

# Long-Run Investment Ambitions and Short-Run Investment Processes

Findings of the 2013 Global Asset Owner Survey

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## Introduction

The central goal of the 2013 MSCI Global Asset Owner Survey was to understand the asset allocation processes of institutional asset owners, with a particularly close examination of the role of real estate assets.

The findings come from in-person interviews with staff at 40 asset owners from around the world, representing \$3.2 trillion in assets, as well as online survey responses from another 40 asset owners, representing \$0.7 trillion in assets.

These in-person interview responses were supplemented by asset-allocation and real-estate allocation data gathered over the same period from the annual reports and other public documents of 138 global asset owners, representing \$10.3 trillion in assets.<sup>1</sup>

To ensure clarity about the survey samples, the in-person and online interview participants are labeled throughout as “Survey Participants,” while the asset owner data obtained from public documents are referred to as the “Sample Universe.”

The main findings of the survey fall into two sections:

- » A: Global asset allocation trends, processes and challenges, and
- » B: Risk management techniques for real estate assets.

## A. GLOBAL ASSET ALLOCATION

In this first section of findings from the 2013 MSCI Global Asset Owner Survey, we address the asset allocation processes of institutional asset owners: their goals, how they make decisions, the inputs they use to make these decisions, and how their governance structures affect the process.

To answer these questions, MSCI held survey meetings with 40 asset owners from around the world; another 40 asset owners participated in an online version of the survey. Together, these are referred to as the Survey Participants. In addition, public data on the asset allocations of 138 asset owners—the Sample Universe—were assembled from their annual reports.

The most striking conclusion from the responses of the Survey Participants is the wide variety of processes used in asset allocation. When the data from the Sample Universe are examined, geography appears to explain some of the variation, but there is also significant intra-region variation.

Possible explanations for differing allocations could be differing investment goals and a wide variety of funding situations. These factors may well be relevant, but the responses from Survey Participants also reveal considerable differences in their processes. The biggest tension in the asset allocation process seems to be that, while asset owners generally have long investment time horizons, they face difficulties in exploiting the opportunities these long horizons offer them.

Asset owners described a wide range of investment processes and governance structures. The Survey Participant data show that strategic asset allocation processes can vary in frequency from six months to five years and do not always follow a set schedule. An even more important point of difference among participants may be in their views on the appropriate time horizon for risk modeling. Their answers varied from six months to ten years and longer.

In some cases, governance structures shortened the effective investment horizon. For example, Survey Participants identified the composition of the board and the length of the election cycle as reasons for the investment process to be shorter. The period over which staff performance was evaluated was also noted as a factor.

However, even if there were a governance structure that allowed long-horizon investment processes to be followed unfettered, there is no consensus on how such processes would operate. Survey Participants had different views on the reasons for investing in private asset classes, some emphasizing their power to diversify a portfolio’s risks, others the return potential they offered. Survey Participants also expressed a variety of opinions on the question of the effectiveness of “factor” or “risk premium” indexes, and reported different stages of implementation of passive investments in these indexes.

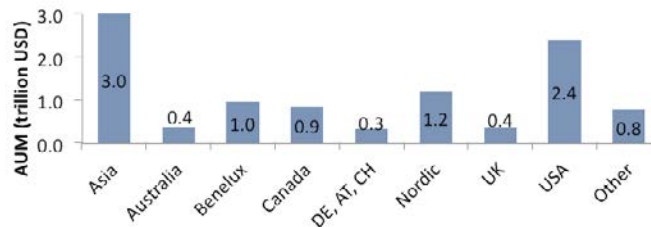
Before looking at the results, it should be emphasized that asset allocation is a topic that attracts strong opinions. A pension fund in the Americas said: “We have no asset allocation,” by which they meant they have moved away from asset class weights as the end product of the process. A pension fund in EMEA jokingly said: “You don’t want to see inside the sausage factory,” referring to the complexity of the problem. Several organizations mentioned the bounds within which they had to work. A pension fund in the Americas told us, “There are so many arbitrary constraints...that there is very little room [to change allocations].” Another said, “History plays a big role, with the changes on the margin.”

Finally, a pension plan in the Americas nicely captured a common theme: “We are in the process of transforming our process.”

## Compiling Asset Allocations around the World

To build a set of data for investigating global variations in asset allocations, the survey team used published asset allocation details compiled from 138 asset owners, which comprised the Sample Universe of institutional asset owners. The results were distributed across different regions as follows:

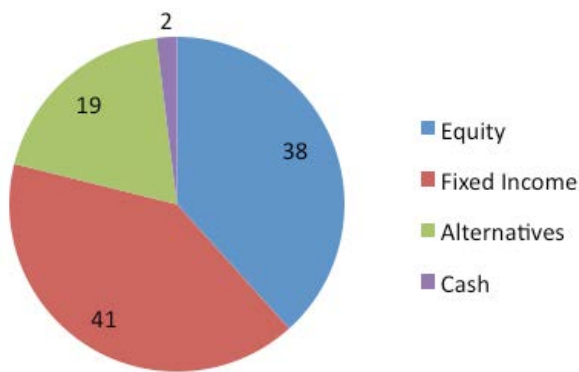
Figure 1: Assets Under Management (AUM) by Region.



By cap-weighting the total assets held by the Survey Participants (about \$10.3 trillion), the following allocation of assets was seen:

<sup>1</sup> Note that there is considerable overlap between interview and online participants, and the organizations whose data were gathered from public sources.

Figure 2: Overall Asset Allocation.



The equity and fixed income allocations are roughly similar, and each about twice as large as the allocation to alternatives (which are defined as hedge funds, private equity, and private real estate).

Looking at the allocation across the eight survey regions, some notable differences appear:

Figure 3: Geographic Differences in Asset Allocation.

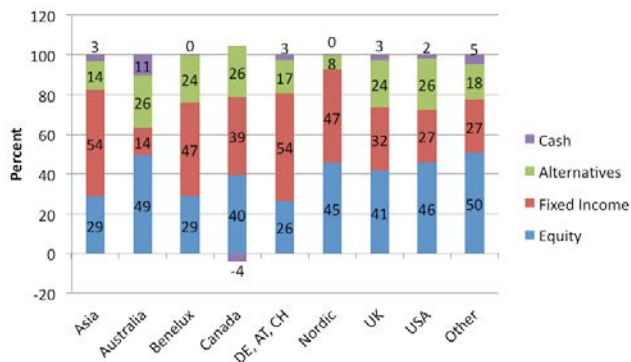


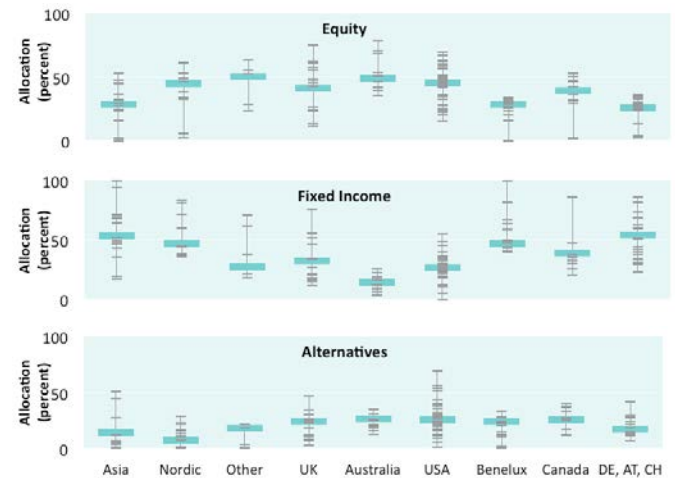
Figure 3 shows notably higher allocations to fixed income in Asia and Germany, Austria and Switzerland (DE, AT, CH) (54 percent) and Benelux and Nordic markets (47 percent) than in the US (27 percent) and Australia (14 percent).

The US sample is weighted towards state pension plans, which tend to be underfunded, and therefore may be seeking return rather than trying to match their liabilities. Australia is primarily a defined-contribution market, where attention is given in the media to the returns of the superannuation plans, and where the domestic fixed income market is relatively small.

