Investment

VALUATIONS NETHERLANDS If real estate is to achieve its full potential, the Dutch pensions industry should implement quarterly valuations and transaction-based data, say **Boris van der Gijp** and **Paulus van Wetten**

Dutch need a truer reflection

The real estate industry is undermining its potential importance within investment portfolios by presenting an overly flattering risk-return profile through its widespread dependence on intermittent valuation data. Despite efforts made by the real estate industry over the past 20 years in providing comparable data to investors, it is still far too dependent on annual valuations.

The pitfalls of this approach were dramatically laid bare after 2008, when many institutional investors in the Netherlands and other markets suffered sharp drops in the value of their real estate holdings months after they took the 'real-time' losses on bonds and equities.

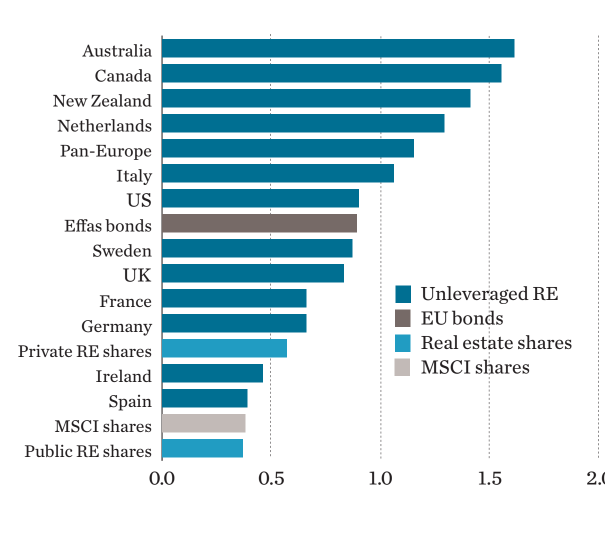
It was the real estate market's Road Runner moment: like the Coyote in the famous cartoon, sprinting off a cliff and being suspended in mid-air for a period of time before plunging straight down like a rock. This experience focused the attention of the Dutch regulator as well as institutional CIOs on whether the risk-return models that pension funds were using might be too detached from market realities. And without truly comparable real estate data, it is hard to convince CIOs of the important role it can play in the diversified investment portfolio.

Our research indicates that the data smoothing effects of annual valuations can be largely overcome in a two-pronged approach: moving from annual valuations to quarterly valuations and from valuation-based indices to transaction-based indices. Higher frequency and transaction-based indices more accurately reflect prevailing market conditions. Making real estate returns more comparable underpins the claim that the 'efficient frontier' for institutional real estate portfolio allocation should be in the range of 15-20%. This is significantly above the 10% allocation that Dutch pension funds have, on average, held in bricks and mortar over the past 30 years.

Unsmoothed investment returns from real estate in the Netherlands, Australia, Canada, and New Zealand have been among the highest and most stable in the world, particularly for residential assets, according to IPD. Between 1994 and 2013, residential real estate had the highest return per unit of risk, followed by retail, while offices delivered much lower returns.

This performance should be encouraging Dutch pension funds to increase their real estate allocations. This is particularly the case with the introduction of new discount rules for institutional liabilities in January 2015 under the Netherlands' Financial Assessment Framework (FTK), which governs the coverage ratios of pension funds and the capital weighting costs they need to apply to various asset classes.

Returns per unit risk



Source: IPD 1994-2013 in local currencies, unsmoothed, after management costs and fees

Under this legislation, pension funds must calculate their liabilities' coverage ratio/funding position each year relative to the required level of equity capital. It also extends the recovery period for a fund to restore its coverage ratio to 10 years from three years. This extension should provide more certainty and stability to institutional investment strategies and plays in real estate's favour, since the asset class offers equity-like risks for bond-like returns over the long term, despite its high risk weighting under FTK rules.

Against this general background, the optimal proportion of property within an institutional portfolio will be strongly determined by how the real estate is held: direct or indirect; leveraged or non-leveraged; listed or non-listed. While leverage offers the opportunity for extra returns, the risks increase more rapidly than the extra returns above a 24-30% gearing level.

Alongside the size and form of the real estate holdings, key factors that feed into institutional real estate investment strategies are control versus liquidity, and international diversification versus specialisation. The themes we identified fall into four main real estate strategies that Dutch pension funds pursue in practice.

