LGPS pooling: Could early transition of indirect real estate avoid future liquidity and performance issues?

The UK Government's 2018 deadline for the onset of investment pooling is fast approaching for Local Government Pensions Schemes (LGPS). According to the "Findings of Project Pool", almost 50% of the real estate exposure of LGPS funds is in indirect investments and the greatest savings from real estate pooling will arise from the migration of assets from indirect to direct ownership. In this snapshot, we detail our successful track record of transitioning indirect to direct real estate exposure whilst delivering outperformance for our clients and outline our wider indirect investment strategy.

Liquidity issues from momentum decisions

Given the likely cost savings, which is one of the key drivers of the entire pooling process, it is our expectation that the newly formed pools will look to sell down the majority of their indirect real estate exposure with the intention of building, or increasing, their direct exposure gradually over time. Pooled investment vehicles are likely to only be used to access specialist sectors or overseas markets going forward. However, we believe that the scale of LGPS stakes in many balanced property funds could create liquidity problems if they all decide to exit at the same time, which in turn could impact upon realisable values later down the line.

Many of these indirect vehicles are also now facing challenges presented by the government's recent proposals to tax gains made by non-residents on UK real estate from April 2019. This is set to include indirect disposals of "property rich" entities such as the offshore entities, e.g. Jersey Property Unit Trusts, used by these vehicles. Should restructuring be required to avoid unintended tax leakage, exit opportunities for LGPS investors from indirect positions may well present themselves.

There are also other headwinds on the horizon economically including the characteristics of the final UK-EU trading arrangements; political uncertainty; and the potential for rising inflation followed by interest rates increases.

Therefore, we believe that now is the time for LGPS pools to start thinking about transitioning their indirect real estate exposure whilst the secondary market, where unlisted property fund units can be traded, remains relatively strong.

Our strategy

For larger clients (typically £100m+), DTZ Investors advocates investing in the mainstream real estate sectors (retail, office, industrial) directly. This is generally the level at which sufficient asset level diversification can be achieved. Segregated accounts benefit from fees which can be less than half of those charged by fund managers of balanced funds.

Besides the cost benefits, direct investors also have complete control over their own assets, whereas in an unlisted fund, control is often relinquished. Furthermore, balanced funds have consistently underperformed the direct market, due to a combination of higher fees and the inherent cash drag in open-ended structures as managers have to keep cash deposits in the fund for liquidity management purposes.

Specialist indirect investment

That said, there are many compelling reasons to invest in unlisted funds, as we have been doing for our clients for over 20 years. We have tended to use property funds to access specialist management expertise in "alternative" sectors such as student accommodation and leisure; for smaller clients for whom a direct portfolio wouldn't make sense; for clients with specific liquidity requirements; or where we see clear arbitrage opportunities between the direct and indirect market. In the right circumstances, the additional cost and reduction in control associated with indirect investment can be justified and implemented quickly at low cost.

International indirect investment

We also use unlisted property funds to enter international markets. With many of our clients already holding investments overseas across their other asset classes, indirect investment commitments to ex-UK real estate represents a logical step.

*DTZ Investors has a **successful track record** of transitioning clients' portfolios from indirect to direct real estate exposure whilst delivering outperformance.*

Successful indirect strategies that DTZ Investors has implemented include using unlisted property funds to:

- obtain immediate exposure to the market at low cost (transaction costs can typically equate to 25bps on the secondary indirect market);
- provide increased exposure to a rising market whilst a direct portfolio was being built up (then selling down the exposure once the direct portfolio reached a critical mass);
- secure tactical exposure to a sub sector of the market anticipated to outperform the wider market to which the client was unable to gain timely and sufficient direct exposure; and
- gain diversified exposure to global real estate markets.

Case Study

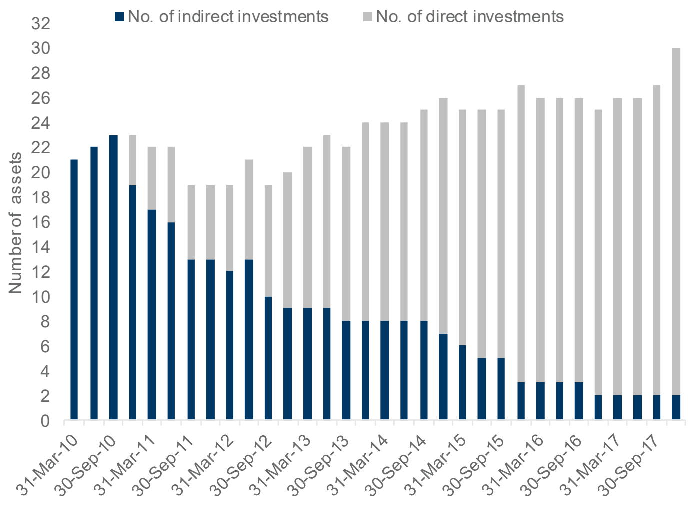
In 2010, DTZ Investors was instructed to manage a portfolio consisting of over 20 indirect assets with a total value of <£50m. Following a period of significant underperformance under the previous fund manager, our target was to significantly outperform the fund's IPD/MSCI based benchmark over a three year rolling period.

Our solution was to transition the portfolio from a wholly indirect portfolio to a predominantly directly held portfolio, using indirect exposure to access specialist investments which cannot easily be acquired or managed directly.

The fund outperformed its benchmark significantly in 2016 and is exceeding its target objective over three years to Q4 2017.

Over time, the client's allocation to real estate has also increased ten fold.

Client transition over time



Risk warning: past performance is not a guide to the future

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