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Friday December 18, 2009

Separate but unequal

Many large institutional investors are expecting to invest in real estate in 2010 through separate accounts, rather than commingled funds. That decision could not only be short-sighted, but also leave them tied to second-tier managers. By Zoe Hughes

In two weeks time, the global private equity real estate industry will breathe a sigh of relief as it bids farewell to a tough and tumultuous 2009, and welcomes in a new and, hopefully, brighter 2010. After battling through a once-in-a-generation real estate recession, it's only natural that investors look forward to a more promising future.

However, as we enter 2010 general partners and limited partners will have to seriously confront one legacy from the past year – the tarnishing of the blind pool, commingled fund.

Much time has been dispensed on debating the future of these funds during the course of 2009. Most agree the model is here to stay, albeit with some major "tweaking" following perceived failures in LP and GP alignment of interests.

Yet despite that consensus, many large, notable, institutional investors are planning to reject the model in favour of structures, such as separate accounts, that offer greater control for themselves, and provide less discretion to managers. After a year in which little new capital was committed, 2010 will be the year in which investors, figuratively, speak with their chequebooks.

Such a shift in strategy though could backfire on investors, according to a white paper from placement agent Probitas Partners, which this week warned choosing to invest with separate account managers for value-added and opportunistic plays made adverse selection more likely.

Strong words, and words which have no doubt ruffled a few, rather large, feathers. But the San Francisco-based advisory firm makes an extremely salient – and timely – argument. As investors weigh the pros and cons of the discretionary, commingled structure, are they also giving the same treatment and consideration to separate account investing?

For Probitas, that answer is no. Just because separate accounts were the dominant investment structure in the US in the 1980s, it doesn't necessarily mean separate accounts are best suited for the fast-moving and global real estate world of the 2010s, especially where investors need higher returns.

In its paper, Probitas warned that separate accounts promote an inherently inferior means of manager selection.

Managers able to raise discretionary capital are at the top of the food chain of third party capital management. Those managers are there because they are the best performers; discretion helps drive performance, giving the manager the greatest competitive ability to win deals, thereby driving their own – and their investors' – returns.

Non-discretionary managers, Probitas added, are there "only because they cannot raise discretionary capital. De facto, that reflects a second-tier manager." Separate accounts may be appropriate for core-like strategies, where the pursuit of alpha is less essential, but for institutional investors looking to execute the best value-added or opportunistic investment strategies it's all about "caveat emptor – you get what you pay for".

Institutional investors say the call for a move away from the commingled fund model is based, primarily, on efforts to improve alignment and governance. However, additional control didn't prevent many separate accounts from making the same mistakes as fund sponsors of buying at the height, employing lots of leverage. It also begs the question of why most institutional investors largely moved away from separate account investing in the first place if control was always so important.

The issue, realistically, boils down to performance. And, as Probitas rightly argues, the key to performance is manager selection. Get that right, and institutional investors stand more chance of enjoying better performance.

Yes, the commingled fund model needs to be "tweaked", as one funds of funds manager recently said, to bring LP and GP interests back into line. But retreating back to separate accounts as a means of replacing fund investing is myopic. The industry needs to learn from history, not try to merely repeat it.