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Lagging indicator

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By: **Evelyn Lee**

Globalinstitutions increasingly are becoming under-allocated in real estate. Thiseventually may give them the losing hand at the negotiation table. PERE Magazine, February 2014 issue

Call it a comeback, if you will. With the recovery in the US commercial real estate market continuing to strengthen, investors have returned to the asset class in full force – and they have more catching up to do than ever before.

Globally, the gap between investors' allocation targets in real estate and their actual allocations has been widening in recent years. On average, institutions have invested approximately 8.8 percent of their portfolios in real estate, against an average allocation target of 9.8 percent – an under-investment of roughly 100 basis points. Moreover, investors are expected to further increase their target allocations by 52 bps in 2014, according to the 2013 Institutional Real Estate Allocations Monitor produced by Cornell University's Baker Program in Real Estate and real estate advisory firm Hodes Weill & Associates.

While it's not unusual for investors to lag their target allocations in any given year, what's notable is that the lag is growing significantly. By way of comparison, many institutions were reported to be close to, or in excess of, their target allocations during the downturn. For example, the California State Teachers' Retirement System was 16.1 percent invested in real estate as of December 31, 2008 compared to its then-target allocation of 11 percent; as of December 31, 2013, the pension plan was 12.3 percent invested against a 13 percent target.

Several factors have contributed to the growing under-allocation in real estate. The lack of investment activity by many institutions following the downturn has played a role, as a number of those investors now are trying to make up for lost time. Meanwhile, large newcomers to the space, such as Norway's Government Pension Fund Global, are in the early stages of their investment programs.

An additional factor that has had an impact on this divide has been the accelerating pace of realizations in real estate as sales activity has picked up over the past couple of years. Consequently, investors have had their money returned to them sooner than expected – and those dollars now need to get reinvested.

Still, the biggest factor has been the so-called denominator effect. As other asset classes, including public equities and fixed income, have performed strongly, real estate has fallen as a percentage of many institutional portfolios – even when the actual dollar amount of allocated capital has remained the same. “You’re chasing a pie that’s growing as other asset classes continue to outperform,” said Doug Weill, co-founder of Hodes Weill.

As it stands currently, investors face an allocation gap of nearly 150 basis points in 2014 if everything holds flat. Factors such as the denominator effect, however, may remain in play for the foreseeable future and, consequently, many institutions may see the spread widen further. Weill estimated that investors might continue to remain significantly under-allocated in real estate for the next three to five years.

This growing divide could become problematic for institutions, although it isn’t immediately apparent. In fact, the Cornell/Hodes Weill report views the gap in real estate investments as a positive for the industry because it already has resulted in greater capital flows into the sector and is likely to cause the pace of investment to continue to accelerate well beyond this year.

Targets, after all, send a message to general partners about an institution’s investment mindset. “It’s communicating what direction you’re trying to head and which investments you’re more bullish or less bullish on,” said one real estate fund of funds manager. An investor that is under-allocated in real estate is communicating to a GP that it is seeking to put capital to work and also may be bullish on the asset class.

Moreover, allocation goals are merely guidelines, not mandates, for how an institution should invest. In most cases, an institution isn’t required to invest at all if it cannot find suitable opportunities to meet its investment objectives. Therefore, an investor isn’t required to revise its targets if it is falling behind, nor is it going to be penalized for being well below target.

Or will it? The danger in there being so many institutions lagging behind their allocation targets is that GPs may end up getting too much capital thrown at them. That’s certainly not going to work in the favor of limited partners, which in recent years have been able to secure more favorable terms on their investments. If the market becomes crowded with capital sources, the laws of supply and demand will point to GPs regaining the upper hand. Of course, this only applies to GPs that have demonstrated strong records, as LPs still are reluctant to invest with a fund manager that isn’t a top performer.

Indeed, if a number of global institutions with very sizable real estate mandates all are clamoring to get into certain funds, GPs may be in a position to start commanding higher management fees and better terms, much like they did prior to the global financial crisis. LPs, on the other hand, will have less negotiating power if they want to be able to invest their real estate dollars with such choice players.

Such a scenario isn’t happening just yet, but it may only be a matter of time. Considering how wide the average real estate allocation gap is currently and how it could increase further in the coming years, we at PERE would be willing to bet that the shift is going to happen sooner rather than later.