INVESTMENT PROPERTY

Property
for
UK Pension Funds

FORUM

June 1996

PREFACE

The Investment Property Forum is a thriving organisation committed to expanding knowledge, stimulating debate and improving the practice of property investment and I am pleased to be able to play my part as its President.

I have been associated with the Forum since its early days. It was instituted in 1987 and now contains upwards of 800 members, from a wide variety of disciplines. Contributions to this report have come from a number of these and I would like to thank everyone involved for their hard work.

I believe that property is a legitimate and potentially beneficial investment for pension funds but that its status with funds has suffered in the past through the failures of both the property industry and pension funds themselves to set about the business of the management of property in the most appropriate way.

Of course as an asset it has also underperformed from time to time and particularly in more recent years. However, perhaps for this reason as much as anything else, its time may be coming again and this makes it all the more important to sweep away the mystery, misinformation and inadvisable approaches to management which have been commonplace in the past. I am pleased to say that there are strong signs of this happening. As a manager of pensions assets I am also pleased by the long overdue expansion which is taking place in the number of alternative investment vehicles open to a pension fund to give them more flexibility, liquidity and management efficiency in the property sector.

For all of these reasons, I think this report is not only timely but likely to prove to be of considerable value to pension funds in the UK.

Alastair Ross Goobey
President, Investment Property Forum

FOREWORD

The Consultative Document which the Investment Property Forum produced just over two years ago provoked considerable interest and in itself was I believe useful for both pension funds and the property industry. Our original intention to finalise the document relatively quickly was reconsidered in view of the issue of the Pensions Bill and subsequently the enactment of the Pensions Act since we felt it important to assess what, if any impact this may have on investment by pension funds in property. This has specifically been the subject of a research project ("Attitudes of Pension Funds to Property") carried out by the City University Business School on behalf of the Investment Property Forum and is covered fully in the Report (copies are available from the Forum).

However, it has become apparent that considerable changes have taken place over the same time period, particularly in regard to valuations and the options available for indirect investment. In some respects therefore the report has changed relatively little, although taking account of the responses which were made to it by NAPF members and the NAPF Investment Committee. In other areas it has been substantially re-written and, we think, sharpened up as to its conclusions.

We have also made an important addition in the "Pension Fund Property Checklist" which we hope will be a valuable aide-memoire for pension fund managers.

Since the issue of the Consultative Document, the NAPF Investment Committee has set up a property sub-committee, currently under the Chairmanship of David Gamble of British Airways Pension Fund. The Forum has been delighted to work closely with the property committee and hopes to continue to do so in the future as we work together to deal with the topical concerns of Pension Funds.

I would again like to thank everyone involved in the preparation of the Report but in particular, Professor Piers Venmore-Rowland of City University Business School for the enormous editorial task he undertook.

Iain A Reid
Chairman of the Investment Property Forum's Working Group

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EXECUTIVE SUMMARY

Property investment has fundamental benefits to a mixed asset investment portfolio:

- A diversifier with low correlation of returns to other investment classes
- Positive real returns: in excess of 6% p.a. since 1963
- High relative income returns, with bond type characteristics, coupled with potential medium to long term inflation hedging characteristics
- Good risk/return profile

BUT it has perceived problems which can obscure these fundamental benefits, for example:

- Illiquidity
- Management intensive nature
- Periodic poor relative short term performance
- Lack of information on prices

These perceived shortcomings have resulted in a steady reduction in pension fund property weightings over the past decade.

Key Issues emerging from this Report are:-

1. **Direct and indirect property investment remains valuable as a core asset for medium and large sized pension funds and small pension funds can benefit from indirect property investment, but there should be a move by pension funds towards:**

   - appointment of discretionary managers for both direct and indirect portfolios.
   - more forward looking asset allocation decisions by pension funds to reflect the time lag to implementation
   - incorporation by property investment managers of indirect forms of investment within direct portfolios to increase diversification and liquidity.
   - quality assurance guidelines or in due course a move towards a regulatory framework and clearly defined threshold competencies should be considered.

2. **Pension funds that have long term liability profiles should consider property's long term performance characteristics, its role in meeting pension fund liabilities, and as a diversifier. It should be noted that:**

- prospective long run real returns are estimated at least comparable to historic real returns of more than 6% p.a.

- continuing efforts are being made by the industry to enable property to be realistically evaluated in a mixed asset portfolio, and on an asset/liability matching basis.

- the amount of subjective judgement which is involved in asset allocation needs to be reduced by improving data reliability and the analytical techniques used by the property investment industry and investment consultants.

3. **More indirect property investment vehicles need to be developed. In particular there will be a need for a vehicle designed for defined contribution plan investors.**

- No existing approved indirect property equity vehicle is entirely suitable.

- Traded Property Index tracking investment vehicles (eg Property Index Certificates) could be appropriate in time as this market grows in size.

4. **Indirect property investment, quoted and unquoted, has a larger role to play for funds of all sizes. When coupled with a secondary market it:**

- improves liquidity
- gives more information on prices
- enlarges the scope of funds
- substantially reduces management time
- improves diversification in terms of property spread

5. **The property market now has robust performance measurement systems and indices. Industry standard data series going back to 1981 have been established through IPD's database. This Report has drawn on other sources for the annual performance of the three sectors from 1960 and we regard this as the best available data set. Consideration needs to be given as to:**

- how the property performance measurement process can be speeded up

- whether these figures are under-representing the true performance of property investment through their treatment of the timing of rents (annually in arrears)

- property performance measurement figures should be consistent with those coming from competing investment markets

The responsiveness of property valuations to market changes is improving and must continue to do so. It is increasingly recognised that open market valuations are as at one point in time and seek to mirror the market price. In contrast appraisal based techniques seek to determine the investment worth to the investor.

Fees relating to direct property investment give the perception of being complex., but funds and managers are finding a range of approaches to meet their wishes. There is a need for:

- greater transparency
- simplification
- fee levels sufficient to sustain and reward the provision of an investment management service
- less reliance on transaction fees
- fees to be put into the context of the fund's expected holding period

This report re-affirms the importance placed by the Investment Property Forum upon the development of research and educational programmes so that pension funds continue to be fully informed and property professionals have the wherewithal to play a full role in the investment community.

INTRODUCTION

The Purpose of this Report

In 1994 The Investment Property Forum commissioned a Working Group to write a comprehensive and authoritative review of Property Investment for UK Pension Funds. A consultation report was prepared, and distributed to all members of the National Association of Pension Funds and the Pension Research Accounts Group, Institute of Investment Management and Research, Institute/Faculty of Actuaries, Pensions Management Institute, Society of Pensions Consultants, Institutional Fund Management Association and National Association of Pension Funds Investment Committee.

Following the feedback received and the advent of the Pensions Act (1995), the Report has now been produced.

The rationale behind the Report is to place property investment into the context of the investment objectives of Pensions Funds, to identify the characteristics of property relative to the other main asset classes, and to address the management issues.

As stated in the Consultation Report:

> "In relation to both property's importance in the economy and its share of the wealth and capital assets of the UK., its representation in Pension Fund investment portfolios is, in overall terms, relatively small and in many instances nil. The decline to this position since property's peak level of over 20% of Pension Fund assets in the early 1980s has taken place for a variety of reasons which are not only pure investment ones. Some of these reasons are obvious and well understood, while others are rather more esoteric. However, many of the reasons for and against property in a mixed asset investment portfolio have the characteristic that they have been poorly defined and inadequately (or at least not independently) explained or argued. There are also instances where the property industry has failed to take on board the legitimate concerns of investors and make real efforts to take corrective action".

This report sets out to meet these needs.

Is property a suitable asset for Pension Fund investment?

Investment in real property has been undertaken by UK pension funds since the mid-1960s. It has featured amongst the assets of insurance companies and other investing bodies for decades prior to this and indeed for centuries in some cases.

However, despite property's long standing as one of the major capital assets, it continues to attract considerable debate between its devotees, those who dismiss it, and others of more neutral disposition, as to its suitability for pension fund investment. This debate is not an issue of investment performance alone, but relates to the characteristics of property as an investment in a mixed asset portfolio and the choices that must be made in its management which are different from other forms of investment.

It is evident that many of these issues have been with us, unresolved and promoting largely the same discussion for many years. Although much has been written in many places on the subject of property investment, the Investment Property Forum believes that no comprehensive and up-to-date review of the topic has been made specifically as to its application to Pension Funds (although due acknowledgement should be made to the publication "Property Investment and Pension Funds" by the Pensions Research Accountants Group in 1987 which covered some aspects in considerable detail) and it is for this purpose that this Report is now being undertaken.

Our primary intention is to identify the issues and questions which commonly concern Pension Fund Trustees and investors, to approach these systematically and to provide carefully considered answers. The Working Group comprises leading experts in the field from a variety of academic disciplines and areas of professional experience. As well as property skills, the group contains three economists, an academic who is a former stockbroker, an investment consultant and an investment manager who is a Past Chairman of the NAPF Investment Committee.

We would hope that the outcome of this Final Report is the offering of advice, explanation and greater clarity, not only to make life easier and perhaps happier for those pension funds who are already investing in this asset class, but to make others more comfortable and confident in doing so in the future. In the process, shortcomings and problems have been identified for consideration by the property industry, which may well have to respond with change.

1.3 What do we mean by "Property Investment"?

The return property provides is a combination of the regular rental income received from tenants and the capital appreciation which accrues over time. This is received principally by pension funds through direct ownership of the assets but can also be achieved indirectly through investment in pooled vehicles such as Property Unit Trusts, insurance company property funds, limited partnerships or other forms of co-ownership. Other methods of sharing ownership or the benefit of ownership are being developed.

The mainstream institutional property types are office, retail and industrial. These classifications cover almost the whole of the institutional market as defined by the Investment Property Databank. It is also possible to invest in more specialised forms of property including UK agricultural, forestry, hotels, leisure and residential. However, the report will concentrate on property investments as an asset class and not with issues concerning different types of property.

The pension fund industry total assets are some £450bn. Their aggregate holding in UK property is some 5.5% (Source CSO Q3 1995).

It is also sometimes perceived that the quoted property share sector can provide a proxy for investment in real property. We examine the extent to which this may be true within the report, but to put this market in context we set out overleaf the relative sizes of the main UK asset classes and the property share sector:

UK Commercial Property	£300 bn
Institutional UK Property	£62 bn
Pension Funds' UK Property	£24 bn
UK Equities Market	£800 bn
Property Share Sector	£15 bn
Fixed Interest Gilts	£165 bn
Index Linked Gilts	£ 21 bn

Source City University, CSO, Datastream

It is also important to distinguish between investment in property and the process of property development. Although it is not uncommon for the larger investors in property, including some pension funds, to finance or carry out development themselves, this activity involves different risks, skills and rewards from investment in income-producing property assets. Insofar as this is, therefore, an extension of property investment which will not involve the majority of pension funds, we do not intend to deal with it specifically in this report.

2. STRATEGIC ISSUES FOR PENSION FUNDS

2.1 Property in the context of Pension Fund Investment Objectives

2.1.1 Pension Fund Investment Objectives

The starting point for the investment of pension fund assets is with the investment objectives. These objectives ultimately drive a pension fund's investment strategy and thus, implicitly or explicitly, determine its allocation to property as well as to other asset classes.

While they may share similar investment aims, pension funds differ markedly in their characteristics and these differences have increasingly led to divergent investment strategies being adopted by fund trustees. A report on performance measurement sponsored by the National Association of Pension Funds (December 1990) recommended that "Trustees of each pension fund have a responsibility to "know their own scheme" and consider whether it has any special characteristics which required it to be invested to a degree differently from the generality of pension funds". However, we would conclude that the point has now been reached where pension funds should be considered individually and that a specific set of objectives can (and should) be determined for each fund.

A fundamental difference that should be acknowledged at an early stage is between defined benefit (or final salary) schemes and defined contribution (or money purchase) plans.

Under the defined benefit schemes the sponsor (or employing body) will usually offer pension benefits related to a member's salary at retirement. The risk that the plan's investments will not have grown sufficiently to meet benefit promises (or liabilities) falls on the plan sponsor who makes good any shortfall between the accumulated assets and liabilities. In general, under defined benefit plans investment policy is the responsibility of trustees appointed by the plan sponsor. Their broad approach will be to determine an investment policy for the plan assets held collectively on behalf of the whole of the plan membership and ensure that the accumulated liabilities can be met by plan assets over an appropriate timeframe. In general, such an approach is relatively "long term" in its application, ie the policy is usually set to achieve its objectives over periods of some years and is reviewed regularly, eg every three years.

In contrast, under a defined contribution scheme, there is no benefit "promise". The amount of benefit purchased for a member is dependent upon the rate of contribution, investment performance of the invested assets allocated to that member and the rates for purchasing pensions at retirement. The risk of investment "failure" is thus borne by the plan member rather than by the plan's sponsor. Where a choice of investment strategies is offered this will rest usually with the plan member and is thus determined on an individual basis. There is also potentially a requirement for plan members to be able to switch investments between these investment strategies as their individual circumstances change (eg as they approach retirement). Thus a degree of flexibility in strategy is desirable.

The potential role of property in the investment of the assets of both types of plan can therefore differ markedly. Currently, in the UK, the defined benefit plan is by far the most prevalent. We therefore focus our remarks below largely on the defined benefit schemes. However, the number of defined contribution plans is growing and hence we devote a sub-section below (2.1.7) specifically to the role of property in relation to their investment needs.

Investment Objectives for Defined Benefit Plans

There are a number of possibly conflicting objectives in investing pension fund assets for defined benefit plans. As a primary objective, trustees will seek usually to maximise the return on the plan's assets. If achieved this will help them meet the plan's liabilities and also keep long term funding costs down. There can be a number of constraining objectives however, including;

- keeping funding costs stable.
- ensuring the solvency of the plan at all times, on a discontinuance basis.
- ensuring the plan meets the Minimum Funding Requirement as laid down in the Pensions Act (see Section 2.2 below)
- generating sufficient cash flow to meet benefits.
- maintaining a low risk investment policy relative to that of UK pension funds in general.

Having set out the potential investment objectives of pension funds it is clear that different emphasis will be placed on these objectives by funds at different stages of development. Two particularly important parameters in prioritising objectives are the maturity of the plan and the strength of its funding.

Plan Maturity

A pension plan at the early stages of development is often described as being "immature". The fund is likely to have the bulk of its liabilities for active members and may have few if any pensioners or deferred pensioners. In general a pension fund of this type is likely to have two key features:

(i) it needs "real" growth from its investments: ie assets which grow in line with, or in excess of, the growth of its salary related liabilities;

(ii) it has a relatively long time scale for investment, ie. any short term investment failure can be expected to recouped over the longer term.

As a pension plan develops, the proportion of liabilities accounted for by deferred and current pensioners will increase.

A mature plan is one in which a significant proportion of the plan liabilities relate to pensions currently in payment. There are two key features of this type of plan:

(i) a larger proportion of these types of liability are more likely to be fixed in nature; particularly where the benefits are not fully indexed (eg to RPI);

(ii) this type of plan has a shorter timescale for investment. Thus there is less time for any short term investment losses to be made good.

Strength of Funding

The strength of a plan's funding can be determined by assessing the value of its accrued assets relative to its accrued liabilities.

There are three principal types of measure of plan funding:

(i) ongoing funding - which assumes the plan's continued existence

(ii) solvency - which assumes the plan is to be wound-up immediately and the assets used to buy out the accrued benefits.

(iii) Minimum Funding Requirement - which assesses the plan's assets against its liabilities under the standard set out following the 1995 Pensions Act.

Plans that are poorly funded on an ongoing MFR basis or have a weak solvency position have less scope to accept fluctuations in asset values. Thus more volatile assets represent a greater risk to such a plan.

Plans that are well funded and/or solvent have a "cushion" that may enable them to accept the greater volatility of some asset classes in the search for the higher returns offered by these types of asset.

It is clear from these considerations that the prioritisation of investment objectives and the determination of a suitable long term strategy depends crucially upon the circumstances of the individual pension fund. It is also evident that the available asset classes may present different attractions to pension funds, depending on their stage of development.

The Pensions Act 1995 requires each group of Trustees to set out a statement of Investment Principles for their pension fund, with effect from April 1997. This statement will provide the Trustees with an opportunity to record any unique features of their pension plan.

2.1.2 The Pension Fund Investment Process

We now look at the process by which pension plans determine their investment strategy in order to meet their objectives. The investment portfolio held by a pension plan will depend on decisions made at three levels:

- **Strategic asset allocation**

  This represents the long-term asset allocation, or benchmark, of the fund. This benchmark will, explicitly or implicitly, set out the allocation of assets to each of the major asset classes.

- **Tactical asset allocation**

  This is the difference in asset allocation, over the shorter term, from the strategic position.

- **Stock selection**

  This refers to the choice of individual holdings within an asset class.

Various academic studies (eg. Brinson, Singer and Beebower USA 1986, 1991) have shown that the key determinant of long term performance is the strategic allocation. Trustees should thus give careful thought to the most appropriate strategy for their fund and ensure that the strategy followed is commensurate with their objectives.

Trustees have a range of choice in how they wish to set their investment strategy. At one end of the range, they can set a specific benchmark allocation which includes or excludes an allocation to property. At the other end, they can give the investment manager full discretion. In this latter case, the strategy is usually set by the investment manager relative to an implicit benchmark of the consensus, or average fund.

Where the investment manager is given full discretion over the asset mix, the manager's "strategic" allocation to property will depend largely on:

- The manager's investment philosophy; ie whether the manager views property as a suitable asset class for pension funds.

- The suitability of the vehicles available to the manager to effect any investment in property.

A considerable number of fund management firms specifically exclude or have a very low allocation to property in their discretionary balanced portfolios because of either or both of these factors. (We comment further on this in Section 3.1.6).

The key alternative to the discretionary approach is for the trustees to determine a pension fund's strategic asset allocation. While the ultimate decision on the strategic allocation rests with the trustees, they will usually arrive at their decision after consultation with one or more of the plan's actuary, investment consultant and investment managers. In doing this, the trustees will usually be seeking to determine a strategic asset allocation benchmark, tailored to their specific objectives and taking into account the individual circumstances, of their plan.

Since the impact of investment strategy on meeting plan liabilities is so significant many groups of trustees have wished to investigate the relationship between asset and liability growth in some detail. Asset liability modelling techniques have been developed by firms of consulting actuaries and investment consultants in order to allow this type of investigation to take place.

An asset and liability modelling study typically uses liability data from the actuarial valuation. There is in practice a variety of approaches to this type of modelling which may differ significantly in their stage of development and sophistication.
The more sophisticated models usually involve projections of the plan's membership and the resulting accrued liabilities, together with projections of the assets invested in a variety of alternative strategies. Increasingly the leading providers are developing models which

carry out projections performed under a variety of different economic environments generated by proprietary economic models.

By using asset liability modelling techniques, it is possible to estimate the expected return of a strategy (and its impact on the future funding level), and the risk (uncertainty of the future funding level) for a range of possible investment strategies. The more statistical of these techniques allow the identification of 'efficient' strategies; ie strategies which, for a given level of expected return, minimise the associated risk. The trustees may then choose the strategy which offers the most acceptable trade-off between risk and return.

The key to the allocation of assets under this approach is the modelling process used and the investment assumptions used for individual asset classes.

In general terms property does not lend itself well to the modelling process (see Section 2.1.5 below) and the allocation to property is often arrived at with a 'subjective' overlay.

2.1.3 Pension Fund Investment Requirements

From comments in previous sections it can be seen that a pension fund may have any or all of the following requirements from its investments:

- **Asset Growth** — The returns on investments should match, or exceed, the growth in the liabilities, in order to keep funding costs down. This is particularly important for a plan where the bulk of its liabilities are for active members and have a long timescale for investment

- **Stability of Value** — The investments should have stable values relative to the plan liabilities. Fluctuations in asset values can make funding levels, and contribution rates, unpredictable.

  Stable values are particularly important to a plan which has a weak solvency position.

- **Income** — The investments should generate income. For schemes with a high level of benefit outgo, it is often desirable for the assets to generate income in order to meet that outgo.

- **Liquidity** — The investments should be realisable over a suitable period of time. This is particularly important for a mature scheme where assets may need to be realised in order to provide cash for benefits.

