POINT OF VIEW

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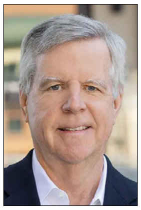
Academics Question the Value of Private Real Estate Funds: What's an Investor to Do?



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A growing body of research has broadly found that closed-end real estate funds, in aggregate, have not delivered acceptable net returns across multiple metrics: relative to alternative opportunities, to risks, or to fees. Rather than avoid these inconvenient results or assume that one's experience is unique (the two most common responses we hear from investors), it is vital to understand the research and its implications and to evaluate alternative approaches to real estate investment.

This article summarizes the recent research related to closed-end real estate funds, posits our own observations for why these funds have underperformed, and suggests and evaluates alternative approaches that institutional investors could utilize to avoid or mitigate the shortcomings of closed-end funds. In particular, we argue that more-direct approaches to investing in real estate more effectively address the characteristics, opportunities, and risks associated with real estate.

What the Academic Research Says

Recent studies that evaluated closed-end real estate private equity fund performance concluded that the value proposition has, on average, been lacking. Closed-end funds in general generated negative alpha for investors, often did not outperform leveraged core strategies or REITs, and had significantly higher fees than alternative investment vehicles. Finally, there is evidence that managers manipulated values and returns to improve subsequent fundraising efforts.

This recent research is especially relevant in that closed-end commingled funds play an important role in most institutional real estate portfolios. Hodes Weill reported that closed-end funds remained the most popular investment product for institutions in 2022, with 74% of all survey participants expressing interest.[1] Though interest was down from prior years, the next-closest product (open-end funds) garnered only 55% interest.

Below is a summary of the recent papers that have generated these findings:

- "Persistently Poor Performance in Private Equity Real Estate."[2] This May 2023 paper by Li and Riddiough found that real estate funds generated negative alphas and did worse over later vintages and that this was specific to real estate and not the case for the rest of the private equity industry. Real estate funds generated a mean size-weighted internal rate of return (IRR) of 7.0% and a direct alpha of –4.6% (based on liquidated funds with vintage dates through 2011), inferior to both buyout funds (IRR of 14.5%, direct alpha of 4.6%) and venture capital funds (IRR of 10.9%, direct alpha of –2.3%). Perhaps more surprising than the lackluster returns was the finding that firm experience did not lead to improved performance. Li and Riddiough found that "RE fund performance deteriorated significantly after the fourth fund offering," again in contrast to other private equity sectors that demonstrated improved performance with additional fund offerings.[3]
- "Another Look at Private Real Estate Returns by Strategy."[4] Bollinger and Pagliari (2019) repeated Pagliari's prior research[5] using different data sources.

1. *2022 Institutional Real Estate Allocations Monitor*, Cornell University's Baker Program in Real Estate and Hodes Weill & Associates, Nov. 16, 2022.
2. Da Li and Timothy Riddiough, "Persistently Poor Performance in Private Equity Real Estate," May 14, 2023.
3. Buyout fund performance stays in a "fairly tight range around the overall mean," despite fund sizes increasing by five to eight times from fund 1 to fund 7. Venture capital funds were smaller than buyout funds and grew slowly over time, with IRRs averaging 30% for funds 6 and higher versus 15% for the overall average.
4. Mitchell Bollinger and Joseph Pagliari, "Another Look at Private Real Estate Returns by Strategy," *The Journal of Portfolio Management*, Aug. 21, 2019.
5. Joseph Pagliari, "Real Estate Returns by Strategy: Have Value-Added and Opportunistic Funds Pulled Their Weight?" *Real Estate Economics*, Dec. 16, 2016. The authors found that opportunistic funds outperformed core funds over the 1996–2012 time frame, which they attributed to stale appraisals.

