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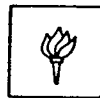
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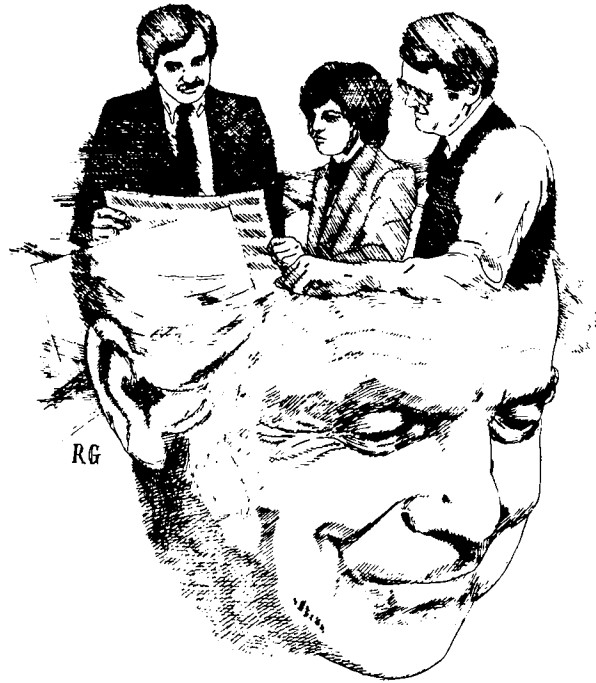
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*Small management firms offer two types of advantages:
diversification potential and professional motivation.*

Pension Fund Management: Is Small Beautiful?

Mike Miles and Jim Graaskamp



PENSION FUNDS ARE now established real estate investors, and, if U.S. Department of Labor estimates are accurate,¹ they promise to be even more influential in the future. This promised future influence has spawned a multiplicity of investment managers, and pension funds can now invest their reserves with a wide spectrum of managers, ranging from good old boys to

three-piece suits.² The managers offer all sorts of analytical competence; traditional real estate analysis, capital asset pricing model adaptations, and all manner of combinations and permutations are available.

¹ The U.S. Department of Labor estimates that total pension fund assets will grow to nearly \$3 trillion by 1995. This growth (from \$8,000 per working American to \$30,000 per working American) is certainly substantial in relation to the magnitude of the nation's tangible wealth. On the other hand, \$30,000 still isn't much to retire on and that says something about the need to maintain the work ethic as the population ages.

² A recent Greenwich Research Associates study showed 71 percent of Fortune 100 pension funds hold equity real estate, but only 36 percent of the Fortune 1000 do so. The median percentage allocation of those that do invest was around 6 percent, and for all pension funds surveyed, the amount devoted to property was less than 3 percent.

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Pension Fund Management

For some, the selection of an investment manager appears quite simple. James A. Kujaca put it succinctly in *Pension World*.³

A pension fund will want to select a real estate investment manager who has an impeccable reputation, an excellent performance record, a thorough knowledge of property evaluation and property management, organizational depth, reasonable fees, no conflict of interests, and who is financially sound and able to locate prime, profitable properties on a sustained basis.

Unfortunately, the Hershel Walker of real estate investment managers has not yet appeared from the playing fields of American business schools. In fact, the selection process is sufficiently difficult that a number of consulting firms are now selling "search" services that purport to assist pension funds in choosing an investment adviser.

We believe that the search process contains within it a combination of financial and motivational factors that not only influence the search but suggest that there may or should be structural changes in the organizational form of real estate asset managers that pension funds employ.

REAL ESTATE AND PORTFOLIO THEORY

Real estate investment management for pension funds starts with a stock and bond mentality because the pension fund client is today primarily a stock and bond investor. Pension funds executives are usually individuals trained in the "MBA" financial analysis tradition. Thus, their formal training is one that assumes a rather efficient market and a "fair game assumption" in return behavior. They are familiar with the traditional measures used to rank the risk adjusted performance of alternative investments.