The relative importance of each of these factors will depend on a pension plan's circumstances. For most plans however the two key factors are real growth and the stability in value relative to the liabilities.

2.1.4 Characteristics of Main Asset Classes

Let us now look at the characteristics of the main asset classes and assess their appropriateness for UK pension funds, given these requirements.

The main asset classes used by UK pension funds are:

- **Equities** — These offer, over the long term, the highest *expected* return of the available asset classes. For this reason they are the most suitable asset for meeting the liabilities for active members which are linked to final salaries. They are however, a volatile asset class, the impact of which is felt particularly over shorter term periods. Overseas markets offer diversification and wider investment opportunities, although are themselves more volatile (partly due to currency risk).

- **Fixed interest** — We refer here principally to securities issued by the UK Government. The expected return on fixed interest gilts is lower than on equities. They do, however, if held to redemption, offer an excellent match for pensioner and discontinuance liabilities for plans which do not provide fully index-linked pensions. Overseas bonds can offer scope for tactical gain.

- **Property** — See Section **2.1.5** below.

- **Index linked gilts** — The expected return is again relatively low. There is, however, a guaranteed return relative to inflation, so that, if held to redemption, these represent probably the lowest risk asset class for salary-linked liabilities.

- **Cash** — Has stable capital values but produces relatively poor long term returns. It can be used as a tactical asset but is essentially a poor match to the long term liabilities of a pension fund.

2.1.5 Characteristics of Property

The relative investment characteristics of property as evidenced by past data are examined in some detail in Section 2.3 of this report and therefore their treatment here is relatively brief.

Most advisers would place the long term expected return on property somewhere between that on equities and that on the other asset classes mentioned above. Property has traditionally been regarded as an "equity type" investment and therefore seen as offering some long term protection against inflation. However, the exclusivity of that role has diminished with the availability of index-linked gilts.

Property appears to have a greater stability (lower volatility) than equities. There is a number of potential reasons for this. Firstly the income on property assets tends to be more stable than for other asset types (see Section 2.3). Secondly the valuation process incorporates a smoothing effect (see Section 5.2). However one of the difficulties here is that property valuations are less frequent and arguably more "subjective" than other asset classes such as equities and bonds. There is a considerable case, however, for seeing property as a diversifying asset, since it reacts differently from equities to the various stages of the economic cycle (in technical terms, property is lowly correlated with equities).

While property appears to acquit itself well in terms of asset growth, stability of values and diversification, there are a number of other features which have a bearing on its use in pension fund portfolios:

- **Liquidity**

  Property is seen as a relatively illiquid asset class in relation to stock exchange assets in that there is no continuously available traded market in property. Furthermore it takes some considerable time to complete purchases and sales and they are generally available only in large unit sizes. Consequently the price achieved upon sale may differ from the previous valuation.

- **Valuation**

  Property valuations are seen as problematic by pension funds in that they are not instantly available and incur significant professional charges to produce. Furthermore, as property investments are heterogeneous, valuations are possibly more subjective than with other asset types (see Section 5.2).

- **Ease/Costs of Management**

  Property is relatively time consuming and costly to manage (see Section 3.1.4).

Property fits uneasily into the type of asset liability modelling mentioned above. This is for two key reasons:

(i) The historically poor amount and quality of past performance data. This means that the assumptions for property are perhaps more open to doubt than with other asset classes. This problem is being addressed by the property industry and the contents of Sections 2.3 and 5.3 outline the steps possible at this stage.

(ii) The nature of property investment. The optimisation process underlying asset liability models can, if unconstrained, produce high weightings to property. This is because the available data described in (i) usually emphasises the attractive features of property: namely the positive real returns and the diversification from equities. However, these models do not always incorporate an adjustment for the other features of property such as the lack of liquidity, subjectivity of valuations etc. Indeed one of the areas that is receiving further attention is whether suitable adjustments can be made in respect of these factors and if so how much adjustment should be made.

For these reasons asset liability models cannot arrive at a "scientific" and precise allocation to property. More than with any other asset class, therefore, the allocation to property is often arrived at with a "subjective" overlay. The trustees' views on the suitability of property and its ease of management thus become significant factors in determining the final allocation to property.

2.1.6 Proportion of Property in Pension Fund Portfolios

There are two notable trends in property weightings in pension fund portfolios:

(i) There is a significant difference in property weightings between large and smaller pension funds. In general, large pension funds have a higher exposure to property than small and medium size funds.

There is a variety of yard sticks which indicate pension funds' exposure to property. These yard sticks differ significantly in their property weightings. The two main surveys of pension fund investment trends and performance are CAPS (Combined Actuarial Performance Services Limited) and the WM Company.

The performance monitoring service provided by CAPS covers some 1592 pension funds with a total value of around £247bn. CAPS publishes an unweighted arithmetic average asset distribution which indicates an average holding in property of just 2.2% at 31st December 1995. On a weighted basis, however, the proportion is 3.5%.

The service provided by WM Company includes some 1455 pension funds with total assets of £375bn. The weighted average holding in property across all funds in the WM sample is 5%, while the top 50 funds in size have an average holding of just over 7%.

(ii) Both large and small pension funds have seen their weightings to property fall significantly over the last fifteen years. This has been for two key reasons:

- **Performance.** During the 1980's property produced poor performance relative to other asset classes. The effect of relative market returns alone has been to reduce the weighting to property.

  Furthermore pension funds with high property weightings saw their performance suffer relative to other funds with low or zero property weightings. Many pension funds responded by reducing or eliminating their property exposures.

- **Liquidity**. The difficulty experienced in disposing of property has led some pension funds to retain a relatively low weighting, even where prospects for property have improved.

2.1.7 Defined Contribution Plans

Defined contribution plans operate on a wide variety of bases and it is therefore not possible to cover all of the aspects here. In general, however, it appears that few defined contribution plans have significant investment in property. This is for two main reasons: (i) administration and (ii) strategy.

(i) **Administration**

A central concept in the investment of defined contribution plans is the allocation and investment of monies to each individual member's account.

In order to determine the value of and administer an individual member's account the scheme administrator needs access to recent and reliable valuations of the invested assets and the ability to carry out transactions within a relatively short time frame.

Furthermore the valuations of individual member holdings need to reflect the gross accumulation (ie including income and tax reclaims) of the asset value.

A directly invested (or segregated) portfolio of properties would present considerable problems in relation to these needs. Certain unitised property vehicles (eg life office property managed funds) do go some way to addressing these problems in that a "gross" unit price is quoted on a regular (monthly) basis. However these funds can still be subject to significant delays in redemptions in depressed market conditions.

(ii) **Strategy**

In terms of investment options offered to plan members, property may play a role, for example in balanced portfolios. Here property provides stable unit values which is an attractive feature in defined contribution plans.

However, where the members are offered specific investment options property may be excluded for the reasons set out above. Thus, those members at the early stages of their career will be encouraged to opt for growth through investment in equities. Those closer to retirement will be offered fixed interest investments in order to protect against fluctuations in annuity rates, and cash investments in order to build up and protect the value of a cash lump sum.

Thus, property to date has had a relatively limited investment role in defined contribution plans. Furthermore the administrative difficulties in particular indicate that property may be likely to continue to be at a disadvantage.

2.1.8 Conclusion

We conclude that property is a valid asset class for pension funds and can bring useful diversification to pension asset portfolios. It is particularly useful as a strategic asset but suffers considerable drawbacks from a tactical point of view, compared to traded securities.

However pension funds have reduced their holdings in property to extremely low levels and many funds have a low or zero weighting to property.

Furthermore, where trustees have set their own asset allocation benchmarks, the difficulties in integrating property into asset and liability modelling studies has led to trustees making subjective overlays to the allocation to property.

The key steps required if property is to take a significant role in the future investment of pension assets for defined benefit plans are as follows:

1. The management difficulties of property investment highlighted earlier need to be addressed (see Section 3).

2. The treatment of property in asset/liability modelling studies needs to be further developed.

Furthermore, the property industry needs to address whether the administrative requirements for defined contribution plans can be met so that property can play a role in investment strategies for these plans, which are attracting substantial sums for investment.

2.2 Property and the Minimum Funding Requirement (MFR)

2.2.1 Issues

- **Is property in the benchmark set by the MFR for assessing pension fund liabilities?**

  No

- **Does it matter?**

  Yes, if your fund is getting close to the 90% funding level where a mismatch in the short term might put you below this level and require an injection of additional funding.

- **Is the MFR benchmark a model for investment strategy?**

  No. Pension funds still can and do make their own minds up.

- **So, are the advantages and disadvantages of property any different?**

  No, but property's investment characteristics need to be put into the context of the MFR parameters.

2.2.2 The Minimum Funding Requirement

The Pensions Act was passed on 19 July 1995.

The Act introduces the Minimum Requirement for pension funds. The aim is to give some protection against a significant degree of under funding where a scheme is wound up unexpectedly, without imposing an unnecessary cost or regulatory burden. The ability of pension funds to meet their commitments is to be assessed annually by an actuary who will value the assets and liabilities on a prescribed basis.

The MFR sets a funding test which is intended to:

a. provide a measure of the extent to which a scheme's liabilities are covered by its assets;

b. specify a level of cover below which corrective action should be taken; and

c. set out arrangements for taking corrective action

If the ratio of the funds' assets to its liabilities is less than 100 per cent, but greater than 90 per cent, action will be required to bring the level up to 100 per cent within five years. Where funding is less than 90 per cent, additional contributions from the sponsor will be required within one year to achieve the 90 per cent standard.

The detailed framework for calculating funding levels was the subject of consultation in January 1996 and has yet to be finalised. However, it is proposed that solvency will be determined with reference to the expected returns from a benchmark portfolio of assets. The proposed benchmark will consist only of UK gilts and UK equities. Other assets, such as overseas equities and property, are to be excluded.

Simplistically, the liability of active members will be based on the expected returns of UK equities. Pensioner liabilities will be based on the expected returns of UK gilts, although larger schemes will be allowed to use expected equity returns for 25 per cent of liabilities.

Officially, property is excluded from the MFR according to the D.S.S. for "good practical reasons" as there is "no clear source of information on which to base a property index that could apply to all schemes". The use of rates of return on equities and gilts is intended to provide an objective method of valuing liabilities. The original proposal was for the MFR to be solely based on gilts and inclusion of UK equities is still regarded as a major concession by many actuaries.

The liabilities will be compared with the market value of all assets held. However, it is to be assumed that the value of liabilities will fluctuate in line with the value of the assets in the prescribed MFR benchmark, but this is not so for excluded assets. The risk from holding excluded assets will therefore be a potential mismatch between a prudently diversified portfolio and the MFR benchmark. In effect, this means that, for example, property's out performance in 1994 would count for nothing.

However, when values fall, as in 1995, liabilities will remain constant (or increase in line with rise in equity values) but the funding position of the scheme will worsen.

These are the brief facts; the implications of the MFR on property remains largely a matter of conjecture. The Government's line is that the benchmark is purely a simplified method of measuring the value of liabilities.

It is not intended to influence investment strategies and indeed, to include all accepted asset classes in such a benchmark could be interpreted as the Government promoting a model portfolio. The DSS have relied heavily on their recent survey which showed 86 per cent of pension funds to be fully funded and therefore having no need to alter their current asset allocation strategy. Whether or not these schemes intended to maintain this level over funding was not examined.

Others, including the Forum, have argued that the MFR introduces a conflict between a new and unwelcome short-term volatility that penalises prudent longer-term strategies, where wider diversification is used to reduce the volatility of an investment portfolio. It is only to be expected that corporate sponsors will wish to avoid the financial penalties of an under-funded scheme. Portfolios in danger of reaching the critical point of 90 per cent funding will therefore tend to move closer to the MFR benchmark in order to avoid this new risk.

Other theories suggest a need for greater diversification (and therefore perhaps an increased weighting to property), in order to reduce the overall volatility of a scheme, particularly as trustees are required to prepare, annually, a five year contribution schedule that is expected to maintain the funding level of a scheme.

Against that, quantitative modelling, to try to match excluded assets with the MFR benchmark, finds (not surprisingly) little correlation between property and UK gilts and equities, i.e. a mismatch. On this basis, property's greatest strength, the ability to diversify, would now become a liability. This prompted the Forum's Research: Attitudes of Pension Funds to Property.

At the present moment, only time will tell, particularly as many of the provisions do not come into effect until April 1997. Whilst there has been a wide discussion of the potential impact of the new regulations, little original research has focused specifically on property. In the second half of 1995 the Forum commissioned an independent survey and research conducted by City University Business School. A targeted questionnaire was sent to senior pension fund advisors and administrators to determine their views on the potential effect of the MFR. This was followed by a series of in-depth interviews to enable the key issues to be pursued in more depth.

Responses covered an estimated 60 per cent of the pension fund universe, amounting to some £282 billion worth of investment assets, including £15.5 billion allocated to property.

The results, published in January 1996 under the title "The Pensions Act 1995 and Property Investment" identified a range of views:-

- 83 per cent of respondents felt that the portfolio diversification characteristics of property were important. The relatively low volatility of property returns and its low correlation with other asset classes was regularly highlighted.

- Over 80 per cent of respondents regarded UK and overseas equities as being more volatile than property.

- 49 per cent of respondents viewed the volatility of conventional bonds as being greater than or equal to that of property (they are, in fact, more volatile measured over the long term).

- 67 per cent of respondents felt that long-term liability matching was important in the context of property. Property was seen to offer the benefit of a secure income stream.

- However, 75 per cent of respondents regarded illiquidity as an important issue. Property was regarded as illiquid because of its indivisibility, the perceived difficulties in buying and selling and the time taken to complete transactions.

- NOTE: The questionnaire was carried out before it was conceded that property could, like all other assets, be valued on an open market basis and concerns over illiquidity may have been overstated. However, the MFR could compound the problems of illiquidity. Investors may be tempted to invest in property to benefit from a rising market. Now, they could be deterred from doing so if they are unable to move quickly out of a sector that they expect to fall, in order to avoid the consequent impact of falling market values on their short-term funding position.

- Whilst 51 per cent of respondents expected the MFR to have a neutral effect on their property allocation, 41 per cent expected to be net disinvestors. Then again, 71 per cent expected to disinvest from UK equities and 79 per cent from overseas equities.

One thing from the survey which could be significant is that property was seen to offer the benefit of a secure income stream. There was recognition that property had some bond like attributes but despite this, it was still widely regarded as an equity.

There has also been the suggestion that for larger schemes, property would be an ideal match for the 25 per cent of pensioner liabilities which can be linked to the expected returns of UK equities.

The higher yielding characteristics of property (relative to gilts and equities) are plain to see and many argue, will be a feature of the sector for the long-term ie. there has been a structural change in property performance. However, this "new" characteristic is not reflected in the historic sector data which is used for asset/liability modelling and this requires a view to be taken of future prospects.

An important conclusion of the research was a need for greater recognition of property's stable, secure income characteristics and the opinion that a wider use of fund specific benchmarks could lead to a comparatively higher weighting in property.

If, as some predict, the Pensions Act and MFR will be a further spur for the move towards defined contribution and money purchase schemes, the characteristics of property will preclude such schemes (particularly those which allow members to select their own portfolios) from choosing property as an asset class, despite the long-term benefit, unless new tradeable and liquid methods of investing are created which meet the requirements of these schemes. The Government has consistently refused to grant the minor regulatory changes to allow tax neutral direct property funds to be quoted on the London Stock Exchange. Without such a vehicle, there is no choice for an increasingly large proportion of the private pensions sector which the Government wishes to see grow. Finally, however, there is a suggestion that the time may be approaching when this may be possible and the Forum is active in promoting such a change.

Finally, it is ironic to return to the Maxwell saga and reflect upon the whole reason why the Pensions Act and MFR were spawned in the first place.

The one asset which could not be "lost" from the pension fund was\ good old, lumpy, illiquid property where Title is registered and proof of ownership paramount! The lengthy and cumbersome transaction process makes fraud or theft very difficult. The existence of this baby should not be ignored when changing the bath water.

3. PERFORMANCE OF PROPERTY

Future performance is a central issue for Trustees, especially the relative performance of each asset class. Whilst we would all like to see the future with the clarity of hindsight, the past is unfortunately not a reliable guide but is all we have to go on. UK Pension Funds were first permitted to invest in property in the 1960's so in looking back at performance we have focused on the long run as well as the recent past so as to capture as much information as possible.

This chapter looks at the past performance characteristics of property since 1962. On the basis of this evidence it goes on to make an assessment of prospective property returns and its risk diversification qualities. Summary findings in relation to these issues are set out below.

- **What has been the long run performance of property, both direct and indirect?**

Over the 1963/95 period directly held property investments have shown a return of 13.9% pa. Since 1970 direct property has out performed property shares by 0.8% pa despite the availability of gearing to property companies. Returns to direct property and managed funds/property unit trusts are similar over the last 20 years, after an allowance for management costs is made.

- **How does property performance compare with other asset classes and inflation?**

From 1963 to 1995 we estimate that direct property showed a real return of 6.3% pa. During this period all forms of property investment have been out performed by UK equities. Since 1963 equities' margin of out performance over direct property has averaged 0.8% pa. This margin has been substantially higher in recent years. Over the last ten years UK equities have out performed property by 5.5% pa.

However, a portion of property's underperformance may be attributed to the practice of calculating returns on the basis of income being received annually in arrears instead of quarterly in advance as is normally the case. We estimate this practice underestimates property returns by between 0.3% and 0.5% p.a., depending upon the period under analysis.

Direct property investment has out performed government stock and cash since 1963 but all forms of property investment have tended to underperform more recently, the main exceptions being 1987, 1988 and, most recently, 1994 when property was the best performing asset class.

Rising yields have persistently eroded returns to property since 1981 when property yields were less than equities. By 1995 property income returns were 7.8% compared with equity yields of 3.8%.

- **What risk diversification benefits has property provided?**

Although showing lower returns than equities, property has offered investors an effective form of diversification from fluctuations in equity markets. The correlation of total returns to direct property against equities is lower than either gilts or property shares; only cash showed a lower correlation, but with a lower long run return. Over the long run rental growth hedges property's income flow against inflation in a way that conventional gilts cannot and at a significantly higher yield than has been available from index linked gilts.

Two forms of benefit derive from these characteristics. Firstly property tends to stabilise the overall value of portfolios in which it is present, reducing the probability of underfunding (although not necessarily "apparent" underfunding in terms of the Minimum Funding Requirement). Secondly, property's higher yield and stable flow of income is attractive to maturing schemes who need predictable sources of investment income to supplement contributions, reducing the risk associated with selling assets to meet current liabilities.

- **What are reasonable assumptions to make about prospective property returns for the purpose of strategic and tactical asset allocation?**

On an historic basis, going back as far as is practical in data terms (1963), property's returns have averaged over 6% pa net of inflation. This is lower than equities but higher than fixed gilts. It has provided an average long term income return of 6.1% pa whilst income growth has matched inflation over the period as a whole. Strategically, real returns in the order of 6% p.a. seem a reasonable starting point for expectations for the future.

However from the tactical viewpoint based on end 1995 yields, prospective returns are higher. The end 1995 income return on the IPD Index was 7.4%. If the relationship between income growth and inflation continues in the long term (as it has in the past) this would point to a prospective long run real returns averaging over 7%.

3.1 Property Returns Compared

Table 1 compares past returns to direct property with other domestic asset classes and inflation over the past 33 years. Direct holdings have been taken to represent the property sector as most pension fund property assets are held in this form and it is represented by the longest run of return data (see note 1, Appendix B).

TABLE 1: PROPERTY PERFORMANCE COMPARED (% pa geometric means)					
Asset Class	**1963/95**	**1966/75**	**1976/85**	**1986/95**	**1995**
Direct Property [1]	13.9	16.5	14.3	9.4	3.5
UK Equities	14.7	9.3	22.3	15.0	23.1
UK Gilts (Fixed)	9.4	3.4	15.7	11.7	19.0
Index Linked Gilts	n/a	n/a	n/a	7.8	12.0
Treasury Bills	9.4	7.9	11.7	10.1	6.7
Inflation (RPI)	7.6	9.4	10.0	4.6	3.2

Note [1] based on returns calculated with income received annually in arrears

Sources: IPD, BZW Equity-Gilts Study 1966

Over the 33 years property has shown 6.3% pa after inflation and has marginally under performed equities. However this margin of under performance widens in recent years. Over the past decade property has shown 4.9% real but lags 5.5% pa behind equities. It has also been out performed by fixed gilts and Treasury Bills.

