Private Market Real Estate Investment Options for Defined Contribution Plans: New and Improved Solutions

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Why Incorporate a Private Real Estate Investment Option into a DC Plan?

Defined Contribution plans are rapidly becoming one of the primary retirement saving vehicles for Americans.[1] Historically, DC participants have had minimal exposure to private real estate holdings due to a lack of viable investment options and concerns regarding private real estate's potential illiquidity, historical valuation policies, and pricing frequency. As a result, if DC Plans have exposure to real estate today, it mainly consists of a small allocation to publicly-traded Real Estate Investment Trusts (REITs). Notably, only 26%[2] of DC participants today have the option to invest in real estate, with overall portfolio allocations averaging only 1%,[3] mostly through REITs as stand-alone investment products. In contrast, the majority of Defined Benefit (DB) plans have exposure to real estate and allocations average 8.9%,[4] with over 85% of this allocation in private real estate.

REITs represent one segment of the real estate asset class, and while they exhibit long-term correlation with private core real estate, REITs have a different risk/return profile and are often used to play a different role in portfolio construction. While both vehicles provide real estate sector exposure, private real estate vehicles provide investors with direct access to the diversifying market and income characteristics of the underlying bricks-and-mortar real estate. They do this without complications from potential financial engineering, business enterprise value, and overall broader equity market volatility that are present in REITs.

The characteristics driving the differences between private and public real estate are as follows:

- The daily-valued private market real estate vehicles available to DC plan sponsors are investment funds that substantially invest in core real estate assets that are typically well diversified by property type and geography and use modest levels of leverage. Core real estate is generally defined as a set of stabilized (well-leased), income-producing assets most commonly garnered in apartments, retail, industrial, and office property types.

- REITs are operating companies and thus offer shares in a company that owns and manages the real estate assets. REITs can trade at substantial premiums or discounts to the underlying real estate values based on non-real estate and broader stock market sentiments, creating a different return profile and offering less of the diversification benefits of investing in private core real estate.

These structural and tactical differences lead private and public real estate to perform differently over a market cycle and provide different benefits, as well as challenges, when added to an investment portfolio.

The Benefits of Private Core Real Estate

The primary inclusion objective for real estate within a DC plan should focus on obtaining income and diversification, with some potential for inflation hedging over multi-year investment horizons. These goals are best met within the real estate asset class by incorporating private core real estate into a multi-asset class portfolio. The key benefits of adding private core real estate are as follows:

- Attractive yields and risk-adjusted returns
- Diversification and increased downside protection, and
- Potential for inflation protection without increased volatility

Returns: A large portion (approximately 2/3rds) of private core real estate returns comes from cash flows generated by long-term leases that contribute to a more stable overall return profile compared to equities. Over the past 20 years,[5] U.S. private real estate's cash yield as measured by the NPI produced an annual average return of 5.1%.[6] Private real estate also provides an attractive absolute return profile with significantly lower volatility when compared to equities over the same time period. Therefore, adding private real estate to a multi-asset class portfolio supports an improved overall risk/return profile for the total portfolio.

Diversification: Given private core real estate's low correlation with equities and its relatively stable and high cash yield, the segment's total return is less likely to be negative at the same time as equities, providing significant total portfolio benefits when adding private real estate to a multi-asset class portfolio. Given that the inclusion of private real estate is done with an eye to mitigating downside risk, we examine how often in the same-period private core real estate[7] experienced negative returns when compared to a standard 60/40 stock/bond portfolio.

Over a 20-year time period, the returns for private core real estate yielded negative returns at the same time as a 60/40 stock/bond portfolio in only 14%[8] of the quarters. In comparison, due to REITs' public format, especially now that many large REITs are included in major stock indices including the S&P 500, REITs experienced negative returns at the same time as a 60/40 stock/bond portfolio in 57% of quarters.

Inflation: Both private and public real estate offer potential inflation protection over the long term. While neither provides a perfect inflation hedge, a rise in inflation over time is generally at least partially offset by rising commercial rents and the pass-through of expenses to tenants, creating the potential to hedge inflation over the medium- to long-term. Private real estate's return profile is less volatile than other publicly-traded, inflation-sensitive assets – such as REITs, commodities, and infrastructure stocks – and this allows investors to add private real estate to their investment portfolios in scale without increasing overall portfolio volatility.

