

Real Estate Investments of the Rich and Famous

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In recent years, there has emerged a separate body of methodology for management of the investments of large, separately-managed portfolios. The aggregate wealth of such portfolios has rapidly grown to unprecedented proportions. Prince and Grove [2004] estimate that the worldwide number of exceptionally wealthy families is somewhere in the range of 912,000 to 1.4 million, with a “best estimate” of about 1.1 million. Their best estimate of the aggregate wealth controlled by these portfolios is \$91.7 trillion. Further, their study estimates that by 2008, the number of families in this category should grow to about 1.9 million (a 72% increase) and the aggregate wealth of these families is expected to grow to \$154 trillion (a 68% increase).

Clearly, the wealth of the wealthiest families is increasing at a record pace. For example, for the first time in 2006, the Forbes 400 index of the world’s richest individuals contains only billionaires. Indeed, being merely a billionaire wasn’t enough this year for inclusion; the cut-off was about \$1.25 billion. Topping the list was Bill Gates, at \$53 billion, and Warren Buffett, at \$46 billion. The *Washington Post* estimates that the wealth of Sheldon Adelson, holder of the No. 3 spot, has grown by \$1 million per hour for the past two years. A 2006 study from Japan, citing 2003 data, estimates that there are over 60,000 households in that country with financial assets exceeding 500 million yen, and these households own aggregate

investments in excess of 36 trillion yen. That study contrasts these numbers with the mere “mass affluent” in Japan, about 720,000 households with investable wealth between 100 and 500 million yen, who are the targets for traditional investments.

Estimating the real-estate portion of this investment pool is problematic. Prince and Grove [2004] show that almost 95% of super-wealthy families got that way through accumulation of business assets, as opposed to celebrity or speculation. While it is axiomatic that real estate usually plays a major role in a portfolio of this size, what is striking is that the Prince and Grove survey of family offices finds that the number of offices investing in real estate partnerships is expected to *double* over the short-term horizon.

Miyamoto, Mutoh, and Ogimoto [2006], writing for the Nomura Research Institute, note that traditional investment strategies are wholly inadequate to deal with the needs of these super-rich families, particularly those with very recent accumulations of wealth. The purpose of this study is to explore the investment strategies of the super-wealthy, leveraging off of the recent surveys of the families themselves and their investment advisors, with an eye to how their investment goals may differ from traditional risk-adjusted net-present-value-maximizing strategies which traditionally govern real estate portfolio decisions. This study finds a significant divergence in

investment goals and suggests a need for further exploration of real estate portfolio strategy to accommodate these more complex investment needs.

The article explores the divergence between “traditional” investment criteria, which generally govern portfolio management today, and the goals of super-wealthy families. To the extent that real estate investment practice is out of step with the preferences of these investors, the real estate investment community will benefit from analyzing this schism.

However, real estate is unique among asset types, and as a class it holds significant promise to meet the investment needs of emerging super-wealthy portfolios. Bridging the gap between real estate investment thinking and the demands of super-wealthy investors opens significant opportunities for both investors and advisors.

TRADITIONAL REAL ESTATE INVESTMENT MODELS

Traditionally, real estate assets were segregated from securitized assets for three primary reasons:

1. Real estate, both residential and investment-grade,¹ has usually been levered with long-term debt, often fully amortizing, and the source of this debt was traditionally very different from commercial or investment financing.
2. Investment-grade real estate often was acquired to facilitate other business operations.
3. Investment-grade real estate usually was owned by a small subset of investors, and most investors (and nearly all investment firms) segregated real estate investments or chose to ignore them entirely.

In recent decades, however, all three of these investment walls have crumbled. Real estate and non-real estate debt markets are nearly fully integrated. Business investors, particularly large chains (retail, etc.) have seen the benefit of securitizing their real estate portfolios with lease-back deals, captive REITs, and other solutions to remove real estate debt from their balance sheets.² Finally, investment advisors have realized that real estate belongs in a well-diversified portfolio, and even trusts and pension plans now have significant real estate equity holdings—both direct investments and investments in real estate securities.

Thus, in a very brief summary, the goal of real estate investing is net present value maximization. Increasingly in recent years, investment-grade real estate has been included within a Markowitz-type portfolio which is designed to minimize overall idiosyncratic risk without trading off portfolio returns.

