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Current Practices in Benchmarking Real Estate Investment Performance

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MAJOR REPORT

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

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Current Practices in Benchmarking Real Estate Investment Performance

Report

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GLOSSARY OF TERMS

EPRA
European Public Real Estate Association publishes the FTSE EPRA/NAREIT Global Real Estate Index Series that is designed to represent general trends in real estate equities worldwide.

Institutional funds
These are generally pension and life funds that are often not distinguished separately and can be typically put into the pooled or segregated fund category. They could also represent money managed by financial intermediaries, such as German open-ended funds.

Lipper Indexes
These indices, constructed by Lipper, track the financial performance of different types of managed fund strategies.

Morningstar Indexes
These are a set of indices developed by Morningstar that track a range of asset performance on a global basis.

Peer Universe
It is typically a real estate index that is derived from the collective investment activities of fund managers. The universe can be the basis of relative performance of investment managers and could be disaggregated to the specialisation of a fund.

Pooled fund
It is a fund in which at least two investors pool their capital in an investment account. Groups such as investment clubs, partnerships and trusts use pooled funds to gather resources to invest. It could be a specialist fund as well. Investors can include financial institutions and retail funds (such as unit-linked, PUTs, PAIFs, OIECs, JPUTs, Club funds, etc.).

Retail funds
Such funds are sold directly to third party investors, typically on a daily trading basis. In some cases, they are open to institutional investment as well.

Segregated fund
This term is used interchangeably with the term separate account. It is a portfolio managed for a single investor. This could encompass public or private pension funds, insurance companies, charities, sovereign wealth funds, etc.

Specialist fund
A fund that is dedicated to a particular strategy, sector or target return.

EXECUTIVE SUMMARY

Benchmarks provide the basis on which performance is monitored and judged. They can also be used to determine strategic asset allocation and form the basis of and characterise investment mandates. The assessment of performance relative to that mandate remains important, but secondary.

The present report examines the nature of benchmarks and investigates the range and application of benchmarks predominantly relating to the UK private real estate market but touches on global practices, wherever possible.

The research questions are addressed primarily by means of a survey of some of the major institutions in the UK, either holding commercial property as an investment medium or providing data potentially used for benchmarking purposes. In addition, two detailed case studies of changing attitudes to benchmarking were carried out using UK funds where formalised benchmarking processes were established in the early 1980s and where property ownership within these portfolios pre-date the MSCI/IPD database.

Evidence from the survey

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

EXECUTIVE SUMMARY

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

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

1. INTRODUCTION

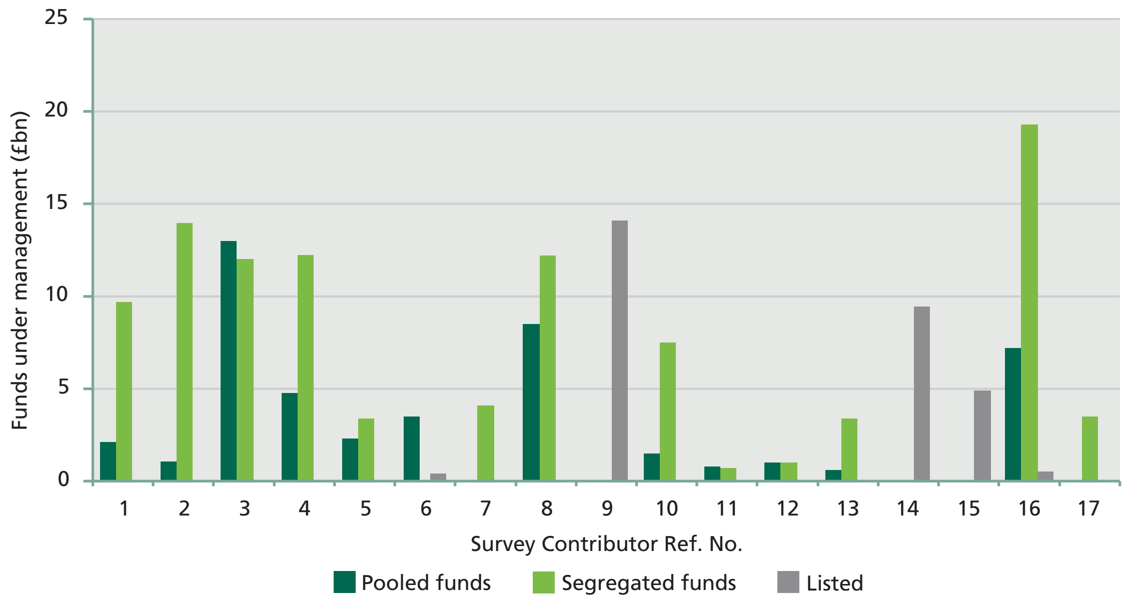
Benchmarking is at the centre of the investment management process and provides the basis on which performance is monitored and judged. Benchmarks can also be used to determine strategic asset allocation and form the basis of investment mandates. Much of the discussion and research to date on real estate investment benchmarks has been on the appropriate market index or their usefulness or representativeness for investment decisions. This perspective is arguably too narrow as it ignores alternative approaches to benchmarks. The present report examines the nature of benchmarks and investigates the range and application of benchmarks predominantly relating to the UK private real estate market but touches on global practices, wherever possible. It takes a behavioural approach to assess:

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

The research questions are addressed primarily by means of a survey of some of the major institutions in the UK, either holding commercial property as an investment medium or providing data potentially used for benchmarking purposes. The questions, where possible, examined practice in overseas markets as well as in the UK. We undertook 23 interviews including 17 investment houses with real estate assets under management in the UK of nearly £180bn (representing over 30% of the property investable universe in the UK (*see Mitchell, 2017*)) and overseas funds under management in excess of £515bn. A breakdown of the structures reviewed is contained in Figure 1.1.

1. INTRODUCTION

Figure 1.1: Breakdown of Contributor by Investment Vehicle Structure



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

The organisations questioned had a range of clients – segregated (separate), institutional and retail. Many of the pooled funds incorporated not only institutional funds but also pooled retail funds. A small proportion of the funds covered were sovereign wealth funds. A glossary of fund definitions has been included at the start of this report since there was a range of definitions used by different fund houses.

The report first examines the drivers of choice of benchmarks for the funds examined and then analyses the process of benchmarking from origination, through oversight to changes with time. It moves on to examine the impact of benchmarks on asset selection, the impact of the global financial crisis on practices and finally looks at the potential for using transaction-based indices to complement existing benchmarks.

2. BENCHMARKS AND REAL ESTATE INDICES

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

Assessing performance against market-based benchmarks is common in the real estate investment business. These benchmarks are useful to evaluate the performance of active investment strategies or to summarise the performance of any given segment of the market. Such segmentation may be geographical, by land use sector/segment, etc. Investment managers/funds that specialise in a particular sector or segment are often referred to as pursuing an 'investment style' (*Lee,1999*). It is logical to have a suitable benchmark that reflects a specific market sector or investment style/specialism.

It should be made clear at the outset that benchmarks and indices are not the same thing[1]. They are related but should not be confused. Conceptually, an index is an historical record of the performance of a market or defined market segment, whereas a benchmark is a yardstick defined for the purpose of assessing the performance of investors (or managers) participating in those markets (*see also MSCI, 2014[a]*). As one of our interviewees commented, **"There are many indices which promote themselves as benchmarks but they are really just indices."** *Investment Manager*

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

A benchmark should also be distinguished from a target. A target is not used as a formal comparator of performance[2]. Nevertheless, benchmarks can be used as targets to decide remuneration of investment managers. Investment managers may also operate within guidelines that set limits on permitted deviations in portfolio construction, which can determine the impact of benchmark composition on the standard, 'day-to-day' investment process.

