LAUNCH OF THE IPF PAPER: ALTERNATIVE USES FOR PROPERTY DERIVATIVES

Chair:

Jon Masters, Arca Property Risk Management and Chairman, Property Derivatives Interest Group (PDIG)

Speaker:

Bill Bartram, Independent Risk Management Solutions Ltd and lead author of the Paper

Panellists:

Nick Fisher, Legal & General Investment Management

Stuart Heath, Eurex Frankfurt AG

Independent Risk Management Solutions Ltd

Alternative Uses for Property Derivatives

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Property Derivatives – Where are we today?

- Available on/off since 1991 (London FOX)
- Versus IPD since 2004 (British Land & Prudential)
  - the “Total Return Swap”
- Volumes reached their peak in 2008
  - Numbers heavily inflated due to interbank trading

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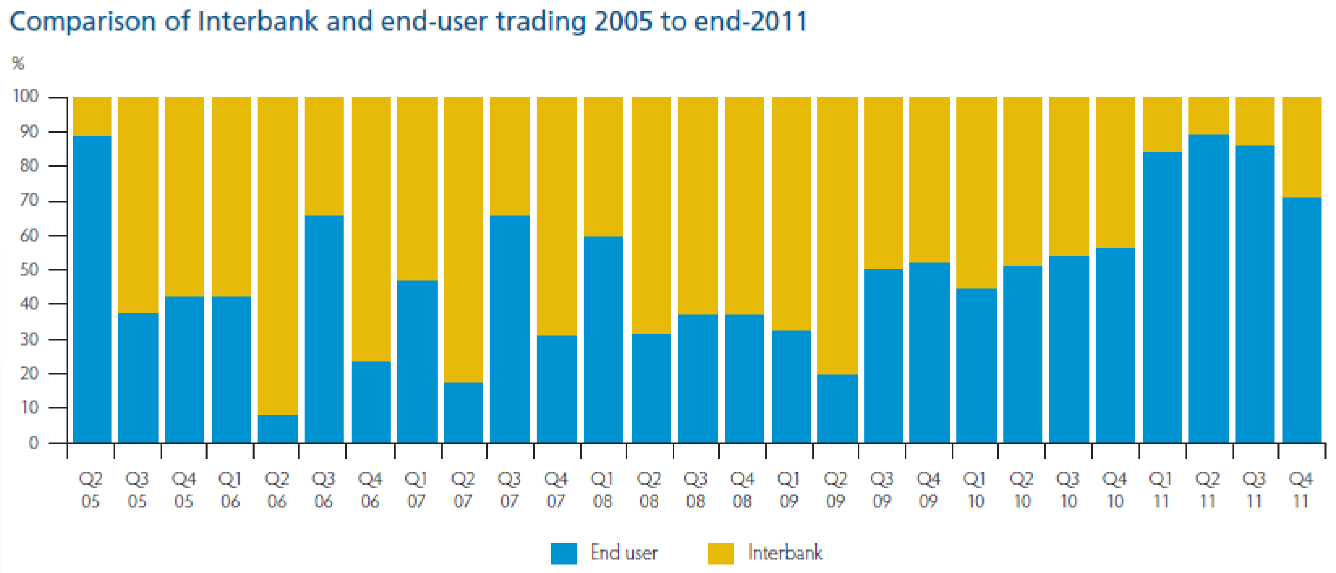
Property Derivatives – Where are we today?



- Today volumes are much lower but there is much more end user involvement

More price efficient market

Property Derivatives – The Paper

Includes;

- Synthetic vs. physical real estate for yield
- Alpha return / market risk management
- Beta returns
- Enterprise risk management
- Property futures for defined contribution pension schemes

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Synthetic vs. physical for yield

- Since GFC real estate values have rebounded with a vengeance
- Pricing today in many sectors higher than 2007/08
- Why?

CRE is not the answer to life, the universe and everything!

- The answer is in fact – Yield!
- CRE offers an attractive risk-adjusted yield relative to fixed income

Synthetic vs. physical for yield

- But CRE is not fixed income!
  - No tenant = No income
- By contrast CRE is;
  - illiquid
  - unpredicatable
  - expensive to buy
  - expensive to own
  - prone to catastrophic shifts in values
- If yield is your objective, is there a better way?

