The Evolution of the Market for Indirect Investments in Commercial Property

IPF Research Programme
Short Paper Series
Paper 6

February 2010

This research was commissioned by the
IPF Research Programme 2006–2009

Investment
Property Forum

This research was funded and commissioned through the IPF Research Programme 2006–2009.

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

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The Evolution of the Market for Indirect Investments in Commercial Property

How did the market for indirect investments in commercial real estate develop and what were the key drivers behind its growth?

IPF Research Programme 2006–2009

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IPF Research Programme 2006–2009

February 2010

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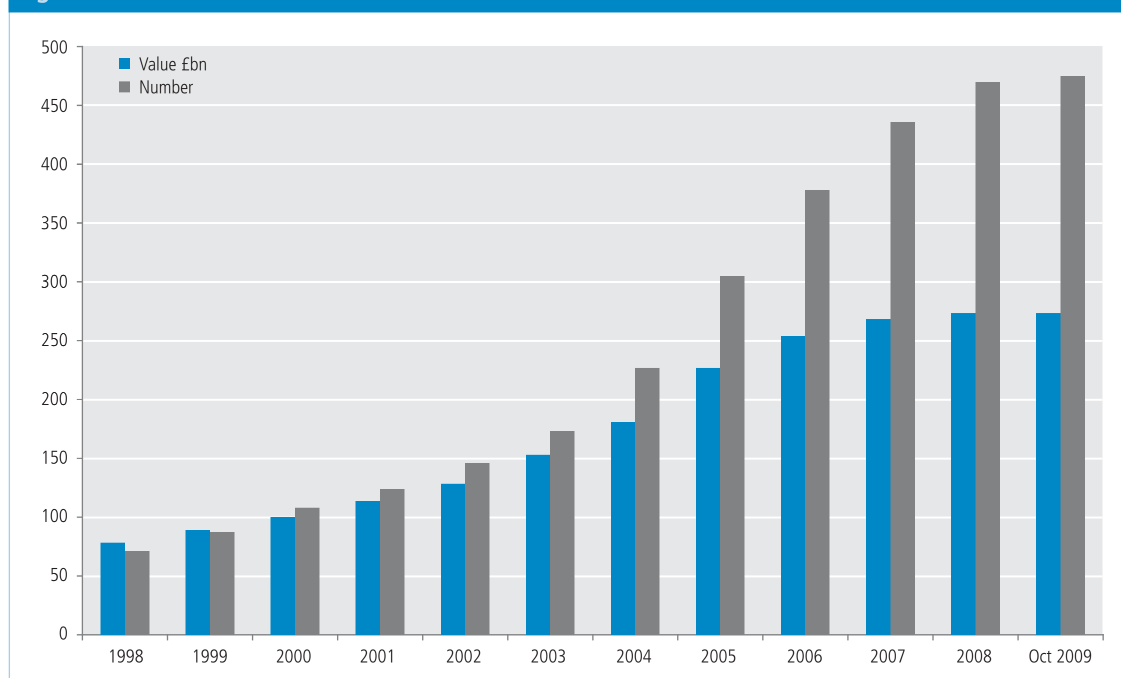
Introduction

The current recession is the first major downturn in the UK economy since the market for indirect funds in commercial real estate has become a significant element of the property investment universe. This paper explores the growth of the market, measured against the wider backdrop of the property boom and bust; the evolution and drivers behind its expansion; and finally, identifies and discusses issues that are emerging from the downturn and need to be addressed for this market to evolve successfully.

Indirect funds: the known universe

The dramatic growth of the indirect funds market over the last decade is relatively easy to measure. The INREV Vehicles Database shows the European indirect funds market grew from 100 vehicles with a gross asset value of just under €100bn in 1998, to 486 funds with a gross asset value of €296bn in 2009.[1] This clearly shows that the "bull run" of rising property values was matched by an explosion of new indirect fund products enabling investors to gain access to real estate.

