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Victoria Edwards

By email: LGPSReform@communities.gsi.gov.uk

Dear Victoria

DCLA consultation: Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies

We, The Association of Real Estate Funds[1], welcome the opportunity to comment on the Government's proposals to reform the Local Government Pension Scheme. In general, and in accordance with the nature of the businesses we represent, we have refrained from commenting on matters in the consultation that do not relate directly to the LGPS's property investments. However, we agree with the Government's comments in the response to the call for evidence that *"Higher returns and better value for money are more likely to be realised if funds have strong governance and decision making arrangements in place."* Proper governance will ensure that the secondary objective *"to reduce investment fees"* is not pursued to the detriment of investment returns and value for money.

Property is an asset class to which investors are attracted for a number of reasons. Firstly, it has a relatively low correlation with other asset classes and therefore provides attractive risk diversification characteristics. Secondly, its price is not overly sensitive to the volatility inherent in stock market valuations. Thirdly it provides a relatively high and stable income stream. Finally, as a real asset, it carries a very low risk of default; where a tenant default does occur there will be a break to the income stream but the asset remains available for re-letting.

Property assets offer an attractive combination of relatively long-term and measurable income streams (similar to those derived from fixed-income investments) with longer-term inflation hedging (through rent-reviews or index linked rents) and defensive/accretive capital strategies (protecting or enhancing investment value). This makes the sector attractive to longer-term asset/liability matching investors such as pension funds.

As a real asset, property is not homogenous and skilled managers, multi-managers and fund of funds managers are able to create value through active management. To achieve the best results from each approach it is essential to focus on net-of-fee returns and the value created and not on the costs in isolation. Fund deficits can be reduced only by reducing liabilities or by growing assets. As property investment managers our members can contribute to reducing fund deficits by maintaining a focus on creating value.

[1] The Association of Real Estate Funds represents the UK unlisted real estate funds industry and has 70 member funds with a collective net asset value of £48 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the AREF/IPD UK Quarterly Property Funds Index and the AREF/IPD Property Fund Vision Handbook.

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Our responses to the specific questions raised follow. In summary we are concerned that the case for restructuring the property component of the LGPS has been poorly analysed in the Hymans Robertson report. In particular:

- There is no statement of the potential cost savings. We have estimated these to be in the range of £5-15 million per annum.
- There is no analysis of the transition costs. We have identified that Stamp Duty Land Tax alone would amount to £486 million if the entire LGPS property allocation were transitioned into new ownership.
- Even if the transition costs could be fully mitigated, it could cost £386 million to rationalise the inherited portfolio(s).

We recommend that Government should consider further the case for restructuring the property component of the LGPS and we would be happy to contribute to this consideration. Please contact me if we provide further assistance.

Yours sincerely

Mark Sherwin
Secretary General
The Association of Real Estate Funds

Q1. Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.

We do not see sufficient empirical evidence in the Hymans Robertson report to demonstrate that such savings will be achieved in the context of investments in property, and therefore it is not possible to agree or disagree. There may be savings to be achieved by collaboration between local funds. However, the report does not indicate the potential savings related to property nor does it analyse the potential transition costs. It must be recognised the property is an expensive asset to transfer into new ownership and the cost benefit analysis will be different to other asset classes. We recommend that Government should provide further analysis of the potential savings in respect of property and the potential costs of transition that could arise.

The report is clear that property is not an alternative asset class. Alternatives are defined as private equity, hedge funds and infrastructure. Throughout the report property is referred to separately from alternatives (for example, on page 3, *"LGPS funds invest in "alternative assets" (private equity, hedge funds, infrastructure) ..."* and table 2 on page 11 analyses investment management costs by the four main asset classes (equities, bonds and cash, property, alternatives). However, it appears in the consultation document (paragraphs 4.3 and 4.27) that property is part of the analysis of the alternatives asset class. We are concerned that the costs and benefits in respect of property have not been assessed and instead it has been assumed that if an assessment of property had been performed, it would have given results similar to alternatives.

