

# Filling the Basket

## Fund of Funds Managers Construct Diversified Portfolios

Interest in real estate fund of funds investing is on the rise in the United States, offering a way to invest in a greater number of real estate private equity funds while limiting the number of manager relationships juggled by an already overextended staff.

"The fund of funds universe in real estate is relatively new, compared to the hedge fund or private equity fund of funds universe," says Ed Casal, CEO of Madison Harbor Capital, a real estate fund of funds manager.

Globally, real estate fund of funds investing has really taken off. According to Maarten Thissen of Kempen & Co., a private placement firm based in the Netherlands, there is not a huge difference between real estate funds of funds in the United States and European funds of funds. The focus is "in general, diversification," says Thissen.

### DIVERSIFICATION EQUATION

In addition to the benefits of sourcing, screening and selecting the managers most prepared to execute attractive strategies, a fund of funds manager should construct an investment portfolio that offers superior diversification. "In our view, geographic regions have their day. ... Property types have their day, too," says Casal. "We strongly believe you have to diversify across a number of elements including geography, property type, strategy and manager. If anything goes wrong along one element, at least it's not hitting all your dominoes. If a particular sector or strategy outperforms at least you're capturing upside exposure."

Fund of funds managers use a variety of approaches to build a portfolio, but most focus on achieving diversification and risk-adjusted returns. Many fund of funds managers argue that it is more important to look at an investment fund's strategy than its "name recognition."

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### Executive Summary

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- ◆ **Similar to a mutual fund, real estate funds of funds provide diversification for investors.**
  - ◆ **Fund of funds managers conduct the due diligence, make the investment decisions and serve as fiduciaries.**
  - ◆ **Fund of funds can invest in pooled funds that are allocators or they can invest with local operators that have specialized expertise.**
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"There are two general categories of underlying funds — operators and allocators," says Casal. "A big name fund might be an operator or an allocator, and a no-name fund might be an operator or an allocator." Casal says he'd prefer to be as close to the real estate level as possible, while still achieving diversification. "All things being equal, I'd rather invest with an operator," adds Casal.

"Brand name" funds are less important in the real estate investment industry than in other alternative asset classes, where funds of funds can offer access that investors might not otherwise be able to achieve, notes Casal. "In the hedge fund world, the focus is on getting in with the big funds. ... [The funds of hedge funds] are selling access," he says. "In real estate, you don't have that many funds that are closed to new investors." Out of Madison Harbor's database of more than 400

funds, Casal says he can count on one hand the number of funds that would be "really hard" to enter for an investor with \$20 million.

"Some funds of funds like the household name approach. We try to look much broader," says David Sherman, president of Metropolitan Real Estate Equity Management (MREEM). MREEM recently closed its seventh real estate fund of funds; the firm now has raised five funds to invest in the United States and two to invest internationally. To date, MREEM has closed more than 75 fund investments with more than 40 managers.

"You don't need to get in big funds to get diversification," adds Sherman. "You can also create great diversification by pairing with local operators."

AVP Advisors, which raised a \$400 million fund of funds with a companion \$230 million co-investment vehicle, also focuses on investments with smaller real estate operators. "We are the conduit between institutional capital and entrepreneurial expertise," says Susan Barlow, managing principal at AVP. "We provide institutional capital to those entrepreneurs and, hopefully, get a higher return," adds Barlow.

### LIFTING THE BARBELL

Real estate funds of funds have found favor with all kinds of investors. Institutional investors in funds of funds tend to follow a barbell pattern, notes Casal. Small pension funds might invest in a fund of funds because they would find it difficult to build a diversified portfolio on their own. "They can invest their \$10 million and get 15 different investment managers," says Casal.

A larger pension fund with an allocation to real estate of \$200 million to \$500 million and a dedicated real estate staff member may be capable of crafting its own diversified portfolio.

"What I think is new is that some very big — really big — pension funds are starting to consider funds of funds," notes Casal. He argues that the largest pension funds have huge amounts of capital but staffs that may be only slightly larger than mid-sized pension funds. With most institutional investors preferring not to invest more than 10 percent to 25 percent of an underlying fund's total equity, commitment of very large amounts of capital would require an extremely large staff to effectively underwrite and asset manage a large number of investment manager relationships. "In practicality, this limits the largest pension funds' ability to invest in the sub-\$1 billion funds — the vast majority of the real estate private equity fund universe," notes Casal.

