Often using a comparison between publicly traded real estate investment trusts (REITs) and private equity real estate funds, the author points out some of the pitfalls of portfolio allocation strategy. He discusses seven aspects of investing that pension and benefit fund plan sponsors should be mindful of as they rebuild the value of portfolios—and beneficiaries' faith in their plans.

The Seven Pillars of Investment Wisdom

by Brad Case

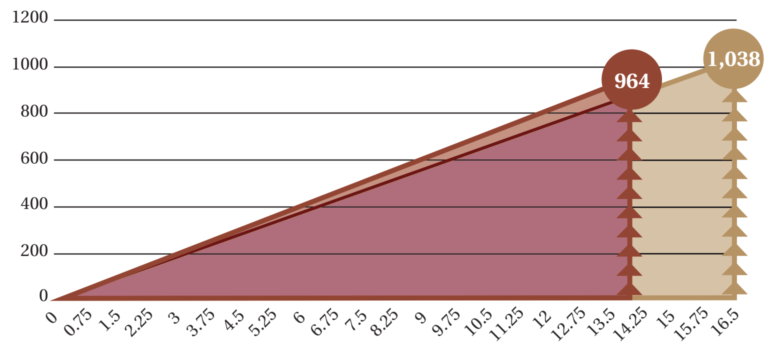
The past two years have been a trial by fire for pension and other benefit funds. The market movements of 2008 and 2009 provided perhaps the most severe possible test of the wisdom of a portfolio allocation strategy. Some plan sponsors appear to have failed that test. The situation is equally dire for current and future beneficiaries: Several reports on plan sponsor investment decisions have, rightly, tested their faith that promised benefits would continue to be funded.

Plan sponsors have a difficult, double rebuilding task ahead of them. First, they must rebuild portfolio values—looking for solid returns going forward, and looking to avoid the errors that the market so mercilessly exposed. Second, they must also rebuild beneficiaries' faith in them—looking to make sure that their investments stand up to the future's more intense scrutiny.

Successfully completing that dual rebuilding project won't require sophisticated financing engineering. In fact, tricks of le-

Figure 1

REITs Produced Larger Bull Market Returns



verage and other conceits of financial engineering are much of the reason that some plans were so devastated in the financial meltdown. Instead, rebuilding both portfolio values and beneficiary trust will require a return to the wisdom of the ages.

In an ancient context, the seven pillars of wisdom are described as *sound judgment, counsel, knowledge, capability, prudence, discretion* and *understanding* (not to mention fear of God). For the fiduciary trustees of a modern benefits portfolio, those same seven pillars of wisdom can perhaps be translated as *returns, oversight, transparency, liquidity, risk hedging, tactical opportunity* and *diversification*. (Fear of God still applies.)

Returns

An important aspect of sound judgment for a fiduciary trustee is to evaluate returns properly—and not to be fooled by false performance. For example, using leverage is a common way for investment managers to goose up reported returns but accomplishes nothing for the investor. It increases the investor's risk exposure by exactly the same extent and frequently results in investment managers grabbing higher fees for falsely "meeting" performance hurdles.

Measuring returns without subtracting fees and expenses is a particularly damaging error in portfolio management. For example, over the 1990-2007 real estate cycle, private equity real estate funds following an opportunistic strategy reported gross returns averaging 14.8% per year. For comparison, publicly traded real estate investment trusts (REITs) had gross returns averaging 13.9% per year. But opportunistic private equity real estate funds charge enormous fees averaging 270 basis points per year, compared to just 50 basis points for an REIT investment manager. As a result, net returns averaged just 12.1% per year for opportunistic funds, compared to 13.4% per year for REITs.

That kind of difference in fees makes a huge difference to beneficiaries. On an initial investment of $10 million, the private equity fund manager would have taken $38 million in fees, compared to just $8 million for the REIT investment manager, over the full real estate cycle of 17½ years. At the end of the cycle, the plan sponsor's investment in REITs would have been worth $90 million, compared to just $74 million had it been invested in private equity real estate funds.

Another problem in measuring returns is the use of selective or even artificial periods. For example, private equity real estate funds are reported to have provided net returns averaging 18.4% during the real estate bull market, compared to just 15.9% for publicly traded REITs. What's hidden in that false comparison is that the bull market in private equity real estate was much shorter—just 14 years (from the fourth quarter of 1993 through the fourth quarter of 2007), compared to 16½ years (from the third quarter of 1990

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through the first quarter of 2007) for publicly traded REITs. (See Figure 1.)

