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Arizona Marches On Into Real Estate

By Chris Larson

The **Arizona State Retirement System** has taken an important step toward adding real estate to its asset mix. The system's trustees have approved a new real estate investment policy, and dollars could begin flowing from Arizona SRS into various real estate vehicles by early next year.

The plan is just one of several public pension funds that are moving into real estate, and experts say that trend will continue.

The $21 billion system has set a target allocation of 6% for real estate. That means, when the allocation is fully funded in a few years, Arizona SRS will have more than $1 billion in real estate.

The decision by Arizona SRS to move into real estate came last August, when the board accepted an asset allocation study that recommended a 6% real estate allocation. Since that time, CIO **Gary Dokes** says, fund officials and staff have been "getting processes and people in place, putting together a plan, and getting the plan approved." Trustees approved the real estate investment program at its July meeting.

Dokes says the policy represents "a recognition of opportunities in real estate. We can add real estate and increase returns slightly, and reduce the volatility of the fund. That seemed to make sense."

It's making sense to more and more pension plans, in fact. "We are starting to see more interest in real estate," says **Dave Jack**, a managing director of **Wilshire Associates** in Pittsburgh.

But it's not really a new trend, he says. "I think it's more a reversal of a trend." Real estate first became popular among institutional investors in the 1970s, Jack says, and by the late 1980s, "most of the big ones would have had a meaningful exposure" to real estate. The sector's horrible performance in the early 1990s led to "a complete halt of new commitments to real estate," Jack says. Real estate has come around, however, "and now, what you find in Arizona and in others, they're now looking at this again, and saying it's really an attractive asset class."

Similar words come from **Jack McAllister**, v.p. of institutional investment affairs at the **National Association of Real Estate Investment Trusts** in Washington, D.C.

"There are probably several factors that are working to influence investors' embrace of real estate," he says. "One is obviously the bear market and the volatility that it created in their portfolios." Also, he adds, low return expectations across asset classes are pushing institutional investors to seek other ways of producing returns to meet funding targets.

McAllister says the real estate market is structured differently now than it was 20 years ago, with more stable financing and more public disclosure of financial information – both factors that make retirement systems more comfortable in investing in real estate.

Arizona SRS's investment policy calls for a portfolio that includes actual real estate, real estate investment trusts (REITs) and real estate operating companies. About 80% of the portfolio will be in core real estate assets, and the program is aiming for diversity in property ownership formats, property types and geographic regions.

The state system is not alone in inching its way toward real estate. According to statistics from Wilshire Associates, among public pension funds with more than $1 billion in assets, the median allocation to real estate was 1.45% as of March 31. That may not be much, but it's up significantly from a year before, when the median allocation was 0.17 percent, according to Wilshire.

Among the funds that are moving toward significant stakes in real estate is the $2.2 billion **District of Columbia Retirement Board**, which has set a goal of 5% for a real estate allocation. And the $74 billion **New York City Retirement System** is planning to move more than $3 billion, a little less than 5%, into real estate.

Officials in New York City opted to move into real estate "as the result of a broad-scale asset allocation study that had the broader goal of diversifying the city's investments," says a spokeswoman for New York City Comptroller **William Thompson**, who is a board trustee for the system's four funds.

As with Arizona SRS, New York City's plans for real estate investments – approved last fall – have yet to take off. As of now, the funds have real estate exposure only through existing private equity programs. "We are currently in the process of hiring a real estate consultant to devise a broader strategy," the spokeswoman says.

Arizona SRS is a step ahead, having already hired Cleveland-based **Courtland Partners** as its real estate investment consultant. Arizona SRS has also hired an in-house real estate specialist to oversee the program.

Still to come is the hiring of a real estate attorney and a selection process to find a number of money managers. Most of the systems for the program should be in place in the next six months, Dokes says. The money will begin to be allocated into the sector after that. Dokes estimates that it will be three to five years before the system has a full 5% of its assets in real estate.

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