3.2 Property Returns Analysed

Detailed and consistent analysis of the components of property returns is only available from 1971, the beginning of the IPD data series (2). They are set out in Table 2, expressed in consecutive five year averages for concision. The decline in relative performance was due to a marked slowing in capital growth in the 1980's followed by a 13% capital loss in the most recent five year period.

Table 2 components of property returns 1971/95

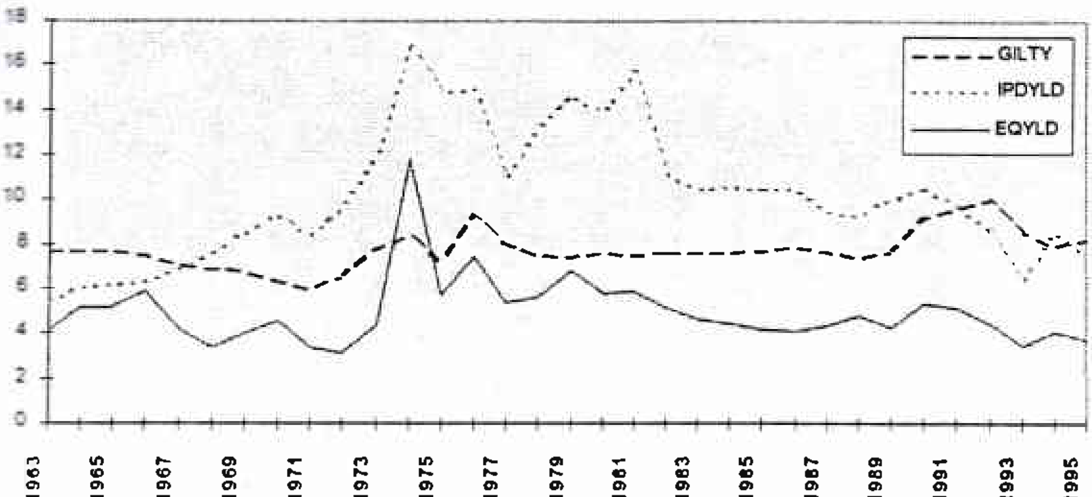
% p.a. geometric means

	Returns			Income Growth			
Period	Total	Income	Capital	Rental	Dividends	Inflation	Fixed Gilt Yields
1971/5	12.3	4.9	7.3	14.0	7.4	14.1	12.2
1976/80	19.7	6.1	13.6	8.5	14.0	13.5	13.5
1981/5	9.1	5.8	3.4	5.0	10.8	6.6	11.7
1986/90	13.3	6.0	7.3	13.7	14.7	6.2	10.1
1991/5	5.5	7.8	-2.4	-5.9	3.8	3.0	8.5
1971/95	11.9	6.1	5.8	6.8	10.1	8.6	11.2

This fall in capital returns was due to a failure of market rents to match inflation after 1975 (with one exception in the late 1980s), in marked contrast to equity dividends (see above).

The failure of market rental growth to match inflation first became embedded in investor expectations in the early 1980's, a period of oversupply and recession. Whereas equity dividends more than shared in the ensuing recovery, rents did not and this began to have two negative impacts on capital returns. The first was via a slower rate of net income growth which at 9.2% pa 1981/5 was only higher than rental value growth because of reversions built up in the 1960 and 1970's slowly unwinding. Slower income growth directly translates to slower capital growth. The second impact was via yields. If growth in rental values could not match inflation or dividend growth, then investors would look elsewhere, to equities, the newly opened overseas markets (1979) and to index linked gilts (1981). Property yields rose, a trend reflected in the rising average income yields shown in Table 2. The late 1980's boom interrupted the trend with higher rental growth but was matched by higher dividend growth, and yields on property did not come down. The 1991/5 period has been a more extreme re-run of the 1981/5 period with market rents falling by nearly 6% pa and yields returning to their upward direction until 1993.

FIGURE 1: COMPARATIVE ASSET YIELDS 1963/1995



To illustrate the point, whereas in 1971 the income yield on the IPD sample was 6.0% compared with 8.3% gross redemption yields on gilts, by 1995 property's income yield had risen to 7.8%, as against 7.6% on gilts. The rise in yield shown in Figure 1 above has been the equivalent of taking 1% off values each year since 1971.

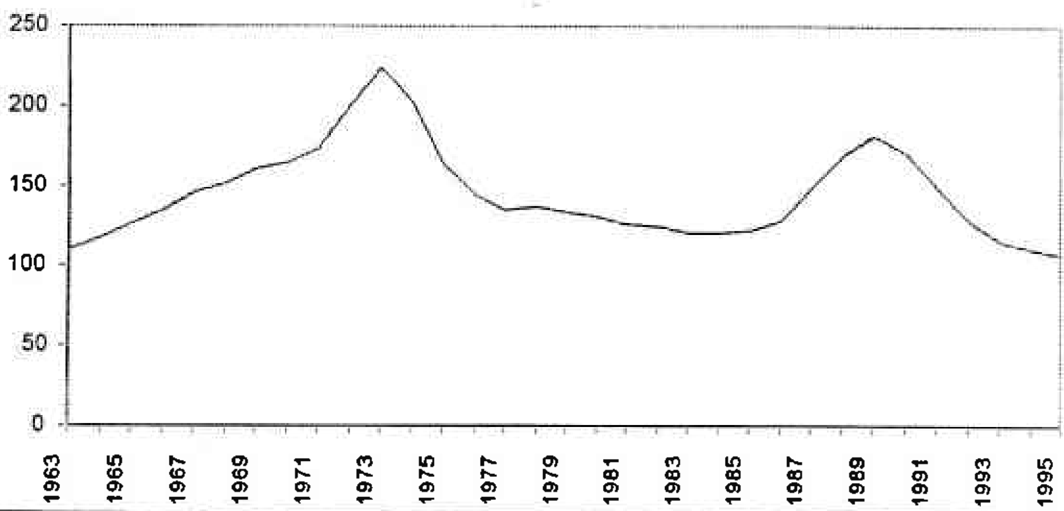
Over the 25 year period property's returns can be analysed into their component parts as follows:-

	1971/95
income	6.1% pa
rental growth (3)	6.8% pa
yield shift	-1.0% pa

Total return	11.9% pa

Why did rents fail to match inflation after 1975? Probably because they started from too high a level. Between 1962 and 1970 IPD estimate that market rentals grew by over 11% pa compared with inflation of under 5% pa. Rents had been forced up by a combination of strong +3% pa) growth in output and limited supply; the Government had imposed a policy of severe planning restraints on office and industrial development in the South East, known as The Brown Ban after George Brown its instigator. By the early 1970's rents were standing in real terms at levels that would be scarcely equalled 15 years later (see Figure 2 below).

FIGURE 2: TRENDS IN REAL RENTS 1963/1995



Rental growth in excess of the total level of general inflation and real economic growth cannot be sustained indefinitely and it was inevitable that rentals would correct; with the benefit of hindsight it was a case of "not if, but when". In fact 1973 was the apogee for real rents; after the first oil shock nominal rental growth was exceeded in all but one year by inflation until 1984.

The building boom of the mid 1980's hastened the process by further eroding the supply controls that had sustained rents. The provision of 'planning free' Enterprise Zones and Development Areas, a loosening of controls over out of town development and changes to the Use Classes Order facilitated a major development boom and the eventual oversupply of space. In the 1990's nominal rents fell and property yields rose to a peak in 1992 since when they have tracked (imperfectly) gilts downwards, most notably in 1993/4. (See Figure 1).

3.3 Long run expected performance

The critical issue now is whether the long process of de-rating in property yields is over. On the positive side the future is unlikely to be a mirror of the last 10 years. Property's relative fall in value was due to a number of factors, many of which cannot be reasonably expected to be repeated:

- overseas investment cannot be further encouraged than it has been by government policy unless it chooses to subsidise investment abroad.

- the rapid growth in equity dividends in the 1980's reflects in part their recovery from dividend restraint in the 1970's. This cannot be repeated.

- inflation and bond yields are unlikely to fall again in the way they did between 1981 and 1995, without rising again first.

- the relaxation of planning constraints cannot be repeated.

On the negative side oversupply has led to tenants being able to negotiate shorter leases and the binding commitment of a lease on the occupiers has been made less onerous by the relaxation of privity of contract. Oversupply has also highlighted the impact of obsolescence on values as it did in the early 1980's.

So what clues does the evidence of the past offer us about prospective returns from property?

One way of estimating long term prospective returns is to equate them with initial yield and subsequent earnings growth less any non-recoverable outgoings (4). This assumes that in the long run yield shift does not add to or subtract from returns.

Historically property's income yield has averaged 6.1% between 1962 and 1995. It is currently estimated to stand at around 7.4%, ignoring unsecured income in excess of current market rentals.

Over the 1963/95 period market rental values grew on average by 8.2% pa, 0.5% pa ahead of inflation. While the year to year correlation between rental growth and inflation has been low (r=.12), on a rolling 15 year basis it was much higher (r = .78). Looking forward it is reasonable to suppose that rental growth will continue to match inflation over the longer term because we have no reason to suppose that especially from its cyclically low 1995 base, the costs of providing space will fall long term relative to other prices.

In performance terms, if we assume that net income growth lags .3% pa behind market rental growth because of the stepped effect on cash flow of rent reviews (5) then real net income growth will be around zero. Taken with yields above 7% at end 95 levels this points to a prospective long run real return of over 7% pa from end 1995 values, or around 6% pa based on 1963/95 average yields. This would suggest property is, at end 1995 prices, underpriced.

3.4 Alternative Forms of Property Exposure

Although most pension fund assets are held through the direct ownership of buildings and land, exposure has, for some time, also been derived through property unit trusts (PUT's), managed funds and holding shares in quoted property companies. The past performance of the main types of ownership are summarised in Table 3 and show in more detail in Appendix 1.

Data on indirect forms of property investment open to pension funds do not extend back as far as direct property, but the table below compares returns for successive five year intervals as far back as 1970 when total return series for property shares begin. Combined data on PUT's and managed funds compiled by UBS Phillip & Drew commenced in 1973.

TABLE 3: PAST RETURNS TO ALTERNATIVE FORMS OF EXPOSURE

Type of Exposure	1970/95	1970/5	1976/80	1981/5	1986/90	1991/5	1995
Direct Holdings	12.3	14.1	19.7	9.1	13.3	5.5	3.2
Property Shares	11.5	7.3	24.3	12.4	11.3	4.2	5.7
PUTs/Funds	n/a	n/a	18.8	9.3	12.0	5.6	3.2
RPI	8.6	13.0	13.5	6.6	6.2	3.0	3.2

Note: Returns are geometricx means, income reinvested
Sources: IPD, Datastream, UBS Philips & Drew, 1996

Ordinary shares in quoted property companies have shown investors returns of 11.5% pa since 1970 when data on this sector commenced. In comparison, over the same period direct property averaged 12.3% pa. For 0.8% pa lower returns property shares offered a higher level of liquidity but at the "cost" of higher volatility.

Performance of PUTs/funds has closely tracked direct property. The differences are insignificant taking into account sampling error and the treatment of central management expenses (6).

3.5 Why Did Pension Funds continue to Hold Property?

The trend in pension fund exposure to property has fallen from 18% of assets in 1981 to 5.5% at the end of 1995. Superficially this is to be expected, given the relative trend in returns, but in fact the decline is less than it might have been.

Working purely on the basis of equity and property values a passive investor holding 18% in property in 1981 and 82% in UK equities would have found his property exposure only 8% by 1986 if his portfolios had tracked market indices. In fact the average holding then was still 13%, which implies that funds had continued to be net cash investors in property. Net investment by pension funds in property indeed was positive in every year from 1981 to 1993 according to IPD. Only in 1994 did the trend turn negative.

In the short term this could be explained by forward committed expenditure for example on developments, or on relative illiquidity: but these are unlikely to be the real reasons over 12 years to 1986. There could have been no liquidity problems for those selling in the boom period of 1986/88, a time when net investment by pension funds rose to a peak of over £0.5 billion pa.

The reluctance of pension funds to disinvest actively from property over the 1982/94 period can only be rationally explained if we assume that funds' asset allocation is influenced by more than just historic returns. Investors carry a view as to long term expected performance which only modifies slowly, and which prevents significant reallocation away from under performing assets in the short term. In other words they seek a degree of diversification to lend stability to overall portfolio returns/asset values.

3.6 Reduced Portfolio Volatility

Some investors and their advisors measure the benefit of such diversification in terms of reduced volatility in portfolio returns. Those seeking to diversify will be drawn towards assets showing relatively stable returns and to an extent towards those assets whose returns do not closely mirror equities, the dominant asset in UK pension fund portfolios. Property has been and is such an asset.

Table 4 shows the volatility of the main asset classes returns over the 1963/95 period and the degree of correlation between assets.

TABLE 4: CORRELATION BETWEEN ASSET RETURNS 1963/95
(annual data arithmetic means)

Asset	Mean % p.a. return	SD (volatility)	Correlation (r) with		
			Gilts	Cash	Property
Equities	18.5	32.0	0.64	0.03	0.13
Gilts	10.3	15.1	1	0.19	-0.06
Cash	9.4	3.4		1	-0.40
Direct Property	14.4	10.7			1

Note: see technical notes 7 & 9
Source: IPD, BZW

The volatility of property is significantly lower than equities or gilts, even after allowing for its lower average returns. Superficially this would suggest property is lower risk than equities and gilts (7).

But there is a problem - while cash, equity and gilt returns are based on market traded prices, property returns reflect values. As a result there is the probability that appraised values lag events in the property investment market and, relative to the equity and gilt valuation processes, tend to smooth the "true" ups and downs of the market. Thus the unadjusted standard deviation most probably understates the relative risk to property. Research in this area is fraught with difficulty as it is not possible in practice to compare valuation and sale prices at the same date on an equal footing (8).

3.7 Why Property Returns should be Smoother than Equities

However even though the valuation process itself may produce capital returns which are smoothed compared to equities, there are features of property itself which do genuinely contribute to more stable returns:

- property portfolio income streams are inherently more stable than dividends because in nearly all institutional types of property, rents are fixed for five year periods. Between 1971 and 1995 property income growth averaged 8.7% pa with a Standard Deviation of 4.6% compared with dividend growth of 10.3% pa with a Standard Deviation of 7.6%.

- in most cases rents are reviewed on an "upwards only" basis. Compared to shares it is therefore rare for property income as a whole to fall and this has not happened in the last 25 years. This feature of property leases is currently the subject of discussion but is unlikely to lead to the retrospective alteration of existing leases. However, a low inflationary environment and an oversupply of vacant accommodation in some locations will lead to some sections of the market showing declining rental values which will impact income when properties are re-let on new terms.

- direct property investment is not geared in the way equity investments are (including property shares). Corporate borrowing may have raised equity returns to shareholders long term but they also make their valuation more volatile.

Because rental income is smoothed in comparison to dividends by the terms of the typical commercial lease it is hardly surprising that valuations of that income stream are relatively less volatile, and the absence of gearing in directly held property will similarly lead to a smoother trend in returns.

The individual volatility of property is, however, not as important to its role in diversification as its correlation with the returns of other assets, especially equities. Holding assets whose returns do not mirror equities will dampen the volatility of the overall portfolio, making its returns more stable and reducing the probability of the scheme unexpectedly requiring additional contributions to meet its commitments, (there is an exception to this as a result of the artificial constraints of the MFR benchmark - see section 2.2).

The right hand side of Table 4 shows the degree of correlation between the main asset classes over the past 30 years. Gilts and equities show the closest correlation; the values of both are influenced in the same way by movements in interest rates. As interest rates fall, both benefit, which is in direct contrast to returns to cash. Property has had no correlation whatsoever with gilts and little with equities. This finding is robust for sub periods of the 1963/95 period and for return periods of more than one year e.g. 2-3 year moving averages.

Compared to gilts, property represents a more efficient form of diversification from equities. It has a lower correlation and has shown a higher average return than gilts or cash over the longer term. It should therefore be of interest as an asset class to pension funds and sponsors concerned to reduce portfolio volatility in a cost effective manner.

3.8 An Alternative View of Risk

Long term strategy for funds is increasingly founded on assumptions about future real growth, inflation and the shares of output enjoyed by capital and labour, all of which can exercise a strong influence on asset returns. Assumptions about future returns can thus be made on the basis of observed relations between past asset returns using assumed economic scenarios about the future. The risk in long term projections is that the unexpected is increasingly likely to happen, in particular:

- unexpected acceleration in real growth
- unexpected inflation
- increased share of output going to wages or to fund public spending, and away from corporate profits.

If growth is faster than expected then real salaries will be higher than expected. This will disadvantage assets whose returns do not share in growth, notably cash index linked and fixed interest bonds. Real assets such as property and equities should benefit from real growth and the benefits should be reflected in faster dividend growth and faster growth in occupational demand.

Similarly equities should be reasonably insulated from unexpected inflation as at least nominal profits will rise, as will property income and short term interest rates. Fixed interest bonds are the losers as they were in the 1960s although index linked gilts are largely insulated from inflation.

Perhaps the most dangerous event for UK pension funds with their high equity exposure is an unexpected shift in factor payments away from profits towards wages. This would put pressure on dividend growth and increase wages/liability inflation. Such an event occurred in the 1970s and it was the reversal of this process in the 1980s that contributed to equities' superior performance then.

Property stands up reasonably well to these potential risks. Unexpected inflation will eventually be reflected in high construction costs and thus higher rents; if wages take a higher share of output then at least retail rents would eventually reflect higher consumer driven turnover. All commercial sectors could be expected to benefit from faster real growth but development activity might erode significant growth in real rental values, depending on the political acceptability of development.

Compared to both equities and gilts which are adversely affected by at least one of the three above sets of circumstances, it can be argued that property is fairly robust. This robustness itself is a source of risk diversification to funds although it is not reflected in risk analyses based only on return volatility and asset return correlation.

4. INVESTMENT MANAGEMENT

4.1 Investment Management Approaches

It is frequently said that property investment managers or advisers should behave more like managers of other assets. This is so but it is also necessary for pension funds to embrace the changes in thinking necessary to allow this to take place. This section seeks to help both sides to reach this objective. A notable change in recent practice has been the emergence of appointments of managers with a mandate or the discretion to invest the whole or part of a portfolio in indirect form in indirect forms of investment. For example traditional property unit trusts or insurance fund holdings; shares in limited partnerships; quoted and unquoted property company shares; or the listed property synthetic "Property Index Certificates". These are described in detail in Section *. We welcome this as a logical and helpful development of services and does in itself introduce the need for a property investment manager to be registered with IMRO. The principles of the appointment of such a manager are the same as for a conventional direct property appointment but will stop short of the full depth of requirements set out here.

- **What is a Property Investment Manager's job?**

  - He is responsible for developing an investment strategy; reviewing tactics for new investment; taking action to optimise the performance of assets held; making sure all action including sales and purchases is implemented properly; overseeing the management of the assets by the property manager.

- **How do you choose one?**

  - You may use a consultant to advise on this but in any event, the most important thing is to make sure you know the kind of relationship and investment style you want. Then choose a manager who can deliver them and has the right investment credentials.

- **How do you know if the Investment Manager is adding value?**

  - Select a benchmark and measure his performance against a target. This may include services such as contribution to the asset allocation debate, efficiency of rent collection and ability to implement the investment plan as well as success in meeting conventional performance targets.

- **What other property services will you need to manage a direct portfolio?**

  - Property Management (including Rent Reviews), Sales and Acquisitions, Lettings, Building Consultancy, Development.

Whilst investment management is a well understood and established process in the securities field, the management of property as an investment as distinct from a physical commodity has been only developing strongly over recent years. Thus there are different approaches which can be taken towards the management of property as an investment and it is important that Pension Fund investors have an understanding of what these are and what are their respective characteristics and implications.

The processes of selection and appointment of a Property Investment Manager and the monitoring of his performance are also important and the implications of different approaches need to be considered carefully.

Investors should also be aware of other property services they will require and what the cost implications are.

