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In-depth Analysis From PrivcapRE.com
Q2 2014

Performance and Portfolio

WITH EXPERTS FROM:

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Cambridge Associates
Pension Consulting Alliance
International Finance Corporation
Crossroad Advisors
Pension Real Estate Association

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On Camera

Gabriel Espana,
International Finance Corporation

This special report includes the following new video programs. Watch them at PrivcapRE.com

Time to Consider Value-added Opportunities?
Investors should brace themselves for a slowdown in core net returns but will see growth in value-added property returns, say experts from Cambridge, PREA, and Crossroads.

2009 Wins in Battle of the Vintages
2009 will be real estate's best vintage year, but only a few will benefit. Experts from Cambridge, PREA, and Crossroads discuss vintage year performance and the winners and losers.

Benchmarking RE Funds: What Works
Experts from Cambridge, PREA, and Crossroads delve into benchmarking value-added and opportunistic real estate funds—what works and what doesn't.

Higher-Yielding Markets Don't Equal Higher Returns
Higher going-in cap rate markets do not pay, argues TIAA-CREF's Martha Peyton. Lower-yielding markets deliver higher total returns in the longer term, she says.

Impact Investing in LatAm with IFC
IFC's Gabriel Espana talks about the organization's LatAm strategy, the preference for direct deals, and the need for funds.

Emerging Markets & Net Returns: Worth The Risk?
U.S. investors are looking to significantly grow foreign RE portfolios as they seek income and total returns, says Pension Consulting Alliance's Dillon Lorda.

COMING SOON on PrivcapRE

The Impact of Returning Liquidity in Europe
Experts from W. P. Carey, AXA Real Estate, and RCA discuss Europe's core and peripheral markets, new Asian investors, and the likelihood of increasing bank dispositions.

Mexico's Emerging Listed Property Market
Equity International's Tom Heneghan on why he's bullish on Mexico's listed property ownership and development vehicles, the FIBRAs.

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Must-see thought leadership from **PrivcapRE.com**

The Hunt for Relative Value in Mezzanine Debt

Jack Taylor of Prudential Real Estate Investors on where to find relative value in mezzanine debt, the attraction of second-tier markets, and the European countries to look at.

The Pan-Latin Opportunity

Tom Heneghan of Equity International discusses the group's presence in Brazil and Colombia, and the room for growth in both economies.

Renewals, Reinvestment & NOI Growth

Experts from Yardi, CBRE, and Taurus discuss NOI growth in 2014, being paid a premium for vacancy, and the challenge of tenant renewals for older properties.

Deal Story: Bank Pekao

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U.S. CRE Market Faces Uneven Recovery

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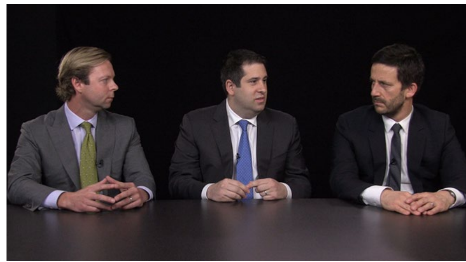

Liquidity, Pricing, and Opportunities to Sell

Experts from W. P. Carey, AXA Real Estate, and Real Capital Analytics on the markets ripe for sales, the growing appetite for portfolio sales, and opportunities for spread investors.

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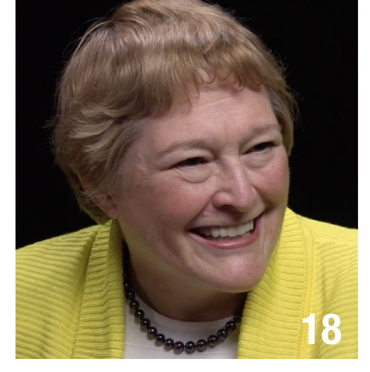

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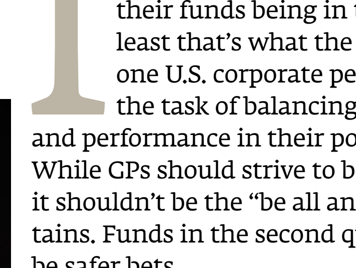
Be Happy With Second-Quartile Managers

Being a top-quartile performer is very different from achieving the best risk-adjusted returns



Market Analysis by PrivcapRE Editor **Zoe Hughes**

It may seem counterintuitive, but managers–and their investors–should be happy with their funds being in the second quartile. At least that's what the head of real estate at one U.S. corporate pension plan, faced with the task of balancing risk management and performance in their portfolio, told PrivcapRE. While GPs should strive to be in the top quartile, it shouldn't be the "be all and end all," he maintains. Funds in the second quartile can sometimes be safer bets.

It all boils down to the use of IRRs as a measurement of manager performance, and how managers can manipulate their IRRs to achieve top-quartile rankings.

Investors and managers know that successful realizations early in a fund help boost IRRs and, therefore, a fund's quartile position. However, that ability to distort a track record also increases the chances that GPs will sell their best assets early to try and stay in the top quartile. Top-quartile performance also often equates to greater use of leverage and risk, meaning that being in the top quartile is very different from offering the best risk-adjusted performance.

The real estate executive says when the next downturn happens, he doesn't want to be "pushed into a corner," forced to pay down maturing loans, or in need of a "cash sweep" and unable to cover tenant improvements to grow net operating income. "You don't know what's going to happen next," he says, "so you can only manage risks based on the dispersion of outcomes you see today." Leverage is one area where his pension is unwilling to compromise, insisting on below-market debt levels. That sometimes leaves the pension investing with second-quartile managers. And that, he says, is fine.

The question of whether it's good to have a manager in the top, second, or bottom quartile could be arbitrary without a focus on the persistence of a GP's track record, says Greg MacKinnon, director of research at the Pension Real Estate Association (PREA). He has found some persistence in top- and bottom-quartile core real estate funds, he told PrivcapRE during a panel discussion on real estate performance. And there's little evidence to support the belief that value-added and opportunistic fund managers perform less consistently than their core real estate peers.

He adds: "The good performers tend to keep on being good, and the bottom tend to keep on being bottom. But when I'm talking about persistence, I'm not talking about any kind of guarantee."

And that is key. There's no measure of performance that will provide you a bulletproof guide to investing in real estate and in real estate managers. Rather, investors need to understand what is driving the returns of each and every GP. How much of the IRR was driven by the use of leverage or growing NOI? Have investors asked for the trailing 12-month NOI figures? If risk is paramount to an investor, do they understand how a GP views risk in the fund and in the wider real estate market?

