

# A GLOBAL OUTLOOK



**Panellists discuss choice in global property investments, the current limitations in the UK property market, direct investments, REITs, and the role of derivatives**

**There is now a lot more choice available to trustees when considering global property investments. Will this upward trend continue and will investors benefit?**

**DENNIS-JONES:** Yes, we definitely believe that this trend will continue in the UK as it has in other asset classes and countries now that there is a much greater choice of funds, markets and instruments to invest in. And yes, investors should benefit from having additional investment opportunities that might offer the possibility of extending the efficient frontier of their portfolio, by either producing higher returns for the same risk or the same return for lower risk.

**EINHÄUSER:** The choice available to trustees when considering property investments is likely to increase as the world economy continues to expand, resulting in new emerging and maturing markets. Greater choice can be of benefit to investors but it also carries a greater element of local risk, enhanced management costs and currency risk. Local knowledge together with correct identification and selection of appropriate investments will be crucial if investors are to benefit.

**FOLLOWS:** More choice is always a good thing but it does make the job of a trustee more challenging – investors will only benefit if the fund trustees are up to the challenge. With property performing well, the rising profile of this asset class and with continued globalisation then we feel that there will be more global property funds coming to the market. Trustees will be able to select property funds that match their specific objectives.

**FRANCIS:** There is no end in sight for the growth in international investment opportunities. The range of opportunities is vast as are the return and risk characteristics.

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When considering global property investment, trustees need to decide whether the investment is for diversification benefit or return enhancement. Furthermore, are the returns to be measured against a UK property benchmark such as Investment Property Databank, an international benchmark or some absolute return measure? For most pension schemes, any international investment will be of necessity via some pooled structure, and the impact of gearing needs to be considered.

With the increased choice of both managers and vehicles and with so many new entrants into the market, track record, experience in the particular global markets, and reputation will be the key in selection.

**HUGHES:** The investment universe for real estate is expanding rapidly. Investment is becoming more possible in a range of less mature markets, and the prospect of investing cross-border is becoming a reality.

The approach can be either to build up regional and/or country investment allocation, or to invest in funds that are overtly globally diversified. Both approaches have merit, with the right choice depending upon the degree to which an investor requires input to geographical allocation.

It is likely that investor interest in this area will continue to grow. The particular

market development that assists investors in internationalising their real estate exposure is expansion in the number and range of pooled funds and other investment vehicles available, which provides access both to diversification and expertise.

**MACLEOD:** Although the global property offer remains patchy, it is growing and we expect more and more vehicles to become available for investors who now fully accept property as part of a balanced multi asset portfolio. In addition, the ability to monitor property performance and demonstrate a clear track record is becoming easier. Investors will achieve better overall performance as the global property market is not synchronised and therefore there are benefits in having global diversification where performance from a number of locations can be blended to provide an overall attractive return. As the global market matures, we would also envisage the cost of entry and management fees to fall.

**MARTIN:** There has been huge growth in the variety of routes for UK-based investors to access international property investments. But in practice most pension fund investors have so far focused on continental Europe. We remain at the early stages of a move further afield, for instance into the US or

Asia-Pacific. There are already a number of vehicles available to access these markets and it seems likely that this will only increase in the next 2-3 years.

While more choice is ultimately a good thing, it does also make the property investment landscape more complex. It will continue to be critical for schemes to consider the risk-return trade-offs available from global property markets relative to the UK.

**MORROGH:** We believe that this trend is very likely to continue and that it will be beneficial to investors. In the short term we see returns from UK property moderating after a very strong run, with a reversion to income providing the greatest contribution to returns rather than capital appreciation, as has been experienced over the last few years. With the European market at an earlier stage of the cycle, returns from Europe are likely to continue building throughout 2007 and 2008, providing investors in the region with excellent growth opportunities. Meanwhile, Asia offers its own exciting opportunities allied to the region's rapid urbanisation and development. Over the longer term, just as has been the case in other asset classes, investors will benefit from risk reduction via geographical diversification.

