DTZ INVESTORS

What lessons can we learn from the suspension of open-ended retail property funds?

The UK commercial property market delivered a total return of 9.9% p.a. over the five year period to June 2016 (IPD Quarterly Index). Towards the end of 2015, DTZ Investors, along with some other investment houses, anticipated property market returns moderating in the second half of 2016.

With a lower return outlook following a period of strong growth, retail funds started to experience outflows early in 2016, before the EU Referendum date was announced. Following the outcome of the EU Referendum in June 2016, and the significant further redemptions requests which were received by a number of the open-ended retail funds, fund managers typically took one of two courses of action: suspending redemptions or imposing discounts to net asset value (NAV) thereby significantly reducing the pricing for exiting investors.

Was suspending redemptions/imposing discounts the best course of action?

Fund managers have a duty to act in the best interests of all their investors. Therefore, if fund managers were acting in the best interests of their investors then the answer is probably, yes. However, there has understandably been lots of questions as to what could (and perhaps should) have been done differently and what lessons can be learnt for next time around.

Suspending redemptions

For an investor making an investment into a daily traded vehicle, regardless of the questions about the liquidity of the underlying asset class itself, an investor should reasonably expect there to be the level of liquidity it has been promised. Although it is arguable that suspending redemptions probably helped to prevent a mass sell-off, which no doubt would have eroded values, only individual investors are in the position to decide whether they would prefer the level of liquidity signed up to, regardless of the price. Additionally, suspension does not help the credibility of the funds because, understandably, no one likes being told they have something (i.e. liquidity) when in fact they don’t.

Imposing discounts

Questions have been raised about how fund managers calculated and decided on the exact level of discounts to impose on redeeming investors. However, that aside, this strategy at least gave investors the option to redeem and access the liquidity which they had signed up to. Again, imposing large discounts probably also helped to prevent a mass sell-off with only those investors who really wanted immediate liquidity opting to incur pricing at this level. Whether these discounts were fair or not, is another matter and perhaps one which warrants further investigation.

Which is better?

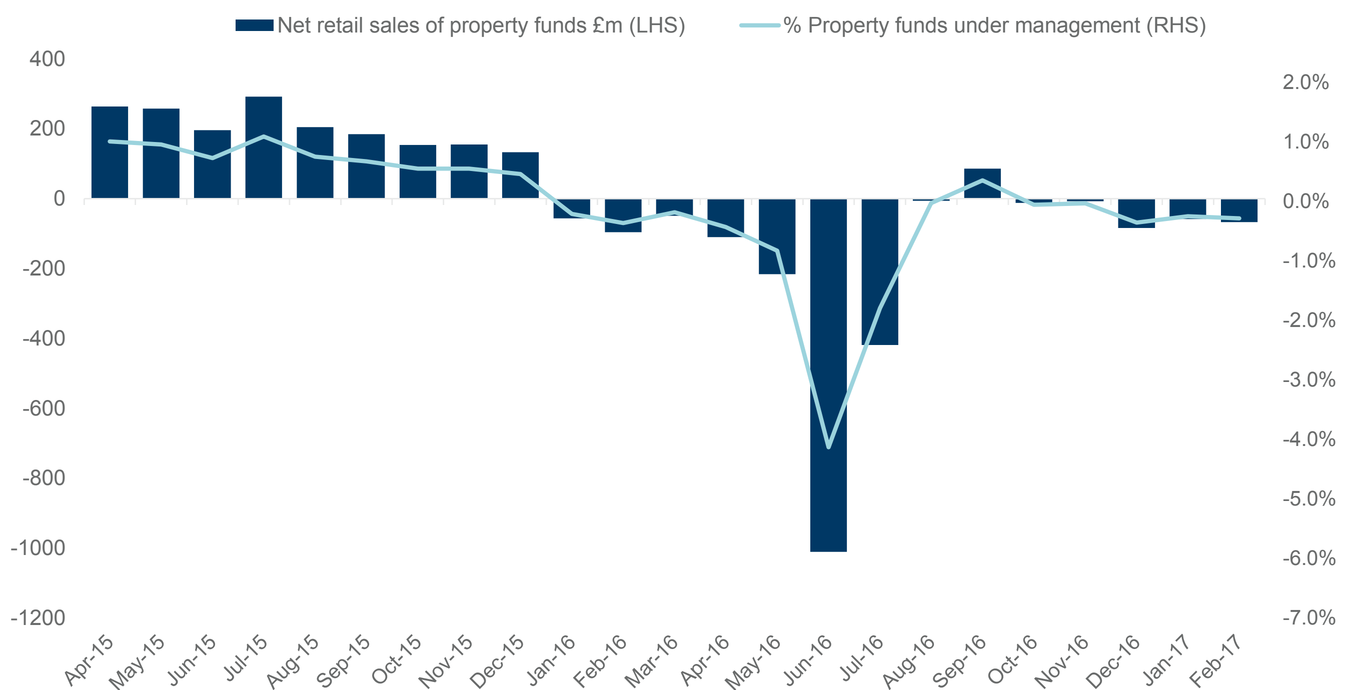
It depends. For an investor looking for liquidity at all costs, then clearly, they would want to be invested in a fund that remains open and simply imposes discounts. For an investor keen to see property returns and less worried about liquidity, they would favour investing in a fund which suspends redemptions during periods of uncertainty. Therefore, a ‘one size fits all’ approach is clearly not favourable – the problem is, an investor does not know how the fund which they have chosen to invest in will deal with high levels of redemptions and therefore cannot make an informed decision as to which fund will best meet their requirements.

