

NCREIF SPRING 2002: BECOMING A BENCHMARK

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The NCREIF Property Index (NPI) has evolved during the past year and progress toward becoming a benchmark has been substantial. Operating changes made have improved timeliness (release is now 25 days after quarter end) and strengthened credibility. The end of routine index revisions is near. NCREIF remains focused on meeting the information needs of the institutional investor community.

BRIEF HISTORY

The NCREIF Property Index was developed in the early 1980s for the purpose of bringing increased credibility to the real estate asset class by providing a means to judge the attributes of real estate as an institutional investment alternative to stocks and bonds. It was never intended to function as a formal investment benchmark, but rather as a reliable way to judge the overall return characteristics of unleveraged real estate. NCREIF was formalized as an organization in 1982 when a founding group of fourteen firms committed to contributing their quarterly property performance data. From that humble beginning, with 781 properties worth \$4.9 billion in the fourth quarter of 1982, the NPI has grown to 3460 properties in the first quarter of 2002, with a market value of \$112.6 billion, from 52 data contributors.

One constant has remained: the stated mission of NCREIF "to foster understanding of the real estate asset class, through the collection and dissemination of information, performance measurement, standards, research and education... providing the membership with the index data-bases as a research tool..."

One key expansion of the mission was made ten years later, in 1992. The industry was facing a credibility crisis, precipitated by the excess development of the late 1980s and the lack of consistent investor reporting by managers. To develop this "common language," NCREIF embarked on an ambitious effort, in conjunction with PREA and NAREIM, to develop Real Estate Information Standards (REIS) to clarify and standardize the information and reporting requirements for real estate investment. With the publication of the initial REIS in 1995, real estate investors were finally able to more effectively compare information and performance returns among their managers.

WHERE ARE WE TODAY?

With growing trust in the reliability of Real Estate performance information and increased demand for benchmarking among institutional investors, the NPI has almost inevitably been commonly adopted as a benchmark for real estate investment. This evolution from a research database for the real estate asset class to a performance measurement tool for real estate investors creates a need to improve the benchmark attributes of the NPI.

NCREIF accepts responsibility for converting the NPI into the best benchmark possible for private real estate investment. While several of the critical features of a public market benchmark are not possible for a private market benchmark (investibility, known composition) there are other areas where the NPI can be dramatically improved. When plan sponsor users of the NPI were surveyed in the summer of 2001, their two biggest concerns with the NPI were timeliness and historical revisions. In the past few years, the preliminary NPI was released 45 days after the end

of the quarter, with significant revisions to the previous quarter's index and possible revisions back over several quarters. This methodology had been developed to allow for the best possible index database for research purposes. When used for research purposes, historical accuracy is far more important than timeliness. While revisions make use as a benchmark nearly impossible, researchers want to have the most accurate possible view of historical performance, even if it involves revisions many quarters or even years after the fact.

In response to the user survey, NCREIF has undertaken two initiatives: to dramatically increase the timeliness of the release of the NPI and to revise the index methodology to eliminate revisions.

INDEX TIMELINESS

In the survey last summer, while 46% of plan sponsors reported that 45 day release of the NPI met their needs, 85% of users cited 20 days is required to meet their needs for timeliness. The First Quarter 2002 NPI was released on April 25th, a full 20 days earlier than previous practice. This was made possible by three changes: first, the deadline for member data submission to NCREIF was moved from the 25th day after the quarter (30th day for fourth quarter submission) to the 20th day; second, NCREIF staff reduced processing time from an average of 15 days to five days; third, data contributors were informed that the names of firms missing the reporting deadline or not timely responding to staff inquiries would be published. The current goal of NCREIF is to release the NPI by the 25th day after each quarter. We will be exploring with our data contributors when the reporting deadline can be moved up to the 15th day, so we can publish index results by the 20th day. Later this year we will also be surveying our data users to determine if further improvement to timeliness is necessary.

ELIMINATING REVISIONS

Changing index methodology to eliminate revisions requires more significant changes. The NCREIF Board appointed a group known as the "Freeze" Task Force to study the sources of data revisions and recommend new policies and procedures to eliminate, if possible, all sources of revisions. The task force identified four sources of revisions: treatment of sold properties, late data submission, new members contributing historical data, and errors in submissions. The Task Force recommended the following procedural changes:

TREATMENT OF SOLD PROPERTIES

Historically, the most significant source of revisions involved the treatment of sold properties. Since a full quarter of property performance information was not available in the quarter of sale, the previous period's market value was overwritten by the net sale price, resulting in a revision to the prior quarter for any difference between the net sales proceeds and the prior market value.