The cost assessment in section 1 of the report analyses the cost drivers primarily for equities and bonds. It is identified that alternatives represent a disproportionate share of costs and these costs could be significantly reduced by eliminating the use of funds of funds. However, this section of the report offers no analysis of the investment management cost for property. It can be deduced from the table in appendix 1b of the report that current fees for property (0.8% of holding value) are considerably lower than for alternatives (1.7%). Section 2 of the report states on page 18 that LGPS make <u>significant use</u> of funds of funds for their allocations to hedge funds, private equity and infrastructure and <u>some use</u> of fund of funds for their property exposure. It is unclear whether the references to funds of funds are intended to include property multi-manager accounts. The report does not provide evidence of whether sufficient cost savings would materialise to justify a change to the investment approach in respect of property assets. Based on these differences in the cost structure and the extent of the use of funds of funds, we are concerned that the conclusions reached using the analysis of costs for alternatives are being projected inappropriately onto property.

It should be noted that the ongoing cost and complexity of maintaining and managing individual property assets is high. Unlike equities and bonds, buildings and their tenants require specialist day-to-day management and much of this management takes place in the locality of the building concerned. Good management and good tenant quality contribute significant value but this additional layer of management has a cost. Nevertheless, the figures in table 2 indicate that these costs are modest relative to the alternative asset classes.

The financial analysis in section 3 of the report makes no reference to property. It is unclear how the figure for potential savings of £240 million per annum is calculated. It is suggested on page 24 that it arises from reducing the use of funds of funds and removing very high cost alternatives. However, the cost of property investment management at 0.8% is less than half that of alternatives at 1.7%. Although there is some use of funds of funds the report implies it is less common than for alternatives. Therefore, we question how much the potential savings relating to property actually are?

Potential savings relating to property

Hymans Robertson identified the costs and potential benefits of using multi-manager and fund of funds approaches in their Property Survey 2011[2]. Multi-manager and fund of funds approaches are broadly similar but are differentiated by scale; funds of funds tend to be used to pool the property allocations of a number of smaller clients whereas larger clients will use a segregated account. According to the Hymans Robertson survey the main advantage of both approaches *"is that smaller investors can gain exposure to a wider range of managers, funds, specialist sectors and investment vehicles, without the associated governance burden. However, this comes with an additional layer of management fee, typically 0.20-0.25% for UK mandates (more for global mandates)."*

It is difficult to estimate how much of the £12.1 billion LGPS property allocation that is held in multi-manager or fund of funds strategies, but we estimate it is less than half. We have set out how we arrived at this estimate in the annex to this response. Using our modestly over-estimated value of £6 billion for the property allocation exposed to these strategies and the top end of the fee range reported by Hymans Robertson of 0.25%, it is apparent that the cost savings are likely to be less than £15 million per annum.

The Hymans Robertson Property Survey also describes the potential benefits of using multi-manager and fund of funds solutions. Skilled managers can combine investments from a wider opportunity set and tactically manage allocations over time in an attempt to add value, net of the additional fee layer, without adding risk. As a result they offer more than simple diversification; they can also add value by working with the underlying managers to improve governance, negotiating improved terms such as fee rates and fee structures and tend to be proactive regarding issues such as negotiating fund extensions and expiries. Therefore multi-managers and fund of fund managers deliver the strong governance and decision making arrangements that are so essential for achieving the second high level objective (improving investment returns) set out in the call for evidence on the future structure of the LGPS. We recommend that Government should consider more thoroughly the benefits of multi-manager and fund of funds arrangements and not just regard them as an additional layer of fees.

