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RETURNING TO THE CORE

Rediscovering a Role for Real Estate in Defined Contribution Pension Schemes

A Pensions Institute report for real estate and DC pensions professionals

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SUMMARY REPORT

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Returning to the Core: Rediscovering a Role for Real Estate in Defined Contribution Pension Schemes

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Preface

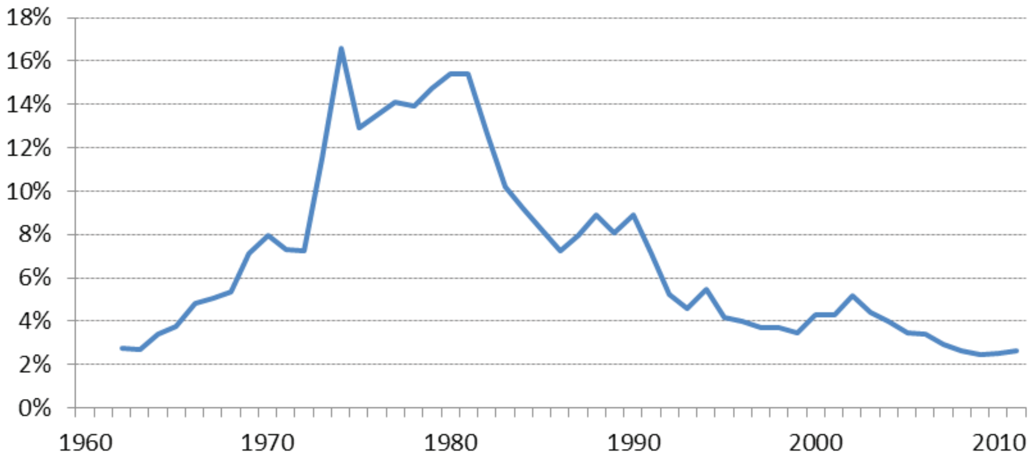
This report was prepared by the Pensions Institute at Cass Business School.

The objective of the research was to analyse and evaluate the role of real estate in the UK's defined contribution (DC) pensions market in relation to auto-enrolment – the new system of pension scheme provision for private sector employees in the UK, which is being phased in by all employers between October 2012 and 2018. The most important feature of auto-enrolment schemes is the 'default fund', which is the multi-asset investment strategy designed for the majority of members who do not wish to make investment decisions.

The research presents what the authors believe is the first comprehensive independent academic study of its kind that investigates the role of real estate in the new world of auto-enrolment. From our research, it was apparent that although there is clear evidence that real estate is being incorporated as a core (significant separate) asset class in default funds, to fully harness the role real estate can play, DC and real estate professionals need to build a better mutual understanding of their respective markets and objectives.

As the chart below shows, forty years ago, real estate (then more commonly known as property) was a 'core' asset class in defined benefit (DB) pension funds, along with equities and bonds. It was also used as a core asset class in some of the early group DC schemes. Yet as DB declined in the private sector and DC gained ascendancy, for a combination of reasons that are not necessarily well understood, real estate became reclassified by DC professionals as an 'alternative' asset, a collective term that includes asset classes whose common characteristic is that they are illiquid (to a wider or lesser degree), such as, commodities, hedge funds, infrastructure, and private equity, among others. Given that allocations to 'alternatives' have been capped at a fairly modest level (e.g., 5%) in most DC pension funds, this switch in classification has had a strongly negative impact on the real estate sector and, it might be argued, constituted a serious flaw in the investment strategy of DC default funds on account of the demand of the DC market for daily pricing and liquidity, among other requirements.

UK Pension Funds Real Estate Holdings as % of Total Net Assets 1962-2012



Source: ONS, Business Monitor MQ5

Yet real estate appears to be a very attractive asset to hold in a pension fund portfolio during both the accumulation stage of a DC scheme and – in due course – the decumulation stage. When pension scheme members are young, they need to invest in a multi-asset strategy that includes an appropriate proportion of growth assets: real estate (with its potential for capital appreciation) and equities are the key asset classes that deliver growth. As members age and approach retirement, they need to reduce the risk of sudden large adverse security market shocks by participating in some form of de-risking asset allocation 'glide-path' (also known as 'lifecycle' or 'lifestyling'), typically where the equities held in the pension fund will be exchanged for bonds and cash, which have less volatile total returns and also match annuities better. We would argue that there is a key role for real estate during this phase, because of its potential for generating stable inflation-matching cash flows linked to rising rental values.