Allocations to equity range from 26 percent in DE, AT, CH, and 29 percent in Benelux and Asia, to 46 percent in the US and 45 percent in Nordic markets. The largest allocations to alternatives are in Australia, Canada and the US (26 percent) and Benelux and the UK (24 percent). In Benelux, these allocations seem to be at the expense of public equity, whereas in Australia and, to a lesser extent, the US, they seem to reduce fixed income allocations. The lowest allocations to alternatives are in Nordic markets (8 percent) and Asia (14 percent). In the former, asset owners appear to seek returns from equity; and in Asia, the low alternatives allocation seems to be part of a generally conservative asset allocation.

There appears to be a reasonable degree of variability in dispersions of allocations within regions. However, the allocations within Asia, the US and the UK are widely spread, with the allocations in Canada, Australia, and Benelux being less so. There is a high variability in fixed income allocations in DE, AT, CH as well.

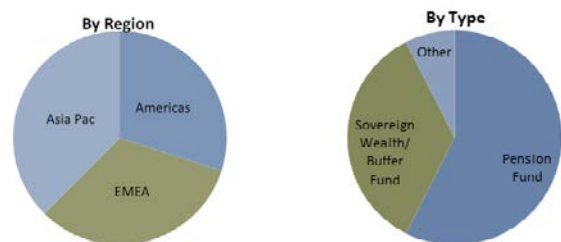
Figure 4: Dispersion in Asset Allocation within Regions.



### Key Questions Posed to Survey Participants

Starting in September 2013, MSCI took two months to meet with 40 asset owners. These participants were divided almost evenly across EMEA, the Americas, and Asia Pac, as seen in Figure 5. The majority of the asset owners surveyed were pension funds, with the remainder dominated by Sovereign Wealth Funds and “buffer”-type funds.

Figure 5: Participation Rates in Personal Interviews.



Another 40 asset owners, representing \$0.7 trillion in assets, answered an online version of the survey. Together, these 80 asset owners made up the Survey Participants.

Apart from background information, the questions MSCI asked included the following:

- » What is the frequency of the strategic allocation processes, and what are the roles of the different parties involved?
- » What is the asset allocation team’s outlook on the global economy and what are their expectations of returns from public asset classes?
- » What are the techniques and models used in the asset allocation process, including views on the optimal horizon for a risk model?
- » To what degree do you believe that active returns may be captured by “smart beta” or “risk premia” indexes, and what is the level of adoption of passive investments in these indexes?
- » What are the motivations for investments in private asset classes, and what is the level of satisfaction with them in the overall asset allocation?

## How Asset Allocation is Performed Today

When the Survey Participants were asked about the core challenges of asset allocation, a recurrent theme was horizon. In particular, participants talked about the tension between the opportunities offered by long-duration liabilities and the constraints on their ability to exploit these. A pension fund in the Americas said: “Who cares about daily volatility? The challenge is to look at the long term and not get distracted.” A similar view was expressed by a Sovereign Wealth Fund in EMEA: “Our big challenge is unifying long-term goals with the short-term nature of asset management—incentives, performance appraisal, and so forth.”

Follow-up questions were asked on this topic during the survey. There were two reasons that it was difficult for investment staff to invest for the long term.

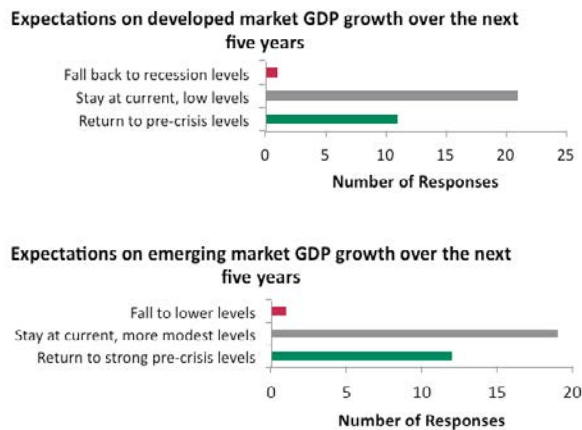
The first related to governance issues. These could be explicit and formal — for example, the time period of performance assessments. They could also be less formal, relating to the patience of boards or electorates for results. In Australia, for example, participants are free to switch among providers of superannuation funds, and quarterly results are widely reported in the media. An Asia-Pac Sovereign Wealth Fund said that the frequency with which elections were held meant that the short run had to be a focus: “We are not Sleeping Beauty,” by which they meant that they cannot wait for a prince to awaken them some time in the distant future.

The second reason was linked to investment staff making long term decisions, if they had free rein. On the whole, Survey Participants were comfortable with trading off risk and return in the short term. For the long term, they were less satisfied with the tools commonly available. As one Asia-Pac Sovereign Wealth Fund put it: “Short-term models are easy to come by. What’s difficult is the long run.” Another Sovereign Wealth Fund in the region said: “We put no great store in the actual 10-year forecasts.” Instead, they provide the backdrop for shorter term allocations.

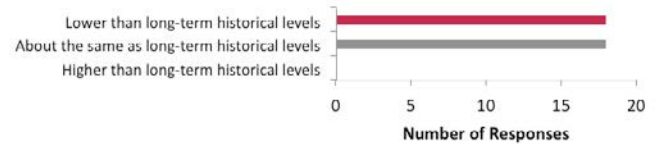
## Economic and Market Expectations

Many asset owners said that long term allocation decisions related in some way to long term economic trends. *Figure 6* shows responses to three survey questions focusing on this area.

**Figure 6: Economic Growth and Investment Return Expectations.**



**Expectations on returns achievable with public asset classes**



Only a few Survey Participants had very pessimistic views on economic growth in either emerging or developed markets. There was slightly more optimism about the prospect of emerging markets returning to pre-crisis growth than there was about those of developed markets.

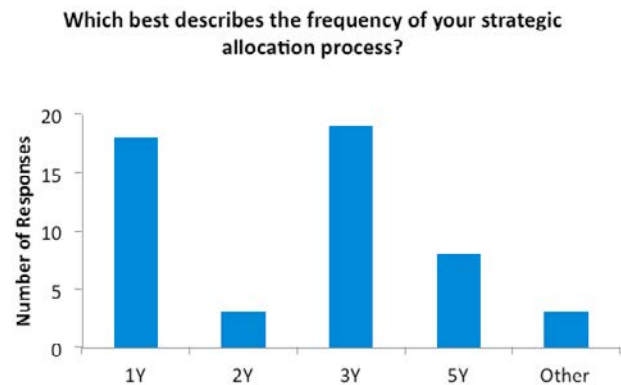
Optimism was less evident when it came to the returns achievable from public asset classes. No one expected higher returns than historical levels. Respondents were evenly split between expecting returns to be about the same as long term levels, or being lower.

## Strategic Asset Allocation Processes

The discussion then turned to the processes that Survey Participants employed for strategic asset allocation.

Survey Participants were asked about the frequency of their asset allocation; the range of responses is shown below in *Figure 7*. The most common frequency was every three years, but annual was very close behind. This suggests that strategic asset allocation may mean different things to different institutions. One pension fund in EMEA, which had a board-mandated annual strategic asset allocation, said: “Annual strategic asset allocation is a contradiction in terms.” That, however, was the framework in which they were compelled to operate.

**Figure 7: Frequency of Strategic Asset Allocation.**



Respondents were asked what they considered to be the appropriate time horizon for risk-forecasting in strategic asset allocation. The most common response was five years, although some thought that six months to a year was appropriate, and others that the relevant horizon was ten years or more. See *Figure 8* for the range of responses.

Figure 8: Relevant Risk Forecast Period for Strategic Asset Allocation.



Based on these responses, it is apparent that there is a wide variety of techniques used by the asset owner investment staff or their consultants. Returns-based models (which typically use the returns of asset classes as represented by indexes) were used in about 80 percent of cases, and were the most popular type of risk model; stress-testing was also used commonly, by about 70 percent of respondents (see Figure 9).

Figure 9: Risk Estimation Techniques in Use.