Based on index data,[6] net returns were 8.0% for core, 10.0% for value-added, and 11.5% for opportunistic over the 2000–2017 period. Alpha metrics, however, were less compelling, with –3.3% for value-added and –2.9% for opportunistic. They also calculated that investors could have added leverage to core funds to generate comparable risk-adjusted returns while saving about $7.5 billion in fees, resulting in approximately 3% per annum in additional returns.

- "Private Equity Real Estate Fund Performance: A Comparison to REITs and Open-End Core Funds."[7] Arnold, Ling, and Naranjo (2021) found that closed-end funds underperformed REITs and had comparable performance to the NFI-ODCE, despite generally higher risk, over the 2000–2019 period.
- "Three Decades of Institutional Investment in Commercial Real Estate."[8] In this 2021 PREA-sponsored report, Carlo, Eichholz, and Kok found that pension funds in the US paid more to external real estate managers than their peers in Canada and Europe. In addition, they found that investment costs (not including carried interest and promotes) averaged 180 basis points (bps) for external approaches, compared to 35 bps for internal approaches.
- "Catering and Return Manipulation in Private Equity."[9] This 2022 working paper by Jackson, Ling, and Naranjo provided evidence that "private equity [real estate] fund managers manipulate returns to cater to their investors." They suggested that investors may even be happy with overstated and smoothed returns.

Other papers and articles have addressed private real estate closed-end fund performance. Those we reviewed come to generally similar conclusions.

Other Problems With Closed-End Funds

In addition to low net returns and high fee loads, we also observe other shortcomings of closed-end real estate funds that have long created heartburn for investors:

- **Lack of Control:** Once committed to a fund, limited partners typically have no input into investment strategy, pacing, management, leverage, and exit timing.
- **Illiquidity:** Interests in closed-end funds are highly illiquid. Although a secondary market exists for some funds, finding pertinent information regarding fund performance and prospects can be challenging. Lack of transparency can lead to value discounts.
- **Alignment of Interests:** By definition, managers are motivated to generate incentive fees. Because incentive fees are typically tied to IRRs, managers have an incentive to maximize IRRs through delayed capital calls, subscription line financing, and early dispositions—often to the detriment of investment multiples.
- **Cycle Mismatches:** Real estate is inherently cyclical and defined by the inelasticity of supply and elasticity of demand. Managers, who have businesses to run, need to raise funds on a continual basis, which includes during poor vintage periods. Admittedly, funds deploying capital during or after downturns and selling before the next downturn tend to do fairly well, but those opportunities are rare and difficult to time.
- **Complexity:** One of the primary forms of value creation in real estate—development—takes a long time, particularly if it runs into snags related to entitlements, construction, or the market. Therefore, it makes up only a modest portion of opportunistic funds. Even well-conceived projects that could ultimately be successful can sink a fund if the timing is off. Other forms of value creation—leasing vacancy, improving operations, growing rents, etc.—can be achievable during a typical fund investment period but generally move the needle more modestly.

Why Do Real Estate Closed-End Funds Underperform, and What Leads Investors to Ignore the Underperformance?

The academic research leaves two obvious follow-up questions without satisfying answers:

1. Why do real estate funds underperform most private equity strategies?
2. Why do investors continue to invest in an underperforming category?

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6. Core: NFI-ODCE; value-added: index weighted 80% Burgiss and 20% NCREIF-CEVA; opportunistic: Burgiss.

7. Thomas Arnold, David Ling, and Andy Naranjo, "Private Equity Real Estate Fund Performance: A Comparison to REITs and Open-End Core Funds," *The Journal of Portfolio Management* Special Real Estate Issue, Oct. 2021.

8. Alexander Carlo, Piet Eichholz, and Nils Kok, "Three Decades of Institutional Investment in Commercial Real Estate," *The Journal of Portfolio Management* Special Real Estate Issue, Oct. 2021.

