

# DETERMINING INVESTMENT DISCRETION

## GUIDANCE FOR DETERMINING INVESTMENT DISCRETION FOR REAL ESTATE INVESTMENT ACCOUNTS

### A REIS GUIDANCE DOCUMENT

#### REIS COUNCIL - PERFORMANCE TASK FORCE

*The REIS Board and Council would like to thank the following individuals who participated in this project.*

##### Task Force Chair

Name	Firm	NCREIF/PREA
Maritza Matlosz	BlackRock	Performance Measurement

##### Task Force Members

Name	Firm	NCREIF/PREA
Stephanie Brower	Russell Investments	Performance Measurement
Brant Brown	INVESCO	Performance Measurement
Christopher Clayton	UBS Realty Investors	Performance Measurement
Joe D'Alessandro	Real Estate Insights	Index Policy
Sara Geiger	State Board of Administration of Florida	Plan Sponsor
John Griffith	Hancock Timber Resource Group	Performance/Timberland
Steven D. Holland, CFA	The Campbell Group	Timberland
Neil Myer	The Townsend Group	Index Policy
Marybeth Kronenwetter	Real Estate Investment Advisors	REIS Administrator

# DETERMINING INVESTMENT DISCRETION

## Guidance for Determining Investment Discretion for Real Estate Investment Accounts

---

### Overview

In order to achieve compliance with the GIPS standards, an investment advisor organization must first define the “firm” in the context of the GIPS standards. In making its determination, the organization may take into consideration legal, regulatory or marketing issues as well as functional or other management lines. Once the “firm” has been defined, one of the next steps is to determine whether or not the firm retains discretion in the management of each of its accounts. To the extent that the firm has discretion, composites are created for every investment strategy the firm has implemented. Within the standards, discretion refers to “investment discretion” or the firm’s ability to implement its investment process for a client(s) account, not “legal discretion” which refers to the authority to manage the account. If the firm has no discretionary accounts it cannot claim GIPS compliance.

In the context of real estate, the fact that a client may have a say in the buy or sell decision of a major asset should not necessarily preclude an investment advisor from considering the account discretionary for composite assignment purposes provided the firm feels that the client’s involvement does not impede the firm’s investment process. Other factors to consider when determining if an account should be considered discretionary are the extent of the firm’s daily property management decision making (including the firm’s authority to make capital expenditures and leasing decisions) as well as the extent to which the firm controls decisions on investment structure. These decisions would heavily impact the value of the real estate investments and the return the investment produces.

### What is discretion for the real estate manager?<sup>1</sup>

Under the GIPS® standards, “*Discretion is the ability of the firm to implement its intended strategy.*”<sup>2</sup> When managing a real estate account, a firm must judge whether or not client-imposed restrictions hinder the firm’s ability to implement the intended strategy for that account. “*There are degrees of discretion and not all client imposed restrictions will necessarily cause a portfolio to be non-discretionary.*”<sup>3</sup> If a firm is presenting a performance presentation for a composite, the performance of that composite should be attributable to the investment manager’s skill and ability to implement the intended investment strategy. If client-imposed restrictions do hinder strategy, it may cause the entire account to be classified as non-discretionary, and accordingly, an account deemed to be non-discretionary would be excluded from the firm’s composites. Performance presentations prepared in accordance with GIPS standards present the

---

<sup>1</sup> CFA Institute, *Explanation of the Provisions of the GIPS standards and Verification, Real Estate*, page 140, GIPS® Handbook, Second Edition 2006 – or  
<http://www.gipsstandards.org/standards/guidance/develop/pdf/RealEstateGuidance.pdf>

<sup>2</sup> CFA Institute, *Guidance Statement on Composite Definition (Revised)*, page 171, GIPS® Handbook, Second Edition 2006.-  
<http://www.gipsstandards.org/standards/guidance/archive/pdf/GSCompDefRevised.pdf>

<sup>3</sup> CFA Institute, *Guidance Statement on Composite Definition (Revised)*, page 171, GIPS® Handbook, Second Edition 2006. -  
<http://www.gipsstandards.org/standards/guidance/archive/pdf/GSCompDefRevised.pdf>

# DETERMINING INVESTMENT DISCRETION

## Guidance for Determining Investment Discretion for Real Estate Investment Accounts

---

firm's performance to prospective and existing clients through composites which reflect the firm's investment strategy and not necessarily the strategies of all its clients.

