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Alpha and Persistence in UK Property Fund Management



Summary Report

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This programme supports the IPF’s wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high quality analysis on a structured basis. It will enable the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

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ALPHA AND PERSISTENCE IN UK PROPERTY FUND MANAGEMENT

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ALPHA AND PERSISTENCE IN UK PROPERTY FUND MANAGEMENT

Research team

Paul Mitchell, *Paul Mitchell Real Estate Consultancy*

Shaun Bond, *University of Cambridge*

Research steering group

John Gellatly, *BlackRock*

Nick Duff, *Hewitt, Bacon & Woodrow*

Malcolm Frodsham, *IPD*

Robin Martin, *Legal & general Investment Management*

Louise Ellison, *IPF*

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EXECUTIVE SUMMARY

At a glance

- The report examines if UK property funds can deliver persistent performance relative to a benchmark and on a risk-adjusted basis, ie alpha.
 - In general, the evidence for systematic out-performance and alpha in property fund performance is not strong.
 - More specifically, it is limited to a small elite who can sustain such out-performance over relatively long periods.
 - Good assets are the most consistent and influential factor behind out-performance and alpha but the effect eventually dissipates.
 - Most of the investors interviewed did not see property as an alpha-generating asset class.
 - No fundamental changes in property investment strategies are indicated.
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- This report, funded by the IPF as part of its Research Programme, examines whether or not there is persistence in the performance of UK property funds. It also compares property with other asset classes, and assesses the implications for property fund management and investment strategies.
 - Assessing if funds maintain their performance rankings over consecutive periods is insightful because performance over a single period may be a one-off, purely random, or due to luck. By contrast, a greater proportion of funds out-performing over successive periods than suggested by random chance or luck would be indicative of systematic fund management skill.
 - The analysis is undertaken on returns relative to a benchmark and also on a risk-adjusted basis (ie alpha). The performance horizons looked at are sets of successive three and five year periods from 1982 onwards, and also over two consecutive 10 year periods, this representing a more challenging test and one encompassing a number of property market cycles.
 - The conclusions on the existence of out-performance and alpha in UK fund management are mixed. Before adjusting for risk, the strongest evidence of general persistence is over three year horizons, less so over five and 10 years. There is, however, a suggestion of performance persistence amongst the very best (ie top decile) funds over 10 years and, to a lesser extent, five and three years.
 - On a risk-adjusted basis, there is evidence of general performance persistence over 10 year horizons, including amongst top decile funds. However, the evidence is more tentative over five year horizons.
 - The overall conclusion is that the generation of systematic out-performance and alpha in UK property is limited to a small elite of top performers.
 - Corresponding to these findings, the performances of good and poor performing funds on average tend to converge during the following period. The relatively few funds which perform consistently well, however, show out-performance of around 2 per cent (and alpha of over 4 per cent).
 - In examining the factors contributing to performance and alpha, good stock is consistently the most influential characteristic but its contribution typically is not sustained. A high yielding portfolio varies from being positive to negative but is the only characteristic predictive of future out-performance.

EXECUTIVE SUMMARY

- Compared to other asset classes, the medium term performance differentials of the top funds in UK property tend to be comparable to equities. By contrast, the potential for out-performance is much greater in the main alternative asset classes, ie hedge funds and private equity. However, only property and private equity seem to be able to sustain out-performance and alpha over long periods.
- Investors and investment consultants were interviewed to understand their requirements from property investment. Most viewed property primarily as a beta asset class. The focus was on minimising the risk of not delivering the market return. The pursuit of alpha was of much lesser significance.
- A minority viewed property in a different way, seeing market inefficiency, illiquidity, active management and also disregard of benchmark structures as sources of extra long term return. There are some indications that this type of strategy has delivered out-performance.
- While there are limits to alpha through investing in mainstream UK property, investors are nevertheless increasingly looking to property to contribute to their multi-asset class quest for new sources of return which are superior to bonds and lowly correlated with their existing exposures.
- The most common ways of doing this are through investing internationally and in alternative property sectors. Some investors explicitly favour those markets which are least accessible, require special skills to extract the performance, and hence where alpha may be available. This inevitably will present opportunities for adventurous and skilful property fund managers.
- Despite the low level of alpha available in UK property, the indications from the survey of investors are that there will not be a major switch among existing investors to derivative or other index-products as a strategic alternative to holding the underlying asset class. Neither will there be substantial use of property derivatives as part of portable alpha strategies.

