

Do Investors Mistime Non-Core Rotations?



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When Oprah Winfrey recommends a new book for her book club, it often goes on to become a bestseller. While I absolutely do not have the cultural cachet or influence of Oprah, I will put forward some recommended reading anyway. A research paper by Spencer

Couts at the University of Southern California, “How Do Non-Core Allocations Affect the Risk and Returns of Private Real Estate Funds?” is an interesting and thought-provoking read for those in the real estate investment industry.¹ In it, the author looks at how open-end funds’ allocations to core and non-core properties vary over a cycle and concludes that open-end funds “poorly time their investment into these [non-core] properties.” The end result is that higher non-core allocations among open-end funds may lead to not only higher risk but also lower returns.

The results of the research do not necessarily mean that non-core investments themselves underperform. Note that, for purposes of the research, Coutts defines non-core as any property classified as currently being in development, predevelopment, conversion, expansion, initial leasing, or renovation, and core properties are those classified as stabilized. The conclusion is not that those types of properties are bad investments but rather that open-end funds tend to increase their holdings of those types of non-core properties at the wrong time in the cycle. Although with empirical research, debate can always occur about the time period examined, definitions, and methodology, and no one research paper can be taken as absolute truth, this is an intriguing and perhaps important finding for real estate investment strategy.

Open-End Funds and Non-Core Allocations

Without going into all the details of the research (interested readers can take a look at the original article), let me give a brief synopsis. Using data from NCREIF on the holdings of open-end funds, as well

as data on queues into or out of the funds, Coutts examines the period from 2004 to 2015. His first finding, not surprisingly, is that non-core properties have higher market risk exposure (i.e., higher beta) than do core properties.² That is, non-core does better than core when the overall real estate market is strong and vice versa when the market is falling. But open-end funds tend to vary their exposure to non-core depending on what is happening in the market. In particular, the funds tend to invest more in non-core when expectations about market returns are low. This is a case of “reaching for yield” when general market returns appear to be low. A simple example where this might happen can easily be imagined: Consider an overall real estate market that is quite strong with rising property values. As values continue to rise, finding attractive investment opportunities by simply buying core becomes increasingly difficult, so funds begin to look at “build-to-core” or value-added investments to meet return targets. I want to emphasize that this is not outrageous behavior, is not an uncommon approach, and seems to make a lot of intuitive sense. But as Coutts explains in his paper, the end result of this may actually work against fund performance. He finds that allocations to non-core in open-end funds are procyclical (higher non-core exposure as the market rises) but—and this is very important—with a lag of 18 to 24 months. Investing in real estate takes time—as the market rises, the funds may have more interest in non-core strategies, but making that final decision, finding the right investment opportunities, and deploying capital may be prolonged. Finally, completing development or value-added projects is time-consuming, leaving the funds with non-core exposure for a period. The lag in investment means that

1. Spencer J. Coutts, “How Do Non-Core Allocations Affect the Risk and Returns of Private Real Estate Funds?” *Journal of Real Estate Finance and Economics*, Vol. 68, No. 4, pp. 715–748.

2. I wrote about this in a prior column, see Exhibit 3 of “Do Core and Opportunistic Funds Have Different Risk Factor Exposures?” *PREA Quarterly*, Fall 2019.

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fund allocations to non-core properties are highest after the market has already peaked—on average, open-end funds have their highest exposure to higher-risk, high-beta assets when the market has already started to turn down. The result is that fund performance is worse than it otherwise would be because the funds tend to have the highest exposure to non-core at precisely the wrong time.

Another aspect of the research is an examination of the effect of entry queues for open-end funds. Coutts reports that larger entry queues result in higher allocations to core (and less to non-core) investments and vice versa. Coutts attributes this to the quickness of deploying capital into core assets, meaning that managers facing pressure to put out capital because of an entry queue tend to gravitate toward core investments. This is another example of how the illiquid nature of the property markets can affect investment decisions.

I find Coutts's research interesting because it highlights the difficulty in timing real estate investments and how this may interact with investors' psychology, sometimes to the detriment of performance. Even if an investor could predict the market, the natural delays built into deploying capital in an illiquid asset class mean that timing the strategy shifts not only is exceedingly difficult but can actually lead to underperformance. Non-core investments themselves are not the problem and may have attractive risk-return characteristics on their own, but as Coutts notes in his conclusion, "investors would be better off if these funds invested with a more constant non-core allocation."