Real estate is different. The asset is by definition heterogeneous due to its unique location. Real estate markets are characterized by local orientation, infrequent trades, private transactions, expensive, often nonpublic information, illiquidity, imperfect divisibility, and property-specific financing. These differences describe markets that are less efficient than the markets for stocks and bonds, markets in which comparative advantage is possible. In such markets, investment management is important, and the management costs more than the management of securities.

Still, because pension portfolio management involves allocations among stocks, bonds, and real estate, management of real estate investment must involve a blend of capital market logic and traditional real estate analysis. The admitted difficulties of applying modern portfolio theory to real estate do not justify ignoring the portfolio attributes of real estate.

The pension funds want better risk-adjusted returns and the risk adjustment should be in portfolio terms. This means simply that the pension funds want to invest in properties that improve the return and/or reduce the risk of their overall portfolios.

Although the academic and professional literature on real estate returns is limited and suspect in many respects, it does appear to demonstrate that real estate (except when purchased through REITs) offers higher absolute and higher risk-adjusted returns than stocks or bonds.⁴ Equally important, real estate returns appear to have a low correlation with stock and bond returns and a high correlation with inflation. Thus, real estate investment may help the pension fund achieve desired results in two ways:

- The real estate properties may be individually better investments than the market average. (This is the natural implication of a less efficient market.)
- The returns of real estate investments may have low or negative correlations with those of the pension fund's existing stock and bond portfolios: consequently, the combined portfolios may have less risk for any given level of return.

THE DIFFICULTY OF EVALUATING INVESTMENT MANAGERS

There are several serious problems involved with the ex post performance evaluation of real estate investment managers.

□ Accounting and appraisal inconsistencies can materially distort performance evaluation. The National Council of Real Estate Investment Fiduciaries (NCREIF) is working on a standard appraisal engagement letter and fuller disclosure of accounting differences, but the possibility exists today for investment managers to affect IRR by means of maintenance policy, leasing strategy, and so on.

□ The turnover of personnel in investment management firms is quite high. Since most of the real estate management firms (or investment management functions in large institutions) are composed of a small number of key people, high turnover makes historic comparisons difficult. (Turnover is a particularly difficult problem because real estate investment managers are typically compensated on the basis of the volume of assets under management. Strong past performance may mean that the volume of assets under management grows, and investment policy changes

³ *Pension World*, April 1981.

⁴ This counterintuitive result (higher risk-adjusted returns) is probably due to the faulty definition of risk (variance of returns) which neglects liquidity risk, skewness (real estate returns appear nonnormal), and/or agency problems (the human decisionmaker has a different perception of risk than the institution).

because there are clear operational economies of scale in investing in larger properties. The result is a "second order" form of incentive compensation, that may well be paid after the key people have moved to another firm.)

□ Billions of dollars of investments and the complexity of most real estate investments create a paper mountain for anyone trying to ascertain how a particular investment manager's portfolio would perform under different economic scenarios. Although many search firms claim to do forward-looking financial analysis, the amount of work involved in rigorously modeling lease expectations leads one to suspect that most are simply asking the investment managers about leasing strategy. This is a far simpler and less reliable approach than auditing leases.



□ Although many pension funds are actively seeking "inflation protection," few are certain whether they mean actual inflation, anticipated inflation, or unanticipated inflation. Since protection against anticipated inflation can be purchased in the capital markets, one presumes that they wish to be protected against unanticipated inflation. But, if so, the search firms may be using the wrong analyses.

□ Ownership structuring and special allocations of tax benefits, like alternative leasing strategies, offer a way for investment managers to alter the risk/return characteristics of underlying real property. There are potential benefits from this flexibility that do not have a stock market parallel. There is little attention to or disclosure of these facts in annual reports.

□ Most investment managers advertise the benefits of diversification across property types and geographic regions. However, the classifications in both cases are so gross that research to date shows insufficient benefits from such diversifications to justify the related costs (primarily collection of market information and property management).

HOW ARE THE SEARCH FIRMS SEARCHING?

