Pacific Rim Real Estate Society (PRRES) Conference 2000

Sydney, 23-27 January 2000

DECISION MAKING BY PROPERTY FUND MANAGERS: A SURVEY

PATRICK ROWLAND *

JAMES KISH

Department of Property Studies

Curtin University of Technology

Perth

Western Australia

* Contact author for all enquiries

Patrick Rowland Phone: (08) 9266-7723 Fax: (09) 9266-3026

Email:rowlandp@cbs.curtin.edu.au

Postal Address: Curtin University of Technology, GPO Box U1987, Perth, WA, 6845.

Keywords: Property funds management, asset allocation, performance measurement, property evaluation.

6th PRRES CONFERENCE

SYDNEY, JANUARY 23-27, 2000

Decision making by property fund managers: a survey

Keywords

Property funds management, asset allocation, performance measurement, property evaluation

Authors

Patrick Rowland, Senior Lecturer, Department of Property Studies, Curtin University of Technology, Western Australia; and
James Kish, Department of Property Studies, Curtin University of Technology, Western Australia.

Abstract

Many property markets in Australia are dominated by the decisions and pricing rules of managers of funds such as property trusts, superannuation funds, public syndicates, property securities funds and other pooled investments in real estate.

This paper describes and analyses the responses to a mailed questionnaire sent to representatives of most property funds management groups in Australia in October 1999. The objectives of this survey were:

1. to learn about the decision-making processes of those responsible for public property funds in Australia; and

2. to explore distinctions between those funds which purchase properties and those which purchase property securities; and

3. to identify any regulatory and institutional changes that are having an impact on property funds management.

The results provide insights into the reasons why mixed asset funds invest in property and show which factors property fund managers consider important in selecting properties. Their responses indicate preferred methods of analysing properties, common measures of return and risk and methods of forecasting. There is evidence of different approaches to the evaluation of properties and property securities.

The responses suggest variations in thinking by managers of different types of funds but the sample sizes make these contrasts of little statistical significance. Some cautious comparisons are drawn with earlier surveys and similar surveys overseas.

The respondents also provided information about their use of debt finance and their use of real estate agents for advice and brokerage. The respondents gave their views on the effects of changing governance and tax laws. Most did not expect there to be significant growth for property funds over the next three years.

Although there are limits to the depth of answers to a mailed questionnaire, the survey has revealed current practices, preferences and approaches to property investment analysis by Australian property fund managers.

Decision making by property fund managers: a survey

1. Introduction

In recent years, the number and variety of property funds in Australia has grown dramatically. A "property fund" may be loosely defined as an investment vehicle that purchases and manages properties on behalf of those contributing and earning a return based upon the performance of the properties. These funds include property trusts, superannuation funds, public syndicates, property securities funds and other pooled investments in real estate.

Between December 1995 and December 1999, the value of the units in listed property trusts in Australia approximately doubled (to about $30,000 million). During this period, "wholesale" unlisted trusts significantly expanded as a vehicle through which superannuation and other funds can share ownership of properties but unlisted property trusts for private or "retail" investors declined. Some superannuation funds without substantial property portfolios have substituted some or all of their direct investment in real estate with stakes in trusts or syndicates. Larger superannuation funds and statutory life funds continue to hold a portion of their assets as real estate but most have a lower percentage of property than in the 1980s.

In the last five years, many public property syndicates have been formed, offering interests to the public (and small superannuation funds). These are interests in Managed Investment Schemes, generally with a finite life (commonly of 5 to 7 years). During this period, property securities funds have also matured, acting as intermediaries by holding stakes in other property funds (primarily trusts).

Many property markets in Australia are now dominated by the decisions and pricing rules of managers of these property funds. It is therefore important for property analysts, valuers, educators and others to understand how fund managers select and price properties. The growth in trusts and syndicates has partly been at the expense of direct investment in property by private investors and some superannuation funds. Further growth will depend upon continuing good performance but may also require transparency in the decision-making of fund managers.

There have been a few earlier surveys of property investors in Australia (such as that by Newell et al., 1993: 450). Several similar surveys have been carried out in other countries (several are referred to in the papers describing the surveys of pension fund managers by De Wit, 1996: 131 and by Worzala and Bajtelsmit, 1997: 47). Although it is of interest to compare the results of surveys at earlier times and in different countries, the wording of the questions and the nature of the respondents make direct comparisons impractical.

This paper describes and analyses the responses to a mailed questionnaire sent to representatives of most property funds management groups in Australia in October 1999. The main objective of this survey was to learn about the decision-making processes of those responsible for public property funds in Australia. It was hoped that the responses would reveal distinctions between those funds which purchase properties and those which purchase property securities and would identify those regulatory and institutional changes that are having an impact on property funds management.

2. Survey method

Questionnaires were mailed in October 1999 to 95 property fund managers who had been identified from a variety of sources such as industry associations, their Web sites and professional magazines. It is believed that there are only about 100 groups offering and/or managing properties on behalf of public or issuing property securities such as units or shares. The questionnaire was mailed to managers of the full variety of public funds that are available in Australia.

Those who had not responded, received a follow-up telephone call in November 99 which increased the response rate significantly. 43 responses were received, including 3 from managers who either had ceased to invest in property or no longer offered investments to the public.

3 The characteristics of the respondents

Of the 40 fund managers who returned completed questionnaires, 25 invested only in properties and 7 invested only in property securities. 4 invested mainly in properties and 4 mainly in property securities. Although most of the respondents had not changed their mix of properties and property securities, 6 of the 8 respondents holding a mix of properties and property securities had increased their portion of property securities during the last 5 years.

The respondents manage the full range and size of property funds in Australia, as illustrated in the Table below. 40 per cent of the respondents managed more than one type of fund, with no dominant combinations. Because of these multiple roles and the number of responses, there is limited statistical validity in dissecting the responses by the type of fund under management.

