Fiduciary Duty and Non-Traded REITs

By Craig McCann, PhD, CFA®

Author's note: This article draws heavily on research performed by the author and others and published in "A Primer on Non-Traded REITs and Other Alternative Real Estate Investments," by Husson et al. (2013); and "An Empirical Analysis of Non-traded REITs," by Henderson et al. (2015).

Non-traded real estate investment trusts (REITs) are registered with the Securities and Exchange Commission (SEC), enabling their sale to unsophisticated investors. Previous REIT research has focused on listed REITs because their risk and returns can be calculated easily from reported transaction prices. Non-traded REITs on the other hand are illiquid, making the data gathering required for empirical research extremely time consuming. This lack of meaningful performance analysis is troubling because at least $116 billion has been invested in non-traded REITs in the past 25 years.

My co-authors and I have analyzed the returns of 81 non-traded REITs, including the 41 non-traded REITs that have become listed REITs or were merged with or acquired by a REIT; and 40 additional non-traded REITs that have started reporting a net asset value (NAV) different from the offering price. The 81 non-traded REITs we study are substantially all non-traded REITs except those that stopped filing Form 10-Ks with the SEC without becoming a traded REIT and those that have not yet updated their NAVs.

We found that investors are at least $45.5 billion worse off as a result of investing in the 81 non-traded REITs compared to investing in a diversified portfolio of traded REITs. Investors in the 41 non-traded REITs that became traded REITs or were cashed out suffered $24.25 billion in underperformance. Investors in the 40 non-traded REITs that are still non-traded but have updated their NAVs have suffered $21.25 billion in underperformance. In fact, investors in non-traded REITs over the past 25 years would have earned as much or more investing in short and intermediate term U.S. Treasury securities without bearing the risks and illiquidity of non-traded REITs.

More than half of the non-traded REITs' underperformance results from $15 billion in up-front fees charged to investors in the offerings. This $15 billion in up-front fees, which largely serves to compensate brokers, would have grown to approximately $25 billion by the time the traded REITs became traded or last updated their NAVs. The rest of the non-traded REITs' underperformance results from conflicts of interest that permeate the organizational structure of non-traded REITs and that are largely absent in traded REITs.

Fiduciary duties require advisors to take due care, have a reasonable basis, and to put clients' interests ahead of their own when making recommendations. Some, but not all, states impose fiduciary duties on brokers as well as investment advisors. The SEC continues to research and debate imposing the fiduciary standard on all brokers (Michaels 2015). In April 2015, the Department of Labor (DOL) proposed to impose fiduciary duties on anybody who provides investment advice for compensation to retirement accounts including individual retirement accounts (IRAs).[1] In addition, many advisors hold a professional designation such as the Chartered Financial Analyst and Certified Financial Planner designations that impose fiduciary duties.[2] Eventually the fiduciary standard is likely to cover most situations where a broker, advisor, or agent gives advice or recommendations for compensation.

Non-traded REITs are so inferior to traded REITs that no advisor taking due care could develop a reasonable basis for recommending a non-traded REIT. Advisors recommending non-traded REITs either are not exercising due care or are succumbing to the corrupting influence of the extraordinary commissions sponsors pay brokers and investment advisors for recommending non-traded REITs. The brokerage industry is well aware that recommending non-traded REITs is inconsistent with fiduciary duties. For example, during LPL's First Quarter 2015 earnings conference call, LPL's chief executive officer stated that DOL's plan to apply fiduciary duties to IRAs effectively would prohibit the sale of non-traded REITs into IRA accounts.[3]

Non-Traded REITs

Non-traded REITs sell shares to retail investors primarily through independent broker-dealer networks in continuous offerings spanning long periods of time at a constant offering price—typically $10. Once a critical amount of capital has been raised, the company is said to "break escrow," and the trust begins purchasing properties. Non-traded REITs are said to have come "full-cycle" when they experience a "liquidity event" typically defined to be a listing on the NASDAQ or NYSE and merger into or acquisition by a REIT.[4]