In most asset classes, investment performance can be compared and contrasted against an agreed index of returns from an investment universe or an appropriate index of investment opportunities. This is not straightforward in commercial property markets because not only do index construction methodologies vary from index to index but so also does the breadth of market coverage and their representativeness. This is a global issue and an array of academic papers have detailed the differences and issues for both listed and unlisted real estate (*see Boudry et al, 2013; Partners, 2014; Serrano and Hoesli, 2009*).

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

[2] i.e. a requirement explicitly referenced in the investment mandate.

2. BENCHMARKS AND REAL ESTATE INDICES

In the UK, in the unlisted sector, a commonly used benchmark for market comparison is that provided by MSCI/IPD (Investment Property Databank). IPD began to generate a reliable UK-specific commercial property index in 1985 but incorporated data back to 1981 using data from some funds and the valuation agencies sponsoring the database. It is an appraisal-based index (i.e. not based on transactional data). The value of the December-valued IPD UK Annual Universe in 1985 was £26.4bn with data from 188 funds being incorporated in the index. Within three years, the universe had risen to £46.6bn with 216 funds contributing to the data set. By the start of the 1990s, the index was being used to a significant extent for benchmarking purposes. By December 2017, the December-valued Universe totaled £217,5bn reflecting the data supplied by 276 portfolios (*MSCI, 2018*).

Its representativeness[3] in certain segments of the market has been questioned in recent years as overseas investors, not contributors to the index, now dominate the central London office market (*Jones et al, 2017*).

In the US, the NCREIF Property Index (NPI) has been the main standard for evaluating unlisted commercial property performance. The NCREIF Property Index is an appraisal-based index. The NPI was launched in 1982 (with data going back to 1977) and was the first attempt to build a comprehensive index that represented the performance of the commercial US real estate market. It consists of over 35,000 properties and over 150 open-ended and closed-ended funds valued at US$559bn at the end of Q4 2017 *(NCREIF, 2017)*[4]. The NPI Trends Report is a quarterly report that tracks the changes in both capitalisation rates and net operating income (NOI). Data is shown both Equal Weighted and Value Weighted. In addition, vacancy rates are presented by property type and by region.

A key question of appraisal-based indices is what is the significance or bias of these indices as benchmarks rather than those based on transactions. Transaction-based indices measure market movements and returns on investment, based on the actual prices of properties sold. These types of indices are in their infancy. The first real attempt at a commercial real estate transaction-based index was that launched by The Massachusetts Institute of Technology Center for Real Estate (MIT/CRE) in 2006. Based on the transaction prices of properties sold from the NCREIF Index database, it was a 'hedonic' price index that used the recent appraised values of those properties, adjusted by their individual characteristics, to construct an average price for each period (*Geltner and Pollakowski, 2007; Partners, 2014*).

Another approach to producing quality-controlled property price indexes is arguably the oldest and most widely used method (*Geltner and Pollakowski, 2007*). This is known as the 'repeat-sales regression' (RSR) technique and has long been applied to residential markets in the USA and other countries. In an RSR index, the database on which the regression is estimated consists purely of properties that transact at least twice in the historical sample. The regression allocates those price changes to individual periods of time. The RSR index might therefore also be described as a 'same-property price-change index'. As such, it is fundamentally comparable to typical securities indexes, such as stock market indexes, which are based on same-stock price changes from one period to the next (*Geltner and Pollakowski, 2007*). Real Capital Analytics and MIT / CRE, who launched a version of this index in 2006, adopted this approach. A second generation of the index was launched in 2011 by Moody Investor's Service and RCA, based on price changes in the US and UK. It is now simply known as RCA Commercial Property Price Indices (RCA CPPI) and provides a broad measure of commercial property price trends.

[3] Representativeness is particularly important if one wants the index to be reflective of the broad market/opportunity set. This is key for all indices but only some benchmarks depending on purpose.
[4] Just under 20% of the professionally managed real estate investment market in the US (using market size data from MSCI, 2018).

2. BENCHMARKS AND REAL ESTATE INDICES

RCA is the first and only producer of an international transaction-based price index. The RCA CPPI covers the traditional commercial property types (office, industrial, retail) as well as apartments and hotels and covering North America, Europe and Asia-Pacific. In the US, there are also indices for various property sub-types. CoStar also produce a commercial repeat sales index in the US using a similar methodology across the price spectrum and Green Street have developed a commercial property price index that captures the prices at which commercial real estate transactions are currently being negotiated and contracted (*Partners, 2014*). These transaction-based indices could be applied as a benchmark measure or indeed simply values of transactions to complement appraisal-based valuations (*see also Chegut et al, 2013*).

Irrespective of the use of valuation or transaction data, there is a major question as to whether geared funds, such as listed REITs, can be reasonably compared to real estate market-based indices[5]. NCREIF and MSCI/IPD indices are, by construction, gross of leverage, fees and taxes, and focus on 'stable' forms of the asset class. This means that, if the objective of the benchmark is to provide a representation of deliverable returns to end investors, unadjusted versions of MSCI/IPD or NCREIF should not be used.

[5] It can be argued that this issue extends beyond leverage and style (including development). Fund and listed indices provide returns that are after leverage, fees and, where appropriate taxes, reflecting the overall investor experience.

3. TYPES OF REAL ESTATE BENCHMARKS

The choice of benchmark can be different, depending on the objectives of investment funds, and may differ in the short- and long-term. Income-orientated funds may prefer income-related benchmarks rather than total return-based benchmarks. 'Style' or 'property type' based funds that are logically measured against a defined property-type also need to address how their specific sector/segment performance relates to the broader property market. Approaches therefore differ across the industry, even within investment houses, reflecting both the nature (structure) of the fund and the specific requirements of fund mandates. The different fund characteristics means that market-based indices may not necessarily be appropriate. Investors can typically employ the following approaches to evaluate real estate performance, considered in detail below:

- Peer comparison;
- Relative return; and
- Absolute return.

3.1. Peer Comparison

In the case of peer comparison, a peer universe is used to reflect the performance of 'competitor funds' or those that invest and manage real estate in the same style or specialist area and with similar investment strategies as that under consideration, e.g. large/small life and pension funds or similar sized and managed retail funds. The definition of size may be explicit, e.g. £50-500m or relative to the size of the benchmarked fund e.g. half to double the size.

In the UK, this peer group comparison has been accepted by many investors and their advisors for nearly two decades (*Rutter, 2013*), in some cases, over three decades (see our case studies for example). The peer group may be defined by the components of a transparent index e.g. that defined by the MSCI/IPD or by a group of funds defined by the Lipper or Morning Star indices. The principal benefit of this approach is that it is a transparent method for the comparison of the constituent funds and proves relatively easy for advisors to understand and advocate.

3.2. Relative Return

Relative return benchmarks are closely related in as much as the fund performance can be measured relative to the 'peer universe' but it may simply be the return that an asset class achieves over a period of time compared to the market or sector of a market as a whole. The relative return being the comparison (difference or ratio) between the absolute return achieved by the asset/fund and the return achieved by its comparative benchmark. A relative return allows the evaluation of a manager over and above what an investor could achieve by investing directly into an index or the respective benchmark.

