______ Local
______ Regional
______ National
______ International

8. Does your fund invest in mortgaged property?

______ Yes
______ No

9. What is the expected annual cash flow return from the fund's investments?

Current Portfolio Average		*New Investment Expectation*
________	Negative	________
________	0 to 5%	________
________	6 to 8%	________
________	9 to 11%	________
________	12 to 15%	________
________	Greater than 15%	________

10. What is the maximum percentage of the total dollar investment of the commingled fund that each participant may own?

______ 0-5%
______ 6-10%
______ 11-15%
______ 16-20%
______ 21-25%
______ Greater than 25%
______ There is no such requirement

11. Who is responsible for locating properties in which your fund invests?

______ Done internally
By whom? ______________________________
______ Generated externally
By whom? ______________________________

12. Who is responsible for managing the properties in the fund?

______ Done internally
By whom? ______________________________
______ Done externally
By whom? ______________________________

13. How long is a participant required to stay in the commingled fund?

______ No minimum time requirement
______ Less than one year
______ 1-5 years
______ 6-10 years
______ 11-15 years
______ More than 15 years

14. How long does it take for a withdrawal request to be honored?

______ 90 days or less
______ Less than one year but more than 90 days
______ 1-2 years
______ 3-4 years
______ Greater than 4 years

15. Give the total dollar investment of your commingled fund in the years below.

______ 1960
______ 1965
______ 1970
______ 1975
______ 1978 (the present)
______ 1980 (expected)

16. Has the poor performance of the REIT's adversely effected the public acceptance of your fund?
   ______ Yes. Greatly
   ______ Somewhat
   ______ Very little
   ______ Not at all
   ______ Cannot determine

17. Who is your major competition for the type of clients investing in your fund?

18. How are you advertising your fund to potential participants?
   ______ Actively marketing to new participants.
   ______ Marketing through clients whose funds we already manage.
   ______ Waiting for potential participants to come to us.
   ______ We do not want to increase our fund.

19. Why did your bank decide to initiate a commingled real estate fund? Please rank from 1 (most important reason) to 8 (least important reason).
   ______ High potential return on investment
   ______ ERISA's diversification requirement
   ______ Disenchantment with stocks and bonds
   ______ Management fees
   ______ Geographical diversification
   ______ Type of investment diversification
   ______ Customer demand
   ______ Other (Please explain) ______________________________

Survey conducted May-July, 1978.

SURVEY RESPONSES

Number of Banks Operating Funds

The first three questions categorize the respondents. There were 12 trust areas currently managing a fund of which 11 fully completed the questionnaire. Of the 36 respondents who are not currently managing a fund, 12 were able to answer the questionnaire hypothetically.

Fund Origination and Current Size

Date Initiated	Assets in 1978
1 in 1961[10]	400 mil[11]
1 in 1965[10]	44 mil
1 in 1967	50 mil
1 in 1971	50 mil
1 in 1973	130 mil
1 in 1974	3 mil
3 in 1975	27 mil, 15 mil, 20 mil
2 in 1976	14 mil, 4 mil
1 in 1977	1 mil[12]

Three of the respondents never expect to initiate such a fund, 28 have no definite plans, and four plan to begin a fund before 1985. Citibank is already in the process of initiating its new closed-end fund.[13]

Growth of Commingled Funds

Fund Size by Bank[14, 15]

	Morgan Guaranty[16]	Chemical Bank[16]	Wachovia Bank and Trust	Continental Illinois National Bank and Trust Company	North Carolina National Bank	Wells Fargo Bank	Bank of America	First National Bank of Boston	First National Bank of Chicago	Crocker National Bank	Citizen and Southern
1960	35	9									
1970	365	32	5								
1975	591	52	35	38	2	11	6				
1978	330	45	50	50	3	20	27	15	130	14	4
(Exp) 1980	400	—	100	75	15	—	100	35	200	75	15

Among the 50 banks, cluster diagrams and cross tabulations indicate no consistent relationships between the banks' operating funds and the banks' sizes, incomes, or trust incomes. However, the largest five banks all either operate a fund or plan to initiate one in the immediate future.