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1. INTRODUCTION

This report, funded by the Investment Property Forum as part of its Research Programme, examines whether or not there is persistence in the performance of UK property funds. The specific objective is to assess if property funds can systematically deliver alpha. The report also considers the implications for property investment strategies and the property fund management industry.

Alpha is a powerful concept in investment and fund management. It relates to the delivery of superior risk-adjusted returns, either from an active fund manager or from an asset class. Investors choose fund managers on the basis of their potential to deliver alpha, and fund managers are often rewarded on this basis. However, there has been a long-running debate across asset classes as to whether active fund management can systematically add value.

Furthermore, there has been a growing interest this decade in the wider investment industry about explicitly targeting alpha where it is available, either as a separate element independent of market performance, or through new ways of investing such as hedge funds. At the same time, some investment strategies, in perceiving the futility of seeking alpha, are also simply targeting beta and doing this in the most cost-efficient way. This is having significant implications for parts of the wider fund management industry, for example a shift away from equities and active equity fund managers.

Such a trend could potentially affect property, particularly given the emergence of derivative forms of investment and also the prospect of relatively low returns. It is clearly important that the property investment community is aware of how these strategies might relate to property and what implications they might have.

The first part of the study, therefore, assesses if UK property investment is characterised by fund managers who can systematically out-perform their peers through superior skill. Section 2 introduces the data and methodology used in the analysis. The section includes an introduction to the concept of persistence, which is the standard test in financial markets for assessing the existence of alpha in fund performance. Section 2 also describes the methodology to risk-adjust the fund performance data.

Section 3 presents the key results on the persistence of both relative and risk-adjusted performance. Even if alpha can be generated by property fund managers, the sources of such out-performance are important. If stock related, this would be very positive for property and fund managers because it is idiosyncratic. However, if more to do with allocations to sectors and fund structure, such an attribute will, in general, be replicable (eg through derivatives). Hence, the broad nature of any such alpha in property is also explored in Section 3.

The second part of the study, outlined in Section 4, moves on to consider the implications of this analysis of alpha for property investment and fund management. There is a particular interest in whether property investment and fund management might go the same way as equity fund management and see a shift to index-products and pressure on fees, or if investors' quest for alpha will provide new opportunities for property. In examining this, the study draws on a series of 12 interviews with major institutional investors and investment consultants. The authors are extremely grateful to the investors and investment consultants who gave their time and insights for this study.

2. DATA AND METHODOLOGY

2.1 The data

The analysis draws on the records, relating to the years ending December, of the commercial property portfolios collated by the Investment Property Databank (IPD). Funds voluntarily submit their details to IPD for independent performance measurement. IPD estimate that their records cover 55 per cent of professionally managed funds in the UK. Full details of the databank are given in The IPD Index Guide which is available from IPD's website.

Controlling for biases associated with the exclusion and inclusion of funds from the database is a common challenge in studies such as this one. IPD's database limits such potential biases on two counts. First, the histories of funds newly entering the database may be retrospectively added. Second, the historic records of funds expiring are also retained up to their last full calendar year. Funds expire not only when they wind up but also when they merge or split, the portfolio manager changes, or when there is a substantial change to the name of the fund. No details are available on the reasons why funds wind up.

In order to limit any bias, this study analyses all funds in the IPD database until they expire, albeit on condition that they are in existence for the duration of a qualifying period.

The fund performances analysed include indirects and transactions, developments and active management in addition to directly held standing investments; they are also net of property management costs but not fund management fees (which for most funds are about 25-40bps, excluding any performance-related fees).

In contrast to IPD practice, funds are combined into a benchmark on an unweighted basis. This is consistent with the approaches adopted in studies of other asset classes and treats each fund equally, avoiding biases brought about by differences in size.

The detailed tabulations for the analysis were generated by IPD but the interpretation and collation of the data in this report are entirely the authors' responsibility.

2.2 Methodology

The primary approach is to examine whether or not funds perform consistently over two consecutive periods. This is the standard approach adopted generally in finance for assessing the existence of alpha in fund performance, and is appropriate because performance over a single period may be a one-off, purely random, or due to luck. By contrast, a greater proportion of funds out-performing over successive periods than suggested by random chance or luck would be indicative of systematic fund management skill. Any such tendency is called *persistence*.