Arguably the role of real estate also extends beyond the glide-path into retirement where the income-generating potential of real estate and bonds are needed to pay pensions. Real estate, therefore, is unique as an asset class in that it has an important role to play throughout the life of a pension scheme (in both the accumulation and decumulation stages), first for its growth potential when the scheme is immature, and then for its income-generating potential when the member approaches and enters retirement. In this report, we argue that real estate needs to 'return to the core' and we present evidence that this trend is already well underway.

Our research took place between September 2012 and September 2013. We would like to thank the many organisations that helped with this research in terms of access to documentation, permission to publish extracts from reports, and, in particular, participation in the extensive series of interviews (conducted between September 2012 and August 2013) that informed our analysis of historic, current and expected future market practice. The organisations that were happy to be named are listed in the Acknowledgements in the full report.

The research was commissioned by the Investment Property Forum (IPF) and jointly sponsored by them together with the Association of Real Estate Funds (AREF), the European Public Real Estate Association (EPRA), and the Institute and Faculty of Actuaries. These organisations did not seek to influence the authors in any way. The views expressed herein are those of the authors.

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Key findings

1. We forecast that the DC auto-enrolment market will increase sixfold by 2030, from £276bn assets under management (AUM) pre-auto-enrolment (2012) to £1,680bn. Several new DC schemes designed for auto-enrolment have selected real estate as the first illiquid or 'alternative' asset class to be incorporated as a core component of 'default' multi-asset investment strategies ('default funds') with weightings of 5-20% and an average of 10%. Default funds will be used by 90-97% of members, which means that if this trend is adopted across the market real estate AUM in these funds might be worth £170bn by 2030.

2. The National Employment Saving Trust's (NEST's) decision in 2013 to allocate 20% to real estate in both its principal and ethical default funds is very significant, although it is important to note that the 20% weighting in real assets will include other illiquid asset classes in due course, such as infrastructure. This move by the national multi-employer auto-enrolment scheme, established by the government, demonstrates that the perceived barriers (i.e., DC conventions rather than regulatory requirements) to real estate in DC – daily pricing, liquidity and cost – can be overcome within an overall cost constraint that achieves a member charge of 0.5% p.a. over the long-term.

3. The main real estate sub-classes favoured by auto-enrolment schemes are actively managed funds of UK property and passively managed funds of global listed real estate companies – typically in the form of real estate investment trusts (REITs). Real estate derivatives are also emerging as a possible sub-class, but the real estate derivatives market has significant capacity problems. The potential for other sub-classes, such as funds of real estate debt, has yet to be tapped, but might have an important role to play in the pre-retirement phase of default funds and in decumulation.

4. While the prognosis overall for real estate in DC schemes is positive, there is currently a wide gap in the understanding that real estate and DC professionals have of each other's positions. On the one hand, real estate asset managers argue that there is a major disconnection between what DC default funds want and what they need. On the other hand, DC professionals argue that real estate asset managers tend to over-engineer their funds and concentrate too much of their marketing presentations on the sub-classes and the underlying holdings. The DC approach, by contrast, typically is to focus on high-level asset allocation and to use funds that offer the potential for market-average (passive) or market-plus (smart beta) returns. Further, DC platforms require daily pricing and liquidity for all assets included on the platform. However, this is not a regulatory requirement and means that asset classes that have a potential role in improving outcomes for DC members might be excluded from the default fund. Nevertheless, there are early signs that the real estate asset management arms of insurance companies are gaining some market share because they are beginning to understand DC objectives better.

5. Despite the overall positive outlook for real estate in DC schemes, it is not at present an open market for third-party asset managers. An estimated eight and possibly nine out of the 10 top providers in the auto-enrolment market

use their own investment management arms (i.e., in-house funds) for the default fund.