Type of funds managed	Number of respondents		**Value of funds under management**	Number of respondents
Superannuation funds	**14**		$1 to less than10 million	**2**
Listed trusts	**20**		$10 to less than100 million	**8**
Unlisted trusts	**10**		$100 to less than 500 million	**16**
Syndicates	**10**		$500 to less than $1,000 million	**4**
Securities funds	**9**		$1,000 million or more	**10**
Note: Some managers are responsible for more than one type of property fund.			Total number of respondents	**40**

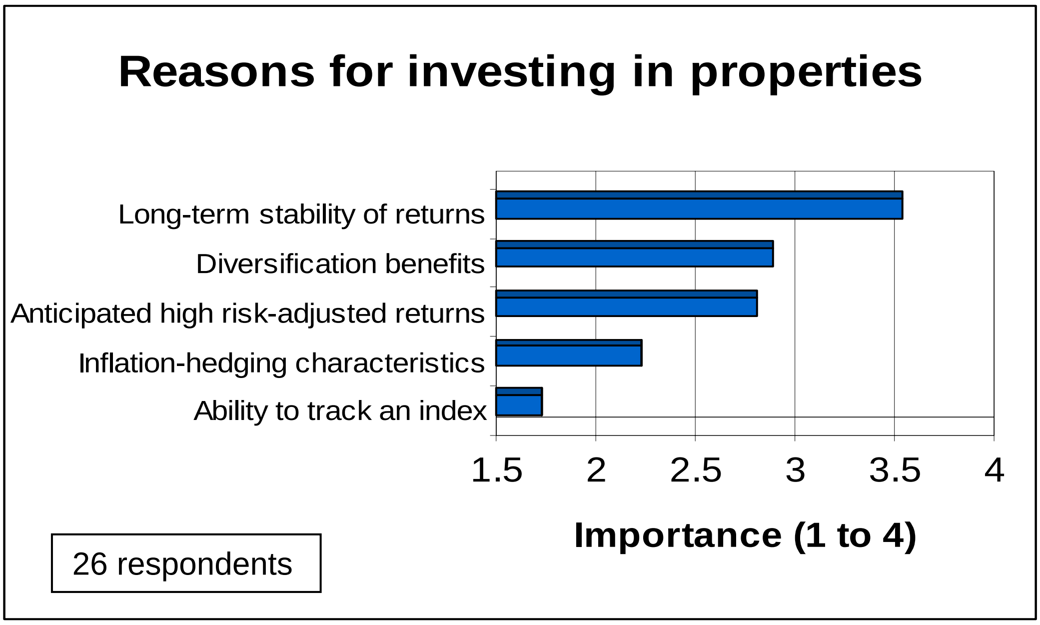
40 per cent of the respondents had funds under management of between $100 and $500 millions and 25 per cent had funds under management of more than $1,000 million. 7 of the 10 funds managing more than $1,000 million of assets held only properties, compared with only one fund managing property securities.

For the larger funds, most of the questionnaires were completed by the research manager or manager responsible for properties or securities. For the smaller funds, the questionnaires were generally filled in by the managing director or chief executive officer.

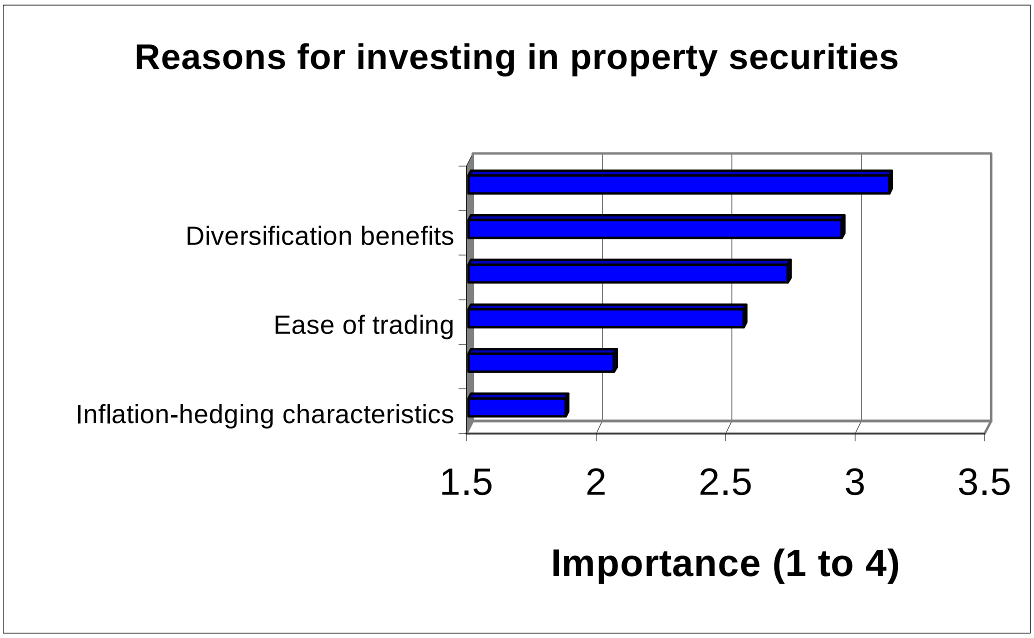
4. Investment decision-making by property fund managers

4.1 Purposes for investing in properties or property securities

The most powerful reason given by fund managers for investing in both properties and property securities is their long-term stability of returns. Other reasons such as diversification benefits and the ability of the asset to track an index are more important reasons for investing in property securities than properties. Inflation-hedging is a more important reason for investing in properties than property securities.



For this and the following questions, the respondents were asked to indicate whether each of the nominated factors was irrelevant (1), minor (2), major (3) or dominant (4). For all these questions, "Don't know" was an option and other factors could be specified.



For those managing unlisted property trusts, anticipated high risk-adjusted returns are ranked as more important than the long-term stability of the returns **from properties**. 6 of the respondents pointed out that their sole function is to invest in property and hence they had no need to consider reasons. 2 respondents mentioned redevelopment potential as an important factor. For those managing unlisted trusts and syndicates, diversification benefits are ranked as more important than the long-term stablility of the returns **from property securities**.

