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REAL ESTATE INVESTMENT

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The role of real estate investments - mortgages and equities:

1. For general accounts of life insurance companies - including the implications of portfolio segmentation.

2. For tax-exempt retirement funds of defined benefit and defined contribution plans - including thrift and profit sharing plans, IRAs, HR-10, etc.

3. For individuals and other taxable entities.

4. For foreign investors.

MR. MEYER MELNIKOFF: I want to take just a few minutes to provide some perspective on the panel's discussions.

First, I want to give you a framework for the big picture on Real Estate Investments, Mortgages and Equities. The slides I'm going to show you are reflective of the aggregates of the primary U.S. institutional asset forms as of the end of 1983. Slide #1 shows the total short-term investments adding up to about $670 billion at the end of 1983. Notice how they are dominated by the U.S. Treasuries. Slide #2 shows the total of the long-term fixed-income investments in the form of bonds, again dominated by the governments.

Slide #3 shows mortgages, a total of $1.8 trillion with the largest amount relating to residential mortgages, both the 1 to 4 family and the multi-family types. Notice that the aggregate of the commercial mortgages is only $350 billion. At the bottom is shown a fairly recent development - mortgage securities based upon the mortgages shown above, primarily the residential mortgages, of $250 billion.

Slide #4 shows the amounts invested in stocks. The Standard and Poors 500 at the end of 1983 had a total market value of $1,220 billion or $1.2 trillion. The New York Stock Exchange, which duplicates to a large extent the

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SLIDE #1

AGGREGATES OF
PRIMARY U.S. INSTITUTIONAL INVESTMENT FORMS
DECEMBER 31, 1983

Short-term Investments	Billions
U.S. Treasuries	$ 340
Commercial Paper	180
Certificates of Deposit	80
Bankers Acceptances	70
Total:	$ 670

Source: Federal Reserve Flow of Funds

SLIDE #2

AGGREGATES OF
PRIMARY U.S. INSTITUTIONAL INVESTMENT FORMS
DECEMBER 31, 1983

Bonds	Face Amount in Billions
U.S. Governments and U.S. Government Backed	$ 1290
State and Local Government (Tax-Exempt)	470
Corporates	590
Total:	$ 2350

Source: Federal Reserve Flow of Funds

SLIDE #3
AGGREGATES OF
PRIMARY U.S. INSTITUTIONAL INVESTMENT FORMS
DECEMBER 31, 1983

Mortgages	Outstanding Principal Balance in Billions
1 - 4 Family Residential	$ 1210
Multi-Family Residential	150
Commercial (incl. Office, Retail, Industrial, Hotel)	350
Other, including Farm	110
Total:	$ 1820
Mortgage Securities Based on Above	$ 250

Source: Federal Reserve Flow of Funds

SLIDE #4

AGGREGATES OF
PRIMARY U.S. INSTITUTIONAL INVESTMENT FORMS
DECEMBER 31, 1983

Stocks	Market Value in Billions
Standard & Poor's 500	$ 1220
N.Y. Stock Exchange	1650
Amex	80
Total, including OTC and Regional Listed	$ 2150

Source: Federal Reserve Flow of Funds

SLIDE #5

AGGREGATES OF
PRIMARY U.S. INSTITUTIONAL INVESTMENT FORMS
DECEMBER 31, 1983

Property (Real Estate Equities) Excluding All Residential and Special Purpose		Total Market Value in Billions
Very Rough Estimates --		
Office	at least	$ 1200
Retail	"	400
Industrial	"	200
Hotels and Motels	"	200
Total:	at least	$ 2000

Source: Goldman Sachs Real Estate Research

SLIDE #6
AGGREGATES OF
PRIMARY U.S. INSTITUTIONAL INVESTMENT FORMS
DECEMBER 31, 1983

Summary	Book Value		Estimated Market Value in Billions
Bonds - excl. Tax-Exempt	$ 1880		$ 1500
Mortgages	1820		1450
Stocks			2150
Property - Excl. Residential and Special Purpose		--at least--	2000
Sub-Total:			$ 7100
Tax-Exempt Bonds	470		400
Sub-Total:			$ 7500
Short-Term Investments			670
Total:			$ 8170

S&P 500, amounted to $1.65 trillion. The total, which doesn't represent the sum of the numbers shown because it includes over-the-counter securities as well as those listed on the regional exchanges, had an aggregate of $2.15 trillion.

Up to now the numbers I have shown you have been generally known and I just brought them together in a concise form. Slide #5 shows rough estimates of the aggregates for property investments, based on work-in-progress of Randy Zisler, Director of Real Estate Research at Goldman Sachs. We believe that the aggregates of the 4 types of property in which institutions typically invest in the United States include office properties, valued at least at $1.2 trillion; retail, which includes shopping centers as well as small retail establishments, at least $400 billion; industrial properties, at least $200 billion; and hotels and motels, again at least $200 billion for a total of at least $2 trillion.

The summary on slide #6 shows that the U.S. institutional investment world is composed of four parts that are very close to being equal. I've made an attempt to put them all on a market value basis in the right-hand column. The slide shows that the bonds (excluding the tax-exempt bonds) have a value at the end of 1983 of about $1.5 trillion. This value is undoubtedly lower as of now. Mortgages also had a market value of almost $1.5 trillion. Common Stocks were at $2.15 trillion and property at least $2 trillion, making an aggregate of $7.1 trillion as the basic universe of institutional investment forms. If you add to this the tax-exempt investments, which most institutions do not utilize, you have a total of $7.5 trillion and, if you add the short-term investments, you get an aggregate of over $8 trillion. The mortgage world is about the same size as the bond world; and the property world, as a form of equity, is about the same size as the common stock world.

I want to make just two other comments. Real Estate is frequently referred to as a tax-advantaged investment. There are essentially two kinds of tax-advantaged investments. The simpler kind, the tax-exempt bonds, provides merely that the income produced is exempt from income taxes. A more complex class of tax advantaged investments is illustrated by real estate where expenses, including both interest and depreciation, are deductible from all income, not merely the income generated by the property investments themselves. This is why real estate is frequently classified as a form of tax shelter investment. Undoubtedly, our panelists this morning will make reference to the tax aspects of real estate. Finally, you may have heard in other sessions about the explosion in new investment forms in the last few years - the development of futures and options and zeros and a great variety of floating rates. All of these and more have their counterparts in the real estate world, and I think you'll hear about some of them from our panelists.

MR. GARNETT L. KEITH: My comments today are on real estate investments for the general accounts of life insurance companies, and Meyer has asked me to comment specifically on the implications of the portfolio segmentation that is being done in many insurance company general accounts.

While I have a reasonably good fix on Prudential's thinking about real estate for our general account, I am much less certain about the views of other insurance companies. If you'll allow me, I would like to use Prudential as an example of where I suspect most major mutual and probably stock insurance companies as well are. Then I will talk a little bit about the outlook for the future, which includes some good news but also some rather large questions about insurance companies increasing their general account holdings of real estate.

Prudential has had a long history of involvement in real estate. In the thirties we were the country's largest supplier of residential mortgage credit. By the sixties we had given up that market to the savings and loans, which had significant tax advantages, and focused our mortgage lending on commercial properties. In the seventies we acquired a substantial number of real estate equities, and for the last seven or eight years have been a major developer of real estate, both directly and with joint venture partners.