Managers of traditional stock and bond investments apply their investment strategies by making buy/sell decisions. These managers are often deemed to have exercised their investment discretion if they have the power to decide which securities are bought or sold for the account subject to the client's risk parameters. In cases where the client develops a strategy or investment allocation based on specific return parameters, but the investment manager makes the buy/sell decisions, the investment manager would characterize the account as discretionary. A real estate investment manager may be no different from the "traditional" investment manager with respect to determining discretion. A client may control the risk/return parameters of the account but the real estate manager may freely make "allocation" or "selection" decisions within those parameters.

The illiquid nature of the real estate assets allows the real estate investment manager additional control than that provided by buy/sell decisions alone. Investment in real estate involves many types of management decisions which can greatly impact the quality and value of the asset. Real estate investment allocation decisions usually involve property type, location and size. These decisions are similar to a portfolio manager making a decision to buy growth stocks or municipal bonds. Decisions involving which particular property to purchase and how to structure the deal (e.g., using leverage, joint venture relationships or a mezzanine debt with participation) are often akin to a stock or bond manager making security "selection" decisions. For example, the choice by the real estate manager to pick Property A, a wholly owned property with no leverage and no joint venture partner, rather than Property B, which has 50% leverage and is owned in a 60/40 partnership can be seen as choosing a less risky security (Property A) versus a more risky security (Property B). Examples of other decisions made by the real estate investment manager who has the ability to materially impact the value and return of the account include property leasing, property management or property development.

Standard real estate investment decisions add a layer of complexity to determining discretion. The real estate investment manager must consider whether or not the intended investment strategy for a specific account has been impeded by any client-imposed restrictions, and if so the account may be considered non-discretionary and must not be included in a discretionary composite. If the strategy has not been impeded, then the account must be included in a composite with any other accounts of similar strategy or restrictions. The goal of this process is to determine if the investment manager has retained enough control of the account's investment strategy to be able to take credit for the performance of the account.

### **What does it mean to be a discretionary account?**

The GIPS Real Estate Provisions, GIPS Guidance Statement on real estate and the GIPS Handbook are important sources of guidance for real estate investment discretion.

The facts and circumstances of the manager's authority and responsibilities can and should be considered in evaluating whether the manager has discretion. In some cases, restrictions imposed by the client may attribute some decision-making authority to the client. However, if the manager retains sufficient authority and decision-making ability to allow the manager to implement its intended investment strategy, the account must be considered discretionary.

# DETERMINING INVESTMENT DISCRETION

## Guidance for Determining Investment Discretion for Real Estate Investment Accounts

---

### Examples of discretionary accounts/funds:

The following examples illustrate cases where the client has retained certain decision-making authority, but there is sufficient control by the manager to allow the manager to execute its investment strategy and therefore the account would likely be considered discretionary by the firm:

- ❖ All acquisition investment decisions are made by the manager without client direction or approval, and the manager makes all decisions regarding: deal structure, leverage, leasing, capital improvements, dispositions, and therefore can fully implement its investment strategy. *[An example of this is a commingled fund. A commingled fund is created and marketed by a manager with specific investment objectives clearly stated in the offering materials (i.e., Private Placement Memorandums (PPM), etc.) or other investment management agreements; therefore commingled funds are typically discretionary. Clients make the decision as to whether or not to invest in the fund, but the manager clearly retains discretion regarding all investment strategy decisions within the manager's self-imposed investment limitations.]*
- ❖ Acquisition investment recommendations and disposition recommendations are made by the manager with approval by the client prior to executing the transaction(s) however; the manager retains control over property management. *“For managers that have discretion with respect to managing the property, combined with an extensive role in managing the acquisition and disposition process, a significant portion of total return may be attributed to their services. Although a manager may not have full discretion on acquisitions or dispositions, and need the client's approval, to the extent the manager has responsibility for sourcing, valuing, and managing the acquisition or disposition, the manager may be deemed to have discretion.”<sup>4</sup>*
- ❖ The manager supplies its clients with annual budgets for client approval. Clients approve budgets but control of the actual operations or leasing decisions for the property is the manager's responsibility. The planning and implementation of capital budgets, leases, and other operational objectives of the manager may be reviewed by the client, but are not determined by the client.
- ❖ A manager has some discretion on acquisitions and dispositions of property investments within the portfolio, so long as the firm does not exceed some agreed-upon threshold (determined by the client).
- ❖ There is a performance related compensation arrangement between the manager and the account or fund whereby the manager is judged based upon its performance to an industry benchmark. , (It should be noted however, that the absence of a performance related compensation arrangement does not necessarily mean that the manager lacks discretion.)

---

<sup>4</sup> CFA Institute, *Guidance Statement on Composite Definition (Revised)*, page 171, GIPS Handbook, Second Edition 2006.

# DETERMINING INVESTMENT DISCRETION

## Guidance for Determining Investment Discretion for Real Estate Investment Accounts

---

Each firm is required to document the firm's definition of discretion and apply that definition consistently to all of its accounts. GIPS real estate provisions require that the firm disclose its description of discretion.

### Checklist for Determining Real Estate Discretion

---

*The determination of whether an account is discretionary for compliance with the GIPs standards is a subjective determination made by the manager. This chart can be used to assist in the determination of discretion for single investor investment accounts, as commingled funds are likely to be classified as discretionary.*

	Client Role	Manager Role
<b>Overall Account (Strategy or Allocation Decisions)</b>		
Timing of Cash Flows to/from Investors		
Ongoing Investment Management		
Buy/Sell/Financing		
Transaction sourcing (including negotiating purchase/sale agreements and terms)		
Compensation		
<b>Buy/Sell/Financing (Selection Decisions)</b>		
Acquisition		
Disposition		
Financing/Re-financing		
<b>Ongoing Investment Management (Investment-level Decisions)</b>		
Property Manager selection		
Operating budgets		
Capital Improvements		
Leasing		
Development/Redevelopment		
Operations Risk Management (i.e., insurance, building codes, etc.)		

#### Notes:

This checklist provides guidance to aid the manager in its determination of discretion. Generally, within each line item, consideration should be given to such factors as: threshold levels; outsourcing; and degree of control.

The manager will need to assess the significance of any client imposed restrictions with respect to its determination of discretion. In situations where the manager has investment discretion within client-imposed limitations that do not hinder the manager's ability to implement its strategy, the account would typically be classified as discretionary.

# DETERMINING INVESTMENT DISCRETION

## Guidance for Determining Investment Discretion for Real Estate Investment Accounts

---

### What does it mean to be a non-discretionary account?

Absence of the above factors may indicate the manager lacks sufficient authority to implement its investment strategy. Consideration should be given to any of the following conditions which may provide evidence of client-imposed restrictions which significantly hinder the manager from managing the account and implementing its intended investment strategy:

### Examples of non-discretionary accounts:

- ❖ Clients have decision-making authority and control over investments.
- ❖ Clients must approve and direct all investment decisions, including acquisitions, capital expenditures, leasing expenditures and dispositions.
- ❖ The manager is not compensated for the performance of the investment (i.e., there is no carried interest or incentive fee arrangement). (It should be noted however, that the lack of a performance fee alone does not necessarily imply the manager lacks discretion, if the manager retains sufficient control and authority to implement the intended investment strategy.)
- ❖ The primary manager out-sources key investment decision-making related functions (no internal expertise), or has no control over key services such as acquisition and/or disposition services, sourcing of deals, portfolio management, or acts solely and fundamentally as only a property manager with only limited authority over operating and investment decisions.

