THE REAL ESTATE INVESTMENT MANAGEMENT INSTITUTIONAL LANDSCAPE

APPENDIX OUTLINE

26A.1 Real Estate Investment Management
26A.2 Salient Features of Real Estate Investment Management
26A.3 Responsibilities and Functions of the Investment Manager
26A.4 Private Real Estate Investment Products
26A.5 Real Estate Investment Management Firms: Objectives and Strategic Considerations
26A.6 Appendix Summary

LEARNING OBJECTIVES

After reading this appendix, you should understand:

- The essential characteristics of the real estate investment management industry for direct investment in the private real estate market in the United States.
- The major responsibilities and functions of the real estate investment manager, and how these relate to the firm's strategic environment.
- The major investment products in the private real estate investment industry, and the major role or type of investor each is designed to serve.

At the outset of Part VII, we said that we would address three major macro-level real estate investment decision arenas: broad strategy, tactical investment, and implementation of investment policy. So far, most of the material we have covered in Part VII has focused primarily on strategic and tactical investment decision making, and on fundamental valuation, performance measurement, and data issues that relate to all decision arenas. In this appendix and the main chapter in the text, we will focus more specifically on the implementation question and related issues concerning the "institutional landscape" in which macro-level real estate investment activity takes place. In particular, this appendix will focus on the professional real estate investment management industry and its interaction with the investor community, particularly institutional investors. It is important to understand this industry because it plays a central role in commercial property investment in the United States. If you work with large-scale commercial property investment in the United States and you don't work directly for a real estate investment manager, then you may very well be either a client of such firms, a consultant analyzing such firms, or a broker trying to sell to or buy from such firms.

This appendix will begin with an introduction and overview of the real estate investment management industry in the United States and the major types of investment products that have traditionally been most popular.

26A.1 Real Estate Investment Management

In Chapter 7, we presented an overview of the investment industry in the United States. There we noted the heterogeneity of investors, including differences along such dimensions as the amount of capital they have available, the nature of resources and expertise they possess relevant to managing investments, and the nature of the legal and regulatory constraints under which they operate. As a result, many investors either cannot, or prefer not to, manage

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directly all of their investments themselves. The result has been the development of a major branch of the investment industry consisting of **professional investment management advisory firms**. Such firms help a variety of investors place and manage capital in many types of investment products and asset classes. The common characteristic is that they operate in a "fiduciary" capacity on behalf of their clients.[1]

Most investment management firms concentrate primarily in investments in publicly traded securities (stocks and bonds), but some firms offer services for direct investment in the private property market. Real estate investment management firms come in a variety of shapes and sizes. Some are independent firms specializing purely in the private property market; indeed, some are very small "boutique" firms specializing in one particular type of property. Others are branches or departments of broader investment or financial firms that offer private property investment management as one of a broad range of investment and financial services. While some firms work primarily for wealthy private individuals (family offices), the most prominent branch of the real estate investment management industry at the macro-level in the United States during recent decades has been oriented toward working primarily for pension funds and other tax-exempt institutions (such as endowment funds). Some real estate investment management firms will manage client investments in publicly traded REITs as well as (or instead of) direct investment in the private property market, and some firms include investment in commercial property debt products as well as equity products (e.g., either CMBS or whole-loan commercial mortgages).

As noted, one of the largest segments of the professional real estate investment management industry in the United States during the 1990s focused on the management of pension fund and other tax-exempt institutions' real estate investments. This branch of the industry has been a leader in developing sophisticated professional management techniques at the macro-level, and it will be our primary focus in this appendix and in the main chapter.[2] The pension fund real estate advisory business has its historical origins in the passage of the **Employee Retirement Income Security Act (ERISA)** by Congress in 1974. As we described in Chapter 7, this law encouraged large to medium-size pension funds to consider real estate investment as a diversifier of their traditional stock and bond portfolios and led to a large demand for specialized real estate investment management.

Many real estate investment management firms evolved originally from one of two sources. Many of the largest real estate investment management firms grew out of (and sometimes remain part of) life insurance companies and other financial service firms, such as investment banks and commercial banks. Historically, many such firms developed expertise in the management of commercial property investments through the experience gained managing their own property investments for their own account.[3] These firms are often focused primarily on traditional **institutional quality commercial property**, the core of the typical pension fund real estate portfolio.

Real estate investment management firms also evolved out of successful private real estate development and/or investment firms. Many of these firms are smaller and specialize in certain types of properties or locations. Sometimes these may include investments that are

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[1]A fiduciary relationship legally binds the agent in a role of "trust" for the principal party, resulting in certain legal standards and responsibilities governing the agent's behavior. For example, a fiduciary must adhere to strict reporting requirements, and investment decisions must be guided by the so-called "prudent investor" rule. This prohibits inappropriate or irresponsible management of the client's capital and often dictates a somewhat conservative approach. While not all investment manager/client relationships are fiduciary relationships in the strict legal sense, many are, and something of this spirit permeates most of the others.