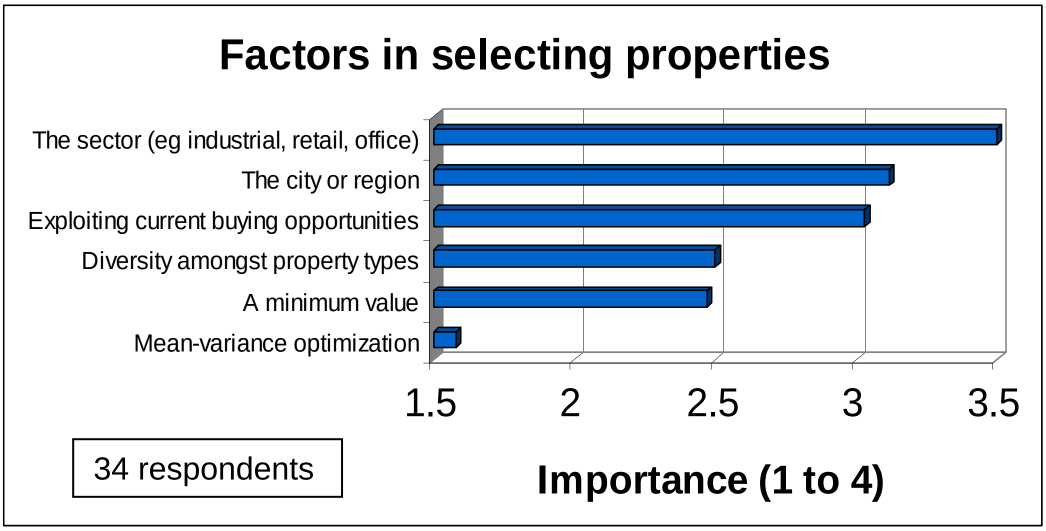
4.2 Asset allocation

16 of the respondents invest in other assets as well as real estate and they were asked which factors are most important in their decision as to how much property (including property securities) to hold.

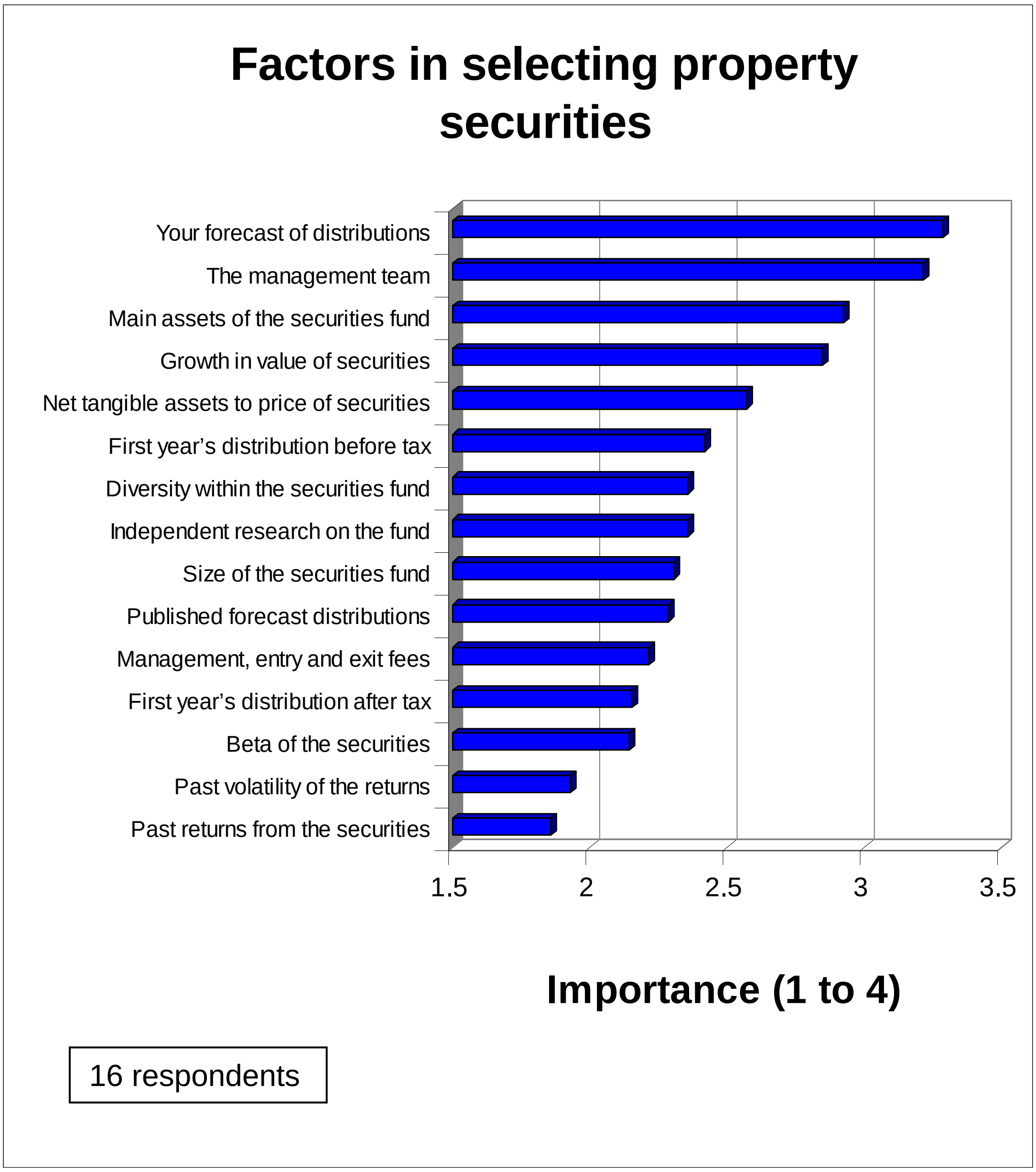
Tactical switching between asset classes is clearly more important than mean-variance optimization for those fund managers with mixed asset portfolios. This is vaguely consistent with the results of a survey on pension fund managers in the United States where "general experience/intuitive diversification" ranked ahead of both "correlation of returns between asset classes" and modern portfolio theory" (Worzala and Bajtelsmit, 1997: 51).