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**YEOMANS:** Undoubtedly, the number and variety of vehicles available will continue to grow for the foreseeable future because the demand for them is there. We are seeing innovative products, different types of investment vehicles and wider geographic coverage.

Markets that are difficult for outside investors to access at the moment, like some of the EU candidate countries, will become more sophisticated and will adopt practices similar to those of western Europe. In this respect the property market is following the trend towards globalisation. But, as always, investors need to feel confident and will only commit if the regulatory framework is sufficiently robust.

**How limited is the UK property market at the moment? Will a lack of supply encourage more schemes to invest overseas in the near future?**

**DENNIS-JONES:** If by limited, reference is being made to the "lack of direct property investments", investors should note that transaction records show very healthy levels of volume. While there is more competition for investments than in the past, a perception of a lack of supply could be due to a number of investors believing that pricing is not particularly attractive at the moment. This fact is encouraging more schemes to look to invest overseas although diversification is another important factor encouraging this trend.

**EINHÄUSER:** While it is true that in recent years demand for property investment has outstripped supply, we would not say that the UK property market is limited. There is supply in the UK property market but often investors were not prepared to accept the low yields UK property offered and as a result some have looked overseas for increased returns and diversification. We believe that schemes will continue to consider overseas investment, but only as part of a larger diversified portfolio rather than as an alternative to UK property.

**FOLLOWS:** The weight of money coming into the property market over previous years has put pressure on the market and has contributed to the yield reduction we have seen. A lack of supply of product could push schemes to overseas investing, but moderating market returns in the UK are likely to be a bigger driving factor to overseas investing. However, we are confident that there are suitable property investments in the UK. For most UK-domiciled investors a UK portfolio will be the core of their exposure to property as an asset class.

**FRANCIS:** Clearly the UK, and a number of international markets, are benefiting from a high level of investor demand. However we are not seeing any lack of investment opportunities in the UK. Furthermore, with over half the commercial property stock still in the hands of owner occupiers, according to the Investment Property Forum report of July 2005, there is still plenty of scope for additional supply. Some of this is already happening, with both HSBC and Merrill Lynch reported as selling their UK headquarters offices. Currently this brings some £1.5bn of additional stock in just two transactions. It would be a mistake to believe that many overseas markets, particularly core markets are not also experiencing high level of demand and so a move overseas may not provide the desired solution.

**HUGHES:** There is a substantial amount of competition for available investments in the UK, and for much of the past three years investor demand has exceeded supply. The inevitable result of this has been an element of price inflation, but at the same time there has been a substantial expansion of the investable

universe, both in terms of a greater volume of sale and leasebacks transferring real estate ownership into the hands of professional investors, and in the emergence of new sectors of the property market. The overseas market provides an additional form of diversification, though this makes it absolutely critical to have access to local real estate expertise, and brings with it the potential cost of currency hedging.

**MACLEOD:** We do not believe the UK market is limited in absolute terms, with performance



projects for 2007 now in the order of 9-11pc per annum and the five-year return forecast of circa 7pc per annum. The question for most investors is the pricing of UK assets and whether the projected returns are attractive relative to the property risks and against alternative investment sectors.

There is currently strong interest in securing overseas property exposure in an attempt to achieve enhanced returns. We expect this trend to continue with the majority of investors looking for an exposure in the medium term of between 15-25pc to overseas property.

**MARTIN:** We have little doubt that the return from UK commercial property in the medium-term will be significantly lower than has been seen over the past three years. But with return requirements increasingly in the 6-7pc per annum range, the sector will continue to attract interest from a range of investors. While investing overseas may offer the potential for higher returns at certain points in the cycle, it brings with it extra complexity. Operating in different currencies, regulatory, legal and leasing markets requires time and expense to mitigate risk.

