Practical Strategies for Managing Risk
and
Adding Value to Your Portfolio

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As a real estate consultant, our clients often ask us how they can manage the risk inherent in their real estate investment portfolios. Almost as frequently, our clients also ask us to help them find ways of adding value to their real estate portfolios. More often than not, these questions are raised at the beginning of a relationship. They are good questions, however, that should be revisited regularly in light of the continuing evolution of the real estate industry.

We note that today, the investment universe is far more complicated and sophisticated than when real estate was first added to many plan sponsor portfolios. Today there are over 130 investment managers and 180 investment offerings; at least four definable real estate sectors (stable, enhanced, high yield and public securities); debt and equity oriented (domestic and international); public/private partnerships and investments with either an operator or an allocator of real estate capital. Real estate investing has become increasingly complex and requires heightened levels of sophistication.

In addition to this higher degree of complexity and sophistication, far more tools are available to construct a portfolio that meets a specific risk tolerance. Thus, the number one suggestion below applies both to risk management and adding value, and it bears repeating several times: *an investor today can add much more value to its overall program, and better manage its risk, by top down strategic planning and developing clear investment guidelines, benchmarks and processes to achieve the strategy and measure the value generated*. It is not enough to build your program from a bottom up approach of picking the best properties or best managers. Other suggestions below also follow from a top down approach to investing. If you were looking for more specific suggestions (e.g., investing in long term leased buildings today in order to bridge the gap of near term market weakness), then you will be somewhat disappointed.

The following paper briefly highlights a few practical strategies that an investor can adopt to both manage risk and add value:

1. ***Top down planning is critical to both managing risk and adding value***. There is no single other step an investor can take, in our opinion, that can add more value than thinking from the top down about the program. Conversely, the failure to bring into the investment process a top down approach, again in our opinion, increases the possibility that over time the program will have more risk than desired or necessary to accomplish the strategic goals and objectives for real estate. This is a simple concept, but one that is often overlooked in the effort to create a real estate program. Top down planning serves as the fundamental building block for the portfolio and its construction.

Why is it even more important today to have strategic top down planning? The answer is related to the evolution of the real estate industry over the last 15 years, which has brought an explosion of products and vehicles to the universe. Today, more so than a decade or more in the past, an investor has a wide range of choices available for it to build its real estate strategy and construct its portfolio. The choices made today can have major implications for the overall performance and achieving investment objectives.

These choices arise from the growth of investment options initially in response to the real estate markets in the early 1990s (the rise of the so-called opportunity funds and the public equity and debt markets), and have expanded as capital markets have become increasingly global in nature.

The investment model for success in today's more complicated world must go beyond the models derived when the real estate investment world was much simpler. Previously, investors could choose domestic core equity open end or closed end funds, or, if larger, a separate account. Approximately 25 managers controlled 70% of the real estate investment assets and 15 managers controlled 50%. Most value added came from property selection by the manager, and manager selection.

As noted above, there are a huge number of investment managers, pooled fund offerings, and myriad investment styles for institutional investors today. Real estate investing has become increasingly complex and requires heightened levels of sophistication. It also requires a new model that takes into consideration the wide range of choices available today to an investor to develop a suitable real estate investment strategy and construct a portfolio.

Practical tip number one: take the time up front (and periodically thereafter) to think strategically about your real estate program. More value comes from top down decisions about how you allocate risk and return than from investment selection (either by property type or manager), yet many investors spend a disproportionate amount of time on investment or property selection and little time on strategy development.

2. ***Articulate a clear understanding of investment objectives***. This is another simple concept but it is surprising how often investors do not apply it to their own programs. While many investors have established some benchmarks and other investment goals, not all have worked through those in sufficient detail to identify a reasonable set of objectives that will be used to measure the effectiveness and successes of an investment program.

