Henderson Global Investors 1999: Institutional Investments in Real Estate

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This case presents the issues facing Henderson Global Investors as it restructured three closed-end commingled real estate funds. This case provides the instructor with the opportunity to cover a variety of topics: a review of modern portfolio theory, including how to calculate the basic statistics that underlie the theory; an historical perspective on asset class returns, examining how stocks, bonds, and real estate performed as asset classes during the last twenty-five years of the twentieth century; an introduction to institutional investments in real estate, including why institutional investors should add real estate to an existing stock-and-bond portfolio, and what investment vehicles are available to accomplish this.

Focus

The objective this case is to present the issues facing Henderson Global Investors as it sought to restructure three closed-end commingled real estate funds. In addition to integrating ten new properties into the three funds, Henderson's portfolio manager would have to satisfy the changing objectives of six institutional investors involved in the proposed transaction. Using this case, the instructor will have the opportunity to cover a variety of topics: a review of modern portfolio theory, including how to calculate the basic statistics that underlie the theory; an historical perspective on asset-class returns, examining how stocks, bonds and real estate performed as assets classes during the last twenty-five years of the twentieth century; an introduction to institutional investments in real estate, including why institutional investors should add real estate to an existing stock-and-bond portfolio, and what investment vehicles are available to accomplish this.

Setting

The case opens as Jay Martha, Henderson's portfolio manager, ponders his options. Martha is responsible for three apartment portfolios, two of which are closed-end commingled real estate funds (CREFs), the third is a separate account. Ownership of the three portfolios is spread across six institutional investors. All six participated in the establishment of the three funds. A very interesting issue revolves around the relative degrees of leverage in the portfolios. The decision facing Martha is how to restructure the three portfolios in order to take advantage of an investment opportunity: the purchase of a ten-property portfolio from a failed life insurance company, which includes three ''sister'' properties of assets in the initial apartment fund. Martha would like to combine the sister properties to achieve economies of scale. Complicating this

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task is the fact that the fund is closed-end; all six investors must unanimously agree to any changes in the fund.

Exhibits

Case exhibits include historical returns for stocks, bonds, and commercial real estate, as well as for the four major types of commercial real estate (office, retail, industrial, and apartment); information on the investments in the three commingled real estate funds by the six institutional investors; and details regarding the properties in each of the CREFs and in the newly acquired portfolio of Mutual Benefit properties that must be integrated into the three CREFs. The formulae for calculating the risk and return of a two-asset portfolio are included to facilitate student response.

Availability

The case study and teaching notes are available from the editor of the *Journal of Real Estate Practice and Education*, William Hardin III, Florida International University, Department of Finance and Real Estate, 11200 SW 8th Street, RB 208-B, Miami, FL 33199 or hardinw@fiu.edu.

Teaching Notes

The teaching notes present a teaching plan that covers a review of modern portfolio theory; an historical perspective on how real estate has performed as an asset class when compared to stocks and bonds; an introduction to institutional investment in real estate and to the available investment vehicles, including discussions of ERISA, the ‘‘four quadrants,’’ and CREFs. It also includes a set of suggested teaching questions and solutions. Finally, the teaching notes outline how Henderson’s portfolio manager actually dealt with the portfolio restructuring.

Introduction

In May of 1999, Jay Martha sensed an opportunity. As property manager for Henderson Global Investors, an international investment-management company, he had been pursuing for several years three properties owned by Mutual Benefit, a large life insurance corporation that was in liquidation. These properties were ‘‘sister’’ phases of existing assets in two of Henderson’s commingled real estate funds (CREFs), which it managed on behalf of six different pension funds.[1,2] Were Henderson able to acquire these three properties, it could unlock significant value for its clients by combining properties in the multi-phase developments. At the same time, such acquisitions would expand the value of assets under Henderson’s management—the basis upon which Henderson was compensated.[3]