4.3 Factors in selecting properties and property securities

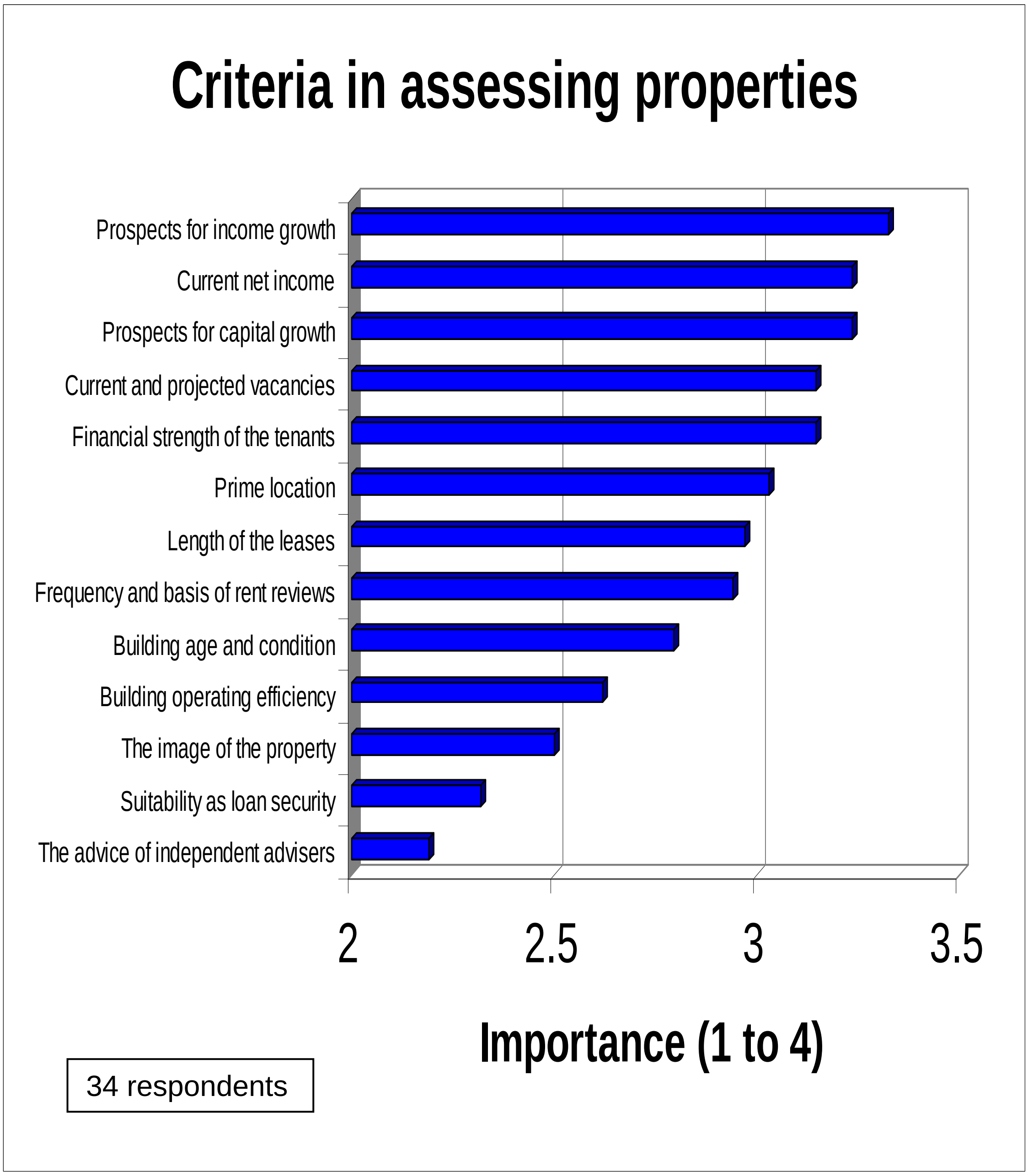
Overall, the property sector appears to be more important in property selection than the location of the property. This is consistent with the survey of Dutch institutional investors by De Wit (1996: 138). In Australia, the number of specialised funds investing in only one property sector may explain its importance to the respondents (and this is consistent with the lower ranking given to the need for diversity amongst property types). Mean-variance optimization is less important within property portfolios than mixed asset funds.



In the selection of property securities, the management team and the main assets of the securities fund are thought of as more important than the diversity within or size of the fund. Past performance of the securities fund is seen as of much less importance than the forecast distribution and growth prospects.



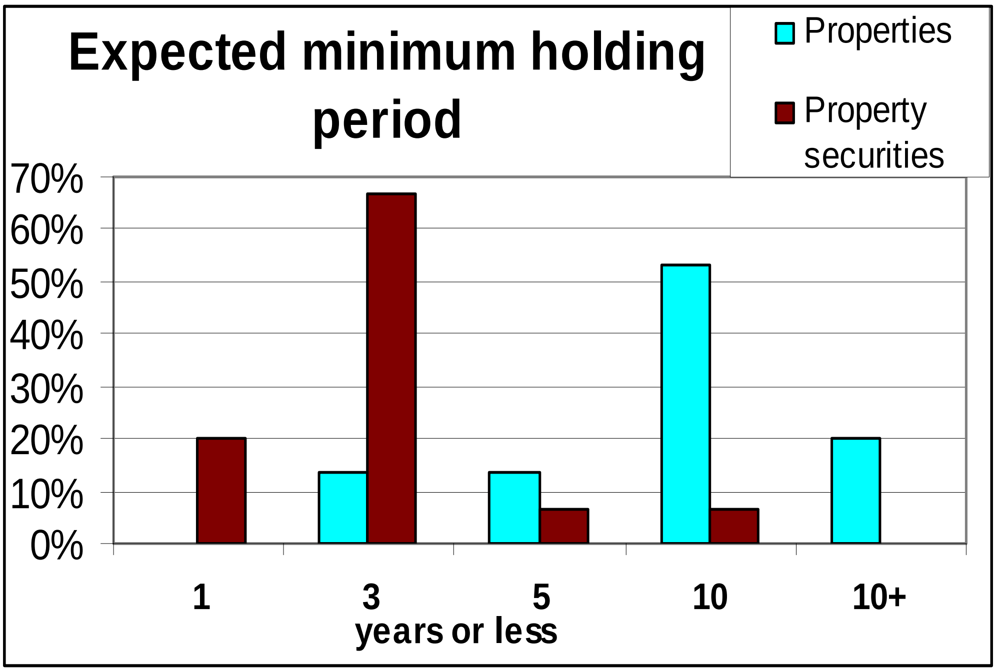
In assessing properties, fund managers rank income and growth prospects as the most importance criteria. Many of the other listed criteria (such as location, lease terms, building features and condition) would influence the income and growth prospects but are thought to be less important in themselves. Interestingly, the advice of independent advisers is ranked lowest on this list.