And perhaps more critical is being comfortable with your judgment as an investor and not worrying about what could have been, once decisions have been made. If that decision results in a second-quartile manager, be happy with that choice, because it could be the best risk-adjusted choice for your plan. ■

"More critical is being comfortable with your judgment as an investor and not worrying about what could have been, once decisions have been made."

Real Estate: How Well Does It Perform?

Real estate investors have lived through a volatile decade with both outperformance and underperformance in their portfolios. In three articles, a panel of experts from **Cambridge Associates, Crossroads Advisors,** and the **Pension Real Estate Association (PREA)** discuss the impending decline of core real estate performance, the best post-crisis vintage year, and how investors should benchmark their portfolios.

Participants

Marc Cardillo
Managing Director,
Hard Assets Research,
Cambridge Associates

Kevin Higgins
Principal,
Crossroads Advisors

Greg MacKinnon
Director of Research,
Pension Real Estate Association

Bios

Marc Cardillo heads Cambridge's research team covering global private investments in agriculture, natural resources, commodities, energy, infrastructure, real estate, and timber. Before joining Cambridge in 2000, Cardillo was an equity analyst at Gannett Welsh & Kotler. He is a CFA charterholder and earned a B.A. from the College of the Holy Cross.

Kevin Higgins is the founder of Crossroads, which provides advisory services to institutional investors and managers. Formerly, he was head of Americas private real estate for Swiss Re Asset Management and previously served on the restructuring team at Mutual Benefit Life. He has an M.B.A. from New York University and earned a bachelor's degree in engineering.

Greg MacKinnon is a fellow of the Homer Hoyt Institute, serves on the board of the Real Estate Research Institute, and is co-editor of The Journal of Real Estate Portfolio Management and the biannual special real estate issue of The Journal of Portfolio Management. Cardillo holds a Ph.D. in finance from the University of Alberta and is also a CFA charterholder.

Videos

1. Core Returns to Slow, Time to Look to Value-Add
2. 2009 Wins in Battle of the Vintages
3. Benchmarking RE Funds: What Works

Video 1

Value-Added Strategies' Time to Shine/

Core real estate has historically outperformed its riskier counterparts. That's about to change, according to our panel of experts from **Cambridge, Crossroads,** and **PREA.**

The returns on value-added and opportunistic real estate strategies have struggled to compete against those of their core counterparts, particularly in the longer term.

Cambridge Associates' latest data is telling. Over a 10-year, 15-year, and 20-year period, core real state, as measured by the NCREIF Property Index (NPI), outperformed value-added and opportunistic strategies by 80 percent, 66 percent, and 54 percent, respectively. That outperformance isn't measured against gross returns—it's returns net of fees, expenses, and carried interest.

However, things could be about to change, according to Marc Cardillo, managing director of hard assets research at Cambridge Associates. "Despite the fact that, looking backwards, core has outperformed on an absolute basis [and] also on a risk-adjusted basis, going forward I think the value-added [strategy] is one that we favor."

His view comes as the most recent Cambridge data showed an uptick in returns from value-added and opportunistic strategies, as measured by Cambridge's Real Estate Index. In the three- and five-year periods to December 31, 2013, value-added and opportunistic real estate matched the performance of the NPI benchmark. In 2013, though, value-added and opportunistic began to outperform their core rival.

The uptick in value-added and opportunistic returns coincides with a "mitigation" in core returns, says Greg MacKinnon, director of research at PREA.

"We do a consensus forecast survey every quarter, and the latest numbers show people expect returns in the core space, on an unlevered basis, to slow down somewhat going forward," MacKinnon says. Rather than the double-digit returns of the past few years, PREA members are forecasting unlevered core returns of roughly 8.7 percent for 2014 and 7.7 percent for 2015. "Certainly not a crash in values, but a mitigation in the returns going forward from the strong returns we've had in the past."

Cardillo says it is in the value-added space that the greatest risk-adjusted returns and performance will be found in coming years. "You know, we think there are good opportunities for managers to buy assets that have been neglected for the last four or five years [that need] cap-ex, and so there's opportunities to add capital to those properties and fill vacancies," he says.

"That basis is more interesting to us than core and perhaps more interesting to us than opportunistic, where the longer-term track record of those managers generating a decent risk-adjusted return just isn't there in the numbers."

Kevin Higgins, principal of Crossroads Advisors and former head of Americas private real estate at Swiss Re., says leverage is a key issue to consider and can turn real estate from an outperformer to a serious underperformer.

"You've got core funds being a strong performer over the past five years," Higgins says. "Most core assets are unlevered or they're very lowly levered. [With] value-add and opportunistic [strategies], you're looking at 70 percent to 80 percent [leverage] in this past cycle, and that's impacted adversely the performance of value-added and opportunistic [strategies]."

The big question for investors is how they weight for risk when assessing real estate opportunities.

"No one's really sure yet exactly what risk is and how you measure it," says MacKinnon. Measures of volatility often used in public equities "don't tell the whole picture" for real estate, "so it's hard to get a really good grip on what risk is."

Trying to compare core, value-added, and opportunistic strategies on a risk-adjusted basis is even more difficult, given the lack of transparency. "It's

"Despite the fact that, looking backwards, core has outperformed on an absolute basis [and] also on a risk-adjusted basis, going forward I think the value-added [strategy] is one that we favor."
–Marc Cardillo, Cambridge Associates

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"The latest numbers show people expect returns in the core space, on an unlevered basis, to slow down somewhat going forward."
–Greg MacKinnon, PREA

harder to get consistent, accurate data on those kinds of funds," MacKinnon says.

For Higgins, risk is akin to "peeling back an onion. You look at operational risk, you look at leasing risk, you're looking at market risk. It's just a puzzle that you just have to keep on pulling apart, layer by layer."

So what does this all mean for future real estate returns, particularly for value-added and opportunistic strategies?

"There'll be good years for performance," Cardillo says, adding that real estate was "in a sweet spot," with relatively balanced supply and strong demand in most property types and markets. Leverage will increasingly come back into play as a driver of returns, despite being employed at historic lows following the financial crisis.

