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# A Decade of Fund Returns



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## A Decade of Fund Returns

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## A DECADE OF FUND RETURNS

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## IPF SHORT PAPERS SERIES: PAPER 8

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## EXECUTIVE SUMMARY

The long bull market and subsequent sharp correction in the commercial real estate market over the 10 years from 2001 to 2010 coincided with a dramatic growth in indirect investment vehicles. From £6.0bn in 2001, pooled funds in this study grew to £48.5bn at the end of 2007, before falling in value to £33.3bn. Growth was funded by net investment of £11.4bn and an increase in debt of £5.9bn.

Many of the fund managers of these investment funds had to manage, firstly, substantial net in-flows at a time of a highly competitive investment market, then, subsequently, the strains of rapid disinvestment into the teeth of falling capital values.

These contrasting conditions really tested their skills to both purchase properties when there is strong competition, and then sell assets into a market bereft of buyers. Fund managers seem to have delivered: indirect funds in this study achieved a 7.1% p.a. return on their investment portfolios over the 10-year period or a £35.0bn surplus on an average capital employed of £24.6bn.

The Managed Funds and Other Balanced Funds had to invest the high inflows into their funds into the direct market and then disinvest to meet redemptions in the ensuing market turmoil. Against this background the two fund categories achieved similar overall total returns on their investment portfolios, 6.8% p.a. and 6.5% p.a. respectively.

The investment flows into the (mostly) closed-ended Specialist Funds were more in the control (although some may smile ruefully at this supposition) of the fund manager. These funds seem to have benefitted from this control and also from their high weight in segments of the market that performed strongly, generating a 7.8% p.a. total return from their investments.

The different fund types have particular mechanisms to manage liquidity that create divergent challenges to their fund managers. Open-ended funds had to fight to minimise cash drag during the upswing in the market when fund inflows were very high – a problem that did not impact upon the mostly closed-ended Specialist Funds. Overall, cash diluted the performance of Specialist Funds by an estimated 9 bps but hit the performance of their open-ended Managed Funds cousins by an estimated 44 bps.

The scope for innovation in cash management to increase investor returns is therefore estimated at potentially an additional 35 bps p.a. The use of derivatives for this purpose to date has been minimal, partly because of restrictions in the fund documentation, which in most cases was written well before the increase in the size and liquidity of the derivative market.

The use of equities for cash management purposes has also been small, with their use peaking at only 0.4% of gross asset value (GAV) in 2005. Investors should seek case studies of individual funds for their experiences of using these two methods of controlling cash.

The degree of leverage employed and the timing of when leverage is employed are estimated to have been the most volatile determinants of eventual fund return. There is little evidence though that pooled funds were able to time their use of debt, with the stock of debt and overall leverage increasing up to the point when property values peaked and then continuing to rise as investment values fell. The observed impact of leverage depended crucially on the performance of the fund's investment portfolio. With the investments of Specialist Funds performing more strongly, their debt added 90 bps p.a. to fund performance on an average debt-to-GAV ratio of 33%. Other Balanced Funds, which achieved lower property returns, lost 19 bps to the impact of debt.

## EXECUTIVE SUMMARY

After the impact of debt and cash, the £11.1bn surplus that the indirect funds in this study generated on their investment portfolios is estimated to have been reduced to £9.1bn, an annualised return of 6.9% – virtually unchanged on the investment return calculated on GAV.

Deductions made for fund costs, funds fees and performance fees are not transparent, although the investors in individual funds are presumably informed of all deductions. Overall, £2.2bn of the surplus is estimated to have been eaten up in this way. Estimates of each factor have been a little crude and the industry would be well-served by more transparent reporting of costs and fees to allow more robust measurements of their impact on investor returns.

An estimate of the costs of administering schemes is estimated at over £500m, 2.0% of average GAV. This reduced average investor returns by 26 bps and by 34 bps on Specialist Funds.

Fund sponsors also took their fee and performance fees, estimated at £2.1bn, for this return delivery, which reduced investor returns by almost one percentage point. Specialist Funds returns were shaved by 135 bps due to fees and Other Balanced Funds by 86 bps. Managed Funds came in cheapest, at less than 49 bps.

It is estimated that funds delivered a net return, after all fees and costs, to investors of 5.8% p.a. A satisfactory return compared to comparable returns on equity and bond portfolios of 3.7% p.a. and 5.5% p.a., as measured by WM over the period. This statement requires the caveat that these returns are not yet realised returns and are based upon the net asset value (NAV) at the end of the period of the analysis.

## 1. INTRODUCTION

Commercial real estate offers attractive investment return characteristics but it also presents a challenge to investors in trying to access this asset class.

Real estate assets are both large and 'lumpy', i.e. ownership is not divided into small value shares as it is for a listed property company. Investing in just one or a small number of buildings exposes the investor mostly to the assets' specific performance characteristics rather than the investment characteristics of the asset class as a whole.

Management of a commercial real estate asset is also complex, with property management and asset management demanding professional skills.

So, constructing a real estate portfolio is a significant hurdle to all but the largest investors. Pooled real estate funds provide a solution to this barrier to entry. Pooled funds allow both smaller institutional and retail investors to gain an exposure to commercial real estate through a share in a large pool of properties.

Indeed, some real estate property types are so large, shopping centres for example, that pooled fund structures can also be used to provide access to segments of the market where even the very largest investors would struggle to achieve a diversified holding.

Pooled funds can also specialise in very management intensive asset types, multi-let industrials for example, where specialist management skills can be applied in a management intensive or niche markets to extract the maximum performance from the properties.

Open-ended pooled funds also provide liquidity to their investors, allowing investors a mechanism to exit their investment at a quoted price without the need to sell an asset in the direct market (although, ultimately, if enough investors in the pooled fund are looking to exit at any one time redemptions need to be delayed via a queuing mechanism and underlying investments would have to be sold).