3.3. Absolute Return

An absolute return benchmark assesses the return of a fund/portfolio/asset over a period of time relative to an investor's target rate of return. The latter will require some assessment of the risk premium attached to property over and above some 'risk free rate' rate of return, e.g. 10-year government bonds. The methodology has the advantage compared to other benchmarking methods in that it is simple and allows the direct comparison of performance, not only against the investors target rate of return but also against market returns globally. This approach also reduces the scenario whereby managers are rewarded when delivering negative total returns to end investors simply because their returns have proved 'less negative' than the benchmark as a whole or managers being rewarded for beating the benchmark although they have delivered relatively poor returns at a property level.

4. EVIDENCE FROM SURVEY

4.1. Benchmarking in the Unlisted Sector

Our survey finds that the types of benchmarks vary and, in most cases, the choice is determined by the characteristic of the fund/client and the investment objective. The legacy (meaning in the main historic practice and custom) and inheritance characteristics of a particular investment house also contributed in part to the choices of benchmarks. The following specific findings have been identified:

- The choice of benchmark as argued above is dependent on the type of fund and the characteristics of the investment house and the investment objective.
- The medium sized houses interviewed in our study (£5-12bn) showed an inclination to manage segregated funds with absolute benchmarks.
- In the larger houses (with funds over £12bn) there appears to be no massive appetite for absolute benchmarks. Where they are used they are confined generally to either income funds or larger value funds with legacy being a significant issue. This could be more about the characteristics of the fund houses themselves rather than the funds per se.
- Almost all houses use absolute benchmarks irrespective of style or type where no transparent market indices were readily available for benchmarking purposes. This was true of many overseas markets
- Use of the NFI ODCE (NCREIF Fund Index Open End Diversified Core Equity) as a benchmark is common for funds based in the US, and is linked to their mandates[6].
- Clients make a significant input into the choice of benchmarks in the majority of cases (see below and Section 5.1).
- Smaller investment houses (with funds under management of less than £5bn) appear to get more comfort from market-based benchmarks, with MSCI and the AREF (Association of Real Estate Funds)/IPD Quarterly Property Fund Index (UK PFI) being identified as benchmarks. The survey identified, in one case, the ad hoc use of the Datastream business time series (building peer group performance analytics) for benchmarking purposes.
- There is little use of Morningstar or Lipper market benchmarks. Nonetheless, in one large investment house all of the daily-priced funds used a Morningstar benchmark.
- One large institutional house still uses MSCI-based benchmarks for their daily-priced funds. Another uses Lipper for pooled retail funds and several other pooled funds but our survey suggested that this was not normal practice.
- Interestingly, there are funds that focus on the Far East that are not benchmarked at all with risk effectively managed at the individual asset level.
- UK clients who have separate accounts (either direct or multi-manager) are mainly using absolute benchmarks in the form of inflation (Retail Price Index) plus targets. Our survey suggested that this allows a longer term view to be taken and permits managers more freedom in constructing portfolios.
- Typically the ‘plus’ element of these benchmarks varies between 2-7% depending on the maturity of the fund (less mature pension funds for example accepting lower required returns because of their lower liabilities in the short term with more mature funds requiring a higher ‘plus’). In the majority of cases, funds using absolute benchmarks typically aim to use them over a seven- to 10-year period.
- One house interviewed uses index-linked bonds for ‘absolute’ benchmarking purposes.
- Many clients/funds with absolute strategies combine absolute benchmarks with peer or relative market benchmarks. Although they wish to hold the business to account on the basis of absolute benchmarks, they still want to compare performance against the market. In the words of one respondent:

[6] The survey did not explore, in any depth, the use of such indices in non-US markets, e.g. in continental Europe.

4. EVIDENCE FROM SURVEY

“this provides protection for our investors. If there is a huge boom in the market, which diverges significantly from their absolute benchmark, then the investors want to know. The use of market-based comparisons (not necessarily formal benchmarks) in addition to absolute benchmarks gives clients comfort.” *Life and Pensions, Institution*

Virtually all UK funds received MSCI/IPD fund reports irrespective of whether they were used for benchmarking purposes or not.

4.2. Benchmarking in the Listed Sector

This section examines benchmarking in the listed sector. In some cases, this is from the perspective of the listed vehicles themselves, which may be ‘stand-alone’ companies in their own right or listed funds operating under the umbrella of a broader investment house.

Listed entities are required to publish substantial portions of information as part of the annual reporting process that is independently audited, introducing a more formulaic component to performance reporting. There is also the legacy of the GFC, which saw the share prices of listed vehicles tumble, leading the level of gearing to shoot even higher from already elevated levels. This pushed many of these organisations close to bankruptcy even if their property metrics, in terms of tenant retention and income generation, remained relatively stable at the time. This legacy has impacted on subsequent management behavior including how performance measurement and benchmarking is dealt with.

A number of the metrics that are published by listed property companies are designed to be comparable to listed companies outside real estate (but not unlisted real estate entities). These metrics include shareholder total returns, interest coverage, net asset value (NAV), earnings per share and others. These are metrics utilised by analysts as they convey their general recommendations to investors. There has been an attempt, through industry bodies such as EPRA (European Public Real Estate Association), to codify and standardize property specific metrics that are published in forums such as annual reports. These include variables such as the EPRA cost ratio, EPRA net asset value (NAV, EPRA net initial yield and the defined EPRA vacancy rate).

Bonuses relating to performance are made publicly available and are open to scrutiny and possible challenge from investors, particularly in the current climate of ‘shareholder activism’. The process of benchmarking must be and be seen to be both transparent and fair.

Several investment houses running listed funds and stand-alone specialist REITS were interviewed. There were a range of benchmark specifications that integrated, to various degrees, measures split between shareholder return-type metrics and MSCI/IPD-based comparative analysis. The following specific findings were identified in our survey:

- The broad market relative benchmarking[7], based on MSCI/IPD data with the segmentation of performance attribution into broader sectors and does not fit well with specialist listed vehicles;
- A standard MSCI/IPD benchmark would attribute performance to investment markets that might be beyond the investment mandate;
- There is a tendency amongst some of the specialist organisations to utilise MSCI data restricted to specific definitions of property that reflect their mandates. These might be based on property type, geography or

[7] Most effective for balanced property funds

4. EVIDENCE FROM SURVEY

a combination of both. Formal benchmarking in this manner would usually involve the comparison of the full listed property portfolio against a section of a balanced portfolio so the comparative power in terms of rankings are somewhat reduced. These metrics are therefore utilised in the main as part of internal business planning and performance targeting;

- One listed investor expressed concerns about the influence large scale portfolios such as their own could have on specific areas of the benchmark sample;
- There was also awareness that the valuation frequency adopted by listed entities and some others in recent years, including a move towards bi-annual measurement, would impact on the representative nature and efficacy of the quarterly valued benchmark data;
- In term of remuneration:
  - One entity had integrated the relative performance versus MSCI/IPD into their bonus structure across the business;
  - Another based its remuneration policies on a combination of share price total returns plus relative MSC/IPD performance, albeit seeing the shareholder portion as more a target measure than formal benchmarking;
  - Others targeted specific dividend yields in terms of pence per share (pps), whilst one had an explicit combination of relative equity total returns matched with a ranking target against general portfolio performance as measured by MSCI/IPD; and
  - A common approach is one of applying a combination of shareholder and explicit property metrics but the precise balance varies across houses.

4.3. Drivers of Choice

Our survey suggests that both the fund and the client (where one exists) influence the choice of benchmark of a fund. Decisions are very much client (or client plus advisor) influenced and what peers do and what is the industry standard is important. This is not always the case though. For at least one fund house, actuaries and consultants drive the choice and, in another fund, decisions are made by the Investment committee and actuaries. Pooled funds are less client-driven given their very nature, with more decision-making being undertaken by governance and other internal committees. This is also true in the listed market.

