Lessons for property funds following the crisis

SUE FORSTER
IPF

The IPF organised a joint seminar with The Association of Real Estate Funds (AREF) on 13 May to consider what has changed within the property funds sector since the global financial crisis (GFC) and whether further changes are required.

PwC kindly hosted the event at its Embankment Place office and the participants were:

Chair: Angus Johnston, PwC

Speakers: John Forbes, John Forbes Consulting
John Cartwright, AREF

Panellists: Matthew Abbott, Mercer
Graeme Rutter, Schroder Property Investment Management
Howard Meaney, UBS Global Asset Management
Andrew Banks, Legal & General Investment Management

To set the discussion in context, John Forbes outlined the main findings of the PwC report, 'Unlisted funds – Lessons from the crisis' commissioned by AREF in 2011 and published in January 2012. The report, based on a survey of fund managers, investors and others in the industry, covered a broad range of issues but the focus was on the underlying issue of the liquidity of property wrappers, namely the trade off between liquidity & volatility and performance & risk over the past 'decade of volatility' (2001-11).

Issues highlighted by the report

- There is an inherent inertia within property fund management as it is very difficult to change managers. At the time of the research, there was a perception that investors would vote with their feet as soon as market conditions improved such that they could get their money out and that, having done so, they would re-invest into new funds.
- When values collapsed (the peak to trough fall was nearly 50%), funds faced different challenges depending on whether they were closed-ended or open-ended. The former, if nearing the end of their term, had to wind-up or extend in circumstances where not all investors were aligned in their aims. This was compounded by the fact that these funds were typically more highly geared than open-ended funds and their loan-to-value covenants came under pressure when values fell. Several of the open-ended funds faced the challenge of large-scale redemptions, while keeping a balance between those wanting to leave and those remaining.
- UK real estate funds model did not provide the range of funds required by investors, e.g. some investors in open-ended funds wanted to deploy capital for the long term and did not require the level of liquidity being offered.

The key conclusions from the report were that:

- The challenges of non-alignment of investors and the co-mingling of different types of investors (e.g. institutional and retail) should be addressed.
- There was a need for greater fund transparency, improved governance and more independent supervision.
- There was investor demand for funds that ‘blur’ open-ended and closed-ended funds and provide for long-term investment with limited opportunities to redeem (semi open-ended funds).
- There should be a better understanding of the role of the manager in regulating inflows of capital.

AREF response

John Cartwright said that AREF was seeking to promote continual improvements in high-level governance, transparency and integrity. The PwC report had been commissioned in order to correct some of the misunderstandings as to what happened during the downturn and to point a way forward post crisis. Since the report’s publication, AREF had held a series of meetings with key figures under Chatham House rules to discuss the findings. As a result, AREF would be re-launching its Code of Practice (since done) as a dynamic document that will consider best practice in areas like the independent oversight of funds, subscriptions and redemption policies, as well as addressing the issues regarding closed-ended funds that were highlighted in the report. AREF would also be policing adherence to the Code on a more formal basis.

Fund liquidity

The chairman, Angus Johnston, asked the panel members whether they thought investors’ perception of liquidity had changed. Matthew Abbott said that for any illiquid asset class investors need to be flexible as performance had to be first and foremost and liquidity affects performance. Daily pricing is problematical so the answer may be the provision of liquidity windows at the end of each year and more openness from fund managers as to strategy for the fund. Andrew Banks remarked that investors want more control over exit points, which potentially constrain performance.

Communication with investors was seen as a key part of managing the level of redemptions. Howard Meaney said he considered it vital that communication with investors is improved in line with the AREF best practice guidelines. The UBS Triton Fund was undergoing modernisation to afford investors protection in time of crisis and an improvement in communication and governance through the establishment of an independent supervisory board. Graeme Rutter agreed that a lot of avoiding the problems of redemptions was communication – a huge challenge when investors see a large volume of redemption requests. Banks pointed to the need to provide more time to effect redemptions and look at alternative funding, such as gearing.

