Faced with a broadening array of investment vehicles and strategies, institutional real estate investors, their consultants and managers have a greater need today for an integrated approach to developing and managing real estate investment programs than ever before. Together with the changing dynamics in the real estate market, economy and pension community, this expanding universe of investment opportunities increases both the complexity of and need for an approach to portfolio management that continuously measures investment performance and expectations against the strategy of the portfolio and the objectives of the investor.

Understanding Clients

The process begins with and is dictated by the objectives of the investor. A clear understanding of the investor’s objectives within the context of both the real estate portfolio and the overall multi-asset portfolio is essential. To construct an appropriate investment strategy, the portfolio manager must know precisely the investor’s risk and return expectations for the real estate portfolio and understand the role of the real estate allocation within the overall portfolio.

There are a number of factors that must be addressed in developing the investment strategy. In general terms, these can be thought of as belonging to one of several categories: investors’ constraints, preferences and unique circumstances. Constraints tend to be absolute boundaries which define the investment parameters. For example, the constraints might preclude or limit investments to one or more property types, geographic or economic regions, or quadrants – public or private debt or equity. Investor preferences, such as an aversion to certain types of investments within an otherwise “acceptable” property type of region, are by definition less absolute than constraints. But managers and investors must ensure that “less absolute” does not translate into “uncertain” boundaries. Similarly, certain investors may be restricted by unique circumstances which are often directed from the fund level.

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1 This article originally appeared in the May 2000 issue of The Institutional Real Estate Letter.
Understanding Markets

It almost goes without saying that the portfolio manager must also be conversant with conditions and trends in the property and capital markets. An understanding of the market conditions and dynamics is essential to developing the investment strategy. Further, to achieve the investor’s objectives, the execution of the strategy relies heavily on the portfolio manager’s knowledge and interpretation of the conditions in and expectations for the property and capital markets subject, obviously, to the constraints, preferences and unique circumstances of the investor.

The portfolio manager must not only monitor the demand and supply fundamentals in those markets in which he or she actively invests, but also must continually assess conditions in other markets to better understand the relative attractiveness and riskiness of all opportunities in the investable universe. At the same time, changing conditions in the capital markets, such as movements in interest rates, can affect the relative attractiveness of alternative investment opportunities. The ongoing analysis of the conditions in the property and capital markets feeds directly into strategic and tactical decisions regarding the composition and financial structure of the portfolio.

Analytics

The process of linking together the objectives of the investor and the conditions in the capital and property markets requires that portfolio managers be proficient in both quantitative and qualitative analytical techniques – science and art. Concepts like Modern Portfolio Theory, Value at Risk and Monte Carlo simulation can be important and powerful tools that provide portfolio managers with a systematic way of analyzing the risk and return characteristics of investment portfolios and managing risk.

As an asset class for institutional investors, real estate is relatively new. As a result, the techniques for analyzing and even the terminology for describing real estate investments are evolving under the direct influence of other asset classes. It is important, therefore, that managers be familiar with and, when appropriate, adapt concepts and analytical techniques from other asset classes.

Portfolio Strategy

While the conditions and expectations in the property and capital markets drive the tactical execution of the portfolio strategy, the essential strategy itself, in terms of where the strategy falls on the risk-return continuum (e.g., core, value-added or opportunistic) and what types of investments (e.g., public or private, domestic or international), is largely a function of the objectives and constraints of the investor.

Beyond the broader investment parameters, there are a number of decisions that further define the portfolio strategy. If leverage is an option, decisions concerning how much leverage is appropriate will be strongly influenced by the property and capital market conditions. The advantages of using debt include improved operational flexibility and, when yields on real estate are higher than mortgage interest rates, the potential to realize higher returns. But the portfolio
manager must also be aware of the impact leverage can have on the overall portfolio at the fund level.

Although passive and active management are used frequently to describe the management of stock and bond portfolios, due to the unique attributes of real estate assets, the approaches described by these terms are quite different in the context of real estate portfolio management. Because indexing is not practical for real estate investors, passive management typically describes a “buy and hold” strategy – acquiring high quality assets and holding them for a long period of time. By contrast, active management typically means a much higher turnover rate of assets in the portfolio to achieve certain portfolio objectives such as the age or capital expenditure profile of assets or yield expectations.