These responses can be compared with a previous Australian survey in which institutional investors ranked location and quality of tenants above total returns and cash flow. As in the current survey, these were all seen as more important than the criteria related to the building (Newell et al., 1993: 453).

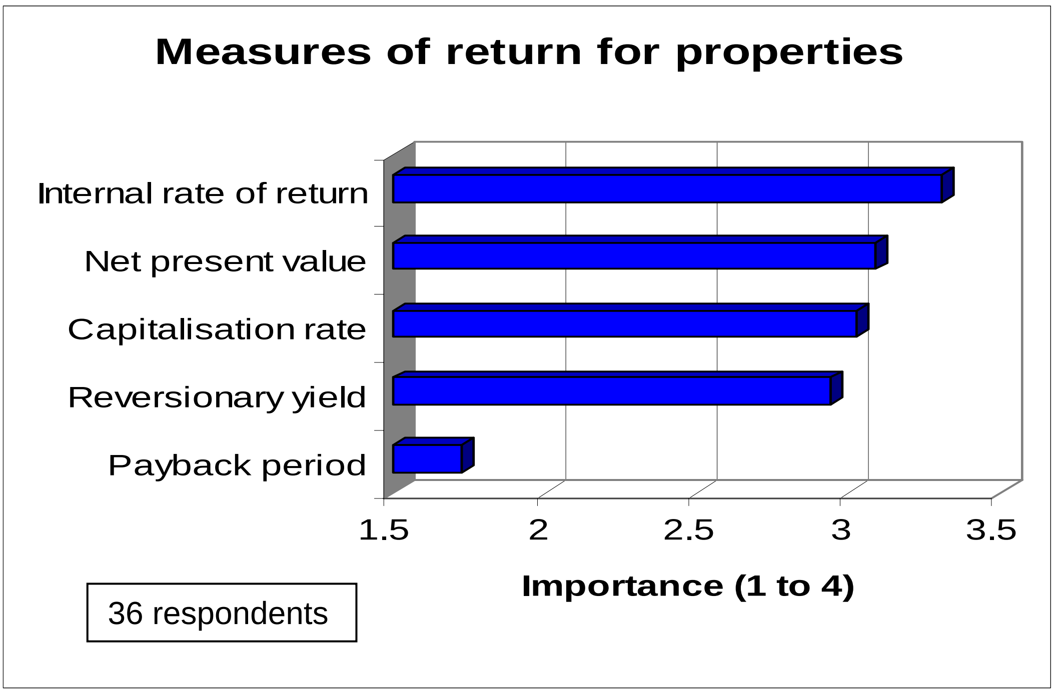
4.4 Expected minimum holding period

The most common expected minimum holding period for properties is more than 5 and up to 10 years. For property securities, the most common period is more than 1 year and up to 3 years. The holding periods does not appear to vary with the type of funds managed.



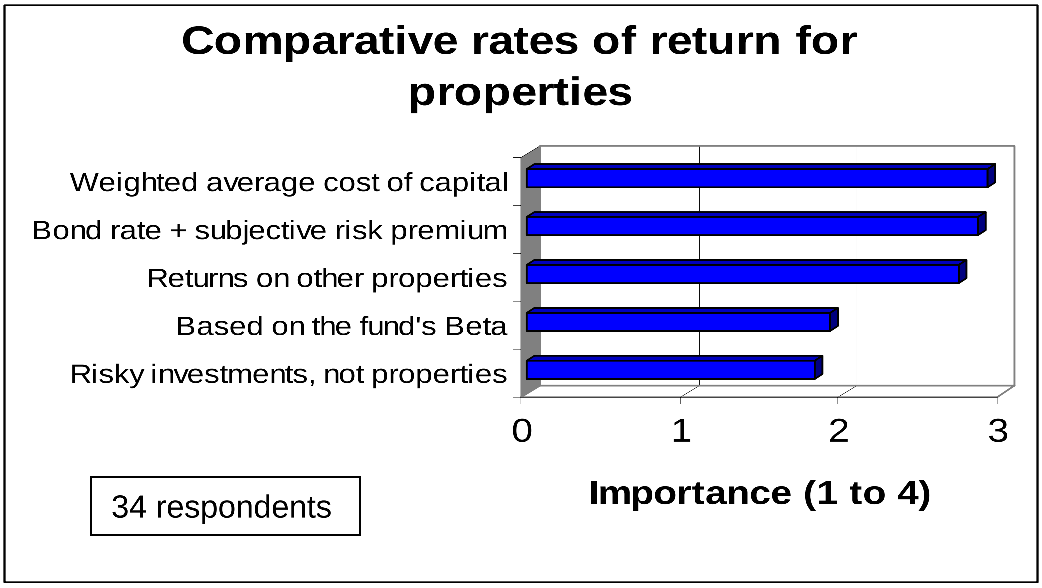
4.5 Measures of return

For fund managers evaluating properties, the internal rate of return remains a more important measure of return than the net present value for property fund managers. However, the relative importance of the net present value (and the reversionary yield) has grown at the expense of the capitalisation rate in comparison with an earlier Australian survey (Newell et al., 1993: 454).

