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RECAP-The Bottom Line

Real Estate Commentary, Analysis and Performance

Risky Business—the dark side of performance

In past articles we discussed performance returns and the inputs necessary for calculating both time-weighted returns (TWR) and internal rates of return (IRR). We delved into the evolving industry standards and the trends for more, better, consistent and faster data. After-all, without quality data, returns would be meaningless. The old adage, "GIGO"; garbage in, garbage out, cannot be more true than when measuring performance. But it's not just about returns. Yes, one of the primary goals of investors is to maximize returns, but in today's volatile and difficult markets, seeking higher returns comes with a price.

That leads us to another goal of investors, to manage risk (there's actually a third goal, to minimize costs, but that's a topic for another day). When you put the two together, there is a risk/return trade-off.

So what exactly is risk? As defined by Merriam-Webster On-line, risk is the possibility of loss. InvestorWords.com defines risk as the quantifiable likelihood of loss or less-than-expected returns. David Geltner and Norman Miller, authors of *Commercial Real Estate and Investment Analysis*, state that risk is the possibility that future investment performance may vary over time in a manner that is not entirely predictable at the time the investment is made.

Risk is a multi-headed monster. It comes in many shapes and sizes, economic, political, country, environmental, currency, inflation, liquidity, interest rate, credit, valuation, business, management, and event risk, just to name a few.

Modern Portfolio Theory (MPT) and the Capital Asset Pricing Model (CAPM) have their roots derived from Harry Markowitz's 1952 doctoral thesis *Portfolio Selection*, that was subsequently refined by the likes of Sharpe, Treynor, Lintner, and others. MPT states that risk should be managed at the portfolio level, rather than at the individual asset level. In other words, if you add an asset to your investment portfolio, focus not on the risk of the asset itself, but how that asset's risk relates (correlates) to the risk of the other assets within the portfolio. An efficient and diversified portfolio therefore would contain a mixed-basket of assets (both across and within stocks, bonds, real estate, and other alternative investments) that are weakly correlated (behave differently) with the same expected returns. Because external forces are numerous, complex, random, and subjective, market risk can not be diversified away completely.

Risk is generally measured by the standard

Inside This Issue:

"BIPS" for thought

1%— Perception vs. Reality. A lack of trust in the public markets has increased scrutiny of anything said or written regarding ethics, codes of conduct, financial reporting, and incentive compensation structures. Will this spill over into private real estate? With weak fundamentals, falling cap rates, and rising prices, are real estate investors and advisors asking the right questions regarding reported results, projected performance and business practices?

2%—The Sarbanes-Oxley Act requires auditors to be independent, and precludes them from certain types of non-audit services, such as bookkeeping, because they can't audit their own work. Does this apply for auditors who provide AIMR / GIPS consultancy (preparation) and verification (audit) services?

Back Issues:

- Accounting & Performance—A Mixed Basket of Fruit
- Industry Standards and Performance
- IRRs and Fund Ratings
- TWRs vs. IRRs, Return Calculations

deviation of the return (i.e. the variance or dispersion of the return from the mean or average expected return). The CAPM defines expected return as the rate on a risk-free asset plus a risk premium. In theory, Short-term Treasury securities are typically used as a proxy for the risk-free rate because the risk of losing your original principal is minimal, if any. Of course, historically, Treasury returns have been low; something slightly above inflation.

There are generally three risk measures used in practice, the Sharpe Ratio, Treynor's Ratio, and Jensen's Alpha. A more in-depth discussion of these measures could be separate topics. For purposes of this article, a summary will suffice. Sharpe's Ratio is calculated as the excess return (expected return less the risk free rate) divided by the standard deviation (variance of the returns from the average). Simply put, it measures how much better you did for the risk assumed. Treynor's Ratio is similar to Sharpe's, but it uses beta (asset volatility compared to the market) instead of the standard deviation. Jensen's Alpha is the difference between a portfolio of assets' actual return and those that could have been made on a benchmark portfolio with the same beta.