These topics are considered below:-

4.1.1 Functions of the Property Investment Manager.
4.1.2. Investment Styles
4.1.3. Responsibility and Accountability
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4.1.1 Functions of the Property Investment Manager

The responsibility of a Property Investment Manager is the strategic management of money invested in property, directly and indirectly, rather than the management of property. Property management, on the other hand, means the care and supervision of buildings and the tenant relationship, including rent collection. It is clearly an important and essential part of the overall process of property investment but good performance mainly depends on timing of the initial investment, "buy/sell/hold/reinvest" decisions, portfolio structure and stock selection.

Property management and other related property services are discussed in Section 5.1.5 beneath. They may be carried out by the property investment manager or sub contracted elsewhere by him although they will still be under his control. With this sole exception, the whole of this chapter relates therefore exclusively to discussion of the investment managers role.

This role has evolved, over the past decade in particular, to model in many respects that of investment managers of other assets. The traditional "advisory" system with its concentration upon conducting transactions - especially purchases - with often only an informal approach to strategic and tactical issues and a lack of clearly ascribed responsibility still prevails with many funds. The limitations and potential difficulties of this approach are exacerbated where fees to the manager are based entirely on transactions. However this is increasingly seen as unsatisfactory, leading to change.

Before setting out alternative approaches to establishing a property investment management service for a pension fund, the overall function and role requires explanation. Issues such as the extent to which it should be in or out of house and the amount of discretionary authority which should be granted can then be fully comprehended.

The range of requirements of the role can be summarised as follows :-

- **Strategic**

  Strategy should be set by the fund in the context of its objectives, perhaps in consultation with its actuary. However, as in other asset classes, the Property Investment Manager will have valuable insights into the strategic level of decision-making, including :

  - In-put to fund's long term asset allocation decision process.
  - In-put to performance benchmark and target setting by the fund.
  - Development of long-term property strategy for portfolio structure and investment policy within the context of asset allocation decisions.

  The manager will need to work closely with the fund to agree upon the kind of portfolio they require to meet the fund's overall objectives taking into account, for example, investment horizons, risk and income versus growth issues.

- **Tactical**

  The fund may now turn over all tactical decisions in running the portfolio to the Property Investment Manager, as described in the brief overview of how the role has evolved. However, whether a manager has discretion or not, requirements will include:

  - In-put to fund's short-term asset allocation decision process.
  - Development of short-term investment plan to implement the strategy or to adapt it to short-term circumstances.

- **Implementation**

  - Active asset management of portfolio to enhance performance. This means, for example, seeking opportunities to add value by extending or improving buildings, marrying sites or interests in the property or by re-negotiating lease terms.
  - Making "buy, sell and hold" decisions either to reflect the needs of the portfolio or the specific asset.
  - Supervising provision of all relevant property services to ensure best results.
  - A good working relationship between the professionals involved is important and these interfaces need to work smoothly and efficiently.

- **Monitoring**

  - The appraisal of investment worth and asset review process: The manager should on a regular basis, value, appraise and review each property's prospects and place in the portfolio. This is not the same as an "independent valuation" (see Section 6.6) which may be useful to the manager as a second opinion but serves a different function.

  - Performance measurement. The manager should readily be able to measure the performance of the portfolio and to compare this to the agreed external benchmark but it is normal and desirable for this to be done by an independent specialist organisation. (see Chapter 6.3)

4.1.2. Investment Styles

A "top-down" approach to investment management has been becoming more prevalent in the property sector in recent years. This involves a reasoned view of the attractions of varying sectors of the property market and of different types of investment which in turn influences investment decisions. This may result in the structuring of a portfolio which, relative to the benchmark, can reflect a more active or passive stance.

However, a "bottom up" approach where "stock picking" skills are given the greatest emphasis is also common, the aim being to identify market price inefficiencies that can be exploited. This approach depends upon the manager's skills at spotting deals in the market place which will offer the potential for superior performance and taking perhaps a more intuitive and opportunistic approach to sales from the portfolio and portfolio structure.

As with investment management of any asset class both of these approaches can be effective. The top down approach is likely to be more structured, with clearer lines of decision-making responsibility thereby making it easier to supervise and regulate. However, the need for skill in property selection is inescapable due to the fact that, unlike a securities market, each investment is different and wholly "top down" approach is therefore not possible.

Both approaches can offer the possibility of excess performance but "bottom up" is likely to be more short-term in nature and perhaps more volatile.

In drawing a distinction between these two styles therefore, one might say that the "bottom up" manager will rely predominantly on his intuitive knowledge and experience and will wish to be unhampered with too much strategic and tactical portfolio planning whereas the "top down" manager will lean more heavily on the benefits of the right asset allocation decisions.

These decisions are likely to involve extensive use of research in both strategic planning and stock selection, including the use of performance forecasts. Success in performance terms will therefore depend to a large extent upon how well this process is effected.

Both of these styles are "active" and there is no method of investing "passively" in real property. No portfolio of real property can be relied upon to track any index used as a benchmark since the underlying constituents of a property index cannot be "bought". However, with the launch of a synthetic instrument known as Property Index Certificates in 1994 it is now possible to create a truly passive exposure to property as numerous pension funds have now done.

4.1.3 Responsibility and Accountability

In considering the whole issue of Investment Management as well as its regulation, we have had regard to the Guide for Trustees on Investment Management produced by the NAPF. We would suggest that this publication should be regarded as relevant to investment management in property as well as the other asset classes to which it primarily relates.

It is important to draw attention to the fact that direct property investment does not fall within the Financial Services Act of 1986 and thus there is no requirement for an investment manager in property to be an "authorised" person or consequently, to belong to a Self-Regulating Organisation. These are recognised and monitored by the Securities and Investments Board. Whether this situation should change is open to debate, although it would appear a logical development if there is a move towards discretionary property fund management.

However, the rapid move towards property mandates which include investment in securities or collective investment schemes brings with it a need for those managers to be authorised in any event. It is therefore likely that this trend will bring regulation to the sector by default.

However, it is worth commenting that it would have a significant effect upon the way in which many funds manage their property assets if property investment were to be brought into line with other markets since it would require decision-making to be carried out by an authorised manager.

In view of the absence of external regulation, the nature and extent of responsibility between the Pension Fund trustees and their property investment manager or advisors should therefore be defined in an Investment Management Agreement. If it is not, difficulties can be encountered particularly in the event of any dispute. This is discussed below in the sections dealing with each type of relationship.

The accountability of the external advisor or manager may be viewed as falling into two areas. The first is an obligation not to be negligent in advising or serving his clients. This is one of the regulations for members of relevant professional bodies such as the Royal Institution of Chartered Surveyors and indemnity against potential losses should be available. Deciding when and whether negligence has occurred, is a matter ultimately for the courts to decide.

As with other asset classes, negligence does not include responsibility for investment judgements which prove to be incorrect or which have led to poor investment performance, if all relevant information available at the time had reasonably been taken into account.

Performance, which is the more normal concern of a pension fund, should be monitored by the use of an appropriate performance measurement system. The subject of performance measurement is dealt with in detail in section 8 of this report but, in principle, a property advisor or manager should be judged by their success in meeting the objectives set by the fund. These ought to include meeting a particular performance target against a prescribed benchmark and over an appropriate time period.

Caution should be used in judging performance in cases where responsibility and authority for decision making are divided between the pension fund and the manager. The ways in which this relationship can be structured are described in the next section.

4.1.4 Choices of Approach to Property Investment Management

The three main choices are set out in this table and discussed further below:

Description	Well established	Common?	Pros	Cons
Internal	Yes	Mainly in very large funds otherwise rare.	Full control	Full responsibility Can require substantial permanent staff commitments compared to other asset classes
External Adviser	Yes	Yes	Widely accepted Retains control by the fund over all investment decisions (and others if required)	Different to other asset classes. Divided responsibility Time consuming Possible conflict of interest.
External Discretionary Manager	Yes	No - but becoming more so.	Comparable to other asset classes Efficient Clear accountability	Still seen as innovative Possible conflicts of interest.

- **Internal**

Some pension funds conduct their property investment activities entirely through an internal property team. In large funds, this team is specialist but in smaller funds it can also be responsible for the property interests of the corporate body to which the pension fund is attached. It in turn will report either to an internal investment controller if one exists or direct to the trustees. The following sections of this report do not specifically deal further with this approach since the manager is directly employed but many of the comments made in describing external appointments are relevant to this type of relationship since they can operate both on the "advisory" or "discretionary" mode. Should property ultimately become covered by the Financial Services Act 1986 provisions, then it would appear that the relevant individuals involved in this within a pension fund would have to become authorised.

It is more common for funds to operate a system involving one or occasionally more than one external advisor or manager and although no doubt large numbers of slightly different customised arrangements exist these essentially polarise to one of the two types of relationship described below.

- **External Property Advisor**

This is the most common arrangement in the industry and it has been found by many in the past to be time consuming for both fund and manager and inclined to obscure responsibility. Nevertheless, although it is now a quite unnecessary (and perhaps imprudent) burden for a pension fund to take upon itself, it has met the wish of many funds to remain in direct control of property decisions, particularly over the period when property has been maturing as an asset class. The positive or negative effect of this on performance is impossible to assess and probably varies widely from fund to fund and manager to manager.

It also often creates conflicts of interest. These may be addressed through appropriate management agreements and fee structures as referred to in Section 4.1.7.

The advisor's primary contact will be either an internal investment controller, an individual trustee, the secretary to the trustees or the pension fund manager. Responsibility for decision taking however frequently does not wholly rest with this individual and usually lies with an investment committee (probably comprising a group of trustees and pension fund staff) or the whole trustee body.

The advisor's role is to make recommendations to this body which will decide whether or not to follow his advice. This will probably extend to all decisions required for investment or disinvestment but may also include every other issue of property management (including rent reviews and lease renewals). Due to dissatisfaction with this process in the past the trend has been over recent years to try to make this a less onerous arrangement to administer by giving increasing amounts of discretion to advisors particularly in relation to matters within the property management sphere, but rarely extending to purchasing and selling.

It should be noted that apart from the management time which this style of management involves for pension fund officials or trustees it will also blur the responsibility for the decisions taken and ultimately the accountability for performance achieved.

Even if all recommendations are approved, they may not represent the whole of the action which would have been taken by a manager with discretion and will have slowed down the process.

It has been the standard approach over the past twenty five years or more for firms of chartered surveyors to be appointed in this role and it is conventional in these cases that all property services are carried out by the same firm. These relationships are built upon a high degree of trust and their popularity also amply demonstrates that there is a demand for an integrated "one-stop shop" service. However, depending upon the fee and other arrangements agreed, they may give rise to conflicts of interest. This is discussed further below in 4.1.7.

An increasing number of appointments are being made of the property investment sections of asset management organisations. These are particularly within banking and insurance groups since most independent investment management companies do not offer a property service. These appointments are more likely to be discretionary in keeping with the type of organisation they represent.

- **External Discretionary Manager**

A trend has developed in recent years designed to tackle the shortcomings of the traditional "advisory" approach and to place property more squarely alongside other assets both in management and in the allocation of funds. This has been to appoint a property investment manager with a similar status to any other investment manager and to give full or substantial discretion over all aspects of the management of property investment accounts. This has gained a small foothold in the pension fund market place and is increasingly being adopted for new appointments. It was recommended in the NAPF Investment Committee Report upon Visibility of Investment Management Fees

This arrangement is probably the norm in those new appointments made of managers within financial institutions. This may be due to their closer alliance to the mainstream investment management industry and therefore familiarity with this style of management as well as their tendency to sub-contract more down-stream services to other chosen organisations. The granting of discretion is also increasingly common in appointments, both new and renegotiated, of leading firms of chartered surveyors who may also under such appointments sub-contract work to third parties when beneficial to their clients. The "one-stop shop" concept is not directly relevant to such an appointment.

Such a discretionary appointment would commonly be constrained by restrictions on the maximum size of individual investment acquisitions or sales but otherwise only by the strategy agreed. The manager then would be required to report on a quarterly basis upon income and capital received and expended with investment performance reviewed annually or more frequently.This relationship should be efficient in management time, disengages the trustees and pension fund officials from direct investment responsibilities and clearly focuses the mind of the manager upon meeting performance objectives rather than more subjective issues.

It will also more clearly highlight any possible conflicts of interest. Whether the manager may profit (generally through transaction business) from his own investment advice is a matter of which pension funds must be clearly aware in drawing up an appropriate agreement. However, it is essential to recognise that the need to find and secure investments distinguishes property from other mainstream asset classes and a manager's ability to do this is essential. The important thing for pension funds is to recognise and be satisfied how this is to be done and create a management and fee agreement which reflects their preferences and objectives.

The approach to fees is covered in more detail in Section 4.1.7.

It should be noted that it is not possible to isolate the pension fund entirely from the activities of the manager since it will require to perform certain routine legal functions for example signing documents. This need only be the subject of an administrative process.

Less predictable is the practice of tenants of the buildings within a funds portfolio who may be tempted, in extremis, to make direct contact with the fund. This may present some incidental commitment of management time. It should be a priority objective of property managers, who are responsible for tenant relationships, to ensure that this never needs to take place and this may be seen as a test of their efficiency.

4.1.5 Key Issues in Selecting a Manager

The principal factors in selecting a manager are to decide either in advance or in the course of the process:

1. The investment policy regarding both the type of portfolio and performance objective the Fund wishes to adopt.

2. The priorities the fund has as to the type of manager they choose. These may include, for example, whether they operate within a financial institution or a property consultancy; whether they offer a discretionary service; whether they provide all services from their own organisation; whether they offer a particular type of fee structure.

This will give initial direction to the drawing up of a shortlist. Choice will thereafter be dependent upon other issues including investment style and competence, compatibility and cost.

Criteria to be considered in selecting a Manager will include the following:

Size and ownership of organisation
Business plan and management structure
History
Experience
Client base size and growth
Continuity of personnel
Reporting, administration and cash management systems
Investment processes philosophy and style
Dedicated research resources
Identity and information on the Individuals directly involved
Range of core services supplied and management of work sub contracted to specialists
Amount and bases of fees available
Policy and attitude to possible conflicts of interest
Ability to provide flexible approach and to handle changing requirements of the Fund
Performance track record

The latter is likely to be based upon the Manager's valuations and should have been audited and endorsed by an independent performance measurer. It should be based upon open market valuations conducted in accordance with the RICS Guidance Notes carried out at least on an annual basis for each property. There is now a noticeable trend towards quarterly valuations.

In view of the nature of the property market and the changes that have taken place within it, the older the performance data concerned the less reliable it may be and certainly less relevant in considering a Manager's current capabilities. It is also necessary to check the extent to which individuals involved in the generation of the record are still involved.

Managers should of course apply the requirements for proper documentation of an investment house's track record as defined by the NAPF's Voluntary Code. In particular, it must include all clients, defined as discretionary or otherwise including those who may no longer use the manager in question and all assets, including developments.

Although all these criteria will be examined, the emphasis placed upon each will be weighted by the Fund's own choice of investment policy and the type and style of manager they prefer.

4.1.6 Additional Property Services

There is a series of additional property services which will be required by the property investment manager either on a continuing or occasional basis, for the full and proper management of a direct property portfolio. These are listed below primarily for information and comprehensiveness since they are not the subject of this report. It is primarily the responsibility of the investment manager to appoint the professionals involved (or recommend appointment to the fund) and to supervise them. Should a pension fund, however, operate either an internal investment management system or appoint an external manager with no or little discretion, they may become involved in appointing or supervising any or all of these professionals.

In any event, pension funds ought to retain the responsibility for appointing the independent valuer, the solicitor and perhaps the property manager.

Property Management, Administration and Accounting

This is an intensive and continuing responsibility which should be regarded as at least a medium-term appointment if it is not actually integrated with the investment management organisation. The primary responsibility is the management of all building or tenant-related matters once an investment has been acquired or after the initial letting of a new development.

On a regular basis this includes the collection of quarterly rents and ensuring that both the landlords' and tenants' obligations under the lease with respect to repairs, insurance and other items are met. It will also include responsibility for instigating and negotiating rent reviews and lease renewals when appropriate, as well as the letting of vacant space. The property manager administers and controls service charges, property insurance and pursues arrears. He produces the portfolio accounts.

Acquisition and Disposal of Investments

Identifying these is the responsibility of the investment manager. The transaction may be conducted by the investment manager himself, by investment agency staff in another part of the same organisation or by the use of entirely separate investment agents who may themselves either be appointed exclusively or used on an ad hoc basis.

The decision by the investment manager (or his client) to invest or disinvest may be for strategic or tactical reasons or perhaps due to his view of the future prospects of a specific investment. This is his primary responsibility. The skills required in the subsequent conduct of a sale or purchase however are quite different.

An effective investment agent or dealer will have widespread market contacts; good access to available transactions or ideally be able to create them; the best possible knowledge of current market prices and immediate trends in order to identify current market price; a close knowledge of the amount of activity and types of purchaser and seller in the market place in order to advise on dealing tactics; a thorough grasp of professional property skills in identifying the physical characteristics of buildings and their locations and assessing their impact on value in detail; a knowledge of landlord and tenant law and current practice in order to advise on leases and their effect on market price in detail; first class tendering and negotiating skills in order to secure the acceptance of a bid as buyer or seller; and the ability to see the transaction through to a successful conclusion in the shortest possible time.

Property Letting

This will in most cases be carried out by a firm of estate agents although in some cases, a property manager may fulfil the role where he is in the position of being contacted by potential occupiers.

Building Consultancy

This is a specialist technical function covering such matters as inspections of potential acquisitions to report upon structural condition and repair, negotiations with tenants on building maintenance issues, improvement and extension of properties and development supervision.

Valuation

Property investment managers should value all the properties under their control on either a quarterly or annual basis as an integral part of their review and monitoring process.

Most pension funds also obtain independent valuations as a form of audit of their managers upon an annual or less frequent basis. Often, a proportion of the portfolio is valued each year. This is always conducted by a separate organisation.
There is more discussion of this issue in Section 7 beneath.

Legal Services

A solicitor is required, to provide legal services in connection with transactions and property management issues.

4.1.7 Fees

Reference was made to property investment management and fees in the 1993 report by the NAPF Investment Committee upon Visibility of Investment Management Fees. One might infer from the report that whilst there was some scope for invisible fee generation in the property field, this was not a major problem for pension funds and the committee was more concerned with fee structures and conflicts of interest. They also put forward the view that discretionary mandates to property investment managers were a desirable development and should be set up in such a way as to avoid conflicts of interest.

We comment upon fee charging practices for investment management and the other major property services separately below:

General Guidance

Guiding principles in setting fee agreements include:

1. Fees should be "visible", i.e. calculated on a "clean" basis.

2. They should provide adequate reward to the manager.

3. They should recognise the value of all services agreed to be provided. A manager may be prepared to negotiate an overall single annual fee for all of these services, including transactions and rent reviews, but probably excluding occasional one-off services. Care should be taken to ensure that this does not create disincentives in specific areas

4. Fee arrangements may, if wished, provide extra motivation to perform well in any area but care should be exercised to ensure that such an arrangement does not create, unknowingly, a disincentive in another area or a conflict of interest.

   Performance-related fees in property investment create, apart from all the usual considerations, an additional issue which needs to be recognised and which cannot be fully resolved. Any target based upon capital appreciation will depend upon acceptance of a valuation of a property or portfolio as the basis and this introduces an element of subjective judgement. Valuations carried out by the investment manager himself are subject to the obvious "conflict of interest" criticism but may be better-informed than anyone else's. Independent valuations may be used as a "bell-wether" for the manager's valuations, but, using them as the measure for a performance-related fee introduces possible conflicts of interest. A manager may, for example, be discouraged or encouraged to sell an asset depending upon the relationship between the price he can achieve and the independent valuer's opinion.

5. Regular fees will probably be payable quarterly.

6. Except for standard professional services, there are no clearly established or standard fee scales. Innovative approaches are being developed to meet rapidly evolving clients' needs or priorities.

Investment Management Fees

The importance of this service is often not fully appreciated and undue, sometimes exclusive, emphasis is placed upon the transactions function. However, the need for it is plain, since experience shows that the need for foresight and planning in the running of a property portfolio is very important to both portfolio performance and timing of investment. It should also mitigate problems arising from illiquidity.

