IPF Research Programme 2006-2009

UK Institutional Investors: Property Allocations, Influences and Strategies

Research Report

July 2010

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UK INSTITUTIONAL INVESTORS: PROPERTY ALLOCATIONS, INFLUENCES AND STRATEGIES

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Disclaimer

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Of course, those contributing information are not responsible for the views expressed in this report.

EXECUTIVE SUMMARY

Key points

- Big investors' exposure to UK specialist non-listed real estate funds is under pressure as they express regret over risk, illiquidity and misalignment of interests. Joint ventures are favoured.
- Institutional exposure to international non-listed real estate funds is expected to grow as investors seek to diversify their multi-asset portfolios and as investors new to property favour global strategies based on non-listed funds.
- A significant minority express longstanding antipathy towards both non-listed real estate funds and international property investment.

The objective of this report is to document and explain the investment strategies which UK institutional investors are adopting towards property. The project has been undertaken in conjunction with INREV (the European Association for Investors in Non-Listed Real Estate Vehicles) for whom a separate report has been prepared.

Most of the research is based on in-depth interviews covering 35 insurance company life funds, defined-benefit pension schemes, and charities. In addition, INREV undertook an on-line survey of investors for its report. Those participating in the research had total investments of £447 billion and property of £44 billion, the latter representing about half the institutional universe. Interviews with institutional investment consultants were also undertaken, as was an analysis of smaller pension funds' annual reports.

Having disinvested during the 2nd half of the 2000s, UK institutional investors on balance are re-investing in property. Pension funds are leading the way, increasing their allocations back-up to longer term strategic levels of around 7% of total investments. By contrast, most of the life funds are still looking to disinvest down to around 10% of total assets. Charities, however, have the highest exposure to property in total at 13%.

Direct is both the preferred and the prevailing approach among the UK institutions. It dominates because the life funds and the big pension funds, who invest mainly through direct property, account for most institutional investment in total and commit a higher proportion of this capital to property than the smaller pension funds. Direct is generally the preferred approach because most investors value control and influence over their investments, and because it is the most cost effective way of managing a property exposure for the bigger investors.

Indirects, accounting for about a third of institutional property investment, fulfil two very different roles. First, most small to medium sized pension funds invest exclusively through non-listed funds because it is widely thought not to be cost effective to have a direct segregated portfolio with less than £150 million of property and also because of the lesser demands on small investors' internal management and governance. This said, there were examples in the research of small and medium-sized pension funds taking the direct route because of their preference for greater control and influence.

Most of these small and medium-sized pension funds invest in core diversified ("balanced") vehicles. However, a growing, albeit still small, proportion of these pension funds are pursuing more adventurous "contemporary" strategies which non-listed vehicles make possible, where the objective is either higher returns or superior diversification for their multi-asset portfolios. These strategies typically involve significant investment in international property, either as a stand-alone exposure or as part of an integrated pan-European or global investment.

EXECUTIVE SUMMARY

In general, international property investment is undertaken primarily to provide diversification to the multi-asset portfolio and in some cases to generate higher returns either through alpha, tactical asset allocation between regions or through taking greater risk than in the UK.

The second role for indirect property lies in the life funds' and big pension funds' substantial investments. The life funds invest in specialist funds to improve the diversification of their property portfolios and, in particular, to access out-of-reach sectors and sectors where they do not have the expertise to invest directly.

The life funds' relatively high weight to international property also contributes to their exposure to non-listed funds. Non-listed funds are in general the prevailing approach to international property investment because they are perceived to facilitate superior returns, are easier to implement, offer greater diversification, and, for the life funds, because they have set up and seeded funds with many of their initial direct investments.

Although having substantial holdings on account of their weight, the big pension funds have been less enthusiastic investors in non-listed property than the life funds. While some follow similar strategies to the life funds, other big pension funds are fundamentally opposed to investing in non-listed property because they perceive that the returns are not commensurate with their risk (including through gearing) and illiquidity and because of concerns over transparency and alignment of interests. Given these disadvantages, such big pension funds believe that the diversification benefits for the multi-asset class portfolio of a specialist sector or an international property exposure can be achieved more efficiently through other asset classes.

Many big pension funds also eschew non-listed funds in favour of getting exposures to out-of-reach sectors and specialist managers through joint ventures. They do this on account of joint ventures' perceived superior control and alignment of interest. Their aversion to non-listed funds also helps explain why big pension funds on average are less likely to invest in international property than the life funds.

Not surprisingly, property strategies are being reviewed. Both the life funds and the big pension funds, whose primary form of investment is direct property, express regret over the unforeseen risk, unfulfilled liquidity, lack of control and misaligned interests (including between co-investors), and previously unrecognised levels of manager risk associated with their non-listed exposures.

Many of these investors are now looking to reduce their exposures to UK specialist non-listed funds. The life funds are doing this as part of their disinvestment from property and the big pension funds are looking to get more of their exposures to "out-of-reach" and specialist sectors either directly or through joint ventures. In this latter respect, they are willing to compromise some of the diversification benefits underpinning their previous decision to invest in non-listed funds.

A theme more favourable for non-listed vehicles is the growth in international property investment. Despite not being their short term priority, most pension funds saw a strong strategic case for international property and on balance investment was expected to increase in the medium term. This will occur through increased investment by many of the big pension funds (where exposures are currently relatively low), through previously uncommitted allocations, and as a result of decisions to invest in international property for the first time. Furthermore, pension funds investing in property for the first time tend to have higher exposures to international property than their peers.

Most international property investment is likely to continue to be through non-listed vehicles and fund-of-funds. With one or two exceptions, investors saw no viable alternative to investing this way outside the UK. The antipathy towards using non-listed vehicles, expressed by a sizeable minority of investors and investment consultants, is most likely to affect the decision whether or not to invest outside the UK rather than the form of any such investment.

The research suggests that the biggest challenge facing the non-listed real estate funds sector is the greater preference of the biggest investors for direct and joint ventures over UK specialist vehicles. However, a further threat is the consideration being given to REIT/listed property company based strategies, which some believe might be cheaper and more liquid, and generally might offer superior risk-adjusted returns than traditional non-listed funds in the longer term. Investment consultants report high levels of interest in these but there is little evidence to date of significant adoption.

1. INTRODUCTION

1.1 Objectives

This report documents and examines the property investment strategies of UK institutional investors, specifically insurance company with-profits life funds, defined-benefit pension schemes and also charities and similar. A particular interest of the research is investors' strategies towards non-listed property vehicles.

