Some Thoughts on “Hot Topics”: Something Familiar, Something Uncomfortable, and Something Controversial

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Hot Topics: An Overview

• Great number of potential topics
• Most everyone (including me) believes their topics are the most worthwhile
• In the interest of time, let’s focus on just three:

The Familiar:
– Transaction Perspective: What Does the Distribution of Bids Look Like?

The Uncomfortable:
– Fund Perspective: Which Characteristics Correspond with Fund Performance?

The Controversial:
– Securitization Perspective: Why Tranche CMBS?
Hot Topics: Distribution of Bids?

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  - Transaction Perspective: What Does the Distribution of Bids Look Like?
  - Fund Perspective: Which Characteristics Correspond with Fund Performance?
  - Securitization Perspective: Why Tranche CMBS?
• What does the distribution of bidders’ bids look like?

• In theory, bid prices ought to cluster around some “intrinsic” value:
  – Sale Price = Value + “Noise” (or error term: $\varepsilon$)

• Noise = $\varepsilon \sim (0, \sigma^2_{\text{Bids}}) = f(\#\text{bidders}) \leftarrow f(\text{Market Liquidity})$

• Let’s consider two cases: $N = 16$ v. $N = 49$

Typical View on # Generic Bidders
Why should we care what the distribution of bidders’ bids look like?

Some theories (e.g., Constant Liquidity) depend on it.

More pragmatically, appraisers, investors and lenders ought to care about the level of liquidity (i.e., size of $N$) – because, holding all other factors constant, Price ($P_0$) varies with liquidity:
- Appraisers care about most probable selling price
- Investors care about reversionary value
- Lenders care about liquidation value (in the event of default/foreclosure)

Again, let’s compare two cases: $N = 16$ v. $N = 49$ as an illustration of time-varying liquidity:

Typical View on # Generic Bidders
Distribution of Bids | Asymmetries?

- Should we really expect the distribution of bids to be symmetrical?
- In general, prices get struck with the outlier.
- How would appraisers, investors and/or lenders react if the underlying distribution looked like? (They should be less confident in the valuation.)
- Assume, $N = 40$:
We should care not only about the distribution of bids, but also about the characteristics of the bidders.

Simplistically, assume sophisticated and unsophisticated bidders:
- institutional vs. non-institutional,
- public vs. private
- domestic vs. foreign, etc.

Like time-varying liquidity, bidder make-up varies over time and, therefore, holding all other factors constant, price varies with make-up.
• In private/negotiated markets, the highest bid is not always accepted by the seller.

• Sellers also care about (& evaluate) the bidders on non-price dimensions:
  – bidder’s reputation for “re-trading”,
  – earnest money (amount, “hard” v. “soft”),
  – contractual contingencies (due diligence, financing, etc.),
  – contractual terms (representations, warranties, indemnities, etc.)
  – financial wherewithal to close.

• Evaluating non-price dimensions of private-market bids is a non-trivial task
Distribution of Bids | Data Gathering?

- Bid data is closely guarded by property brokers.
- Who’s information is it? Sellers! (Typically, sellers higher broker.)
- Rightfully, sellers are very concerned about disclosing this information before the transaction is consummated.
- How do we persuade sellers to provide such information after the sale has closed?
Hot Topics: Characteristics & Fund Performance?

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We seem to know little about the dispersion of fund-level returns about the index?

Consider this hypothetical:

Hypothetical Illustration of the Difference between the Average Fund's Volatility and the Index's Volatility

- 40% of the possibilities
- 65% of the possibilities

Realized Returns vs. Standard Deviation of Realized Returns
• Because of diversification, the $\sigma_{\text{Index}} < \bar{\sigma}_{\text{Fund}}$