Figure 1: Number and value of funds launched

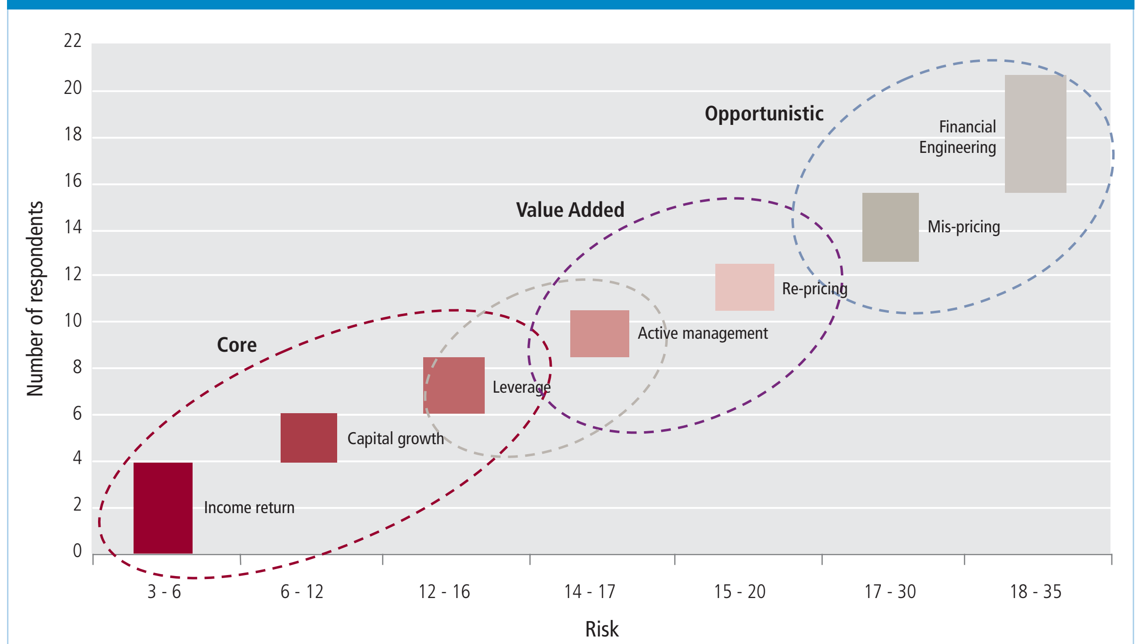


Source:INREV Vehicles database/IPD

This expansion of the market started in 2002, with the peak years for fund launches being 2005 and 2006, where nearly 80 separate funds were brought to the market each year.[2] Greater differentiation between funds began to emerge as the market became more crowded. Figure 2 shows how differentiation between funds is commonly organised. Between 1998 and 2003, core funds (those focussed on assets producing unexciting yet reliable returns) made up the majority of products launched in a given year. After 2003, higher risk value-added and opportunity funds established a greater prominence; a phenomenon that will be examined in greater detail later in this paper.

[1] INREV Vehicles Database Analysis, July 2009

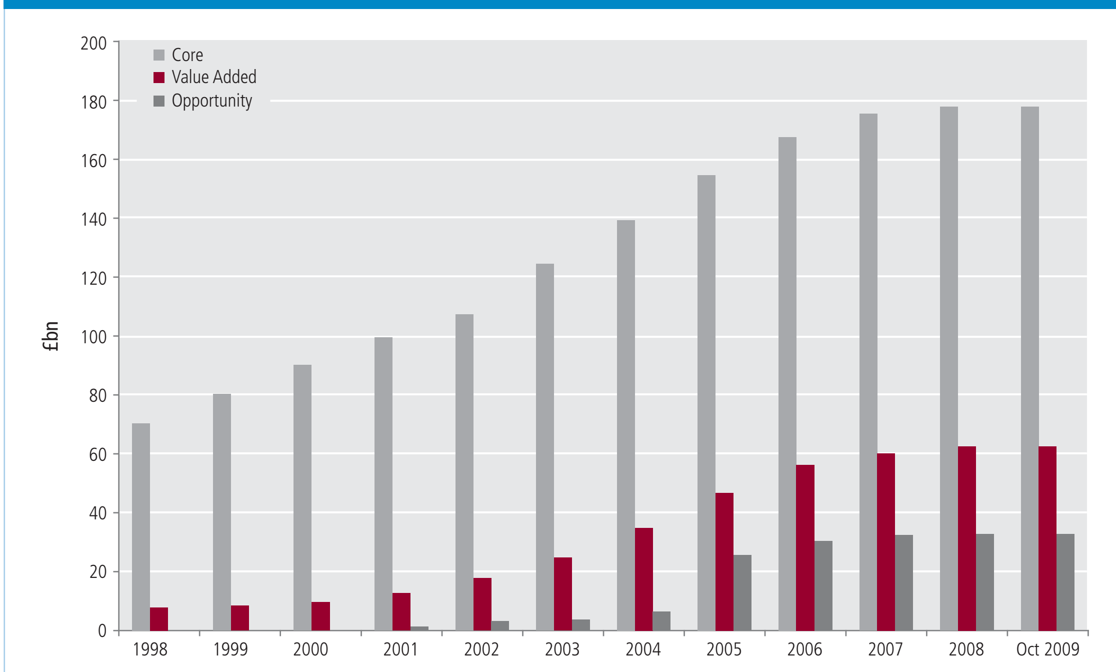
Figure 2: Risk and return contributors - Illustrative example



Source: Aberdeen Property Investors, Investment Strategy

The sector-split of funds in the INREV universe is telling; the majority (52% measured by gross asset value) are diversified funds, investing across more than one property sector. The continued dominance of this strategy reflects the key driver behind the growth of the indirect funds arena - a means of diversifying institutional commercial property exposure away from what had been the norm - a smaller pool of directly-held assets. However, sector-specific funds have grown to occupy a significant portion of today's market; the most popular segments are retail (14%), offices (12%), industrial (8%) and residential (8%).

Figure 3: Market Growth (Core/Value added/opportunity)



Source: Data prior to 2009 INREV/IPD, 2009 data INREV

When it comes to the target location of indirect funds, simplicity still rules the day. Today, 62% of funds in the INREV universe are targeted on a single country. The next largest group are pan-European, accounting for 21%. Whilst the desire for diversity has certainly expanded the geographies of the indirect funds world (see Box 1 - Fund of Funds), the peculiarities of tax, domestic real estate legislation and management issues means single-country funds remain the norm.

To put the size of the indirect market in context, one must appreciate that not all unlisted European vehicles are covered by the existing indices. Property researchers estimate that the total value of investment grade commercial real estate in Europe is circa €1,500bn. According to INREV's database, unlisted funds would then account for 20% of the investment universe. However, researchers estimate that the true figure could be as high as 50%, if the gross asset value of private equity funds and the plethora of retail funds available to high net worth individuals and private investors are included.

Of the remainder, researchers broadly agree that circa €200bn (13%) of direct assets are held by pension funds and life funds, although the trend has been for this to decline and for indirect investment to increase. The gross value of assets owned by the European listed property sector is approximately 200bn, and the gross asset value of the German open ended funds is approximately €120bn. Judging by recent transactional evidence, the Sovereign Wealth Funds now own about 60bn of European investment property.[2]

[2] All estimates Investors Chronicle research

The range of investors who participate in the indirect market is diverse. The institutions are the dominant force; European pension funds and insurance companies control stakes in unitised and pooled funds, property unit trusts and limited partnerships. In the UK, institutional investors own an estimated 40 per cent of core commercial investment stock (by value). Of this total, approximately one-third is held indirectly, and two-thirds in direct holdings.[3]

Of course, indirect property funds were not just popular with the institutions. Private investors also invested substantially in open-ended unit trusts as the property boom picked up pace (see Box 2 - Property funds and the private investor).

