

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

B. Assessors and Other Public Officials

8. "Real Estate as an Investment for Pension Funds", presented to the State of Wisconsin Investment Board, April 14 1981

State of Wisconsin Investment Board
Real Estate as an Investment for
Pension Funds

April 14, 1981

- I. Some Introductory Concepts About Contemporary Real Estate
 - A. Real estate defined (ULI development process)
 - B. Real estate business defined
 - C. Real estate project defined
 - D. Real estate investment defined
 1. Classic return on the use of money
 2. As a straddle on the commodity market of space/time
 3. As a straddle on the money market - interest rate over time
 4. As a hedge against deflation

- II. Real Estate as a Standard Component of Investment Portfolio
 - A. Stocks and bonds (Roulac)
 - B. Lack of definitive measures of performance (Miles)
 - C. Theories of the efficient market versus real estate markets (Roulac)
 - D. Theories of variance versus co-variance investment mix (Eagle)
 - E. Theories of a growth investment
 1. Increasing consumption per capita
 2. Inelastic demand and fixed cost
 3. Increasing profit spreads through efficiencies of scale
 - F. Theories of purchasing power preservation through ties of investment product to commodities which take the place of a gold standard. (Corpus versus purchasing power standard of prudence)
 - G. Trustee participation in all forms of group or mutual fund shares
 1. Delegation of duties that others can do better or cheaper
 2. Wisconsin State law not completely clear on authorizing trustees to use segregated funds
 3. Only delegation is executory - not judgmental or discretionary since trustees must decide to accept strategy of the fund or pool
 4. Ethical issue of a double fee for fund management not applicable to Wisconsin fund
 5. Trustee would do less in the operations of a directly owned real estate project than he could owning shares in a manufacturing company
 6. The second issue is prudence in a buy-the-market strategy, with or without leverage
 7. Unlike stocks and bonds, Wisconsin Retirement Fund does not have enough money to achieve adequate diversification or the management skills to assemble the portfolio. Therefore fund shares in real estate provide less risk better planning of outlays, and lower administrative costs than any alternative.

- III. Alternative Investment Media for Funds Committed to Real Estate
 - A. Secondary mortgage market shares (FNMA, GNMA & collateral trusts)
 - B. Secondary mortgage market specialties (wraparounds, portfolios of second mortgages, etc.)
 - C. Real estate equity investment trust shares

- D. Real estate development company shares
- E. Commingled fund shares
- F. Direct mortgage lending
- G. Short term leaseback to arbitrage opportunity cost of money
- H. Direct ownership of joint venture units
- I. The participation mortgage
- J. The convertible mortgage

IV. Major Factors in the Selection of Institutional Real Estate Equities

- A. Political silhouette and exposure
 - 1. Parochial investment board politics
 - 2. Land use control issues
 - 3. Dependency on government subsidized demand for space
 - 4. Dependency on government subsidized costs of supply
- B. Degree of market demand control
 - 1. Identity of interest with tenant
 - 2. Demand channelized by physical limitations of supply
 - 3. Reciprocity
 - 4. Superior market research
- C. Degree of management intensity
 - 1. Superficial real estate valuation does not attribute income correctly among land, structure, tangible and intangible personalty and management
 - 2. Entrepreneurship versus industrial management
 - 3. Bank of America solution
- D. Financial parameters and measurement
 - 1. Static concepts of loan to value, gross income multiplier, capitalization rates, etc. are dead
 - 2. Institutional investment is analyzed in terms of cash flows with a spread sheet, breakeven points, modified internal rates, cash on cash rates, etc.
 - 3. Analysis is of assumptions and sensitivity analysis rather than fixed return
 - 4. Each deal custom structure to provide reward, pain, and bailout options
- E. Role of leverage in pension fund investments
 - 1. Removal of unrelated business constraint on leverage
 - 2. Function of leverage has changed from cost of funds spread to risk management and improved trading power of tax shelter to other partners
 - 3. Increased frequency of acquisition subject to closed loans
- F. Legal constraints on fund management
 - 1. Enabling statutory powers
 - 2. Impelling implications of prudent man rule
 - 3. Confusion with constraints on delegation
 - 4. ERISA
 - 5. Future capital rationing constraints

- V. Questions Raised on Behalf of the Board by Ken Codlin and Donald Loose
- A. What is the outlook for real estate and mortgages in relation to the economy for the next five years, and thereafter?
 - B. What important permanent changes, if any, are taking place in real estate investment opportunities?
 - C. Can investors reasonably expect to earn a rate of return over inflation over the long term from real estate equities, from mortgages?
 - D. How does the return from real estate equities, from mortgages compare to bonds, stocks in the past?
 - E. Will these relationships change or remain about the same?
 - F. Why should nontaxable pension fund of our size allocate money to real estate equities or mortgages or both; or should they not?
 - G. What mix would you recommend for a fund our size?
 - H. Suggest methods and avenues, for a fund our size, to invest in real estate equities or mortgages or both. Advantages and disadvantages of each, such as:
 - 1. Outside portfolio management
 - 2. Commingled funds
 - 3. Equity trusts
 - 4. Direct - joint ventures, participation, etc.