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PENSION FUNDS

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Pension funds are once again exerting their dominance as players in the commercial real estate markets.



By Jennifer S. Cowley and Trisha D. Spillman

Over the past decade, real estate investment trusts (REITs) had been bidding up the costs of real estate, pushing pension funds out of the market. Currently, REITs are facing a shortage of capital, allowing pension funds to purchase more real estate equities.

Pension funds have traditionally invested in real estate to diversify their portfolios. Today, investors are increasingly yield driven. Pension funds look to real estate to provide stable cash flows. The cash flows are used to pay off the fund's current liabilities, including benefits paid to retired employees. According to Institutional Real Estate Inc., the first goal of pension fund managers is to minimize risk; the second is to maximize returns.

Few pension funds have employees whose specific role is to invest or to oversee real estate investments. Even if a fund does have specific real estate staffers, third-party advisors or managers are usually hired to buy, sell and manage real estate assets. For example, RREEF Funds manage \$9.8 billion in real estate for more than 160 domestic and international pension funds.

The investment advisor industry is highly concentrated and will probably consolidate more in the future. Institutional Real Estate Inc. states that the largest ten advisors handle

48 percent of the business, and the largest 86 advisors control 98 percent of the business. Developers or brokers wishing to access pension fund capital should focus their efforts on building relationships with individuals working for these investment advisory firms, as opposed to the actual pension fund employees.

Pension funds also use third parties to obtain investment advice. Consultants are often used to identify strategies, select advisors and monitor the performance of the chosen advisors.

Largest Pension Funds in the United States

Invests in Real Estate

California Public Employees' Retirement System	X
New York State Common Retirement Fund	X
California State Teachers' Retirement System	X
Florida State Board of Administration	X
General Motors Investment Management Corporation	
Federal Retirement Thrift Investment Board	
New York State Teachers' Retirement System	X
Texas Teacher Retirement System	
New Jersey Division of the Investment	
General Electric Company	X

Source: Pensions & Investments

It is not uncommon for a fund to fire underperforming advisors and hire a different firm in hope of increasing returns.

According to Institutional Real Estate Inc., several trends can be found and forecasted among pension plans. Pension funds are expected to continue to diversify by property type and investment structure to invest without driving up prices through competition.

Investors usually have clear exit strategies in place before investing in a new piece of real estate. This allows for more accurate holding period projections and can affect the return of the investment. Pension funds are most attracted to deals involving properties that could potentially be securitized. These properties are of higher quality and increase the exit strategy alternatives for the fund. Pension funds are also investing in more REITs and investment funds managed by other institutional investors.

The Pension Real Estate Association (PREA), National Association of Real Estate Investment Managers (NAREIM) and the National Council of Real Estate Investment Fiduciaries (NCREIF) have joined to write real estate information standards for reporting real estate investments. This is an effort to increase the uniformity and accountability of records, as well as to reduce risk in the industry and increase investor participation in the market.

According to the January 1999 issue of *Pensions & Investments 1000*, the largest 200 defined benefit pension plans have assets totaling more than \$3.2 trillion. Of this, 2.4 percent, or nearly \$77 billion, is invested in real estate equities. Institutional Real Estate's *Investment Property Report* reports that during the 18 months between January 1998 and June 1999,

advisors spent an average of more than \$1 billion each month to acquire new properties for pension funds.

Pension funds are based in one specific state, but there are no geographical limitations as to where their funds may be invested. For example, an Ohio-based teacher pension fund bought the 508,500-square-foot Mattel Distribution Center just south of Dallas-Fort Worth. Randy Baird of Cushman & Wakefield said, "This offering was pursued by nearly every active institutional investment group in the United States."

Another example is the Alamo Quarry Market in San Antonio, purchased by the California State Teachers Retirement System. The 520,000-square-foot retail power center includes tenants such as Pottery Barn, Whole Earth Provision Co., Regal Cinemas, Whole Foods, Bed, Bath & Beyond and Victoria's Secret.

Texas is home to 13 of the largest 200 U.S. pension funds with a combined asset total of \$244 billion. Four of these funds hold real estate equities amounting to \$953 million. These four Texas funds invest an average 1 percent of their portfolios in real estate, much less than the national average of 2.4 percent. SBC Communications Inc. is the Texas pension fund with the most invested in real estate, \$487 million. JCPenney Co. Inc. invests the largest percentage of its portfolio in real estate equities, 5 percent.

