Benchmarks and measuring performance – what is changing?

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The question of how to benchmark and measure the performance of a real estate portfolio is not a new one. However, it is a topic that is attracting increasing attention as the real estate market becomes more sophisticated and the number and type of products continue to grow. The aftermath of the Global Financial Crisis (GFC) has really focus investors' minds on this, not least what impact the use of different benchmarks may have.

To review the changes in benchmarking and the reasons for these, the author invited Stephen Elliott of Royal London Asset Management, Dan Batterton of Legal & General Property and Charlie Ferguson-Davie of Moorfield, to a round table meeting. The members of the group, therefore, cover advice to institutional investors, managing UK open-ended balanced funds, sector specialist funds and absolute return value-add/opportunistic funds. The following is a record of their discussion.

What recent trends are we seeing among investors and in what aspects of benchmarking and performance measurement are they most interested?

Abbott: If I go back to pre-GFC times, the vast majority of real estate portfolios were benchmarked against some sort of IPD index. Exactly which one would depend on the type of mandate, including its size, risk profile and structure (pooled or separate account). While it is undoubtedly the case that IPD continues to dominate the landscape, we have seen a definite increase in the number of our clients who are looking to move away from IPD to a more 'absolute' return benchmark. A lot of our clients who have separate accounts (either direct or multi-manager) are moving towards RPI+ targets in order to allow a longer-term view to be taken and to allow their managers more freedom in constructing portfolios. This approach also tends to focus the mind when it comes to investing in (or avoiding) more volatile sectors and searching for those assets which are more likely to deliver inflation-linked cash flows, either explicitly or implicitly.

Elliott: As manager of an open-ended UK balanced fund, benchmarks have always presented an unsolvable problem. Even prior to the GFC, there were questions as to the most appropriate method of performance assessment and which was best – relative or absolute. Most institutional UK investors task their fund managers with achieving a return in excess of the market, which by default is evaluated with reference to an IPD/MSCI index. In the absence of an alternative, this does remain the best assessment of balanced pooled real estate products.

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The period of assessment is an area that requires change; removing the focus on short-term performance and realigning the interval of assessment more closely with the long-run nature of the asset. The target of a market return over a five-year time horizon would provide reduced volatility for investor returns.

Batterton: The cyclicality of investors' approach to property and the rationale for investment in it mirrors the underlying investment market. The GFC, low interest rates and a search for income has led to a reappraisal of what property offers as an asset class and therefore what benchmarking is appropriate. Benchmarking is not simply a way of assessing a manager's success; it helps structure the strategy of the respective fund and communicate this to investors. There can be a wide range of reasons for investing into commercial property, including diversification, inflation hedging, growth, income and capital protection. Investors must commit to funds where the strategy and benchmark aligns with their own rationale for being in the sector.

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The extreme highs and lows of returns through 2005-09 have greatly increased investors' focus on benchmarking. The market highlighted strategy 'creep', as well as the payment of often significant performance fees where financial skills rather than property skills were delivering returns. All of this despite benchmarks being linked to the property market.

Ferguson-Davie: Moorfield manages closed-ended private equity vehicles with a value add/opportunistic strategy and our investors have typically been interested principally in absolute returns, rather than relative returns, for the purpose of measuring and rewarding performance. For most private equity vehicles this means having a hurdle IRR, which needs to be exceeded before the manager can share in the profits generated by the fund. I have seen these hurdles range from 6% to 11%, depending on the targets for the fund, the share of the excess received by the manager and whether there is a 'catch-up' or not.

There are a range of different types of investors that will invest in private equity funds and each has a different view on what the right performance measurement should be. I would say that the trend overall is away from catch-up structures and towards lower hurdles. This is perhaps due in part to a desire from many investors for lower risk and a greater focus on profit multiple, rather than just IRR. The shift is gradual though and driven to some degree by thought being given to what activity and investment strategy the performance benchmarks drive; high IRR hurdles can encourage managers to take greater risk and use higher leverage, as well as to hold investments for a shorter period of time at the expense of profit multiple.

IPD is seen as the key UK real estate benchmarking service by the majority of investors. Should this continue being the case? Does its use result in optimal portfolios or are there better ways of delivering performance for clients?

Abbott: IPD is undoubtedly changing with the increased amount of cross-border capital which is coming over to invest in the UK. I suspect this is most prevalent in central London and the proportion of this market covered by the IPD index is likely to be falling. However, it remains the best measure we have and, as such, is the go-to barometer for many of our clients. Even those clients who have RPI+ benchmarks like to see how their managers are doing relative to the IPD (which can cause issues in itself).

In terms of building optimal portfolios, whether IPD is used or not, we like to see managers who show a high level of conviction in their strategies and are effectively operating in a more unconstrained way. Risk can be measured and managed in many different ways and looking at risk relative to IPD is not necessarily all that meaningful. Real estate is a long-term asset class and using a long-term, absolute return benchmark can also lead to a lower level of transactions, reducing the negative impact of transaction costs on performance.