Mutual Benefit Life Insurance Company had been taken over by state regulators in 1991 after taking heavy losses on investments in ‘‘junk bonds.’’ Since 1991, regulators had been slowly liquidating the assets of the insurance company in order to pay off policy-holder claims. Joe Townsend, a trustee in charge of liquidating Mutual Benefit’s real estate assets, had just offered Martha a deal whereby Henderson could purchase the three properties it coveted, but only as part of a package that included seven additional properties in which Henderson had not been interested previously. All of the properties were heavily levered with bonds issued under the ‘‘80/20 Program.’’[4] Consequently, there would be little equity involved in a sale of the properties. However, Townsend’s compensation package was tied to liquidation of Mutual Benefit’s assets, so he was motivated to unload as many properties as possible to Henderson. By packaging attractive properties with unattractive properties, Townsend also would be able to avoid selling individual properties at a loss, and would have a better chance of unloading the least desirable properties from Mutual Benefit’s portfolio.

To seize this opportunity and obtain the three sister properties that Henderson had been pursuing, Martha would have to find a way to restructure Henderson’s existing CREFs that would integrate all ten of the Mutual Benefit properties. This was going to be exceedingly difficult because the two CREFs involved were finite-life, closed-end funds that were not scheduled for liquidation until 2007. There were no provisions for early liquidation or restructuring, so Jay would have to obtain *unanimous* approval from all six of the pension-fund investors involved in the two funds.

Real Estate as an Institutional Investment ‘‘Asset Class’’

Prior to the 1970s, real estate did not exist as an identifiable institutional investment ‘‘asset class.’’ Instead, the portfolios of institutional investors such as pension funds consisted almost exclusively of stocks, bonds, and cash. This situation changed during the 1970s, as two fundamental developments led to the emergence of real estate as an institutional investment asset class: modern portfolio theory and the Employee Retirement Income Security Act (ERISA) of 1974.

Modern Portfolio Theory

The first of these developments was the emergence of Modern Portfolio Theory (MPT) as the reigning paradigm in finance. The key principal of MPT is the importance of diversification, which leads to a linear relationship between risk and expected return. Academics and practitioners applied the mathematics of MPT to historical returns on differing groups of assets and found that real estate had a low correlation with stocks and bonds and high correlation with inflation. These statistics made it an ideal candidate for inclusion in a mixed-asset portfolio. By allocating a portion of their stock-and-bond investment portfolio to real estate, pension funds could increase the risk-adjusted returns on their investments while, at the same time, hedging against inflation (Exhibit 1a). Martha often used these data to demonstrate to clients why they should include real estate in their investment portfolios. Martha used similar data on returns from individual property types (Exhibit 1b) to demonstrate the need to diversify across apartment, industrial, office, and retail properties in order to obtain the portfolio real estate returns that work well in diversifying a stock-and-bond portfolio.

ERISA

The second fundamental development leading to the development of real estate as an asset class was passage of the Employee Retirement Income Security Act (ERISA) of 1974. ERISA set forth minimum standards for private pension funds, including the ‘‘prudent man’’ rule. The prudent man rule requires fiduciaries such as pension funds to manage their investments ‘‘with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.’’

In light of the MPT, evidence on real estate returns, many argued, and pension funds agreed, that institutional investors would be in violation of the prudent man rule unless they included real estate as a significant part of their investment portfolio.

Vehicles for Institutional Investment in Real Estate

Institutional investors can participate in the real estate market by purchasing debt or equity either in the public or private capital markets. These distinctions gave rise to the idea of the ‘‘four quadrants’’ of real estate capital market activities. The four quadrants refer to the elements of a two-by-two matrix defined by public versus private ownership and debt versus equity ownership. This concept gained traction in the mid-1990s as the markets for Real Estate Investment Trusts (REITs) (public equity) and Commercial Mortgage-Backed Securities (CMBS) (public debt) took off.