Synthetic vs. physical for yield

Case Study

"We propose to invest in a well-established industrial park inside the M25 with passing rent of £1m per annum. Offers are sought at ca. £18.8m, which would reflect an initial yield of 5% (allowing for standard purchasers' costs). We believe that the market can support income growth of 2% per annum. The property would therefore provide an unleveraged IRR of 6.02% over seven years."

- IRR can be increased from 6.02% to 7.19% through use of property futures
  - Lower costs = greater exposure

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Synthetic vs. physical for yield

<u>Physical Return</u>

- 6.02% includes purchase and sale costs
- Adding asset management fees of 0.85% reduces IRR to 5.25%

<u>Synthetic Return</u>

- Depositing cash at 7 year gilt rate (1.40%) increases IRR to 8.34%
- Breakeven for IRR (5.25%) if contracts priced at 103 or below

Synthetic vs. physical for yield

Optimal pricing will be different for every investor;

Contract Price	Rf Rate (7yr)	IRR
104	1.40%	4.36%
104	1.80%	4.75%
103	1.40%	5.35%
103	1.80%	5.75%
102	1.40%	6.35%
102	1.80%	6.75%

Where do you draw the line?

Focus on Beta

- Beta is the oft maligned cousin of Alpha
  - Where Alpha is ‘sexy’, Beta is just ‘average’
- Alpha requires property and is therefore expensive
  - Alpha can go both ways; excess returns are not always positive!

Question?

“Is Alpha what you really want, or do you just want market exposure?”

Focus on Beta

In the case of a new allocation to CRE an investor/fund manager has four options;

Sector	Alpha or Beta
Physical Property	"Alpha or bust"
Listed Vehicles	Alpha relative to peers
Unlisted Funds	Explicitly Alpha
Property Futures	Pure Beta

Is Beta enough?

Modern Portfolio Theory teaches us that through diversification;

$$ER_p \rightarrow ER_m$$

If this is true, significant cost savings could be made for large funds by buying a laddered portfolio of bonds and using them as collateral for a portfolio of property futures

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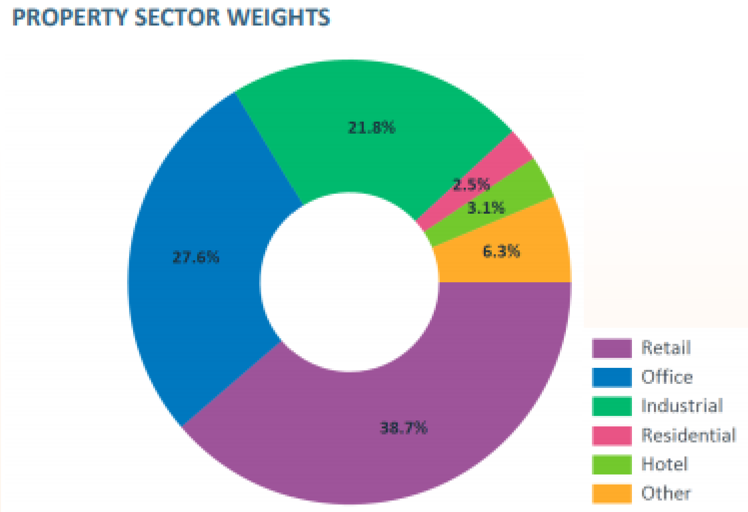
Enhanced Beta

- Widely acknowledged danger of over-exposure to certain sectors through index composition in ETFs (tracker funds).
- Property futures allow you to change your Beta by buying or selling exposure in different sector and sub-sector contracts