6. Competition and the downward pressure on member charges have triggered a battle to secure market share. Scale is considered crucial to deliver good quality default funds at low cost. It is likely that fewer than 10 multi-employer schemes will emerge as the dominant players by 2020; their business structure and investment philosophy will determine the openness of the market to opportunities for third-party real estate asset managers.

7. Our research indicated that there was no clear consensus about the most appropriate asset allocation model for determining the optimal weighting to real estate relative to other asset classes. There was widespread criticism of mean-variance optimisation models. Yet the alternative proprietary models in use are not accessible to independent scrutiny and hence lack transparency. This is a significant point, since, unlike in DB, where the sponsoring employer is ultimately responsible for meeting the liability for the salary-linked pensions, in DC, the investment risk falls solely on the individual members. Currently DC scheme members have little idea what the asset allocation selected by any given default fund means in terms of the ultimate pension in retirement.

Areas of concern include:

a. The lack of a meaningful target for a DC investment strategy to aim at, such as a target income replacement ratio (RR). Without this, the potential for real estate in the default fund – and in the decumulation vehicle (typically an annuity) – might not be fully realised.

b. The strong disagreement between professionals about the modelling assumptions and methodologies that should be used to evaluate the potential performance characteristics of real estate relative to other asset classes. A particular issue was how to deal with the low liquidity of real estate in portfolio optimisation models. Such disagreements might undermine confidence in this 'new' core asset class, but also indicate a disconnection between the needs of DC default funds and the ways in which real estate asset managers present their rationale for inclusion in such funds.

c The use of third-party proprietary modelling services, which appears to be standard practice. While outsourcing this function might represent a prudent allocation of resources, the proprietary nature of these services mean that they are not available to independent academic scrutiny.

d. The application of significant judgmental adjustments to modelling results, which means that there is no clear relationship between the de-smoothed optimal weightings for real estate – that result from the quantitative modelling exercises – and the actual weightings used in practice.

8. There are important messages for both the real estate and DC markets from the research:

a. The real estate asset management market needs to understand better the political, regulatory and economic implications of and pressures on auto-enrolment. The disconnection between DC professionals and the real estate market identified in the research is far from unique – it extends to other managers of ‘real asset’ funds, such as infrastructure and commodities, both of which were cited as examples of future ‘must-have’ asset classes in a diversified default fund. Arguably, real assets (i.e., those that match inflation) are essential to the success of auto-enrolment default funds, but they need to be delivered in a DC-friendly format, which requires a new approach. This is not so much about the tax status of the fund (which can be readily made compliant with the DC tax regime), it is more about the sub-class combinations. The preferred format favoured by NEST, and several other new multi-employer schemes designed for auto-enrolment, is to combine a domestic fund of actively managed properties with a global REITs tracker.

b. The DC market needs to understand better the role of real assets in delivering optimal member outcomes. Ultimately, it is the member who suffers if restrictions on asset classes due to their low level of liquidity result in sub-optimal investment strategies throughout both the accumulation and decumulation stages.

Conclusion

Our research has raised a number of questions that DC scheme providers, in conjunction with real estate asset managers, should consider. We summarise these questions here and offer answers based on the evidence from the research. The issues raised here might best be addressed via a cross-practice working group that brings together experts in the real estate and DC auto-enrolment investment strategy.

1. Should DC schemes' default fund have a weighting in real estate?

The evidence indicates the beginning of a clear trend towards the inclusion of real estate as a core asset class in DC default funds, especially in the new schemes designed for auto-enrolment. These schemes have chosen real estate not only to diversify investment risks and increase risk-adjusted returns, but also for its growth potential during the accumulation stage and its ability to generate reliable inflation-linked cash flows during the decumulation stage. However, we should be aware of the risk of speculative bubbles or liquidity-enforced closures of funds, both of which are key risks in the accumulation phase and more so in the decumulation phase.

2. What is an appropriate weighting?

At the time of writing, the weighting to real estate in schemes designed for the multi-employer auto-enrolment market varied considerably. In some cases, the allocation was zero; where real estate was used, as a separate asset class, weightings varied from 5% to 20%. Our analysis of portfolio optimisation models in use did not, however, did not give a clear cut answer as to what the optimal weighting in real estate should be. Nevertheless, the increased use of asset-liability modelling techniques in the DC world should enable the attractiveness of real estate in both the accumulation and decumulation stages of a DC pension scheme to be more fully recognised.

