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RECAAP -The Bottom Line

Real Estate Commentary, Accounting, Analysis and Performance

Inside This Issue:

"BIPS" for thought

1%—Real Estate Investment predates the securities market by centuries, yet standards, technology, and benchmarks lag behind. Is this by design or because the asset class is complex, time-consuming and highly heterogeneous?

2%—Are REITs real estate or public equity securities for asset allocation purposes? With 6 REITs in the S&P 500, one could argue it's stock, not real estate.

3%—Joe D'Alessandro will be presenting at the AIMR Annual Conference in Chicago, October 21st and 22nd. The topic will be an update on the GIPS Real Estate Provisions and the tie-in to the Real Estate Information Standards (REIS) published by NCREIF, PREA and NAREIM.

Back Issues:

Benchmarking—an Art, Science or Both?

In the June 2003 *RECAP* article "Risky business -- the dark side of performance" we talked about risk measures, governance and strategic planning. Now we will focus on one of the more challenging tasks of investment management (really any business), benchmarking. As you will see, benchmarking is a critical process used to monitor any strategic plan to control risk and to help interested parties make efficient, effective and prudent decisions to continually improve and add value.

What is a benchmark? A benchmark, strictly speaking, is a surveyor's mark made on a stationary object of a previously determined position and elevation and used as a reference point in tidal observations and surveys. The mark was used as a place to insert an angle iron that served as support for a leveling rod. Because of the importance of the benchmark itself, the term soon came to be applied figuratively to any point of reference. In general, a benchmark is a standard that is used for comparison. As it relates to investment performance, the standard can be an absolute return, a peer group, an index, an opportunity cost, or possibly a combination of each. Benchmarks therefore must be representative of the overall market and are preferably passive, meaning that the underlying investment allocations are relatively constant (i.e. no one is actively managing or trading the investments).

Benchmarking in the public markets is well established and numerous indexes have been constructed by strategy or styles. The private markets, however, are not as developed and are considerably more challenging due to lack of information, complexity and uniqueness of vehicles and deals, and the cost / benefit of producing such benchmarks.

Why do we need benchmarks? Benchmarks play an important role in performance measurement as a means of evaluating actual results. Plain and simple, benchmarks tell us how investment managers are doing (evaluation) and provide insights as to why performance is what it is (attribution and tracking error). This article focuses on the former. Attribution analysis, which typically highlights the effectiveness of asset allocation decisions vs. asset selection decisions, and tracking error, the degree of deviation from the benchmark, are topics for another day. In addition, the AIMR / GIPS Performance Standards require the disclosure of a benchmark, or an explanation as to why no benchmark is presented.

What are the characteristics of a valid benchmark? According to Jeffery V. Bailey's 1992 article in the *Journal of Portfolio Management*, "Are Manager Universes Acceptable Performance Benchmarks?", benchmarks must be unambiguous, investable, measurable, appropriate, understandable, and specified in advance. The S&P 500 for example is widely regarded as the best single gauge for U.S. Equities providing 80% coverage. The Index is maintained by a committee who meets on a regular basis to ensure turnover is minimized and that it is a leading indicator reflective of the risk and return characteristics of the market. The article, by the way, concludes that manager universes are not good benchmarks because they fail certain benchmark quality tests, and they are subject to survivor bias (poorly performing managers' drop out).

What benchmarks are available for real estate? It depends on which quadrant you're in. In the public arena, market indexes can be used. But not all indexes are benchmarks. An index is simply a means of approximating the valuation of the market. By contrast, a benchmark serves to measure investment performance and reflects the risk characteristics and asset allocation strategies that an investor and a portfolio manager are seeking. In public equities, NAREIT, Morgan Stanley or Wilshire are typically used. For public debt securities, Lehman publishes a CMBS index, but the Lehman Aggregate index is generally used even though the CMBS component is relatively small. On the whole loan side, the Gilberto-Levy Index (a simulated index), Lehman and Life-Comps are available. In real estate private equity, NCREIF is the most widely used for institutionally owned core properties. Internationally, the Investment Property Databank provides direct investment indexes for various countries.

In the past few years, there was controversy regarding the use of the NCREIF Index as a benchmark, although it was never originally designed to be used as one. The NCREIF Index's original objective was to provide historical measurement of property level returns in order to both increase the understanding as well as lend credibility to real estate as an institutional investment asset class. As the index grew over the past 25 years to over $120 billion and 3,800 properties (781 at inception), it became a popular tool for incentive fee contracts and performance bonuses for investment officers and portfolio managers. When times were good and everyone beat the benchmark (used facetiously as by definition that's impossible), not too many questions were asked. When things turned south in recent years, people began to ask questions.

Does Benchmarking Hinder Risk Taking? Are managers gaming the benchmark?

