
**UNDERAPPRECIATED RISKS IN TODAY'S
INSTITUTIONAL INVESTING
ENVIRONMENT**

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The Townsend Group
Institutional Real Estate Consultants
Cleveland, OH Denver, CO San Francisco, CA

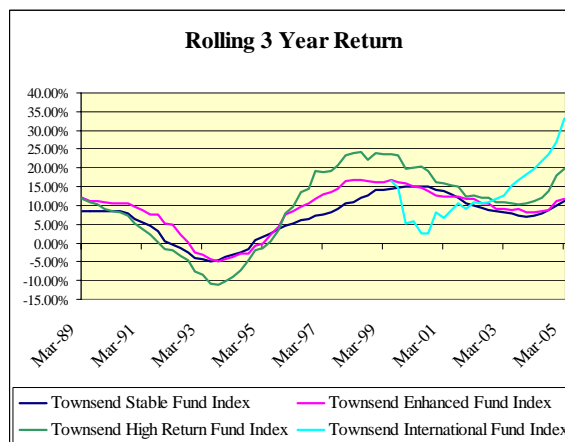
Institutional investors in real estate have enjoyed a relatively favorable environment for most of this cycle, coming out of the depression of the early 1990s with a strong economic and real estate recovery. The last five years have been a period of unique circumstances, with strong capital flows to the asset class supporting increased pricing and valuations during a period of weak and slowly recovering fundamentals. Given this unique set of circumstances, one of the biggest risks facing institutional investors is whether current pricing is sustainable. Many articles have been written about this topic, but that is not the nature of the risk addressed in this article.

This article raises a few areas that I will call “underappreciated” risks facing institutional investors. I believe these risks have the same potential to create poor results for a number of investors today, but they may not be receiving the time and attention they should. These risks broadly relate to (i) the potential underestimation of the volatility of returns in High Return investing¹ due in part to high levels of leverage in what has been a low interest rate environment, (ii) a focus on gross expected returns when an investor evaluates High Return investments, but not the net return after all fees, costs and carried interests, and thus not clearly determining if the investor is realizing an appropriate risk adjusted return, and (iii) the level of due diligence in selecting international investments and underwriting global investment managers.

The Masking of Volatility

One of the major investment trends over the past decade has been the investment appetite for real estate “opportunity funds” and more broadly, High Return real estate funds. These are pools of risk capital aimed at taking advantage of the investment opportunities then available in the market. Most opportunity funds have broad investment mandates that make them challenging to underwrite. However, a common feature is the use of relatively high levels of leverage—generally 75% loan-to-value or higher (or a 3:1 ratio of leverage to equity).

The recent performance of the real estate asset class has been very strong, including the High Return funds. I would argue this strength has masked the actual volatility in the High Return funds. The chart below illustrates performance for Stable, Enhanced and High Return funds (core/value/opportunistic) over the past 15 years, as measured by rolling three year time weighted returns.



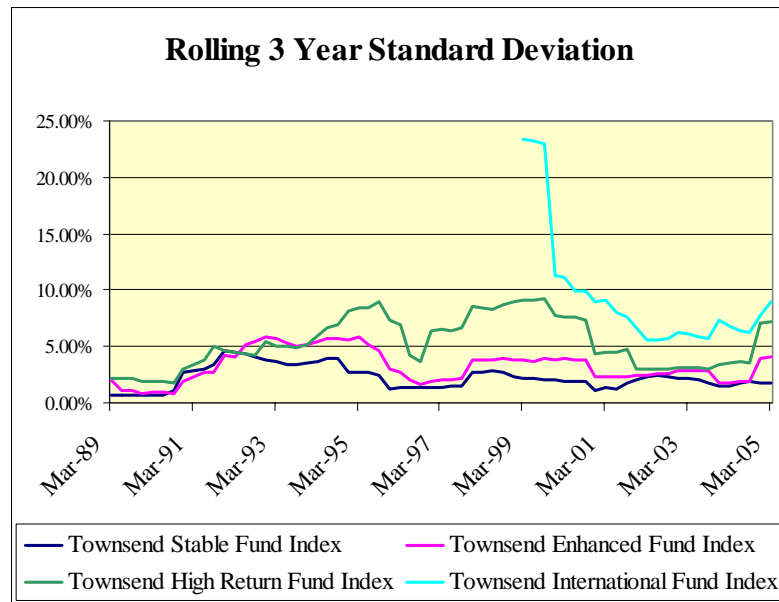
¹I use the term “high return” to encompass both so-called “opportunity funds” as well as other forms of higher risk/return investing, such as taking on risks arising from engaging in new development or substantial redevelopment, international investing, Brown-field redevelopment, leveraged structured finance and such other forms of real estate related investing that may not fall into the rubric of an opportunity fund.