Type of Client

All of the existing funds have 100% pension and profit-sharing clients. Five of the hypothetical answers (banks planning funds) would split their investment to include personal trust dollars or endowment funds.[17] Moving to individual accounts would involve federal income tax complications as well as increased competition from investment counselors and may involve the banks in investments beyond their traditional scope of expertise.

Investment Size

Only three of the banks' operating funds have a minimum for potential investment size (all $1,000,000), while all but four banks have maximums of 10% of the funds' assets (three banks report no maximums).[18] Of the planned funds, five anticipated no minimum while eight anticipated a maximum varying from 5% to 15% of the funds' assets.

Types of Property

Commercial/retail and industrial/warehouse properties are the most popular form of investment for operating funds with office building investment seemingly on the upsurge. Non-income producing property is included in only three of the funds. Only one fund has "all of its eggs in one basket." Eliminating this 100% response, the average number of property types in each fund is 3.5.

PERCENTAGE INVESTMENT IN TYPES OF PROPERTIES ACQUIRED—OPERATING FUNDS

Number of Funds Investing the Given Percentage of their Assets in Each Type of Property

	Number of Funds Investing in This Type of Property	≤ 20%	21-39	40-59	60-79	80-99	100%
Office	6	3	3				
Commercial Retail	9	2	5			1	1
Industrial/Warehouse	9	3	2	1	3		
Residential	4	3		1			
Raw Land	3	3					
Farm, Forest and Mineral Land	0						
Hotel/Motel	3	3					
Other	4						

Leverage

On the leverage issue, actual fund managers still prefer straight equity investment with eight of the operating funds not investing in mortgaged property (one of these has future plans to include mortgaged property). However, the hypothetical responses were more in favor of mortgaged property with 60% intending to include some mortgaged property in the portfolio.[19] Comparing the growth in operating funds to whether the fund invested in mortgaged property, there was no significant correlation. Only two funds decreased in value: one was a strictly mortgage fund (i.e., no equity) and one invested in equities of mortgaged property.

Returns

Seven of the operating funds have at least a 9-11% current annual cash flow return and eight expect this return to be attainable with new investments. (Hypothetically, three of the respondents planning a fund would expect a 12-15% return on new investments while only one of the existing funds expected such a return.) While four of the existing funds have a current average return of less than 9%, only two expected such a rate on new investments.[20]

Seemingly, several of the funds have not been meeting expectations. Yet, Chemical Bank provides a chart to compare its fund's annual rate of return to returns of alternate investments. This return was figured including capital gains and ordinary income. The compound rate for the life of the fund exceeds the alternative investments by at least 2% as shown in *Exhibit II.*

EXHIBIT II

ANNUAL RATES OF INVESTMENT RETURN INCLUDING CAPITAL GAINS AND INCOME

Year Ending 9/30	Commingled Real Estate and Mortgage Fund	Dow Jones Industrial Average	Standard & Poor's 500	S.P. High Grade Bonds
1969	(6.5)%	(9.0)%	(9.0)%	(7.3)%
1970	6.9	(2.2)	(5.7)	(0.7)
1971	23.3	20.2	19.8	12.1
1972	11.3	10.7	15.2	8.9
1973	9.5	2.9	1.1	2.5
1974	0.9	(29.7)	(35.8)	(2.2)
1975	8.1	37.0	37.7	7.9
1976	0.5	29.5	30.0	15.3
1977	11.8	(10.2)	(4.0)	11.0
COMPOUND RATE				
9 years	7.0	3.5	3.5	5.0