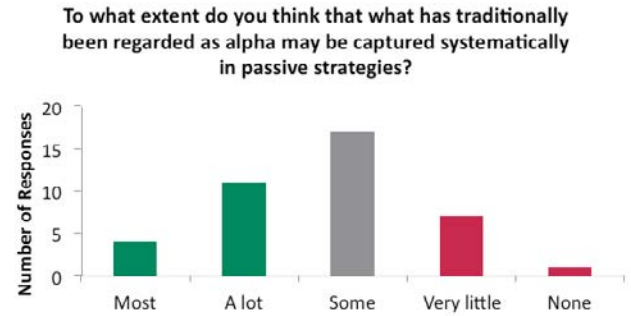
No organization surveyed had a purely quantitative asset allocation process. Indeed, there was some doubt expressed about quantitative techniques. One pension fund in Asia-Pac said that, in their organization, “optimization is a dirty word” when it came to asset allocation. Several organizations made comments similar in spirit to that of a pension fund in the Americas, which said that their process was “semi-quantitative.”

A pension fund in EMEA expressed its frustration with the quantitative techniques available, noting that, as long-term investors, “financial risks are not fully appropriate for our goals... we want to move to real economy risks.”

### Factor Premia

One type of investing that asset owners are considering today is passive investing that tracks indexes designed to capture risk premia. This has strong appeal in terms of potential cost savings. Respondents were asked to what extent they believed premia that traditionally have been regarded as alpha may be captured passively. The most common answer was “some,” with a number of asset owners thinking most or a lot might be captured. Relatively few thought very little or no alpha might be captured (see Figure 10).

Figure 10: Perceptions of Passive Equity Strategies.



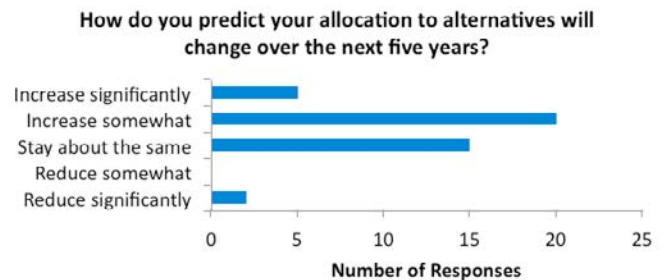
Only 34 percent of respondents currently allocate assets to passive strategies, but another 34 percent are considering allocating assets this way. The survey found that 29 percent are not considering allocating to these passive strategies.

Some respondents did in fact rule out allocating to these passive strategies because of their beliefs about their effectiveness. One pension fund in EMEA said they would not allocate to them, “because we believe in active management.” However, a Sovereign Wealth Fund in Asia-Pac, while open to the concept, explained that their problem in implementation lay in fitting these investments into their investment process: “The asset allocators don’t know how to allocate to it, and the portfolio managers prefer to select stocks.” Other organizations are not ready to allocate funds because they are still investigating the effectiveness and durability of premia strategies.

### The Role of Private Asset Classes

Survey participants were asked about private asset classes and their role during asset allocation. One pension fund in Asia-Pac said: “Asset owners are natural investors in alternative asset classes.” The sacrifice in terms of liquidity is something that asset owners may be able to afford in order to capture a premium or premia. Most of the plans surveyed predict that they will increase their allocation to alternatives (see Figure 11) with only two saying they expected to reduce their allocation.

Figure 11: Predictions of Changing Allocations to Alternatives.

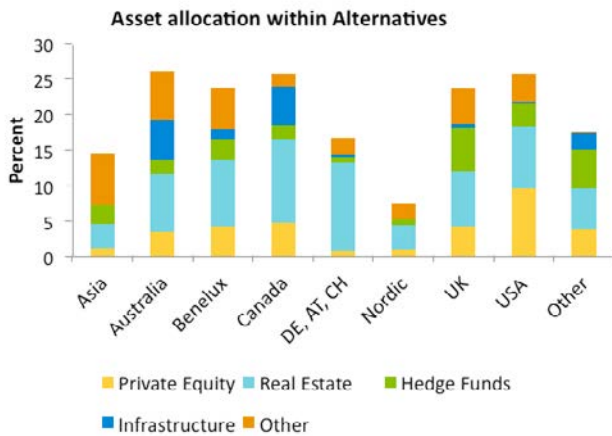


One of the impediments to larger allocations has been getting board approval. A Sovereign Wealth Fund in Asia-Pac said: “We may increase our allocation to real estate as our board is comfortable with the asset class.”

There was some broad concern that there might be an issue of scale that could hinder an organization’s chances of getting superior returns. A pension fund in the Americas said: “Because of our size, we will struggle to get anything other than the market return.”

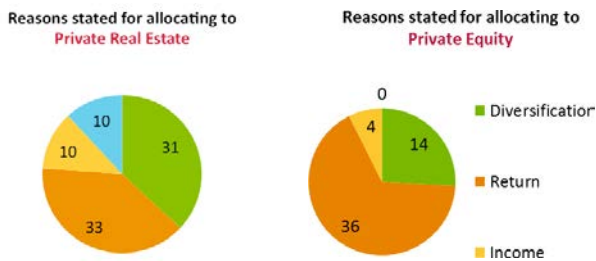
There is significant regional variation in the popularity of each alternative asset type. Infrastructure allocations are largest in Canada and Australia, but very low elsewhere. Real estate has relatively high allocations in the US. Real estate has the largest allocation among alternatives in all regions except the US, where private equity is top. It is strikingly high in DE, AT, CH at just over three-quarters of the alternatives allocation. See *Figure 12* for the range of responses.

**Figure 12: Regional Variation in Asset Allocation within Alternatives.**



Survey Participants were asked why they invested in private equity and private real estate (more than one reason being allowed). Participants’ motivations for investing in private equity were dominated by return seeking, with over a quarter of the reasons given being diversification. They looked for more varied benefits from private real estate, with return and diversification roughly equally important. Inflation protection and income were mentioned less frequently. (See *Figure 13*.)

**Figure 13: Reasons Stated for Allocating to Alternatives: Diversification, Return, Income, Inflation Protection.**



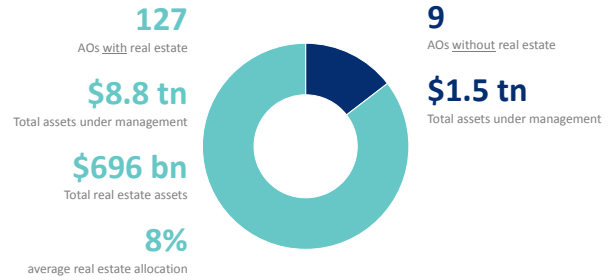
## B. RISK MANAGEMENT FOR REAL ESTATE ASSETS

### Asset Owner Real Estate Exposure

For the 138 asset owners within the 2013 MSCI Sample Universe the average real estate holding was 6.7 percent, representing close to \$700 bn out of their total \$10.3 tn of assets under management (see *Figure*

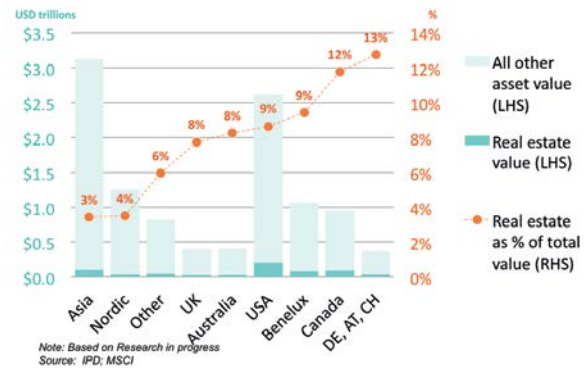
14). If the nine asset owners with no exposure to real estate are excluded from the Sample Universe, the average allocation rises to 7.9 percent.

