

Benchmarking of pan-European real estate funds: challenges and achievements

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Introduction

One of the more profound implications of the global financial crisis has been the drive for greater transparency of the real estate investment process. The pressure for such transparency has come from a range of sources, including investors and regulators, as well as managers¹. One particular aspect of the improved transparency relates to the benchmarking of performance. Benchmarking has become a well-established process for improving the quality of decision-making within fund management houses and increasing transparency in relationships with investors². The insights have, to date, focused most on national markets by comparing similar types (or “peer groups”) of portfolios in those markets. As the momentum behind pan-European investing has grown, there has been increasing demand for benchmarking across European markets, but there remain a series of significant challenges in developing such benchmarks. These challenges include differences in appraisal regimes, definitions across markets, and in the frequency of reporting. It is in this context that this paper analyses the process behind the creation of meaningful benchmarks across European markets.

The analysis focuses on two important areas in respect of the recently launched pan-European pooled fund index (pEPFI). First, the process by which a discrete group of fund managers club together to pool their data to create meaningful benchmarks. The second issues focuses on the technical considerations associated with building a meaningful benchmark including the criteria for including or excluding relevant funds, and the process for reconciling asset and fund level performance. These issues, addressed through a case study analysis of the pan-European pooled fund index, provide important insights into the process of building benchmarks and the performance of the pan-European fund market.

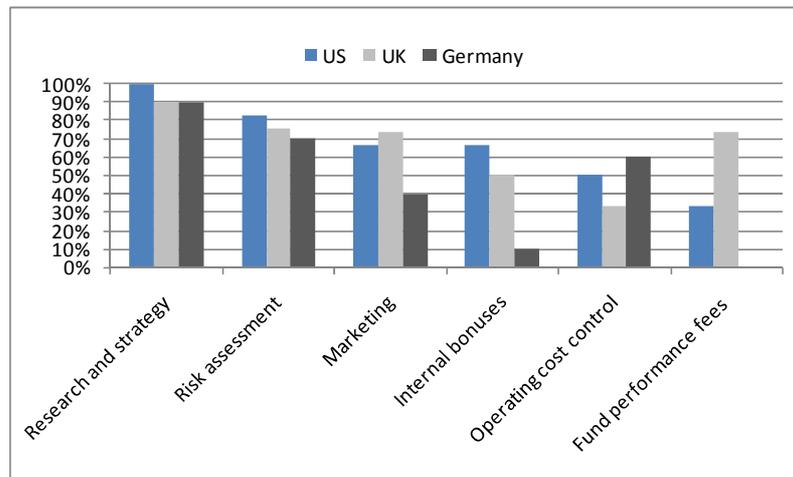
1. Benchmarking – scope and benefits

A recent survey demonstrates the wide range of reasons for conducting benchmarking analysis, as well as the variations from country to country (Figure 1). In all markets, the central rationale for benchmarking is to provide insights into portfolio performance and to strengthen risk management. But the process has a series of additional important benefits including marketing, cost analysis and in compensation and fee management.

¹ INREV (2011) *Legacy of the downturn*

² Hobbs, P. et al (2012) *Building Investor Confidence*, The Institutional Real Estate Letter – Europe, February;

Figure 1 Reasons for using real estate portfolio benchmarking services in three leading global markets



Note: Based on respondents to client survey in each market rating the use as “Essential” or “Useful”
Source: IPD, 2011

The fundamental reason for benchmarking is to provide strategic insights to improve decision-making through the investment process³. Fund managers and their investors can drill down from the headline statement of overall relative return to gain a comprehensive understanding of that result through attribution analysis and other analytical tools; these can provide insights which can help managers improve performance. Attribution analysis, as also applied widely across other asset classes, allows all those involved to assess the effectiveness of portfolio strategy and stock picking. It also provides pointers to areas of strength and weakness within the portfolio which can then be scrutinized further.

In this analysis, relative performance is broken down into the key drivers of performance including the components of return and strategic and stock specific factors, as well as the contributions from fund structure. And the careful use of this analysis really does seem to improve performance. Investigation of the performance of a selection of UK segregated accounts and commingled funds over the past twenty years demonstrates that after three years of commencing benchmarking analysis, relative performance had significantly improved for 48% of funds. More strikingly, after five years of measurement, performance had improved for 72% of funds with an average outperformance of 150 basis points per fund.

Greater uncertainty in economic conditions and the outlook for real estate has inevitably led to increasing concerns of investors to limit the downside of their portfolios and to introduce stronger risk management. In this market environment there is a growing recognition that accurate portfolio measurement and benchmarks are necessary to identify the true level of risk inherent in portfolios. The range of these benefits means that benchmarking is becoming more deeply embedded throughout the real estate industry, both in domestic markets and, increasingly across multinational or global portfolios⁴.