Elliott: Given the heterogeneous nature of real estate, trying to construct a portfolio that mirror a chosen IPD /MSCI benchmark will not produce market outperformance. The key to outperformance is individual stock selection, coupled with active asset management, particularly over a period of assessment in excess of five years. Whilst an IPD/MSCI benchmark will at a high level provide a total return (TR) assessment, investors typically will be attracted to real estate by the relatively stable income return delivered. As we witnessed during late 2007 onwards, capital values fluctuate in line with economic market forces (as in most markets) and perhaps a separate assessment on maintaining durable but increasing income stream should be undertaken outside a total return calculation.

Batterton: IPD collates information of properties and tenants for over 200 UK-focused commercial property portfolios. The majority of these funds are intended to provide unleveraged long-term exposure to the sector, designed for life and pension investors looking for market performance. IPD remains highly relevant for these funds.

Whilst the 'benchmark tracking' investors are likely to remain the majority, there are an increasingly significant number of private equity style investors looking to invest within, rather than throughout the cycle, and also looking for strategies focused on inflation, income or growth. These strategies often have leverage and may also allow for the use of derivatives.

Since the GFC, we have designed a number of funds with a two-tier benchmark approach. Investors are looking for fund managers to exceed market returns at a property level, but equally recognise that the end investor receives a return net of costs and the impact of leverage. Our private equity style funds have an initial hurdle of outperforming the market in an unleveraged 'IPD' basis. There is then a secondary hurdle, often absolute, which is a target return net to the end investor. The aim is to stop leverage being a free ride in a rising market as property skills have to be the cornerstone to the delivery of any strategy.

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Ferguson-Davie: We benchmark our performance against IPD as it is seen as a proxy for market performance and because we are aiming to outperform the market and deliver 'alpha' returns. However, IPD does not provide a perfect comparison; our investments are typically leveraged and we will incur transaction costs and tax. The IPD dataset may also not be perfectly correlated to the investment being compared and so calculating the true 'alpha' performance is not easy.

Investors will also look at our performance relative to that of the listed sector property companies, the funds that other private equity managers have delivered and other asset classes. Whilst performance relative to IPD is a helpful tool, I do not think it should be considered the only one and the overall track record of the manager over an extended period should be the main area of focus.

Where do you feel the industry is moving to when it comes to benchmarking? What would you like to see happen?

Abbott: I have spoken a lot about RPI+ benchmarks. Unfortunately, these are only available to investors with separate accounts. I would like to see some pooled funds adopting this approach as up until now all of them use only the IPD Pooled Property Funds Index. This would offer investors greater choice. In all likelihood these funds will have dual benchmarks (as investors will still want to see performance relative to IPD). However, I feel that a move towards more unconstrained real estate investing could have significant benefits for investors and would enable investment managers to invest in a high conviction manner. I am sure this would be welcomed by clients and managers alike.

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I also think it is important for our clients to think about why they are investing in real estate as the asset class can now play different roles and, because of this, the choice of benchmark becomes less straightforward.

Elliott: We have seen the globalisation of benchmark reporting across all asset class and IPD is now incorporating this into to real estate indexes to provide a level of consistent comparison. The link between the performance of the direct UK real estate market and that of the UK economy as a whole is crucial. This is particularly so during periods of economic growth, where increases in rental levels across UK real estate will outstrip RPI or CPI measures, providing an enhanced return when assessed against an indexed-based benchmark. The best method of assessment for direct UK real estates remains a relative benchmark, as currently provided by IPD.

Batterton: Perhaps in the longer term we will see the creation of investable benchmarks. The heterogeneous nature of the asset class has always been a restriction to investors as it is not possible to buy the market – a problem for those building model portfolios. The Pooled Funds Index is a great step forward, but investable benchmarks could widen the appeal of the sector. The next step of the benchmark evolution is then smart beta.

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Ferguson-Davie: I think investors expect greater transparency and this extends to all areas of activity – certainly track record and reporting. I would like to see investors and managers be more transparent about the performance of investments from acquisition to disposal (or current value if not yet sold).

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Looking at quarterly or annual valuation movements relative to IPD, when the valuations are not necessarily perfect and neither is the correlation to the IPD Index, should only be part of the benchmarking and performance measurement practice. It should be possible to show the performance of each investment (and in aggregate) from acquisition to disposal (or current value), as well as the change in value between periods.

Benchmarking that forces institutional investors to increase or decrease exposure to a particular sector can exacerbate market movements and may risk promoting portfolio decision making at the expense of doing the right thing at the asset level. Having said that, this is often the source of opportunity for investors like Moorfield, so perhaps I should not encourage any change at all!