The objectives can cover a number of important topics that affect both risk profile and the ability to generate returns. The objectives include those related to the level of return needed for the real estate program to be successful (is it a 5% real? 15% nominal? Match or exceed an index or benchmark?), as well as its characteristics (how much return is required as current income to pay liabilities or provide other cash flows? How much of the return can be more speculative in nature, including its magnitude and timing?). How important is being well diversified in your program? Are you willing to take concentration risk, or be absent or significantly underweighted to a sector, in order to generate higher expected returns? These issues all will affect how you build your program (e.g., allowing for a component of net leased investments or operating properties that generate high current income returns, or allowing for some portion of the portfolio to be invested in appreciation oriented investments), and where risk is taken or mitigated in the real estate program (e.g., a stable foundation with little risk and discrete risk allocations for alpha).

Another large issue for establishing objectives is the role of real estate in the portfolio and how it is measured. Is it a traditional role, of diversifying total plan assets and serving as a hedge to unexpected inflation? Or is it a source of alpha for the entire portfolio, taking advantage of the private and relatively inefficient nature of the asset class? Is the role of real estate measured on a portfolio basis, i.e., what does real estate do for the total plan assets? Or is it measured on a stand-alone basis, *i.e.*, what can I do with my real estate portfolio separate from other asset classes? The answer to these questions, in our opinion, also will affect how you construct a program and the level of risk sought relative to the expected return.

We suggest these issues should drive a significant amount of the planning and construction of an investor's portfolio. For example, if liquidity and the best risk adjusted return from the real estate portfolio are important drivers, these may suggest either a strategic or tactical allocation to the public real estate securities markets. These factors may suggest a fairly sizable component of the portfolio be allocated to relatively low risk, stable income producing investments to establish a foundation, and the portion of the portfolio where greater risk is taken be limited or fall within a range (or maximum percentage) of the portfolio.

Within that riskier component, the investor may further break out the portfolio between higher and lower risk elements (e.g., enhanced return or value added investments versus high return strategies), or an investor may set aside some percentage of its portfolio that is relatively free from any constraints in order to enhance total expected returns.

Although many tools exist to help an investor plan its portfolio, one tool Townsend uses is a customized asset allocation model and other proprietary analytics tools that use historical and projected risk and returns from various sectors and asset classes. The output can be a range of allocations between the private and public markets, and within the private markets allocations by investment style or risk category.

These tools (and others) and their results are not the answers *per se*, but they do provide outputs that allow for a disciplined (and somewhat quantitative) basis to evaluate the issues and to help identify constraints and other parameters for strategic planning. The end results should be an allocation of the real estate program by risk and return expectations consistent with the level of desired return and other major attributes, and a basis to clearly measure in the future how your portfolio is constructed and performs relative to this standard.

Practical tip number two: use these major objectives as a principal guide to portfolio construction, including making longer term allocations of the portfolio to various levels of risk and/or return. Stick to those longer-term allocations unless you have developed a tool to make tactical decisions within permissible ranges, and measure the results of such tactical decisions regularly.

3. Identify other risk management objectives that are important to you as an investor and understand the impact it may have on your choices. Item 2 above identified many of the more important issues involved in establishing the overall investment objectives for a real estate program. Other objectives could be important in assessing how much risk an investor is willing to take. We explore a few in this section.

Most of these other objectives relate to issues of investment control, liquidity, investment time horizon, Staff and Board resources and time, and in some cases, other specific investment objectives (e.g., foster growth of employment opportunities for beneficiaries). Other issues include the more subjective question of what happens if you underperform your benchmark? How does that result compare to the result of outperforming your benchmark? If these are not symmetrical (and rarely do we find they are), then that information is important in setting overall portfolio risk as well.

Answers to some of these questions can impact the investment vehicles and choices from which you can build a portfolio. For example, if control over the manager, the actual assets and operational aspects is very important, then the investor may want to use a separate account investment vehicle wherever possible. A joint venture vehicle may also be useful, but it may not offer the same degree of control and may introduce other risks. The separate account or joint venture investment vehicle may be a good choice from a control perspective, but it has its own limitations. One of the largest is trading off control over diversification. The investor must ask if there is sufficient capital available to invest using this vehicle that will allow it to obtain an adequate level of diversification, or to access the segments of the market that will accomplish other objectives? If not, are you willing to accept a higher degree of asset specific risk or not fully eliminate most non-systemic real estate risk?