³ ULI (2011) *Global Investment Performance Standards* Infoburst; Hobbs, P. (2011) *Risk Management - Assessing Active and Beta Risk*, Institute of Fiduciary Education.

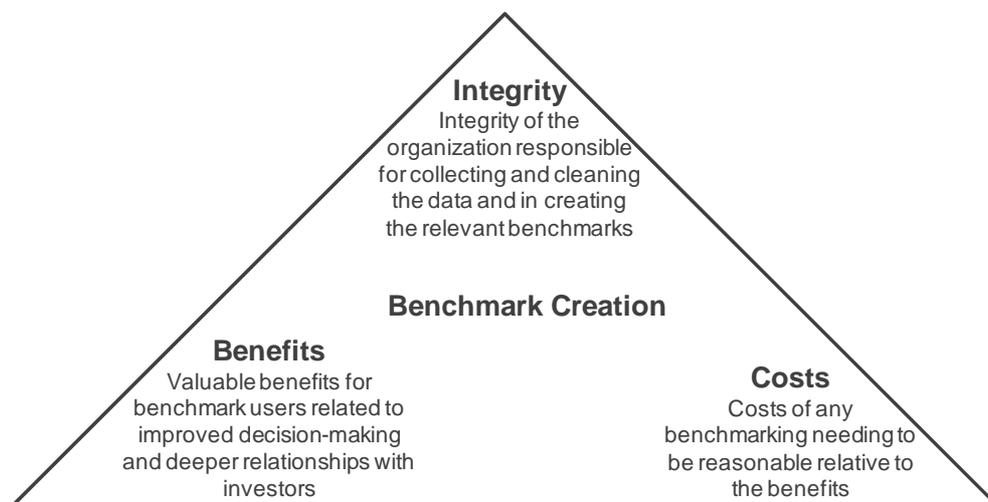
⁴ Hobbs, P. et al (2012) *Building Investor Confidence*, The Institutional Real Estate Letter – Europe, February; Newell, G. (2008) *Global perspectives on property benchmarking*, International Real Estate Research Symposium held in Kuala Lumpur, Malaysia.

2. Building Benchmarks: a. peer group analysis

If there are significant benefits to be gained from benchmarking, there are also a series of important challenges, both behavioural and technical. The behavioural challenges relate to the process by which discrete groups of fund managers club together to pool their data to create meaningful benchmarks. To a large extent these managers compete with each other in raising capital and in securing investment opportunities. They also pursue unique investment strategies so there are inevitable limitations in the ability to build comparable benchmarks. Despite these issues, there are significant mutual benefits in sharing data and knowledge as part of a peer group benchmarking process. It is these benefits that have driven the growth of benchmarking in equity and bond asset classes, and have lain behind the growth in real estate markets.

The critical requirements for the effective development of benchmarks are summarized in Figure 2 on three main dimensions. Clearly, there needs to be benefits to be gained from the insights, along the lines of those summarized in Section 1 of the paper. Alongside these benefits is the need for the costs of any benchmarking to be reasonable relative to the benefits, in terms of the cost of providing the data and making use of the benchmarking insights. The third critical requirement relates to the trust and integrity of the organization collecting and cleaning the data and in creating the relevant benchmarks.

Figure 2: Critical requirements for the effective development of benchmarks



Building Benchmarks: b. Technical considerations

The second substantive issue associated with building benchmarks relates to the technical considerations in building meaningful benchmarks. This covers the criteria for including or excluding relevant funds, and the process for reconciling asset and fund level performance.

One of the principles of benchmarking is the need to compare similar types of funds or portfolios that share comparable profiles or mandates⁵ so that any differences in performance are due to strategy rather than the structure of the vehicle. The heterogeneity of real estate assets and funds complicates the creation of such benchmarks. For direct real estate, the heterogeneity can be overcome by building

⁵ ULI (2011) *Global Investment Performance Standards* Infoburst

benchmarks that comprise a large number of assets so that it reflects the nature of the overall market or universe. The relatively small number of portfolios or funds creates difficulties in overcoming their heterogeneity and, for this reason, the focus is on identifying similar types or “peer groups” of funds. The similarity of the funds can be based on a range of dimensions but usually include:

- The “style” or the Risk/Return focus of the funds
- The investment profile and, particularly, whether the funds are open-ended or closed-ended
- The geographic and sector focus of the funds
- The scale of the funds and the assets (lot size) of the assets within the funds

A second, but related, technical issue associated with building benchmarks of real estate funds is the reconciliation between asset and fund level performance, and the need to assess the specific drivers of “fund” performance, that might include leverage, fees and cash⁶.

3. Case study: the pan European pooled property fund index

The behavioural and technical issues associated with building relevant benchmarks are explored through the pan-European Pooled Fund Index (pEPFI). This index, launched at the start of 2012, took a number of years to develop, with the major work on the technical dimensions to the index being carried out during 2011. This section covers a series of themes associated with the development of the index, including the background to pan-European investing, the process involved in the creation of the index and some of the insights provided by the index and its related benchmarks.

