RESEARCH HIGHLIGHTS

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AN ANALYSIS OF PENSION AND RRSP INVESTMENTS IN CANADIAN RENTAL HOUSING

Introduction

Accumulated savings of Canadians in registered pension plans (RPPs) and registered retirement savings plans (RRSPs) represent a potentially major source of equity investment in rental housing. In 1998, RPPs totalled $644 billion in book value while RRSPs were $241 billion. Together, this stock of accumulated savings comprises approximately one-half of the net financial wealth of Canadian persons and unincorporated businesses. It is also in excess of one-quarter of the value of all commercial and residential real estate (land and structures) in the country, or about one-half of the value of all residential real estate. However, existing statistical evidence suggests that real estate forms a relatively minor component of RPP/RRSP portfolios in Canada and of pension plans and retirement savings plans in the United States.

Research Program

The purpose of this study was to examine patterns of RPP/RRSP equity investment in Canadian rental housing and the factors that affect the inclusion of such investments in RPP/RRSP portfolios. The study uses an integrated methodology that consists of a number of key elements, including:

- a review of the legislative and regulatory environment;
- a synthesis of the theoretical and empirical literature on modern portfolio theory;
- a survey of pension funds and money managers to collect data and to ascertain their current investment practices, perceptions and attitudes;
- a comparative assessment of the Canadian/United States environments and results; and
- a quantitative analysis of rental housing investments by RPPs/RRSPs.

Although the number of respondents to the survey was small relative to the total industry population, the author believes that the results are likely to be generally indicative of the industry practices and views.

Findings

RPPs/RRSPs under-invest in rental housing

The evidence presented in the study strongly supports the contention that RPPs/RRSPs currently under-invest in rental housing equity. Two general categories of evidence bolster this contention.

First, statistical evidence presented in the report indicates that RPPs/RRSPs hold far less real estate equity in their portfolios than the share of national wealth that is comprised of that asset. Real estate accounts for 27% of the value of national assets, but only for about 4% of pension fund assets and less than 1% of money manager assets. Data show that the real estate holdings of pension plans in Canada are comparable in magnitude to holdings by United States funds. Evidence from the survey shows

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that only 6% of pension funds and 3% of money managers hold rental housing equity investments. Moreover, the magnitude of rental housing investments is minuscule: 0.1% of assets in the case of the pension funds and 0.05% in the case of the money managers. The data show that the trend is stagnant. Over the past five years, real estate as a percentage of total pension fund assets has declined by about 0.9 percentage points (i.e., from 5.2% to 4.3%). This breaks down very roughly into a 1.1 percentage point drop for commercial properties and a 0.2 percentage point gain for rental housing properties.

The second category of evidence derives from the responses to the survey undertaken as a component of the study. These responses indicate that managers of pension funds and money management firms have strongly held negative views towards rental housing investments.

This evidence of under-investment does *not* imply that RPPs/RRSPs should under current circumstances hold more rental housing assets. A conclusion that they should under current circumstances hold more rental housing assets would imply that investment managers either don't know their business or are behaving irrationally–both of which are unlikely given the high degree of competition within the financial industry. Rather, the results should be interpreted as indicating that there is potentially substantial scope for increasing investments in rental housing by these organizations, *assuming* that the reasons for the low levels of investment are uncovered and that at least some of these obstacles are removed.

Obstacles to RPP/RRSP investments in rental housing

The study identifies many factors that could be impeding rental housing investments by RPPs/RRSPs.

Low rates of return

Data on returns to real estate investments for Canada, the United States and various other countries indicate that returns have consistently been lower and more volatile than the returns for stocks and, for most of the time, even bonds. Evidence for the United States shows that these low returns also apply in the case of rental housing investments. While there is currently no direct evidence specifically relating to rental housing in the case of Canada, the available indirect evidence suggests that returns may have been low relative to other types of investments.

While only one survey respondent (out of 30) specifically referred to low returns as a significant obstacle to investment in rental housing, a number of general comments were made that expected returns didn't warrant the effort that was required to make such investments. Among the factors identified by the respondents that might have a bearing on this are:

- rent controls;
- zoning restrictions and other regulatory rules;
- competition from public housing; and
- income tax rules that deter the turnover of existing buildings.

