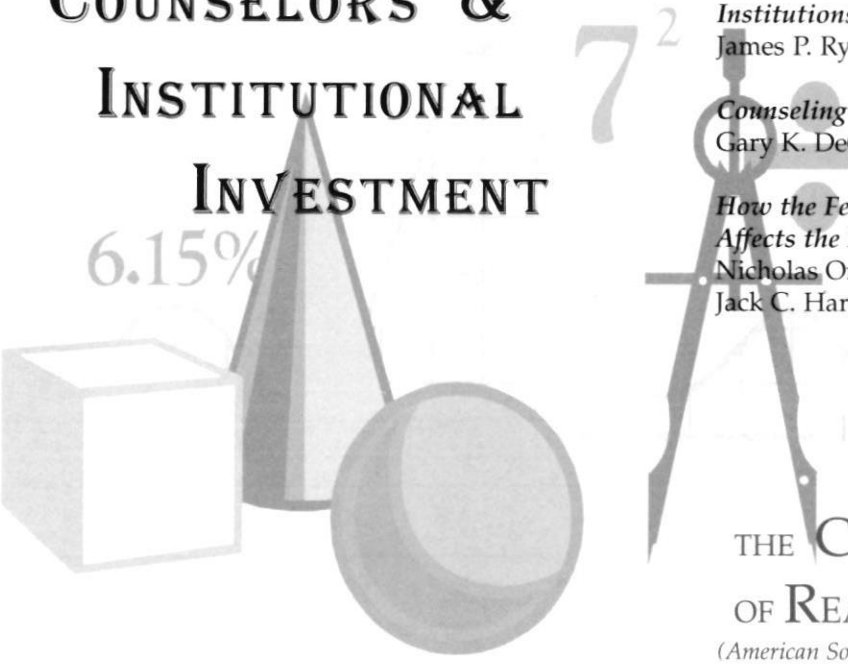
December 1995

Volume 20
Number Three

# REAL ESTATE ISSUES

## REAL ESTATE COUNSELORS & INSTITUTIONAL INVESTMENT



## $PECIAL EDITION



THE COUNSELORS OF REAL ESTATE™
(American Society of Real Estate Counselors)

# ABOUT THE COUNSELORS OF REAL ESTATE

The Counselors of Real Estate, now in its 40th year, is an international group of high profile professionals including members of prominent real estate, financial, legal and accounting firms as well as leaders of government and academia who provide expert, objective advice on real property and land-related matters.

Membership is selective, extended by invitation only on either a self-initiated or sponsored basis. The organization's **CRE Designation** *(the Counselor of Real Estate)* is awarded to all members in recognition of superior problem solving ability in various areas of specialization such as litigation support, asset management, workouts, valuation, feasibility studies, acquisitions/dispositions and general analysis.

Networking is the hallmark of The Counselor organization. Throughout the year, educational programs provide Counselors with opportunities, both nationally and locally, to meet with fellow members and professional colleagues to discuss the latest trends affecting commercial real estate. A publications program, highlighted by our award winning professional journal, *Real Estate Issues*, provides a venue for members to showcase their knowledge of such areas as office buildings, retail centers, hotels/motels, real estate counseling , etc.

### *What is a real estate counselor?*

A counselor is a real estate practitioner whose primary business is providing expert, experienced advisory services to clients for agreed-upon fees. Counseling denotes an activity that is, by its nature, relational. The client relies upon the counselor for skilled and objective aid in the client's real estate needs, implying both trust on the part of the client and trustworthiness on the part of the counselor. The counselor typically has acquired a broad range of experience in the real estate field, possesses technical competency in more than one real estate discipline, and places those competencies at the service of the client. While objective in analysis, the counselor directs his efforts toward the client's best interests through the development of particular strategies, evaluating options available to the client, advocacy of the client's interests, and - where required - execution of strategy on the client's behalf.

Those designated as Counselors of Real Estate (CRE) have been recognized and esteemed by their peers as persons meeting the above definition in an exemplary fashion. They have demonstrated knowledge, experience, integrity and judgment in their real estate expertise. The CRE subscribes to and is bound by The Counselors' Code of Ethics and Standards of Professional Practice and endeavors to generously assist fellow CREs who are performing client services in a spirit of collegiality. Thus, the commitment to the individual client is complemented by a commitment to raise the standard of counseling practice for the industry as a whole.

### *Users of counseling services*

The demand increases for expert counseling in real estate matters worldwide. Through the years, institutions, estates, individuals, corporations and federal, state and local governments have recognized the necessity and value of a Counselor's objectivity in providing advice. These real estate professionals honor the confidentiality and fiduciary responsibility of the client-counselor relationship.

CREs service both domestic and foreign clients. Assignments have been accepted in Africa, Asia, the United Kingdom, the Caribbean, Central and South America, Europe and the Middle East. The Counselor has the benefit of proven knowledge and experience which qualifies him for practical application and proper interpretation of trends affecting real estate. A major player in the technological revolution, the Counselor regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

### *Determinants of compensation*

The CRE is compensated by pre-agreed fee or salary for services, rather than by commission or contingent fee. The counseling fee itself is assured and rendered for advice rather than achievement or outcome of the transaction. Overall compensation can be determined by the complexity of the service performed, its value to the client, the time and expense involved, the breadth of the Counselor's knowledge and experience, and the responsibilities assumed. **Anyone involved in real estate should consider consulting with a CRE.**

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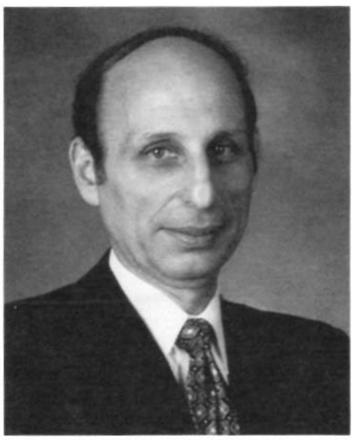
# SOL L. RABIN RECEIVES 1995 BALLARD AWARD



Sol L. Rabin

I am pleased to announce that Sol L. Rabin, Chairman of Investment Research, Westmark Realty Advisors, Los Angeles, has been named the 1995 William S. Ballard Award recipient for his article "Institutional Real Estate Investors Confront the Frayed-Collar Economy," published in this edition of *Real Estate Issues*. The award, presented annually, recognizes the author whose work best exemplifies the high standards of content maintained in *Real Estate Issues*, published by The Counselors of Real Estate. Funding for the William S. Ballard Award, which carries an honorarium of $500, is provided by the generous contribution of the William S. Ballard Scholarship Fund in memory of the late Ballard, a former member of The Counselors of Real Estate.

In his article, Rabin proposes that the American economy is in the midst of a long term transition from a middle income to lower income society. He states that the frayed-collar economy will have profound impacts on American real estate and institutional real estate preferences. Rabin concludes that while some products will lose status, other new real estate investment opportunities will emerge as core.

Along with his research at Westmark, Rabin also teaches at the UCLA Graduate School of Management and the USC Graduate School of Business Administration. He previously served as associate director of UCLA's Business Forecasting Program.

The Counselors of Real Estate applaud the efforts of Sol Rabin along with the other contributing authors whose fine works enable the journal to serve as a forum for leading information and trends in real estate.

Macdonald West.

**Macdonald West, CRE**
*1995 President*
*The Counselors of Real Estate*

*REAL ESTATE ISSUES*

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# *Real Estate Issues*





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# GIFTS OF KNOWLEDGE

In the midst of the holiday season our thoughts may turn to love, sharing, family, friends and gifts. Or, we may be more in tune with Ebeneezer Scrooge and say "Bah humbug" to any diversions from business as usual. While CREs (Counselors of Real Estate) are more likely to exhibit traits of charitableness, giving and consideration for others, this Special Edition of *Real Estate Issues* should appeal to all types of personalities. After all, while it is about business, we can appreciate the articles within as the gifts of knowledge and wisdom they represent.

Ebeneezer Scrooge, for purposes of investment, certainly would be interested in knowing who owns and controls most of America's large properties. And, of course he would know that such ownership rests with the large institutions–primarily real estate investment trust (REITs) and pension funds. But would he know that CREs are some of the primary advisers to these large institutional investors? So that other Ebeneezer types and real estate professionals are better informed on the issues and trends relevant to institutional real estate and the talents Counselors provide to the owners and managers in this sector, *Real Estate Issues* is devoting the special edition to this subject.

CREs are uniquely qualified to provide counseling services to large institutional investors. They are experts not only in analyzing individual properties, but also in portfolio risk analysis, portfolio construction, strategic planning and performance measurement. The edition includes articles by some very knowledgeable professionals in the field. They provide their analyses of the changing economy and its effect on institutional investment, portfolio decisions and strategies, the impact of the information revolution on CREs, real estate performance measures and market segmentation. We are particularly proud to begin the edition with the William S. Ballard award-winning article by Sol Rabin on how institutional investors can confront the "frayed-collar" economy.

I suspect that CREs and other subscribers to *Real Estate Issues* will want to gather their families and friends around the dinner table (or perhaps the fireplace) each evening of the season to read and discuss one or more of the articles presented here! May the spirit of Christmas and Chanukah prevail. To all our readers I wish the added insights that deep reflection of profound truths can bring and hope that your new year will be happy and prosperous.

Hal Smith

**Halbert C. Smith, CRE**
*Editor in chief*

# CHARLES SHAW RECEIVES 1995 JAMES D. LANDAUER AWARD

**Charles Shaw**

The Counselors of Real Estate has presented Charles Shaw, president of The Shaw Company, Chicago, as the 1995 recipient of the James D. Landauer Award. Shaw is the first non-member in the history of the award to receive this honor since its establishment in 1986. The Landauer Award is given annually, when appropriate, to a real estate professional who has furthered the ethical and professional ideals of The Counselors of Real Estate and its CRE (Counselor of Real Estate) designation. Shaw was honored during a luncheon ceremony at The Counselors' Annual Convention in Atlanta.

"The Counselors are extremely pleased to recognize Charlie for his remarkable career in real estate," said Logan Babin, Jr., CRE, president of Logan H. Babin, Inc., Houma, LA, and 1996 president of The Counselors of Real Estate. "Charlie was unanimously chosen as our first non-CRE to be honored with this award for the high degree of professionalism that is reflected in his work, and for the many benefits that his developments have brought to numerous communities around the country. Above all, his work epitomizes the high standards of practice that are reflected in our own CRE membership," said Babin.

In real estate for over 35 years, The Counselors recognized Shaw for his many notable contributions as a real estate developer. Shaw began his career as a consultant to corporations in 1960 and later lead the development of such projects as United Nations Plaza in New York City and Lake Point Tower in Chicago. Through the years, many of The Shaw Company's development projects have broken new ground for the industry—for example, Museum Tower, built in the air rights over the Museum of Modern Art in New York; and the $180 million renovation of The Chicago Hilton and Towers, which revitalized one of the world's largest hotels as well as Chicago's South Loop.

Continuing this commitment to urban renewal, The Shaw Company today is involved in the creation of a large-scale affordable housing and commercial development in the inner city of Chicago in conjunction with Sears, Roebuck and Co. In addition to one million square feet of commercial space, "Homan Square" will include a community center as well as 600 units of housing for rental and purchase, and is designed to bring new hope to North Lawndale.

Another innovative project in progress is a single-family "conservation community," located north of Chicago in Grayslake. "Prairie Crossing" will feature open space and the preservation of agricultural land, wetlands, and prairies as well as up to 317 single-family homes designed to conserve energy and the environment.

Shaw is a director of Harris Bankcorp and Harris Trust & Savings Bank. He serves as a trustee of Northwestern University, Rush Presbyterian-St. Luke's Medical Center, Illinois Institute of Technology, and as a director of The Rehabilitation Institute of Chicago. He is also active in the Economic Club of Chicago as well as the Financial Research and Advisory Committee and the Civic Committee of the Commercial Club. Shaw also just completed a two-year term as president of the Urban Land Institute.

The Landauer Award is named for the late James D. Landauer, CRE, who played a key role in the establishment of The Counselor organization and the preeminence of the real estate counseling profession.

Other recipients of the award have included CREs Roland Rodrock Randall, James E. Gibbons, Roy P. Drachman, John Robert White, Boyd T. Barnard, George M. Lovejoy, Jr., Daniel J. Rose, Jared Shlaes, and J. Daryl Lippincott.

# CONTRIBUTOR INFORMATION FOR REAL ESTATE ISSUES

The journal is published three times annually (April, August and December), and reaches a lucrative segment of the real estate industry as well as a representative cross section of professionals in related industries.

Subscribers to *Real Estate Issues* are primarily the owners, chairmen, presidents and vice presidents of real estate companies, financial corporations, property companies, banks, management companies, libraries and Realtor© boards throughout the country; professors and university personnel; and professionals in S&Ls, insurance companies and law firms.

*Real Estate Issues* is published for the benefit of the CRE (Counselor of Real Estate) and other real estate professionals, planners, architects, developers, economists, government personnel, lawyers and accountants. It focuses on providing up-to-date information on problems and topics in the field of real estate.

### Review Process

All manuscripts are reviewed by three members of the editorial board with the author's name(s) kept anonymous. When accepted, the manuscript and any recommended changes is returned to the author for revision. If the manuscript is not accepted, the author is notified by letter.

Every effort will be made to notify the author on the acceptance or rejection of the manuscript at the earliest possible date. Upon publication, copyright is held by The Counselors of Real Estate (American Society of Real Estate Counselors). The publisher will not refuse any reasonable request by the author for permission to reproduce any of his contributions to the journal.

### Deadlines

All manuscripts to be considered for the April edition must be submitted by January 15; for the August edition by May 15; for the December edition by September 15.

### Manuscript/Illustrations Preparation

1. Manuscripts **must be submitted on disk** (along with hard copy): ASCII file format, Word Perfect or Word for Windows 6.0 preferred. All submitted materials, including abstract, text and notes, are to be **double-spaced** on one side only per sheet, with wide margins. Recommended number of manuscript pages is not to exceed 15. **Submit five copies of the manuscript accompanied by a 50- to 100-word abstract and a brief biographical statement**.

2. All notes, both citations and explanatory, are to be numbered consecutively in the text and placed at the end of the manuscript.

3. Illustrations are to be considered as figures, numbered consecutively and submitted in a form suitable for reproduction.

4. Number all tables consecutively. All tables are to have titles.

5. Whenever possible, include glossy photographs to clarify and enhance the content in your article.

6. Title of article should contain no more than six words including an active verb.

7. For uniformity and accuracy consistent with our editorial policy, refer to the style rules in *The Chicago Manual of Style*.

# REAL ESTATE ISSUES 1996 Editorial Calendar

**April** (Deadline for manuscript submission—January 15)
**Articles on general real estate-related topics**

**August** (Deadline for manuscript submission—May 15)
**Focus Edition "Cap Rates/Yields: Market Trends and Relationships"**

**December** (Deadline for manuscript submission—September 15)
**Special Edition "The Dynamics of Sports and Community Development"**

Readers are encouraged to submit their manuscripts to:

Halbert C. Smith, CRE, editor in chief
Real Estate Issues
The Counselors of Real Estate
430 North Michigan
Chicago, IL 60611

# THE BALLARD AWARD MANUSCRIPT SUBMISSION INFORMATION

The editorial board of *Real Estate Issues (REI)* is accepting manuscripts in competition for the 1996 William S. Ballard Award. The competition is open to members of The Counselors of Real Estate and other real estate professionals. The $500 cash award and plaque is presented in November during The Counselor's annual convention to the author(s) whose manuscript best exemplifies the high standards of content maintained in the journal. The recipient is selected by a three person subcommittee comprised of members of The Counselors of Real Estate. Any articles published in *REI* during the 1996 calendar year are eligible for consideration and must be submitted by September 15, 1996.

# INSTITUTIONAL REAL ESTATE INVESTORS CONFRONT THE FRAYED-COLLAR ECONOMY

by Sol L. Rabin

American real estate is beginning to surrender some of its secrets. Like the shadow on Plato's cave wall, real estate is the physical reflection of the needs and tastes of the American economy. Real estate has served as a lagging social indicator of short term trends, and now coincidentally, it is one of the leading indicators of long term fundamentals.

The thesis of this paper is that American society is undergoing a profound, deep and troubling long term transition from a middle income to a predominately lower income society. This transition erodes the value of some traditional forms of institutional real estate, but it also increases the economic viability of newer forms of real estate. White collar workers decanted into blue collar jobs lead to a "frayed-collar" economy, and institutional investors who now shun some of the newer frayed-collar product will embrace it in coming years.

This fundamental socio-economic shift is having and will continue to have profound impacts on American real estate, some of which today are all too visible to the naked eye. The Schumpaterian process of creative destruction has always been championed by the real estate community as obsolescence creates new profit making opportunities. Change is the only constant and major factor in earning real estate profits.