A member of the audience asked whether the panel thought communication between fund manager and investors suffered as a result of the key role of investment managers. Abbott responded by saying that he would like to see an increase in the level of communication with fund managers but that it was difficult where there were a number of clients in the same fund, all with different strategies and views.

There was also comment from the audience about the size of a funds investor base. Rutter thought that diversification of the investor base was normally a good idea but for some investors there were advantages in being in a ‘club’ of like-minded organisations, for example defined benefit schemes that have similar aims. However, he agreed it was possible to have too narrow an investor base.

Given that the primary market does not provide the liquidity some investors require, one member of the audience considered that more attention should be given to developing the secondary market, which also provides a true value of an investor’s holdings, rather than the primary liquidity price. This is important as investors need to show fair value rather than net asset value (NAV) in their report and accounts. Rutter commented that this was not as straightforward as was being suggested since there are the problems of relying on secondary evidence from indirect property in that the traded volumes are often very low, the motivations/pressures on purchasers/vendors can produce some unreliable traded prices and there is the issue of reflecting quantum, i.e. a different price should probably be applied if an investor is looking to sell very small or very large quantities of units. The panel thought that some of the longer-term funds may well end up as investment trusts if current (out-dated) fund documentation made it impossible to treat all investors equally.

Fund governance

So would all the issues of liquidity, transparency and pricing be solved by listing? Members of the panel pointed out that this would restrict the choice of investors and that progress had been made in improving the transparency of funds, particularly open-ended ones, and may introduce greater volatility of returns. Many funds had also established independent advisory boards, although Meaney said that the members of the UBS investor board, for understandable reasons, started to act principally in their own interests at the time of crisis in the fund. The independent supervisory board is to be established to ensure the Triton fund acts in accordance with its mandate and in the best interests of investors. Banks commented that negotiating changes to a fund, such as a proposed rollover, can be a long and difficult process where different sets of investors have conflicting interests. One fund managed by Legal & General has been rolled over three times. Fortunately, the documentation allowed for the establishment of an investors' advisory committee as it would have been near impossible to get agreement to the extensions from the 100 investors acting individually.

Asked by a member of the audience about the impact of regulation on investor behaviour, fund raising and fund managers, Banks said the 'raft' of regulation (AIFMD, EMIR etc.) had imposed extra costs on investors. People understood the need for regulation but it had taken fund managers time to get up to speed, especially as the respective regulators were not themselves clear on all aspects. The regulatory environment was also challenging as much of it was not set up with real estate in mind, for example with regard to liquidity measures. Forbes pointed out that regulation affected investors and fund managers so the behaviour of the former was changing as well.

Fund management fee structures

Rutter said that one of the positive outcomes from the crisis was the change to fund management fee structures. The movement away from gross asset value to NAV as the basis for calculating base management fees had reduced the pressure on managers to use gearing. With regard to performance related fees, a significant number of post-GFC launched funds have fees that are payable on realisations rather than valuations, with a significant proportion of the fees held back until the final asset is sold, ensuring that fees are payable on the performance of the whole fund. Another development is that managers are now often required to outperform over the medium term, typically a three-year rolling period, not just for one year, and they should produce positive returns, rather than merely outperform their peers. However, where fund extensions are agreed and key terms modernised, there is a perception that investors will look to exploit an opportunity to negotiate lower fees. In practice, Rutter did not think that this was the case as there is a need to ensure that good managers are adequately compensated for delivering above target levels of risk-adjusted returns.

Better next time round?

In conclusion, the panellists were asked whether the industry would be in a 'better place' next time around. Abbott pointed out that it hadn't been doom and gloom this time round – in 2008-09 a few funds ran into difficulty but many others managed. Ultimately, if market values almost halve again, there will be problems. He felt that the changes required to ensure funds are better placed next time include reducing fund liquidity and providing more certainty as to the respective managers' strategies. Managers should also address their governance of the amount of equity coming into a fund at any time. The other panellists concurred with this view.