Regulatory restrictions

The study identifies a number of regulatory restrictions that could create obstacles to increased RPP/RRSP investment in rental housing. First, about 90% of pension funds in Canada are regulated at the provincial level (the rest are regulated federally) and there continues to be a lack of harmonization of the pension investment rules for provinces east of Ontario. This unnecessarily complicates the pension investment environment for rental housing.

Second, while the federal and provincial pension regulatory authorities have recently adopted the much more flexible "prudent person portfolio" approach to plan management, there still continue to be quantitative and qualitative restrictions on the ability of fund managers to make rental housing investments. The two most important quantitative restrictions in the case of rental housing investments limit a fund's investment in a single parcel of real property to not more than 5% of total assets, and the combined total of real and resource properties to not more than 25% of assets. While data and survey results show that most funds are well below these limits, they could still be preventing investment since even a modest amount of property diversification in portfolios would result in these limits being exceeded for a majority of funds.

In terms of qualitative restrictions, regulatory authorities require that a detailed investment plan be developed by each pension fund that specifies, among other things, the fund's investment strategy, categories of investments, approach to diversification, asset mix and objectives. The investment plan must be consistent with the prudent person portfolio philosophy, yet there are no clear guidelines as to how this would apply in the case of rental housing investments. This may create reluctance on the part of investment managers to venture into the rental housing area. This is particularly likely since very few funds have experience making such investments. It is also likely given the fact that, prior to the adoption of the prudent person portfolio philosophy, real estate investments were classified as "basket clause" investments and, together with other non-qualifying investments, could not exceed 7% of a fund's total assets. While the basket clause restriction has been removed, it may still create a psychological barrier for investment managers. Once the investment plan is developed, there may be a tendency for it to become institutionalized, which may create permanent barriers to rental housing investments.

The results from the survey confirm the legitimacy of these concerns. A number of respondents indicated that they thought rental housing investments were inconsistent with the prudent person portfolio philosophy, and a number of others referred to internal fund guidelines as preventing such investments.

Income tax restrictions

The impact of the income tax system was also examined in detail. Income tax legislation generally forbids direct investment by RRSPs in rental housing, although RRSPs are able to hold units in real estate investment trusts (REITs). In the case of RPPs, income tax legislation imposes complex conditions on the different arrangements that a fund can utilize to invest in rental housing, such as those through various pooled fund, corporate and partnership arrangements. Also, certain arrangements for structuring rental housing investments have complex interactions with the income tax foreign property rules, which limit foreign investments for an RPP or RRSP to a maximum of 30% of the fund's assets. Some arrangements run the risk of being classified as foreign property and thus either using up valuable foreign property room or exposing the fund to penalty provisions; alternatively, other arrangements may earn extra foreign property room for a fund. In general, while there are a wide variety of options available for pension investments in rental housing, income tax restrictions create many specific obstacles to pension funds that do not exist for other investors.

A number of survey respondents did identify income tax rules for investment vehicles as a significant impediment to investment. It may also be the case that many fund managers are simply unfamiliar with all of the complexities.

Factors relating to portfolio selection

The study assesses the ways in which the theoretical approach to portfolio management followed by fund managers could affect the attractiveness of an asset such as rental housing. Different frameworks focus on different risk-return features of assets and the way in which these characteristics interact with those of other assets in a portfolio setting. The major models in the modern theoretical finance literature that were examined in the study were:

- asset-specific and portfolio mean-variance models;
- the capital asset pricing model (CAPM);
- the asset pricing theory (APT) model;
- the international CAPM; and
- the international APT.

The survey responses indicate that of the 10 funds that responded to the question as to which model or approach they use:

- 50% do not use a specific formal model,
- 20% use a portfolio mean-variance approach,
- 10% use an asset-specific mean-variance approach,
- 10% use a synthetic derivative based approach, and
- 10% rely on fundamental analysis applied to each asset.