**Figure 14: Scope of the 2013 Asset Owner Survey.**



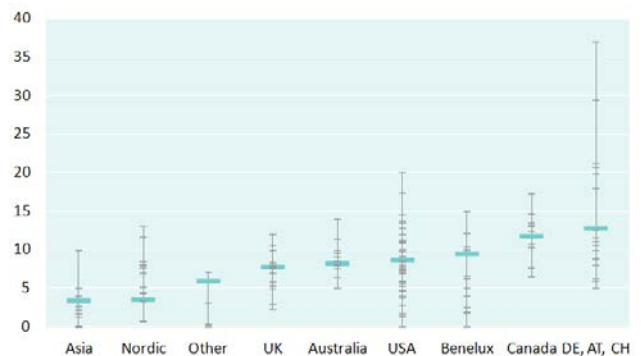
Although the total allocations represent a large quantity of real estate, there are marked variations by region and, more significantly, within regions (see *Figures 15 and 16*). On a regional basis, the lowest allocations of 3 to 4 percent are in Asia and Nordics, compared with the 12 to 13 percent in Canada and Germany/Switzerland.

**Figure 15: Asset Owner Real Estate Holdings across Regions.**



The variations within regions are more significant than between regions; for example, the low allocation regions of Asia and Nordics have funds with 10 percent or above in real estate, while some of the high allocation regions such as DE, AT, CH, Benelux and USA have some asset owners with 5 percent or below in real estate. There is no relationship between size of asset owner and real estate allocation.

**Figure 16: Range of Allocations to Real Estate across Regions.**



### Role of Real Estate for Asset Owners

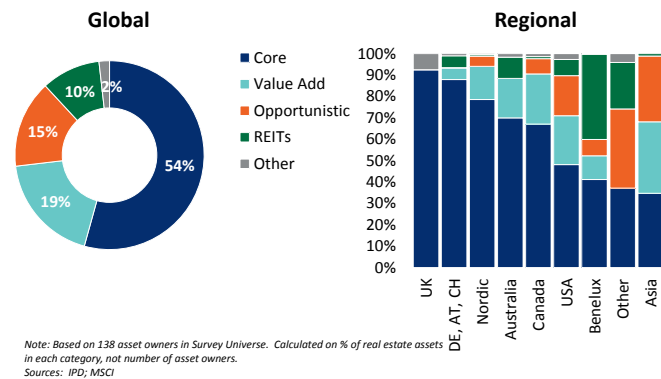
It is well established that there are significant variations in the performance patterns of real estate within the asset class, ranging

from Core to opportunistic, and from real estate debt to REITs. The MSCI Sample Universe data confirm the primary focus on Core real estate in the allocations of most investors, with 50 percent of exposure in this category. The high allocation to Core real estate is not surprising given the desire for relative stability, high income return, and diversification benefits, as well as some scope for appreciation.<sup>2</sup> These reasons for holding Core real estate were apparent during the face-to-face interviews with Survey Participants, with persistent references made to these positive characteristics:

» “The real estate programme produces two-thirds of its return through income and a third or less through capital. We like the income as it is linked to CPI. Capital is linked to meeting the growth element of our liabilities.”  
[Canadian Pension Fund]

» “We feel the main risks to the overall portfolio are growth and inflation, and want to hedge ourselves against these – hence the attraction of the real assets portfolio.”  
[Nordic Pension Fund]

**Figure 17: Allocation of the Sample Universe to Different Styles of Real Estate, by Region.**

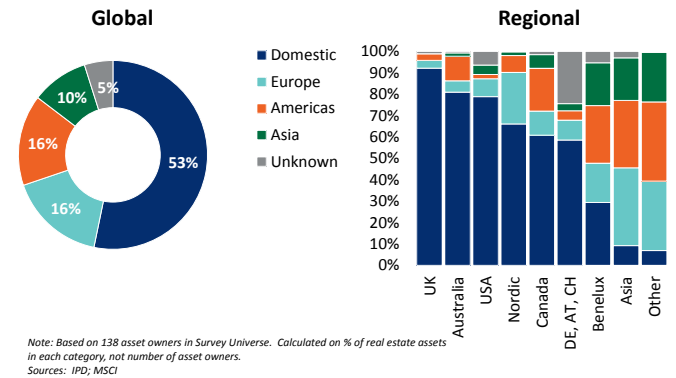


Although Core dominates, other categories represent 46 percent of the total allocation, confirming the different roles that real estate plays within asset owner portfolios. There are marked variations in the emphasis on different styles across markets. The strongest focus on Core real estate is in Australia, Canada, DE, AT, CH and the UK where its allocations exceed 80 percent.

**Domestic versus Global Exposure**

During the past 30 years, the liquid asset classes of equities and fixed income have become “global,” with most investors seeking to build exposure across markets. Real estate, in contrast, retains a strong “home bias” with over 80 percent of asset owners focusing primarily on domestic markets. There are exceptions, most notably Sovereign Wealth Funds, who have made an explicit decision to diversify away from domestic exposure, and some large asset owners in relatively small real estate markets that have a large asset owner industry, such as the Netherlands and Canada.

**Figure 18: Geographic Exposure of Real Estate Portfolios in the Sample Universe.**



There tend to be two major reasons for retaining a home bias: one relates to the role of real estate in the portfolio, and the other is due to the perceived execution risks of overseas exposure. In a number of cases, the asset owners surveyed said that given the role of real estate in providing a hedge against domestic inflation there was little benefit in investing globally. As one Nordic investor said: “We are mostly domestic as most of it is ‘Core,’ and we want real estate as a hedge against inflation within our overall portfolio. If we have, for instance, US real estate, this doesn’t help as a hedge against the overall portfolio.” [Nordic Pension Fund]. The second reason for home bias is due to the perceived risks of investing overseas, particularly related to execution.

The MSCI Sample Universe data reveal a change in asset owner appetite for foreign real estate, which is confirmed by other studies.<sup>3</sup> This increasing appetite is driven by supply and demand factors. The improved availability of execution options has removed some of the supply barriers that existed in previous years. Alongside this, there has been greater demand for foreign investment, whether due to concerns over the pricing of domestic markets (particularly in Canada and Australia), or to the desire to exploit the diversification benefits of international real estate.<sup>4</sup>

**Real Estate Investment Options**

A number of recent studies identify a long-term trend to external management,<sup>5</sup> but the new MSCI Sample Universe data suggest that there has been some reversal since the global financial crisis. We find in the Sample Universe that only 23 percent of real estate exposure is managed in-house, while another 21 percent is managed through separate accounts and joint ventures (see Figure 19). Along with this finding, the interviews with MSCI Survey Participants indicate a general move to more direct control, through separate accounts and joint ventures, and through internalizing real estate programs.

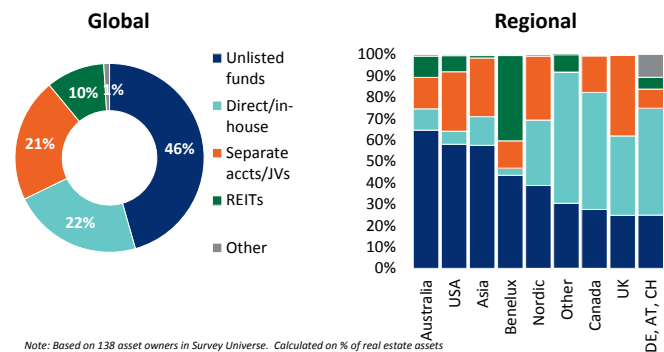
<sup>2</sup> Hudson-Wilson, S., et al (2005) “Why Real Estate?” *The Journal of Portfolio Management*, Vol. 31, No. 5, pp. 12-21.

<sup>3</sup> Cornell and HodesWeill (2013) “Institutional Real Estate Holdings Monitor 2013”

<sup>4</sup> IPD (2013) “Private Real Estate: from asset class to asset.”

<sup>5</sup> Andonov, A. et al (2013) “A Global Perspective on Pension Fund Investments in Real Estate” *The Journal of Portfolio Management*, Vol.39 No. 5, pp. 32-42.; Cornell and HodesWeill (2013) *ibid*.

Figure 19: Allocations to Different Modes of Execution by Region.