The research has been undertaken in conjunction with INREV (the European Association for Investors in Non-Listed Real Estate Vehicles), for whom a separate report has been prepared[1]. The INREV report differs from this one to the extent that its primary interest is to estimate the total size and composition of the property exposures of UK institutional investors.

The research focuses on the monies invested in property globally by UK institutional investors, rather than those managed by fund managers. Monies invested in the UK by foreign investors are outside the scope of the research, as are those managed by the UK insurance companies on behalf of other institutional investors and retail investors.

Section 2 provides background information on the size and shape of the UK institutional investment universe and, within this, current and prospective exposures to property. Section 3 describes the types of property which institutional investors incorporate within their allocations to property and outlines the magnitude of these exposures.

The influences behind these allocations and exposures to property are explored in Section 4. Section 5 extends this analysis by documenting the various types of strategy – both traditional and contemporary – which institutional investors are following. The conclusions and implications for the future are outlined in Section 6.

1.2 Methodology

Most of the research is based on face-to-face and telephone interviews covering 35 insurance company life funds, defined-benefit pension schemes, and charities[2]. The interviews were with either multi-asset class chief investment officers or heads of property investment, and lasted between 30 and 90 minutes.

The total assets (equities, bonds, property, etc) of the investors surveyed measured £447 billion, representing over a third of the institutional investment universe. Their property exposures (net asset value), totalling £44 billion, represented about half of the estimated UK institutional property universe[3].

Interviews with three institutional investment consultancies were undertaken to provide further information and data on the property allocations and strategies of pension funds. Their insights on small pension funds were particularly helpful, adding to the limited information from the investor survey.

A desk top review of small pension funds' investments and property allocations, drawing on their published annual reports and accounts, was also undertaken. State Street Investment Analytics (formerly WM), the institutional performance measurers, provided detailed information on the property exposures of UK pension funds and charities. Both these additional sources were valuable supplements to the information collated through the interviews. Additional data used to quantify the institutional universe is detailed in the INREV report.

The research also drew on information collected in two earlier IPF research projects, *Multi-asset Allocation in the Modern World* and *Alpha and Persistence in UK Fund Management.*

[1] *Investor Universe UK Survey 2010,* INREV, 2010.

[2] 21 pension schemes, 11 insurance company life and other funds, and three charities. While the total assets of the pension schemes participating in the research ranged from £750 million to over £15000 million, small and medium sized pension funds with total assets <£2500 million were under-represented. Similarly, small charities were under-represented. The universe estimates prepared for INREV and the general analysis adjusted for this under-representation.

[3] See Section 2.1 for further details of the universe estimate.

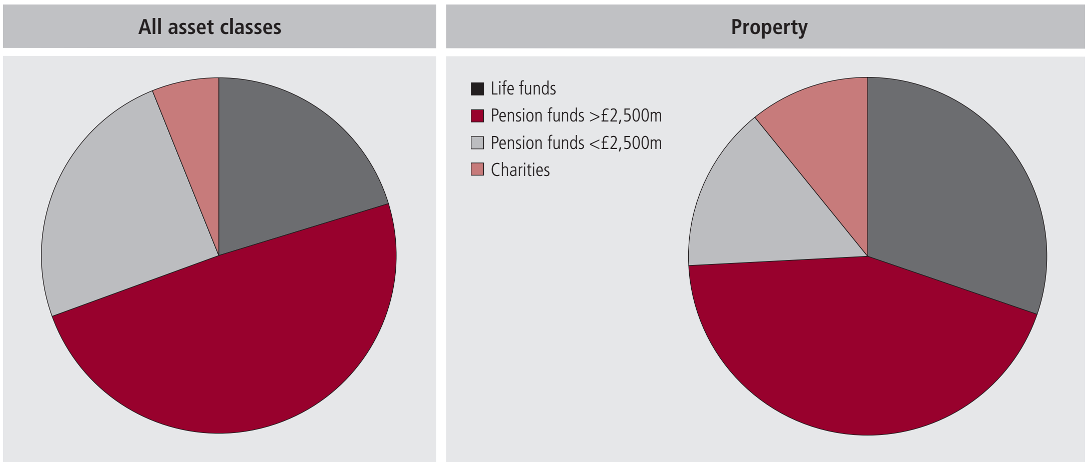
2. CURRENT AND PROSPECTIVE INSTITUTIONAL EXPOSURES TO PROPERTY

2.1 Institutional investment and property

The total investment universe of the type of UK institutions covered by the research is estimated to be approximately £1,225 billion, and the investor survey covered over a third of this. As Figure 2.1 shows, the universe estimates show that life funds and the big pension funds (total assets >£2,500 million) dominate total assets.

Figure 2.1 also shows the institutional property universe estimates prepared for INREV. The investors in the survey accounted for half of this investment. Mainly reflecting their share of the overall multi-asset universe, Figure 2.1 indicates that the life funds and the big pension funds dominate the institutional property universe, accounting for three-quarters of the total. Both the life funds and the charities account for disproportionately high shares of property while the small to medium-sized pension funds (total assets <£2,500 million) have a disproportionately low share.

Figure 2.1: Composition of UK institutional universe, by type of investor



Source: INREV Investor Universe UK Survey 2010

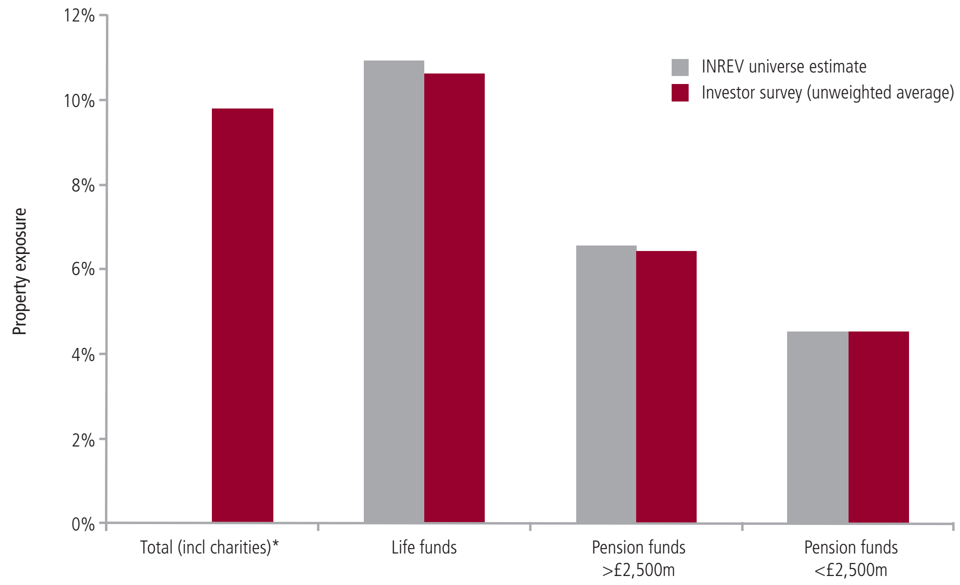
2.2 Current exposures to property

Figure 2.2 draws on the analysis in the INREV report and presents the universe estimates of the proportion of investors' total investments (i.e. exposures) in property. The results from the investor survey are also shown, on an unweighted basis which gives equal weight to each investor.