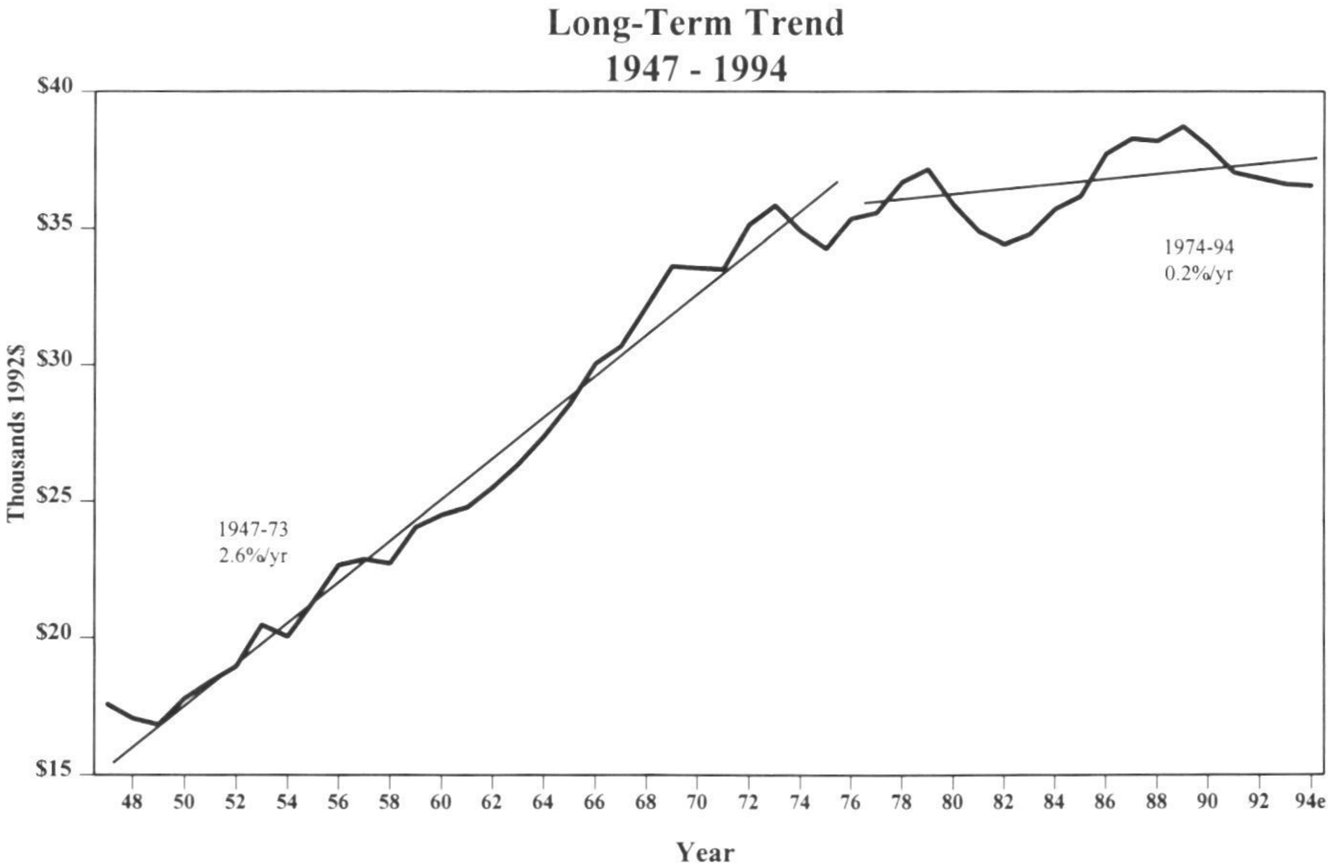
**Income Trends**

American households have not been winning the battle to keep median income growth ahead of inflation. Figure 1 shows the long term trend in real median family income measured in thousands of 1992 pretax dollars.[1] Added to the series are two piece-wise linear regression lines which illustrate two distinct periods—the Ozzie and Harriet years after 1947 and the Roseanne years after 1973.[2] From 1974 to 1994 real median family incomes increased at a modest 0.2% per year (despite the sizeable number of women entering the labor force). This slow growth trend, however, has been turbulent and filled with micro-cycle ups and downs. Note that over the ten year period 1985-94, real median family incomes increased and then fell back; that is, median family income in 1994 was about the same as it was in 1985 on a real basis! Without question, a new reality has set in since the early 1970s when competitive global pressures (especially from Japan and emerging Asia) destroyed millions of middle income jobs in automobiles, electronics, textiles, etc.).[3]

*Sol L. Rabin, Ph.D. is a founding and senior partner and Chairman of Investment Research for Westmark Realty Advisors, an independent real estate investment management firm with $4 billion under management. He has pioneered the use of research in the institutional real estate investment process.*

**FIGURE 1**

Real Median Family Income
In Thousands of 1992 Pretax Dollars




Source: U.S. Department of Commerce, Bureau of the Census

**Household Distribution By Income Class**

It is not a new observation that the middle income class is shrinking. But the extent of the change is not fully understood. Figure 2 shows three groups of four vertical bars, each of the three groups representing lower, middle and upper income households as a percent of total households, and each of the four bars representing years 1973, 1985, 1991 and 2000.[4]

Middle income households are on a down escalator shrinking from 53% of total households in 1973 to a projected 39% in 2000.[5] The results have been an increase in lower economic income classes from 39% to 49% over the 28-year period. What is emerging on the American landscape for the first time in half a century is a majority economic household class in the United States that is not the middle income but rather the lower income household.

The upper income group is modestly increasing market share (4%), the middle is losing sizable market share (-14%) and the lower income group is gaining (10%).[6] While income redistribution is an arresting subject, it does appear that the biggest and most important battle is preventing too many middle income households from stepping on the down escalator and not pushing a few upper income households onto it.

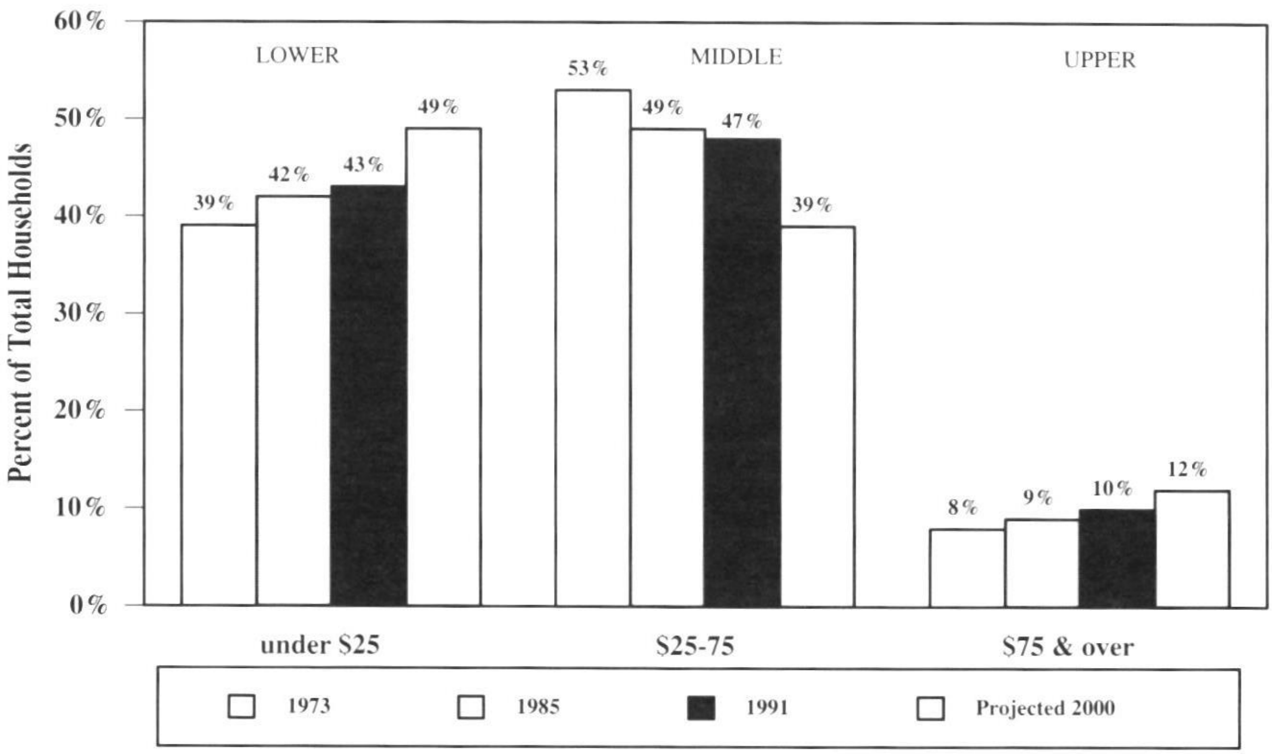
**Federal Income Tax Shares**

The polarization of incomes is even more dramatically shown in Figure 3 which illustrates for 1991 the percent of federal income tax returns filed by three economic groups (left cluster of bars) and the share of income taxes paid by each group (right cluster of bars).[7] A staggering 58.7% of the households contributed only 9.4% of income tax paid. This is in stark contrast to 6.1% of the households shouldering 46.8% of the tax burden. The middle income class at 35.2% of households contributes 43.8% of the income. This chart reinforces the concept that significant gains in U.S. income tax receipts would be dramatic if both lower and middle economic households were moved up the economic escalator. But it is not the long term trend, and economic miracles are difficult to execute.

**Conclusions**

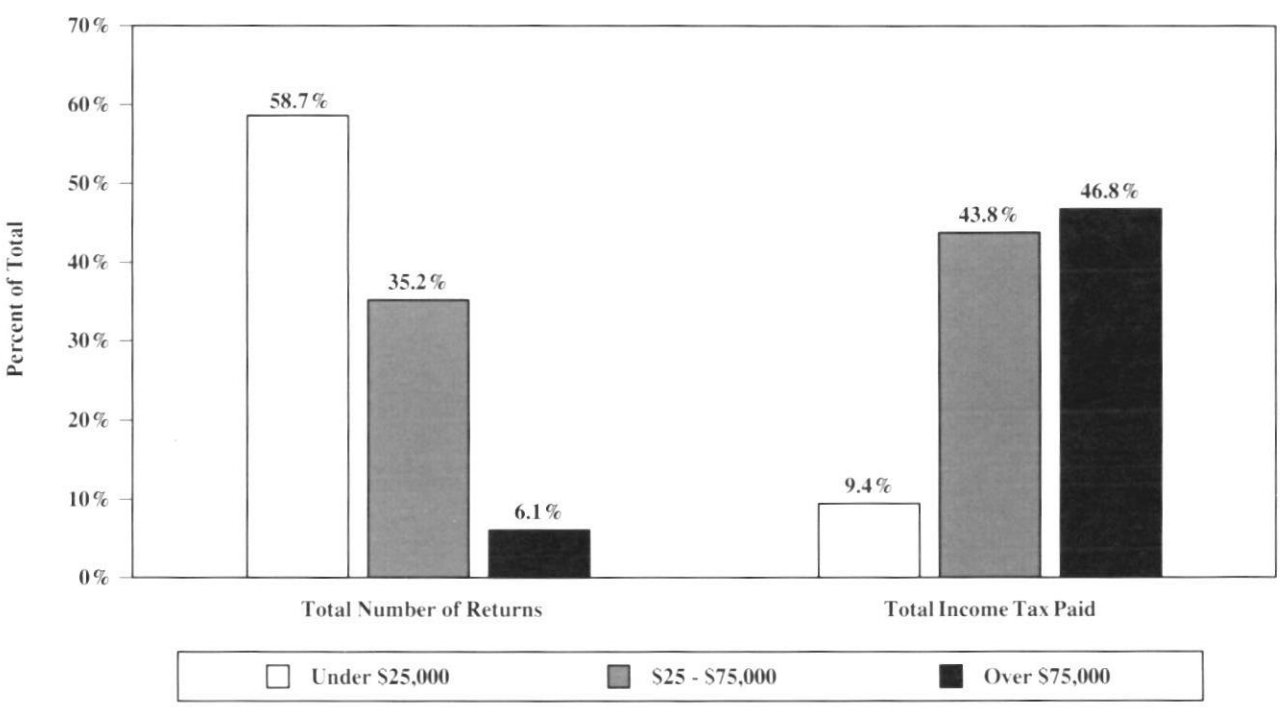
Real median family income has barely increased in over 20 years (4.8% in total during that period). The

**FIGURE 2**
Percent Of Households By Income Class
In Thousands Of 1992 Pretax Dollars




Source: A. Gary Shilling & Co., Inc.; Westmark Realty Advisors

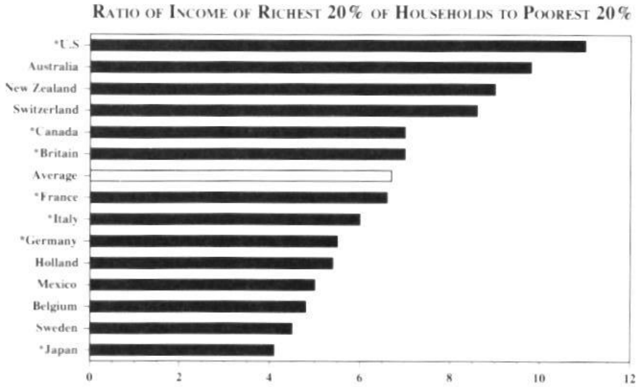
**FIGURE 3**
Share Of Income Taxes Paid By Adjusted Gross Income Level—1991




Source: U.S. Internal Revenue Service; Westmark Realty Advisors

FIGURE 4

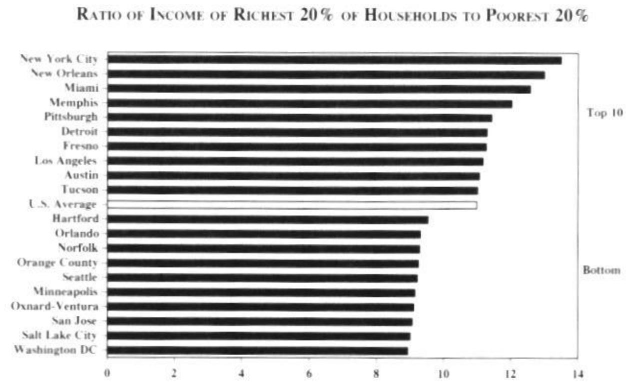
Income Inequality By Country




*G7 Countries
Source: The Economist, November 5th, 1994

FIGURE 5

Income Inequality By City




Source: CACI Marketing Services; Westmark Realty Advisors

middle income household class is shrinking and will not be a majority or dominate class in the future. There is substantial income polarization. These are very deep and long term trends which define the frayed-collar economy. Such trends make institutional investors nervous.

### International And Domestic Polarization Comparisons

The previous section illustrated the dynamics of U.S. income polarization. Turning to cross-sectional data will allow comparisons between countries and metropolitan areas. A convenient method for showing income disparity is to compare the income earned by the top 20% of the households to the income earned by the bottom 20%: the higher the number, the greater the income polarization. The income inequality indices of 14 countries for 1994 are shown in Figure 4.[8]

A major surprise is that the U.S. has the highest income polarization of any of the countries shown, including the G7. Of little surprise is that Japan has the lowest income polarization. Reasons for the high level of income polarization in the U.S. can be attributed, in large measure, to our national economic policy which staunchly protects the U.S. consumer at the expense of the U.S. manufacturing base.

The U.S. Antitrust Division has taken action to vigorously prevent the formation of monopolistic firms in the United States in order to keep consumer costs low. A recent example is the blocking of the acquisition of Intuit by Microsoft due to fear of monopoly pricing power. The cost for preserving low price levels for U.S. consumers comes at the expense of losing U.S. jobs. The general free trade policy[9] in the United States is to advocate free trade (e.g. GATT, NAFTA), and few economists voice concern about the loss of jobs to overseas locations if those losses mean that products imported into the U.S. are provided to the consumer at a lower cost (and theoretically lead to increases in real incomes). Even the Federal Reserve Board has, as its primary focus, the stabilization of prices by keeping a firm grip on inflation.[10] Almost the reverse philosophy is followed in Japan by the Ministry of Finance. The ministry has not been concerned about the level of consumer prices but has been adamantly worried about the preservation of jobs.[11]

### Frayed-Collar Cities

Figure 5 shows the respective levels of income polarization for the top ten and the bottom ten of 55 U.S. cities.[12] New York City has the highest income inequality and Washington, D.C. the lowest among 55 MSAs (metropolitan statistical areas).[13] Income polarization in New York is well chronicled. Less chronicled is that Washington, D.C., the center of the federal government, is by definition a middle income white collar economy.

### Conclusions

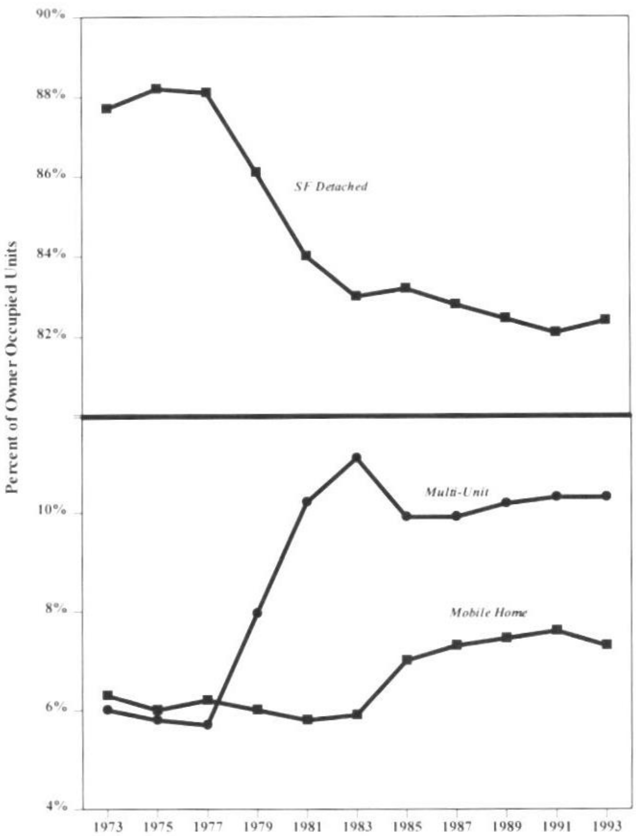
The political and economic philosophies of the U.S. endorses income polarization. The U.S. has the highest income inequality of 14 industrialized countries and the highest among the G7 countries. Income polarization by U.S. cities is substantial with New York City the highest and Washington, D.C. the lowest among 55 metropolitan statistical areas.

### Real Estate Implications

Income polarization has had clearly discernable affects on U.S. real estate, and this will become more acute during the next decade. Adjustments will have to be made as institutional investors grasp the new frayed-collar reality.

**FIGURE 6**

Home Ownership By Type Of Unit–1973-1993




**Source: U.S. Bureau of Census, American Housing Survey**

### Housing

Figure 6 (top) illustrates the decline in single family detached home ownership rates since 1973, and (bottom) the rise in lower priced attached multi-units and mobile homes as housing choices. Further, most new construction today is focused on entry level housing—the bulk of residential activity—for all three sectors. The scenario of course is income-driven: declining or stagnant real incomes burden and decrease the opportunity of home ownership. Less expensive alternatives to traditional single family detached units will be a mainstream growth sector.

### Retailing

Figure 7 shows the aggregate annual sales in nominal terms since 1987 for two classes of department store retailers. The first class (solid line) is for the traditional department store, including Nordstroms, May, Federated, Dillards, Mercantile, Sears, etc. The second class (diamond line) is for the discount department store with essentially four retailers: WAL-MART, K Mart, Target, and Caldor.[14] The dramatic increases in the retail sales of discount department stores (10.3% annually) and the less successful increases of traditional department store sales (1.6% annually) almost tell the entire story. These numbers show that consumers are shifting their retailing dollar from fashion to value, the only way to stretch the consumer dollar and keep the family budget under control.[15] Sales figures for traditional department stores have not kept up with inflation and these stores are losing market share.

The implications of frayed-collar retailing are quite deep. Traditional enclosed malls are in retreat. Power-value center malls are running at full gallop. If WAL-MART didn't exist, someone would have to invent it. There is no retreat from this trend (because of the underlying economic income shifts). Therefore, we are seeing a new malling of America, and these malls, unfortunately, will have open air plain Jane architecture of an imminently forgettable variety. But, they will be value oriented and enjoy enormous market acceptance. At the same time, we will see a demalling of America, that is the conversion of attractive fashion oriented enclosed malls to something more in tune with the economic realities of income polarization shifts.

### Office Buildings

Figure 8 graphs the percent of net annual office demand (absorption) occurring in the CBD and suburbs of 55 MSAs.[16] It underscores the flight of office building tenants away from center cities and into the suburbs. This flight is pushed by the proximity to lower income households and perceived social unrest in the CBD but, at the same time, it is also pulled by the economics of suburban locations (lower total costs, including labor). Over the five years 1990-1994, 75% of office demand was experienced in the suburbs and 25% in the CBDs. This suburban market share has not remained stagnate but has continually increased over the past decade and a half.