Much of the growth in the underlying fund management industry occurred in the UK, which soon emerged as Europe's indirect fund management capital. Of the 486 indirect funds tracked by INREV today, the largest group (38%) are managed by UK fund managers, the next largest segment being run by German fund managers (16%).

The UK has an established history when it comes to open-ended real estate funds, in the same way that Germany has traditionally favoured the open-ended fund structure. Both groups were early pioneers in the real estate market, spreading out of their domestic markets in search of greater diversity and more enticing returns. Such an established real estate knowledge base provided a firm foundation for the UK fund management industry's position as the number one importer of capital.

"The UK is a destination for international capital and there are a lot of good reasons why it is so dominant," says Bill Hughes, Managing Director at Legal & General Investment Management and president of the Association of Real Estate Funds (AREF). "The UK is easily the most developed and largest real estate market in the world for the size of its economy. The proportion of assets in institutional ownership is much higher, and the transparency of valuation methods and maturity of the market all helped to sustain the rise."

The relative maturity of the UK real estate research industry also aided the expansion of the indirect funds market. The launch of Investment Property Databank (IPD) in 1986 was not only ahead of its time, but provided a sound statistical basis upon which to base real estate investment decisions.

What came first - the vehicle or the investor?

A key question to emerge is whether the intense growth witnessed in the last decade was down to the increasing investor demand for real estate exposure or the creation of new indirect real estate vehicles? The short answer is that the same drivers were responsible for the rise of both, and within this, three key themes emerge:

- An institutional movement towards diversity
- The rise of outsourcing
- Performance and transparency

Across the investor spectrum, indirect funds fulfilled the need for diversification in a market characterised by rising capital values. The institutions, who had amassed portfolios of directly held property, managed by in-house teams, were beginning to recognise that a small portfolio of directly held assets concentrated asset risk.

"A pooled exposure of units in a bigger fund offered much better diversification, plus the added extras of better fund management skills and financial understanding such as greater tax efficiency," says Mr Hughes.

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[3] IPF estimates

The option of investing in units also gave investors access to sections of the market where large lot sizes prevented them from owning, particularly prime assets, in their own right. Retail warehouses, central London offices, and large shopping centres all produced attractive returns, but the rise of indirect investment meant they were now within reach of smaller investors for the first time in history.

For this reason, Phil Clark, Investment Director of AEGON Asset Management and chairman of the IPF's Indirect Property Funds Interest Group argues that the fundamental principle of indirect investment funds is offering "optionality".

"Balanced funds and pooled funds had been around for many a year, giving a general exposure to commercial property," he says. "But the non-listed funds industry started developing what I call optionality - being able to buy into management expertise in specific sectors. Aside from 'core' property, there were shopping centre funds, alternative property sectors such as PFI and healthcare, student accommodation. This has evolved into the plethora of sector-focussed funds that exist today."

Thus, the much sought-after diversity was achieved firstly by the indirect model itself, and secondly by the creation of a variety of niche products within this, from which investors could pick and choose according to their own investment strategies. And when it came to the buying in of specialist management, performance was key.

"There was a change in the architecture of the industry," says Rachel McIsaac, outgoing chief executive of AREF. "In the beginning, a lot of institutional investors had their own mandates, a basket of directly owned properties, and a whole department of people to manage them all. Having a whole internal department to manage assets that were typically a single percentage point of their total investment portfolio by value was madness. Hence the rise of the big fund managers."

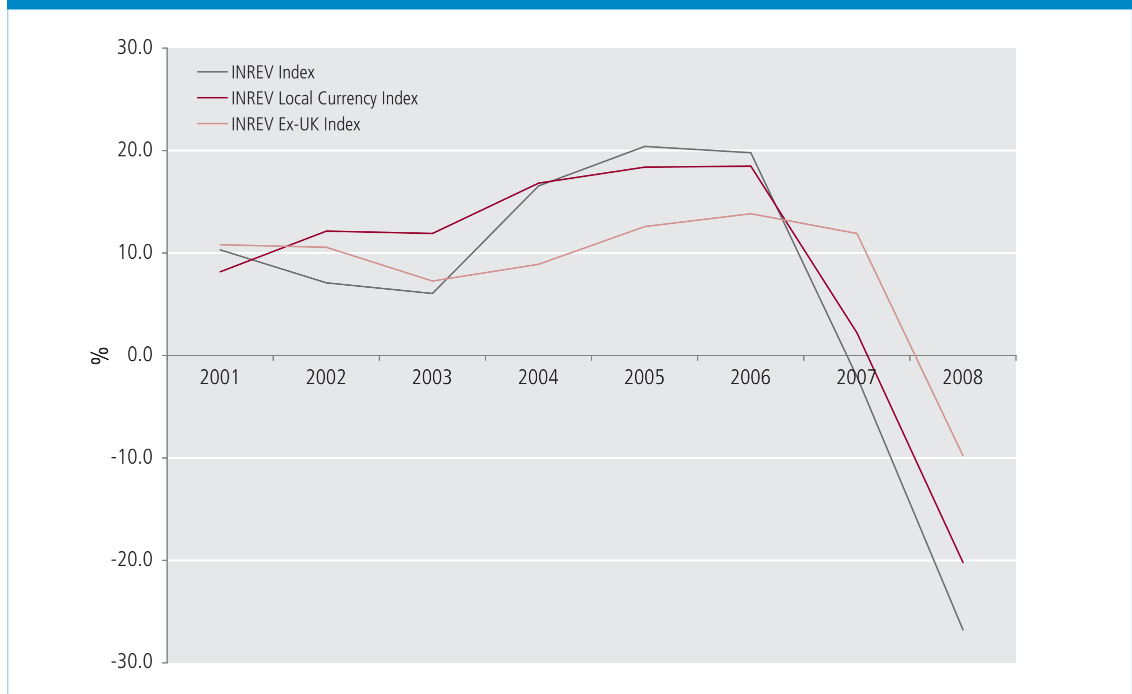
Particularly for smaller investors, building an in-house team to deliver a comprehensive investment strategy was simply not viable. "Another factor is the underlying outsourcing trend witnessed in institutions, listed companies and governmental entities, and the belief that it was more cost effective to "buy in" expertise," adds Lisette Van Doorn, former chief executive of INREV.