3. Which schemes offer the best examples of the use of real estate?

The auto-enrolment scheme market is in its infancy. However, NEST's decision in 2013 to allocate 20% to real estate is a very significant move in the development of the DC market. At the same time, it should be remembered that NEST does not intend to maintain this weighting over the long term, but will reduce it when other 'real' asset classes become available in a suitable pooled fund format, e.g., infrastructure.

4. Which are the most appropriate real estate sub-classes?

At the time of writing, the two main sub-classes being used were funds of UK property (actively managed) and funds of listed companies (typically global tracker funds of REITs). NEST's choice of a 70% UK/30% global REITs fund might provide a benchmark for the market going forward.

In future, it is possible that real estate debt funds might have a role to play in default fund bond portfolios, especially if real estate is used as an asset class during the later stages of the accumulation glide path and into decumulation.

Derivatives, in theory, appear attractive for hedging purposes, but the current lack of a robust market that can readily scale up undermines their present prospects.

5. Which are the most appropriate investment vehicles?

In theory, any fund that can accommodate the tax-exempt status of DC schemes and offer the required pricing and liquidity features might be used. However, convention plays a strong hand in the decision, and the dominance of life offices in the market – and the widespread use of life office platforms – suggests that, at present, life funds have an edge over PAIFs and UCITS IV funds. We cannot explain why this should be the case, but suggest that this is a subject for debate between the DC and real estate markets.

6. What is the potential impact of the liquidity requirement on member outcomes?

Under a strong governance framework, default fund optimal investment strategies must determine the most appropriate asset classes and glide path to meet members' requirements in terms of a realistic and reliable target replacement ratio. They should not be constrained by DC conventions. The research indicates that DC funds would benefit from the inclusion of illiquid asset classes such as real estate – during the initial growth phase of accumulation, the de-risking glide path prior to retirement, and also during the decumulation phase via products delivering retirement income.

7. Is the current liquidity constraint likely to be eroded over time?

There is no doubt that the need for a relaxation of the daily dealing/pricing requirements for illiquid asset classes is crucial if default funds are to achieve their optimal level of diversification. We stress that there is no regulatory barrier to illiquid asset classes, so this is also a subject for debate between the DC and real estate markets.

8. How large, and how quickly, could real estate AUM grow under auto-enrolment?

We have provided projections of the growth of the auto-enrolment markets in this report. We forecast that the market will increase sixfold by 2030, from £276bn AUM pre-auto-enrolment (2012) to £1,680bn. Assuming default funds allocate 10% to real estate and that these funds are used by 90-97% of members, real estate AUM in these funds might be worth £170bn by 2030. However, we do not know at this stage which of the current schemes will be the emerging 'winners' in the battle for market share and presently each scheme has a different allocation to real estate (in some cases zero).

9. How much of this market will be captured by third-party asset managers?

At present, 'vertical integration' is the most common business model, which means that most scheme providers are using their own in-house real estate funds. The observation we make in point 4 above – the potential for NEST's allocation to a fund of 70% domestic (active) and 30% global REITs (passive) to become a benchmark in the market – assumes that multi-employer DC schemes will have access to such hybrid funds. At present, the majority do not.

Real estate asset managers, together with the wider asset management community, might consider the questions vertical integration in the auto-enrolment market raise for market competition and take up these issues with government, regulators and the OFT.

10. Does the use of real estate in default funds open the door to other illiquid assets?

Our view is 'yes' and we would cite NEST's stated objective with respect to its 20% weighting in 'real assets' as an example, with infrastructure standing out as the second 'alternative' asset likely to transition into the class of 'core' assets, providing asset managers can develop fund structures that are DC-friendly in relation to taxation, liquidity and pricing frequency.

One option suggested to us was the potential for 'real asset' funds of real estate, infrastructure and commodities, which together might offer a strong inflation-hedging instrument. This might represent a more focused method of categorising and grouping the illiquid assets classes that currently are incorporated within funds of 'alternatives', which also include hedge funds and private equity.

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