There is a significant cost to providing such a service and we believe that it is in the interests of both the pension fund and the manager that this should be specifically rewarded.

If it is not, there will be a tendency for the quality of the service to follow investment cycles and suffer when the ancillary income which pays for it declines. This is usually from transactions.

It is common however that no fee is paid for this service. This arises in cases where the appointment carries the exclusive right for the same organisation to conduct all or much of the "downstream" property business and, in particular, all transactions.

It would be surprising if the level of profitability on dealing and other fees earned were to be consistently capable of financing an adequate property investment management service, including the necessary research especially given the volatility of market activity but many such arrangements have survived for long periods.

This implies also that the obvious conflicts of interest inherent in this system are not necessarily seen as a critical issue and that a substantial degree of trust exists, probably founded upon lengthy personal and corporate relationships. However, the potential for abuse clearly exists. In general, we consider this approach in today's market to be undesirable; it is against the long-term interests of the fund and it could, consciously or otherwise, encourage short-term thinking by the manager. We believe that it is declining in popularity for these reasons.

Where an investment management fee is charged it is commonly on an "ad valorem" basis as a percentage of the capital value of the fund and we believe that this is appropriate. It can also be charged as a percentage of rental income and in these circumstances could well incorporate the fee for property management. This will provide a more stable and predictable fee but will not directly recognise success in meeting capital growth objectives.

Fee arrangements incorporating an incentive to produce agreed performance targets have been adopted in some cases. They have a superficial attraction but are difficult to manage. However, it is to be hoped that the market will develop acceptable solutions. These types of fees have been commented upon above.

Because of the range of different approaches there is no "market standard" for the quantum of these fees.

Investment Sales and Acquisitions Fees

It is long-established market practice for a fee of 1% of the price of a property investment to be paid on successful completion of a transaction by purchasers and sellers to their representatives, This is generally increased to 1.5% in purchases where, as is common, another introductory agent is involved and will share the fee. These fees may be negotiated up or down in cases of exceptionally large or small transactions or according to market circumstances.

In some cases investment management fees have been negotiated to include part or all of the cost of sales and acquisitions and, although not simple to achieve, this type of arrangement is likely to meet increasing acceptance in the market place. The principal difficulty with this arrangement is that the processing of such transactions involves a substantial amount of professional work and the number of transactions in successive years might vary substantially. This could merely bring in its wake another conflict of interest for the manager in discouraging dealing. It is also possible to negotiate a basis by which fees are spread in part over a period of years and the amount paid varied according to performance.

Property Management

This has historically been charged as a percentage of rents received although the charge may also be based on a specified sum per tenancy. Rent reviews and lease renewals will generally be charged for separately, often dependent upon achieving an increase in rent and geared towards the amount of that increase.

This fee is frequently recoverable from the tenants of a multi-let property through the service charge. In these cases it is not chargeable to the investor.

Property managers also place, maintain and negotiate appropriate fire insurance for the properties they look after. For this they normally receive a commission from the company which reflects the volume of cover and covers the work involved, often including fire insurance valuations.

Valuations

Where these are carried out by the investment manager the cost is likely to be incorporated in the investment management fee. Where an independent valuer is instructed this is likely to be arrived at by a fee tender between competing organisations and to be based upon either a percentage of capital value of the portfolio or a charge per property.

Other Property Services

These, including Building Surveyors services, are generally charged on hourly rates as consultancy work, except for lettings which are usually charged at 10% of the rent agreed or 15% where the fee is to be shared between two agents.

4.2 Indirect Investment - Available Options

Since the publication of the consultation document which preceded this report in early 1994, there has been a very marked swing of attitudes both within the property industry and within pension funds towards the use and benefits of indirect forms of investment in property. At that time, the options available were very limited and had been unchanged for many years. Since then, the market has seen the emergence of an entirely new synthetic investment vehicle known as Barclays Property Index Certificates ("PICs") and a number of new opportunities for co-investment outside the traditional unit trust and insurance company fund structure, normally in the form of limited partnerships. A group of major property investing institutions is also planning the creation of a market in forward contracts relating to sectors of the market. The title of this venture is Real Estate Investment Market (REIM).

Another important development is that whereas traditional forms of indirect investment in real property were normally seen as an exclusive alternative to direct investment this is now no longer the case and both direct and indirect investment are being increasingly combined to useful effect in the same portfolio.

Alongside this, the convention was that indirect holdings were held direct by the Pension Fund themselves unless they were held within a balanced management mandate, typically in the form of units in the Manager's own unit trust. This has changed substantially. Internal teams are giving much more attention to the issue but also it is now increasingly accepted practice to appoint a Manager with a mandate to manage indirect holdings both in traditional or non traditional vehicles.

Following the advent of PICs, at least three funds have taken the step of defining an entirely passive mandate for property and have selected managers on this basis.

These changes are very much to be welcomed as part of the process of the assimilation of property investment management in to the practices of investment management generally.

Changes in this area would have been even more marked if the option had existed to create tax transparent vehicles for property investment in the UK such as those which exist in America (real estate investment trusts) and Australia (listed property trusts) but this is not the case. The importance of this development for Pension Funds and other investors is reflected in a comprehensive report recently published by the Investment Property Forum entitled "Property Securitisation". Copies of this are available from the Forum.

- **What indirect property investment vehicles are available and are they suitable for pension fund investment?**

Traditionally, Unauthorised Property Unit Trusts and Insurance Company Managed Property Funds. Both are suitable.

New suitable options include PICs, Authorised Property Unit Trusts and Limited Partnership vehicles.

- **How well have these vehicles performed in relation to the market?**

There are of course wide variations but in general, prior to the last 5-10 years, they were inclined to underperform. This has changed in recent years and they now mostly provide average or better performance. PICs returns are related to the IPD Index. Limited Partnerships return will depend upon whether they are for specific properties, sectors or the whole market but there is no reason why they should not produce acceptable returns.

- **Can an investing institution liquidate its investment quickly and at what cost?**

Normally redemptions are available within a few weeks in the traditional vehicles but this is not guaranteed. The total costs of sale and purchase are similar to that of direct property.

The liquidity of PICs (listed on the Stock Exchange) and holdings in Limited Partnerships are as yet uncertain. Neither allow for redemption.

- **What control does an investor have over the investment strategy or operation of the vehicle?**

Normally very little - other than by disinvesting - unless he has a place on the investment committee. He is prohibited from having real control in a partnership and PICs are entirely passive.

Investors attitudes to this are changing rapidly with increasing acceptance of third party professional management and the consequent lack of management involvement is seen as an advantage

- **What are the risks of investment in these vehicles?**

The risks are the normal investment performance risks both as to the market and the manager, plus the possibility of illiquidity. This is only likely to happen occasionally and usually around the bottom of a market cycle which may not be the most prudent time to disinvest in any case.

- **What are the main benefits of indirect investment?**

Indirect property investment vehicles offer pension funds the ability to invest in diversified or specialist holdings of real property from which they may otherwise be precluded, because of the significant capital outlay required in investing directly on their own behalf.

These vehicles also allow pension funds to delegate the management responsibility to specialists who have visible track records.

There is considerable choice for the investor and careful and thorough investigation of the available products is required to ascertain individual characteristics, constraints on investment and likely performance prospects.

To assist pension funds in their selection of appropriate indirect property vehicles this section considers firstly the traditional vehicles and secondly new vehicles and instruments.

4.2.1 The Traditional Vehicles

4.2.2 There are only two forms of indirect property vehicle with established track records of performance. These are Managed Funds operated by insurance companies (MAF's) and Unauthorised Property Unit Trusts (PUT's). Another historic form of indirect property investment is the joint venture arrangement between pension funds and property companies where the fund relies on the expertise of the partner to maximise investment value. These joint ventures are formed for specific purposes, upon such terms as the partners deem appropriate and have a limited life. They are not generally available and are not considered in this report.

Property shares have different characteristics to direct property investment, performing more closely to the equity market as detailed in Chapter 3.2. They are therefore also not considered in this report.

PUT's and MAF's are open-ended funds and first came into existence in the 1960's providing pension fund investors with a straightforward and tax efficient method of investing in property. Through these vehicles the investor can gain access to the property market quickly by acquiring units whilst relying on the expertise of the vehicle's appointed managers.

There are over thirty PUTs with a combined capital value in 1996 of around £2bn (UBS PUT Bulletin). Although accounting for just over 1% of the £175bn commercial property investment market (City University, 1996) they have provided investors with returns comparable to that of the direct property investment market (see chapter 4.2).

PUT and MAF's are created for the small fund which would otherwise be precluded from investing in property as they have neither the buying power nor the investment expertise necessary. They can also help diversify an existing direct property portfolio by simply providing spread or into particular areas where a pension fund may find it difficult to gain access or where they have limited investment capacity, such as would be required for investment in shopping centres.

There have been major differences in performance between individual PUTS and MAFs and whilst these differences may be accounted for in the make up of the underlying assets, the variations may also be due in part to the structure and operation of the vehicle. It behoves an investor to thoroughly investigate each vehicle to determine whether it can satisfy the investor's criteria for investment. Items which require consideration are the following:

- The investment objective: what is the PUT or MAF attempting to deliver to its investors?
- The strategy: how are the managers applying funds to meet the objective.
- Gearing arrangements: the greater the level of borrowings, the greater the volatility or risk of the vehicle failing to meet its objective.
- Distributions policy and practice: how are distributions made and what is the record of payments.
- Unit pricing: the frequency and method by which units are valued.
- Performance track record: has the PUT or MAF produced good results and are the managers properly fulfilling their functions.

4.2.3 Structure of Property Unit Trusts (PUTs)

PUTs comprise a pool of investments held in the name of a Trust divided into units which are then issued by the manager of the Trust. A Trustee is appointed which is responsible for operation and custody of the Trust within the normal constraints of trust law. They are not covered by Securities and Investment Board regulation. Investment powers and day-to-day management responsibilities for the portfolio are generally handled by an Investment Committee or Board who are governed by the terms of the Trust deed, a formal contract between the Trustee and the managers.

The Investment Committee or Board in turn appoints advisers and property managers so that they can fulfil their duties.

The role of the Trustee is important as it is the Trustee who safeguards the interests of the unit holders by ensuring the Fund Managers operate within the terms of the Trust, providing a proper service in management and administration of the investments. There are no guidelines or codes of good practice governing the structure of trust deeds and great variation exists. Newly formed PUTS are giving greater discretion to the managers to formulate the investment strategy and management of the portfolio.

Two important areas where individual PUTS operate differently are in their distributions and dealing arrangements. The majority of PUTS provide regular distributions to their unitholders, although they can operate as accumulation funds which re-invest all income in the Trust for the future benefit of unit holders. PUTS pay income tax, although pension funds are able to claim a tax credit which effectively makes the investment tax free.

The dealing arrangements vary depending on whether the funds are open-ended or closed. The majority are open-ended funds where the Managers can issue new units when there is sufficient demand and unit holders may redeem units upon request although redemption may be deferred to a date determined by the Trustee. Closed-end funds are those where either no new units can be issued and/or where the Trust would be brought to an end on a certain date.

4.2.4 Structure of Managed Funds (MAFs)

MAFs operate similarly to PUTs, but are very different in their structure, organisation and governing legislation. However, from a pension fund view point their objective is indistinguishable. They are unitised funds managed by insurance or life companies specifically for occupational pension schemes.

MAFs usually form a "family" of funds covering the main investment sectors of equities, bonds and gilts. They can be unit linked products where the insurance company fund manager may have devolved powers to determine asset allocations between the various asset classes or where the clients determine their own asset allocations and invest directly in the relevant fund. Both these arrangements can provide added flexibility as investments can be switched between different asset types to optimise overall performance.

In general MAFs fall into two categories, those that are relatively small tend to invest in indirect property such as property shares and PUTs, whilst the larger funds invest directly in the property market. The performance of these two types of MAFs will differ because of the underlying nature of the assets.

Investors in MAFs do not hold any legal interest in the assets themselves as would be the case for PUTs. They instead have an interest in an investment product where performance is based on the assets of the fund. The unit holders investment is protected by the operation of Company Law.

MAFs are tax efficient as no capital gains or income tax liability arises for either the fund or its investors because of their pension based status.

The terms governing the operational management of a MAF are determined by the sponsoring company with no independent guidelines or rules setting out codes of good practice. Each fund can and does operate differently on redemptions, fee arrangements and relationships with unit holders.

4.2.5 Investment Objectives

PUTs and MAFs share a common objective of providing a tax efficient method for tax exempt pension funds to invest in property. The performance objective is often not clearly defined and can vary from fund to fund. For those investment managers who are aggressively marketing their funds to attract new investors, their primary objective is to outperform their peer group as this will give them a competitive edge in the market. Their secondary objective is to perform at least in line with the property market, the benchmark for which is normally seen as the IPD Index, either Annual or Monthly.

4.2.6 Dealings and Liquidity

The perceived advantage of Property Unit Trusts and Managed Funds over direct property investment is that they are easier to convert into cash, allowing the unit holder a better opportunity to realise his investment swiftly. This is generally true in stable market conditions when the unit holder is only seeking to redeem relatively small amounts of capital. However, difficulties may arise when investors seek to redeem large holdings in particularly poor market conditions compelling the manager to sell properties when markets are moving slowly and prices are depressed. This may result in deferment of redemption and a redemption price below expectations.

The bid and offer spread in normal market conditions is 5%, with the investor bearing approximately half this cost when either purchasing or redeeming units. The spread represents costs the investment manager will incur when acquiring or selling properties within the portfolio.

In volatile market conditions when values are rising or falling rapidly the managers may be able to increase the spread in anticipation of these shifts in value. It has been known when a run on units has occurred for bid-offer spreads for certain funds to reach 20%, although this would be highly unusual and would only be countenanced to protect other unitholders who would otherwise be forced to sell property quickly at distressed prices.

Bid and offer spreads may also vary from the norm to take account of cash or gearing in the fund. Funds with large cash balances may provide smaller spreads whilst highly geared funds may increase them. The variability of market spreads is an area where fund managers should be able to reassure investors that they will be treated fairly and that they can withdraw their funds without penalty.

An investor when seeking to redeem units in a PUT or MAF will serve notice on the manager of the wish to do so. Hereafter redemption procedures and practice varies considerably both between PUTs or MAFs and between individual funds.

It is usual that when a redemption request has been submitted the manager will immediately determine a redemption price which the unit holder is free to accept or decline. The time period for dealing with redemptions can differ substantially, but normally the manager will redeem units the following quarter.

In the case of those MAFs whose unit prices are quoted daily redemptions are likely to be handled more swiftly. However, if large sums are requested or if the market is depressed the managers of both MAFs and PUTs can defer meeting redemptions for a considerable period. The delay has, in the past, sometimes extended to up to two years, if it was felt that selling property could disadvantage the majority of unitholders. These have been very exceptional circumstances and considerable efforts are now being made by the managers of these vehicles to ensure that this is not repeated.

An alternative to requesting the managers to redeem units is to take advantage of the secondary market that exists for the leading PUTs. Here prospective sellers and purchasers can deal more quickly on a matched bargain basis where one of a small number of stock brokers specialising in this area will broker a transaction from which they will derive a commission.

4.2.7 Pricing of Units

The price of units when issued, purchased or sold is normally determined by the Investment Committee or Board of Management based on the net asset value of the fund divided by the number of units in issue.

The accuracy of the property valuations relative to the market is fundamental to determining the correct net asset value of the fund. If valuations fail to accurately state true market worth unitholders may be disadvantaged by any trading that takes place. PUTS and MAFs use independent valuers to undertake monthly or quarterly valuations of the properties on an open market basis in accordance with the RICS asset valuation rules.

The managers may have a relatively free hand in determining the bid or offer price of units after taking account of the net asset value and potential investors should satisfy themselves that the pricing mechanism operates correctly relative to any independent valuations.

4.2.8 Performance

Funds which are seeking to invest in PUT's or MAF's do so in anticipation of achieving returns that are comparable to the commercial property market. These vehicles themselves therefore have a dual performance objective of performing at least in line with their immediate peer group, so as to attract investors, whilst also providing returns comparable with the direct property market.

There are numerous indices by which performance of these Funds can be assessed. UBS, Micropal, CAPS, WM and IPD are the leading providers of such information. Owing to anomalies that occur in measuring the short term performance of such funds, only year by year or longer term comparison should be undertaken.

Section 3.2.1 compares the past performance of PUT's and MAF's with direct property. The long term performance over ten years indicates indirect property investment falls slightly behind that of direct. This can partly be explained by the fact that the returns for indirect property are net of all investment management and fund administration costs, whereas the returns for direct property, as with other asset classes, are not. All other costs are reflected in direct property returns in the IPD Index.

4.2.9 **Risks**

An investor chooses a PUT or MAF with the objective of obtaining an investment return comparable to or greater than the property market. The risk is the likelihood or otherwise of that objective being achieved over a given time period.

The factors that determine the level of risk lie in the structure of the vehicle concerned and can be summarised as follows:

- Asset mix: The greater the variation from the market average exposure to each sector the greater the risk of performance deviating from the benchmark.

- Gearing: borrowings held within the vehicle may assist unit redemptions, however the interest charges will have first call on the rental income and performance though potentially boosted by gearing will rely heavily on capital appreciation, thereby increasing the risk. Not all funds borrow.

- Dilution: managers of PUTS will normally be able to issue additional units. New units are usually offered on a "rights issue" basis i.e. pro-rata to existing holders. This may dilute existing unitholders equity and may adversely affect performance if it creates a high liquidity ratio in the fund. Managers seek to control this carefully.

- Investor control: the degree of control exercised by investors varies considerably between each vehicle. Often PUTS have an Investment Committee or Board, the members of which may be personal appointments, but they may also comprise some of the larger investors who can influence the managers and their proposed strategy. This can be both a benefit and a disadvantage as the Committee may constrain the managers from making investment decisions impairing their ability to achieve the performance objective.

- Redemptions practice: there is considerable variation in the procedure and timescale so it is important to thoroughly investigate the rules of operation and track record before committing monies for investment.

  The historic performance data will show the track record of each property fund and this information will go some way in indicating the level of risk an investor will be taking. However, as with any manager, their ability to repeat a successful (or any) past track record is subject to questions of staffing, investment philosophy, processes, etc.

4.2.10 **Conclusion**

The benefits of investment in PUT's and MAF's can be summarised as follows:

- Small amounts of capital can be invested in diversified property portfolios.
- Investors can rely on expertise of specialist property managers with established track records.
- The vehicles are tax efficient for exempt pension funds.
- They involve the investor in virtually no management time.

- They can be used by Funds to increase property weightings and diversification.
- They can give exposure to overseas and other specialist property markets.

Disadvantages are:

- The structure and method of operation of funds are not explicit.
- They can be illiquid at certain times in the property cycle.
- The costs of management are often hidden.

4.3 New Vehicles and Instruments

It is plain that there is a considerable need for new indirect vehicles for investment in property as an alternative to the creation of a segregated direct portfolio and to supplement the traditional vehicles described above. The primary goal which virtually every pension fund would welcome is the promise or potential for liquidity.

The obvious solution would be to replicate vehicles which exist overseas, for instance, the "Real Estate Investment Trust" in the US, but at the present time Treasury rules do not permit this kind of tax transparent vehicle. Representations for change are being led by the Investment Property Forum and there is some promise that this may become an available route in the future. In the meantime, the choice of the vehicle to allow pooled investment in direct property is more or less limited to the authorised property unit trust and the limited partnership.

Beyond this, the emergence of an entirely new investment instrument, Barclays Property Index Certificates, in the recent past, has been a revolution for pension fund investment in property.

4.3.1 Authorised Property Unit Trusts (APUTs)

The only successful introduction of a new unitised vehicle is that of APUTs in 1991, which were designed to overcome some of the problems of regulation and liquidity to render them suitable for the private investor. They make special allowance for quick redemptions by holding at least 20% of the fund in liquid form. There are currently only two of these Trusts in the commercial property field and they are gaining increasing acceptance by the "man in the street" at whom they are aimed. Moves are afoot at present to bring this vehicle to bear in the institutional arena and it is likely that this will prove to be a new and useful alternative for pension funds in the near future.

