

# Private Market Real Estate Investment Options for Defined Contribution Plans

New and Improved Solutions

*November 2014*

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## Executive Summary

- Investment vehicles using private real estate have, historically, been largely unavailable to defined contribution (DC) plan participants, but that is now changing.
- The maturation of daily-valued private real estate funds, along with a shift in DC plans toward the use of multi-asset portfolios such as custom target-date and objective-based funds, has introduced a new investment environment that is now well positioned to incorporate private market investment vehicles into a DC investment plan.
- Daily-priced real estate funds that address legacy vehicle concerns—namely, liquidity, valuations, and pricing frequency—are now available and offer a viable and executable solution for DC investors. With these products, DC investors can incorporate the return profile and diversification benefits of private core real estate into their multi-asset class investment portfolios.

## Why Incorporate a Private Real Estate Investment Option into a DC Plan?

### Background

DC plans are fast becoming the primary retirement saving vehicle for Americans<sup>1</sup>. Historically, DC participants have had minimal exposure to private real estate, due to a lack of viable investment options as well as concerns regarding private real estate's potential illiquidity, historical valuation policies, and pricing frequency. As a result, most DC plans' real estate exposure today, if any, consists of a small allocation to publicly traded real estate investment trusts (REITs). Notably, only 26%<sup>2</sup> of DC participants today have the option to invest in real estate, with actual overall portfolio allocations averaging only 1%<sup>3</sup>, mostly through REITs as standalone investment products. In contrast, the majority of defined benefit (DB) plans have exposure to real estate. Allocations average 8.9%<sup>4</sup>, with over 85% of this allocation in private real estate.

REITs represent one segment of the real estate asset class. While they exhibit a long-term correlation with private core real estate, REITs have a different risk-return profile and often play a different role in overall portfolio construction. Both vehicles provide real estate sector exposure, but private real estate vehicles provide investors with direct access to the diversifying market and income characteristics of the underlying bricks-and-mortar real estate. They do this without the complications from potential financial engineering, business enterprise value, or overall broader equity market volatility that are present in REITs.

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<sup>1</sup> Department of Labor Pension Bulletin. 81% of all active U.S. pension participants are in DC plans. Report as of June 30, 2013.

<sup>2</sup> PSCA's 56th Annual Survey of Profit Sharing and 401 (k) Plans.

<sup>3</sup> 2013 *Trends & Experience in Defined Contribution Plans*, Aon Hewitt.

<sup>4</sup> 2014 Global Investor Survey, IREI and Kingsley Associates.

The characteristics driving the differences between private and public real estate are as follows:

- The daily-valued private market real estate vehicles available to DC plan sponsors are investment funds that invest substantially in core real estate assets typically well diversified by property type and geography, and utilizing modest levels of leverage. Core real estate is generally defined as stabilized (well-leased), income-producing assets most commonly garnered from apartment, retail, industrial, and office property types.
- REITs are operating companies and thus offer shares in a company that owns and manages real estate assets. REITs can trade at substantial premiums (or discounts) on their underlying real estate values—based on multiple non-real estate and broader stock market sentiment—creating a different return profile and offering fewer of the diversification benefits of private core real estate investments.

These structural and tactical differences lead private and public real estate to perform differently over a market cycle and to create different benefits, as well as challenges, when added to an investment portfolio.

## The Benefits of Private Core Real Estate

The primary inclusion objective for real estate within a DC plan should focus on obtaining income and diversification, with some potential for inflation hedging over multi-year investment horizons. These goals are best met within the real estate asset class by incorporating private core real estate into a multi-asset class portfolio. The key benefits of adding private core real estate are:

- Attractive yields and risk-adjusted returns
- Diversification and increased downside protection
- Potential for inflation protection without increased volatility

**Returns.** A large portion (approximately two-thirds) of private core real estate returns come from cash flow generated by long-term leases, which contribute to a more stable overall return profile versus equities. Over the past 20 years<sup>5</sup>, U.S. private real estate's cash yield as measured by the NPI produced an annual average return of 5.1%<sup>6</sup>. Private real estate also provides an attractive absolute return profile with significantly lower volatility than equities compared over the same time period. Therefore, adding private real estate to a multi-asset class portfolio supports an improved overall risk-return profile for the total portfolio.

**Diversification.** Given private core real estate's low correlation with equities and its relatively stable and high cash yield, when adding private real estate to a multi-asset class portfolio, the segment's total return is less likely to be negative at the same time as equities' total return—providing significant total portfolio benefits. Given that private real estate is included in a portfolio with an eye to mitigating downside risk, we

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<sup>5</sup> Time period 6/30/94 to 6/30/2014.

<sup>6</sup> NCREIF Property Index.

examined how often in the same period private core real estate<sup>7</sup> experienced negative returns when compared to a standard 60/40 stock-bond portfolio.

