When Your Lookalike Funds Don’t Act Alike

Similar assets can have very different returns in private and public markets

By Jason Zweig, *The Wall Street Journal,* appeared in print edition on May 23-24, 2020, p. B2.

What an asset is worth depends on who owns it – and how. If you own publicly traded real-estate investment trusts, your REITs are worth an average of 21% less than they were at the end of 2019. If, however, you hold the TIAA Real Estate Account, a $25.2 billion variable annuity invested mostly in private assets, your stake is down only 1.1% for the year.

These differences highlight the gap between how public and private markets work. The common fund abbreviation NAV, which stands for "net asset value," in reality often signifies "near asset value." That can be the case whenever a fund owns nontraded assets —not just private real estate, but private equity, venture capital and whatever else doesn't have a daily market value.

Look what happened on March 16, when markets went into meltdown and REITs were wrecked. Yet the TIAA Real Estate Account dropped only 0.7%. That's largely because most of its properties don't trade. That same day, TIAA-CREF Real Estate Securities, offered by the same firm but investing primarily in public REITs, lost 17.7%. TIAA offers the Real Estate Account only in retirement savings plans for teachers and other not-for-profit employees. The Real Estate Securities fund is available to the general public.

Although the pandemic's impact on rents across office, industrial and residential properties isn't fully clear yet, rents at U.S. retail properties have collapsed by 30% to 50% , estimates the National Association of Real Estate Investment Trusts. Funds from operations, a measure of earnings, fell 9% at all traded U.S. equity REITs in the first quarter, according to Nareit. As of March 31, the Real Estate Account's properties were spread across four major sectors: offices, at 37% of total assets by fair-value estimates; apartments, at 26%; retail, at 20%; and industrial, at 16%.

Other big managers of private real estate also reported a minimal change in value in the first quarter. The National Council of Real Estate Investment Fiduciaries, which tracks data on the performance of institutional property, says its main diversified index fell only 0.98% before fees. "We might have expected more of a drop in value," says Jeffrey Fisher, a research consultant for NCREIF. "The managers and their appraisers were challenged to determine how much the appraisals needed to be updated to reflect the impact of Covid-19."

That's because the pandemic froze the property market immediately before the end of the quarter, eliminating the transactions that normally would provide prices on which valuations can be based.

In Mr. Fisher's opinion, the "truth" about how much property values changed probably lies somewhere between the extreme losses on REITs and the flat performance of the NCREIF index.

Blackstone Group Inc., the giant private-equity manager, reported in its earnings announcement last month that the firm's two major real-estate strategies lost 3.9% and 8.8% in the first quarter. In its quarterly report , filed May 8, Blackstone cited "significant declines in the unrealized valuations of investments in sectors that are materially challenged" by the pandemic, including retail.

Michael Brennan of Chicago-based Brennan Investment Group, one of the nation's largest developers and owners of industrial real estate, says he is "amazingly bullish" in the long run and expects any declines to be transitory. However, "it would be foolhardy to say we can still lease or sell buildings at the same rates as before March," he says. "I'm not so sure anyone's value estimates are worth the paper they're written on for the time being."

The risk of sudden erosion in values—and the murkiness between the pricing of private and public real estate — has prompted some investors to bail out of the TIAA Real Estate Account. Among them is Jay Ritter, a finance professor at the University of Florida, whose retirement plan is invested at TIAA. "The smoothness of the reported returns [in the Real Estate Account] can lull the investors into thinking things are more stable than they really are," he says. Prof. Ritter says he sold out of the account on Apr. 17, when he estimated that it was about 20% overvalued.

Ian Matthew, a senior director at TIAA, declined to discuss whether the account might have to mark down its holdings. "There may be times when market values of properties or even perceived market values might change faster than they can be appraised," he says. "That's in the nature of private assets that are not priced every day in a public market." The Real Estate Account's properties are appraised quarterly, although those valuations come in steadily rather than all at once at quarter end "so you don't get big lumpy spikes" in valuation changes, says Mr. Matthew. The account keeps a large cushion of cash, more than 10% at last reckoning, to meet the demand from selling investors without having to liquidate real estate.

Returns have been impressive. The account returned an average of 8.8% annually over the 10 years ended March 31, according to TIAA. The S&P U.S. REIT index returned 7.3% over the same period. Still, says Mr. Ritter, if the account's value turns out to have been even slightly overstated, he will have benefited by selling at the expense of investors who stayed put. Getting out at a higher price "allows people like me to dilute the other investors," he says ruefully.

At funds that own private assets, potentially higher long-term returns often come with the short-term risk that some holdings might turn out to be worth less than the managers thought.