We have studied 81 non-traded REITs that had a liquidity event or had updated their NAV by May 1, 2015. Of the 41 non-traded REITs that had a liquidity event, 18 listed on an exchange and 23 merged with or

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Table 1: 81 REITs With Some Price Discovery

Name	Price Discovery Date	Name	Price Discovery Date
23 Merged into or were Acquired by REIT			
American Realty Capital Trust III	3/1/2013	Cole Corporate Income Trust	1/30/2015
American Realty Capital Trust IV	1/3/2014	Corporate Property Associates 10	12/27/2002
Apple Hospitality Five	10/5/2007	Corporate Property Associates 12	12/1/2006
Apple Hospitality Two	5/23/2007	Corporate Property Associates 14	5/2/2011
Apple REIT Six	5/14/2013	Corporate Property Associates 15	9/28/2012
Apple Residential Income Trust	4/18/2001	Corporate Property Associates 16	1/31/2014
Apple Suites	1/31/2003	Griffin-American Healthcare REIT II	12/3/2014
Boston Capital Real Estate Investment Trust	1/15/2008	Inland Diversified Real Estate Trust	7/1/2014
Carey Institutional Properties	9/1/2004	Inland Retail Real Estate Trust	2/27/2007
CNL Hotels & Resorts	4/12/2007	Paladin Realty Income Properties	1/28/2014
CNL Restaurant Properties	2/25/2005	Spirit Realty Capital	7/18/2013
CNL Retirement Properties	10/5/2006		
15 Listed on the NYSE			
Bluerock Residential Growth REIT	3/28/2014	Independence Realty Trust	8/13/2013
CatchMark Timber Trust	12/12/2013	Inland Real Estate Corporation	6/9/2004
Chambers Street Properties	5/21/2013	Monogram Residential Trust	11/24/2014
Cole Real Estate Investments	6/20/2013	New York REIT	4/15/2014
Columbia Property Trust	10/10/2013	Piedmont Office Realty Trust	1/30/2011
Cornerstone Realty Income Trust	4/18/1997	Retail Properties Of America	10/7/2013
DCT Industrial Trust	12/13/2006	Whitestone REIT	6/27/2012
Healthcare Trust Of America	11/7/2013		
3 Listed on the Nasdaq			
American Realty Capital Healthcare Trust	4/7/2014	United Development Funding IV	6/4/2014
American Realty Capital Trust	3/1/2012		
40 Updated their Net Asset Values			
American Realty Capital Daily Net Asset Value Trust	4/1/2015	Inland American Real Estate Trust	2/4/2015
American Realty Capital Trust V	9/30/2014	Jones Lang LaSalle Income Property Trust	12/31/2014
Apple Hospitality REIT	12/31/2014	KBS Legacy Partners Apartment REIT	12/9/2014
Apple REIT Eight	12/31/2014	KBS Real Estate Investment Trust	12/31/2014
Apple REIT Seven	12/31/2014	KBS Real Estate Investment Trust II	12/31/2014
Apple REIT Ten	12/31/2014	KBS Real Estate Investment Trust III	12/31/2014
Behringer Harvard Opportunity REIT I	10/31/2014	KBS Strategic Opportunity REIT	12/31/2014
Behringer Harvard Opportunity REIT II	10/31/2014	Landmark Apartment Trust	12/31/2014
Carey Watermark Investors	9/30/2014	Lightstone Value Plus Real Estate Investment Trust	9/30/2014
CNL Growth Properties	2/24/2015	NorthStar Healthcare Income	12/31/2014
CNL Healthcare Properties	9/30/2014	NorthStar Real Estate Income Trust	10/31/2014
CNL Lifestyle Properties	12/31/2014	RREEF Property Trust	12/31/2014
Cole Real Estate Income Strategy (Daily NAV)	12/31/2014	Sentio Healthcare Properties	12/31/2013
Corporate Property Associates 17	12/31/2014	Signature Office REIT	12/31/2014
Dividend Capital Diversified Property Fund	3/31/2015	SmartStop Self Storage	6/30/2014
G REIT	4/13/2012	Steadfast Income REIT	12/31/2014
Global Income Trust	12/31/2014	Strategic Realty Trust	3/31/2014
Hines Global REIT	12/31/2014	Summit Healthcare REIT	12/31/2014
Hines Real Estate Investment Trust	12/31/2014	T REIT	12/31/2011
Industrial Income Trust	12/31/2014	TIER REIT	10/30/2014

