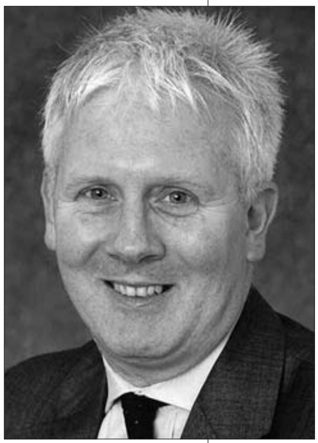
Institutional investors – are they going to change their approach to property?



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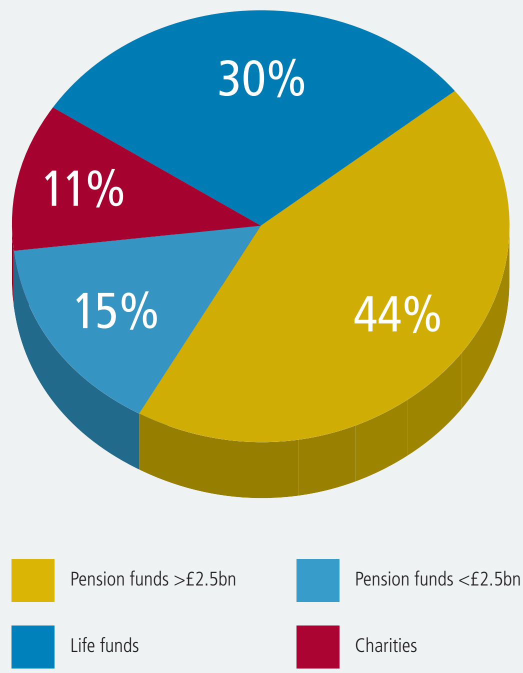
A new report undertaken for the IPF's Research Programme explores the types of property strategy adopted by UK institutional investors and how these are likely to evolve in the wake of recent market turbulence. The research, undertaken in conjunction with INREV, involved in-depth interviews with 40 pension funds, insurance company life funds and charities whose £447bn of total assets represented about two-fifths of the universe's capital.

Figure 1 illustrates how the large pension funds and the insurance company life funds dominate property investment within this universe. Not surprisingly, there were a range of property strategies being followed by these investors. This article outlines the themes identified.

Figure 1: Estimated UK institutional property universe by type of investor

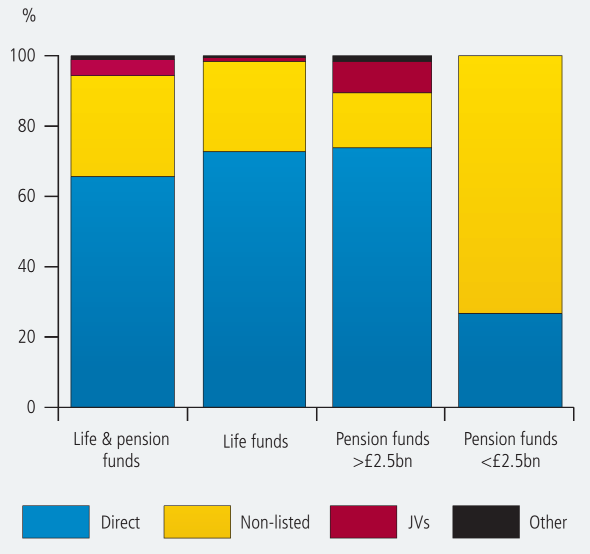


A preference for directly-owned property

As Figure 2 illustrates, most institutional investment is through direct property. This reflects both the dominance of the life funds and the big pension funds in the UK institutional universe and, according to the interviews, a strong preference, wherever practicable, for the control and influence which a direct portfolio provides. Taking the direct route is not a viable option for the small to medium-sized pension funds and charities where investment in property is primarily through non-listed funds.

Even so, and emphasising this preference for direct, some small investors have direct portfolios of less than the £100-150m, which investment consultants believe is normally the minimum necessary.

