EDITORIAL

by Sheila Hopkins

Shifting Horizons

A couple of months ago, *The Institutional Real Estate Letter* held its fall editorial advisory meeting, which focused on international and high-return investment. For two days, pension fund managers, real estate consultants and investment advisers discussed and debated the reasons to invest internationally. And what did they agree on in the end?

International investment is a good idea — for other people.

When the first funds began moving overseas a decade ago, it was common wisdom that, as time passed and investors saw how the front-runners fared, others would follow in increasingly large numbers. It was assumed, of course, the front-runners would fare well. For a lot of them, however, that hasn't been the case. And the tortoises of the industry are beginning to think the international finish line might not be all it's cut out to be.

> "Perhaps the most significant event of 1989, despite those who continue to bury their heads in the sand, is that the U.S. institutional investment community is beginning to gear itself to enter the global markets."
>
> ***The Institutional Real Estate Letter,* Dec. 1989**

Almost every pension fund manager at the meeting was interested in international investing. Most said they thought globalization was inevitable, and they would probably be doing some overseas investment one day. Some were even doing a little already, though mainly as an unintended consequence of investing in opportunistic funds that had some overseas holdings. But most simply couldn't justify making the leap at this time.

We've been talking about international investing for at least 15 years now. During that time, everyone's mantra has been, "It's not a matter of *if*, it's a matter of *when*." If the fund managers at our recent meeting are representative of their peers, it may indeed be a matter of *if*.

Why isn't it easier to invest overseas after all this time? In short, things we thought would happen haven't. Markets were supposed to become more transparent. European managers were supposed to become more expert. And globalization was supposed to mitigate some of the currency issues. Although there has been movement in that direction, particularly in the equity markets, international property markets are still very difficult to get a handle on.

"Asset classes in the international markets are just a lot less efficient," explains a plan manager with international equity experience. "We have lower-quality stock managers in a variety of different countries who continue to outperform indices,

Continued on page 7

GLOBAL Quarterly

Vol. 1, No. 3 Fall 2003

Institutional Real Estate, Inc.
1475 North Broadway, Suite 300
Walnut Creek, CA 94596 USA
Tel: (925) 933-4040
Fax: (925) 934-4099
e-mail: irei@irei.com
www.irei.com

Shifting Horizons

Continued from page 2

and they would get creamed in the United States. We always thought Europe would get more efficient on the stock side, but we're not convinced it has. If anything, we're more of the belief that they're less efficient today than 10 years ago. The ability to outperform, and their reason for benchmarking or indexing, is lower today."

Managers also are trying to get a grip on why they should be overseas. The idea that the returns more than make up for the risks hasn't panned out, for the most part. However, a new element is creeping in. Just maybe, international investment fits better into a core portfolio than an opportunistic one. Investors in other countries see investing outside their own region as a diversifier; why don't U.S. investors?

"I think Americans are just more parochial than other people," explains a manager of a large investment firm. "For example, we've got a U.S. fund and an international fund which, for most U.S. investors, makes all the sense in the world because, if it's not home it's away. When you take that proposition to the Netherlands, they look at you like you have two heads. 'Why in God's green earth would you mix Europe and Asia?' They're very different. Americans are just much more parochial. We have the biggest, most productive, highest-grossing economy in the world through every cycle. So it's easy to take that perspective."

Yet even those who see the possibility of investing in core as a safer and, therefore, more likely overseas move, insist on some sort of premium — and while they hope this is a "just now" requirement, most think it will be a "forever" requirement. Fund managers are being judged against a U.S. benchmark and need to exceed that benchmark.

"Ultimately almost everyone comes to the conclusion that, for the same liquidity, for the same track record, for the same whatever it is, just given the vagaries of going overseas — whether it's different interest rate environment, whether it's the currency risk — you do need some premium," says an international investment manager.

> "We predicted that U.S. pension, foundation and endowment funds would become much more global in their outlook, and in just about every area of their portfolio except property they have."
>
> ***The Institutional Real Estate Letter,*** **Dec. 1992**

But even if all these risks could be worked out — if markets were more efficient, if returns matched risk — would pension funds really flock to overseas investing? Probably not now. Maybe not ever. Most funds don't see a compelling need, nor do they have the staff, to perform the due diligence needed to invest wisely overseas.

"With the United States being the largest market in the world, we really don't have to go overseas just yet. I don't see us having to go overseas for an awful long time. If you have a choice of investing here or investing there, why invest there? It just doesn't make sense," explains the manager of a large public pension fund.

And finally, the managers noted they have to overcome a special hurdle, a "scrutiny" premium. Fund managers are well aware their investments are not judged simply against a benchmark; they're also judged against a commonsense hurdle. A bad investment in Chicago simply isn't as upsetting to the public as a bad investment in Paris.

So what's the future of international investing? No one is willing to predict it wouldn't become commonplace at some point in the future. But that point appears to be a pretty tiny speck on the horizon.

"We're probably facing a 10-year timeframe, where we'll look back at these kinds of conversations, and there will be the same feeling we have today looking back 10 years ago domestically, and how we perceived real estate then," says an international fund manager.

If I'm not mistaken, that's pretty much what we said 15 years ago. ❖

> "The one hot area in tax-exempt investor land in 1997 clearly was international real estate investing. While actual investment activity has not yet kicked into high gear, a growing percentage of respondents to surveys of all kinds continue to affirm expanding interest in international real estate investment."
>
> ***The Institutional Real Estate Letter,*** **Dec. 1997**