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LISTED EQUITY REITs WERE TOP-PERFORMING ASSET IN STUDY OF 200 MAJOR PENSION FUNDS

Shows "Complete Disconnect" By Pension Funds: REITs The Lowest Of All Allocations At Under 1%

WASHINGTON, DC, June 28—With a total of $8.4 trillion in assets under management, public and corporate sector pension funds represent a major portion of the $24.7 trillion of assets on which millions of Americans rely for their retirement security. With funding liabilities on the rise, pension funds are under increased pressure to maximize returns and generate steady income. Many funds have responded by shifting their asset allocations, including increasing their allocations to alternative investments and real assets. A new study by pension research firm CEM Benchmarking, sponsored by the National Association of Real Estate Investment Trusts (NAREIT), provides insights into how well alternatives, real assets and other investments have paid off for the nation's largest pension funds.

The study provides a comprehensive review of investment allocations and actual investment performance across 12 asset groups. The analysis looks at fund performance over 17 years, the longest period for which CEM had data for some of the assets studied, and it utilizes a proprietary dataset covering more than 200 public and private sector pension plans with over $3 trillion in combined assets under management.

The CEM methodology also introduces a new standardization process for illiquid assets, including Unlisted Real Estate and Private Equity, to eliminate the reporting lag between the time when an underlying asset changes value and when that value is reported to the pension fund. Adjusting for valuation reporting lags improved the accuracy of the comparisons of returns, volatilities and correlations among all assets analyzed.

The results of the study highlight a compelling disconnect between the increasing reliance on some alternative and real assets, most notably hedge funds, and the net investment performance of these assets, which have underperformed lesser allocated assets, such as Listed Equity REITs.

Key takeaways from the study, entitled "Asset Allocation and Fund Performance of Defined Benefit Pension Funds in the United States Between 1998-2014," include:

Listed Equity REITs were the best-performing asset class over the study period, Hedge Funds the second-worst. Listed Equity REITs outperformed all other 11 assets in the study, generating average annual net returns of 11.95 percent. Average annual investment costs of 0.51 percent, the lowest of any of the alternative or real estate asset groups, contributed to REITs' net return performance.

Hedge Funds, with average annual investment costs twice those of REITs, produced less than half the net returns at 5.50 percent. The Hedge Fund average annual return was the second-lowest of all assets surveyed, outpacing only U.S. Other Fixed Income, a category that included cash. Excluding cash from U.S. Other Fixed Income, Hedge Funds were the worst performing asset in the study, underperforming all other categories of stock, fixed income, real assets and alternative investments.

While Private Equity had a higher average annual gross return than REITs at 13.46 percent, its net return was lower at 11.37 percent, pulled down by management fees that were nearly four times higher than those of REITs. REITs also outperformed Unlisted Real Estate, which delivered an average annual net return of 8.59 percent with more than twice the annual fees of REITs.

Large increases in capital allocations over the study period flowed to hedge funds. Pension funds made substantial changes to their capital allocation strategies over the course of the study period, especially their allocations to Hedge Funds and Tactical Asset Allocation strategies. This asset category averaged 1.46 percent of pension fund portfolios at the start of the study period in 1998 and grew to 8.36 percent of portfolios in 2014 – a nearly 500 percent increase.

Private Equity also grew from 1.97 percent of portfolios in 1998 to 5.93 percent in 2014. The portion of portfolios allocated to Unlisted Real Estate also increased from 2.90 percent in 1998 to 4.46 percent in 2014.

Listed Equity REITs were an extremely small allocation in pension plans' portfolios in 1998 at 0.36 percent and the smallest of all allocations in 2014 at 0.62 percent.

"The fact that Listed Equity REITs were the top performing asset class, but represented only 0.6% of total allocations, the lowest allocation in the study, and have only realized an increase in capital of 30 basis points since 1998, is a complete disconnect," said Alexander Beath, Senior Research Analyst at CEM Benchmarking and the author of the study. "The combination of limited portfolio allocations and outsized returns of REITs led to a significant missed opportunity for pension funds and may point to a strategy for improving future returns," he said.

If the pension plans included in the CEM study had reversed their REIT and Hedge Fund allocations over the 1998 through 2014 period, at the end of 2014, they would have had plan asset balances that were 2 percent larger. Applying the 2 percent additional assets to the approximately $3.2 trillion in private defined benefit plan assets in the U.S. would yield an additional $64 billion in assets – more than three times the estimated $20 billion in private pension underfunding. Applying the 2 percent additional assets to the $3.8 trillion in non-federal public defined benefit plan assets would yield an additional $76 billion in assets – nearly 6 percent of the estimated $1.3 trillion in underfunding in these plans.

Listed Equity REITs provide optimal exposure to the real estate asset class. CEM Benchmarking's advancements in the standardization of illiquid asset returns with those of liquid assets provide new insights into the relationship between listed and unlisted real estate returns. CEM's research shows the as-reported correlation of Listed Equity REITs to Unlisted Real Estate as 0.09. However, CEM's methodology for de-lagging Unlisted Real Estate returns shows the true correlation between this asset and Listed Equity REITs is 0.91. Both Listed and Unlisted Real Estate had low correlations with other assets, underscoring the value of both as portfolio diversifiers.
The CEM methodology also shows the true volatility of Unlisted Real Estate was 19.03 percent on an annualized basis over the study period, comparable to the 20.74 percent volatility of Listed Equity REITs.

"The strong correlation and comparable volatility of Unlisted Real Estate and Listed Equity REITs is very logical, given the fact that the underlying assets in these two categories are essentially the same," Beath said.

Private Equity was the most volatile asset in the study. CEM's standardization methodology showed its true annualized volatility over the study period to be 28.04 percent, approximately 20 percent greater than as reported. Volatility of the Hedge Fund category was 12.30 percent.

The CEM methodology also provided new insight into risk-adjusted returns, as measured by Sharpe ratios. Excluding two U.S. fixed income categories with extremely low volatilities, Listed Equity REITs had the highest Sharpe ratio – 0.45 – over the 17-year study period, reflecting the optimal combination of performance and volatility of all assets studied. Unlisted Real Estate and Private Equity both had 0.32 Sharpe ratios – the same as U.S. Large Cap Stocks. The Sharpe ratio of the Hedge Fund category was 0.25, reflecting the asset's underperformance.

DOWNLOAD THE CEM STUDY
Learn more about the CEM Benchmarking study and download a pdf of the full report.

ABOUT CEM BENCHMARKING AND ITS PENSION FUND RESEARCH
CEM Benchmarking is a Toronto-based provider of investment cost and performance benchmarking for large institutional investors, including pension funds, sovereign wealth funds, buffer funds and others. The results of this study are derived from CEM's unique database, which contains detailed information regarding asset allocation, investment

performance and investment expenses for approximately 1,000 large institutional investors around the world. The study used realized investment performance information, rather than performance data as measured by broad asset class benchmarks, providing a window into actual pension fund investment choices and their performance.

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