Building on Real Estate

BY SIMON SEGALL

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Pension funds have had a rocky relationship with real estate. In the early 1990s, Canadian pension plans had, on average, almost 7 percent of their assets invested in real estate. But by the end of 2005, this percentage had fallen to less than 4 percent. In truth, for most pension plans the figure is much lower—large plans have much higher weightings, such as the 13 percent of the Ontario Teachers’ Pension Plan that is invested in real estate, so medium and smaller pension funds have little or no real estate exposure anymore.

It seems that many pension funds have ignored Mark Twain’s dictum: “Buy land, they’re not making it anymore.” To some extent, low use of real estate can be traced back to the real estate bear market of the early 1990s, coupled with the low liquidity of direct real estate holdings. Plans holding real estate directly, or using pooled funds that directly own real estate assets, found themselves trapped in investments that were not meeting their needs. Bad memories linger.

This is unfortunate, as real estate has investment characteristics that are very suitable for pension plans. Fortunately, there are now more ways to invest in real estate than to simply buy buildings. Interest in real estate investing is growing sharply as Canadian pension plan sponsors become aware of these approaches as part of a resurgence of the asset class.

Why Real Estate?

When pension fund managers consider investing in real estate, they are generally considering income-producing properties: shopping malls, office buildings, warehouses and industrial space, rental apartment buildings, and so on. As an asset class, these properties have a number of characteristics that are attractive to pension plans.

Because of the focus on rental properties, real estate investing generates strong cash flows for the pension portfolio. Furthermore, these cash flows tend to be quite responsive to inflation, providing an inflation hedge for the pension fund. Real estate is relatively lowly correlated with the main asset classes of equities and bonds and thus provides diversification. And finally, over the longer term real estate has historically delivered competitive returns.

As a result of the first two characteristics—cash flow generation and inflation hedging—real estate is a natural liability-matching asset for pension funds.

Types of Real Estate Investment

Unfortunately, direct real estate ownership also has a number of drawbacks. Properties must be managed, which can prove both costly and onerous for a pension fund that owns and operates its own real estate. In addition, purchasing commercial properties can require sizable investments, making it very difficult for the average pension fund to own a diversified portfolio of real estate holdings directly. Consequently, pension plans that own real estate directly typically do so through managed pooled funds or similar vehicles rather than by owning individual properties outright.

Even in pooled form, direct real estate investing may involve lower liquidity than the more familiar equity or bond pooled funds, as the pool itself may not always be able to raise cash at will by selling a holding. Furthermore, real estate properties are not valued in a daily bid/ask marketplace but are valued by appraisal on an annual basis, so interim asset values are smoothed interpolations that are not necessarily an accurate reflection of the true market value of the holdings. While there may be some benefit from an actuarial perspective when an asset class is automatically smoothed, the gap between the stated value and the actual value of a property can be problematic for the pension fund when the property is sold or reappraised.

Fortunately, pension funds seeking exposure to real estate are not limited solely to direct investment. There are three other ways to invest in real estate: by investing in publicly listed units of real estate investment trusts (REITs) and/or publicly listed shares of real estate operating companies; by investing in private commercial real estate debt, such as loans or mortgages, either individually or through pools; and by investing in commercial mortgage-backed securities available on public markets.

At this time in Canada, the resurging interest in real estate investing is mainly focused on the first of these alternative approaches: so-called indirect real estate investing by investing in portfolios of publicly listed units of REITs and publicly listed equities of real estate operating companies.
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Indirect real estate investing offers the key characteristics of direct real estate ownership. For example, the historical dividend yield of the Global Property Research (GPR) 250 Net Index, a globally listed real estate index, has averaged more than 4 percent per annum since the end of 1989.

In addition, over the past five calendar years globally listed real estate (represented by the GPR 250 Net Index) gained 12.3 percent per annum in Canadian dollar terms, while the S&P/TSX Capped REIT Total Return Index gained 20.2 percent per annum and the S&P 500 Total Return Index turned in a measly 0.5 percent per annum (in U.S. dollars), the direct and indirect real estate returns over the past five calendar years were definitely appealing.

Finally, over the 10 years ending June 30, 2006, the correlation of monthly returns of the GPR 250 Net Index with Canadian equities (S&P/TSX) was a low 0.36; with Canadian bonds (SCM Universe) it was an even lower 0.11; and with global equities (MSCI World) it was a still-modest 0.44 (all in Canadian dollar terms). Thus, like direct real estate ownership, indirect real estate investing is also a powerful diversifier for Canadian pension portfolios.

Indirect real estate investing offers the key characteristics of direct real estate ownership. At the same time, because indirect real estate investing involves owning a portfolio of publicly listed equities and REIT units, the usual beneficial characteristics of equities also apply—these securities are liquid, continuously valued in a bid/ask marketplace, and subject to the transparency and reporting requirements of the listed equity markets. Capital requirements are minimal and lock-up requirements are nonexistent.

Finally, indirect real estate makes it much easier for institutional investors to obtain broad diversification across geographic regions and real estate industry sectors. Diversification in this fashion is as easy as diversifying in general equities, but is even more gratifying from an investment perspective due to much lower correlations between the property markets in different countries. As an example, based on MSCI country indices and the country components of the BPR 250 Index (all in local currencies), the correlation between general U.S. equities and French equities was a high 0.87 over the five years ending May 31, 2006. Contrast this with the listed real estate correlation of a modest 0.46 between the United States and France over the same period and the greater diversification effect in global real estate securities becomes clear. It is also not surprising due to the local nature of the real estate industry.

While long-term results from indirect and direct real estate are similar, the different valuation environments for securities and for buildings mean that the short-term volatility of indirect real estate can be higher than that of the smoothed values of direct real estate. Over the long-term, these differences in risk/reward characteristics disappear, according to numerous academic and practitioner studies.

As with equity investments, indirect real estate securities are also subject to the vagaries of the management teams of the companies or REITs that issue them. REITs may also employ leverage in their business operations, which poor management can turn into a serious problem. As a result, the managers of indirect real estate portfolios must conduct the same intense scrutiny of each potential holding as an equity manager would be expected to do, with specialty knowledge of the real estate business being a critical additional requirement.

The research process can be further complicated for global portfolios by the fact that real estate is not so much a global asset class as a “multilocal” asset class—most real estate companies and REITs operate in local or national markets rather than globally. Thus, the portfolio managers and analysts must be able to conduct their investigations all around the world.
What are Pension Funds Doing?

Because of the beneficial characteristics of real estate from a pension plan perspective, and because of disappointing results at times this century from the more common asset classes, Canadian pension funds have been turning their attention back to real estate over the past 12 months.

This reassessment has also been stimulated by new asset/liability studies that were conducted largely as a result of the elimination of the Foreign Property Rule (FPR). And in turn, the end of the FPR has encouraged Canadian plans to consider real estate from a global perspective as well as from the traditional Canadian viewpoint.

Currently, it appears that many Canadian pension funds are planning to increase their real estate exposure by adding a global indirect real estate portfolio to their existing Canadian direct holdings.

By adding a global indirect real estate portfolio to Canadian direct real estate, these pension funds are obtaining the benefits of both kinds of real estate investing, while still ensuring that part of their real estate income stream is denominated in Canadian dollars to help match their Canadian dollar pension payments.

In this way, these plans are demonstrating that there are roles for both direct and indirect real estate within a properly constructed Canadian pension fund.

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