Note: Based on 138 asset owners in Survey Universe. Calculated on % of real estate assets in each category, not number of asset owners.  
Sources: IPD, MSCI

### Risk Management through the Real Estate Investment Process

Although the MSCI survey provides important insights into the role of real estate in investor portfolios, the more innovative element of the research involved asking the Survey Participants about their approach to risk management. The key question is the extent to which risk management processes are in place to ensure alignment between investment objectives and their execution.

The survey covered two important dimensions of real estate risk management. First, how are real estate exposures and risks integrated within the multi-asset-class investment process? Second, how are risks of real estate exposure monitored and managed within the real estate department?

### Real Estate in the Multi-Asset-Class Risk Management Process

Real estate is one of the most mature alternative asset classes, with a tradition of allocation in institutional portfolios for 40 years or so in North America and a number of European countries. During this time, there has been an increasing availability of performance and risk data on the asset class, and considerable experience of holding and managing real estate in institutional portfolios. Despite this experience, real estate remains an alternative asset class often poorly integrated with the overall strategic asset allocation process.

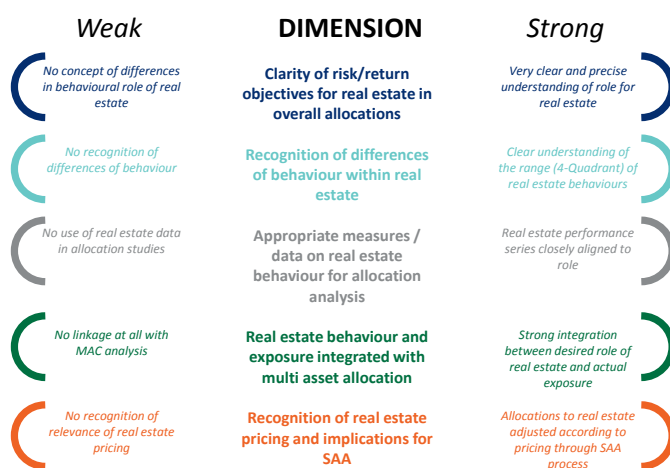
The MSCI survey confirms the challenges faced by CIO’s and risk departments as they seek to oversee their real estate exposure, and integrate it with other asset classes. These challenges are based on a number of related factors, including the complexity of the real estate asset class, data limitations and a relatively weak understanding of the different roles that real estate can play in the overall portfolio. The combination of these factors has tended to create a gulf between central risk functions (CIO, risk, and allocation departments), and the real estate departments. As stated by one major Sovereign Wealth Fund respondent: “There is a fundamental difference between equities and real estate where Implementation is so much harder for the strategic asset allocation team to get involved in. Specific risks are much harder to trade away than alternatives.” [Sovereign Wealth Fund].

In effect, the relatively small scale of the real estate exposure coupled with its idiosyncrasies has meant that many risk teams have left real estate departments to manage their own risks, contributing to the poor integration with other asset classes. This certainly was the case prior to the global financial crisis, but the crisis provided a catalyst for strengthening risk management throughout the

industry. The drivers for this change tended to be tighter regulation and moves from central risk functions to increase their oversight of the real estate departments. This desire for greater oversight was clearly revealed through the MSCI survey. One major US plan sponsor said: “I don’t see much from our real estate teams from a risk perspective, and feel the risk team didn’t know much about portfolio risk except for leverage. There is a case for a ‘no charts’ discussion with the real estate team.” [US Pension Fund].

Beyond signs of change across most of the asset owners, there are marked variations in how to integrate real estate in the overall strategic asset allocation process. The leading asset owners surveyed by MSCI offered some useful guides for “best practice” on a range of dimensions. These dimensions are summarized in Figure 20, and explained in more detail in the following sections.

Figure 20: Key Dimensions of Real Estate Risk Management in a Multi-Asset-Class Context: Characteristics of “Weak” and “Strong” approaches.



### The Role of Real Estate in MAC Portfolios: Clarity of Risk/Return Objectives

The fundamental starting point for asset owners with exposure to real estate is understanding asset-specific objectives and, more specifically, the risk/return objectives within a multi-asset-class context. As explained earlier, real estate plays very different roles within investment portfolios, from inflation hedging to absolute return, with varying degrees of liquidity. There are marked variations in the sophistication with which these differences are recognized. On the one hand, there are investors who have limited understanding and seem to be happy “just holding real estate.” At the other extreme, there are those with a very clear understanding of real estate behavior and its role in a multi-asset-class context. One major Survey Participant pension fund, for instance, has a clear role for real estate as an inflation hedge: “We want to measure ‘duration’ and understand the impact of changes in interest rate on the real estate asset class. The risk information we want to monitor relates to the duration sensitivity of the portfolio – if interest rates change then what is the implications for the market.” [Nordic Pension Fund].

A number of Survey Participants who recognize these differences have moved to creating different “buckets” for the real estate exposure. More generally, however, many risk officers seem to be unsure of the role that real estate should play in the overall portfolio. They often echo the views of one US investor in the



survey who stated that “real estate characteristics are not well understood and not well integrated into the overall allocation and risk process. We want to better understand the inflation and interest rate sensitivity of real estate; how this varies according to the quality and vacancy rates of discount rates.” [US Pension Fund].

### Real Estate Data in the MAC Modeling Process

Most survey respondents face difficulty in modeling real estate risk. One major Nordic pension fund has “struggled to get the right real estate data to use in our ALM process,” while a US pension fund said that they have “good understanding of real estate in the return space, but not in the risk space.”

Asset owners face two distinct difficulties in appropriately modeling real estate behavior. Fundamentally, the difficulties relate to the scope of real estate used for modeling purposes. Clearly, there is a range of behaviors within the asset class; for instance, opportunistic, core and REIT exposures generate very different risk/return characteristics. For those asset owners with global exposure there are also issues associated with the geographic focus, whether a purely domestic or more global time series should be used. A second set of issues are more technical, related to the availability of good quality data that appropriately capture the asset behavior. This is particularly the case for opportunistic and debt-based strategies, but also for core strategies in more emerging economies.

### Integration of Actual Exposure with MAC Allocation Analysis

There are also marked variations in how real estate exposure is integrated with multi asset allocation studies. As explained above, many asset owners take great care to ensure that the strategy towards real estate is aligned with the role that real estate is meant to play in the multi-asset portfolio. There is, however, scope for the actual exposure to diverge from the strategy by “style drift,” for example, leading to higher risk exposure than intended in the strategic allocation.

A number of surveyed asset owners recognize this issue and devote considerable effort to ensuring that the actual exposure is aligned to strategic objectives. One Nordic pension fund, for instance, has real estate playing an inflation-hedging role for the overall portfolio and they take care to monitor the asset-specific exposure: “We monitor the extent to which our portfolio provides these characteristics, so we look at the nitty gritty of the portfolio – we have people dedicated to doing this at the asset level. We really like [a specific manager’s] portfolio given its inflation hedged nature – this is the type of real estate we want to hold for multi-asset-class purposes.” [Nordic Pension Fund].

Although these two examples show how some asset owners connect their real estate risks to the broader portfolio, the vast majority of risk teams tend not to monitor the portfolio and asset-specific risks of the underlying real estate portfolio. This is primarily due to the perceived difficulty in measuring these risks on a systematic basis, and rolling them up for the portfolio as a whole. Some asset owners draw parallels with the more liquid markets from a different era, as stated by one head of fixed income: “Private asset managers think like fixed income managers 30 years ago when there was little regard to investment-specific risks. The risk team struggles to drill through to the real estate risks and boil these down to six or seven numbers.

The more you can boil down to measurable attributes that can be monitored and policed, the better the solution.” [Sovereign Wealth Fund.]