[2]Of course, the more basic points and principles raised here and in the Chapter 26 text are generally applicable to other branches of the industry as well. Depending on how one defines the real estate investment management industry, the other major branches might include bank trust departments that work primarily for wealthy individuals, insurance companies that work for their own accounts, and corporate real estate departments.

[3]In the life insurance industry, this is referred to as the company's "general account," as distinct from third-party management business, which typically involves the use of "separate accounts" and/or various types of fund vehicles.

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beyond the traditional conception of "core" institutional quality property, such as specialized property types, "turnaround investments," development projects, and land investments.[4] These types of investments are often regarded as "**value-added**" or "**opportunistic investments**" in the institutional portfolio, with the objective of seeking higher returns even though this implies taking on more risk.

A more recent evolution in the real estate investment management industry is its greater integration with the rapidly growing private equity branch of the broader overall investment management industry. Large investment banks and commercial banks and diversified financial institutions have established private equity businesses including units specializing in private real estate investment. Sometimes these units have been grown from within the parent firms and sometimes they have been acquired from previously independent or life-insurance-originated firms.

In the late 1990s and early 2000s, investment in the direct private real estate market became classified into three major investment "styles," which effectively are different points on the risk/return frontier (see Chapter 22). These include **core**, **value-added**, and **opportunity** (or "opportunistic") styles. Core investment is at the low end of the risk and return range. It involves investment in stabilized (well leased) prime quality properties, i.e. classical "institutional" real estate. Opportunity funds are at the other extreme, seeking high returns by taking on considerably risk, investing in development projects, turnaround deals, distressed debt, international investments, operating companies, and other types of assets, often using considerable debt. Value-added funds are in between. (See additional discussion in section 26.2.2 in the textbook.)

Real estate funds typically specialize in one style or another. The major real estate investment management firms typically have a menu of funds or other vehicles that enable investors to choose at least two of the investment styles. Many opportunity funds are run by independent or relatively new investment management firms, although the general movement toward consolidation in the industry has resulted in large holding companies owning funds that sometimes start out as independents.

Of course, there are also other sources and types of real estate investment management firms. Equity mutual funds are involved in some aspects of the business, especially for investments in REIT shares. Some REITs have set up vehicles to manage private investment funds separately from the general assets of the REIT. Also, a few large pension funds directly manage much of their real estate investments themselves, as do some sovereign wealth funds, which have become the largest individual pools of investable capital in the world in the early twenty-first century.

26A.2 Salient Features of Real Estate Investment Management

In Parts I and II of this book, we noted that real estate space markets are highly segmented (both geographically and functionally, that is, for different types of property). We also noted in Chapter 7 that direct investment in real property involves **operational management responsibility** for the investment assets. In Chapter 12, we described how the private trading of whole, unique assets tends to make the property market less informationally efficient than securities market. We noted that this brings both dangers and opportunities at the micro-level, such as the possibility of doing deals that have nonzero NPV, even when evaluated from a market value perspective.[5] Because of these characteristics of direct investment in private real estate, specialized expertise is required. Real estate investment management firms

[4]Some specialized property types include, for example, agricultural and timber lands, golf courses, parking lots, hotels and restaurants, and speculative land. The term "turnaround investments" refers to properties that are currently underperforming and typically in need of substantial capital investments to "turn them around" in the space market.

[5]See section 12.2 in Chapter 12.

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provide this expertise. In particular, such firms provide expertise both in commercial property markets and in property asset operational management.

This expertise distinguishes real estate investment management firms from investment firms that deal strictly in the securities markets. Securities investment managers do not have to go out and *find* specific assets to invest in. The available securities are publicly listed. Nor do securities managers have to *negotiate* purchase and sale terms for the assets they invest in. Securities are purchased at market value (or via limit orders) in the public exchanges. Finally, securities managers are not responsible for the operational management of the assets they own or manage for their clients, as investors in stocks typically own only a small fraction of the controlling interest in the listed firms. For all of these reasons, real estate investment management services are typically quite a bit more expensive per dollar of assets under management than are securities investment management services.[6]

As is discussed in some depth in the main part of Chapter 26, asset operational management responsibility is particularly important in real estate investment. Because transaction costs for buying and selling real property are relatively high (as a proportion of asset value), real estate assets must generally be held for long periods of time in order to mitigate the impact of transaction costs in the multiperiod average return obtained by the investor. Furthermore, as noted in Chapter 7, most types of commercial property provide investment returns primarily from the generation of operating income, rather than capital gain. For both of these reasons (long holding periods and income-based returns), much of the total return ultimately earned by the investor derives from how well the asset management function is carried out by the investment manager.