Limitations on Client Participation

The commingled funds offer pension clients a way to invest a portion of their funds in fairly liquid and diversified real estate fund participations. However, the bank operated funds usually have broad limitations on participating interests in terms of the maximum percentage of the fund which any pension client can own and the length of time to which the pension client is committed to the commingled fund. Most of the operating funds allow up to 10% ownership by a single client,[21] and nine have no stated minimum length of investment. In fact, nine of the operating funds try to honor a withdrawal request in 90 days or less making commingled bank trust funds fairly liquid pension investments.[22]

Open Ended

Most of the existing and planned funds are open ended. Citibank's fund is the exception as it is a closed-end fund and has an 11-15 year holding requirement. Other respondents planning a fund felt that any closed-end fund would involve a holding period anywhere from 10 to 30 years. Closed-end funds were seen appealing to large pension clients with possibly a 20% maximum participation of any one client of the total dollar investment of the fund which should exceed $40 million. Correspondingly, open-end funds were seen for smaller pension and tax-exempt clients with a 5% maximum participation in portfolios between $10 and $70 million and one to five-year withdrawal times.

Locations of Investment Properties

Locating quality real estate is a key element of any fund. While four of the existing funds characterize themselves as regional investors (with one intending to become national) and seven as national investors, all of the trust areas use internal means to locate the property with five using supporting external sources. Internally, six of the operating trusts use specially hired personnel, two simply employ existing personnel, and two use both. Of the five that employ supporting external personnel, the following were listed:

Appraisers and counselors	1
Agents and broker/developers	2
Real estate firms (as advisors to the fund)	1
Mortgage brokers	1

The percentage of planned trusts anticipating the assistance of outside-the-bank professionals in locating investments did not vary greatly from the existing funds' responses. Use of outside professionals by planned commingled funds included:

Appraisers and counselors	2
Brokers	7
Developers/builders	4
Industry contacts	1
Mortgage bankers	2

Property Management

All but one of the banks gave the same responses to the internal management of the properties as they did to the internal location of investments. The external management firms, used primarily for on-site assistance by operating funds, were:

Local property management firms	4
Specialized agents	1
General real estate firms	1

Competing Investors

With more dollars seeking investment in the real estate area, the competition for properties is increasing. Insurance companies, with large stable flows of funds and expertise in the area, represent the respondents' greatest source of competition. Foreign investors, other banks, individuals, and syndicates also represent significant competition for quality properties. Due to the level of competition driving down yields on suitable properties, some respondents are starting to look at properties in the construction and development stage. Clearly the risk situation shifts dramatically as funds consider development alternatives. However, as one respondent noted, the banks that have funds may not be able to achieve, in the next five to seven years, what they thought they could and there will be pressure to shift to entrepreneurial activities.

Major Competition for Properties
(respondents marked more than one)

	Planned Funds	Operating Funds
Mortgage Banks	0	0
Insurance Companies	8	11
Foreign Investors	3	5
Other Banks	3	5
Individuals	4	3
Syndicates	4	4

Competition for Clients

In terms of the type of client served, the responding banks clearly saw insurance companies and other banks as their principal competition.

Major Competition for Type of Client

	Planned Funds	Operating Funds
Mortgage Banks	0	0
Insurance Companies	7	11
Other Banks	4	7
Syndicates	4	0
Other		
Investment counselors	2	1
Individuals	1	0

The REIT Legacy

The failure of so many REITs has been seen by many authors to have affected the establishment of other real estate ventures by banks. The majority of the total respondents felt that REITs had *somewhat adversely* affected the acceptance of commingled bank-sponsored funds.

SUMMARY AND RELATED ISSUES

Commingled real estate funds are increasingly becoming a feasible way for commercial bank trust departments to meet the demands of pension clients. Stable return, diversity in property type and location, liquidity, and expertise in management combine with the general advantages of real estate investment to make commingled bank funds attractive. As pension funds grow, so will the potential for bank operated funds. Many banks contacted in the survey, who do not currently manage funds, expressed a strong interest in receiving the survey results. Based on recent growth, expressed interest, and potential, the authors see bank trust departments becoming a much more important influence in certain real estate markets.