Exhibit 1a
Historical Returns on Institutional Investment Asset Classes: 1975–1992

Year	Stocks	Bonds	Real Estate	CPI
1975	37.2	14.6	8.8	7.0
1976	23.8	18.7	10.3	4.8
1977	−7.2	1.7	15.2	6.8
1978	6.6	−0.1	16.0	9.0
1979	18.4	−4.2	20.7	13.3
1980	37.4	−2.8	18.1	12.4
1981	−4.9	−1.2	16.9	8.9
1982	21.6	42.5	9.4	3.9
1983	22.4	6.3	13.2	3.8
1984	6.1	16.9	13.1	4.0
1985	31.6	30.1	10.0	3.8
1986	18.2	19.8	6.5	1.1
1987	5.2	−0.3	5.4	4.4
1988	16.5	10.7	7.2	4.4
1989	31.4	16.2	6.1	4.6
1990	−3.2	6.8	2.3	6.1
1991	30.6	19.9	−5.6	3.0
1992	7.7	9.4	−4.3	2.9
Mean	16.63	11.39	9.41	5.79
Std. Dev.	14.25	12.36	7.15	3.27

Correlations	Nominal
Stock-Bond	0.403
Stock-R.E.	−0.076
Bond-R.E.	−0.379
CPI-R.E.	0.707

Notes:
Rates of Return and Inflation:
(1 + nominal rate) = (1 + real rate) * (1 + inflation rate)
Two-Asset Portfolio Statistics:
Portfolio Return: $r_P = w_B r_B + w_S r_S$
Portfolio Variance: $\mathrm{VAR}(r_P) = w_B^2 SD_B^2 + w_S^2 SD_S^2 + 2 w_B SD_B w_S SD_S \rho_{BS}$
Portfolio Standard Deviation: $\mathrm{SD}(r_P)$ = square root of $\mathrm{VAR}(r_P)$

Where: w_B + The portion of the portfolio invested in asset S;
r_B = The average return on asset S;
w_S = The portion of the portfolio invested in asset D;
r_S = The average return on asset D;
SD_B = The standard deviation of returns for asset B;
SD_S = The standard deviation of returns for asset S; and
ρ_{BS} = The correlation between the returns of assets S and B.

Exhibit 1b
Historical Returns on Commercial Real Estate: 1978–1992

Year	All	Apartment	Industrial	Office	Retail
1978	16.10	16.96	14.12	21.25	10.93
1979	20.46	31.76	19.01	19.60	11.24
1980	18.09	18.69	16.28	25.99	12.78
1981	16.62	13.75	17.55	20.24	11.03
1982	9.43	15.57	9.82	9.82	7.02
1983	13.13	18.85	12.77	12.73	13.84
1984	13.84	13.12	13.36	12.40	16.90
1985	11.24	11.59	12.24	9.05	14.40
1986	8.30	7.10	8.68	5.70	12.52
1987	8.00	6.94	9.88	3.97	12.38
1988	9.62	10.34	9.89	5.98	14.94
1989	7.77	8.82	8.75	4.15	12.53
1990	2.30	5.80	1.95	−1.06	5.96
1991	−5.59	−1.35	−3.87	−11.44	−1.86
1992	−4.26	1.72	−4.47	−8.05	−2.25

The Four Quadrants

	Debt	Equity
Public	Mortgage-Backed Securities	REITs
Private	Mortgage Loans	Direct Investments Separate Accounts/CREFs

Initially, pension funds had only one option for investing in real estate: direct investment by purchasing and managing a portfolio of properties. Pension fund advisors quickly developed alternatives to this cumbersome form of direct investment that enabled pension funds to avoid having to deal with the day-to-day concerns of managing a real estate portfolio. These alternatives included real estate separate accounts, CREFs, REITs, and MBSs.

As the name suggests, a separate account is an investment vehicle for an individual pension fund (known as the fund sponsor) that is managed by a pension fund advisor. In fact, the advisor firm holds title to the assets in the account, but the cash flows from the assets pass through to the investor/fund sponsor. This enables the investor to obtain the financial benefits of real estate ownership without the exposure to the direct risks of ownership, such as property management, leasing, etc. In addition, the investor can delegate some or all of the investment decisions to the advisor/fund manager. In order to be adequately diversified within real estate, a separate account would need to own a number of properties, each valued at several million dollars. Consequently, separate accounts are best suited for very large investors who can allocate millions of dollars to an account. Separate accounts fall in the private equity quadrant of the real estate financing matrix.