Potential transition costs in relation to property

The cost of transition is provided in relation to transfer of assets to passive management. However, if ownership of all the £12.1 billion LGPS property assets were transferred to a new vehicle, Stamp Duty Land Tax alone would amount to £486 million. It is observable that this barrier is so significant that transfers of property assets into new vehicles do not take place in the absence of SDLT seeding relief. This is why eight retail property funds were launched during the period that Unit Trust seeding relief was granted (December 2003 to March 2006) satisfying the industry's demand to transfer life company assets into collective investment vehicles. Prior to the introduction of this seeding relief, only two retail property funds existed. It is also why

[2] Hymans Robertson Property Survey 2011

Government announced in the 2014 Budget an intention *"to consult on the SDLT treatment of the seeding of property authorised investment funds and the wider SDLT treatment of co-ownership authorised contractual schemes."*

The full cost of transferring ownership of properties is typically 7.5%, made up of about 1.75% in legal and agents' fees when buying, the same for selling, and 4% SDLT when buying. It is likely that some of these costs could be mitigated as part of a well-managed transition although the need to spread the transition over a long period would dilute the effectiveness of the transition strategy.

The resultant pool would contain too many assets, many of which would be too small to be managed effectively in the resultant pool or that otherwise would not fit with the collective investment strategy. Borrowing an assumption from the equity transition (page 51 of the report) it might be necessary to sell 40% of property assets and buy replacement properties. Such transactions would necessarily be on the open market where the costs would amount to £386 million. Therefore, it is essential to understand the potential savings that might be achieved in respect of property.

It should be noted that larger property funds invest in larger assets making them less able to react to changing market conditions. Smaller funds are more nimble and able to reposition more quickly in response to changing market dynamics. Whilst it may be the case that larger funds holding larger assets can be expected to have lower fees, very large funds tend to be less nimble and more generalist and the performance trends towards benchmark rather than outperformance. Moreover, a trend towards owning larger assets could have an adverse impact on the UK regional property markets and a bias towards London and the South East where land and asset values are higher.

Fund of funds versus internal management

Table 14 compares real estate returns to a customised benchmark. Without more transparency it is impossible to draw conclusions, but we would observe that it is not appropriate to compare property returns with REIT indices which are influenced as much by stock market sentiment as underlying property fundamentals. More appropriate indices exist for direct property[3] and property funds[4]. It is stated that the fund of funds style of investing under-performed direct internal investment by 5.5% for property (1995-2002). Again, without more transparency it is impossible to draw conclusions about this comparison. Have the internally managed funds invested in the same products, styles, geographies as the property fund of funds performance they are being compared against? Is performance being compared on the same basis net of all costs and fees?

Hymans Robertson identified the costs of using multi-manager and fund of funds approaches in their Property Survey 2011 as being typically 0.20-0.25%. This level of fees can account for only a fraction of the 5.5% difference in performance over 7 years. What evidence is there to suggest that a newly formed LPGS property investment manager will be better able to overcome this performance difference than the existing industry? We recommend that Government should consider more thoroughly the case for property funds of funds.

[3] IPD UK Monthly Property Index
[4] AREF/IPD UK Quarterly Property Fund Index

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Q2. Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?

It is essential that local fund authorities continue to make asset allocation decisions and have a sufficiently wide range of options to suite the specific needs of the local fund whose liabilities they are seeking to match. However, it is unclear whether they will be able to simply make an allocation to property or to make allocations to a variety of property investment strategies. This question is critical because it will shape the nature of the property portion of the Government's proposed solution. If the local fund authorities have a range of property strategies at their disposal, the vehicle will need to accommodate property assets dedicated to each strategy. However, if a simpler option of allocating to a single property pool is all that is available, the local fund's assets will be more difficult to match with their liabilities.

Q3. How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

The question suggests that each CIV will be an umbrella over a number of sub-funds where each sub-fund holds assets dedicated to a particular asset class or investment strategy within that asset class. For example, UK property funds allocate their portfolios geographically and/or by sectors such as shopping centres, retail warehousing, offices, industrial estates, residential, leisure or healthcare. Often specialist funds in each sector provide balanced funds with access to each specialism where they might not have specific expertise. Other funds specialise in very long leases in order to provide reliable long term rental income streams. Therefore different strategies will be appropriate depending on the mix of active, deferred or pensioner members within each local fund. This suggests it might be necessary to have a number of property sub-funds, and it might be appropriate for specialist managers to look after each one.