In particular, APUTs are valued weekly and are relatively liquid they may be suitable for inclusion within defined contribution pension plans as units can be allocated to individual accounts.

4.3.2 Property Index Certificates (PICs)

This is a form of "synthetic" investment whereby investors purchase paper entitling them to index returns rather than any interest in real property.

The first synthetic vehicle to become established, the PIC, is essentially a bond, secured upon Barclays Bank PLC, providing a quarterly income return and a capital return upon maturity (the latest issued so far run until the end of 1998) the same as that measured by the Investment Property Databank Index as representing the property market. The first issue, which took place in 1994, totalled £150m and was unlisted.

In 1995 a second issue of £100m took place and was listed on the Stock Exchange. Since then a number of private issues of PICs have taken place.

This instrument has given UK and overseas investors an opportunity to invest in the property market in a less risky form, with no management responsibilities and at much lower cost. Trading in the after market has been limited as to amount but has generally been quickly transacted and improved liquidity should follow the continued expansion of this market. Returns are paid gross of tax to investors.

4.3.3. Limited Partnerships

These are considered to be the best available form of co-investment being open to any class of investor and being tax transparent. However, they are not capable of listing on the London Stock Exchange and therefore suffer from a perception of illiquidity. Nevertheless there is no reason why their shares should not be readily traded and there are definite signs that they are becoming more common in the pension fund field.

4.3.4 Conclusions

The range of options presented by these vehicles and instruments, real property and synthetic, can and will make the process of property investment much easier and more acceptable to pension funds. There will always be those who lead and those who follow and the industry is at the stage in the development of innovative tools that a certain amount of adventurousness is required. However, it is more likely that their availability will lag the appetite of pension funds rather than the other way around and over the next three or four years it is likely that they will become an accepted and substantial part of the pension fund investment scene.

5. PROPERTY TRANSACTIONS AND LIQUIDITY

5.1 Tactical Issues

- **In what ways can a Pension Fund invest in property to get tactical advantage?**

  By forward planning, timing sector switching and mixing direct and indirect forms of investment.

- **Does the Fund have a choice of investment policies?**

  Yes. Risk profile, income and liquidity requirements will determine the investment policy.

- **Is it complicated and time consuming to buy and sell direct property?**

  Not necessarily complicated but the time taken can vary widely, as with some securities, according to whether the market is rising or falling.

- How reliable are valuations in relation to selling prices?

  On individual properties the selling price would normally be within 10% of the valuation. Difficult or rapidly changing market conditions and the valuation of complex properties may test this parameter.

- Can a Fund increase the liquidity of its portfolio?

  Yes - by careful stock selection - but this may affect performance.

Once the objectives of the property portfolio have been set by the trustees, together with the responsibilities of the Fund Managers, then the Managers can consider how to structure the portfolio in the long term so that these objectives may be met. Additionally, the Manager needs to consider shorter-term tactical issues.

Tactical changes in the structure of the portfolio will not only influence the performance, but will substantially affect the overall liquidity within the portfolio.

The degree to which the Funds' trustees devolve responsibility to the Managers for these decisions is likely to influence the Manager's ability to out-perform or to perform in line with the stated target.

5.2 Direct and Indirect Property Investment

The decision as to the method of gaining exposure to the property market normally will relate to the Fund's size and forecast cash flows. However, these decisions can be tactical as well as strategic.

Funds which are able to commit less than £20 million to property investment should not normally consider direct property unless they are prepared to have an undiversified portfolio with the consequential risk.

However, if it is likely that the Funds available for property investment will quickly build to exceed £20 million then there will be the choice of starting to construct a direct property investment portfolio. Where the Funds available exceed £50M, there are strong arguments for the trustees to have a direct property portfolio, though some indirect holdings may be considered desirable to improve the diversification of the portfolio. In all other cases an indirect property investment vehicle should be used.

Indirect property investments potentially have an important role to play where frequent valuation of the Fund's assets are required, as is for example the case with Defined Contribution Schemes.

Indirect property investments can also have a valuable role to play where Fund Managers seek exposure to property markets outside their range of expertise, (for example overseas properties) or to properties with large lot size (for example City office buildings or shopping centres) or to properties which need specialist management (for example residential or agricultural).

For those Fund Managers seeking to change their overall property weightings or weightings by region or sector indirect property can also prove a useful investment class over both long term and short term time horizons.

Pension Funds do not tend to gear up (borrow against) their property investment portfolio. In periods when property returns are expected, by the Fund Manager, to exceed the cost of debt, enhanced returns can be gained through investing in appropriate indirect property vehicles with gearing.

5.3 Timing

The timing of investment in and out of the property market will normally be determined by the prospects for the property market relative to other investment opportunities and with due regard to the Fund's forecast cash flows. A two year projected cash flow should be assessed, including anticipated expenditure, revenue, new monies and cash calls. Sudden requirements to either spend monies or to switch monies out of property can cause trauma.

Unlike equities and bonds, direct property is a "first past the post" investment, i.e. only the highest bidder is successful in securing the purchase. Investment managers need to maintain a close knowledge of market prices and to have a flexible approach to the type of property which can meet investment criteria. Priority needs to be given to achieving timely investment based upon sound appraisal of worth rather than strict adherence to fixed property-related criteria.

Substantially increasing tactical weightings in property in anticipation of a market upturn need to be undertaken over a reasonable timescale and, even more so than with securities investment. This will enable Funds to increase exposure to the market before it becomes too competitive. It should also be recognised that not all sectors and types of property are always available in the market place (eg currently there are few rack rented City office buildings).

Given the relative illiquidity of the direct property market, the timing of transactions needs careful forethought. The use of external or internal forecasting services can prove to be a valuable resource in helping the Investment Manager to making tactical decisions.

5.4 Liquidity in Property Investment - Direct and Indirect

Relative to the bond markets and that of the major quoted companies, direct and indirect property investment are relatively illiquid and have dealing costs that are significantly higher. However, relative to small listed companies property's illiquidity is less pronounced.

The need of liquidity is primarily for portfolio rebalancing purposes and not for meeting liabilities which can usually be met more easily from bonds, gilts, equities or cash holdings. *Liquidity in the property market is a function* of investor sentiment towards the market.

- **Direct**

  In normal times property transactions can take two to four months although transactions can take less or more than this in extreme market conditions. In many instances sales can be agreed within days of a property coming onto the market and it is the legal formalities that slow down the process rather than the marketing period.

  There is strong pressure in the property industry, sponsored by the Investment Property Forum, to improve the liquidity of the direct property market, particularly the speed of the transactions (see 1995, Investment Property Forum Report on "Streamlining Property Transactions").

  The perceived quality of the property investment will also determine its liquidity. Prime property investments tend to be more easily saleable than non-prime properties and saleable in all but the most depressed markets. Non-prime properties may stick on the market when market conditions are not buoyant. The higher valuation yields applicable to non-prime property, implicitly take into account this additional illiquidity risk. However, the ultimate determinant of sale is price.

  The quality of properties and sector balance within the portfolio however will determine the level of income returns. A tactical issue is therefore the appropriate balance between lower yielding properties and those which are not 100% prime. This will be determined by the skill and expertise of the Property Investment Manager.

- **Indirect**

  For most indirect vehicles it is easy to buy units although for some Funds the dates on which units can be bought may be limited (eg quarterly) and some limitations may be placed on the number of units that can be acquired. On acquisition of the units there is immediate linking with the value of the properties in the Fund. Large cash flows into indirect property vehicles can leave them under-invested in property in the short-term.

  The policy on redemption of units from an indirect vehicle can vary widely and is an important factor to establish when considering the acquisition of units. Some

Funds have a policy and a track record on redeeming units on the first available date (frequently 3 months after the notice).

Indirect property vehicles are liquid at the margin, but in periods when sentiment towards the property sector is poor, and levels of investors seeking redemptions is high, Funds may have to defer redemptions of units until such time as cash can be raised. Investors should examine the long term record of the funds in this aspect. In such markets indirect investments may not be dissimilar to direct in terms of liquidity. In more normal markets indirect investments will be more liquid. For various of the property unit trusts, secondary markets may be made on a matched bargain basis by one or more of the City investment houses.

So that Managers of indirect vehicles can plan ahead it is helpful to maintain a dialogue on the intentions of the trustees to invest or redeem units. The property Managers will maintain a liquidity position with the Fund, which will vary according to their projected cash flows. This liquidity slightly reduces investors actual exposure to property within the Fund.

Pressure is being brought to bear on the Government by the Investment Property Forum to allow tax neutral Stock Exchange tradeable securitised property vehicles. These vehicles would assist Property Fund Managers in managing property investment risk by shifting the mix of their property portfolios. The lack of tax neutrality for listed property vehicles remains a major stumbling block for the development of securitised investment vehicles and the expansion of this market. These vehicles would be an attractive alternative to the existing indirect property vehicles.

5.5 The Transaction Process

The lack of homogeneity and the lack of a central market place makes direct property investment a process for specialists. However, the process is similar to the sale of residential property. A timetable for a typical transaction is set out below:-

Decision to invest/sell.

Search for property/buyer.

Put in offer/accept offer, subject to contract, trustees approval and survey.

If the offer is accepted instruct Solicitors and seek to remove all conditions to the offer. This period may span anything from a few days to several months but perhaps typically is one month.

Approximately four weeks later (the period can vary from days to months) exchange contracts. A deposit of 10% may become payable at this stage on purchase.

Approximately a month later (varies from simultaneous exchange and completion to months) complete the transaction, at which time the purchaser pays the balance of the monies outstanding.

It is important to recognise that for the purchase/sale of direct property to proceed efficiently, it should be viewed as a team process, with the team comprising: The Fund Managers, the Funds Lawyers and the outside advisers (eg. Agents and Building Surveyors, etc).

The individual responsible for overseeing the transaction should be clearly identified. Frequently it is necessary to take a commercial judgement of the effect upon price aspects of the transaction which emerge at the legal stage or on survey. This individual needs experience in the property market and an understanding of the possible alternatives.

Transaction costs if taken over the holding period of the property become much more reasonable and compare favourably with those of equities where holding periods are much shorter.

5.6 Price Versus Liquidity

It is possible to argue that "any property is saleable at any time at the market price". This, however, assumes a reasonable time to find a buyer. In circumstances where sales proceeds are required in a shorter timescale than this implies - especially in inactive markets - the price achieved may well be less than the valuation. This is "forced sale". Having to sell, but achieving market value, is not.

Given that a valuation is an estimate of the realisable price that would be expected to be achieved at a specific point in time, and that it takes time to sell a property, in a falling market the price achieved is likely to be lower than the valuation, in contrast in a rising market the price may be expected to be higher.

Most properties experience periods when they may not sell for the optimum price (eg to sell a property immediately just prior to major rent review may be seen by the market as being a risky investment and purchasers may not take full account of the increase due).

It is possible to create property portfolios with differing degrees of liquidity. Prime properties let on long leases with regular five year upward only rent reviews and with a good tenant in occupation (or guaranteeing the rent) are normally saleable in all but the severest market conditions. Properties with defects (physically, locations, in lease terms or covenant strength) will be less liquid. A higher price will obviously have to be paid for prime more liquid properties.

5.7 Switching Between Asset Types

Property as a market is cyclical but the sectors within the property market, such as offices, shops and industrial, are also cyclical and need not match. The balance of the portfolio between the sectors may therefore be adjusted to take advantage of these cycles. Switching sectors is expensive because of the total transaction costs of about 5% and often the rebalancing of sectors is achieved by the allocation of new monies into those sectors where increased weightings are required coupled with a few selective sales of properties which have relatively poor performance prospects.

The weightings given to individual property types will often be determined in the context of the benchmark against which the funds performance is being measured. The IPD annual index for example splits property into: Retail, Offices, Industrials and Other, and by 15 economic regions. Switching between asset types will be seen by the Investment manager as a way of producing superior returns relative to peer investment funds.

6. CONTROL OF POLICY AND MANAGERS

6.1 Issues

- **How should pension funds be involved in setting portfolio policy?**

  The trustees should decide what kind of investment approach they want in conjunction with the manager and set an appropriate performance benchmark. If investment is pooled, they may choose the policy which suits them best.

- **Should pension funds be responsible for individual investment or management decisions?**

  Not unless they wish to retain responsibility for investment performance and to employ the necessary in-house expertise required. This is entirely devolved with all forms of indirect investment.

- **What contact is necessary with managers?**

  Quarterly or half-yearly meetings are probably all that is necessary in normal circumstances coupled with written reports.

- **What form should meetings with managers take and how frequent should they be?**

  Meetings may be with nominated individuals from the fund, special investment panels or full trustee board. All have their place and will determine their own level of formality. Meetings with the fund's manager of pooled fund holdings should be held in the same way.

- **Should pension funds have contact with the occupiers of their properties?**

  No. Such contact may be used by tenants to try to circumvent the property manager's authority.

6.2 Investment Policy and Managers

These questions can be answered more fully by reference to the approach to investment chosen by the pension fund. For example, whether investment is indirect or direct, internal or external, may determine different options, and these are discussed below:

In any case, the management hierarchy for reporting and monitoring needs to be clear and the following is recommended as being suitable, in principle, for all.
In this chapter we have used the expression 'Property Investment Manager' throughout to avoid confusion although, in cases where no or only limited discretion is given, 'Property Advisor' would be more accurate.

6.2.1 **Controlling Indirect Investment**

All available forms of indirect investment involve a devolution of responsibility and authority. However, there is a choice to be made between types of vehicle and their managers. For the large majority of Funds, indirect investment means investment in a Property Unit Trust or insurance company Managed Fund.

In these cases, Funds will neither be involved in setting portfolio policy nor be responsible for individual decisions, nor should they have contact with the occupiers of the properties involved.

There is therefore a temptation for this to be an entirely constant form of investment but it is unlikely that a Fund will be prepared to make an indefinite commitment to a fixed holding in any asset class without periodic review. Failure to recognise and make provision for this has been at the root of the difficulties some funds have experienced with disinvestment from pooled property investments in the past.

In the absence of any process for regular and informed review, decisions, particularly to disinvest, tend to be made too late in the market cycle when redemption values are slipping. An excess of investors wishing to redeem at this time may lead to illiquidity.

These investments, whether in one or more vehicles, should be reviewed at least quarterly with a view to recommending whether allocations to the sector should be increased or decreased and whether any tactical alterations need to be made to the investment holdings. This may result in increasing or decreasing holdings in specific funds.

This process may be carried out by investment personnel within or outside the Fund but it is clearly important that relevant knowledge and expertise needs to be brought to bear on these important questions. Some property investment managers offer a service of this type, and some balanced managers include it within their remit.

The individual responsible for such a review will undoubtedly have contact with the managers of the vehicles concerned and others being considered, probably at least at the same frequency as the review takes place. It is important to bear in mind that it is the responsibility of the managers of a pooled vehicle to maximise performance, not to recommend disinvestment.

Having a proper and methodical approach to the monitoring of pooled investment holdings need be neither onerous nor expensive. The lack of one may, on occasion, bring results which are both.

In summary, a proper approach should have a series of layers. The manager responsible will require to have:

1. A strategic and tactical asset allocation to property looking at least six and preferably twelve to eighteen months ahead agreed with the trustees to determine the overall exposure.

2. An agreed investment policy to help determine risk and return objectives. This will primarily dictate whether the Pension Fund should invest in one or a series of funds.

3. If this policy indicates the need for tactical adjustments, a clear and quantified view of the prospects for different sectors of the market.

4. An up-to date knowledge of the management and investment styles, risk preferences, strengths and weaknesses of the managers of different funds.

5. Skill in acquiring and switching units at the lowest cost.

6.2.2 Controlling Indirect Investment

The answers to the questions at the start of this chapter depend largely upon whether the Fund engages a manager for direct investment in property who is given discretionary powers or not. Simply, the less discretion given, the greater degree of control which must be carried out and, implicitly, the greater the degree of accountability which is retained by the Fund and its Trustees.

A Fund may choose to establish and maintain an internal specialist property expertise which is sufficient to justify retaining responsibility for investment and other decisions. The same hierarchy of control will apply and the same decisions as to the granting of discretion need to be made. Where an external manager is engaged more formality may be required and clearly there will be the need for regular and frequent contact on a series of levels. We are only concerned in this report with contact between the fund and the property investment managers and this could take the following form depending upon whether full discretion is given or not:

Client	No Discretion		Full Discretion	
	Event	Objective	Event	Objective
Trustees	Annual Meeting and Report	Review Strategy, Recommendations, Asset Allocation and Performance	Annual Meeting and Report	Review Strategy, Recommendations, Asset Allocation and Performance
Investment Panel	Quarterly Meeting and Report	Review of all Activity, Market Commentary and Investment Recommendations	Quarterly or Half-yearly Meeting and Report	Review investment activity and cash holdings in light of strategy
Investment Controller	Quarterly Constant as necessary (written & verbal)	Portfolio Review. Decision making	None except in rare circumstances	For example need to renegotiate Investment Management Agreement

Relationships lying between these two poles are common and this requires compromises but an effective decision-making mechanism is always essential.

Where discretion is limited or absent, it is sometimes the case that the suggested hierarchy of control and decision making has not been consciously delineated. Diffused and sometimes elusive accountability creates potential for bad decisions both positive and negative and sometimes for no decisions at all. Such an approach is likely to indicate a wish to be cautious and to keep risk under control and frequently achieves quite the opposite. At worst, strategy may be scant or non existent and decisions may be taken on short term and doubtful considerations based on recommendations made in a vacuum.

6.2.3 Investment Management Agreements

Where discretion is contemplated, an Investment Management Agreement is necessary.

Broadly there are two areas of discretion to be addressed, namely, investment management and property management. However, the guiding principle is that the fund's primary concern in entering the agreement is achieving its investment performance objectives. The relationship should therefore be framed with this in mind.

Taking property management first, this is the responsibility of the property investment manager to oversee on behalf of the fund. His job is to ensure that it is not only being carried out effectively and efficiently but that it is being done with the Fund's objectives and portfolio strategy in mind.

Apart from the collection of rent and supervision of tenants and buildings, it will involve decisions to be made on many issues including service charges, maintenance, rent reviews, lease expiries, lettings and assignments.

The fund need not be concerned with this process if the Investment Manager's role is clear, with the exception of notification of potential or actual litigation. The fund may, however, specify policies in relation to any of these management issues but these will need to be considered in assessing performance. The fund should specify the levels of property management information which it wishes to know but may include rental income, arrears and voids.

The property investment manager is accountable for the finances and investment performance of the portfolio. Given an allocation by the Fund to property, he is responsible within the sector for all strategy, tactics, investment and disinvestment as well as active asset management. This primarily involves seeking opportunities to enhance returns by further investment in the portfolio either through renegotiating the legal relationships of tenure and leases or by improving or extending the properties themselves.

Prudence however suggests that there are several checks and balances which should be incorporated into the Investment Management Agreement, some of which may apply to other asset classes and some of which do not. Differences arise within property as an asset class because of the relatively large sums and costs involved in property transactions and the existence of situations which can create future financial obligations for the Fund, primarily arising from development activity.

Areas of constraint which need to be considered for inclusion in the Investment Management Agreement include:

1. The amount of buying and selling which may take place in any one year. This may comprise a percentage of the existing portfolio plus the amount of new money.

2. The size of individual transactions. This may be defined as a percentage of the value of the portfolio at the last valuation.

3. Investment may be limited to the mainstream property sectors or others such as agriculture or leisure may be specifically prohibited.

4. Limits of deviation from the market average on asset allocation to sectors within the portfolio but this needs to take account of manager's investment style and performance expectations.

5. Ability to commit funds to development may be prohibited or constrained by reference to the level of risk adopted. This ranges from the full risk of the fund carrying out a speculative development entirely at its own risk under the direction

of the investment manager through to entering into a commitment to provide finance for a development to be conducted by a third party of substantial financial strength and where the property itself may have been pre-let. There are many stages between these two extremes.

It should be remembered that these constraints as well as others which may be adopted are intended only to limit powers of discretion and can of course be varied upon specific approval by the Fund. The guiding principle is that they should be agreed with the manager so as not to unduly fetter his ability to achieve the Fund's policy and performance objectives but to contain the level of risk which the Fund feels comfortable for him to adopt in doing so. This is particularly so if a performance related fee has been agreed.