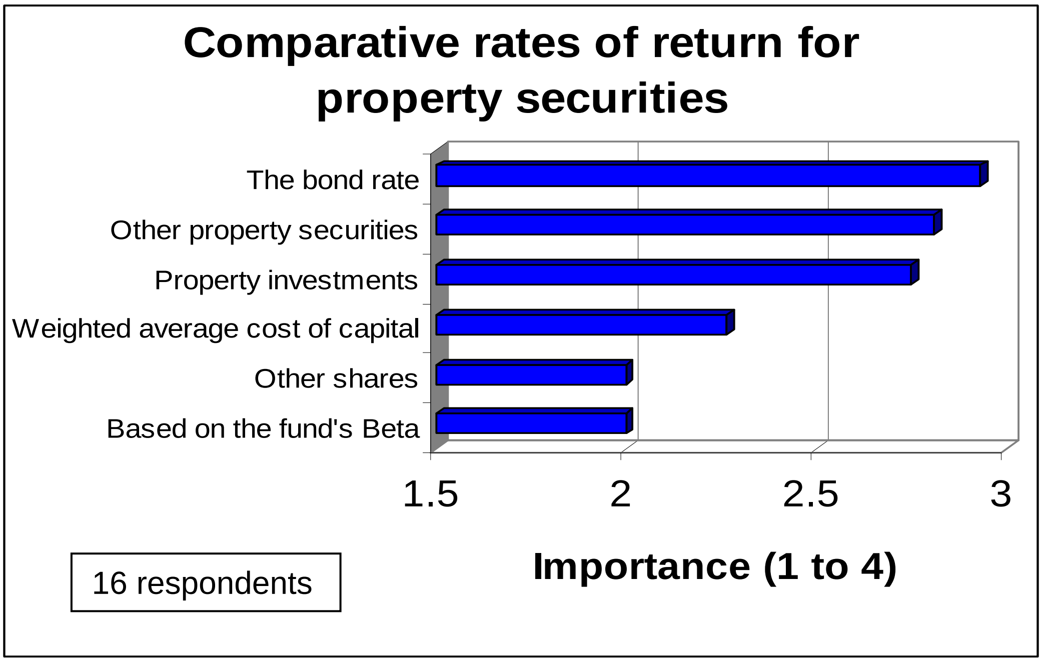


4.6 Comparative rates of return

In purchasing properties, fund managers considered the weighted average cost of capital to be more important than comparisons with alternative investments (either risky or default-free), whereas in purchasing property securities, the bond rate was considered the most important measure.

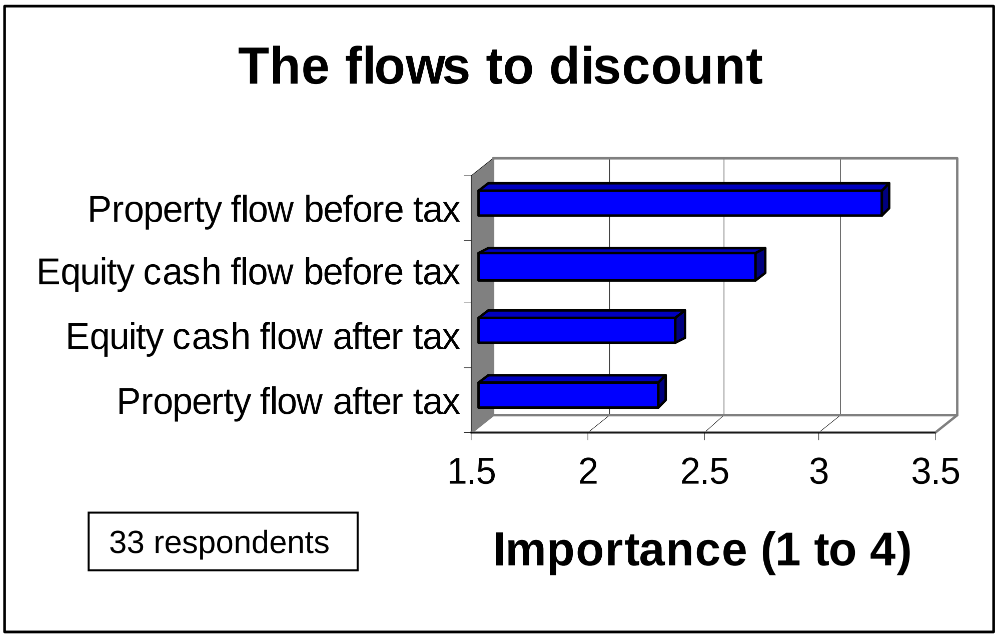


In evaluating properties, the bond rate with a subjective risk premium is considered more important than the weighted average cost of capital **for managers of superannuation funds and unlisted trusts**. In evaluating properties and property securities, returns on other properties and property securities respectively are considered the most important benchmark **for syndicates and property securities funds**. In evaluating property securities, the weighted average cost of capital is considered more important than the bond rate **by managers of listed property trusts**. It should be borne in mind that these variations do not meet the usual statistical requirement for 95 per cent confidence that the variations are not merely random.

