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Response to FCA consultation on illiquid assets and open-ended investment funds: DP17/1

Q2: Do you have any observations on our analysis of liquidity management tools? Are there other factors affecting the liquidity management of open-ended funds investing in illiquid assets that we should take into account?

We believe it is relevant to consider increasing the time intervals of underlying fund pricing from daily to quarterly. It is not the first time in recent years that the open-ended real estate investment funds faced the difficulties that were witnessed in June and July 2016.

Listed real estate securities are the truly liquid product in the market place that provides daily pricing in a cost efficient and transparent format. The free float market capitalisation of the listed real estate sector in the UK, as measured by the FTSE EPRA/NAREIT Developed Index Series, was approximately £54 billion as at 31 March 2017. The size of the investible European listed real estate market as viewed through the FTSE EPRA/NAREIT Index Series was approximately £193 billion at the same date. It is important to recognise that this free float market capitalisation only relates to the most investible, liquid and real estate focused listed real estate companies through the application of stringent index entry criteria. This compares to the invested figure of approximately £35 billion by UK open-ended funds provided within this discussion paper. The liquidity that the listed real estate sector brings to the otherwise illiquid property market provides the following key benefits:

- Allowing investors to effectively manage their overall blended real estate exposure – particularly important in stressed market situations
- The democratisation of real estate - providing the opportunity for small investors to participate alongside larger investors
- Enhancing the quality of the built environment – liquidity improves information flow and allows good and bad management decisions to be rewarded or punished by investors

It is also important to recognise that listed real estate companies are perpetual businesses operating and managing similar underlying long-term assets that are owned by the open-ended investment funds. The listed market in which they function provides the opportunity for investors to invest over their own required time horizon and buy or sell their holdings daily. On average, every share of a property company is transacted once a year, compared to about every ten years for direct property in the UK and as little as every 20 years in other European countries. The listed property sector delivers a much more dynamic trading market than the direct property market, due to its liquidity, low transaction costs and accessibility.

Listed property company securities also trade eight times more frequently than units in the UK's non-listed property funds. The challenges facing the non-listed funds sector in providing liquidity were highlighted by the failure of the German open-ended funds sector after the great financial crisis, where access to a quarter of invested capital was frozen.

Furthermore, as the great financial crisis unfolded, pension funds, banks and other investors looked to reduce their exposure to real estate and the liquidity of the public markets provided those investors with a convenient exit. While this had a negative effect on underlying listed real estate share prices – which proved to be relatively volatile during this time – without the liquidity and financial transparency provided by them, the property markets and the economy in general would undoubtedly have been in a much worse situation.

Liquidity in the secondary markets enhances the quality of the underlying built environment. A more efficient, liquid real estate market ensures that the invested equity rotates around the system at enhanced rates and which, by default, will ensure that the built environment is renewed more often than historically has been the case.

Q4: What are your views on these, or other, possible approaches to the portfolio structure of funds?

We believe open-ended fund structures should hold more liquid assets if they are to remain open-ended and be priced daily in a true and fair manner.

There is a compelling body of academic research that demonstrates the value of increasing the allocation of listed real estate securities within a real estate portfolio. The research demonstrates to investors that by keeping to the traditional non-listed real estate strategy they are missing out on superior returns, as well as the benefits of liquidity and efficient pricing that come from integrating listed property companies into their real estate allocation.

EPRA sponsored research demonstrates that defined contribution (DC) pension schemes combining both non-listed and listed real estate in their property investment allocations generate consistently superior returns compared with portfolios without a blended approach.

A UK pension fund portfolio that combines a 30% global real estate securities allocation with non-listed funds delivered an annualised total return of 7.5% a year, or 0.9 percentage point more than a portfolio without real estate securities, according to 15 years of performance data compiled by consultants Consilia Capital and The Townsend Group.

The study, which covers the period from June 1998 to June 2013, showed that a 70/30 blended portfolio generated a 13.6% outperformance in returns compared with non-listed funds. For the decade to June 2013, a blended portfolio achieved a 38.7% outperformance, while for a five-year period the difference was more than five-fold in favour, again, of the blended approach.

The results of the research are clearly in line with the findings of the Maastricht University report on global pension fund performance issued in 2012 – that investors who ignore the listed real estate market seriously risk underperforming those that embrace it.

The UK's National Employment Savings Trust (NEST) indicated it will earmark one-fifth of its total investment to Legal & General's Hybrid Property Fund, which currently invests 30% of its assets in global listed real estate securities through a FTSE EPRA/NAREIT Global Index tracker. NEST, which was established under reforms introducing automatic enrolment to the UK workplace DC pension schemes, indicates that its assets under management may rise to as much as £150 billion by 2030.