As an example, if a plan with a 60/40 stock/bond portfolio had added a 7%[9] allocation to private real estate over the past 20-year time period, the real estate returns would have decreased the portfolio's overall volatility by 60 bps.[10].

In comparison, a 7% allocation to REITs would have increased the portfolio's overall volatility by 23 bps. In summary, the addition of private core real estate presents smart investment selection and offers significant room to enhance overall portfolio construction within DC platforms.

How to Incorporate Private Real Estate into a DC Plan

Early generations of daily-valued private real estate funds were predominantly participant-directed, making them susceptible to market swings and increased trading activity. Due to the potential illiquidity of private real estate and the perceived complexity of the daily-valued private real estate funds, DC plan sponsors were hesitant to include these vehicles in their plan options. While a number of the legacy participant-directed options still exist, the new generation of daily-valued private real estate vehicles seek inclusion in multi-asset funds only. This limitation creates an additional layer of liquidity control and we believe that the current generation of daily valued private real estate funds can offer significant benefits when utilized within multi-asset funds.

Funds such as target date funds reduce the concerns about liquidity because the professional manager has several options other than real estate to create any liquidity required. Within target-date structures, professional asset managers weigh the investment merits of private real estate against a multi-asset fund's liquidity needs in order to decide on an allocation. This not only avoids the potential for misunderstanding and misuse by individual participants allocating to real estate on their own, but also curbs the potential liquidity stress on these funds as they are used as diversifying components only.

When participants invest through target date funds, they also receive exposure to a diversified portfolio more tailored to a desired end objective. Outcomes-based investment offerings including target date funds can be more effective with a broader set of strategies. Though these implementation structures were once rare, they are now increasingly common.

Daily-Valued Private Real Estate Vehicles

Daily-valued private real estate investment funds have evolved over the past three decades, with improvements focused on addressing specific legacy concerns—namely liquidity, valuations, and pricing frequency. There are currently a variety of daily-priced, direct real estate products in the market and there are even more in development. However, during the 1980s and 1990s, only a limited number of funds were available. Older versions lacked today's transparency, which raised concerns about valuation methodologies, daily pricing mechanisms, and potential "gating" during periods of market dislocations. These legacy issues often discouraged DC plan sponsors from including the vehicles in DC line-ups.

Today's daily-valued real estate funds are focused on providing investors with exposure to predominantly private core real estate. To help facilitate liquidity, the majority of these funds also maintain a liquidity sleeve of cash and REITs. The current generations of daily-valued private real estate vehicles are largely structured as funds-of-funds and are generally limited to investment through multi-asset funds only.

Exhibit 1outlines the general characteristics of the funds that Aon Hewitt views as viable investment vehicles.

Investment Strategy

The investment strategy of these funds focuses on providing investors with exposure to private core real estate through investment in stabilized, income-producing properties. The funds are well diversified geographically and the majority of investments are in the following property types: apartment, office, retail, and industrial, though some also have a minority exposure to property types such as self storage, hotels and/or senior housing, among others.

A number of managers also include small allocations to core plus or value-added strategies. The inclusion of a second or third private real estate strategy provides additional channels for direct investments and strategy diversification. However, it also changes the risk profile of the overall private real estate exposure, therefore a DC plan's desired risk/return profile should be well defined prior to selecting a private real estate option.

Structure and Liquidity

The vehicles are generally structured as funds-of-funds and utilize a manager's existing institutional open-end private real estate funds while adding a liquidity sleeve consisting of REITs and cash. The daily-valued vehicle's investment philosophy is focused on maintaining the underlying fund allocations within the target ranges of 75%-85% to direct real estate and 15-25% to REITs and cash.

The investment process is actively managed by running daily forecasts of investors' liquidity requirements and determining cash flow needs for rebalancing and participation flows. This allows the funds to manage their allocation to the underlying private real estate, REITs, and cash on a monthly or quarterly basis.