A CREF is a special type of separate account that ‘‘commingles’’ the investments of several pension funds in a single portfolio of real estate assets. The pension funds then share the income and capital appreciation return from the portfolio, while paying a management fee to the advisor. Typically, this fee is between 50 and 100 basis points of the value of assets in the portfolio. There are two types of CREFS: open-end and closed-end. Open-end CREFs are ‘‘open’’ to entry and exit by pension funds based upon quarterly appraised values of the fund’s portfolio. Closed-end funds are open only at the time the fund is created and have a finite life, at the end of which the assets are liquidated and proceeds are distributed to pension fund investors on a pro rata basis. The primary advantage of CREFs over traditional separate accounts is that an investor can participate with a much smaller investment. Hence, an investor can diversify across a number of CREFs that might specialize in individual property types, for example. As a separate account, the CREF falls into the private equity quadrant.

The public equity quadrant of the matrix is occupied by the REIT, a tax-favored publicly traded corporation that must invest primarily in real estate assets and pay out most of its net income in the form of dividends.[5] Like CMBSs, REITs have grown from a very small base during the early 1990s, reaching a market capitalization of about $150 billion in 1999. However, this was still small relative to the investment needs of pension funds.

The private debt quadrant of the matrix typically has been occupied by commercial banks, thrift institutions (savings-and-loan associations and savings banks), and life insurance companies. These financial institutions invest directly in real estate debt by extending construction and permanent loans on real estate properties. When real estate values plummeted during the late 1980s and early 1990s, these institutions lost tens of billions of dollars and many went bankrupt. The decline in the value of commercial real estate was one of the primary causes of the savings and loan crisis. Losses forced these institutions to scale back their role as providers of commercial real estate funds. This opened the door for the emergence of the REIT and CMBS markets.

The public debt quadrant of the real estate financing matrix is occupied primarily by MBS.[6] A MBS is a publicly traded debt security collateralized by a pool of mortgages on residential or commercial real estate. Often the pool receives credit enhancement in the form of a guarantee of repayment by a third party. Fannie Mae and Freddie Mac, two government-sponsored enterprises set up to facilitate the development of the secondary mortgage market, issue most of these guarantees, but some are issued by private mortgage insurers.[7] The market for MBSs is extremely large and very liquid, with more than $4 trillion in outstanding securities as of year-end 1999. By comparison, the market for CMBSs is relatively small with only $300 billion in outstanding securities as of year-end 1999.

Henderson Global Investors

Henderson was founded in 1934 to administer the estates of Alexander Henderson, the first Lord Faringdon, and has been managing pension funds since 1974. The company went public in 1983 and, in 1992, acquired Touche Remnant, establishing the firm as the largest investment trust manager in the United Kingdom. In March of 1998, Henderson was acquired by the Australian firm AMP and integrated with AMP's Australasian and U.K. management operations as Henderson Global Investors.

Henderson Global Investors is headquartered in the U.K., but its offices span five continents: North America, South America, Europe, Asia, and Australia. The head office is located in London, while its U.S. presence is centered in Chicago. Henderson is a global fund manager with expertise in numerous asset classes, including stocks, bonds, and real estate. The firm has been advising pension funds for more than forty years.

Pension fund advisors such as Henderson make their money on fees paid by fund clients. Fees are collected for purchasing and disposing of fund assets, as well as for managing the assets. Typical management fees are based on the value of the fund's portfolio of assets and range between 50 and 100 basis points per year, paid on a monthly or quarterly basis.

The Real Estate Funds

Casa Group

Casa Group was a closed-end CREF that owned a tax-exempt and unlevered portfolio of ten suburban garden-style apartment properties with an appraised value of $120 million as of May 1999. The properties were owned in fee-simple and were unleveraged. The average age of the properties was seven years and the average occupancy rate was 94%. The properties were institutionally managed and maintained. The properties were purchased from the general account of Cardinal Life. The fund closed in December of 1993 with six investors (Exhibit 2).

The ten properties were geographically diversified across five states in the U.S.: Texas (five properties valued at $61.8 million), North Carolina (two properties valued at $22.9 million), Minnesota (one property valued at $18 million), Indiana (one property valued at $12.1 million) and Colorado (one property valued at $4.9 million). Two of the properties—Logan's Mark and Chatham's Mark—were sister properties to assets in the Mutual Benefit portfolio (Exhibit 3).