A greater diversity of fund management strategies began to emerge, moving from the early dominance of core real estate funds, to value added (property that can be improved in value via asset management or redevelopment) to niche (a bet on certain sectors performing more strongly than others) and latterly opportunity funds (undervalued real estate that can be repositioned at a later point in the cycle).

It also appears that the choice of fund manager was influenced by a common geography. "Investors started with direct property investment in their home country, then progressed to indirect investment, and eventually moved to indirect investment outside of their home country," explains Ms Van Doorn. "In my experience, they often travel with the party they know. For example, Dutch investors went very much with ING, and UK investors went with UK fund managers to the Continent."

And when it came to selling fund management expertise to institutions seeking to outsource, the best weapon in the fund manager's arsenal was data. IPD's method of measuring total property returns (income plus underlying asset value), showed property's strong performance relative to other asset classes in the best possible light. From the mid-1990s, total returns just kept on growing (see Figure 5).

Figure 4: Returns for Non-listed real estate funds 2001 - 2008



Source: INREV

"The main driver in the UK was performance, which was really impressive as we came out of the 1990s slump, and in this respect, transparency drove the market," says Ms McIsaac. "People were able to make investment decisions on the back of solid performance data. You could walk into a presentation with trustees and you had all the numbers in black and white. Independently audited figures from IPD satisfied governance issues of the big pension funds, making them an easy sell."

Property had started to become popular once more. As fund managers jostled to market new products to a captive and growing audience, leverage and specialisation would play a greater role.

Driving further growth

The use of debt to enhance investment performance grew in popularity from the turn of the millennium. The real estate market continued to deliver strong returns, but in a low interest rate environment, investors had the appetite to take on more risk by taking on debt to drive them even higher. Put simply, gearing was used as a tool to increase the value of assets under management which unsurprisingly grew from approximately €125bn to nearly €300bn between 2000 and 2007.[4] This produced strong performance in the rising market but proved fairly catastrophic once the market moved into the downturn.

Core funds tended to be conservatively leveraged, containing typically less than 20 per cent debt, but the introduction of higher risk "added value" and sector specialist funds tapped into a new investment mind set, and higher gearing was considered to be acceptable. Plus, whilst property continued to rise strongly in value, returns appeared to be sustainable, and liquidity seemed not to be an issue - what was there to worry about?

[4] Source: INREV 2009 Vehicles Database, market growth

The emergence of specialist funds coincided with the rising popularity of gearing. "The idea was that through buying into a dedicated specialism, investors could gain an additional return through the knowledge of the funds' operators," says Mr Hughes.

Additional returns were on offer with value added and opportunity funds, where the skill of a new breed of specialist real estate fund manager was active asset management; in the words of one fund manager, "buying the worst house on a good street and putting it right." This achieved, investors were left with a core asset, and enjoyed higher returns to compensate for the risk, whilst market values continued to rise.

Gearing was also embraced by sector-specific fund managers (for example retail, central London offices, retail warehouses and later, even more niche areas such as student accommodation and healthcare property). Market commentators agree that along with added value vehicles, these funds typically out-performed the wider market between 2001-2007.

However, it is possible to argue this was down to their use of gearing, rather than any specialist knowledge of their sector. Specialist funds may have successfully borrowed to enhance performance in a rising market but this again exposed them to the risk of very poor performance once the market turned.

By 2003, indirect funds with gearing of 60% of asset value had emerged onto the market. There was a woeful under assessment of the risks contained by such highly geared business models if the market turned. At the time, a sudden and devastating collapse of property values was seen as having a low probability, although in fairness, nobody could have predicted how steep and severe the correction would be when it came.

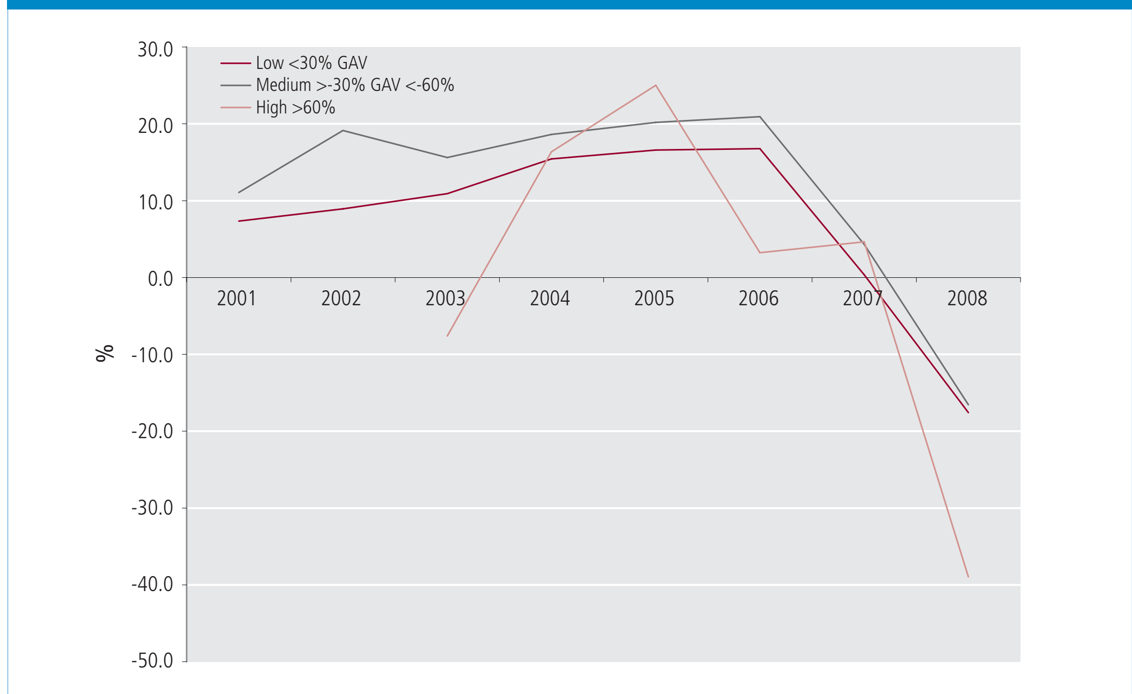
Mr Hughes ascribes the fund management industry's growing acceptance of gearing to "a presumption that either the bull market would go on forever, or that they would have the opportunity to reverse the gearing and sell assets before the top of the market arrived."