9. Blake Jackson, David Ling, and Andy Naranjo, "Catering and Return Manipulation in Private Equity," Oct. 18, 2022.

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To the first question, researchers observed that real estate investments lack access to the level of "engineering gains" available to private equity (such as buyout and venture capital).[10] Real estate is simpler, offering fewer opportunities to increase income or financially engineer, with fewer potential exit paths. In addition, as we commented above, two of the more meaningful paths to create value—development and redevelopment—frequently are not feasible within closed-end fund time frames or, when they are pursued, give up much of any alpha generated to operating partner fees.

As to why investors continue to allocate to an underperforming category, academics seem mystified. Li and Riddiough observed that public pension funds were more dominant investors in real estate funds relative to buyout and venture capital funds, and they tentatively concluded that this must have had something to do with it, euphemistically concluding that public pension investors seem to be "maximizing something other than investment returns."[11]

We can't conclude that pension fund investors make inferior decisions relative to other institutional investors. It seems more likely that the data challenges academic researchers were working to address and mitigate were major contributors to seemingly irrational decision-making: investors in closed-end real estate funds did not have sufficient information to conclude that they were underperforming. In addition, investors probably did not have enough alternative options.

Commonly Suggested Alternatives

In the articles critical of closed-end funds, the most commonly suggested alternatives were (1) leveraging up core real estate (to enhance returns) and (2) investing in REITs.[12] Both these are important parts of a response but are unlikely to be the full answer.

Investors can apply additional debt to core real estate by increasing the loan-to-value ratio across directly owned properties or portfolios or by investing in core funds through both equity and debt (potentially secured by the institutional fund). Most investors are too small to own real estate directly, however, and/or may not have the mechanism or policy approval to leverage core funds. Other drawbacks to core funds include these:

- Investing in core funds does not allow investors to express points of view regarding property type or geographic performance. An investor delegates all allocation discretion to the fund, hoping that the manager makes good market decisions. (The recent growth of property-specific open-end funds does aim to address this shortcoming.)
- Although most core funds are open-end to provide liquidity, the ability to exit is often very limited during times of market disruption.

REITs[13] offer superior liquidity and lower fees relative to private real estate vehicles and have been demonstrated to experience similar performance to private real estate over the long term.[14] REITs therefore should compose an important component of an institutional real estate portfolio, with some consideration to over- and underweighting the sector when public and private values diverge greatly. Although long-term returns have been similar to private real estate, REITs exhibit meaningful correlation to the broader public equities market—and therefore volatility—over the short to medium terms. Academics and participants can (and will) argue whether or not this volatility reflects "true" value—whether the relative stability of private real assets is a bug or a feature. But for practical purposes, volatile public values can lead to wide allocation swings in the short term, which could impact decision-making around acquisitions/dispositions and portfolio allocations.

In addition, neither of these commonly suggested approaches permits investors to take advantage of one area in which real estate can add value and generate higher returns: development when there is a significant gap between property values and development costs. Development does not work well within closed-end funds and is a minor component of open-end funds and REITs.

Direct Investing Is a Better Model

In our view, direct ownership of private real estate addresses the inherent drawbacks of closed-end funds

10. Li and Riddiough, "Persistently Poor Performance."
11. Li and Riddiough, "Persistently Poor Performance."
12. Arnold, Ling, and Naranjo, "Private Equity Real Estate Fund Performance."
13. PREA Research reports that REITs represent 62% of the institutional US real estate market. "Why Real Estate—2Q 2023."
14. Arnold, Ling, and Naranjo, "Private Equity Real Estate Fund Performance."

and the limitations of open-end funds and REITs, and it offers the best opportunity for investors' real estate portfolios to meet their strategic objectives, which are almost universally diversification, income generation, and a total return in the 7%–8% range. At the same time, direct investing involves lower fees and other expenses and provides greater control over timing, leverage, property type, and risk-strategy decisions.