Over a 20-year time period, the returns for private core real estate yielded negative returns at the same time as a 60/40 stock-bond portfolio in only 14%<sup>8</sup> of the quarters. In comparison, due to REITs' public format (especially now that many large REITs are included in major stock indices including the S&P 500), REITs experienced negative returns at the same time as a 60/40 stock-bond portfolio in 57% of quarters.

**Inflation.** Both private and public real estate offer potential inflation protection over the long term. While neither provides a perfect inflation hedge, generally a rise in inflation is, over time, at least partially offset by rising commercial rents and the pass-through of expenses to tenants, creating the potential to hedge inflation over the medium to long term. Private real estate's return profile is less volatile than other publicly traded, inflation-sensitive assets such as REITs, commodities, and infrastructure stocks—and this allows investors to add private real estate to their investment portfolios in scale without increasing overall portfolio volatility.

As an example, if a plan with a 60/40 stock-bond portfolio had added a 7%<sup>9</sup> allocation to private real estate over the past 20 years, the real estate returns would have decreased the portfolio's overall volatility by 60<sup>10</sup> basis points. In comparison, a 7% allocation to REITs would have increased the portfolio's overall volatility by 23 basis points. In summary, the addition of private core real estate presents smart investment selection and offers significant room to enhance overall portfolio construction within DC platforms.

## How to Incorporate Private Real Estate into a DC Plan

Early generations of daily-valued private real estate funds were predominantly participant-directed, making them susceptible to market swings and increased trading activity. Due to the potential illiquidity of private real estate and the perceived complexity of daily-valued private real estate funds, DC plan sponsors were hesitant to include these vehicles in their plan options. While a number of the legacy participant-directed options still exist, the new generation of daily-valued private real estate vehicles seeks inclusion in multi-asset funds only. This limitation adds an additional layer of liquidity control; therefore, we believe the current generation of daily-valued private real estate funds can offer significant benefits when utilized within multi-asset funds.

- Funds such as target-date funds reduce liquidity concerns because the professional manager has several options other than real estate to create any liquidity required.

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<sup>7</sup> Direct Real Estate: NCREIF Fund Index—Open End Diversified Core Equity (NFI-ODCE); U.S. REITs: FTSE NAREIT U.S. Real Estate Index; Equities: S&P 500 Index; Fixed Income: Barclays Aggregate Index.

<sup>8</sup> HEK removed the appraisal bias by de-smoothing the private real estate returns utilizing a regression-based analysis. The de-smoothed returns provided negative returns at the same time in only 37% of the quarters.

<sup>9</sup> Allocating 3.5% each from equity and fixed income. Direct Real Estate: De-smoothed NCREIF Fund Index—Open End Diversified Core Equity (NFI-ODCE); U.S. REITs: FTSE NAREIT U.S. Real Estate Index; Equities: S&P 500 Index; Fixed Income: Barclays Aggregate Index.

<sup>10</sup> HEK removed the appraisal bias by de-smoothing the private real estate returns utilizing a regression-based analysis. The de-smoothed returns lowered the volatility of the portfolio by 34 basis points.

- Within target-date structures, professional asset managers weigh the investment merits of private real estate against a multi-asset fund’s liquidity needs in order to decide on an allocation. This not only avoids the potential for misunderstanding and misuse by individual participants allocating to real estate on their own, but also curbs the potential liquidity stress on these funds because they are utilized as diversifying components only.

When participants invest through target-date funds, they also receive exposure to a diversified portfolio more tailored to a desired end objective. Outcomes-based investment offerings such as target-date funds can be more effective with a broader tool set of strategies. Though these implementation structures were once rare, they are now increasingly common.

## Daily-Valued Private Real Estate Vehicles

Daily-valued private real estate investment funds have evolved over the past three decades with improvements focused on addressing specific legacy concerns—namely, liquidity, valuations, and pricing frequency. Currently there is a variety of daily-priced direct real estate products in the market and even more in development, but during the 1980s and 1990s, only a limited number of funds were available. Older versions lacked today’s transparency, which raised concerns about valuation methodologies, daily pricing mechanisms, and potential “gating” during periods of market dislocation. These mostly legacy issues more often than not discouraged DC plan sponsors from including the vehicles in DC lineups.

Today’s daily-valued real estate funds are focused on providing investors exposure to predominantly private core real estate. To help facilitate liquidity, the majority of these funds also maintain a liquidity sleeve of cash and REITs. The current generation of daily-valued private real estate vehicles is largely structured as fund-of-funds and is generally limited only to investment through multi-asset funds.

The following table outlines the general characteristics of the funds that Hewitt EnnisKnupp views as viable investment vehicles.

