

# Deutsche Asset Management

## An approach to real estate risk management

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**Todd Henderson** is a managing director and head of real estate, Americas, Deutsche Asset Management, where he is responsible for all facets of the direct real estate investment management business in the Americas. Previously, Henderson served as the CIO of RREEF Real Estate, Americas, as well as supervised RREEF Real Estate's value-added and development team.

Recently, **Jonathan A. Schein**, senior vice president, managing director of business development at Institutional Real Estate, Inc., spoke with **Todd Henderson** of Deutsche Asset Management about their approach to real estate risk management. The following is an excerpt of that conversation.

### After the recession, investors have become laser-focused on risk. How does Deutsche Asset Management manage the inherent risk found in real estate investments?

Risk is simply the uncertainty of outcomes resulting from different strategies. Technically speaking, it is variance and volatility. When you talk about variance and volatility, however, you need to distinguish upside volatility from downside volatility.

### One is more attractive than the other?

Absolutely, upside volatility is always much more attractive than downside volatility. In a perfect world, you want to limit downside volatility while not limit-

ing your upside volatility. At the end of the day, however, risk is just uncertainty around value and cash flows combined with the uncertainty around liquidity.

### What causes that uncertainty of outcomes in real estate?

Risk is a collection of factors that fall into two broad categories — operating leverage and financial leverage. Financial leverage refers to how much financing you put on a property — the risk associated with having a highly leveraged property. It is the risk associated with interest rate fluctuation. It is the risk associated with refinancing that particular loan. Financial leverage magnifies the outcome of the results, so if you have either a positive or a negative result on an unleveraged basis, the financial leverage is going to magnify that result by a multiple depending upon the degree of leverage employed. Operating leverage refers to asset risk, market risk, occupancy risk and the quality and durability of that asset and its cash flows. It is the variance of the NOI on the asset, which is highly dependent upon the strategy that is being implemented. Operating leverage tends to be multi-faceted, however, and in most cases can generally be summarized as the potential volatility in property cash flows.

### How do you evaluate those risks?

We look at risk at both the asset and portfolio level. Operating risk factors are evaluated in detail during the asset due diligence phase. Then we manage risk more broadly at the portfolio level by having a predictable and disciplined process, which is highlighted by our multiple channels of feedback. We own and manage more than 100 million square feet of real estate in the U.S.; there are a considerable number of signals that come from a portfolio of that size. In addition, our transactions team has bought and sold over \$50 billion of real estate during the past 10 years through the end of 2015. That \$50 billion, however, is only about 10 percent of all the assets that we actually pursue. So there is a uni-

Figure 1

	Sensitivity ("Beta") to NPI
All	1.00
Office	1.19
Industrial	1.00
Apartment	0.88
Retail	0.78

Source: NCREIF Property Index (NPI), as of December 2015. Period: 1981-2015. Quarterly year-over-year total returns.

verse of \$500 billion of U.S. real estate that we have actively pursued and, correspondingly, there are a number of signals that come off of those successful and unsuccessful bids. We also have a global investor base that has over \$50 billion of capital invested in real estate, as well as additional capital in other asset classes. There are material amounts of signals that come from our investor base as it relates to the attractiveness of the real estate asset class relative to the other asset classes. All of this information affects our strategy.

### What exactly do you do with all these signals?

We aggregate, dig down and distill all of those signal into a disciplined, executable strategy that drives our NOI forecast, our acquisition and disposition plans, our capital market decisions, and our market and sector tilt within our portfolios, as well as our strategy as to how much and when to take on more risk.

### You earlier mentioned volatility and variance. How do those factors enter into your process?

There are certain products, sectors and markets that perform better in pro-cyclical environments versus the opposite. The office sector and the industrial sector, for example, tend to outperform the retail and the apartment sector from a total return basis in a pro-cyclical environment. Sector selection, combined with a good market and asset selection — which is where our real estate expertise comes into play — should produce long-term outperformance relative to

your objectives. Conversely, if we have a contracting market, we are more likely to overweight the retail and multifamily sectors. These sectors, combined with market selection highlighted by characteristics such as constrained supply, historical job growth and good liquidity, will tend to outperform in a downturn.

### How do you use your research team in making these decisions?

Research is a big part of what we do. We go to great lengths to connect our research and strategy teams with our asset management, portfolio management and transactions teams. This allows us to combine realtime market feedback with extensive top-down and bottom-up research to make the most informed decisions with respect to our strategy in a particular market environment. We use the words “multiply the IQ of the organization” regularly to describe this process, which means we use the information generated by our scale to provide better and deeper information to our investors. The goal is to have an investment process that combines our real estate expertise with market-leading research to create actionable strategies, as well as the discipline to execute upon them.

### What does classifying risk mean to the portfolio construction process?

Well, it is not just overweighting and underweighting sectors, it is also overweighting and underweighting markets. For example, we have underweighted the Houston and Washington, D.C., office markets over the past couple of years, and it has been a big part of our outperformance. In a pro-cyclical environment, you may be more attracted to shorter-term leases than longer-term leases to capture improving rents. In a contracting market, the alternative is more attractive. Longer-term leases can bridge

you over the contraction phase, and allow the stability of cash flow through that downturn. We also look at risk a little differently than others. For example, development is considered an opportunistic investment and therefore higher risk. But in many cases, a development in a supply-constrained market where costs, overrun risks and loan guarantees are structurally subordinate to our overall returns can be much less risky than repositioning, releasing and refurbishing an investment. So we are trying to help investors focus on true risk as opposed to standard industry nomenclature.

### Would you then say that the industry should be classifying risk differently?

Our view is to place existing investments and prospective investment opportunities first in the context of risk and not necessarily return — not simply classifying it as core, core-plus or opportunistic return profile. By simply “bucketing” investments in those categories, it could impact the perceived risk profile of the individual property or investment. It should not stop with a simple definition but rather a full picture of the risk profile.

### How does your risk management methodology manifest itself for investors?

Investors are looking for managers that are going to achieve the best risk-adjusted return within a particular strategy. So, for example, a core real estate investor will be looking for a manager who can produce stable income with low volatility and consistent growth in NOI. Said differently, they are looking for a manager that can produce the best Sharpe ratios in that strategy. That is, of course, what they look for across all strategies — managers who can produce their target returns at the lowest level of risk.

### How does an investor know that you are producing their target returns at the lowest level of risk?

Our industry has gotten much better at capturing and evaluating information that allows an investor to compare and contrast different strategies, and to really determine the risk that a particular strategy embedded to achieve its returns. Investors and their consultants have really been given the tools to dig into a particular portfolio and strategy to understand 1) what risks are inherent in that strategy and 2) to be able to speak to a manager about how they may be mitigating the risks inherent in that strategy or that portfolio. Frankly we welcome that discussion because we believe that it helps investors make significantly more-informed decisions. And with informed decisions there are ultimately fewer surprises, and the relationship between a manager and investor benefits greatly when there are no surprises.

### Is the focus on risk management something that remains within the investment committee, or does it permeate the culture throughout the company?

It definitely permeates the organization. You cannot have an investment process that requires the input and execution from the entire organization, if the entire organization does not support or believe in it. We understand risk. From top to bottom, we attempt to capture all the signals that come off of our large, diversified investment platform and combine them with our real estate expertise and disciplined execution to produce above-benchmark returns. At the end of the day, we leverage information, expertise and a bias for action to make it all work.

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