To revise this procedure, NCREIF will collect additional data from data-contributing members related to property sales such that results are included in index return calculations for the period of sale. Data requirements include, but are not limited to, sale date, and income and capital improvements through the time of sale.

Property sales will be treated as a partial sale for purposes of the index calculation. Essentially, this will treat the sale of the entire property using the same formula we currently use for sale of a portion of the property during the quarter, a method that effectively assumes that the sale occurred at mid quarter and that income was realized at the end of each month. At the individual property level this would have the impact of magnifying the appreciation return volatility relative to the way we currently treat sold properties, as a result of magnifying the quarterly return impact of the difference between the transaction price and the prior appraised value. When calculating a value-weighted aggregate return, however, the result should be about the same as the way we currently handle sales, because the sold property weighs less in the calculation of the aggregate return due to the reduction of the denominator.

The impact of this change will be to reverse the prior policy of treating sales of index properties as having occurred at the end of the prior quarter. This will eliminate a routine source of index changes and contribute positively to index credibility.

LATE DATA SUBMITTALS

The treatment of late data submissions will be modified to allow for index publication if late data is not significant to overall index or sub-index (property-type and region) results. The Index Oversight Committee (IOC, discussed later) will determine the statistical significance of the outstanding data.

If the outstanding data is insignificant, the index should be published by effectively "turning off" the outstanding properties in the index calculations. The data should be submitted once available and should continue to be utilized in the database. Upon timely submission of data in the following quarter, the property would re-enter the index at the last reported ending market value, adjusted for capital improvements, partial sales and purchases during the "turned off" quarter. This would ensure that any changes in property value are reflected in the NPI. Properties that are not submitted on time for index publication in any two quarters in a four-quarter interval will be deemed ineligible for further inclusion in the index.

If the outstanding data is significant to the NPI, the IOC may delay publication of the index or define the related assets as ineligible data, excluding them from future index calculation. The IOC may also recommend that the NCREIF Board formally review the continued membership of the data contributing firm involved.

The impact of this change will be to eliminate a potential source of index changes, while reserving the right to delay release of or restate the NPI if circumstances warrant.

RECOMMENDATION REGARDING NEW MEMBER HISTORICAL DATA

For many years, it had been the policy of NCREIF to incorporate historical data from new data contributing members if possible. This policy was changed last year, as the breadth and depth of the greatly expanded NPI makes inclusion of historical data from most possible new members an insignificant contribution to the overall index.

RECOMMENDATION REGARDING TREATMENT OF ERRORS

The IOC should be delegated the authority to determine the statistical significance of identified errors. Insignificant items will be recorded in the period in which they are identified. Significant items will be disclosed to users of the index and the index will be restated. Users may be notified of the identity of the data contributor(s) committing such errors. It is the responsibility of each data-contributing member to assure the quality of their data submissions.

The impact of this change will be to eliminate a potential source of index changes, while reserving the right to restate the NPI if circumstances warrant.

CHANGES REGARDING NPI POLICIES AND PROCEDURES

To strengthen the data quality and control procedures of index contributors, NCREIF has initiated a data contributor compliance review. Third party experts in real estate accounting and performance measurement, supported by the NCREIF staff, began in the fall of 2001 to perform on-site data submission compliance reviews. These reviews will be performed on a rotating basis going forward. Primary responsibility for data integrity continues to rest with the contributing member.

Compliance with the Real Estate Information Standards will be one of the criteria for eligibility for inclusion in the NPI. This will ensure that managers and plan sponsors who are following the standards can fairly be compared to NPI results. Since it is impractical to allow full transparency of individual property performance information, the requirement that all included properties be managed in accordance with REIS will provide a measure of increased data homogeneity and credibility.

Finally, the Task Force recommended and the NCREIF Board of Directors has approved the formation of a formal Index Oversight Committee. The IOC has been delegated certain specific Index related oversight responsibilities: i) refinement of index processing rules, ii) quarterly index production decisions (such as significance of late data submissions and error checking), iii) determination of property eligibility and iv) recommend index policy changes to the Board. The IOC is comprised of five members, appointed by the NCREIF Board for three-year terms to assure continuity.

When taken in their entirety, we believe that these changes should significantly increase the credibility and utility of the NCREIF Property Index as both a research tool for the real estate asset class, as originally envisioned, and as a performance measurement tool for tax exempt institutional investors.

CONCLUSIONS

Progress has been substantial; much remains to be done.

Routine revisions will be discontinued by the end of 2002.

Data integrity will be monitored on an ongoing basis.

A timeline for publishing the index in 20 days will be established.

This progress is not possible without substantial industry support. NCREIF is grateful for both member and industry support.