Newsletter

Investment Insights

Property: Is it time for pension schemes to take the next step on the property ladder?

Over the last two decades UK pension schemes have doubled the share of their assets invested in property from around 4% to 8% of assets. Typically they have focused on UK "Core Commercial Property".

Schemes now have more options on the table than ever before. Global property and alternative UK properties are becoming more accessible and dozens of Real Estate Investment Trusts (REITs), have been launched since legislation for them was introduced in 2007. Is it now time for pension schemes to expand beyond UK core and take the next step on the property ladder?

In Part I of this Investment Insights Note, we look at the reasons why pension schemes should consider investing in property in the first place. In Part II, we consider the outlook for UK core commercial property and finally, in Part III, we consider a range of alternative property investments available to UK pension schemes and whether they offer a better, or complementary, alternative to UK core property.

PART I

Why invest in property?

Investment returns on property come from the rental income received and an increase in the value of the property ('capital growth'). Historically, 70% of the return comes from income and we firmly believe this should be the focus of investing in property.

As chart 1 shows, the level of yield has been fairly stable over the past 40 years, moving between 5% and 10% per annum. In contrast, capital values can be volatile in the short term, as witnessed by the 25%+ falls in 1991-93 and 2007-09. However, over the long term, they have provided an additional positive return.

For UK defined benefit pension schemes, we feel the income will be valuable as they move towards a position of needing to use their assets to meet benefit payments (i.e. become increasingly 'cashflow negative'). Furthermore, the income is higher than that received from lending to the UK government or investment grade companies and remains very attractive as shown by the yellow line in chart 2. The higher income will be partially a result of 'credit risk' and an 'illiquidity premium', receiving higher returns as a result of being unable to disinvest quickly at all times, which should be a key consideration for investors.

There is some validity to the claim that property provides an inflation linked return. However, we feel this claim is often overplayed and shouldn't be overly relied upon. Historically, property has therefore provided investors with a stable level of yield and over the long-run and a small amount of capital appreciation. Looking forward, do we expect these steady returns to continue?

Chart 1: UK Core Property Historic Returns

Source: MSCI

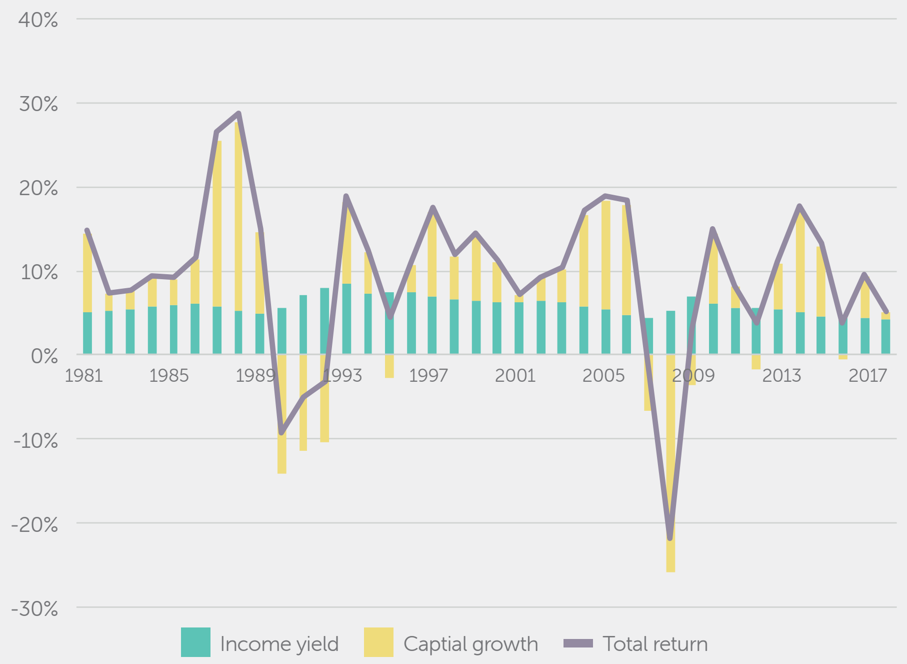
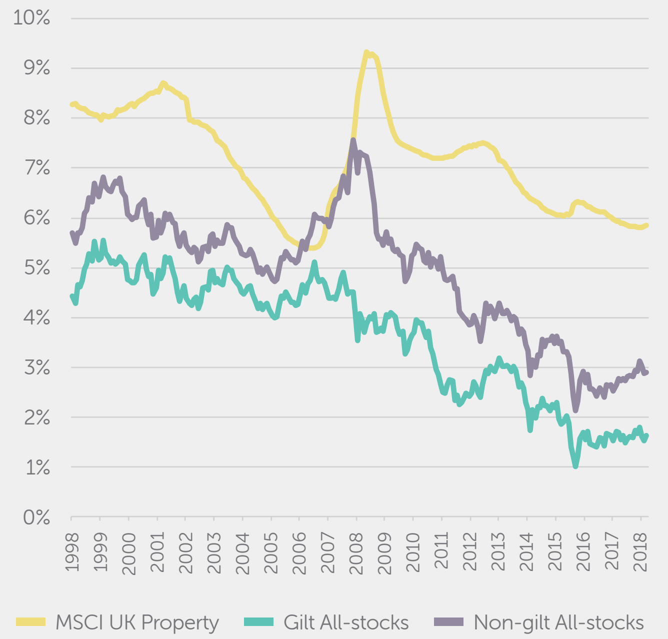


