

ACTIVE VS. PASSIVE INVESTING IN PUBLICLY TRADED REAL ESTATE

Conventional industry wisdom seems to be that portfolios of publicly traded real estate securities (generically referred to as REITs) should be actively managed, as this is an inefficient market segment in which active management can be expected to add value. But is this belief grounded in fact or is it an invention? In the early 1990s, the handful of active REIT managers for which data is available in a popular fund database handily outperformed the index on average. We believe, however, that there is no inherent advantage to active management in this area. Thoughtful investors considering publicly traded real estate securities should think about using low-cost passive management (indexing), and choose a strategy just as they would when evaluating the pros and cons of active and passive management in the broader U.S. stock market. We recommend clients treat REITs no differently than their other publicly traded U.S. equity investments when making the active/passive decision.

Background

The Hatfields versus the McCoys, the Yankees versus the Red Sox, active versus passive management in the broad U.S. equity market—all great feuds, and opponents stand steadfastly on one side or another. Active versus passive management of publicly traded real estate securities has so far not received as much critical evaluation.

In the great debate of active versus passive management of U.S. stocks, we summarized our thoughts in a research paper titled *U.S. Equity Strategy*:

- Active management *adds value* for an investor if it achieves a return greater than that available through passive investment. To do this it must earn back its cost and then some. The principal costs are (1) investment management fees and (2) transaction costs. **The body of credible, impartial evidence indicates that active stock portfolio managers *do not* add value¹.** [Emphasis in the original.]

Is the situation different with respect to portfolios of publicly traded real estate securities? This is the

question we set out to answer. There seems to be limited research on this topic, although the question of active versus passive management in publicly traded real estate securities is becoming increasingly important as institutional investors continue to increase their allocations to real estate. The 2005 Greenwich Market Dynamics Report notes that 28% of defined benefit plans and endowments expect to make a “significant increase” to their real estate allocations in the next three years. Similarly, many defined contribution plan sponsors are choosing to make a publicly traded real estate securities fund available to their participants. One of the largest 401(k) plan recordkeepers reports that 12% of the plans it administers offered a real estate option in 2005, up from 3% in 2001.

Fees and Trading Costs

The question on whether publicly traded real estate securities investors, on average, beat the real estate market is not debatable. Collectively they cannot. For every buyer, there is a seller, for every winner, there is a loser. With no management fees and no trading costs, it is a zero-sum game. Including investment management fees and trading costs, it is a negative-sum game.

So how big of a hurdle does the average real estate investor have to overcome and how does this compare to a traditional stock investor? Our research indicates that institutional REIT managers charge an average of 83 basis points for a portfolio of \$25 million, which is very close to the average traditional stock manager fee of 80 basis points for a similarly sized \$25 million mandate. Therefore, the average annual management fee for an institutional REIT portfolio is as high a hurdle as is the average active traditional stock manager's fee².

Trading costs can be an even larger drain on performance, although they are not easily identifiable and are typically not routinely reviewed by most investors. Annual trading costs for an actively managed small-cap stock portfolio are estimated to be roughly 0.6%-1.2%, per year. The estimated trading costs for a REIT portfolio are estimated at 0.7% to 1.3%, per year³.

Our analysis, then, leads us to believe that the costs of actively managing a REIT portfolio (both the expected active management fee of 0.8% and the expected transactions costs of 0.7%-1.3%) present a high hurdle for active management. Passive vehicles typically charge expenses of 0.10% - 0.20% for REIT

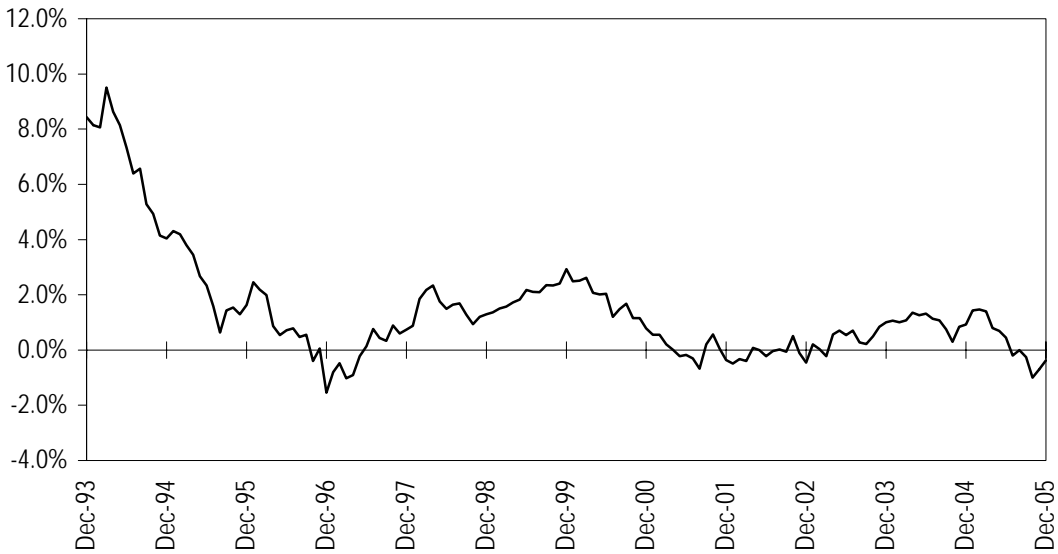
products. To put this differently, the cost savings that passive investments in traditional stock mandates enjoy appear to exist in the REIT market as well.