According to Sherman, MREEM's approach is particularly appealing to mid-sized institutions, although recently it has received an increase in interest from larger institutions with multibillion dollar portfolios. One-third of MREEM's capital comes from high-net-worth individuals, and two-thirds comes from institutions, including endowments, foundations, and corporate and public pension funds. Sherman describes the typical investor in one of MREEM's funds of funds as a \$500 million college endowment with a 5 percent allocation to real estate. With only \$25 million to invest in the asset class, most institutions of that size can't keep a full-time real estate investment officer on staff. "Somebody's got to go pick managers," says Sherman.

Barlow also points to the difficulties of handling multiple manager relationships. In recent years, plan sponsor staffs have been managing more relationships with investment managers. According to *Tax-Exempt Real Estate Investment 2007*, a survey conducted by Institutional Real Estate, Inc. in conjunction with Kingsley Associates, the number of relationships managed by plan sponsors has steadily increased, from six relationships per staff member in 2001 to nearly 11 in 2007. Institutional investors have increased the number of investment managers, but staffing has not kept pace. This may be why even large institutions like having a gatekeeper to look over the many opportunities and make selections.

"Our product is marketed to public pension funds," says Barlow. AVP's first fund targeted large public pension funds, which "get flooded with potential opportunities," says Barlow.

Oftentimes, public pension funds' investment criteria prevent them from looking at managers without an extensive track record of institutional fund investing. But while a pension fund may not be able to invest with a first-time fund, they can invest in those opportunities through a fund of funds manager. "We are there to act as a fiduciary," notes Barlow.

AVP currently targets emerging managers and first-time funds. In the future, AVP will add products to appeal to smaller institutional investors. Barlow says diversified portfolios for small pension plans are "a very viable product and much needed."

### OPERATOR INSTRUCTIONS

In many ways, fund of funds managers are looking for the same things that plan sponsors and consultants are looking for when selecting managers for their investment dollars — track records, alignment of interests, ability to add value.

One difference is that CIOs have so many different demands on their time that evaluating hundreds of emerging or niche investment managers is way down at the bottom of their list, while it is a top priority for fund of funds managers.

Sherman says MREEM currently is looking at two different types of investment manager — focused specialists/operators and distressed opportunity players — with different investment criteria for each.

When evaluating real estate operating companies, MREEM looks for "people who really understand value," says Sherman. MREEM will examine the previous one to three years of an operator's history, looking at a large number of recent transactions. In addition, Sherman is looking for a firm with "squeaky clean documents," a "deep track record" and "relatively moderate fees."

Like MREEM, AVP's strategy is to target real estate operating companies that have a niche strategy and are very good at what they do, notes Barlow. She says AVP tries to "find the best of those operating partners." AVP's principals bring a real estate

operating perspective to the due diligence process when evaluating a firm's experience. "We're able to identify which track records are a result of value creation and which are market-driven," says Barlow.

Casal believes it also is key to "really delve into character issues," when choosing real estate operators with which to invest. "When we're selecting our managers, their personal character and past behavior is very important to us, particularly in this turbulent investing environment," says Casal.

Investing in specialized or niche real estate funds also requires the investor to make a market call, notes Sherman. If a particular property type or geographic region is poised to underperform, then it makes sense to avoid investing with operators focused on that region or property type, no matter how skilled the operator may be.

### PENNY FOR YOUR THOUGHTS

One of the reasons investors may hesitate to sign on to a fund of funds is concern about an additional layer of fees — in addition to fees paid to the underlying investment funds, the fund of funds manager also takes a cut.

"It's an extra layer of fees, but it reduces your cost relative to doing it for yourself," argues Casal. He compares fund of funds fees to those charged by mutual funds or other investment aggregators.

The skill of the fund of funds manager can really matter. According to Sherman, "the difference between the best underlying funds and average underlying funds more than makes up for the fees."

The fund of funds "is a fantastic structure if there's really value added," Sherman adds.

"I'm very passionate about the fund of funds business and its value to institutional investors," says Barlow. As someone who came to multi-manager investing from the consulting side of the business, she draws a distinction between consultants and fund of funds managers. "We are fiduciaries, we have discretion, we make the investment decision, and we are accountable for it," she says. ♦

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