• Typically, this difference widens as the strategy becomes riskier:
The preceding ellipses were based on the following assumptions:

| Major Assumptions Used to Illustrate the Dispersion in Fund-Level Returns |
|-------------------------------------------------------------|-------|-------|-------|
| Number of Funds \((N)\)                                    | Core  | Value-Added | Opportunistic |
| Expected Return \(E[k]\)                                   | 9.5%  | 10.9%    | 14.0%    |
| Volatility of Index Returns \(\sigma_i\)                   | 12.0% | 15.0%    | 22.5%    |
| Average Volatility of Fund Returns \(\hat{\sigma}\)        | 12.6% | 17.9%    | 29.0%    |
| Volatility of Volatility \(\sigma_\sigma\)                 | 6.3%  | 8.9%     | 14.5%    |
| Average Correlation among Funds \(\rho\)                   | 0.90  | 0.70     | 0.60     |
| Correlation between Risk and Return \(\rho_{\mu,\sigma}\)  | 0.80  | 0.80     | 0.80     |

We need to better understand the empirical evidence!
Fund Characteristics | What Leads to Good (and/or Bad) Performance?

- Let’s revisit the hypothetical dispersion in fund-level returns:

Hypothetical Illustration of the Difference between the Average Fund's Volatility and the Index's Volatility

- 65% of the possibilities
- 40% of the possibilities

Realized Returns

Standard Deviation of Realized Returns
Fund Characteristics | What Leads to Good (and/or Bad) Performance? (continued)

• What are the characteristics that correlate with good performance?

• Some of the suspects:
  – Co-investment capital
  – Base Fees (%, front- v. back-end v. ongoing)
  – Preferred Return
  – Promoted Interest
  – Consider some interaction term(s)
  – Previous Success
  – Length of Sponsor’s History
  – Reliance on Leverage
  – Offering Size
  – Etc.
If some of these factors are predictive, what should investors do?

“Load” on those factors with highest predictive ability (assuming these factors are stable across time/cycles).

or

Could consider conditional predictability: Given an expected market cycle, which factors to load on?

If none of these factors are predictive, what should investors do?

Minimize fee loads and maximize governance provisions.

In the same way, advisors should be evaluating these same factors with regard to their operating partners (with which they have joint ventures)
Hot Topics: Why Tranche CMBS?

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An Illustration of Security Design: Starting Point

Assume a $2.0 billion market capitalization
An Illustration of Security Design: Separation

Assume a $1.5 billion market capitalization
Assume a $0.5 billion market capitalization

Expected Return

Risk
An Illustration of Security Design: Consolidation

Assume a $1.0 billion market capitalization

Assume a $2.0 billion market capitalization

Expected Return vs. Risk

Risk

0% 2% 4% 6% 8% 10% 12% 14% 16% 18% 20%

0% 2% 4% 6% 8% 10% 12% 14% 16% 18% 20%
An Illustration of Security Design: Profiting from Separation?

Note: Lower returns equate to higher prices

Examples:
1) Treasuries into STRIPS & "zeros,"
2) REITs' (generally) property-type focus,
3) GGP's bifurcated emergence from bankruptcy, and
4) CMBS into multiple tranches.
Security Design: What About CMBS?

• Generally, the market prefers simple stories (as compared to complex stories)
• But, is CMBS really like the other three examples?
• I don’t think so; the other three instruments are without conflicts amongst security holders:
  – Treasuries ← no defaults
  – REITs and GGP (good/bad bank) ← no interaction after separation
• CMBS ← conflicts amongst security holders upon monetary default within the pool:
  • A-piece holders → foreclose
  • B-piece holders → forebear
• This conflict/adversity should be priced:
An Illustration of Security Design: Losing Due to Separation?

Note: Higher returns equate to lower prices

Example: CMBS into multiple tranches = \( f(\text{conflicts}) \)
Security Design: What About CMBS?

• If the foregoing theory is true, how can the market nevertheless prefer *CMBS to “whole” loans?
• Is there another explanation or factor?
• I would argue that it is regulatory arbitrage!
  – A-piece security holders enjoy lower (equity) capital requirements when holding investment-grade securities
  – The total (equity) capital requirements for the A- and B-piece security holders is lower than the (equity) capital requirements for the whole loan
  – Let the arguments begin?!?!

* This must be the case; otherwise, investment bankers would not profit from securitization