Today real estate accounts for $18 billion or about a third of our invested assets at cost, and probably a slightly greater proportion if you marked all our bonds, mortgages and real estate equities to market. Of that 1/3 in real estate, roughly one-third is in equities, and roughly two-thirds is in mortgages. These numbers exclude $2 billion of mortgage securities - GNMA's - which represent another 4% of our assets. Obviously we think real estate equities, mortgages, and mortgage-backed securities can and should play an important role in a life insurance company's general account portfolio.

You know the historical arguments for mortgages and real estate equities as well as I do. There was a time when residential mortgages provided a premium yield, although perhaps not a premium return if you risk-adjusted the yield for the uncertainty of the principal repayment. There was a time when commercial mortgages provided premium yields, although today that seems to be true for only the easy money half of the cycle. When money is tight, new commercial mortgages cannot compete because real estate projects simply cannot carry the interest loads of 15, 16, or 18%.

Prime real estate equities have traditionally been seen as the premier investment inflation hedge. Lease rates move up following construction costs when leases roll over, and the rising income stream gives proportionate lift to the property values. Not only was the return inflation-hedged, but in an absolute economic sense it was generally higher than the total return on bonds or other fixed-income investments.

More recently, as modern portfolio theory has captured investment minds, the fact that real estate returns are not highly correlated with stock and bond returns made property holdings additionally desirable as a diversifying element in an overall portfolio.

Finally, although insurance company tax rates are generally not as high as corporate or individual tax rates, the tax shelter benefits associated with ownership of real estate equities has provided an additional incentive during the early ownership years of an equity property when cash flow returns are relatively lower than you expect them to be eventually.

Because of Prudential's size, over the past five or ten years we have moved into the development business in a big way. We are currently one of the top three or four developers of real property in the country. Prudential currently has over $2 billion committed to real estate projects in the process of development, and we are likely to continue this activity at approximately this level.

I could stand here and regale you with the stories of successful real estate developments with returns that would warm the cockles of an actuary's heart. I could also stand here and tell you of a few world-class failures that made us wonder why we ever strayed from Treasury bills. On balance, development projects have provided us with a somewhat higher return than purchased properties. But in these days of tighter zoning restrictions, consumer movements and variable interest rates, it is a hard way to make a living. There are days when I wonder whether the glamour and the premium return in development are commensurate with the problems and risks.

Meyer asked me to make a special comment on general account segmentation's impact on an insurance company's appetite for real estate. In the past our portfolios have tended to be one big pool or a few pools holding asset types in which all branches of business participate. More recently we have been allocating investments to a larger number of investment year pools with specified risk, maturity, and return characteristics. This segmentation allows the various branches to choose the asset characteristics standing behind their liability commitments more carefully. I believe some insurance companies have gone so far as to abandon the diversification of pools and allocate each bond, stock, mortgage or property to a specific branch or GIC owner.

Under any of these segmentation steps, the branches which have wanted more real estate can now have it, while recalcitrant branches wanting less real estate are no longer forced to eat it. We are all convinced that we can run our business more intelligently this way. Whether or not it will mean a greater appetite for real estate is not clear. My guess is that it will mean a slightly lower demand for realty equities.

The reason has to do with statutory accounting for real estate and the pressures of Universal Life and other visible yield products. There seems to be a relentless drive in the individual insurance business to show a high statutory accounting yield that can be used for illustration purposes in selling interest sensitive products. A visible "certain yield" of 11% is preferred to a hidden, somewhat uncertain economic return of 13 to 17%. Whatever real estate equities are, they are not an animal that shows up well in the early years on a statutory earnings basis. Early yields are depressed by depreciation charges and most of the economic return resides in the hidden surplus of unrealized appreciation. Therefore, as more insurance products go more and more to visible yield comparisons as a basis of selling, and as branch actuaries have more control over their asset mix, I believe the general account demand for real estate equities will decline - perhaps sharply.

If the proposed tax legislation proceeds as it appears that it will, there will be a tax on the surplus of mutual companies. In this situation, real estate equities have an extra plus - they provide a hidden and untaxed element of surplus that makes chief actuaries more comfortable about ultimate solvency, without having to pay a higher tax bill. This factor will somewhat offset real estate's statutory yield disadvantage I just described.

However, if the balance is to be struck between current marketing considerations which reduce the appetite for real estate versus vague questions about capital adequacy and taxes, my guess is that the marketing voices will be heard first and loudest. Branches will feel they need a highly visible statutory yield for illustration purposes and building hidden surplus will be seen as a luxury we cannot afford.

One final item which should be considered by general account actuaries at this time is the syndication boom. My impression is that we are now seeing syndication of tax-oriented real estate products at prices and on a scale that is unprecedented. Following TEFRA the tax advantages of the 15 year depreciation life have been enormous. Moveover the public, even down to blue collar workers, have been frustrated by bracket creep and the size of their tax bills. Will it be forever thus? If not, does that judgment influence timing for general account property strategy?

The impact of the proposed tax bill is insignificant - both on real estate but also in curing the deficit. If we should have a post election deficit reduction tax bill that reduces tax advantages for real estate equities, the short run impact on property values could be significant. I cannot tell you that we will have a tax bill that hits real estate - a flat tax or some other scheme that substantially reduces shelter opportunities. But as an investor I have learned to be sensitive to booms and their painful aftermaths.

Perhaps the syndication boom will accelerate for years, but already the enthusism feels like Atlanta in 1973 or Houston in 1980. My best guess is that we are now into a period that will be seen as an unusual selling opportunity in retrospect, and which will be followed - after the fall - by an unusual buying opportunity.

We are not by any means dumping our portfolio of some $7 billion in real estate equities. However, for the last two years and for the foreseeable future we will be on a sustained yield harvesting basis (to use the timber industry analogy). Our real estate equity exposure will stay at approximately its current size with newly developed projects coming into the portfolio replacing holdings that are being sold in a market that is very enthusiastic about buying fully leased commercial property.

So much for equities; in the world of segmented portfolios, mortgages have some complications too. As I mentioned, we are trying to define maturities in the various asset pools, and the maturity uncertainty of mortgages is a bit of a problem. Moreover their lack of availability in the primary market during high interest rate periods and their shorter call protection relative to governments give mortgages a problem in bidding for a large portfolio position when rates are high.

How to keep commercial mortgages from being an on-again-off-again asset class is the big challenge. The answer probably lies in the securitizing of commercial mortgages as has been done to make home mortgages more appealing for institutions. We, and several other large institutions are working on that, but we are not quite there yet.

To sum up, real estate mortgages in the past have provided premium yields, and in the future it appears they will provide adequate yields. The securitizing of residential mortgages, and the prospective securitizing of commercial mortgages will certainly make those holdings more attractive to insurance company segmented portfolios.

The higher returns of purchased equities and even higher returns of developed equities are attractive notwithstanding the complications of statutory accounting. On the other side, segmentations, leading to demand for greater liquidity and higher visibility of statutory return, tend to militate against real estate equities. Finally, tax product syndication is creating a boom that gives us pause, and we are holding exposure under tight rein in 1984-85 rather than going on a accelerating buying spree in what may prove to be a boom market.

MR. WILLIAM L. RAMSEYER: It is not only a pleasure to address your Society on real estate investment, but also a distinct honor to be included in a gathering of professional colleagues who so greatly influence the asset strategies of our country's retirement plans. I look forward to sharing with you this morning many of the insights and observations our firm has developed in providing consulting services to pension fund clients.

