New Note to Investors: In a Rising Market, New Acquisitions May Lag, at Least in Year-One!

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In the middle of 2007, during a period of outstanding positive total return for the NCREIF Property Index (NPI), Doug Poutasse wrote an article for the NCREIF Performance Report[1] entitled Note to Investors: In a Rising Market, New Acquisitions May Lag. Doug was then the Executive Director of NCREIF and his article was in response to investors that were questioning why their managers were producing subpar results. Many funds and separate accounts were buying heavily during those 'best of times', creating portfolios that were over concentrated in new acquisitions.

Doug grouped properties into acquisition year cohorts and measured, for each cohort, excess return versus total NPI. He found that in the current annual period (at the time, that was 2006Q3 to 2007Q2), the properties purchased in the most recent year (2006, let's call it V-1 for VintageYear=one year ago) underperformed considerably. Properties purchased the year before, in 2005 (V-2, for VintageYear=two years ago), underperformed as well, but not as severely. The 2004 (V-3) cohort of properties were on average, neutral to the NPI total, and for the most part, earlier cohorts all outperformed to some degree or another.

Before that article was written, the result was already largely intuited. Newly acquired product, in a rapidly rising market, will tend to lag as they generally price at the top of market. In turn, existing properties in the NCREIF portfolio take some time to adjust, marking up to meet the new pricing highs. Doug also found that the converse is true: in a declining market, new acquisitions tend to outperform. Either way, the data showed him that by year four or five, the returns generally normalize.

That was then. But all investment advisors are drilled in that good old compliance footnote which states, 'prior experience does not guarantee future results'. Still, we expect that what Doug found remains true. We set out to prove it.

Let's look again at the results from 2007. In order to not get bogged down in the numbers, Exhibit 1 to the right shows relative performance in color. Pink shading denotes underperformance greater than 50 basis points, green denotes outperformance greater than 50 basis points, and no shading denotes neutral performance, which we are defining as within 50 basis points. All the details of the data nuances can be found in Doug's article.

EXHIBIT 1

Purchase Year	Excess Return in 2006Q3 - 2007Q2		NPI Appreciation during Purchase Year
2000 (V-7)		Outperform	Positive
2001 (V-6)		Outperform	Negative
2002 (V-5)		Neutral	Negative
2003 (V-4)		Outperform	Positive
2004 (V-3)		Neutral	Positive
2005 (V-2)		Underperform	Positive
2006 (V-1)		Underperform	Positive

Does the same hold true today, again in a period of strong appreciation? And digging a little deeper, now that we easily can, did it really hold true during the last cycle? At the time that Doug ran his numbers, the NCREIF query tool was not yet available, so this analysis was much more onerous than it is today. Furthermore, in the seven years since the article, data cleanup efforts have been implemented, leaving us a much cleaner data set. Given those facts, we re-ran the numbers, and while the exact basis points of out / under performance are not

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[1] Note to Investors: In a Rising Market, New Acquisitions May Lag, NCREIF Performance Report, 2007 Q3, pps 2-5

exactly as Doug found them, the green – pink – white pattern in the table above holds true. As you see, the most recent acquisitions, shaded pink, were laggards.

In order to compare the mid-2007 pattern of vintage year cohort performance to a current period, we wanted to use a mid-year look. We also wanted to pick a period which corresponded to the same point of this upside versus the last. In the last cycle, 2007 Q2 was 17 quarters past a trough. In this cycle, 17 quarters past trough lands us at 2014 Q2. Perfect! So, our excess returns compare vintage year cohorts to total NPI for the period 2013 Q3 to 2014 Q2. Results are shown in Exhibit 2 to the right.

EXHIBIT 2

Purchase Year	Excess Return in 2013Q3 - 2014Q2		NPI Appreciation during Purchase Year
2007 (V-7)		Underperform	Positive
2008 (V-6)		Outperform	Negative
2009 (V-5)		Outperform	Negative
2010 (V-4)		Underperform	Positive
2011 (V-3)	9	Neutral	Positive
2012 (V-2)	0	Neutral	Positive
2013 (V-1)		Underperform	Positive

The results are somewhat similar, but not quite the same. The most recent vintage, V-1 does underperform, as they did in mid-'07. But the V-2 cohort is neutral to NPI, unlike in mid-'07, when it underperformed. The V-3 cohort is neutral in both cycles, but the V-4 portfolio underperformed in this cycle whereas it outperformed in the last. Perhaps 50 bps for 'neutral' is the wrong number? Actually changing the cutoff, or eliminating a neutral category all together does not make the pattern of vintage year performance the same this cycle versus the last.

Let's dig deeper, now that we can, unlike in 2007 when it was much more difficult without the query tool. First of all, remember the comment above that we were at the same point in the cycle? That is true, but the intensity of the two cycles is quite different as you can see in Exhibits 3 and 4 below.