- **Specialised in Dutch real estate:** This is popular with mid-sized pension funds that value control and supervision over their real estate portfolios. Returns are historically solid, while risks are low and manageable;
- **Diversification through multi-sector funds:** Indirect investments in multi-sector and multi-national funds with, on average, half of the portfolio in listed real estate. Popular with smaller pension funds that value liquidity more than control and supervision. There is a high amount of leverage, with more than average returns and risk;
- **Diversification through specialised funds:** The portfolio consists of sector or country-specific non-listed funds. This strategy is popular with smaller pension funds that value control over their investment strategy with regard to sectors and countries, more than liquidity. Listed real estate is a small, but strategic, portion of the portfolio. This approach delivers the lowest returns of the four strategies, but with controlled risk;
- **Combined strategy, directly within the Netherlands and indirectly abroad:** Only really large investors are able to combine the best of the three strategies. This approach delivers the highest returns and the most optimal relationship between risks and returns.

In an institutional regulatory system governed by risk-return metrics, the real estate investment industry needs to improve the accuracy and timeliness of its data. If necessary, this could be achieved by imposing obligatory quarterly valuations, despite the additional costs involved, and ultimately moving towards transaction-based indices that reflect actual values paid rather than from appraisals (see Transparency with transaction-led indices).

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Transparency with a transaction-based indices

The StiVAD (Real Estate Data Foundation) initiative by the largest Dutch real estate owners has now reached about 20% coverage of the €5.4bn in deals that were completed in the Netherlands last year. The foundation was set up in 2011 to provide a comprehensive transactions database targeting complete transparency in the domestic investment market.

StiVAD is being closely monitored by financial regulators and the market as the ultimate goal is to move to transaction-based indices from ones using appraisal values. Potentially, it will transform the Dutch real estate investment landscape by underpinning confidence in price and asset data, thereby boosting liquidity and ending the conflicts of interest inherent in the combined valuer and advisory roles of agents.

"Our aim is to provide as high a level of transparency in Dutch real estate as possible so that domestic and international investors are operating on a level playing field, with access to the same comprehensive information on deals that have actually been transacted in the market," says Pieter Jager, real estate economist and StiVAD manager.

StiVAD is a not-for-profit foundation and membership is open to Dutch property investors, such as pension funds, family offices and foreign investors, provided they share their deal information through the transactions database. It is not the intention that their own data will be sold back to them in the form of expensive market analysis, Jager says.

The database registers 50 key pieces of information on each reported investment transaction across all the property sectors, ranging from the price, to yields, vacancy rates and lease terms. This offers investors a more complete view of market trends than has been available before in the Netherlands and one that is based on actual deals.

"We want to establish a type of 'Kadaster Royale' and maybe, in the future, registration of all investment transactions will become obligatory for domestic and foreign investors," Jager says, referring to the Dutch Land Registry.

StiVAD was originally an initiative of the Dutch Association of Institutional Investors in Real Estate (IVBN) as a response to the lack of price information and to wide disparities in valuations in the market when liquidity had largely dried up in the wake of the global financial crisis. Another catalyst was the consequent sharp drop in valuations from one day to the next for previously solvent institutional real estate portfolios that occurred months after markets were obviously in free fall.

"Our aim is to provide as high a level of transparency in Dutch real estate"

Pieter Jager

StiVAD has attracted the attention of the pensions regulator, and the financial markets regulator, which want the investment market to be self-governing and to identify potential systemic risks to the financial system, because of the importance of property finance on bank balance sheets. Another key role of StiVAD is to act as a forum for market participants, such as investors, agents and accountants, to discuss market trends and regulations through organised expert meetings.

A move towards a transactions-based system might reduce fraud, which is inherent in a valuations-based approach, as a number of embezzlement cases has shown.

VALUATIONS INDICES New transaction-based indices could provide investors with more timely measurement of price. **Kenneth Yuen, Nigel Almond** and **Hans Vrensen** explain

Transaction indices launched

The real estate industry has long been reliant on valuation-based indices for measuring investment performance. Valuation-based indices are often criticised for their inability to show the volatility of price movements, as well as a lagging nature in displaying price movements. This has made it difficult to compare real estate with other asset classes, such as equities and bonds.

In order to address these issues, DTZ Research has recently launched Transaction-Based Price Indexes (TBPIs) for Europe and Asia Pacific. The TBPIs are constructed by measuring the price performance based on actual paired sales of transacted buildings. This is sourced from our extensive historical Investment Transaction Database (ITD).

Based on the latest TBPIs, we observe that European commercial property prices stabilised in Q2 2014. This followed a decline in the previous two quarters. Since the global financial crisis, the three regions have experienced different recoveries (figure 1). In particular, European real estate markets appear to be lagging both ►