NEST demonstrates how some DC pension schemes are happy to proceed with a blended private and listed portfolio approach for their real estate investments because they recognise that the superior returns outweigh the incremental increase in volatility. Indeed, the research demonstrates that

investors are more than compensated for the additional increase in volatility while also receiving the benefit of increased geographic diversification within their portfolio.

Q6: What are your views on these, or other, possible approaches to the fund manager's use of specific liquidity management tools?

It would make sense for open-ended investment funds to have less regular redemption points than daily trading to allow fund managers to manage the fund more equitably. It would also assist the fund managers if there were more liquid investments within the fund – being a higher cash and near-cash balance. However, the purpose of the fund should be to give the investor exposure to a stated asset class.

The further problem of daily trading within these vehicles that has not been addressed is the impact on the returns to the investor. Daily trading in an open-ended investment fund of illiquid investments forces the fund manager to trade investments that are intended as longer-term investments. The impact on the investor is that they are not rewarded by the true returns from investing in the underlying assets for the longer-term. The investor is also held responsible for the significant charges incurred by the regular purchase and sale of large, illiquid assets and consequently suffers impaired returns.

Q7: Do you think our analysis of the possible benefits and risks of direct intervention by the regulator is correct? Do you think the FCA should be more proactive about directing the actions of fund managers in a stressed situation, and if so how?

We believe that the possible benefits and risks of direct intervention by the regulator are largely correct. However, the range of different responses by fund managers in June and July 2016 alongside the range of the discounts attributed to the underlying funds does not reflect well on the open-ended real estate investment fund industry. Moreover, the need to apply such a range of discounts to exit the fund investments does reflect negatively on the real estate industry.

Q10: Are there any other issues related to the subject matter of this paper that we should consider?

We believe the following points are relevant to the discussion on open-ended investment funds with daily pricing and appreciate the support of the FCA in growing the listed real estate sector with a continued stable regulatory environment.

- Listed real estate securities provide liquidity and this is crucial for investors (especially for the less informed retail investors) in times of political or financial challenges, e.g. Brexit, the great financial crisis or real estate bubbles. In contrast to the listed real estate sector, the non-listed real estate sector faced difficulties in times of the global financial crisis. If we have a look at Germany, 22 of the 127 (almost a fifth) closed-ended investment funds (CIF) that were launched in 2007 were prematurely wound-up. Further, open-ended real estate funds are equally vulnerable to crises as shown by the experience of German open-ended real estate funds. During the great financial crisis one third of them, accounting for approximately €30 billion of property, found themselves in a vulnerable position (meaning either in liquidation or closed for redemption). Now, Germany has one of the fastest growing and best performing European listed real estate sectors.

- In the listed real estate sector, investors do not need to wait to receive their capital as they can sell immediately via the public markets. At the same time, listed real estate securities themselves are not forced to sell their underlying real estate assets (potentially below their value in times of crises) and instead access further capital through the public markets. Having such liquidity is a strong advantage in an industry in which most property owners are reliant on the secured debt capital markets. The simple fact is that offering daily liquidity in open-ended funds, when the underlying assets are illiquid and take up to six months to sell, creates situations that impact negatively on the whole real estate sector
- Transparency: All investors have equal access to regularly produced reports (a standardised set of information in relation to the company and both financial & non-financial reporting)
- Listed real estate securities provide an open market available to a broad range of investors which enables wider categories of investor and hence democratises real estate investing
- No additional up-front fees: Shares are easier to buy and easier to sell. There is no additional fee charged by the intermediary (i.e. bank)
- No conflicts of interest: Listed real estate securities are typically internally managed. They are active commercial companies which are required to have an internal management structure. They have their own employees who are aligned with the interests of shareholders in a much deeper way than is the case with the external managers in non-listed real estate structures
- They follow a business strategy which is based on a 'buy & hold' principle rather than an investment strategy, meaning they hold their real estate for the long term so that they can manage it in an active manner
- If open-ended investment funds were REITs, it would result in them being better understood and analysed by whole of the investment market. Liquidity would be higher within the public markets and there would be no need to plan for the risks associated with daily fund redemptions as REITs are closed-ended vehicles

About EPRA

EPRA, the European Public Real Estate Association, is the voice of the publicly traded European real estate sector. With more than 220 members, covering the whole spectrum of the listed real estate industry (companies, investors and their suppliers), EPRA represents over EUR 365 billion of real estate assets and 93% of the market capitalization of the FTSE EPRA/NAREIT Europe Index. EPRA's mission is to promote, develop and represent the European public real estate sector. We achieve this through the provision of better information to investors and stakeholders, active involvement in the public and political debate, improvement of the general operating environment, promotion of best practices and the cohesion and strengthening of the industry.

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