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Russell index creator launches duETS, synthetic securities for commercial real estate exposure

Russell index creator launches duETS, synthetic securities for commercial real estate exposure

By Emma Trincal

New York, March 31 – **Global Index Group** (GIG), the index firm whose co-founder created the Russell 2000 index, launched a new structured-like investment in the form of a trust, which mimics some of the features of a structured note without the counterparty risk.

Designed for large institutional investors, the trust securities will offer exposure to a well-known but not investable U.S. commercial real estate index, the NCREIF NPI, Kelly Haughton, chief executive of GIG, told *Prospect News* in an interview.

"The products are designed to address institutional investors' appetite for commercial real estate and offer them a tool to hedge this very illiquid asset class," he said.

The Down/Up Equity Trust Securities (duETS) for commercial real estate is the group's first offering. The securities are patent-pending.

Access

Similarly to a structured note, duETS allow investors to get exposure to a hard-to-access underlying.

"We designed a financial instrument idea for use with the NCREIF Property index, which is the benchmark for private real estate," said Haughton.

NCREIF Property index, or NPI, is the standard measure of institutional investor-owned U.S. commercial real estate investment performance. It is designed to compare returns between property funds.

"The NPI is not investable, which is part of why we created the duETS. The index consists of loans of buildings, which you can't buy and sell," Haughton said.

Pairing the players

Another similarity with structured investments is the use of leverage, although unlike most return enhancement notes, the leverage for the duETS is applied both to the upside and downside.

The innovative part however is the way the designers of the securities produced a two times multiplier through the pairing of the securities.

At the end of a two-year period, the securities will be valued based on the performance of the index, with gains on Up Securities mirrored by losses on Down Securities and vice versa with a 2X multiplier effect based on the index movement.

Duet

But one difference with structured notes is that the leverage exposure is not achieved via options.

"The duETS are sold as a pair," Philip Barker, senior managing director at CBRE Capital Advisors, told *Prospect News*.

"When someone buys the duETS Up an investor on the other side takes the opposite view and buys the duETS Down."

This parity explains the use of the acronym duETS, as a duet.

A "long" investor, if the market is up, will win twice – first from being right on his bet and second from benefiting from the loss of the owner of the duETS Down, who was wrong.

This pairing allows the "winner" to double up on his gains while the "loser" will incur the opposite outcome, Barker

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explained.

Both parties put the full capital amount in the same size. The assets are invested in U.S. Treasury notes and held in a trust by Bank of New York.

"It's the same thing as when you buy a bond. The custodian holds it for you. There's no counterparty risk however," Barker said.

Price only

Just as with structured notes, investors in the index-based synthetic financial product must forgo yield.

"This is not an income investment," said Haughton.

"Buyers of duETS are just exposed to price movements. We stripped out the yield."

Private placement

duETS may echo a new trend in structured investing, which consists of avoiding the debt format and opting for other wrappers in an effort to avoid credit risk exposure.

Dramatic progresses have been made over the past few years to produce 1940 Investment Act securities such as mutual funds and unit investment trusts that employ derivatives to offer known outcomes in the same way as a structured note. The difference has been added liquidity and elimination of the counterparty risk. But this market remains nascent and small in size, sources said.

duETS are different in their format and in the technology employed. But the goals of removing counterparty exposure and increasing liquidity remain the same.

"We're 1933 Act, not 1940," said Haughton.

The 1933 Securities Act promulgated Rule 144 and Regulation S, which govern private placements. Those rules allow the sale of certain securities without registration under certain conditions.

"It's a security we put together for private commercial real estate investors," said Haughton.

"It's not an exchange-traded product, not a futures contract, not a swap. It's a duETS."

In essence, duETS are private equity investments, he clarified.

QIBs

The duETS will be marketed to Qualified Institutional Buyers (QIBs) and offshore investors and traded under Rule 144A and Regulation S.

Because of the size of commercial real estate investments, this market is essentially institutional, said Haughton.

So far, large pension funds and hedge funds have used direct investments, mutual funds and private equity as well as REITs to get access to the asset class. But their portfolios were difficult to manage and hedge. REITS for one thing do not perfectly match the commercial real estate investment universe, which CBRE estimates at more than $1.7 trillion worldwide.

Secondary market

To facilitate transactions in the secondary market, GIG signed an agreement with CBRE Capital Advisors, CBRE's investment banking arm, to be the exclusive broker for the new securities.

CBRE will not take any positions and will act as an agent only, said Barker.

Haughton explained that CBRE will play a key role in matching bids and asks.