### So, what is the final word on discretion as related to the GIPS standards?

A key consideration within the context of compliance with GIPS standards is the requirement to define and consistently apply the determination of discretion. In doing so, the firm must evaluate its ability to execute the firm's investment strategy for each of its accounts. These strategies include making buy/sell or operational decisions such as the use of leverage or joint venture partners, capital spending and leasing authority. If these decisions can be made by the manager—either within restrictions that do not significantly hinder the manager from implementing its strategy or without any restrictions at all—then the firm can make the determination that it has discretion for that account. The firm must objectively evaluate all accounts to determine whether each is discretionary.

One of the key conclusions from the discussion above is that the manager's ability to implement its investment strategy decisions should be the sole consideration for determining discretion. Implementing accounting or valuation policies for client reporting purposes should not have a role in the determination of investment strategy discretion. Discretion over the implementation of a particular valuation or accounting policy is not normally the discretion that should be considered under the GIPS standards as any applicable accounting or valuation requirements under GIPS would still need to be adhered to. Only discretion as it relates to the implementation of an investment strategy should normally be considered.

It is the responsibility of the firm to determine the status of each fund/account as to whether or not it is discretionary. Each firm, as part of its documentation required under the GIPS standards,

# DETERMINING INVESTMENT DISCRETION

## Guidance for Determining Investment Discretion for Real Estate Investment Accounts

---

should have a periodic written review of the discretionary status of each account, and update that report whenever there is a material change in the management of the account.

It is the firm's responsibility to determine whether it can comply with the GIPS standards. The information here is only meant to provide guidance to the firm. For additional information, please refer to the Explanation of the Provisions of the GIPS standards and Verification - Real Estate section of the GIPS Handbook.

### **I have determined which accounts have discretion, so now how do I determine what is a real estate composite?**

One of the key principles in the Standards is the presentation of composite returns, where a composite is defined as an aggregation of one or more accounts representing a particular investment objective or style. In this way, the real estate investment class and other asset classes are treated in the same manner. Composites for stock and bond investments are composed of groups of funds or accounts that have the same or similar investment strategy. Stock portfolios may invest in certain "growth/value" strategies, while real estate investment composites are often composed of accounts with similar "core/value-added/opportunistic" real estate investment strategies. Real estate composites consist of an aggregation of one or more funds or accounts that represent a particular real estate investment strategy. For example, you may have a "Core, Diversified, Single-Client Structured, Real Estate Accounts Composite" or a "Value-Added, Retail, Closed-End Real Estate Accounts Composite". Using the GIPS "Suggested Hierarchy for Composite Definition"<sup>5</sup> can help the real estate investment manager to clarify composite creation for the real estate asset classes.

### **Can a firm create a composite that consists of individual properties drawn from various funds that reflects a property level strategy as opposed to a composite made up of funds?**

Real estate consultants and clients frequently ask their investment managers for performance presentations for property level strategies, instead of the account's investment strategies that their GIPS composites are based on. Let's say, for instance that we wanted to show a prospective client our experience in investing in office buildings. The real estate investment manager will then provide the firm's investment performance for office buildings purchased through various portfolios which have been acquired under differing portfolio-level investment strategies and risk/return parameters. The investment manager has the option to create composites comprised of particular properties that share a property-level strategy or style; these composites are called "carve out composites". So following the initial example, suppose the manager creates a "carve out" composite of all office investments made over the past five years. If this "carve out" group of office investments does not represent what would have been achieved by investing in a portfolio with a portfolio-level strategy dedicated to office investments, carving out the property level office building investment returns from portfolios with vastly different investment objectives and strategies will likely NOT satisfy the composite construction requirements of the Standards. This property level grouping should then only be presented as **SUPPLEMENTAL** to

---

<sup>5</sup> CFA Institute, *Guidance Statement on Composite Definition (Revised)*, page 173, GIPS® Handbook, Second Edition 2006.