As was typical for asset managers, Henderson was compensated based upon a percentage of the value of assets under management. Henderson's compensation as asset manager for Casa Group was 12.5 basis points per quarter times the lesser of the quarterly appraised value or the acquisition cost (including debt) of the portfolio. In addition, Henderson was entitled to a disposition fee for each property sold out of the portfolio if the return on that property exceeded a guarantee in real terms of 6%.

Exhibit 2
Fund Owners

	Casa Group		Casa 94		Canyon SA	
Investor	% of Fund	Total Investment	% of Fund	Total Investment	% of Fund	Total Investment
Northwest	19.64%	$21,426,411	45.00%	$37,748,035	0.00%	
Pacific	22.32%	$24,350,873	0.00%		0.00%	
Desert Life	9.22%	$10,055,434	0.00%		0.00%	
Buckeye	13.82%	$15,083,150	0.00%		0.00%	
Cardinal Life	10.00%	$10,910,134	10.00%	$8,388,804	10.00%	$5,611,341
Canyon	25.00%	$27,275,334	45.00%	$37,748,181	90.00%	$50,502,069
Total	100.00%	$109,101,336	100.00%	$83,885,020	100.00%	$56,113,410

Exhibit 3
Casa Group Properties

	Property	Address	Units	Property Value
1	Logan's Mark	Irving, TX	252	$11,400,000
2	Conservatory	Minnetonka, MN	318	$18,000,000
3	Lemay Lake	Eagan, MN	282	$15,500,000
4	Chatham's Mark	Irving, TX	260	$10,600,000
5	Hunt's View	Greensboro, NC	240	$11,000,000
6	Park at Wells	Austin, TX	304	$11,300,000
7	Enclave	Denver, CO	156	$4,933,054
8	Williamsburg	Dallas, TX	171	$13,200,000
9	Brookstone	Chapel Hill, NC	224	$11,900,000
10	The Springs	Indianapolis, IN	180	$12,100,000

This fee was equal to 10% of the excess cash flow for the first 100 basis points and 5% for each additional 100 basis points, not to exceed 30% of the excess cash flow.

Casa 94

Casa 94 also was a closed-end CREF that owned a tax-exempt portfolio of suburban apartment properties, but these properties were moderately leveraged in keeping with changing conditions in the commercial real estate market. Interestingly, the leverage on these properties took the form of 80/20 Program housing bonds similar to the ones used to leverage the Mutual Benefit portfolio.

The portfolio consisted of nine properties with an appraised value of $131 million as of May 1999, and an outstanding loan balance of $36 million. Casa 94 closed in May of 1995 with three investors, each of whom also participated in Casa Group: Canyon, Cardinal Life, and Northwest (Exhibit 2).

The nine properties were geographically diversified across five states in the U.S.: Texas (three properties valued at $38.4 million), Ohio (two properties valued at $40.4 million), Florida (two properties valued at $29.5 million), Virginia (one property valued at $11.8 million), and Georgia (one property valued at $10.7 million) Of particular interest was the fact that one of the three sister properties in the Mutual Benefit portfolio matched up with a property in the Casa 94 portfolio—Huntington (Exhibit 4).

Henderson's compensation for Casa 94 was rather unusual. Instead of receiving a percentage of assets under management, Henderson received 7% of the portfolio's cash flow after operating expenses but before debt service. This arrangement was intended to better align the interests of the asset manager with those of the investors.

Exhibit 4
Casa 94 Properties

	Property	Address	Units	Loan Balance	Property Value
1	The Wyndham	Hampton, VA	276		$11,800,000
2	Polo Club	Strongville, OH	336		$18,900,000
3	Remington Station	Westerville, OH	344		$21,500,000
4	Aspen Hills	Smyrna, GA	246	$8,600,000	$10,700,000
5	Tuscany Bay	Orlando, FL	396	$6,250,000	$15,550,000
6	Oakwood	Orlando, FL	304	$9,000,000	$14,300,000
7	Preston Village	Dallas, TX	326		$15,300,000
8	Huntington of N. Dallas	Dallas, TX	370	$12,305,000	$15,850,000
9	Sawgrass	Corpus Christi, TX	216		$7,250,000

Institutional investors are seeking to maximize cash flow whereas managers, under typical compensation schemes, are seeking to maximize asset value.