*Healthcare Trust of America, Piedmont Office Realty Trust, Retail Properties of America, and Whitestone REIT each converted their non-traded common stock to listed common stock through a series of four partial liquidation events. We use all of the partial liquidations, but only present the final liquidation date in the table.

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were acquired by a REIT. The time from initial offering to a liquidity event ranged from 1.6 years to 13.5 years and averaged 6.9 years. We also included 40 non-traded REITs that are still non-traded but for which the REIT has published updated NAVs. These updated NAVs systematically overstate observed secondary market transactions in the non-traded REITs, but they provide some price discovery information. By including the 40 non-traded REITs for which updated NAVs were available, we eliminate the potential selection bias that comes from only evaluating non-traded REITs that have become traded REITs or have been acquired by another REIT.

The REITs in our study are listed in table 1, sorted by the type of price discovery event and the date on which we value the non-traded REIT investments.

Our 81 non-traded REITs include all 70 of the 91 non-traded REITs filing their first Form 10-Ks with the SEC after January 1, 2000, for which data were available to calculate returns. Thirty have listed or merged or been acquired by a REIT and another 40 have published updated NAVs. Of the remaining 21 non-traded REITs, two stopped filing Form 10-Ks but there was not enough information for us to determine what became of them, and 19 were still in the capital raise period and had not updated their NAVs by May 1, 2015. We add 11 non-traded REITs that started filing Form 10-Ks before 2000 and had a liquidity event.

Non-traded REIT investors pay up-front fees that average 13.2 percent and dramatically reduce the capital available to purchase portfolio holdings. Non-traded REIT offerings are sold primarily to retail investors through an affiliated dealer-manager. The REIT compensates the dealer-manager with commissions that are large percentages of the offering proceeds. Across the 81 non-traded REITs, selling commissions range from 3 percent to 7.50 percent and average 6.96 percent. Very few broker-sold mutual funds charge more than a 5-percent sales load and mutual fund breakpoints ensure that sales loads decline significantly with the size of an investment. Also, directly comparable traded REITs can be purchased in secondary market transactions at minimal commissions. Thus, sponsors pay brokers and advisors extraordinarily high commissions, charged to investors through the offering costs, to recommend and sell non-traded REITs rather than other forms of real estate exposure.

Non-traded REITs' Returns are Inexcusably Bad

We compare the market value of each of the 81 non-traded REITs as of the liquidity event or the latest share-price update for REITs that are still non-traded to the market value investors would have if they had made the same investments and received the same distributions from the Vanguard REIT Index Fund (VGSIX). VGSIX is a passive, low-cost mutual fund that invests in a diversified portfolio of traded REITs. We compute the annualized internal rate of return on the non-traded REIT and traded REIT investments for each non-traded REIT.

The cumulative shortfall for the 81 non-traded REITs is $45.5 billion. Investors' non-traded REIT holdings were worth $89.7 billion, dramatically lower than the $135.2 billion the same investments in traded REITs would have been worth. Non-traded REIT investors would have had more than 50 percent more wealth had they invested in a diversified portfolio of traded REITs instead of the 81 non-traded REITs. The $45.5 billion understates the true harm to investors in non-traded REITs because it counts a $1 shortfall measured in 2001 the same as a $1 shortfall measured in 2015. Bringing forward each non-traded REIT shortfall to May 29, 2015, at the returns to Vanguard's Short-Term Treasury Fund makes the shortfall $47.9 billion as of May 29, 2015 (see table 2). Bringing forward the shortfalls at traded REIT returns makes the shortfall $54.6 billion.