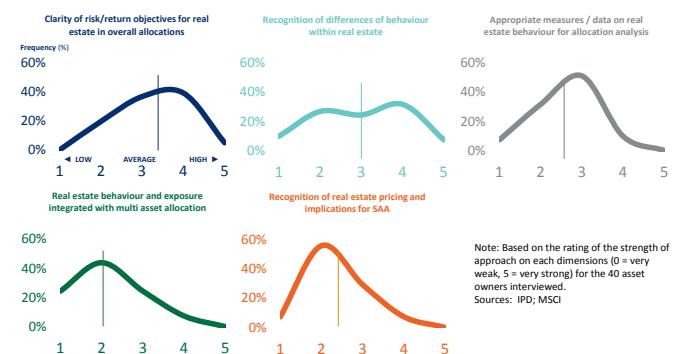
### Recognition of Real Estate Pricing in the Allocation Process

Many Survey Participants are grappling with the pricing behavior of real estate and trying to compare it on a consistent basis with other asset classes. Most feel they are not at the stage of adjusting their exposure according to the pricing of real estate, often stating that the illiquidity of real estate makes it hard to change allocations on a short term basis. There is, however, an important group of some of the world’s largest and most sophisticated investors who make an explicit assessment of relative pricing when making real estate investment decisions. These investors tend to make investment decisions relative to a multi-asset-class portfolio-wide “reference” portfolio. Such investors prefer to evaluate the merits of individual investment opportunities relative to the portfolio as a whole. One Australian respondent in the MSCI survey said: “We do not have explicit allocations to real estate as this tends to encourage teams to fill up the allocation bucket rather than make investments that are appropriate for the portfolio as a whole.” [Australian Pension Fund]

### Summary of Real Estate in the Multi-Asset-Class Risk Management Process

The Survey Participants provide a series of important insights into the way real estate is considered in the multi-asset-class risk process. First, this is a major issue for asset owners, with concerns over the appropriate role for real estate and the risks that it represents. In the wake of the global financial crisis, there seems to be a concerted effort by the risk teams to increase oversight of the real estate departments in order to better manage the risks of the exposure, and to integrate it with overall risk management. Second, asset owners without effective risk oversight of the real estate departments are exposed to potential misalignment between strategic allocation decisions and the implementation of strategy. Third, the variations in approach across asset owners point to a number of clear areas of best practice that can be followed by individual asset owners. The results summarized in Figure 21 are based on the positioning of individual asset owners on the five dimensions discussed earlier.

**Figure 21: Strength of Approach to Key Dimensions of Multi-Asset-Class Risk Management of Real Estate Exposure.**



The Survey Participant results in this figure show the range of scores for each of the dimensions, with the highest average scores in the chart labeled “clarity of risk/return objectives for real estate when making allocations to the asset class”. This indicates that most Survey

Participants have a good understanding of the role of real estate in the multi-asset-class portfolio. Against this is the weaker “exposure integrated with multi-asset-class allocation” risk analysis, whether due to limitations in modeling capability or in data capture. These low scores confirm the generally weak alignment between investment objectives and risk management of the real estate exposure.

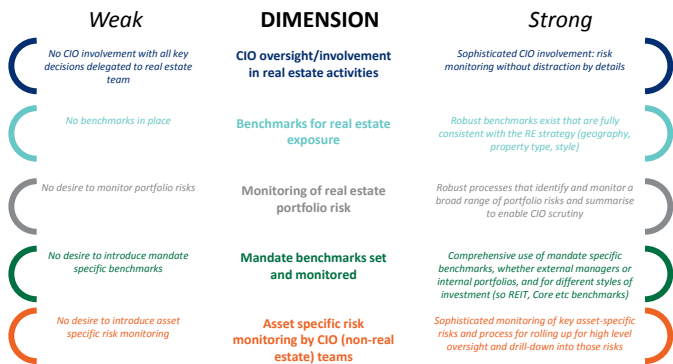
### Benchmarking and Risk Management for the Real Estate Department

If the first dimension of “risk management” explored in the survey relates to the way real estate is integrated with broader multi-asset-class processes, the second dimension relates to risk management within the real estate department.

An important factor that determines the alignment between allocation and implementation is the effectiveness of risk monitoring through the real estate investment process. The MSCI survey explored these issues and identified two related dimensions where steps towards stronger risk management are taking place within the real estate department.

First, the use of real estate benchmarks that can monitor exposures and ensure alignment with investment objectives. Second, the monitoring and reporting of asset and portfolio-specific risks of the actual real estate exposure. These different dimensions are summarized in *Figure 22*, and explained in more detail in the following sections.

**Figure 22: Key Dimensions of Real Estate Risk Management: Characteristics of “Weak” and “Strong” approaches.**



### Benchmarking of Real Estate Performance and Risk

The increased desire of CIO’s to have greater oversight of real estate departments coupled with the rising availability of real estate benchmarks,<sup>6</sup> has led to an increase in the use of such benchmarks in recent years. These benchmarks have tended to be applied at two different stages of the real estate investment process. First, in terms of overall real estate exposure through “policy” or “reference” benchmarks and, second, more portfolio and asset specific benchmarks associated with specific “mandates”.

The MSCI interviews and on-line survey confirm that the overwhelming use of benchmarks among respondents tends to be at the policy level, rather than for mandates.

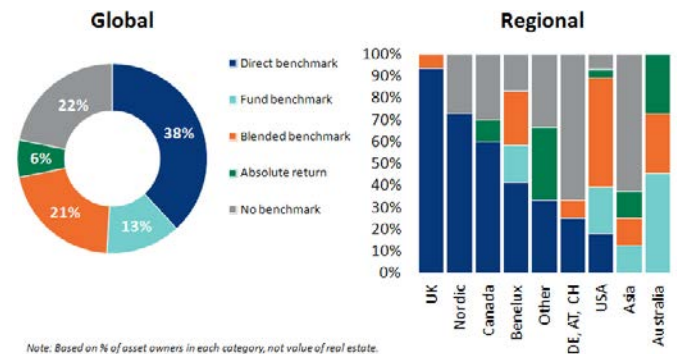
<sup>6</sup> ULI (2011) “Global Investment Performance Standards”, September; Towers Watson (2012) “Survey of private market benchmarks report,” January.

In terms of policy benchmarks for real estate, there are many options, ranging from absolute return measures to those based on relative performance, with relative benchmarks tending to be based on direct, fund or listed (REIT) performance.

Where benchmark information is available, the results show some form of policy benchmark for more than 70 percent of the Sample Universe (see *Figure 23*), generally on a rolling three, four or five-year basis. A large proportion of these benchmarks are based on “direct” or property-specific indexes (38 percent of the total), with “blended” and “fund” benchmarks also being used by a large number of asset owners. Their usage is most widespread in the more established “western” investment markets, with the Asian, German and Swiss asset owners having a relatively low benchmark adoption. There is a strong national influence on the type of benchmarks being used. In Australia there tends to be more use of fund level benchmarks, while in Canada, the UK and Continental Europe there is a tendency to use direct benchmarks.

The US is the main market in which “blended” benchmarks are used, often combining private real estate performance (direct or fund) with listed market indexes. This increasing use of blended benchmarks seeks to address some of the alignment issues mentioned throughout this report. If the allocation strategy involves both listed and direct real estate, the policy benchmark should reflect these intentions. Asset owners making use of such blended benchmarks often have a secondary set of strategy benchmarks for the specific investment style (for example, core, opportunistic, or listed).

**Figure 23: Use of Policy Benchmarks for Asset Owner Real Estate Exposure.**



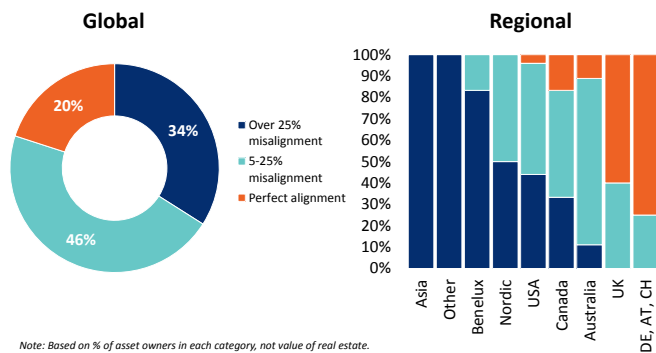
Note: Based on % of asset owners in each category, not value of real estate. Sources: JPQ; MSCI

The majority of Sample Universe asset owners not using benchmarks are relatively new to real estate investing and most are based in Asia and the Middle East. In other markets there is a subset of investors who prefer to monitor their real estate exposure through absolute return targets. Often these investors have deep experience of real estate investing and feel that the uniqueness of their exposure means that it is not possible to construct relevant real estate benchmarks. In these cases, real estate is often provided with absolute targets that are generally based on CPI plus a margin (often 300-500 bps), or government bonds plus a margin (often 200-300 bps) or a combination of the two. The use of absolute return targets has some important limitations, with general dissatisfaction over the use of absolute benchmarks for real estate, echoing the views of one asset owner: “We have a relative benchmark for real estate in contrast to infrastructure which is CPI+5 percent. We don’t like this absolute measure as it is a non-volatile benchmark that we compare with a volatile portfolio.” [Canadian Pension Fund].