Some of the national firms that now do searches for pension clients undertake largely qualitative efforts while others use more quantitative techniques that follow stock market traditions adjusted to fit the real estate product. In almost all cases, the search service involves some education of the pension fund client. On the qualitative side, the searchers examine the people and the

investment strategies of the management firms. On the quantitative side, the search firms analyze return rates. One search firm claims that there are nearly 1,000 basis points difference between the high and low performers that it has studied. More remarkably, it claims that the same firms stay at the top and at the bottom year after year.

In addition to examining rankings of return rate, the search firms try to establish which investment managers achieve the best portfolio balance for their pension clients.

Several search firms are looking for smaller investment managers that have specialized operations (say, managers that invest only in new retail properties in the Sun Belt) and that do their own "homemade" diversification for the pension client. The searchers examine the client pension fund's existing portfolio and then try to find an investment manager whose real estate investments produce returns that show low correlation with the existing stock and bond returns. Note that when the search firm does this, it is offering the pension fund diversification of the pension portfolio. This is quite different from offering the pension fund a diversified real estate portfolio.

Looking to the future, it appears logical to expect the search firms to become more quantitative as the data improve. Because the real estate product remains different from the stock and bond market, the searchers will probably continue to do more financial analysis than traditional performance evaluation. Because the pension funds' goal is overall portfolio performance, it makes sense to expect either the pension funds directly, or the search firms acting for the pension funds, to look for opportunities for homemade diversification, i.e., to achieve risk diversification by using an appropriate combination of specialized investment managers. Since the pension funds must deal with the allocation decision between stocks, bonds, and real estate, the additional step of allocating between real estate investment advisers is a small one.

THE STRUCTURE AND PERSONNEL OF SUCCESSFUL REAL ESTATE MANAGEMENT FIRMS

If there is room for comparative advantage in real estate investment planning (i.e., if the quality of the investment manager is truly important), then the pension funds want to look at the internal operations of the investment managers and ascertain what type of organization is most likely to perform best. We believe that the following characteristics are important:

□ *Incentive reward for performance.* The investment manager (the individual, not necessarily his firm) should be compensated in a way that rewards good

Pension Fund Management

performance and punishes bad. Structuring the incentive is not easy, because pension funds may make honest men millionaires while flirting with ERISA restrictions regarding risk avoidance and conflict of interest.

☐ *Creative innovation.* The investment manager must be able to "see" deals. The ideal environment not only fosters such innovation but also protects the innovator from hasty condemnation during the periodic downside stages which are inevitable in such endeavors.

☐ *Deal making.* The investment manager must be able to negotiate and to close purchases or sales quickly.

☐ *Administration.* The investment manager must have plan and budget discipline. He should be in a small enough organization to have close contact with his ultimate customers and the high level of informal communication often associated with success in such ventures.

Since it seems unlikely that one individual would possess all of the last three qualities, the ideal investment management firm is probably a team. On the other hand (despite exceptions), few large organizations are innovators, expeditious negotiators, or able to offer their personnel truly performance based compensation. The conclusion is that a small entrepreneurial team with defined spans of control would be most likely to exhibit the traits that best enable investment managers to exploit market inefficiencies. Note

that smaller teams are consistent with the specialized fund concept which has already been shown to be best suited for homemade diversification.

CONCLUSION

There are two types of potential benefits to pension funds from real estate investment: higher returns for a given class of risk and diversification of risk. The type of investment manager best able to provide both benefits is the small (but not one-man) specialized entrepreneurial firm. Both search firms and several of their pension clients today tend to look for this type of manager. It is therefore logical to expect a trend toward such firms in the real estate investment management industry.

This does not argue that the giants will fade away. Prudential and Equitable could quite easily establish a series of specialized smaller funds, supplied with products from their existing inventories and staffed from their stables of trained managers. Thus, a pension fund could start down the learning curve, employing first a large diversified real estate investment manager and then move to specialization without ever leaving the one institution.

Nevertheless, there is substantial reason to believe that modest-sized operations are best able to provide pension funds with the two basic benefits of real estate investment, and that consequently the industry will move toward that format.