For the universe, the overall exposure to property in life and pension funds and charities is estimated to be about 7.25% of their total investments.

[4] The INREV estimates are not comparable with those presented in the 2005 IPF report *The Size and Structure of the UK Property Market.* The INREV estimate relates to a sub-set of the investors covered in this earlier IPF research, excluding for example the insurance companies' unit-linked funds. More significantly, in contrast to the IPF research which measured the value of the UK property stock, the INREV estimates relate to the "equity" value (or NAV) of investors' exposures to property; these exposures include indirect investments and, in some cases, REITS/listed property, securitised and other debt and derivatives etc and, unlike the *Size and Structure* report, extend to international property.

Figure 2.2: UK institutional investors, proportion of total investments in property



*Universe estimate not available for charities
Source: INREV Investor Universe UK Survey 2010

The disproportionately high amount of property accounted for by life funds, highlighted earlier in Figure 2.1, is reflected in their relatively high exposure to property of almost 11%.

The correspondingly low proportion of the property universe accounted for by small and medium-sized pension funds reflects two factors:

- A relatively small proportion of them invest in property. A pension fund's decision to invest in property generally declines with size. Inconvenience and governance demands were cited to be the main reasons by investment consultants, the few surveyed who were not investing perceived that diversification benefits for their multi-asset portfolios could be achieved more conveniently through investments in alternative asset classes;

- When small to medium-sized pension funds do invest in property, they commit relatively low proportions of their capital. In the survey, their average exposure was less than 5% compared to 7% in the very big pension funds. The reasons for such lower exposures are not clear, although a minor factor is the delay in investing allocations among the growing number of funds new to property.

Charities are somewhat polarised in their exposure to property. The three spoken to, all large investors, were the heaviest property investors in the survey, each having more than 12% in the asset class. By contrast, State Street Investment Analytics, whose data cover more small investors, report an overall exposure of only 2.5%. Taking this wide range of investors into account and reflecting the dominance of the large investors, the estimate in the INREV report is an overall charity exposure of around 13%. This is in line with an estimate by JP Morgan in its 2007 *Charity Investment Industry Survey.*

2.3 Changes in exposure to property since the mid-2000s

Table 2.1 summarises the current and past exposures to property; the mid-2000s estimates draw on the IPF research *Multi-asset Allocation in the Modern World*. The INREV 2009 estimate for the large pension funds is slightly higher than State Street's, precedence being given to the greater coverage in the INREV research.

Table 2.1: Property exposures of life funds and pension funds, 2006 vs. 2009

	2006	2009	
		State Street/WM	INREV Universe estimate
Life funds	15%	-	11%
Pension funds	7.5%	5.3%	6%
Pension funds >£2,500 million assets	-	5.7%	6.5%
Pension funds <£2,500 million assets	-	4.3%	4.5%
Charities	-	2.6%	13%

Sources: IPF report *Multi-asset Allocation in the Modern World*, State Street Investment Analytics, INREV Investor Universe UK Survey 2010

The current life and overall pension fund exposures are lower than in mid-2006 when the IPF's research reported exposures of 15 and 7.5% respectively.

Investors reported that exposures had fallen since the mid-2000s partly because property had been viewed as unattractive relative to other asset classes, and in some cases also because the closure of their funds to new investments and the increasing maturity of their liabilities had led to a shift in strategy in favour of bonds[5]. The life funds' mid-2000s exposure of 15% was also exceptional by the standards of the last 20 years, and the reductions during the 2nd half of the 2000s had moderated this.

2.4 Prospective changes in exposure to property

In the survey, those investing in property were asked first, what their current target or allocation to property was, and second, how this target or allocation was likely to change over the next three years.

Monies invested in property at present tended to be less than current targets/allocations and to achieve these targets investors were currently seeking to invest more in property as soon as possible. This applied in particular to pension funds whose property exposure typically was below target by more than one percentage point – equivalent to about £12 billion across the pension fund universe. By contrast, most life funds' current exposures were above current targets/allocations. These contrasting patterns reflected:

- Pension funds had either recently raised their property allocation as the asset class had become more attractively priced, or had allocations which had not been fully committed/invested during the market weakness between 2007 and 2009. With respect to the former, it is notable that, having tactically reduced their allocations in the 2nd half of the 2000s, pension funds were now restoring their allocation to property back-up to longer term strategic levels;

[5] The relatively sharp decline in property values since 2006 would have also led to a reduction in property's share of institutional investors' portfolios.

- The opposite applied to life funds – they either had had their property allocations reduced because of an asset allocation shift in favour of bonds, or had not been able to sell during the market's weakness. The illiquidity of their indirect investments and unwillingness to sell at distressed prices were the main reasons why they had not sold. They were looking to disinvest when feasible.

Looking forward to the next three years, most investors did not anticipate significant change in their allocations to property[6]. On balance and entirely reflecting the strategies of pension funds, more were anticipating a rise in allocations than were expecting a decline, implying that a further – albeit modest – increase in property investment is in the pipeline. Most life funds, having seen a reduction in strategic allocations to property throughout the second half of the 2000s and still looking to sell property in order to meet these lower targets, anticipated a stabilisation in allocations.

Having held back between 2007 and the middle of 2009, pension funds seeking to invest in property for the first time were returning to the market, according to investment consultants. State Street Investment Analytics' data show the proportion of pension funds with property investments rising from 60% in mid-2006 to 66% in late 2009. If this trend were to continue, it would generate a further approximate £1.25 billion of new investment over the next three years.