The role of real estate in investment portfolios of retirement funds which Meyer has asked me to address has taken on a new level of importance as investment strategists have looked backward to the decade of the 70's which witnessed substantial shifts in the capital markets, deregulation, and fixed income and equity asset erosion spurred by inflation. Many strategists concluded during this period that equity real estate has specific investment characteristics which have the effect of reducing portfolio volatility, softening the effects of inflation on portfolio performance and producing a real rate of return comparable to other equities over the long term.

To put the role of real estate in proper perspective, it is important to understand the participants in the real estate investment business and the level of investment commitment retirement funds have made to equity real estate. Let's indulge in some industry overview. As you know, the retirement fund universe is divided into two general categories - defined benefit plans where contributions are made by the employer and employee in exchange for certain agreed-upon retirement benefits, and defined contribution plans where contributions are made by employees and/or their employers for benefits which are determined by the performance of the invested assets.

Total retirement fund investment assets are dominated by defined benefit plans, represented by the major pension plans in the country. However, we see substantial growth on the horizon for defined contribution plans, namely Keogh Plans for the self employed and Individual Retirement Accounts (IRA's) for employees who may also be covered by other retirement benefit plans. IRA/Keogh balances at commercial banks, thrifts and mutual funds as of March, 1984 were about $85 billion, up 22% over March, 1983. These figures, of course, do not include balances in self-directed accounts or those handled by the securities brokerage community. The IRS projected last month that over 19 million tax returns this year will include IRA contributions.

Including the IRA/Keogh market, total assets of retirement plans are approximately $1.2 trillion of which only $320 million represents defined contribution plans with an estimated segmentation as follows:

Corporate	52%
Government	27%
IRA/Keogh	8%
Endowment/Foundation[1]	7%
Union	6%

1. Although not a retirement plan by structure, endowments and foundations are often categorized for investment purposes with retirement plans because they also are exempt from income taxation.

SOURCE: Money Market Directories, Inc.
Federal Reserve Bank
Pension Realty Advisors, Inc.

At this point, we should define equity real estate. It is any direct investment in real property, the return on which is primarily dependent upon the property's net operating income or disposition proceeds. This asset class definition, therefore, excludes conventional or adjustable mortgages, traded shares of real estate investment trusts or other security interests in real estate, the value of which is more dependent upon a trading market than the underlying property asset. The primary components of this asset class are direct equity interests in real property, either leveraged or unleveraged, interests in convertible or participating mortgages, or interests in commingled funds, i.e., group trusts, insurance company separate accounts, limited partnerships, real estate investment trusts or other title-holding entities which invest primarily in equity real estate.

Given this enormous asset base of $1.2 trillion, what has been its investment allocation to equity real estate? Depending upon the category of retirement funds selected, our research indicates that investment in equity real estate in aggregate is about 2.5% of current portfolios, or a total of $30 billion, the majority of which is found in commingled funds managed by insurance companies, banks, or advisors registered under The Investment Advisers Act of 1940. However, a growing number of retirement funds are now investing in real estate on a direct basis as opposed to investing with others through a commingled fund.

Investment management services to the IRA/Keogh markets are provided by syndicates registered under The Securities Act of 1933 and distributed through the retail network of securities brokerage firms. Their investment offerings are normally in the form of registered limited partnerships or real estate investment trusts, which accounted for nearly half of last year's syndication market - two of the four billion dollars in new investment capital raised in 1983.

Now that we have identified the primary participants in this pension real estate business, let us turn to the process by which pension funds become investors in equity real estate. I am going to borrow, for the moment, the process used by consultants as they systematically develop a real estate investment strategy for pension clients. I suspect many of you in the audience have been through this process with clients, so let me share with you our approach. As you know, this procedure includes first, establishing investment objectives; secondly, adopting investment policies; thirdly, implementing an investment strategy; and lastly, measuring performance such that adjustments, if necessary, may be made to the prior stages.

Shortly after the passage of ERISA in 1974, increased focus was directed toward asset allocation. This was the beginning of an era when differentiation between the investment performance of asset classes became well known and documented, all of which underscored the importance of investment diversification. This drive for diversification became the basis on which many pension strategists looked seriously at equity real estate.

It is interesting to note when our firm began to offer consulting services to pension funds, the very first research it completed was a determination of the historic returns on equity real estate. As many of you know, real estate does not enjoy the abundance and quality of data as does the world of stocks, bonds and cash. Therefore, most of the existing data needs to be adjusted for inaccuracies and inconsistencies. After such adjustments, our research indicates that the historic performance of equity real estate has been in the 5 to 6% real rate of return range over the past ten years.

I might add at this point that the most valid data on the performance of equity real estate to date is maintained by the Frank Russell Company and distributed by the National Council of Real Estate Investment Fiduciaries, a non-profit organization consisting of managers contributing to the index. The data base currently includes approximately 845 properties owned by pension funds on an unleveraged basis and held generally by the major commingled funds. The market value as of December 31, 1983 of these 845 properties was slightly in excess of $6 billion. The index indicates that real estate continues to operate on a current basis in excess of the 6% real rate of return cited earlier. The components of return include both realized and unrealized gain or loss and current income.

The reason I mention this historic performance is that the very first step a pension fund takes, if exercising a disciplined process, is to establish a real rate of return objective. Certainly, if you subscribe to the "past as prologue", it is reasonable to assume a 6% real rate of return expectation over the near term for real estate.

However, establishing this real rate of return objective is not as easy as simply assuming a 6% real figure. In today's market place, the real rate of return expectations range from approximately 3 to 10%. This range introduces the subject of risk in real estate investment, the second element of a statement of investment objectives. The expectation in the 3% to 4% range assumes investment in a credit-oriented sale leaseback of perhaps corporate facilities. At the other end of the projected return spectrum is investment in new properties, which entails the very substantial risks of development, construction and initial leasing. Depending upon the posture of the pension fund with regard to risk, an objective can be established in this wide range of 3% to 10% real rate of return. An explicit statement of risk is therefore advised in the overall statement of investment objectives.

The next stage in the drafting of a statement of investment objectives is the subject of asset allocation to this class of equity real estate. As indicated in the statistics stated earlier, about 2.5% of pension assets are currently invested in equity real estate. As one might expect, this ranges from 0 in the case of many pension funds to 100% in a few funds (most of whom find themselves as defendants in claims by beneficiaries under ERISA).

Given the relatively low volatility of equity real estate and its negative correlation to stocks, our recommended allocation to clients ranges from 10% to 20%. This allocation recommendation is dependent upon, among other things, the fund's need for liquidity, investment style, and frequency and depth of portfolio shifts between stock, bonds and cash equivalents. An allocation exceeding 20% may well disturb the ability of some funds to execute appropriate debt-equity shifts.

A last consideration under investment objectives, beyond rate of return, risk, and asset allocation, is a definition of legal investments in real estate. In addition to prevailing state law on real property, portfolio strategists must also consider the restrictions under ERISA, or state and local law in the case of public retirement systems. Restrictions embedded in these statutes and regulations can often affect a pension plan's real estate investment objectives.

Once these objectives are clearly documented and adopted by a governing body of trustees, it is then appropriate to establish a statement of investment policy, which is to serve as the investment guidelines for those given the task of implementing investment strategy.

