

The crisis brought into focus real estate portfolio construction. Adding REITs could improve performance and liquidity, says **Joseph Harvey**

# Allocations: the truth



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**A**s the recovery in the commercial US real estate sector continues, institutional investors are re-evaluating the composition of their real estate allocations. In our view, the historical performance of private real estate funds does not justify the high allocations to direct property typically found in corporate and public pension plan portfolios. Notably, investors have not

been compensated for the costs or risks of illiquidity. The recent downturn has illuminated those costs, and has demonstrated why US REITs provide a superior investment vehicle for core and value added real estate allocations.

We will make the case that:

- Listed REITs have outperformed core and value added real estate funds consistently over the long term, while providing the benefit of liquidity;
- Returns for opportunistic funds have been comparable to REIT returns over time. However, their different return cycles have resulted in distinct periods of outperformance for each;
- Core and value added funds have not adequately compensated investors for the risks of illiquidity, and they do not generate enough alpha to justify their fee structures;
- The REIT business model explains most of REIT performance advantage over private real estate funds;
- In a good vintage year, opportunistic funds can be an attractive vehicle for distressed, appreciation-oriented real estate strategies;
- A rational, merit-based reallocation would drive significant capital flows away from core and value added allocations and into REITs.

## Historical performance of listed vs direct

Over the past 30 years, which encompass two commercial real estate crashes, REITs have outperformed diversified core funds by 470bps annually. Over the past 10 years, they outperformed core funds by 560bps annually.

We measured listed REIT performance using the FTSE NAREIT Equity REIT Index (NAREIT Index) – a market-capitalisation-weighted index of 106 US REITs. We used the NCREIF Fund Index–Open-End Diversified Core Equity (NFI-ODCE) series, which is also capitalisation-weighted, to chart the performance of those open-end commingled funds that pursue a diversified core investment strategy. At 31 March 2010, the REITs in the NAREIT Index had an aggregate market capitalisation of \$273bn and owned an estimated \$515bn (€422.7bn) of real estate. As of

31 December 2009, the last period for which data are available, the funds in the NFI-ODCE had appraised net equity of \$48bn and owned gross real estate assets of \$71bn.

Table 1 compares their performance. Both indexes show results on a leveraged basis, with NFI-ODCE funds operating with less leverage (33%) than the NAREIT Index companies (47%, per Cohen & Steers estimates). Leverage, which adds to the volatility of returns, is a drag on returns in bear markets but enhances returns in up markets. Greater leverage has benefited REIT performance versus core funds over the long term, but has detracted from performance since the peak in real estate values in 2007.

In practice, the advantage for REIT investors shown in table 1 is understated, as most institutional investors hire active managers for their REIT allocation, many of whom outperform the NAREIT Index benchmark. Active REIT management for a diversified strategy should add 200bps of alpha; REITs' stock-exchange liquidity enables portfolio managers to capitalise on valuation anomalies and performance variances across property types and markets as economic and real estate cycles change.

## REITs vs core, value added and opportunistic

We expanded our study to evaluate the returns of REITs, core, value added and opportunistic strategies. Gross of expenses, opportunistic funds performed the best over 15 years and actively managed REIT portfolios placed second. For the past 10 years, actively managed REIT portfolios performed best, while a passive REIT portfolio strategy based on the NAREIT Index was second.

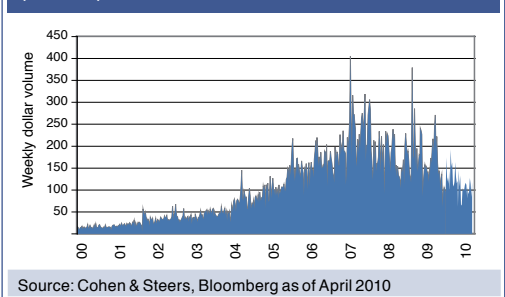
However, looking at the more important net-of-expenses returns, actively managed REIT investors realised the highest returns for the five-, 10- and 15-year periods. For the 15-year period, they earned an annualised 10.6%. Of the other active strategies, opportunistic funds placed second, at 9.8%. Core and value added funds lagged significantly, with annualised returns of 6.5% and 5.6%, respectively, over 15 years.

