JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS
VII. INDUSTRY EDUCATIONAL COURSES - LONG TERM
G. Australian Lecture Series
8. "Real Estate Investment Portfolio Management", Sixth Module

Index

SIXTH MODULE

REAL ESTATE INVESTMENT PORTFOLIO MANAGEMENT

Presented By

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FIRST HOUR

I. OBJECTIVES OF A REAL ESTATE PORTFOLIO APPROACH

Theoretical development in stock and bond investment management relative to risk and return characteristics of an investment portfolio have made it stylish to focus institutional real estate investment strategies in terms of portfolio concepts. There is a tendency to shift the concern of fund managers from the evaluation of individual real estate projects to the portfolio impact of real estate investment.

A. Security investors have been brainwashed with theories developed by Markowitz and Sharp to the effect that security markets are very efficient and that market price of a given security reflects a return for the use of capital plus a return for compensation of risk.

1. Risk is defined as variance in terms of market price of a specific security relative to an index of market prices for all securities.

2. Risk is caused by systematic changes which affect all securities as a result of market related risks and non-systematic risks which were inherent in specific industries and businesses.

B. Since risk was variance in price or value and market price was present value of collective expectations of future income, variance could be controlled by diversification within industry to reduce the mean variance of all investments and market related risks could be mitigated by arbritraging among different investment markets if a variance/co-variance relationship could be shown to exist.

C. Investors have always recognized that you shouldn't put all your eggs in one basket even though it may be possible to have a higher return if you put your eggs in one basket and then watch the basket very closely. Safety in numbers and averaging of offsetting errors through safety in numbers is described as naive diversification, and that generally describes the state of art of portfolio management for real estate.

D. Portfolio people in securities distinguish between safety in numbers and efficient diversification in which there is a scientific statistical tradeoff between measures of return and measures of risk which maximizes investment returns for a given level of investment risk. Ideally portfolio management could theoretically neutralize business risk.

E. To be relevant to real estate the efficient diversification concept would presumably require the following elements:

1. Standardize time series data on net incomes and resale prices by property type.

2. Efficient exchange of market information among knowledgable investors.

3. Computed measures of systematic and non-systematic variance comparable to those available in the appropriate securities market.

4. Availability of investment units representing a crossection of the real estate investment market.

5. Liquidity of real estate investment to permit instant readjustment of the pricing model.

6. All investors' choices based on expected return and risk relative to market means.

7. Independent of business management from investment management for individual ownership interests.

F. Naive diversification in real estate may, in fact, provide a high degree of co-variance between real estate investment and security investment, thereby stabilizing market related risks rather than business risks over intermediate periods of time. (Professor Miles and Professor McCue - preliminary data.)

G. Naive diversification may involve multiple levels of spreading of risks:

1. Regional dispersion
2. Urban neighborhoods
3. Property type
4. Property size
5. Leasing mix
6. Tenant mix by size and industry
7. Age of property
8. Duration of estimated holding period
9. Percent of ownership
10. Degree of leverage

H. Traditional methods of real estate risk management are from risk and insurance literature and include:

1. Risk avoidance
2. Combination of units to improve prediction of frequency and severity of gains and losses
3. Shift by contract to insurance pool in exchange for small certain loss of premium
4. Shift by contract to arbitrage skills or market position
5. Limit liability by contract or ownership structure
6. Hedge

I. Thus, risk management in real estate has generally presumed active asset management by those contracting the web of agreements, contracts, and defined interests in any given project, or by means of naive diversification. The shift toward passive institutional investment and the conditioning of money managers to the fads of portfolio theory have led to the hope that real estate can be treated like other security interests.

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SECOND HOUR

I. OBJECTIVES OF SCIENTIFIC PORTFOLIO SELECTION

Trustees of institutional funds need protection from losses from business and systematic upsets when those losses exceed the mean losses suffered for lack of clairvoyance by all trustees of the group. Trustees also want praise when they out-perform the average profitability of their fellow trustees who are competing to expand the base of assets managed.

A. The first requirement of such a system is basic agreement on definition of the ingredients of average performance statistics and a vehicle or institution for maintaining the sacred scrolls of such an index.

B. For the first time in real estate there is an attempt to create such an index - the FRC Property Index sponsored by the Frank Russell Company of Tacoma, Washington, and the National Council of Real Estate Investment Fiduciaries (NCREIF). (See Exhibit 1.)

C. Efforts to construct such an index are confronting a variety of major problems that distinguish real estate from securities:

1. Most prices are set by appraisal rather than by actual transaction.

2. Appraisal is expensive and therefore occasional.

3. Appraisal is futuristic while accounting is historic.

4. Securities accounting is cost or market, whichever is less while real estate values are cost or market, whichever is more.

5. Real estate accounting is controlled by the fund manager who controls operations.