The evidence strongly shows that benchmarks are not designed simply for the measurement of a fund manager's performance. Instead they are aimed at investors/clients. In a number of cases, there are distinct processes for fund manager remuneration. In this context, the absolute rate of return may be used in some cases and key personal performance indicators are also used. The view was expressed on a number of occasions that: **"… benchmarks are aimed at investors not managers and a variety of measures may be used in a fund manager's assessment."** *Investment Manager*

And that: **"Mandates are wider than simple benchmarks."** *Investment Manager*

Generally speaking, the measurement of performance for internal purposes is carried out annually and quarterly. Some houses only monitor on an annual basis, whether for absolute or MSCI/IPD-based benchmarks. When performance is monitored on both an annual and quarterly performance it is usually on the basis of the same benchmark but, in some cases, where MSCI/IPD is the primary benchmark, the annual index is used for annual reporting and the quarterly for quarterly reporting. Normally, there is no difference between the benchmark used for internal and external reporting. There may be a difference in the frequency of reporting but as noted above no difference in the benchmark used.

5. THE PROCESS OF BENCHMARKING

5.1. Unlisted Sector

Our survey highlights that clients are involved at all stages of the benchmarking process whether in the origination, oversight or in the process of change, with internal governance systems being involved in one way or another to varying extents. There is much more hands-on client involvement in segregated (separate) funds and much less in pooled funds and the listed market. It seems to be the case that clients (often advised by consultants) have the final say on the benchmark (but not for pooled funds) but that various intermediaries are involved both in the day-to-day assessment of the benchmark, the origination and in any change.

In the case of one of the large houses, there is a tri-partite approach to establishing the benchmark between strategy/research, investment governance and the fund manager. The rationale for the benchmark operates around [the question of] what is a realistic workable target? In particular, what is the clients' appetite for risk and how can that be reflected in the benchmark? What do they want, for example, in terms of short termism and volatility?

Asset allocators were assigning money to real estate because they wanted real estate characteristics and expectations.

"What they put into their models determines their benchmark. If they want the market returns they will use/recommend MSCI or Morningstar." *Life and Pensions Institution*

Pooled funds tended to be treated differently from segregated funds, with one large house noting that for pooled funds the governance committee has the final say. Smaller fund houses make decisions generally in house, with the fiduciary manager (FM)/compliance officer/investment consultant (IC) and head of commercial real estate being variously involved. Usually the same teams were involved with origination, final decision and overview but the nature of those teams might be different in terms of the input from actuaries, performance, ICs, FMs and clients.

One large private equity fund manager took the view that clients wanted direct property performance and that they were aware that heavy net investment dragged down relative performance against market benchmarks. They went on to state that, while their job was to get their retail client's money invested as efficiently and effectively as possible, they did have the scope to state that it was not a good time to be investing whenever they thought this was the case.

A number of interviewees expressed dissatisfaction with the effectiveness of the benchmarks available for 'long income' funds and cautioned against these portfolios being incorporated into more 'generalist, balanced' benchmarks.

5. THE PROCESS OF BENCHMARKING

5.2. Listed Sector

There are a number of differences in the development, processing and application of benchmarking policy in the listed sector when compared to the approach undertaken by the unlisted sector. These are, in the main, driven by the external reporting requirements required of listed vehicles noted above in order to satisfy the diverse investor base who invest in these particular entities.

For single entity REITs in particular, remuneration committees play a crucial role in the design and implementation of benchmarking policy. These often contain executive and non-executive directors and are usually reporting directly to the board of the REIT. The board is usually the forum where any changes to benchmarking are likely to be ratified so any decisions in this area are taken at the very top of the business.

6. CHANGES TO BENCHMARKS OVER TIME

Most fund houses indicated a reluctance to change benchmarks regularly but suggested that developments such as a degrading sample (whereby assets and portfolios leave the benchmark dataset and are not replaced) would eventually stimulate a rethink. Changes are rarely fundamental in terms of the nature of the approach to benchmarks (relative, absolute, peer, etc.) but more often relate to change in the composition or scale of the original benchmark. Where a fund uses a peer benchmark it could be that the actual peer group composition might be reviewed and adapted to its needs. In the case of absolute benchmarks it may be the value of the plus element in RPI (+) is amended or, alternatively, the inflation measure used in the definition. These changes are heavily influenced by changes in market conditions[8], with the most obvious reason being is the benchmark still relevant?

The following examples illustrate these issues. One investment house expresses the view that benchmarks are modified as funds change, noting in particular,

"How the MSCI sample evolves needs to be managed." *Investment Manager*

There can be a loss of confidence due to external factors that lead to a revision in the market covered by the benchmark. The London market is now dominated by overseas investors that are not members of IPD/MSCI.

One fund articulates the problem as: **"... with coverage by MSCI/IPD only 10-11% in a particular sub-market, there is little value in the comparison but what else would you do?"** *REIT*

In this respect, one listed fund argues that,**"... the main reason for change is performance – are you setting the appropriate targets? Can you realistically change portfolio allocation to mirror the benchmark?"**

One investor had moved from applying a bespoke arrangement that re-weighted defined market sectors that reflected its own portfolio structure to a more straightforward comparison with the full universe.

Another fund also noted issues regarding the definition of distribution yields. It expressed concerns about the inclusion of charity funds within a peer benchmark (tax issues), comparative funds being on manifestly different strategies, e.g. long income funds. It also noted that some of the constituent comparative funds of a particular benchmark did not accept external investment on remotely similar terms.

A large fund house articulated that there is a variety of internal reasons why benchmarks may be changed, including the running down of a specific fund, changes in fund structure and revisions to the investor base. The strategy team reviews the benchmark and interacts with the client to discuss options. A paper is produced outlining the options, which goes to the client and, if agreed as suitable, the changes are adopted.

These views can be summarised as,**"There is a need to periodically review to ensure that they are fit for purpose."** *Life and Pensions Institution*

Similarly, another fund stated that it tries not to change benchmarks frequently as the benchmark frames the investment mandate.

[8] For example changes in market dynamics, such as the consolidation of investment portfolios and the acquisition of assets by purchasers who do not contribute to benchmark databases such as MSCI.

7. CASE STUDIES

The two case studies presented are both long-standing funds that predate the development of benchmarking culture that began in the late 1980s. One is a unit-linked fund and the other is a balanced portfolio, but both demonstrate how the industry has evolved over time, including, in particular, the greater transparency required today. Despite having broadly the same objectives, they have changed their benchmarks as both property market circumstances and data availability has improved.

While the case studies demonstrate a process of continuous adaptation in the decision-making processes and new technology, both funds have only changed their benchmarks a limited number of times in four decades. In the main, these changes are driven by the use of increasingly sophisticated approaches to the MSCI/IPD database. However, the unit-linked fund also adapted its benchmarks in the aftermath of the global financial crisis to take account of a requirement to have liquid assets to address sudden redemption requests. The revised benchmarks continued with an IPD index but added a listed property index and a cash index.

CASE STUDY 1: THE BENCHMARKS OF A LONG-ESTABLISHED UNIT-LINKED PROPERTY FUND

Background

Case Study 1 is of a UK unit-linked property fund, formed in the early 1980s. Over its first 37 years, it has only been managed by three individual fund managers. All three were interviewed for this case study.

The fund was subdivided internally into a life assurance fund and a pension fund. From the property manager's point of view, the fund was regarded as a single fund with a single cash flow. The fund required a different investment objective to what managers had been used to – agents and fund managers alike had to adjust to investing in assets with a much shorter investment horizon, while the concept of managing a fund – including the requirement of managing liquidity in an open-ended structure – was often new to the players at the beginning.

