Business School

Department of Real Estate & Planning

University of Reading

Working Papers in Real Estate & Planning 05/07

German Open Ended Funds: Was there a Valuation Problem?

Neil Crosby
Professor of Real Estate
University of Reading Business School
Department of Real Estate and Planning
PO Box 219,
Whiteknights
Reading
RG6 6AW
UK.

Email f.n.Crosby@rdg.ac.uk

Abstract

In late 2005, a number of German open ended funds suffered significant withdrawals by unit holders. The crisis was precipitated by a long term bear market in German property investment and the fact that these funds offered short term liquidity to unit holders but had low levels of liquidity in the fund. A more controversial suggestion was that the crisis was exacerbated by a perception that the valuations of the fund were too infrequent and inaccurate. As units are priced by reference to these valuations with no secondary market, the valuation process is central to the process.

There is no direct evidence that these funds were over-valued but there is circumstantial evidence and this paper examines the indirect evidence of the process to see whether the hypothesis that valuation is an issue for the German funds holds any credibility. It also discusses whether there is a wider issue for other funds of this nature or whether it is a parochial problem confined to Germany. The conclusions are that there is reason to believe that German valuation processes make over-valuation in a recession more likely than in other countries and that more direct research into the German valuation system is required to identify the issues which need to be addressed to make the valuation system more trusted.

Introduction

This paper addresses the issues surrounding the use of periodic valuations for financial statements in the property investment process. In particular it addresses the valuation issues raised by the German open-ended fund crisis at the end of 2005 and into 2006 where significant withdrawals caused some funds to freeze transactions and other funds had to be propped up by parent organisations. First, were there any valuation issues or were the crises purely based on issues of market state and liquidity? Second, if there are suspicions over valuations and they have an effect, were there specific circumstances related to German valuations processes and methods or are there more general themes relating to valuation based unit pricing which mean that similar investments in other countries are vulnerable.

There is no direct evidence in the public domain of systematic over-valuation of the German open ended funds so this paper examines the circumstantial evidence surrounding this issue and makes. The objective is therefore to discuss whether there is a case to answer and whether this case raises issues for other indirect investments where the units are priced by reference to valuations rather than traded in a secondary market.

German open-ended fund crisis

The problems faced by the German open-ended funds have been described elsewhere. Bannier, *et al* (2006) provide a detailed account and analysis of the crisis while Maurer, *et al* (2004) provide an analysis of the risk / return characteristics of those funds. Both of these papers mention the valuation process and accept the literature which suggests that appraisals generally smooth and lag real prices (see, for example, the recent review for the Investment Property Forum by Key and Marcato, 2007).

However Bannier et al (2006) do not identify particular issues arising from the German system of valuation and relate valuation issues to those more general theories of smoothing and lagging coupled with the institutional design of those funds. But other practice based commentators, both privately and, more rarely, publically, have suggested that there are additional issues with German valuations which created additional pressures on the German funds.

There are aspects of the German open ended funds regulatory process that have been important in underpinning the success of these funds in the 50 years up to 2005. They have an offering charge of 5% which effectively introduces a major constraint on short term trading. The valuation regime provides for a valuation on purchase and sale of the funds assets, and sales cannot be effected at significantly below the valuation (more than 3%) and thereafter rolling annual valuations are required. These do not occur at the same date which effectively introduces elements of any change in asset values more frequently than the annual valuation period. Discrete jumps in the prices of units are therefore smoothed and the opportunities for short term arbitrage are therefore limited. As a last resort, funds can delay the repurchase of units for up to 2 years but that had never been used between 1959 and 2005.

Bannier *et al* (2006) discuss the triggers for the German open ended fund crisis. The prolonged bear market in German real estate created pressure on German funds during 2004 and 2005. In several funds, parent banks such as Deka, HypoVereinsbank and Commerzbank stepped in and provided liquidity but on December 11th 2005, Deutsche bank announced an unscheduled revaluation of its $7.2 million Grundbesitz Invest real estate fund and the expectation of a major devaluation caused a run on the fund which wiped out the liquid assets. Deutsche Bank then chose to freeze the fund rather than take the Deka course of action which was to buy in units.