"Leverage is accretive to returns," he says. Deals closed in the years following the crisis would be the primary driver of returns in the near term. "Managers, both in the value-add and the opportunistic side, have been able to acquire properties with a pretty healthy unlevered yield and are able to lever that to an attractive number." ■

The Long and Short of Real Estate Performance

Returns on core real estate strategies and value-added and opportunistic real estate strategies, as measured by the NCREIF Property Index and Cambridge Real Estate Index, respectively

	1-Year (%)	3-Year (%)	5-Year (%)	10-Year (%)	15-Year (%)	20-Year (%)
Cambridge Real Estate Index	14.83	11.23	5.62	4.81	5.34	6.07
NCREIF Property Index	10.98	11.92	5.69	8.64	8.86	9.34

Source: NPI and Cambridge Associates' Real Estate Index, December 31, 2013

2013: Quarterly Review

Quarterly returns on value-added and opportunistic strategies steadily rose through 2013 and rallied strongly in the fourth quarter

Quarter Ending	End-to-End Return (%)
2013 Q1	2.55
2013 Q2	2.83
2013 Q3	2.98
2013 Q4	5.85

Source: Cambridge Associates' Real Estate Index, December 31, 2013

About Cambridge Associates' Real Estate Index
The index is an end-to-end calculation based on data from 753 real estate funds—including value-added funds, opportunistic funds, and fully liquidated partnerships—formed between 1986 and 2013. Returns are net of fees, expenses, and carried interest. The index is made up of 69 percent opportunistic and 31 percent value-added, comprising roughly 60 percent U.S. funds, 20 percent Europe, and 20 percent Asia.

Video 2

Why You'll Wish You'd Invested in '09/

While 2009 is set to be the best real estate fund vintage year since 2001, few investors are expected to benefit from it. Experts from **Cambridge, Crossroads,** and **PREA** discuss vintage year performance and why the embattled 2005 and 2006 vintage years are performing better than expected.

If they knew then what they know now, investors would have deployed plenty of capital to private real estate during the economic turmoil of 2009.

According to Cambridge Associates' Real Estate Index, 2009 is on track to be the best-performing vintage since 2001. At the end of 2013, the 2009 vintage was reporting a 24 percent pooled IRR and 1.37x multiple.

This outshines the pooled IRRs of 14 percent and 22 percent for 2010 and 2011 vintages respectively, and the multiples of 1.24x for 2010 and 1.22x for 2011.

However, as Marc Cardillo, managing director of hard assets research at Cambridge Associates, says: "It is a relatively small vintage year in terms of the number of funds [deploying equity]." Just 19 funds are tracked by Cambridge for the 2009 vintage, compared to more than 100 in the 2007 vintage.

But as Greg MacKinnon, director of research at PREA, says, investors shouldn't regret their missed opportunities. "That's sort of me saying I wish I'd bought Microsoft in 1982," he says. "I wish I had, but if you were an investor in 2009, you have to recall the world was falling apart and the denominator effect and all kinds of other things were going on. It may have been a perfectly rational decision at the time not to invest."

The consolation for the many investors who invested heavily at the peak of the real estate cycle is that 2005 and 2006 funds aren't performing as badly as originally feared.

"Certainly with [the Cambridge] benchmark, the

Investing in the Top Quartile

Investors should focus on the duration of a GP's stay in the top quartile, not just their rank

What's the importance of being top-quartile for investors?

MacKinnon: I don't think I've ever met an investor who didn't want top-quartile performance. And the important question was whether or not that performance was persistent in terms of allocating new capital. Does a top-quartile performer from the past indicate that GP will be top-quartile in the future? There's not a lot of evidence on that question at all.

There's some academic evidence, and researchers have looked at this... If [a manager is] a top-quartile performer with one fund, the next fund has a slightly higher probability of being top-quartile again. But slightly higher probability does not mean anything's guaranteed.

I did some work at PREA on quartile persistence with core funds, and top-quartile and bottom-quartile performance tends to persist. The good performers tend to keep on being good, and the bottom tend to keep on being bottom.

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"If you were an investor in 2009, you have to recall the world was falling apart. It may have been a perfectly rational decision at the time not to invest."
–Greg MacKinnon, PREA

2005 and 2006 vintage years are the poorest performers on the real estate side, but they're not as bad as they were at the depths of the downturn," Cardillo says. Reporting multiples of 0.88x and 0.81x for 2005 and 2006 respectively, Cardillo says the vintages are unlikely to reach par. But he expects to see some "modest improvement from those numbers" as the funds hit maturity.

Performance expectations for the 2005 and 2006 vintage years have improved, says Kevin Higgins, principal at Crossroads Advisors and former head of Americas private real estate at Swiss Re.. Using the secondary market as a barometer of investors' initial expectations for performance, Higgins says that in late 2008, the 2005 and 2006 vintages were seeing discounts of 30 percent to net asset value (NAV). By 2009, the "haircut" to NAV was topping 70 percent. "[For bottom-quartile performance] it's probably pretty much in line with what was anticipated in the fall of 2008," he says, "but not as bad as what people were anticipating when we got into 2009."

The returns highlight the importance of vintage year diversification. So how can investors achieve it? Cardillo and MacKinnon stress the importance of the pace of commitments.

"I think there's two ways," Cardillo says. "Getting a sense of how GPs think about vintage year diversification and if it's important to them. But also, from the LP's side and the consultant side, be very careful in terms of the pace of committing capital [and having conservative] assumptions in terms of when you expect to get distributions."

MacKinnon adds: "We have to keep in mind it's not just when you make the commitment but when you expect the capital to be called, and that can give you a much different vintage diversification than just concentrating on when you signed the documents."

For investors, vintage year diversification can be easier said than done. "An investor would like to be in the market reasonably consistent, but it doesn't always work out that way," Higgins says. With strategic and allocation issues to contend with, real estate could be emphasized and de-emphasized in any given year. "And as we've seen in the past cycle, most investors balked from the market for a few years." ■

Class Performance

Quarterly returns on value-added and opportunistic strategies steadily rose through 2013 and rallied strongly in the fourth quarter

	IRRs (%)	Top Quartile (%)	Bottom Quartile (%)	Multiple (Total Value to Paid-in Capital)	Number of Funds
2005	-2.45	2.4	-8.25%	0.88x	75
2006	-4.22	5.96	-9.73%	0.81x	79
2009	24.29	18.24	6.57%	1.37x	19

Source: Cambridge Associates' Real Estate Index, December 31, 2013

Benchmarking: What Works/

Benchmarking value-added and opportunistic real estate funds is a challenging task with no universal standard. Experts from **Cambridge, Crossroads,** and **PREA** discuss why.

PrivcapRE: What benchmarks and indices do institutional clients use for their value-added and opportunistic real estate portfolios?

Marc Cardillo, Cambridge: I don't know that there's a lot of consistency. [Investors are] using the Cambridge real estate database; sometimes they're using NAREIT. They can be using a CPI plus some number of basis points. A lot of times clients will include real estate as part of a broader real-assets benchmark. Another important aspect that's grown stronger post–financial crisis is the extent to which clients are comparing [opportunistic real estate] to a broader all-equity benchmark. Real estate serves a different role in different client portfolios, so there's not a lot of consistency.