The early (non-) benchmark years

For the first six or seven years, the subject fund had no official benchmark. The then fund manager recalls a conversation with the chief investment officer of the time in which it was agreed that the fund should *"have representation across the main sectors and in the major cities"*. No attempt to place sector, segment or geographical weightings were made at that time.

Benchmarking was still in its infancy. Attempts at benchmarking used the offices' marketing departments to find out competitor funds' unit prices and compare with one's own. That comparison focused more on performance than any true benchmarking exercise.

The question for all property investors was 'what is the optimum sector allocation for a property fund?' Pre-the IPD database, before the advent of forecasting and before risk analysis became commonplace, it was a very difficult question to answer. As the fund grew, so did its average lot size and it became clear that, even if a benchmark could be chosen, it would have to reflect both the shorter-term nature of the assets and its size.

The fund's benchmarks

Benchmark A

This property fund was measured by IPD from the beginning of IPD's existence. Indeed, the fund was only the second fund to be placed in the IPD Universe. The first genuine benchmark created for the fund was around 1987/88. It used the embryonic data from the newly published All Funds Index from IPD and was simply:

- **All funds in IPD Annual Index**

It was not clear whether that benchmark was appropriate in terms of lot size, fund size, rate of growth or investment objective, but at least *"… the fund had made a step in the right direction."*

Benchmark B

By 1990, a more rigorous approach was used, aided by the rapid acceptance of performance measurement by institutions and of IPD in particular. It was now possible to construct a meaningful benchmark that combined funds of a similar size and of similar investment objectives.

CASE STUDY 1: THE BENCHMARKS OF A LONG-ESTABLISHED UNIT-LINKED PROPERTY FUND

This benchmark took the form of:

- **All unit-linked funds in IPD Annual Index between 50% and 150% of the value of the fund assets**

That form of benchmark was chosen jointly by the fund manager and the house Research and Strategy team. At this time a fund's benchmark report was not published until the end of the second quarter of the following year and pressure built up from both the fund management side and the marketing/risk teams for a more frequent comparison. Consequently, the practice grew of informally using both the IPD Monthly Index and the monthly unit price performance (from the likes of Lipper or Statspack) as a proxy for assessing the fund's performance during the year.

It was fully understood that statistics from these sources were not always consistent with those from the official benchmark. From a property point of view, a fund may have beaten its benchmark but may have underperformed its peers' unit price performance owing to differing levels of cash or a move from an 'offer price' basis to a 'bid price' basis. This became an important issue during periods of rapid fund growth (2002-mid 2007) and fund contraction (mid 2007-2010).

As fund management became more accountable, the fund's client introduced performance targets based on the performance of the fund's property assets against those of its peers. The client adopted the same benchmark as that used by the fund with an outperformance target of 50 basis points per annum over three years. Meeting, or beating, that target earned the investment house a performance fee in addition to the annual management fee.

The benchmark was not changed every year, altering (infrequently) as the fund's assets increased. Only when fund assets approached the upper limit of the then benchmark was it deemed necessary to alter it. There was concern within the Property Department that changing benchmarks could be seen as occurring only when it would be to the fund manager's advantage and not necessarily at a time justified by property fund or asset fundamentals. At the time, the choice of benchmark was left to the Property Department.

Benchmark C

A further change occurred in 1999 as the fund continued to increase in size, when the benchmark was changed to:

- **All unit-linked funds in IPD Annual Index**

By the end of the last century, the unit-linked universe and value of the funds being captured and measured by IPD was sufficiently large to enable the targeting of a more relevant benchmark. However, Benchmark C did still suffer from the fact that the Annual Index was published only once a year. The fund manager, the marketing department, risk departments, etc., were all seeking more frequent comparisons. The IPD Quarterly Index was about to be launched and that would address many of these concerns.

CASE STUDY 1: THE BENCHMARKS OF A LONG-ESTABLISHED UNIT-LINKED PROPERTY FUND

Benchmark D

In the late 2000s, the fund moved to its current set of benchmarks:

- **Direct property: The IPD All Funds Quarterly Index**
- **UK shares (REITs): EPRA/NAREIT UK index**
- **Cash: cash index**

The change in the benchmark was driven by the change in investment policy, brought about by the global financial crisis, notably the need to have more liquid assets to cope with sudden redemption requests. Although the three separate components were appropriately benchmarked, the overall fund was not, meaning that, while all three asset components could outperform their benchmarks, the overall fund may underperform at a unit price level; the opposite could, of course, also happen. Overall fund performance (the unit price) continued to be monitored informally through Lipper.

The change in investment policy and, consequently, the benchmark, to address liquidity issues, implies that investors in the unit-linked fund indirectly influenced the choice of the benchmarks at that point. Notwithstanding this, no other benchmark change over the years came about through investor influence. Current benchmarks rarely impede asset selection. There is sufficient leeway, above and below target sector weights, that stock selection is not compromised.

Purposes of fund benchmarks

- **Performance analysis**

The prime function of the benchmarks over time were for internal performance analysis. They have also always assisted in monitoring divergences from peer funds' sector allocations.

- **Risk analysis**

This was rarely considered in the early years but is now an extremely important element of fund management. Analyses into tenant concentration, rent review dates, lease renewals etc. are now carefully monitored and action taken if any are deemed too high a risk.

- **Remuneration**

Fund performance has been only one of a series of aspects considered when it comes to individual bonus remuneration. Overall, house performance (all funds and all asset classes), the overall performance of the property division and the performance of the particular fund, the profitability of the business, house and division, new business targets and so on have all played a role in determining remuneration. Performance for this purpose in the property division tends to be over a rolling three years.

Acknowledgement

Our thanks to the two former fund managers and the present fund manager for giving so readily of their time to discuss the fund's benchmarks.

CASE STUDY 2: A LONG-ESTABLISHED BALANCED INSTITUTIONAL PORTFOLIO

Case Study 2 refers to a balanced institutional portfolio that sits within a substantial multi-asset Investment house, which has invested in commercial real estate over a long time period. This particular portfolio has been the cornerstone of the wider real estate offer for decades, is a segregated mandate that accepts no external investment and retains substantial holdings across the three 'traditional' UK property sectors of retail, office and industrial. The portfolio directly and the asset house in general also invest in some of the more recently established 'alternative' sectors. The portfolio now sits within an expanded real estate offer that includes retail investment products, specialist and international investment vehicles. In the course of this study, the authors have spoken directly with members of staff who carried and retained responsibility for the development and implementation of benchmarking policy leading towards its formal establishment, with the adoption of IPD in 1985. Since that time, the portfolio itself has been headed by five separate managers and stability of fund managers has proved, to date, a characteristic across the house's portfolios. We also have gained the consent of the current fund manager(s) to their participation in this research.

The early years

The fund has participated in IPD benchmarking since its foundation. It retains to this day a preference for relative benchmarking and the investment house has extended, over the years, its coverage across a range of investment vehicles and international markets. Prior to the formation of IPD, performance measurement was much more rudimentary, when viewed from today's perspective at any rate. Data collection in this era was a completely manual process. This involved sourcing data through deriving a 'Commitment List'. This involved a young researcher 'wandering around to speak to the investment surveyors in the organisation and finding out what projects were ongoing'. As there was no formal recording or logging onto fledgling systems of proposed purchases or sales, the researcher would sit in the Investment Committee meeting on a weekly basis. This was the forum where investment surveyors would seek authority to buy/sell/develop and enter the room armed with plans and maps as they attempted to get their proposals approved. The researcher would minute the proceedings and if, say a development of £20m was approved, they would 'log' that manually and record it. At the end of the month, the researcher would present a crude 'cash flow' showing how much was under 'commitment' across the portfolio.

