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FEATURE: The efficient frontier is far away

Three investment experts share their views on the role of modern portfolio theory in real estate allocation policies – and the limits that weak data impose on attempting to treat real estate like just another asset class. PERE magazine, February 2010 issue

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When it comes to allocating actual dollars to real estate as an asset class, how do institutional investors arrive at their decisions?

Is it a case of relying on experience, a person's gut instinct for deals or by adopting a structured mathematical theory devoid of human nature's idiosyncrasies? In reality, it's a mix of the three, but in the wake of the credit crisis there is a growing resurgence for more structured applications of portfolio theory.

"Modern portfolio theory has many limitations for real estate but it is coming back and looking increasingly valid as a means of derisking your portfolio," says Michael Hoffman, president and partner of placement agent Probitas Partners.

PERE spoke with three professionals about their thoughts on how real estate fits into portfolio theory and asked just how (and whether) institutional investors can ever really hit the promised land of the efficient frontier where risk and rewards are perfectly matched.

PAUL MOUCHAKKAA
Managing director
Pension Consulting Alliance

No mathematical theory can ever be used in isolation, and that's certainly the case for modern portfolio theory as it applies to real estate, according to Mouchakkaa – not least because MPT has certain limitations when it comes to the asset class.

Mouchakkaa

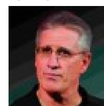
Aside from concerns over data availability for private markets, lagging valuations and the static nature of any theory when compared to a dynamic living world, Mouchakkaa argues MPT, although a useful tool, fails to address one major factor for real estate – the fact it is typically an income-producing investment.

"There is a premium placed, insofar as minimally acceptable return levels, on illiquid assets such as real estate. But if you have a core portfolio you are clipping some coupon and that's an important factor that I haven't seen accounted for in any allocation model. It's a positive aspect and should reduce the illiquidity premium placed on the asset class."

The PCA managing director also stresses institutional investors need to view real estate as a long-term asset class. "It's not something you should be blowing into and out of. It has to be evaluated over a long period of time. There are points in time when you can press down harder on the accelerator and others when you should slow down, but we are not advising clients to go full throttle or slam on the brakes. What we believe is that today is attractive for pension funds to come back into the market for the right opportunities."

DR. PETER LINNEMAN
Principal, Linneman Associates
Professor of real estate, finance and public policy at the Wharton School of Business

When it's all said and done, modern portfolio theory boils down to one simple rule: diversification. That is, not putting all your real estate eggs in one real estate basket. "It's an old idea and was always an old idea even when it was formalised into what we now know as MPT in the 1950s," says Linneman.


Linneman

Different institutional investors will apply the theory in a multitude of different ways, but for the Wharton School professor common sense should prevail. "It's a great idea and a great framework to have in mind but I wouldn't live my life by it, personally I don't advise clients to either."

One of the main problems, he adds, relates to data, which in the US relies on the NCREIF Property Index, reporting unlevered returns. "Real estate has stability, but you opt out of that stability when you apply debt. Instead you own a residual income and you have volatility. We went through a period of time when we transformed real estate investing into residual investing. LPs need to understand that."

DOUG POUTASSE
Executive director
National Council of Real Estate Investment Fiduciaries (NCREIF)

Theories are only ever as good as the data they rely on, and that's certainly the case for MPT. However, when it comes to real estate and MPT, there is one major limitation that arises from the use of data such as NCREIF's Property Index and IPD's market indices: that of leverage.

Poutasse

Both indices measure unleveraged property returns, however Poutasse says: "When you go and invest in property funds it's on a levered basis. It's like looking at the S&P stock returns when you're investing in NASDAQ."

Practitioners of MPT are, of course, able to feed the unlevered data into various other formulas to try to account for leverage in investments. But as Poutasse, former chief investment strategist at AEW Capital Management, adds: "You are comparing apples to oranges. MPT is constructive but you need to understand its limitations as well."

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