Time-weights for no one

Investors' focus should be on current income, not unrealized gains

by Roy Schneiderman

I once heard someone say, "You can't pay pension benefits with unrealized gains." But the current market's focus on benchmarking and, by extension, time-weighted returns may be driving attention to unrealized gains when it would be better to focus on cash to pay benefits.

For an extended period of time, U.S. public and corporate pension funds enjoyed an expanding economy and expanding employment base that meant there were more contributors to pension plans than there were beneficiaries. And the ratio of years in retirement (i.e., collecting pension benefits) to years working (i.e., contributing to a pension plan) was relatively low. That is to say, people are living longer these days.

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This dynamic created a situation where a pension fund CIO's biggest challenge on Monday morning was figuring out where to invest all the net cash flow that came into the fund over the weekend. Interest and dividend income only exacerbated this "problem."

But just about every piece of this metric has changed. Population growth and job growth have slowed in the past 70 years, while the ratio of years collecting pension benefits to years contributing to a pension plan has increased dramatically as lifespans have increased. In the past century, the anticipated future lifespan for people who reach the age of 65 has increased roughly six years, from 77 to 83 — and a much higher percentage of people are reaching the age of 65. Corporate pension plans reacted to these changes by jettisoning defined benefit plans but, for the most part, public pension plans have not.

The impact of these changes hit the older, Eastern states first, but it has inexorably moved west; even large California pension plans are at, or nearing, the point where they are paying out more in benefits and operating expenses than they are collecting in contributions. The clear implication is investments that generate cash to pay for benefits are becoming more and more important.

This is not news to anyone who follows the industry, and "big picture" stories are legion as to the underfunded status of pension plans. But as pension funds' need for cash increases, what are the implications for real estate investment? After all, real estate is widely recognized as an asset class that generates cash flow; it should profit from plans' need to generate cash to pay benefits.

So, is it really true you can't pay benefits with unrealized gains? Two ways of doing so immediately come to mind.

First, you could "realize" the unrealized gains by selling assets. Using this cash to pay benefits rather than for reinvestment, however, reduces the assets of the plan and is clearly not a long-term sustainable solution. In addition, real estate transactions are not cheap. On exit, broker commissions, legal fees, and a host of "ordinary and customary" costs are borne by sellers. On the entry side, acquisition fees may well be paid to an investment adviser, in addition to legal fees and the costs borne by buyers. And assuming some of the sales proceeds are

reinvested, between a sale and a purchase there is "cash drag." So, while selling stocks to realize unrealized gains may be feasible — at least in the short run — this seems like an inefficient way for real estate to provide cash flow to pay pension benefits.

A second way to pay benefits from unrealized real estate gains would be through leveraging assets. If an asset were leveraged at 40 percent and it increased in value by $10 million, for example, an investor could generate $4 million of cash simply by holding the loan-to-value ratio at 40 percent and borrowing an additional $4 million. Of course, when people were doing this with their homes 10 years ago, it was referred to as "using their homes as an ATM," and we all know how that ended. Using debt in this manner has all of the issues that arise with respect to selling real estate assets, albeit to a lesser extent. The investment corpus declines, interest needs to be paid, and costs are involved in securing the debt, the precise nature of those costs dependent upon the nature of the debt.

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So if indeed one cannot, or should not, pay pension benefits with unrealized gains, real estate still can play an important role because real estate in many of its forms is a wonderful generator of operating cash flow. Indeed, many institutional investors explicitly include generating cash flow as an important objective for their real estate allocation. But we are not aware of many that evaluate their real estate investment programs in terms of cash flow. More common is to evaluate real estate investment programs in terms of total time-weighted returns, often benchmarked against an index such as the NCREIF Property Index or NCREIF's Open-End Diversified Core Equity fund index.

While nothing inherent in the concept of benchmarking or time-weighted returns favors appreciation over cash flow, as a practical matter, increased focus on benchmarks and total time-weighted returns has had, and is continuing to have, that effect.

First, while IRR generally is calculated based solely on cash flows, time-weighted return calculations use cash flow as an underlying element but not a direct factor. Income return is based on a constructed numerator that may or may not reflect actual investor cash flow in any given period. Furthermore, appreciation return for unrealized assets is not cash-flow based at all. Some may argue the income return and appreciation return will converge with IRR/cash flow (more or less) in the long run — particularly when an asset is sold — but certainly there can be significant divergence between attractive TWRs and attractive cash flow in the short and medium terms.

Second, as anyone who has followed ODCE returns the past few years can attest, the "action" has tended to be in the appreciation component of return. Indeed, as the appreciation component of time-weighted returns increases, the income component may well decrease. This occurs if the appreciation is due to cap rate compression rather than income growth.

Third, cash flow is largely the byproduct of the totality of prior decisions made by the managers of real estate assets over time, and there is little ability to influence it quarter over quarter. Time-weighted returns, however, are highly dependent upon (typically) quarterly net asset values. These NAVs can vary based on who is providing the NAV any particular quarter (internal versus external valuations), appraiser rotation policies, and such arcane topics as when and how to recognize profit for a value-add initiative or a development property.

Finally, both early and late in an asset or venture's life, time-weighted returns can have large swings (the J-curve is but one example), and not insubstantial effort has gone into engineering away negative TWRs that do not reflect economic reality. Such focus on asset or venture TWRs may well produce better TWRs at the asset or venture level, but it is unclear to what extent this will generate real dollars to pay real benefits, or even help returns at the pension-fund level, for that matter.

For all these reasons, there has been an increasing tendency to focus attention on maximizing time-weighted returns and, in particular, their appreciation component. At the margin, we are aware of at least one manager that is compensating personnel based on the total TWRs achieved for its capital partner. The theory here is deceptively simple: If the partner is being evaluated based upon a total TWR benchmark, then evaluating the manager's personnel based on the total TWRs produces excellent alignment.

Excellent alignment, that is, unless the ultimate goal is to pay pension benefits. ❖

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