These pressures have been seen in other international markets at other times and caused similar events. RODAMCO, the Dutch fund had about three-quarters of its capital invested in US and UK real estate and was valued annually. In 1989/1990 there was a property crash in the UK and investors speculated that there would be a substantial devaluation at the annual re-valuation, so they withdrew large amounts of capital. Selling before re-valuation and re-purchasing after became a significant arbitrage possibility and in September 1990 this is what occurred. However, rather than fund the net disinvestment the parent company suspended its policy of the previous 9 years of buying back the units. The fund was later transformed into a closed end fund (Bannier *et al*, 2006). In Australia, the Australian Government moved in when similar events occurred there in the late 1980s and stopped all redemptions for 12 months and forced all funds to list on the stock exchange (Maurer *et al*, 2004). So the major issues are the illiquidity of real estate in a vehicle that offers immediate or relatively quick redemption of units and pricing based on periodic valuation and there is no or a very small secondary market, especially where valuation frequency is low or valuations are perceived to be inaccurate reflections of prices in the market place.

Bannier et al (2006) speculate concerning the motives of Deutsche Bank in not supporting the sales of units. They appear to have less regard to their reputation in the open ended fund market and one reason may be that they are supporting the movement towards German

REITs. They also speculate concerning the two types of crisis, self-fulfilling and fundamental, and suggest that this may be self fulfilling in that investors withdrew because they thought all the others would do so. A fundamental crisis would be that the fund was significantly over-valued.

They appear to ignore the possibility on the basis that, after re-valuation, the fund price dropped by a small 2.4%. This assumes that the valuations are objective and accurate and this paper argues that the German valuation system may not be as objective and accurate as the UK.

German valuation systems

There is nothing wrong with the open-ended fund valuation process according to the German Investment and Asset Management Association (BVI). In their 24/01/06
Press statement they commented:

"*The BVI is confident that the current use of a committee of experts results in realistic valuations. Property sales completed in recent months confirm this view. The Association therefore regards public criticism around valuation as unjustified*" (BVI, 2006).

Unfortunately, it appears from most other comments that there is perceived to be a problem and these comments are not all based on hindsight. Bruhl (2001) in his address to RICS Europe drew attention to valuation problems with German open-ended funds and at a similar time Crosby *et al* (2000) were suggesting that the use of Sustainable Value concepts in lending valuations were not grounded in theory and were a dangerous practice. While the rest of the world were refining market valuation definitions within the International Valuation Standards Committee, The European Group of Valuers (TeGOVA) were convincing the Basel 2 committee of the arguable benefits of Mortgage Lending Value. It may seem that Sustainable Value concepts in bank lending have little to do with the valuation of assets within open ended funds but this paper will argue that the same valuers were undertaking both financial statement and lending valuations and were influenced by Sustainable Value concepts when undertaking what were supposedly market valuations.

Bruhl (2001) suggests that in 2001 the German valuation profession was a heterogeneous group of mainly self-employed and locally operating individuals. Their background was technical and based in the built environment paradigm. Frequently they were practising architects and engineers. Their status ranged from self-appointed freelance valuers to publicly certified and sworn-in valuation experts. Regulation and appointment was mainly through Chambers of Industry & Commerce. Professional bodies had a lower level of organisation by comparison with the United Kingdom, there was a fragmentation of professional associations and a lack of generally agreed standards of education and qualification. TeGOVA has tried to introduce an approval process but this has been resisted by RICS, the leading valuer's organisation in the UK, which believes that the levels of qualification fall below that provided by its own RICS membership.

Not only is the approach to education, professional qualification and practice organisation different in the UK and Germany, the valuation methods used also appear differ. Friedrich (2003) in his Master's Thesis suggests that survey work confirms that there are systematic differences identified between the German investment method and relevant international approaches. The main German specialities in this regard are separation of value for land and building, consideration of only one income (sustainable long-term rent) and arriving at gross values. Kilbinger (2006) in her Wall Street Journal article concluded that the feeling in the market is that the future of the funds will be less bleak if limitations are imposed on large shareholders' withdrawals of capital on short notice.

However, she also suggested that at the heart of the problem is the way real estate owned by the funds is valued.

"Each regulated fund has a committee made up of Sachverständigen, or evaluators with a Germany-recognized qualification. This committee evaluates properties in a fund's portfolio once a year, using the "sustainable long-term value model," rather than the "open-market value model," which is more commonly used internationally. The sustainable long-term value model smooths peaks and valleys in the market, because evaluators don't adjust the value of properties as soon as there is a big market fluctuation. Instead, they wait and see if it is a temporary blip or a more permanent market movement.". (Kilbinger, 2006)

The basis of valuation is not formally "sustainable value" as defined within mortgage lending, but is based on market value definitions. However, the sustainable value concept of actively smoothing valuation series can be undertaken within an average market valuation interpretation rather than a best price concept of market value.

The author carried out a very small scale confidential survey of the opinions of a number of leading international investors to see if these opinions were held by others and the unanimous response was that the German approach to market valuations did appear to them to be based on an explicit approach to smooth the perceived peaks and troughs of the market.