6.2.4. Fund Responsibility

If a Fund enters into an IMA giving a manager the degree of discretion envisaged above, it will have certain responsibilities to fulfil if they are to be able to fully monitor the manager's performance.

1. An appropriate performance benchmark should be set and it should be clear how often and over what time period this is to be assessed.

   The normal benchmark is the IPD Annual Index but customised ones can readily be created by IPD. Other alternatives also exist.

   Performance can and should be reviewed annually against this benchmark. However, if more frequent, say quarterly, valuations are carried out, performance can then be reviewed less formally against alternative indicators. Caution should be exercised and recognition given to the differences between any other indicator and the IPD Annual Index. With the exception of extreme results, which may cause a re-appraisal of strategy, annual performance comparisons should not be regarded as critical. We would recommend that a minimum of a three year period should be regarded as significant but that a complete market cycle is probably required to fully judge a manager.

   This may be a reflection of not only the implications of varying investment strategies and styles but also the aggression with which the industry and particular valuers seek to follow market movements more or less closely. Portfolios may seem to over or undershoot market peaks and troughs for this reason alone or to move faster or slower in either direction than the market. This is an effect which we believe has been strong in the past but is being diminished in the market place as pressure increases from investors for ever greater realism in valuations in representing market volatility and estimating clearing prices for individual investments. Whilst recognising that this is easier for valuers in some market conditions than others and that in some conditions it is very difficult, this trend it to be welcomed.

   Performance may simply influence the continuation of the appointment or also be enshrined in a performance related fee basis.

2. The Fund should be prepared to consider its tactical view of property on at least an annual basis and with a longer time horizon than they perhaps might with other asset classes in view of the timescale required to implement property decisions. This is to allow the manager a proper background against which to address investment policy and portfolio structure.

This is not to say that decisions may not be reversed and that policies are necessarily binding for several years but that these matters must be given regular consideration. Action can then be taken against a plan. Indecision and paralysis brought about by concentration upon short term or current issues should be avoided since the inevitable result is that action, when taken, will invariably be too late and possibly fail to achieve what was intended.

3. Tactical plans should envisage the allocation to property for up to a two year period ahead. This will enable the manager to plan portfolio structure and to create acquisition and disposal strategies accordingly.

7. VALUATIONS

- **Why are valuations needed?**

  To provide a basis for performance measurement, portfolio asset allocation and individual investment decisions.

- **How reliable are valuations, how are they carried out and what affects them?**

  Valuations are an estimate of the open market price at which it is expected that the property would have sold, as at the valuation date. Valuations carried out under the approved RICS "Red book" guidelines are reliable, but are ultimately a matter of professional judgement.

- **Is the most useful information provided to pension funds?**

  Pension funds should they wish it, may seek from their valuers that information which clarifies how the valuation has been arrived at. They may also request an opinion on the direction and speed of current market movement and likely marketability of investments.

- **Should valuations reflect today's clearing price or what an investment is worth to the Fund?**

  Valuations must reflect the open market value of the property. Investment worth calculations are personal to the pension fund, are not market determined, and are used to determine whether, from the Fund's perspective, properties are under or over priced.

- **How frequently should valuations by managers and independent valuation be undertaken?**

  Valuations should be carried out at least annually, and perhaps quarterly for larger portfolios. Independent valuations are not essential but are commonly used as an "audit". They vary from annual to every three or five years in frequency, sometimes by valuing a proportion each year.

This section critically assesses the role of valuations and identifies the purpose for which valuations are required and what these valuations mean. The framework and bases on which valuations are carried out will be critically examined as will be the way in which valuations are presented. Property valuation techniques will be contrasted with those of other assets.

7.1 The Role of Valuations

A "valuation" of a building will normally be required by a pension fund for one of four purposes:

- to monitor the investment performance of the asset when there is no *a priori* intention to trade

- to assess the total value of the fund's assets to set against its liabilities
- to identify the normal market price at which an asset might trade in order to inform a buy/hold/sell decision
- to identify the worth to the fund of an asset.

Whilst the appropriate figure for the first and second purposes are likely to be the same, the other two will, or may, differ. This is explained in more detail below. In addition to the above, the fund will also require a fire insurance "valuation". This is an assessment of the replacement cost of the physical structure and bears no relationship to the investment value of the property. No further consideration is given to these as their provision forms part of the management of the properties.

7.2 Regulation of Valuations

Apart from a requirement that property assets should be valued for inclusion in a pension fund's statement of assets by a suitably qualified valuer at Open Market Value as defined below, there is no statutory or quasi-statutory regulation of property valuations. However, professional valuers (members of RICS, ISVA and IRRV) are required by their professional bodies to observed the provisions of the RICS Appraisal and Valuation Manual. This document, an extension of the "Red Book" which was in force until 31 December 1995, applies to all valuations and appraisals. It largely defines best practice in the way a valuer approaches his task, in obtaining instructions, ensuring his suitability for the task, the thoroughness of his research, the prudent use of caveats, and the quality and content of the eventual valuation report. The content of the Manual is therefore not of direct concern to pensions funds although its existence is intended to reassure on the credibility and reliability of professional valuations. However, the Manual contains detailed definitions of a number of "bases of valuation" which clients should understand. A "basis of valuation" sets down some fundamental assumptions a valuer must make in reaching his figure. This standardisation is deemed necessary to avoid the anarchy which would arise if valuers made assumptions ad hoc.

Following the recommendations of the Mallnson Report on property valuations, changes have been incorporated into the "Red Book". There are now four bases which will commonly be used by pension funds, Open Market Value (OMV), Market Value (MV), Estimated Realisation Price (ERP), and Calculations of Worth. OMV and MV, although having differing definitions, in the opinion of the RICS will provide the same figure. The reason for the two bases is that OMV has been the defined basis for valuations for financial statements for 20 years and has a high degree of market acceptance within the UK.

MV is a definition produced by the International Valuation Standards Committee and it is hoped that this will acquire wide international acceptance. If indeed it is found that both produce the same figure, then it is likely that OMV will gradually drop out of use over the years and in due course will be removed from the Manual.

However, for the time being, it is recommended that pension funds continue to instruct their valuers to produce OMV to meet the first two purposes above.

7.2.1 Open Market Value is defined as follows:

"An opinion of the best price at which the sale of an interest in property would have been completed unconditionally for cash consideration on the date of valuation, assuming:

a) a willing seller;
b) that, prior to the date of valuation, there had been a reasonable period (having regard to the nature of the property and the state of the market) for the proper marketing of the interest, for the agreement of the price and terms and for the completion of the sale;
c) that the state of the market, level of values and other circumstances were, on any earlier assumed date of exchange of contracts, the same as on the date of valuation;
d) that no account is taken of any additional bid by a prospective purchaser with a special interest; and
e) that both parties to the transaction had acted knowledgeably, prudently and without compulsion.

Because of its timing assumptions, in b) and c), OMV does not identify the price which might be achieved if marketing and negotiation began today. Rather it is intended as a snapshot valuation, designed to capture the market level at the date of valuation. It was originally designed for, and must be used when, a valuation is intended for a financial statement which will be relied upon by third parties. It thus meets the second purpose above, and will normally be used for the first also. Indices are built using assessments of OMV.

7.2.2 Market Value is defined as follows:

"The estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably."

As will be seen, the definition is far less tightly defined, but should produce the same figure as OMV with the same timing features.

7.2.3 Estimated Realisation Price is defined as follows:

"An opinion as to the amount of cash consideration before deduction of costs of sale which the valuer considers, on the date of valuation, can reasonably be expected to be obtained on future completion of an unconditional sale of the interest in the subject property assuming:

a) a willing seller;

b) that completion will take place on a future date specified by the Valuer to allow a reasonable period for proper marketing (having regard to the nature of the property and the state of the market);

c) that no account is taken of any additional bid by a prospective purchaser with a special interest; and

d) that both parties to the transaction will act knowledgeably, prudently and without compulsion."

As will be seen, ERP has similar terms of definition to OMV except that the valuer must assume that marketing starts today and he is required to estimate the price which will be achieved when marketing and negotiation are completed. The valuer is required to give his opinion of the length of this period, ie when the price will be achieved. Because ERP introduces a new element of uncertainty (how the market will behave during marketing etc) the valuer is required to give first OMV (the snapshot value today) and then ERP. If there is a difference he should be required to explain the reason for it, which will give the client an insight into the dynamics of the market as the valuer sees them. ERP will be a less certain figure than OMV, but in other ways it may be more informative. It addresses the third purpose above, providing an assessment of how much a property might actually fetch. ERP is a new concept to valuers in a formal sense, and opinions differ as to how much variance it will show from OMV. However, when facing a buy/hold/sell decision, the valuer should be asked to assess ERP.

It will be noted that both OMV and ERP exclude a bid from a "special purchaser", someone who might be willing to pay above market price for reasons unique to them. This must be correct for OMV as it is not known whether the special purchaser would have been in the market and willing to buy. It must also be the correct starting point for ERP. However, the valuer, whilst excluding the special purchaser's bid, should be asked to identify whether there is likely to be a special purchaser. If there is, he should be requested to give some assessment of the bid which could be negotiated. This may be a very different figure and would greatly influence a buy/hold/sell decision.

7.2.4 Calculations of Worth.

These are only very generally defined within the Manual. As much as anything the definition is given to differentiate such calculations from the other bases which are about price, not worth. However it is intended that the RICS should produce guidance for valuers on the framework suitable for calculations of worth.

Such a framework will, of course, commonly require considerable adaptation to the needs and perspectives of an individual client because, ultimately, worth is an individual concept. But a common basis, as a starting point, should improve the quality of advice on worth.

Calculations of worth are intended to meet the fourth purpose above. It will be a subjective calculation which will normally include some of the client's own assessments of future prospects. To the extent that any elements are property-related the valuer is likely to be able to give his own opinions about those prospects and the property factors which may affect them. But the calculation will be no more than an appraisal of the current worth of forecast cash flows. It will not, therefore, carry any element of certainty and will commonly be produced with some form of sensitivity analysis. The produce of the calculation can be compared with OMV or ERP to inform a buy/hold/sell decision. It will be normal for a calculation of worth to be produced either in the form of a net present value of future revenue and capital flows, discounted at some desired rate of return, to be compared with the market price, or as an internal rate of return based on the same cash flows plus the market price which may be compared with the investor's desired rate of return.

7.3 Accuracy of Valuations

Almost all valuations require the valuer to take as evidence transactions on other properties, often at other times. These figures must be adjusted for the geographic, physical, legal condition of the subject property and for any timing difference. The calculation is therefore an assessment of a probability and cannot be expected to be "accurate" in the sense that a calculation of the price of a shareholding may be the accurate produce of a mid-market quoted price. The courts will often allow a valuer a tolerance of between 10% and 15% either side of a reasonable median, but for most property normally held and traded by a pension fund, and in most reasonably liquid market conditions, research has shown that competent valuers operate well within the margins permitted by the courts. However it must be recalled that the valuation is a probability. If an investment decision hangs upon the valuer's figure it would be good practice to discuss with him the "range" within which his figure stands and the present factors affecting that range.

A number of much publicised cases (eg Queen's Moat and Scotts Restaurants) have focused attention on valuation accuracy. It is fair to say that most such cases result either from profit-based or turn-over based valuations which are known to be very volatile calculations, or from "residual" valuations, usually for a site, where the valuation is the "residue of" a calculation involving much larger figures which are, in themselves, quite variable. For normal investment properties these problems do not arise and, certainly at the portfolio level, reasonable accuracy can be assumed. This underpins the veracity of the various indices which are all the produce of valuations. The valuation process relies on comparable transactions and smoothing of values can occur when periodic valuations draw upon data sets which overlap. Normally more than one transaction is required for a valuer to change their view of levels of value.

7.4 Depreciation and Obsolescence

As a fixed capital asset, commercial property is liable to depreciation: namely the fall in the real or relative capital or rental value. This may result from shifts in the local economy (altering the supply and demand balance) or from changes in the environment in which the building is located or from obsolescence. Buildings are liable to both *physical* and *functional* obsolescence, in that they fall increasingly short of tenants' requirements.

The former results from the ageing process and the finite life-cycle of building components; the latter relates to shifts in occupiers' functional requirements. For example, the widespread use of information technology necessitating raised floors and/or suspended ceilings reduced the functional utility of offices with restricted floor to ceiling heights.

Depreciation overlays overall market movements. In a traditional, "all risks" yield valuation, depreciation is implicity accounted for in the yield (leading to an increased yield) and is derived from comparable sales - that is the market should have fully priced the depreciation.

As a check it is possible to carry out an explicit discounted cashflow based appraisal, depreciation may be accounted for in the cashflows either via an increase in the risk premium element of the discount rate, or through a slowing down in the rental growth rate or additional capital expenditures. There is a growing body of evidence on the nature and impact of depreciation and the balance between physical and functional obsolescence that can impact on values. It is often not easy to incorporate the affects of depreciation implicitly.

It should be noted that as the vast majority of pension funds have regular revaluations, these revaluations will take into account the effects of obsolescence/depreciation from year to year.

7.5 Due Diligence in Valuations

When undertaking a valuation the valuer frequently has to rely on information given to them by the client or by third parties. It is important to ensure that this information is correct.

Currently, it is not always possible for the valuer to undertake due diligence enquiries of this information in order to check that it is not misleading or it not the whole story. In consequence pension fund trustees should check that the key information required in valuations is available to the valuers and has been confirmed by the valuers or other appropriate experts. This includes: lease terms; restrictions in title; floor areas; structure of the building; the presence or otherwise of deleterious materials; whether comparable evidence used the full information (eg capital inducements, rent frees, break clauses etc). Where a valuer relies on somebody else's information it is a requirement of the RICS Red Book that it should be so stated.

Obviously, the longer a valuation takes the more the client may have to pay. However, there is an argument that the information fundamental to a valuation should be, where ever realistically possible, confirmed and made explicit in the valuers report to the client. Where someone else's information is relied upon then it is prudent that this fact should be identified.

If it known that, for example, a property is structurally poor or suffers from deleterious materials, then is it realistic for the valuation to be undertaken on the basis that the defects are ignored?

7.6 Valuation Reports

It has been argued that many of the criticisms of property valuations arise from a failure by the critics to appreciate the nature of the valuation and the underpinning assumptions. The RICS Appraisal and Valuation Manual is intended to alleviate this problem by focusing as far as possible the way in which valuers work. But this is not, in itself, sufficient. The Valuation Report is the document in which the valuer must make clear his conclusions and what he has done, and not done. This is no easy thing as there will be a large number of facts and opinions to be recorded; the Manual lists up to 57 headings which must be considered for inclusion in Reports: The valuer must set down the physical and legal context of the valuation so that the reader of the Report has all the facts. However, it may be good practice to require the valuer to identify separately those facts, and particularly those judgements on his part, which are crucial to the valuation and where the figure would be materially different if they were otherwise. The Manual requires the valuer to provide "any additional information available to or established by the valuer which he believes to be crucial to the Client's ability to understand and benefit from the valuation having regard to the purpose for which it is to be provided." Clients should make use of this. Good valuers will willingly respond, within their knowledge, to help mutual understanding.

7.7 Valuation Frequency

The purpose for which valuations are undertaken will help determine the frequency of the valuations. For performance monitoring purposes, annual (frequently external) revaluations have become the established norm and quarterly valuations are becoming more common. Internal valuations should be undertaken in the interim should sell or portfolio reweighting decisions be contemplated.

7.8 Conclusions

Annual or more frequent valuations are valuable for performance measurement, investment management and asset allocation purposes.

Property valuations have an essential role to play but given the nature of the direct property market it is important to recognise their limitations.

8.0 PERFORMANCE MEASUREMENT

8.1 The Issues

- **Can property investment performance be measured to the same standards as that of other asset classes?**

  Yes - subject to the limitations associated with valuations which are estimates of market prices rather than public quotes.

- **Can this analysis be integrated with analysis of other asset classes?**

  Yes - the measures are the same.

- **What time periods are appropriate?**

  Monitoring can be carried out at any frequency depending upon valuations availability.

- **Are different benchmarks relevant to different funds?**

  Perhaps - depending upon whether a fund wishes to compare with the market representing the asset class or a peer group.

8.2 Background

Other parts of this report have shown how property stands as an investment class within a pension fund's portfolio. Property has performance characteristics which contribute to the investment objectives of funds not dissimilar to that of equities and bonds. In recent years there has been a rapid growth of portfolio analysis techniques and practice: virtually all institutional investors now employ independent external measurement services to monitor their property investment portfolios.

Portfolio analysis systems for property have been developed in line with the special characteristics of the asset class but with an over-riding need to give a clear description and analysis of property returns which are presented in a form which allows property portfolio returns to be compared directly with those of other asset classes.

The aims of portfolio analysis for property investment are precisely the same as those for other investments:

- to compare the composition and pattern of investment with that of the fund's peers,
- to show the performance of the portfolio relative to market indices and comparable funds
- to attribute the performance to different investment decisions

Source: NAPF Committee of Enquiry Report into investment performance measurement (December 1990)

Property has a number of peculiarities as an investment that need to be accommodated within its portfolio analysis:

- It is rarely traded. There is no openly available register of market prices and valuation of property assets are therefore prepared by market professionals, rather than being based on quoted prices. A property asset remains in a portfolio for an average of 15 years.

- Property assets are individually unique and not replicable in a portfolio. A very complex and heterogeneous array of individual investments are available to property owners.

- Individual property investments in portfolios can vary from less than £100,000 to upwards of £200m. Property is only rarely divisible and the largest (for instance regional shopping centres) are only available to funds with significant exposure to property investments. Differences in portfolio structure and asset allocations can therefore result from the size of fund and its cash flows since these will help determine its ability to purchase certain types of asset.

- Direct responsibility for maintaining and improving a portfolio's "quality" rests with the fund and its manager. This is particularly important since property assets are subject to obsolescence. Additional returns and risks can be taken on by developing new buildings, or through the active management of the buildings in the property portfolio. Property investors can therefore operate directly in the property market in a way that is not a feature of equity or bond markets.

There is one major difference between the basis of performance measurement for property and that of other classes which should be noted. For property, there is no open, traded market: property indices have, therefore, been developed from valuation data drawn directly from information on the property investments owned by financial institutions. To this extent, the role of property measurer goes beyond that of measurers for other investment types: they are responsible both for the production of market indices and also for portfolio analysis services.

8.3 Portfolio Analysis Services

Currently four types of portfolio measurement and analysis services are available to property owners. Each provides a different function:

- <u>Independent Measurement Services</u>

  Investment Property Databank (IPD) has emerged as the largest supplier of property data for investors. Started in 1985, the company has created a record of the individual property assets of a large proportion of the financial institutions. This database is widely regarded as providing the industry's definitive benchmarks for most purposes.

  It now holds details of more than 80% of the total value of institutional investment in property, representing a pool of some £50bn of property investments.

Property managers and owners agree to supply IPD with information about the cashflows and values of the individual properties in their portfolio: the data is collected on site by IPD staff and a rigorous methodology is applied to the property data to ensure consistency.

Measures of property returns are available from 1971. This standardised information on all investment properties is held on a central databank which is used:

- to supply property owners/managers with portfolio analysis services
- to break down the performance of a Fund's property portfolio into its constituent parts by undertaking attribution analysis (eg income returns, capital gains, stock selection, geographic location, user type etc)
- as a database for research
- to provide market indices
- to show market trends in yields, capital values and rents for markets overall and particular market segments.

To contribute to IPD, funds must have annual property revaluations and the main IPD outputs cover the calendar year. The published annual indices include only December valued properties. Procedures are applied whereby valuations conducted at other times of the year on individual funds are standardised for comparative purposes to an "as at December" measure.

A short term index (the "Monthly Index") is also available using information from properties revalued monthly. The sample for this, a sub-set of the annual index, is much smaller (approximately 2000 properties worth £3.5bn).

- <u>Measurement Services of the Property Managers</u>:

Leading managers of property investments have also developed measurement services as part of their reporting processes to clients. A number of leading firms publish indices based on in-house data which can be used as benchmarks for their client's portfolios and other purposes particularly research.