These responses are significant since they indicate that virtually none of the funds, in a formal sense, make use of information relating to the specific risk profiles of individual assets that derive from modern portfolio theory. This could have significant negative implications for the demand for rental housing equity investments because real estate is frequently promoted by analysts and academics on the basis of their beta-risk profile characteristics (particularly their inflation-hedging attributes and their low correlations with the stock market). The effects on asset demand can be dramatic. Research indicates that pension funds in the Netherlands typically allocate about 15% of their portfolios to real estate equity, roughly four times the historical level for Canadian and United States funds, primarily because Dutch managers focus more on the inflation-hedging attributes of real estate.

Analysis in the report shows that the use of derivatives is proliferating among pension fund and money managers and that this might also be having a negative effect on the demand for rental housing equity investments. Derivatives can be used to construct designer portfolios of virtually unending risk/return characteristics, and might be used for portfolio diversification purposes at the expense of assets like rental housing.

Negative attitudes of investment managers

The survey responses indicate that the following factors are the primary sources of negative attitudes towards rental housing investments on the part of pension fund and money managers:

- Internal Fund Management Considerations (46% of negative responses), including, "general management attitudes," "lack of relevant investment expertise," "fund investment objectives and guidelines," and "prudent person investment considerations;"

- Characteristics of Rental Housing Investments (36%), including, "illiquidity of rental housing investments," "high management overhead," and "unavailability of suitable investment instruments," "high transaction costs for acquisitions/dispositions," "inability to value investment holdings precisely," "insufficient suitable investment opportunities," "competition from government subsidized housing," "high maintenance," "low return," "lack of interest," and "no market;"

- Legislative and Regulatory Restrictions (18%), including, "rent controls," "other landlord-tenant legislation or regulations," "federal *Pension Benefits Standards Act* or equivalent provincial legislation," "federal or provincial RPP/RRSP regulations," "other income tax rules on eligible investments," and "zoning regulations and rules."

Managers also expressed concerns about the negative "optics" potentially associated with such "social" investments, including landlord tenant disputes and tenant evictions. The views expressed indicate that in the typical case, rental housing investments are outside the sphere of investment choices made or considered by funds.

Suggestions to improve the investment environment

The study makes a number of suggestions that might encourage rental housing equity investments by RPP/RRSP funds. The study cautions that, while these could improve the investment environment, there is still insufficient knowledge about the relative importance of the different obstacles to predict what the result would be in terms of increased investment, the availability of equity financing for rental housing, or the level of rents. The major suggestions are to:

- determine whether low rates of return to real estate also extend to rental housing and, if so, take steps to identify and eliminate the contributing factors

- make improvements to the regulatory environment, such as:

  - completely harmonize the federal-provincial pension investment rules

  - relax the quantitative pension investment limits under federal and provincial regulations

  - develop clear qualitative regulatory guidelines on prudent investment in rental housing

- amend restrictions under the *Income Tax Act* to:

  - permit RRSPs to hold direct passive rental housing investments and interests in real estate investment corporations (REICs), and new partnership and pooled trust vehicles

  - develop new partnership vehicles for RPP rental housing investments that:

    - are exclusively for domestic rental housing investments

    - are not treated as foreign property

    - permit greater participation in management by limited partners

  - clarify acceptable joint venture arrangements for RPPs in rental housing

  - permit REICs to hold idle land and to participate in developing properties

- develop new pooled trust investment vehicles for RPP rental housing investments that are
  - non-taxable
  - able to accumulate earnings
  - open-ended
  - exclusively for domestic investments, and
  - exempt from foreign property rules
- improve REITs as a vehicle for investment in rental housing by:
  - improving liability protection for investors
  - permitting REITs to function as fully integrated companies able to finance, develop and manage rental housing properties
  - allowing tax-deferred property transfers into REITs, as is currently possible under United States rules

• encourage the rental housing industry to promote to RPP/RRSP investment managers the desirable risk-profile attributes of rental housing that derive from modern portfolio theory

• improve access to specialized investment and property management expertise for RPP/RRSP funds to better enable them to identify, make and manage rental housing investments.

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