### Warehousing

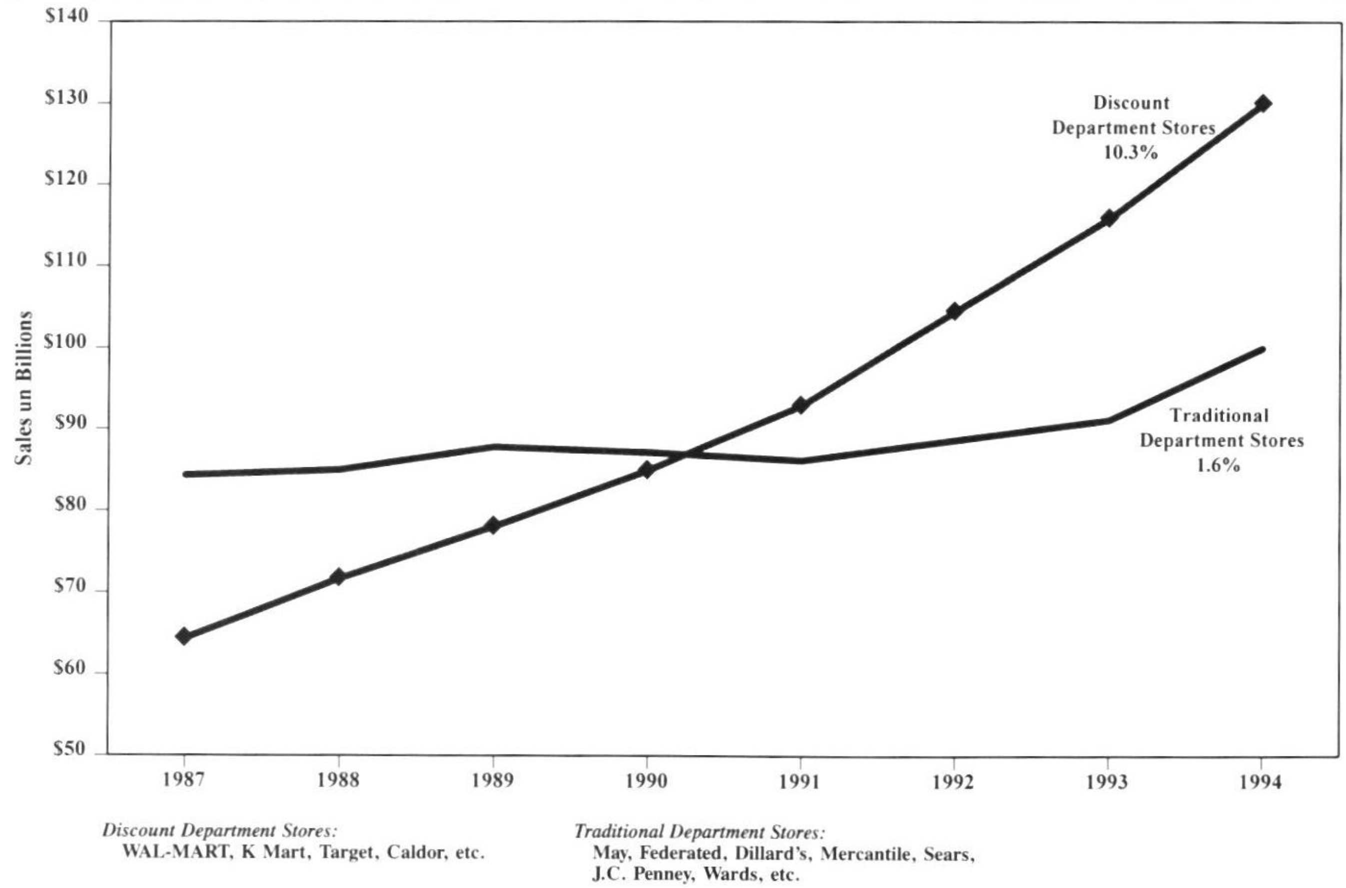
America is being hollowed out of manufacturing. The majority of consumer goods are produced in foreign countries and imported into the U.S for final consumption. Inter-industry warehousing space is being supplemented by finished product (final demand) warehouse space. Hence we are seeing the gradual disappearance of very small warehousing and the emergence of very large buildings required to handle mass shipments of produced goods from major distances. This trend is evidenced by the predominance of wholesale trade establishments (Figure 9) and the predominant construction of larger warehouse buildings (Figure 10).[17]

### Conclusion

Income polarization in the U.S. has dramatically impacted the real estate markets long term. A rise in home ownership levels is doubtful without major changes in national policy. Most Americans are

## FIGURE 7

Structural Shift To Value Retailing




**Source: Department of Commerce, Annual Report**

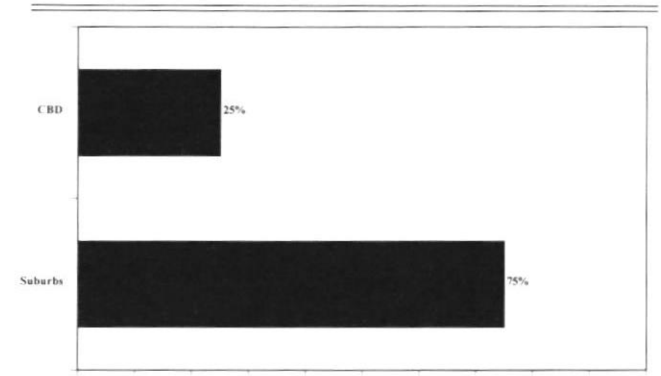
finding it difficult to own a home. In an effort to stretch the budget, American households are flocking to value retailers and abandoning enclosed fashion-oriented malls. With concentrations of lower income households in or near center cities, the office market has relocated to the suburbs. With respect to warehousing, megasize distribution warehouses are emerging as the focus of the distribution system. Virtually all consumer goods are imported from foreign countries as final product—with little need for smaller inter-industry warehousing space to support the manufacturing process.

### Observations And Reflections

Income polarization in the United States has produced a frayed-collar economy and will continue to require substantially different real estate products. Much upscale real estate will be destroyed and new real estate will be created to serve a rapidly growing down-scale market. This is the Schumpaterian "gale of creative destruction" in a more concrete manner. Institutional investors cannot invest looking backwards. They must anticipate these far reaching changes. At present, institutional investors are shying away from investing in lower income real estate, such as power retail centers, believing they are just a fad. Eventually investors will understand that this product has solid economic underpinnings.

## FIGURE 8

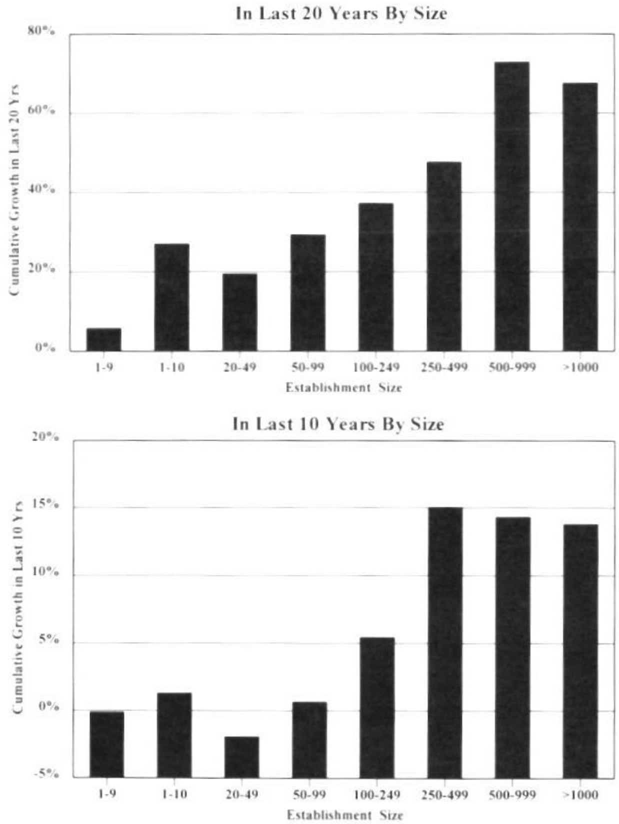
Structural Shift To Suburban Office Markets
Share Of Average Absorption




**Source: Westmark Realty Advisors, MIDAS IV-XXVL**

## FIGURE 9

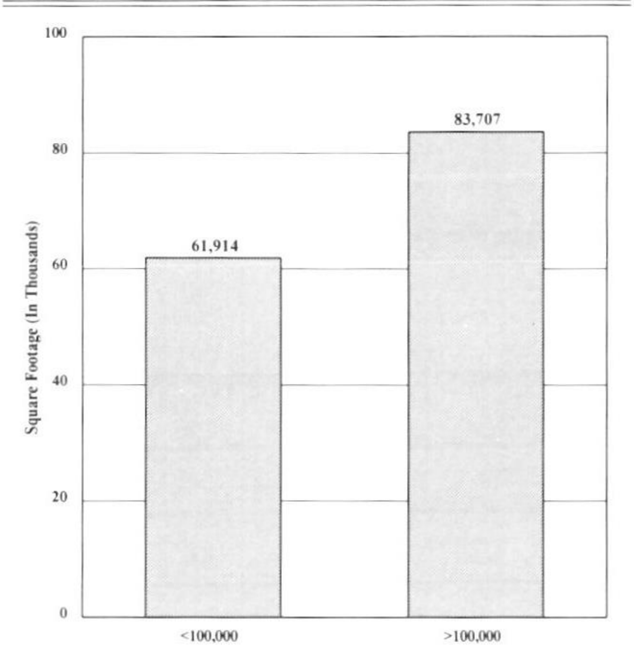
Cumulative Growth Of Wholesale Trade Establishments




**Source: County Business Patterns**

## FIGURE 10

Warehouse Square Footage Built In Last 5 Years In 43 Major Warehouse Markets




**Source: Torto Wheaton Reports**

Profit opportunities abound in real estate if we can anticipate and capitalize on major trends. A new gale of real estate development and investment is here. Yearning for the past is fruitless. Take the escalator to the basement for that is where real estate investment bargains are found among the frayed-collar merchandise.

## NOTES

1. Data is shown as median family income. Note that average income would bias the trend line upward. Income includes wages, salary, rental, interest and dividend income, plus premiums for fringe benefits paid by the employer. The 1993-1994 data are estimates based on CACI Marketing Services data.
2. Generally this graph is interpreted as the end of the American Dream. Irving Kristol of the American Enterprise Institute tends to argue that dreams suggest responsibilities, thereby laying the blame on the American worker. (See footnote 10.)
3. Herbert Stein argues that this is due more to a slowing in the growth rate of productivity. See "A Primer on Pay and Productivity", *Wall Street Journal*, Wednesday, August 23, 1995.
4. A household comprises all persons who occupy a housing unit. A housing unit is a group of rooms or a single room occupied as separate living quarters. Occupants do not live and eat with other persons in the structure. This definition eliminates institutional-type quarters (education, transient, penal).
5. Forecasts from A. Gary Shilling and Co. are forecasts of 1973-1991 data which fundamentally take into consideration the behavior of wages, increases in foreign competition and growth of information technology. The U.S. Department of Commerce median family income series were forecast then broken into quartiles.
6. Obviously social unrest, political instability, trade wars and xenophobia could all emanate from this condition—and are.
7. Adjusted gross income does not entirely equate to median household income. The point of this exhibit however, is to demonstrate income polarization.
8. *The Economist*, November 5th, 1994, for 13 of the countries shown. Information on Mexico is derived from the article "Mexico in Crisis" in the *Los Angeles Times*, April 23, 1995.
9. The aim is to reduce tariffs, quotas, export subsides and other trade-influencing measures.
10. Labor Secretary Robert Reich said that companies have responsibilities to provide decent wages to their employees. A meta-argument can be made that countries have the responsibility to provide economic policies that allow companies to offer decent wages.
11. This opens up a Pandora's box of arguments. Generally, however, analysts on all sides agree that lingering protectionism of APEC (Asian Pacific Economic Community) countries makes the problem worse.
12. This data was derived from *CACI Marketing Services Census Edition*, Volume II, page 74-B by transforming CACI data for income distribution for the bottom 25%–top 25% to bottom 20%–top 20% categories using normalization techniques. For example, for the U.S., the top 25% of households earn above $49,410, while the bottom 25% earn below $15,382; the ratio is 3.21. The ratio from Figure 2 for ratio of income for the richest 20% of households to the poorest 20%, is 11.0. The ratios for the 55 cities were calibrated to this 11.0.
13. This index suggests itself as a valid measure of social tension and unrest.
14. Retail sales for discount department stores (as defined by the Department of Commerce) versus sales for conventional department stores and national chain department stores. Forecasts based on 1987-94 sales increase.
15. Another way of saying this is that consumers are increasing their destination shopping and decreasing their impulse shopping.
16. Share of recent five-year average absorption, *MIDAS Reports*, Westmark Realty Advisors.
17. These establishments have multiple locations so interpretations of firm size over say 20 is ambiguous. Note, however, the smaller and presumably sole location establishment virtually disappeared within the last ten years.

# REAL ESTATE RECOVERY: FACT OR FICTION?*

by Jane Holmberg Dorrel

**Data included in this article is provided by the in-house data banks at Westmark Realty Advisors in Los Angeles.*

The air is filled with talk of recovery. Optimism is finally returning in the commercial real estate industry. Is it warranted? Have the markets really recovered? What is generally meant by the term "recovery"? And, does this hopefulness apply to all land uses? While not all real estate is fully recovered, it is definitely "in recovery". This article will discuss the office, industrial and retail markets, and what has brought them into recovery. The future market conditions of these product types also are forecast, along with five-year projections of their NCREIF returns.

### The Meaning Of Recovery

The term market recovery has many different meanings. The following lists some possible indications that market recovery has occurred:

1. Market vacancy has begun to fall.
2. Market vacancy has fallen to previous lows or to equilibrium.
3. Real rents have begun to increase.
4. Real rents have returned to previous peak levels.
5. Returns have increased significantly.
6. Returns have reached levels that were achieved before the decline.
7. Returns have reached 10 percent or 6 percent real.

All these indicators have merit. For our purposes here, full market recovery is defined as having occurred when market vacancies reach equilibrium and NCREIF returns (by land use) have rebounded to previous healthy levels. Therefore, the term "in recovery" implies that the tide has turned, conditions are improving, but full recovery has not yet been reached.

### United States Office Market

*Low Construction Is Key To Market Recovery*

According to recent data, the national vacancy rate has fallen to 15.9 percent. This has made many in the industry increasingly aware that the United States office market is finally in recovery. The essential ingredient to this market's recovery has been the curtailment of new supply. According to building permits authorized, construction of office space is now near 1964 levels. It is reported that only 5.1 million square feet of office space was completed in the past 12 months. However, there has been a slight increase in the amount of space now under construction relative to one year ago. The 6.9 million square feet now under construction reflects an increase of 13.5 percent over one year ago, but it is

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still very low relative to recent history and annual absorption. It is forecast that completions will remain at historic low levels for the next year, with slight increases in activity beginning in 1996.

*Absorption Rebound With Economic Recovery*
A second critical ingredient to the recovery of the office market has been the steady return of absorption. However, a resurgence in demand alone could not have corrected the office market. It should be remembered that despite very strong absorption in the mid-1980s, the national office market still had an average vacancy rate of 20 percent.

In 1994, over 59 million square feet of office space was absorbed. This is more than double the absorption experienced at the lowest point during the recession. Looking ahead, with continued employment growth in the major office sectors of the economy, national absorption should continue to expand, reaching approximately 75 million square feet in 1995. Over the next five years, the average absorption is forecast to be roughly 62 million square feet per year. In contrast, over the past five years (1990-94), the nation averaged 50 million square feet annually. During the peak period of 1984-88, absorption averaged over 107 million square feet per year.

*Vacancy Rates Now At Ten Year Lows*
Today, due to the rebound in absorption and very limited new supply, the U.S. office vacancy rate stands at 15.9 percent, down significantly from 20.0 percent three years ago. This is the lowest vacancy rate in over ten years. With new construction still expected to remain at historically low levels, any future demand will result in further declines in vacancy over at least the next two to three years.

It is expected that the U.S. will experience significantly declining vacancy rates over the next five years. If longer-term forecasts of future supply and demand come to pass, vacancies could be in the range of 7.5 to 12.9 percent by year end 1999. The nation has not had vacancies this low since 1983.

*Suburbs: Where The Action Is*
This past year has confirmed a major shift in a long-standing trend; the downtown office markets now have a higher vacancy rate than the suburban markets (17.0 percent versus 15.2 percent) for the second year in a row. In 1986, the suburban markets had a vacancy rate almost ten points above the downtowns; in the past eight years the gap between the two has steadily narrowed. One reason for this is the increasing share of absorption going to the suburbs. Over the past five years, the suburbs have accounted for over 75 percent of the nation's office absorption, well above their fair share of 58 percent. If recent supply and demand trends continue, the suburban markets will experience significantly declining vacancy rates while the downtowns will stagnate above 14 percent.

*NCREIF Returns Projected To Reach 10 Percent By 1996*
What will the decline in overall vacancy rates mean to the returns from office investment, as reported for the office component of the NCREIF Index? There is a significant correlation between these office returns and two factors: 1. the national vacancy rate (lagged one year); and 2. the real Gross Domestic Product (two year average). Using this relationship, it is forecast that the total returns for office space will have a sustained recovery, reaching 10.0 percent (nominal) by year end 1996 and 12.0-17.0 percent by year end 1999, depending on construction levels. The average annual NCREIF return is projected to be 10.8 percent for the years 1995 through 1999.

*Office Conclusions—Full Recovery By 1999*
The recovery of the office market continued to broaden and strengthen over the past year. In response to economic expansion and low construction, the nation has seen a steady increase in office demand, a rapidly declining vacancy rate and stabilizing and/or rising rents in select markets. With a continuation of these trends, the 1995 returns from office investments will reach levels not seen in ten years. The shift from a tenant's market to an owner's market is imminent.

**United States Industrial Market**

*Rebounding Absorption Tightens Market*
The national industrial market has gradually recovered from the devastating effects of the 1991-1992 recession, with the vacancy rate now standing at 8.7 percent, down from a peak of 10.5 percent at year end 1991. Historically, the industrial market has had tight market conditions, with vacancies generally in the 7 and 8 percent range. However, in 1991 when the recession wreaked havoc on the demand for industrial space, resulting in absorption of negative 16 million square feet, the vacancy rate soared to a peak of 10.5 percent. Fortunately, with the recovery in the economy, industrial absorption has rebounded from this collapse, averaging over 90 million square feet annually during the past three years.

In 1994, almost 146 million square feet of industrial space was absorbed, a 108 percent increase over 1993. This illustrates that industrial absorption is very sensitive to changes in general economic conditions. It is forecast that absorption of industrial space will moderate slightly in 1995, reaching 142 million square feet. Over the next five years, the average annual absorption is expected to be 127 million square feet. For comparison, during the peak years of 1985 to 1989, the average absorption was almost 145 million square feet per year.

*Construction Of New Space Expected To Increase*
Reduced construction has helped drive the industrial market to a more normal vacancy rate. From 1991 to 1993, the volume of building permits in the nation was at 1962 levels. In 1994, the value of industrial permits authorized increased slightly (by almost 18 percent), and it is forecast that in 1995 there will be a significant increase of almost 45 percent. Currently, surveys indicate that 38 million square feet is under construction in 55 cities, up from 11.6 million square feet last year. It is expected that new development will remain at a moderately low level in 1995 but will more than double in 1996 and will increase to almost 125 million square feet in 1997 in response to low vacancies in 1996.