Liquidity can be proactively managed using various levers within the structure of the daily-valued vehicle and through cash flow management as well as liquidity in other areas of the overall DC portfolio. Within the fund-of-fund structure, the following levers are common:

- Fund structures often call for a minimum allocation to cash and/or REITs, which are available to support immediate liquidity
- Trading restrictions. While these vary by manager, they generally define a maximum NAV percentage to be traded over a defined period (e.g., 5% of NAV over 10 days), and
- A line of credit

All this said, liquidity is not guaranteed in the vast majority of the direct real estate vehicles, making them inherently less liquid than public market real estate vehicles. This potential risk must be acceptable to the DC plan sponsor prior to their inclusion in a DC investment plan.

Asset Class	Real Estate
Fund Structure	Open-end commingled Fund-of-Fund
Fund Composition	75-85% Direct Real Estate; 15-25% Cash/REITs
Risk Specturm	Largely Core Real Estate
Manager Nominal Target Returns	7%-9% annualized over a full market cycle
Pricing Frequency	Daily
Trading Frequency	Daily with limitations
Restrictions	Limited to Multi-asset or Target Date Funds
Fees	85 bps - 115 bps

Exhibit 1 Characteristics of Daily Valued Real Estate Vehicles

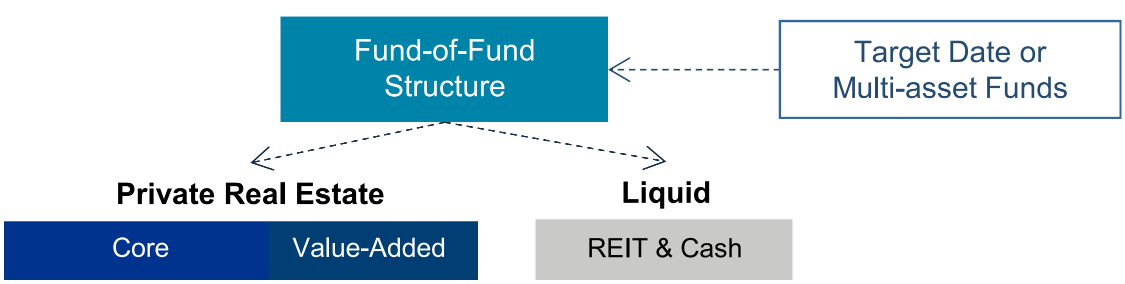

Exhibit 2 Diagram of a Third-Generation Fund Investment Structure

Daily Pricing

While daily trading isn't mandatory for DC plans, most plan sponsors still won't consider fund options without the capacity for at least daily pricing. Today's generation of private real estate vehicles available to DC plans provides for both.

The assets in the funds-of-funds are priced daily by adding up the values of the interests in underlying private real estate funds, the REITs, and cash; and then subtracting liabilities, fees, and other expenses. Independent third parties now generally value all assets in the private real estate funds on a quarterly basis; appraisals are staggered throughout the quarter with values being incorporated on a daily basis. In addition, income is forecasted and adjusted for major lease events or material market changes, if required. The daily recognition of value changes and material events in the direct funds reduce the potential for "gaming" the investment in the fund-of-funds prior to the quarter-end true-up.

While the individual processes between managers vary slightly, all methodologies are transparent, timely, and validated by third-party providers. The process of adjusting private market valuations to daily pricing has been considerably refined since the first-generation of funds entered the market. Overall, we believe that the market has evolved to the point where daily values are typically robust and daily pricing provides a fair representation of the underlying real estate value.

Fees

Fees for the fund-of-funds vehicles available today are generally in line with fees DB investors would pay to access private core real estate. Management fees range from 90 – 115 bps per annum, with expenses ranging from 3 – 25 bps per annum.

Summary

There is strong investment rationale for incorporating private real estate into DC plans. We believe that DC plan providers will be well-served in reevaluating the role as new and innovative solutions using custom products are available; vehicles for gaining exposure to the characteristics of private real estate that also meet the valuation and liquidity requirements of the DC marketplace are now a viable option.

