For Professional Advisers Only

A Spotlight On:
The Property Sector

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Introduction to Sector

According to the Investment Association's (IA) latest data, the UK Direct Property sector has assets under management of £18.4 billion as at March 2019. The sector is home to those funds that invest predominantly in real estate located in the UK and to qualify, at least 70% of a fund must be invested in the asset class over rolling 5-year periods. The sector itself was launched in September 2018 to help improve the comparability of direct property funds. Thus, funds investing into property securities and hybrid investments were moved into their own sector called the UK Property Other, of which there are 31 constituents.

The funds in the new Direct Property sector, are monitored by the IA and those that invest less than 70% of their assets in direct property for any continuous 12 month period or fall below 60% for any month may be removed. The sector has 17 constituents and is dominated by a few very large funds but assets under management in the sector range from under £45million to over £3 billion.

Sector Nuance

Investing in property comes with its own unique and significant challenges. Fundamentally these challenges stem from the illiquidity of the underlying asset, particularly when properties are held in a fund structure looking to deliver daily liquidity to investors. As a result, open-ended property funds typically carry higher cash balances than funds investing in more liquid assets. Indeed, according to FE Analytics, at the end of April the average cash balance within the sector was 16%, whilst the highest cash weighting in the sector is currently 24%. Although holding cash helps managers to meet the redemption requests of their underlying investors, excess cash can also prove to be a significant drag on returns over time, both for capital gains and income generation.

At times of significant market stress the sector also becomes vulnerable to fund suspensions and gating. This was evident in the aftermath of the EU referendum in June 2016, when many funds in the sector were suspended when outflows spiked. Those that remained open applied significant fair value adjustments to their price. This meant that those investors that wished to redeem any of their holding could do so, but only at large discounts to the value of their investments, in some cases between 15-20%. These events were a relatively short but painful reminder of the illiquidity mismatch between the daily dealing being offered to investors and the illiquidity of the underlying assets into which these funds invest. Indeed, this is now an issue under review by the FCA who have issued a consultation document on open-ended funds investing in illiquid assets.

Recent Sector Performance

Property funds are used by investors to provide income and long-term capital accumulation. They may also offer diversification within portfolios as they exhibit a different risk/reward profile and low correlation to other main asset classes. Since the financial crisis of 2009, the sector has delivered positive absolute returns in every calendar year in contrast to most other asset classes.

Sector Returns	2019	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009
Sector : IA Global	11.08	-5.72	14.02	23.33	2.77	7.09	21.65	9.43	-9.27	15.78	22.95
Sector : IA North America	13.06	-1.37	10.53	29.31	4.18	17.79	30.87	6.90	-1.55	17.40	18.98
Sector : IA Sterling Corporate Bond	4.43	-2.22	5.06	9.08	-0.27	9.83	0.64	13.01	4.36	7.57	14.31
Sector : IA UK All Companies	11.08	-11.19	13.99	10.82	4.86	0.64	26.21	15.05	-7.04	17.53	30.40
Sector : IA UK Direct Property	**0.78**	**3.91**	**7.85**	**0.29**	**8.35**	**11.24**	**7.51**	**1.62**	**2.94**	**9.29**	**4.68**
Sector : IA UK Gilts	3.19	0.25	1.72	11.06	-0.26	14.52	-5.11	1.85	15.80	6.38	-2.06

Source: FE Analytics.

However, the property market is not without vulnerability to sharp and painful market downturns as we saw when the market turned in 2006, leading to returns in 2007 of -9.5% and -15.4% in 2008.

Dispersion within property sectors can also be significant, something which can be an opportunity for property managers. For example, during 2018, the retail sector suffered from falls in capital values as the outlook for high street retail became increasingly pessimistic in the face of growing online shopping trends and so it was the worst performing sector. In contrast, industrial units to facilitate retail distribution to service online purchases has been an area that has shown strong capital growth.

Source: FE Analytics (28/01/19)

Funds in Focus

Square Mile currently recommends three funds that we consider to be solid options within this space as they are run by asset class experts and well supported by internal and external resources to help meet their objectives.

Amongst these, the **Henderson UK Property PAIF** invests in commercial property and property related assets. The fund aims to provide a steady level of income with the potential for capital growth over the medium to longer term and is managed by TH Real Estate, an experienced and well-resourced property team appointed to manage the fund on a sub-advisory basis by Janus Henderson. As well as the traditional property sectors of offices and retail, this fund also includes an allocation to the alternative property sector which includes assets such as student accommodation, hotels and care homes.

Legal and General UK Property is co-managed by Michael Barrie and Matt Jarvis who are supported by the wider resources of LGIM's real estate team. The fund is well diversified across sectors and the managers look to exploit the team's sector views. The overall philosophy of the fund rests on a belief that the key to delivering consistent performance is to focus on property selection and active management within a research driven framework for portfolio construction. The approach combines both top down and bottom up elements with the aim being to deliver around two thirds of performance from property selection and the remainder from sector selection. The fund is currently the largest in the sector with assets of circa £3.3 billion and Industrials are currently the fund's largest sector allocation at 34% of the portfolio.

The **M&G Property Portfolio** seeks to provide long-term growth through both income and capital appreciation from a well-managed, quality portfolio of property assets. It aims to meet this objective by investing in prime and high-quality secondary properties as well as from identifying asset management initiatives within its property portfolio. The fund benefits from the substantial resources of M&G Real Estate, M&G's specialist property business, and also from the experience of the lead managers on the fund; Fiona Rowley and Justin Upton. This is also a large fund, with assets of circa £3.2 billion and retail sectors make up the largest sector exposure of the fund at approximately 40% of the portfolio, though this is diversified across retail warehouses, supermarkets and standard retail.

As with all open-ended commercial property funds, the above invest into an illiquid asset class, which can lead to high cash levels, price swings and fund closures at times of market stress. For example, both M&G and Henderson suspended their funds in the aftermath of the EU referendum in 2016. Whilst L&G remained open, it did apply a significant fair value adjustment to the fund. Henderson has also recently announced a change to its pricing basis for the fund by adopting a full spread pricing approach.

Sector Outlook

Although the UK property sector provided positive returns for 2018 while most asset classes fell in value, as a consequence of Brexit uncertainty, outflows picked up notably towards the end of the 4th quarter in 2018. This trend has continued into 2019, with data from FE Analytics showing outflows of nearly £900 million to the end of March. Many investors fear a re-run of fund suspensions and falling property prices if a bad Brexit materialises. Sentiment has been further undermined by concerns over the decline of the retail high street and the exposure of the direct property funds to this sector. While a benign Brexit outcome may see capital return to the sector and therefore lift prices, the cycle does appear to be relatively mature, with returns from property likely to primarily come from income over the next few years.

Outflows have recently increased as investors worry not only about risks to property fundamentals but also at the fund level about the potential for suspensions and pricing adjustments that can further impact returns. Cash drag in most of the funds already means returns will be lower than the headline forecasts for open-ended property funds, however in a period of falling capital prices the impact of holding cash is to some extent reduced.

On the plus side for long-term investors who are unconcerned by the potential for short-term suspensions given their time horizon, property funds can continue to provide relatively reliable returns, including a reliable income stream and many continue to hold them as part of diversified multi-asset portfolios.

Source: FE Analytics (28/01/19)

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