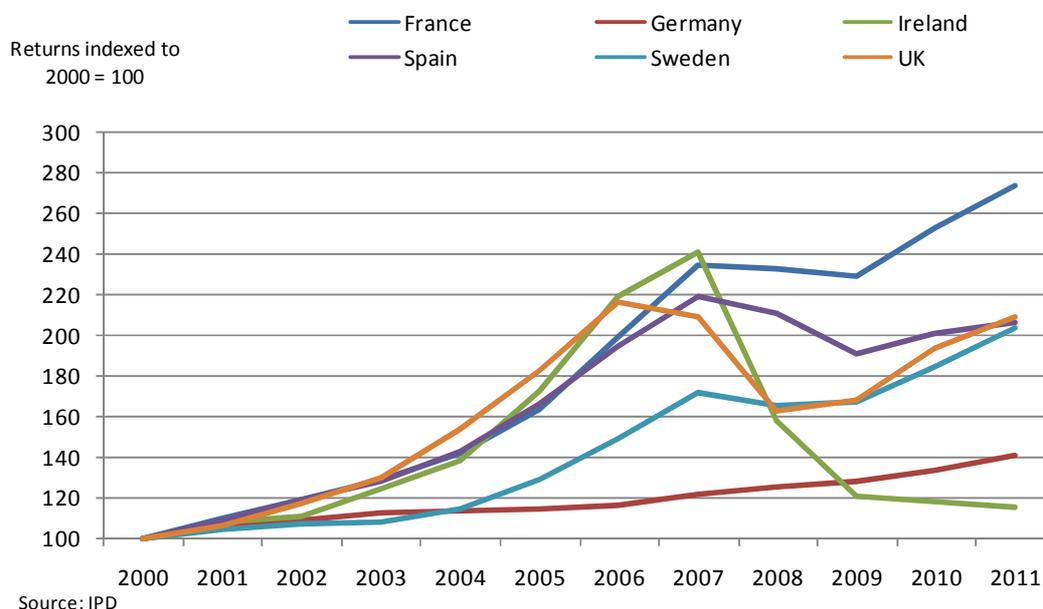
Pan-European investing

Prior to the 2000s, the pan-European real estate market was held back by a number of factors, the most important of which was the complexity and variety of real estate markets across Europe. These variations from country to country mean that it was difficult for managers and investors to build platforms with the scale and depth required for investing across the European market. This problem was compounded by the relatively small scale of European mandates, which restricted the possibility of creating the critical mass needed for investing across Europe. Running alongside this was the lack of familiarity of such a wide range of non-domestic markets.

A number of pressures generated greater momentum for pan-European investing. On the one hand, the behaviour of markets through the recent crisis reinforced the case for diversified exposure to European real estate. A number of studies have demonstrated persistent differences in the timing and amplitude of European market returns, with the INREV/IPD Solvency II study concluding that capital adequacy requirements should vary across Europe to reflect these differences. The major variations in performance over the last ten years are shown in Figure 3, both in terms of the timing of cycles and levels of national market volatility. This degree of variation is emphasised, for instance, by the very low (34%) correlation between the two most liquid European markets, France and the UK through the recent crisis. The clear implication is that significant risk reduction benefits can be gained from diversified exposure to European real estate.

⁶ Baum, A. and Farrelly, K. (2009) *Sources of alpha and beta in property funds: a case study*. Journal of European Real Estate Research Volume: 2 Issue: 3

Figure 3: Performance of major European real estate markets, 2000-11



On the other hand, there has been significant growth in the scale and expertise of pan-European managers, investors and advisors. At the start of the last decade, euroProperty reported that the top ten European managers had an average of Euro 11bn under management, with the portfolio of the largest manager worth just under Euro 20 bn. By the end of 2010, Real Estate Capital reported that this average had doubled, as had the scale of the largest manager, to just under Euro 40bn. Besides the growth in the largest European managers, there has also been an increase in the number of specialist pan-European managers. Although not necessarily the largest in terms of assets under management (AUM), these specialists have focused on building up expertise across the European market.

Running alongside the growth of these pan-European investment platforms has been a strengthening of their advisors. A range of different organisations have experienced dramatic growth across Europe over the past 20 years, including professional advisors (agents, accountants, consultants and lawyers), industry bodies (such as EPRA, INREV and ULI) and information providers (including IPD, IREI, PMA and RCA). The growth of these organisations has increased the transparency of the market and created greater opportunities for developing and implementing effective pan-European investment strategies.