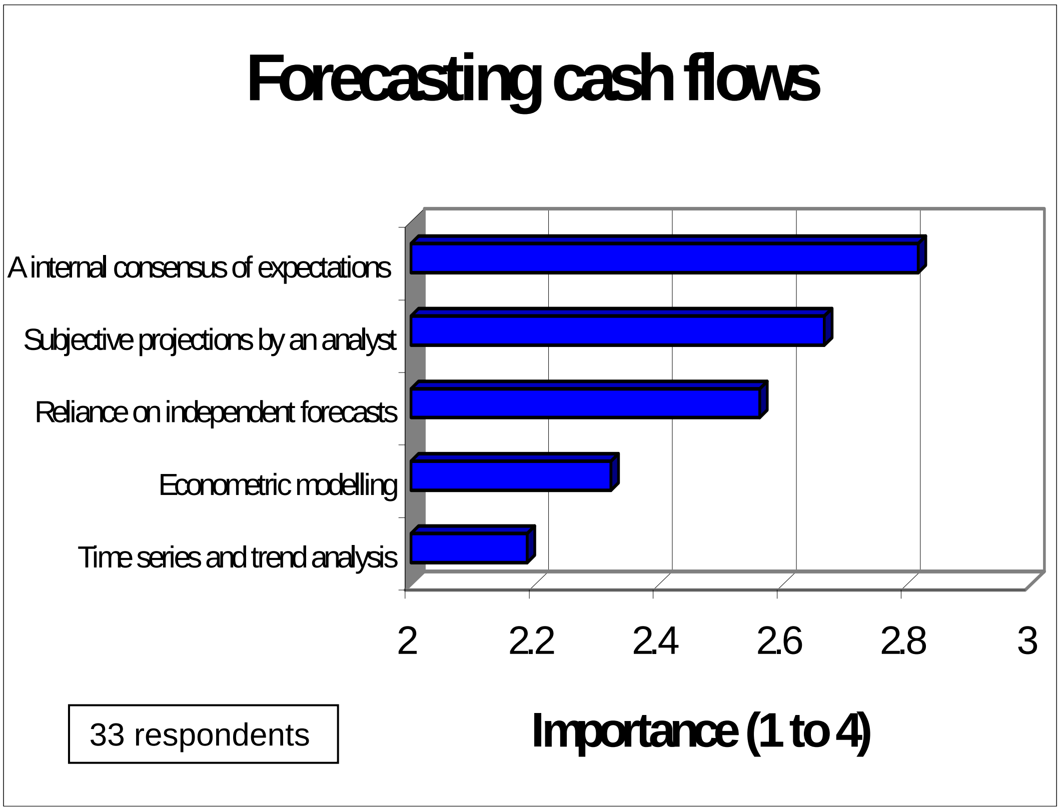


4.7 The use of discounted cash flow analysis

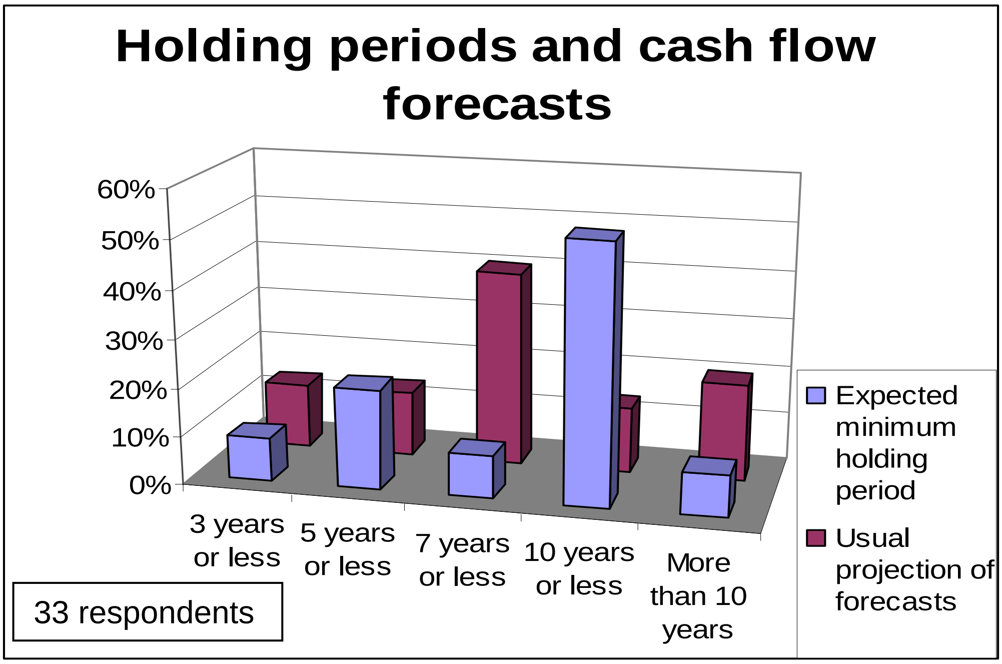
In evaluating properties discounting the property flows before tax is more important for most fund managers than discounting the equity cash flow or discounting after tax flows.



Informal methods of forecasting property and cash flows are more important than statistical techniques, with a preference for a consensus approach to projections.

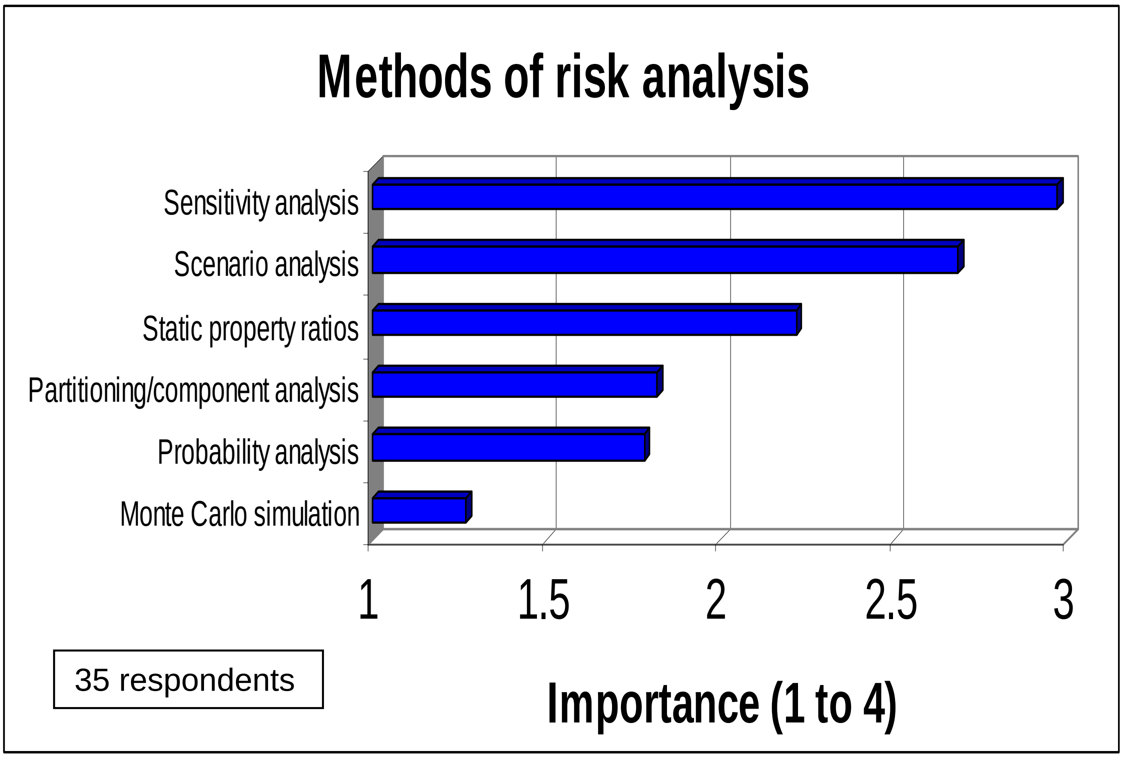


The most common period for forecasting property and cash flows is for 5 to 7 years, which is consistent with the most common expected minimum holding period of 7 to 10 years. 31 per cent of the respondents stated that they forecast for longer periods than their **minimum** expected holding period.



4.8 Analysis of risks

In evaluating properties, sensitivity analysis, and to a lesser extent scenario analysis, dominate the methods of defining risk. More quantitative measures of risk are less important for property fund managers.