Other issues include rules within the German open-ended funds which include a prohibition to sell at less than the appraised value (or within 3%), the non-use of international firms of valuers on the valuation committees and the allowing of a significant amount of a valuer's business to come from one client. Even if two funds are within the same stable, the valuer can count both funds as separate entities. The majority of their business could be based on fees from basically one client. The moral hazard implications are huge and this issue is addressed later in this paper.

Therefore many of the necessary ingredients for a problem are present. If a fund wished to hide the true market value of its assets or to change the nature of its performance through time for any reason, it would have the necessary levers to exert undue influence.

German Open Ended Fund Objectives

The organisation and objectives of open-ended funds are set out in the BVI (undated) sales brochure. Fund units are priced by the fund managers based on asset values of the properties in the funds. The main selling platform of those units is based on a clear commitment to offer a product that has very low risk and volatility. The BVI "sales" document is sub titled "*An investment in solid value*"and is packed full of statements like "*a low volatility alternative*", "*steady growth in value at a low risk*" and "*stable profitability and the absence of wrenching moves in market price*". How is that low volatility policy delivered within a property fund?

There are two basic answers to that question and those are to invest in a truly diversified portfolio, if one can be constructed, or to ensure that the true volatility in the performance measures are hidden. In order to hide the true volatility, employing valuers who practice sustainable valuations, or are at least comfortable with the sustainable valuation mentality and practice, may be a start. Using client influence may be the second string although there is no evidence that client influence has been exerted on valuers in Germany. Equally there is no research in Germany on this subject. All the client influence on valuations research relates to the North American market, the UK and Australasia, according to Jones Lang LaSalle the most transparent real estate markets in the World (JLL, 2006). Germany lies in 12th place on that index behind a number of other European countries (Netherlands, France, Sweden and Finland) and JLL comment in the text on concerns regarding German open-ended fund valuations, specifically that they are "not based on current market conditions".

There is evidence that the volatility of property in Germany is less than other markets in the world. Investment Property Databank produce world wide indices and Table 1 illustrates the last 17 years annual performance and volatility of seven world markets including the UK and Germany. It shows that German office markets have had a very different profile to all of the other countries with very low volatility. The next least volatile country is the Netherlands, who have double the volatility of returns of Germany, while the UK has four times the volatility of Germany.

Table 1 : Annualised Performance and Volatility of Office Markets 1989-2005

Country	**Annual Performance (%) 1989 - 2005**	**Annual Volatility (%) 1989 - 2005**
Germany	4.69	2.45
UK	7.48	9.8
France	6.51	9.43
Sweden	4.86	13.27
Netherlands	7.96	5.00
USA	6.34	9.24
Canada	6.98	9.42

Source : Kurzrock (2006)

This lack of volatility is coupled with a very long bear market in German real estate markets. Over the last three years capital values of offices have fallen by over 12% and in the last 10 years by over 16%. However, these are based on valuations and may be suspect if the valuer has been pressured to smooth the blips in the market. If investors believe that actual falls in the market are understated with a hope that the cycle will reverse, a long bear market would lead to the assumption that values were much lower than stated. Any announcement of a major revaluation (which happened in the Deutsche Bank Real Estate Fund) might produce a run on the fund if investors felt that the revaluation would more accurately value the assets downwards, and so hit unit prices. Regardless of the truth or otherwise of the perceptions, the perception alone is all that is required to cause the crisis. Any perception of undervaluation may also relate to all similar funds, not just those in the same stable.

In the event, the revaluation was quite small at 2.4%. However, all that does is raise some longer-term questions concerning the revaluations. As they were undertaken within the same context as previously, there may still be a perception that assets remain over-valued

The problem is crystallised in an attempt by the Degi fund to sell a portfolio of German offices in July 2005. The portfolio was held in the fund at a book value of Euro 350 million. The highest offer that could be obtained was Euro 250 million. The Estates Gazette reported that this was the third German fund that had tried to offload a domestic property portfolio with much higher book values and reported that “many funds are saddled with properties at higher book values than the market is prepared to pay”. This is despite the BVI reporting that German property fund values had been lowered by 2.6%, 2.3% and 3% in 2002, 2003 and 2004 respectively (Estates Gazette, 2005).

This discussion raises a number of issues for other funds. There are obviously different issues for funds whose units are priced by share markets (REITs and Investment Companies), funds priced by periodic valuations (Property Unit Trusts), funds valued less regularly (closed end PUTs and Limited Partnerships) and derivative contracts based on valuation based indexes. Where the valuations are used to price the units or the valuations used to determine returns to derivatives, the issue of accurate and trusted valuations is very important Are valuation processes more transparent and objective elsewhere in the world and are they more trusted?