As the capability to deliver pan-European investment strategies has increased, so has the demand from investors. One of the more profound implications of the recent financial crisis has been a shift in investor appetite towards traditional “core” real estate investing, and this is particularly the case for a range of global investors. During the 1990s and 2000s, most US and Asian investors pursued “opportunistic” investment strategies when investing in foreign markets including Europe. The crisis of recent years and the changing requirements of these global investors mean that many are now seeking “core” exposure when investing in Europe. These changes, coupled with the stronger inherent demand from European investors for core strategies, have boosted demand for the pan-European vehicles covered by the pEPFI.

The pan-European Pooled Fund Index

As the European real estate market has matured, there has been a growth of appropriate benchmarks, most particularly at the national and asset specific level. IPD indices now cover 18 European countries, with pooled fund indices available in seven of these countries or regions. These national benchmarks are used by many industry participants to help monitor their relative performance. Running alongside these national benchmarks has been the development of pan-European benchmarks, especially at the direct level and for listed real estate companies. For the listed markets they tend to be based off the EPRA or GPR indices⁷.

As the pan-European unlisted fund market has grown, a number of services have emerged to help monitor this market⁸ but, until recently, there have been major restrictions in the ability to benchmark performance off such services. These restrictions relate to the very different characteristics of the funds that generate difficulties in making meaningful comparisons, or benchmarks, across them.

It was in this context that there was increasing pressure to create a meaningful unlisted fund benchmark covering pan-European funds. Comparisons were made with established fund level benchmarks such as those in the UK (IPD's UK PFI) or in the US (NCREIF's ODCE), and steps were taken to launch a relevant pan-European benchmark.

The process by which this occurred centred on the recognition of the contributing managers of the mutual benefits of developing a relevant index. This recognition led to a series of meetings between all of the managers and a smaller subset of individuals that could debate the various rules that were to be used to govern the index. Given the desire for a robust benchmark, there was a focus on as much consistency in the scope and strategy of the funds as possible. On this basis, the rules were analysed and debated at length with the key criteria for inclusion of funds being summarised in Table 1. These rules led to the identification of 17 relevant pan-European funds that could be considered for inclusion, and all but one of these funds decided to participate. There is a broader range of funds that fall just outside of the index as they fail to comply with one or more of the rules for inclusion, and there is scope for these funds to be included in due course if their scope changes to reflect the rules.

Table 1: Key Rules for Inclusion in the pan-European Fund Index

Rule	Details
Open Ended	<ul style="list-style-type: none">• Open-ended funds, so as to be "investible"
Appraisals	<ul style="list-style-type: none">• Red book or similar methodology• Quarterly externally appraised asset valuations• Agnostic on NAV calculation methodology as long as GIPs compliant
Asset-level measurement	<ul style="list-style-type: none">• Requirement for asset level performance analysis
Disclosure	<ul style="list-style-type: none">• No requirement for fund-specific disclosure
Leverage	<ul style="list-style-type: none">• Leverage cap of 60%
European exposure	<ul style="list-style-type: none">• At least 80% of gross assets are required to be within "Europe"
Diversification: Geographic	<ul style="list-style-type: none">• Funds must have an intended strategy to invest in at least 3 regions of Europe
Diversification: Property Type	<ul style="list-style-type: none">• No restriction

⁷ www.epra.com; www.globalpropertyresearch.com.

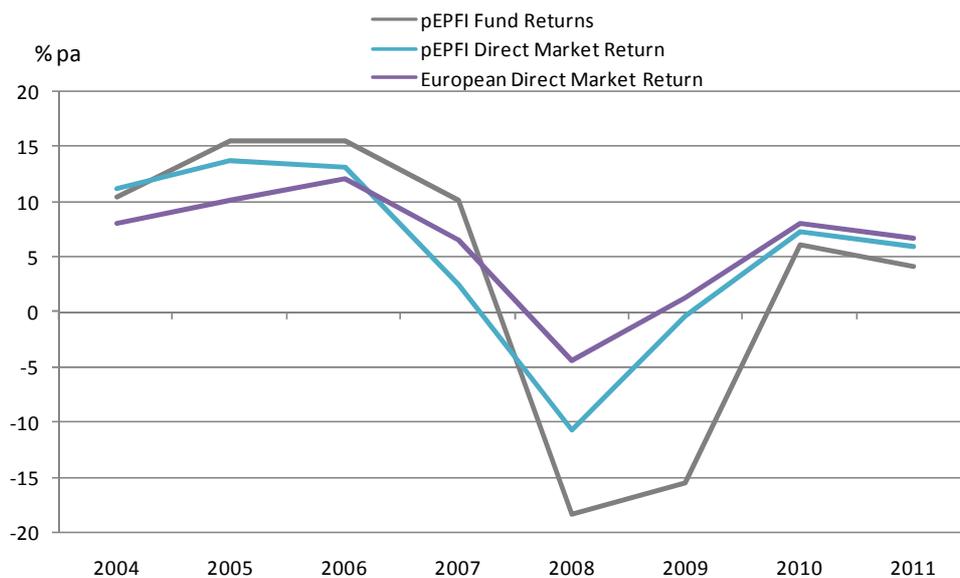
⁸ Such as those provided by INREV; Preqin; PERE; IREI; IPD, see ULI (2011) *Global Investment Performance Standards* Infoburst

Insights provided by the pan-European Fund Index

The central benefits of the Index relate to the increased transparency on the performance and risks of the funds within the index, and these benefits are reinforced by the quarterly frequency of asset and fund-level performance measurement. This transparency involves two major dimensions. First, the “market” as defined by the overall set of funds that comprise the index. Second, the individual “funds” in the index through benchmarking against the other funds. An illustration of these insights are provided in the charts and commentary below.

