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While real estate investment trusts (REITs) have been out of favor with the investment community for the past two years, pension funds have remained dominant buyers in the market. Of more than 48,000 pension funds, 200 control more than 70 percent of total assets.

Pension funds invest employee contributions and matching employer contributions in a portfolio of stocks, bonds and real estate to provide retirement funds for retiring employees. While the bulk of pension fund investments are in stocks and bonds, 3 to 10 percent of their assets are commonly invested in real estate. Pension fund managers like real estate investments for several reasons.

- Returns are not correlated with the stock market and, therefore, help reduce volatility in an investment portfolio that includes stocks and bonds.
- They can provide cash-flow return every year from rental income. Many commercial properties produce an 8 to 10 percent return when purchased for all cash.
- They can provide an attractive total rate of return on investment, including possible price appreciation.

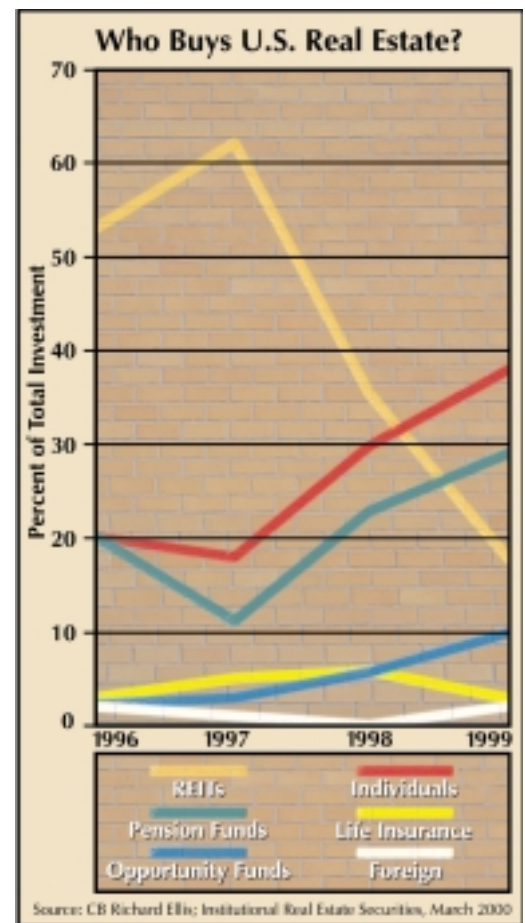
In 1996 and 1997, pension fund managers were selling investment-grade commercial properties and using the cash to

purchase shares of REITs. The perception at that time was that it was easier to sell shares of stock than buildings to raise cash. But in the past three years, that perception has changed substantially. Fund managers now find it easier to sell commercial properties than to sell large blocks of REIT stock. Consequently, pension fund managers are big fans of direct ownership of properties.

Comments made by participants at a New York University Symposium on pension fund real estate investment provide insight into the psychology of pension fund real estate investors.

According to Peter Lewis, director of real estate at Massachusetts Institute of Technology (MIT), which has a \$9 billion endowment fund, the fund is 10 percent invested in real estate. MIT's time frame for investment is 150 to 200 years, so Lewis explains that he buys even if prices are high.

Lewis includes real estate in his portfolio to provide balance. He believes that when financial assets are down, real estate is up, or that they are negatively correlated. Not all share Lewis' thinking. Another symposium participant estimates that return on individual properties has a low correlation (.2-.4) with the stock



market, while REITs have a higher correlation (.6-.7) with the stock market.

In Lewis' experience, direct investment in real estate has outperformed comingled fund investments. He is indifferent to liquidity because he does not need to sell the properties. He views REIT stocks as fixed-income investments, not as growth stocks, and is skeptical about accepting the stated net asset value of a REIT as an accurate measure of the underlying value of its real estate.

Marjorie Tsang of the New York State Common Retirement Fund reports that this fund is not a major investor in REITs and is more likely to partner with a REIT in direct investment in a large property. Tsang is more interested in purchasing the assets of REITs than purchasing their shares.

According to Tsang, the fund has two investment categories for real estate: core portfolio with after-leverage returns of 10 to 13 percent and enhanced portfolio with after-leverage returns of 13 percent to percentages in the "upper teens."

According to John Seckman, real estate manager for Delta Airlines, real estate is attractive for the fixed-income portion of their portfolio because of its low correlation to the stock market. He believes the real estate market is inefficient, so that active management pays off.

The target return for Delta's separate accounts is 15 to 18 percent, with 50 percent leverage. The target return for their opportunity funds is 20 to 25 percent, with 50 percent leverage. Seckman says few U.S. real estate investment niches remain untapped.

"We are an opportunistic investor looking for inefficiencies in the market," says Russell Appel, president of Praedium Group. "We look for something broken that we can fix.

"Our goal is to earn a 20 percent return," says Appel. "We believe that real estate long-term is about a 10 to 12 percent investment." Appel says his firm likes to have a local partner while maintaining control of the investment.

Whitehall Funds is the real estate investment fund for Goldman Sachs and

Company. Goldman Sachs has an average equity investment of 19 percent in their own funds, according to Managing Director Ralph Rosenberg, who seeks 15 to 20 percent on most real estate deals. His firm is big on mezzanine financing deals, which provide capital for highly leveraged real estate purchases.

Pension funds are significant buyers of Texas commercial real estate properties. While they often purchase trophy properties — the nicest properties in the local market — some look for properties that need renovation or are suffering from neglect. These turnaround investments offer a higher rate of return than trophy properties.

For more information about this segment of the real estate market, visit the Pension Real Estate Association (PREA) website at <http://www.prea.org/>.

Dr. Dotzour is chief economist with the Real Estate Center at Texas A&M University. His e-mail address is dotzour@tamu.edu.



LOWRY MAYS COLLEGE & GRADUATE SCHOOL OF BUSINESS

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

<http://recenter.tamu.edu>
979-845-2031
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