*Vacancy Rates To Stabilize Near 7.5 Percent By 1996*
In the short run, strong demand and moderate construction will result in a declining vacancy rate. The average vacancy should fall from the current 8.7 percent to 7.7 percent by year end 1995 and 7.3 percent by year end 1996. Healthy market conditions should begin to spur new construction in 1996, causing the vacancy level to stabilize. By year end 1999, the nation could have an average vacancy of 7.4.

*NCREIF Returns To Peak At 12 Percent In 1996*
The NCREIF Index for warehouse returns began to rebound in 1994 (+9.0 percent), after experiencing three years of dismal returns. Based on the relationship of warehouse returns to GDP and vacancy, it is expected that by year end 1996 the returns for the warehouse component of the NCREIF Index should reach 12.0 percent (nominal). The future returns are projected to average 10.5 percent per year from 1995-1999.

*Industrial Conclusions—Market Recovered By 1996*
The overall industrial market is the healthiest it's been in five years, and, in terms of recovery, is at least three years ahead of the office market. With absorption rebounding to pre-recession levels and completions near all-time lows, the average vacancy is predicted to continue falling over the next two years. However, these tightening conditions will spur new construction, especially in 1996 and beyond. This will stabilize the vacancy level and perhaps lower the NCREIF returns in 1997.

**United States Retail Market**

*The Market Tightens*
The national retail real estate market has clearly recovered from its market low experienced in 1991 (first quarter 1991 to first quarter 1992). In the past three years, real retail sales have increased 12.4 percent, absorption has grown by over 76 percent and the national vacancy rate has fallen from 11.2 percent in early 1992 to 8.7 percent in early 1995.

The retail market had been going through a period of significant change rocked by low retail sales, department store restructurings and bankruptcies, the strengthening of "value" retailers (such as WAL-MART), and the changing demographics and attitudes of the American shopper. Many of these factors will continue to impact the retail market for years to come.

*Consumers Are Buying And Driving Demand*
Overall demand for retail space is driven by changes in real retail sales. In 1991, during the worst of the recession, real retail sales declined 3.1 percent. This decline significantly eroded the absorption of shopping center space which fell to 38.9 million square feet. Total absorption had not been that low since the last recession in the early 1980s. In 1992, a national pick-up in retail sales helped absorption to rebound slightly. Most of this early rebound was due to increased activity by the "big box" value retailers.

In the past year, with real retail sales increasing 5.6 percent, demand increased to over 70 million square feet (a gain of over 12 percent). This caused the national vacancy rate to fall from 9.5 percent one year ago, to 8.7 percent today. Based on forecast retail sales, the absorption of retail space will continue to rebound in the coming 12 months and then will moderate, averaging 66 million square feet per year over the next five years. This is well above the 41.7 million square feet averaged during the recession, but is below the 82 million averaged during the 1980s expansion.

*New Supply Is Being Revived*
The overall vacancy rate would continue to decline if absorption were to remain strong while construction stayed at low levels. However, U.S. building permit data indicates that the nation could soon see a significant increase in construction of retail space. It is estimated that in 1995 the value of permits authorized (in real dollars) will increase 15 percent over the 1994 level, which increased 15.6 percent over 1993. This pick-up in permit activity is already reflected in the increased actual square footage under construction. As of early 1995, almost 50 million square feet of space was under construction, up 23 percent from 1994.

Historically, construction of retail space has been very cyclical. After the low number of completions in 1992, there has been a steady increase in the delivery of new space. It is expected that completions will increase further over the next two years and then slow. By 1999, an annual completion level of between 62 to 76 million square feet is projected.

*Vacancy Rate Reductions To Continue At Slower Pace*
It is estimated that the rebound in demand and the moderate increase in completions will result in either a slowly falling or stabilizing vacancy rate, depending on the level of construction. By the first quarter of 2000, the vacancy level should range between 6.2 and 8.4 percent.

*Community/Neighborhood Centers Thrive At Regional Malls' Expense*
The retail vacancy rate is significantly different when the data is segmented by center type. Historically, regional malls have had much lower vacancy rates than other centers, due to the constraint on development offered by department stores and mall developers. Today, regional malls have a 6.3 percent vacancy rate compared to 9.3 percent for community/neighborhood/strip centers. Both sectors experienced a 1.1 percentage point decline in vacancy over the past year (down from 7.4 percent and 10.4 percent respectively).

Interestingly, community/neighborhood/strip centers have a lower vacancy today than they had in 1990 (12.5 percent), while the average regional mall vacancy has increased (from 4.3 percent). In the past six years, the gap in vacancy between the two types of centers has steadily narrowed, going from a difference of 8.2 percentage points in 1990 to only 3.0 points in 1994 and 1995. One reason for this is the rapid expansion and absorption by several of the "big box" value retailers which primarily locate in community (power) centers. This expansion not only strengthens the demand for community center space but also weakens marginal regional malls by sapping their retail sales.

These different trends reflect some of the previously mentioned changes affecting the retail market, changes which have strengthened value (discount) retailing. Traditional retailing (i.e., regional malls) has lost a significant amount of market share to value retailing because of the latter's better price and customer convenience. In 1994, retail sales for traditional department stores only increased 4.5 percent (nominal), while discount department stores (WAL-MART, Target, etc.) increased 11.5 percent.

*NCREIF Returns Soon To Be Double-Digit*
The NCREIF retail returns turned positive again in fourth quarter 1993 after experiencing two negative years. In 1994, retail returns were 5.2 percent for the year. Using the relationship of NCREIF retail returns to the Gross Domestic Product and vacancy, it is predicted that by fourth quarter 1995 the annual return should exceed 12 percent (nominal). This suggests that retail should reach full recovery four years before the office market. Returns could range between 10.7 and 16.3 percent by year end 1999, depending on the level of construction. For the period 1995 to 1999, NCREIF returns are predicted to average 11.0 percent per year.

*Retail Conclusions—1995 Recovery*
The national retail market, which bottomed in 1991, should fully recover this year. The demand for retail space should remain strong over the next two years, causing the national vacancy rate to either stabilize or continue to fall, depending on construction. The future success of retail investment will become increasingly more dependent on choosing the right type of center and the right anchor tenants.

**Conclusions**
A recovery in the real estate market is definitely occurring. The office, industrial and retail product types are, however, rebounding at different rates and will reach equilibrium in different years. The trend in the NCREIF Index suggests that the industrial market was the first sector to show a significant rebound in returns, having experienced a positive return of 9 percent in 1994. It is forecasted to peak at 12 percent by 1996. Retail is forecast to have a major jump in returns in the coming year, increasing from 5.2 percent in 1994 to above 12 percent by year end 1995. After 1996, returns for both industrial and retail are projected to moderate with slight dips in 1998. The office market, however, should experience gradual accelerating returns, peaking at 14.6 percent in 1999.

# REAL ESTATE PERFORMANCE MEASURES

by Jeffrey D. Fisher

The commercial real estate market is increasingly dominated by institutional investors who require periodic performance measures of their investment portfolios. This presents a challenge to private real estate investments because individual properties are not bought and sold on a regular basis like stocks and bonds. Therefore, investors cannot measure gains or losses in their real estate portfolio based on actual transaction prices. They must use alternative measures of real estate performance.

This article will provide an overview on how performance measures for real estate investments are constructed and used by institutional investors. In particular, the article will focus on an index of real estate performance published by the National Council of Real Estate Investment Fiduciaries (NCREIF). The index includes over 1,500 properties whose market value in 1995 exceeds $20 billion dollars of commercial real estate.[1] This article will show how the index is used both to gauge the performance of real estate compared to other asset classes and to measure the performance of different property types and geographic areas so institutional investors can make diversification decisions. Understanding these indices helps real estate professionals understand the motivations of institutional investors when purchasing, valuing and selling real estate income property. These indices can also be used to track trends in real estate values and capitalization rates for different property types and geographic areas.

**Construction Of Performance Measures**

Indices of real estate performance measure change in the rate of return over time, e.g., annual or quarterly rates of return. As indicated earlier, this is easy for publicly traded investments like stocks and bonds because transaction prices are available to measure changes in value. In the case of real estate, it is necessary to rely on appraised values as a proxy for transaction prices. Institutional investors which hold property for pension funds are required to mark to market, i.e., report the market value of their holdings. Thus, appraisals are done on a periodic basis, usually once per year by an outside appraiser with quarterly updates by inside appraisers.

Performance measures essentially calculate an internal rate of return (IRR) for each time period, e.g., each year, based on the appraised value of the property at the beginning and end of the period as well as the net operating income (NOI) received

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EXHIBIT I

| Year | NOI | Value | Income Return | Appreciation Return | Total Return | Income Index | Appreciation Index | Total Index |
|---|---|---|---|---|---|---|---|---|
| 0 | $100 | $1,000 | | | | 100.00 | 100.0 | 100.00 |
| 1 | 105 | 1,050 | 10.00% | 5.00% | 15.00% | 110.00 | 105.0 | 115.00 |
| 2 | 107 | 1,100 | 9.73% | 4.76% | 14.49% | 120.70 | 110.0 | 131.66 |
| 3 | 105 | 1,060 | 9.91% | −3.64% | 6.27% | 132.66 | 106.0 | 139.92 |
| 4 | 100 | 990 | 10.10% | −6.60% | 3.50% | 146.06 | 99.0 | 144.81 |
| 5 | 98 | 995 | 9.85% | 0.51% | 10.35% | 160.44 | 99.5 | 159.80 |
| 6 | 96 | 990 | 9.70% | −0.50% | 9.19% | 176.00 | 99.0 | 174.50 |
| 7 | 95 | 960 | 9.90% | −3.03% | 6.87% | 193.42 | 96.0 | 186.48 |
| 8 | 92 | 940 | 9.79% | −2.08% | 7.70% | 212.35 | 94.0 | 200.84 |
| 9 | 90 | 900 | 10.00% | −4.26% | 5.74% | 233.58 | 90.0 | 212.38 |
| 10 | 90 | 900 | 10.00% | 0.00% | 10.00% | 256.94 | 90.0 | 233.62 |
| Average | | | 9.90% | −0.98% | 8.91% | | | |
| Standard deviation | | | | | 3.51% | | | |

during the period. This is shown in the following equation:

**Equation 1**

$$\text{Total Return} = \frac{\text{NOI} + (\text{Sale price} - \text{Purchase price})}{\text{Purchase price}} \quad (1)$$

Equation 1 calculates an internal rate of return for a single period of time. The return is called the total return because it includes return from net operating income and change in value (sale price −purchase price). This return assumes that the property could be sold each year at its appraised value.[2] In the case of stocks and bonds, dividend and interest income respectively would be used in place of NOI and actual transaction prices would be used for the sale price and purchase price.

**Income And Capital Return**

The total return already discussed can be broken down into an income return and a capital return. The income return is equal to

$$\text{Income Return} = \frac{\text{NOI}}{\text{Purchase Price}} \quad (2)$$

The income return is analogous to an overall capitalization rate (cap rate) for a property. There may be differences, however, because the NOI used by the institutional investor may differ from the NOI used by an appraiser. For example, the institutional investor may not include any replacement allowance in the operating expenses which, compared to what the appraiser might estimate, may tend to understate the NOI. Alternatively, the institutional investor might include expenses for remodeling, leasing commissions, tenant improvements, etc. which, compared to what an appraiser would use as a stabilized expense, would overstate expenses.

Aside from these differences, trends in the income return can provide valuable insight into trends for capitalization rates. Thus, performance measures can provide a valuable complement to other sources of capitalization rates used by appraisers and counselors.

The capital return measures the effect of any appreciation or depreciation on the rate of return. It is calculated as follows:

$$\text{Capital Return} = \frac{(\text{Sale price} - \text{Purchase price})}{\text{Purchase Price}} \quad (3)$$

The capital return assumes gain or loss which is recognized each period, e.g. the property is sold and repurchased. The capital return is also referred to as the appreciation return. It is possible, of course, that the appreciation be negative, i.e., depreciation in capital value.

**Index**

An index is often calculated from the return measures. The index indicates how much wealth the investor would have accumulated if he invested in the property and held it over time. It reflects cumulative rates of return over time. For example, if the total return was 5 percent in year 1 and 6 percent in year 2, n, an investment of $100 would increase to ($100 × 1.05 × 1.06) or $111.30 by the the end of the second year.

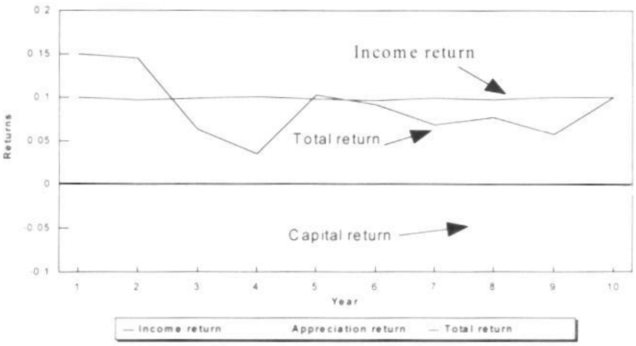
**Example**

Exhibit I is an example of the calculation on the income return, appreciation return and total return. The table also indicates how an index could then be calculated with 100 as the starting point.

Exhibit II illustrates the returns for the example in the graph. Note that the income return is relatively constant when capitalization rates do not vary significantly over time. Most of the variability

## EXHIBIT II

Performance Measures




is in the appreciation return. The average total return is 8.91 percent and the standard deviation of the total return is 3.51 percent.[3]

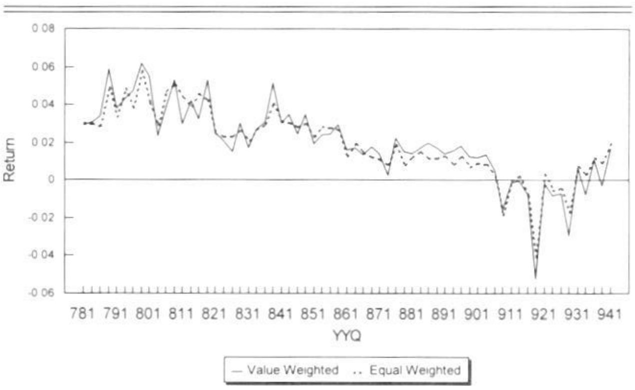
### NCREIF Property Index

Institutional investors who are members of NCREIF report the information necessary to calculate income and capital returns on properties they hold. The formula used by NCREIF is a slight variation of the formula already discussed that includes the impact of any capital improvements and partial sales on the return. The differences are not material and do not affect the interpretation of the index.[4]

The NCREIF index is calculated by averaging the returns for all the individual properties reported to the organization by its members. The average can either be equal weighted or value weighted. Value weighting places more weight on the return from properties that have greater appraised values. This is the manner in which the traditional NCREIF Index is calculated. Exhibit III shows the total returns over time based on both equal and value weighted returns.[5]

## EXHIBIT III

Russell-NCREIF Property Index
Value vs Equal Weighted Index




## EXHIBIT IV

Russell-NCREIF Property Index
Quarterly Income and Appreciation Returns

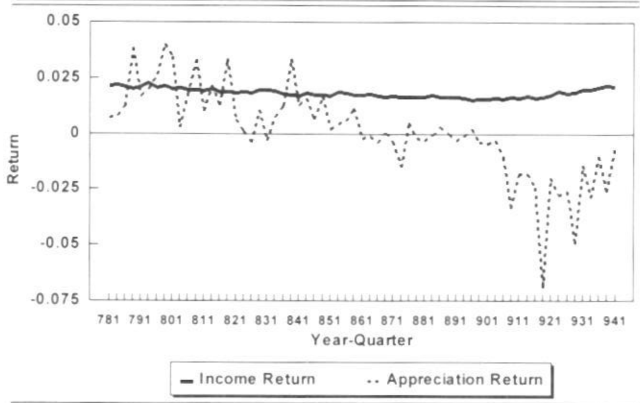



Exhibit IV shows a breakdown if quarterly income and appreciation returns for the NCREIF Index. Note that income returns (cap rates) have been relatively steady over time and most of the volatility has been in the capital (appreciation) return. Because the returns are quarterly, they have to be multiplied by 4 for an estimate of the annual return.

### Performance Of Different Property Types

NCREIF also reports performance measures for the different property types held by its members. Exhibit V shows a breakdown of quarterly returns by property type. Note that the relative performance of different property types varies over time. This is important because it indicates that institutional investors can receive diversification benefits by including different types of properties in a portfolio.

### Performance Measures For Different Geographic Regions

NCREIF also breaks down performance measures by geographic regions. Exhibit VI shows the

## EXHIBIT V

Property Types
Total Returns

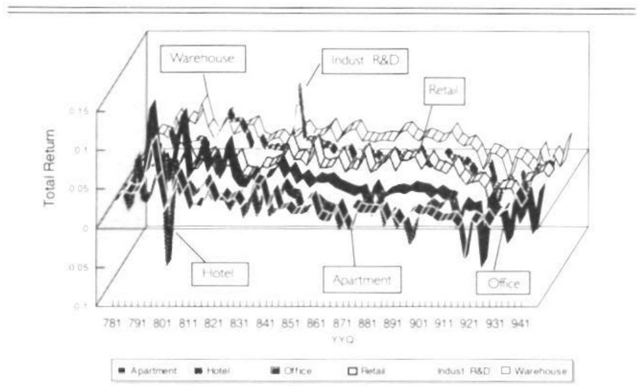
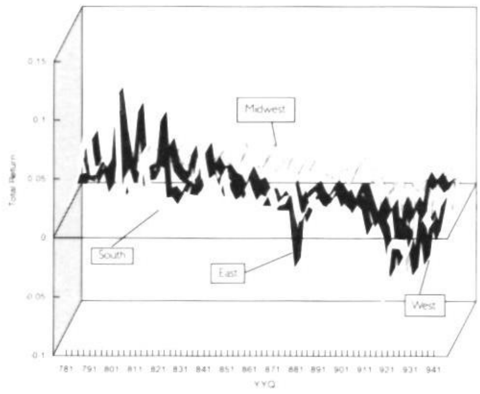


**EXHIBIT VI**

NCREIF Regional Returns
Unlevered Properties



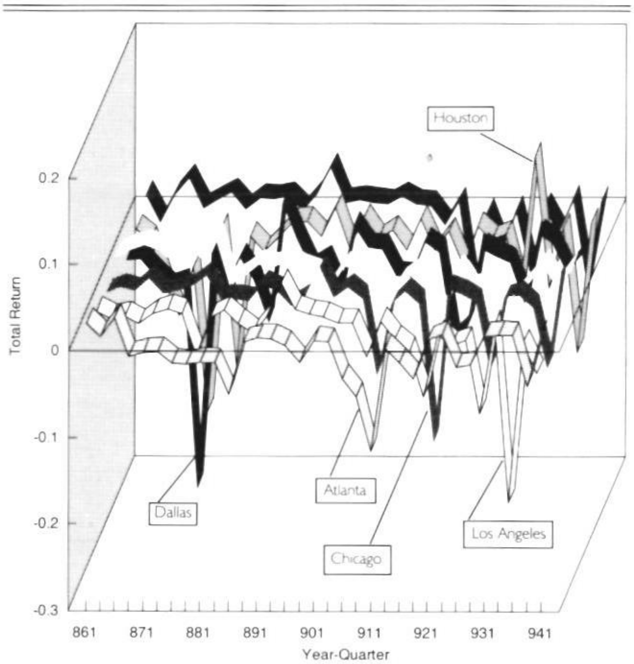

results. Again, note that performance differs over time for different regions which suggests diversification benefits for holding properties in different regions of the country.