Actually, REITs achieved higher net returns than opportunistic private equity during the bull market: 1,038% vs. just 964%. Compressing their total returns into a shorter period enables fund managers to claim higher annualized returns, but that doesn't help investors. At the end of the bull market—by definition—the limited chance that investors had to achieve any positive return was over.

Governance and Oversight

The ancient notion of *counsel* implies working together—sharing information and resources—toward a common goal. The idea translates well into the investment context, where a raft of academic research shows that risk-adjusted returns are stronger when there is a close alignment of interests between investors and investment managers.

But financial incentives aren't necessarily enough to achieve this alignment. Both research and recent experience show, for example, that fees "earned" by exceeding *hurdle rates* are too easily achieved simply by taking on more risk, leaving upside for the investment managers but downside for the investors.[1] (The *hurdle rate* is the minimum return that the investment manager must produce before collecting the *promote*, which is the performance-based part of the compensation and generally is 20% of the return in excess of the hurdle. Investment managers collect a management fee—generally 2% of the committed capital—even if they don't reach the hurdle return, but in that case they won't get the promote. The author notes that because those are nontransparent investments, nobody except for the investment manager determines whether the investment manager has exceeded the hurdle, or by how much.)

Investment returns are stronger, with less risk, when there are effective mechanisms for monitoring the asset selection, asset management and other decisions of investment managers. Academic researchers have compared the returns produced by managers with different access to investment capital—those who amass cash through retained earnings or one-time capital raises versus those who must interact frequently with different parts of the capital market including banks, institutional investors, credit analysts, equity analysts and the public to raise capital through secured debt, lines of credit, private equity placements, public debt or equity offerings, and preferred or other hybrid sources.[2]

The research shows that those managers with access to large blind pools of cash tend to make poor investment decisions and produce weaker returns, while those whose management is continually monitored by investors from different parts of the capital market tend to make better decisions and produce stronger returns. Some research looked specifically at publicly traded REITs—which are restricted from amassing pools of cash and instead must turn to capital markets whenever an investment opportunity arises. The research found that the continual oversight by investors with different stakes is one of the reasons that publicly traded REITs have produced stronger returns than other investment managers.[3]

Transparency

Possibly the most important condition for effective monitoring, oversight and governance is *transparency*—the investor's knowledge of the decisions that the investment manager makes regarding asset selection and management, capital and risk budgeting, and other performance drivers. Again, research and recent experience both show that it's not enough that someone be permitted access to such information. An auditor's report, for example, did not protect investors from the "Madoff murk." Instead, investors benefit from broad transparency that makes it possible for a wide range of parties—banks, credit-rating agencies, equity analysts, and not just other investors but potential investors, too—to evaluate the investment managers' effectiveness and performance.

Investment managers sometimes argue that transparency hurts returns—that they can produce spectacular returns only by hiding their investment strategy. Independent academic research, though, shows the opposite: There is no "secret ingredient," and investors generally derive no benefit from the investment manager's cloak of secrecy. Instead, nontransparent managers tend to waste capital, while investments with more transparency produce stronger returns—benefiting from lower cost of capital, greater responsiveness to profitable investment opportunities, and more effective monitoring and feedback on the quality of their investment decisions.

Liquidity

In a sense, none of the other pillars would matter without *capability*—the power to act and to accomplish. The crisis of 2008-2009 vividly illustrated the importance of this power in the investment context. Many investors could clearly see the coming meltdown of asset values, but could do nothing to avoid it because they were locked into illiquid investments.

A misunderstanding of the importance and the function of *liquidity* may be one of the prime culprits in the collapse of portfolio values for some benefit plan sponsors. Many fiduciary trustees seem to have been fooled by the notion of an *illiquidity premium* into thinking that they would earn stronger returns if they simply gave up the ability to act on new market information—if they sacrificed liquidity. But the hypothetical illiquidity premium doesn't generally exist in the real world; illiquid investments don't, in fact, produce better returns than liquid ones.

The reason is essentially the same with liquidity as it is with oversight and transparency: Liquidity plays a critical role in producing better investment decisions. In fact, liquidity can be thought of as the ultimate form of governance and oversight. When an investment manager makes a bad decision—on asset selection, capital structure or the like—the holder of a liquid position can dump it immediately, while the holder of an illiquid decision has to suffer the eventual consequences.