The establishment of IPD came along at a similar time to significant improvements in information technology – one contemporary researcher taught himself the SAS programming language – which, along with the development of electronic spreadsheet programs, enabled more effective aggregation of data and portfolio analysis to be undertaken. As IPD reporting started to become a regular feature of performance reporting, there were significant differences in how the data was disseminated across the business compared to today. Similar to the 'Commitment List', the bulky IPD fund and comparative reports that were issued in the 1980s (the author remembers packing huge fund and comparative reports into big boxes in the late 1990s) were for restricted consumption. The fund managers of the time would not allow anyone else to see them as a confidentiality/gate keeping mentality prevailed. That stance has changed substantially, of course, with performance and attribution numbers now shared widely throughout the business.

A further change to note, when comparing 'the early years' to present practice, stands in relation to valuation practice and frequency. In the 1980s, the portfolio was valued once every three years. In the intervening years, a 'basket' of assets was reviewed annually, with an uplift applied to the overall portfolio based on how the 'basket' had changed. It is also interesting to note that at the time and, indeed, up until the late 1990s, valuations of the portfolio's assets were conducted internally. As benchmarking became more integrated into business processes, valuations were moved onto an annual basis and undertaken externally.

CASE STUDY 2:
A LONG-ESTABLISHED BALANCED INSTITUTIONAL PORTFOLIO

From January 2009, valuations were to be carried out on a quarterly basis; the normal year-end frantic mission of getting the portfolio valued had been streamlined, as the bulk of the work, in theory at least, had been carried out across the year. Nowadays, reporting requirements, along with compliance issues, have increased greatly. The organisation has developed its own internal performance system where data across portfolios is readily available. This is, indeed, a far cry from the early 1980s, when one of the young researchers referred to was pointedly told by a superior, '*there is no future in what you are doing!*'

Fund benchmarks

Benchmark A

- **1985-2003: Non-unitised life funds**

This property fund was measured by IPD from the beginning of IPD's existence. This included the backdating of performance measurement figures to 1981. Some of the fundamental concerns of the investment house in terms of property benchmarking relate to the size and stability of the data underpinning benchmarks. They require a minimum number of funds, a view that benchmarks should be retained for at least three years (longer, ideally) and size bands should be defined by a lower threshold.

Benchmark B

- **2004-2010: Life funds greater than £1bn**

By the late 1990s and early 2000s, the mis-selling of endowments had produced serious challenges for life assurance companies, particularly in relation to their 'with-profits' business. Further difficulties for this 'traditional' form of business included concerns that the inherent smoothing in bonus rates encouraged the perception that investment surpluses were not being fully distributed. There was also increased competition driven by the establishment and success of lower-cost unit-linked vehicles. This led to a major reduction in the number of non-unitised life funds so the benchmark had to be redefined.

Benchmark C

- **2010-2014: Life & Pension Funds >£500m, with specific benchmarking data removed**

In a similar vein, the benchmark had to be adjusted again to reflect changes and consolidation in the market, so the benchmark definition was changed in terms of extending the criteria to pension funds and in reducing the threshold size required. In addition, a contested decision was taken to remove one 'traditional IPD PAS segment' from the benchmark data as the view was taken that the sample contained in the benchmarking data was not representative of that particular market.

Benchmark D

- **2015-H1 2018 Life & Pension Funds >£500m**

In 2015, the decision was taken to remove the exclusion of benchmarking data agreed when implementing the previous change in respect of 2011. There continue to be concerns over how representative the benchmark data was in relation to the growing 'other category', as well as the challenges in incorporating indirect vehicles and gearing into overall performance measurement.

CASE STUDY 2: A LONG-ESTABLISHED BALANCED INSTITUTIONAL PORTFOLIO

Benchmark E

- **H2 2018: Quarterly Universe**

The benchmark has now changed to the Quarterly Universe because of the reducing sample size. Measurement in respect of 2018 will reflect Benchmarks D and E.

The principal driver behind the changing of benchmarks has been the declining sample upon which benchmarks have been based. This particular fund has been in existence for decades with essentially the same objectives. It has, however, been maintained in an era where the industry itself in terms of structure, access and measurement has undergone fundamental changes. A process of continuous adaptation has therefore proved essential.

Acknowledgement

We express our great appreciation for the time and insights into benchmarking policy at the investment house across several decades provided by senior members of the Performance and Research teams plus the current fund manager for consenting to the publication of this case study.

8. IMPACT OF BENCHMARKS ON ASSET SELECTION

A key perceived issue in the use of peer-based benchmarks is a tendency to encourage herding, with implications for the weights between property sectors or segments and the localities of individual assets in a fund's portfolio. Many funds that use the MSCI/IPD benchmark are conscious of this question and many argued that they did not follow the industry-wide weightings slavishly. As one fund puts it, they are "trying not to let MSCI/IPD determine their structure." In some cases managers have big tolerance bands, up to plus or minus 20 percentage points, and strategy is not excessively led by MSCI/IPD structure.

One major investor highlighted the need to distinguish between asset allocation and asset selection. For market-based benchmarks with shorter time horizons, it has a sharper view of asset selection, which will subsequently have a knock on effect on asset allocation.

Many funds argue that management should only use a market benchmark for comparison and not necessarily as a strategy tool. It was argued that indices are backward rather than forward looking. In this context there was some circumspection regarding the appropriateness of using MSCI/IPD given the changes noted in London offices above.

A minority view, however, was that there is too much of an impact of the MSCI/IPD benchmark on structure with managers too focused on weightings and not the sustainability of underlying income. Notwithstanding this, the structure of the MSCI/IPD benchmark is inevitably relevant for larger funds (£1bn +) but pointless for small funds.

"… in terms of fund structure, you can get to client requirement (performance) in many different ways." *Life and Pensions institution*

"A benchmark should be used to inform strategy – a guide to where we want the portfolio to be but flexibility is needed from the top down." *Life and Pensions Institution*

"Use benchmark data to reflect sector and do something better." *REIT*

"Focus on the sectors you like and remember, it's all about the buildings – just buy good buildings!" *Investment Manager*

With regard to absolute benchmarks, a typical response was that the fund manager has as much leeway as they want in terms of asset selection, so peer review is not really an issue. However, in the words of one respondent, there are big expectations that the manager is 'convictional'.

Beyond the question of the impact of type benchmark on asset selection it is important to remember that there are other important factors that impinge on asset selection that link to the duration of the fund, type of target and size of fund. In particular, one respondent notes,

"There are points in the cycle when allocation [sector] is important and where selection [stock] is important." *Investment Manager*

Finally, in this section it is important to note a wider view of peer benchmarking, raised by one investment house, namely the question of data provision per se and its contribution to herd behaviour. The argument is that investors are conditioned by receiving the same (or similar) forecast and performance data from a small number of sources. The contention is that these data sources frame if not dictate decision-making in the industry especially the institutional space.

9. PROPERTY BENCHMARKS IN A MULTI-ASSET CONTEXT

Common benchmarks were not found across different asset classes in the responses to the survey. Funds that operate in a multi-asset environment have to take cognisance of target returns, relative income returns and real returns of its assets. Property funds, however, are recognised as providing a different dimension in the investor space as funds seek to target equity market performance without the volatility. Multi-asset funds' strategies therefore normally use different benchmarks for each asset type. The real estate benchmark is determined by the fund's mandate and how to make it work relative to other asset classes.