### Indices For Different Metropolitan Areas–Office Buildings

It is also possible to request performance measures from NCREIF for different metropolitan areas where a sufficient number of properties are held by its members. This provides a more refined analysis on the performance of different property types and trends by metropolitan area for different property types. More sophisticated institutional investors make diversification decisions by evaluating returns for different metropolitan areas. Exhibit VII shows the performance of office buildings in different metropolitan areas.[6]

**EXHIBIT VII**

Russell-NCREIF Index
Total Returns for selected Office Markets




### Performance Of Private And Public Markets

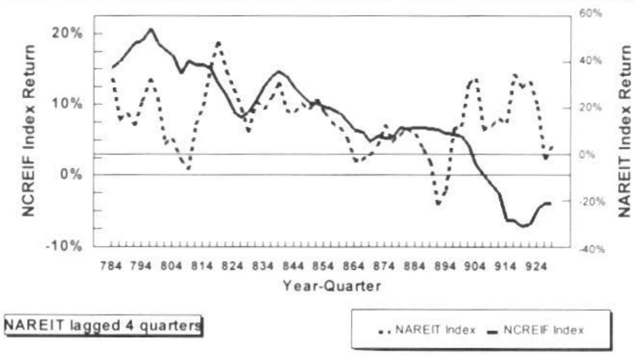
With the tremendous growth of the REIT industry in recent years, public markets have become an alternative vehicle for institutional investors to hold real estate rather than make investments in the private market. As discussed, the NCREIF Index is based on appraised values of individual properties held directly by institutional investors. Performance measures also exist for REITs such as the NAREIT and Wilshire Indices. An important issue to consider is whether we can directly compare the performance of public and private market indices.

Two problems have been identified in making these comparisons. First, public market indices have much more volatility. Perhaps this is because they are based on actual transaction prices rather than appraised values. Another explanation is that trading by Wall Street introduces more volatility because REITs behave more like stocks, and thus are subject to the whims of the market. In either case, the differences in volatility must be considered. Second, transaction prices in public markets seem to lead appraised values in private markets. This may occur because public markets are better at anticipating and are quicker to reflect changes in market conditions. It may also be because the appraiser is less likely to put as much weight on the most recent transaction when estimating market value. We know that transaction prices for individual properties may not be indicative of market value. Furthermore, comparable sales are, by nature, historical despite attempts to make adjustments in market conditions.

To better understand the difference in performance of public and private markets, Exhibit VIII compares the NCREIF and NAREIT Indices. The differences are handled by 1. using different scales for the performance of the NCREIF versus the NAREIT Index to adjust for differences in volatility, and 2. lagging the return for the NAREIT Index by one year since it tends to lead the NCREIF Index. The performance over the period shown in the graph, 1978 to 1992, is quite informative. Note that the NAREIT Index rises relative to the NCREIF Index in 1991. This is the result of the 1981 tax act which increased the tax benefits to private market investors and produced a repricing of real estate. The returns in the exhibit are before tax. Thus, lower before tax returns were needed on private market investments relative to public market investments after 1981. These tax benefits were essentially eliminated in 1986, and we see the NAREIT Index

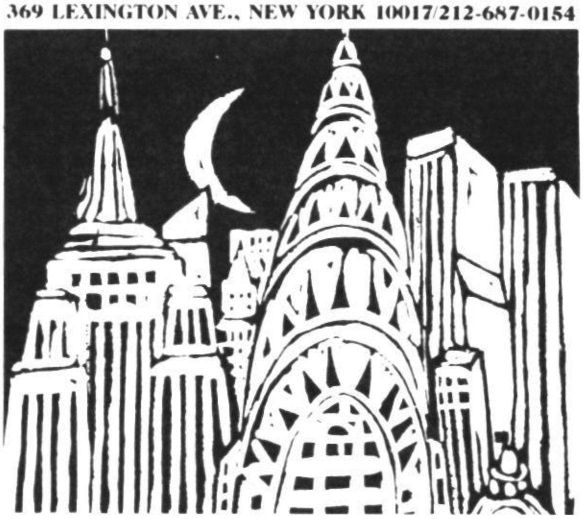
**EXHIBIT VIII**

NCREIF vs. NAREIT
4 Quarter Moving Average




decreasing as we move into 1986. This is followed by a significant decline in the NAREIT Index during the late 1980s as public markets appear to anticipate the real estate recession much faster than private markets. The NCREIF Index was slow to respond to declining real estate prices and the effect this had on performance. The opposite may have occurred in the early 1990s when public markets anticipated a recovery and prices rose for REITs faster than appraised values used for the NCREIF Index. The author expects these two markets will get closer in the future as institutional investors move funds between these markets and attempt to take advantage of any perceived arbitrage opportunities.







## Conclusion

Indices of real estate performance can provide valuable insights into trends in real estate values and cap rates for different property types in different geographic areas. Although indices for private real estate markets are difficult to compare with their public market counterparts based on stocks (including REITs) and bonds, trends in the performance of REITs can provide insight to trends in private market performance. Real estate counselors and other industry professionals can use these performance measures to supplement more traditional sources of cap rate and return information for commercial real estate.

## NOTES

1. Information about the index can be obtained by contacting NCREIF at Two Prudential Plaza, 180 N. Stetson Avenue, Suite 2515, Chicago, IL 60601. Telephone (312) 819-5890.
2. Although this seems quite reasonable, there have been several studies that suggest appraised values lag changes in transaction prices. See for example "On the Reliability of Commercial Appraisals: An Analysis of Properties Sold from the Russell-NCREIF Index (1978-1992)", R. Brian Webb, *Real Estate Finance*, Spring, 1994.
3. The standard deviation is a measure of the variability of the cash flows as defined in any standard statistics book. It is often used as a measure of the riskiness of an investment's returns.
4. For further discussion see Giliberto, S.F. "The Inside Story on Rates of Return," *Real Estate Finance*, Spring 1994.
5. The equal weighted returns were calculated by the author with permission of NCREIF and first appeared in Fisher, Jeffrey D. "Alternative Measures of Real Estate Performance: Exploring the Russell-NCREIF Data Base," *Real Estate Finance*, Fall 1994.
6. This exhibit first appeared in "Real Estate Portfolio Management and Strategy," a seminar prepared by Jeffrey D. Fisher and sponsored by the National Council of Real Estate Investment Fiduciaries (NCREIF) in Chicago, August 1994. The reader should note that metropolitan indices are based on relatively small sample sizes and may not always be representative of returns for the entire metropolitan area.

# THE PRUDENT USE OF ELECTRONIC INFORMATION

by Brian A. Furlong

ERISA demands prudent investment decision making. In an ERISA environment, it is essential that plan sponsors, their consultants and advisors operate with as much information as possible pertinent to the performance of the plan assets. A key to the prudent garnering and management of information for pension plans is the appropriate use of technology.

Recently the financial and business press has been awash with talk of the Internet, the Web, Cyberspace, Bandwidth, etc. While some real estate professionals have been at the vanguard of recent developments in telecommunications and computing, many have only vaguely followed new developments. What's going on with electronic information, and what does it mean for real estate counselors?

**What Changes Are Afoot?**

From the 1940s through the early 1980s, most Americans had little direct experience with computers. The typical computer was a mainframe, run by professional information processing professionals for big corporations, institutions and the government. The hardware was expensive, and the software was generally a programming language, such as FORTRAN or COBOL, which only specially-trained people could run.

In the early and mid-1980s personal computers came into widespread usage. They were affordable to small businesses and home users. To meet the new market of users who where not computer professionals, programmers developed high-level software for the general public. This included word processing and spreadsheet applications for general business use and easy-to-use special purpose programs such as lease-by-lease analysis programs. People who had never turned on a computer became regular users. The way in which offices carried out business changed forever, as evidenced by the fading away of old technologies such as the IBM Selectric, Correct-O-Type and ruled accounting paper.

Throughout the 1980s, the main changes in technology involved increases in processing speed and memory, or software improvements designed to enhance the functionality or ease of use. Most people operated on single computers, and the only way they shared data with other users was by distributing printouts or floppy disks. In the 1990s, improvements in memory capacity, software functionality and ease of use have continued at a rapid and apparently inexorable pace. However, the real innovation of the 1990s is shaping up to be another phenomenon, networking.

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For most business users, networking started with the installation of Local Area Networks (LANs)[1] for use within their offices. Many companies with multiple offices followed up with the installation of proprietary Wide-Area Networks (WANs).[2] On the home front, most people first became networked with modems to join a commercial on-line network service such as America On-Line, CompuServe or Prodigy. Over the last year or two, the Internet caught the attention of many home users. Each of the commercial on-line services began to provide their members with an easy interface to the Internet, as did numerous firms concentrating directly on Internet access. In 1995, commercial real estate professionals are catching Internet fever in large numbers.

**What Is The Internet?**

The Internet is a network of constituent computer networks all linked with a common protocol called TPC/IP.[3] It is the world's largest network linking tens of thousands of other networks. With well over 30 million users, it is growing by leaps and bounds, and some analysts expect that it will link over 100 million people before the decade is over.

It is relatively inexpensive for a firm or organization to offer its own information or services over the Internet, and thousands have. As a result, the breadth of services offered over the Internet is vast. Some of the principal services and tools available to most Internet users include:

- **Electronic Mail**, for sending and retrieving electronic messages. Each user of the Internet has an E-mail address, and E-mail can be sent to any other user around the world. Typically, the user only incurs a local phone charge for using E-mail, even if the recipient of the mail is far away.
- **Electronic News** (or **USENET**), is used for computer-assisted live conferences. USENET is a system of electronic bulletin boards with ongoing user dialog. As with E-mail and any other Internet service, the user only pays for local phone charges to the user's service provider, even if the user ends up communicating with people thousands of miles away.
- **File Transfer Protocol** (**FTP**), for sending or receiving files across the Internet.
- **Navigational Tools**, for organizing the contents of the Internet into easy-to-navigate hierarchies, so users can search the Internet for specific content. Two of the most widely used organizational systems for the Internet are **Gopher** and the **World-Wide Web**. Gopher organizes the content of the Internet into a hierarchy, and it includes a search engine. World-Wide Web (called the Web or the WWW) is a system which lets users access and download files and jump from one document or Internet site to another through **Hypertext** links. Hypertext is a mechanism which allows users to access new sites on the Internet by simply clicking the mouse on a highlighted description of the place the user is going.

**What Can The Internet Be Used For?**

The Internet started out as a network for non-commercial purposes, chiefly the military, other government users and universities. Recently, it has become a powerful tool for commercial real estate professional users to:

- Send messages to co-workers and clients. These messages can be prepared once and sent to either an individual or to a specified list of individuals. If the recipient is not available to read the message when sent, it is stored until the recipient is prepared to receive it. This eliminates telephone tag. If requested, the sender will receive a notice when the message is read by the recipient.
- Send files, such as spreadsheets, word processing files, databases and property or asset management reports, over the phone lines. Internet and private networks will, in many cases, make postal service and express mail delivery obsolete. Delivery by computer network is faster and cheaper, and the item delivered is more useful in electronic than in printed form.
- Retrieve files from another computer. Any type of file you can receive from a colleague or client through an exchange of floppy disks can be retrieved over the Internet. For example, it is possible to send or retrieve rent rolls, cash flow analyses, property or asset management files, word processing documents, etc.
- Set up a home page on the Web to post information useful to clients, colleagues and potential clients who are connected to the Internet. A home page can be a content-rich advertisement which explains and perhaps demonstrates the products and services your firm offers. If set up properly, the home page delivers its information in multi-media with pictures, sound and video to accompany text.

  A home page on the Web can be used for electronic publishing purposes, e.g., to publish brokerage listings. With so many commercial property brokers beginning to use home pages to post listings, it is likely the Internet soon will support a multi-media electronic multiple listings function where users can screen investment, leasing or financing opportunities throughout the world. The contact database or Rolodex of an individual broker or even a large brokerage firm eventually will be no match for the breadth and depth of the contacts available through the Internet.

- Perform research. Internet has vast, easy to search and access information resources for use in business of all types, including commercial real estate. Many periodicals are available over the Internet in searchable form. The nation's largest libraries have their catalogues on-line, including the Library of Congress and many university libraries. The books and information found in these catalogues are often available by request from local libraries which, in turn, borrow these items using inter-library loans.

  All securities documents filed with the SEC, including the annual 10-K and 8-K reports of all publicly-traded REITs, are available for immediate free downloading from the Internet's EDGAR service. These reports include a wealth of information on REITs as investment entities, and they often provide transaction and other data regarding individual properties.

  The government maintains many Internet sites with public access. For example, data from the Commerce and Labor Departments are available. The FDIC provides detailed narrative and statistical reports each quarter on the nation's commercial banking and thrift industries. Even the CIA has an accessible home page on the Web which, among other things, provides a detailed summary of the economy, demography, geography, weather, political system, military strength, drug trafficking patterns, etc., for each nation, island, island group and commonly-referenced group of nations.

  There is more information available on the Internet than in any physical library. It is accessible wherever there is a computer with a modem and a phone line. Access is cheap, starting at about $10 to $20 per month for access through popular commercial networks such as America On-Line, and it requires little training or strong computer skills to use. It has become a mass market phenomenon and no longer is the exclusive province of computer hackers, scientists and professors.

**Internet's Limitations**

The Internet has two principal problems for business users. First it is difficult to charge for goods, services and information over the Internet. Therefore, many information providers prefer to contract with privately run commercial networks and services, such as America On-Line, Bloomberg or Teleres, which charge for their services and share the proceeds with the information provider.[4]

The second problem is network security. Once a local area network (LAN) is linked to the Internet, hackers or criminals from elsewhere on the Internet may try to damage or steal data from the LAN. Partial, although not absolute, protection can be provided if appropriate electronic fire walls are set up to control unauthorized access to sensitive parts of the LAN's data.[5] For security reasons, some companies prefer to maintain proprietary wide area networks to carry out certain communications tasks.

**GIS And CD ROM**

Besides networking, other recent changes to computing by real estate practitioners involve applications made practical by increased memory capacity, faster processing speeds and improved software applications. Two of the most noteworthy applications to achieve recent prominence are Geographic Information Systems (GIS) and CD ROM products.

GIS applications allow a user to convert tabular data into color coded or custom shaded maps which clearly represent the spatial relationships in the data. GIS has been around for a long time, but it has been too costly and difficult to use for many real estate professionals. Further, much of the data necessary to feed the geo maps had been difficult to acquire and organize. Recently, data sources have come way down in price, the variety of data available on CD or disk has increased greatly and mapping and database programs have become much easier to use. For example, vendors now sell updated employment, demographic and income information for the entire country. Many data elements are available on a census block group, census tract, zip code, county, MSA, state and national level. Other vendors sell real estate information, such as the location and updated sales of virtually every supermarket in the country. At our company, we have developed a menu of standard maps which can be used repeatedly as templates to attractively represent employment, income, demographic and other spatial relationships. Once set up, these maps take little time and money to produce for specific properties or areas.

CD ROMs are becoming a major source for real estate counselors to use. A single CD ROM disk can carry an immense amount of data, and the storage capacity of CD ROMs will surely increase over time. Entrepreneurs and governments now are putting all sorts of information in data format on CDs, as well as scanned images. This includes:

- comparable property sale information with the basic information downloaded from electronic records kept by the government or transfer tax authorities for deed recording;
- property-specific assessment records and tax maps;
- economic and demographic data;
- descriptions of all the space available for let in a given market;
- descriptions of individual buildings of a defined class in a defined geography;

- operating statistics which had only been published previously in printed guides;
- property market conditions;
- recorded deeds, mortgages, legal descriptions and other documents scanned from public records and sometimes converted into searchable data files.

Information on a disk is a big improvement over the old hard copy representations. It can be searched using electronic search engines, and the data can be sorted, averaged, arranged in charts, graphed, etc.

Although a number of CD products are used in real estate analysis throughout the nation, many more cover only certain states or parts of states. It is likely that in the next few years there will be some consolidation and cooperative marketing of the CD information products. This would make them easier to find and contract for, thereby increasing the user base and making the production of this information more economically viable. It is also likely that some information now available exclusively on a CD will find its way onto the Internet or private on-line services such as Teleres.[6]

**How Will This Technology Change Commercial Real Estate Practices?**

Real estate has always been characterized by private information, but technological advances are making it ever more public. Technology is also leading to standardization of how data is organized and presented. For example, real estate companies previously might have used varied methods to present the same type of information in charts. Now computerized databases can present data in a common set of charts, graphs and maps which are primarily generated by the computer with limited interaction required by the analyst. This not only saves a great amount of time, but it leads to consistency of presentation. Standardized charts are easier for a third party to review, particularly when a large portfolio is involved. The use of common data elements, processed by database and GIS programs, allows for easy comparisons of one asset to another. It also allows for more process control by management.

Technological advances are causing an evolution in the type of knowledge and research skills which are valuable to a real estate counselor. Previously one needed to know how to use the library's physical card catalogue and guide to periodic literature. Now, it's better to know how to search for information on the Internet and other on-line sources. Increasingly, local property market knowledge is becoming less valuable. Today database products enable users located throughout the country to intensively map the property stock, availability, rents, income patterns, new construction patterns, population movements, household size and other variables of locales that used to take years for a local expert to understand. There used to be so little data or it was organized so poorly that in many areas an expert was needed who intuitively understood the local realities. We are getting to the point where hard data will often replace gut feel, if effectively manipulated.

The new technology will lead to centralization of gathering information. Just as garage-based car manufactures were replaced by the efficiencies of the Ford assembly line early in this century, data firms will centralize many information gathering tasks which practitioners previously did independently. For example, it doesn't make economic sense for each appraiser in America to gather his or her own public records information on comparable sales when this can be done for far less aggregate cost by firms such as REDI Data or COMPS. In a competitive world, most cost savings are passed on to the users of the information. Those who persist in inefficient methods of data investigation and processing will see their profitability suffer.

Advances in computing and telecommunications, such as the Internet, will affect many aspects of the office business, retail business, lodging business and others directly connected to the commercial property markets. The ability to communicate at a distance decreases the need for office tenants to agglomerate. It makes office hoteling and telecommuting more feasible. On the retail front, the possibility to present one's wares electronically changes the type of space required and the best location for that space. For example, electronic banking has greatly reduced the demand for large, well located bank branches. The ability to order music CDs over the Internet and to preview the sound, will hurt CD sales in malls. Computer networks will encourage more comparison shopping as computerized agents seek out the best deal among competing vendors. For the lodging industry, electronic booking is coming into play. The prospective guest can call up a detailed description of a hotel, sometimes including electronically transmitted photos or videos together with pricing options. This will change common booking procedures which affect the value of franchise agreements and booking association memberships held by hotels.