To examine persistence, this study groups funds into quartiles according to their performance over the first period; they are also allocated to another quartile according to their performance in the following period. This information is quantified in a *transition matrix*.

2. DATA AND METHODOLOGY

For instance, if there were 100 funds, and assuming there was perfect persistence in manager performance, the resulting transition matrix would look as follows:

		Percentage of funds in quartile in following period					Number of funds
		Top	2nd	3rd	Bottom	Total	Total
Initial period quartile	Top	100%	0%	0%	0%	100%	25
	2nd	0%	100%	0%	0%	100%	25
	3rd	0%	0%	100%	0%	100%	25
	Bottom	0%	0%	0%	100%	100%	25

All the 25 funds which were in the top quartile in the initial period were also in the top quartile in the following period, similarly all the 25 funds which were in the 2nd quartile in the first period were also in the 2nd quartile in the following period, and so on.

The table below shows the probabilities where there is no persistence whatsoever. Instead, the results correspond to the probabilities expected by chance.

		Percentage of funds in quartile in following period					Number of funds
		Top	2nd	3rd	Bottom	Total	Total
Initial period quartile	Top	25%	25%	25%	25%	100%	25
	2nd	25%	25%	25%	25%	100%	25
	3rd	25%	25%	25%	25%	100%	25
	Bottom	25%	25%	25%	25%	100%	25

So, of the 25 funds with top quartile performance in the first period, 25 per cent were in the top quartile in the following period, 25 per cent were in the 2nd quartile in the following period etc.

Because it represents the probabilities which would be generated purely by chance, the last table represents the basis by which the transition matrices actually identified in the analysis can be compared. Statistically different probabilities to 25 per cent in each cell, especially relatively high ones in the top left and bottom right cells, would be indicative of persistence and systematic alpha.

2.2.1 Time horizons

The analysis focuses on the performance of funds over three, five or 10 year horizons. Performance over one particular period is then compared with the following period three, five or 10 year period. In total, 12 sets of data are examined:

- Four sets of five year periods (1982–1986 vs 1987–1991, 1987–1991 vs 1992–1996, 1992–1996 vs. 1997–2001, and 1997–2001 vs. 2002–2006);
- Seven sets of three year periods (1983–1985 vs 1986–1988, ..., 2001–2003 vs 2004–2006); and,
- One set of two consecutive 10 year periods (1987–96 vs 1997–2006), this representing a more challenging test and one encompassing a number of cycles.

2. DATA AND METHODOLOGY

As noted above, funds are organised into performance quantiles (quartiles, deciles etc) in the first three/five and 10 year period; in also looking at the fund's performance quantile in the subsequent three/five and 10 year period, a transition matrix showing the probability of a fund subsequently being in the same or a different quantile can be constructed.

The study does not focus on the persistence of performance over one year horizons. The discussions with investors and advisers indicated that performance is not judged and that strategies are not pursued over such a short horizon (although the latter is becoming less the case given the strategies followed by fund-of-fund managers). One year performance is also prone to a high degree of specific risk which might distort the analysis. Finally, it can be both impractical (given property's illiquidity) and inefficient (on account of transacting costs) to rebalance portfolios over such a short horizon.

2.2.2 Performance and risk

Performance is quantified in two ways in this report. The first is simply the fund's performance relative to a universal benchmark. This is referred to as *relative performance*. The appeal of this as a measure of a fund's skill lies in its lack of ambiguity.

The second measure is potentially more accurate but is more subjective and harder to quantify. Underpinning it is the possibility that some performance may be associated with risk rather than skill. A fund achieving higher returns than another is not more skilled if the higher returns are only compensating for the higher risks. This is important as investors not only target returns but also risk. In line with these considerations, studies of persistence in other asset classes, for example equities, typically focus on such risk-adjusted performance.