The use of MSCI benchmarks provides a significant level of comfort to asset allocators and third party consultants when benchmarking commercial property performance. However, the overarching decision should be what works for the overall portfolio. These views are summarised by the following quote:

"Not sure this is about benchmarks. Asset classes have to deliver performance characteristics. For a pension fund, this is diversification and providing a higher level of income. This is a broader strategy question, not benchmarking".

10. IMPACT OF THE GLOBAL FINANCIAL CRISIS (GFC)

The GFC caused a dramatic collapse in property values, with severe consequences for some property funds and REITs *(Jones et al, 2017)*, but the evidence from the survey is that it has not generally changed the policies on the type of benchmark applied. On the other hand, the subsequent macroeconomic environment has meant that funds have reappraised the numbers and targets inherent in their existing benchmarks. The legacy of the GFC is also seen in greater wariness about real estate cycles, such that investors/clients are very sensitive to strategy drift at different stages in the cycle. Investors also want less risk and debt in vehicles.

The impacts therefore have been on the style of funds, in terms of reducing risk and gearing, and the levels applied to RPI plus benchmarks, given the low interest and bond rates applicable in the post GFC environment. One respondent suggests that more benchmarking has followed the GFC, with managers preferring market benchmarks and investors wanting absolute ones. Some of these policies are reflected in the following quotes:

"Still use absolute benchmarks over 7 to 10 years and relative benchmarks over 3 years."
Investment Manager

"Important not to believe or follow a dream on what property can do." *Investment Manager*

"Prior to the GFC, many fund managers were allowed to drift from the mandate(s) implied by their benchmark(s) in order to secure enhanced returns. Over a significant period of time, higher asset prices fuelled ever-greater risk exposure, resulting in a deeper misalignment between portfolios and their benchmarks. You could view this as a failure of the investment managers themselves and the wider controls, governance structures, etc. under which they operated." *Investment Manager*

11. TRANSACTION-BASED INDICES

The survey finds no enthusiasm for using these indices as benchmarks. They are, however, seen as analytical tools. They are used by investment houses to gauge the dynamics of the market but in the words of one respondent:

"We are a long way from trusting them enough to bet our performance on it." *Investment Manager*

"… would be interested in transaction-based indices as an early warning system." *Investment Manager*

These indices are seen as having potential as strategic tools as the following notes,

"… particularly at very specific points in the market cycle, when asset prices change rapidly." *Life and Pensions Institution*

There is a recognition that such indices are used in listed asset markets to offer some sort of comparison but they are only seen as having a role if there are enough transactions. There are concerns around the lack of comparability and reliability that exist in valuation-based indices and transaction-based measures could be seen as augmenting them. These views are seen in the following quotes:

"… may be worth doing additional work to look at the possibility of using them in conjunction with other benchmarks." *Consultant*

"There is a consistent valuation framework in existing benchmarks but there is not a consistent sample of transactions and never will be." *Investment Manager*

12. DISCUSSION

12.1. Selecting a benchmark

Our survey indicated that there was no consistent pattern to the choice of benchmark for funds. It was dependent on the type of fund and the characteristics of the investment house and their investment objective.

Appraisal-based indices, such as MSCI, dominate the provision of market-based benchmarks in the UK. There was a general view from our interviewees that they are transparent and provided effective comparative data across a substantial range of measures in addition to total returns. They are not, however, without their problems. There are issues with regard to how the constituents of the benchmark databases accurately reflect the overall market and MSCI have themselves published analysis in this area, suggesting that they capture 41%[9] of the 'professionally managed' UK market MSCI (*2018*). Market coverage is not just an MSCI issue, however. It is a feature of private markets generally. NCREIF's coverage, using MSCI's estimate of the investable US market, is just under 20% (see also Section 2).

In this context, a major issue, which has come to the fore since the GFC, is whether such benchmarks are appropriate or even fit for purpose. The GFC, low interest rates and a search for income have led to a re-appraisal of what property offers as an asset class and, therefore, what benchmark is appropriate (*Abbott 2015*). Does the use of peer or even market-based benchmarks constrain strategy and encourage beta tracking, affecting the whole management of a fund in terms of its structure? There was no real evidence of this in our survey but it was recognised that the IPD database and probably all of the appraisal-based indices discussed earlier, do not always reflect the broader market appropriately.

This is true, not only in the sense that they only cover a proportion of the overall investable market to start with, (albeit that part of the market they capture is the most relevant for the investment houses using it). They also face the fundamental challenge of large amounts of commercial property that they have covered being withdrawn from the database as these assets are acquired by a range of investors who do not contribute to the data sample. There are also issues with the broadening definition of real estate in terms of geography, scope and style, e.g. new forms of real estate, debt structures, higher risk exposures, etc.

Rutter (*2013*) notes that with respect to peer group benchmarks, 'the changing benchmark constituents and restatement of indices due to data amendments has resulted in unwelcome volatility and uncertainty'. That article, supported by our survey, also highlights that investor choices may assume that their funds are similar in style and substance but in reality they are different, for example in sector structures, exposure to leverage and average cash weightings. There is also the danger of short-termism – judging performance over recent history rather than over the longer term given that market returns are reported on a monthly or quarterly basis. Should investors just be happy to accept a benchmark based on the overall/whole market, which then allows a discussion and comparison of the impact of their fund structure on performance overall? Would this be considered a true benchmark?

[9] This specifically refers to the December-valued annual index sample. MSCI collates additional data from organisations that operate on different valuation schedules.

12. DISCUSSION

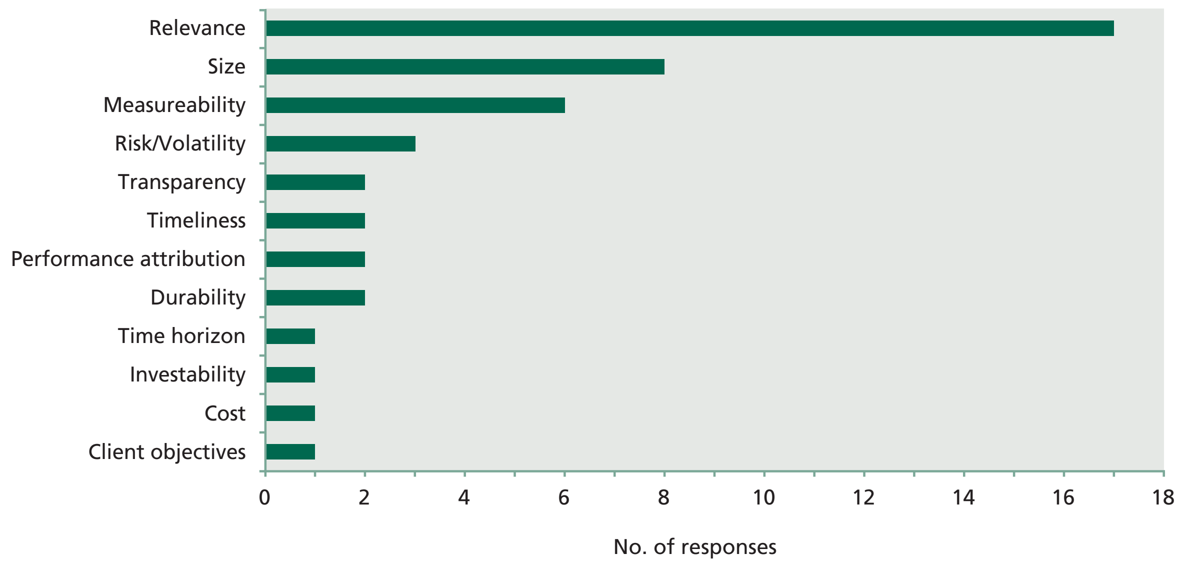
12.2. Important considerations when selecting a benchmark

There are limitations with using appraisal-based indices, whether they are used for peer group comparisons or simply full market comparisons, because of the representative nature of the dataset. Even where investors are using absolute benchmarks, however, the adoption of MSCI peer/relative benchmarks allows managers to assess their investment performance relative to the market.