Three different teams of independent academic researchers have compared the asset-level returns on core property investments achieved by publicly traded REITs and by private real estate investors such as core private equity funds and separate account managers.[4] (See Figure 2.) After controlling for other differences, all three found that REITs outperformed private real estate managers substantially—by about 30%—at the asset level. Far from earning an *illiquidity premium*, investors in private real estate seem systematically to have endured a rather huge *illiquidity penalty*.

Risk Hedging

While prudence is never inappropriate, certain risks can be foreseen more easily than others. With the federal government working on its third stimulus package at the time this article was written, many investors are concerned about a likely surge in inflation—and are looking for investments to hedge the risk of a price increase. That's especially important for endowments, foundations and other trusts with spending mandates that are likely to be severely affected by inflation.

The three classic hedges against the risk of inflation are real estate, commodities and inflation-linked bonds such as Treasury inflation-protected securities (TIPS). All three asset classes have strong, but different, inflation-hedging attributes. Commodities, for example, generally increase in value almost contemporaneously with inflation, while real estate and TIPS generally react with a lag averaging about four months. Commodities also have particularly strong returns during high-inflation months—but particularly bad (even negative) returns during low-inflation months. That means that the main problem of commodities as a risk-hedging instrument is not just their extreme volatility but also the difficulty of predicting just when inflation will surge. Guess wrong, and you've put money into perhaps the worst-performing asset of all.

TIPS and publicly traded REITs are much more dependable in their returns—generally stronger during high-inflation months, but not bad during low-inflation months, either. TIPS, though, are a low-return instrument. In fact, during high-inflation periods the returns on TIPS are no higher than the inflation rate on average. In contrast, REITs and other real estate investments provide strong equity returns during both high-inflation and low-inflation periods.

Finally, REITs and commodities are much more dependable than TIPS as an inflation hedge, as shown in Figure 3. Historically, total returns on TIPS have met or exceeded the inflation rate during only about 52% of high-inflation periods. In contrast, returns on commodities and REITs have exceeded the inflation rate in almost 70% of high-inflation periods.

Figure 2

REIT Managers Outperform Private Real Estate Managers: Findings From Three Academic Research Teams

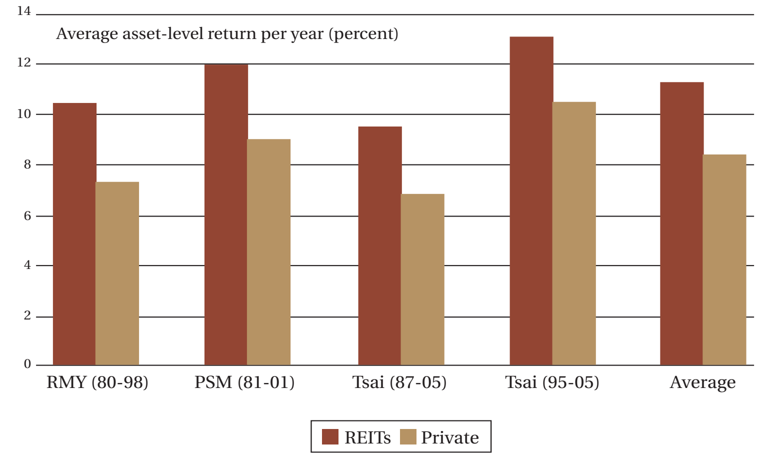
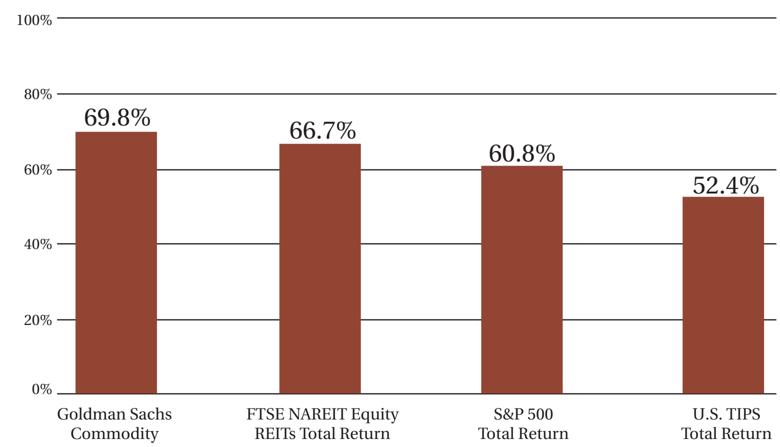


Figure 3

Dependability in Inflation Hedging Inflation Coverage During Six-Month Periods of Relatively High Inflation



Tactical Opportunity

Wisdom also encompasses *discretion*: the willingness to act, with well-considered forethought, both to forestall problems and to take advantage of genuine opportunities. In the investment context, this means making tactical allocations to asset classes that are positioned for extraordinary returns, or away from those positioned for underperformance.

