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Staking Out Real Estate

This asset class offers many sub-sectors and ways to get into the market.

2002 AIC CONFERENCE ■ Queen's Landing, Niagara-on-the-Lake, Ontario

There is a growing interest in real estate as an alternative asset class among pension funds. This interest is being driven by the stock market's negative returns in recent years and the expected returns for fixed income in the near future.

Real estate provides diversification for a global portfolio. This applies to direct investments in properties and to a portfolio of real estate public equity, either listed real estate securities or real estate investment trusts (REITs). Real estate provides various benefits, including a low correlation with other asset classes, high current returns over the medium to long term and a hedge against inflation. As well, real estate investments are a good alternative to fixed income products when plan sponsors want to implement a partial immunization strategy.

Over the last decade, real estate has become more transparent. This is largely because defined benefit pension funds in Canada are now actively involved in this asset class, owning large portfolios of properties that represent up to 10 per cent of their total portfolio mix. Also, discipline is required by commercial mortgage-backed securities.

Plan sponsors wishing to invest in real estate need to address the issue of asset management if they cannot hire an internal management team. The choice of asset and portfolio managers is crucial to ensure that the investment strategy and product selection produce the desired performance over the long term.

Real estate cycle timing and acquisition price are also

important to consider. Owning a building means hiring a property manager for all operational matters and giving a mandate to an experienced asset manager. The manager will determine the best strategy to pursue for the building or portfolio. The duties handled by an asset manager include identifying the best timing for acquisition and disposition, positioning the properties in terms of their local environment as well as developing various assumptions for cash flow projections.

Although real estate is considered an asset class, it consists of different sectors. Analysis and selection of individual sectors are important. The office, industrial, commercial and residential sectors do not react in the same way, with the same amplitude or at the same time in a given market during a recovery or a recession. The cycles can also differ with geography.

Options to consider

Depending on the size of the pension fund, tax considerations, required liquidity and desired control, some real estate investment vehicles will be more suitable than others. They include REITs, funds, limited partnerships and direct ownership.

Despite the weaker real estate fundamentals in Canada, supply and demand are currently better controlled than they were at the beginning of the 1990s, and there is a lot of liquidity in the market. Pension funds that have over-allocated in the market are gradually disposing of certain assets in order to maintain the value of their investments. As well, the demand for real estate products is rising. Foreign investors are interested in the Canadian market, mainly in the business districts of major cities. As a result, the market values of properties have remained relatively stable in the last year.

Various options are available for pension funds wishing to invest in real estate, including direct and indirect equity vehicles that provide some of the benefits of real estate combined with greater liquidity. Plan sponsors wanting to move beyond traditional asset classes can choose from a range of strategies in today's real estate market. ■