Furthermore, the case for investing overseas may now be less compelling than it was several years ago. Yields in many parts of the Eurozone are now at levels similar to the UK. With euro rates likely to rise in the coming months, the positive impact on Eurozone property returns from the positive yield gap over debt costs may fall back.

**MORROGH:** Supply of super-prime, 'trophy' assets is tight, but there is plenty of stock to be found in the tier just below that, i.e. quality stock that provides a superior yield. This is the tier that we operate in and we believe that there are decent gains to be made from managing assets in this part of the market, especially as the shape of market returns normalises with income reverting to the key driver.

The trend towards overseas investment is

probably more driven by a wish to diversify and by the growing availability of international funds.

**YEOMANS:** The market is limited, in the sense that it is relatively expensive due to huge demand. Inevitably, investors seeking exposure to property must consider alternative options overseas. That's not to say there are no opportunities in the UK, particularly if investors are prepared to consider new developments or regeneration schemes rather than just existing buildings.

a substantial fund as they can produce higher performance while giving trustees greater control over investment strategy, risk profile and target returns.

**FOLLOWS:** Direct property investment would require a reasonable fund size in order to be able to spread investments between equities, bonds, cash, direct property and achieve a diversified portfolio in each asset class, which is why so many schemes invest indirectly through funds rather than directly. Ultimately if the fund were of a big enough size it may be able to consider direct investment if it so wished.

Most UK investors now hold property portfolios that blend direct and indirect investments. A particular attraction of some indirect funds is access to specialist manager and exposure to special sector or joint ownership of large properties – such as shopping centres.

**FRANCIS:** The choice of investment route is driven by the particular objectives of each scheme and by the amount they wish to commit to the sector. For a portfolio of direct investments a scheme would need to be able to commit £100m or more to the sector. By direct investing the return characteristics can be more easily matched to the particular scheme's requirements and costs more closely managed. The early evidence is that REITs are influenced by the equity markets more than by the property market. However, they should offer liquidity to schemes, but at a price.

There is a well-established range of pooled funds available and an increasing range of specialist funds. Pooled funds provide a route for smaller schemes to gain a diversified exposure to the market. Funds of funds can provide access to range of underlying funds, including specialist funds, and take on the burden of fund selection but at an additional cost. These are probably more suitable for schemes taking a larger property exposure, whereas the pooled funds should offer sufficient diversification for most schemes.

**HUGHES:** The specifics of scheme investment objectives will be the key determinant of defining the appropriate route into real estate investment.

Each way of investing has specific advantages, and some potential negative features. Pooled funds provide greater diversification than investing alone, though this results in strategy and stock selection being delegated to a single manager. Fund of funds provide manager diversification, but in return the investor is one additional step removed from the property fund manager, and there is another layer of fees to pay. REITs provide greater liquidity, but their performance is inevitably more volatile. Direct investment provides the greatest level of control in decision-making, but for all but the largest investors brings with it problems over the degree of possible diversification.

There is now a variety of complimentary forms of accessing real estate performance, which collectively make the asset class more appealing.

**MACLEOD:** Direct property investment can only realistically be considered for schemes where the property allocation is over £80m. We would however advocate a combination of direct and indirect investments for smaller property allocations.

While REITs are still a relatively immature market, with a strong correlation to the equity markets, we would recommend a caution approach for institutional investors. Our preference would be for schemes to use pooled vehicles and fund of funds.

Although, we prefer the pooled fund route, the fund of funds route can offer better access to funds looking for specialist management operating in niche markets.

**How do schemes decide between investing through pooled funds, through fund of funds, or via real estate investment trusts? And can they realistically consider direct investments?**

**DENNIS-JONES:** Our past experience seems to indicate that the size of their potential investment is one of the main factors affecting UK schemes' decisions to invest in pooled funds, fund of funds or direct property. The larger schemes tend to choose a segregated portfolio, while smaller schemes usually choose pooled funds. Fund of funds seems to attract more mid-sized schemes and investments. However there seems to be an increasing interest in indirect investments, whatever the scheme size, due to the flexibility and expertise advantages they offer.