The UK is one of the longest established moature markets in the wqorld and is included in the top rank of the JLL transparency review (JLL, 2006). Valuation process in the UK has been subject to very detailed research and scrutiny over the last 10-15 years since the UK property crash and the next section of the paper examines this research to identify the likelihood of the German situation repeating itself in the UK market.

The UK valuation process

Regulatory issues

The UK valuation process research includes issues of concepts, bases, methods, reporting, client/valuer relationships and valuation accuracy, smoothing and lagging. Market value is the main basis for all valuations for financial statements and performance measurement and, more importantly, UK valuers do not see it is their responsibility to manipulate this exchange price concept to smooth the peaks and troughs of the property cycle. In fact they came in for some misguided criticism in the wake of the property crash of 1990 for failing to reflect the potential fall in values *prior* to the 1990 crash. The British Bankers Association and the RICS did agree a change in valuation basis in 1992 for bank lending which aimed to give a market value some future shelf life looking forward but this flawed new basis of Estimated Realisation Price was rightly consigned to history in the latest edition of the UK Valuation Standard (RICS, 2003). For a discussion of bases of valuation in the bank lending process see Crosby *et al*, 1998; 2000 and 2006).

The debate following the property crash in 1990 included the Mallinson (1994) Report from the RICS and the guidance and standards regulating commercial property valuations responded by attempting to deal with issues relating to selection of the valuer, instructions, reporting standards and conflicts of interest (RICS, 1996). However, Baum *et a*l (2000), a wide ranging study of the performance measurement valuation process, identified a range of issues connected to the concentration of valuations in a small number of firms and the relationship between valuer and client. It found that fee competition had concentrated performance measurement valuations within the larger firms who could experience economies of scale in information collection and analysis by valuing several properties within each location across a number of portfolios. Small and medium sized businesses valuing a few diversified portfolios could not compete. Also conflict of interest regulations made cheap valuation work less attractive compared to more lucrative consultancy and agency work for the same client.

This concentration had a number of disadvantages but did have one advantage. No one client of the larger firms was that significant to the overall fee income and therefore client influence, the major issue uncovered by the Baum *et al* study, was less of a potential issue. However, interviewees in the Baum *et al* research, including those from major firms, did recount numerous stories of overt and covert client influence. The use of draft valuations meetings was a universal part of the process where valuers presented their draft valuation to the fund manager client and a discussion of each property followed. There are advantages in this meeting as new or other information important to an objective valuation could be passed between client and valuer, but it also presents an opportunity to pass on partial information while withholding other information and to generally influence the outcome.

A number of reasons were identified why an owner or fund manager may wish to move a valuation. Where there were restrictions on the freedom to sell out of a fund at less than valuation, valuers had experienced pressure to reduce the year-end valuation to facilitate a later sale. Where fund manager bonus payments were based on performance, some valuers had been asked to move a few valuations upwards to enable a particular target to be reached, so “releasing “ the bonus payment. In another case, a change of fund manager had precipitated a fall in portfolio value by a significant amount, the suspicion being that that had reduced the starting point for the new manager and his bonus payments.

In response to this research the RICS invited the Director General of the Office of Fair Trading Sir Bryan Carsberg to produce a committee report to address the findings of the Baum *et al* study. The Carsberg (2002) Report came out at about the time the Enron scandal broke and therefore the RICS were seen (by the Financial Times) to be ahead of the worldwide financial transparency and objectivity agenda precipitated by that scandal. The Carsberg (2002) Report produced 18 recommendations with the aim of minimising the risks of valuers' objectivity being compromised and ensuring that public confidence in the system is maintained. A number of the recommendations precipitated changes in the subsequent UK valuation standards 5th Edition (RICS, 2003) including more recent amendments and additions and these concerned amongst others conflicts of interest, rotation of valuers and record keeping in draft valuation meetings.

Rotation of valuers is based on individuals rather than firms. The regulatory process therefore recognises the issue of a particular client being very important to a single valuer within a large firm, even if the client is not critical to the firm as a whole and has recently introduced guidelines for rotation of individual valuers for regulated purpose valuations (RICS, 2003, UK PS 5.2). This chapter also includes provisions for disclosure of the time the individual has been undertaking valuations for the client, the extent and duration of the firm's connection with the client and the percentage of firm income from this particular client expressed in 5% bands (UK PS 5.4).

The RICS has also recently introduced a valuation quality assurance scheme whereby valuation files can be audited by the RICS compliance personnel for all regulated purpose valuations, which include valuations for financial statements and for insurance companies, pension funds and property unit trusts. Where draft valuations were changed the inspection should reveal the reasons for the changes which have to be recorded on the file (PS 5.10).