# DETERMINING INVESTMENT DISCRETION

## Guidance for Determining Investment Discretion for Real Estate Investment Accounts

---

a compliant composite presentation (see the Guidance Statement on the Use of Supplemental Information).<sup>6</sup>

If the real estate investment manager has chosen to create “carve out” composites today by allocating cash, the manager will face larger challenges in 2010 when the GIPS standards will require the manager to maintain separate cash accounts for each underlying carve-out segment. This requirement will make it impossible to create “carve out” composites without managing all portfolio cash to each investment.

---

<sup>6</sup> CFA Institute, *Real Estate*, pages 139-140, GIPS® Handbook, Second Edition 2007. and CFA Institute, *Guidance Statement on the Treatment of Carve Outs (Revised)*, page 234, GIPS® Handbook, Second Edition 2006 - <http://www.gipsstandards.org/standards/guidance/archive/pdf/GSCarveoutsRevised.pdf>

# DETERMINING INVESTMENT DISCRETION

## Guidance for Determining Investment Discretion for Real Estate Investment Accounts

---

EXHIBIT A: The following excerpt is taken from the **Interpretive Guidance for Real Estate**.<sup>7</sup>

### REAL ESTATE - GIPS

The GIPS® standards require that all actual, fee paying discretionary portfolios be included in at least one composite, although the definition of discretion remains with the firm. Discretion is the ability of the firm to implement its intended strategy. As stated in the Guidance Statement on Composite Definition, there are degrees of discretion and not all client-imposed restrictions will necessarily cause a portfolio to be non-discretionary. The firm must determine if the restrictions will, or could, interfere with the implementation of the intended strategy to the extent that the portfolio is no longer representative of the strategy.

The following guidelines are recommended to facilitate appropriate and consistent classification of real estate portfolios as discretionary or nondiscretionary.

### DISCRETIONARY MANAGEMENT:

Real estate portfolios are considered discretionary if the firm has sole or primary responsibility for major investment decisions. Major decisions may include portfolio strategy, investment search and selection, purchases, sales, investment structuring, financing, capital improvements, and operating budgets. Clients may not delegate complete investment discretion to firms for real estate investments, but in many cases, the consent requirements and investment constraints imposed do not inhibit the firm's investment policy or decision making to any significant extent. Therefore, the existence of client-imposed investment restrictions – such as leverage limits or required client approval of major decisions – does not preclude the classification of a real estate portfolio as discretionary. Acceptance of primary responsibility by the firm and, therefore, the presence of a discretionary management relationship may be inferred if a portion of the firm's compensation is tied to performance or if the Firm's success is assessed based on comparison of the Firm's performance to a selected industry benchmark.

### NON-DISCRETIONARY:

Real estate portfolios are considered non-discretionary if client-imposed investment limitations and restrictions hinder or prohibit application of the firm's desired investment strategy. As an example, taxable clients may prohibit or significantly limit repositioning of their portfolios through active sales in order to minimize capital gains taxes. Alternatively, clients may mandate liquidation of their portfolios at a time when the firm believes pricing is not optimal. Additionally, firms may accept special assignments such as portfolios taken over from other firms, with mandates that are not consistent with their own investment strategy.<sup>8</sup>

---

<sup>7</sup> CFA Institute, *Explanation of the Provisions of the GIPS standards and Verification, Real Estate*, page 140, GIPS® Handbook, Second Edition 2006:  
<http://www.gipsstandards.org/standards/guidance/develop/pdf/RealEstateGuidance.pdf>

<sup>8</sup> CFA Institute, *Real Estate*, page 140, GIPS® Handbook, Second Edition 2007.