IPF Research Programme

Current Practices in Benchmarking Real Estate Investment Performance

SEPTEMBER 2018

SUMMARY REPORT

This research was commissioned by the IPF Research Programme **2015 – 2018**

This research was funded and commissioned through the IPF Research Programme 2015–2018.

This Programme supports the IPF's wider goals of enhancing the understanding and efficiency of property as an investment. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high-quality analysis on a structured basis. It encourages the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

The Programme is funded by a cross-section of businesses, representing key market participants. The IPF gratefully acknowledges the support of these contributing organisations:

Summary Report

IPF Research Programme 2015–2018

September 2018

Research Team

Edward Trevillion, Alan Gardner, Stewart Cowe and Colin Jones
The Urban Institute Heriot-Watt University

Project Steering Group

Andrew Angeli, *CBRE Global Investors*
Paul Kennedy, *ADIA*
Simon Wallace, *DWS*
Will Robson, *MSCI*
Pam Craddock, *IPF*

Acknowledgement

The authors would like to express their sincere thanks for the time and assistance provided by participants in the survey that was conducted in support of this research.

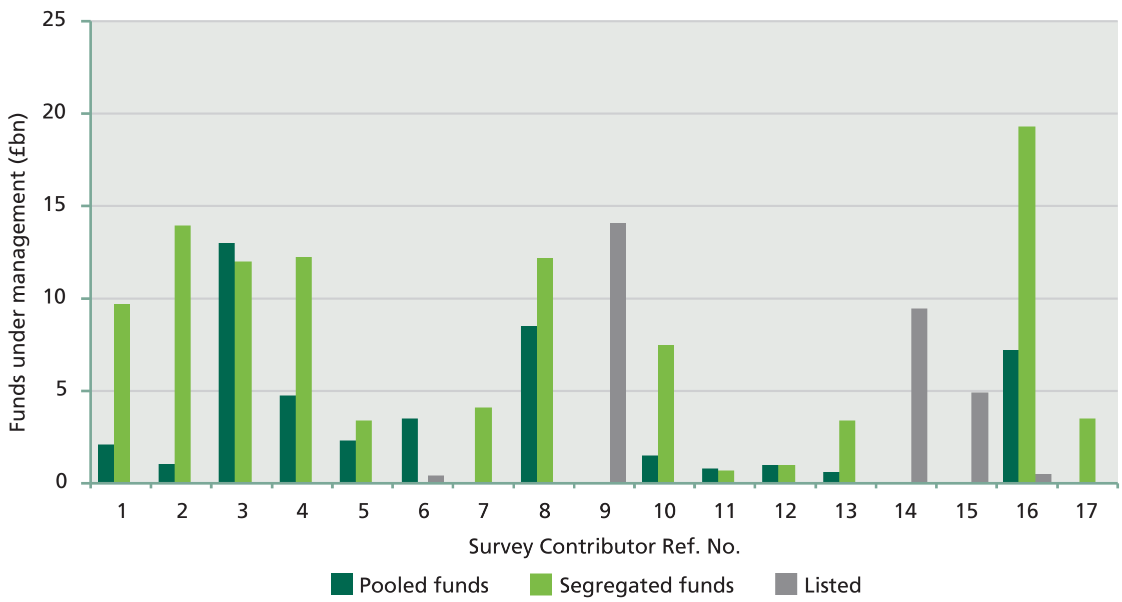
Introduction

This report examines the nature of benchmarks and investigates the range and application of benchmarks, predominantly in relation to the UK private real estate market but touching on global practices, wherever possible. It takes a behavioural approach to assess:

- What are the drivers for the choice of different benchmark types, such as market-based, liability based, real return or absolute return benchmarks?
- How common is it to specify dual or multiple benchmarks for a real estate portfolio?
- What are the motivations for this and what problems does this create?
- How have market benchmarks changed through time with regard to the types of assets (sector, location, quality) and types of investors being motivated?
- Have changes to the composition of market benchmarks kept pace with changes in the nature of the underlying private real estate market?
- What are the implications of changes in benchmark composition for performance measurement and asset selection, particularly for institutional investors?

The research questions are addressed primarily by means of a survey of some of the major institutions in the UK, either holding commercial property as an investment medium or providing data potentially used for benchmarking purposes. The questions, where possible, examined practice in overseas markets as well as in the UK. We undertook 23 interviews, including 17 investment houses with real estate assets under management in the UK of nearly £180bn (representing over 30% of the property investable universe in the UK, *see Mitchell, 2017*[1]) and overseas funds under management in excess of £515bn. A breakdown of the structures reviewed is contained in Figure 1.

Figure 1: Breakdown of Contributor by Investment Vehicle Structure



[1] Mitchell, P. (2017) The Size and Structure of the UK Property Market.