However there are numerous other factors that seem to influence the decision: past experiences, trustees' property experience and knowledge, trustees' appetite for risk, consultants views and influence, the geographical investment area and views on the need for manager diversification, to name a few.

REITs are very new in the UK so we will have to see how schemes view them. However, the experience from overseas is that they are often viewed more as an equity than property given their higher correlation with equities.

We believe that only the larger schemes can justify direct property investment due to the costs, time and diversification issue with building and managing a small property portfolio. If a scheme wishes to invest globally, then direct property investment is, in most cases, only likely to be viable for the schemes of global companies and extremely large pension funds.

**EINHÄUSER:** This depends on the size of the scheme, objectives of the fund and attitude to risk. Smaller schemes may benefit from the pooled funds or indirect investment such as fund of funds or REITs to achieve diversification and exposure to a larger investment market. Direct investments are still very attractive within

At the other end of the spectrum, the fund of funds route is also an easier way for small schemes to gain a core balanced property exposure.

**MARTIN:** For a scheme to invest directly, it must have critical mass to achieve a diversified exposure across sectors at reasonable cost. In practice, many schemes do not reach this threshold, explaining the strong interest in investing indirectly. A number of factors come into play when deciding between different indirect investment routes. The key issues are the 'purity' of property return desired, appetite for gearing, liquidity requirements as well as the degree of focus on manager alpha. A particular consideration regarding REITs is the tolerance for performance in the short term that is often more highly correlated with equity than is property returns.

**MORROGH:** There is a big difference between pooled funds, REITs and direct investments; understanding the characteristics of each approach is key to selecting the most suitable investment vehicle for a scheme.

Schemes, other than the largest and/or most sophisticated, are unlikely to invest directly in property due to the demands this would place on a scheme's operational infrastructure. Most schemes wishing to make direct property investments, that is investing in "pure" bricks and mortar, are likely to do so through a pooled fund (or a segregated account managed on their behalf). This approach provides pure property characteristics, but without requiring a fund to have in-house property managers.

REITs are a relatively new vehicle in the UK that enable schemes to invest in property by purchasing shares in companies that invest in property. The argument is that this should produce property-like returns as the income of these companies' is linked to the property market. In reality, a large number of REITs are exchange-traded and so provide investors with returns that are somewhere in character between equities (they are, after all, investing in companies and not property itself) and property.

Exchange-traded REITs are considerably more volatile than pooled property investments with, normally, slightly lower (than property) returns. Moreover, the recent strong performance of REITs, which was largely driven by legislative changes, is unlikely to be sustained in the longer term.

A sensible approach for schemes that do not want a large exposure to a single manager, region or investment vehicle is to invest in a fund of funds. By providing schemes with diversification across these factors, a fund of funds approach is a practical alternative to property investment, especially when direct-manager expertise across a large number of jurisdictions (such as Europe) is often limited. Fund of funds are able to provide investment insight, access skilled local property managers to implement this knowledge while providing investors with optimised fund blending, all by a well-known UK-based house. These well-established managers are also able to access funds that would not, otherwise, be available to your typical pension scheme.

**YEOMANS:** Of course they can – and should – consider direct investments, because the returns tend to be better. The current imbalance between supply and demand means pooled funds are having to hold a lot of cash, which dilutes their returns.

The choice of vehicle will depend on one's investment objectives. We believe the further away one gets from direct property investment

the less that returns will correlate with those from pure property. The types of vehicles mentioned represent a spectrum all the way from pure bricks and mortar to what are virtually equity investments.

Care needs to be taken when investing in such vehicles as they will tend to reflect stock market performance to a greater or lesser degree and therefore will provide less diversification than intended. Another aspect to be considered is that all these types of investment have different cost structures that will have an impact on total returns.