Nationwide, nine of the top ten pension funds investing in real estate are public funds. In Texas, the four largest pension funds investing in real estate equities are privately owned and managed. Public pension funds in Texas do not ordinarily invest heavily in real estate equities. The Teacher Retirement System of Texas decreased their real estate asset allocation from 5.5 percent in 1993 to 1.5 percent in 1998 to 0 percent in 2000.

The California Public Employees' Retirement System (CalPERS) has \$9.8 billion, representing 5.8 percent of its assets, in real estate. Fund officials report they would like to increase the funds' real estate investment to 6 percent. Currently, only 11 percent of the fund's assets are located in the State of California. CalPERS, in a venture with Burnham Pacific Properties, a REIT, has purchased two portfolios and plans to purchase a third. Five Houston retail centers, all anchored by Randall's, are included in the portfolios. CalPERS also owns four apartment complexes in major Texas cities, valued at \$45.8 million by the appraisal districts.

Henderson Investors, a division of Sydney, Australia's AMP Co., invested \$205 million in an 11-apartment-complex

The largest 200 defined benefit plans have assets totaling more than \$3.2 trillion, \$77 billion of which is invested in real estate equities.

Largest Texas Pension Funds	Invests in Real Estate
Texas Teacher Retirement System	
SBC Communications Inc.	X
Texas Employees Retirement System	
Shell Pension Trust	
Exxon Corporation	
American Airlines, Inc.	
Texas County & District Retirement System	
Southern Baptist Convention Annuity Board	X
JCPenney Company Inc.	X
Texas Municipal Retirement System	

Source: *Pensions & Investments*

Pension Funds Investing the Largest Amount of Money in Real Estate	
U.S. Pension Funds	Texas Pension Funds
California Public Employees' Retirement System	SBC Communications Inc.
Michigan (State of) Department of Treasury Bureau of Investments	JCPenney Co. Inc.
Florida State Board of Administration	Kimberly-Clark Corporation
Pennsylvania Public School Employees' Retirement	Southern Baptist Convention Annuity Board
Lucent Technologies Inc.	
New York State Common Retirement Fund	
Illinois (State of) Teachers' Retirement System	
Los Angeles County Employees Retirement Association	

Source: *Pensions & Investments*

Pension Funds Defined

There are several different types of pension funds. **Defined benefit plans** are those in which members know from the outset how much money they will receive. **Defined contribution plans** are those such as 401(k)s or profit-sharing plans in which the amount of money an employee receives from a fund is determined by the amount the employee puts into the plan. Since 1990, defined contribution plans have experienced greater growth in participants than other types of plans.

More than 300 companies have converted to **cash-balance pension plans**, which reduce costs by decreasing benefits to older workers but offer employees a larger payout if they leave the company before retiring. This plan is beneficial to the mobile workforce but may violate age discrimination laws if it mandates that all employees switch away from their former plan.

The trend away from the more traditional defined benefit pension plans steers pension fund investors away from direct property ownership. This, according to Sydney Donnell of European Investors, is because "pension plans need liquidity" and must have *fungibility*, the ability of the fund's beneficiaries to take their benefits with them to a new retirement account should they change jobs.

A 1998 study by Hewitt Associates found that "57 percent of participants in 401(k) retirement-savings plans took cash payments when they changed jobs," in spite of negative tax consequences. More advantageous options are to roll the money over into an IRA, roll balances into the fund of the new employer's plan or leave the money in the old plan (if the balance is greater than \$5,000).

Employees cannot easily move or convert their retirement accounts if their assets are intertwined with long-term illiquid assets such as real estate. This fungibility requirement may make REITs and real estate debt increasingly common investment vehicles for pension funds in the future. REITs also make it easier for smaller pension funds to invest in real estate if they do not have the capital to purchase institutional real estate directly. Large defined benefit pension funds continue to participate in the direct ownership of real estate. ♣

portfolio in June. Three of the complexes are in Dallas, two in Austin and one in Houston. This purchase demonstrates the confidence pension fund advisors have in the market, because the properties are not new and were purchased by an international firm.

The Pennsylvania Public School Employees Retirement System put a large portfolio of retail properties in Austin and Temple up for sale this year, after owning the properties for 15 years, so it could make other investments. The nine centers had an estimated value of \$110 million. RREEF has purchased three retail shopping centers in the Dallas-Fort Worth metroplex, including the Inwood Village Shopping Center. RREEF also has been active in purchasing industrial property in the metroplex.

In Houston, the 777 Post Oak office building was purchased by Lend Lease for one of its pension fund clients. A March 22, 1999, article stated Lend Lease had completed \$2 billion in equity transactions, approximately \$225 million of which were for Texas properties. Pension funds and their advisors are important players in the current real estate cycle, especially in Texas. ♣

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