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High Return funds (in green) performed very well coming out of the trough of the early 1990s, peaking near 25% in 1999. The bursting of the technology bubble, the US and concurrent global recession, September 11th and the Afghanistan and Iraq wars that followed, and SARS, all resulted in falling investment performance across all types of real estate generally from 2001 to 2003, as shown above. The drop in the High Return investments—represented by the High Return Fund Index in green—was the greatest in terms of percentage from its prior peak in 1999, but was surprisingly mild in terms of absolute returns. A fairly strong recovery began in 2004 that has been most dramatic in the High Return (green line) and International (blue line) investments tracked by these indices. This is a far different result than the crash in the early 1990s, when High Return funds posted negative returns for multiple periods.

What made this trough relatively shallow? The answer is capital flows—not the recovery in fundamentals. The Federal Reserve pumped liquidity into the financial markets to stimulate the U.S. economy, and Congress passed President Bush's tax relief legislation. These factors have helped to generate positive GDP growth since 2002. Unfortunately, job growth has been fairly weak during this economic recovery, and demand for real estate and positive absorption has been slow to return in the United States (and in Europe). However, the strong flows of capital to real estate commencing in 2002 and strengthening in 2003, 2004 and year-to-date 2005, have bailed out many of these funds. Much of that capital has been facilitated by an accommodating monetary policy.

The fact remains that High Return and International investing is much more volatile than domestically-oriented Stable (core) and Enhanced Return (value added) investments. The underlying investments in High Return funds are inherently less stable in their return profile than are stabilized income producing, fully occupied investments. This is shown in Exhibit B below.



According to our data, over the last ten years High Return funds have an annual standard deviation of 7.1% (measured on a rolling basis) almost double the standard deviation of the Enhanced Return funds (at 3.6%). The High Return funds have more than three times the volatility of the Stable Return funds (at 2.3%).

Leverage is part of the source of volatility, but so are the underlying risks these funds take to generate their higher returns.

Given the volatility of the underlying investments, it is surprising how few "crashes" there have been over the past 10 years (e.g., funds that have negative returns or barely positive returns) in light of the economic and political events that have occurred over that period. I suggest we should consider our asset class fairly lucky during this period. It would not be prudent to expect this will continue indefinitely.

We are concerned that this confluence of events may create a false sense of complacency about the risks inherent in high return investing. When an investment has a 3:1 or 4:1 leverage ratio, investors should be sensitive to the potential volatility in the investment, regardless of whether it is real estate or any other asset class. Over the past few years, the low interest rate environment has made leverage very attractive, and many funds have increased their use of leverage to take advantage of this situation. We note that leverage works both ways, as it magnifies both positive results (e.g., increases in property valuations driven by declining cap rates) but also magnifies negative results (e.g., falling NOI and decreases in valuations due to rising cap rates).

We are facing some interesting challenges in the markets. Pricing is strong, but fundamentals are lagging. Recent high energy prices, even before the impact of Hurricane Katrina, raised warnings about slower economic growth in the United States. If that occurs, the recovery in the fundamentals—already weak by historical standards—may slow or stall. If the favorable capital markets were to turn away from real estate, the performance we have seen over the past few years could fall to levels more commensurate with the fundamentals—and that could result in much greater volatility in the High Return funds than shown over the past five years. If you add the fact that many of these funds are highly leveraged, investors may feel the downside risks in these investments without the amelioration of increased levels of capital flows.