Historical Active Management Success/Failure

Active management may not be doomed to failure, though. The market could be segmented, and some investors may be more informed in their purchases and sales than others. REITs, for example, can be purchased both by a traditional stock manager (in a small cap value portfolio) and by a dedicated manager in a REIT portfolio. If the REIT-only portfolio manager has better access to information, that manager might be able to outperform. Similarly, if REITs are owned both by individual investors and institutional investors, the institutional investors might have better access to information.

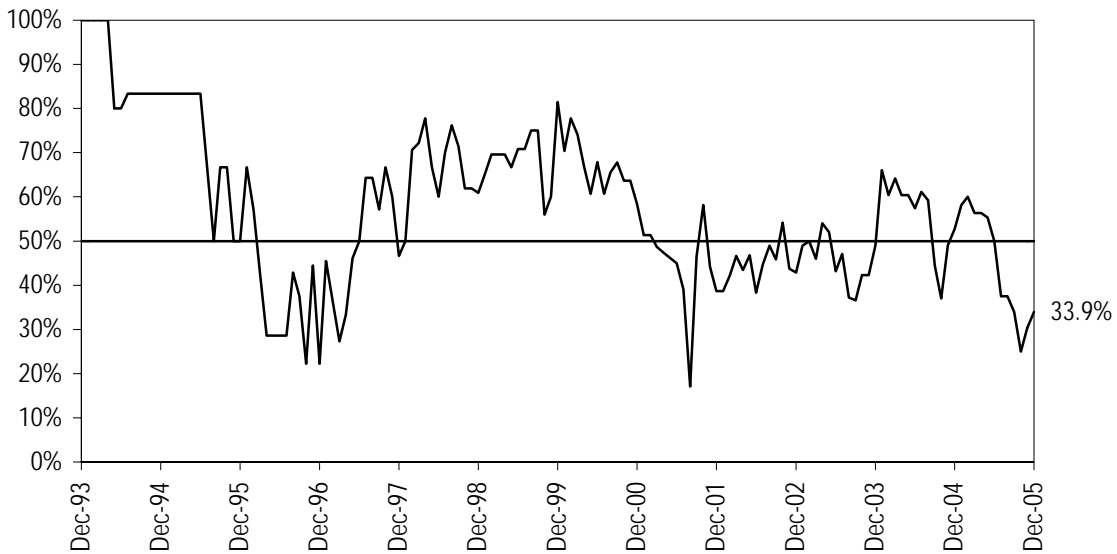
Has the average dedicated REIT manager historically outperformed the Index, after all fees and costs? Our results shown below indicate that the average REIT manager appeared to beat the index handily in the early 1990s, when the database consisted of only a handful of managers. Since then, performance has been mixed.

Average REIT Fund Trailing 3-Year Performance vs. DJ Wilshire Real Estate Securities Index



Source: Morningstar

Percentage of Managers Outperforming the DJ Wilshire Real Estate Securities Index Over Trailing 3-Year Periods



Source: Morningstar

What could explain the apparent success of the average active manager in the early years, and lackluster results since then? There are three possibilities that make the most sense to us.

1. Survivorship bias

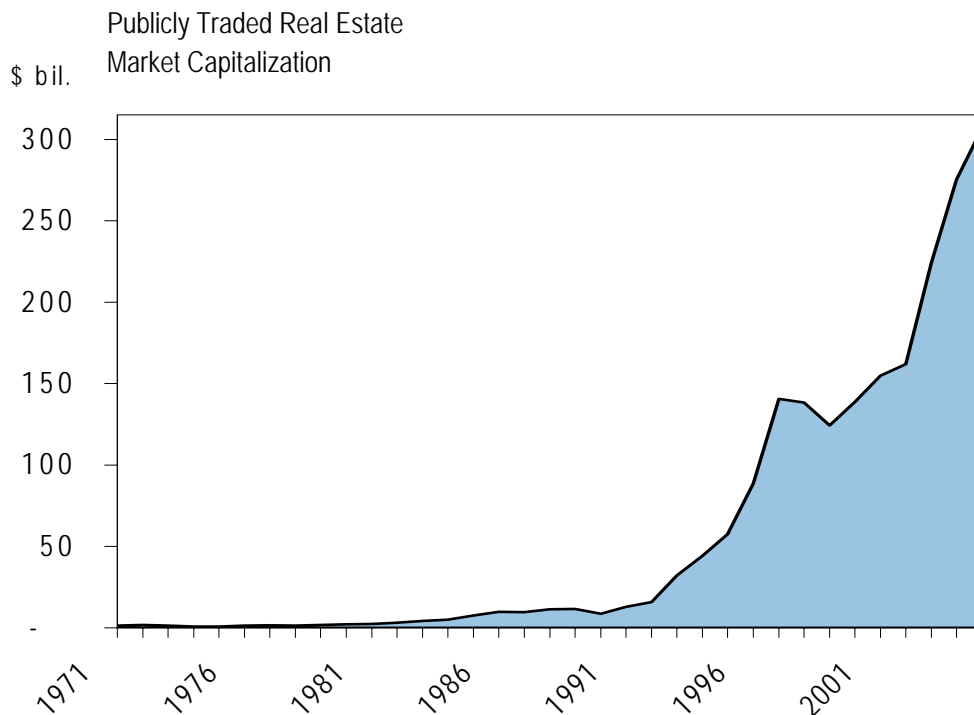
Survivorship bias can greatly distort historical universe performance, as poorly-performing funds often disappear through either liquidation or merger. If poor performers from the early 1990s were eliminated from the database, we would see only the better-performing managers who remained.