Kevin Higgins, Crossroads: Marc hit on some of the bouncing balls in terms of trying to find a benchmark. [At Swiss Re] we had the NCREIF Property Index, and you make some adjustments to that [for non-core investments]. The ODCE [Open-End Diversified Core Equity] index is used by some folks. But the idea of real estate being an alternative investment [means] you're being graded against buyout funds and hedge funds and, for some investors, a broader real-assets categorization.

How prevalent is the use of core benchmarks plus the addition of a risk premium?

Greg MacKinnon, PREA: That is very common—you know, [using] ODCE or the PREA/IPD index plus-X

Comparing Benchmarks

Consultant Hewitt EnnisKnupp surveyed the largest U.S. public pensions on their private real estate benchmarks. NCREIF's NPI and ODCE indices were the benchmarks of choice among the top 10 plans

CalPERS	NFI-ODCE + 100bps
CalSTRS	NPI
New York State Common	25% NFI-ODCE/75% NCREIF Townsend Fund Index
Florida SBA	76.5% NFI-ODCE/13.5% NFI-ODCE + 150bp/10% FTSE EPRA/NAREIT Index
New York City Teachers	NFI-ODCE + 100bps
Texas TRS	NFI-ODCE
State of Wisconsin	20% NPI/80% NFI-ODCE
North Carolina	NFI-ODCE
Ohio PERS	NFI-ODCE + 85bps
New Jersey	NPI

Key	
NFI-ODCE	NCREIF Fund Index Open-End Diversified Core Equity
NPI	NCREIF Property Index

Source: Florida SBA Asset Liability Study by Hewitt EnnisKnupp, March 2014

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percent. Or even some investors use an absolute return and pick a return or CPI plus something. It's supposed to reflect the increased risk of moving up to the value-add and opportunistic space. My fear is that coming up with that plus-X percent is in large part a little bit of muted hand waving.

How do we account for risk in value-added and opportunistic benchmarks?

MacKinnon: Risk is a tricky situation in real estate. A lot of the standard measures used in public equities don't really apply that well. Risk is multi-dimensional in real estate, and you have to really understand the various sources that any real estate investment you're making is exposed to, whether it's the rolling of the leases or vacancy or development. It's not a matter of understanding the level of risk but the types of risk that you're exposed to, and looking at what different risk factors each of those investments might be exposed to.

How can we compare private real estate against public benchmarks?

MacKinnon: It does make sense on a long-term basis to compare, but in terms of a benchmark on a quarter-by-quarter basis, you could run into some serious trouble comparing your private equity manager to a NAREIT benchmark.

Cardillo: I would agree with Greg. From a client's perspective, if you're investing in private funds, particularly value-add and opportunistic, you're expecting to get some sort of premium to justify the illiquidity and the higher fees [of value-added and opportunistic funds], and so having NAREIT be one benchmark makes sense. ■

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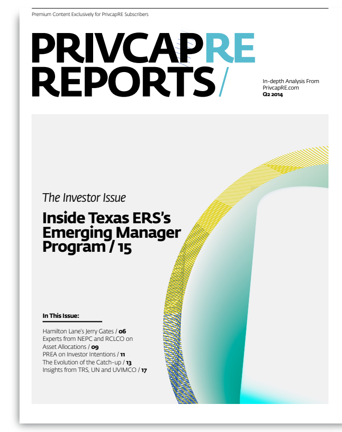

By **Ainslie Chandler**

Building Better Returns

Portfolio construction can have a big impact on returns. PrivcapRE takes a look at how three LPs execute their property strategies and their plans for the asset class, how they measure performance, and what their results have been.

Like most property investors, the California Public Employees' Retirement System (CalPERS) saw its real estate portfolio hit hard during the financial crisis. In 2011, the pension fund introduced a new strategic plan aimed at improving and de-risking its exposure to property.

Despite the new plan, the fund's real estate allocation continues to underperform compared to the benchmark, delivering only 2.84 percent in 2013.

CalPERS benchmarks its real estate performance against the NCREIF Fund Index Open-End Diversified Core Returns (NCREIF-ODCE), with the goal of exceeding it—net of fees—according to its March 2014 benchmarking policy statement.

In 2013, the benchmark posted a total return of 7.07 percent. "The real assets performance still carries the effects of the housing crisis and economic meltdown," a CalPERS spokesman told PrivcapRE in an email. "A new strategic plan was put in place for the asset class several years ago and we continue to operate according to that plan."

CalPERS uses real estate as both an inflation hedge and a counterbalance to the heavy equities weighting in its portfolio, according to fund documents. Property's role is to provide an investment with a low correlation to equities, to generate stable cash yields, and to give the fund an inflation hedge.

"As the equity allocation in the overall CalPERS investment portfolio is high and the risk contribution from equities is higher, the role of real estate in the overall CalPERS investment portfolio will be… moderately levered, low risk, and low correlation with equities," according to the pension fund's 2013 investment policy. "To fulfill this role, real estate will have ownership risk in real properties with stable cash yields. The major driver will be income, of which the majority will be cash yield. Real estate is also a partial inflation hedge."

As of December 2013, CalPERS' real estate allocation was 9 percent of the total fund, with a target range between 7 percent and 13 percent. Real estate comprises 87 percent of its $27.8B real-assets program.

CalPERS

Total fund assets	$283.5B
One-year total fund return (ex overlay)	10.64%
Real estate weighting	8.61%
One-year real estate total returns	2.84%
Real estate portfolio benchmark returns	7.07%

Source: CalPERS CIO Total Fund Performance and Risk Report, December 31, 2013

Its program has an emphasis on investing with market-leading real estate investment managers and a focus on the United States.

The fund uses commingled funds, separate accounts, manager accounts, real estate operating companies, and downstream joint ventures, with a preference for separate accounts, CalPERS' investment policy states.

"The focus of the portfolio should be in large strategic relationships. Investments may be made in public or private debt or equity positions or other related real estate investments."

CalPERS has a focus on developed markets, targeting a 75 percent to 100 percent allocation, with 85 percent to 100 percent of that allocation to be in the U.S.

Its target allocation for investment outside of the U.S. is zero to 25 percent, while emerging markets has a zero-to-25-percent allocation and frontier markets a zero-to-5-percent allocation.

SURS

The State University Retirement System of Illinois (SURS) is building its exposure to real estate assets. The fund has more than $1B in real estate investments, comprising about 6.5 percent of its total portfolio, and aims to hit 10 percent exposure by the

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Illinois SURS

Total fund assets	$16.73B
One-year total fund return	13.2%
Real estate weighting	6.5%
One-year real estate total returns	3.1%
Real estate portfolio benchmark returns	2.5%

Source: SURS Investment Update, March 2014

end of the 2016 financial year, according to its strategic plan.