26A.3 Responsibilities and Functions of the Investment Manager

Professional real estate investment management involves a number of tasks or functions. At the most basic level dealing directly with the physical assets that underlie the success of the firm there are the "four fundamental responsibilities" that were described in section 26.1.2. But more broadly a successful investment management firm must perform a number of other functions:

1. **Investment Advisory Services**. Broadly, *investment advisory services* refers to advice regarding macro-level real estate investment decisions, potentially including both strategic and tactical policy. For example, many management firms offer advice concerning the allocation of all or part of the client's real estate investments.[7] Should the client include apartment properties in her portfolio? If so, what percentage of her overall real estate investment should be allocated to apartments, and what geographical distribution should be targeted? What size, quality level, and type of properties should be targeted at the present time? These are the types of allocation and tactical questions, starting from the broad and moving toward the more specific, for which real estate investors need

[6] During the 1990s, typical real estate investment management fees for large institutional investors were in the neighborhood of 100 basis points per year, as a fraction of the value of the assets under management. Apart from pecuniary considerations, we hasten to add that, if you are fascinated by cities and land and geography and economics and finance (in short, if you've got real estate "in your blood"), then the fact that real estate investment management has this unique characteristic of encompassing and integrating investment management per se with financial and operational management of real assets makes it an exciting and appealing career consideration.

[7] In some cases, allocation advice or analysis may extend beyond the real estate asset class, or beyond the private property market, to the mixed-asset or "multiquadrant" level.

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expert answers. Although less common, investment managers also offer advice on the timing of the client's real estate investments, at least within the real estate asset class.[8]

2. **Asset Selection and Transaction Execution**. The one function that virtually all real estate investment managers perform is to find, buy, and sell properties on behalf of their clients (or for property "funds" that they operate for investors). As distinct from the advisory function described previously (with which it should be integrated), asset selection and transaction is essentially a micro-level function. It requires familiarity with the local space and asset markets in which the firm operates. It is a transaction-oriented function that encompasses both acquisition and disposition of properties. A big part of the daily activity in carrying out this function is *searching*, either for properties to acquire or for buyers who will purchase properties the manager wants to sell.[9] This function also includes *deal structuring* and negotiation.[10] Investor clients rely on managers to help them avoid the negative NPV danger posed by the inefficiency of the private real estate market.

   Sometimes managers go beyond dealing only with existing fully operational properties to pursue acquisitions that include a considerable construction component, either new development or rehabilitation of existing buildings. Most commonly, real estate investment managers undertake such projects in a team with a firm that specializes in real estate development and construction. The developer partner might often be a REIT or a private development firm with the necessary local expertise and development experience. Investment in development projects is generally more risky than investment in existing fully operational buildings. If the manager's investor clients are rather conservative (that is, relatively risk averse, as is often the case, for example, with many pension funds), then the deal may be structured so the manager has a lower-risk preferred or senior position, perhaps involving a debt instrument.

3. **Investment Product Development**. Many real estate investment managers offer somewhat standardized "products" or "vehicles" designed to enable a relatively large number of smaller investors to place capital into the private real estate asset class. At one extreme, these products may be structured as securities, with relatively small, homogeneous "units" offered for sale to the general public. This type of operation comes under the regulation of the Securities and Exchange Commission (SEC), whether or not the securities will be listed and traded in a public stock exchange. This type of product is relatively rare in the United States. More common are private offerings designed specifically for tax-exempt institutions or wealthy private investors. In any case, there is considerable work, as well as scope for entrepreneurial creativity, in the design and development of vehicles that pass the investment performance characteristics of private property ("bundled" or "unbundled" in various ways) from the property level to ultimate investors. As noted in Chapter 7, this is a classical role of the investment industry, enabling underlying physical assets to serve the variety of investment needs and objectives of a heterogeneous population of investors.

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[8]Obviously, a manager specializing in one type of investment product or asset may not be the most unbiased source of advice about the timing of placing capital into, or out of, that particular type of investment product or asset. At least as a general characterization, investment managers, as such, make their living largely by procuring and managing investment capital for their specialty of investment. For broader and more objective advice about investment strategy and timing, investors often hire consulting firms, some of which specialize in the area of real estate investor "client-consultant" services. In principle, such firms do not manage capital, and they do not work for investment managers. Indeed, one of their functions is often to help the investor client evaluate and/or select an investment manager.

[9]Professional commercial property brokers assist investment managers in the search function.

[10]Brokerage firms may also help in these functions, and investment managers often hire legal firms or specialized consulting firms to assist in various ways. However, the investment manager will typically be the only party that is in a formal fiduciary relationship with the ultimate investor client.

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4. **Asset Management**. We already mentioned that one of the salient features of direct investment in private property assets, as compared to securities investments, is the responsibility for operational management of the assets that are held. This is because *whole assets* are typically traded in the private property market, so equity investors generally have controlling ownership shares (sometimes with one or a small number of joint venture partners). As noted, the long holding periods typical of private property investment mean that asset management is often a major profit center for the management firm and/or its investor clients (as a major source of investment returns).

   The typical large-scale real estate investment management firm is organized into departments or disciplines, one of which will typically be **asset management**, while another will often be called something like **acquisition and disposition**. The latter is populated by transactions specialists, the "deal-doers," whose workload is directly and immediately impacted by the volume of capital flow into or out of the firm's management. The asset management department, on the other hand, has an ongoing function, with a workload more proportional to the *stock* of assets under management than to the *flow* of capital.