Chart 2: Property Yields Attractive Relative to Bonds

Source: MSCI, FTSE



PART II

UK core property

We start by considering the UK core property market as a whole and consider the supply and demand for UK properties. Core properties are usually large buildings, centrally located in major cities and of prime quality. If we first consider the supply of new properties, this has been limited over recent years, particularly in the aftermath of the EU Referendum in 2016. There has therefore been no 'construction boom' in the sector, suggesting there is no over-supply of properties in aggregate, as was the case in the run up to the fall in capital values in 2007/08. If we turn to the demand for properties, we see this can be influenced by:

- **The level of economic growth** – The better the economy is doing, the more companies and individuals will be willing to pay in rents to secure the best properties. The outlook here for the UK is mixed, given the ongoing Brexit uncertainty.
- **Demographics** – A growing population pushes up demand for property as the economy grows and people look for somewhere to live, work, or make purchases. Changes within the population, such as the size of the working-age population and changing consumer tastes can also change the distribution of growth between sectors. The UK population continues to grow faster than other European nations and as a result, the UK's working age population is one of the few in Europe's forecast to continue growing.
- **Interest rates** – This has an impact on the availability of credit that often underpins the cost of construction and purchase of properties. At present, interest rates are low. However, regulatory changes have meant that lending to the property sector remains well below historic levels, thereby restricting any construction boom. Overall, this is supportive of current market pricing.

Taking this all into account, we therefore see reasonably supportive metrics for UK property over the medium term. However, whilst we believe the medium term outlook in general looks supportive for property, this is not true for all parts of the market and in particular, the retail sector which we focus on below.

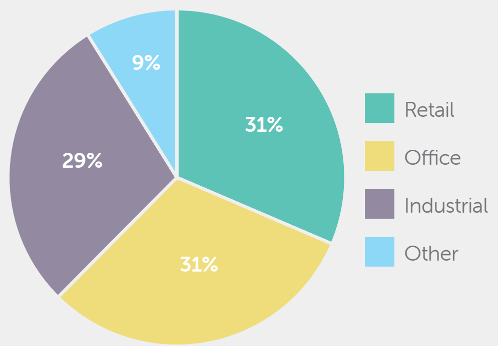
Retail sector challenges

The UK Core Property market is currently divided into three key sectors; retail, office and industrial sectors, which each make up about 30% of the index. Over the past 12 months, the industrial sector has vastly outperformed all other sectors. In contrast, the retail sector, that only 5 years ago comprised nearly 50% of the index, produced a negative total return. The retail sector's woes are well documented, with BHS and House of Fraser being two of the largest renters of retail space among a string of bankruptcies and companies that walked away from properties and reduced their remaining rental payments through Company Voluntary Arrangements (CVA's).

The problems for the retail sector stem from two distinct trends:

1. The increasing consumer use of online shopping at the expense of physical stores.
2. Consumer spending growth is slowing and evolving, for example, more focus on leisure and 'experiences' spending from younger generations. This puts further pressure on the more traditional 'bricks and mortar' retailers.

Chart 3: UK Sector Share Source: MSCI



These trends are not unique to the UK and are replicated in some form across the developed world. However, the UK consumer has moved faster in adopting an on-line approach to retail, compared to its global peers. Compounding the problems for the retail sector in the UK, are falling profit margins from rising costs. Partially resulting from the rising minimum wage and the fall in sterling following the 2016 referendum on EU membership.

These trends illustrate that the decline in property values in the retail sector is driven by a long term decline in the profitability of retailers, which results in property owners needing to negotiate rent reductions or face their tenants going insolvent. The key question is, whether these long-term trends are now fully priced into the price of retail assets? We think there is a very good chance that these trends are yet to run their course and are not fully reflected in prices.