The effect on funds' performance due to risk therefore has to be controlled for. This study uses so-called factor models to do this. The difference between the overall return of the fund and the part of its return attributed by the factor model to risk (ie beta) is known as *alpha*. This is the second measure of fund manager performance. In particular, *our definition of alpha relates to the excess return resulting from selecting good properties, better asset management, successful timing decisions for example. It also relates to better asset allocation to those sub-sectors not in the risk (factor) model.*

As alpha is a residual, the more factors which are controlled for in the risk model, the lower the alpha will tend to be. For example, if a fund has 'bets' either in or out of retail, offices and industrials, the return attributed to the fund's asset allocation in these sectors will not be quantified as alpha if the sectors are included in the risk model. There are a range of factors which may or may not be included in the risk model, each correspondingly affecting the value of alpha. Herein lies the subjectivity of the measure.

A number of potential risk models, to be applied to each fund, were subject to exploratory analysis. For the 10 year analysis, the risk factors were represented by the IPD Universe returns (in excess of the risk-free rate) in each of the four property sectors (including 'other').

It was not statistically possible to do this in the five year analysis, so the all-property IPD Universe (in excess of the risk-free rate) was used. The *beta* in this model simply measures the sensitivity of the fund's return to that of the IPD Universe. For the three year horizons, there was an insufficient time series of data to estimate any risk models and thereby derive risk-adjusted performance.

In both models, the estimate of alpha represents the fund's (expected) excess return, that is the overall return (over the risk-free rate) less that due to risk.

3. PERSISTENT OUT-PERFORMANCE AND ALPHA IN UK PROPERTY FUND MANAGEMENT

3.1 Relative performance and its persistence

Tables 3.1 and 3.2 present the key details from the transition matrices of persistence of relative performance over three, five and 10 year horizons. The tables:

- focus on the top and bottom performing groups of funds, with Table 3.1 showing the proportion of funds in the top 10%, 25% and 50% in the first three, five or 10 year period retaining such rankings in the following three, five, or 10 year period. Table 3.2 shows the corresponding proportions for the poorest performing funds¹;
- are summaries, representing the average from each set of horizons. So the five year figures are the average from four sets of transition matrices (see Section 2.2.1), while the three year figures are the average from seven sets of transition matrices. As noted earlier, there is only one set for the 10 year horizon.

If performance was random, it is to be expected that 50 per cent of funds in the top half of performers in the initial period would be in the top half in the following period, and similarly that 10 per cent of top decile funds would be in the same decile/25 per cent in the same quartile during the following period. If the proportions are significantly higher, this would indicate persistence in good/poor performance, whereas if they are lower, it would indicate a reversal of previous performance.

Table 3.1: Proportion of funds remaining in top rankings – relative performance

	Top decile in both periods	Top quartile in both periods	Top half in both periods
10 year horizon	29%	35%	48%
All five year horizons	19%	36%	53%
All three year horizons	17%	34%	54%

Source: Authors' calculations using data supplied by IPD

Table 3.2: Proportion of funds remaining in bottom rankings – relative performance

	Bottom decile in both periods	Bottom quartile in both periods	Bottom half in both periods
10 year horizon	0%	13%	46%
All five year horizons	13%	27%	53%
All three year horizons	17%	27%	53%

Source: Authors' calculations using data supplied by IPD

The evidence of persistence is mixed. The indications are strongest for the very best performers. In particular, Table 3.1 indicates that those experiencing top decile performance have a relatively high probability of repeating such good performance; evidence of persistence amongst those in the top quartile is less strong. There is no evidence of persistence within the top 50% of funds. The statistical tests of significance indicate that evidence of persistence is strongest over three year horizons and weakest over 10 year horizons.

¹ For ease of interpretation, the results presented in this summary report exclude funds which subsequently expire. This does not substantially affect the findings.

3. PERSISTENT OUT-PERFORMANCE AND ALPHA IN UK PROPERTY FUND MANAGEMENT

Among poor performers, the proportions (see Table 3.2) are typically lower and indicate a lesser tendency of persistence than amongst the top performers.

The overall impression, therefore, is that persistence in property fund relative performance exists only among the very top performers.

Corresponding to this relatively low tendency for top and bottom performers to persist, there is a convergence in the subsequent performance of the top and poorest performing groups of funds. Figure 3.1 illustrates this for the 10 year horizon, while Figure 3.2 shows the averages of the four sets of five year horizons. Both charts show that the relative performances of the top ranking funds subsequently are close to the benchmark. The opposite happens to those funds which initially were in the bottom ranking groups.