   Asset managers are responsible not only for overseeing property-level operational management, but also for the longer-run strategic management and development of the property portfolio. Thus, like the deal-doers, asset managers also need to be expert in both real estate space and asset markets, and intimately familiar with the local markets in which they operate. It is not uncommon for individuals to rotate between asset management and acquisition/disposition either within or between management firms. It is important for the asset management function to be integrated rationally with the acquisition/disposition function, for one of the strategic jobs at the intersection of these two functions is the decision of when (and how) to sell assets currently held by the manager, and what sort of new acquisitions to target for the portfolio.

   In commercial property investment, the management function is typically divided into two levels. At the more "macro" level is the function referred to as asset management per se, which involves the oversight of an entire portfolio of properties. This function is almost always carried out directly by the investment management firm "in house." At the "micro" or property level, operational management is referred to as **property management**. This includes such activities as physical facilities management, leasing, tenant servicing, property cash flow budgeting, collection and management, and capital improvement planning and budgeting. While property management is sometimes performed directly by the investment manager, it is often contracted out to specialized property management firms. In any case, it is in the purview of the management firm's asset managers and should be integrated with the overall asset management strategy of the portfolio.[11]

5. **Managing Financial Leverage**. While some core style investment funds use little or no debt, most real estate investment is made with some financial leverage. We have seen in Chapter 13 how crucially such leverage can affect the investment performance of the equity investment. In principle leverage decisions should probably be made by the investor principal parties whose money is being risked. But in many cases investors effectively delegate that decision to the investment manager, at least within some range of discretion. The management of leverage policies and capital structure in general is one of the most important and challenging functions of the real estate investment manager. One of the great challenges is apparently to avoid taking on more debt when property prices are at or approaching a cyclical high point. Such times are often accompanied by easy credit

[11]For example, leasing strategy and the marketing or positioning of properties within their space markets needs to be rationalized between the "macro" asset management level and the "micro" property management level. Property managers typically work with leasing brokers to help with the leasing function. Leasing will be discussed in more depth in Part VIII.

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terms and low interest rates and an exuberant atmosphere, making it tempting to employ more leverage. Sometimes the results can be disastrous, but more commonly in the typical institutional investment management circumstances the result is simply a diminution of long-run returns for the investors, below the returns actually achieved by the underlying property assets. While financial engineering is certainly part of the tool kit of the successful real estate investment manager, in general there is far less ability of leverage to actually add value for investors than it often appears superficially or in the short run. (See discussion primarily in Part V of this text.)

6. **Support Functions: Communication and Research**. The four previously described functions represent service "products" the real estate investment management firm sells to its clients. In order to effectively "produce" or deliver these services for their clients, and in order to build and operate the investment management business, the management firm must also provide or acquire several other support functions or services.[12] For example, communication with clients is extremely important in a fiduciary business in which one is managing the clients' money. A key part of this is the compiling, analysis, and reporting of investment performance information. This analysis function can also provide a useful diagnostic and decision-support function within the investment management firm.[13]

    Related to this latter function, another very important support activity for the investment management firm is **investment research**. In fact, the real estate investment management firm's research department can focus quite broadly, providing valuable insight and information for any and all of the four products described previously, as well as useful internal analytical and diagnostic information. The research department should be the long-range eyes and ears of the investment management firm, as well as its repository of wisdom. The research department needs to develop and organize decision-relevant information and knowledge concerning both the space markets and the property asset markets, as well as the broader capital market. To do this, the research department will often work with specialized consultants and data vendors dealing with both the space and asset markets, as well as the general economy and capital markets as a whole.

    While a few of the largest real estate investment management firms have always had research departments, the property market downturn and financial crisis of the early 1990s led to a substantial expansion of the role of research in the industry. In some management firms, the director of the research department sits as an ex officio voting member on the firm's **investment committee**, a high-level interdepartmental committee that typically has the final review and approval authority over all of the firm's acquisition and disposition decisions. Many investment management research departments include "quant" types with Ph.D. or technical graduate degrees. However, industry research must always provide information that is directly useful to decision making, and research departments are also typically expected to be able to help with the firm's marketing efforts and to communicate effectively with clients who may lack specialized expertise.

Not all investment management firms undertake to provide or offer all of the products or services described here. Some provide only one or two of these functions in house.

[12]In addition to the communication and research functions described here, other functions and departments in a typical large investment management firm might include risk management (e.g., hazard insurance), engineering, information technology, and, of course, accounting.

[13]Specialized consulting firms also help to provide analysis and diagnostic services to investment management firms. For example, in Britain most investment managers (and other major commercial property owners) contribute standardized property-level and fund-level investment performance data to a private firm (the Investment Property Databank—IPD) that is then able to compare each owner's performance (on a proprietary basis) with the average performance of similar properties held by other owners in a "peer group" of similar owners. This type of service is expanding in a number of countries, although as of the end of the 1990s, this type of service was not exactly available in the United States. In the United States, a variety of consulting services and information vendors, as well as the National Council of Real Estate Investment Fiduciaries (NCREIF), provide investment managers with information relevant to the commercial property asset and space markets.