As simple as those two sentences may seem, they summarize quite a few Nobel Prizes in Economics. While it would be nice to leave it there, further exploration is necessary to lay the groundwork. Net present value maximization refers to the process of discounting future returns with a risk-adjusted discount rate. Two investments with similar expected future benefits (usually measured as cash flows, including cash flow at some future disposal), but with wholly different risk profiles, will be discounted differently. The investment with the higher risk will have a lower net present value.

The whole stream of portfolio literature, which is usually traced to Markowitz, Tobin, Sharpe, and others, tells us that the risk associated with a financial investment can be captured in the expected variation of future cash flows. That variation can be bifurcated into two categories: idiosyncratic risk, which is unique to the particular investment, and systematic risk, which affects the entire market. The market will not reward an investor for taking on idiosyncratic risk, since that can be diversified away through building a portfolio designed to minimize the covariance matrix of the portfolio constituents. Hence, the market will reward the investor only for taking on systematic risk.

Also, in a perfect world the investor can achieve a theoretical risk-free return, R_f , which should be the “real” interest rate. In practice, this is usually proxied by the short-term U.S. T-bill rate.

Systematic risk is traditionally measured, in a single-factor model,³ as the covariance between the asset and a hypothetical market portfolio. In practice, this is called “beta,” since it is usually derived as regression coefficient (“beta,” as opposed to the constant, “alpha”). Beta is normalized, so a beta of 1.0 indicates perfect co-variance with the systematic risk of a market-diversified portfolio, while a beta of 0.0 would indicate a riskless asset (zero co-variance with the systematic risk of the market portfolio) and the investor would be rewarded with only the risk-free rate of return. Investing in asset j with a beta of 1.0 should provide the investor with a return R_j , equal to the market returns K_m . If asset j has any other beta, the expected returns will be equal to a beta-scaled proportion

of the premium the market portfolio enjoys over the risk-free rate, as shown in Equation (1).

$$R_j = R_f + \beta(K_m - R_f) \quad (1)$$

Once R_j is determined, the price, P , of asset j can be shown as a simple function of the required return and the expected cash flows (for real estate, usually proxied by Net Operating Income, or NOI). Equation (2) illustrates this for a stable perpetuity, and Equation (3) offers an example of pricing an asset for which there is anticipated growth, at an annual rate of g , in the earnings stream.

$$P_j = \frac{NOI}{R_j} \quad (2)$$

$$P_j = \frac{(NOI)(1+g)}{R_j - g} \quad (3)$$

Assets with varying cash flows, or with varying risk over time, will have more complex pricing models, but the fundamentals remain the same.

In an efficient market, there is universal knowledge, or at least universal agreement, about anticipated cash flows. Hence, all assets are priced fairly and there are no “deals.” While different investors may have different risk tolerances, every investor at a given risk tolerance level would invest identically in the same portfolio and all would have the same net present value profile. Of course, perfect market efficiency is a theoretical construct, and in practice real estate markets are highly inefficient. Indeed, structural inefficiencies (e.g., insider trading, which would be a felony in the securities market) are considered the norm in private real estate markets. Hence, net present value maximizing becomes much more of a challenge. As the aggregate size of the real estate investment pool grows larger, the challenge expands. In recent years, following the bear markets in securities, real estate has been viewed as a source of greater stability and higher risk-adjusted income, both present and future (Kaiser [2005]).

Analysis of real estate equity investments, in the net present value maximization context, has focused on advisor styles. See, for example, a recent study developed for the

National Council of Real Estate Investment Fiduciaries (Baczewski, Hands, and Lathem [2003]). Investment styles range from “value” to “growth” or some combination thereof. Within this analytical paradigm, there is substantial research on issues such as developing appropriate benchmarks (Geltner and Ling [2001]). Much of the current research focuses on equity versus debt or on style differences between public and private portfolios, and Kaiser [2005] notes there is little focus on such marginal—but growing—segments as derivatives, futures, and other complex instruments. Kaiser’s comments can be extended to instruments which provide the opportunity to move income and other benefits from one period to another or from one risk profile to another.

We know that there are differences in style between those portfolios which take direct investments and those which take securitized investments (i.e., REITs and REOCs). Back in 1998 (a long time ago, in the real estate investment universe), Gordon posed the question whether a REIT should behave as though it manages a direct portfolio, or in the manner of an ongoing enterprise that just happens to have a lot of real estate on its balance sheet? Gordon noted that private portfolios have a more value-added focus, while the securitized portfolio is more focused on portfolio management. Gordon showed that private portfolio managers concentrated attention on the beginning and end of the asset ownership, while the REIT focused on the middle. His findings, taken from his Exhibit 1, are summarized in Exhibit 1.