Looking at expenses over the 15-year holding period, REIT investors with actively managed portfolios saw the greatest efficiency, with just 7% slippage from gross to net returns. Core funds lost 13% of their gross returns to fees and expenses. Value added funds had 21% slippage and opportunistic funds lost 22%. While opportunistic fund expenses appear to be high, the index data include the promote fees that the successful funds earned above their hurdle rates.

## Rolling return analysis

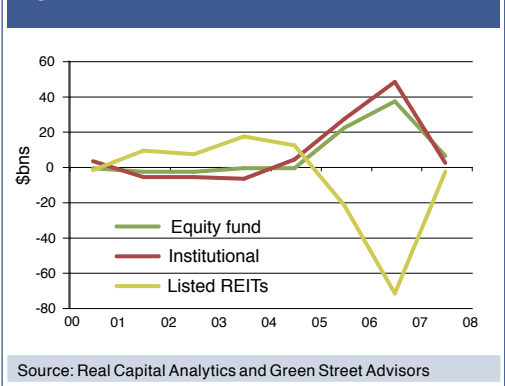
We also looked at rolling periods of returns, to eliminate any bias from endpoints selected that may favour one strategy. Table 3 tallies the NAREIT Index and

**FIGURE 1: RMZ INDEX LIQUIDITY (\$BNS)**



Source: Cohen & Steers, Bloomberg as of April 2010

**FIGURE 2: NET ACQUISITIONS LESS DISPOSITIONS OF COMMERCIAL REAL ESTATE**



Source: Real Capital Analytics and Green Street Advisors

three private fund strategies for rolling three-, five-, 10- and 15-year periods. Note that all results are gross of expenses, which provides a performance advantage to private funds.

Starting with a comparison of REITs with core funds, we analysed 85 quarterly periods of 10-year returns. The simple average of compounded REIT returns was 12.7%, compared with 7.8% for core funds. REITs outperformed in 96% of the periods. For 15-year periods, REITs outperformed core funds in each of the 65 periods. Over the three- and five-year rolling periods, REITs outperformed core funds 79% and 81% of the time, respectively.

REITs' record of outperformance tells the same story when compared with value added funds.

Opportunistic funds outperformed REITs in 68% of the rolling 15-year periods and 74% of the 10-year periods. Looking at net returns, however, passive REIT strategies and opportunistic funds performed about the same. Even though the net returns are similar, REITs still have the advantage over the opportunistic fund averages due to their lower-risk business models and liquidity.

Interestingly, while the returns are similar, the return cycles for REITs and opportunistic funds had distinct, sustained periods where one outperformed the other, suggesting meaningful diversification benefits between these two strategies.

## Liquidity comparison

Of the \$270bn in property held in private fund indexes, just 38% is controlled by open-end vehicles; the remaining 62% is controlled by closed-end vehicles, which have no investor liquidity. The broader

**TABLE 1: ANNUALISED TOTAL RETURNS THROUGH 2009 LISTED REITS VS DIVERSIFIED CORE EQUITY FUNDS**

	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years	30 Years
<b>NAREIT index</b>	28.00%	-12.4%	0.40%	10.60%	9.80%	9.90%	11.80%
<b>NFI-ODCE Core (gross)</b>	-29.7%	-9.8%	0.70%	5.00%	7.50%	5.40%	7.10%
<b>Listed vs direct performance (bps)</b>	5,770	-260	-30	560	230	450	470

Source: Cohen & Steers, NAREIT and NCREIF

2,700 private fund universe controls significantly more property than the funds in this study, and comprises predominantly closed-end vehicles.

Open-end fund liquidity ranges from quarterly (in most cases) when times are good, to zero when private market transaction activity shuts down – as it did from 2007 to 2009. When redemption requests spiked in early 2009, most open-end private funds were forced to rescind liquidity and halt redemptions.