There is little doubt that the RICS takes its regulatory responsibilities very seriously and has responded to the objectivity and transparency agenda and the revelations of the Baum *et al* study. Similar processes do not exist in many other parts of the world; even for example in Australia and New Zealand which make up two of the top three of the Jones Lang LaSalle Real Estate Transparency Index (JLL, 2006). Their standards are very well developed but there has been more focus on methods in their standards and less on process.

However, a strong process may create a more transparent and objective approach but might not in itself produce accurate valuations and the next section briefly reviews the research into accuracy of valuations.

Valuation accuracy, smoothing and lagging

There is a substantial literature from both the US and the UK concerning the effect of valuations on the measurement of property returns. Key and Marcato (2007) conclude that the theoretical, empirical and practice based evidence that valuation based indices smooth the peaks and troughs of the market and that investors expect an increase of around 1.3 – 1.5 times above the volatility of a valuation based index to be more reflective of true market risk. Would this necessarily mean that all valuations would overvalue in a bear market and undervalue in the bull market.

Three inter-related issues are addressed. First, are individual valuations an accurate reflection of actual prices? Second, do valuations lag prices and introduce a systematic bias towards under or over-valuation? Third, does the use of valuations in performance measurement smooth the indices so that the volatility of returns is understated?

Investment Property Databank has sale price and prior valuations for over 20,000 commercial property transactions between 1983 and 2003. The basic differences between valuations, updated for the time delay between valuation and sale date, and prices is illustrated in Figure 1. First valuation accuracy appears to have improved since 1990 and more recently the average error between the valuation and the price is around 10% ignoring whether it was an under or over valuation. Taking into account the signs, valuations are lower than prices by about 5% in the recent past and this indicates that valuations systematically fall below prices. This is in a time of rising property prices. This evidence therefore suggests that valuations differ from prices by an average of about 10% and there is a bias towards under-valuation of about 5%.

However, Figure 1 also indicates that valuers lag price movements in both rising and falling markets generating a hypothesis that valuers follow markets, but do not increase or fall at the same rate as prices. This does not mean that valuers are behind prices in rising markets and behind them in falling markets. It suggests that in a rising market valuers fall further and further behind prices and when a falling market occurs they start to catch up (reduce the gap). In 1995, five years after the beginning of the major recession in the UK, valuations finally caught up prices having been nearly 15% below prices in 1989. Had the recession in the UK lasted for longer, UK valuations may have exceeded prices, as they appear to have done in Germany. However, the market recovery created an increasing gap between valuations and prices after 1995.

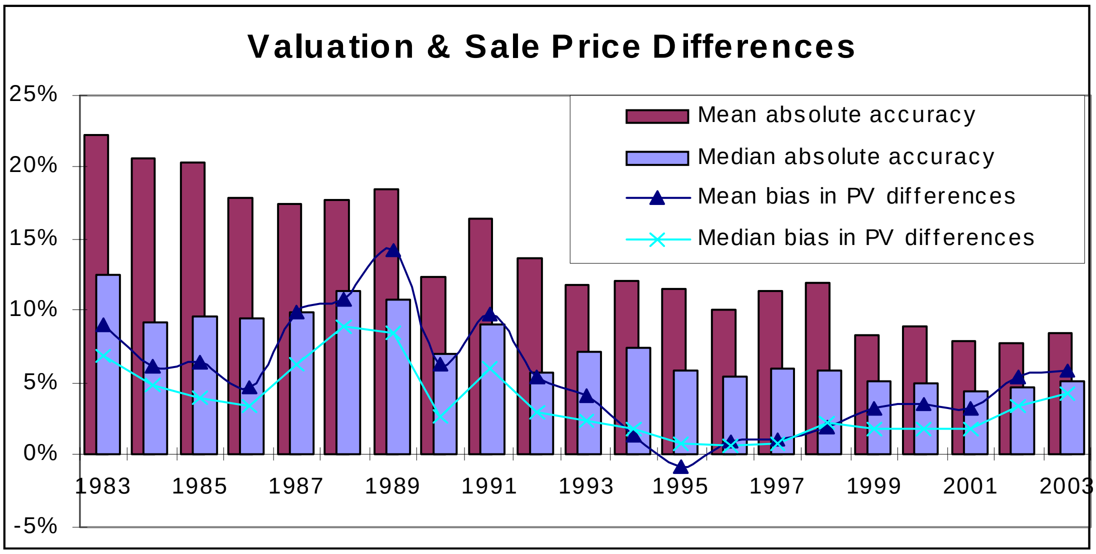

Figure 1 : Valuation and Sale Price Differences – UK 1983 to 2003 – Source RICS/IPD (2005) . PV = Price/Value

Another hypothesis from this data is that valuations will not follow the market up to the peak so smoothing the volatility of returns. Quan and Quigley (1991) suggest that valuers quite rationally anchor comparable based appraisals on past valuations and current comparables and therefore introduce lagging and smoothing of the indices. More recently Edelstein and Quan (2006) confirm that valuation based appraisals show about 55% of the volatility of transactions data on the same properties and conclude that property market volatility is not dissimilar to equity markets. Finally investment managers also must accept these conclusions as asset allocation models which adopt valuation based property performance measures invariably make property the major asset class in the portfolio rather than equities.