The goal is to have 4 percent of the total assets invested in REITs and 6 percent in private real estate.

The objective of SURS' real estate allocation is diversification and income, according to its 2013 strategic plan.

Maintaining some liquidity is a priority for the fund, so a 40 percent allocation is made to property securities, and a 60 percent allocation is made to private real estate.

The fund is targeting a portfolio of 80 percent core assets and 20 percent non-core assets.

It invests in open- and closed-ended commingled funds for private real estate, and in separate accounts and commingled index funds for public securities.

In 2013, the fund approved $400M in commitments to core and non-core private real estate managers. The fund is underweight on property compared to its target allocation and this year is looking for non-core real estate managers to help meet its target.

The fund benchmarks its direct real estate investment portfolio to the NCREIF-ODCE. Its U.S. REIT portfolio is benchmarked to the Dow Jones U.S. Select Real Estate Securities Index and its global REITs to the FTSE EPRA/NAREIT Developed Index.

The fund's direct real estate portfolio slightly underperformed the benchmark in the 12 months leading up to March 31, 2014, delivering a 12.1 percent return compared to the benchmark return of 12.9 percent. However, its REIT allocation outperformed the benchmark's 2.5 percent return, delivering a 3.1 percent return.

In the past five years, SURS' direct portfolio has outperformed the benchmark with a 4.7 percent return compared to the benchmark's 2.8 percent. Its REIT portfolio underperformed, delivering a 25.8 percent return compared to the benchmark's 26.1 percent.

SBAF

The Florida State Board of Administration's (SBAF) real estate investments have consistently outperformed in the past decade, so there is little wonder why this year its board of trustees committed to raising its real estate allocation from 7 percent to 10 percent by the end of 2018. This represents an additional $4B in capital, according to a report from advisers The Townsend Group, who were first engaged to aid the pension fund in 2004.

The pension, which now has a $10.2B real estate portfolio and manages more than 30 funds, started investing in the asset class in 1983, according to a March presentation given by SBAF senior investment officer Steven Spook. He said the role of real estate investment was to diversify the fund's asset base as a hedge against inflation and to provide competitive returns throughout market cycles.

Its real estate portfolio comprises 72.5 percent core, 9.7 percent value-added, 7.4 percent opportunistic, and 10.5 percent property securities.

The portfolio is almost evenly split between principal investments (SBAF staff retain approval rights on acquisitions, disposals, and financing) and externally managed investments (where the manager has been given discretion to make decisions).

It is anchored by core private market investment through direct-owned assets and pooled funds. SBAF's preference is to invest through direct-owned separate accounts, which Spook says in his presentation delivered "superior real estate staff control and lower fee structures." Pooled funds were used for "diversification, specialized strategies, and non-core investments," he says.

SBAF has a goal of a 90 percent weighting to physical property and a 10 percent weighting to property securities.

Until June, SBAF aimed to outperform the five-

Florida SBA

Total fund assets	$178.24B
One-year total fund return	14.38%
Real estate weighting	7.4%
One-year real estate total returns	14.34%
Real estate portfolio benchmark returns	11.81%

SBA Florida Board of Administration Real Estate Update to the Investment Advisory Council, June 2014, and Real Estate Introduction and Annual Review, presented to the Investment Advisory Council on March 17, 2014

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year rolling average of a blended benchmark, which includes the NCREIF-ODCE, net of fees (90 percent weighting), and the EPRA/NAREIT Global index (10 percent weighting).

However, at its June meeting, the pension's investment advisory committee approved a change to the benchmark.

The core part of the portfolio will be benchmarked to NCREIF ODCE (net of fees), weighted at 76.5 per cent, the non-core portion benchmarked to an average of the NCREIF-ODCE (net of fees), plus a 150 basis point premium, weighted at 13.5 per cent, and the FTSE EPRA/NAREIT Developed Index, weighted at 10 per cent.

A spokesman for the pension says the change would better reflect the expected risk/return profile of non-core assets.

Based on the old benchmark, to the end of 2013 the real estate portfolio's total net return exceeded the five-year rolling benchmark by 250 bps. It has underperformed the benchmark for only one month during that period (in September 2014 it underperformed by 50 bps), according to the Townsend report.

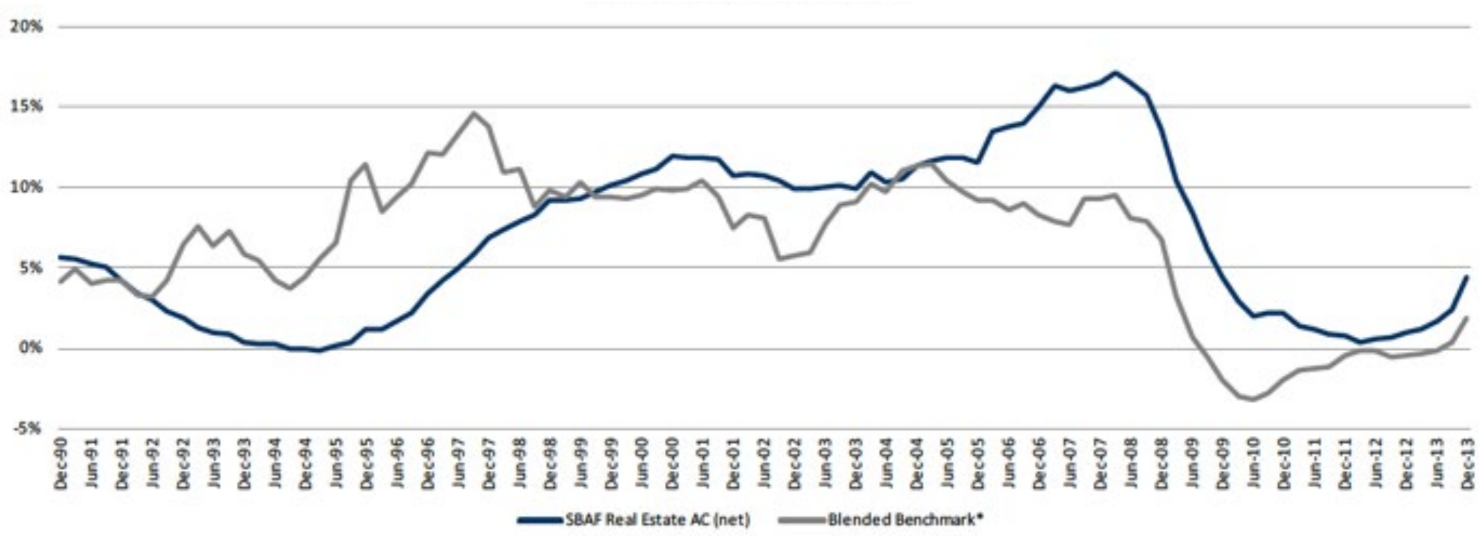
"The portfolio's net return has consistently exceeded the benchmark since Q3 2002. As of Q3 2013, the portfolio exceeded the benchmark by 180 bps. This outperformance has been driven by SBAF's core investments, which outperformed the ODCE by 420 bps over the same five-year period," according to the Townsend report, which notes the strength of two of the biggest investments, the Heitman Core I.M.A. and the L&B I.M.A..