The liquidity in the REIT market has grown significantly, as the market developed and more investors embraced the investment case for REITs. The growth has been driven by new strategies, such as income-orientated strategies; new vehicles, such as closed-end funds; the development of indexing and ETFs; the addition of REITs to the S&P 500; and the entrance of more participants, including hedge funds. Over the past year, REIT volume averaged \$129bn weekly, as measured by the MSCI U.S. REIT Index (RMZ). While liquidity in the private market shut down during the global financial crisis, significant liquidity for REITs was sustained, enabling REIT portfolio managers and asset allocators to rebalance.

**Business models favour REITs**

We believe structural factors explain the majority of REIT outperformance. First is the agency issue: investment decision makers for most core and some value added private funds are paid fees based on assets under management. Once private fund capital is raised, they have strong motivations to put the money to work, regardless of available returns.

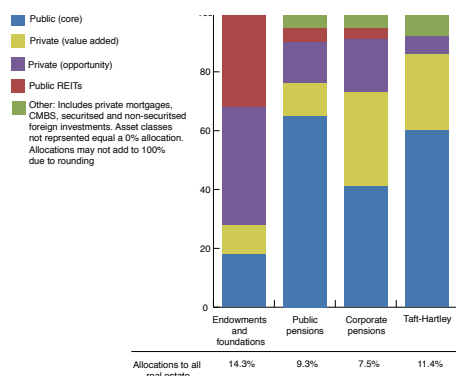
By contrast, REIT managements have significant ownership stakes, and that acts as a governor on capital allocation decisions. In addition, REITs are subject to performance-based incentive compensation tied to fundamental objectives. Further, REIT managements are governed by boards of directors, SEC and NYSE regulations and, perhaps most importantly, by the invisible, efficient hand of the public market.

Value added and opportunistic fund advisers also have incentive compensation through promoted fee structures tied to hurdle rates, but several factors make these features less effective. First, there has been an asymmetrical payoff opportunity between co-investment amounts compared with the reward of management fees plus a 20% promote. Second, many sponsors move on to the next fund in the series, where a poor vintage fund might be followed by a strong vintage fund.

These structural dynamics are illustrated by the capital allocation decisions made through the peak of the last real estate cycle. Figure 3 shows that REITs sold \$130bn in assets from 2005-08, while private real estate investors were net buyers.

REITs have a significant advantage today through

**FIGURE 3: US INSTITUTIONAL REAL ESTATE ALLOCATION**



Source: IREI text-exempt real estate 2009 survey; Casey Quick Analysis

**TABLE 2: ANNUALISED TOTAL RETURNS THROUGH 2009 (%) REITS VS CORE, VALUE ADDED AND OPPORTUNISTIC STRATEGIES**

	5 Years		10 Years		15 Years	
	Gross return	Net return	Gross return	Net return	Gross return	Net return
<b>Listed REITs</b>						
Active	1.90	1.20	12.10	11.30	11.40	10.60
Passive	0.40	0.10	10.60	10.30	9.80	9.50
<b>Direct</b>						
Core (NFI-ODCE)	0.70	-0.20	5.00	4.00	7.50	6.50
Value Added	-3.10	-4.70	3.90	2.40	7.10	5.60
Opportunistic	3.10	0.20	8.90	6.10	12.60	9.80