Edelstein and Quan (2006) note that there is a large and respected literature which basically agrees that appraisals lag market movements and therefore tend to miss the peaks and troughs of the market. This author would question that literature in one respect; whether the smoothing relates both to the peaks and the troughs. The UK data on valuations and prices suggests that the peaks are smoothed but that the lagging effect means that valuations did not catch prices until after five years of down market. Given the fact that markets have on average grown and had more years of growth than decline, there is no evidence of valuations actually exceeding prices. Smoothing of peaks only would have the same effect of reducing volatility so this does not invalidate the smoothing results of many studies.

To summarise, quite rationally, valuers anchor on past valuations and current comparables, some of which are historic compared to the valuation date. McAllister *et al* (2003) reinforced the rational anchoring arguments of Quan and Quigley, by examining the IPD UK Monthly Index between January1987 and April 2001 and showing that on average 69% of valuations were unchanged month to month. There were some interesting seasonal variations which suggested that valuers were not very active in the skiing and summer holiday seasons of January and August, but were more likely to move valuations on quarter days of March, June, September and most likely to move them in December when the evidence is being collected for the annual valuations. However, November is also a lively month for changing monthly valuations and this is explained by the fact that a number of the annual (December) valuations have their draft valuation meetings as early as November so more evidence is collected in November as well.

There is evidence to suggest that valuers lag prices, smooth the peaks and possibly the troughs, subject to a lengthy bear market. They appear to follow prices up and down at slower rates than prices actually change. There is less research on whether this is a conscious or unconscious response to the task. Valuation has been subject to litigation in the past, albeit mostly from lenders rather than other clients, and valuers are even more likely to anchor on hard information such as comparables and previous valuations than vague notions of market movements in an environment which might see them having to justify their approach and data. So there is a rational argument for valuers consciously producing valuations at less than prices. This situation could change if there is a very prolonged bear market as there was in Germany until recently. In the UK, even a five-year falling and then depressed market was not enough to generate over valuation but the shortfall measured between valuations and prices in 1989 was very high. In Germany the bear market lasted longer so giving even objective, rational market valuations the opportunity to create over-valuation.

There is one major limitation to these analyses. They suffer from the fact that most of them are based on individual property data where both a transaction and a valuation have taken place. There are arguments that valuations influence prices and what properties are sold at so they are not independent of one another (Baum *et al*, 2000). If the data is not independent and some funds cannot easily sell at less than prior valuation then the observed characteristics of the data would be expected. Valuations would on average lag prices with some properties not coming up to valuation and being withdrawn from sale, or not offered in the first place, if that were suspected when assets were being chosen for disposal.

The final complicating factor in this analysis is that market valuation is primarily based, regardless of approach, in comparable sales. Rising markets tend to have more transactions than falling markets, when many investors stop selling until markets recover and find it more difficult to fund purchases even if they want to become buyers. Fewer comparables mean that the valuer is more likely to anchor on previous valuations and either the same number of more historic or fewer comparables. These transactions may be those from the top of the price distribution and this may be another cause of a reducing fall in recorded values and then over-valuation in a long bear market. Fisher *et al* (2003) conclude that actual prices assuming a constant liquidity or number of transactions fall below those recorded in indices.

Discussion

First, there appears to be some empirical and some practice based evidence that Germany is a special case as far as both markets and valuation approach is concerned. The bear market was particularly long and coupled with the lack of liquidity of the assets, annual valuations and the ability for unit holders to ask for reimbursement of unit value with no waiting period, funds may only have escaped pressure if the value of units was trusted. It appears that they are not trusted and therefore investors would be tempted to withdraw while they thought the units were over-valued. Any price recovery in markets would not be fully reflected in the next set of total returns as valuers and fund managers may use the increases to start to redress the valuation imbalance. Investing in higher growing overseas assets which have not be artificially smoothed would attractive in the short term.