The CAPM introduced two categories of risk, systematic and specific (unsystematic). Risk which is common to an entire class of assets is known as systematic or market risk. For example, retail in general significantly outperformed all other property types in 2002, fueled by low interest rates and a consumer driven economy. Specific risk, on the other hand, is the risk of price change due to the unique circumstances of a specific asset, such as its tenants, local surroundings or environmental problems.

In today's environment how much does fear, uncertainty, and personal biases influence our risk assessment and decision making abilities? Are assumptions, forecasts and valuations reflecting reality, dreams or our worst nightmares?

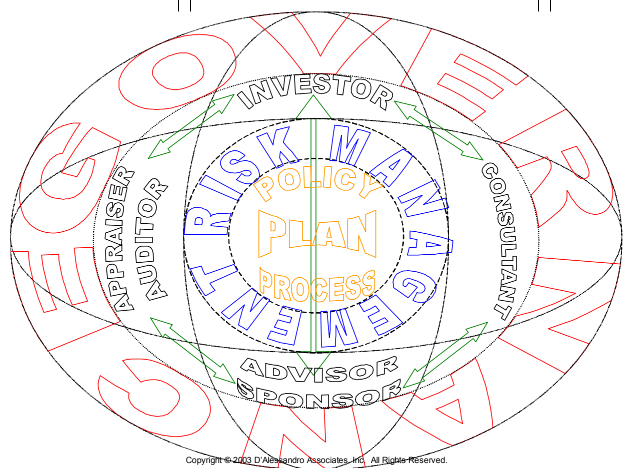
But is there another piece to the puzzle? The portfolio management process is dynamic. Conditions are constantly changing and managers must make adjustments and tactical and operational decisions over the short term. In order to make effective decisions, one must gather information, analyze, develop, evaluate and rate alternatives. Understanding risk and uncertainty are therefore critical to success. Frank H. Knight, an economist, recognized the importance of these concepts in his treatise, *Risk, Uncertainty and Profit*, published in 1921. He defined risk as situations where the decision-maker can assign mathematical probabilities to the randomness with which he is faced. He defined uncertainty as situations when this randomness "cannot" be expressed in terms of specific mathematical probabilities (i.e. a lack of knowledge).

In today's environment how much do fear, uncertainty, and personal biases influence our risk assessment and decision making abilities? Are assumptions, forecasts and valuations reflecting reality, dreams, or our worst nightmares?

It is impossible to be right all the time and no one can predict the future. By effectively managing risk, however, portfolio managers can be successful overall, even when mistakes are made. Although past performance is not an indication of future results, knowledge and experience are useful tools when dealing with the unknown. Given this conclusion, it is critical that real estate assets are managed under one comprehensive strategic portfolio plan, which has a formal Risk Management Plan as an integral component of the overall plan. The Risk Management Plan should: 1) identify the systematic and unsystematic risks, 2) describe the potential consequences of failing to adequately mitigate risks, 3) provide likelihood ratings (low, moderate, high), 4) model the impact on performance, 5) develop treatment strategies to reduce risks, and 6) provide target dates for implementation and assign responsibility for the program.

We've talked about maximizing returns, managing risk and minimizing costs, but it sounds too easy. So what's missing? How does an investor actually achieve these three ambitious goals? Just like any challenge or opportunity, it takes careful planning, perseverance, and a principle framework to operate within. Essentially this translates into a business plan and a governance structure. At the Investor level, this means an asset and advisor allocation strategy and investment policies and guidelines. At the Advisor level, this means a strategic, tactical and operational investment plan. Both levels require an understanding of who is accountable and responsible for results. Continuous measuring, monitoring and assessment is essential. Frequent and timely communication is critical. Independent oversight is prudent to ensure that the plan is implemented properly.