From 2003, the turbo-charged performance of highly geared funds was enough to silence any of their critics, or at least made it difficult to them to establish a case for caution.[5] With returns of 20 per cent or more now achievable, suddenly commercial property was on everyone's radar including the private investor. By comparison, funds which didn't use as much gearing appeared to have an impaired performance. These were strong drivers for investors to demand gearing and managers to oblige.

Large volumes of real estate changing hands lulled investors into a false sense of security about the liquidity of property as an asset class. What was commonly described as a 'wall of money' chasing real estate meant fund managers were under pressure to get money spent. The greater problem at the time was lack of product, i.e. too few assets on the market. Such high levels of demand may have give a false impression of the ease with which assets could be traded.

[5] See figure 5, Returns by gearing levels 2001-2008, which shows highly geared funds (60% or greater) pushed through the 20 per cent returns barrier in 2005, the peak of their ill-fated performance.

Figure 5: Returns by gearing levels 2001-2008



Source: INREV

Certainly up until the summer of 2007, the capital was chasing the fund managers and real estate was in danger of becoming, if it wasn't already by that stage, over popular as an asset class. The impact of leverage meant the indirect funds had more buying power, but the banks were not just lending to institutional investors. Listed and unlisted property companies, private equity property funds, consortiums of private investors - the bankers rewarded for meeting origination targets were willing to lend to them all. This ratcheted up demand creating competition for real estate assets that created a classic asset-price bubble.

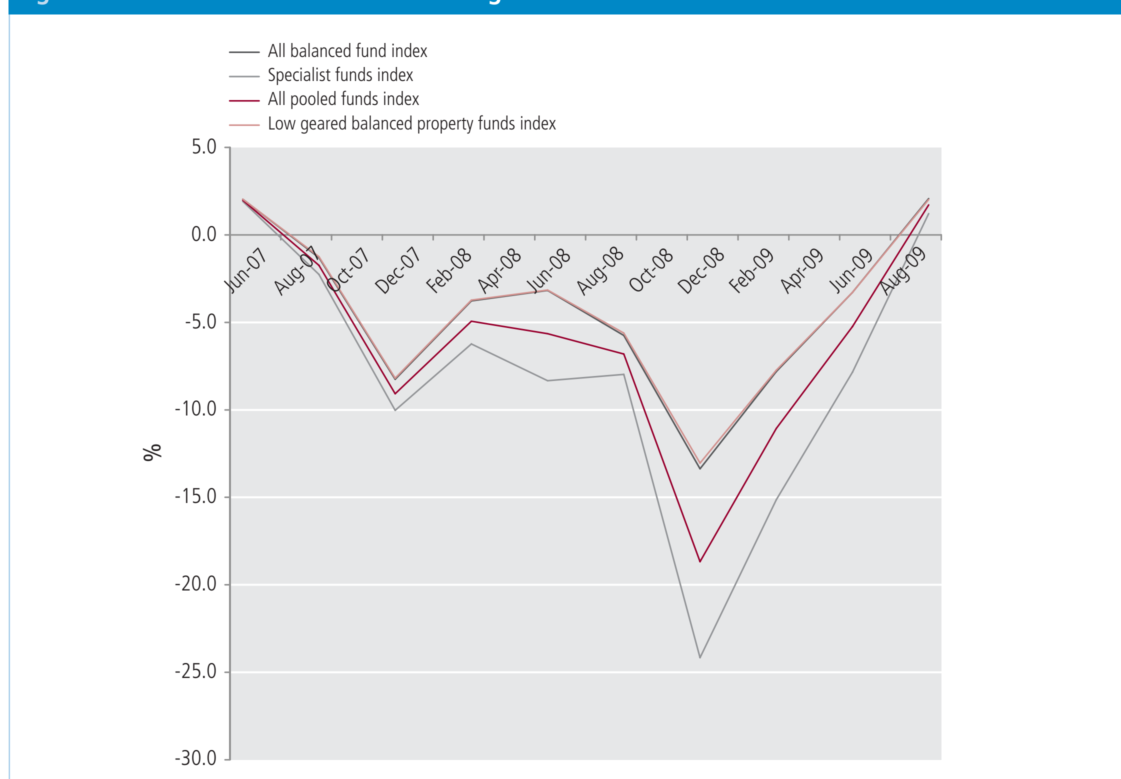
The response from some fund managers including UBS Triton was to close funds to new investors for many years. "There was a lot of money waiting to come in, but you couldn't buy the right type of properties," recalls Ms McIsaac. By closing off to new investors, fund managers had to suffer reduced performance figures. So for many, it was easier to carry on buying regardless of the risks.

"The impact of gearing was not thought through enough," says Ms Van Doorn. "There was no stress testing done for an event with low probability, and a very, very high negative outcome. On the one hand, it is a step in the development of the indirect funds market, which is by and large only 10 years old. We've never had a real downturn before now. There have been a few property market downturns, but not in the non-listed market itself. This is unfortunately a big step back after many steps forward."