The tendency to follow the market down at a lower gradient than actually occurring may put the UK, or any other countries', valuation based unit trusts under pressure in a long term bear market. However, there are suggestions that the German valuers adopt a different interpretation of value, have a different educational and practical background, use different applications of methods and are more vulnerable to coercion from clients. Despite the protestations of the client's representative body, the aims and objectives of the German funds, the method of appointment of valuers and the appraisal based performance measures of the German investment market also provide motive and some element of empirical backing respectively for these suspicions.

There is therefore a major case for a comprehensive review of valuation processes and application of methods in Germany, perhaps adopting the UK Mallinson and Carsberg Reports as a guide to issues to be addressed.

The UK is less likely to have the same problem. First, a ten year bear market is exceptional and UK data suggests it has not happened in any property market since records began. Second the units are valued far more frequently, once per month for PUTs, and the UK index is going quarterly at present, this makes the move from one year to 6 months proposed in Germany look cosmetic. Third, there are no major suspicions concerning the valuation process and the education, training and approach of valuers. The basis of valuation is not subject to different interpretations and valuers are all aiming at the same target, the identification of the price if a transaction took place at the date of valuation. Client influence does exist and it is important that motives are reduced to a minimum. This author has argued that bonus payments to fund managers based on performance targets set by reference to valuation-based indices should be outlawed. However, responses in the UK to valuation issues have largely been the domain of valuers rather than clients with the RICS at the forefront of introducing more information, guidance and enforcement of standards. This is despite the fact that there was no evidence that client influence was endemic or was introducing a serious problem into the pricing of commercial property, or vehicles based on commercial property.

However, there is an issue of accuracy of valuations and the smoothing, lagging and accuracy literature and data analysis does suggest that valuers lag the market and generally this means that prices are more than valuations. However, it has been suggested that in a long bear market the situation could reverse and valuations systematically exceed prices, with the Fisher et al (2003) constant liquidity theory suggesting that the over-valuation would be even more pronounced than an actual transaction based index would show, let alone a valuation based index.. They also show significant smoothing of valuation based indices. However, the lack of a long bear market and the tendency to seek to answer the exchange price, market value, question truthfully suggests that any significant over-valuation is unlikely.

Conclusions

To conclude, any outcome of this situation would depend upon the role valuations play in pricing, which is crucial. Where property investments are based on units or shares traded in the market place, the valuation is only part of the information base. The research on valuations is in the public domain and investors are able to take a view of the veracity of valuation information and the research and price units accordingly. It is not unusual for such units to trade at prices very different to net asset values (NAV), both premium and discount, and some of that may relate to valuation issues. REITs will fall into that category. Secondary markets for units priced by direct reference to valuations can also trade at premiums and discounts to NAV.

The issue of investments priced by direct reference to the asset valuation, or by reference to indices based on asset valuations, is a more important question. Authorised Property Unit Trusts are such an investment and they have been in operation since 1991 without a major crisis and are increasingly subject to secondary market trading via the individual managers operating a matched bargain service. HSBC also operate a bargain service. However, where the pricing is directly related to the valuation there must always be some caution, and the regulatory framework for these valuations should be particularly well policed by the RICS. There may be some grounds for biasing the random samples adopted by the compliance unit towards this group of regulated purpose valuations. Derivative contracts are also part of this process with the indices on which they are based heavily dependent upon valuations.

In the German funds, a revaluation of the assets to market value would have had a direct effect on unit price as it would in a unit trust in the UK. Any suspicion that overvalued assets were about to be more correctly valued should cause a run on the fund, which is what happened. However, this discussion suggests that the valuations in the UK are far more objective and conceptually correct than Germany who had, and still have, major issues to address. The UK valuers aim to identify price and do not aim to smooth markets. However, the nature of valuation may lead to some element of smoothing and lagging of prices although this is not proven and the same results could be obtained by reference to the effect of valuations on the buy/sell activity of funds. The problems introduced by infrequent revaluation are not an issue for property unit trusts which are valued monthly, although the anchoring issues are very pronounced.

But, if the data is accepted and smoothing and lagging thought to be present, then there is some evidence that in a very long run bear market, units priced by direct reference to valuations could become significantly over-valued, the situation which was perceived to exist in Germany. However, a secondary market in these investments should provide evidence of the emergence of a gap between valuations and prices if it occurred. Where units are traded in markets, valuations become much less influential and the information from trading should also filter back into valuations.

The valuation regulatory process in the UK is arguably at least as good as either the US or Australia and they have had no valuation created crises in their REIT markets, which have been established many years. The UK's most vulnerable property investment vehicle for a valuation-based crisis is the authorised property unit trust (or derivative contracts) and they have had no crises of this nature since inception in 1991, despite the major crash and slow recovery of the 1990s. However, the UK property market has not had a bear market of longer than 5 years and has therefore not been put under the same pressure as the German open-ended funds. There is no doubt that the unit trust concept is similar to the German open-ended funds with an illiquid asset owned in units with redemption of the units based on periodic valuations. However, the organisation of the redemption and the frequency, objectivity and transparency of the valuations are better and the valuations more soundly conceptually based on exchange price.