Figure 3.1: Average fund relative performance, according to initial quantile, 10 year horizons.

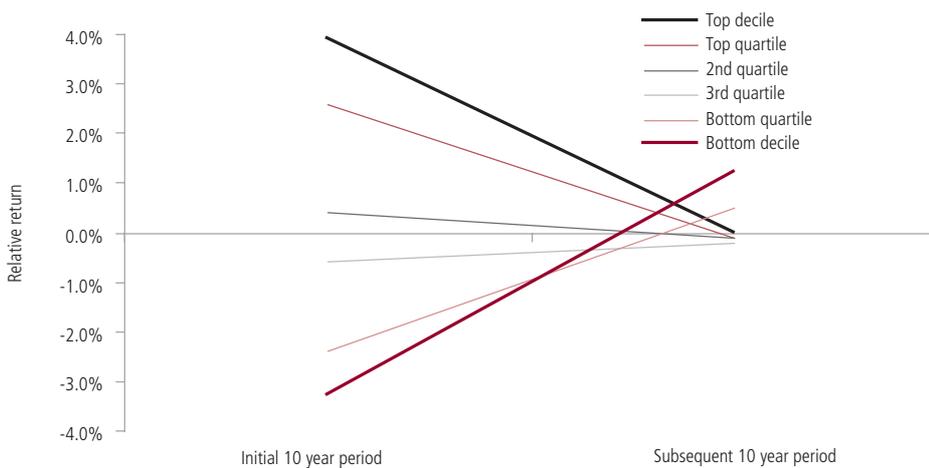
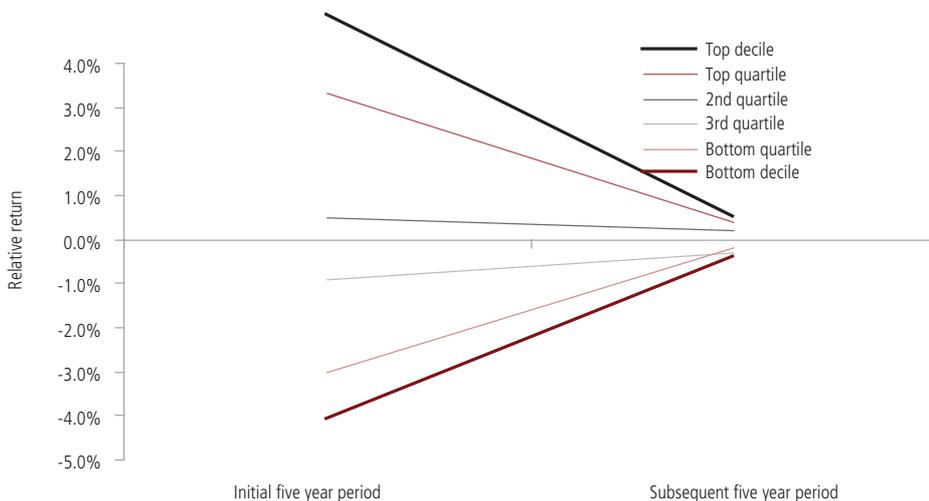


Figure 3.2: Average fund relative performance, according to initial quantile, five year horizons.



3. PERSISTENT OUT-PERFORMANCE AND ALPHA IN UK PROPERTY FUND MANAGEMENT

The subsequent weakening in the performance of the top quantile of course reflects the impact of the large proportion of initially out-performing funds which then regress. The performance of the small number of funds which persistently out-perform therefore will be better than portrayed in Figures 3.1 and 3.2. For example, those with an above median performance in successive periods show relative returns of 1-2 per cent per annum in the second period. Conversely, the vast majority of funds show medium and long term returns within 1 per cent of the benchmark.

3.2 Risk-adjusted performance and its persistence

The results presented above provide an analysis of the persistence in property returns not adjusted for risk. However, a fund manager may consistently achieve higher returns than another manager, but this does not necessarily imply the first manager is a better manager, if the higher returns are only compensating for the higher risks taken by the manager.

The approach to deriving estimates of risk-adjusted performance (alpha) for the funds in the IPD database was outlined earlier in Section 2.2.2. These measures of alpha are used instead of relative performance to construct the same type of transition matrices illustrated in the previous section. These results relating to the persistence of alpha are shown in Tables 3.3 and 3.4.