EXHIBIT 3

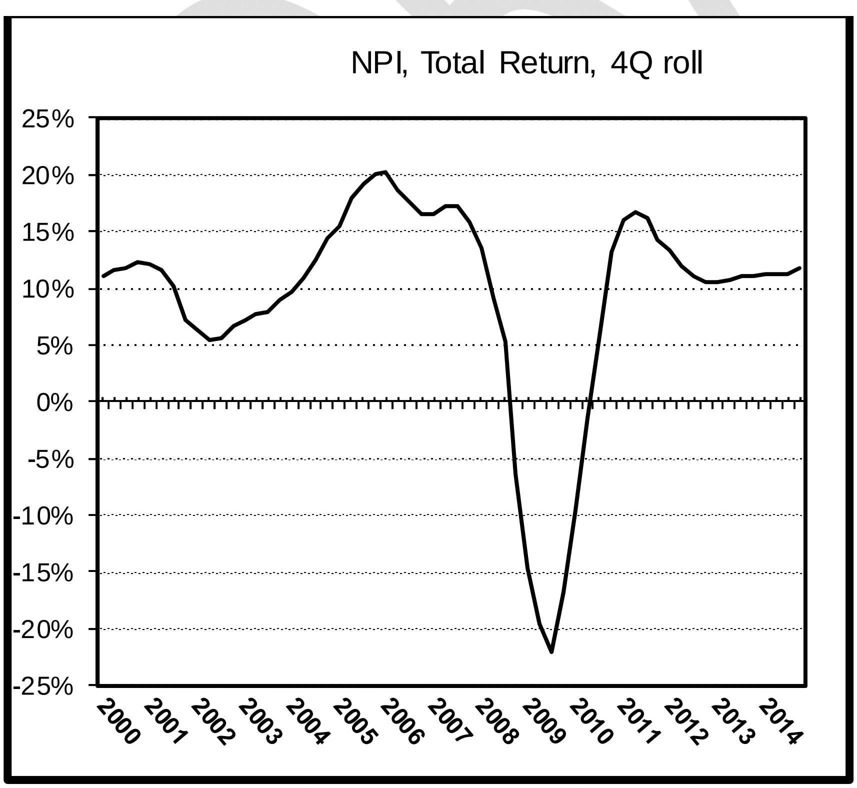

EXHIBIT 4

Year	NPI Appreciation	
2000 (V-7)	Positive,	3%
2001 (V-6)	Negative,	-1%
2002 (V-5)	Negative,	-2%
2003 (V-4)	Positive,	1%
2004 (V-3)	Positive,	7%
2005 (V-2)	Positive,	13%
2006 (V-1)	Positive,	10%

Year	NPI Appreciation	
2007 (V-7)	Positive,	10%
2008 (V-6)	Negative,	-11%
2009 (V-5)	Negative,	-22%
2010 (V-4)	Positive,	6%
2011 (V-3)	Positive,	8%
2012 (V-2)	Positive,	5%
2013 (V-1)	Positive,	5%

The downturn in the early part of the 2000s was mild enough that annual total returns never went negative, having been sufficiently buoyed by income returns. That is very different from the experience of the most recent downturn when total return was trashed by rapidly declining prices. Also quite different is the upside profile. After the mild downturn in the early 2000s, appreciation growth started out tepid, but ended with multiple years of double digit appreciation. This time, after the deep decline, value growth was relatively strong from the get-go. Yet, it still has not reached a double-digit annual pace.

Might this explain the different pattern of vintage year performance? Well, we also know that the pattern of outperformance by sector has been different this cycle. For example, for the first several years after the most current trough, the apartment sector was the clear winner. That was not the case after the trough in early 2003. But how have new acquisitions fared within each sector? Exhibit 5 below shows vintage year excess returns by sector, in both cycles. To be clear, for each sector, the vintage year cohorts are compared to NPI for that sector, not total NPI. So, recent apartment purchases compares to total apartment performance, for example.

EXHIBIT 5

	Vintage Year Excess Return 2006 Q3 to 2007 Q2				
Purchase Year	Total NPI	Apt	Ind	Off	Ret
2000 (V-7)					
2001 (V-6)					
2002 (V-5)					
2003 (V-4)					
2004 (V-3)					
2005 (V-2)					
2006 (V-1)					

	Vintage Year Excess Return 2013 Q3 to 2014 Q2				
Purchase Year	Total NPI	Apt	Ind	Off	Ret
2007 (V-7)					
2008 (V-6)					
2009 (V-5)					
2010 (V-4)					
2011 (V-3)					
2012 (V-2)					
2013 (V-1)					

First, you can see the variation across sectors. No two patterns of out/under performance are the same. Second, you can see that, like total NPI, the patterns for each sector differ from one cycle to the next. Look at industrial for example. Last cycle, in our study period (year ending 2007 Q2), four of the five most recent vintage year cohorts were underperforming and one was neutral. This cycle in our study period (year-ending 2014Q2), three of the five most recent cohorts were neutral to the bench and two were outperforming. Interestingly, industrial is the exception to the only commonality across sectors and cycles. Year-one performance is nearly universally subpar. You see pink boxes nearly all the way across the bottom row, for both cycles.

We've explored just two ways in which this cycle experience was not like the last when it comes to vintage year performance. Other reasons certainly exist. One which comes quickly to mind is geographic concentrations. Another is fund type. Is there a difference between acquisition activity and vintage year experience between primary and secondary markets? Between open and closed end funds? This topic does deserve more time and probably needs more pages in which to write about.

We do believe vintage matters. While this piece proposes more questions than answers, we continue to explore the hows and whys of vintage matters and look forward to publishing findings in the months to come.