As you may know, Governance is a hot topic these days. In response to the recent corporate scandals, Congress passed the Sarbanes-Oxley Act (S-O Act) in July 2002, that requires public companies' management (the chief officers and boards of directors) and independent auditors to take specific actions to achieve greater corporate accountability and transparency, including corporate governance. But what exactly is corporate governance? According to Merriam-Webster On-line, it is defined as government or the act of governing that is the "continuous exercise of authority over the performance of functions for a political unit". The S-O Act is currently targeted at large public companies, however private and non-profit companies are applying the spirit of the provisions to their business. In the investment management world, especially for pension fund investors, everyone is a fiduciary and must exercise due care when carrying out their duties.

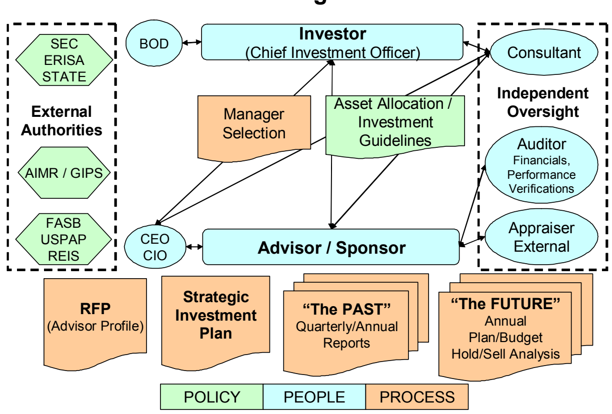


The basic steps for strategic planning for any venture include: establishing a purpose or mission statement, selecting goals, designing approaches or strategies to achieve goals, creating action plans to implement each strategy, and monitoring and updating the plan.

Characteristics of any good governance system include: independence, transparency and disclosure of information and decision making, no conflict of interest, quality practices, process-based (not people-based), linkages between responsibility and accountability, practical, reliable and flexible to change, as is noted in an article *"Good governance = sustainable performance"* by the Australian Sports Commission.

In today's environment, we need to focus on ethics, codes of conduct, internal controls, checks and balances, communication, and reporting. We need to improve our understanding of risk, and develop better qualitative and quantitative tools to measure, monitor and manage risk at the enterprise level. In the realm of investment management framework, the "enterprise" encompasses investors, advisors, sponsors, consultants, auditors, appraisers, and other fiduciaries involved in the overall process. Like any project, it will require team-work, communication, experience, perseverance, and commitment. With this approach we will all do a better job, make better decisions, and make it easier for all of us to sleep at night.

Investment Management Framework



Special thanks to Kent Jones, Amber Degnan and Bob Stammers for their assistance with this article.

Location, Location, Location!

Total Returns by State with economic statistics.

Did You Know That…

The NCREIF NPI unlevered total return for the four quarters ended March 31, 2003 was 7.1%. This compares favorably to -21.5% and -24.8% for the Dow and S&P, respectively.

By region, the NCREIF returns were 9.9% East, 6.0% Midwest, 5.6% South, and 6.6% in the West.

As of March 31, 2003 the NCREIF NPI included 3,847 properties with a gross market value of $124.3 billion.

Eight States represent 50% of total Gross State Product. They are California, New York, Texas, Florida, Illinois, Pennsylvania, Ohio, and New Jersey.