"These two accounts represent nearly $3B of market value as of Sept. 30, 2013, and have outperformed the ODCE index by 650 bps and 510 bps, respectively, over the five-year period," according to the report.

An SBAF spokesman says the strength of the performance could be attributed to the pension's "structure and strategy [which] emphasize direct investment and low leverage. Together, these attributes create long-term advantages because of lower fees and far less vulnerability of becoming a forced seller in down markets," he says.

During 2013, SBAF made about $350M of commitments to three non-core closed-ended funds targeting investments in the U.S., Europe, and Asia. A further $50M was committed to a student housing joint venture. In its principal property business, SBAF made about $218M of commitments to three investments: a retail aggregation strategy located in Boston, a multifamily property in Irvine, Calif., and a Denver industrial asset. ■

Consistent Outperformance



Source: The State Board of Administration of Florida, Real Estate Program Report, The Townsend Group, March 2014

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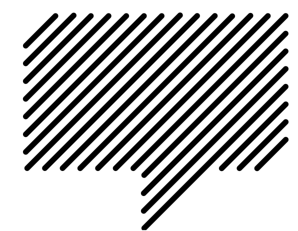
Doing Good: IFC's Impact Investing



International Finance Corporation's Gabriel Espana tells PrivcapRE about the group's investment philosophy, its $1.2B real estate portfolio, and why he's eyeing frontier markets

Bio

Gabriel Espana is principal investment officer at at IFC, focusing on emerging markets. He formerly held senior investment banking positions at Rothschild and Banamex/Citibank. Espana received an M.B.A. in corporate finance from Instituto Panamericano de Alta Direccion de Empresa.

"The approach is commercial but, at that same time, doing good while doing well."

–Gabriel Espana, International Finance Corporation

PrivcapRE: Can you describe IFC's overall portfolio and how real estate fits into it?

Espana: We are impact investors. And we look for investments in which we can maximize the impact of IFC, bringing new services and bringing solutions to lower-income families and also helping the emerging middle class. In real estate, we have a portfolio of close to $1.2B, of which 45 percent is commercial real estate and 55 percent is affordable housing. In general, we are heavily involved in the development stage of real estate. We have our own green building standards, and we help companies develop the real estate assets that are needed.

Part of that mission is driving sustainable economic growth. How does that shape new real estate investments?

Espana: We tend to invest in real estate that makes sense economically and also in terms of environmental and social aspects. As you can imagine, construction is heavily dependent on labor. It involves 200 or 300 different industries, depending on the country, and that's just the beginning. It's how we can, through real estate, improve living conditions for the masses in the emerging countries in which we operate. The approach is commercial but, at that same time, doing good while doing well.

How do you quantify the impact of your investments?

Espana: We have indicators in terms of inclusiveness—how we, through these investments, help people get access to water, electricity, and other urban services. This is part of the shared-value-and-prosperity approach that we have.

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"For us, it's an industry that has irreversible environmental impact. In most cases, these real estate assets will live for more than 50 years, and if we are going to be promoting these investments, we want to do it in the right way."

–Gabriel Espana, International Finance Corporation

It's basically giving access to the people who are lacking public services and infrastructure like water, electricity, and transportation. The other is related to industrial parks, free trade zones, and the kind of real estate projects that help the industrial base of the relevant country to be more efficient, competitive, and more attractive for investment. Our principle is that these investments will create new jobs, and through this we'll also help the development of local industry.

How much of the Latin American real estate portfolio is focused on Brazil and Mexico versus some of the more frontier markets such as Colombia, Peru, Chile?

Espana: Because of the recent history in social housing in Mexico, we are heavily concentrated on that country's housing. The first four markets for IFC in Latin American real estate are Mexico, Brazil, Peru, and Colombia.

Do you prefer to have more control over the investments with the operating partners?

Espana: That's exactly the case. In real estate, we have a direct and clear agenda on green buildings. And we like to have a certain level of influence, if not control, in the design of the real estate assets that are going to be developed. For us, it's an industry that has irreversible environmental impact. In most cases, these real estate assets will live for more than 50 years, and if we are going to be promoting these investments, we want to do it in the right way.

So when it comes to real estate in Latin America, where do you see investment growth?

Espana: Frontier regions and countries where there is a clear need for real estate assets. We would love to see more. At the same time, there is a global mega-trend of urbanization, and Latin America is not an exception. One of the positive things is the free trade agreements they've signed in Latin America. That is opening the door for a lot of industrial real estate investments. A lot of international real estate investors are taking their positions in those markets in certain countries, and that's going to be the future.

What advice would you give to other emerging-markets investors?

Espana: When you talk about investing in Africa, it's a quite exotic market that a lot of investors don't even consider. But we have seen investments in Africa that, when done properly and with a long-term view, are doing fantastic—even better than the best investment in a middle-income country in Latin America. It's because they were willing to take additional risk and are compensated for it. I'm not going to say it works for every investor. The name of the game is location, plus a sponsor. Real estate is local, and as investors, we have to find local partners with the expertise and skills to deliver what they are promising. ■

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Lower Cap Rates Can Equal Higher Returns

Research has shown that U.S. real estate markets with lower initial cap rates tend to produce higher long-term returns, **TIAA-CREF's Martha Peyton** tells PrivcapRE

Bio

Martha Peyton is managing director and head of real estate research and strategy at TIAA-CREF. Previously, she worked with HSBC/Marine Midland Bank's credit policy division and domestic economics group. She also taught economics at Fordham University and Manhattanville College. Peyton received a B.A., M.A., and Ph.D. in economics from Fordham University.

"The data leads to the conclusion that, historically, those higher-cap-rate markets have not paid."
–Martha Peyton, TIAA-CREF

PrivcapRE: We've seen a shift in capital flows as investors have moved beyond the major six markets in the U.S. into the more secondary and even tertiary markets. What are some of the factors driving that capital shift?