"The trust issues two securities: up and down. In order to do that, we have to have a buyer for the up and a buyer for the down," said Haughton.

Once the securities are created they can be bought and sold on their own.

Legally, the trust is structured in a way that allows the securities to be traded between two eligible investors anytime they can agree to a price, he explained.

"Legally it's potentially as liquid as any other [over-the-counter] securities," he added.

"Phil [Barker] will be in the middle, facilitating trade execution."

Hedges for funds

Haughton expects duETS to be popular among institutional investors, who tend to have significant exposures to commercial real estate.

"We began to realize that the industry, institutional investors in real estate such as hedge funds, pension funds, insurance companies or banks, needed a vehicle to invest in the asset class and to hedge," he said.

As a management or asset allocation tool, investors may buy duETS Up securities to take a bullish position on the asset class.

"If you're a fund and want to allocate to real estate but haven't identified where to spend your money, this is a tool that gives you direct exposure to the benchmark, something that didn't exist before," said Barker.

A large public pension fund that invests billions in real estate could also benefit from downside protection, he added.

"They may have a correlation to the NPI and a need to hedge this position. They

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may like the income they're receiving from this portfolio but also worry about value if price goes down like in 2008," he said.

"Now you can hedge the pure price exposure. A simple way to do this is to buy the duETS Down."

CMBS

The same hedge could also apply to the loan-to-value risk of a commercial-backed securities portfolio.

"It creates an opportunity," said Haughton.

"It's hard to hedge a CMBS portfolio. You can't hedge it with REITS because it's not the same exposure," he said.

That's because the underlying NPI index contains only private real estate.

"Publicly traded REITs experience different return patterns than private real estate," he said.

Credit enhancement

The uses of those hedges expand even further in structured finance territory. Barker for instance suggested that the vehicle could be used to enhance the credit of collateralized debt obligations.

"If you issue a CDO for $1 billion based upon mortgage loans, you can have it embedded with duETS Down. It gives you a higher credit. Your loan is much more secure. It's a way to protect a collateralized debt obligation," he said.

CMBS and CDOs are types of debt securities backed by the cash-flow of pools of loans and bonds sliced into tranches in decreasing order of seniority. Those instruments are part of a multi-billion dollar market.

Partly as a reason of the size of this industry, Barker said he was optimistic.

"We expect duETS to be the foundation for further product innovation in the real estate space," he said.

But the world of CDOs has very little in common with retail structured notes, although the word "structured" used to describe both markets (as in structured finance and structured products) often leads to confusion.

A bridge to structured deals

Haughton and Barker however identified potential bridges between the two industries.

"You can definitely use duETS in a structured note to hedge against an up or down market," said Haughton.

"DuETS are new and they are different from structured notes. But they can be put in a structured note."

Barker went one step further, saying that the new securities offer financial institutions new opportunities to construct structured products.

"They could be using this product as an overlay for more sophisticated structures. This could be the basis of a new development in this industry," he said.

"For people involved in the creation of structured products, in particular banks, this may just be another tool to design products."

Registration, retail

But the use of duETS in the retail market remains unlikely.

"If this is going to be distributed to retail you'd have to have an institution able to sell it," he said.

However one of his goals remains to make the product more mainstream.

"We're going to be applying to register the securities. If the SEC approves, it would be listed," he said.

The Russell journey

Improved liquidity precedes growth.

Sometimes the creation of a new tool is enough to take an entire industry into the next level, said Haughton.

A case in point was the invention of the exchange-traded fund, a new product, which led to a trillion dollar industry.

When he built the Russell family of indexes in the 1980s, at Frank Russell Co., Haughton said his colleague, Blake Eagle, was also working on his own index, the NPI. Eagle, a pioneer in the real estate asset class, would later found a real estate industry association that produces and publishes the NPI index.

The creation of duETS is in part the result of the relationship between the two legendary index inventors.

But the Russell has been so far more successful in generating liquid instruments attached to its name than its real estate counterpart. Haughton said he wanted to change that.

"When I created the Russell I was looking for a useful tool for small-cap exposure. We were told that we wouldn't be able to succeed because of the illiquidity of the asset class," he said.

"It turned out to be untrue. You now have folks who produce ETFs based on the Russell.

"We're doing the same thing today. We want to bring liquidity to an illiquid asset class.

"Because of the experience we have, we're confident we can do the same thing with real estate."

The marketing of duETS has just started.

"We're taking orders. We're open for business. We had good responses so far," he said.

CBRE Group, Inc. is a holding company and investment firm that specializes in commercial real estate.

Global Index Group develops and sponsors index-based synthetic financial products.