Keep ’em separated

Investors face different considerations with real estate separate accounts

by Loretta Clodfelter

Most investment vehicles come with their own set of pros and cons, and separately managed accounts are no exception. For many large institutional investors, real estate separate accounts bring greater flexibility, control and alignment of interests — all with lower fees. But to achieve diversification, separate accounts require substantial commitments, keeping them out of reach for smaller investors. And with greater control comes greater time commitment, and not all investors are staffed to handle the challenge.

“Institutional investors have increasingly been looking for alternatives to discretionary fund investing,” says Reid Bourgeois, CFO at Transwestern Investment Group. He notes the two most common structures to accomplish this have been through co-investments and separately managed accounts. “These structures offer a variety of benefits to the investor, including increased control over the investment allocation process, reduced fees, ability to control the amount of capital put to work, increased exposure to preferred asset classes and markets, and stronger investor/manager relationships,” adds Bourgeois.

Discretion

One of the big questions for investors is how much discretion to give the manager of a separate account. With a nondiscretionary account, the investor has complete control over investment decisions — but that also means being on the hook for making decisions quickly. For many large public pension plans, that can be a challenge.

“There are different levels of discretion,” says Eric Smith, executive vice president of L&B Realty Advisors. “It’s also highly collaborative,” he adds, “a tremendous amount of communication.” L&B focuses on separately managed accounts.

The level of operational challenges varies both with the role separate accounts play within an investor's greater real estate portfolio and the structure of the separate account, notes Denis Curran, managing director and portfolio manager with Ascentris. Ascentris manages multiple separate accounts, with a total of more than $1.9 billion in assets under management.

"We generally give discretion in a box," says Troy March, director of real estate at the North Carolina Retirement Systems. In such cases, the investor will have a desired strategy and investment parameters, but the manager can make investment decisions within the bounds of those parameters. North Carolina Retirement Systems has approximately 35 percent of its real estate portfolio invested through separate accounts — about $3 billion placed in 10 tranches across four managers.

"The separate account structure can be a burden on investors that do not grant investment discretion to the manager," agrees Curran. "However, when granting discretion, many investors find the separate account structure can significantly reduce the operational strains and burdens that often come with investing and managing real estate at scale."

The required time commitment, when it comes to investor oversight, will depend on the amount of delegation. The primary advantage of giving more discretion to the manager is allowing them to react quickly. "With control comes the obligation to be responsive," notes John McClelland, principal investment officer – real estate at the $60 billion Los Angeles County Employees Retirement Association (LACERA).

For investors, separate accounts balance operational intensity against greater control.

The benefits of the separate account structure come from the customization of the strategy and the relationship with the manager, points out Curran.

"As a single investor vehicle, the vehicle can be optimized and tailored to investor needs, including target allocation, investment term, return targets, managing risk, manager compensation, reporting requirements and governance provisions," says Curran. "The opportunities to customize the account can help sophisticated investors use separate accounts to meet their exact needs."

"One of the pluses is the control over design of strategy and the pace," agrees McClelland. LACERA has eight separate account relationships, representing approximately 75 percent of its real estate portfolio.

"Separate accounts are attractive because they're more customized to an investor's goals. They also make it easier to exclude certain investments if the investor has a conflict of interest or wants to avoid certain industries for ESG or other reasons," says Vittoria Reimers, vice president of investor services at Juniper Square.

Smith says another advantage of separate accounts that has become more important over the past few quarters is having a direct source of cash flow to pay beneficiary liabilities. And separate accounts can offer more liquidity than open-end commingled funds because, instead of waiting in a redemption queue, the manager can sell assets as the investor requires capital.

One challenge for investors, though, is concentration risk. Separate accounts require a fairly substantial outlay of capital to achieve diversification across assets. That means, despite its advantages, the structure isn't appropriate for smaller investors. A new separate account may need a commitment of several hundred million dollars to achieve the necessary scale.

Relationships

By its nature, a separate account means a one-on-one relationship between an investor and a manager. For it to be successful, the parties need a basis of trust and communication.

"There's a relationship that gets built, and it takes two," says McClelland.

Curran agrees on the importance of the relationship built between manager and investor. "A strong relationship with the manager provides transparency and open lines of communication, direct access to the firm's senior leadership team, along with a dedicated portfolio management team," says Curran.