With the evolution of daily-priced private real estate funds and the DC market's shift toward multi-asset platforms, especially custom target date funds, DC plan providers have the tools and access to provide DC plan participants with exposure to the same attractive private real estate characteristics that DB plans have been enjoying for decades.

Endnotes

1. Department of Labor Pension Bulletin. 81% of all active U.S. pension participants are in DC plans. Report as of June 30, 2013.
2. PSCA's 56th Annual Survey of Profit Sharing and 401 (k) plans.
3. 2013 Trends & Experience in Defined Contribution Plans, Aon Hewitt.
4. 2014 Global Investor Survey, IREI and Kingsley Associates.
5. Time period 6/30/94 to 6/30/2014
6. NCREIF Property Index
7. Direct Real Estate: NCREIF Fund Index - Open End Diversified Core Equity (NFI-ODCE); U.S. REITs: FTSE NAREIT U.S. Real Estate Index; Equities: S&P 500 Index; Fixed Income: Barclays Aggregate Index.
8. HEK removed the appraisal bias by de-smoothed the private real estate returns utilizing a regression based analysis. The de-smoothed returns provided negative returns at the same time in only 37% of the quarters.
9. Allocating 3.5% each from equity and fixed income. Direct Real Estate: De-smoothed NCREIF Fund Index - Open End Diversified Core Equity (NFI-ODCE); U.S. REITs: FTSE NAREIT U.S. Real Estate Index; Equities: S&P 500 Index; Fixed Income: Barclays Aggregate Index.
10. HEK removed the appraisal bias de-smoothed the private real estate returns utilizing a regression based analysis. The de-smoothed returns lowered the volatility of the portfolio by 34 basis points.

Authors' Bios

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Catherine serves as the co-leader of the firm's global real estate research group and is the primary consultant for a select number of Aon Hewitt Investment Consulting, Inc.'s real estate retainer and project clients. Catherine's primary focus is on the development of real estate strategy, portfolio design, and asset class investment policy; as well as the management of the North American real estate research and consulting team. Catherine has a unique blend of public and private, domestic and global commercial real estate experience that spans over 20 years.

Prior to joining Aon Hewitt Investment Consulting, Inc. in 2009, Catherine was the Director of Research for real estate at Fidelity Investments. Previously she served as the Director of Strategic Consulting at Torto Wheaton Research (now CBRE-Econometric Advisors). Other work experience includes private real estate development and investment management in both the U.S. and Southeast Asia, and teacher and co-coordinator of mathematics at the Chinese International School in Hong Kong.

Catherine earned a Bachelor of Science degree in Civil Engineering from Brown University and a Master of Science degree in Real Estate Development from the Massachusetts Institute of Technology. She is very active in several industry organizations including National Council of Real Estate Investment Fiduciaries' (NCREIF) and Pension Real Estate Association's (PREA). Catherine is a current member of NCREIF's board of directors, and past-Chair of the Board and the Research Committee. She is also the current chair of NCREIF's Defined Contribution Committee and a member of PREA's Research Committee and Affinity Group. Catherine is the recent recipient of the Hank Spaulding Award from MIT's Center of Real Estate, which acknowledges a significant industry contribution by MIT professionals and graduates. She also received a Hoyt Fellow in 2010 in recognition of outstanding accomplishments in professional real estate, and holds the Counselors of Real Estate (CRE) designation.

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Jani is a senior consultant in the firm's global real estate research group and manages research and consulting assignments for a number of Aon Hewitt Investment Consulting, Inc. clients. Jani leads the defined contribution and European real estate products coverage and is a senior manager researcher across the full spectrum of real estate core and non-core managers.

Prior to joining Hewitt Aon Hewitt Investment Consulting in 2012, Jani was director of U.S. Business Development at IPD and director in Research at CBRE Global Investors where she focused on developing the company's real estate derivative initiatives. Other work experience includes performance measurement, benchmarking, and risk analysis in portfolio management and investment strategies. Jani has authored publications and industry whitepapers on the analysis of fund style classifications as well as real estate derivative strategies and has 12 years of industry experience.

Jani holds a Master of Science in Real Estate Development from the Massachusetts Institute of Technology and bachelor's degrees in Building Science and Architecture from The University of Port Elizabeth, South Africa.