Amongst these, the Jones Lang Wootton (JLW) index is the longest standing property performance measure although based on a relatively small, but statistically significant, pool of properties. In addition Richard Ellis (RE) produces a monthly index based on valuations that it conducts for clients. It should be noted that the pools of properties and the measurement conventions of the JLW and RE indices are not the same as those used by IPD.

- <u>General Performance Measures</u>:

The World Markets Company (WM Co) and the Combined Actuarial Performance Services (CAPS) are the leading measurers of the total performance of pension fund's investment portfolios (equities, bonds, property, cash, etc). These services can give an overall picture of the returns relating to the individual asset classes and of the fund as a whole. However, in respect of the property investment portfolio, the figures do not break down performance into its constituent parts, nor undertake attribution analysis which shows why a fund's performance differs from that of the norm.

IPD operates a formal "link service" with the WM Co which allows trustees to integrate a detailed performance analysis of property with that of their wider investment portfolio.

- **<u>Services Based on Property Unit Prices</u>**

Unitised property vehicles are available from insurance companies (managed funds; managed pension funds) and investment managers (Property Unit Trusts). The price of these units have been monitored over time by Micropol, Wyatt, Phillips and Drew and other actuaries. Tables are produced which rank the performance of individual funds. This information provides benchmarks for comparing indirect property investment with direct.

Of these four types of performance service IPD has adopted the criteria for portfolio analysis laid down by the NAPF. Accordingly its indices have emerged as the principal measure of the direct property market's performance. The other types of service provide more specialist functions:-

- portfolio analysis provided by in-house managers helps the manager plan, control and provide feedback on their own client portfolios.

- WM overall property performance measures may be helpful for the smallest portfolios but cannot attribute causes of over or under-performance.

- services based on unit prices help actuaries and financial advisors in their search for suitable funds for client monies, but relate to the indirect property investment markets.

8.4 Property Measurement Techniques

- **<u>Definition of property assets</u>**:

Portfolio analysis of property should include all property interests within a portfolio which are directly owned. It is customary to divide properties into their main classes: UK holdings of offices (central London and provincial), retail property, and industrials. A general category can be added to cover: housing, hotels, land, agricultural/forestry assets which are occasionally held by pension funds; and similarly to cover investments held in PUTs funds; a separate category can be added for overseas property holdings.

Properties which are owned and occupied by a fund will only normally be included as an investment where a formal lease exists.

- **<u>Valuations</u>**:

Because of the unique nature of property transactions valuations are prepared by professional valuers. Valuations are conducted according to RICS Red Book Guidelines. Most funds are now valued annually with a very high proportion carrying out their valuations at end December. Internal valuations carried out by qualified RICS valuers are in some instances used for portfolio analysis, but external valuations are increasingly the market norm carried out by an independent firm of chartered surveyors.

- **Calculation of Returns**:

  The main performance measure calculated by IPD is the annual Money Weighted total return. The return is calculated as the increment in capital value net of expenditure, plus the net income receivable, expressed as a percentage of the capital employed. Income is accrued annually and is not assumed to be reinvested.

  Measures of performance for periods longer than one year are calculated as time weighted annualised returns by chain linking the annual rates of return and taking the geometric mean of the final product. This standard procedure weights each time period equally and is the recognised methodology for preparing fund's results against an index.

  Transactions are included and are weighted in the denominator of the expression to reflect the number of months for which the properties have been held in the portfolio. In the IPD analysis, all capital expenditures (largely development and refurbishment expenditure) on existing assets is assumed to have occurred at mid year.

- **Presentation of Results**:

  Returns of the fund are presented to include returns from transactions and development activity. More detailed analysis then considers underlying investment returns broken down by sector, region and individual property.

  Attribution analysis is designed to quantify the extent to which a fund's relative performance has stemmed from portfolio characteristics or stock selection decisions. Reports from IPD include measures of the volatility of returns and show risk adjusted returns, which split this into systematic and specific portfolio risks. Internal rates of return for periods greater than one year can be calculated.

  The process of valuation and reporting of property data can lead to delays between the year end of the fund and the collation of complete data on which its property returns can be calculated.

  Practice differs considerably between funds and this problem is generally overcome by presenting funds with two reports each year: the first is presented at the time that fund accounts are available and reports on the fund's own performance; the second compares the fund's performance to that of all other funds.

  Portfolio analysis results are difficult to interpret for periods of less than one year, and ideally should be considered and put into the context of three, five and ten year periods.

- **Benchmarks**:

  Considerable care needs to be taken in choosing suitable benchmarks for measuring property performance. The substantial size of the funds under IPD's analysis ensures that most needs can be met.

Suitable benchmarks will depend on fund objectives and may be presented either in terms of outperforming an index or the result of a median fund. Similarly, significant differences may exist between returns of funds of different sizes at different points in time. In theory all funds should be measured against an overall property market measure, either an index or the returns of a median fund. When analysing shorter time periods, special benchmarks may also be relevant and can be drawn from a sample of funds of similar size and objectives.

It may be noted that particular difficulties exist in measuring the relatively early years of the life of property portfolios, when transaction costs may be high and the holding periods for a significant proportion of the Fund are less than one year (see Calculation of Returns above). Suitable benchmarks for this type of fund may be drawn from other funds with rapid expansion in their property investment portfolio.

- **Special Reports**:

Portfolio analysis of individual portfolios to judge property performance is clearly one of the main reasons for which trustees and portfolio managers subscribe to a portfolio analysis service. However, portfolio analysis can serve two other requirements:

- providing full compatibility with the wider portfolio analysis services operated by CAPS and WM Co. It will not always be the case that property measures are the same from, for instance, IPD, and these services: where differences occur they can, however, be explained by the measurement services in terms of the types of investment undertaken by the fund.

- Manager Reports: It may be useful for managers to have available standardised reports on their performance collating returns from funds under their management. These reports are often required for consideration in situations where new investment managers are being appointed and independent validation is frequently required.

APPENDIX A

THE INVESTMENT PROPERTY FORUM AND THE WORKING GROUP

The Investment Property Forum was founded in 1987. The membership now is in excess of 900 and whilst the largest group is chartered surveyors, membership is open to all operating in the property investment market and incorporates bankers, investment analysts, lawyers, accountants, actuaries, academics and others concerned with the property investment markets.

Prior to its foundation no body was concerned purely with the activity of property investment and the Forum was founded to correct this. More specifically, its aims are to enhance the status of the property investment industry and those within it through education and greater communication both amongst its members and the world outside.

The members of the Working Group are all members of the Forum with the exception of John McLachlan and have been chosen carefully to reflect what they can bring to this study. Apart from the general knowledge and experience which each possesses they have a varied academic or practical background which enables them to make a specialist input.

Members are as follows :-

IAIN REID FRICS

Iain Reid is Chief Executive of BZW Property Investment Management Limited, which has £900m property assets under management. He is a member of the Investment Property Forum's Management Committee, its Vision Committee and is Chairman of the Working Group.

Until 1992, he was Head of Research at Richard Ellis, a major property consultancy and asset management organisation. In this role, he was responsible for market forecasting and strategic planning for Pension Fund investors. Before taking that position in 1986, he was Managing Partner of Ellis's Investment Management Department.

Iain is also a member of the Pension Research Accountants Group and was in its Performance Measurement Working Party in 1990. He spoke at the NAPFAnnual Investment Conference in 1992 on the Case for Property and again in 1994 to launch the Consultative Document which preceded this report. He is also a speaker at NAPF Investment Fundamental Courses on the subject of property. As well as numerous other relevant speaking engagements, he has also written on various themes relating to investment in property and upon the involvement of Pension Funds in this asset class.

He was responsible for the creation and launch of Barclays Property Index Certificates in 1994 and subsequent issues.

MICHAEL MALLINSON CBE FRICS

Michael Mallinson spent his entire career at the Prudential retiring from the position of Property Director of Prudential Portfolio Managers in 1990. Property funds under management totalled approximately £4bn. Michael has held and still holds a number of positions in academic, public sector and industry bodies and has given a number of papers on investment in property. He has also contributed to a book entitled "Real Estate Finance", and chaired the RICS committee which produced the Mallinson Report on Property Valuations. Michael was President of the Investment

ROBERT BAKER BA

Robert joined Wm. M. Mercer in 1978 and is a Deputy Head of Investment Consulting (Europe). Aswell as consulting to clients, he also has responsibility for new business development and public relations throughout Europe for the investment consulting practice. He contributes regularly to the press and is an established speaker at conferences.

Having worked with clients in a number of countries outside the UK, Robert has considerable experience in international investment consulting. He now advises a number of larger pension funds, focusing on those who require a full range of investment consulting advice.

Robert has taken a particular interest in property, having worked on a number of asset allocation studies which have looked at the role of property in pension fund portfolios.

TIM BELL FRICS

Tim Bell is a Director of ESN Pension Management Group Limited a company formed by the privatised electricity companies in England and Wales to provide specialist pensions and investment management services. As part of this role ESN PMG manage the Electricity Supply Pension Scheme whose assets are in excess of £11 billion, including £665m in real property. The property portfolio is now operated as an unauthorised Unit Trust for the Pension Funds of the privatised electricity companies.

Tim has been actively involved in institutional and pension fund investment in property throughout his career. He was previously employed by Sun Life Properties Limited and Jones Lang Wootton before joining ESN in 1982 where he became Property Investment Director to the Electricity Supply Pension Scheme in 1989.

GERALD BLUNDELL BSc (Econ) MPhil FRTPI

Gerald Blundell is an economist and partner responsible for Investment Strategy within Jones Lang Wootton Fund Management. He leads a team which prepares property forecasts, performance analysis and investment strategy advice for over £3bn of property assets in the UK.

He has written and spoken extensively over the past ten years on the theory and practice of investment in property and has been a pioneer of the application of performance measurement and econometric forecasting techniques to property.

JOHN McLACHLAN

John McLachlan is Investment Director of United Friendly Group plc and is responsible for Managing the company's investments in equities, bonds and real estate, which aggregate £3.0 billion.

Qualifying as a Chartered Accountant in 1966, he has worked in a number of City roles, moving from Barclays Bank to become Director, Pension Funds Investments at British Rail pension Funds from 1974, then Investment Manager for Reed International plc from 1984 to 1988.

Mr McLachlan was Vice President of the National Association of Pension Funds (NAPF) and past chairman of their Investment Committee. He was a Director of the Investment Management Regulatory Organisation (IMRO), and member of the Takeover Panel. Mr McLachlan also serves as a non-executive Director of several companies.

IAN D MASON

Ian Mason, a director of Mercury Asset Management Property Division, was born in 1960 and educated at Reading University. He qualified as a Chartered Surveyor in 1984 and was in private practice with two firms of surveyors before joining Mercury in 1985. He is now responsible for the management of Mercury Property Fund which has assets of over £350 million. Ian chaired the Investment Property Forum Working Group, looking at the effects of the 1995 Pensions Act on property investment and has recently been invited to join the Working Group looking at property securitisation. He also sits on the Committee of the Association of Property Unit Trusts.

RUPERT NABARRO MA MPhil

Rupert Nabarro is an economist with special experience of property markets; investment analysis; urban research; and economic development. After management training at the Economist Intelligence Unit and J Henry Schroder Wagg, he joined Roger Tym and Partners in 1974. For the next 11 years he was in charge of the firm's UK urban economic work. He left in 1985 to establish the Investment Property Databank.

IPD is a database holding details of the individual investment properties of financial institutions, property companies, and other owners of commercial real estate in the UK. These organisations give details of all their property holdings to IPD, whose market coverage now extend to more than £45bn of property assets and includes more than 75% of all institutional property holdings. Subscribers receive a portfolio analysis report on each of their Funds and close links have been developed with the WM Company. IPD produces the largest annual and monthly property market indices, which are used by the Financial Times and RICS.

He is the author of books and articles on both property and urban matters and has taught at University College, London.

ANDREW STRANG BSc FRICS

Andrew Strang is Managing Director of Threadneedle Property Fund Managers Ltd, which was formed in 1994 by merging the property investment management activities of Allied Dunbar and Eagle Star, with a total of £1.4 billion under management in five funds. Over 1994/1995 the Funds have carried out over £0.5 billion of transactions.

Andrew trained as a Chartered Surveyor in private practice, specialising in property investment. In 1982, he moved to Hill Samuel Property Services where he was responsible for their Life Assurance Property Funds and Property Unit Trust. In 1988, he joined Schroders as Managing Director of their property investment subsidiary, with responsibility for rebuilding the team which managed the Property Unit Trust and Life Fund. In 1991 Andrew joined Allied Dunbar to run their two unit linked property funds.

In 1995 Threadneedle was voted "Top Investment House" in the Pensions World/Hillier Parker Property Awards.

PROFESSOR PIERS VENMORE-ROWLAND MA MSc FRICS AIIMR

Piers Venmore-Rowland is Professor of Property Valuation and Finance in the Department of Property Valuation and Management at City University Business School. He was previously a Senior Investment Analyst (Assistant Director 1985-86) with Laing and Cruickshank, stockbrokers and a Senior Investment Surveyor at Richard Ellis.

Piers is an Associate Member of the Institute of Investment Management and Research and a Fellow of the Royal Institution of Chartered Surveyors. He gained his MA in Contemporary European Studies at Reading University in 1977 and his MSc in Finance at City University Business School in 1979. He has published a wide range of articles in refereed journals and his academic publications are on areas such as: Valuation Accuracy; Property Versus Actuarial Valuation Techniques; Direct Versus Indirect Property Investment; Property Derivatives; and European Land Use Changes Post 1992. He is editor of the Investment Property Forum reports on Property Securitisation and Threshold Competing for Investment Suyveyors: Standards and skills (forthcoming).

Professor Venmore-Rowland is the editor of this report.

APPENDIX B

TECHNICAL NOTES AND DATA TO SECTION 2.3

1. The data used in the original IPD study terminated in 1992. For the purposes of this exercise we have updated the series to 1995 and retrospectively to 1971. The data relates only to completed properties for consistency over the 1962/95 period. The formula used by IPD to calculate these returns implicitly places receipt of income at the end of the year in question as opposed to quarterly in advance which is the norm for institutionally held property. It should be noted that over the 1971/1995 period, during which income yields have averaged 6.1%, the effect of this deferral would have reduced return by 0.3% pa compared with an analysis based on a quarterly in advance assumption. It should be noted that IPD in doing this were seeking consistency with property valuation practice which also values annually in arrears. Such discrepancies do however matter when long run comparisons are being made with other asset classes.

2. IPD data on property income growth only extends back to 1971.

3. Based on growth in market rents. It has been pointed out that this growth takes time to be reflected in capital values because income growth is deferred by rent reviews which only occur every five years. This is true, the average deferral period is 2.5 years in a representative portfolio and 6.8% pa income growth deferred 2.5 years in a 6.1% yielding portfolio reduces returns by .45% pa compared with simply adding income growth to yield. However property was highly reversionary in 1971 (that is to say received income was lagging well behind market rents). Over the 25 years income fully caught up with market rents, growing faster at 8.5% pa, and the reversionary condition of property was eliminated. This catching up added to growth in values and offset the deferred impact of rent reviews on income.

   In estimating prospective returns from yields and prospective rental growth, allowance should be made to the negative impact of rent reviews although strictly speaking this will be mitigated by the fact that property income is normally received quarterly in advance. When the greater share of prospective returns are from income rather than capital growth the quarterly in advance factor can outweigh the negative effect of rent reviews. For example a 10% yielding property generates a 10.7% IRR when income is received quarterly in advance. This is not reflected in the historic IPD figures (see note 1).

4. In the case of property the arithmetic of this model is slightly complicated by the quarterly in advance nature of rental income payments and the deferred nature of income growth. See notes 3 and 5.

5. Precisely how much should be deducted depends on how long it takes market rents to translate into income, the rate of growth in market rents, and the discount rate. With five year rent reviews growth is deferred 2.5 years on average, so for example at a yield of 7.4%, we have calculated 4% pa growth is "worth" 3.67% pa at present values.

6. It should be noted that property unit trust returns reflect certain central management expenses incurred by the portfolio manager that are not deducted from the IPD data on direct property holdings. The also reflect cash balances which will have a beneficial effect on returns in the 1990's but which will have diluted returns longer term.

7. One year correlations are of course not the only periods that could be used. However the correlation coefficients are fairly stable through time. For example on 1963/81 data property has a correlation of 0.17 with equities and 1982/95 a correlation of 0.14. On a rolling five year average basis the correlation is -0.07, on a rolling ten year basis property and equity returns have a -0.21 correlation. It seems reasonable to conclude that Table 6 is not overstating property's diversification potential against equities.

8. But see G. Blundell "Investment in Property a Victim of the Quants?" The Actuary October 1995.

9. If property returns had been a perfect match with equities its correlation coefficient (r)would have been 1.00 and if they had been the reverse image $r = -1.00$.

10. By using net income figures to estimate income growth this analysis has accounted for the negative effect on returns of depreciation. The IPD net income figures deduct outgoings to maintain the buildings which are deducted from the cashflow before the net income growth is calculated. Studies seeking to quantify the effect of depreciation on property returns have pointed to an estimated impact of -2% to -3% pa. Comparison with indices of rent and value which do not reflect the effect of ageing similarly show value and rental growth 2%-3% pa greater than the IPD data used in here which corroborates these studies.

APPENDIX C

PENSION FUND PROPERTY INVESTMENT CHECK LIST

1. Strategic Issues

	YES	NO
1.1 When deciding on the appropriate strategic allocation for property investment has the fund's maturity and funding level been taken into account?	☐	☐
1.2. Has an appropriate and relevant property performance benchmark been chosen e.g. one comprising similar sized funds?	☐	☐

2. Tactical Asset Allocation

2.1 Has a realistic range around the fund's strategic allocation been chosen to allow for tactical shifts?	☐	☐
2.2 Is a two to three year forecast of returns in the property market in place to facilitate the planning of tactics?	☐	☐
2.3 Is an agreed plan governing the time scale for any necessary liquidations in place?	☐	☐

3. Investment Management

3.1 Have any property investment decisions been retained in the hands of the trustees or pension fund officials?	☐	☐
- Do the individuals have the relevant skills to take these decisions?	☐	☐
- Are they, if necessary, authorised under the Financial Services Act?	☐	☐
	☐	☐
3.2 If the "discretionary manager" route has been chosen, has a detailed investment management agreement (I.M.A.) been drawn up and completed?	☐	☐

	YES	NO
Have you considered and, if relevant, does the IMA cover restrictions upon the manager as to :		
•Level of annual turnover	☐	☐
•Size (maximum and minimum) of individual property assets.	☐	☐
•Limits on participation in:	☐	☐
- direct development	☐	☐
- funded development	☐	☐
•Types of property to be invested in	☐	☐
•Limits on sector distribution	☐	☐
•Exposure to a single tenant.	☐	☐
•Exposure to leasehold property	☐	☐
•Exposure to non-income producing property	☐	☐
3.3 With reference to the performance benchmark chosen for the Fund, has a sensible performance target been established which reflects the risks the fund is prepared to take?	☐	☐
3.4 Has enough money been allocated to create a diversified portfolio of direct property?	☐	☐
3.5 Will a diversified portfolio be achieved in a reasonable time frame?	☐	☐
3.6 Has indirect investment been considered?	☐	☐
- Exclusively?	☐	☐
- As part of the portfolio?	☐	☐

PENSION FUND PROPERTY INVESTMENT CHECK LIST (CONT..)

		YES	NO
3.7	Has a decision been taken as to whether the following would make a contribution to improving the risk profile and return expectations of the Fund?	☐	☐
	Property Unit Trusts	☐	☐
	Limited Partnerships	☐	☐
	Authorised Property Unit Trusts	☐	☐
	Property Index Certificates	☐	☐
	Other "synthetics"	☐	☐
	Property Equities	☐	☐
	New Property vehicles	☐	☐
3.8	Is your manager prepared, empowered and authorised to invest in these vehicles or instruments, if appropriate for your portfolio?	☐	☐
3.9	Have the Fund's Trustees and property advisors got a copy of the Investment Property Forum's report on Property for UK Pension Funds?	☐	☐
	- Have you considered its manager selection advice? (3.1.5.)	☐	☐
	- Have you considered its comments on fee and commissions? (3.1.7.)	☐	☐
	- Have you considered appointing a Valuer (6.)	☐	☐
	- Have you arranged for performance measurement? (7.)	☐	☐