The Growth of **Pension Fund Investment** in Real Estate

In the old days, pension funds were rarely as involved with real estate investment as they are now. In truth, even not so long ago the real estate industry was not ready for them, and they were not ready for us. This has changed, for a number of good reasons.

JUST A BUNCH OF COWBOYS

I asked a leading pension fund manager why real estate has not featured prominently in pension fund portfolios until now and he said, "Because previously you were just a bunch of cowboys!" We were not sufficiently "professional"; we could not express our figures in a way that suited fund managers, and we lacked objective policy. In addition, real estate was too unpredictable, couldn't offer quickly determined values, and lacked liquidity. The last point was a key one.

Philip White was my tutor at London University before he came to Canada. I remember well the very first thing he chalked on the board about the characteristics of real estate: "lack of liquidity." To a large extent that problem has been solved with the number of real estate investment vehicles now available (closed-end, open-end, specialty, and separate accounts, etc.), and by the sheer size and diversity of the industry.

Philip came here in the fifties and set up the original real estate program at UBC, which has become an important component of our education process in BC. Real estate professionals and pension funds have both certainly grown since those early days; along with education programs, our increased professionalism and our ability to express returns and business information in a way that can be understood and used by investors has finally made real estate an accessible pension fund investment.

THE "POSSIBLE" APPLICATION OF COMPUTORS

Technology has helped enormously. Around 1969 or so, Dr. Stan Hamilton and I attended the first-ever symposium in North America on "the possible application of computer technology to real estate investment." Possible application! Stan subsequently taught the first program on the new-fangled measurement known as internal rate of return. Heavens, all we needed in those early days

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John D'Eathe's career in the real estate industry spans well over 50 years. He has worked mostly in Canada and the US, but also in various other parts of the world. He hopes that he has improved over the years while working in many different roles: urban planner, appraiser, property manager, developer, asset manager, consultant, and professional director. John founded a development company with some wary pension fund investors long ago (in 1970). This early experience with pension funds was rapidly dwarfed by his subsequent association with the $24 billion Bentall Kennedy, where he was honored to serve as Chairman.

was to project a four-year cash payback. Now we produce 20-year and longer projections.

This new ability for analysis created a common ground with pension funds; we were able to express financial projections the way they needed in order to produce quarterly (or shorter) valuations and figures that everyone understood. Now, fund managers can have direct online access to any level of documentation or financial statements they require.

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GROWTH IN PENSION FUND INVESTMENT

When I first worked with pension funds in the late fifties only a handful of them were considering real estate. By the eighties, Canadian pension fund equity investment in real estate moved up to the $5 billion mark. In the early nineties it hit $10 billion. Investment barely reached $20 billion by the turn of the century, but then a steady expansion of investment took place that has swept pension fund real estate investment to nearly $80 billion. When you add financing, this becomes a very significant figure. Pension funds now own over 50% of prime office buildings in major Canadian central business districts.

We cannot pat our industry too heartily on the back for justifying this remarkable expansion of investment. In the general pension fund asset mix, problems with other competing forms of investment pushed capital our way during the many swings in the economy—and the overall size of the pot kept growing. We have provided very good sustained returns, notwithstanding the recent downturn, that stand out as excellent comparable medium- and long-term performers in any asset mix.

Real estate investment trusts have had a good run in recent years with investment support from pension funds, but by comparison stand at only $25 billion. Other real estate operating companies are below $15 billion. So pension funds, approaching that $80 billion mark, clearly dominate the market. Add to this the generally higher-quality pension fund properties, excellent maintenance, and very low debt levels and we can see the importance of these investments to our economy.

WILL IT CONTINUE?

Can we expect the pension fund love affair with real estate to continue? Actually, it is still on a roll. In the early nineties, the $10 billion pension fund equity in real estate constituted less than 3% of total fund assets. Even now, pension fund real estate holdings stand at only 6.5% of an average portfolio's total assets. The larger funds can justify holding 10–15% in real estate but the medium-sized and smaller funds are under-invested in this asset class. Perception of investment unsuitability, concern with the competence of asset managers, or worry about real estate itself may still present a problem. Also, while the larger funds have highly skilled in-house expertise to manage real estate, the smaller funds often do not.

The medium-sized funds still have between $20 billion and $30 billion of equity capacity to put into real estate; add modest debt to complete this amazing gross figure. Of course, we will still have to find the real estate product in Canada for them to invest in, which is increasingly becoming a problem. However proud we are, this is not such a big market. Pension funds are already at the exciting next stage of seeking real estate investments in other lands, focusing particularly on the prospect of catching the inevitable US upswing.

NOI REIGNS

As an industry we are justified in being proud of the general state of our nation's real estate portfolio, and we can now also boast a number of competent asset managers. Pension funds are restricted from trading in real estate, so the skill and ability to predict net operating income at acquisition and then to manage the properties to achieve those results is key.

Competent property management and leasing, as part of the asset management process, are now becoming of critical importance and emerging as one of the primary factors in comparative performance. Remember, over a reasonable holding period that vast majority of yield comes from income rather than from capital appreciation. Some investors do not yet appreciate the distinction between asset management and property management, but we are slowly learning each other's language!

GOOD GOVERNANCE

Finally, an all-important thought: good governance. Pension funds invest other people's money under very strict conditions and expectations. They demand and get total honesty and transparency and the full disclosure of facts from their asset manager. It is expected that any problems that arise will be disclosed early, with solutions in place. You may well be a competent asset manager but if you are not first and foremost a fiduciary, then you are not a starter in today's asset management business. *Cowboys no more!*