Overall, the estimates for INREV suggested (assuming the allocations were realised) that pension fund exposure to property would rise from 6% at present to about 8% over the next three years, while life funds' exposure would fall from about 11 to 10.5%.

[6] No account is taken of prospective changes in the total amount of institutions' capital, which respondents could not estimate.

3.1 Permitted forms of property investment

Investors were asked which forms of property they were allowed to invest in as part of their property allocation, and which forms were permitted elsewhere in other asset class allocations. Table 3.1 summarises the information and also shows the proportion that were actually investing[7].

Table 3.1: Permitted forms of property investment and current exposures

	Proportion of direct property investors in the investor survey…		
	Permitted to invest in as part of property allocation	Currently investing as part of property allocation	Permitted to invest in as part of other asset classes' allocations
Direct property	100%	100%	0%
Joint ventures	100%	52%	0%
Non-listed property	97%	86%	0%
Property fund-of-funds	31%	0%	0%
REITs/listed property	17%	3%	79%
Property debt	17%	7%	69%
Infrastructure	17%	3%	79%
Other	41%	10%	0%

Almost all the property investors spoken to could invest in non-listed and direct property. All investors permitted to do so were investing directly, and most of those allowed to were currently investing in non-listed. Most could invest in joint ventures, although only half were actually doing so.

Very few could invest in REITS or listed property companies as part of their property allocation and even fewer were doing so; similarly, none of the investors spoken to indicated that they were investing in funds of REITs/listed property companies[8]. REIT and listed property company investments were more likely to be part of other allocations (i.e. equities). Investors attributed this to tradition and to the equity-like expertise they believed was required to manage a listed exposure.

Similarly, very few were allowed to invest in property debt (including securitised debt) and infrastructure and even fewer were doing so – in the same way as listed property, this was more likely to be allowed elsewhere, as part of the fixed-income and alternative asset class allocations respectively.

[7] Those investing primarily through indirect property were under-represented in the survey and therefore the table understates the proportion investing in non-listed funds and fund-of-funds. The table is less likely to understate the proportion investing in REITs/listed property or debt, for example in these respects, those investing primarily through indirects had similar characteristics to the direct investors.

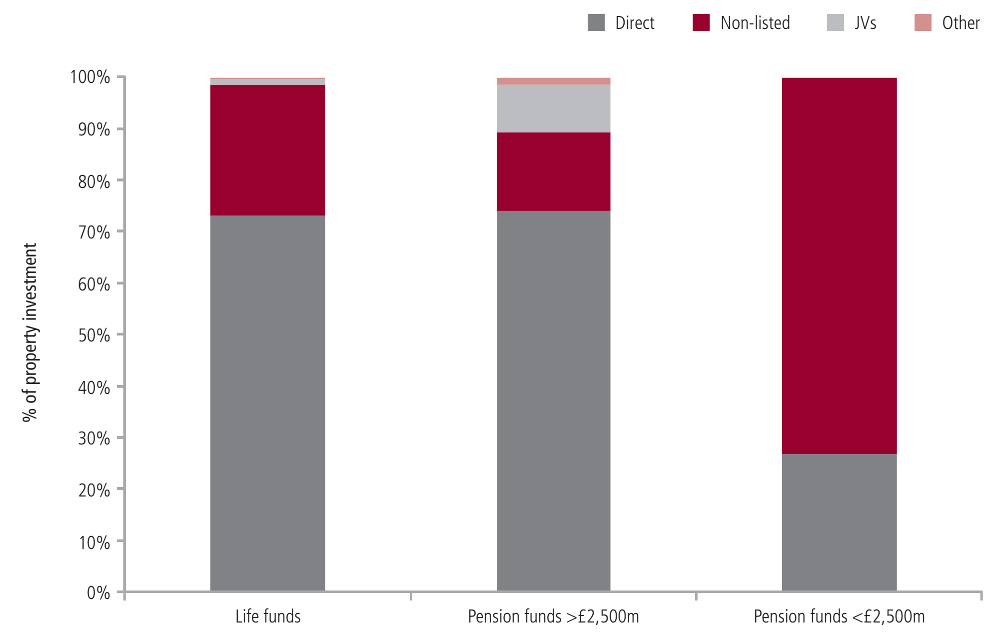
[8] There were indications, however, that such strategies were being given consideration – see Section 5.

3.2 Current exposures to the various forms of property

Figure 3.1 illustrates the types of real estate which make up the life and pension fund universe, as estimated for INREV[9]. These estimates adjust for the under-representation of small to medium – sized pension funds in the survey.

Most institutional property is held directly. This reflects the weight in the market of the big investors – the life funds and the big pension funds – whose property portfolios are dominated by direct investments.

Figure 3.1: Institutional property universe, by type of property and investor



Source: INREV Investor Universe UK Survey 2010

Non-listed funds, including fund-of-funds, account for about a third of the life and pension fund universe. A more detailed examination of the non-listed exposures among the investors in the survey is outlined below.

Figure 3.1 highlights two interesting themes identified during the interviews with investors: first, the relatively high exposure to joint ventures in the big pension funds (contrasting with the negligible exposure in the life funds), and the higher exposure to non-listed in the life funds than in the big pension funds. These two themes are explored in more detail later.

[9] All the investors in the survey measured their indirect property exposures on the basis of their NAVs.

In the survey, international investments accounted on average accounted for about a tenth of the investors' property portfolios. The estimates for INREV suggest that the overall proportion is marginally higher than this[10]. A number of themes were apparent from the interviews and pension fund annual reports:

- The life funds, having been the pioneering investors, tend to have a relatively high proportion of their property portfolios invested overseas;
- Medium-sized pension funds (i.e. total assets £1,000-£2,500 million) tend to be the most adventurous, in some cases committing half of their property investment overseas; and,
- The biggest pension funds have relatively low exposures to overseas property, being more likely to have no investment and, when doing so, committing less capital than the life funds and their smaller pension fund peers.

3.3 Non-listed investments

The investor survey, the supplementary data on pension funds and the discussions with investment consultants all identified a number of ways in which non-listed funds were used. The three main ways outlined below each account for a similar share of total non-listed investment:

- As a supplement to a direct UK exposure, for example in out-of-reach sectors or, to a lesser extent, to achieve higher returns. These are predominantly specialist (sometimes "value-added") vehicles. The life funds and the big pension funds account for most of their use;
- As a means of getting an exposure to international property. Non-listed funds used in this way are spread evenly between the life funds, the big pension funds, and the small to medium sized pension funds. Most international property investment is undertaken through non-listed vehicles;
- As an alternative to a direct UK exposure. The vehicles used in this way traditionally have been mainly balanced funds, and their use is concentrated among the small to medium – sized pension funds. Some big pension funds with predominantly direct portfolios were also using balanced funds for liquidity.