Part II Conclusion: The outlook for UK core property

We therefore remain very nervous about the value of retail assets held in many UK Core Property Unit Trusts and would encourage investors to steer clear of those funds with large retail allocations. However, we retain a generally positive outlook for UK property over the medium-term. Given our concern over the retail sector, we turn our attention in the next section to alternative options for investors to gain exposure to property.

PART III

Alternatives

There are a number of alternative sectors to the property market other than a Core UK allocation and we consider three such sectors; UK Long-Lease, UK Private Rented Sector and Global Property.

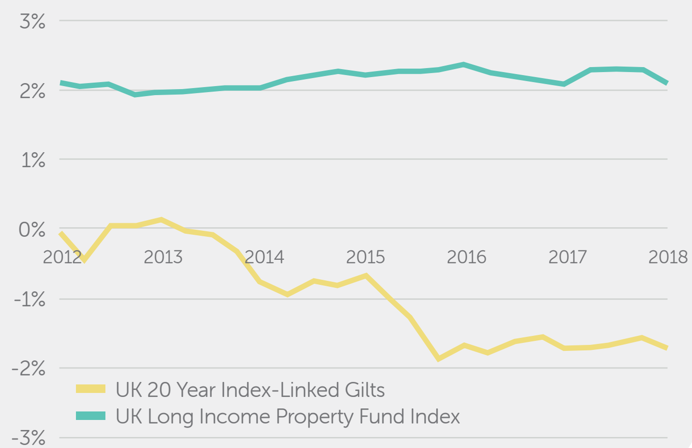
Long-lease property

Long-lease property funds focus on properties which are leased for very long terms, often more than 20 years. The contracts often include inflation-linked increases in the rent payments and with yields on index-linked gilts currently around -2%, there is huge demand for this sector.

A common form of long-lease property is a sale and leaseback deal, where an existing building owner sells the property and signs a long-lease deal as the new tenant.

Whilst attractive to pension funds with long-dated inflation linked liabilities, this is a market with a very constrained supply. There are not many tenants which the investor can be confident will remain strong decades into the future. Despite this imbalance, we find that long-lease fund managers have generally kept their discipline and yields have not reduced significantly, as evidenced on the chart to the right. However, this has led to long waiting times to become invested in this asset class (up to two years) and so would need to be weighed up carefully before making such an investment.

Chart 4: Inflation-Linked Asset Yield Source: MSCI



Private Rented Sector

The Private Rented Sector (PRS) involves a long-term investor providing the capital to fund the development and then operation of residential properties. This will often be purpose built apartment blocks, although there are funds available that have more of a focus on affordable, or social, housing. These type of properties currently only make up a tiny share of UK property. However in the United States and Europe where this market is more developed, PRS makes up 20-25% of the commercial property indices.

Over the last 25 years, PRS has been the best performing property sector in the US with the lowest volatility. A core differentiator between the PRS and commercial sector is that the volatility of income yield has been far lower within PRS. This is, in part, due to the fact that each building has a large number of small units rather than one large tenant. This means that a tenant default or an empty apartment has a much smaller impact on income.

There are a number of reasons why we feel the PRS looks likely to benefit from long-term structural changes in a similar way that retail property looks likely to struggle. These changes include:

- Rising house prices relative to average incomes have made buying a house unaffordable for many people. This problem is particularly acute in London.
- A societal shift in preferences, meaning renters are staying in rented accommodation for longer than they used to in the past.
- Renters are becoming more likely to pay extra for certain facilities that cannot be provided by individual landlords, such as on-site gyms.
- Fundamentally, there is a lack of supply of housing in the UK relative to the demand and therefore there is an opportunity for long-term investors to provide the funding, and make reasonable returns, to help address the shortfall.

Furthermore, residential property rents behave differently from traditional core commercial property. Whereas commercial property, is dependent on corporate demand and the growth rate of the economy, residential property returns are more closely linked to population and average income growth. This provides diversification from a core portfolio.

Ultimately, we believe that over time the PRS sector will grow and find its way into the benchmark of a core UK Property mandate in the same way that it has in the US and Europe. There is therefore an argument, that investors could "front-run" such an opportunity and make an allocation to the sector.