"With hindsight, it was a flawed supposition to assume returns could be enhanced through gearing," says Mr Hughes. "Even moderate levels of gearing have turned into high levels in a falling market, and destroyed returns."

By Autumn 2007 property values had started to fall (see figure 6), and it was not long before the loan-to-value covenants attached to the bank loans agreed in boom time were in danger of being breached, particularly in the highly geared funds. By late 2007, for the first time, funds had to sell properties in order to stay inside their debt to equity limits. In the rush to divest, they discovered the structural fault lying at the heart of the indirect investment model - property is an illiquid asset however you package it.

Figure 6: IPD PFFI Performance June 07-August 09



Source: IPD

Liquidity: the mirage of an oasis in the desert

Uncomfortable questions have been raised as a result of the downturn, chiefly does the indirect fund model still work, and furthermore, has it failed? If any judgement were to be given, the liquidity myth would form the basis of the naysayer's case.

"There was a misplaced belief that liquidity in units would be better than liquidity in direct assets," says Bill Hughes. "The logic has some basis - the speed and due diligence of transacting units is substantially shorter in most market conditions. But in a rapidly falling market, units in pooled funds are no more saleable than direct assets."

The twin pressures of falling capital values and rising redemptions as investors lost their appetite for property made the funds forced sellers of assets - and the higher the leverage, the greater their pain. By selling into the downturn, funds were realising less than "fair value" on their assets and crystallising losses. In turn, these lowly valued sales

formed market evidence that hit the net asset value of funds even further, creating a vicious circle. The result? Gearing, illiquidity, demand for redemptions and distressed selling have rendered fund-level performance far worse than the direct market.[6]

Recently, evidence of certain funds being withdrawn from the IPD PPFI index has emerged[7]. To be included, funds must have quarterly valuations. However, a growing number of funds would prefer to have annual valuations, assuming this is acceptable to policy holders, in order to retreat into the background, and not advertise to the world that they are in breach of loan-to-value covenants.

It is a controversial talking point - transparency shouldn't be optional. Off the record, the fund managers lay blame for the shift to annual valuations at the door of the banks, who now find they have an enhanced position of power within the indirect funds world.

"The genie's out of the bottle," says one. "Most of the funds out there are bust. Most of UK real estate is fundamentally bust. Valuations have fallen 50 per cent, give or take, and most funds were at least 50 per cent leveraged. Well, hello there - you've just blown all your equity."

Conclusions

Having come so far, so fast, the next ten years of the indirect real estate funds market will face a new set of challenges as it continues to evolve.

Some investors have expressed dissatisfaction at the recent performance of some unlisted funds in recent years, calling into question the future prospects for this type of vehicle. However, it is important to separate out the various issues. Clearly, the performance of the underlying real estate within these vehicles has suffered along with the rest of the market, but this is to be expected. The real issue is structural: many of the unlisted vehicles that were created offered all the disadvantages of listed real estate but without any of the compensating advantages.

"Attracting large amounts of capital from numerous disparate sources, often with very different investment intentions, individual investors had little control over management decision-making and asset selection without the exit route of selling out of the vehicle, which is the primary attraction of the listed sector," argues Nick Axford, head of research and consulting at CB Richard Ellis. "However, the fundamental features of unlisted vehicles remain attractive: the ability to draw upon specialist management expertise, either at geographic or sector level; to spread risk and access types of product on a co-ownership basis that would not be feasible via direct single ownership; and to have a direct stake in the underlying real estate without the wider equity market influence on performance that affects quoted vehicles".

The disparate nature of ownership, coupled with the speed and severity of the downturn, was a bewildering combination for fund managers. Tentative signs of the market picking up[8] provides a more positive backdrop for the next challenge - de-leveraging.

[6] The catastrophic impact on performance of the highly geared funds (60% +) is clearly shown by INREV's Returns by Gearing Levels chart, which touched -40% in 2008.

[7] In the footnotes to the quarterly IPD PPFI index, names of funds who have been withdrawn from the index are listed. In April 2009, the Henderson UK Shop Fund was withdrawn following its winding up. Additionally, the Arlington Business Parks Partnership, ING Retail Property Fund Britannica and The Osprey Unit Trust were stated to be "no longer eligible for inclusion in the Index" though no reason is given. In September 2009, the Aberdeen UK Active Property Fund was withdrawn from the index by its fund manager, who stated: "the Fund's directors are actively considering options to secure and develop [the fund] in the context of an improving market… the Fund's directors consider it appropriate as this work progresses to withdraw [the fund] from the Index."

[8] AREF quarterly investment report for April to June (released in August 2009)recorded positive net inflows, showing that £320m of new investment flowed into pooled property funds, compared to £268m of redemptions. Improved performance in the UK equities market is causing many institutions to grow their property weightings accordingly.

Conducted in September 2009, INREV's Debt Study showed that almost 90 per cent of investors in non-listed real estate funds were concerned that funds they are invested in are likely to breach loan-to-value covenants. The obvious solution is for fund managers to persuade investors to commit fresh equity to cure any breach. However, the study also revealed that a third of existing investors have already refused to commit further funds. Gaining support from the investor base remains a pertinent challenge for fund managers.

However, not all the indicators are so troubling. Rather than try and cut their losses, market evidence shows investors will choose to extend the life of their funds rather than terminate them. An INREV study launched at Expo Real in October 2009 revealed that 59% of funds scheduled to terminate between 2009-2011 would continue, as neither investors nor fund managers wanted to sell assets at the bottom of the market.[9]

"Some investors are forced to stay invested in funds they would prefer to exit due to difficulties in liquidating at prices acceptable to the other investors," the survey notes. A greater level of involvement from investors was also evidenced, with respondents reporting that some investors are demanding business plans for all assets.