Figure 2: Estimated UK insitutional universe by type of property

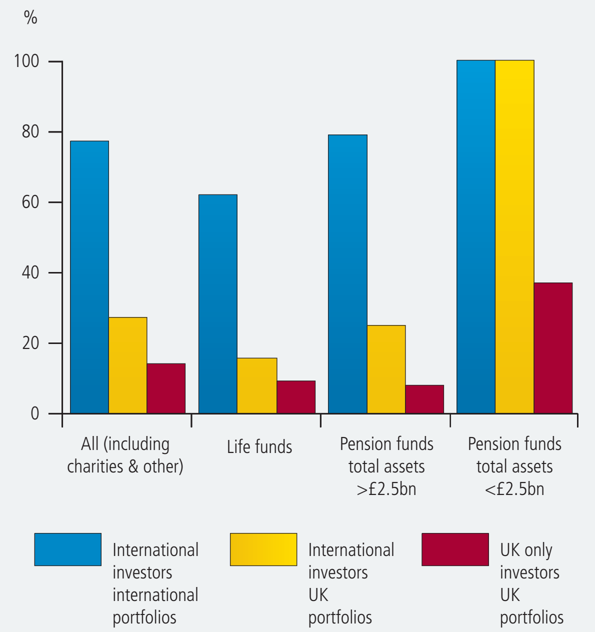


Divergent attitudes towards non-listed funds

While having predominantly direct portfolios, most life funds have significant exposures to non-listed funds. Some large pension funds have also embraced non-listed funds enthusiastically; diversification being their primary rationale. In this respect, non-listed funds are used in two ways; first to enhance their predominantly direct UK property portfolios by providing access to out-of-reach or specialist sectors, and second to lower the risk of the multi-asset portfolio by providing an exposure to international property. As Figure 3 reveals, non-listed funds are the main route by which investors get this international property exposure. According to the investors in the survey, superior returns are a less widespread motivation in using non-listed funds.

Figure 3 also reveals how cross-border investing in UK institutions is heavily intertwined with attitudes to non-listed funds. Generally, those investing internationally have a higher exposure to non-listed funds than those restricting their property investments to the UK. Those investors with negligible exposures to non-listed funds and not investing internationally have a different investment philosophy to the majority for whom a well-diversified property exposure is central. They consider that multi-asset portfolio diversification can be attained more efficiently elsewhere, such as through hedge funds; that the returns are not

Figure 3: Average proportion of non-listed property in UK institutions' international and UK property portfolios



worth it given risk, illiquidity, and governance issues; and/or have a very specific return requirement for property that, in their eyes, would be corrupted by a non-listed and cross-border exposure. These investors represent a significant minority of UK institutions.

There are also those who avoid specialist funds because they prefer to get access to out-of-reach or specialist sectors through joint ventures, which are perceived to offer superior control and alignment of interest. For this group, joint ventures are very much an alternative to non-listed funds, a view backed up by the observation across the survey that those with low exposures to non-listed funds had relatively high exposures to joint ventures. This explains the relatively high exposure to joint ventures amongst big pension funds illustrated in Figure 2.

These investors who have a longstanding antipathy towards using non-listed funds are now being joined by some who have become disenchanted, given recent performance. In particular, they are expressing regret over unforeseen risk, unfulfilled liquidity, lack of control, and misaligned interests, both with fund managers and co-investors. Overall, more investors in the survey were planning to reduce the proportion of non-listed investments in their property portfolios than were anticipating an increase. Not surprisingly, there was a desire to see less gearing in non-listed exposures.

The focus of such a reduction in investment in non-listed is typically UK specialist funds. At the same time, there was a greater desire 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. Joint ventures were also being considered by more as an alternative to specialist non-listed funds.

The research provided some interesting insights into the strategies being adopted by small to medium-sized pension funds. Although most traditionally have gained their property exposure through a domestic balanced non-listed fund, there was evidence of a wider range of strategies being adopted. These investors are particularly interesting as most institutions investing in property for the first time come from their ranks and they are not necessarily bound by traditional approaches to property investment. Notably, there were examples of smaller pension funds with much higher (percentage) exposures to international property in percentage terms than their bigger peers – in some cases 50% of their property holdings, compared to the typical 10-20% in the larger institutions. Their strategies involved either appending an exposure to a separate UK balanced fund, or taking an integrated pan-European or global approach. The latter, according to some investment consultants, is becoming the norm in new mandates.

Changing attitudes towards listed property

There were also some indications of changing attitudes towards listed property. Very few investors in the survey could invest in REITs and listed property companies as part of their property allocation: such exposures were typically part of the equity allocation. However, one investment consultant reported significant interest – but little take-up to date – across new mandates in 'cheap and liquid' beta strategies based on REITs and listed property companies.

Conclusions

There are four important conclusions from the research. First, institutional exposures to property are set to increase as pension funds restore their allocations to strategic levels and those looking to invest in property for the first time return to the market; such investment, however, would be partly offset by the insurance company life funds reducing their exposure.

Second, exposures to specialist funds are likely to reduce as the life funds, which have relatively high exposures, generally reduce their property investment and as disillusioned big pension funds shift towards direct and joint ventures.

Third, international investing is set to increase relatively quickly. Although most investors were attaching short term priority to the UK, the majority were committed in the longer term to an international property strategy. This should lead to an increased focus on non-listed funds and help offset the shift out of specialist funds.

Finally, the indications are that a significant minority will continue to eschew investments in non-listed funds and international property, focusing instead on a core UK direct exposure and looking in other asset classes for diversification and superior returns and risk.