**Conclusions**

Real estate counselors need to explore what is important about new technology as well as its business ramifications. Since real estate is an information-based business, it is inevitable that most commercial real estate professionals will be on the Internet and will use other products such as CD ROM and geo-maps. For many it makes sense to get on-line and up to speed with the new technology. These professionals will reap the benefits of the new technology and not lose out to technology-savvy competitors.

NOTES

1. A LAN is a system which links computers and peripheral devices within a building or some other small, local area. LANs allow co-workers to communicate with each other's computers and to share resources through a client/server system. In a client/server system, one or more server computers centrally maintain data for, and execute tasks for, a group of interconnected client computers.
2. A WAN is a communications network which links two or more Local Area Networks which are located at a distance from each other. Communications in a WAN may be by way of public or private lines.
3. A *protocol* is a set of rules or agreements on how to communicate. *TCP/IP* stands for Transmission Control Protocol/Internet Protocol. Hence the name *Internet* for the network operating under TCP/IP.
4. Many people are working hard to develop better ways to charge for information and products distributed over the Internet. Once it is effective to charge for Internet information, it will become economically viable for many information providers to offer their wares directly over the Internet. Strong products will reach a vast market, which will result in low per-use charges.
5. If you access Internet by a modem connection with an Internet gatekeeper such as America On-Line, there is little risk of a breach of security involving your computer. The risk is more acute if you open your network to outside visitations by acting as a service provider on the Internet rather than just a service consumer.
6. Teleres is an on-line information service dedicated to the commercial real estate industry which is being developed by AEGON, a Dutch insurance conglomerate, in partnership with the Dow Jones Corporation.

# 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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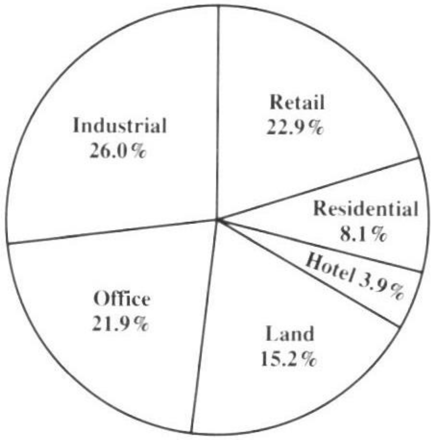
types and regions, but on specific properties. Investors increasingly looked to direct property acquisitions, or fully or partially-specified pooled funds, as the preferred investment mode. In 1988, office acquisitions (in terms of dollars invested) hit an all time high. By the end of the decade, the 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

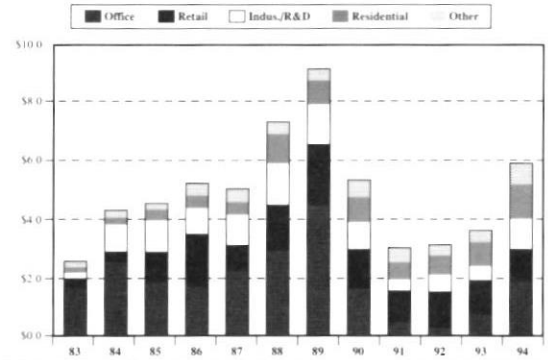
**FIGURE 2**

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.

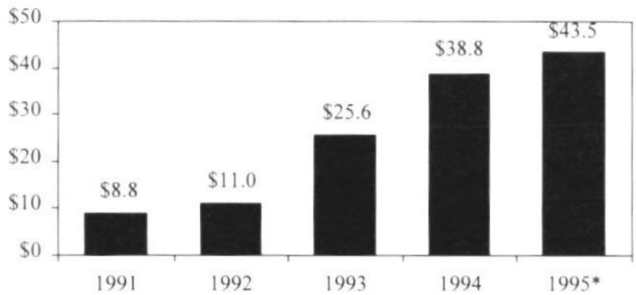
During the same period of time, the capital markets were beginning to respond to the shifting capital demands of the real estate sector. Just as changing regulatory conditions led the traditional sources of real estate finance to withdraw from new investment in real estate, Wall Street was seeking ways 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 re-examination 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.

# 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.

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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.

# THE COMMERCIAL PUBLIC DEBT MARKET

by John J. Healy, Jr., CRE, and Patricia R. Healy, CRE

Five years ago an article written on the commercial public debt market and securities backed by commercial real property obligations would have been very brief. While the market had completely accepted the residentially traded security, significant volume had not yet occurred in the commercial market. Today this has definitely changed. This article will explore the CMBS vehicle (commercial mortgage-backed security) and its potential impact on the real estate financial markets.

***Premise One: CMBS is a financing strategy, a mechanism to monetize/liquify a mortgage portfolio. The process results in a vehicle that tranches risks while permitting an investor to assess and determine the desired return.***

The following terms are used colloquially and interchangeably: 1. CMO–Commercial Mortgage Obligation; 2. CMBS–Commercial Mortgage-Backed Securities; and 3. REMIC–Real Estate Mortgage Investment Conduit. While there are specific differences between the three, all are vehicles generally used to convert pools of non-liquid real estate mortgages into a capital market instrument. Each is a vehicle that can move a mortgage off the balance sheet (or lever an asset) in an efficient manner. By placing mortgages into pools, tranching risk and selling individual shares as a security (in each tranche), liquidity is created.

A comparison of corporate bonds to CMBS is described here for further clarification. Simply stated, corporate bonds base their repayment on net income, sales growth, controlling costs and expansions. Mortgage bonds base repayment on the regularity of scheduled interest and principal payments of mortgages which secure various types of commercial properties (from multifamily to hotel). Should a mortgagee fail to make the scheduled payments and a foreclosure occurs, repayment from that specific asset would then be based on net cash flow after portfolio level asset expenses.

These pools of securities are rated by the agencies with varying yields based on risk. Investment grade ratings result from a high degree of certainty that investors will receive interest and principal as expected. The subordination of the junior and

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*Patricia R. Healy, CRE, is managing principal of Hanford/Healy Asset Managment Company, a national firm specializing in mortgage restructures and securitization and rated as a Special Servicer. She received an MBA in finance from Southern Methodist University and an MIM from the American Graduate School of International Management.*

below investment grade tranches provides the credit support for the investment grade senior bonds. To the extent that delinquencies or defaults in the underlying mortgages create losses, these losses are absorbed first by the lowest rated/unrated tranches.

*Premise Two: Just as the commercial paper market changed the way Fortune 1,000 companies obtained financing, the CMBS market will alter the real estate financial market. As in all emerging markets, growth will be erratic and slower than originally projected.*

As a percentage of all originated commercial loans, the CMBS market is small. The value of all commercial mortgages is estimated to be greater than $750 billion, with the portion attributed to the publicly traded market less than 4 percent. (The residential market is estimated at 70 percent+ of all mortgages traded.) The volume generated in 1994 was by far the most substantial, with over $20 billion placed in the commercial public market. This is significantly greater than the $7.5 billion which was placed on the market in 1991. The RTC/FDIC issued half of all product from 1991 to 1993. In 1994, additional originators (non government- related) supplemented the market. Included in the expanded base of issuers were owners, developers, corporations, banks, insurance companies, REITs and conduits.

Additional market changes have occurred during the past five years. The first collateral type to be securitized was multifamily. The primary reasons for this selection were the limited variances between NOI and NCF, a revenue stream that marks to market frequently, stable operating expenses and a projected cash flow predictable for rating agency and investor purposes. By 1994, mortgage pools expanded to include most collateral types, including multifamily, mobile home parks, hotel, office, industrial and retail. Mechanisms to accommodate floating rate loans were developed, servicing capabilities improved, rating agency capacity increased and improved documentation instituted.

While both diversification and growth have been dramatic, concerns do exist. As reported by CS First Boston, CMBS transactions are complex to analyze, and there are no standard industry-accepted analytical tools. In addition, since the product is not homogeneous and historical information is absent, there are no simple means to perform acquisition/due diligence or to track and report operating performance. Initial pooling and servicing agreements lacked the flexibility that subsequent documentation incorporated. As a result, problems are likely to occur in previously originated transactions. Finally, as interest rates increased, alternative financing vehicles (more traditional) became prevalent. The result is that volume for 1995 is projected only to be in the $15 to $17 billion range.

*Premise Three: Unlike corporate bonds, securitization is not a single company underwriting. There are numerous risks and little historical information.*

Risk analysis in the CMBS market is perhaps the most daunting obstacle. Considerable experience exists in underwriting a traditional commercial loan, with the following five major considerations consistent with both individual loan and CMBS underwriting:

1. Regional and property market conditions
2. Underlying property's operating performance (historical/projected)
3. Borrower's credit worthiness
4. Underwriting current and projected value
5. Individual default risk of the mortgage.

In addition to traditional real estate and mortgage risks, consideration also must be given to pool risk, documentation risk, interest rate risk and operational risk. Pools carry inherent geographic and property concentration concerns. For example, a concentration of Southern California multifamily loans might be perceived to have a higher level of payment risk than a similar pool in Chicago due to the inability to forecast earthquake activity. Similarly, an office collateral concentration with a high tenant turnover profile would require significantly greater reserves for tenant improvement dollars than a mobile home portfolio. Further, if an individual asset or a small group of assets constitute a large percentage of value in the pool, concentration risk must be evaluated.

The indenture and the pooling and servicing agreement are two of the major documents which control portfolio activity. The documents must permit flexibility in management while affording controls that provide protection for the bondholders. For example, if the only action a servicer can take is to foreclose on a non-payer, then high levels of delinquency will likely occur. Alternately, if the servicer is permitted to arbitrarily extend or reduce payments, potential losses to the bondholders may not be immediately identified. Understanding the controlling documents is essential to properly underwrite the investment.

Financial risks are significant and should be considered. In addition to the interest rate risk (if the bonds are not of a fixed rate), there are prepayment, delinquency and default risks. While hedging may mitigate an interest rate risk, it is a sophisticated and complicated tool. The delinquency risk is somewhat more problematic. Credit enhancement and/or low collateral historical delinquency rates would obviously reflect a high credit quality; however, projections to accurately forecast delinquency are difficult to create. Still more complicated is the projection of defaults since there are no reliable historical statistics or defined industry standards. The market perception however, is that the default rate for CMBS is higher than it is for corporate bonds.

Finally, there is the operational risk. In underwriting a CMBS issue, it is critical to understand the entities involved from both an operational capacity and a corporate viability standpoint. The investment bank may be both the issuer and the underwriter. The trustee has the responsibility for document control. The master servicer may have servicing/special servicing responsibilities in addition to payment collections.

The special servicer (when different from the master servicer) must possess a high level of technical ability to enable the facilitation of restructuring or foreclosure of a loan or pool of loans. Lastly, the coordination of all parties must be seamless, and conflict(s) between classes of bondholders must be minimized, to the greatest extent possible.

***Premise Four: Risk pricing and increased liquidity will be the competitive advantages to this financing vehicle.***

Pricing cash flow opportunities from rated bonds correlate directly with the perceived level of risk. For example, imagine that each loan is individually tranched. Clearly, the first 20 percent of debt (senior position) on a commercial building is very secure. The value would have to decrease 80 percent before a loss would occur. This tranche may be rated triple A (AAA) and carry a relatively low spread over the appropriate index rate (say, 50 basis points).

At the other end of the spectrum would be the single B (B) rated tranche. This category represents the last portion of rated debt. Simply stated, in a building worth \$100 that has \$70 of debt, this would be the \$5 between \$65 and \$70 (assuming no unrated portion). Clearly, the risk is greater with a required rate of return 15 times (for example) the AAA spread. Further, there is generally a portion of the security referred to as the unrated piece or the first loss position. This portion is referenced as a discount over face value with investors seeking a significant yield on dollars invested. Individual whole loans, by comparison, have perceived tranches of debt that reflect risk(s) while not technically priced via the tranching mechanism.

In summary, an ideal investment would exist if: the loan risk is easily assessable, a range of yield driven returns was created, market surveillance and current statistics were readily available and the portfolio mix could be altered, when necessary, to maintain a desired composition. The CMBS vehicle has the ability to fill that market void.

***Premise Five: Recognition of the impact that public disclosure will have on real estate valuation and refinancing.***

The single greatest constraint to the expansion of the commercial public debt market is the absence of reliable, unbiased information. Without a mechanism affording easy access to cost effective reliable data, a secondary market will be slow to emerge. Without a secondary market, there is limited benefit/viability to the CMBS market. With the provision of adequate information and the development of the CMBS secondary market, this financing vehicle offers the single most significant liquidity opportunity in real estate today.

# INSTITUTIONS RE-EXAMINE REAL ESTATE

by James P. Ryan, CRE

As we near the end of 1995, real estate is reemerging as a viable investment product for institutional investors. Many were so badly burnt over the last five years that real estate is still a dirty word. But others have recognized that real estate, like most investments, is cyclical and that pricing probably went past its peak on the high side and now has probably dropped below a normal ebb on the low side. Many opportunistic funds have been structured to take advantage of this market opportunity, and institutions are participating in various areas, from direct equity to debt. This article will look at three major institutional players: pension plans, life insurance companies and banks. All have been affected by real estate and are responding to the changing market in different ways.

The total value of United States real estate, estimated at about $3.08 trillion, is divided approximately $1.86 trillion or 60% to non-institutional owners comprised mostly of government and private concerns. The balance, or $1.22 trillion, is considered institutional real estate and represents about 40% of the total. The institutional segment is further divided between debt and equity. The debt component is about $992.53 billion and the equity is $231.55 billion.

As indicated in Figure 1, the two largest players in the equity area are pension funds (43.4%) and life companies (21.6%). Combined, they represent 65% of the market. And the largest investors in the debt market are commercial banks with 39.4% market share. It wasn't until the late 1970s that pension funds started investing in real estate in a meaningful way. One of the strong arguments to invest in real estate was that it provided a good diversification to stocks and bonds which accounts for the bulk of invested pension dollars. Life companies have invested in both equity and debt for a number of years; recent regulatory changes have affected their investment strategy and many are becoming net sellers. Commercial banks were stung by many bad loans and, consequently, had growing REO (Real Estate Owned) portfolios which hurt earnings. Many banks have been restructured and others have merged or acquired other banks to expand market presence and create greater efficiencies.

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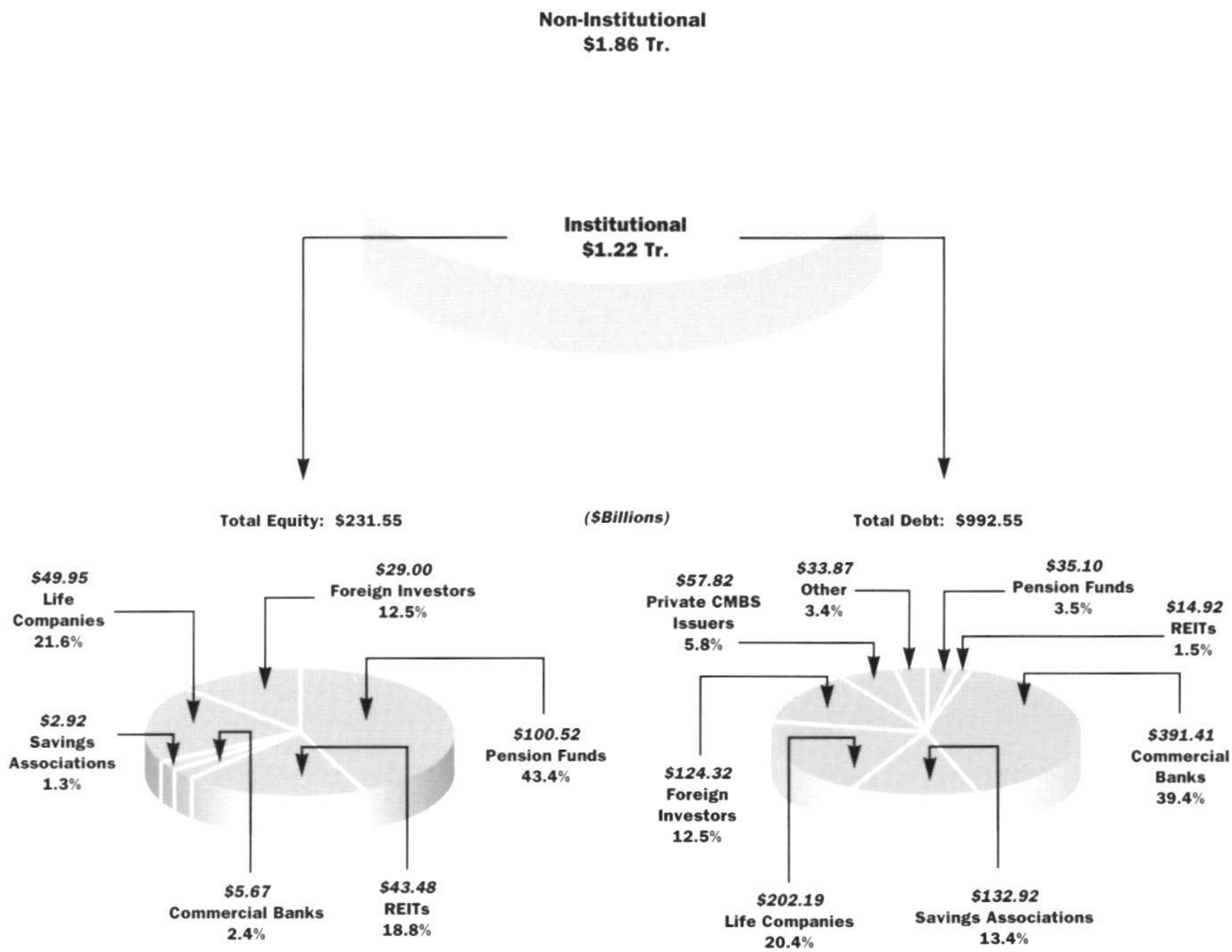
FIGURE 1

Capital Sources: The Flow of Funds
Total U.S. Real Estate: $3.08 Trillion
As of 6/30/95




Source: Equitable Real Estate Investment Management, Inc.

**Pension Funds**

Pension Funds represent one of the fastest growing pools of capital in the United States. As shown, pension funds assets are projected to double from 1987 to 1997, or grow from $1.5 trillion to $3.2 trillion. Over this period, the mix of assets has changed and is expected to continue changing.

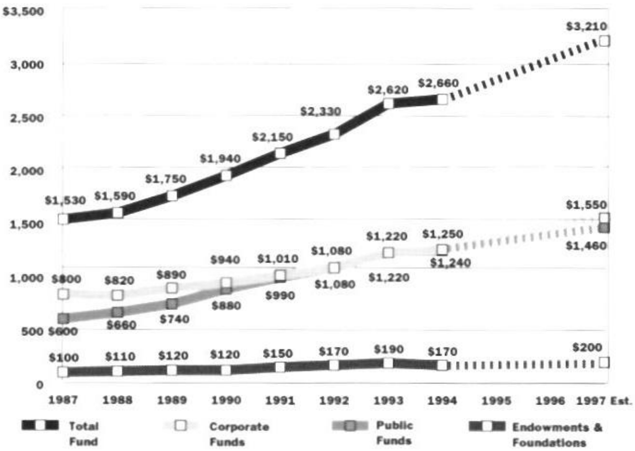
The major change has been a reduction in domestic bonds from 35.3% in 1984 to 24.9% estimated in 1997. International stocks/bonds, or those emerging markets, picked up most of the excess growing from 3.7% in 1989 to 13.8% estimated in 1997. Equity real estate, as we all know, has not fared well in recent years. Due primarily to value declines, equity real estate has dropped from 5.2% of pension assets to about 3.2% in 1994. The good news is that by 1997 this asset class is expected to grow by about 1% or $32 billion.