Today's market conditions present further challenges for fund managers – should they sell out of property assets, or try and buy more? Property values are rapidly increasing, with the IPD monthly index leaping up by a record 3% in December (the fifth consecutive monthly gain). In an uncertain world, the pressure to lock in gains via further asset sales is tempting, and will no doubt be a theme of 2010.

Conversely, property's strong income characteristics have boosted its appeal amongst institutional investors. UK institutions finally became net investors in UK property in the fourth quarter of 2009, according to KASPAR's UK Property Investment Bulletin, released this month [January]. A balance of £486m was recorded, the first positive figure since the first quarter of 2007.

Over the course of a year, the institutions share of total investment activity grew to 29%in 2009, up from 21% in 2007. However, the UK institutions were still the largest sellers at 41% by value in 2009 – some £9bn of commercial property assets – although this figure is down on the 43% level recorded in 2008.

Other fund managers are using bolstered valuations to carry out refinancing deals, with the aim of paying down debt early. In January 2010, Henderson's largest balanced UK property fund, the £450m Caspar fund, asked its lenders to waive loan-to-value covenants and grant permission for the fund to sell more property than the current limit of 13% of the portfolio a year. At the time of writing, investors in the CMBS secured against the fund's assets were about to vote on the proposals. Such complicated debt structures, invented on the way up, will take time and patience to dismantle on the way down.

The challenges of aligning the interests of disparate investor groups are just becoming known. Outside of the growing opportunity fund space, the era of multi-sector, pan-European indirect vehicles that attract dozens of different investors may well be over, but it doesn't follow that the trend for indirect investment itself will die.

"There is no reason why tightly focussed funds with strong, specialist management targeted at a limited number of co-investors who have common investment objectives should not remain a vibrant and important part of the real estate investment landscape in the future," Mr Axford concludes.

[9] INREV Fund Termination Study 2009

This paper has attempted to draw together the main features and highlight the key issues impacting on indirect investments in commercial property over recent years – a challenge given the rate of change and speed of development. Arguably there has been nowhere else in the commercial real estate investment landscape where developments have been as frenetic as in the indirect investment space. In such a market, opinion is inevitably divided about what have been the most significant drivers and developments and, importantly, how the market will evolve next.

That said, it does seem clear that whilst many investors were able to get exposure to real estate in a more attractive form than had been previously available, some of the growth in indirect investments was at least partly driven by some misunderstood characteristics and misguided motivations. As this paper shows, the extent of liquidity in many vehicles was misjudged by many unit holders and for some investors at least, the negative impacts of leverage were either ignored or deemed to be less significant than the outturn proved them to be. Both these issues seem set to continue to be significant ones and will be the subject of serious debate for both investors in, and managers of, indirect vehicles.

For the future the IPF research programme will continue to play its part in that debate to provide a forum for discussion and produce high quality research which outlines the forthcoming challenges and potential solutions for the market for indirect investments. Future topics of interest seem likely to be how the secondary market for indirect real estate units will develop; how valuation practices need to evolve over time in such vehicles; and the recurring issue of charges and fee structures. From an investment perspective too, what will be the most appropriate market segments and strategies to deploy? Will investors seek sector specific or diversified exposures? Will the market deem that core and opportunistic strategies are equally desirable and appropriate in indirect vehicles or will one style dominate in the future? If recent history teaches us anything it is that the market will continue to evolve creatively to meet needs of investors and that the speed of that evolution can often be surprisingly swift.

BOX 1: FUNDS OF FUNDS

It seems only natural that the strong growth witnessed in the indirect property funds sector should result in the creation of the "fund of funds" model, where expert multi-managers distil a diversified portfolio of holdings via the selection of several indirect vehicles.

The first such fund emerged in 2000; a year when target equity totalled just €2bn. Following a boom in popularity throughout 2006, 2007 and 2008, the total fund of funds universe is now estimated at some €20bn[1], showing the globalisation of real estate investment.

Further diversification was the key driver of growth in the fund of funds industry, with Asia and Europe being the most popular destinations for capital. Demand for exposure to Asian real estate markets stemmed from investors seeking increased exposure to emerging property markets, attracted by the breakneck economic growth in the Far East.

"Many of the UK institutional funds ventured into European investment allocations, and the next step was looking at a global one," says Phil Clark, Investment Director of Aegon. "Those global investors have two choices: either buy into indirect funds around the world, which takes a lot of time, resource and expense, or go down the fund of funds route. This is the most logical for small and medium sized investors."

[1] INREV Fund of Funds study, May 2008

However, the model also proved popular with larger investors keen to access emerging markets. INREV's Fund of Funds study shows that nearly 42% of investors had allocated €50m or more to funds of funds, although the majority of respondents (58%) only invested in one fund of funds. Asia was selected as a target region by 67% of the survey's respondents, compared to 42% for Europe.

This method of investment is not without its critics; key investor concerns are higher fees and potential conflicts of interest if the investment manager's own house funds are selected for inclusion. However, the chief concern is now indebtedness. High gearing levels and falling asset values in the underlying indirect investment vehicles is a problem multi-managers cannot easily fix. At the end of August, an INREV study revealed that 88% of investors and 85% of fund of funds managers were worried about breach of loan covenants in funds. For fund managers, the prospect of having to inject fresh equity into multiple underlying vehicles to cure breaches is a major challenge.

Of those INREV surveyed, half of fund of funds managers who had been approached about committing fresh equity had said no, with value added funds reported to be experiencing the greatest difficulties. This could be down to the fact that the majority of fund of funds products follow a value-added strategy,[2] and that these funds typically have the highest levels of gearing and hence are likely to require substantial equity injections.

How this crisis of indebtedness will play out is the subject for another paper. However, those using fund of funds as a diversification tool are now finding, to their cost, that the model has served in fact to concentrate their exposure to risk.