Source: Cohen & Steers, eVestment Alliance, NCREIF and The Townsend Group

**TABLE 3: ROLLING RETURN PERFORMANCE ANALYSIS OF REITS VS CORE VALUE ADDED AND OPPORTUNISTIC FUNDS DURING 2009**

	Three years	Five years	10 years	15 years
Number of Periods Starting Q1 1978	113	105	85	65
NAREIT Index <sup>(1)</sup>	14.50%	14.20%	12.70%	12.80%
NFI-ODCE Core (gross)	8.70%	8.50%	7.80%	7.30%
<b>% of periods listed REITs outperform</b>	<b>79%</b>	<b>81%</b>	<b>96%</b>	<b>100%</b>
Number of Periods Starting Q1 1983	92	84	64	44
NAREIT Index <sup>(1)</sup>	12.90%	12.40%	11.90%	11.90%
NCREIF Townsend Value Added Funds (gross)	8.90%	8.50%	8.60%	8.70%
<b>% of periods listed REITs outperform</b>	<b>75%</b>	<b>73%</b>	<b>80%</b>	<b>100%</b>
Number of Periods Starting Q1 1988	70	62	42	22
NAREIT Index <sup>(1)</sup>	13.60%	13.40%	12.00%	13.20%
NCREIF Townsend Opportunistic Funds (gross)	13.90%	15.00%	15.20%	14.90%
<b>% of periods listed REITs outperform</b>	<b>43%</b>	<b>35%</b>	<b>26%</b>	<b>32%</b>

Returns are simple averages of compounded annual return snapshots.

Source: Cohen & Steers, NCREIF and The Townsend Group.

<sup>(1)</sup> The NAREIT performance is calculated using a four-quarter lag.

their access to low-cost capital in the public market. In the depths of the credit crisis, they raised significant common equity to address debt maturities and deleverage. Since March 2009, US REITs have raised more than \$45bn through common stock, corporate debt and convertible offerings.

By contrast, many private real estate owners have been unable to recapitalize. Without equity injections, they will be hard pressed to refinance loans that exceed lenders' current underwriting criteria. Overleveraged owners may be forced to default, bring in high-cost equity partners or sell outright.

**Volatility**

Historically, proponents of direct real estate investment have argued that real estate is less volatile than other asset classes. This is misleading, in our view, because real estate cannot be measured in a real-time transactional framework in the same way that stocks and bonds are measured in the capital markets. Furthermore, the appraisal-based valuations for the NCREIF Index or the private fund indexes smooth returns so that volatility is understated. Green Street Advisors has developed an index for its valuation of REIT portfolios that we believe gets closer to the truth on commercial real estate volatility.

We believe the Green Street CPPI is the superior real-time indicator of commercial real estate prices. It is an equal-weighted index of real estate values calculated by Green Street's team of analysts for the key property sectors. Since its inception in March 1994, the Green Street CPPI shows that the volatility of commercial property values (not total returns) is 55% greater than volatility measured by NCREIF. Volatility for REIT share prices – due to leverage, real-time discounting and the transaction-based framework of the public market – is still higher than for direct property; but we believe proper measurement would close the perceived volatility gap meaningfully between listed and direct.

**Institutional RE allocation will be changing**

Despite this evidence, US corporate and public pension plans have allocated three-quarters of their real estate portfolios to core and value added private

investments, according to research by Casey Quirk. Listed REITs comprise just 5% of their real estate allocation, as figure 5 shows.

But this appears to be changing. REITs' superior performance, liquidity, access to capital and transparency are attracting a growing number of institutional investors.

Corporate and public pension plans have an estimated \$252bn of the \$325bn of institutional capital that is invested in real estate. Currently, about \$12bn of that is allocated to REITs. If these plans increased their REIT investments to the 32% allocation that endowments and foundations have – which is easily justified by performance – another \$68bn would shift into REITs.

Considering the new equity that we expect to be issued by existing REITs that have begun to acquire properties, and by initial public offerings of private companies, we believe the public market could easily accommodate those flows over the coming years.

In conclusion, the global financial crisis illuminated the benefits and shortcomings of a number of investments. For many institutions the costs of illiquidity were devastating. Investors have become more sensitised to illiquidity risks, and will demand a premium for locking up their capital. Some institutions are starting over to create a portfolio with the proper beta and alpha components.

We believe that institutional real estate investors know that with private real estate, investing is more a function of timing the cycle than picking the right property sector, strategy or manager. Accordingly, we expect to see institutions and their consultants design frameworks that allocate effectively along the cycle and opportunity set, and between private and listed real estate.

Crisis is often the catalyst for change. We believe the global recession and financial crisis will be the catalyst for institutional investors to re-evaluate their real estate investment decisions. Considering the case put forward in this paper, we believe that many institutional investors will seek to increase their investments in listed real estate over time; the data simply do not support the old way of making real estate allocations.

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