Policy issues which are important to pension plans include the decision to manage assets internally or through the services of outside investment managers. The majority of funds have chosen to engage outside investment management. However, we are seeing a trend of increasing internal asset management responsibilities for less management-intensive assets. This assumption of asset management by internal personnel, however, is tempered by trustees concerned about fiduciary responsibilities and the exclusive dependence upon internal staff for the execution of prudent management services.

Pension fund managers must also determine if they are best served by single or multiple investment managers; if they should participate exclusively in commingled funds for purposes of diversification or execute direct ownership situations; how they are to handle the investment discretion or decision making process; if they should invest in properties through an equity position, or a participating convertible loan position; the implications of investment income being distributed versus reinvested; and a policy with regard to the compensation of investment managers.

On the latter policy issue, it is interesting to note that after considerable effort by members of the investment management community, the SEC and Department of Labor have together considered the subject of incentive compensation for investment managers, and just recently the SEC announced that it is withdrawing its proposal after industry participants had more time to reflect on the potential problems associated with incentive compensation.

It seems that in our business, like anyone else's, there are always issues of current controversy or divided opinion. A couple of them involve real estate investment policy matters. I recall the focused topic of 1982 was the strength and weakness of open-end versus closed-end funds. The 1983 topic appears to have been, and continues to be in 1984, the equity versus participating debt investment decision. Briefly stated, the issue centers around the tax efficiency of properties being held by taxable versus tax-exempt institutions. The theory goes that if one is able to structure a transaction such that tax advantages remain with a taxable owner/developer, then the present value of these benefits can be translated into greater investment return over time. In many cases, this can result in an increased rate of return to the tax-exempt investor over the holding period of about 75 to 125 basis points. However, from a pension fund's point of view, for the potential increase in investment return, flexibility, control, liquidity, and legal certainties are compromised. Suffice it to say that prior to entering into tax-efficient transactions, it is essential to have a full understanding of the potential ramifications of the hybrid debt position, as opposed to possessing full equity and title to real property.

In addition to these structural policy issues, it is important to consider a series of property level policy positions: analyzing appropriate investment size, lease duration, regional location, type of property and stage of that property in its life cycle. These property level policy issues can have a significant impact on return as investment size affects diversification, location affects income stability, type of property and lease structure affect sensitivity to inflation and stage in life cycle affects investment risks.

With the statements of investment objectives and policies in place, pension funds than turn to the onerous task of selecting managers. In the early 1970's, the pension real estate investment business was characterized by a dozen or so managers, primarily from the major insurance companies and banks. As investment diversification efforts grew and the acceptance of equity real estate gained monentum through the '70's, many new organizations appeared providing real estate equity services - both generalists and specialists. Today these organizations can be classified into four major categories: insurance companies, banks, investment advisors registered under the Investment Advisors Act of 1940 and lastly, public syndicators who are primarily serving the IRA/Keogh markets. Of the entire universe of investment managers in these four categories, approximately 120 are now offering real estate asset management services to the pension market.

The selection process is a little bit more complex than it used to be when the universe was so small. In addition to the quantitative selection factors such as assets under management, years of experience, and prior performance, it is important to understand the qualitative aspect of a real estate investment management organization. Due diligence inquiries include such determinations as the permanency of the professional staff, their reputation among peers and clients, their acquisition outreach, the thoroughness of their internal systems and controls, their experience in property operations, their acquisition process, their ability to take on new investment capital and their ability to disclose and manage conflicts of interest. These management factors are an invaluable complement to the quantitative analysis to which each manager candidate should be subjected.

To complete this cycle of objectives and policies and manager selection, retirement funds are increasingly looking at new techniques of performance measurement, both for purposes of selecting new advisors and making certain portfolio adjustments. It is important not only to measure the performance of investment managers against established portfolio guidelines, but also to measure performance against the benchmark of peers and against the proforma expectations of the manager.

I would like to close my comments with a brief look into the future, which we know is a dangerous but necessary exercise.

First, there's no doubt that retirement plans will continue their commitment to real estate. Greenwich Research Associates surveys indicate that large corporations alone will allocate another $22 billion to equity real estate in the 3 year period ending in 1985. Similarly, our surveys indicate that the 50 largest public retirement systems will invest another $4.8 billion over the next three years.

We see expected rates of returns diminishing slightly as the real estate markets become more efficient. We see more emphasis on the enhancement of real estate assets, not just the acquisition of properties. We see the role of the taxable investor diminishing as Congress continues to tighten tax policy. And probably as important as any other factor, we see the skills of the management community increasing significantly as real estate becomes a more sophisticated investment medium.

To proceed with real estate investment in a disciplined manner, therefore, continues to be in the best interests of plan beneficiaries. Serving these best interests is collectively our ultimate objective.

MR. BENJAMIN D. FEIN: My colleagues have referred to the syndication boom of the 1980's. Actually, syndicated investments are not a new phenomena. Historically, a syndicate was meant to mean a group of financiers organized to profit by a monopoly. It's far from a monopoly today. At the present, the word is used to refer to any group of individuals, firms or corporations which organize for a limited period of time to accomplish a given purpose. Lloyd's of London is an amalgamation of private "syndicates" which take and spread risk in the insurance industry for a premium. The Rothschild empire was a syndicate of Rothschild family members engaged in various forms of trade. All mutual funds - whether stock, bond or venture capital funds - are syndicates of individuals who pool their money and entrust its management to certain individuals - money managers- within certain investment objective criteria.

What then is unique about the "explosion of syndications" in real estate for individual and other taxable entities? What has led to the creation of professional syndicators and syndication companies and why have they generally employed limited partnerships and the sale of limited partnership interests as the preferred format for creating and distributing such investments? The following discussion will focus on the <u>real estate</u> syndication industry for the answers to these questions. As a result, the statistics which follow will grossly understate the size and volume of syndicated limited partnership investment vehicles. By necessity, they will exclude syndicated limited partnership investments in energy (i.e., traditional oil and gas exploration and development programs, as well as more exotic investments ranging from solar energy panel parks in the Southeast to windmill farms in California), research and development of all kinds, equipment leasing (ranging from computers to telephonic communication systems to jet airplanes), agriculture and farming (including cattle feeding and breeding, horse breeding, wineries, orange groves and the like), movie production and distribution and leverage buy-out transactions of existing businesses. However, the real estate syndication industry is the single largest segment of the private investor syndication business. One reason for that is that it is the only investment vehicle which permits the investor to claim tax losses in excess of his actual cash investment plus any amount for which he must be personally at risk. In short, real estate is the only investment that permits an individual or other taxable entity to claim a tax loss to be used as an offset against other income which exceeds the amount of the investment and hard cash they actually have at risk.

Most syndicated real estate programs are structured as limited partnerships, wherein investors pool their money in a fund. This fund then purchases assets, such as real estate, or finances activities, such as oil drilling or property construction. The partnership, in effect, operates a business. As a limited partner, an investor's financial exposure is limited to the fixed amount to which he has agreed to contribute, in exchange for which the investor shares in the economic and tax benefits derived from that business. The business is actively run and controlled by the general partners, who usually possess an expertise in the partnership's business and who generally only have a minority interest, often as little as one percent (1%) in the profits and capital of the enterprise.

