JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

1. Risk Management/Investment Related Topics

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COMINGLED FUNDS

April 18, 1987

I. The Concept of the Core Portfolio

A. 60-75 million invested in four to five properties, diversified as to type and location and leasing maturities.

B. Portfolio performance should be counter cyclical to securities market.

1. REIT's track with the stock market -- except for finite trusts.
2. Initial size exceeds capacity of most pension funds for a single point in time.

C. Additional strategic issues are: timing, purchase for upturn in real estate cycle, liquidity of investment, dilution if future investment is permitted and measurement of performance versus risk.

D. Comingled funds include:

1. REIT's
2. Segregated accounts
3. Open-end real estate funds
4. Closed-end real estate funds
5. REMIC's and MLP's
6. Limited partnerships
7. Real estate investment corporations

E. Pension funds edged into real estate with REIT's and then open-end funds; the larger fund then moved to closed-end fund and direct ownerships once they had adjusted to the fact that investments did not have to be liquid and performance did not have to be measured monthly or quarterly.

1. Early open-end funds by Prudential (PRIS A I) was thought of as a crudely indexed bond providing real returns of five or six percent plus an inflation adjustment to both income and principal.

2. Stock and bond funds were often managed by specialists within an industry -- boutiques of investment counseling so that pension funds began looking at real estate asset managers as special situation managers

3. Ironically, pension fiudiciaries who were risk averse were eager to employ real estate asset managers who were willing risk takers as long as the investment could be made to appear cautious in order to enjoy high returns and a reduction in pension sponsor contributions from earnings of the sponsor .

4. Appearance of safety led to participation loans, convertible mortgages, and joint ventures structured to tier priority of claim on the assets and preferences in allocation of income.

II. The Open End Fund is TAilored to a Specific Group of Investors, Such as Tax Exempt Institutions, Tax Exempt Pension Funds, Endowment Funds.

A. Initially underwritten for a core of fifty million or more. Assets to be valued quarterly to set unit share price at which investor can liquidate or buy additional units. If everyone wants to liquidate the fund goes on call and investors are paid off pro rata as funds are generated from the sale of properties . Open end funds were pushed for liquidity and definitive quarterly reports on performance as well as the fact that it could accommodate a progressive shift of pension fund assets into real estate as projects were acquired while pension funds sponsor managed their own short term cash--particularly since the interest curve was upside down in the early 80's.

B. The critical problem was appraisal..Each property was to be appraised independently each year and updated quarterly by an in-hous appraisal committee. In fact the independent appraisal was only advisory and became a factor only if an investor left and was not paid what the appraisers thought the unit share value was. Since marketing depended on performance there was and is a suspicion that the appraisal process has produced a smooth and steady increase in values.

1. If investors think a portfolio is overvalued, the play is the exit early at unit values which hurt the net value of those who stay behind.

2. If values are too low existing investors feel that new money will dilute the old money to benefit the asset manager's fee and postpone a favorable reduction in pension sponsored contributions to the pension fund which owns shares in the real estate fund.

3. The open end fund is very sensitive to public perception of the appraisal process and the quarterly reports sensitize the investor to short-term performance of a long-term asset.

4. WHile ope-end funds are the largest funds with the longest record, the pendulum is swinging to closed-end funds.

III. The Closed-end Fund is an Adventure For a Specific Term, Say 10 to 15 Years in a Specific Portfolio of Property. At Some Point the Fund is Liquidated or 95% of the Shareholders Can Vote to Continue for Another Specific Term of Time.

A. Once the fund is operating at some minimum scale, cash dividends are distributed to the investor to provide liquidity. Every three years management may provide an estimate of value to benchmark progress, but the proof of the pudding will be liquidation of the portfolio. Investors have accepted at the beginning that they're in for the duration or they must liquidate in a negotiated private placement at their own risk.The fund manager may begin subsequent closed-end funds on the same terms but the investors can ochoose to reinvest or not depending on alternatives, perceived performance, and the relationship with the asset manager.

B. Evidence suggests that naive diversification can be achieved in real estate with less than ten properties in a region as small as a metropolitan district or perhaps a hundred leases from diverse tenants. Moreover, investors have matured from real estate as a bond index to real estate as a special situation with significant value to be created by management rather than systematic rising prices due to population growth, inflation or changing market preferences.

C. As a result, closed-end funds are tending towards specialization in shopping centers, or hotels, or industrial parks or participating mortgages or whatever. The investor can create his own diversification by selecting different combinations of funds.

III. For the investor choosing an openend or closed-end fund means choosing an asset manager who has the ability to execute on the investment strategy which is being marketed as the funds are raised. There must be capacity to sustain performance and at the same time an onging record of performance even though the industry or function is only about ten years old. Only two or three closed-end funds have reached the point of liquidation; they all did very well given the unexpected rate of inflation which occurred after their creation in the early 1970's.

A. A number of monitoring agencies interview asset managers quarterly and track numerical performance of various funds and real estate trusts.

1. The Frank Russell Company
2. Pension Real Estate Services, Inc. (PRESI)
3. The Willow Index (Los Angeles)
4. Evaluation Associates (Baltimore)
5. The National Real Estate Index

B.. The Frank Russell Index is the first attempt to create a base line for national performance by property type and region using quarterly reports from a couple thousand properties owned free and clear by clients of the Frank Russell Company .

1. Originally dominated by office buildings, prudential and questions about data quality.
2. Responsibility taken over byNECRIF and ULI with broader participation base and gradual improvements in data .
3. Problems remain with accounting, appraisal, lack of leverage, and supersensitivty to marketing implications, so there is lack of uniformity.
4. Miles has tested relationship of actual sales to reported values and found wide variance but on the average a lag in appraised values.
5. Hogue at Berkeley criticized FRI for smoothness of line and rigidity on the down side.
6. Suspicion that public relations and institutional politics may influence objectivity.

B. PRESI produces a quarterly statistical service covering approximately 150 pension fund choices with quarterly performance data which is then organized by quartiles in various combinations reflecting property types, regions, age of fund, and proportion of assets in liquid versus real estate investments. PRESI will serve either to monitor investments or to select investments which will provide certain parameters of probable success.

1. PRESI was originally organized by Professors Serbst and Barbara Cambon who wrote the definitive article on comparative yields that you read earlier this semester and should look at again.

2. The information power of this type of service means that fund managers make every effort to report and fear getting caught distorting information.

3. PRESI will monitor and choose fund investments for 25 to 35 basis points per year.

4. PRESI has eight or nine field researchers visiting fund managers quarterly, sitting in fund management meetings on a random basis, and visiting fund buildings on a random basis to match reports against reality. More of this typeof on site review and auditing is necessary to separate fact from balance sheet fiction.

C. The National Real Estate Index is a new effort to report sales data by property type and by ownership type. Still not statistically clean but is backed by the Rosenburg Fund and others to create more data on 1;everage properties and outside the NECRIF club.