The shortfall as shown in table 2 is 40 percent for firms that have listed, 22 percent for firms that have merged into or been acquired by a REIT, and 37 percent for the 40 firms that have updated NAVs. This suggests that non-traded REITs that have underperformed the broad REIT market less are more likely to be acquisition targets than non-traded REITs that have performed much worse.

The $45.5 billion wealth loss listed in table 2 results from non-traded REIT investors bearing similar real estate risk but earning much lower returns than traded REIT investors. An alternative perspective on these inexcusably bad risk-adjusted returns is to note that U.S. Treasury securities have earned the same returns as non-traded REITs but at much lower risk. Investors who invested more than $116.2 billion in the 81 non-traded REITs received $43.1 billion in distributions and had $89.7 billion in value in the non-traded REIT shares at the time of a liquidity event or an updated NAV. The non-traded REIT investors thus had a net gain of $16.6 billion. The same net investments would have had a gain of $11.1 billion in Vanguard's Short-Term Treasury

Table 2: Comparison of Non-Traded and Traded REIT Accumulated Wealth (millions)

Event	Number	Non-Traded REITs	Traded REITs	Shortfall
Liquidity Events	**41**	$53,556	$77,808	**$24,252**
Listing	18	$23,338	$38,839	$15,501
Merger	23	$30,218	$38,969	$8,751
Updated NAV	**40**	$36,161	$57,398	$21,236
Total	**81**	$89,717	$135,206	**$45,488**
With Short-Term Treasury returns				**$47,918**
With traded REIT returns				**$54,636**

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Figure 1: Investors in Non-Traded REITs Earn Only Short-Term Treasury Returns (in billions)

Table 3: Summary of 81 Non-Traded REITs Internal Rates of Return

Name	Non-Traded REIT	Traded REIT
Minimum	–14.7%	–24.3%
25th Precentile	3.0%	7.5%
Mean	**6.3%**	**11.6%**
75th Precentile	9.3%	15.4%
Maximum	36.8%	25.4%
Aggregate Investment	**4.0%**	**11.3%**

Table 4: Effect of Up-Front Fees (millions)

Event	Up-Front Fees	Future Value of Invested Fees	Investor Shortfall
Liquidity Event	$8,303	$15,075	$24,252
Updated NAV	$6,092	$10,261	$21,236
	$14,395	$25,335	$45,488

fund (VFISX), $21.9 billion in Vanguard's Intermediate-Term Treasury fund (VFITX), $37.6 billion in Vanguard's Long-Term Treasury fund (VUSTX), and $62.1 billion in Vanguard's REIT Index Fund (VGSIX) (see figure 1).

The average non-traded REIT internal rate of return (IRR) is 6.3 percent, compared to 11.6 percent for the traded REITs. The non-traded REIT IRRs range from −14.7 percent to 36.8 percent, with an interquartile range of 6.3 percent (3.0 percent to 9.3 percent). The IRR of the aggregated non-traded REIT sample is 4.0 percent. The same cash-flow stream applied to a diversified, liquid portfolio of traded REITs would have generated an IRR of 11.3 percent. In other words, investors in a liquid, diversified portfolio of traded REITs that exposes investors to the same underlying real estate market as the non-traded REITs received returns of 11.3 percent per year in comparison to the 4.0 percent returns earned in the non-traded REITs (see table 3).

The traded REIT IRR is more than the non-traded REIT IRR for 72 (86 percent) of the 81 non-traded REITs. The 12 non-traded REITs with higher IRRs than the traded REIT benchmark reflect cross-sectional variation in REIT returns and don't suggest an ability to pick non-traded REITs *ex ante* that will have higher *ex post* returns. VGSIX had between 97 and 139 individual REIT holdings at the start of each year from 1999 to 2014. Between 36 percent and 68 percent of the individual REITs held at the beginning of the year had higher returns than VGSIX over the following year. On average, 51.5 percent of the individual REITs beat the VGSIX in any given year and beating the index one year doesn't predict beating the index the following year. Thus, the evidence is that not even the best portfolio managers with the right incentives can reliably select individual REITs that will beat a diversified portfolio of REITs.