In many cases, tactical opportunities arise because of the different timing of responses to market cycles. Across asset classes this is well understood. Stock returns generally outperform during the recovery from a recession to an expansion, while bond returns outperform when the economy exhausts its growth and softens toward recession.

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Figure 4

Tactical Opportunities: The 1990s Real Estate Crisis

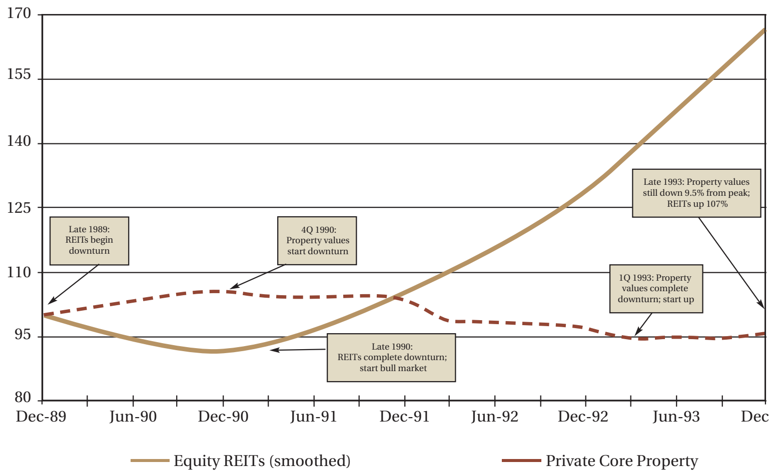
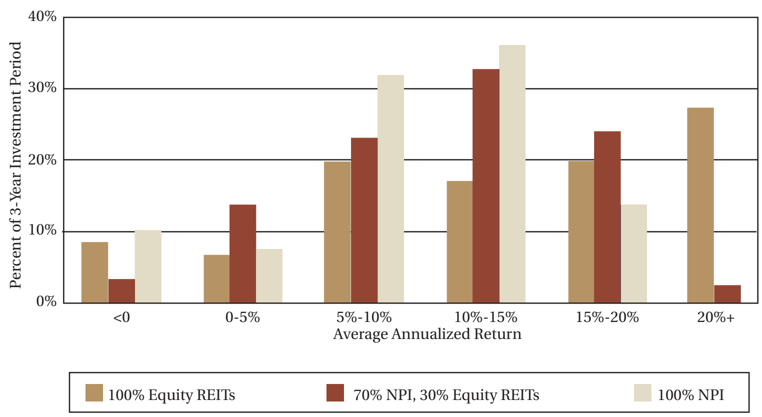


Figure 5

Public and Private Real Estate: Diversification Within the Asset Class Three-Year Returns



Less well understood are tactical opportunities created by the timing mismatch between liquid and illiquid investments in the same asset class. In the real estate market, liquid investments through publicly traded REITs respond immediately to changes in anticipated market conditions, while illiquid private real estate investments respond much more slowly after those changes have passed. In fact, there is an average lag of about 18 months between movements in REIT stock prices and the corresponding movement in underlying property values. This happens mostly because of long delays on the private side, first in marketing and transacting properties and then in reporting the transactions and incorporating them into subsequent appraisals on nontransacting properties. But that public-private lag isn't constant over the cycle; it is typically shorter at peaks and longer at troughs, because downturns are much more prolonged in private real estate investments.

As a result, real estate investors have a tactical opportunity to earn extraordinary returns by shifting resources from private to public holdings during the period between the start of a recovery in REIT stock prices and the end of the downturn in private real estate returns. (See Figure 4.) For example, during the real estate market downturn of the early 1990s, publicly traded REITs hit their bottom in late 1990, just as private returns were peaking. Over the next four years, REIT investments doubled in value—with returns averaging 18.6% per year—while investors in private real estate lost 5.7%. Similarly, in the current downturn, publicly traded REITs hit their bottom at the end of February 2009 and have started what is widely expected to be a prolonged bull market, while private real estate values aren't expected to hit bottom until approximately 2012.

Diversification

In the context of managing a plan portfolio, no understanding is more important than that of the power of *diversification*. To boil all of investing down to its essentials, you simply cannot expect to systematically achieve higher returns without accepting greater risk (or greater volatility)—except through diversification. Borrowing money, for example, boosts returns only to the extent that it boosts risk. There is no "free lunch" in financial engineering; the only free lunch in all of investing is through diversification.