Net Returns Matter

One of the challenges in assessing the performance of High Return funds over the past ten years has been obtaining comparable, reliable data. One of the most difficult areas to obtain that information relates to understanding the various costs, fees and carried interests associated with these funds. Most fund sponsors understandably focus on gross returns, as they sound more attractive to potential investors. Surprisingly, many investors also focus on gross returns in their underwriting, even though at the end of the day they never realize that gross return.

In part due to the difficulty of obtaining consistent data on costs and fees, I believe that investors are not looking closely enough at the risk-adjusted returns for High Return funds net of all fees. It generally takes considerable scrubbing of the numbers and substantial additional due diligence to determine and evaluate how much of the premium over a core type return is going to the investment manager and its asset management subsidiary, and to the operating partner, to produce that return.

This issue raises two interrelated risks for investors. First, it may lead an investor to underestimate the level of risk inherent in such funds. This happens most often when a fund uses operating partners to source and/or manage underlying investments. In our experience, the fees and costs paid to operating partners usually range from 200 to 500 basis points, depending upon the success of the investment, the nature of the services provided, and the exact structure of the distribution to the partner. These fees and carried interests are typically accounted for at the property level. Thus, if the fund targets a gross 20% IRR, it needs

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underlying property level investments to generate a gross IRR above that 20% in order to bear operating partner costs. Thus, the investment must generate a higher required return at the property level, and that usually comes only from taking on risk. A similar situation often arises when an asset management fee is paid to an affiliate of the investment manager.

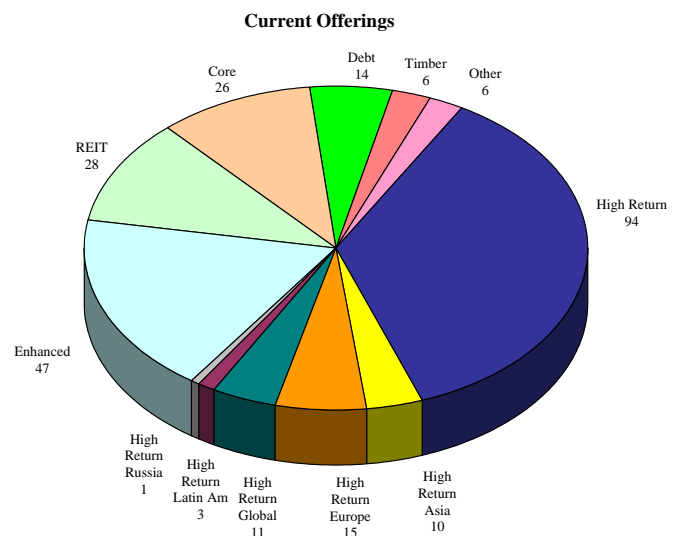
The second risk is that investors tend to bear most of the risk of underperformance in High Return funds, due in large part to the mechanism of the carried interest and its catch-up feature. Today, a standard High Return fund distribution schedule is a 9% preferred return to the investor, followed by a return of the invested capital, at which time the fund manager begins to participate. Most High Return funds have some form of catch-up, and it is typical for it to be 50/50 or even 60/40 in favor of the investment manager until it has received 20% of all amounts distributed. The investment manager's split then usually reverts to an 80/20 distribution in favor of the investors.

If the fund hits its gross return target of 20%, most investors are satisfied with a 16% net return. If the fund underperforms, it is the investors who tend to bear the brunt of that risk. The primary reason is the catch-up feature inherent in most of these funds. For example, if the fund generates a gross return of 15%, the net return to the investor will most likely fall in the range of 11% to 12%, depending upon the specific structure and fees. The fund sponsor still participates in the upside through the catch-up, but because the performance is not as high as expected, it ends up earning a disproportionate amount of the excess return that is actually generated (say 50% of the excess above the 9% preferred return, or 300 basis points).