**Table 1: Characteristics of Daily-Valued Real Estate Vehicles**

Asset Class	Real Estate
Fund Structure	Open-End Commingled Fund-of-Fund
Fund Composition	75-85% Direct Real Estate; 15-25% Cash/REITs
Risk Spectrum	Largely Core Real Estate
Manager Nominal Target Returns	7%-9% Annualized Over a Full Market Cycle
Pricing Frequency	Daily
Trading Frequency	Daily With Limitations
Restrictions	Limited to Multi Asset or Target-Date Funds
Fees	85 bps - 115 bps

## Investment Strategy

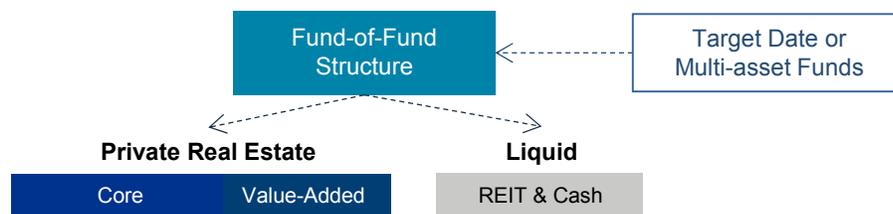
The investment strategy of these funds focuses on providing investors exposure to private core real estate through investment in stabilized, income-producing properties. The funds are well diversified geographically and the majority of investments are in the following property types: apartment, office, retail, and industrial. Some also have a minority exposure to property types such as self-storage, hotels, and/or senior housing, among others.

A number of managers also include small allocations to core plus or value-added strategies. The inclusion of a second or third private real estate strategy provides additional channels for direct investments and strategy diversification. However, it also changes the risk profile of the overall private real estate exposure; thus, a DC plan's desired risk-return profile should be well defined prior to selecting a private real estate option.

## Structure and Liquidity

The vehicles are generally structured as fund-of-funds and utilize a manager's existing institutional open-end private real estate funds, while adding a liquidity sleeve consisting of REITs and cash. The daily-valued vehicle's investment philosophy is focused on maintaining the underlying fund allocations within the target ranges of 75%–85% to direct real estate and 15%–25% to REITs and cash.

**Figure 2: Diagram of a Third-Generation Fund Investment Structure**



The investment process is actively managed by running daily forecasts of investors' liquidity requirements and determining cash flow needs for rebalancing and participation flows. This allows the funds to manage their allocation to the underlying private real estate, REITs, and cash on a monthly/quarterly basis.

Liquidity can be proactively managed largely by utilizing various levers within the structure of the daily-valued vehicle, and through cash flow management as well as liquidity in other areas of the overall DC portfolio. Within the fund-of-fund structure, the following levers are common:

- Fund structures—these often call for a minimum allocation to cash and/or REITs, which are available to support immediate liquidity.
- Trading restrictions—while these vary by manager, they generally define a maximum NAV percentage to be traded over a defined period (e.g., 5% of NAV over 10 days).
- A line of credit.

These considerations aside, liquidity is not guaranteed in the vast majority of direct real estate vehicles—making them inherently less liquid than utilizing public market real estate vehicles. This potential risk must be acceptable to the DC plan sponsor before such asset classes are employed in a DC investment plan.

## Daily Pricing

While daily trading isn't mandatory for DC plans, most plan sponsors still won't consider fund options that do not have the capacity for at least daily pricing. The private real estate vehicles available to DC plans today provide for both daily pricing and daily trading.

The assets in the fund-of-funds are priced daily by adding the values of the interests in underlying private real estate funds, the REITs, and cash; then subtracting liabilities, fees, and other expenses. Independent third parties now generally value all assets in private real estate funds on a quarterly basis; appraisals are staggered throughout the quarter with values incorporated daily. In addition, income is forecasted and adjusted for major lease events or material market changes, if required. The daily recognition of value changes and material events in the direct funds reduces the potential for "gaming" of the investment in the fund-of-fund prior to the quarter-end true-up.

While the individual processes between managers vary slightly, all methodologies are transparent, timely, and validated by third-party providers. The process of adjusting private market valuations to daily pricing has been considerably refined since the first generation of funds entered the market. Overall, we believe that the market has evolved to the point where daily values are typically robust and daily pricing provides a fair representation of the underlying real estate value.

## Fees

Fees for the fund-of-fund vehicles available today are generally in line with the fees defined benefit plan investors would pay to access private core real estate. Management fees range from 90–115 bps per annum with expenses ranging from 3–25 bps per annum.

## Summary

There is strong investment rationale for incorporating private real estate into DC plans. Hewitt EnnisKnupp believes DC plan providers will be well served by reevaluating the role of private real estate and the vehicles that gain exposure to its characteristics and benefits. New, innovative solutions utilizing custom products are now available that meet the valuation and liquidity requirements of the DC marketplace.

With the evolution of daily-priced private real estate funds and the DC market's shift toward multi-asset platforms, especially custom target-date funds, DC plan providers now have the tools and access to provide DC plan participants exposure to the same attractive private real estate characteristics that DB plans have been enjoying for decades.

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