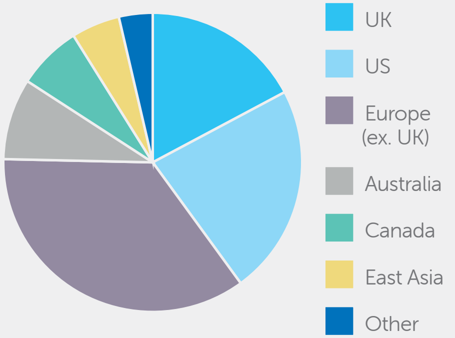
Global property

UK pension schemes have largely neglected to invest in foreign property markets. However, just as schemes have reduced their allocation to UK equities and bonds in favour of the rest of the world, is it time to update property portfolios for a globalised world?

The MSCI Global Property Index, has a total market value of more than $1.7 trillion, with around 23% ($388bn) of the total located in the US and 17% ($294bn) in the UK, making it the second largest property market in the index.

The arguments for diversifying into global property are very similar to those that apply to equities and bonds; it provides a greater pool of assets available for investment and hence brings diversification benefits. For example, and as highlighted in the previous section, PRS has a far higher weighting in US and European markets and thereby a global property approach will provide that diversifying exposure.

Chart 5: MSCI Global Property Index - Regional Allocation Source: MSCI



However, the diversification benefits should not be overstated, as global property is often drawing from similar pools of buyers attracted to a relatively restricted supply of property. This leads to a higher degree of correlation between the markets than would be expected from their regional growth rates and diverse property and planning regimes. Overall, investing in global property provides a similar degree of diversification from UK property as investing in overseas equities does compared to UK equities. Moreover, the stability of rental income yield from overseas is undermined by movements in foreign exchange rates and although this can be avoided using currency hedging, and hedged funds do exist, this will inevitably come at a cost.

Part III: Conclusion

Investing in global property is one option that pension schemes can consider as a way to provide property exposure in their portfolios. However, it is just as reasonable to invest in newer areas of UK property to provide diversification. Each option considered above has its own advantages and disadvantages.

- Long lease property funds provide a greater stability of income yield than the other options, but lack of supply means long waiting times to invest.
- The private rented sector has the potential to provide better returns as a result of structural factors. However, the market is immature and will require schemes to devote a higher level of governance to any investment.
- Global property provides diversification while maintaining exposure to similar underlying assets, but places a burden on governance as a result of currency considerations and unfamiliar risks to property investment.

Of these options, we feel the residential sector offers perhaps the most interesting investment opportunity at present.

A comment on alternative approaches to accessing property - Real Estate Investment Trusts

The majority of institutional investors access property through a unit trust. In this structure the scheme buys a number of units in the unit trust which correspond to ownership of a portion of the investment fund's property portfolio. The investment manager will use cashflows into the fund to purchase additional properties and if the investor wishes to exit the unit trust, the trust must sell property. Both of these processes can take a long time. As a result these funds are not fully liquid. Investors can face queues to enter, and those looking to disinvest can be temporarily prevented from disinvesting. Transaction costs are also high at around 5-7%.

Real Estate Investment Trusts (REITs) are publicly listed property, meaning that they are always liquid. Investors will always be able to withdraw their investments by selling their shares to another investor in the open market, but must accept market price, which may be well below the 'fair' value of the property. In the short term REITs behave more like equities than underlying property prices. Their price being determined not just by the value of the underlying properties, but also by the general level of demand in the wider equity market. As a result, REITs have high correlations with equity markets in the short-term. However, over longer periods REITs become less correlated to equities and more correlated with the property market.

There are arguments for and against REITs providing better returns than an equivalent Unit Trust:

- More specialism in certain niche areas of the market within REITs
- Greater management focus & 'skin in the game' within a REIT
- Loss of the illiquidity premium, although we find that by offering daily dealing this can be diluted in Unit Trusts as well.

Overall, we view REITs as providing a similar long-term return to Unit Trusts, the underlying assets are ultimately the same. Despite the fact that in the short-term, REITs will have more volatility, this is reflecting more frequent pricing points and so believe that for DC investors (where a 'guarantee' of liquidity can be important) or slightly more 'tactical' investors then REITs are potentially suitable. For longer-term investors, we think a more closed ended unit trust, structure remains preferable.

BARNETT WADDINGHAM
beyond the expected

Overall conclusion

We feel property should remain an important part of pension scheme's strategies and may become even more important than it currently is, as more of the market opens up to investment. We remain concerned about the retail sector and so some care is needed over allocations to UK core property funds. Although investors should not completely discount UK core property, pension schemes can now access a wider universe and should consider all the available options for their property portfolio. In general, we favour diversifying within UK areas first, before considering the extra governance challenges around global assets.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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