#### Is there a role for derivatives in a scheme's property investments?

**DENNIS-JONES:** Yes, there is a role for property derivatives as with other asset classes. The range of derivatives is not yet as extensive as with other classes. The main option currently available is a total return swap although a few brokers are now offering property options. (property investment clubs only seem to be offered sporadically.)

We would view the use of swaps at the current time as a tactical tool to enhance portfolio returns only. We would not view them as being suitable as a strategic investment. The manager can use its research, views and knowledge to more quickly and cheaply achieve market timing and take sector, country and asset allocation views.

Property derivatives also have a role in achieving absolute return benchmarks.

**EINHÄUSER:** This again would depend on the scheme's attitude to risk. Derivatives tend to carry a higher degree of risk than other forms of direct and indirect property investments. While they may be considered as part of an overall fund investment strategy they should not be viewed as an alternative to other forms of investments.

**FOLLOWS:** It depends on how risk-averse the scheme is and what proportion of the fund would be used for derivatives.

If solely used to achieve out-performance

then derivatives can be risky plays.

However, derivatives can also be used as a vehicle for hedging strategies, specifically in order to reduce risk (i.e. they can be used to offset an over-weight allocation in a particular sector to reduce the risk involved in being over-weight to that specific sector).

We have incorporated several derivatives deal into different funds where it has worked and the risk profile has allowed. The use of derivatives in a scheme would therefore depend on the intention behind the use – but it would seem possible and reasonable to use them for risk reduction/off-setting purposes where appropriate.

**FRANCIS:** Use of property derivatives, which tend to take the form of swaps, continues to increase. Most trades remain at the all property level and can provide schemes with a means to manage their overall exposure to property. However the development of market sector or sub sector trades will increase the opportunities for property managers to tactically manage their exposures within the portfolios. It is likely that most schemes will delegate their use to their property managers. As liquidity improves you can expect derivatives to play an increasing role for property investors.

**HUGHES:** Many schemes should be actively considering property derivatives as a cost-effective way of achieving market exposure, bringing with it the potential to re-weight portfolios cheaply, and also to substitute a property return for unwanted cash holdings. The residual obstacles over the use of derivatives are diminishing as the market develops scale, volume and diversity, though the most significant concern will be the liquidity of derivatives for those that would consider using them as a short-term tool.

**MACLEOD:** For a large scheme, the simple answer is yes. In today's market, derivatives can provide an added value opportunity as a tactical play. Positive positions can be taken against the market where the investor believes

there is mis-pricing in a particular sector or over a particular time period. In addition, smaller schemes can use the synthetic market such as PICs and IPD notes as a means of obtaining a low cost property exposure.

Looking forward, the derivatives market will undoubtedly mature to become a sufficient critical mass that will enable more and more schemes to participate.

**MARTIN:** To recall Oasis' debut album of 1994, 'Definitely Maybe'. Derivatives offer the same potential to schemes as to the wider spectrum of property investors. But despite the huge growth over the past several years, the derivatives market is still relatively immature and many property professionals face a steep learning curve before fully understanding the implications of derivatives and the range of trading strategies on offer.

Perhaps the key issue for schemes to consider is that derivatives are by their nature purchases and sales of indices, and so there is no role for alpha. In a lower return environment, schemes may not wish to sacrifice this proportion of return and so may find one of the more 'traditional' investment media more attractive.

**MORROGH:** There is a role for derivatives but their usefulness should not be overplayed. While they can be useful liquidity tools, we have reservations about the depth of what remains a relatively under-developed market.

**YEOMANS:** Yes, in a tactical sense. You might use them to manage the risk of over or under exposure to a particular asset class. For example, if a fund is seeking to invest in the market but unable to find a suitable product, it could gain exposure by acquiring units that would provide an IPD index-based return for a fixed period – typically three or five years.

Equally, derivatives might be a useful tool for gaining exposure to particular sectors, such as West End offices. Because the market is still in its infancy it is not yet possible to do this for all specialist sub-sectors but, if demand is there, this diversity should follow in due course.



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