Amongst the direct investors in the survey, there was wide variation in the extent to which non-listed vehicles were used. There was a skew towards a low exposure. On the other hand, around a fifth, mainly life funds, had more than 25% of their property investment in non-listed vehicles.

These divergences among direct investors in the use of non-listed vehicles were analysed. First, those investors at the top and bottom end of the range had similarly sized property portfolios. Size therefore is not a factor behind the use of non-listed funds.

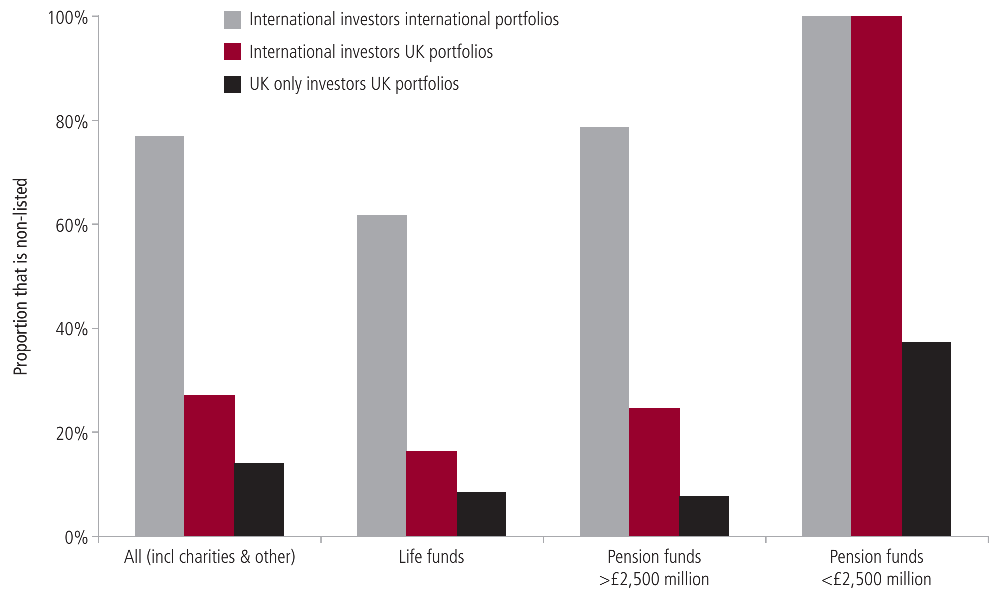
Second, the biggest investors in non-listed vehicles had a relatively high proportion of their property portfolio invested outside the UK. As Figure 3.2 indicates[11], non-listed is the primary means by which international property investors get their exposure.

Finally, as Figure 3.2 also reveals, those investing outside the UK have higher proportions of their UK portfolios in non-listed than those limiting their property investments to the UK. This suggests that those investing outside the UK are more comfortable in using non-listed vehicles generally.

[10] The reason being that, in the survey, small to medium-sized pension funds were under-represented. These investors tend to invest proportionately more in international property than their larger peers.

[11] The chart includes those who invest exclusively through non-listed vehicles.

Figure 3.2: Proportion of UK and non-domestic portfolios in non-listed funds



Source: INREV report

Finally, those investors with a low exposure to non-listed had a relatively high exposure to joint ventures, suggesting that they are something of a substitute for non-listed.

These themes are explored in the next section.

4 THE INFLUENCES BEHIND THESE PROPERTY EXPOSURES

4.1 Direct property

Direct property (either managed internally or through a segregated account managed by an external fund manager) was preferred by most investors spoken to because of the control it gave over their property investment and because it was perceived to be the most cost effective means of fund management.

This was not an option for smaller pension funds and charities where investment consultants reported that it was difficult to have a competitively priced segregated fund with a property allocation of less than £150 million; furthermore, the management and governance demands for such smaller investors were too great.

This said, investment consultants cited examples of investors with small property allocations, who wanted to retain control, opting for the direct approach; there were also examples in the survey. The reasons for investing this way varied. Some were legacies of portfolios which had been much bigger[12], others were part of organisations which had other, much bigger funds, and some had consciously chosen to go the direct route. All emphasised a preference for control over their property investments.

Only one big pension fund investor (out of 18) in the survey had chosen to go the non-listed route, citing the greater convenience. The interviews with investors, with investment consultants and the analysis of pension fund annual reports all emphasise that, wherever possible, the direct approach is the preferred option. The evidence is that small funds investing directly in preference to the more normal indirect approach outweigh the proportion of big funds investing exclusively through indirects in preference to the more standard direct approach.

While most direct investors supplemented their portfolios with non-listed exposures, a significant minority invested almost exclusively through direct property. The motivations of such investors fundamentally opposed to using non-listed funds are outlined in Section 4.5.

4.2 Joint ventures

Joint ventures were considered specifically to be those managed by a third party rather than internally (which were defined as direct investments). Overall, they account for about 5% of the institutional universe but in some of the big pension funds represent over 10% of their property.

They were used primarily to provide exposure to out-of-reach or specialist sectors, or to a manager or opportunity perceived to be very attractive. They were seen by those using them as very much an alternative to a non-listed fund and were preferred because of the perceived greater control and alignment of interest. As noted earlier, those with a low exposure to non-listed tended to have a relatively high exposure to joint ventures.

Joint ventures were being considered by a number of investors expressing regret over the performance and management of their non-listed funds, including by one pioneering investor who had used non-listed funds primarily to get an exposure to international property.

[12] This potentially has implications for the funds, particularly the life companies, which may shrink significantly in the future – see Section 6 for further discussion.

4.3 International property investment

Half of the property investors in the survey had investments outside the UK; the supplementary information and the interviews with investment consultants suggest that this is on the high side and that the true proportion, including those with uninvested allocations, is slightly lower at around 40%. For those with international investments in the survey, the proportion of their property outside the UK was clustered around 10 or 20%.

In some cases, however, the proportion invested outside the UK was as high as 50%. Such investors tended to be following an integrated strategy, rather than appending an international exposure to a longstanding UK portfolio, and the rationale was that such a share was a closer representation of the worldwide property universe and comparable to the global strategies in their other asset classes.

