IPF Indirect Property Funds Special Interest Group

Phil Clark, AEGON Asset Management and Chairman of the Indirect Property Funds Special Interest Group

Recognising that the IPF needed to take a more focused approach towards the unlisted pooled investment funds sector, the Management Board decided that a new Special Interest Group should be established to sit alongside the two existing groups that cover matters relating to property derivatives and sustainability issues.

The Group's remit covers unlisted pooled investment funds (whether closed or open-ended) that are managed by an independent third party. This would include private equity-style real estate funds together with sector specific, balanced and opportunity funds. Geographically, the focus is on UK property, so funds based in Jersey and Luxembourg with UK property holdings are included within this.

The objectives of the Group are to:

- Be a focal point for the IPF on indirect property investment;
- Seek to increase the industry's understanding of indirect investment and associated vehicles/structures;
- Lead on promoting research into key issues such as 'What lessons can we learn from the current financial crisis and what action should we promote as a result';
- Liaise with other relevant organisations, e.g. AREF and INREV.

The current top priorities of the Group are to consider the valuation of funds and the determination of NAVs; the degree of liquidity within indirect property products; and levels of debt within funds.

To further discussion and knowledge within these areas, the Group will be contributing papers to the IPF Research Programme Short Papers Series and producing standalone articles for the IPF website and Investment Property Focus. The two papers that follow are the first in the standalone series.

Why invest via indirect property funds?

Graeme Rutter, Head of UK Property Multi-Manager, Schroder Property Investment Management

Traditionally investors in commercial property would buy 'bricks and mortar' assets to gain exposure to the sector. This has the benefits of being able to: have full control over the property; add value through active asset management; and take ownership of a tangible asset. However, owning properties directly also has its drawbacks including: limited diversification unless you are a very large investor; relative illiquidity and typically a long period to conclude transactions; for inexperienced investors management and administration issues are a deterrent; there are lot size barriers for gaining exposure to certain sectors of the market, such as shopping centres; and finally it is relatively expensive to buy and sell direct property with purchase costs in the region of 6% of asset value.

As a result of the drawbacks to owning direct property, there has been an increase in demand for products that provide an indirect exposure to property. Principally this has been through unlisted property funds, but has also included an increased appetite for listed property companies, offshore property investment trusts, property derivatives and interest in multi-manager and fund of funds services.

Over the last five or six years in particular, there has been a pronounced rise in investor demand for unlisted indirect property funds. From 2003 onwards there was a steady increase in the value of indirect property funds, followed by an exponential increase from mid 2005 to mid 2007 (see Figure 1). This upsurge was due partly to a prolonged period of valuation increases, but also due to the launch of a number of new indirect property funds and further investment into existing products.

This growth has also been seen in terms of the number of new funds that have been created. Figure 2 shows the number of new unlisted UK funds that have become members of the Association of Real Estate Funds (AREF) over the last 10 years.

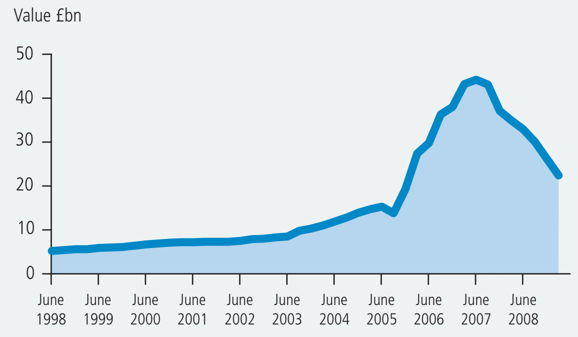
These figures exclude UK funds that are not part of the AREF universe, as well as funds in Continental Europe and further afield.

