30 YEARS OF CHANGE: The KEY STILL remains the TALENT

As NAREIM marks its 30th anniversary, we asked five founding members to discuss the biggest structural changes over the past three decades and to look ahead to the largest challenges that will impact real estate investment management.

For AEW's* Pam Herbst, *Clarion's* Steve Furnary, *Northwestern's* Tom Zale, *PGIM's* Cathy Marcus *and* David Reilly, *former CEO of Cornerstone Real Estate, the move from institutional to individual investors will represent a tectonic shift for the industry over the coming decades. But that could be dwarfed by the changes happening within investment management firms themselves as the industry moves to diversify and invest in its own talent.*

By Zoe Hughes

* This discussion took place in February 2020 before the outbreak of coronavirus in the US.

PARTICIPANTS

Steve Furnary

Executive Chairman, Clarion Partners

Stephen J. Furnary is an equity owner and the Executive Chairman of Clarion Partners. Steve led the 2011 management buyout of Clarion Partners from ING Group after a 12-year affiliation. Most recently, he led the sale of an interest in the firm to Legg Mason, where Clarion became Legg Mason's global real estate investment platform. He has been responsible for the firm's strategic direction since its inception. Steve began working in the real estate industry in 1974.

Pam Herbst

Managing Director and Head of Investment Group, AEW Capital Management

Pamela Herbst is a Managing Director at AEW and Head of the Direct Investment Group. She is responsible for all of the firm's investment activities on behalf of core and value-added clients. She is also a member of the firm's Management Committee, Investment Committee and Risk Management Committee. Over her 36-year career with AEW, she has served in a variety of roles that have encompassed asset management, portfolio management and acquisitions. She is former Chair and board member of NAREIM.

Cathy Marcus

Global Chief Operating Officer and Head of US Equity, PGIM Real Estate

Cathy Marcus is a Managing Director, Global Chief Operating Officer and Head of the US Equity business at PGIM Real Estate. She is responsible for overseeing PGIM Real Estate's business and investment operations globally, and for the development and implementation of PGIM Real Estate's strategy and operations in the US. Cathy is a member of the Global Management Council, the Global and US Investment Committees, the Global Operating Council, the Global Product Committee and the Valuation Committee.

David Reilly

Former CEO, Cornerstone Real Estate Advisers

David J. Reilly is the retired CEO of Cornerstone Real Estate Advisers (now Barings Real Estate). His career in real estate spanned more than 45 years with extensive experience in acquisitions, asset and portfolio management, dispositions, development and operations. His experience also included all institutional property types, including office, industrial, residential, retail and hotels. He is presently an adjunct professor at the University of Connecticut and teaches classes specializing in real estate theory and investment.

Tom Zale

Vice President and Head of Real Estate, Northwestern Mutual

Thomas D. Zale serves Northwestern Mutual in the position of Vice President—Real Estate. He is responsible for the company's investments in mortgage loans and real estate. He also serves as a member of the Investment Committee and Diversity & Inclusion Committee, as well as Executive Sponsor of the African American Employee Resource Group and Managed Investments Diversity & Inclusion Council. He joined Northwestern Mutual in 1995.

As you look back over the past 30 years, what have been the biggest structural changes to the real estate investment management industry?

Cathy Marcus, PGIM Real Estate: The biggest change in our industry has been the drastic increase in transparency across all facets of the business. This shift started to play out about 20 years ago, but the Global Financial Crisis was a moment in time where transparency was no longer a nice to have — it was a must have and it has filtered from the public side of commercial real estate to the private side, as institutional investors have become more and more insistent on transparency.

To me, that transparency is what has led to the greater comfort that investors have with alternative illiquid assets in general. And it has also led to the place we're in right now, where the individual investor wants to gain access to institutionally managed real estate through defined contribution [DC] plans, private REITs, distribution through wealth management, or even through technology platforms.

