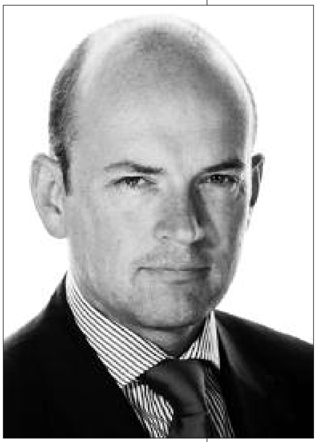
The benchmarking of property fund performance – 'Under Pressure'?



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At a time that David Bowie has returned to the top of the album charts after a long absence we can perhaps take inspiration from his back catalogue to draw some conclusions about how we can best benchmark the performance of property funds when it feels as if the traditional methods of comparison are 'Under Pressure'.

'Absolute Beginners'

For many investors in property, there is a growing feeling that the UK property market has turned the corner from the crash period of 2007-09. Following the downturn, there seemed to be an acceptance that values had over-corrected, resulting in the rally of H2 2009 and 2010 and the stalemate that has followed since. Encouragingly, there are signs that the handbrake is slowly being released and the market is prepared to embrace an element of risk where over the last two years it has been obsessed with secure long income streams.

With other asset classes looking relatively expensive, this is a time when the relatively high-yield and diversification qualities offered by commercial property should be attractive. There is a challenge for property investors, however, if there are concerns over whether commonly used property benchmarks are fit for purpose.

'Golden Years'

The most commonly used benchmark for the managers of core UK property funds is a collection of comparable property vehicles that have similar styles and performance objectives. This peer group comparison has been accepted by investors and their advisors since the 'Golden Years' of the first half of the 2000s but the stresses and strains of the financial crisis have sparked a debate about the merits of this approach. The main benefit of a peer group benchmark is that it is a transparent method for the comparison of the constituent funds. It also allows managers to attribute their performance relative to benchmark and enables managers and investors to analyse funds relative to their peer group in huge detail.

'Sorrow'

There are growing concerns however that using a peer group benchmark has some significant problems, which can be summarised as follows:

- **Comparability of funds.** The commonly used benchmark index nominally includes 'balanced' funds that broadly aim to replicate the structure and performance of the UK commercial property market. Investors may assume that these funds are similar in style and substance, but there are some marked differences between funds. This includes different sector structures, exposure to leverage and average cash weightings, the proportion of indirect holdings, development projects and the underlying style of assets. Although many funds are often described as 'balanced' or 'core' (there are various definitions but in essence core describes lower risk funds with limited levels of volatility), the very wide dispersion of returns witnessed over recent years suggests that there are some equally wide discrepancies between the make-up of funds.
- **Benchmark stability.** In recent times, there have been a number of new funds entering the benchmark and several funds exiting it due to mergers, funds being wound up or funds being removed because they are considered unrepresentative of the wider peer group. The changing benchmark constituents and restatement of indices due to data amendments has resulted in unwelcome volatility and uncertainty.
- **Investor access.** The final criticism of a peer group benchmark index is that not all funds in the benchmark index are open to all investors. This may be because some funds are only available to certain types of investors (charity funds and managed pension funds for example) meaning that it is impossible for investors to replicate the benchmark.

In aggregate, these criticisms have prompted a number of investors and managers to consider the appropriateness of a performance benchmark comprising other property funds.

'Day In, Day Out'

Another failing of the current practice is that there is a huge focus on recent history rather than the longer term. Market returns are reported on a quarterly basis so there is inevitably a convergence on the near rather than the longer term. Given the high 'round trip' costs of exiting property funds and entering new ones (sometimes up to 7% of net asset value), investors should accept that they must look at the performance of their investments over longer periods.

Ideally, investors should review the success or failure of their managers over a complete property cycle, but unfortunately the duration from the peak to the trough and back again is difficult to predict. In practical terms, investors should probably look at the performance of their holdings over a minimum of five-year rolling periods to avoid short term influenced behaviours.

'Changes'

Taking on board the criticisms above, what could we as investors use for performance comparison as an alternative to the current practices? The starting point for this re-appraisal must be 'What do the investors want?'

For managers of core-style property funds, investors want to know that, as a minimum, the performance of the property assets in a fund will at least match the returns delivered by the UK property market. A good manager, with strong stock selection and asset management abilities, should be able to outperform the market average by a comfortable margin. The degree by which a fund should be expected to outperform should reflect the amount of risk a manager takes. Investors should be happy to accept a property-level return that mirrors the market, assuming that the characteristics of the portfolio are not widely different to the composition of the market. These similarities should include the look-through sector structure, the portfolio void profile, exposure to development within the portfolio and the quality of the individual assets.

Over the long term, UK commercial property has provided an average total return of 6% to 8% per annum, so it is not unreasonable for investors to assume that managers should be able to provide, say, a 7% return at a property level on average over the long term.

Investors need to accept that by investing in pooled funds they must embrace the positive and negative drivers of return that are associated with this method of gaining exposure to the property market. Putting the performance of the underlying real estate to one side, the four most significant influences on returns associated with investing through pooled fund structures are fund management fees, transaction costs, gearing and cash.

Fund management fees will dilute the net returns received by investors, as will cash holdings in most normal market conditions (when the returns from property should exceed the returns received from cash). Fund management fees will normally depress fund performance by 60bps to 100bps whilst holding cash in portfolios effectively results in a zero return for that part of the fund at present.

The impact of fund level transaction costs will vary depending on market conditions, with discounts often available in periods of market distress. In normal conditions, and unless the investor is able to trade efficiently via the secondary market, they will face an offer price to enter an open-ended fund and a bid price to exit. The total spread can be up to a 7% round trip. These transaction costs should be understood by investors.

The positive or negative impacts of gearing/leverage will depend on market conditions and the terms of the individual debt arrangements. In strong market conditions, such as those experienced in the early to mid 2000s, gearing has an almost exclusively positive impact on returns by amplifying the robust returns experienced in the property market. Unfortunately much of this excess return was lost during the credit crunch of the latter half of the 2000s as negative total returns were also compounded by gearing. From an investor's perspective, we should demand stronger returns from managers that actively employ the use of debt as part of their fund strategy. Using debt increases the volatility of fund returns and risk within portfolios, so investors should be compensated for this by experiencing stronger returns. The higher the level of gearing in the fund, the higher the out-performance target that should be set.

The same general principles should apply for specialist funds. The performance of the properties in a sector or regionally specialist fund should be measured against an appropriate sub-sector sample of UK or regional properties. Explicit adjustments should be made to reflect management fees, cash weightings and fund gearing. Given the specialist nature of the market segment (concentration risk) and management teams, often with higher fee levels to reflect this, one could argue that the performance objective for specialist funds should be considerably more demanding than for core funds.

'Where are we now?'

So, should we call time ('Ashes to Ashes' maybe?) on the traditional peer group method of assessing whether our managers have delivered? Perhaps we should just look at the long-term average returns for property adjusted for the features of the holding vehicle.

There are certainly merits in using a total return target referencing the long-term performance the property market, but also reflecting the pros and cons of investing via pooled fund structures. However there will always be a temptation to keep one eye on what the competing funds are doing. If suitable changes can be made to the way we assess whether funds have delivered there is a good chance that both managers and investors will be 'Dancing in the Streets'.