The main rationale for investing in property outside the UK was said to be extra diversification for the multi-asset portfolio. The potential for higher returns than in a purely domestic portfolio was less frequently cited, although for many this was a secondary consideration and perceived to be achievable through either alpha (whose potential was seen to be greater than in the UK), tactical asset allocation between countries, or higher risk. Such higher risk was tolerable because the diversification benefit for the multi-asset portfolio was perceived to be greater.

Most international property investment was through non-listed funds, although the pioneering investors also retained significant holdings directly or through joint ventures. Investing directly was too challenging for most and non-listed exposures were preferred on account of the greater diversification a pooled vehicle with more assets provided. In transferring some of their original direct international investments, some life funds also had high international exposures to non-listed through the seeded vehicles set up by their subsidiary fund management arms.

While some of those currently not investing internationally were seriously considering the possibility, most said it was unlikely or were fundamentally opposed to investing outside the UK. The reason for such opposition was that diversification for the multi-asset portfolio could be achieved more efficiently through other asset classes (e.g. hedge funds). Concerns over the risk (including through gearing), illiquidity and governance of the non-listed funds were also widely expressed and strongly echoed by one investment consultant. Such investors were generally averse to using non-listed funds, which were the only way they could get an international exposure.

4.4 The attractions of investing in non-listed vehicles

The investor interviews – covering mainly large investors with predominantly direct property portfolios – indicated that the primary motive for using non-listed property vehicles was to provide access to out-of-reach sectors, new markets such as healthcare, and generally to skills and expertise not available directly. Investors typically were using non-listed investments in these ways to improve the diversification of their pre-dominantly direct property portfolios and, in fewer cases, with the objective of providing superior returns.

Non-listed vehicles were also seen by around a third of investors as useful in facilitating an international property exposure. Most of those investing outside the UK mentioned the easier implementation that a non-listed approach provided, compared to direct investment.

Easier implementation compared to investing directly was also strongly emphasised by those predominantly using non-listed to get a UK property exposure. The few big pension fund investors getting their property exposure this way said that a non-listed approach obviated the need for costly specialist property staff. Investment consultants reported that it was difficult to have a competitively priced segregated fund for the medium – sized investors with a property exposure of less than £150 million, while smaller investors also did not have the wherewithal (in terms of management time and expertise) to oversee a segregated portfolio run by an external fund manager.

4.5 Concerns about investing in property through non-listed vehicles

Those with unfavourable attitudes towards using non-listed vehicles fell into two broad groups: those fundamentally opposed to using non-listed property vehicles, which represented about a fifth of respondents and were all large funds, and those whose recent experiences had led to a re-appraisal of their attitudes and strategy, who also represented about a fifth of respondents and, again, were all large investors.

Those with fundamental concerns cited the following (the first three being the most common):

- That the prospective returns were not commensurate with non-listed vehicles' risk and illiquidity. The dilution in returns from relatively high fees and the effect of gearing on risk were specific concerns;
- That the nature of the return (including through gearing) delivered by non-listed funds was different from the core UK IPD-type return that the investor aspired to;
- The weak control and influence that the investor had over non-listed funds. Joint ventures were preferred in this respect;
- The illiquidity and unpredictability of cashflows, compared to directly-owned properties; and,
- The high cost of non-listed funds relative to the marginal cost of adding additional properties to a direct portfolio.

The second group were those re-appraising their strategies and exposures to non-listed. As outlined in the following section, more investors were looking to lower the proportion of non-listed vehicles in their property fund than to increase it. All these investors expressed regret about their non-listed exposure.

The most common regret was that the returns from non-listed vehicles had not been commensurate with their risk (including the effect of gearing) and liquidity.

Many of these investors were now expressing a preference to invest directly in sectors previously perceived to be out-of-reach or where the expertise to invest directly had been thought to be lacking. Such investors were happy to compromise the diversification benefits that had originally justified the non-listed approach. In the same way as those fundamentally averse to investing in non-listed vehicles, joint ventures were now being recognised as an alternative to non-listed exposure. The appeal in joint ventures corresponded to those attributes (greater control and alignment of interest) highlighted by those already investing this way.

Finally, the downturn had exposed previously unrecognised high levels of manager risk in non-listed exposure and misalignment of interest, not only between fund managers and investors, but also between co-investors. Such factors would lead to a lowering of exposure to non-listed vehicles, in favour of direct and joint ventures.

4.6 Allocations to and restrictions on non-listed investments

Few investors in the sample had an explicit allocation or target for investing in non-listed property. It seems to be more a case of specifying the allocation to property and the investment objective and then determining the best way to achieve them.

Of those supplementing their direct property portfolios with indirect investments, the majority imposed limits on their exposure. The rationales for such limits were mainly to control risk and liquidity and, to a lesser extent, to minimise extra fund management costs.

These limits on indirect investment were mainly expressed in relation to the size of the overall property exposure and were predominantly measured on the basis of NAV; in such cases, the limit was typically 20%, but it ranged from 15 to 45%. Most exposures were below these limits, although they had been breached in a few cases where investors had been required to reduce their property exposure but had found their non-listed investments harder to sell than direct assets.

A small proportion of investors imposed restrictions on the basis of gross asset value (GAV) or the amount of debt (a LTV of around 20% for the whole portfolio was the norm), either instead of or in addition to a NAV-based limit.

Almost 40% of those investing in non-listed property did not impose any restrictions on their exposure, however, some of these had other controls, which had the effect of limiting non-listed investment. Some others felt there was no need for any controls because their strategy was not to invest significantly in non-listed property. The average exposure to non-listed for those direct investors without any constraints was only marginally higher than those that had a limit or allocation.

5 DEVELOPMENTS IN INVESTORS' STRATEGIES TOWARDS PROPERTY

5.1 Property strategies

The survey responses and interviews with investors and investment consultants portray a number of property strategies, each with different exposure to and roles for non-listed vehicles. These complement the above analysis and add to the understanding of the variations in non-listed exposures described in Section 3. The strategies are summarised in Table 5.1[13].

The predominant strategy is the ***direct property based "benchmark plus" approach.*** The objective of the property exposure is to provide diversification for the multi-asset fund and a return between bonds and equities that is marginally better than the UK IPD Index (or similar). Investors require performance to closely track the IPD benchmark, for example with a tracking error <2.5%.