Gordon’s implication is clear: investment strategies developed in a securitized world have inappropriate emphases for direct investment portfolios. However, Gordon’s work focused on relatively traditional direct investment portfolios and did not explore the criteria of the very wealthy portfolios.

Miyamoto, Mutoh, and Ogimoto [2006] are among the first to begin asking the question about how “different” these super-wealthy portfolios really are. Their study focuses both on the “mass affluent” (100 to 500 million yen) and the super rich (above 500 million yen). While they limit their study to banking services, they make several observations that are important for both banking and non-bank-based portfolios:

1. The “suddenly rich” lack both the knowledge and experience dealing with investments as well as the contacts (what they call “human contacts”) to gain adequate counsel.

EXHIBIT 1

Differences in Investment Style

Portfolio function	Portfolio Management Emphasis	
	Direct Investments	Securitized Portfolio
Acquisitions	High	Low
Initial Strategy	High	High
Strategy Adjustments	Low	High
Fundamentals Research	High	Medium
Peer Group Analysis	Medium	High
Valuation Models	Low	High
Accounting/Reporting	High	Low
Value-Added to Portfolio	High	Low
Dispositions	High	Low

Source: Gordon(1998).

2. Current portfolio options (what they call “banking products”) are inadequate to deal with high-net-worth individuals.
3. In many circumstances, such as in Japan, institutions are unable or unwilling to provide differentiated services such as complex, generation-spanning trust services.
4. The linkages between sources of customized portfolio strategies and clients needing customized portfolio strategies are limited, at best, to non-existent.

INVESTMENT GOALS OF THE SUPER RICH

Prince and Grove [2004] are among the first to intensively analyze the investment goals and criteria of the super-wealthy. They focus primarily on management of the family office, and while the family office is not the focus of this article, a brief review of this unique and relatively modern investment management phenomenon is illustrative of both the issues at hand and the research processes needed to study these issues.

The family office has emerged as a one-stop financial shop for managing a large (typically \$10 million or more of investable assets) portfolio. Generally, but not always, family funds are commingled and commonly managed, and the family office handles an array of duties including, but not necessarily limited to, tax and estate planning, day-to-day bookkeeping, financial planning and investments, and legal issues. For smaller estates (Grove and

Prince use the taxonomy of \$10 million to \$49 million), these chores may be carried out by a commercial office. Many of these offices have emerged as boutique private firms, private banking offices of larger banks, elite brokers in larger brokerage houses, and in accounting firms. In a recent survey of 327 such offices, the median net worth of clients was \$19.8 million, and the median investable asset size was \$17.5 million.

For mid-range families (\$50–\$99 million), the typical model is a smaller multi-family office, which may have one “anchor” family and several smaller accounts. The larger family estates (\$100 million or more) will usually have a single family office devoted to its financial affairs. Prince and Grove estimate that there are roughly 76,000 worldwide of this last category of large family estates, controlling an aggregate wealth of \$53.8 trillion.⁴

Studies by Prince and Grove as well as Gray [2004] show that this unique investment management paradigm has developed to deal with five core characteristics common to these wealthy families:

1. *Complexity:* The mere volume of money requires a sophisticated level of planning, including interlocking wills, investments, trusts, and taxes. As such, sophisticated ongoing planning is needed. Gray notes that very wealthy families may be members of more than one country and live, work, or go to school in yet other countries, necessitating geopolitical considerations. She says that, “[O]ften,

these complexities...require families to *accommodate* rather than *optimize*" (emphasis added).

2. *Control*: At this level, money and power are two sides of the same coin, and financial management requires an understanding of this relationship. Gray shows that control involves egos and emotions but also boundaries and restrictions.
3. *Connections*: Miyamoto, et al., [2006] note that the major investment problem of the "suddenly rich" is lack of connection to provide insight and information about wealth protection. The super-rich are often targets of scams and fraud. As such, carefully developing personal connections has a financial as well as social overtone.
4. *Capital*: Having money—lots of money—means being able to use that money to define oneself. As such, capital preservation is often paramount over, say, putting existing capital at risk simply to make more money. Gray emphasizes that the "capital" part of the equation balances not only investment capital but also human, social, and intellectual capital.
5. *Charity*: While headlines resound with the massive gifts of the two wealthiest families (Gates and Buffett), the rest of the Forbes 400 and other super-wealthy benefactors are active in all aspects of charitable giving. However, charity at this level tends to me more than just good works; it is a way of making a statement, of building and preserving business and social connections, and cultivating political and economic power.