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INDUSTRY ASSOCIATIONS AND REAL ESTATE INFORMATION STANDARDS

Our description of the private real estate investment management industry in this appendix focuses on private firms and investment products. But private firms alone are not sufficient to establish and maintain a well-functioning investment industry. Industry associations, nonprofit organizations of the major interest groups, and "players" in the industry serve several vital functions. Three major industry associations are:

- **National Council of Real Estate Investment Fiduciaries (NCREIF)**. Formed in 1982, NCREIF's mission is to promote private real estate as a credible asset class for institutional equity investment by collecting and disseminating information. NCREIF is most famous for the NCREIF Property Index (NPI) that it produces and publishes quarterly. NCREIF also plays a leading role in developing, updating, and implementing the Real Estate Information Standards (discussed later in this box).
- **Pension Real Estate Association (PREA)**. This is the major forum of the major group of institutional investors in private real estate, the pension plan sponsors. The major investment management firms are also members of PREA, and PREA meetings are important forums for managers and investors to get together at the executive level. (In contrast, NCREIF tends to focus more on the technical or research level, although NCREIF also encompasses both plan sponsors and managers.) PREA's mission emphasizes promotion of the private real estate asset class through research and education.
- **National Association of Real Estate Investment Managers (NAREIM)**. This association is specifically for the private real estate investment management firms, and it serves as the major forum for the executives of such firms to exchange ideas and concerns. Along with PREA and NCREIF, NAREIM is responsible for promulgating and updating the Real Estate Information Standards.

One of the most important functions of industry associations such as these is to improve the efficiency and credibility of the private real estate asset class through the development and promulgation of common information standards regarding the measurement and reporting of investment performance. A major advance was made in this regard in 1997, with the formal adoption by all three of the previously described associations of the official **Real Estate Information Standards (REIS)**. The REIS serve a role in the private real estate investment industry much like that served by the investment performance reporting standards promulgated by the **Association for Investment Management and Research (AIMR)** in the securities industry. Indeed, the REIS are based on, and consistent with, AIMR standards wherever possible, but go beyond AIMR guidelines in areas peculiar to private real estate.

Information standards such as the REIS enable more meaningful apples-to-apples comparisons to be made across investment managers and private real estate funds. They help to standardize, clarify, and make "transparent" the accounting, appraisal, and performance measurement definitions and procedures that underlie the quantitative reporting of investment performance, building on other industry standards, such as those promulgated by the accounting industry (GAAP) and the appraisal industry (the Appraisal Institute). For example, the REIS address the nuts and bolts of procedures for calculating holding period and multiperiod returns and return components (e.g., what expenditures should be capitalized as opposed to expensed). They also help to standardize useful definitions, such as property type classifications (e.g., what the definition of an office building is, or how rentable square feet should be measured).

The development of the REIS in the late 1990s, and their annual review and updating by the three associations noted earlier, represents an unglamorous, easily ignored activity that nevertheless contributes greatly to the long-run efficiency and credibility of private property investment.*

*For more information about the REIS, contact any one of the organizations noted. A general introduction to the REIS is presented by Greig (1997).

They may contract out for some functions, or work in tandem with other firms. As a general rule, at least two or three of the previously described products and services are bundled together, not sold separately by investment management firms.[14] In some cases, the investor clients provide some of the functions for themselves on their own, or contract directly for some functions with other specialized firms. However, it should be clear that the overall process of investment management typically should encompass all of the functions noted, in whatever manner they are organized and structured (not necessarily in a single firm).

[14]For example, it is rare for investment management firms to sell advisory services separately. Such services are provided as part of the capital placement and management service, or are provided separately by consulting firms as opposed to management firms.

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26A.4 Private Real Estate Investment Products

The major traditional types of investment products and vehicles offered by real estate investment management firms span a range designed to accommodate investors of different sizes and types. Some of the most common types of products are described briefly here:

- **Open-End Commingled Funds (CREFs) or Property Unit Trusts (PUTs)**. With this type of product, an ongoing portfolio of properties is offered to many investors, with investors allowed (in principle) to cash in and out at stated (fairly frequent) intervals (e.g., quarterly), based on appraised values of the properties in the fund or trust.[15] In the United States, this type of product is typically aimed largely at institutional investors (defined-benefit pension plan sponsors) with fund units typically selling for a few hundred thousand dollars, which aims this type of product at investors wishing to put less than $50 million into real estate. However, it is possible in principle to offer smaller-denominated units, and at least one pension plan sponsor in the United States has set up a vehicle like this to enable individual defined-contribution plan members to invest directly in private real estate at their own discretion. In some countries, vehicles like this are fairly actively traded in secondary markets, where their unit prices are quoted. Some secondary market trading also occurs in the United States, though a mechanism to facilitate such trading, called the Institutional Real Estate Clearinghouse, failed in the 1990s.
- **Closed-End Funds or Unit Trusts and RELPs**. This is similar to the open-end product just described, only the investors cannot cash in and out at will; the fund is closed to new investors once it is capitalized, and it faces a finite lifetime at which point it will be liquidated. Units in such funds for institutional investors are typically purchased for a few hundred thousand dollars, and the product is typically designed for institutional investors wishing to put $50 to $100 million in real estate. This type of product was marketed widely to individual investors, with much smaller unit sizes, as real estate limited partnerships (RELPs) in the 1970s and 1980s. At that time RELPs were oriented primarily toward tax shelter, as the partnership structure allowed the liberal tax allowances that were available on private real estate in those days to be passed directly through to the individual taxed investors. Whenever products such as this are offered to individual investors or the public at large, they come under regulation by the Securities and Exchange Commission (SEC).
- **Private REITs**. In the 1990s, funds of the type just described were sometimes structured as private REITs, a structure that facilitated coinvestment and active management by the investment manager, and which made it easier to transfer ownership shares among a broader potential clientele of different types of investors. (As noted in Chapter 23, REITs must have at least 100 shareholders, no five or fewer of which can own more than 50 percent of the outstanding shares, but they need not be publicly listed.) Private REITs are often viewed as vehicles to develop an investment performance track record, which might enable the REIT to be taken public in the future when the stock market is favorable (so-called “incubator REITs”). More recently, private REITs have been developed aimed at the retail (small-scale individual investor) market. These vehicles are not traded on well-organized secondary markets, and their share prices offered to new investors are often fixed at constant prices for long periods of time.
- **Discretionary Separate Accounts**. With this type of service, the investor hires the manager to buy and manage properties on the investor’s behalf, with the manager having the discretion as to which properties to buy and sell. Each separate account is managed on

[15]To be more precise, CREF unit values are based on the fund net asset value (NAV), which typically includes some small non-real-estate holdings (primarily cash). The real estate assets are valued based on appraisals.

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behalf of a single investor, allowing a more custom-tailored service for larger investors. Separate accounts typically require a minimum investment of several dozens of millions of dollars. They are aimed at investors wishing to put a total of several hundred million dollars into real estate altogether (typically using several managers).

- **Nondiscretionary Separate Accounts**. These are the same as discretionary separate accounts, only the manager cannot make final property-level purchase and sale decisions without approval by the client.[16] This vehicle requires more client expertise and involvement and is most appropriate for investors whose total private real estate investments are on the order of $1 billion or more, giving them the scale to be able to afford some specialized real estate investment staff of their own. Many of the largest pension funds fall into this category.

The types of products described here are the major categories for investors interested in the private property market in the United States in the 1990s. As noted in previous chapters, an alternative approach to real estate equity investment via the public stock exchange is to invest in REIT stocks, either directly or through specialized equity mutual funds or separate accounts. Most REIT mutual funds in the 1990s were "actively managed," with the investment managers attempting to select REIT stocks that they thought would outperform the average. But at least one major mutual fund offered a "passively managed" REIT index fund.[17] The 1990s also saw the advent of "hybrid" or "multiquadrant" investment vehicles that would place capital into both private property holdings directly, and/or into REIT shares (or CMBS investments).[18]

These were offered to institutional investors by some mutual funds as well as some traditional real estate investment managers and specialized firms, either as funds or separate accounts.

26A.5 Real Estate Investment Management Firms: Objectives and Strategic Considerations

Exhibit 26A-1 schematically depicts the ends, means, and major causal relationships acting strategically on the typical real estate investment management firm. At the top of the diagram is the major overall long-run consideration for the owners and managers of the firm, namely, the value of the firm. This value is shared by the partners and/or shareholders of the firm, and its maximization may be considered to be the primary goal of the firm's management. At the bottom of the diagram are four broad causal factors that underlie the firm's results. These include the overall capital market, the real estate asset and space markets, client preferences, and actions taken by the real estate investment management firm itself.

The underlying causal factors interact with each other to determine the flow of investment capital into or out of the management firm. The only one of the four causal factors directly under the control of the investment management firm is the firm's own actions, indicated in the box at the bottom right. The manager's actions are of course reactions to past,

[16]In practice, the distinction between discretionary and nondiscretionary accounts is a relative one, and rather fuzzy at that. Even so-called discretionary accounts often subject the manager to some constraints and a formal approval process.

[17]Passive funds do not try to "beat the market." They maintain low turnover and low management expenses by pegging their allocations across individual stocks to the asset weights in a market-value-based index. The most widely used REIT indices in the 1990s were the NAREIT, Morgan-Stanley, and Wilshire indices.

[18]The term "quadrant" in this usage refers to a division into public and private asset markets, and into equity and debt types of investment products, a classification similar to what we used to classify asset markets in Exhibit 1-6 in Chapter 1.