Unlike traded REITs, non-traded REITs offer virtually no secondary-market liquidity before their liquidity event. Returns on non-traded REITs returns should be higher than returns on traded REITs to compensate investors for illiquidity. Also, our benchmark contains more than 100 traded REITs and so is much less volatile than the average REIT. Thus investors in diversified portfolios of traded REITs bear less liquidity and market risk and earn substantially higher returns than investors in non-traded REITs.

Across the 81 non-traded REITs, investors paid $14.4 billion in up-front fees, the majority of which compensated brokers. If instead of having been used to pay commissions and other offering costs, these up-front fees had been invested in the traded REIT benchmark they would have grown to $25.3 billion by the liquidity event or latest NAV update when we determine the shortfall for each non-traded REIT. Thus, the high up-front fees explain 56 percent of the total investor shortfall of $45.5 billion (see table 4).

Conflicts of Interest

Conflicts of interest permeate non-traded REITs. These conflicts of interest include portfolio managers affiliated with the sponsor, transactions with related parties, and governance structures ensuring absolute power and discretion to affiliated parties. Non-traded REITs compensate the affiliated portfolio manager with fees, including asset-based fees and incentive fees. Sponsors effectively determine how much REIT investors pay to the sponsor-owned firms for these services.

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Table 5: Analysis of Fees Paid to External, Affiliated Advisors and Managers

Expenses (percent of annual revenue)	Prior Year	Year of Exchange Listing	Subsequent Year	Pre- to Post-Listing Change	*t*-statistic
Property Operating Costs	25.0%	22.8%	22.9%	–2.2%	–1.026
Management Expenses Paid to Affiliates	4.8%	3.2%	1.6%	–3.2%	–2.252
General & Administrative Expenses	7.3%	9.6%	8.1%	0.8%	0.939
Total Expenses	89.4%	82.2%	80.4%	–9.0%	–1.836

Non-traded REITs have corporate-control and governance structures that concentrate power and completely eliminate channels for investors to effect change or impose discipline on management. Top executives of the sponsors of non-traded REITs frequently own controlling interests in other business entities that serve as the portfolio manager and dealer-manager. By ensuring dispersed ownership across non-institutional investors, and maintaining control of every level of corporate decision-making (executive positions) and oversight (the board of directors), this structure effectively prevents any form of shareholder activism.

Although institutional investment in traded REITs is common, institutional investors almost never own material stakes in non-traded REITs. The absence of large, sophisticated investors ensures non-traded REITs are not subject to the same discipline shown to effectively discipline externally advised and managed traded REITs.

My co-authors and I analyzed Form 10-K filings for each of the 18 non-traded REITs that list their shares on major U.S. exchanges. From inception the 18 non-traded REITs select sponsor-affiliated advisors and portfolio managers, but 13 severed their advisory and management relationship with sponsor-affiliated firms on or before the listing date. This pattern suggests that capital markets view management that is independent of the sponsor and accountable only to the REIT's investors as important.

Institutional investors tend to invest only after non-traded REITs exchange listings. Among the three instances where institutions invest in non-traded REITs before an exchange listing, the investments took place only after the internalization of advisory and management roles. These patterns are consistent with the view that among non-traded REITs, institutional investors do not function as activist investors capable of controlling conflicts of interest that arise through the use of sponsor-affiliated advisors and managers.

“Among the three instances where institutions invest in non-traded REITs before an exchange listing, the acquisitions took place only after the internalization of advisory and management roles.”

Operating expenses decline by an average of 9.0 percent of revenues around the exchange listing, and the decline is statistically significant at standard levels. The overall patterns are consistent with the view that, on average, payments to affiliates before the exchange listing exceed the cost structure required to efficiently operate the REIT. Some combination of the liquid secondary markets, institutional ownership, and reduced influence of sponsor-affiliated service providers forces reduced expenses (see table 5).