In addition, two detailed case studies of changing attitudes to benchmarking were carried out using UK funds where formalised benchmarking processes were established in the early 1980s, and where property ownership within these portfolios pre-date the MSCI/IPD database.

Benchmarks and Real Estate Indices

A benchmark may be narrowly defined as a point of reference that is used to compare investment performance and which forms an objective test of the effective implementation of an investment strategy for all asset classes. Benchmarks can also be used to compare the structure and the weighting of property portfolios to the constituents of a particular index. A benchmark may therefore not just be simply about financial performance in terms of returns but also about perceived risk relative to an industry norm. Risk in this context can be viewed as either that characterised by the benchmark itself (beta) or the level of risk that reflects permitted deviations from the benchmark (alpha).

Benchmarks and indices are not the same thing[2]. They are related but should not be confused. Conceptually, an index is an historical record of the performance of a market or defined market segment, whereas a benchmark is a yardstick defined for the purpose of assessing the performance of investors (or managers) participating in those markets.

An index becomes a benchmark when it is used as a reference point to quantify the relative performance of an asset or a portfolio of assets (*Serrano and Hoesli, 2009*[3]). It can be argued, however, that the primary role of a benchmark is to characterise an investment mandate. The assessment of performance relative to that mandate remains important, but secondary.

Types of Real Estate Benchmarks

The choice of benchmark can be different depending on the objectives of investment funds, and may differ in the short and long-term.

Approaches therefore differ across the industry, even within investment houses, reflecting both the nature (structure) of the fund and the specific requirements of fund mandates. Different fund characteristics mean that market-based indices may not necessarily be appropriate. Investors can typically employ the following approaches to evaluate real estate performance:

- Peer comparison
- Relative return
- Absolute return

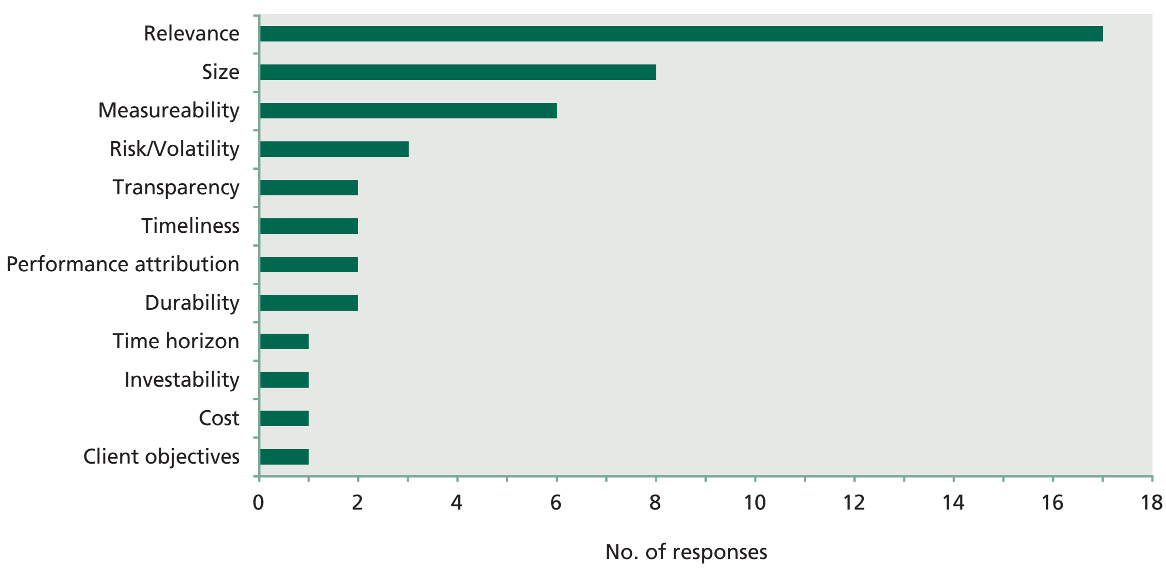
[2] For example, the MSCI/IPD Index reflects standing investment performance only, in order to provide an indication of market movement. The IPD Universe methodology, which forms the basis of benchmark analysis, also includes the performance of transactions, developments and actively managed assets.

[3] Serrano, C. and Hoesli, M. (2009) Global securitized real estate benchmarks and performance, Journal of Real Estate Portfolio Management, 15, 1, 1-19.