On the premise there will be a large number of sub-funds; the actual number of CIVs is arbitrary. As a minimum we think property should not be included in a CIV with alternatives. Property is a core asset not an alternative. It is indicated on page 67 of the report that the characteristics of the top ten performing LGPS funds include the following:

- They adopt a simple structure focused on equities, bonds and property;
- They make limited use of alternatives;

We think the number of CIVs is largely unimportant because it amounts to little more than an umbrella around a series of sub-funds. It is the sub-funds that hold assets, are managed and are subject to oversight. To be effective in delivering value to the LGPS it is good governance of the sub-funds that is important and the existence of the umbrella neither contributes nor detracts from this.

We have no views to express in relation to questions 4 and 5.

Annex:

Estimating the cost of property multi-manager and fund of funds approaches

1. According to the Hymans Robertson Property Survey 2011[5], the typical cost of multi-manager and fund of funds approaches is 0.20-0.25% for UK mandates (more for global mandates). For the purpose of this analysis we have used the top end of the range for UK mandates and ignored the additional cost for global mandates ie 0.25%. We have also ignored the fact that multi-managers and fund of funds managers are successful in negotiating improved terms and fee rates from the managers of the underlying funds in which they invest.

2. Assume the entire £12.1bn property allocation utilises multi-manager and fund of funds approaches. This is clearly not the case, but it defines **a theoretical maximum cost saving of about £30m.**

3. Based on their knowledge of their business and that of their competitors, some of our members have suggested that the total market for property multi-managers and funds of funds is about £20bn. This is spread across the entire range of UK institutional investors' property allocations which has been estimated to be worth £119bn[6]. This would imply that the use of multi-manager and fund of funds approaches represent about 17% of the entire allocation to property. We think the LGPS use of multi-manager and fund of funds approaches is likely to be higher than it is for other types of institutional investor because typically the LGPS mandates are smaller. Nevertheless, this provides **a possible minimum cost saving of about £5m.**

4. AREF's 70 member funds have a collective net asset value of £48bn under management on behalf of their investors. Approximately half of these funds are authorised retail property funds, charity funds or the managed pension funds of life companies. We estimate that about half of the remaining £24.3bn is held by multi-managers and funds of funds, and that about half of these holdings are on behalf of LGPS clients. This suggests that about £6bn of the LGPS property allocation is in multi-manager and fund of funds arrangements.

5. It is generally agreed (by our members in the sector) that multi-manager solutions are typically favoured by clients with £30-300m to allocate to property with smaller clients making use of funds of funds. As allocations become larger, direct investment in property becomes increasingly appropriate and an allocation of £200m is likely to be predominantly directly invested. The table at the end of this annex uses data taken from table 1 of the report to provide an estimate of the collective LGPS exposure to direct property. This estimate is £6.3bn which means the remaining £5.8bn of the LGPS property allocation is indirectly invested either in individual property funds or in multi-manager and fund of funds arrangements.

[5] Hymans Robertson Property Survey 2011
[6] Section 11 of the Property Data Report 2012

6. In paragraph 5, £5.8m is an overstatement of the use of property multi-manager and fund of funds arrangements because there is some use of individual property funds within the figure. Nevertheless it is broadly similar to the £6bn estimate based on our view of our member funds in paragraph 4. We think using an estimate of £6bn will comfortably compensate for the fact we ignored the higher fees for global mandates in paragraph 1. Based on our analysis we think **a reasonable estimate on the high side of the potential cost saving is less than £15m.**

Fund size (A)	All LGPS (B)	Property (A*6.8%)	Direct (C)	Possible direct value (£180bn*6.8%*B*C)
£5bn +	29.9%	£340m +	90%	£3.3bn
£2-5bn	35.1%	£135-340m	70% at £200m	£3bn
£1-2bn	20.9%	£70-135m	Small	-
Less than £1bn	14.0%	Less than £70m	None	-
Total	**100%**			**£6.3bn**