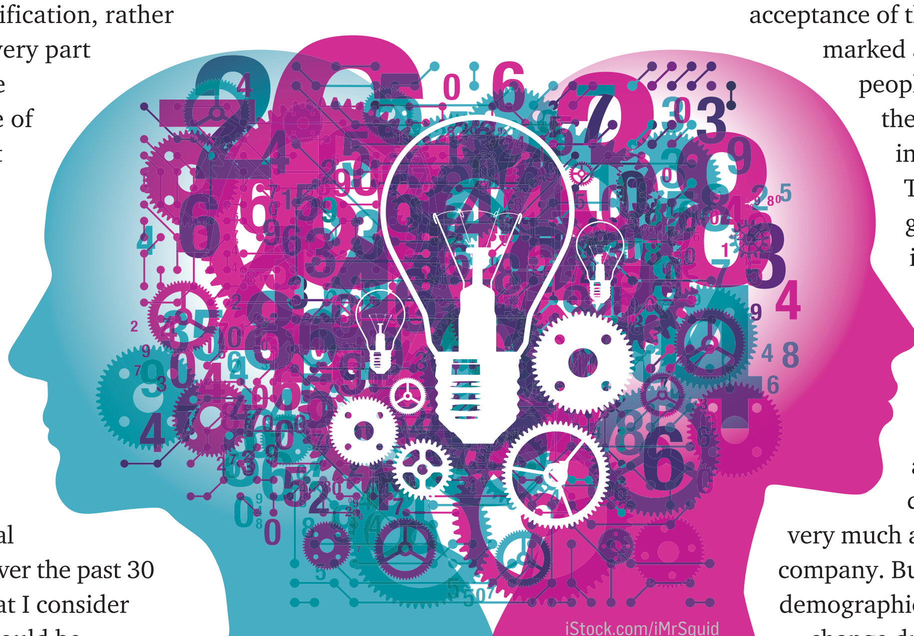
Another huge change has been the globalization of the industry. Thirty years ago, investors might have said that they have an allocation to "international," but there wasn't this holistic construct around a global investment strategy that we have now. From a portfolio allocation perspective, it's really a case for diversification, rather than a need to be in every part of the world to achieve higher returns because of the risk premiums that are out there. Instead, it's important to have global exposure for diversification purposes. That has been a very significant shift in our industry.

David Reilly: In reference to structural changes in real estate over the past 30 years, there are two that I consider critical. The first one would be technology, which has affected all property types in so many ways. For example, retail impacted by Internet sales, apartments incorporating websites quoting real-time rents, visual tours, etc.

The second is a very low interest rate environment. If you go back 30 years, 10-year Treasury rates were hovering around 8%. Today, 10-year Treasuries are below 1% and [coronavirus aside] we have been in a low interest rate environment for about the last 10 years, which has been a definite advantage. Low rates will extend into the foreseeable future and continue to benefit the real estate asset class. An inevitable recession will dampen demand for a period, but attractive interest rates should help mitigate the adverse impact of a downturn.

Steve Furnary, Clarion Partners: I think the most profound change for real estate investment management has been the evolution of our business into a real asset class. People make a decision to put a percentage of assets, say 10%, in real estate and they leave it there. They do that because we have evolved as an industry, we have good benchmarking, and we have a lot of alternative investment structures and property sectors to invest in.

The diversity of the investment universe and the acceptance of it in the investment world overall is really, I think, quite profound, and why this industry is now a real business. I also believe the accelerating use of open-ended funds and the acceptance of the ODCE Index has marked a big shift in the way people invest and given them a longer-term investment perspective. That's fascinating and a great step for our industry.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Pam Herbst, AEW Capital Management: We spend a lot of time around technology and data. We've always been very much a research-based company. But research and demographics have and continue to change dramatically thanks to data. It's daunting when you look at companies and realize the size you need to be as a platform, and the financial resources required to be able to collect and analyze your data simply to be able to respond to your capital. That's something that's just going to continue.

To also echo Steve and Cathy's comments on investors, I believe there's an ongoing structural change in our industry — that of non-traded private REITs. It's exploding. There is a huge amount of capital flowing into the space and it shows you the appetite globally for institutional quality real estate. It's really incredible because you are seeing a lot of retail investors aging and looking for current income and capital preservation rather than appreciation.

Steve: This transition from defined benefit [DB] pensions to DC pensions is large and pronounced. As an investment manager, if you're thinking about your long-term plan one would naturally want to include access to the DC market as well as individuals who invest part of their net worth in private equity real estate. Pam made reference to it.

We have been focused on retail capital flows for several years. We've created a retail product structured as a REIT, wrapped in a 1940 [Investment Advisers] Act vehicle that is listed and traded at NAV. Fees are lower and it's a way to help individual investors access institutional quality real estate.

The private real estate industry is going to need to diversify its equity sources and, if the longer-dated capital is in the hands of individuals, there have to be new aggregators to funnel that capital into real estate. Over the next five to 10 years you're going to see many, many businesses in this industry moving in this direction.

Tom Zale, Northwestern Mutual: A major factor in our business has been the increased central bank intervention, which has meaningfully reduced performance volatility. It's

reduced performance volatility for all asset classes, but particularly real estate.