Main Research Findings

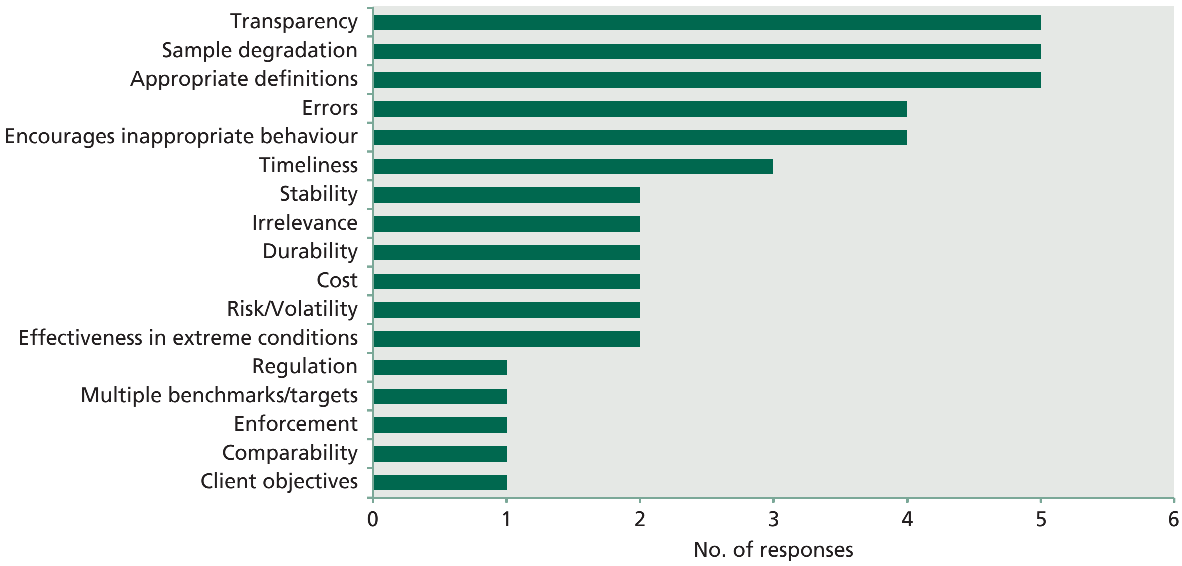
- In the UK, in the unlisted sector, a commonly used benchmark for market comparison is that provided by MSCI/IPD. However, there were some specific concerns raised in our survey around the use of these benchmarks, such as the lack of transparency, the degradation of samples as markets change, the effectiveness of designated risk measures and timeliness of delivery, particularly in relation to data availability of other asset classes.
- The types of benchmarks employed vary and, in most cases, the choice is determined by the characteristics of the fund/client and the investment objective.
- Almost all houses use absolute benchmarks, irrespective of style or type, where no transparent market indices were readily available for benchmarking purposes. This was true of many overseas markets.
- Clients make a significant input into the choice of benchmarks in the majority of cases.
- Many clients/funds with absolute strategies combine absolute benchmarks with peer or relative market benchmarks.
- Most fund houses indicated a reluctance to change benchmarks regularly but suggested that developments, such as a degrading sample, would eventually stimulate a rethink.
- There is a question whether investors are conditioned by receiving the same (or similar) forecast and performance data from a small number of sources.
- The global financial crisis has not generally changed policies on the type of benchmark applied.
- There is no enthusiasm for using transaction-based indices as benchmarks. They are, however, seen as analytical tools.
- There was no real evidence that the use of peer or market-based benchmarks constrained strategy.
- Our survey identified relevance as by far the most important factor in the choice of benchmark. This was followed by size (defined both as number of funds and market coverage) and the measurability of the benchmark (see Figure 2).

Figure 2: Most Important Considerations in Benchmark Construction



- It was also clear from our survey that the main problem/hazard faced when choosing a benchmark was in ensuring transparency. Sample degradation was an important issue, as was the confidence in the metrics provided (see Figure 3).

Figure 3: Hazards in Defining and Implementing Effective Benchmarking Policy



The Future

Looking to the future, the authors believe that the challenge is to design a system that can cope with changing market conditions. It should also deliver a good balance between the measurement and attribution of performance that adequately captures risk and return, combined with the position of the portfolio in the contemporary real estate cycle.

Our work suggests that there is a need for a better understanding of what benchmarking means. Benchmarks should reflect the investment mandate in a multi- or sole-asset class environment. Headline investment performance is almost a secondary consideration.

Risk in this context can be viewed as either that characterised by the benchmark itself (beta) or the level of risk that reflects permitted deviations from the benchmark (alpha) and we need to understand whether market-based benchmarks and absolute benchmarks capture different elements of risk. This leads us to consider whether both ought to be used in parallel when benchmarking property portfolios.

In any event, we believe that there should be a consideration of the short-term dynamics in the relationship between the investor and client, which facilitates the achievement of the longer-term objectives of both parties.

Research
Programme

Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH

Telephone: 020 7194 7920
Fax: 020 7194 7921
Email: ipfoffice@ipf.org.uk
Web: www.ipf.org.uk

Printed on recycled paper