Unlike the analysis of relative performance, evidence of persistence in risk-adjusted performance over 10 year horizons is strong. Sixty per cent of funds with above median performance in the first 10 year period were also above median in the following 10 year period. Persistence in poor performance is even more compelling—65 per cent of funds initially with below median performance subsequently repeated such poor performance, while an extraordinary 56 per cent of funds in the bottom quartile remained there in the following 10 year period.

Evidence of persistence over five year horizons, however, is much less compelling. For example, 53 per cent of funds initially in the top half remained there during the following period. Furthermore, the strong persistence among the top decile performers apparent before adjusting for risk is less obvious on a risk-adjusted basis, particularly over five year horizons.

Table 3.3: Proportion of funds remaining in top rankings – risk-adjusted alpha

	Top decile in both periods	Top quartile in both periods	Top half in both periods
10 year horizon	17%	35%	60%
All five year horizons	11%	31%	53%

Source: Authors' calculations using data supplied by IPD

3. PERSISTENT OUT-PERFORMANCE AND ALPHA IN UK PROPERTY FUND MANAGEMENT

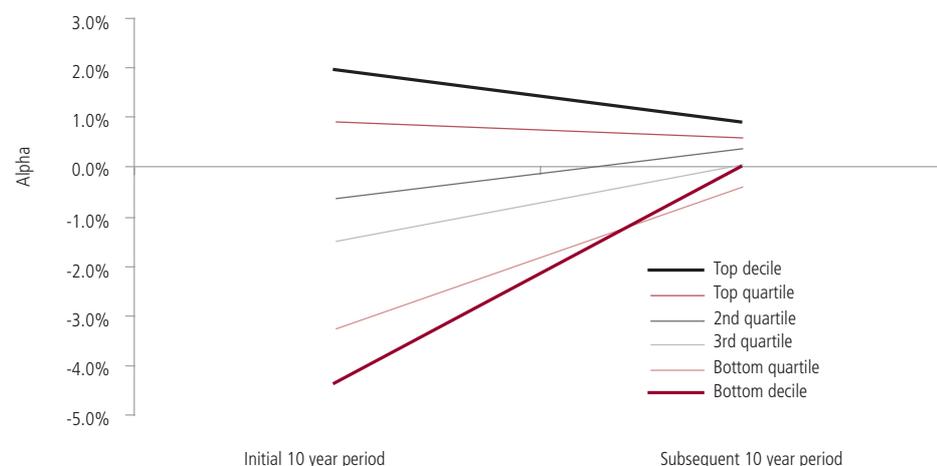
Table 3.4: Proportion of funds remaining in bottom rankings – risk-adjusted alpha

	Bottom decile in both periods	Bottom quartile in both periods	Bottom half in both periods
10 year horizon	6%	56%	65%
All five year horizons	12%	28%	53%

Source: Authors' calculations using data supplied by IPD

The pattern of convergence in the subsequent performance of top and poor performing funds, illustrated in Figures 3.1 and 3.2, is also apparent when performance is measured in terms of risk-adjusted alpha. This can be seen for the 10 year horizon in Figure 3.3. In the same way as relative performance, those funds managing to persist with top performance would have done better.

Figure 3.3: Average fund alpha, according to initial quantile, 10 year horizons.



3.3 The attributes and predictability of performance and alpha

The results from the previous section suggested that there are some instances of persistence in relative performance and risk-adjusted alpha in UK property funds. If this information is to be useful to investors, it would be helpful to know whether there is any way top performing managers can be identified. Analysis in this respect was undertaken using regression models, and the results are outlined below.

First, using contemporaneous information on fund characteristics, an analysis was undertaken to determine which, if any, are most closely linked to manager out-performance and alpha. Then, these fund characteristics were tested to see if they hold any predictive ability for future levels of performance and alpha. The analyses were undertaken for the 10 year horizons and every five year horizon.

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The specific fund characteristics examined were the fund's:

- type (eg life fund, segregated pension fund, unregulated PUT);
- size, as measured by capital value;
- average equivalent yield;
- development exposure;
- net investment (as a percentage of fund value);
- IPD structure score (which measures the contribution of a fund's segment bets to its performance relative to the IPD Universe);
- IPD property score (which measures the contribution of a fund's properties within each segment to its performance relative to the IPD Universe); and,
- sector specialisation.