The NCREIF Index on the surface appears to violate most of the valid benchmark characteristics mentioned above. You can't invest in the index, and it's not passive (property and region weights change based on contributing member profiles). Further, the index is not market-based but appraisal-based and therefore contains lag and smoothing effects. Upon a closer examination, however, according to David Geltner in his 2000 *Real Estate Finance* article "Benchmarking Manager Performance within the Private Real Estate Industry", "If you watch out for lags and random noise (compare "apples-versus-apples"), consider the ex ante incentive role of benchmarking, and match evaluation criteria to the manager's responsibility and authority, then the NCREIF index can be quite useful and appropriate as a benchmark".

Do we need more… perhaps a variety of qualitative and process-based indicators or a balanced scorecard approach?

How does one construct a benchmark for private equity real estate? A good place to start is to understand the investor's investment strategy, objectives, risk and return tolerances. Evaluate what decisions are controlled by the investor vs. authority delegated to the manager. It wouldn't be reasonable or fair to hold the manager accountable for performance if they didn't have the ability to make decisions and influence performance.

If an absolute return (either time-weighted or dollar-weighted) is used, a survey of the marketplace and/or an in-depth analysis of historical returns and risk might be warranted. But what time period should be used? Don't forget that historical performance is not necessarily a good indicator of future results. If the NCREIF Index, Sub-index, or combination thereof is used, what premium adjustments are made to reflect the risk and return characteristics of the subject portfolio? Remember the NCREIF Index consists of core operating properties held by tax-exempt institutions. It is time-weighted, unlevered and before advisory fees. Any variation from this profile will require premium or discount adjustments for fund level activity, investment advisory fees, inflation, leverage, risk, etc. If the manager has no control over property type allocation decisions, maybe a custom index based on the property weights of the investor portfolio is more appropriate. This would eliminate the allocation effect from the equation.

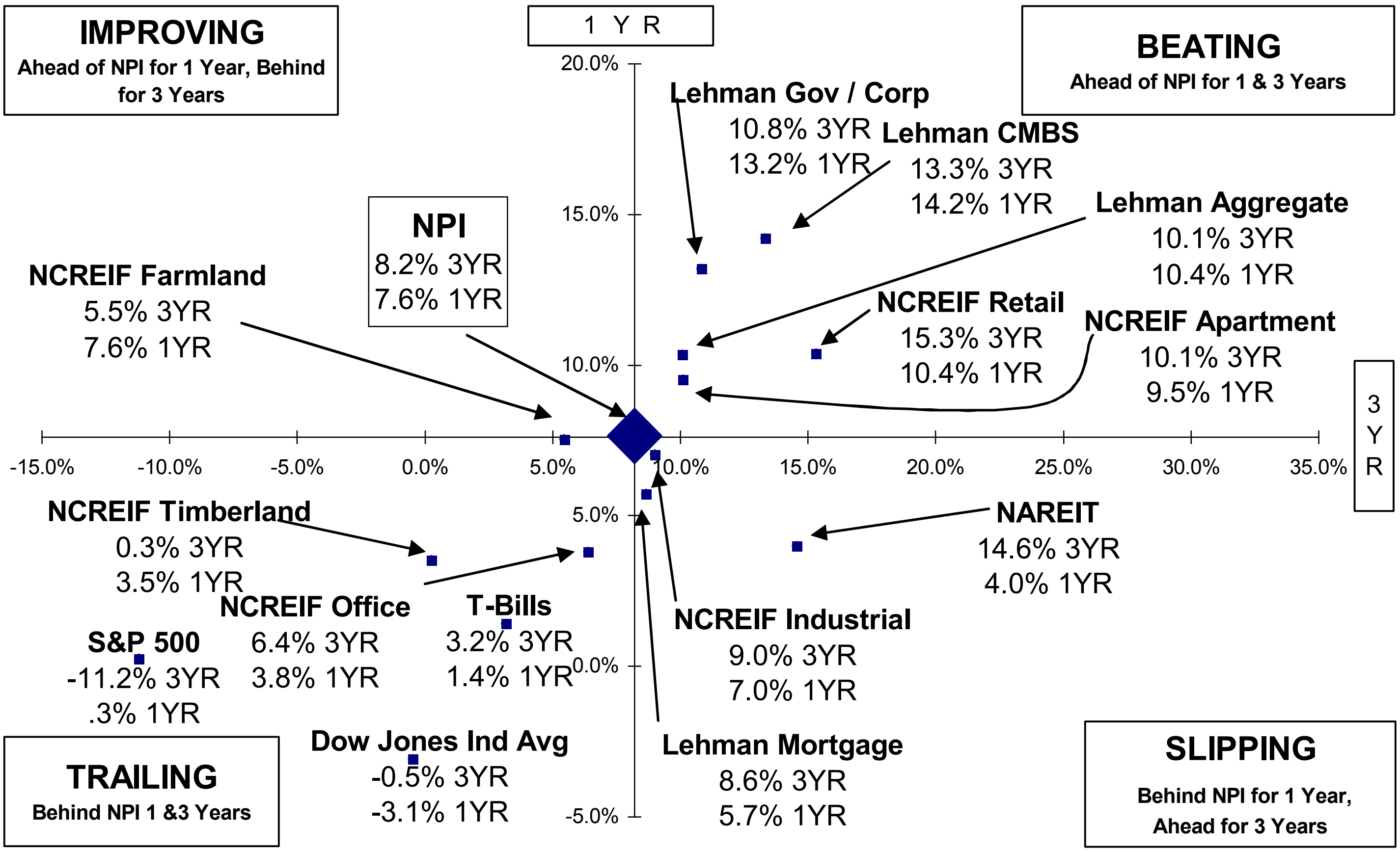
The bottom line is that there is no one perfect benchmark. Benchmarking is not an exact science. In real estate, with little to work with, it's more of an art form. There are many unknowns and questions to ponder. Who determines the benchmark, the manager or the investor? Does benchmarking hinder risk taking? Are managers "gaming" the benchmark? Does benchmarking adequately consider all the relevant forces of the dynamic marketplace? Do we need more than just a return outcome measure, perhaps a variety of qualitative and process-based indicators or a balanced scorecard approach?