Lastly, while risk management is implicit throughout the portfolio strategy, it can be addressed directly through diversification. Diversification is a very powerful and perhaps the least expensive tool available for risk management. There can be many dimensions to portfolio diversification. The most commonly used methods, however, include diversification by property type and economic region.

Investment Management

The execution of the investment strategy is a dynamic process by which the risk and return objectives of the investor are reconciled with the conditions in and outlook for the property and capital markets. Market and submarket analysis is critical to the tactical execution of the strategy as the portfolio manager must continually assess market conditions to identify investment opportunities and evaluate risks.

From time to time, this analysis might signal an opportunity to overweight or underweight a particular property type or region to take advantage of (or avoid) mispriced risk. The tactical decision to skew the weightings in the portfolio towards or away from a particular sector raises the issue of concentration risk, a risk that must be carefully monitored by the portfolio manager. Concentration risk can take many forms including overexposure to certain regions or property types, a single asset in the portfolio, or even a single tenant or industry. While over- or underweightings might be deliberate, the portfolio manager must be aware of the exposure and make sure that the execution is consistent with the client’s risk and return objectives.

The ability to take advantage of market timing opportunities highlights the importance of developing and maintaining a strategic plan for each asset which relates directly to the portfolio strategy. At the time of acquisition, for example, specific consideration should be given to the legal structure through which each asset will be owned and the exit strategy for its disposition so that the portfolio manager can act decisively when an opportunity to liquidate the asset arises. Most importantly, the portfolio manager must take care to ensure that the investor is adequately compensated for increasing complexity of ownership.

Maintaining and updating a strategic plan for each asset also provides an important and relatively simple mechanism for evaluating the contribution and compatibility of the asset to the portfolio strategy. In particular, a buy/sell analysis should be prepared for each property on a regular basis to assess opportunities to liquidate the asset to either redeploy capital or to distribute capital to
the investor. Like a buy decision, the hold decision means that the portfolio strategy, market conditions, and risk and return expectations for both the asset and alternative investment opportunities support the acquisition of the asset at the current pricing.

Similarly, because the physical nature of assets requires that real estate investments, unlike stocks and bonds, be maintained, which can mean significant capital expenditures and hence less cash available for distribution to investors, the strategic plan should also include a capital budgeting plan for each property to ensure that the property can realize its expected performance.

Finally, an effective system of investment reporting is an important part of the investment management process. For both performance and compliance reasons, information must be transmitted from the property level to the portfolio manager and the investor in a timely, consistent and accurate manner.

Performance Attribution

In most cases, a portfolio manager generally will have some intuitive understanding of why performance met or varied from what was expected. More feedback, however, both qualitative and quantitative, is necessary to help identify deficiencies and/or anomalies and to assess the portfolio strategy and execution. Attribution analysis techniques for decomposing returns into contributions from various types of manager activities are increasingly being applied to real estate portfolios to quantitatively measure the sources of value-added and to better understand investment performance.

Conclusion

The conceptual framework outlined here offers some insights into the art and science that need to be incorporated into the portfolio management process to help investors achieve their goals. Importantly, investors, consultants and managers must be aware that the process is highly dynamic. Information must flow in a continuous, iterative loop. The objectives of the investor, the manager’s assessment of market conditions and even the quantitative and qualitative methods of thinking which drive the portfolio strategy and execution must be evaluated against the performance of the portfolio not only to achieve the risk and return objectives of the real estate portfolio, but also to ensure that the real estate allocation fulfills its role at the fund level in the overall multi-asset portfolio.
Portfolio Strategy
- Domestic versus International
- Four Quadrants
- Core, Value-Added, Opportunistic
- Leverage
- Passive vs. Active Management
- Diversification

Investment Management
- Market/Submarket Analysis
- Market Timing Management
- Concentration Risk Management
- Entrance/Exit Considerations
- Legal Structure and Joint Venture
- Buy/Sell/Hold Analysis
- Capital Budgeting/Property Mgmt.
- Investment Reporting

Performance Attribution
- Quantitative Analysis
- Qualitative Feedback