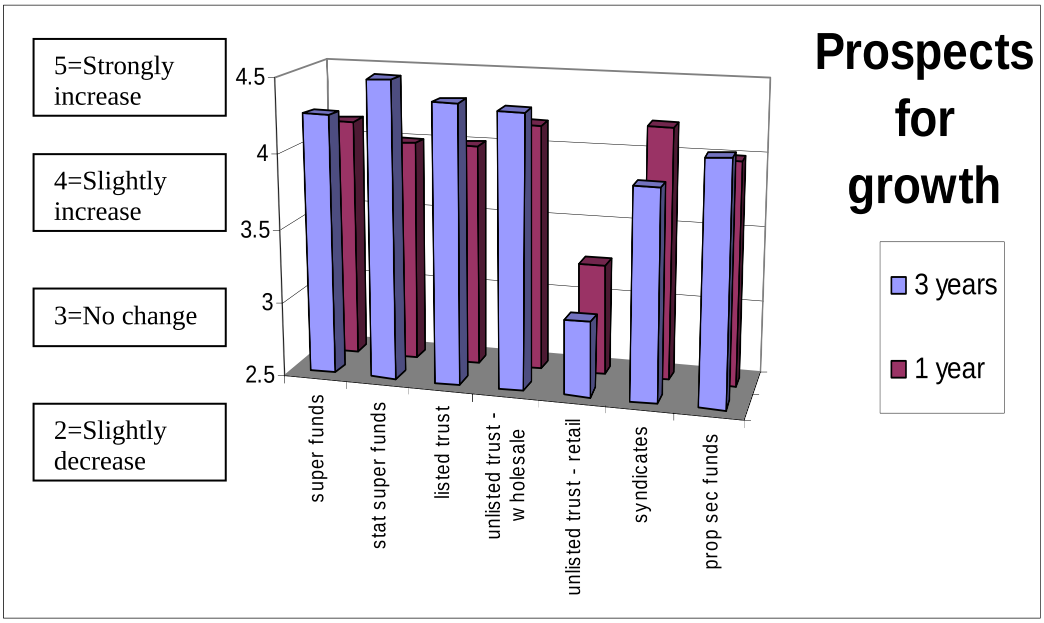
5 Use of debt

68 per cent of the respondents sometimes use debt finance to purchase properties, with an average target debt of 36 per cent of value. A further 3 per cent of property fund managers arrange loans for their investors. Because the managers were not asked to indicate the level of debt in each fund, it is not possible to estimate average debt levels by types of fund. However, half of the respondents who do not use debt finance manage only superannuation funds or property securities funds. The remainder who do not use debt manage property trusts.

The average target level of debt indicated by those fund managers responsible for listed property trusts was 25 per cent and the average for those responsible for syndicates was 60 per cent. All of those organising syndicates used some debt finance, with half sometimes arranging loans for their clients.

6. Views of industry and institutional changes

Most of the fund managers were reasonably confident of continued, but slight, growth in their types of fund. The graph below shows that the only funds expecting some contraction are unlisted "retail" property trusts).



Respondents were asked to indicate whether the following issues were expected to change the amount held in and the number of their type of funds.

Possible issues changing property funds management
Compliance with the Managed Investments Act
Changes to the taxation of public trusts
A lower company tax rate with capital & other allowances removed
The emergence of property index funds
Trading of unlisted securities through the Exempt Property Market
A shift from defined benefits to contributors' asset allocation

Most of the fund managers expect that none of these issues would change the value of funds under management nor the number of funds. Nor did they specify any other current issues as significant to the property funds industry. The only change from which more expect a negative influence than a positive one is the changes to the taxation of public trusts. This survey was administered after the government's announcement that widely held investment trusts would continue to be tax transparent but syndicate managers in particular remain concerned. A significant number of respondents (30 per cent) felt that compliance with the Managed Investments Act might reduce the **number** of their type of funds.

7. Use of real estate agents

The respondents (except for those holding property securities only) were also asked about the frequency of their use of real estate agents or consultants for a variety of property services. For most funds, sales and leasing are predominantly carried out by real estate agents. Valuations are almost invariably carried out independently.

Property services	Always	Generally	Rarely	Never
The sale of properties	44%	50%	3%	3%
Asset management	6%	3%	22%	69%
Property management	41%	21%	21%	18%
Leasing vacant space	50%	32%	9%	9%
Valuations	82%	9%	3%	6%

Although asset management is rarely delegated to those outside the fund, the responsibility for property management is varied.

Only 10 per cent of the respondents are planning to change their use of real estate agents and consultants during the next two years. None of these are planning to use agents more. Those planning to use agents less are intending to reduce leasing services and, to a lesser extent, sales and property management.

8. Conclusions

Although a survey by mailed questionnaire has obvious limits to the depth of responses, this survey has proved to be an economical way of exploring the decision-making of a reasonable cross-section of property fund managers. It is inevitable that with a narrow target group such as these managers, the sample size would not be large enough to obtain statistical significance for analysis that involves subsets or cross-tabulations of the responses.

In this instance, it is also difficult to categorise some of the funds and fund managers because one manager may be responsible for several funds of different size and type. There is also a considerable amount of cross-investment between funds of different types, blurring the distinctions between the activities of each type of property fund.

Nevertheless, the survey provides a clearer picture of property funds management in Australia, confirming several issues that had previously been assumed. It gives an overview of the industry for those who may know their own sector intimately. It provides background data for researchers and a picture of the industry for students aspiring to join.

In conclusion, the authors would like to acknowledge the assistance of all the property fund managements who kindly competed and returned the questionnaire.

References

De Wit, D.P.M. (1996) “Real Estate Portfolio Management Practices of Pension Funds and Insurance Companies in the Netherlands: A Survey”, Journal of Real Estate Research, Vol. 11 (2) 131-148.

Newell, G., Stevenson, K. and Rowland, P. (1993) “Institutional Investor Criteria for Property Investment”, *The Valuer and Land Economist*, Vol. 32 (6) 450-454.

Worzala, E.M. and Bajtelsmit, V.L. (1997) “Real Estate Asset Allocation and the Decisionmaking Framework Used by Pension Fund Managers”, *Journal of Real Estate Portfolio Management*, Vol.3 (1) 47-56.