Although relative benchmarks are widely used by respondents, the Sample Universe reveals inconsistencies in their implementation, often caused by the use of relatively narrow benchmarks compared with the active decisions being taken within the real estate department (see *Figure 3.7*). Despite steps taken to create more appropriate benchmarks, there seem to be two main areas in which benchmark misalignment exists. First, the style of real estate covered by the benchmark, with many using a core benchmark for a strategy that includes opportunistic and REIT investments. This misalignment is less of an issue for those asset owners holding real estate for core purposes with little REIT exposure (such as those in Australia, Canada, Continental Europe and the UK), but it can be an issue for those in the US, Middle East and Asia with a mixed exposure to real estate.

The second area of misalignment, that of geographic coverage, is a more pervasive issue with 80 percent of the Survey Participants seeing a disconnect between their geographic exposure and their policy benchmark (see *Figure 24*). The greatest alignment tends to be found in those countries where there is a strong domestic focus to investment, including Australia and the UK. Among the Survey Participants, the most striking disconnect is in the US, where over 40 percent of asset owners using benchmarks have more than a 25 percent misalignment. Such asset owners might, for instance, be using a domestic fund benchmark when they have over 25 percent of their assets in overseas markets or in REITs. A further 50 percent of US asset owners have a five to 25 percent benchmark misalignment. Such misalignment also exists in Canada and the Nordics, where there are rising trends for asset owners to increase their foreign real estate exposure.

**Figure 24: Alignment of Real Estate Benchmarks with Investment Strategy.**



Note: Based on % of asset owners in each category, not value of real estate. Benchmark alignment based on those for which a Policy benchmark is in place. Sources: IPD; MSCI

Discussions with Survey Participants also reveal relatively low use of mandate benchmarks, although in all markets there are a small number of asset owners making use of them at least on an ad hoc basis. This limited use of mandate benchmarks contrasts sharply with the liquid equity and fixed income markets where such benchmarks are the norm in investment management. There are signs that this is changing, particularly in Nordics, Australia, the UK and US. In these markets, asset owners are increasingly seeking mandate-specific benchmarks to help monitor individual strategies and improve transparency and communication between the CIO/strategy teams and those responsible for implementation. Such mandate-specific benchmarks are often accompanied by risk controls, including limits on leverage and the amount of development activity, as well as ranges within which allocations may be made to different markets. An important theme raised through the MSCI interviews is that these

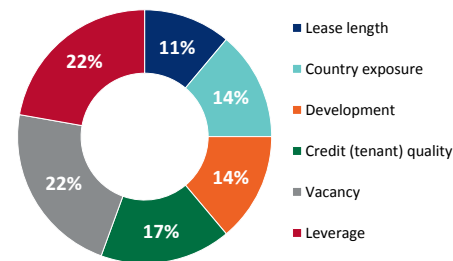
mandate benchmarks can be helpful in avoiding style drift, whether it is related to internally or externally managed real estate exposure.

### Asset and Portfolio Risk Monitoring

Beyond the use of benchmarks as risk management tools, the meetings with the Survey Participants reveal considerable effort to focus on more asset and portfolio specific risks of real estate exposure. The monitoring of these risks is seen as a way of avoiding the style drift that plagued many asset owners through the global financial crisis. This risk monitoring can be related to the use of benchmarks, but requires additional data and monitoring. As stated by one European pension fund: "We do review all the individual projects that we acquire, but are not so good at reviewing the portfolio across our funds and properties. I feel there should be a 'benchmark tree' all the way down to help in reporting to the board and in providing discipline for the real estate teams." [*Nordic Pension Fund*].

The main dimensions where these risks are monitored relate to the "asset" and the "portfolio." The heterogeneity of real estate assets and the dynamic nature of these risks through the market cycle can complicate the understanding of these risks. Despite these difficulties, there is a considerable body of research that identifies the main sources of asset and portfolio specific risks, and the MSCI survey confirms the importance of these dimensions (see *Figure 25*).

**Figure 25: Real estate Risk Factors to be Monitored through the Risk Management Process.**



Note: Relative importance of real estate risk measures, based on results from on-line Asset Owner survey. Source: IPD/MSCI

The discussions with the Survey Participants reveal that many asset owners receive summary reports on portfolio and asset risk metrics from their managers or consultants. These metrics tend to cover the issues identified in *Figure 25*. Although these metrics provide a useful way of summarizing the risks of the real estate exposure, there are two distinct shortcomings. First, in terms of the range of metrics covered with a desire for data across a broader set of risk factors. As summarized by one US survey respondent: "Beyond the location and leverage risk data we have, I would like to see more on 'income analysis' including tenancy exposure by sector and the length of leases across the portfolio, as well as more on 'fees'". [*US Pension Fund*].

This paucity of asset and portfolio specific data is a particular issue for asset owners seeking to integrate real estate risk exposure with multi-asset-class analysis. One such investor explained: "We have good data on the portfolios we control directly, and many of our managers also provide the necessary asset-specific data, but there are just as many funds where we have little insight into such granular data. This poses real challenges for us in monitoring the risks across our entire portfolio." [*Sovereign Wealth Fund*].

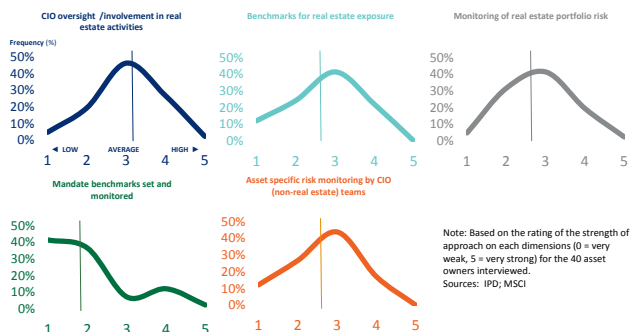
While asset owners can overcome this first challenge by devoting more effort to the collection of appropriate data, the second area, the timeliness of reporting and valuation accuracy, is a more fundamental issue. The appraised nature of real estate performance metrics means there is a lag and potential smoothing in the reporting of performance, and the MSCI on-line survey identified this as the biggest challenge for risk analysis of the real estate portfolio. This is a challenge for the real estate industry as a whole, and a particular issue for asset owners seeking to more closely integrate real estate risk analysis and reporting with other asset classes.

The Survey Participants identified a range of issues including data shortages, timeliness and valuation accuracy facing risk departments seeking to build real estate into multi-asset-class risk analysis. These information issues have also been a major reason for asset owners historically excluding real estate exposure from such analysis and relying on the judgment and expertise of the real estate departments instead. In many circumstances, certainly for the smaller asset owners, the CIO, or the boards themselves, are involved in reviewing individual property specific investment decisions. Such CIO oversight can improve risk management of the real estate exposure and alignment with broader investment objectives. It is, however, relatively inefficient and a number of larger and more sophisticated asset owners have found ways to summarize real estate risks on a number of key metrics. In such organizations, the CIOs focus on these portfolio-wide risk metrics and their relationship with other parts of their portfolio, rather than the individual assets.