As banks and other institutions (both domestic and foreign) move increasingly into the real estate field, they bid up prices and returns drop. This prompts the often heard comment "there just aren't enough *good* properties." As this trend accelerates, the individual investor may be price-risk adjusted into properties not well suited to institutional investors, particularly high-risk development and tax shelter investments whose prices will not be as affected by the market entrance of institutional buyers. If banks learn from the REIT experience, and avoid these types of investments, an interesting interface will emerge with individual investors making development decisions to provide future investment alternatives in a market heavily influenced by institutions.

REFERENCES

1. Returns over the last decade have substantially exceeded common stock returns. (See *Exhibit II)*
2. In fact, through certain combinations of contractual arrangements, such as percentage rents and cost escalation clauses, some real estate investments actually show net annual cash flow improvement due to inflation.
3. Inclusion of real estate assets can improve the risk-return aspect of pension portfolios due to the low correlation of real estate returns with returns evidenced on stocks and bonds.
4. Manufacturers National Bank has a mortgage only fund which is currently being amortized through regular payments. Chase Manhattan had a fund which was liquidated when mortgage yields became less attractive than marketable longer-term bonds.
5. Morgan Guaranty does not purchase operating positions in either of its two funds.
6. For debt financing to be fully effective it must of course involve positive leverage. However, any debt decreases the stability of annual cash flow and should be viewed by the pool manager as a way to divide claims on a property's cash flow rather than enhance risk-adjusted return.
   Refinancing can be a useful way to provide for periodic distribution of price appreciation, but the potential for accounting irregularities is not insignificant when refinancing is combined with "market value" income statements. (Note that the audit opinion on existing commingled funds is typically a "subject to" opinion.)
7. In addition to investment questions, structural issues involving the extent of distributions and closed vs open funds must be settled again mindful of the anticipated client profile.
8. The March 1978 issue of *Pension World* covers a survey of 31 organizations managing large-scale real estate portfolios. Eight of these organizations were commercial banks with the data reported in that survey being generally consistent with the more detailed responses reported in this survey for those eight banks.
9. Academic literature in this area is practically non-existent. A computerized data search of business periodically produced a series of articles citing the importance of the area and discussing several of the issues involved.
10. Three of the banks which had pre-1965 funds are now also managing a second fund.
11. The combined total of both of Morgan Guaranty's strictly mortgage funds.
12. Second Chemical Bank Fund.
13. To summarize, 12 banks have a fund in operation, two have operated a fund, three never plan to have a fund, 28 have no definite plan, four plan to initiate a fund before 1985, and one is beginning currently, for a total of 50 banks.
14. Figures not available for Bankers Trust.
15. Relative sizes are not always good measures of market impact due to variations in use of mortgage financing.
16. Both funds included in total.
17. According to the *Comptroller's Handbook for National Trust Examiners,* funds held by national banks as fiduciary may *currently* be collectively invested (1) in a common trust fund maintained by the bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as trustee, executor, administrator or guardian; (2) in a fund consisting solely of assets of retirement, pension, profit sharing, stock bonus, or other trusts which are exempt from federal income taxation under the Internal Revenue Code.
18. National Banks managing collective funds face a 10% maximum under regulation by the Comptroller of the Currency.
19. In terms of risk exposure, a fair generalization would be that strict mortgage funds are least risky, then strict equity funds, then funds which hold equity in mortgaged properties.

20. Funds' reported investment performance must be carefully examined as the funds report annual "appreciation in value" as income according to "Comptroller of the Currency Requirements." Annual revaluation is necessary to unit-value participants' proportionate share on withdrawal.
21. Chemical Bank has a varying percentage requirement depending on the characteristics of the individual account.
22. The time element involved in many of the funds was both flexible and complex. There is often an unwritten understanding about clients being locked-in; at least longer than month to month. For example, a comment from one respondent who checked "no minimum time requirements" was "to gain full benefit, an account would be required to regard its participation as a long-term commitment."