This has played a role in rate and spread compression because [until the outbreak of coronavirus] the markets were getting numb to risk. Even now, there's a perception that if there's a hiccup central banks are going to step up and do everything they can to minimize the risk or minimize the impact. We used to have a business cycle that allowed for market-clearing events, which allowed the strongest to survive and thrive and also cleared out some of the weaker performers. That feels muted now.

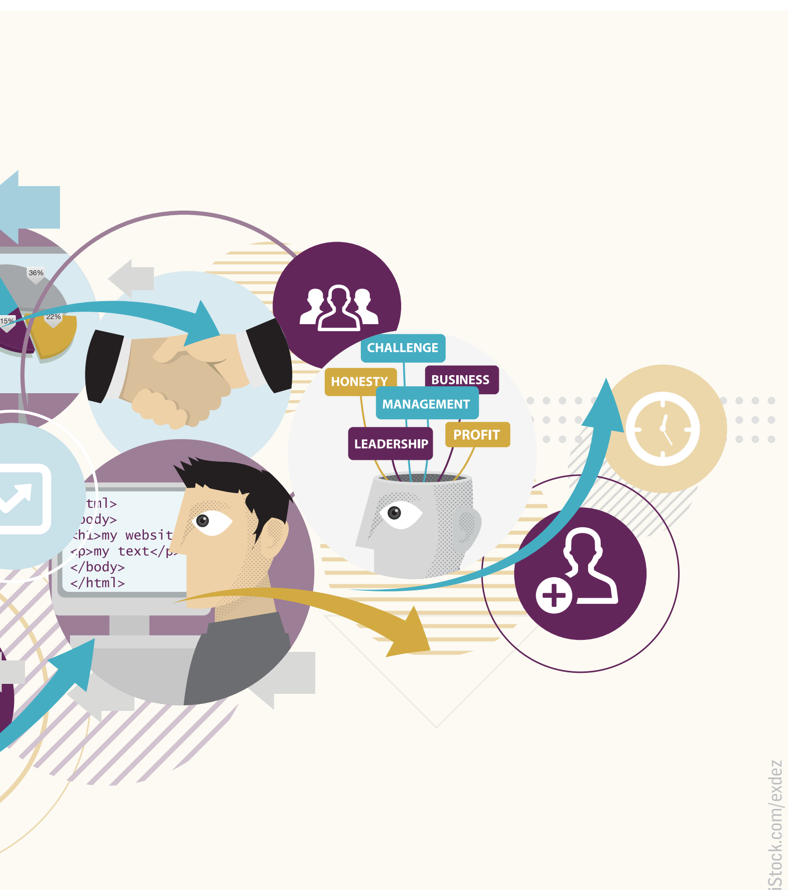
This isn't a bad thing, but together with increased transparency, data and the amount of capital in the market, it has reduced our ability to capitalize on opportunities in the market. A couple of years ago, we thought there was some opportunity to buy core retail, grocery-anchored and it went away before we could even get going.

SURVIVAL OF THE LARGEST

Picking up on what Tom has said and given what you all say about diversification of capital and the globalization of institutional investor portfolios, does size matter more today than even just a few years ago? Does the future favor the big?

Steve: This is not just true with real estate; it's true with everything. Scale makes a difference. When you're small and you're a boutique, you move quickly. There's a whole millennial group that is chomping at the bit to start new businesses. They'll pick a property type, be really good at it and then they'll do what we all did. Then they will merge their way together and grow.

I can tell you it's harder to perform when you're 10% of the index. If you start falling behind as a larger manager then the money rotates to smaller managers.



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Cathy: For me, I see it as more of a barbell type industry, where large multi-product investment management firms can exist alongside small niche, private equity-style firms.

Pam: There's always going to be room for smaller boutique managers. But you've got to have the resources to be able to tackle all of these initiatives to compete effectively. Take responding to an RFP. You need to have all the data readily available, with attribution sliced and diced in 15 different ways. The CIOs and heads of real estate at institutional investors are asking us to step to the plate and be able to prove out our stories.

David: We've said for many years that the real estate investment management firms of mid-size will be the one that are under pressure. They cannot compete in terms of the demands in the industry today and will seek out stronger platforms. And as Steve said, the industry is changing. The medium-sized players aren't one-trick ponies, but they probably don't have a lot of ponies in their stable to offer the diversification that investors seek. On the other hand, smaller firms can be more tactical, offering unique products on a smaller scale.

Steve: Here's a great word and it goes back to Cathy's point — it's all about diversification. It is so important to be diversified, every way that you can, on a risk-adjusted basis. You have to roll up your sleeves and do a lot of work to do the next thing, and then the thing after that and the thing after that and the thing after that. But if you do the work, you will find you're diversified by many property types, regions, geographies, vehicles, deal structures and client sources.