Top Quartile State	Overall 2002 State Economy Index	% of 2001 GSP	GSP Change % '00 to '01	Unemployment % April '03	Unemployment Change % April '02 to '03	NCREIF State Sub-Index 4 Qtrs End March 31, 2003
Massachusetts	***90.0***	***2.8%***	1.7%	5.4%	1.9%	3.6%
Washington	***86.2***	2.2%	2.2%	7.3%	-5.2%	4.5%
California	***85.5***	***13.4%***	2.2%	6.7%	1.5%	6.4%
Colorado	***84.3***	1.7%	2.6%	6.0%	5.3%	2.7%
Maryland	***75.6***	1.9%	***5.4%***	***4.4%***	-4.3%	***15.3%***
New Jersey	***75.1***	***3.6%***	2.2%	5.8%	0.0%	8.7%
Connecticut	***74.2***	1.6%	2.6%	5.3%	26.2%	***9.5%***
Virginia	***72.1***	***2.7%***	***4.7%***	***4.3%***	-2.3%	***9.9%***
Delaware	***70.5***	0.4%	***8.8%***	***4.3%***	-2.3%	***11.2%***
New York	***69.3***	***8.2%***	***3.5%***	6.1%	0.0%	***11.2%***
Oregon	***68.9***	1.2%	-1.1%	8.0%	2.6%	8.9%
Minnesota	***68.7***	1.9%	1.0%	***4.3%***	***-6.5%***	3.7%
Utah	***68.7***	0.7%	2.9%	5.3%	***-15.9%***	***9.1%***
New Hampshire	67.6	0.5%	-0.4%	***4.0%***	***-13.0%***	***11.9%***
Texas	67.6	***7.5%***	***3.5%***	6.6%	4.8%	5.2%
Arizona	67.2	1.6%	***4.7%***	6.0%	-1.6%	***12.4%***
Illinois	64.7	***4.7%***	2.0%	6.3%	-3.1%	6.4%
Florida	62.7	***4.8%***	***4.2%***	5.3%	-3.6%	7.1%
Pennsylvania	62.3	***4.0%***	2.2%	5.9%	7.3%	7.6%
Idaho	61.6	0.4%	0.4%	5.7%	-1.7%	4.6%
Rhode Island	61.5	0.4%	2.4%	5.3%	8.2%	7.6%
Georgia	60.1	***3.0%***	1.5%	4.7%	***-7.8%***	3.5%
Michigan	60.0	***3.2%***	-1.0%	6.6%	4.8%	7.7%
Missouri	58.9	1.8%	2.5%	5.0%	***-9.1%***	2.2%
Maine	58.3	0.4%	3.2%	4.8%	11.6%	4.8%
North Carolina	57.5	***2.7%***	1.0%	6.4%	***-7.2%***	***11.2%***
New Mexico	57.2	0.5%	***5.4%***	5.9%	7.3%	***10.8%***
Vermont	56.9	0.2%	***5.7%***	***4.3%***	13.2%	***9.1%***
Kansas	56.7	0.9%	3.2%	4.8%	***-5.9%***	-2.9%
Ohio	56.5	***3.7%***	0.8%	6.2%	5.1%	6.7%
Alaska	56.3	0.3%	1.6%	7.2%	-5.3%	6.9%
Nevada	55.7	0.8%	***4.9%***	5.5%	-3.5%	5.7%
Nebraska	54.4	0.6%	2.4%	***3.9%***	5.4%	6.8%
Oklahoma	54.1	0.9%	3.2%	5.1%	10.9%	***11.3%***
Hawaii	53.7	0.4%	2.8%	***3.8%***	***-13.6%***	4.6%
Indiana	52.8	1.9%	0.1%	5.1%	-3.8%	8.4%
Montana	52.8	0.2%	***4.3%***	***4.0%***	***-13.0%***	4.7%
Iowa	52.2	0.9%	1.4%	***4.1%***	2.5%	8.4%
Tennessee	52.2	1.8%	2.9%	5.0%	-5.7%	7.1%
Wisconsin	52.0	1.7%	2.5%	5.4%	-1.8%	4.5%
South Carolina	51.1	1.1%	2.7%	6.1%	3.4%	8.1%
Kentucky	48.6	1.2%	2.6%	5.7%	0.0%	5.9%
South Dakota	47.4	0.2%	3.4%	***3.1%***	***-6.1%***	8.1%
North Dakota	46.1	0.2%	2.4%	***3.4%***	***-17.1%***	***11.2%***
Louisiana	45.9	1.5%	2.6%	6.2%	0.0%	4.8%
Wyoming	45.7	0.2%	***6.8%***	***4.0%***	***-9.1%***	4.5%
Alabama	45.3	1.2%	1.8%	5.8%	-1.7%	6.0%
Arkansas	41.7	0.7%	1.7%	5.3%	-5.4%	3.2%
Mississippi	40.9	0.7%	1.5%	6.5%	***-7.1%***	6.5%
West Virginia	40.7	0.4%	***3.5%***	6.0%	-1.6%	4.5%