The limited partnerships are either "public" or "private" offerings. Technically, this distinction only refers to certain Securities and Exchange Commission (SEC) registration requirements. Public partnerships must be registered with the SEC; private placements do not require such registration, but they must adhere to strict guidelines set forth by the SEC and the various states in which such programs are sold. Because of the foregoing, the main differences between public and private offerings are that private offerings usually require a higher minimum investment, require higher suitability requirements for investors and differ in regard to the methods of payment and the identification of assets in the program.

An interest in a public program may be purchased for relatively modest amounts, usually for minimum investments of $2,000 to $5,000 and total payment is required at the time of purchase. Net worth requirements vary from state to state, but are consistent with the minimum investment size and therefore, begin at income requirements of $25,000 and net worth requirements of not much more. Public programs typically, but not universally, employ investor funds to purchase a portfolio of several assets. Generally, a significant number of specific purchases are not identified until after an investor has purchased his partnership interest and all or most of the partnership's funds are raised. These are referred to as "non-illuminated" or "partially-illuminated" funds. Basically an investor is buying a syndicator's track record and the general investment criteria set forth in the prospectus.

In privately placed offerings, investor contributions usually may be paid in over several years, evidenced by the investor's promissory note and secured by his partnership interest (and sometimes a letter of credit or other security). The minimum subscription (usually ranging from $50,000 to $500,000-$1,000,000) and net worth requirements are substantially greater than in public offerings. Partnership funds are typically invested in a single property asset or activity which is specifically identified in advance.

Often, private programs offer more attractive tax benefits than public programs. There are two explanations of this phenomena. First, private programs are by nature marketed to individuals with a greater net worth and higher income levels than are public programs. As a result, economic benefits of depreciation and other tax deductions are more "valuable" to such high bracket investors. Secondly, an investment in a private program is typically paid in over several years, increasing leverage in early years and increasing the ratio of tax benefits to cash invested in the year in which the asset is acquired.

The advent of a "syndication industry" is a democratization of business opportunity, very much as was the growth of mutual funds. Mutual funds gave middle and upper class individuals access to the investment expertise of money managers who previously were only accessable to the "super-rich". Public and private syndications now permit individuals with more limited investment capital to pool their funds, obtain the expertise of real estate experts who serve as general partners and share directly the economic and tax benefits of such investments.

The clarification and simplification of certain securities rules and regulations, together with inflation and "bracket creep" which have increased the awareness of the public as to the value of the tax benefits often associated with direct investments in real estate limited partnerships has led to an explosion of this type of investment among all forms of taxpayers, including closely-held corporations and business partnerships. The shortening of the useful lives by Congress under TEFRA to 15 years, thereby increasing the corresponding annual depreciation deduction for real estate, have made these investments even more attractive. The liberalization of the securities rules relating to private investments and private placements through various rules promulgated by the SEC (known as Rule 146 in Regulation D) has also fueled this explosion. In any event, the largest single group of investors in this area is the middle and upper class individual.

According to a recent newsletter published by Kenneth Leventhal & Company, real estate public limited partnerships raised a record $4.7 billion in 1983, a 250% increase over the approximately $1.3 billion raised in 1981 and a 63% increase over the almost $2.9 billion raised in 1982. It is estimated that almost $7 billion will be raised publicly in 1984, involving over $20 billion worth of properties. The 20 largest sponsors, which captured 72 percent of the public marketplace in 1983, anticipate raising more equity in public offerings in 1984 than the entire Real Estate Investment Trust (REIT) industry has done in its entire history.

Information regarding privately placed real estate syndications are not readily available and the number of syndicators involved in such activities outnumber public sponsors by well over one hundred to one. The top 5 private placement real estate syndicators in 1983 raised more than $1.2 billion, led by Integrated Resources with approximately $475 million, VMS at $350 million and First Winthrop at $305 million. In way of comparison, 1983 sales of equities by all REITs (which more than doubled their 1984 figures) equalled $926 million, significantly less than the money raised in private placements by the three aforementioned firms. It is estimated that private syndications raised between $20 billion and $40 billion in 1983, four to ten times the size of the public market volume.

With the advent and introduction of new real estate related products to the tax-exempt or tax-deferred markets, such as variable rate single premium tax-deferred annuity contracts, invested in participating mortgage or partnership originated mortgage instruments, the future growth of real estate syndications - in the form of both equity and debt interests, reflecting a broadening of the market - appears very probable. If our business forecast is accurate, Integrated Resources in 1984 will become the first sponsor in history to raise more than $1 billion in equity (and acquire close to $3 billion of real estate) in one year in combined public and private sales.

Syndication sponsors serve an important social purpose - raising capital for capital intensive industries - such as real estate, oil and gas and equipment leasing. They have democratized such areas of investment by opening this investment market, previously the playing field of only the super rich and the giant insurance companies and pension funds, to millions of individuals. They can also afford, in many instances, to outbid foreign investors and the large insurance companies and pension funds, all of which do not realize the same economic benefits from certain tax advantages inherent in real estate, because those entities are not taxpayers. Joint participations between syndicates of tax-sensitive investors and yield-sensitive tax-exempts in the ownership of real estate appears to be a logical, if not inevitable, economic direction of the future.

Proposed tax law changes regarding certain accrual of interest issues and requiring Original Issue Discount (OID) rules to be expanded to certain types of participating mortgages seem to accelerate the realization of this inevitability. Notwithstanding proposed tax legislation and notwithstanding some views as to the possibility of a minimum tax and other changes in Washington, and notwithstanding the increased activity that we have seen by insurance company and pension funds, we believe that real estate investments for individuals and other taxpayers through syndications will continue to be not only a viable but a continuing area of growth and a continually viable investment from an after-tax rate of return point of view over the near and intermediate future.

MR. MELNIKOFF: Thank you very much Ben. I haven't checked the records of the Society, but I think that may well be the first discussion of a tax-advantaged investment we've ever had. I know that the firm of Integrated Resources has done a lot of innovative things. One that I can mention is that they've combined two of my favorite ideas - one of their insurance companies offers a variable annuity based upon investment in real estate. If I can make a bold prediction, I'm sure there will be future opportunities for actuaries to get involved in all kinds of instruments related to tax-sheltered investments.

MR. CHRISTOPHER D. BUDDEN: I would like to start my brief talk by citing a few interesting statistics. Recently our Company calculated that foreign investors were major equity participants or owners in nearly 20% of the 675 or so regional or super-regional shopping centers in the United States. They are particularly dominant in markets such as California, Arizona, Texas and Florida. We further calculated that such entities also control nearly 15% of the 400 million square feet of office space in New York City as well as many of the principal high-rise central business district office buildings in Dallas, Houston, San Francisco, Los Angeles, Denver and Minneapolis, to name but a few cities.

The investors represent a veritable "international" cocktail. From Europe there are the British, Dutch, German, Italian, Belgian, Norwegian and Greek investors. From the Middle East, investors include the Kuwaitis, Saudis, Syrians and funds from Abu Dhabi and Dubai. The Pacific Basin is represented by Singapore, Japan, Hong Kong, Philippino, Australian and Indonesian interests. These are supplemented by manifold investors from South Africa, Canada, Venezuala, Argentina and Brazil.

These investors tend to fall into six principal groupings. The three most significant are as follows:

1. The major life insurance companies from countries such as Japan, Germany and Holland.

2. Foreign pension funds principally from the United Kingdom and Holland. The U.K. funds include all of the nationalized industries (Coal/Post Office/British Rail/Electricity/Gas/Water Council/Joint Airways), a wide range of major corporate pension funds (Barclays Bank/ Imperial Chemical Industries/Shell Transport & Trading/B.P./ Midland Bank) and ten commingled funds, including American Property Trust and North American Property Unit Trust.