If liquidity is important, that may suggest a variety of options, ranging from public markets components, property types, and market selection. What is the preferred time horizon for investments? If you need to recycle investments and generate results over shorter measurement periods, then do you place any capital in longer-term strategies in closed end funds? Are there sufficient staff time, resources and expertise to monitor multiple investment managers, particularly those where the investor retains some degrees of control? If not, what is the risk of keeping such control rather than delegating it away to a qualified party? Does it affect manager selection? The mix of these other objectives can have a fairly significant impact on portfolio construction and thus risk and expected return.

Practical tip number three: use these objectives as a guide to fine-tune the most desirable portfolio construction, including investment vehicle selection. Among what appear to be equivalent risk and return investment options, select those that meet the other investment objectives related to control, liquidity, investment time frame or similar objectives. Reassess if these remain important objectives regularly, or at least periodically.

4. Design a strategy that is matched to the defined objectives. If an investor follows this advice and takes the time to walk through the first steps listed above, it seems logical that the strategy selected by the investor will match the objectives and risk profile. Usually that is the case. Allocations are made across risk sectors that are consistent with the overall program risk and return objectives, cash flow needs and risk tolerance; the best investment vehicles that meet other needs are chosen; and the Board and Staff have the time, resources and expertise to implement these strategies.

Sometimes, however, that is not the case. The reasons for differences vary. For example, one objective (e.g., a need for a higher level of return) may conflict with another objective (e.g., extremely limited tolerance for downside performance risk). As is more of then the case, however, the objectives for the portfolio or program evolve over time (and changes in personnel) and the portfolio does not.

Even if one builds a strategy that matches the defined objectives, sometimes the portfolio suffers from “mission creep” that individually does not create apparent undue risk, but overall, when combined with other areas of creep, it leads to a higher degree of risk than intended. For example, an investor hires a firm to execute a specific value added strategy. It does a superior job of executing this strategy, and so the investor looks to use their skills in another related area. This works as well, so the investor is receptive to yet another strategy that appears to be consistent with the firm’s skill sets and capabilities. The net result may be that each incremental expansion of the mandate makes sense, but overall the portfolio may inadvertently have greater risk than intended, unless the investor carefully tracks the amount of capital allocated to each bucket.

Other tools that many investors can use in moderation can also create more risk than intended in a portfolio. Leverage is one such tool. Leverage can both increase the expected risk of the portfolio (volatility, default, refinance, etc.) and also enhance the expected return. In certain environments, such as today, it may be extremely attractive to use very low cost debt to enhance both cash flow and total returns. It would be easy, however, to attempt to utilize even greater levels of leverage because of current market conditions and then make the incorrect assessment that level of risk inherent in a portfolio limited to 50% loan to value is only slightly greater than one limited to 40%.

This leads to practical suggestion number four: it is important to conduct a periodic assessment of the goals and objectives in order to ensure they still reflect the current preferences and thinking. It also suggests that an investor should build into its investment and management processes a defined, regular means by which it undertakes this exercise periodically to ensure that the strategy still works relative to the objectives and the market conditions.

5. ***While planning is important, be flexible and allow innovation.*** The foregoing all suggests that one of the most important means of establishing risk controls and adding value is a relatively high level of strategic or top down planning. We also suggest that implementing a program consistent with the program goals and objectives also is important to success.

This does not suggest that an investor should not be flexible and allow evolution and innovation. What is important is to make those decisions in the context of the top down planning that drives the total program. Particularly in real estate, one of the inefficient asset classes, we believe it is important that investors allow the flexibility to have its program evolve as does the market, the skills and capabilities of the Staff and the investment managers. In fact, the goal is to be proactive and most investors seek to anticipate those types of changes and position a portfolio to take advantage of superior information and planning. Don't be wed to a single strategy and let your experience help guide the development and implementation of a strategy over time.

This leads to practical suggestion number five: periodically revisit the strategies and implementation of those strategies. Be open to new ideas, new techniques, new tools and other means to improve performance or reduce the risk of your program. Be disciplined in your thinking and approach, but be flexible and practical in assessing what works and whether it should be modified or changed.