Canyon Separate Account Fund

In 1997, Henderson put together a third apartment fund in the form of a Separate Account for Canyon. Also participating in this fund was Cardinal Life, with a 10% ownership stake. Canyon held the remaining 90% (Exhibit 2). This fund held a high-risk/high-return portfolio, consisting of seven apartment properties valued at $111 million, but leveraged with $55 million in bond financing. Like the two Casa portfolios, the Canyon Fund portfolio was geographically diversified across five states (Exhibit 5).

Mutual Benefit's Portfolio

Mutual Benefit's portfolio consisted of ten apartment properties that were highly levered in the extreme. Average leverage was 92%, but some properties were levered in excess of 100%, so that the properties actually were worth less than the outstanding amount of their bond financing. Five of the properties were located in Texas, two each in Florida and California, with the remaining property located in Tennessee. Three of the ten properties were sisters to existing Henderson properties: Presidio Park was a sister to Logan's Mark and Champions was a sister to Chatham's Mark in Casa Group while Huntington was a sister to Huntington in Casa 94 (Exhibit 6).

Martha realized that integrating Mutual Benefit's highly levered properties into either Casa Group or Casa 94 would require that the leverage of the restructured funds increase significantly. This increased leverage would significantly increase both the risk and return of the funds. He wondered how receptive the fund investors would be to this proposed change in the risk/return profile of their investments.

Exhibit 5
Canyon Separate Account Properties

	Property	Address	Units	Loan Balance	Property Value
1	Belcourt	Roswell, GA	324	$13,600,000	$16,156,000
2	American Isuzu	Roswell, GA	223		$8,130,000
3	Pureland	Bridgeport, NJ	237		$7,744,000
4	Wood Chase	Norcross, GA	380		$18,750,000
5	Apple Creek	Omaha, NB	384	$11,100,000	$17,944,000
6	Woodlands	Orlando, FL	525	$20,000,000	$27,660,000
7	Newport	San Antonio, TX	258	$10,375,000	$14,577,744

Exhibit 6
Mutual Benefit Properties

	Property	Address	Units	Loan Balance	Property Value	Leverage
1	Arboretum Oaks	Austin, TX	252	$10,310,000	$13,400,000	76.94%
2	Rancho Corrales	Simi Valley, CA	229	$18,266,068	$25,700,000	71.07%
3	Mirada	San Diego, CA	444	$41,789,747	$49,800,000	83.92%
4	Arbors	Memphis, TN	384	$17,756,152	$15,000,000	118.37%
5	Los Prados	Plantation, FL	444	$31,508,244	$30,700,000	102.63%
6	Banyan Bay	Coconut Creek, FL	416	$26,052,255	$26,400,000	98.68%
7	The Vinings	Houston, TX	512	$21,910,000	$22,900,000	95.68%
8	Presidio	Irving, TX	252	$14,869,512	$14,700,000	101.15%
9	Champions	Irving, TX	264	$14,273,700	$15,200,000	93.91%
10	Huntington	Dallas, TX	180	$9,750,000	$9,710,000	100.41%

The Six Clients

1993

After the crash of the commercial real estate market during 1991–1992, when the total return on real estate was actually negative, Cardinal Life Insurance Company, a relatively small institutional investor, found itself paradoxically overexposed to equity investments in commercial real estate. This paradox came about because Cardinal Life had been an active lender in the commercial real estate construction loan market during the late 1980s. Following the collapse of real estate values in 1990–1991, Cardinal Life was forced to foreclose on a large number of delinquent construction loans. In so doing, Cardinal Life was forced to change its role from that of a creditor to that of an investor. The end result of these foreclosures was that Cardinal Life found itself with a much larger equity interest in commercial real estate than it deemed prudent.