Peyton: We've done considerable research in the past two years determining how going-in cap rates are related to total return on a metropolitan market basis. What we've found is higher going-in cap rates do not necessarily guarantee higher total returns over a holding period. In fact, we've found just the opposite. Markets with lower going-in cap rates tend to produce higher total returns over holding periods. If we look at the dynamics of the market in the last two, two and a half years, the beginning of the recovery period was concentrated in markets that have historically had low cap rates. They led the recovery, and about a year and a half ago they started to settle down, and capital then flowed into smaller, higher-cap-rate markets, and we then saw their recovery.

About six months ago, they also settled, and we're now seeing a much more equal total return performance, with a slight preference to the low-cap-rate markets.

What drove the move from low-cap-rate markets into the higher-cap-rate markets?

Peyton: The driving force was the more attractive going-in yield, and there were no supply worries at that point in time, because no construction was on the horizon. So it's very much market timing of "I can get a higher yield now, and I can probably get myself out if supply does appear on the horizon and if it's troubling."

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"What we've found is higher going-in cap rates do not necessarily guarantee higher total returns over a holding period. In fact, we've found just the opposite. Markets with lower going-in cap rates tend to produce higher total returns over holding periods."
–Martha Peyton, TIAA-CREF

In some of those higher-cap-rate secondary markets, we have elastic supply chains. In others, supply is more disciplined, and the higher cap rates in those markets were attractive and sought after by our portfolio managers.

You've written a report where you broke the markets into four quartiles across property types. Were there any surprises about which markets were in the top quartile and in the bottom quartile?

Peyton: The top-quartile markets did contain a couple of surprises. The Bridgeport [Conn.] metropolitan area turned out to be a very strong office market. It's about the strength of a node of offices in Greenwich, which happens to be ground zero for hedge funds. That space has generated strong total returns.

When it comes to the bottom quartile, there seems to be a mixed bag of markets. Why did we have such a variety of markets in the bottom quartile?

Peyton: Markets that are weak performers generally come in two flavors. You have markets that produce boom-bust cycles. They generally have strong economies and demographics, but they also have undisciplined supply. So as rents start to recover, developers come out of the woodwork, and new supply then puts a lid on returns.

The other flavor is one with a structurally weak economy that has weakness demographically. They're losing population. They're losing industries. Those are markets in the old Rust Belt cities, whereas the boom-bust markets are concentrated in the Sun Belt.

How does all of this relate to returns?

Peyton: We took markets and gathered historic transactions going back to 2001. We identified the market and property type and then put them in buckets and divided those into four quartiles, depending on the average cap rate on transactions over that period. We then looked at those buckets in terms of the total return produced over the entire period. We found that the lowest, tightest cap-rate markets produced somewhere between 400 and 500 basis points higher total return than the lowest, which had the highest cap rates.

So should investors avoid those higher-cap-rate markets?

Peyton: The data leads to the conclusion that, historically, those higher-cap-rate markets have not paid. That's not to say that at some point in time going-in cap rates might become attractive enough to make those markets pay in terms of ultimate total return, but we haven't found that to be pervasive.

Where are we in the real estate cycle, and do you see significant risks building?

Peyton: We track the phase of the cycle closely. It's an umbrella over all of the decisions that we make. We are 17 quarters past the trough of the recession. If we take a look at the length of the last expansion, it was 21 quarters. With that information alone, we can conclude that the cycle is maturing. That's not enough information, so we've developed a template of indicators that we track as forward-looking signals of continued upside. Those eight indicators are all signaling green, which says we have another year before we have to worry about peaking out of the cycle. ■

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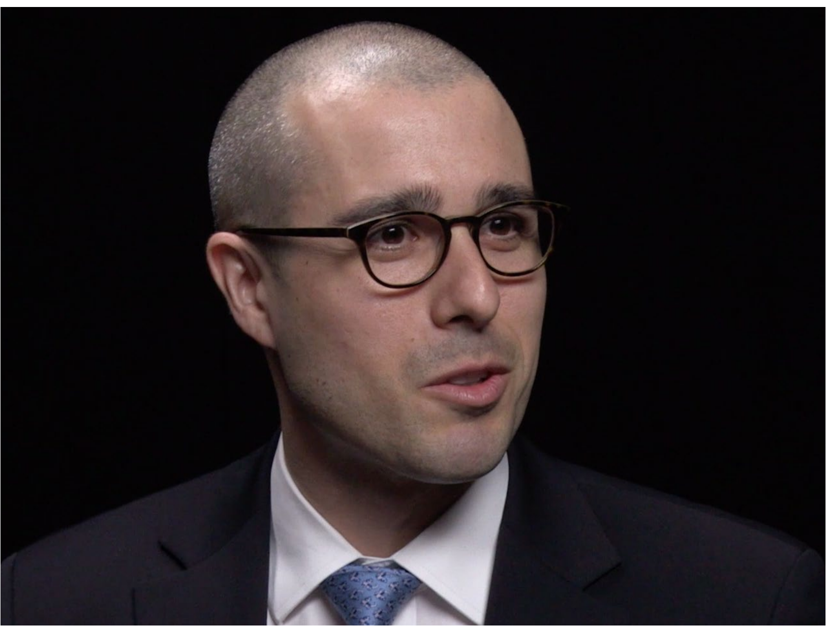
Looking for Yield Out of Bounds

Investors are increasingly looking abroad for better returns than those offered in the U.S. **Dillon Lorda** of the **PCA** talks about countries where the search for yield is taking place, and how Latin America fits into a portfolio.



Bio

Dillon Lorda is a principal at the Pension Consulting Alliance (PCA). He previously worked as a development associate in Mexico for Del Mar Development and on the acquisitions team of Time Equities, Inc. Lorda has also worked in international agricultural trading at Bunge Global Markets and ED & F Man. He received degrees from Hamilton College and New York University.

"If you look quantitatively at the yield premium needed to invest in these markets, I don't think anyone would allocate capital internationally. So there are a number of ways that you can try to quantify the yield premium needed to invest in, say, Brazil or India or Russia."

–Dillon Lorda, PCA

PrivcapRE: Real estate capital flows are becoming increasingly global, and for investors that means there's more emphasis on asset allocation. Dillon, are real estate investors looking beyond their own borders?

Lorda: It seems that there is a bifurcation in the market. There are certain investors who are increasing their exposure internationally, and others who are refocused and retrenched and trying to expand their footprint domestically.

What's driving the global search?

Lorda: There are a number of factors. Our clients are looking for increased yield, and they're looking for increased exposure to income-producing assets. There has been a shift in the last several years away from using international exposure for total return and looking for higher-yield opportunities relative to the U.S.