A similar event is concluded to be much less likely to occur even in a long bear market as long as the valuation regime for those property investment types at risk continues to be transparent and objective and is closely observed, researched and regulated. Germany needs to take on board the need to be transparent and if it is to rid itself of the suspicions concerning the valuations and performance measures based on valuations, it needs to carry out its own objective review.

References

Bannier, C., F. Fecht and M. Tyrell (2006) Open- End Real Estate Funds in Germany – Genesis and Crisis. *Working Paper No 165, Finance and Accounting*. Johann Wolfgang Goethe-Universitat, Frankfurt-am-Main. www.finance.uni-frankfurt.de/wp/1248.pdf.

Baum A., N. Crosby, P. Gallimore, A. Gray and P. McAllister (2000) *The influence of valuers and valuations on the workings of the commercial property investment market*. London: Royal Institution of Chartered Surveyors/Investment Property Forum.

Bruhl M. (2001) *Real Estate Valuations :Standards and Models of Professional Organisation.* Conference paper to RICS Europe, Brussels, September.-BVI (undated). *Open Ended Real Estate Investment Funds - An Investment in Solid Value.* Frankfurt am main : Bundersverband Investment und Asset Management .e.V.

BVI, 2006). *Investment Information 24th January*. Frankfurt am main : Bundersverband Investment und Asset Management .e.V.

Carsberg, B. (2002). *Property Valuations*. Report of the RICS Committee. London: Royal Institution of Chartered Surveyors.

Crosby, N. A. Lavers, and H. Foster. (1998). Commercial property loan valuations in the UK : implications of current trends in valuation practice and legal liability. *Journal of Property Research,* 15(3) : 183-209.

Crosby, N., A. Lavers and J. Murdoch (1998b). Property valuation variation and the margin of error in the UK. *Journal of Property Research*, 15 (4), 305-330

Crosby, N., N. French and M. Oughton (2000) Bank Lending Valuations on Commercial Property: Does the European Mortgage Lending Value add anything to the process? *Journal of Property Investment and Finance*, 18(1), 66-83.

Crosby, N. (2006) *Bank Lending Valuations of Commercial Property : Learning From Mistakes?* Keynote address to the International Valuation Conference of the Australian Property Institute and the Property Institute of New Zealand, Cairns, May.

Edelstein, R.H. and D.C. Quan (2006) How Does Appraisal Smoothing Bias Real Estate Returns Measurement? *Journal of Real Estate Finance and Economics*, 32(1): 41-60.

Estates Gazette (2005). Degi again fails to offload portfolio. *Estates Gazette*, July 2nd, 12:16.

Fisher, J., D. Gatzlaff, D. Geltner and D. Haurin (2003). Controlling the Impact of Variable Liquidity in Commercial Real Estate Indices. *Real Estate Economics*, 31(2), 269-303.

Friedrich, R. (2003) *European Convergence in Property Valuation : How do the German Open-Ended Property Funds measure up?* MSc Thesis abstract catalogue www.diplom.de/db/diplomarbeiten8019.html

JLL (2006). *Real Estate Transparency Index*. Chicago: Jones Lang LaSalle.

Kilbinger, S.S. (2006) Run on German Real Estate Funds Exposes Flaws in Regulation. *Wall Street Journal online* www.realestatejournal.com/reits/20060131-kilbinger.html.

Kurzrock, B.M. (2006) *Extending the Index Time Series : The Performance of the German Property Market from 1989 to 2005*. Paper to European Real Estate Society Conference, June, Weimar.

Mallinson (1994). *Commercial Property Valuations*. London: Royal Institution of Chartered Surveyors.

Maurer, R., F. Reiner and R. Rogalla (2004) Return and Risk of German Open-ended Funds. *Journal of Property Research*, 21(3), 209-33.

McAllister, P., A. Baum, P Gallimore and A Gray (2003) Appraiser Behaviour and Appraisal Smoothing: Some Qualitative and Quantitative Evidence. *Journal of Property Research*, 20(3) 262-80.

Quan D.C. and J.M. Quigley (1991). Price formation and the appraisal function in real estate markets. *Journal of Real Estate Finance and Economics*. **4**, 127-46.

RICS (2003) *RICS Appraisal and Valuation Standards (5e).* London: Royal Institution of Chartered Surveyors.

RICS/IPD. (2005). *Valuation Accuracy Report*. London: RICS.