

Fund pricing for institutional open end real estate funds

- > Two main methods used: the dual pricing mechanism and the capitalisation and amortisation mechanism
- > Modelling illustrates that long term investors receive relatively similar returns under either of the mechanisms
- > Fund pricing mechanisms protect investors from the potentially dilutive effects of transaction costs

Since the financial crisis fund pricing mechanisms in open end real estate funds have seen increased investor interest, alongside traditional differentiators including investment approach and quality of management team.

Real estate carries transaction costs which significantly exceed those of most other asset classes. If every investor in an open end real estate fund pays their fair share, the outcome is equitable. However, if existing investors pay more than their fair share of transaction costs incurred on subsequent capital calls from new investors (or new investors fail to pay their fair share of transaction costs already incurred by the fund), then existing investors will receive less than their fair share of future returns. This is dilution and if not effectively managed offsets the benefits of investing in commingled products, such as risk sharing and diversification.

Dilution can be minimised if the pricing of the units in the fund correctly reflects transaction costs. This is a complex task

because investors are entering the fund (buying units) and redeeming (selling units) at different times and in different volumes. To compound this complexity, transaction costs are not static over time. A fixed spread charged on subscription and redemption of units that is fair today may not be fair tomorrow. Institutional open end real estate funds use some form of pricing mechanism to address the problem. A pricing mechanism governs how units in a fund are valued for the purposes of subscriptions and redemptions. The mechanism aims to protect long-term investors from the effects of dilution.

To promote debate and facilitate a better understanding of the topic INREV has partnered with AREF to discuss and analyse the issues involved. A simplified hypothetical model was developed for the purposes of the Phase 1 discussion and to explore the impact of two common pricing mechanisms, classic dual pricing and the capitalisation and amortisation, on institutional open end real estate funds. Its results illustrate that having a pricing mechanism, whichever one it is, is

better than not having one. Put another way, doing something is better than doing nothing. These results are based on the assumptions used in the hypothetical model. Other aspects of this subject will be explored in Phase 2.

‘When properly applied, either mechanism will provide investors with similar protection from the effects of dilution.’

Table 1: Different pricing mechanisms

| | Single Pricing | | Dual Pricing | |
|-------------------|--|--|--|--|
| Sub-category | SWING | NAV | CLASSIC | CAPITALISATION AND AMORTISATION ('Cap & Am') |
| Typically used in | Daily priced funds targeting retail investors | US domestic funds | UK domestic funds | Pan European and Asia Pacific funds (multi-country funds) |
| Brief description | Provides for a mechanism whereby the NAV is 'swung' upwards or downwards by a predetermined factor depending on whether the net capital flows are positive or negative | Trades are directly based on the NAV of the fund determined in accordance with the prevailing financial reporting framework. | A defined spread exists and is applied to the NAV. Units can be bought at a premium to NAV and sold at a discount to NAV. | Similar to the classic dual priced model but in this instance a spread is established using the capitalisation and amortisation approach coupled with a defined redemption levy. |
| Pros | + Protects against dilution + Acts as a deterrent against frequent trading | + Readily understandable + Determined with reference to market standard financial reporting framework + May not result in immediate write off of the spread at investment in books of investor | + Protects against dilution + Relatively simple + Well understood in some markets | + Protects against dilution + Easier to market this model internationally + No subjectivity in the setting of a spread |
| Cons | Complex Distorts ability of investors to compare fund performance Not understood in all markets | Full exposure to dilution Not in line with economic fundamentals of underlying asset class | Challenging to market this model internationally Subjectivity in the setting of the spread Results in immediate write off of the spread at investment in books of investor | In an inactive fund, capitalised costs may be fully amortised Not as simple as the classic model |