

LOOKING LONG TERM

Wilky Fund Management's managing director NICK YEOMANS discusses what the potential for a slowing UK property market should mean for trustees, the feasibility of direct investment for smaller schemes and what sectors hold the most opportunities



With signs suggesting the UK property market may be slowing, should trustees be altering their investment strategies or allocations?

With the sudden flight from bonds we saw in early June, fears over the potential for a realignment in equity values and the prospect of a property market slowdown, trustees and their advisors have a lot to consider in terms of strategy and allocations. However, as property should be used as a long-term strategic asset to match long-term liabilities, rather than as a tactical tool capable of taking advantage of market fluctuations, the necessity for significant change should be limited.

What the property advisers should be identifying to trustees at this time is where, from within the existing portfolio, they believe they can extract value. They should also be identifying and seeking approval for any adjustments to their long-term investment strategies to ensure they are able to react rapidly to take advantage of any change in investor sentiment as a result of a market slowdown.

What is the real role of UK property investment in pension fund portfolios: an alternative to bonds for schemes matching assets to liabilities, or a means to generate returns with diversification benefits?

Historically property has performed in a counter-cyclical manner and is the only true contrarian to equities and gilts, smoothing out overall investment performance throughout the economic cycle. A meaningful exposure to property should, therefore, be seen as an essential component of investment strategy.

Not only are a pension scheme's needs predictable, they are often long term. Given this sort of requirement, the returns generated by property and its diversification benefits

should make it an essential component of most portfolios.

This is particularly true for mature pension funds that have well-defined current and future cash needs, since property provides a relatively high steady income stream from rents when compared with other investments – and with the added benefit of preserving or enhancing capital value.

For some smaller pension schemes, direct property investment is not feasible. But what are the benefits over pooled fund investment?

It has long been held that unless a fund can effectively cover the whole property market in terms of its direct property holdings, it is too risky for them to invest directly. This is not necessarily so.

By investing in market segments with smaller lot sizes (for example, high street shops, industrial units and provincial offices) it is entirely feasible to build a relatively low value, well-diversified portfolio. If exposure to larger lot sizes, such as retail warehouses or larger London offices is required, then indirect methods of investment can provide the solution. In fact, some research we commissioned from Property Funds Research has identified a ratio of direct to indirect investments that was particularly effective in maximising returns whilst, at the same time, limiting risk.

It should also be remembered that the further away one gets from direct property investment, the less returns will correlate with those from pure property. Some vehicles are so close to equity investments that they will tend to reflect stock market performance to a greater degree and therefore provide less diversification than might have been intended.

Moreover, the current imbalance between supply and demand means pooled funds are

having to hold a lot of cash, which dilutes their returns.

What sector holds the most opportunities for returns: retail, office or industrial?

With the market as it is today, there seems to be little margin for further yield compression. In terms of sectors, offices represent the best opportunity, particularly West End offices where there is a scarcity of available office space, and more particularly grade-A space, giving rise to the opportunity for further rental growth.

As far as regional offices are concerned, there is also scarcity value for new grade-A space in some of the major regional centres. However, as the secondary rental market is more in equilibrium, restraining rental growth, careful stock selection is vital.

Industrial will continue to be steady, if unspectacular, but retail is a concern. High street and retail warehouses have been suffering because consumer behaviour is changing, with the rise of internet shopping and the discounting culture. Rising interest rates and mortgage pressures will only make matters worse as families continue to draw in their horns.

Whilst there is growing interest in specialist sub-sectors of the market – like health, leisure and business centres, where investors perceive there may be value to be found – to invest effectively and profitably in these sectors, you require very detailed knowledge of the businesses themselves as the investment is as much in them as it is in the property.

Overall, we expect total returns from property of around 8pc this year and an average of around 7pc for the next three years. While we anticipate a period of much lower returns, property will continue to offer very respectable performance.