   Dutch funds range from Royal Dutch Shell through Philips, KLM, AKZO, and include P.G.G.M., the major Dutch medical fund.

3. The third most significant grouping is the monetary and investment agencies of various government entities including the Kuwait Investment Office and its three or four related financial agencies, the Singapore Government Investment Corporation and the Abu Dhabi Investment Authority.

The three principal groupings are followed by three other principal types of investment as follows:

First, publicly held real estate companies such as Trizec, Doan and Cadillac Fairview, all of which are traded on the Toronto, Vancouver and Calgary Exchanges; MEPC and Hammersons who are traded on the London Stock Exchange; and Hong Kong Land and Swire who maintain quotations in both Hong Kong and London.

The fifth group comprises the multi-national syndications designed to provide an investment channel for wealthy, taxable individuals. The principal groups are Lehndorff, who have been active investors for upward of 12 years, along with the three principal German commercial banks, namely Deutsche, Commerce Bank and Dresdner.

The final and least quantifiable group of investors are those wealthy individuals whose names are often known widely in connection with other activities such as the Marcos family from the Philippines, the Saudi Royal Family, the van Vlissingen and Brennichmaier families from Holland, and the Niarcos and Onassis families from Greece.

What prompts these institutions' and individuals' interest in investing in real estate in the United States?

1. The most dominant reason for investing in the USA is to obtain some diversification outside what are relatively narrow-based economies. This is particularly true in the case of the British and Dutch-based funds.

2. This is compounded by a belief that the U.S. dollar and economy will have a potentially stronger growth profile than their own economies and currencies.

3. Also the yields and returns are perceived as being attractive by comparison to the returns available in their own countries, taking into account economic and political factors. This is particularly true in the case of Japanese-based institutions.

4. In the case of the government entities such as Kuwait or Singapore who are charged with investing huge capital surpluses, the country's own economy would simply be unable to absorb the capital flows without causing severe strategic or social disruption.

5. In certain instances, investment overseas and specifically in the USA may be prompted by an inability to achieve an effective portfolio balance between various property types by investment in the fund's own country. This factor has certainly played a key role in the attitude of certain British investors toward retail investment in the USA. In the United Kingdom there is an accute shortage of quality retail investment situations in the principal metropolitan areas, a disproportionate percentage having already been acquired by the major life insurance companies. Thus extension of the funds' asset base to the United States assists in creating a more balanced portfolio between the principal types of commercial real estate.

There are also a number of negative or passive reasons for investing in the U.S.:

1. The Japanese Ministry of Finance has stated that one of the reasons they are encouraging overseas investment by Japanese life insurance companies is to ensure that some of their real assets are protected from the very high earthquake risk which threatens three or four of Japan's principal centers of population, including Tokyo and Osawa.

2. Many individual investors and certain government agencies may be prompted to undertake an overseas investment program, motivated by a concern over internal political or economic stability or alternately a threat from a neighbor or close neighbor such as Iran or China. These types of reasons are at the forefront of investors' minds in countries such as Kuwait, Germany, the Philippines, Saudi Arabia, Italy, and Hong Kong.

The question which is most commonly asked is what returns and yields are the foreign investor seeking. I would also like to extend this question further to what influences these yield targets.

In my experience the more qualified foreign investors are seeking net internal rates of return, cash-on-cash or free and clear yields which are in line with domestic U.S. institutions. I think this may be less true when one starts examining smaller buildings in locations which are popular with foreign buyers such as Washington, Atlanta or San Diego. Also some of the foreign government entities and syndicators may have sacrificed too much upside in their search for comfort from local developer/partners - although that is very difficult to judge. Foreign investors are not the wild men that most people consider them to be - in my experience some of them, such as the Singapore Government Investment Corporation, are among the most sophisticated. In performance terms, many have fared as well or better than local U.S. institutions or commingled funds.

Apart from yield constraints, it is helpful to examine what form the capital eventually takes. Generally speaking, it is equity oriented in character. The principal variable is the risk profile which the investor is prepared to adopt. With such a wide range of foreign investors, it is very difficult to generalize. However, I think it is accurate to state that the overseas life companies tend to be security oriented and thus lean toward situations which are effectively fully leased and income producing.

Pension fund attitudes vary enormously. For instance, some of the British funds, having established a "core" portfolio, are now seeking more risk-oriented or creative opportunities such as regional shopping centers which call for expansion, remodeling or remerchandising. On the other hand, some of the British funds such as B.P. Pension Fund and some of the foreign government entities are only prepared to invest with a local institution such as the Prudential or Aetna or alternately with a well-established national developer.

Some of the investors have shown a willingness to contemplate the risks associated with funding during construction or alternately as and when a certain amount of leasing has been achieved. The capital may be injected as a combination of debt with conversion or participation features as well as pure equity capital. A fairly conventional arrangement has been the one whereby the financial partner receives a guaranteed return on a portion of the capital, preferred (accrued or otherwise) on the remainder with the developer achieving a similar return on his imputed equity. Generally speaking the individual investors are prepared to take a higher risk profile in their investment activity.

What role does investment in U.S. real estate serve for the principal institution and individual overseas investors?

Many of the roles afforded by their investment program in U.S. real estate are mirrored by the original motivation for investing in real estate in the USA.

To summarize, these are basically as follows:

1. To provide further diversification in the fund's equity based portfolio and specifically in real estate. This diversification may be undertaken with a view to assuming risk beyond a narrowly based economy or alternately to achieve some exposure to a property type which may not be freely available within the investor's own economic framework. This particularly applies to retail investment in the case of a number of British-based pension funds.

2. Investment in U.S. real estate also affords the opportunity to obtain exposure to the U.S. dollar which may complement the funds' exposure to investments which are held in other foreign currencies such as the German Deutsche mark or the Japanese yen.

3. The investments generally assume the form of equity type positions, although they may frequently be expressed in the form of convertible loans or participating debt, thus affording the investor the opportunity to realize some of the tax benefits which may be achieved through the favorable treatment of interest payments due to a foreign based entity under the terms of the withholding tax legislation. In the context of the funds' portfolio, these investments are generally segmented in the higher yielding section to compensate for the inevitable risk associated with any foreign or overseas investment and the particular risks which arise in relation to conversion from one currency to another.

To summarize, the role played by U.S. real estate in the foreign investors' portfolio usually encompasses a combination of factors including diversification, protection and higher yields.

<u>What are the major distinctions between the foreign-based investor and the U.S. investor?</u>

<u>Taxation</u>:

Firstly, the majority of the foreign investors are fully taxable entities although certain government agencies such as the Kuwait Investment Office and Singapore government are exempted from payment of income or capital gains taxes in the USA. However, these exclusions generally only extend to sovereign governments or their agencies. However, many foreign investors are able to take advantage of the favorable treatment of interest payments remitted to an overseas investor domiciled in certain countries. The British/American Treaty effectively provides exemption from any form of withholding tax or income tax in relation to interest payment remittances to a British-based investor, although income distributions and dividends are of course subject to both income tax and withholdings.