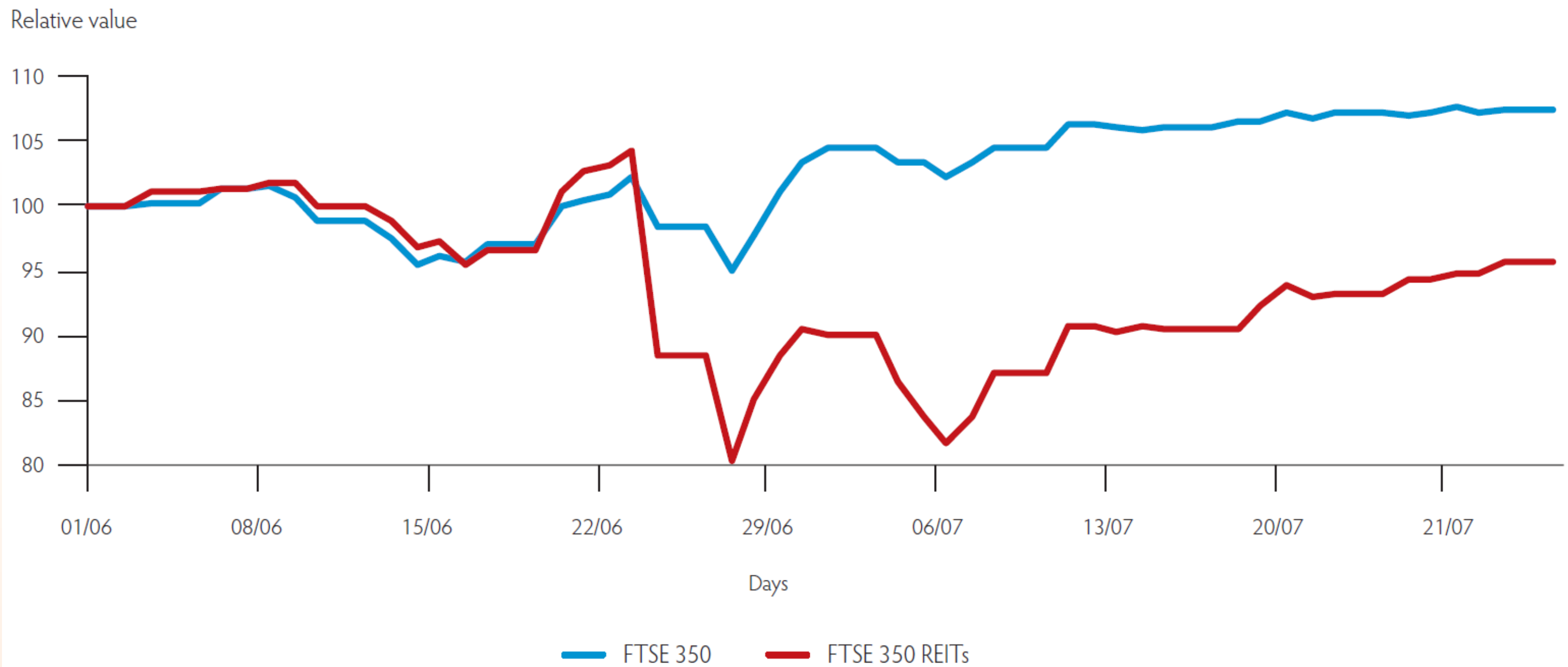
Source: MSCI (December 2017)

Property Futures for DC Pension Schemes

- DC Pension Schemes require daily pricing
- Solution: Hybrid funds
  - 70% physical & 30% REITs
  - Price of physical is inferred from value change in REIT
- Then something goes wrong ….

Property Futures for DC Pension Schemes

Comparison of REIT and FTSE 350 share price indices before and after the Brexit vote on 23 June 2016



Property Futures for DC Pension Schemes

- REITS exhibit risk in relation to real estate, but also risk in relation to equity
- Possible reasons for post-Brexit shift include;
  - Uncertainty about occupier market
  - Relative value of foreign earnings
  - Mad dash for liquidity
- The real reason is likely to be a combination of all of the above
- Regardless, prices inferred from post-Brexit REIT values were not representative of changes in the value of physical property

Property Futures for DC Pension Schemes

- A fully collateralised property futures contract offers liquidity on-demand
- End of day settlement pricing is available on Eurex
- Property futures reference IPD only
  - Immune from equity specific risk
- Adding property futures to hybrid funds increases the amount of data available for inferring value of physical property

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Thank you for listening!

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Q&A

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