Pam: And people. It's important to be diversified by your talent. Everybody can't look alike.

DIVERSIFICATION OF TALENT

Diversity is an increasingly important part of the real estate investment management industry, not just in terms of investors wanting more information on what you are doing within your organizations — but also simply in terms of retaining your existing talent and recruiting new talent to your firms. How are you changing the makeup of your platforms?

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> **Pam Herbst,** *AEW Capital Management*

Pam: Because I'm a female senior leader, I'm very focused on it! I'm proud to say that nearly 50% of our workforce are women. Many of them are in senior roles, particularly in portfolio management, investor relations and asset management, although we have done less well in acquisitions. We're very focused on social causes within the community to get our young people involved because a lot of them are very focused on how we look at the world. We try to get people involved in corporate giving committees, volunteer days and doing all the things that we should be doing to try to create a culture of inclusion.

Cathy: This is one of those things that you simply have to invest in because you believe it's the right thing for your organization and the industry.

People hire investment managers for their talent. We don't have factories and we're not making any goods. We are only as good as our talent, but in order to attract and retain the best talent these days — particularly in the more junior ranks — we have to be focused on the social impact. People want to work for an organization that they feel good about, where there is an alignment of mission. This makes employees feel that what they do for a living is about more than just earning a paycheck, and that they are having a positive impact on the world and in their communities. While that's difficult to quantify, it's now table stakes from a talent perspective and from a client perspective.

David: I'm currently a professor at the University of Connecticut teaching real estate investment, and the one thing we see in terms of class population is that, on average, 20% of the class is represented by females and minorities. We're trying to improve the ratios at the introductory level so that future participants in the industry are more balanced and represent diversification objectives of the industry.

Steve: What has been fascinating and great to see is the increased focus here from investors and consultants. We have just won an RFP where there was a lot of conversation and digging into the compensation of the entire team, instead of just asking of titles. They wanted to make sure people were not being given cute titles. I can tell you with new hires, we're at 52% women and minorities. We're really working very hard on that.

Tom: Northwestern has a great set of employee resource groups, which I recently leveraged when we were competing for a candidate. I asked the head of our African American ERG group to independently reach out to an individual candidate to give him an opportunity to ask questions about what the environment and culture of our firm was like. He said it was a meaningful factor in his decision to join us.

As an industry, we need to improve the diversity profile of our entry-level career path people because to build that leadership pipeline and really make meaningful improvements in leadership diversity, it's a long-term effort. And it's at every stage of developing talent, from talent acquisition to development and management. If you ask what I think about and where I spend most of my time, talent is the answer.

BACK TO THE FUTURE … REAL ESTATE IN ANOTHER 30 YEARS

If globalization and diversification have completely transformed the real estate investment management industry over the past 30 years, how will it change again over the next 10 to 30 years?

Tom: Real estate and commercial mortgage loans will continue to be an important part of our general account and the portfolios of institutional investors and, as we've discussed, I think you'll see real estate appetite from individual investors, which will support more vehicles like the private REITs. I still believe margin spread compression is going to continue relative to public alternatives, which will only drive further acceptance of the asset class.

Technology as well will also impact everything we do from both a strategy and execution standpoint. I would say technology will be critical to the business.

David: I'll just add on to what Tom said. I think the other issues that are going to be forefront in our conversations and our business are infrastructure in the US and climate change.

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> **Cathy Marcus,** *PGIM Real Estate*

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Climate change isn't just a US issue but global. It's going to be extremely interesting to figure out not just how we adjust to this environment but how we provide products that make sense in this environment.

Pam: I agree with David on climate change, which is going to have a significant impact on real estate investment policy.

Cathy: The biggest changes are going to be around technology — how we use technology and the role that technology plays in the investment management industry. Right now, technology is playing an enabling role, but I imagine that's going to be very different in the future. It will move from being an enabler to increasingly informing and directing decisions.

In 30 years, it will also be interesting to see if there has been more of a democratization of the investible universe between institutional and individual investors, which is already beginning to happen. I think it's very easy to envision a future where there is a more level playing field in terms of who can access the best investment products, and technology will play a major role in that evolution.

Steve: I think investment management firms are going to be for real estate what they are for other investment products, where distribution is a bigger part of the firm. In our business, we have 15 people out of 300 doing institutional investor distribution, which represents the bulk of our capital sources. In 10 years time, I think distribution will represent 25% of our employees. We'll be managing something that is no longer just a real estate firm with distribution into the institutional market. We'll be managing a distribution firm. ◆

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David Reilly