Interestingly, the Prince and Grove study finds that only 7.7% of family offices currently invest in real estate partnerships. While this number is expected to grow in the next few years, all such growth is expected to come

from the family offices managing the smaller and medium-sized families. Currently, about 17.4% of the offices managing the largest family funds invest in real estate trusts, but those high-net-worth families are planning no new real estate trust investments. This contrasts with other specialized investment vehicles, as shown in Exhibit 2.

Exhibit 2 suggests that real estate trusts somehow do not provide the same anticipated benefits as do other investment vehicles. This particularly contrasts with venture capital investments: currently less than 10% of the offices invest in these, but this is expected to triple in the immediate term. What does a venture capital investment, for example, provide to a family office that a real estate trust does not?

To explore this, the Prince and Grove study finds four hot-button areas which these super-wealthy clients currently look for from their investment advisors: wealth enhancement, wealth transfer, asset protection, and charitable giving. Leveraging off their study, we explore each of those four areas and link them to specific real estate investment questions.

Wealth Enhancement

Real estate investing classifies wealth enhancement in terms of net present value maximization, as discussed earlier. Traditionally real estate is viewed as an inflation hedge as well as a tax hedge. However for the very wealthy, these passive hedges may not be sufficient. Wealth enhancement requires more sophisticated and active tax planning and complex investment vehicles. Investment grade real estate is frequently thought of as a cash-flow vehicle, priced not unlike a bond. On the other hand, complex tax strategies include income deferral, conversion

EXHIBIT 2

Current and Planned Investments of High-Worth Family Offices

Investment Vehicle	Currently Invest	Plan to Invest
Real Estate Trusts	17.4%	17.4%
Venture Capital	9.8%	29.3%
Private Equity Fund	20.7%	33.7%
Hedge Fund	32.6%	41.3%
Hedge Fund-of-Funds	31.5%	66.3%

Source: Prince and Grove (2004).

of ordinary or investment income into long-term capital gains, and intergenerational deferral of taxes. These usually require more complex hedges and swaps, and until recently, the real estate market has been ill-prepared to deal with these concepts.

Wealth Transfer

Estate taxes have major implications for intergenerational transfers. Depreciable real estate offers some advantages over non-depreciable assets, but more often the very wealthy are thinking in terms of generation-skipping trusts or giftless dynasty trusts. The role of real estate within such trusts is not well defined from an investments perspective and requires additional interface between real estate and accounting researchers. Establishment of a family legacy is the key issue here, and these family legacies require multi-generational approaches which may not be congruent with current real estate investment thinking.

Asset Protection

Family offices are acutely concerned with two aspects: tort protection and intergenerational protection. Direct ownership of real estate is problematic in this regard and almost always requires establishing some form of trust, off-shore ownership, or other complex ownership strategy. While traditional trusts provide some manner of tort protection, this typically is not an effective way of protecting the assets in an intergenerational sense. Most strategies on the cutting edge today require some form of monetization, transformation, or replication (i.e., derivatives). Notably, net present value maximization is secondary to protection of the core assets themselves. Net present value maximization strategies usually entail a certain degree of risk-taking, but the paramount issue in asset protection is risk-avoidance.

Charitable Giving

With Bill Gates and Warren Buffett leading the way, many super-wealthy families are thinking in terms of the role a family charity plays in their family legacy. Of course many super-wealthy families throughout history have embraced such a focus, but traditionally the establishment of a charity has been an estate issue. Today, wealthy families view charity as a lifetime and intergenerational

opportunity. They often view good works as interconnected with other aspects of business activity and wealth accumulation.

Real estate as an investment vehicle offers solutions to all four of these "hot button" issues but requires more advanced portfolio strategy than traditionally has been used. For example:

Direct, private real estate is a traditional wealth-enhancement vehicle when managed properly. Unfortunately, many portfolios incorporate real estate only in a securitization mode, and then as a "buy-and-hold" strategy. However, significant returns in real estate are usually enjoyed in development projects, real estate turnaround situations, and other management-intensive projects. Wealthy portfolios are uniquely situated to establish private investment pools that can take advantage of these opportunities, and there are many high-profile examples such as Paul Allen, co-founder of Microsoft, or the Walton Family, who invest in Wal-Mart real estate. This sort of real estate becomes management intensive, not only on a project-specific basis but also on a macro-level. Families in fact become professional real estate developers and need to be advised by teams who not only understand real estate but also understand global business.

