

A big shift

The impact of GICS changes on institutional investment in real estate

by Roy Schneiderman and Michael McGowan

Private real estate has been widely accepted as a distinct asset class by institutional investors for decades. But the industry still has a hard time determining what to do with public real estate. A pending change in the somewhat arcane Global Industry Classification Standards, however, will better define public real estate, with potential ripple effects for private real estate, as well.

Introduced in 1999 by S&P Dow Jones Indices and MSCI, GICS is the leading global framework for classifying stock investments. There have been no top-tier changes since the system's inception, and since inception the real estate industry has been a subsector of financials. In a major milestone, however, this changes Sept. 1, 2016, when GICS will reclassify real estate as the 11th top-tier sector.

Possible implications of the GICS change can be seen in three areas: First, what this change generally means for the real estate asset class. Second, how the change may affect real estate capital flows. And finally, what the possible impact will be for private real estate and the management of private real estate at institutions.

The GICS announcement is good news for both public and private real estate, insofar as it reaffirms what many institutional investors already believe: Real estate is a legitimate asset class and should be an important component of large institutional investment portfolios. Indeed, 84 percent of U.S. defined benefit plans with assets greater than \$5 billion reportedly have exposure to real estate as an asset class. Real estate's appeal also is borne out by target real estate allocations that are approaching 10 percent, according to the *Institutional Real Estate Allocations Monitor*, which is jointly published by Cornell University's Baker Program in Real Estate and Hodes Weill & Associates.

In announcing the GICS move, Remy Briand, managing director and global head of research at MSCI, said the change "reflects the position of real estate as a distinct asset class and a foundational building block of a modern portfolio, rather than an alternative." During interviews explaining the impetus for the creation of the new real estate industry

designation, a primary reason cited for the change was the desire to provide investors with greater access to real estate as an asset class — not only as a new subset within stocks. Thus, the GICS overseers want to highlight how real estate stocks can be used by all investors to obtain an allocation to real estate, as an asset class distinct from other stocks or bonds.

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Roy Schneiderman
Bard Consulting

Such language points in the direction of the long-term debate over whether REITs and other real estate stocks are more like public equities or more like private real estate. Leaving that debate aside, however, it is likely real estate's position as a top-tier GICS category will get more investors focused on real estate as an asset class and could create some additional pressure to "draw a circle around" public and private real estate and call it all "real estate." Having said that, we do not believe the GICS affirmation of real estate as a distinct asset class will spur major increases in overall real estate allocations by institutions in the short-term. Over time, however, it may well affect the mix of real estate investments held by institutions.

The GICS change is likely to impact capital flows in several ways. In the public markets, active fund managers will no longer find it easy to be over- or underweight real estate stocks because any such under- or overweighting will be readily apparent when looking at a fund's holdings at the top-tier GICS level. Several sell-side brokerage firms have issued detailed research regarding the impact of the GICS change. Most agree U.S. mutual fund managers are largely underweight REITs versus their bench-

marks, whether from a conscious decision based upon perceived high valuations or due to a “lack of understanding” of the nuances of investing in REITs. Accounting differences are many; most obvious is the trouble of earnings hurt by the depreciation expense of real property (which is often appreciating in value) — this also results in book values that can be far from realistic, depending on the date of asset purchase and the timing of the real estate cycle.

Thus, we believe one impact of the GICS change will be a flow of capital from active securities fund managers into the real estate space, as they will tend toward a proportional representation of real estate

through ETFs or index funds is more likely to have come from other public equities than from private real estate. Thus, the estimated new capital flowing to real estate catalyzed by the GICS change could be higher than discussed above.

The reallocation of capital already in the public equities markets to REITs is one thing; a reallocation of private real estate capital to REITs would be another. We believe the enhanced visibility of the public real estate sector may start to divert some capital from private real estate to public real estate.

First, despite the sizable increase in market capitalization and liquidity since their creation in the 1960s, REITs have yet to capture significant shares of institutional investors' real estate allocations. Academic real estate leaders have produced many thoughtful and in-depth papers examining the query, “Are REITs Real Estate or Stocks?” yet no matter the mathematical conclusion, volatility from the daily pricing of REITs trading on stock exchanges (versus the lagged or “smoothed” valuation of private real estate assets) has historically given many institutional investors enough cause for pause, or at least inaction.

We don't believe the GICS change will do anything to solve this issue in the short run, as few large institutions are expected to decide this fall that REITs should partially, let alone substantially, replace their private real estate holdings simply because of a new industry standard designation. But, over the course of a few years, the change in GICS could be the catalyst that starts the process. Whether this occurs or not depends on two factors: (1) if the new GICS classification can help increase REIT market size and liquidity; and (2) if a larger, more liquid and standalone real estate sector results in lower realized volatility, as well as lower correlations with other stock market sectors.

But we suspect the more “real” public real estate is perceived, the more likely (a) institutional real estate allocations will be seen to encompass both private and public real estate, and (b) public real estate will find itself housed inside real estate departments rather than public equity departments. And to the extent public real estate starts to be counted in asset allocation calculations where it was not previously, there could be a modest amount of “crowding out” private real estate capital.

Of course, the phenomenon described above easily could be mooted by simply increasing the overall allocation for an institutional portfolio to real estate, or by providing separate allocations to public and private real estate. But such changes are likely to take some time to ripple through an organization. ♦



Michael McGowan
Consultant

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in their funds (unless they have a compelling rationale for being underweight). An ancillary effect may be more stock fund managers gain a knowledge and appreciation of REITs, and with increased familiarity may come an increased appetite for the sector.

Combining some ad hoc statistics with the “conventional wisdom” that, marketwide, real estate has been underinvested historically, we estimate something on the order of \$60 billion to \$90 billion of additional capital is likely to find its way into U.S. real estate stocks — primarily REITs — over the next few years, much of which likely would enter the market through new share issuance. For context, consider REITs raised more than \$15 billion in common equity in first half 2016, and the entire U.S. REIT market today is about \$950 billion.

Capital of this magnitude may not have a major impact on the estimated \$4 trillion domestic institutional real estate market, but it could serve as a buffer on pricing if the anticipated expansion of cap rates ever arrives. An increase of this magnitude represents a much larger expansion of the U.S. REIT market, however, and thus could provide a powerful amount of downside-protection.

In addition, both S&P Dow Jones Indices and MSCI believe the promotion of real estate to a new top-tier GICS sector will spur the creation of new real estate-related financial products — most notably, new indices, benchmarks, mutual funds and exchange-traded funds. The discussion above about capital inflows centers only on actively managed mutual funds, yet the stock industry as a whole is increasingly embracing passive mandates. Capital heading toward real estate

Roy Schneiderman is a principal with **Bard Consulting**.
Michael McGowan is a San Francisco Bay Area-based consultant.