Consequently, Cardinal Life actively sought to reduce its exposure. Henderson offered it an opportunity to do so by selling a large portfolio of apartment properties into a new commingled real estate fund that would be known as Casa Group. Cardinal Life decided to take advantage of this opportunity and sold off 90% of its interest in these properties, leaving it with a 10% ownership share of Casa Group. Henderson then resold the remaining 90% ownership interest in Casa Group to five institutional investors that each had its own motivation for choosing a CREF as a means for investing in real estate:

- Desert Life was another small insurance company that was seeking to increase its asset allocation to real estate, in general, and to apartments, in particular, but it was far too small to own a separate account. By investing in a CREF, it could invest in a relatively diversified portfolio of large apartment properties.
- Northwest Public Employees Retirement Fund was large enough to own a separate account, but lacked any significant experience investing in commercial real estate. By investing in a CREF, Northwest would be able to piggyback on the expertise of more experienced pension fund real estate investors.
- Pacific Teachers Retirement Fund, Buckeye State Employees' Retirement Fund and Canyon Public Employees' Retirement Fund each were large and experienced real estate investors; in fact, each had its own separate account. However, each was seeking additional exposure to real estate, in particular to the apartment sector. By investing in Casa Group, an apartment CREF, they were able to meet this objective.

1999

By 1999, conditions in the financial markets bore little resemblance to those observed in 1993, when the Casa Group fund had closed. The commercial real estate market had turned around in 1994, outperforming both stocks and bonds. From 1994 to 1998, real estate returns had increased each year, peaking at an annual rate of more than 16%. Because of this, real estate was back in favor among institutional investors. Stocks also had roared back during the 1995–1999 period, averaging almost 29% annual returns during this time. Investors, who tend to have short memories, had become accustomed to these double-digit returns and expected more of the same (Exhibits 6 and 7a,b).

From 1993 to 1999, the investment goals and objectives of the Casa Group investors also had changed in response to these developments in U.S. financial markets and in response to the differing obligations of their individual pension liabilities. Some investors had begun to pursue investment strategies that had a higher risk/return profile; some liked their original risk/return profile and wanted to maintain the status quo; and some were interested in liquidating their positions to pursue other strategies. Martha met with each of the clients in an attempt to gauge how they felt about going after the Mutual Benefit properties.

Exhibit 7a
Historical Returns on Institutional Investments: 1993–1999

Year	Stocks	Bonds	Real Estate	CPI
1993	10.0	13.2	1.4	2.8
1994	1.3	−5.7	6.4	2.7
1995	37.5	27.2	7.5	2.5
1996	23.3	1.4	10.3	3.6
1997	33.4	12.9	13.9	1.7
1998	28.8	10.8	16.3	1.6
1999	21.1	−7.5	11.4	2.7
Mean	22.20	7.47	9.60	2.51
Std. Dev.	12.85	12.23	4.98	0.69

Exhibit 7b
Historical Returns on Commercial Real Estate Investments: 1993–1999 by Property Type

Year	All	Apartment	Industrial	Office	Retail
1993	1.38	8.72	−0.75	−3.95	4.83
1994	6.39	12.07	7.65	3.92	6.01
1995	7.54	11.67	12.30	7.19	3.99
1996	10.31	11.54	13.56	13.57	4.86
1997	13.90	12.89	15.92	17.86	8.53
1998	16.24	14.09	15.86	19.62	12.90
1999	11.36	11.71	11.64	12.29	9.54

- Because of its pension obligations, Buckeye was seeking annual returns in excess of 20%; to achieve such high returns, Buckeye was moving into high-risk real estate investment, such as developments, hotels, and resorts. Even with the additional leverage available from infusion of the Mutual Benefit properties, the Casa Group portfolios would not be able to provide such lofty returns. Consequently, Buckeye would most likely have to be bought out by investors remaining in the funds, and indicated that it was open to this possibility.
- Canyon had established its own separate account for investing in levered properties; consequently, it was comfortable with the introduction of moderate leverage (loan-to-value in the 20% to 30% range) into Casa Group.
- Pacific expressed interest in achieving higher returns from its real estate investments; it also was comfortable with moderate leverage.