BOX 2: PRIVATE INVESTORS AND PROPERTY FUNDS

Indirect property investment didn't just appeal to the institutions - the "man on the street" or retail investor also sought exposure to commercial real estate. Just as the pension fund trustees had been convinced by potential returns, mainstream advertisements publicising very attractive historic investment performance were soon appearing everywhere, from roadside billboards to the pages of *Hello!* magazine.

Unsurprisingly, the money rolled in. In 2004, private investors ploughed £454m into property funds; by 2006, sales had spiralled to £5.6bn. At the market's peak in August 2007, UK authorised property funds had £15.7bn total assets under management.[3]

Sustained performance meant the good headlines kept coming, generating more awareness and creating demand for more products focussed on different property sectors. Soon, products for riskier emerging markets such as India and Africa were on offer. In popular investment consciousness these locations were at the start of a "property boom" in their own right.

[2] INREV Fund of Funds study May 2008 shows 41% of fund managers surveyed were targeting a value added approach

[3] All figures: Investment Management Association

But the open-ended structure of retail funds meant that once sentiment reversed, investors were caught in a liquidity trap. The mass clamour for the exit exposed the biggest structural difficulty - funds could not sell underlying real estate fast enough to cope with demands for redemption. Combined with the fastest plunge in property values in living memory, fund managers had to act quickly.

Many high-profile funds managed by major institutions were left with no option other than a 'fire sale' of property assets to meet redemption demands. Queuing systems had to be imposed on exiting investors, already reeling from the drop in value of their units. The greatest fear - a total suspension of withdrawals – was thankfully avoided at most of the big houses.

The problem was not confined to the UK - Santander had to freeze payments from its main real estate fund after Spanish investors tried to withdraw 80 per cent of the capital[4], showing the 'herd mentality' of investors. For fund managers trapped in the stampede, the focus switched to managing liquidity rather than managing the assets.

Chris Turner, veteran property fund manager at Thames River Capital, believes the sheer volume of properties such funds tried to dump on the market in the last quarter of 2008 was responsible for the record fall in the IPD Index.[5] He also believes the desire to spend money on the way up meant fund managers were left with assets of questionable quality on the way down.

"Looking through some of the property portfolios we have seen coming in [from funds trying to sell in the last quarter of 2008] you wondered how they ever came by them," he comments. "But in the good times, the money was piling through the door, and the more money they got under management, the bigger their bonuses became."

Property values became caught in a vicious circle; funds trying to sell assets to meet redemption payouts found there were few buyers, and had to sell at distressed discounts to book value, which dragged down the net asset value (NAV) of the fund even further - prompting more investors to head for the exit. Add on the costs of stamp duty and legal fees, and the picture gets worse.

"The really important thing to get across is that this is not a real estate problem," says Duncan Owen, CEO of Invista Real Estate Asset Management. "Retail investors behave in the same way, whether its equities or real estate. They tend to follow things that have *just* performed really well, and sell things that have *just* performed really badly. They were helped on the way with the market, which had delivered one of the longest sustained periods of out-performance."

Nevertheless, the rapidly changing sentiment in property valuations is not lost on the income-seeking private investor. Property funds have now become so popular, fund managers have a new set of problems to grapple with. UK private investors have been net investors in commercial property since the third quarter of 2008, according to KASPAR's UK Property Investment Bulletin. In 2009, they pumped £1.4bn in to the sector, through pension fund allocations and open-ended unit trusts. Property funds

[4] *Santander fund seeks to halt redemptions,* Financial Times, 16th February 2009

[5] The IPD UK Quarterly Property Index fell by a record 14.3% in the last quarter of 2008

achieved a record £417m in net retail sales in just two months at the end of 2009, according to the Investment Management Association – the highest levels recorded since the peak of the property boom.

The rapid rebound in property sentiment means that many UK funds are sitting on as much as 40% cash – once again, it is flooding through the doors faster than fund managers can spend it. This is a further blow for private investors who have stuck with their original investments, only to see recovery potential diluted by a substantial 'cash drag' on performance.

The way the majority of these funds are structured means fund managers are powerless to restrict inflows, or impose delays upon new investors until fresh assets are acquired. Instead, accusations of overpaying for assets abound within the investment community. In the rush to spend cash in a tight market, a further temptation for managers is to move up the risk curve, buying secondary or asset-management intensive stock. Where the investment model allows, fund managers are now also considering purchasing property equities (which introduces an additional element of volatility).

Concern that lessons of the past have not been learned, and are simply being repeated is not lost on Ian Mason, head of UK property fund management at Schroders. "Retail inflows are now back up to 2006 levels, so here we go again," he says wryly. "Is anyone listening at the Bank of England or the FSA?"

It stands to reason that the current momentum in the market cannot be sustained. Therefore, retail investors – again – stand to learn that property is a risky and illiquid asset class the hard way, and currently there is very little that fund managers can do to prevent this.

At the time of writing, many funds are still grappling with redemption requests, some remain suspended due to liquidity issues, and notice periods and exit fees are still in evidence across the sector. However, funds that had little or no gearing have been able to manage redemptions, and as market sentiment improves, they are turning cashflow positive. Many of these are actively back in the market looking to acquire property again. For example, the Scottish Widows Investment Property Trust has invested £160m in new acquisitions since July 2009, and still has £150-£200m of fire power if it is to reduce its current cash position from 33% to the targeted 10-15% level. Funds run by Legal & General and M&G have also turned cashflow positive, and are back looking for assets.

Since being taken over by Henderson Global Investors, New Star's flagship retail property vehicle has began to look for new acquisitions in October. The fund is now receiving net inflows of £20,000 to £50,000 a day, though as much as £300,000 is still being withdrawn daily by some investors. Furthermore, Standard Life has stated that "attractive property pricing" means it is considering the launch of a new property recovery fund, and Aviva and M&G are also rumoured to be considering such a step.[6] How scornfully the private investor community might view any new products remains to be seen.

[6] Fund Groups talk up commercial property again, Sunday Telegraph, 30 August 2009

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