The attractions of indirect property funds

There are a number of reasons why investors have chosen to invest in property through indirect funds rather than through the traditional direct investment approach, as detailed below:

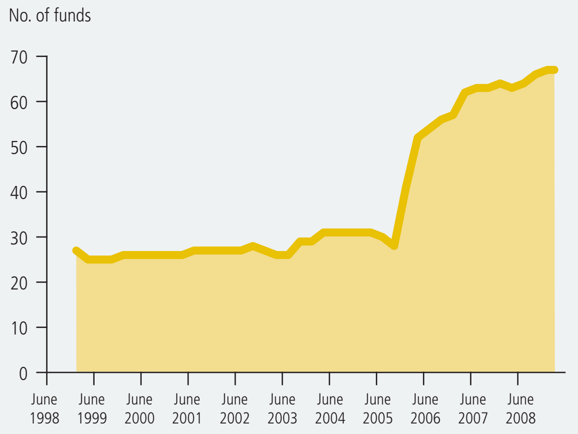
- Greater diversification – smaller investors can gain exposure to a pool of assets, creating far more diversification than could be achieved by assembling a portfolio of direct holdings.
- Access to certain sectors / stock – for smaller investors it would be very difficult to gain exposure to niche parts of the market, for example student accommodation, and there is also

Figure 1: Value of indirect property funds within the AREF Funds Indices



Source: Association of Real Estate Funds (AREF)

Figure 2: Unlisted property funds registered with AREF



Source: Association of Real Estate Funds (AREF)

a lot size barrier against investment in typically large lot size assets such as central London offices, fashion retail parks or shopping centres. Some investors with direct holdings have complemented their existing assets by acquiring indirect funds.

- Expert management – smaller investors are unlikely to have the necessary skills or experience to manage certain types of asset.
- Management / administration – by investing in an indirect property fund the investor manages to minimise the red-tape associated with holding direct assets.
- Accurate sector positioning – because individual units in indirect property funds tend to have a relatively low value it is possible to construct a portfolio of holdings with a fair degree of accuracy relative to target benchmark positions, this is more difficult to achieve when holding purely direct property which is indivisible.
- Tax – many of the unlisted property funds have been structured in ways to ensure maximum tax efficiency, for example many funds have been created as offshore Jersey property unit trusts, which are generally regarded as transparent for the purposes of assessing UK tax on income. As a result, the investor should, broadly speaking, be placed in the same position as if he had invested directly in the underlying asset. In addition, non-transparent structures are generally set up with the objective of minimising tax leakage in the underlying property holding structure.
- Exposure to gearing – some investors are not permitted to raise debt to enhance performance when conditions are beneficial. They have however been permitted to hold indirect funds with an exposure to gearing to achieve this aim.
- Entry cost – many investors have been able to trade units via the secondary market, so benefiting from transaction costs below those incurred when buying and selling bricks and mortar assets.
- Liquidity – in strong markets it has been possible to transact indirect units within a matter of days compared to months in some cases in direct markets. The open-ended funds also have redemption provisions which have enabled investors to decrease exposure to property.

Disadvantages of indirect property funds compared with direct investment

Not surprisingly, there are some downsides to accessing the property sector via indirect funds including:

- Lack of control – by investing in an indirect fund an investor cedes control of the management of their holding to the manager. It may be in the long term that the manager strategy changes and is then different to that of the investor. The investors typically have very limited powers to influence the decisions of the managers.
- Manager specific risk – although pooled funds have the benefit of greater asset diversification they do have risks associated with the manager, for example a star fund manager could leave or the management company could get into financial difficulties. Manager specific risk can be mitigated by investing via a multi-manager or fund of fund service, but this does come at a cost with additional overlay fees.
- Liquidity – although in strong markets the secondary market was a very efficient way to trade units in indirect property funds over the last 18 months the indirect funds have seen the same low levels of transactions experienced in direct markets. In addition, although open-ended funds do have redemption provisions to enable investors to exit funds these have not operated as effectively as outgoing investors would have hoped. Due to the unprecedented market conditions some managers have suspended redemptions or have imposed punitive spreads to prevent exiting investors from prejudicing remaining ones.