Such property portfolios are mainly direct, according to investors and investment consultants, because of investors' preference for control over their property investments and strategy. This is the strategy pursued by most large institutional investors and is feasible because it is cost effective to manage the property portfolio either internally or on a segregated basis.

Such strategies may be exclusively UK-based or may have an international exposure appended to them. The aim of the latter is primarily to diversify and reduce the risk of the multi-asset fund and the property portfolio and, to a lesser extent, deliver a comparable or marginally higher return than the UK portfolio.

The non-listed investments in such strategies, according to the interviews with investors, are primarily a supplement to the direct portfolio, providing exposure (and hence diversification) to out-of-reach sectors and those where expertise is not available directly. Non-listed exposure is therefore primarily specialist (with the remainder mainly international – see below). The aim is to keep the tracking errors of the property within the typical 2.5% target.

A smaller proportion of investors also used non-listed vehicles to access favoured assets (such as a shopping centre fund with one or two assets). In addition, a few looked to fund managers' specialist skills to deliver moderate out-performance.

Some of the investors following this *direct property based benchmark plus* strategy also had part of their exposure in non-listed funds with the objective of providing liquidity. The life funds found this rationale (together with the concomitant business interest) particularly attractive, as it would enable them to retain an interest in favoured assets as the fund shrank. This rationale as now discredited as a number of investors using non-listed funds found themselves with higher than desired exposure as a result of the vehicles' illiquidity during the downturn.

The international exposures of investors following the *benchmark plus* strategy were predominantly through non-listed vehicles. The role of these vehicles was to generate the necessary diversification to lower the risk of the property portfolio and the multi-asset fund.

Funds pursuing this multi-national variant of the *direct property based benchmark plus* strategy on average had relatively high exposure to non-listed property vehicles – see the earlier Figure 3.2.

[13] These strategies were either explicitly identified or alluded to by investors, identified on the basis of the strategies they described, or referred to by investment consultants. There were examples of almost all of them in the research.

Table 5.1: Representation of UK institutional investors' property strategies

Strategy	Variant	Investor objective*	Proportion of property portfolio invested in		Proportion of universe's capital
			Non-listed funds	Ex-UK	
Traditional	**Long term core beta**	2–2.5% in excess of cash (=direct UK property return), multi-asset portfolio diversification.	Negligible	Negligible	10–15%
	Benchmark plus	2.5–3% in excess of cash (=IPD return plus), annual tracking error <2.5%, property and multi-asset portfolio diversification.	<15%	Negligible	10–15%
	Benchmark plus	2.5–3% in excess of cash (=IPD return plus), superior multi-asset and property portfolio diversification	15–30%	0–20%	60–70%
	Benchmark plus	2.5–3% in excess of cash (=IPD return plus), superior multi-asset and property portfolio diversification	100%	0–30%	5–10%
Contemporary	**Traditional core and alpha satellite(s)**	3–4% in excess of cash, superior multi-asset portfolio diversification	20%–50% (including opportunistic funds)	0–30%	0–5%
	Pan-European, Global	2.5–3.5% in excess of cash, superior multi-asset portfolio diversification	100%	30–70%	0–5%
	Cheap beta and alpha satellite(s)	3–4% in excess of cash (= geared property return plus) at low cost	10–40%**	30–70%	0%
	Cheap beta	2.5–3.5% in excess of cash (= geared property return) at low cost	0%**	30–70%	0%
	"Absolute return"* **	3–4% in excess of cash over the medium term	>20%	>20%	0–5%
	High lease value	1–2% in excess of bonds	0 or 100%	0–10%	0–5%

* Note that the absence of a tracking error objective in some strategies reflects the difficulty in benchmarking and that the UK component may still be subject to such an objective. ** Remainder in (funds of) REITs/listed property companies.

***Absolute return strategies aim to make a gain in every market condition. Property investors following "absolute return" strategies in practice are not aiming for this, rather the aim is to meet a target return on average over a three-five year period. In this respect, such strategies are not "true" absolute return strategies like those pursued by hedge funds.

This ***direct property based "benchmark plus" approach*** is the predominant model in terms of capital value because it is practiced by most life funds and big pension funds, investors who represent about 85% of the total institutional property universe.

Smaller pension funds seeking the same objectives from their property investment pursue a ***non-listed property based "benchmark plus" approach,*** using a single or multiple balanced funds, because it is not feasible to do this directly for a satisfactory fee; for the smallest investors, investment consultants also cite the internal management demands as a rationale for avoiding direct investment.

Investment consultants also report that investors following this model are increasingly appending a separate international property exposure. The aim, in the same way as their bigger pension fund peers, is to lower the risk of the property portfolio and multi-asset fund and in some cases also to moderately inflate returns. These two strategies (with and without international exposure) are the predominant models for those institutions investing exclusively through non-listed property vehicles.

All these strategies can be seen as "traditional." However, investment consultants report the emergence over the last five years of new strategies that might be described as "contemporary"; there were a number of examples of these among the survey responses with most based on investments in non-listed property vehicles.

The typical objective for the investor following these contemporary strategies is to deliver either a significantly different (net) return or a lower level of risk for the property portfolio and the multi-asset fund than in "benchmark plus" strategies. The strategies seeking higher returns involve either a ***core traditional balanced exposure*** (direct or non-listed) ***and an "alpha" satellite*** (intended to generate high risk-adjusted returns and achieved through a non-listed vehicle, either within the UK or internationally), or ***a pan-European or global property strategy.*** Rather than higher returns, the latter may instead be used primarily to provide superior diversification for the property portfolio and therefore lower risk for the multi-asset fund.

Non-listed vehicles feature centrally in these strategies, either providing the source of higher returns (either alpha through specialist skills, on account of risk such as through an opportunistic fund, or through the tactical flexibility that a large choice of non-listed vehicles enables). Similarly, the large set of vehicles globally facilitates greater diversification. The investors' internal management and governance capabilities determine the types of vehicle used (e.g. multi-manager, or a collection of separate funds).

At the opposite end of the return spectrum, some investors – specifically those whose liabilities are more fixed-income like – are seeking a lower risk and returning type of property exposure and, in particular, are following a ***high-lease value property strategy.*** This is typically achieved through non-listed vehicles, although some life insurance companies are using a direct property exposure within their internal, predominantly fixed-income annuity funds.