Plans achieve diversification by having significant holdings in assets whose actual returns don't move closely together. Mostly, that means holding assets whose values respond to different macroeconomic forces, even if those macroeconomic forces influence each other. For example, returns on most stocks reflect corporate earnings, which respond primarily to the health of the overall economy. Bond returns respond primarily to interest rates—which are, of course, influenced by the overall economy, but are different enough that stock returns and bond returns have a low correlation, meaning that they provide diversification.

Similarly, domestic and foreign stock holdings provide diversification because—although economies are increasingly tied together—economic activity differs enough across countries so that corporate earnings, and therefore stock returns, also have relatively low correlation. Real estate returns respond to conditions in the real estate economy—which, although related to the overall economy, runs according to a different cycle of about 18 years. So real estate, too, offers important diversification benefits.

It's important for fiduciaries to understand that diversification benefits arise from how asset returns are earned, not how they're measured and not how they're accessed. If a portfolio consisted of two privately held real estate funds, holdings would obviously not be diversified. If one of those funds were taken public, the holding might be listed as "stock market" rather than as "private equity" but would be otherwise unchanged, even if the returns on the privately held company were reported differently from those on the publicly traded REIT.

On the other hand, by holding both private and publicly traded assets, investors may be able to find a diversification benefit within the same asset class by taking advantage of differences in the responsiveness of private and public assets to the same market forces. (See Figure 5.) This is certainly true in the real estate market, where investors can realize a diversification benefit because differences in liquidity create a lag between returns from publicly traded REITs and from private real estate.

Conversely, just because two holdings are accessed through the stock market does not mean that they are highly correlated. For example, the correlation between the broad stock market and publicly traded REITs—that is, real estate investments accessed through the stock market—is only about 50%. That means that U.S. REITs provide good diversification against a U.S. stock portfolio, even though they're accessed through the same market.

The bottom line: A well-diversified portfolio must include assets in at least the four fundamental asset classes—stocks, bonds, real estate and cash. It should probably include international as well as domestic assets, but can also benefit from intra-asset-class diversification with both private and public holdings.

Building a Foundation From the Seven Pillars

An investment portfolio built with respect for the seven pillars of wisdom can provide the basis both for rebuilding ravaged portfolio values and for rebuilding trust among plan beneficiaries. Strong returns, evaluated using sound judgment, are of course critical to meeting long-term benefit obligations.

Effective governance and monitoring align the interests of investors with their investment counsel, providing better returns without leaving plan sponsors to clean up reckless investment decisions. Transparency ensures that benefit plan sponsors are aware of the investment decisions being made using their capital, while liquidity provides them the means to take action to protect their investments. The long-term investment characteristics of private real estate and publicly traded REITs vividly illustrate the importance of these differences in returns, governance, transparency and liquidity.

Concerns about impending inflation can be hedged using allocations to the classic effective hedging instruments of real estate, commodities and TIPS. The three asset classes differ in their particular investment return characteristics, so a prudently hedged, inflation-protected portfolio will probably include allocations to all three.

Plan sponsors with an understanding of the differences in market cycles, as well as the responses of different assets to those cycles, can employ discretion to make tactical adjustments in their asset allocations. The current market environment in commercial real estate presents a very strong opportunity to overweight an asset with extraordinary near-term prospects while underweighting an asset with poor near-term prospects. The fact that this tactical opportunity exploits the difference between public and private exposures to the same asset class makes it more likely that the savvy tactical investor can find advantage in a lead-lag relationship that other investors may overlook.

Finally, an understanding of diversification puts the most powerful tool in all of investing in the hands of the plan sponsor. The effectively diversified portfolio will have significant strategic allocations to all four fundamental asset classes—stocks, bonds, cash and real estate. It will take advantage not only of superior performance and tactical opportunities but also of long-term diversification opportunities within each asset class.

Portfolio managers will note that the importance of diversification often implies trade-offs. In real estate, for example, plan sponsors will generally want to have holdings in both public and private exposures. Although publicly traded REITs have consistently provided stronger returns than private real estate investment managers, the long lag in returns between publicly traded REITs and private real estate investments creates a diversification benefit that all-public or all-private investors cannot attain. **B&C**

Endnotes

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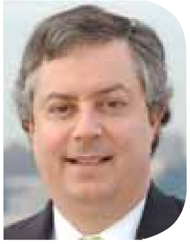

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