Real estate investment allows for geo-political diversification. Real estate investors can fine-tune portfolios to take advantage of specific geographic opportunities or to diversify into or out of specific markets. This provides an opportunity to enhance other aspects of a portfolio, such as supplying real estate to support business, charitable, or lifestyle decisions. For example, real estate investment is often viewed, locally, as an economic driver. Wealthy families wishing to make economic investments in developing nations can use real estate investment to facilitate a win-win situation. In such a scenario, core family real estate advisors need to engage on-site assistance in areas being examined for diversification. Optimum choices are made when multiple opportunities can be considered as alternatives.

Real estate can facilitate intergenerational transfers. Real estate is a long-lived asset and can be used to transfer assets on a historical-cost basis among generations and across family units. However, real estate ownership laws vary from country to country, and careful management and planning are in order. For example, passing ownership when various members of one family have different citizenship can be tricky. Nonetheless, the same problems exist with many regulated industries, and various mechanisms are available

to facilitate or proxy such transfers. The important point is that the stability and lifespan of real estate, coupled with historic inflation hedge sensitivity, make it an excellent vehicle for storing family wealth and transferring that wealth among generations. In this arena, legal and tax accounting advisors usually need to take the lead, but they need to be assisted by real estate investment advisors who understand the nuances and complexity faced by the family.

Real estate facilitates contacts. As noted previously, real estate investment is regularly viewed as a positive economic incentive, particularly in emerging or disadvantaged economies. Substantial real estate investments can establish local bona fides, paving the way for other family investments. Wealthy investors with such an agenda are well advised to engage advisors to scout out choice investments with an eye to the synergies created. As a pure real estate play, this is usually an overly expensive way to make investments and the net present value calculations rarely pencil out. However, when real estate is viewed as leverage into local contacts, the added cost of investment makes sense.

Real estate diversifies away from non-real estate core holdings. Many highly visible, wealthy investors quietly use real estate not only as a storer of “sudden wealth” but also as a hedge against downturns in their core fortunes. However, for every success story there is a corresponding story of sloppy investment. Typically, the “suddenly wealthy” (e.g., actors, athletes, dot-com fortunes) who make careful, selected investments in conservative income-producing assets are well hedged against future downturns in their core fortune. On the other hand, many of the “suddenly wealthy” overpay for homes, resort property, or highly speculative scams. In practice, unfortunately, real estate as a diversifying asset seems to work very well for families with long-established fortunes, but it appears that the suddenly rich frequently are not well advised.

In short, real estate is a traditional inflation and tax hedge, and well-managed real estate portfolios are resilient against economic shocks, cycles, and sudden problems. Unfortunately, the traditional stability of real estate has led to over-leveraging, speculation, and lack of management. Nonetheless, real estate is usually viewed as a core holding in long-lived family portfolios. Problems with real estate, in the portfolios of the super-wealthy, often stem from lack of understanding by real estate advisors as to the complex investment criteria of the rich. Additionally, the rich themselves often do not know how to avail themselves of better real estate advisors, who usually are not as public or as available as traditional financial advisors.

The optimum solution is for advisors to wealthy portfolios to bring real estate advisors into the mix, professionals who understand these issues and can design and develop real estate assets to suit the specific needs of their wealthy clients. “Off-the-shelf” investment solutions rarely fit for super wealthy portfolios, but real estate provides an opportunity—and a unique one among asset classes—to develop custom tailored solutions.

ENDNOTES

A version of this article is currently scheduled for presentation at the American Real Estate Society annual meetings in April, 2007.

¹“Investment-grade” typically refers to a subset of non-residential real estate which is analogous to “blue-chip” stocks and bonds. For purposes of this article, “investment grade” is used interchangeably with “non-residential.” While traditional real estate portfolios would not consider low-end real estate as “investment grade,” current thinking, particularly in opportunity funds, see low-end real estate such as brownfields as high-potential investments.

²High levels of long-term debt coupled with aggressive depreciation schedules left some industrial firms in the position of having the book value of their debt exceeded the book value of the assets securing that debt, thus depressing the book value of the firm. Off-balance-sheet financing with securitized debt solves that paradox.

³While acknowledging the “single factor beta versus multi-factor beta” discussion, such is beyond the scope of this study.

⁴Prince and Grove’s study surveyed 653 family offices.

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