Thus, it is possible for a moderately underperforming high return fund (e.g., it hits a 15% gross not a 20% gross return) to have a net return that is barely above the net return an investor could have achieved for a lower risk Enhanced Return fund (which tends to have a much lower total fee load as many do not have catch-up provisions), or even leveraged core real estate. In that case, is the reward worth the risk taken to generate the level of actual net results? I would argue it is not.

International Investing Due Diligence

One area experiencing strong recent growth is international real estate investing. The early forms of most offshore investing came in the wrapper of the opportunity fund, particularly as it searched globally for distressed markets, disequilibrium and secular changes that produced attractive returns in the United States. Over time, we have seen a steady increase in the number of funds offered that have either an international focus (exclusively investing outside of the United States) or a global focus (investing some capital in the United States). The current offerings universe includes more than 40 funds investing in either global or international investments, as shown below. This represents approximately 15% of the total universe of 260 funds currently open for investment in our database.



Most of the current international fund offerings are focused on Asia and Europe (25 of the 40), with limited offerings in other regions. The global funds currently comprise 11 or almost 25% of the offshore oriented funds.

While this clearly has been a growing segment of investment for US institutional investors, the task to underwrite offshore funds and their sponsors is immense. In our experience, it demands a considerable amount of resources to fully vet a track record, strategy, operating platform, local partners and all of the other risks inherent in international investing.

A third potential risk that I believe is underappreciated is the generally superficial underwriting that many institutional investors are doing for offshore investments. Some institutional investors are very diligent, and they undertake significant amounts of due diligence when evaluating offshore investments. Other institutional investors, particularly those with limited staff resources, cannot afford to be as diligent when underwriting international or global funds. There are several reasons why this is the case:

The performance results, at the property and the fund level, are generally more opaque than in the United States due to the valuation process, or the lack thereof. This makes gathering the data more difficult, and it presents significant challenges in understanding the results.

Many of these funds, particularly the global funds, have broad investment mandates and strategies which are inherently more difficult to underwrite. This requires the investor to develop an understanding of the markets and how these strategies fit into the opportunity set in that market/region, and to assess whether they are timely in any given market/region. In our experience, that requires on the ground, local intelligence that comes from multiple trips to these markets to obtain a much greater degree of familiarity.

There are structural issues that can be technically sophisticated and require considerable expertise, such as the impact of local taxes (and structuring to minimize the same), currency issues (and the fund's hedging strategy), and unrelated business taxable income (UBTI) issues, to name three. These can require costly experts to sort out and if handled incorrectly can have dramatic consequences to the net returns.

Generally, these funds are investing in a less transparent market than the United States. That usually means that investors have less access to information on their specific investments, the underlying regional or national market conditions and local market conditions, as well as fewer disclosures related to fees, costs, conflicts of interest, etc.

Collectively, these factors can illustrate why a considerable amount of resources are needed to fully conduct due diligence on global investment strategies and firms. Most investors have some constraint on staff resources, whether it is lack of trained or experienced personnel, limited travel budgets to offshore markets, or simply the lack of time to dedicate to understanding these complicated investments. Thus, it is not surprising that some investors have undertaken a relatively superficial level of due diligence in making international and global fund selections.

I am not being critical of these investors; I admire those who have undertaken this challenge. I can appreciate the effort. My firm needs the full depths of the resources we have established (15 consultants and 10 analysts) to be able to stay ahead of the curve on these issues and allow us the time to spend on the

ground in these global markets and develop the requisite expertise. It would be an impossible challenge if our staff were comprised of only a few professionals, which incidentally is the level of staffing in many real estate departments in our institutional investors.

This raises the final risk that I should address, and that is a risk related to the real estate consultant in providing advice to institutional investors. In order to provide the appropriate level of guidance to institutional investors in these three areas, let alone the areas outside the scope of this article (e.g., the public REIT market, CMBS and structured finance investments, domestically focused core and value added investment strategies, etc.), a real estate consultant today needs an unprecedented breadth and depth of resources. The investment universe is simply too big and sophisticated to effectively navigate it with a small number of bright and experienced professionals. To be successful today, a consultant needs to develop the resources that allow it to provide advice on a global basis and stay ahead of a constantly changing asset class.