Depending on the objective, careful planning, experience and creativity are essential for constructing meaningful benchmarks and information ratios. A variety of realistic indicators can give valuable insight into performance. To take real estate performance analysis to the next level, the broader real estate industry must collaborate, and enhance and broaden the standards, technology and data collection. NCREIF has been taking steps in the right direction. Data contributing membership is growing, standards are improving, data elements, property types and investor profiles are expanding. The long-awaited and much needed Fund Level Database project is well underway.

The industry must keep the momentum going. Change and improvement must occur across the entire global real estate community, incorporating all investor types, all product types, and all investment styles. It won't be easy, it won't happen overnight, it won't be cheap and we may need to look at other industries for our role model, or should I say benchmark?

NCREIF (NPI) and BENCHMARK COMPARISONS

For 3 and 1 Year(s) Ended June 30, 2003



Performance Returns across asset classes may not be comparable due to appraisal based pricing for privately held investments vs. transaction pricing for publicly traded securities. Public security indexes typically do not reflect transaction costs or advisory fees and assume reinvestment of earnings. Private investment indexes typically do not reflect advisory fees. Index definitions are as follows:

Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. **Lehman Aggregate Bond Index is** composed of the Lehman Gov't/Credit Index, Lehman Mortgage Backed Securities Index and Lehman Asset-Backed Securities Index. The Lehman Asset-Backed Index is composed of debt securities backed by credit card, auto and home equity loans that are rated investment grade or higher. **Lehman Government/Credit Bond** is composed of debt securities issued or guaranteed by the U.S. Treasury, U.S. Government agencies and quasi-federal corporations and fixed rate dollar denominated SEC-registered corporate debt that are rated investment grade or higher. **Lehman Mortgage-Backed Securities** is composed of fixed rate 15- and 30-year securities backed by pools of mortgages, balloon mortgages, and graduated payment mortgages backed by Government National Mortgage Association, Federal National Mortgage Association, and Federal Home Loan Mortgage Corporation that are rated investment grade or higher. **Lehman Mortgage** is a market index representing fixed rate mortgages issued by the Federal Home Loan Mortgage Corporation. **NAREIT** consists of 173 publicly traded companies with a market capitalization of $197.2 billion representing 94.4% equity REITs and 5.6% mortgage REITs. Property sector breakdown is 28.0% Industrial/Office, 25.1% Retail, 16.9% Residential, 8.1% Diversified, 4.0% Lodging/Resorts, 3.1% Self-Storage, 5.0% Health Care, 4.2% Specialty, 3.7% Home Mortgage, 1.9% Commercial Mortgage. **NASDAQ Composite** is a broad-based capitalization-weighted index of all NASDAQ National Market & Small Cap stocks. **NCREIF (NPI)** consists of 3,832 core de-levered operating properties owned by tax-exempt institutional investors with a market capitalization of $124.5 billion. Property type breakdown based on market capitalization is 40% Office, 20% Retail, 20% Industrial, and 20% Apartment. **NCREIF Farmland** consists of 292 properties with a market capitalization of $813 million. **NCREIF Timberland** consists of 264 properties with a market capitalization of $5.1 billion. **Standard & Poor's 500** is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Treasury Bills** are negotiable debt obligations (securities) issued and backed by the U.S. government with maturities of one year or less.

D'Alessandro Associates, Inc. (DAI) does not represent or warrant that the data or analysis contained herein is accurate, correct, complete or timely and shall not be responsible for the results obtained from its use. As with all investments, you must make your own determination of whether an investment is consistent with your investment objectives, risk tolerance, financial situation, and your evaluation of the merits of the investment. DAI is not recommending any investment. Past performance is no guarantee of future results.

www.RealEstateInsights.com

Cell: 404-395-4498
Home Office: 770-338-8474
E-mail: JoeD@RealEstateInsights.com

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.

Value Added Services

Project Assistance/ Management, Consulting, Outsourcing and Training

Accounting, Reporting, Systems, Process Improvements, Performance Measurement, Analysis, Benchmarking, Marketing, Research, Risk Management and Governance

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