The Russell-NCREIF Property Index reported positive returns for all four quarters of 1994, and it ended the year with a healthy 6.73% annual return. The first quarter of 1995 has continued the trend with a positive 2.0% return.

As of 1994, about 43% of all pension funds invested in equity real estate. This was down slightly (about 2%) from 1993. During 1995, corporate and public funds are expected to increase their equity

FIGURE 2

Pension Fund Capitalization

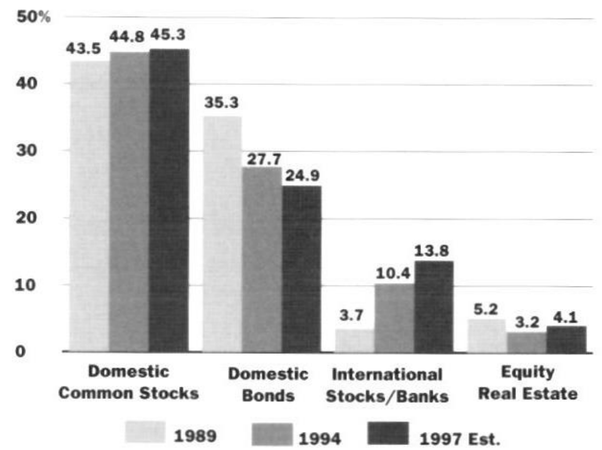



Source: Greenwich Associates

real estate slightly, but endowments and foundations should grow by about 7%. Pension funds are moving back into the market, but they are using their experiences of the 1980s to ask the right questions and understand the risks prior to committing. Many funds are deciding whether an average fund's real estate allocation of 3.2% is worth the time and effort, since an allocation of approximately 10% is necessary to achieve any diversification benefits. Some funds wonder whether real estate is worth the effort; it commands higher advisory fees than stocks and bonds and demands more attention.

FIGURE 3

Pension Fund Asset Mix

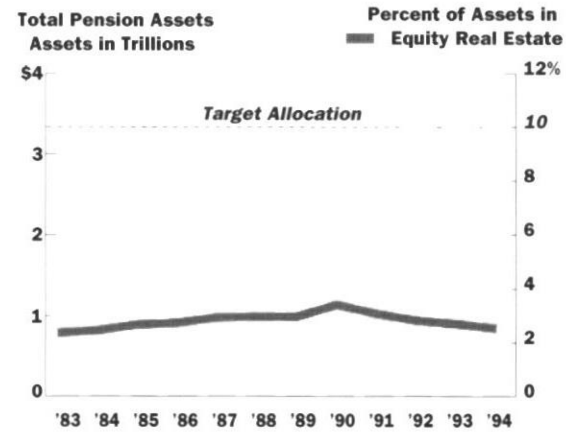



*Note:* International figure for 1989 does not include International bonds.

Source: Greenwich Associates

FIGURE 4

Pension Fund Assets in Equity Real Estate

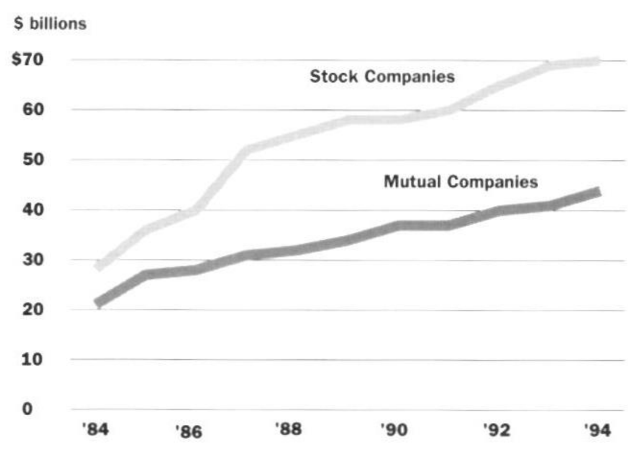



Source: Federal Reserve; *Money Market Directory*; Equitable Real Estate Investment Management, Inc.

Those that do stay with the asset class will probably look for greater diversification within the real estate sector and grow into REITs and mortgages. Currently pension funds are the largest investors in the private equity real estate market. As their real estate appetite grows, they are expected to expand into the public equity market which provides more liquidity and debt investments—private or public. Private debt investments would be traditional whole loans, whereas public debt would be CMBS (Commercial Mortgage Backed Securities). Mortgages, whether private or public, tend to address fixed income needs rather than pure real estate mortgages.

FIGURE 5

Insurance Company Revenues




Source: A. M. Best Company

## Life Insurance Companies

Life companies are the second largest source of capital in the equity market with about $50 billion dollars, but they are even a larger participant in the debt market with about $200 billion. The insurance industry, particularly mutual insurance companies, is in the midst of major restructuring. Many insurance companies are consolidating and others are downsizing; some are selling nonessential businesses to raise capital, while others are refocusing management on core business areas. For example:

- Prudential Insurance lost over $900 million last year and is embroiled in lawsuits over agents' sales practices. They are also selling their mortgage company.
- Metropolitan Life sold its health care, home mortgage and real estate brokerage businesses. It is currently in the process of merging with New England Mutual.
- New York Life is merging various business lines.

Many mutual insurance companies, which are owned by policyholders, are looking at converting to stock ownership to raise additional capital on Wall Street. The mutual structure limits their ability to attract investment capital and therefore inhibits growth.

The Equitable Companies converted from a mutual insurance company to a stock company in the nation's largest demutualization in 1992 and has raised its capital base significantly. It also has restructured other assets to increase capital. Alliance Capital, a subsidiary of Equitable, recently was taken public, and Equitable just restructured Donaldsen, Lufkin & Jenrette from a privately held firm to a public company. Equitable sold 20% of the company to the public and retained 80% ownership. This not only generated income but established a value for the remaining shares.

There are three reasons why equity real estate is being reduced in life insurance companies:

- risk-based capital
- rating agencies
- variable life policies.

Life insurance companies have been heavily impacted by regulatory restrictions. The massive real estate problems that brought down many banks and thrifts in the late 1980s prompted the federal government to place tighter controls on the insurance industry. Due to problems associated with junk bonds and real estate, the NAIC (National Association of Insurance Commissioners) developed new regulations for the insurance industry that negatively affected real estate.

**FIGURE 6**

Statutory Risk-Based Capital Requirements For Life-Insurance Companies
(Selected Assets)

| Asset Category | Statutory Risk-Based Capital (Percent of Assets) |
|---|---|
| **MORTGAGES** | |
| 1-to-4-Family Residential | 0.6% to 1.0% |
| Commercial and Multifamily-Current | 1.0% to 3.0% |
| Commercial and Multifamily-Delinquent | 3.0% to 6.0% |
| Mortgages in Foreclosure | 20.0% |
| **REAL ESTATE** | |
| Company Occupied | 10.0% |
| Investment Property | 10.0% |
| Foreclosed Property (REO) | 15.0% |
| **STOCKS** | |
| Common | 0.0% to 30.0% |
| Preferred | 2.3% to 30.0% |
| **BONDS** | |
| Class 1 (A or higher) | 0.3% |
| Class 2 to 3 (BBB to BB) | 1.0% to 4.0% |
| Class 4 to 6 (B, CC, D) | 9.0% to 30.0% |

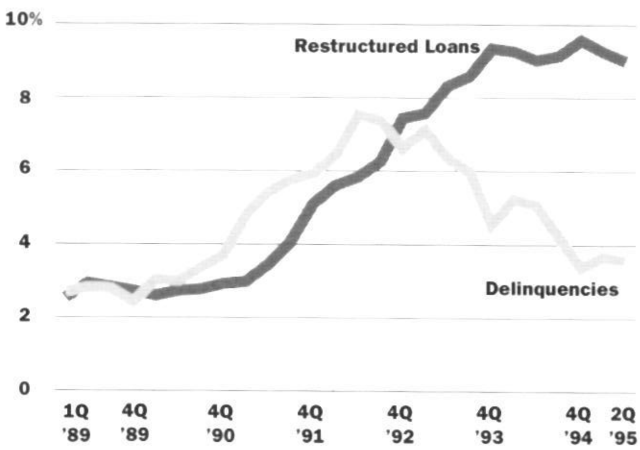
Source: National Association of Insurance Commissioners

In 1993, the NAIC introduced risk-based capital (RBC) rules requiring that minimum levels of capital be reserved on a sliding scale to reflect the riskiness of investments and operations. In addition to NAIC requirements, many rating agencies have taken a dim view of real estate assets on the balance sheet of insurance companies. Ratings by credit agencies have an impact on the cost of capital for insurance companies which can affect their ability to sell insurance. Therefore, equity real estate has become a drain on many insurance companies and has prompted sale programs among many large insurers. As shown in Figure 6, the reserve requirement for a Class A bond is .3% compared to 10% for investment real estate. It is interesting that a Class BBB bond only requires a 4% reserve while a Class A investment property requires a reserve of 10% against a company's asset base. The third reason equity real estate is becoming a difficult investment option is that the market is changing from whole life policies to variable life policies. With whole life policies, an insurer could match the duration of a policy closer to long-term investments. With variable life, the duration of a policy is less certain, and shorter term investments, like bullet loans, match better.

As life companies have disposed of real estate assets, they have also tightened their underwriting standards. Delinquency rates have shown marked improvement, dropping from 5.25% in early 1994 to about 3.5% in the second quarter of 1995.

FIGURE 7

Life Insurance Companies' Underperforming Commercial Mortgages




Source: American Council of Life Insurance

Today, life insurance companies are moving back into the mortgage market for larger loans in the $15 to $50 million range. The spreads on mortgages over like term treasuries still are very good compared to the spreads on bonds of similar rating.

**Banks**

In today's banking industry, big certainly means better. Most banks are either in the process of acquiring or being acquired. The focus is on creating market efficiencies by cutting expenses. Recently, Chase and Chemical merged. Today Bank of America and Nationsbank are in discussion about a possible merger, as are First Interstate and Wells Fargo.

FIGURE 8

Commercial Bank Lending
($ Billions)

| Period | Real Estate Loans Outstanding* | Loan Delinquencies** | REO | Loan Delinquency Rates |
|---|---|---|---|---|
| 1991 | $249.58 | $14.50 | $13.18*** | 5.81% |
| 1992 | 257.78 | 13.43 | 13.20 | 5.21 |
| 1993 | 267.70 | 10.60 | 8.36 | 3.96 |
| 1994 | 283.18 | 7.39 | 5.19 | 2.61 |
| Q1'95 | 288.80 | 8.17 | 4.25 | 2.83 |

**Excludes development, construction and multifamily loans.*

***Defined as "Loans Noncurrent," i.e., loans that are past due 90 days or more or that are in nonaccrual status.*

****Estimate*

Source: American Council of Life Insurance

Banks have been moving aggressively to fill gaps in the mortgage market. They are writing shorter term loans with floating rates and recourse construction loans. Many are extending lines of credit to REITs and other pools of investment capital with reasonable loan-to-value ratios.

During the first half of the 90s, the real estate loans portion of banks' assets has grown from about $250 billion to about $289 billion, while loan delinquencies and REOs have declined. The banks have worked hard to improve their balance sheets. As the industry becomes more competitive and margins continue to get squeezed, banks will have to grow their asset base to improve earnings. As the real estate market recovers and new construction becomes more plausible, the banks will function as a control lever on the supply of new real estate. Their renewed focus on conservative underwriting should help discipline the market which will benefit all.

Real estate, like any investment, is cyclical. The perception that real estate is a dirty word is changing. Opportunity funds and REITs have led the capital market back into real estate and posted some excellent returns by taking some risks. The early funds focused on acquiring large loan packages of performing and nonperforming loans from the RTC and savings and loans. These opportunities have diminished dramatically. However, other opportunities still are very strong. Many institutions, particularly banks and insurance companies, are in a sales mode and need to reduce their real estate exposure. Therefore, some excellent buying opportunities are available.

Ten year treasuries currently are about 6% and average projected real estate yields (as measured by Real Estate Research Corporation) are 11.4% (as of June 1995), indicating a 540 basis point spread. This compares favorably to the normal spread of 200-400 basis points which indicates the returns to real estate are above the normal range. In other words, on a relative basis compared to other capital assets, real estate is undervalued indicating now is a good time to buy. Finally, inflation is projected to remain in check for the balance of this decade. This is good news for all, particularly the debt market. Lenders are returning to the market which is good news for borrowers. The key is that real estate is again becoming attractive in many different forms, equity or debt, private or public ownership.

The institutional real estate market is definitely in better shape today than it was a year ago. Some are moving back in while others are moving out. I think it is fair to say we are all a lot wiser today than we were before the bottom fell out. Let's hope our memories last a long time so we all can enjoy a prosperous future.

# COUNSELING THE INSTITUTIONAL CLIENT

by Gary K. DeClark, CRE

Real estate counseling can take many forms. According to official CRE definitions, a real estate counselor is a real estate practitioner whose primary business is providing expert, experienced advisory services to clients for agreed upon fees. The client relies upon the Counselor for skilled and objective aid in the client's real estate needs, implying both trust on the part of the client and trustworthiness on the part of the Counselor. While being objective in the analysis, the Counselor maintains the client's best interest by considering and/or executing various strategies, developing available options and advocating the best position.

Among the various clients who require counseling services, this article focuses on the institutional user. Institutional clients are generally considered high-profile clients who deal with properties which are either larger in scale, larger in value, larger in size or typically part of a larger scale portfolio. These clients will oftentimes acquire, manage, renovate, rehabilitate and/or dispose of investment-grade properties for their domestic or international owners. Many institutional clients require sophisticated, computer-based analyses of the multiple-tenant cash flow oriented parcels of real estate. Institutional clients typically will require a high level of expertise from the Counselor due not only to the high grade investment nature of the property, but also because of the large amount of money involved. Given the basis of institutional practice, how does the Counselor provide service?

**Appraisal Possibilities**

Those Counselors who also are appraisers may find ample work opportunities with institutional clients. Most pension fund managers, life insurance companies or REITs require annual portfolio appraisals either as a requirement of law or as corporate policy. Many also require appraisals upon property acquisition or disposition. Those clients subscribing to banking law dictum will require a full self-contained narrative-styled report on each property. Others may need something less substantive—a summary report where only a limited appraisal is performed. In the latter instances, typical assignments suggest some sort of a restricted report or limited format. They might include a brief property and area description but would additionally include a detailed income analysis (usually a discounted cash flow on Pro-Ject™, Argus™, Dynalease™, 0/2™ or some other commercially available software), a

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thorough rental study, a complete market analysis or overview and a strong supporting analysis on improved property sales. Sometimes a cost approach is excluded in a traditional sense, but usually a land value analysis is included. Property inspections are sometimes substituted for desktop analyses. Other times only a sampling of the properties are inspected.

Depending on the requirements, an alternative portfolio review could be engaged where previously prepared discounted cash flow analyses are reconsidered and updated; any supplemental corroborating market data could be obtained by telephone research. This latter service provides a second look at properties already under scrutiny by asset or property managers.

With the advent of the technological revolution, clients will be more cognizant of speed and accuracy in their requests for services. Electronic data transfer of information on a matter-of-fact basis is just around the corner. Professionals who have data will be in enviable business positions. Computer analysis, now commonplace in the industry, will continue to be vitally important in real estate analysis. A word of caution suggests, however, that with such electronic information availability, more emphasis will be placed upon proper data input and more so upon proper data analysis undertaken by seasoned and experienced professionals. Clients who traditionally have relied upon larger, national appraisal firms are beginning to re-examine their policies in favor of contracts with smaller boutique-styled firms where seasoned, experienced professionals have greater input into the assignment. Electronic data analysis, speed and computerization cannot take the place of experience and judgment.

**Management Opportunities**

Opportunities abound for Counselors in management areas, as well. Property and asset management services can be offered regularly to institutional users. Property managers maintain the day-to-day operations of properties either directly or indirectly. By knowing building operations, profitability can be heightened by a knowledgeable Counselor. Keeping operating costs in check and making a contribution to the leasing efforts could translate to increased returns, so vital in today's ultra competitive market.

Asset management, as distinguished from property management, is more concerned with global performance of the portfolio. Asset managers consider all the portfolio's components and attempt to maximize returns. Counselors may lend expertise to the asset manager's decision making regarding how best to maintain the portfolio.

**Troubleshooting**

Assume a pension fund manager is managing a portfolio of retail properties for a client. Included in this portfolio are several types of shopping centers with various levels of performance. If one of the poorer performing centers is singled out as an asset requiring analysis, the Counselor could offer his professional services including:

a. analyzing the center's tenant mix;
b. suggesting ways to reconfigure the tenants' locations;
c. suggesting possible lease buyouts for non-performing tenants who may be experiencing sales difficulty;
d. analyzing the various gross sales volumes relative to contract rental payments to determine whether rental payments are too large for sales generated; and
e. providing ways to restructure any leases (e.g., Is rent too large a percentage of sales volume suggesting a struggling tenant who may not be economically viable?).

The Counselor would also examine any deferred maintenance on the property and consider the ultimate impact on a center's investment return. If the property is sub-standard relative to physical attributes, he could analyze what impact renovation dollars would have on a retenanted or revitalized shopping center.

- Will the expected higher lease payments from new tenants more than justify the renovation expense?
- Will the new tenanting require substantial tenant improvement expenditures in order to attract a new class of tenancy?
- Will there be a higher shopping center value and/or return to ownership realized by bringing in more creditworthy tenants than those currently in occupancy?

Theoretically, more creditworthy tenants would have a positive impact on expected cash flow and, hence, suggest a reduced risk of investment which in turn augments value.

Ultimately, the Counselor could maintain involvement in the portfolio project analysis from beginning to end by identifying problem properties. Pointing out income and/or expense problems within each property and aiding in retenanting the center may ultimately provide opportunities to dispose of the revitalized property, if such a maneuver is an appropriate exit strategy. Alternatively, would ownership be better served by effectuating a refinancing of the property (if it is currently encumbered by debt) in order to extract cash from the property while still continuing to manage and own it? This is one of many questions a Counselor would need to address.

**Build-To-Suit Options**
Another scenario for Counselors in the institutional arena is to develop a property under a build-to-suit scenario whereby the counselor/developer constructs a building for a specific user who in turn leases the property on a long term basis from a third party owner. Once the building is built and occupied by the tenant, the Counselor could assist in selling the leased property to an institution which, in turn, maintains ownership and enjoys the cash flow. Obviously, the Counselor can propose a price for the property in part predicated upon the occupying client's creditworthiness and length of leasehold. Comparisons to bond yields or other real estate investment options are sometimes made to properly reflect the risk associated with the build-to-suit rental payment schedule.