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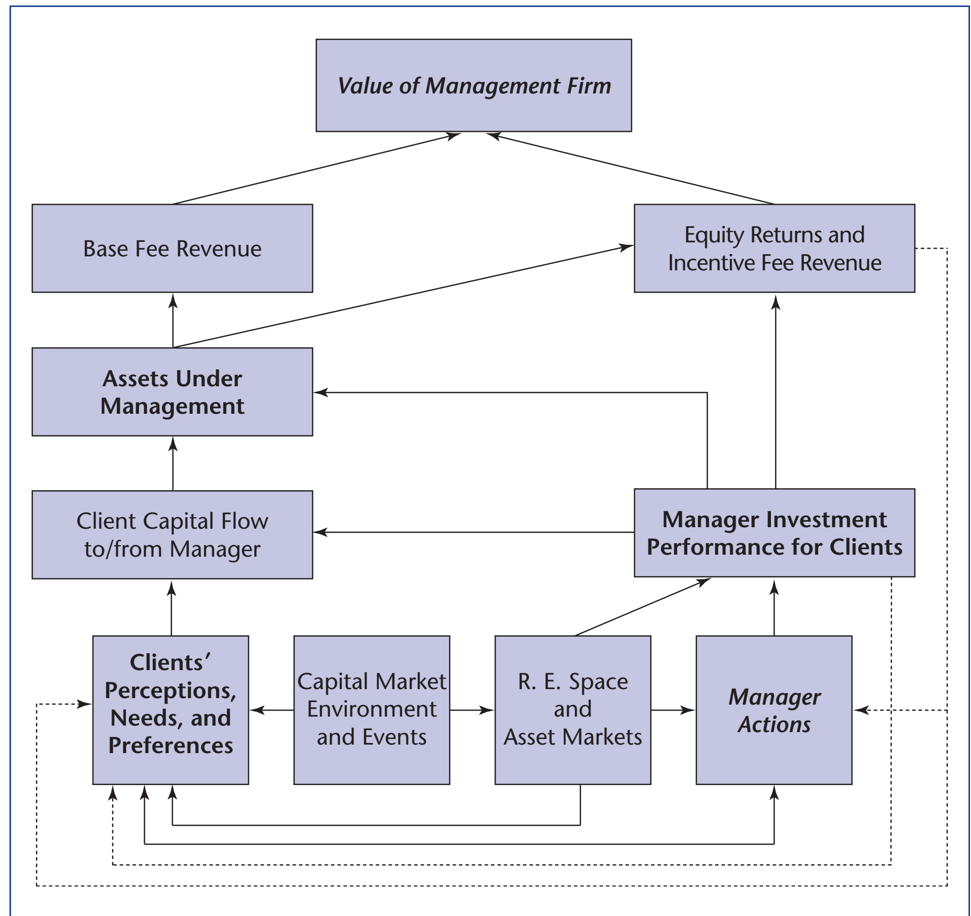

EXHIBIT 26A-1 Real Estate Investment Management Firm: A Schematic Diagram of Ends, Means, and Causal Elements

present, and perceived future trends, events, and opportunities (or dangers) in the commercial property space and asset markets (which in turn are affected by the capital market and the real economy, broadly defined). The manager's actions include real estate asset management and investment decisions (such as acquisition, disposition, and leasing or capital improvement investment decisions) that, interacting with the space and asset markets, result over time in a certain investment performance outcome for the client (indicated in the box to the right at the next level up in the flow of causality).

The manager's actions are also influenced by client needs and preferences, and the manager can take actions to directly influence client attitudes, perceptions, and preferences regarding real estate in general, and the manager in particular. This would include actions such as client communication and advisory services. Thus, the direct flow of causality between manager actions and client preferences is two-directional. The client is also influenced directly by the capital market (and the general economic environment, as well as the client's own particular needs and circumstances) and by the client's own direct perception of the real estate space and asset markets.

Note that there is an important long-run feedback loop of causality (or it might be called a "reputation loop" or "trust loop") running from the manager's performance outcome for the client back to the client's preferences (and perceptions) regarding the manager.

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Obviously, the better the investment performance outcome the manager achieves for clients, other things being equal, the more favorably clients will be disposed toward the manager as the relationship develops over time. Client attitudes and preferences relevant to the manager will interact with client perceptions of the manager's performance results to determine the amount of capital flowing to (or from) the manager (represented by the left-hand box in the second level of causal flow in the exhibit).