What are your expectations in terms of the growth of investors looking beyond their own borders?

Lorda: We expect significant growth and that the GP universe will try to broaden the suite of opportunities through which U.S. investors can access these markets—either through open-ended commingled funds or funds that offer optionality for longer-duration exposure. So clients, when they build to a 15 percent yield on cost, might be able to retain that asset and benefit from the income thrown off by that asset for a longer period of time.

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"There are still a disproportionate number of investors who are focused on the total-return opportunity. Many investors see this opportunity set for a higher-yield, longer-duration exposure to these markets and want to include that in their portfolio."

–Dillon Lorda, PCA

Are investors looking for a longer-duration vehicle when they're looking for a global allocation?

Lorda: There are still a disproportionate number of investors who are focused on the total-return opportunity. Many investors see this opportunity set for a higher-yield, longer-duration exposure to these markets and want to include that in their portfolio. Given the income return that's currently available in the U.S., it seems particularly attractive with long-term liabilities at 7.5 percent to 8 percent.

How are investors accessing global opportunities? Are they looking at the fund structure, or starting to look more at the open-ended commingled products?

Lorda: Those who can—the big limited partners—are trying to access assets either directly or through large separate accounts. There is a broader universe of smaller investors who currently don't have vehicles in which they can readily access those assets and hold them for long periods of time. And somehow the market needs to address that.

We talk a lot in real estate about finding the best risk-adjusted returns. How does PCA, and how do investors, assess the net returns of global investments that come back to the LPs?

Lorda: If we're going to be completely honest, it's an art more than a science. If you look quantitatively at the yield premium needed to invest in these markets, I don't think anyone would allocate capital internationally. So there are a number of ways that you can try to quantify the yield premium needed to invest in, say, Brazil or India or Russia. But the reality is that few markets actually offer the yield premium that would be required, using a strictly quantitative analysis.

Latin American real estate opportunities have been on the radar for investors since 2000. How does that area fit into today's investor portfolio?

Lorda: For most investors, Latin America is still an emerging part of their portfolio. Brazil has garnered a lot of attention from investors, and given the current economic headwinds, many have pulled back and are waiting to see what happens. Over the coming years, there will be interesting investment opportunities in Brazil, precisely because there isn't the flood of capital we saw previously. There are other interesting Latin American markets, such as Colombia and Mexico, that have their own unique implementation challenges that merit attention.

What are some of the most exciting opportunities in Latin America?

Lorda: There is a lot of downward pressure in Brazil. From our vantage point, the concern is less about the macro economic environment, but there's a lot of inventory that's come online. There will be interesting opportunities to buy some of the office assets that have been built, and we'll have slower absorption than previously underwritten. There are interesting opportunities in logistics and infrastructure in Mexico and Brazil, and Colombia is a nascent market.

And what worries you about Latin America?

Lorda: Certainly the pricing and flood of capital that's become available in some of the smaller markets. And more generally, some of these markets look very appealing on paper. The implementation, for various reasons, has been challenging for U.S. investors. The dynamics of a market like Mexico seem strong and like they would provide great investment opportunities for U.S. investors. When you look through the track record of that market, for various reasons the implementation of those strategies has been challenged. ■

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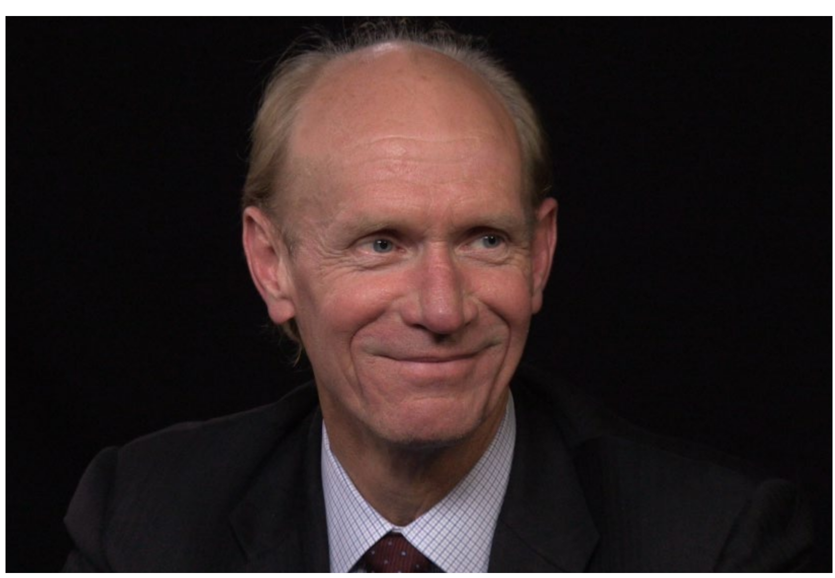

Bio

Experience:
Alan James brings more than 20 years of real estate enterprise sales experience to Yardi, along with a solid history of building and scaling world-class sales and alliance organizations in the real estate industry to create dynamic business growth.

Education:
James received a B.S. degree from Portland State University in accounting and finance law.

What sets Yardi apart in the way it works with real estate firms?

At Yardi, our philosophy is to provide a single stack of solutions that cover the entire real estate spectrum, from acquisition all the way through disposition and all the disciplines in between. The alternative option would be that a company would have to go out and buy point solutions to cover those different disciplines and then integrate those together.

Is real estate a laggard in terms of adopting technology for performance tracking and measuring?

I've been doing this for a long time. I would say yes, unfortunately, real estate has historically been a laggard on the use of technology. When I say that, I'm not talking about back-office accounting technology but rather business intelligence, predictive analytics. What's going to help the marketplace is [the use of technology such as we're seeing] from the consumer's side. Things like using iPads and smartphones in our personal lives [and] starting to carry them through to our professional lives. The escalating use of those technologies within the real estate sector [will help the marketplace].

Where is the technological innovation for real estate going to come from?

Today we hear all about "big data." The key there is putting information in the hands of the stakeholders and the consumers of that information in a way they can understand it, read it, and disseminate it.

On the big-data side, it's not just capturing the historical data, historical performances, etc., but it's taking that, along with forecasting assumptions, to look at where we may be. [In real estate], the number one [thing] we look at is credit risk. The number two [issue] is where are technologies taking themselves? When you have key performance indicators (KPI) you're tracking, and tied to big data, [you want] to be able to collaborate [on] that information through discussion threads. That is starting to lead itself to social media-type concepts, having discussions on that KPI you can share internally or externally within the organization on what's going on with that particular metric and why. ■