**Trade Offs**
Because institutions typically have large blocks of cash available for a series of investment types, real estate investments must compete on returns with stocks, bonds and other investment modes for investment dollars. Typically only a portion of the entire portfolio can be devoted to real estate ventures either on the side of equity or in the form of debt. The Counselor can aid in the decision as to how much of each form, debt or equity, is optimum. Should comparatively low risk equity dollars for a long term credit deal be chosen over an alternate deal with possibly higher returns and greater risk? In other words, how will a property net leased for 20 years to a strong manufacturer be compared to a similarly sized industrial redevelopment project? Contributions to such problem solving by the Counselor could be invaluable to the client.

Of primary importance in understanding the institutional client's needs is the fact that this type of client is sophisticated and will likely become even more so. The Counselor must be at least as sophisticated as the client in order to adequately assist the problem-solving process. Thus, the Counselor is a perpetual student of real estate. He must be abreast of current market dynamics, changing legal issues and investment criteria, and he must have knowledge of the market and be a participating member of the market in order to know where to locate information if it is not already available.

**Conclusion**
It is no surprise that a world of opportunity exists for Counselors in the institutional area. Institutional owners, just like other real estate professionals, are confronted daily with problems which require the high level of integrity, experience and judgment of a skilled, competent real estate counselor. These qualities can only prove invaluable to the institutional client.

# HOW THE FEDERAL REGULATION CYCLE AFFECTS THE REAL ESTATE INDUSTRY

by Nicholas Ordway, Jack P. Friedman, CRE and Jack C. Harris

Many real estate professionals believe real estate is becoming dysfunctional due to the degree of federal regulation. Regulations are not a free good. Costs of regulation are transferred to consumers in higher prices, to labor in lost jobs and to business firms in a decline of competitiveness. Today, Congress is reacting with "Contract with America" designed to reduce government costs, along with the U.S. Supreme Court's new property rights doctrine against exactions in cases such as *Dolan v. City of Tigard* (1994). The purpose of this article is to present the regulation cycle of federal government agencies and explain why pressure mounts to begin dismantling the system.

In recent years, the federal government's role in real estate regulation has been all-pervasive and all-expansive. At least since the National Environmental Policy Act of 1969, the federal government has intruded into areas involving the real estate industry that previously were left to states and municipal governments. As the federal government becomes involved in various areas, it writes a wide array of regulations. For example, the Environmental Protection Agency has 9,000 pages of environmental rules; the Occupational Safety and Health Administration has over 4,000 regulations.

### How Federal Laws And Regulations Impact The Real Estate Industry

Federal regulation of commerce and consumer protection has been widely accepted for decades. Laws implementing such regulation include: the Sherman Antitrust Act (1890), which protects trade and commerce against unlawful restraints and monopolies and establishes a policy in favor of competition; a Supreme Court ruling which establishes that real estate agents who charge identical commissions in the same area may be found guilty of price fixing; the Magnuson-Moss Warranty Act (Federal Trade Commission Improvement Act) of 1975 which affects housing and housing products by establishing mandatory standards for warranties on consumer products to improve consumer information.

There are, however, numerous other federal government agencies that carry out laws and regulations affecting individuals, specific properties,


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financing terms and societal matters. Many of these agencies go beyond the traditional scope of government regulation on real estate activities contemplated by the original authors of the U.S. Constitution.

A partial list with brief descriptions of some prominent federal government laws that affect real estate is provided in this article. While state and local regulations also exist and are a powerful force, especially with regard to specific proposed developments, they are too varied and numerous to include here. The federal acts listed have been classified into the following categories: environment and energy, finance, foreign ownership, health and safety, and housing. These laws represent only the tip of the iceberg. Government is also involved in tax laws, investment regulations, drug enforcement activities and other areas that impact the real estate industry.

**Environment And Energy**

Environmental laws include the Clean Air Act (1970, amended 1977); the Clean Water Act (1972 and 1977); the Coastal Zone Management Act (1972; amended 1976); the Federal Water Pollution Control Act (Wetlands) and Amendments (1972); the Resource Conservation and Recovery Act (1976); the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA, also referred to as Superfund); and the Superfund Amendment and Reauthorization Act of 1986 (SARA). Also under environmental laws is the National Historic Preservation Act (1966). The Energy Conservation Standards for New Buildings Act (1976) requires the Department of Housing and Urban Development to implement building energy standards for new residential and commercial construction. Many of these laws have resulted in halting new developments and increasing costs. While the laws themselves usually are understandable and involve broad policy issues, the regulations to implement them often are incomprehensible and deal with minutiae.

**Finance**

Laws affecting finance can be grouped into several categories including regulations which define the powers of financial institutions, e.g., the Depository Institutions Deregulation and Monetary Control Act (1980); the Farm Credit Act (1971); and the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) (1989). Also pertinent are the Farmers Home Administration (FmHA) Act (1946); the Federal Home Loan Bank Act (1932); the Federal Reserve Act (1933), and the Garn–St. Germain Depository Institutions Act (1982). These laws set the ground rules for operating financial institutions and generally contributing to the safety and security of our banking system.

Another category of finance laws provides for disclosures and protections to consumers. These include the Consumer Credit Protection Act (1960); the Equal Credit Opportunity Act (1974; amended 1976); the Truth-in-Lending Act (1968); the Truth-in-Lending Simplification and Reform Act (1980), which amends the Truth-in-Lending Act of 1968; the Home Mortgage Disclosure Act (1975); the Real Estate Settlement Procedures Act (RESPA) (1974; amended 1975); and Regulation B (Title VII, Consumer Credit Protection Act) and amendments. Regulation Z includes regulations pertaining to consumer credit disclosure issued by the Board of Governors of the Federal Reserve System pursuant to Title I of the Truth-in-Lending Act and Title V, General Provisions, of the Consumer Credit Protection Act. The Interstate Land Sales Full Disclosure Act (1968; amended 1979) is another law in this finance category. Overall, these laws have benefited consumers by providing for better disclosures and reducing credit discrimination against women and some protected minorities.

A third category of finance laws creates special benefits for select groups. These laws include the Section 8 Program, created by the Housing and Community Development Act of 1974; the Senior Citizens Housing Act (1962); the Uniform Relocation Assistance and Real Property Acquisition Policies Act (1970); and the Veterans' Housing Benefits Act (1978) that amends Title 38 of the United States Code to improve the housing benefits programs of the Veterans Administration (now the Department of Veterans Affairs). These laws have had mixed results and have become regarded as entitlements by some beneficiaries.

**Foreign Ownership**

Laws impacting foreigners include the Agricultural Foreign Investment Disclosure Act (1978) and the Foreign Investment in Real Property Tax Act (1980; amended 1984). These laws eliminate techniques by which a nonresident alien (a foreign national temporarily present in the United States) or a foreign corporation could sell U.S. real estate without being subject to U.S. tax laws.

**Health And Safety**

Health and safety laws include the Americans with Disabilities Act (1990) and the Occupational Safety and Health Act (1970), which established the Occupational Safety and Health Administration (OSHA) and set up the Occupational Safety and Health Review Commission and the National Institute for Occupational Safety and Health (NIOSH). Some of the regulations have actually increased hazards instead of reducing them. OSHA requirements have also, in many cases, increased costs and paperwork and resulted in delayed construction.

**Housing**
Laws impacting housing include the Community Reinvestment Act (1977); the Condominium and Cooperative Abuse Relief Act (1980); the Consumer Home Mortgage Assistance Act (1974); the Emergency Home Finance Act (Title III) (1970); the Federal Flood Insurance Program (1968) and National Flood Insurance Act (1968); and the Flood Disaster Protection Act (1973; amended 1975 and 1976). Fair housing laws prohibit discrimination; these are the Civil Rights Act of 1875; the Civil Rights Act of 1964 (Title VI, Nondiscrimination in Federally Assisted Programs); the Civil Rights Act of 1968 (Title VIII, Fair Housing); and the Federal Fair Housing Amendment Act (1988). The government also has laws involving development regulations. These include the National Mobile Home and Construction Safety Standards Act (1974) and the Neighborhood Self-Help Development Act (1978). Overall, these laws have been highly effective in lessening discrimination and in opening up housing markets and contributing to their equity and economic efficiency. Since 1988 however, some critics maintain that the fair housing amendments have been used by litigation entrepreneurs to intimidate innocent defendants into costly settlements.

**Why Some Government Regulations Create More Costs Than Benefits**
Why are some laws passed by Congress effective and others not? To answer this question, we must look at how some agencies and their regulatory structures tend to evolve through a four-stage process including:

Stage One: Creation and Implementation
Stage Two: Bureaucratization
Stage Three: Exploitation
Stage Four: Dysfunction

Not all agencies fully reach the exploitation and dysfunction phases. How far an agency evolves depends on the preciseness of its mission and the stakeholders involved. For example, the Federal Deposit Insurance Corporation (FDIC) guarantees (within limits) funds on deposit in member banks and thrift institutions. It also makes loans to or buys assets from member institutions to facilitate mergers or prevent failures. In 1989, the FDIC was reorganized to incorporate the functions of the Federal Savings and Loan Insurance Corporation which ceased to exist. The FDIC has been instrumental in inspiring great confidence in the U.S. banking system for more than 60 years. Earning its revenues from small assessments on bank deposits, it is highly effective and functional. On the other hand, agencies such as OSHA have the vague mission of creating a workplace that is in compliance with OSHA's work rules. It has been reported that OSHA itself indicates that 80 percent of workplaces are not in compliance. Few knowledgeable people will argue that OSHA has had a positive net effect in recent years. However, people who have suffered injury in the workplace will remark positively as will their coworkers when a dangerous situation is alleviated.

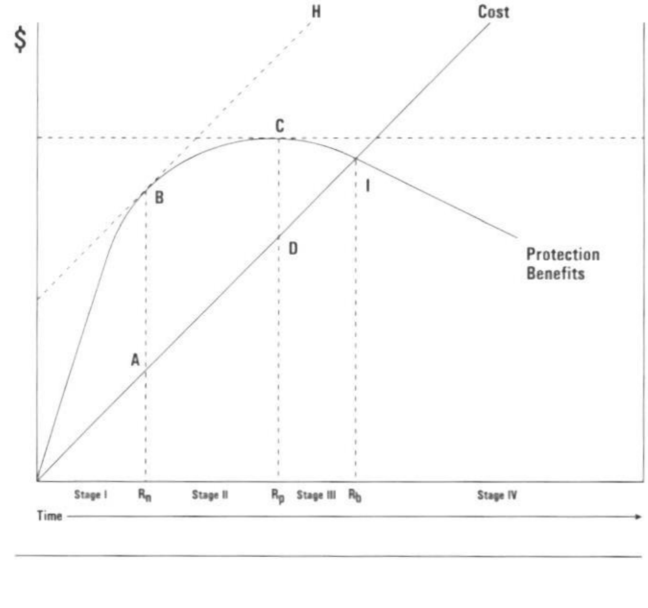
**Stage One: Creation And Implementation**
A system of federal government regulations often begins with good intentions. A problem is identified that is harmful to the public and is not being addressed by state governments. For example, the problem of DDT and pesticides was identified in Rachel Carson's classic book *Silent Spring* (1962). This exposure resulted in a public outcry for environmental legislation some of which is listed in this article. Other motivations for new legislation might include economic benefits for the special interest groups which are favored by a political party in power. Often model legislation from specific states or other countries can lead to "me-too" laws on the federal level.

Laws passed by Congress usually set broad policy and require implementation by an administrative agency. If a law does not fall under the purview of an existing agency, a new one may need to be established. Stage I is illustrated in Figure 1.

Agencies dealing with popular issues, such as the environment, attract professional administrators as well as idealists recently out of law schools and graduate programs. Often the benefits of the regulations far outweigh the costs on the regulated. Initial regulations generally attack obvious abuses

**FIGURE 1**

Costs and Protection Benefits of Regulation Over Time



underway in the free market. Such overt abuses usually can be quickly corrected at relatively low cost. As indicated in Figure 1, this causes a net social benefit reflected by A-B. At point B the net social benefit is the greatest. This point is indicated when the protection function created by the regulations becomes tangent to line H, which is drawn to run parallel to the cost function line. The quantity of regulation reflecting the greatest net benefit is indicated as $R_n$.

**Stage Two: Bureaucratization**
Due to the nature of state and/or federal regulation, new administrative roles continue to be added even when the net social benefit begins to shrink. The key is to increase the protection or benefits to the special interest groups involved. Once the net social benefits begin to diminish, the bureaucratization stage begins.

Bureaucratization occurs for several reasons. As described in Philip K. Howard's book *The Death of Common Sense* (1994),[1] "Our regulatory system has become an instruction manual. It tells us and bureaucrats what to do and how to do it. Detailed rule after detailed rule addresses every eventuality, or at least every situation lawmakers and bureaucrats can think of."

The major stakeholders who contribute to bureaucratization are the bureaucrats themselves. The fixation is on paperwork, and make-work becomes the pattern for many of these employees. However, the bureaucratic operational rule is that if a regulation does not permit the firm's action, it is probably illegal and the regulated business firm must prove it has acted correctly. Bureaucrats don't want to make decisions for fear of setting a precedent. Often decisions are delayed or not made. Bureaucrats also make rules to make their jobs easier and more convenient however, this can result in considerable expense for the private sector.

**Stage Three: Exploitation**
At some point in the process, the number of regulations increases and become so detailed that the level of protection can begin to decrease. This point is designated as C in Figure 1 and occurs because the quantity of regulations has become $R_p$. Too much regulation can create an incomprehensible system that results in ignoring rules or spending considerable effort to find loopholes or use the system to create exemptions.

Such situations also create the possibility of exploitation by various stakeholders. Lawyers, accountants, former agency employees, lobbyists, retired or active politicians and others can find themselves in a position to exploit an overcomplicated regulatory system by becoming expediters in bypassing red tape. A highly regulated structure can create a barrier to entry by new competitors. Regulations also can change the economies of scale, driving smaller firms out of business. For this reason, entrenched firms, especially if they have grandfathered exemptions, often will defend the regulatory structure.

**Stage Four: Dysfunction**
Dysfunction occurs once the cost of regulation exceeds any protection or benefits created by regulation. This occurs at point I in Figure I when the protection function and the cost function intersect at a quantity of regulations designated as $R_b$. Past point I, the net social costs to society begin to increase. However, there may be very little incentive to change the regulations.

To illustrate, suppose that a special interest group receives $25,000 in benefits because of a particular regulation. The cost of this regulation creates an annual cost of $.05 for each of the two million people in a particular city. Therefore, the total cost for the city is $100,000. The $25,000 benefit creates a net social cost of $75,000. Furthermore, because the benefits are concentrated in one firm and the costs are spread over millions, the group will have great incentive to maintain the regulation.

**Conclusion**
This article outlined the Regulation Cycle of federal government agencies and their regulatory structures. Economic conditions almost always exist to push the regulations into the exploitation stage. However, not all agencies and regulatory structures are dysfunctional. As described, some laws are essential to our economic system, while others have created better information and protection for both consumers and business firms.

Despite good legislative intentions and initial benefits realized by many regulations, an improperly managed and monitored regulatory structure can evolve into the dysfunction stage. Protecting the system will require better identification of costs and benefits and a heavy application of common sense by both Congress and the courts.

**NOTE**

1. Howard, Philip K., *The Death of Common Sense: How Law is Suffocating America* (New York: Random House, 1994): pp.10-11.

*New Technology*

# Don't Let Arachnophobia Keep You Off The Web

by Patty Dupré, CRE

The World Wide Web, known as the Web for its web-like organization, is a global information system within the Internet which enables users to view almost instantly text, images, video and audio clips from around the world. What makes it so popular is the easy point-and-click access, the visual display and the ability to link to other data anywhere. One moment you can access information from a computer in Seattle, then from a computer in Australia reading population trends for Atlanta, Georgia.

What is required to explore the Web? You need a modem (the faster the better) for your PC, an Internet connection and a Web browser. Your Internet connection can be with a direct access provider, which typically offers Internet access and little else, or with a commercial on-line provider like CompuServe, America On-line, Genie, etc. Many of the commercial providers have Web browsers included in the software, or they can be purchased separately. Some browsers can be transferred, or downloaded, from the Internet directly to your PC. You can take it out for a test drive, and if you decide it's the one for you, pay a license fee within 30 days. For example, Netscape's Navigator, a popular browser, can be downloaded by going to *http://home.netscape.com/*

An important aspect of the Web is hypertext, or data linked to other information on the same computer or on another computer anywhere in the world. Hypertext data is usually a word or picture that is underlined or highlighted in a Web document. Just click on the hypertext, and you are immediately linked to another document.

**Web Sites for Real Estate Data**

| Site | Comments | URL |
|---|---|---|
| The Counselors of Real Estate | CRE products/services; member names, addresses; REI (journal) index of articles; Meeting information | http://www.cre.org/ |
| American Real Estate Exchange (Amrex) | Daily news on real estate issues from a number of sources | http://www.amrex.com/ |
| Appraisal Institute (AI) | Data on the AI organization | http://realworks.com/ai/ |
| Census Bureau | 1990 and other census data | http://www.census.gov/ |
| Commercial Investment Real Estate Institute (CIREI) | Data on the CIREI organization, listing of CCIMs, Publications | http://www.ccim.com/ |
| Marcus & Millichap Commercial Brokerage Co | Listing of offices and 60% of their active listings | http://www.mmreibc.com/ |
| Internet Real Estate Directory | Directory for real estate sites | http://www.onramp.net/ired/ |
| Realty Links | Listing of real estate sites throughout the US | http://www.xmission.com/~realtor1/ |
| Rent Net | This lists over 119,000 apartments for rent around the country | http://www.rent.net:1000/ |
| WWW Virtual Library | Demographic and population study data | http://coombs.anu.edu.au/ResFacilities/DemographyPage.html/ |

To view a document on the Web, you first need to know its unique name or URL (Uniform Resource Locator). URLs consist of an address that must be typed exactly as shown; this address will typically begin with "http://" Above are some real-estate related sites on the Web.

There is not a central index or catalog for the millions of sites on the Web. So how can you find the information you need? One way is to use a "search engine," or a computer which will search the Internet for the information you need. Simply call up one of the engines (by typing the URL), and type in the information you want searched in the box provided. Within seconds of my request for population statistics, 481 references were found along with a listing of the first 25 sites. The following are three good search engines to try:

**Webcrawler**
*http://webcrawler.com/*

**Yahoo**
*http://www.yahoo.com/*

**Lycos**
*http://www.lycos.com/*

The Web is a useful tool and growing resource for real estate counselors and all real estate practitioners who require important data quickly. Instead of using snail-mail to receive government statistics for an analysis you are working on, hop on the Web, enter the URL and download the data you need directly into your Excel, Lotus or other spreadsheet program.

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# Experts & Consultants Guide to CRE Services

*Service Categories*

**Acquisitions/Dispositions**
**Appraisal & Valuation**
*Environmentally Impacted Properties*
**Asset Management**
**Capital Market Analysis**
*Joint Venture Analysis*
**Environmental Analysis**
**Litigation Support**
**Market Analysis**
**Pension Funds**
**Portfolio Analysis**
**Property Management**
**Property Tax Services**
**REITS**
**Real Estate**
*Commercial/Retail*
*International Corporate Services*
*Office & Industrial Parks*
**Other**
*Corporate/Institutional*
*Development/Management*
*Facility Management*
*Highest & Best-Use Studies*

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