Client capital flow to (or from) the manager is the major long-run determinant of how much capital the manager has under management. However, assets under management are **marked to market**, that is, regularly appraised on the basis of their market value in the current property market. Thus, the total value of the manager's **assets under management (AUM)** is also influenced by movements in the real estate asset market and the manager's investment performance therein. The magnitude of the AUM is typically an important determinant of the profitability of the management firm, especially for the more traditional "core" real estate investment managers. A large proportion of managers' revenues consist of **base fee revenue**, which is determined as a constant percentage (per year) of the total value of the AUM.[19] Thus, the manager's base fee revenue is directly proportional to the magnitude of the AUM.[20]

Another source of manager revenue and/or long-run profitability and firm value growth derives directly from the manager's investment performance. Real estate investment management firms sometimes take equity positions of various types in the investments they manage for their clients. For example, the manager may be an equity **coinvestment** or joint venture partner with its clients, or it may have residual general partnership interests (for example, in a RELP), or the manager may simply have levered equity positions in assets in which clients have debt or preferred equity positions. Even in the absence of equity participation, the manager's compensation package from the client may include performance incentive fee components. For example, the manager may get a bonus if the client achieves a higher return (perhaps relative to some benchmark indicator of relevant investment performance) over a specified time period.[21]

Smaller, more entrepreneurial investment management firms, often (but not always) specializing in "opportunistic" properties (such as opportunity funds), have traditionally relied more heavily on equity and incentive fee components than do the large "institutional core" investment managers.[22] However, the 1990s saw an expansion in the use of such arrangements even among the traditional core managers. If equity and incentive fee arrangements are well structured, they can help to align the interests of managers and their clients. If they

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[19]This may raise a potential for conflict of interest between the client and the manager regarding the appraisal of the properties under management. The manager stands to lose revenue if the properties are appraised at a lower value. The contractual arrangement between the client and manager (or the governance procedures of the fund) will often address this problem by providing for the use of independent fee appraisers (at some minimum interval for each property) and/or for the investors/clients to have some voice in the hiring or review of the appraisers.

[20]Some revenue is also often obtained as lump sums either going in (a.k.a. front-end fees) and/or going out (a.k.a. back-end fees), that is, when the capital flows into or out of the manager's management. However, much of this revenue may be in the form of acquisition fees or disposition fees, much of which must be used to cover expenses associated with the search and transaction costs of real estate purchase and sales.

[21]One form of incentive fee arrangement pays the manager a bonus regularly, for example, at the end of every year based on performance during the preceding year (often based on appraised values of the properties held for the client, as well as net operating income). Another form of incentive fee is strictly "back end," based on the realized IRR and paid only after liquidation of the investment, or after a multiyear holding period or management contract period (based on appraised value at the end of the period).

[22]Some legal restrictions, for example in the ERISA, place limits on the use of incentive management fees by certain types of investors. In the extreme, if the manager does not provide investment advice or take fees for AUM, then the manager is no longer a manager as such (a fiduciary), but rather a pure joint venture partner (or debtor) of the investor.

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are poorly structured, they may exacerbate agency costs and cause ill feeling on the part of the client, the manager, or both.[23] Thus, there is a potential long-run feedback loop from the equity or incentive fee arrangements to both manager actions and client perceptions. Ultimately, the total profits of the investment management firm (both present and future, and therefore, the value of the firm for its partners and shareholders) derive from the combination of the AUM-based and the performance-based revenues and profits.

26A.6 Appendix Summary

This appendix introduced some of the major features of the "institutional landscape" of commercial property private equity investment in the United States at the turn of the century. Real estate investment management plays a pivotal and important role in the overall real commercial property investment industry. It is a dynamic, ever-changing business in a rapidly evolving investment industry. Technological development, regulatory reforms, and the constant working of entrepreneurial innovation will carry the real estate investment industry forward into the twenty-first century. Perhaps you will be a part of this progress!

KEY TERMS

professional investment management advisory firms
Employee Retirement Income Security Act (ERISA)
fiduciary relationship
institutional quality real estate
opportunistic investments
core investment style
value-added investment style
opportunity investment style
operational management responsibility
investment advisory services
asset selection
transaction execution
investment product development
asset management
acquisition and disposition
property management
investment research
National Council of Real Estate Investment Fiduciaries (NCREIF)
Pension Real Estate Association (PREA)
National Association of Real Estate Investment Managers (NAREIM)
Real Estate Information Standards (REIS)
Association for Investment Management and Research (AIMR)
investment committee
commingled real estate fund (CREF)
property unit trust (PUT)
open-end fund
closed-end fund
real estate limited partnership (RELP)
private REIT
separate accounts
discretionary accounts
nondiscretionary accounts
marked-to-market
assets under management (AUM)
base fee revenue
coinvestment

[23]The different ways in which the manager's equity and/or incentive fee interests can be structured can have important implications for the degree to which the client and manager share common interests or face conflicting pecuniary incentives, under different circumstances. To take a simple example, suppose the manager's bonus incentive fee (or subordinated equity position) pays off significantly for the manager only if the investment yields a very high return (e.g., there is a "hurdle" or client-preferred return component). Then, other things being the same, the manager has a greater incentive than the investor client to invest in assets that have a lot of specific risk and volatility, as the manager loses less from the downside of such risk and gains more from the upside. Another problem to consider is how manager equity involvement may constrain investors' flexibility to change managers or decide on their own when and how to sell assets. Real estate deal structures and investment management relationships can be quite complicated and require careful attention by all parties so as to minimize potential conflicts of interest and resulting agency costs. The art of successful relationship design is based on good communication and a recognition of the strengths and weaknesses, the objectives and constraints, of all parties to the arrangement.

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