Investment Property Forum

PDIG PAPER NO. 2
November 2016

MANAGING COMMERCIAL PROPERTY RISK: A DIFFERENT PERSPECTIVE

The ***Property Derivatives Interest Group (PDIG)*** *is pleased to present this second paper in a series exploring the use of property futures contracts.*

This paper focuses on how property futures may be used to help better manage property risk. PDIG will expand on many of the ideas raised here in subsequent papers.

N.B. References are to UK commercial property throughout this paper.

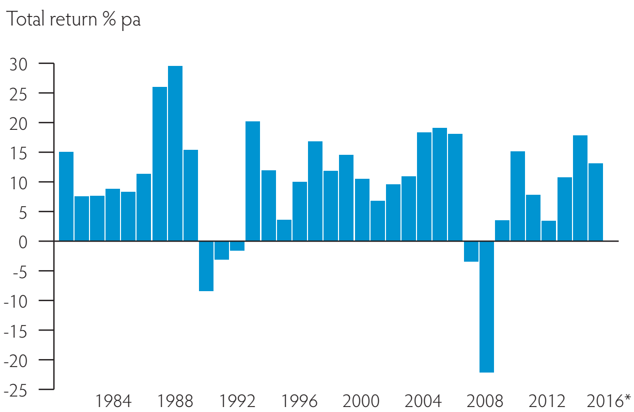
1: Why consider a 'different perspective' to manage commercial property risk?

Whilst UK commercial property returns have always been cyclical (see Figure 1), events over the last 10 years (i.e. the Global Financial Crisis and the UK's decision to leave the European Union) have reinforced the need for investors/managers to explore a variety of options to better manage property risk.

As emphasised by Figure 1, the industry has need of an efficient, flexible and inexpensive (terms not often associated with commercial property) way to:

- Decrease the volatility of property returns;
- Increase long-term return performance;
- Give investors greater certainty of return; and
- Protect/insure a portfolio against market weakness.

Figure 1: Total return performance of UK commercial property



* -0.05%, 8 months to August 2016

Source: MSCI, using IPD UK All Property Total Return Index

It is now possible for investors/managers to achieve these outcomes by using financial contracts (called property futures) in their property portfolios alongside traditional risk management techniques.

2: Enhancing traditional property risk management techniques

Risk management techniques for commercial property are constantly evolving and improving. However, traditional techniques, such as diversification, lack the speed and flexibility necessary to respond to rapidly changing circumstances. Direct property (bricks and mortar) can take time to buy and sell, with high transaction costs, particularly when compared with other asset classes, such as equities and gilts. For example, it is difficult to quickly reposition a property portfolio in the face of an imminent downturn in the market; and it is equally difficult to adjust the composition of a portfolio (i.e. sell London office property and buy shopping centres) to take advantage of short-term opportunities.

Therefore, adding speed and flexibility to existing risk management techniques – via the use of property futures contracts – gives managers an additional valuable and inexpensive tool to manage risk and potentially enhance returns.

3: What are property futures contracts?

The first paper of the PDIG series (see: Property Futures: An Introduction, November 2015) explained how property futures contracts work.

In summary, property futures are short-term financial contracts that allow owners/managers to buy or sell commercial property exposure quickly at little cost. For example, if a fund manager wanted to adjust its portfolio of London city offices (i.e. either buy more, or sell all/part) within say a month, it could do so by entering into a property futures contract. In such a transaction, no physical property (i.e. the bricks and mortar) is bought/sold, but exposure to London city offices is adjusted via a property index.

The indices that underpin property futures contracts are produced by MSCI and essentially act as a proxy for the performance of physical property. These indices range from the measurement of 'All' UK commercial property performance (as shown in Figure 1), to more specific indices such as London city offices or UK shopping centres.

4: What aspects of risk management can property futures be used for?