In terms of overall performance of the index, there are a series of valuable insights given the measurement of both “fund level” and “direct market” performance. This is demonstrated in Figure 4 that compares three important measures of pan-European performance. The purple line charts the original IPD pan-European direct market index, which is the aggregation of all underlying European markets weighted by the size of those markets. The grey line shows the performance of the pan-European property fund market and the blue line the direct performance of the portfolio of assets held within the peer group of pan-European funds.

Figure 4: Pan-European real estate: Direct and Fund level performance

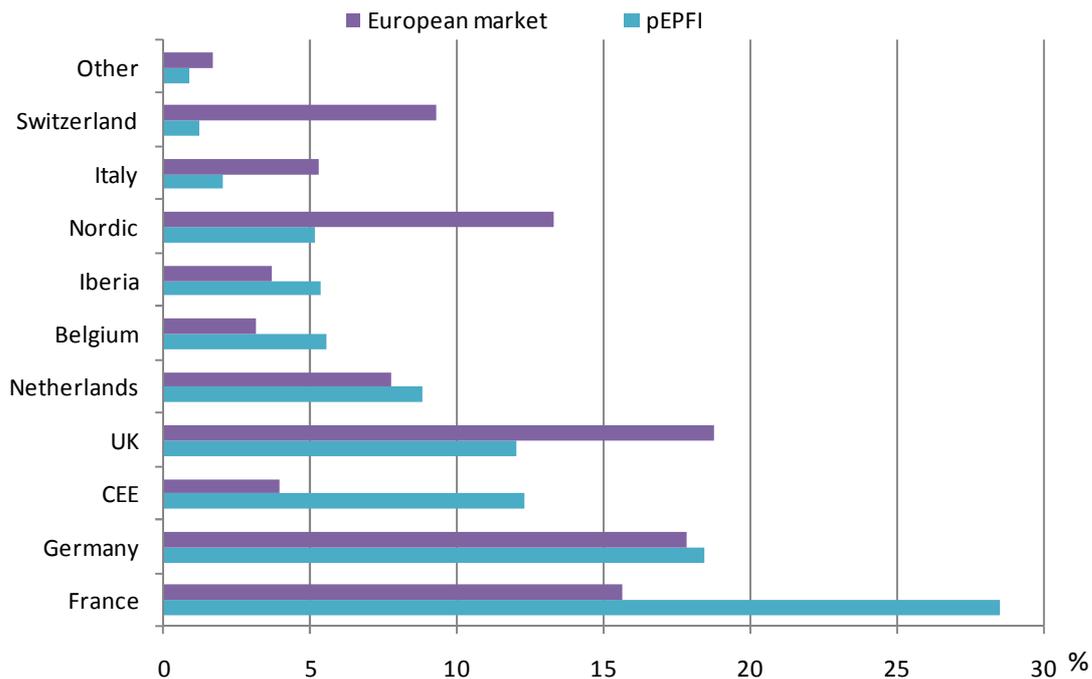


Note and Source: IPD, with pEPFI Direct Market returns prior to 2011 being based on a sample of the 16 funds included in the overall Fund returns

There is an important series of differences between the indices, such as for the more volatile fund indices (driven by the leverage that averages 40% across the funds, shown in the grey line) and the smoother series for the unlevered portfolios of assets (blue line). There are also differences between the overall European market and the pan-European peer group. On the one hand, the pan-European peer group is based on “Red-book” valued assets while the overall European market includes assets appraised by the German *verkehrs Wert* valuation methodology. Given the size of the German market, the inclusion of

verkehrswert assets is likely to smooth the pan-European (purple) performance series. On the other, there are important geographic differences, with the pan-European peer group having a lower weighting to the UK and the Nordic region, and conversely a higher weighting to France compared with the overall market (Figure 5).