Data Sources and Notes: National Council of Real Estate Investment Fiduciaries (NCREIF), Dow Jones, S&P, Bureau of Economic Analysis, Department of Labor, and the Progressive Policy Institute. Return Calculations & Analysis by D'Alessandro Associates, Inc.

The Progressive Policy Institute (PPI) *2002 State Economy Index* uses 21 economic indicators to measure and assess states' progress as they adapt to the new economic order. The 21 indicators are divided into five categories that best capture what is new about the New Economy: 1) knowledge jobs, 2) globalization, 3) economic dynamism and competition, 4) transformation to a digital economy, and 5) technological innovation capacity. NCREIF Returns are total return, property level, before advisory fee, presented on a time-weighted annualized (geometric average) basis.

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Value Added Services

Project Assistance/ Management, Consulting, Outsourcing and Training

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Dear Real Estate Professional:

I hope you find ***RECAP-The Bottom Line*** informative, useful and entertaining. I'd appreciate your feedback, so please contact me.

Are your resources stretched? Do you need assistance with recurring work or special projects? I can provide help in many areas, including new product development, research, marketing strategies/RFP's, merger and acquisitions, operations/process improvements, financial reporting/analysis, performance measurement, benchmarking, systems/ spreadsheets, training, and industry compliance — just to mention a few! My areas of expertise are performance, reporting and analysis. I'm an active member of the AIMR/GIPS Real Estate Sub-Committee and the NCREIF Performance Measurement and Education Committees.

I will provide your team with new perspectives, creative ideas, and solutions to problems. My background, skills, experiences, and representative assignments are highlighted below. I look forward to helping you achieve your goals.

Best regards,

Joe D'Alessandro, CPA

President, D'Alessandro Associates, Inc.

Representative Assignments

Governance, Policies and Procedures

Established internal policies framework for an advisory firm's Investment Committee to comply with operating agreements and fiduciary standards, including flowcharting key processes and decision making.

Accounting and Reporting

Created first time executive summary and detail annual budget / business plan and quarterly internal and external reporting templates. Assisted in the conversion of financial statements from Historical Cost GAAP to FMV GAAP.

Training and Marketing

Educated finance, operations, and marketing groups about institutional investor reporting, industry organizations and standards, and performance measurement and benchmarking.

System Design

Assisted business and technology personnel with a system design project to calculate and analyze performance returns.

Risk Management and Compliance

Performed reviews of operations to ensure compliance with industry standards and recommended process efficiencies.

Research

Analyzed public pension plan investment profiles, including investment allocations, guidelines, historical performance, portfolio composition and advisor selections.

Profile

15+ years experience
Active member of AIMR / GIPS Real Estate Sub-Committee, NCREIF Performance Measurement / Education Committees

Diversity

Internal / external reporting, technology, budgeting, tax, audit, marketing, treasury, project management

Expertise

Performance measurement, benchmarking, process efficiencies, system design, strategic planning

Leadership

Visionary, people oriented, motivator, team player, mentor

Skills

Creative, resourceful, problem solver, proactive, enthusiastic

Training

Institutional Investor Reporting, Rate of Return Theory
Performance Returns Workbook Seminar
Performance Measurement Nuts & Bolts
AIMR / GIPS Compliance, Data Collection & Reporting
Excel Tips and Tricks

Results

Founded a strategic performance reporting department, implemented a critical ERP business intelligence performance return system project, chaired the leading industry performance measurement committee