One way not to align interests

by Roy Schneiderman

I was chatting recently with a client about one of many alignment issues that haunt institutional real estate investors: How can you make sense of an arrangement where investors are evaluated on the basis of time-weighted returns, while incentive fees paid to managers are structured on an IRR basis?

It would seem the industry could take one of two fundamental approaches to resolve this conundrum: Either start evaluating investor performance using IRRs (or some other money-weighted metric), or create an incentive-fee scheme that rewards managers on a time-weighted basis.

Changing the way institutional real estate investors are evaluated would require changing the way chief investment officers, boards and industry organizations think. This likely would take a concerted effort by many industry participants over a considerable period of time. But any institutional real estate investor could start experimenting with alternative incentive-fee structures. It would only require finding a manager who was willing to try something different. To this end, I started pondering how a time-weighted incentive-fee structure might work, but rather than finding a workable solution, I came to the realization it is simply a bad idea.

Start with the premise the fundamental goal of an institutional real estate investor is to fund some future liability, using the term "liability" somewhat loosely. It could be pension and health benefits (pension funds), operating expenses (endowments), grants (foundations), public welfare (sovereign wealth funds), or stipends for progeny that may not even be born yet (family offices).

Irrespective of the specific liability, one common factor is it takes money to satisfy these future obligations. To justify incentivizing managers with a time-weighted structure, it would be important to find a nexus between higher TWRs and creating additional money for the investor (whether on a nominal or present-value basis). IRR hurdles pass this test except under the most unusual of circumstances, such as multiple IRR solutions.

But although improved TWRs can yield more money to the investor, there are ways to improve TWRs without materially improving either the real dollar or present-value return to an investor. Some of these can be dramatic.

Take, for example, the issue that often besets new funds from a TWR perspective — funding early management fees. Many a non-institutional manager has discovered, after the fact, its TWR track record is badly bruised by the choices made in this regard.

Using simple numbers, if a manager calls $100 in capital to cover $90 in fees in a fund's first period, leaving $10 in the bank for working capital, the TWR for that period is –91 percent. That –91 percent is going to weigh on that fund for the rest of its life.

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But if the manager drew $10,000 in capital to fund the same $90 in expenses and ended the period with $9,910 in the bank, the TWR return for the first period would be a mere –0.9 percent. Not stellar but certainly something that could be overcome by future positive performance.

But "overcalling" capital is clearly a noneconomic decision that no investor would want to incentivize. Furthermore, it is quite unlikely any manager would actually use an approach such as this to "manage" its time-weighted returns, especially because this particular issue can be addressed in other ways.

But the underlying fact is, in certain circumstances, it is advantageous from a time-weighted standpoint to call more capital than is necessary.

During the life of a project or a fund, it will not always be as easy to see this phenomenon at work as in the "first period" example above. If managers were incentivized to beat a TWR hurdle, however, one would expect them to be looking for such opportunities, comfortable in the belief this is precisely the behavior the investor was incentivizing.

The example above also highlights a broader issue with time-weighted returns. TWRs for real estate investments and real estate funds can be unduly influenced by early periods and late periods where the net asset value is likely to be low. As is well known, TWRs do not care how much NAV is in any given period. A 10 percent return on $100 has the same impact as a 10 percent return on $100,000.

Thus, if an incentive structure were to be based on a time-weighted hurdle, one likely would find managers becoming more focused on returns in the earliest and latest periods of an investment. The example above related to an early period. In the later periods, one might find reserves booked when NAV was higher being reversed (i.e., creating income) in periods with a lower NAV. This could generate improved TWRs, while generating little, if any, financial benefit to the investor.

Incentives are designed to incentivize, and human nature suggests if compensation is tied to TWRs, then managers will focus on improving TWRs, whether it increases the overall economics of an asset, a venture or a fund.

Other factors also can have anywhere from a marginal to a material impact on time-weighted returns that have no or negligible impact on a money-weighted basis. The first of these are the periodic valuations, which are essential to TWRs, but in and of themselves provide no real monetary return to investors.

Consider a value-added asset, for example, that is acquired for $100, with a second $100 invested one year later to reposition it. For simplicity, assume no operating cash flow and the asset is sold at the end of a three-year hold for $300. The time-weighted return for this asset would be influenced by the year-one and year-two valuations.

- Approach A: Valued at $200 at the end of Periods 1 and 2; TWR = 14.5 percent
- Approach B: Valued at $225 at the end of Period 1 and $275 after Period 2; TWR = 18.6 percent
- Approach C: Valued at $250 at the end of Period 1 and $325 after Period 2; TWR = 21.6 percent

As with all of the examples in this column, this one is oversimplified for effect. But the underlying phenomena are real. Making pro forma assumptions at the high end or low end of a "reasonable range" during quarterly valuations will affect TWRs but not real economic performance.

More subtly, time-weighted returns can be influenced by whether certain capital events happen at the end of one period or the beginning of the next. This includes not only acquisitions and dispositions, but refinancing as well. Suffice it to say, from an IRR perspective, a 10-day delay or acceleration of a purchase, sale or refinance of a property within a fund will have a 10-day impact no matter where within a period those 10 days occur. But from a TWR perspective, the impact of a 10-day acceleration or delay can have a disproportionate impact if the acceleration/delay straddles two periods.

Nothing is particularly right or wrong, beneficial or sinister about the areas mentioned above — decisions can be made that influence time-weighted returns but do not really help an investor fund future liabilities. But incentives are designed to incentivize, and human nature suggests if compensation is tied to TWRs, then managers will focus on improving TWRs, whether it increases the overall economics of an asset, a venture or a fund. And to the extent the investor pays higher incentive fees but receives no improved "real" economics, the investor actually is worse off, even if its TWR is improved.

In addition, and ironically, because of the manner in which time-weighted returns roll up in an investor's portfolio, it is possible improving the TWR of any particular venture actually will decrease the TWR for the investor. This does not always happen, but it can, and it does.

So while any number of circumstances exist where time-weighted returns provide a valid evaluation metric, trying to use this metric as the basis for an incentive-fee structure is simply a bad idea. Circling back to the opening premise of this column, if it is not possible to conform manager-compensation structures to the TWR metric, perhaps it is time for a concerted effort by the industry to use a money-weighted metric for measuring institutional real estate performance, as some in private equity already are doing. ❖

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