Figure 5: Geographic exposure of pan-European funds compared with overall European market

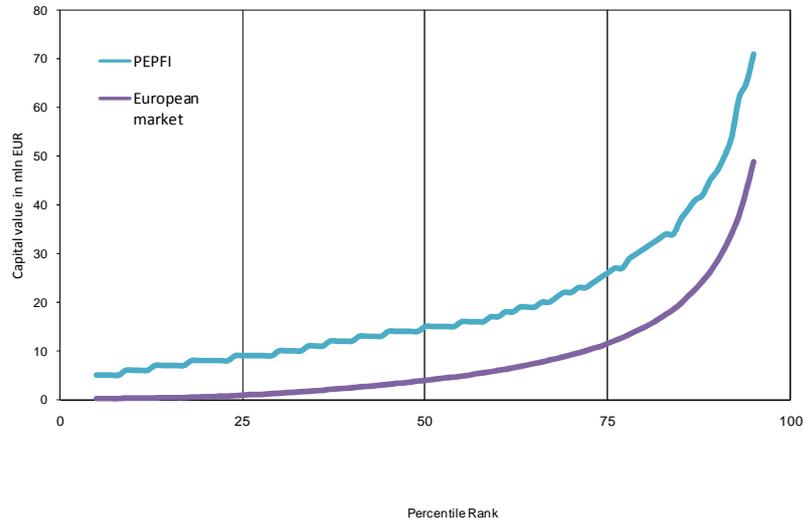


Source: IPD

The characteristics of these indices help explain the performance of different forms of investment. One of the main rationales behind the creation of pan-European funds is that diversification across markets can deliver stronger risk-adjusted returns than country-specific exposure. The tracking of performance at the level of the fund and the asset enables investors and managers to substantiate this rationale. This information also enables important investment themes to be addressed relating to the scope and style of the funds within the index⁹. This might include the appropriate exposure to different markets at different times, the number and value of assets that are required to create effective diversification across markets, the difference between “balanced” and “specialist” funds and, as illustrated in Figure 6, the differences in the distribution of capital values in pEPFI compared with the market as a whole.

⁹ Fuerst, F. and Marcato, G. (2009) *Style analysis in real estate markets: beyond the sectors and regions dichotomy*. Working Papers in Real Estate & Planning. 01/09. Working Paper. University of Reading, Reading. pp27.

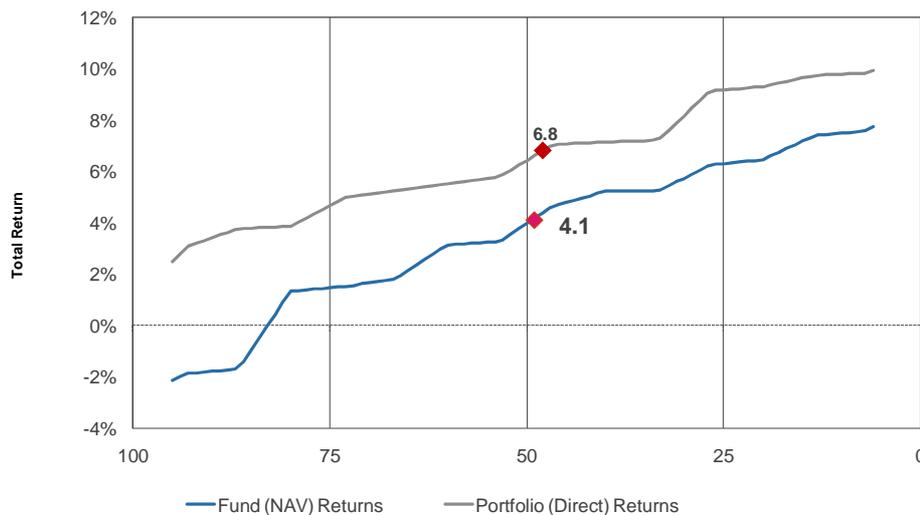
Figure 6 Distribution of capital values for pEPFI funds and European Market as at Dec 2011 (between 5th and 95th percentile)



Source: IPD

It was clear from Figure 4 that there is a divergence between the direct market and fund level returns, and this divergence is also apparent in Figure 7 that compares the 2011 range of returns at the “fund” and “asset” level. Direct market, or “asset” returns, averaged 6.8% during the year, significantly higher than the 4.1% fund returns, and this seems to persist for all of the funds in the index. There is a range of reasons for this discrepancy including the costs of running the funds, the holding of cash, the impact of leverage and, particularly during 2011, the unwinding of swaps during the course of the year.