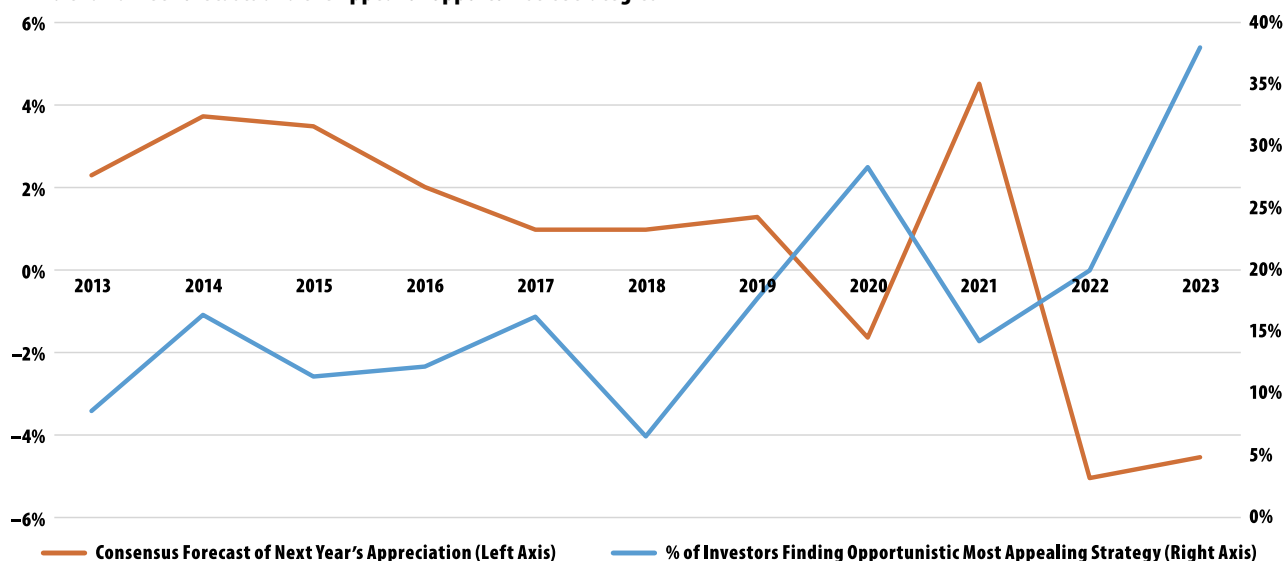
Market Outlook and Strategy Tilts

As a simple way of determining whether this type of behavior can be seen in the market outside open-end funds during the 2004–2015 time Coutts's research looks at (and without the effect of queues), Exhibit 1 combines historical results from two surveys from 2013 to 2023. First is the fourth-quarter result in each year from the PREA Consensus Forecast Survey, showing the market expectation for market appreciation the following year (e.g., the 4Q2013 consensus is for appreciation in 2014 and is shown

on the graph at 2013). The other line on the chart is from the annual PREA Investment Intentions Survey. Each year the survey asks, among other things, which investment strategy institutional investors currently find the most appealing from a risk-return perspective. The line shows the percentage of investors indicating opportunistic strategies are most attractive. Because the Investment Intentions Survey is conducted in the fourth quarter each year and published the following January, the results are contemporaneous with the Consensus Forecast (because of the turn of the year between when the survey is conducted and is published, the data on the chart each year are lagged by one—e.g., the 2013 Investment Intentions Survey is based on the survey conducted in late 2012, so the data are shown on the chart as 2012).

As can be seen in the exhibit, in 2020, when the COVID-19 pandemic hit, return expectations in the market fell. At the same time, interest among institutional investors in opportunistic strategies spiked. Once the effects of COVID became better understood, and with the industrial and multifamily sectors showing significant strength, market return expectations rose in 2021 and interest in opportunistic declined. In 2022 and 2023, as interest rates climbed and property values fell, expectations of future returns in the real estate market fell at the same time the attractiveness of opportunistic investing spiked again. Apparently, there is also a negative relationship between market return expectations and interest in non-core (in this case opportunistic) investments among institutional investors, just as Coutts found among open-end funds.

Many investors will see this as entirely rational and intuitive behavior—at times of market dislocation, when straight core strategies are not expected to perform well, investors start looking for opportunities in the dislocation. How can investors take advantage of the upheaval in the market? Oftentimes, the answer is to look toward opportunistic investment strategies. But this is essentially the same type of behavior seen in the results for open-end funds. Although a single, simple chart such as Exhibit 1 is certainly not as in depth and robust as Coutts's research on open-end funds, it does

Exhibit 1: Market Forecasts and the Appeal of Opportunistic Strategies

Sources: PREA Consensus Forecast Surveys (2013–2023), PREA Investment Intentions Surveys (2014–2024)

suggest that similar behavior can be seen throughout the markets and is not just a quirk of the open-end fund space.

I do not look at how increased or decreased interest in opportunistic strategies through the cycle may translate into actual return performance. In fact, the Investment Intentions Survey results show only how appealing opportunistic investments are to investors, not whether that appeal translates into actual investment. Still, a situation in which a lagging investment can occur is easily imagined: A dislocation in the market occurs, investors start to consider how to take advantage of the dislocation and begin to find opportunistic strategies appealing, final decisions take time to be made and approved, appropriate managers for such a mandate must be considered, further due diligence on managers and consideration of fund terms occur, and capital is committed, but there is a delay until the capital is actually deployed. In trying to take advantage of a market dislocation, investors may find that by the time the capital is put to work, the dislocation has already resolved itself. Obviously, the time it takes to make final capital deployments can vary greatly across investors, depending on their internal systems and requirements, and across specific funds and types of investments.

But consideration of these lags should be part of any decision process.

Conclusion

The results discussed here do not imply that non-core or higher-risk investment strategies are not appropriate for investors. They may be very attractive on their own and, for investors with the right risk tolerance and return target, the strategies may be an important part of an overall real estate portfolio. However, timing entry and exit may be extremely difficult and sometimes counterproductive given the nature of private market real estate. Core and non-core allocations can coexist within an overall portfolio, but investors should carefully consider the structural impediments to timing the real estate market before tilting those allocations in response to market cycles. Failure to do so may lead to outcomes that are ultimately disappointing. ■

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