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Alternatives

Direct real estate for DC plans seen as growing business

By Arleen Jacobius

Traditional equity real estate money managers are following the money.

A growing number are preparing investment strategies for what they consider a potential $50 billion business opportunity — offering direct real estate for defined contribution plans.

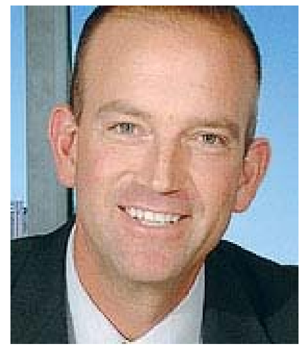
"It comes down to economics," said Kelly Cliff, senior vice president and chief investment officer for public markets at San Francisco-based Callan Associates Inc. "Defined benefit is a nice market, but if you are planning for the future, (the) defined contribution market is growing much faster and you have to diversify into it."

Rather than creating a stand-alone direct real estate investment option, these managers are aiming to persuade plan executives and target-date fund managers to replace their REIT-only allocations with a direct real estate strategy in their target-date or asset-allocation funds.

A number of real estate managers are redoubling their efforts or are entering the defined contribution market for the first time. They include Prudential Real Estate Investors, J.P. Morgan Asset Management, Deutsche Asset Management, Clarion Partners LLC, and UBS Global Asset Management.

The way most managers have overcome the liquidity and daily valuation dilemma that once prevented plan executives from offering direct real estate is by including allocations to cash and REITs as part of their strategies. Most of the investment strategies are collective trusts, set up as funds of funds using the managers' existing open-end fund vehicles.

Callan Associates' asset management group included direct real estate when it first developed its set of target-date funds more than three years ago, Mr. Cliff said. So far, there are 40 DC plans offering Callan's target-date funds, which have a total of $150 million. And Callan executives may soon add other types of direct real estate such as a real estate debt strategy to its target-date funds, he said.



EXPANDING: Kelly Cliff cites the growth of the defined contribution market as a reason for the push among managers.

"We've been in the industry for 30 years, consulting with defined benefit plans, and decided to offer best-thinking to the defined contribution world," Mr. Cliff said.

Prudential manages the direct real estate sleeve of Callan's target-date funds, he said.

David Skinner, principal, defined contribution practice leader, Parsippany, N.J.-based Prudential Real Estate Investors, said Prudential developed the equity real estate strategy for defined contribution plans five years ago, but did not market it during the downturn. Mr. Skinner, who joined Prudential in June, is relaunching marketing efforts.

"We believe that in the long run, 60% of all defined contribution money will be in target-date funds," Mr. Skinner said.

Up to $1.5 trillion

Cerulli Associates estimates that target-date funds in defined contribution plans will grow to $1.5 trillion by 2015 from an estimated $426 billion so far this year.

"It's good to have access to real estate, but REITs only make up 10% of the commercial real estate universe; most of the universe is privately held," Mr. Skinner said. "By adding direct real estate, it adds to the risk-reward profile and dampens the volatility of REITs because REITs correlate to equities."

Some 70% to 75% of Prudential's portfolio is direct real estate, including core, value-added and opportunistic, and between 20% and 30% in REITs. Roughly 2% to 3% is in cash.

The strategy gets its liquidity from the REITs and cash. The direct real estate portion is invested in Prudential's open-end funds: PRISA I. II and III.

"Daily valuation has been managed in the strategy, which is very very important to defined contribution plans," Mr. Skinner said.

It could not be learned by press time how much Prudential managed in the strategy, but Mr. Skinner said it is being used by 13 plans, which he would not identify.

The strategy's return objective is to exceed a customized benchmark of the NCREIF Open-End Diversified Core Equity Fund, the S&P Developed Property and the CitigroupU.S. Domestic 3-Month T-Bill Total Return indexes.

As of March 31, the strategy underperformed the benchmark for the five- and three-year periods, primarily because of the challenging markets of 2008 and 2009, but it outperformed the benchmark for the 12-month period, John Chartier, Prudential spokesman, said in an e-mailed response to questions.

JPMAM also is offering a direct real estate strategy for defined contribution plans, both in its own target-date funds and to other target-date fund managers and plan sponsors for custom target-date funds, said Dave Esrig, New York-based managing director and defined contribution portfolio manager at J.P. Morgan.

Three-quarters of the assets are invested in the firm's open-end funds, mostly in core funds. The rest is invested in a J.P. Morgan REIT fund and cash, Mr. Esrig said.

The strategy includes U.S. REITs because they are an extra source of liquidity and REITs offer another way of pricing domestic real estate, Mr. Esrig said.

Mr. Esrig said J.P. Morgan has gotten a few new DC clients this year and projects that the strategy will have $300 million in assets by year end. J.P. Morgan has been offering the strategy for five years.

One of the first plans to offer target-date funds that included J.P. Morgan's direct real estate investment strategy was the Los Angeles County Deferred Compensation Plans, comprising a $12.6 million (401k) plan and a $59.6 million 457 plan. The plans' target-date funds are custom made using existinginvestment managers, William Yuen, finance analyst for the plan, said in an e-mailed response to questions.

Lower correlation

Plan officials decided to include J.P. Morgan's real estate strategy in the target-date funds "for diversification with lower correlation to traditional assets of equities and fixed incomes," Mr. Yuen said.

Josh Cohen, defined contribution practice leader at Russell Investments, said while he has seen a few plans adding direct real estate as a stand-alone investment option as well as a sleeve in a target-date fund, they are first adding more liquid strategies. Mr. Cohen, who is based in Chicago., said those strategies include commodities, REITs, futures, listed infrastructure, emerging markets debt equity and debt and high-yield debt, he said.

Russell's target-date funds include REITs, rather than direct real estate. "Over the long term we expect them to track the overall real estate market and asset class," Mr. Cohen said.

Clarion Partners, New York, waited until the June completion of its management buyout from former parent ING before marketing its new direct real estate strategy for target-date funds, said Douglas L. DuMond, managing director.

Mr. DuMond noted that the average defined benefit plan has more than 5% invested in direct real estate. "It is estimated that target-date funds will grow to $1 trillion in five years," he added. "Five percent-plus of $1 trillion is a significant opportunity."

Unlike most of its competitors, Deutsche Bank's real estate strategy is in a limited partnership, rather than a collective trust structure, said Scott Brooks, director, head of U.S. retail client relations and business development. The firm is structuring the strategy as a limited partnership so it can also be included as part of a mutual fund as well as a target-date fund, he said.

Hartford, Conn.-based UBS Global Asset Management's global real estate management U.S. unit is just now developing an equity real estate investment option for multistrategy portfolios including target-date, target-risk, custom balanced or diversified real asset funds, Laurie M. Tillinghast, executive director of defined contribution product and strategy at UBS, said in an e-mailed response to inquiries.

"Our strategy is to offer larger institutional DC plans a "single diversified solution' for investing in real estate. This means that we will incorporate several existing direct real estate strategies, primarily with a "core' approach, along with a smaller allocation to "value-added' direct real estate as well as more liquid real estate securities," she stated.

Direct real estate will make up about 75% and real estate securities about 20% of the strategy, with a small cash residual, she stated. UBS plans to launch the strategy at the end of the year.

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