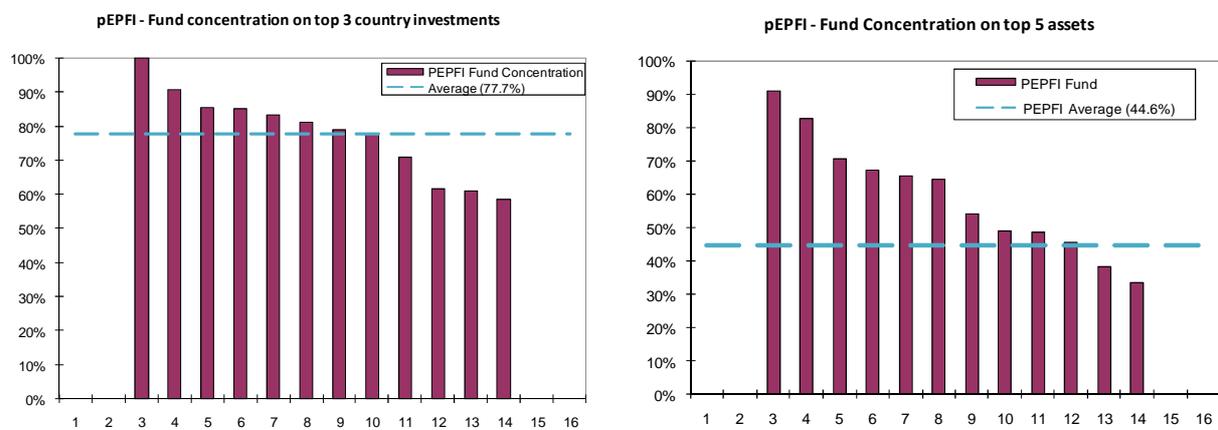
Figure 7: Range of Fund Returns – 1yr to Dec 2011 (Portfolios ranked between 5th and 95th percentiles)



Source: IPD

The preceding charts and commentary illustrate the important insights into the behaviour of the European fund market that arise from the monitoring of fund and asset level performance of this group of funds. Beyond this “market” analysis, there is a set of more profound insights that can be provided at the individual “fund” level through benchmarking specific funds against the rest of the peer group. Figure 7, for instance, raises important questions as to the reasons for the relative strong or weak performance of the different funds within the benchmark. Benchmarking and attribution analysis can help diagnose the reasons for this relative performance, and can help guide management action to reinforce the reasons for strong performance and rectify reasons for weaker performance¹⁰. The analysis also provides valuable risk management insights, such as the extent to which specific funds face “concentration” risk, whether on specific markets or on a relatively small number of assets, as illustrated in Figure 8

Figure 8: pEPFI Concentration Metrics – Country and Top 5 Asset exposure

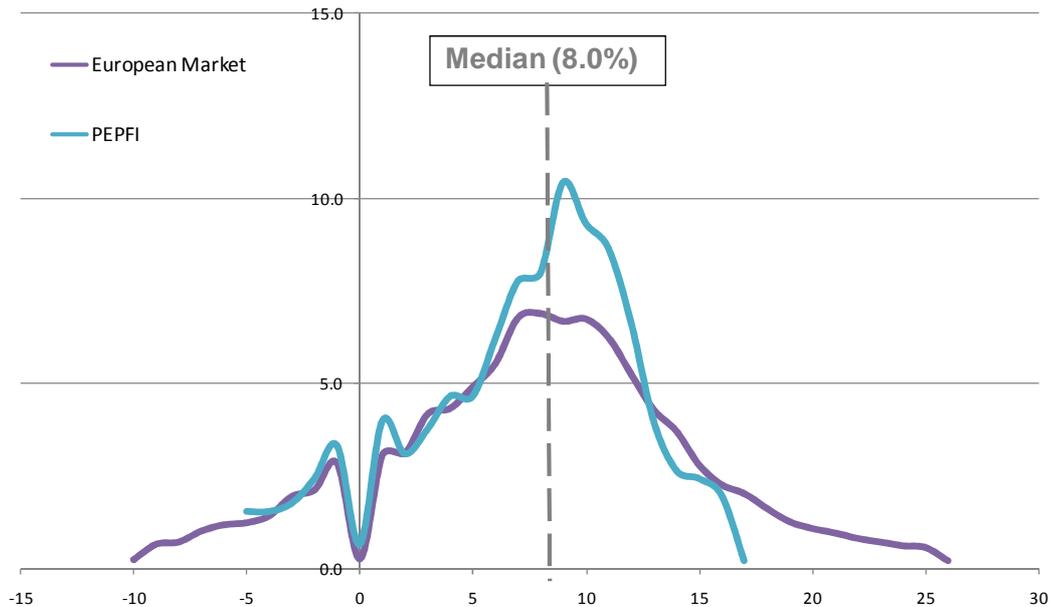


Source and Note: IPD, data for 1st, 2nd, 15th and 16th ranked funds removed for reasons of confidentiality

As stressed throughout the paper, one of the main strengths of the pEPFI is the ability it provides to monitor both fund and asset relative performance. Given the measurement of the performance of all the assets within the index it is possible to compare the distribution of returns for these assets with the market as a whole, as shown in Figure 9. The narrower spread of the pEPFI assets is likely to be influenced by the relatively small sample compared with the European market. This spread might, however, also be influenced by the nature of the assets and could be an indication that there is less asset-level variability, and risk, for pEPFI assets than the market as a whole. Such insights could have important implications for portfolio management, risk management and regulatory oversight.