### A Summary of Benchmarking and Risk Management for the Real Estate Department

As for the analysis of real estate risk in the multi-asset class context, the meetings with the Survey Participants provided a series of important insights into the monitoring of real estate specific risks (see Figure 26). With the exception of mandate benchmarks, the clustering of the results around the “average” score suggests that there is widespread understanding of the relevance of these dimensions of real estate risk management. But despite this awareness, there are relatively few asset owners surveyed who score highly (4 or 5 in the rating), suggesting that only a few asset owners excel in each of the dimensions. Although there are only a few “global leaders,” their approaches nevertheless represent the best practice that others seem to be trying to follow.

Figure 26: Strength of Approach to Key Dimensions of Real Estate Risk Management.



In terms of best practice in benchmarking, there is a group of asset owners in the Sample Universe (see Figure 3.7) who have benchmarks that are closely aligned to the investment strategy

and the active decisions that can be taken by the real estate team. These leaders also tend to focus on ‘granular’ benchmark analysis involving the attribution of performance as way of building insight and communication between risk teams and managers. In terms of asset and portfolio specific risk monitoring, the key dimensions of differentiation seem to relate to ‘depth and scope,’ as well as ‘strategic perspective.’ Some asset owners monitor a wide range of risk metrics including the conventional leverage, vacancy and development exposures, as well as more asset and tenant specific metrics. These leading asset owners tend to find effective ways of summarizing these risks for the real estate portfolio as a whole. These summaries enable the CIO and CRO to monitor the key risks and integrate them with broader multi-asset class analysis.

### Real Estate Asset Implications of the Survey

This part of the MSCI Survey results provides a series of insights into the risk management of real estate within the multi-asset-class context, including some clear guides for best practice. The description of asset owner real estate exposure confirms the important role for real estate in their portfolios, with an average of at least 8 percent being held in real estate. The Survey Universe results also reveal that while home bias remains an important feature for most asset owners, there is a general trend to increase non-domestic exposure with some having an explicitly “global” remit for their portfolios.

The Survey Participants explained the significant variations in the role of real estate from low return inflation-hedging through high absolute return seeking. In certain cases asset owners divide the real estate allocation into different “buckets,” but for most it is the combination of characteristics (income, inflation hedging, diversification and return) that makes real estate assets attractive. It is precisely this combination that can create significant challenges for asset owners, since it is difficult for risk managers to understand the risks of real estate exposure and integrate any analysis with other asset classes.

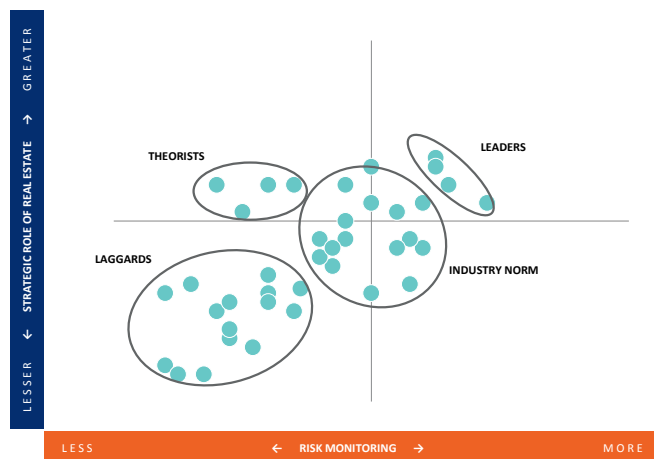
This lack of clarity over the role of real estate creates the potential for misalignment through the real estate investment process. Most fundamentally, this misalignment can occur between the strategic role for real estate and the actual exposure of the real estate portfolio. This potential for strategic misalignment is often created by more tactical mismatches such as the use of inappropriate benchmarks or limited strategic monitoring of portfolio and asset specific risks. Both of these mismatches can lead to style drift in the actual real estate exposure.

Although the MSCI survey reveals significant cases of potential misalignment, it also identifies a series of asset owners who represent “best practice” in real estate risk management. This spectrum of sophistication is captured in Figure 27 for the two dimensions of real estate in the multi-asset class risk management process, and the more specific process of real estate risk management. Each mark on the chart represents an individual asset owner that has been rated on the series of dimensions covered in the survey findings. The chart reveals four main types of asset owner. On the bottom left, there is a group of less sophisticated investors with minimal formal real estate risk management, and poor integration between the real estate team and the broader portfolio (‘laggards’). A number of these investors

are relatively new to real estate investing, and are starting to improve processes on both dimensions. But there is another set within this category that have relatively large real estate teams that have tended to operate in a semi-autonomous way apart from the rest of the portfolio. The experience and judgment of such teams places them in a good position to manage the real estate exposure. Despite this, the limited nature of formal risk management processes and weak integration with the rest of the portfolio leaves the real estate team, and the portfolio as a whole, exposed to the mistakes suffered by a number of asset owners through the global financial crisis.

The group of investors in the top left quadrant tend to have a highly sophisticated strategic perspective on the role of real estate, with clear risk/return objectives as well as tools and processes to integrate with multi-asset-class risk monitoring ('theorists'). The sophistication of this approach is often led by a small group of individuals within the central risk or strategy teams familiar with multi-asset class risk analysis. Despite this sophistication, there tends to be a disconnect between the strategic objectives and the implementation of the strategy. This is often due to relatively weak asset and portfolio-specific risk metrics within the real estate departments. Most of these asset owners are taking steps to better integrate risk management at strategic and more tactical levels but, until there is closer alignment, these asset owners are particularly exposed to style drift.

**Figure 27: Sophistication of Approach to Real Estate Risk Management.**



The largest group of asset owners is bunched in the middle of the diagram, with efforts being made to monitor the risks of the real estate portfolio, and to integrate this with other asset classes ('industry norm'). Although there is considerable activity in both these areas, the bulk of asset owners fall short of the fourth category, the "global leaders" identified in the top right hand quadrant. Such asset owners tend to be very sophisticated on most of the dimensions related to real estate risk management.

## Conclusion

The 2013 MSCI Global Asset Owner Survey identifies a number of key themes in the areas of asset allocation and real estate.

The findings come from in-person interviews with staff at 40 asset owners from around the world, representing \$3.2 trillion in assets, as well as online survey responses from another 40 asset owners, representing another \$0.7 trillion in assets. These comprise the Survey Participants.

These in-person interview responses were supplemented by asset-allocation and real estate allocation data gathered over the same period from annual reports and other public documents of 138 global asset owners, representing \$10.3 trillion in assets - the Sample Universe.

The Sample Universe data showed a wide variation of asset allocations across, and in some cases within, regions. When discussing asset allocation, Survey Participants described a wide range of investment processes and governance structures. Perhaps the central issue raised was the tension between the long investment horizon that asset owners should be able to exploit (by harvesting various premia) and the shorter-term investment processes they actually followed. Some Survey Participants mentioned governance issues as the principal driver of the tension. Others, however, noted that they saw a lack of a methodological framework for making and monitoring long-horizon investment decisions. The data from Survey Participants showed differing frequencies of strategic asset allocation processes and differing expectations of what the appropriate horizon should be. Survey Participants expressed different degrees of enthusiasm for investments in passive portfolios that track indexes as a means of harvesting premia; they also reported differing views on implementing these strategies. Finally, Survey Participants gave a variety of reasons for holding private asset classes (see summary in *Figure 13*).

The Survey Participants also expressed a variety of motivations for the role of real estate, from low return inflation-hedging through high absolute return seeking. For most asset owners it is the combination of characteristics (income, inflation hedging, diversification and return) that makes real estate attractive. It is, however, precisely this combination that can create significant challenges for asset owners, since it is difficult for risk managers to understand the risks of real estate exposure and integrate any analysis with other asset classes.

This lack of clarity over the role of real estate creates the potential for misalignment through the real estate investment process. Fundamentally, this misalignment can occur between the strategic role for real estate and the actual exposure of the real estate portfolio. This potential for strategic misalignment is often created by more tactical mismatches, such as the use of inappropriate benchmarks or limited strategic monitoring of portfolio and asset specific risks. Both these mismatches can lead to style drift in the actual real estate exposure. Although the survey reveals significant cases of potential misalignment, it also identifies a series of asset owners who represent "best practice" in real estate risk management.

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