Investment consultants report significant nascent interest – but so far little take-up – in strategies seeking to deliver ***cheap and liquid beta,*** through an exposure to a fund of REITs/listed property companies. The aim is to achieve a geared, but otherwise underlying, property return for a relatively low fee[14] and superior liquidity; such ***cheap and liquid beta*** strategies may be supplemented ***with an alpha satellite*** (achieved through a non-listed vehicle) in order to enhance returns.

[14] The low cost may be partly deceptive because the REITs'/property companies' own costs will already be reflected in the investor's "gross" return.

These contemporary strategies, while featuring significantly in the new mandates that investment consultants are currently dealing with, at present account for a low proportion both of UK institutions' property exposure and of the non-listed vehicles they invest in.

Finally, a small number of investors in the sample were eschewing the objective of a benchmark property return and, instead, setting a target return that was independent of their peers' property performance. This is a contemporary strategy, sometimes labelled misleadingly as ***absolute return,***[15] which seeks the target return wherever and in whatever form it is available. The investors adopting such a strategy have used non-listed vehicles, very selectively, with the objective of earning superior risk-adjusted returns ("alpha") through their specialist expertise.

A related, traditional variant of this absolute return approach was reported in the sample by a significant minority of large pension fund investors. Their objective was to achieve a ***target core property return*** and not to benchmark themselves against or match their peer group's property performance and structure. It could involve strategically under-weighting and over-weighting unfavoured and favoured sectors, and eschewed exposure that could corrupt delivery of this core property target return.

Non-listed exposure was largely avoided in this strategy, both because there was no need to diversify the property exposure with the objective of tracking the benchmark and because of their perceived greater risk. Superior risk-adjusted returns ("alpha") and multi-asset fund diversification could be achieved efficiently in other asset classes, for example through hedge funds.

This type of investor also avoided investing non-domestically, first because there was no desire for more diversification from property, and second due to their aversion to non-listed property vehicles, which was the only way by which a non-domestic exposure could be attained.

Not surprisingly, investors following this strategy featured prominently among those with a negligible exposure to non-listed vehicles. They represent as much as a tenth of the institutional property universe.

[15] Absolute return strategies, such as those run by hedge funds, normally aim for a steady return that is independent of market conditions.

6 CONCLUSIONS AND IMPLICATIONS FOR THE FUTURE

As highlighted in Section 2.4, significant re-investment in property is anticipated by UK institutional investors over the next few years. This results from the restoration of pension fund allocations to longer term strategic levels and the return to the market of pension funds new to property making their first investments. This investment by pension funds should more than offset the dis-investment by life funds.

As noted below, this dis-investment by life funds is likely to impact particularly on exposures to UK specialist non-listed vehicles and to international property, although illiquidity is likely to limit the pace at which this occurs. However, even as they shrink, life funds' investment in property is likely to remain primarily direct. Many of the rationales for investing in non-listed funds have, in their eyes, been discredited, while exposures in the foreseeable future were not expected to fall to levels where the direct approach became unviable. In this latter respect, the experiences of those pension funds in the survey that had a retained direct property despite a much reduced exposure are particularly pertinent.

In general, investors said they were currently focussing on UK property where current opportunities are perceived to be more attractive than in most other regions. However, the longer term strategies of the majority are to increase their exposure to international property. This would occur either as:

- uninvested allocations are committed;
- allocations are made for the first time or are raised to the levels attained by the pioneering investors;
- those pension funds investing in property for the first time commit higher proportions of their portfolios to international property than their peers.

Overall, these investors outweigh both those who are sceptical about investing overseas and those (mainly life funds) who plan to reduce their international exposure.

Not surprisingly, there was a strong reaction to the performance, risk and illiquidity of non-listed funds and concerns over mis-alignment of interests were almost as prevalent. The responses from investors in the survey implied that the upward trend in the proportion of property investment in non-listed funds, having recently reversed, was unlikely to resume: More anticipated a decline in the share of non-listed funds in their property portfolios than an increase. In particular, heavy disinvestment by some funds was indicated when liquidity and pricing permitted. According to the investor feedback, UK specialist vehicles are most vulnerable as life funds generally reduce their property investments and, together with the big pension funds, reduce the proportion of their property invested in specialist funds.

This said, non-listed funds are likely to share equally in the medium term growth in property investment. The positive influences in this respect are the relatively fast growth in international property, which is primarily undertaken through non-listed funds (most investors expected this to remain the case), and investments by those new to property, which in the 2000s were predominantly through non-listed funds.

The investor feedback nevertheless indicates that non-listed faces some major challenges. Some of these were fundamental concerns over the contribution which non-listed funds could make to a property strategy:

1. *The magnitude and value of the diversification which specialist and international non-listed exposures bring to a multi-asset portfolio.* As already noted, a significant amount of capital is represented by those who are sceptical of such diversification benefits and for this reason do not invest in non-listed vehicles. Now, those who have become disenchanted with non-listed funds are either also challenging the diversification rationale which led them to invest in specialist funds or are willing to compromise any such benefit.

2. *The extent to which the returns, risk and illiquidity from non-listed vehicles are worth it.* Again, a significant minority have consistently eschewed non-listed investments on account of such concerns but a number of investors in non-listed funds had become uncomfortable with the high beta and the manager risk they had been – and potentially are – exposed to. The extent to which non-listed fund managers add alpha (i.e. returns over and above those associated with risk, and due to skill) was also questioned.

This last concern was leading some to consider if a strategy based on (funds of) REIT/listed property companies would be more efficient than a non-listed strategy. While these did not feature significantly in portfolios at present, the observation by one investment consultant that most new mandates (which tend to be associated with small investors) are considering such strategies is highly notable. A shift in this direction would undermine the prospective growth in non-listed investment, as outlined above.

The issue of whether or not, net of fees, a REIT/listed property company strategy provides superior long term risk-adjusted returns/alpha and diversification to a strategy based on a portfolio of non-listed vehicles is an area for further research.

A further challenge to non-listed investment was the better alternative that joint ventures were perceived to offer. JVs were seen to provide many of the benefits which non-listed offered but to be superior in terms of control and alignment of interest. A shift towards joint venture investments, either in the UK or internationally, was being considered by around a fifth of the direct investors with an indirect exposure.

Again, a more widely spread shift in favour of joint ventures would challenge the anticipated growth in non-listed investment. Some investors and investment consultants expressed scepticism over the perceived advantages of joint ventures over non-listed funds, and little is known about whether or not they generate more efficient investment performance; this may be an area for further research.

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