Another advantage is investors can hire and fire managers without cause, and, unlike a joint venture, without worrying about asset sales. That control is "a very powerful tool," says McClelland, but also notes it is hardly ever used. That structure means the manager's interests must be aligned with the investor's — or the relationship will be ended.

"Investing through a separate account often comes with increased governance provisions in favor of the investor. With this additional right comes a fiduciary responsibility to manage the manager, creating a need for a culture of communication and transparency. Though it is somewhat counterintuitive, these strong governance provisions can become powerful tools to align interests," says Curran.

The nature of the one-on-one relationship of separate accounts does provide a specific challenge for investors: "It's all on you to negotiate the LPA. That's a challenge and a risk," says March. By contrast, in a commingled fund, 20 to 30 other

organizations may be reviewing the limited partnership agreement. Though a separate account also means a general partner cannot "divide and conquer" among the investors, adds March.

Reporting

In addition to giving investors the opportunity to exert more control over the investments managers make, separate accounts also allow investors to exert more control over the reporting and communication managers provide.

"You can have varying degrees of reporting and oversight," says McClelland.

"We're in more control over the reporting in our separate accounts than our commingled funds," notes March. He explains that his separate account managers produce all of the reporting the system desires. "I get what I want from my managers," says March.

"The communication and transparency allow an investor to view its investment from a very wide lens, while still having the ability to dig into details to deeply understand the intricacies of the portfolio," says Curran. He adds: "Separate account managers tailor the content and frequency of all client reporting. This helps investors get the information they need, when they need it, and without having to ask follow-up questions."

But while there are many advantages for the investor in separate accounts, such structures involve "a lot more intensity than commingled funds," says March.

"The operational intensity of separate accounts is frequently overlooked," says McClelland. Typically, each property needs its own special-purpose entity, and the legal and administrative work has to be maintained over time, he adds.

"The resource burdens that come with separate-account investing likely deter some, but separate accounts are still widely adopted among investors," says Reimers. She points to a 2018 McKinsey & Co. survey of general partners, which found 50 percent of firms offer separately managed accounts to clients.

Technology can also make the process easier on investors.

"Technological innovation can help by systematizing information and reporting, which leads to increased accuracy and transparency. If designed well, technology, such as an investor portal, can improve the investor experience by giving the investor real-time access to their portfolio allocations and other information," says Reimers. She notes investment managers can reduce the burden of operational intensity by investing in technology and analytics that help to provide more standardized information and reporting about their investments; streamline the investor reporting process; and better analyze trends to develop insights and offer investment recommendations that are tailored to their investors' unique circumstances and strategies.

And third parties can take on some of the operational intensity.

"Third-party service providers can offer tremendous support to the real estate investing process," says Bourgeois. Investment-management platforms can be used to create efficiencies in investor reporting, administration, capital calls and distributions, customer relationship management, capital raising, and data management. "Technological advances in investment-management software in the last five years have allowed investors and managers to enjoy detailed, high-quality financial reporting and analytical tools in a cost-effective and efficient manner," says Bourgeois.

"No different than a commingled fund, separate accounts can engage third parties to help with portfolio administration, portfolio analysis, and valuations, and utilize a subscription facility to minimize the frequency of contributions and distributions to and from the vehicle," says Curran.

"Another way to manage the operational intensity is by investing through managers with robust technology and analytics. These managers will more easily be able to analyze trends and extract insights to recommend investments that align with the investor's strategy and preferences, and they will be able to provide more robust, customized reporting to the investor. This reduces the number of staff the investor needs to process and analyze that information," says Reimers.

Conclusion

For investors, separate accounts balance operational intensity against greater control. For those investors with the resources to take advantage of the structure, it's important to find managers who will execute on their vision.

"Manager selection is very key," says March.

And for managers, it's important to mitigate the operational intensity faced by investors. As Curran notes, each of the following can help mitigate the operational intensity of the separate-account structure for the investor: quick and thorough communication, transparency, strong governance and compliance policies, reporting and operational efficiencies, and thought leadership.

The bottom line, says Smith, is: "A decent diversified account will enhance your performance through more control and a more efficient structure." ❖

Loretta Clodfelter is senior editor of *Institutional Real Estate Americas*.