The main applications of property futures in a commercial property portfolio are:

- **Liquidity management (managing cash & fund redemptions):** Because of the flexible and inexpensive nature of property futures, property funds that have excessive cash holdings can use property futures to either reduce the impact of cash drag on their fund's performance or help manage redemptions by avoiding the forced sale of assets.
- **Protection against declining capital values:** In a situation where owners/managers believe there is a real risk that property values may decline, it is possible to use property futures to protect against the worst of these falls if they occur.
- **Lock-in positive returns and give investors certainty of return with low volatility:** Using a property fund with a portfolio of London city offices as an example, if the view/forecast today (November 2016) is that London city offices will only deliver 0.0% total return for 2017, the fund manager could lock-in a 3.0%[1] total return today (November 2016) for 2017, using a London city office property future (IPD UK Quarterly City Office). Serious consideration should be given to taking this approach because:
  - The 3.0% is much higher than the 2017 forecast return at 0.0%;
  - It gives investors in the property fund certainty of a positive return; and
  - The 3.0% return is certain now for 2017, thereby significantly reducing the portfolio volatility going forward.
- **Quickly adjust between different property sectors/sub-sectors:** As highlighted in Section 2, it is possible to quickly adjust the composition of a portfolio using property futures contracts (e.g. sell IPD UK Quarterly City Office and buy IPD UK Quarterly Shopping Centre) to take advantage of short-term opportunities as identified by individual fund managers.

5: What are the costs and risks of using property futures?

The buying and selling cost of physical property is typically around 7.0%, this compares with property futures of between 0.35% to 0.5%.

The key risks to consider when using property futures are:

- **Understanding the differences that drive the performance of the respective property index (underpinning the future), and the performance of the actual physical property in a property fund:** Understanding these differences is critical in managing not only the cash flow and valuations within a property fund, but also in achieving many of the benefits of using property futures contracts.
- **Perceived liquidity risk:** when entering into a property futures contract, users should consider the term for which they expect to hold the position. Each contract has guaranteed liquidity at maturity, but if the user needs to exit from the trade ahead of maturity this can only be done at market price, which may be higher or lower than when the trade was contracted.
- **It is a financial derivative product:** Derivatives have not received the best press over recent years and it is true that they can add significant risk. Provided that the features of property futures are understood, they are a useful tool in risk management, as outlined in Section 4.
- **Credit risk:** The credit risk of property futures is extremely small, regardless of the nature of the counterparties. Property futures are centrally cleared via a financially-regulated exchange so the credit risk of both the buyer and seller is held by the clearing house, Eurex Clearing, which acts as a central counterparty (CCP) to each and every trade.

Fund managers need to ensure that their mandate allows the use of property futures. Many mandates and prospectuses do permit the use of property futures for 'efficient portfolio management', and, hence, allow for many of the uses in Section 4.

6: Other users of property futures

Whilst this paper focuses mainly on the owners/managers of property, other users of property futures can equally benefit, including property developers, lenders (banks and non-banks), multi-asset funds and asset allocators.

1 This is a proxy for London city offices.

About PDIG

PDIG was set up by the IPF in 2005 to support the development of the market, partly in response to the needs of investors and partly following the changes to the regulatory and tax environment, which made property derivatives more accessible and attractive.

This paper was written by the PDIG Committee, the members of which are: **Philip Ljubic** (Chairman), **Adam Alari** M&G, **Stephen Ashworth** tpsynrex, **Bill Bartram** IRM Solutions, **Douglas Crawshaw** Willis Towers Watson, **Sue Forster** IPF, **Steven Grahame** North Row Capital, **Stuart Heath** Eurex Exchange, **David Hedalen** Standard Life Investments, **Helen Hermant** Santander, **Luke Layfield** Aviva Investors, **Emma Long** Legal & General, **Mark Long** Blackrock, **Jon Masters** Arca Property Risk Management, **Alex Moss** Consilia Capital, **Kate Pedersen** MSCI and **Ken Soh** Grosvenor Group