Standard and Poor's (S&P) publishes a survivorship bias-free study of active manager performance that includes REIT manager performance dating back seven years. The evidence in this database supports the hypothesis that many poorly-performing real

estate managers likely go out of business. Seven years ago, the database included 46 real estate funds. As of March 31, 2006, 13 of those funds had either liquidated or disappeared in a merger (for a 72% survivorship rate). S&P notes that during the seven year period only 39% of the REIT funds outperformed the S&P Composite REIT Index⁴.

2. Growth of the Publicly Traded Real Estate Market and Related Market Efficiencies

There has been tremendous growth in the publicly traded securities market. The market has seen increases in efficiencies gained through greater analyst coverage and more widely available and detailed information on the finances of the REITs. The exhibit below illustrates the growth in the publicly traded securities market



Source: NAREIT

3. Growth in Assets Under Management of the Most Successful Managers

It is often said that size is the enemy of active management. The more assets managed, the more difficult it is to find new inefficiently priced stocks for a portfolio, and the more expensive it is to trade. Particularly among smaller-cap stocks and REITs, an investment manager taking too

large a position in a company can move prices against it. Even managers with superior investment teams and access to information may have become so large as to mitigate their skill. The managers with the best 5-year track records as of the end of 2003 have grown dramatically in assets.

	5 Year Track Record Rank as of 12/31/03	Assets as of 12/31/03	Assets as of 12/31/05	Increase in Assets
Fund 1	1	\$644,420,000	\$1,031,966,000	60%
Fund 2	2	183,410,000	641,224,000	250
Fund 3	3	107,753,000	556,648,000	417
Fund 4	4	852,000,000	3,015,000,000	254
Fund 5	5	39,299,000	59,042,000	50

Source: eVestment Alliance

Likely some combination of these three factors is responsible for the mixed performance of REIT managers since the early 1990s. Survivorship bias essentially makes the early results seem better than they probably were. The market has matured and many managers must now manage much larger portfolios.

Availability of Attractive Index Fund Investments

Indexing loses much of its luster if there is no index that captures the opportunity set, or if the manager cannot track the index closely with very low costs. Where once there were no passive index products in the publicly traded real estate securities market, several are available today. The table on the following page describes the characteristics of some broad REIT index funds.

Manager	Investment Vehicle	Minimum Investment	Annual Fee	Tracking Error*	Benchmark
Manager A	Commingled fund	No minimum investment. \$5,000 minimum fee per quarter.	0.15% on first \$50 million 0.12% on next \$50 million 0.10% thereafter	0.07%	DJ Wilshire REIT Index
Manager B	Mutual fund	\$5 million	0.13%	0.35%	MSCI U.S. REIT Index
Manager C	Commingled fund or separate account	No minimum investment. \$10,000 minimum fee for commingled fund, \$50,000 minimum fee for separate account, per year.	0.20% on first \$50 million 0.15% on next \$50 million 0.10% thereafter	0.18%	DJ Wilshire REIT Index

Conclusion

Conventional industry wisdom seems to be that portfolios of publicly traded real estate securities (generically referred to as REITs) should be actively managed. The rationale is that real estate is an inefficient market in which active management can be expected to add value. But is this wisdom grounded in fact?

Our research shows that there is currently no inherent advantage for active investment managers in the

publicly traded real estate market. Thoughtful investors considering REITs should consider using low-cost passive management (indexing). We recommend clients treat REITs no differently than their other publicly traded U.S. equity investments when making the active/passive decision.

David J. Keil, CFA
Christian N. Reel
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* Tracking error is defined as the annualized standard deviation (volatility) of a fund's returns relative to its benchmark. Index funds generally seek to minimize tracking error.

REFERENCES

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ENDNOTES

¹ See Ennis and Sebastian (2000).

² Figures calculated using the eVestment Alliance (www.evestmentalliance.com) universes of REIT/ real estate and equity managers assuming a \$25 million portfolio.

³ Small-cap and REIT portfolio trading costs are estimates provided by leading transition management firms for portfolios ranging from \$100 to \$200 million in size.

⁴ SPIVA (S&P Index Versus Active Management) Scorecard, 4Q 2005. (see www.spiva.standardandpoors.com/)