The results are summarised in Table 3.5. The most notable findings are that stock is consistently the most important factor in explaining both performance and alpha; a high equivalent yield has tended to enhance performance and alpha until recently, but it has now switched to being detrimental; and that more often than not a relatively high development exposure has undermined performance and alpha.

It is also interesting that while good stock is consistently the most powerful factor behind performance and alpha, it is not at all predictive of future performance and alpha – possibly indicating mean reversion over time in the performance of specific assets. By contrast, a high yield in a fund is the single characteristic predictive of future good performance and alpha.

Table 3.5: Fund characteristics associated with and predictive of performance and alpha

	Explains performance/alpha	Predicts performance/alpha
Fund type	Occasional tendency for life funds to show poor performance/alpha, no strong evidence for other types.	Not predictive
Fund size	Occasionally positively associated with performance and alpha, negatively most recently.	Not predictive.
Equivalent yield	Varies over time, more often than not associated with good performance and alpha although negative most recently.	Predictive of subsequent good performance and alpha.
Development exposure	Varies over the cycle but typically associated with substantial under-performance.	Not predictive.
Net investment	Varies over time.	Typically not predictive.
Sector specialisation	Typically does not affect performance and alpha.	Not predictive.
IPD structure score	Mildly positive up to the mid-1990s but subsequently negligible.	Not predictive.
IPD property score	Consistently the most powerful influence behind good performance and alpha.	Not predictive.

3. PERSISTENT OUT-PERFORMANCE AND ALPHA IN UK PROPERTY FUND MANAGEMENT

A more specific look at the characteristics of the funds revealed that segregated pension funds dominated those consistently in the top decile and quartiles of relative performance over 10 and five years. The traditional institutions (ie the type which includes organisations such as the Church or charities) were the 2nd largest fund type (after the segregated pension funds) consistently in the top decile over the full set of five year horizons. In general, the proportion of segregated pension funds and traditional institutions in both the top deciles and quartiles was higher than expected.

The consistent top performers also tended to be smaller than average, although this was largely attributable to the low representation of (typically big) life funds amongst the top performers.

The tracking errors of those consistently in the top decile and top quartile were higher than average. The suggestion therefore is that the consistent out-performers had relatively large bets relative to the benchmark and higher risk.

3.4 Property by comparison to other asset classes

In order to understand how property might be affected by investors' general quest for alpha, it is helpful to review the extent of systematic out-performance and alpha in other asset classes.

The academic evidence and industry data suggest that equity and bond fund managers exhibit persistence in performance and alpha over the short term but not longer periods. The underlying alpha for UK equities for a top quartile manager seems to be no more than 2 per cent and possibly under 1 per cent once fees are taken into account. In the US, the evidence is stronger, suggesting that persistence does not last for long and is focused more on poor rather than out-performing funds. For bonds, alpha is much lower if not negligible.

For hedge funds and absolute return, the potential alpha is much greater. Like equities, there is persistence over short periods but it is debateable if this lasts for more than a few years; the balance of opinion is that the magnitude of any persistent alpha diminishes over time. This said, the most sophisticated investors believe that, through the judicious selection of funds/managers, significant risk-adjusted net returns of around 5 per cent can be attained through an exposure to hedge funds. A private equity exposure also has the potential to deliver significant alpha to investors.

In conclusion, while its potential alpha is lower than from private equity and, possibly, hedge funds, property stands apart from other asset classes (with the exception of private equity) on account of its potential to deliver sustained, albeit relatively modest, alpha over extended periods.

4 IMPLICATIONS FOR PROPERTY INVESTMENT AND FUND MANAGEMENT

4.1 Introduction

This section considers the high level implications for property investment and fund management of the findings on alpha and persistence. It draws largely on a series of interviews with 12 major investors and investment consultants.

4.2 Investors' requirements from and perceptions of property

Consistent with the recent IPF report *Multi-asset allocation in a modern world*, investors saw property's primary role as a diversifier, reducing portfolio risk and enhancing returns over and above those available from bonds. Most interviewees were also seeking an overwhelmingly beta return from property, albeit with the aspiration to receive a small out-performance premium from alpha. Such out-performance, however, was secondary to ensuring that the fund did not deliver significantly less than this beta market return and was also seen to be modest relative to the alpha they were seeking in other asset classes, notably alternatives such as private equity.