Likewise, the majority of the overseas funds are also subject to the payment of capital gains tax. Many foreign investors initially handle their activities out of tax havens such as the Netherlands Antilles, utilizing the favorable arrangements arising under the tax treaty between such domains and the United States to protect themselves from exposure to capital gains tax and other forms of taxation. Most of these loopholes have now been closed by the Foreign Investment in Real Property Tax Act, which has effectively stopped the avoidance of payment of capital gains tax on the sale of stock and real assets by transferring the contingent tax liability to a purchaser and introducing certain reporting requirements.

Another major distinction between many United States investors and the overseas entities is that the foreign investor very rarely enjoys the benefit of "in-house" expertise. Thus the majority of the foreign investors have had to align themselves with one of the principal investment banks, consulting or investment management companies along with a wide range of other advisory entities. The difficulties associated with working through an independent advisor are frequently compounded by the problems associated with speaking a foreign language, understanding an alien legal system and interpreting the myriad of differences which exist between any two sophisticated societies.

How long have they been investing?

The dramatic expansion of foreign investment activity in the real estate area has really only occurred during the last 10 to 12 years initiated by principally Dutch and British pension funds, closely followed by a wide range of wealthy individuals hailing from many different domains scattered as far afield as Eastern Europe through to South America. It is fair to state that the former entities can generally be characterized as highly responsible institutional type entities, whereas the latter category has frequently taken the form of flight capital seeking a safe haven from an overly harsh tax or political regime.

Before rounding off my comments, I just wanted to briefly allude specifically to the contrast between the attitude toward real estate which exists in the United Kingdom, for instance, and the United States. In the United Kingdom, unfortunately, statistics are far less freely available than in this country. However, my firm has estimated that the total pool of investment quality buildings amounts to a total value of approximately $110 billion. The total value of the stocks quoted on the London Exchanges currently equates to a figure of approximately $300 billion. By contrast with the U.S. situation, which Meyer alluded to prior to our discussion, approximately 15% of all pension funds are invested in commercial real estate, this figure having reduced from a level of approximately 20% in 1981 due to the material rise in the value of other forms of investment securities, principally common stocks. Furthermore, I think it is particularly worth noting that just over 3% of the U.K. pension funds assets are now held in U.S. real estate.

As noted earlier in my talk, investment in commercial real estate in the United States and certain other foreign countries such as West Germany, Japan, Australia and Holland has been principally motivated by a desire to achieve some element of diversification in the fund's underlying portfolio and specifically in the real estate area. The merits of pure diversification have been further enhanced by the higher returns which have generally been achievable in relation to quality commercial real estate investments in the United States, combined with the frequent desire to seek some form of U.S. dollar-based investment as a hedge against future dramatic movements in the relative values of the principal world currencies.

In my judgment, the movement of investment capital between responsible institutions based in stable economic areas is likely to extend dramatically over the next 10 years with dramatic improvements in transportation, communication and the level of understanding and advice which is available on a global basis. As the world's principal economic regions become increasingly interdependent on each other for their future welfare and growth, there is considerable merit in extending the concept of global investment to the specific area of real estate.

Thus, as the British economy becomes increasingly dependent on the welfare and growth of other major manufacturing and trading nations, we have heralded a dramatic diversification in the location of real estate investment in the United States through to all the principal European nations and extending as far afield as Japan, Singapore, Australia and Canada. It is through the medium of this multi-national or global investment activity that many of the more sophisticated funds have been able to minimize the volatility in their underlying portfolios through relative currency movements, fluctuations in economic stability and other factors which may adversely affect investment in an isolated overseas investment location.

MR. MELNIKOFF: Gentlemen, my compliments. I think the Society is in your debt for having made a significant contribution to the body of knowledge in our Record. We are now in a position to be able to accept questions.

MR. WILLIAM STENGROSS: I have a question for Mr. Keith regarding Prudential's attitude toward the leverage of existing real estate, income producing real estate and using leverage on development properties.

MR. KEITH: In reverse order we do use leverage on some of our development properties, particularly where we have a joint venture partner and the joint venture partner wants to have a significant proportionate interest with a limited capital investment. The joint venture will borrow from a third party to help the partner have a higher proportionate interest than he would be able to carry if we did things on an all cash basis. In our own account we do have some properties that are leveraged. Particularly, if we acquire a property with an attractive leverage on it, we don't repay the mortgage. At the same time we value very much the ability to manage properties which Bill alluded to. In general we would just as soon have a property unleveraged and with total flexibility to manage it. I guess the answer is we're very pragmatic. We don't have a fixed position. We do what seems to be best in the particular situation.

MR. MELNIKOFF: May I ask Chris two related questions? What is the extent of leverage used by the British pension funds in Britain and to what extent do they use leverage when they invest in the United States?

MR. BUDDEN: In the United Kingdom there is virtually no commercial mortgage market. In fact, as far as we're aware, there is only one insurance company now extending commercial loans. That's the Royal Insurance Company, based in Liverpool. So, effectively all the U.K. pension funds and insurance companies are totally unleveraged and are free and clear of any form of debt. In this country the philosophy has generally been to acquire, where available on economic terms, leveraged interest rather than free and clear interest. The philosophy behind that being to try and diversify as far as possible the limited number of dollars that are available for investment within the United States.

MR. HUNGPING TSAO: Being a subsidiary company, what investment strategy would you recommend that I use?

MR. BUDDEN: That is a very difficult question, obviously, without any detailed insight as to the size of the portfolio and your objectives. All I can say at a glance is the philosophy of investors which are institutional in character, as opposed to some of the individual investors I mentioned, is to concentrate on the acquisition of larger holdings, primarily for three reasons. Firstly, we see a changing zoning and basic social interest structure occurring, similar to the one that's occurred in Western Europe as opposed to over here, which in our judgment is likely to result in much more constraint on high rise or large scale settlement activities such as major regional shopping centers in areas such as California. Secondly, the evolution which has been occurring or has occurred in the financial markets has reduced the number of developers who can effectively contemplate major commercial development undertakings, thus reducing the competitive influence in those areas and hopefully the number of projects that may be initiated and concluded. And thirdly, and by far probably the most important, is the caliber of management that we found we can attract in relation to major projects far exceeds what is available in relation to strip shopping centers for instance, and other smaller types of investment.

MR. RONALD KARP: I have a question that I'd like to address to Garnett Keith. You mentioned that with the trend toward segmentation of life company assets and toward the increased use of interest competitive products that you saw a movement away from real estate investing for the general account of life companies. I think that you longingly thought that this might be foregoing some attractive return opportunities. Isn't this a situation that would lend itself toward some kind of participating mortgages or convertible mortgages where the return could be available to the line that needs a fixed income and perhaps even to separate the return components of a given investment within different lines of business or subsidiaries of a company? I don't know if there are any technical problems with that.