Many international (especially Canadian) and a handful of US institutional investors have embraced direct ownership, although it necessitates large internal real estate management teams. That model is difficult to implement for many US funds because of complex hiring requirements and processes. In many cases, direct ownership is best accomplished by utilizing outsourced "extension of staff" advisors and through separately managed accounts with investment managers and real estate operators. This leads to a hybrid model that employs both internal expert resources and strategic external partners. Different regulatory and governance frameworks and internal capabilities dictate different approaches to direct investing, as the following case studies demonstrate. Two involve a larger (but relatively small) investment in utilizing nondiscretionary advisors to generate significant savings and superior performance through more-direct investments.

- One relatively large state pension plan employs a diversified, hierarchical model featuring internal staff, staff extension consultants, strategic advisors, separate accounts, and joint ventures. With about 70% of real estate net asset value (NAV) held in direct vehicles, staff retains discretion for both overall investment strategy and the most important portfolio and asset-level decisions (buying, selling, and recapitalizing). Staff members, with about $2 billion in NAV per investment team member, primarily spend their time overseeing this wide range of strategic partnerships. Capital is relatively concentrated with the most important partners; 43% of NAV is controlled by the largest five managers, which enables the relatively small internal staff to effectively monitor partnerships and make important decisions. "Build to core" is a predominant investment approach, enhancing returns and generating a majority stabilized portfolio comprising new, high-quality properties. The fund has made meaningful investments in reporting and analysis to be able to identify and understand trends within its large portfolio. When this investor invests in funds, it does so largely through structuring broader, collaborative relationships featuring commitments that span the manager's funds, sidecar/coinvestments, and direct "best-idea" opportunities. The portfolio has meaningfully outperformed its benchmark since the hybrid approach was implemented, and fees have steadily declined as a percentage of NAV for the past decade.
- A more moderately sized US pension fund has both fewer staff members and more concentrated oversight of a predominantly (70%) direct real estate portfolio. With about $5 billion in NAV assigned per internal team member, this fund relies heavily on a single and well-

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■ A large Canadian pension fund founded a start-up, vertically integrated real estate company (currently more than CAD$70 billion in assets under management) with a mandate to shift its portfolio from a passive investment strategy. The new company was able to reduce the portfolio's commingled fund exposure from 50% to 4% over a five-year period and adopted a direct investment strategy that significantly increased control and reduced external manager fees. The investment strategy focused on creating a global portfolio of operating platforms that would enable it to invest in public and private, debt and equity real estate assets in high-conviction sectors and growth markets. To support this effort, the company recruited a team of professionals in investment management, private equity, debt, development, and property operations. This vertical integration enabled the company to significantly increase the fund's allocation to real estate (five-year compound annual growth rate of 20%), greatly improve returns relative to its peers, and meaningfully outperform its benchmark while reducing volatility. The company's business model has provided strong investor alignment, active control, access to liquidity, and the ability to manage strategic decisions. Management emphasizes that these benefits have been invaluable in optimizing results in recent volatile market conditions.

A direct real estate program is more feasible for larger (more than $1 billion in real estate NAV) institutional funds, given the needs for dedicated expert resources and diversification. Even smaller funds, though, can receive many advantages of direct investing through more strategic deployment of resources and capital. Focusing on forming relationships and investing with real estate operators as opposed to allocators, for example, can reduce the overall fee load and enable greater control over portfolio allocations. Securing resources (internal or external) to source and underwrite coinvestments or other ad hoc opportunities can also enhance net performance.

Conclusion

Closed-end funds are likely to have an ongoing role in institutional real estate portfolios. Closed-end funds can be an effective way to capitalize on meaningful market dislocations (the real estate fund business largely started in the Resolution Trust Corp. era of the early 1990s), can implement specific short-term value creation strategies, or facilitate exploration of new markets or products before investing in the infrastructure for more direct approaches. Small investors need to commingle capital to gain sufficient diversification, with certain attractive strategies not available in open-end funds or REITs.

Recent research mandates, however, that investors and their advisors critically evaluate closed-end funds' place in their portfolios and, if necessary, make changes that generate higher net returns without commensurate increases in risk. Direct and/or hybrid approaches to real estate investment are likely important alternatives to explore. ■

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