A minority of investors eschewed this balanced approach, instead following what could be loosely termed an absolute return approach to property investment. In financial markets generally, alpha plays a fundamental role in absolute return approaches as its return is (theoretically) independent of overall market performance.

This minority recognised that, in following this strategy in property, some beta could not be avoided. However, these strategies represented a fundamentally different approach, eschewing reference to relative benchmarks, investing only when and where the prospective return was above the absolute return target, explicitly pursuing returns from active management and cashflow, and looking to exploit systematic mis-pricings and illiquidity.

4.3 Investors' attitudes towards property derivatives

Derivatives are potentially an important theme in this study of alpha first because in seeking a market return (beta) from property, it may be more efficient to achieve such an exposure through a derivative or some other index product, and second because, if investors possess good sector allocation skills and if this was an important factor behind out-performance, the use of sector-based property derivatives would enable a much more active (and rewarding) approach than is possible at present, given property's illiquidity and transacting costs.

Such use of derivatives would be particularly preferable if investors believed their fund managers could generate alpha at the overall market or sector level, thereby allowing the assets and their alpha to be retained whenever there was a need to reduce exposure (which could now be achieved through derivatives rather than selling good assets).

The final potential for derivatives would be through an explicit targeting of, and allocation to, alpha through the use of portable alpha, in line with the strategies more generally being followed by some investors².

² Portable alpha is an approach whereby an exposure to an underlying asset class which has alpha is combined with a short position in the index derivative of that asset class, leaving the investor with the asset class's alpha (which is ported to the portfolio) but a zero exposure to the market.

4 IMPLICATIONS FOR PROPERTY INVESTMENT AND FUND MANAGEMENT

The investors and investment consultants spoken to, however, were generally sceptical of using property derivatives in such sophisticated ways other than as a tactical means of increasing or reducing the underlying exposure to the market. The reasons cited were a lack of confidence and understanding of the market's pricing of property derivatives, illiquidity, and concern over basis risk³.

Furthermore, it was felt that the potential alpha in property was insufficiently large compared to that available elsewhere. At the same time, investors were also fairly relaxed about the level of fund management fees (at least for balanced mandates), comparing them favourably with the fees in other asset classes requiring heavy management. High fees therefore are unlikely to represent a factor pushing investors towards cheaper index-products and derivatives in the way which has occurred in equity fund management.

This said, it was recognised that the property derivatives market would continue to develop and eventually would become more liquid, efficiently priced and comprehensible. It was also conceded that use of derivatives might be more appealing to those looking to invest in property for the first time.

4.4 Emerging strategies towards property

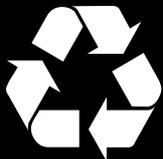
The suggestion from the above analysis is that alpha as a major plank to a property investment strategy is being pursued only by a minority of investors. Nevertheless, some emerging themes in the quest to improve returns and reduce risk in the multi-asset portfolio were apparent.

First, in making allocations to overseas property, investors were looking to generate out-performance from good asset allocation (a form of alpha which has long been sought in strategies towards overseas equities), through taking on more risk (eg through value-added and opportunistic strategies) than they did in the UK, and in also looking for specialist managers capable of delivering active alpha in markets less developed than the UK.

Second, an appetite for alternative property sectors mirrors investors' strategies elsewhere in the search for new markets which are lowly correlated with existing asset classes (thereby increasing the return to a portfolio without increasing risk) and which are difficult to access (on account of which there is a premium return). As specialised expertise may also be required to tap into such returns, there can also be an element of manager skill (ie alpha) in the return.

Both these approaches present opportunities for adventurous and skilful property fund managers to generate alpha.

³ whereby, because of property's heterogeneity and consequential specific risk in a portfolio, there is not a perfect correlation between the derivative and the underlying portfolio of the hedger.



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Investment Property Forum

New Broad Street House

35 New Broad Street

London EC2M 1NH

Telephone: 020 7194 7920

Fax: 020 7194 7921

Email: ipfoffice@ipf.org.uk

Web: www.ipf.org.uk