Discussion

Open-end funds from established mutual fund companies such as the Vanguard REIT Index (VGSIX), Nuveen Real Estate Securities (FREAX), and Fidelity Real Estate Investment Portfolio (FRESX) provide investors with professional management with established track records, access to a wide variety of real estate markets, transparent pricing, large portfolios, and ready liquidity.

In addition, closed-end real estate funds such as Cohen & Steers Quality Income Realty (RQI), CBRE Clarion Global Real Estate Income (IGR), and Nuveen Real Estate Income Fund (JRS) typically own shares of traded REITs. REIT exchange-traded funds (ETFs) include Vanguard REIT ETF (VNQ), iShares' Dow Jones US Real Estate ETF (IYR), and iShares Cohen & Steers Realty ETF (ICF).

Rather than investing in real estate mutual funds or ETFs, retail investors can purchase shares issued by individual traded REITs. REITs tend to be less diversified than real estate mutual funds and ETFs, but they can be used for targeted exposure to particular geographic regions or asset classes within the broader real estate market.

Non-traded REITs underperform traded REITs by approximately 6.8 percent annually. Investors have lost $45.5 billion investing in 81 non-traded REITs that have had liquidity events or updated their NAVs by January 30, 2015, rather than investing in low-cost, liquid, traded REITs. Approximately 56 percent of the underperformance is due to the up-front fees that primarily compensate salesmen. Non-traded REITs' operating performance predictably suffers from high fees paid by the sponsor in related-party transactions. The wealth transfer from investors to sponsors and their salesforce only survives because of the lack of price discovery. If there was an active market for

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non-traded REIT shares, transaction prices would quickly reflect wasteful offering costs and inefficient management, making it impossible for brokers and investment advisors to continue to sell non-traded REITs.

Many retail investors add real estate exposure to their portfolios despite already having a leveraged and undiversified real estate investment in their own homes. What, if any, additional real estate exposure is suitable for investors depends on the extent to which alternative real estate investments are plagued by high costs, risks, and illiquidity.

Institutional investors' allocations and published literature provide useful guidelines on the level of appropriate real estate exposure for the typical investor. Pennachi and Rastad (2011) find that federal, state, and local government pension funds allocated an average of 3.1 percent to 6.5 percent of their total portfolios to U.S. real estate from 2000 to 2009. I have observed investors' portfolios with more than 50 percent invested in non-traded REITs as a result of brokers and investment advisors' recommendations.

Brokers and investment advisors may have a good-faith basis for recommending that a client make a focused real estate investment, but they cannot justify a recommendation to purchase a non-traded REIT. Clients' interests clearly are better served by investments in low-cost, liquid mutual funds, closed-end funds, ETFs, and individual REITs managed by individuals with the expertise and incentives to construct diversified portfolios of the best real estate investments.

Craig M. McCann, PhD, CFA®, is a principal with Securities Litigation and Consulting Group, Inc. in Fairfax, VA. He earned a BA and an MA in economics from the University of Western Ontario and a PhD in economics from University of California, Los Angeles. Contact him at craigmccann@slcg.com.

Endnotes

1. See http://www.dol.gov/ebsa/regs/conflictsofinterest.html.
2. Code of Ethics and Standards of Professional Conduct, 2014, CFA Institute, www.cfapubs.org/doi/pdf/10.2469/ccb.v2014.n6.1 and *Rules of Conduct*, CFP Board, https://www.cfp.net/for-cfp-professionals/professional-standards-enforcement/standards-of-professional-conduct/rules-of-conduct.
3. See www.investor.lpl/events.cfm at 39:30 of 1:21:42.
4. The terms "full cycle" and "liquidity event," used in other direct participation programs as well, have more marketing than economic significance. Many non-traded REITs fail completely and they surely have gone full cycle, just to a different outcome. Nothing in the underlying exposures makes "full cycle" or "liquidity event" necessary or even meaningful concepts.

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