- Desert Life was a low-risk investor whose charter required that its investments have little or no leverage. If the restructuring required the use of leverage, then Desert Sands could not participate and indicated that it was amenable to being bought out by the other investors.
- Cardinal Life indicated that it was moving out of real estate, but felt that Casa Group had been an unusually good investment. Consequently, Cardinal Life was willing to hold on to Casa Group while reducing its exposure to real estate by liquidating some of its other real estate investments, even if the new portfolios were moderately leveraged.
- Largely through its participation in Casa One, Northwest had gained experience investing in the apartment sector that it had lacked in 1993; it still wanted exposure to the apartment sector, but now wanted a controlling interest in its investment.

Governance Issues

Complicating Martha's task was the closed-end structure of the three apartment funds. This precluded him from simply liquidating the funds and starting from scratch. The scheduled liquidation (termination) dates for the funds were several years down the road, so there were no automatic mechanisms for accommodating the investors whose objectives had changed. In addition, any changes to the funds' portfolios, such as infusion of the Mutual Benefit properties, would have to meet with the unanimous approval of affected investors.

Valuation of the existing assets also presented a challenge, as the investors clearly realized that any restructuring would involve the sale or transfer of fund shares among the six investors. Martha recognized the need to ensure that no individual investor benefited at the expense of another. At the same time, he needed to keep as many of the investors as possible interested in the restructuring, as Henderson's fee stream flowed from the value of assets under management.

Conclusion

Martha faced the challenge of developing a portfolio-restructuring plan that would satisfy a diverse pool of clients that had incompatible desires with respect to risk/return profiles. Specifically, he had to develop a plan for integrating the ten Mutual Benefit Properties into Henderson's existing three apartment funds that would meet with unanimous consent of the six affected clients. Placement of the three sister properties was straightforward, but where should the remaining seven properties go? How could he accommodate Northwest, which wanted control of its own portfolio? How could he accommodate Desert Life, which required an unleveraged investment? Finally, there was the issue of leverage. At the time, ''moderate'' leverage was considered to be loan-to-value ratios in the 20% to 30% range, while ''high'' leverage was in the 30% to 50% range. Portfolios with leverage much above 50% were considered too risky for institutional investors. Should some or all of the bonds be paid off? After all, Henderson was marketing real estate. Why should institutional investors be short in the bond market through their real estate investment while they are long in their traditional bond investments? Was there some way to reshuffle the properties comprising the four portfolios that would accommodate all parties? If not, as seemed likely, then who would need to be bought out by the remaining investors? Would the remaining investors be willing to commit new assets in order to buy out those wishing to leave and/or to keep leverage at acceptable levels? What properties would end up in which portfolios?

Endnotes

1. ''Sister'' properties are properties that are built in different phases of a large multi-property real estate development. When ownership of all sister properties in a multi-phase development are consolidated into a single entity, there are significant operating efficiencies to be gained, such as by consolidating common facilities, reducing onsite staff, and upgrading amenities. In addition, the single owner can ''gate'' the combined communities, making them more exclusive. Liability issues prevent gating when sister properties are owned by different entities. Also, it is more effective to upgrade the properties when all phases are owned by a single entity. This avoids conflicting ownership strategies, such as having one well-maintained and one poorly maintained phase of the same development.
2. CREFs are discussed in more detail later in the case.
3. CREF managers typically are compensated on the basis of some percentage (typically 1%) of the value of assets under management, where values are set on the basis of independent third-party appraisals.
4. The ''80/20 Program'' refers to a provision of the Federal Tax Code that enables states, counties, and municipalities to issue tax-exempt bonds with the proceeds used to help developers finance the construction of housing units, typically apartments. ''80/20'' refers to a program requirement that 80% of the units be rented at market rents and 20% of the units rented to low-income households at subsidized rates.
5. Statutory requirements for REITs can be found at: www.reitnet.com.
6. For more information about the market for mortgage-backed securities, go to www.mortgagebankers.org.
7. For more information about these entities, go to www.fanniemae.com and www.freddiemac.com.