¹⁰ Giannotti, C. and Mattarocci, G. (2009) *How to evaluate risk for Italian real estate funds*; Journal of European Real Estate Research Volume: 2 Issue: 2

Figure 9: pEPFI and European market 2011 Asset Return Spread by 1% band (between 5th -95th percentile ranking)



Source: IPD

The detailed asset specific measurement also provides valuable insights as to the drivers of relative performance through attribution analysis. This analysis decomposes the relative return into structure-specific and stock-specific factors, allowing the influences of strategic allocations and asset selection to be clearly distinguished. These insights can be of great assistance for portfolio management by, for instance, identifying structural impacts on portfolio performance, which if persistently negative can suggest the need for rebalancing between market segments. They can also lead to the identification of persistent stock effects, indicating the potential for disposals, acquisitions and active management to improve the building, income and/or location quality of the portfolio.

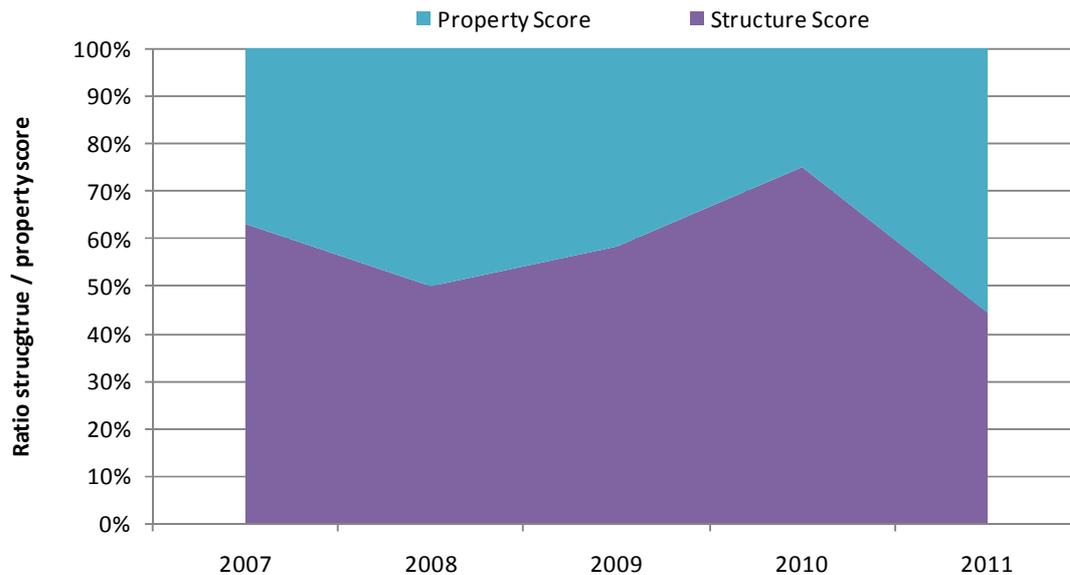
Attribution analysis of real estate portfolios generally demonstrate that “stock-specific” factors are more important than “structure-specific” factors¹¹, with evidence from the UK and Sweden suggesting that stock-specific factors account for around 70% of the relative performance of portfolios in the market¹². Structure-specific factors tend to be more significant in periods of market dislocation, such as through the recent credit crisis, but they rarely account for more than 50% of relative performance. It is within this context, that the results shown in Figure 10 for pEPFI are of such interest, as they reveal a structure-

¹¹ Jackson, C. and Orr, A. *Real estate stock selection and attribute preferences*; Journal of Property Research, [Volume 28, Issue 4](#), 2011

¹² Bjora, H. and Hobbs, P. (2011) *Managing Risk in an Uncertain Environment*, KTI-IPD Nordic Property Investment Briefing, May

specific score of 58% compared with the stock-specific score of 42% over the five years. The small sample size and relatively short time period means the results need to be treated with caution but they seem to point to the significance of the diversification potential of pan-European funds in investing across markets and property types that differ markedly in their behaviour.

Figure 10: Impact of Structure and Asset selection on relative return for pEPFI funds



Source: IPD

4. Conclusions

This paper has used case study analysis to explore a number of important dimensions associated with the benchmarking of real estate portfolios. On the one hand, the paper explored the process by which a discrete group of fund managers club together to pool their data to create meaningful benchmarks, and some of the technical considerations associated with building a meaningful benchmark. On the other hand, the paper provided substantive insights into the nature of the pan-European fund market in terms of performance and geographic exposure, as well as some of the insights that result from the benchmarking of individual funds against the peer group. The short timescale over which the pEPFI has been in existence, small samples sizes, and the limited analysis that could be presented in this paper restricts the conclusions that can be drawn from the paper. Despite this, it is hoped that the paper contributes to the understanding of some important themes for real estate research, associated with the benchmarking of performance and in pan-European fund investing.