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Elston Insights

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Property funds: rethink and be ready

- Property is a traditional Alternative Asset diversifier
- Performance has suffered on slowing growth and rising rates
- Consideration of geography, fund format and liquidity is key

Why has property been a popular diversifier?

Property funds are one of the most popular Alternative Asset "diversifiers" used by financial advisers. And for these good, well-established reasons. Firstly, from a fundamental perspective, property has both equity-like (property value) and bond-like (rental income) that makes it a different alternative to both. Secondly, from a valuation-frequency perspective, whilst fund NAVs are priced daily, the underlying land and building NAVs are adjusted less frequently. This makes property fund values (appear) less volatile than Real Estate Investment Trusts (REITs) or property companies (like British Land Securities plc) whose valuations can change every minute the stock market is open. Finally, there is something tangible about a property fund. Top 10 holdings could include office blocks you walk past on your way to work: one property fund manager famously took advisers on a bus tour of London to visit all the buildings they own there. Relative to other, more complex types of Alternatives – like Absolute Return funds for example – property funds are easy to understand and easy to explain to clients. These are and remain good long-term reasons to hold property funds.

But is it the only diversifier?

There's another reason property funds are one of the most used diversifiers. It is typically the "only" diversifier used in asset allocation frameworks provided by risk profiling companies and the models that those allocations indirectly drive. This is probably because unlike absolute return funds and other alternative assets, there are long-standing property indices that can be used to study risk, return and correlation with other asset classes. We find this approach limiting and have consistently advocated for a broader mix of alternatives than property alone.

In the headwinds

In the chaos of the pandemic, all asset classes came under different and extreme pressures before recovering with the "restart". However the key headwinds for the sector are the combination of 1) the risk to growth – a slowing economy is not supportive for property demand; 2) post-Covid work patterns are changing business' requirements; and 3) rising interest rates means that variable interest and/or refinancing costs are far higher, eating into property owner margins.

The sharp falls of the past year or two have reflected these headwinds. The outlook for both growth interest rates will determine in which region (Global/US, UK, Europe, Asia) the property market will first get past the point of maximum pain and be ready for a potential recovery.

The changing shape of property demand

It has been a challenging past year or so. The FTSE Real Estate index has lost a third of its value since the beginning of 2022. MSCI – another index provider – estimates that the value of underlying commercial real estate in Europe fell 10.8% in the year to March 2023 while in the UK that number was 16% for the same period[1]. Chief among the problems assailing the commercial property market has been a profound shift in working and shopping habits prompted by the Covid-19 pandemic. As home working normalised, demand for office space fell. The increase in appetite for online shopping also affected traditional retail spaces and fuelled a tangential boom in warehousing.

Additionally, the introduction of the Minimum Energy Efficiency Standard has increased costs for landlords and developers as tighter requirements are enforced, having a particular impact on what are termed 'second tier' offices where valuations have suffered.

Leverage is common in commercial property ventures and the rising cost of capital as interest rates have ratcheted up has had a heavy impact on the servicing and refinancing of debt. Particularly problematic was the period in the wake of the disastrous Truss/Kwarteng mini-budget last year when Gilt yields spiked, surpassing property yields.

As a result of the gilts market dislocation, institutional investors running LDI strategies that were required to post margin became sellers of other less liquid assets with poorer near-term outlooks – property included. The pace at which de-allocations from property funds took place led to gatings of institutional funds and some fire sales of holdings in 4q22[2].

Is the sector recovering?

As property companies try and adapt to recover, flexibility is proving a keyword. However, both in terms of the way in which commercial property companies adapt to the new landscape – which they are doing – and in terms of the nature of leases (short-term, low commitment). A retail outfit may now occupy one or two floors of a building and then rent the basement out to a bar or restaurant and let the upper floors as offices.

This flexibility is required to increase gross rental income to maintain or increase profit margins in the face of higher debt servicing and refinancing costs. In the current regime, property income is becoming more of a focus than sales proceeds.

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[1] https://www.bloomberg.com/news/articles/2023-06-12/europe-s-commercial-property-decline-is-catching-up-with-uk-rout

[2] https://www.bloomberg.com/news/articles/2023-01-04/blackrock-halts-withdrawals-from-3-5-billion-uk-property-fund

Property funds that use debt and have successfully locked in low, long-term interest rates during the low interest rate era are at a distinct advantage. So understanding the shape, term and refinancing risk of that leverage is key.

Towards a turning point?

So is the property market and specifically the UK property market past the point of maximum pain? Not yet, in our view, as the world is still adapting to higher interest rates and falling growth prospects. But it's worth starting to watch.

It's also worth considering how to implement any future allocation to include both geographic diversification (e.g. regions with better near-term economic outlook than the UK) and liquidity diversification (e.g. if using direct property funds, consider property securities funds too).

Timing an inflection point is always a challenge, but having a clear plan of action can help speed up the decision-making process should the outlook for growth improve, or the outlook for interest rates ease.

Implementation

Advisers can use that time to also consider the relative merits of the different fund formats for gaining property access to ensure they are comfortable with the various idiosyncrasies those fund formats bring. Direct property fund or property securities fund (and if so, active or index)? And the implications of using different fund formats: OEIC (and now LTAF), Investment Trust or ETF and what that format decision means for a fund's liquidity. Finally – as the returns show, property funds and property securities are subject to the same underlying economic risks that drive performance outcomes, even if reported volatility is very different. The difference in reported volatility between the two is "just" a function of underlying asset valuation frequency: advisers relying on volatility alone to evaluate the risk of this traditional diversifier have an incomplete picture.

Summary

The long-term rationale for holding property as a diversifier amongst alternative assets remains intact. But it should not be the only one. A broader mix of alternatives can help bring more efficient diversification, and this should adapt with changing market regimes. Furthermore as investment committees review portfolios, giving careful thought to size of position, regional exposure, fund format, and liquidity profile, these decisions are even more important than the fund selection decision within the UK property fund sector alone.

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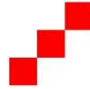

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