In this context, Abbott (*2015*) suggests that the use of dual benchmarks (absolute and market-based) would result in a more unconstrained approach to real estate investing that could have significant benefits for investors. This would enable investment managers to invest in a high conviction manner. There is a sense from a number of our interviewees that, whatever the theoretical approach adopted, it would come with its own challenges and that any new offer, say in comparison/competition to IPD, would have to provide robust historical metrics and this would prove challenging.

Notwithstanding these overall issues, our survey identified relevance as by far the most important factor in the choice of benchmark. This was followed by size (defined both as number of funds and market coverage) and the measurability of the benchmark. (See Figure 12.1, which lists the most important considerations in constructing a real estate benchmark as perceived by those interviewed in our survey.)

Figure 12.1: Considerations in Constructing a Benchmark



Beneath these broad factors, there is a series of questions that need to be addressed when choosing a benchmark.

A number of these relate to the nature, knowledge and preferences of the client (it is their money after all). The client will have an appetite for risk and the benchmark should reflect this in matching client objectives with the capability or not of the manager in meeting those objectives. Another explicit comment coming from the interviews relates to the role played by third party advisers in advising clients. The effectiveness of certain advisers, particularly in relation to their broader knowledge of the real estate sector, was questioned.

12. DISCUSSION

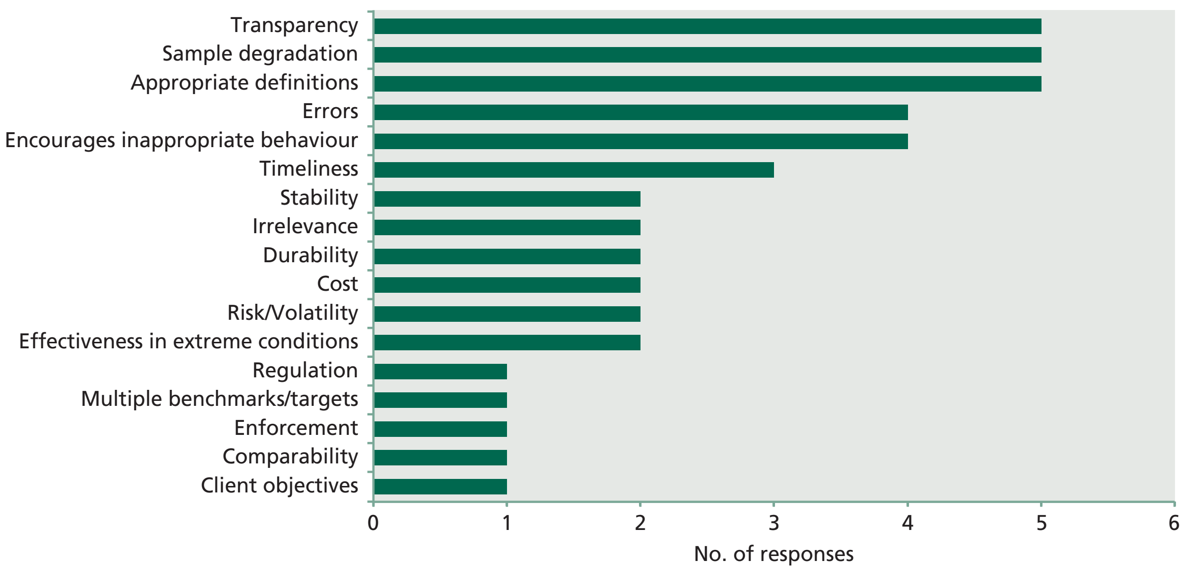
Clearly, the durability of a benchmark is important, as is the connection between the benchmark and portfolio strategy, particularly with regard to the types of assets. It is necessary to frame a benchmark in a way that enables a range of investment strategies to be undertaken, matching those strategies to the risk profile/investment objectives of the end investor. These can vary, from attempted beta tracking through targeting a low or modest tracking error, allowing for the costs and challenges present when constructing an effective 'market portfolio' in direct real estate, to strategies that explicitly take on additional risk in relation to the defined benchmark, directly targeting a higher level of tracking error. The investment mandate will indicate the parameters in which the chosen strategy must operate and the benchmark plays a significant role in the judgment of whether the employed strategy, in terms of execution and outcome, was successful. Has the move towards more frequent measurement, i.e. quarterly valuations, encouraged shorter-term benchmarking? Indeed, have we already seen a pushback against this in recent years?

12.3. The hazards

It was clear from our survey that the main problem/hazard faced when choosing a benchmark was in ensuring transparency. Sample degradation was an important issue, as was the confidence in the metrics provided. (See Figure 12.2, which lists the most important hazards when defining and implementing effective real estate benchmarking policy, as perceived by those interviewed in our survey.)

"The key though is acceptability, transparency [sic]. Does it reflect the strategy? Is it generally accepted and is it affordable?" *Consultant*

Figure 12.2: Hazards in Defining and Implementing Effective Benchmarking Policy



It was also apparent from our discussions that regulatory issues, particularly concerning the recent EU Benchmarks Regulation (BMR) Directive, need clarification. Whilst the BMR directive was discussed in detail with some investment houses, it was not seen as a major issue for most organisations. It was acknowledged that there could be an issue in using unregulated benchmarks where performance fees were involved. The broad consensus was for an agreed industry response and those investors most concerned with the issue have already instigated appropriate action.

12. DISCUSSION

While appraisal-based indices, such as MSCI, dominate the provision of market-based benchmarks in the UK, they are not without their problems. In addition to the long-debated concerns around the impact of valuation smoothing on reported figures, there were some specific concerns raised in our survey around issues such as the lack of transparency when the components of a benchmark change, the degradation of samples as markets change and the effectiveness of designated risk measures. There were also issues around the timeliness of delivery, particularly in relation to data availability of other asset classes, and in some of the stated definitions of property data, which gave a degree of ambiguity as to how contributing funds construct their data submissions. It was suggested that this final point could open the door to manipulation/cherry-picking.

Concerns were raised as to the effective monopoly status MSCI hold on the provision of unlisted benchmarks in the UK market. These concerns expressed by interviewees, however, are not only relevant to MSCI. They would also apply to organisations such as NCREIF in the USA and INREV/ANREV in terms of fund level benchmarks. To a certain extent, this reflects 'the nature of the beast' in establishing a pooling of the data required to produce the benchmark measures, particularly when based on asset level metrics.

Notwithstanding these issues, it is clear from the project survey that MSCI/IPD remains the index of choice when constructing market benchmarks in the UK. It is notable that many industry practitioners in roles ranging from fund management, research and strategy have direct experience of being employed by MSCI/IPD. This provides a forum to address some of these issues and adapt the product for a changing world.

13. THE FUTURE

As for the future, **"the challenge is to design a system which can cope with changing market conditions and that delivers a good balance between the measurement and attribution of performance that adequately captures both risk and return"** *Consultant*. It was suggested on number of occasions that there ought to be different remuneration structures and consideration of investment performance in a wider sense'. One consultant suggested constructing a metric, which could be seen as 'an industry wide performance score'. This metric would explicitly capture risk and return, the position of the portfolio in the contemporary real estate cycle and incorporate a greater emphasis on longer term performance than has been the case to date.

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

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

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

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