Implications – the liquidity/return trade off

If an investor’s preference is to receive long-term property returns with a buy and hold strategy, then the suspend approach will better meet their objectives as this will better protect the value of their holding. The basis for this view is that managers who apply a discount are looking to discourage redemptions and encourage subscriptions to cope with a liquidity problem. Should the fund have net inflows during a period where the trading price is discounted, new subscribers will receive their holding at a discount to the market value so will dilute the enduring investors’ holdings once the discount is removed.

Investors with shorter-term investment objectives will find the uncertainty of which approach a manager will adopt more problematic. In this case, an investor will feel aggrieved if they cannot get their money back at the normal redemption price relative to the NAV, or are powerless to take action to minimise potential further losses by being unable to redeem.

Figure 1. Retail inflows/outflows to open-ended property funds (April 2015 to February 2017)



Source: IMA

If a fund were to remain open in all market conditions, thus favouring liquidity, then key factors for investors to consider include the likelihood that the fund manager will have to hold a greater proportion of the fund in cash (or highly liquid investments such as listed real estate). In these circumstances, a fund is less likely to deliver property style returns and will underperform when property returns exceed those on cash. Therefore, an investor should consider whether this strategy really meets their requirements for property exposure. Alternatively, if an investor wants truly liquid property exposure, real estate investment trusts (REITs) might be more appropriate. However, returns are more volatile, often driven by external factors which are not directly related to the property market. REITs correlate more strongly with equites rather than the real estate market in the short term and often employ gearing which increases the level of risk.

Ultimately, only an investor can truly decide what their preferences are but there is undoubtedly a lot more that the wider industry could (and should) be doing to help make these decisions easier for retail investors.

Conclusions

Information provision. Better information needs to be provided to investors (and their advisors) in order that better informed decisions can be made. The more information that is available, the better.

Transparency & communication. Clearly, better transparency goes hand in hand with information provision and the more transparent that fund managers can be, and the more efforts which are made to educate investors and to improve knowledge and understanding, the better.

Manager selection is crucial. Investors need to be confident that the fund managers with which they invest their money, and that they trust to do what they say they will do, are well prepared and are making the right decisions to meet their objectives. Investors should be even more discerning when it comes to selecting their fund manager and, when investors are dissatisfied, they should be unafraid to vote with their feet and it should be easier for them to do so.

Alignment. Ensuring that managers are well aligned with investors remains of paramount importance.

The role of valuers. Valuers reacted more quickly following the result of the EU Referendum than during the global financial crisis of 2008-9 which probably helped because there was limited opportunity to 'take advantage' of market mispricing. Although some questions arose as to whether some of the daily or monthly valued funds saw an over-correction given that values subsequently recovered somewhat towards the end of 2016, this was relatively minor. The valuation industry must continue to communicate and share information given few valuation houses value the open-ended funds.

DTZ Investors' Recommendations

Better education for investors and advisors. The industry needs to better educate both advisors and investors. This should lead to better decisions being made and less anxiety and frustration when things do not go to plan or the unexpected happens.

Consistent fund documentation. Although it could be argued that it would be more straightforward if all funds adopted the same approach and have the same terms, we do not advocate standardised terms and in fact believe that it is beneficial for there to be more variety in the market and differentiating factors between funds because one size does not fit all. However, we do believe that if all funds were forced to present their fund terms consistently in the same tabulated format, it would enable the differing terms to be compared by investors and advisors more easily.

Certainty. Of course nothing is certain but if all investors knew exactly how a fund would react to certain market conditions i.e. whether they would suspend redemptions or impose discounts and remain open, they would be able to choose which vehicle would be most suitable for then. Clearly, no fund manager has a crystal ball or the ability to plan for every possible eventuality. However, the more clarity there is, the better.

FCA regulation. We do not advocate further regulation being implemented by the FCA. However, we believe that the FCA should do more to encourage the implementation of some of our recommendations including improving education, helping to increase the availability of information and standardising fund documentation. Additionally, the FCA should provide more guidance as to how and when funds can suspend redemptions and impose redemption discounts in order to ensure that there is proper oversight and protections in place where necessary.

Important information

Past performance is not a guide to the future. The value of investments can go down as well as up. Investments in small and emerging markets can be more volatile than other overseas markets. For funds that invest in overseas markets, the return may increase or decrease as a result of currency fluctuations.

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