It used to be simple

Investors' economic motivations have gotten complicated

by Roy Schneiderman

One of my favorite Will Rogers sayings is, "Things ain't what they used to be and probably never was." That is, as time moves on, one tends to develop an overly fond and idyllic view of just how things used to be.

But when it comes to real estate equity investment, I think there is some truth to the thought that it sure used to be simpler to figure out what institutional investors were looking for than it is today.

It "used to be" that the universe of large investors was smaller and more homogeneous. The large pools of equity capital for U.S. investment were primarily concentrated in domestic pension funds. The California Public Employees' Retirement System was the original mega-investor, but today CalPERS is not the largest institution on the real estate block, and nobody even knows for sure how many institutions are larger. It would not be difficult to quickly rattle off five or 10 candidates, and none of them are domestic institutions.

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But as the universe of large investors interested in equity real estate expanded, so have the goals and objectives of these investors. If there was any one area where it "used to be" so much easier than today, it is in the area of understanding institutional real estate investors' economic motivations. Today the situation is much more complicated and offers more challenges to for the investment manager.

In addition, as the amount of institutional real estate capital coming from overseas increases, the level of transparency in the market decreases. Many of the newer investors come from parts of the world where opacity is more the norm than transparency. Even domestically, the percentage of capital coming from public pension funds is decreasing. Public funds generally exhibit a tradition of openness, have public boards and, in some cases, must comply with "sunshine" ordinances and the Freedom of Information Act. Most other investors do not.

Thus, not only is there a wider array of objectives manifested by investors, but even getting visibility into these objectives is more challenging. Against that backdrop, below is a quick synopsis of the reasons an institutional investor might be investing in real estate today:

- **Total return.** Four decades ago, heady with having achieved its status as an institutional asset class, real estate followed the fashion of its time and focused on total return. The income/appreciation distinction was recognized, of course. But with theoretical thinking driving the more liquid asset classes toward total return, and few institutions actually needing cash flow in the 1980s and into the 1990s, it was easy for institutional real estate investors to focus on total return, except for some disciplined foundations and endowments where investment income was actually used to fund institutional operations. Total return has by no means disappeared as a financial objective and is still one of the more important. But its prominence has certainly diminished.
- **Income.** During the past decade, more U.S. institutions have focused on income return. There are several reasons for this. "It used to be" that a U.S. pension fund had a steady stream of capital to invest because contributions (not to mention investment income) were in excess of the benefits that needed to be paid out. Today that is no longer the case. The number of workers paying into a system has generally been shrinking, while the number of beneficiaries is rising and those beneficiaries are living longer. Today, many

institutions are relying on investment income to make distributions and provide benefits. Secondly, in reaction to the global financial crisis, many institutions have lowered their risk tolerance. One manifestation of this is investment in assets with more predictable income characteristics than speculative appreciation potential.

- **Inflation protection.** While this is one of the older rationales for investment in real estate, one does not hear it cited as frequently in the United States, although in markets such as Brazil with inflation-indexed leases, this concept still applies.
- **Risk-adjusted return.** Probably no phrase is more common in presentations to investors than this one, although we are still waiting to see a summary table that outlines a manager's (or investor's) risk-adjusted track record.
- **Capital preservation.** Clearly nobody wants to lose money. But with the advent of a global institutional real estate market, it is clear that there are some investors whose primary motivation is to ensure that their capital is safe and can be monetized (even if slowly) at some indefinite point in the future rather than the maximization of return. This drives some of the tendency to focus on trophy/irreplaceable assets.
- **Capital sanctuary.** This concept is related to capital preservation, but with a bit of a twist. In addition to seeking assets that have a high likelihood of retaining their value, some investors are also keenly interested in investing in jurisdictions where they are comfortable that asset value can be monetized and easily moved to another jurisdiction. Alternatively, in some cases the capital is being invested in places that might eventually provide a sanctuary for the investors themselves. This has been one of the major stories of the past decade. As individuals and corporations create wealth in geographic areas that are perceived as more risky over time, some capital remains behind to finance new wealth-creating endeavors, while some capital leaves for safer pastures. To the extent that one believes that the next decade will continue to see wealth creation in emerging markets, this phenomenon is likely to continue.
- **Diversification from source of wealth.** Some investors may prefer real estate as an asset class, or real estate in a particular location, simply to diversify away from the source of that investor's wealth. For example, Middle Eastern investors whose wealth originates with oil might prefer real estate simply because the asset class is not directly tied to oil. Or Chinese investors whose wealth has its origins in an expanding Chinese economy might prefer some investments that have a lower correlation with the Chinese economy.
- **Diversification based on correlation.** Perhaps the granddaddy of all the reasons to invest in equity real estate, institutional asset allocation models have long put forward this objective. One wonders, though, just how real this is as a motivating factor when it comes to actually making decisions about which real estate strategies to pursue. When is the first flip-book going to come along that argues an institution should invest with a specific real estate manager or adopt a particular real estate strategy "because it has a particularly low correlation with other asset classes"?
- **Meeting/exceeding benchmark.** If "low correlation with other asset classes" was the lever that initially brought real estate into the institutional investment universe, "meeting or exceeding a benchmark" may be the newest motivator for institutional real estate investors. For a variety of reasons, institutional real estate investors have become dramatically more focused on benchmarks during the past decade. This is a particularly difficult objective to meet because real estate benchmarks are not as fully developed as benchmarks for stocks and bonds. Reasonable benchmarks exist for domestic core and core-plus properties, although applying those benchmarks to strategies that are more limited in terms of geography or precise property type is still challenging. For riskier domestic strategies and global strategies, benchmarking is even more difficult.
- **Non-quantitative objectives.** Finally, increasingly there are investors that have nonfinancial goals associated with their real estate investments. Sharia compliance is one example, and a quick Internet search uncovered a half-dozen related indices, although none real estate specific. More relevant in the United States are social and political objectives that become either explicit goals or preferences. These include preferences, requirements or prohibitions relating to sustainable/green investment, emerging managers, "prevailing wages" and/or "responsible contracting," and some types of tenants such as payday loans or gun manufacturing and distribution.

In conclusion, perhaps it "used to be" that all a manager had to do to attract institutional capital was demonstrate that the investor was going to make money. Today, institutional real estate investors are more varied, complex and opaque. And sorting through their various objectives is a challenge that the investment manager must meet. ❖

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