MR. KEITH: Ron, I do longingly forego higher economic returns in the name of a highly visible and more marketable lower return. I guess I'm showing my investment background as opposed to my marketing background in making that statement. We do look at, and, as interest rates are moving up fairly rapidly, we are certainly seeing more project managers willing to contemplate a participating mortgage. Just yesterday we were looking at an opportunity in the form of a mortgage that looked like it would provide a total return of about 16%, of which 11-3/4 to 12% was current and the balance was participation. We concluded that that was still enough below what we needed as a current yield in the general account in some of the interest sensitive products so that it was not a candidate for the general account. But we do have other kinds of separate accounts, some of which are for pension customers, for whom we concluded that a 16% total return, with some upside potential if the participation proved to return more than a fairly conservative inflation assumption, was attractive. We do have a problem in putting part of something in our general account and the remainder in an account that is covered by ERISA. ERISA, as you know, is very strict on those kind of things. I think there may be more opportunities to work together with someone like Integrated Resources where we might be putting shared appreciation mortgages into an ERISA account to help them leverage a property where they're getting the tax benefits. I think there is more engineering going on. Having said all that, we are great believers in the importance of being able to manage the property over a period of time. Managing the property includes not only what you do to the lease role, but what you do to the physical structure of the property, the timing on when you buy it, when you sell it and, the more complex the transaction gets, the more you give up that ability to manage. We really think long and hard about getting what appears to be a 50 or 100 basis point nominal increase in the return up front, but substantially impairing our ability to manage that property fully five or ten years down the road.

MR. MELNIKOFF: Ron, if I could just add a comment to that, Claude Ballard, who is a close associate of mine, is fond of creating aphorisms and in this context he says the more complex the real estate investment, necessarily the less liquid it becomes. Are there any other questions?

If not, I have one on which I would like to get a reaction from someone in the audience. I understand that some insurance companies have been creating guaranteed investment contracts based largely on mortgages and in some cases perhaps matched to specific individual mortgages. Is there anyone here who would care to comment on that? I'm speaking about commercial mortgages being used as the basis for insurance company-offered guaranteed investment contracts. I understand this has become a fairly large business and it means that it is very difficult to trace the relationship of pension funds to providing mortgage finance because it's done indirectly through an insurance company.

Chris and Ben, is there anything further that you can add on the potential impact of what is currently being considered in the tax bill, on all kinds of real estate investors?

MR. BUDDEN: Specifically in relation to foreign investors, I don't see any further regulations being introduced in the near future. As you know, both houses introduced some filing requirements and then allocated three members of the executive to monitor those requirements and found that they were so deluged with the volume of the reporting information they've had to abrogate them, and I think that's probably now a permanent situation. In the domestic arena I'm getting word that there are likely to be some very extensive changes after the election. In our investment stragegy we're certainly now trying to contemplate some possible changes in relation to the at-risk group, maybe a diminution of its employment in relation to real estate, specifically in relation to commercial assets. This would obviously have a very significant impact on the industry on a short and early-medium term basis.

MR. FEIN: Right now there are two tax bills, one passed by the House and one passed by the Senate, which are similar but different in many respects. The bills are now pending before the conference committee. The conference committee plans on beginning their meetings next Tuesday. We ought to have a very good fix on what the bill will look like between the 15th and the 25th of this month. The various items that are being discussed, and some of the more controversial ones, are that the Senate proposal would increase the useful life of real estate from 15 years to a sliding scale that would be 20 years this year, 19 next year and 18 thereafter. The House has no provison with respect to changing the useful life. There was a recent vote to get a sense of the House and give direction to the conferees. The vote was something like 350 to 50 to direct them not to make any move whatsoever with respect to depreciable lives. Integrated Resources had testified before the House Ways & Means Committee, and supported an extension of the useful life of real estate from 15 years to 18 or 20 years. We don't think such a modification will have a major negative impact on the tax benefits or the economics of real estate investments given the probable market adjustments which will follow. An 18 to 20 year depreciable life often more appropriately reflects the real economic useful life of such property. In fact, it's still a very beneficial basis and sort of gets the focus off the "real estate loophole". Notwithstanding that, I would say there is a very good chance of the 15 years standing up or alternatively a compromise around 18 years. There are two other major items that would affect real estate. One has to do with some very very complex accounting rules with respect to sale lease-back transactions that is only in the Senate bill and not in the House bill. Also, both houses are discussing certain rules that relate to extending the OID rules to purchase-money debt. Right now purchase-money debt is excluded from those rules. Therefore, in a transaction whereby purchase-money debt is taken back by a cash basis taxpayer, there could be accruals which are deducted by the buyer and not included in the income of the tax sensitive seller. That is viewed as a loophole that will be closed, but I think once it is it increases the need, the possibility, the desirability of tax-exempt entities such as pension plans to sit in that position with accruing mortgages where otherwise, if it were in other institutions, they would be picking up phantom income and paying tax on it. That obviously has little effect on a tax-exempt pension fund, and I think is an area of great opportunity in the future for funds to act on that capacity.

MR. MELNIKOFF: Garnett, I wonder if you have ever thought of what role there might be for insurance companies in tax-sheltered or tax-advantaged forms of investment for the consumer?

MR. KEITH: We thought about it. I think we thought about it more through our subsidiary Prudential-Bache which serves a more upscale market than the traditional Prudential agency force. I understand that some of the insurance companies who do serve principally an upscale market through their own agency force or general agents have made connections with the providers of tax-advantaged products and are distributing those in some volume, although I think not nearly as much volume as the securities firms.

MR. MELNIKOFF: Bill, will you comment briefly on what difference there seems to be in the attitudes of the public retirement systems and the corporate pension plans with regard to real estate?

MR. RAMSEYER: Generally speaking, the public employee retirement systems which, as you may recall from my earlier comments, represent about a quarter of the market, are relatively new to equity investment in real estate. Their corporate counterparts started back in the early days when you and your colleagues formed the PRISA account at Prudential. Public employee retirement systems differ in a sense that the trustees and the decision makers are often political appointees or people with other governmental responsibilities who do not have professional backgrounds in investment, finance and economics as do their corporate counterparts, who often come from the Treasurer's Office or the Controller's Office of a corporation, and therefore are associated with business in economic and investment decisions. As a result, I think the public employee retirement systems have been more cautious and generally less exposed to equity real estate. I can say with some certainty that their commitment to equity real estate is very real and they're very serious about increasing their diversification. They too suffer from a lot of pressures to reduce contributions. As you know, state and local governments are not terribly flush these days and they, like employers, must make contributions to retain the integrity of the retirement systems. There is a lot of political pressure now upon the trustees of these funds to increase their performance which, generally speaking, has been pretty dismal over the past many years, primarily because they're so heavily dependent upon debt instruments. If you look at the asset allocation of public systems vs. private systems you'll see that they have about 10 to 12%

higher commitment to debt-oriented instruments as opposed to equities. They have not made the equity shift, both stock and real estate, to the extent of their corporate counterparts.

MR. MELNIKOFF: As tax payers, we all should support the move that seems to be taking place throughout the country, at liberalizing the investment restrictions on the public pension plans. Chris, there is in the United States a great move toward internationalizing the securities portfolios of U.S. pension funds. To what extent do you think it is valid to consider doing the same with the real estate equities?

MR. BUDDEN: On the face, it is extremely difficult to justify encouraging any U.S. fund currently to look at the principal markets overseas that I mentioned during my talk, namely the Japanese, German or British market, and on the basis of the fairly significant current yield differential which exists, in relation to real estate in those centers as against those available in this country. For instance, in Tokyo, first class commercial buildings change hands on the basis of current returns of 3 to 4%. Likewise in the United Kingdom, 4 to 5-1/2% and in West Germany, marginally higher than that. However, I think if you look at relative currency movements and anticipated movements over the next three or four years and a number of other factors, there probably is some justification for having a small percentage of one's assets in real estate outside this country, in some of the more stable economic centers. Thus you will obtain some exposure to economic movements in those countries and insulate the portfolio against the exclusive exposure to a dollar-based economy.