In summary, the diversification, management efficiency, management specialisation and liquidity of pooled funds add up to a sound investment rationale for accessing the commercial real estate investment market.

This paper addresses the question of how much this route to market alters investors' delivered return, particularly the impact of fund costs, cash, debt and fees.

The paper does not address whether the requirements of those funds that often seeded these indirect vehicles were met.

Life Funds were usually motivated to seed pooled funds as a means to sell down their holdings in large assets and reduce their total real estate allocation.

This push factor was significant in the development of the indirect fund industry and delivered additional benefit to Life Funds that would otherwise have had to unwind their large portfolios. This could have led to unbalanced portfolio structures if the funds had been left with reduced number of assets, and therefore high asset concentration risks and insufficient diversification across all segments of the market.



# 1. INTRODUCTION

## 1.1 Pooled Fund Return Drivers

Pooled fund units entitle the investor to a share in the returns from a portfolio of real estate assets. The investor has an exposure to the properties in the fund but also to the debt and cash within the vehicle.

Debt and cash alter the capital employed in the fund: leverage magnifies returns and losses whilst cash does the reverse. The interest received on cash and interest paid on debt will also alter the income distributed by the fund.

Cash and debt within pooled funds will create a divergence, therefore, in investor performance from that of the underlying market.

Pooled funds incur costs to administer and fund sponsors will also deduct an investment management fee for their services. It should be noted that the costs incurred in running a segregated portfolio are excluded from direct property return indices. These costs are either incurred directly if there is an internal investment management function or through the fees payable on a mandate if the investment and management functions are outsourced to a third party.

This report seeks to quantify the impact on fund performance of these additional dimensions to accessing the real estate market through a pooled fund. The figures are constructed at a fund level so no analysis is included on the final influence of investor return: the timing of their investment into and out of funds and the prices achieved.

## 2. POOLED PROPERTY FUNDS INDEX SAMPLE

### 2.1 Managed Funds

Managed Funds typically seek to give pension funds an exposure to a portfolio of direct real estate properties diversified across different use types and regions.

These funds use no debt directly within their portfolios, although there were five funds that invested in indirect vehicles which may have injected some leverage into their overall exposure.

Managed Funds are open-ended vehicles.

The GAV of Managed Funds grew in the sample from £2.1bn to £7.1bn.

### 2.2 Other Balanced Funds

An Other Balanced Fund (mainly comprised of Property Unit Trusts) is typically seeking to give retail or institutional investors an exposure to a diversified portfolio of real estate, with a spread of properties of different types (retail, office, industrial, etc) and in different regions of the country.

Debt within these funds ranged from two funds that had no leverage over the period, 11 that had utilised, on average, less than 10% debt, five funds that had averaged between 10% and 40% gearing and four that had used an average of over 40% leverage.

It is possible for these funds to invest in other indirect vehicles (which themselves may have debt or cash and carry fees) with 11 examples amongst the 22 funds.

Most, but not all, Other Balanced Funds are open-ended.

The GAV of Other Balanced Funds grew in the sample from £2.0bn to £8.9bn.

### 2.3 Specialist Funds

Specialist Funds typically provide investors with an exposure to property types that are difficult for investors to access due the size of the properties or the level of specialist management skills required.

These funds often use significant debt in their portfolios. 18 used an average level of leverage (calculated as debt/GAV) of over 40%, eight funds had leverage of over 10%, nine had an average debt level of less than 10% and only 2 were completely unleveraged.

In addition, 11 funds invested in other indirect vehicles, which themselves may have debt or cash and carry fees.

Most, but not all, Specialist Funds are closed-ended.

The GAV of Specialist Funds grew in the sample from £1.9bn to £17.3bn.

## 2. POOLED PROPERTY FUNDS INDEX SAMPLE

**Table 2.1: Description of funds measured**

|                      | Count     |               | Leverage?* |            | Unlisted fund holdings |
|----------------------|-----------|---------------|------------|------------|------------------------|
|                      | Total     | Entire period | No (<10%)  | Yes (>10%) |                        |
| Other Balanced Funds | 22        | 9             | 13         | 9          | 11                     |
| Managed Funds        | 9         | 6             | 9          | 0          | 5                      |
| Specialist Funds     | 37        | 7             | 11         | 26         | 11                     |
| <b>Total</b>         | <b>68</b> | <b>22</b>     | <b>33</b>  | <b>35</b>  | <b>27</b>              |

\*debt/GAV

### 3. METHODOLOGY

#### 3.1 The Drivers of Pooled Fund Returns

To quantify the impacts of each of the drivers of pooled funds' performance, particularly the impacts of debt, cash, funds costs and fees, quarterly changes in NAV for each of the funds within the IPD Pooled Property Funds Index (PPFI) have been attributed to one of twelve categories.

**Table 3.1: Categories of performance impacts**

| Investment portfolio                         | Cash / leverage           | Fund costs / fees      | Bid-offer price mechanism           |
|--|---------------------------|------------------------|-------------------------------------|
| Capital movements on directly held portfolio | Interest received on cash | Fund level outgoings   | Premium/discounts on net new issues |
| Income received from directly held portfolio | Interest paid on debt     | Annual fund level fees |                                     |
| Indirect investments                         | Marking debt to market    | Performance fees       |                                     |
| Listed investments                           |                           |                        |                                     |
| Derivatives                                  |                           |                        |                                     |

Using this breakdown of changes to fund NAVs, the evolution of fund returns can be traced from that derived from the underlying property portfolio through the impacts of other investments, cash, debt, costs and fees to the final investor return.

**Table 3.2: From direct portfolio return to fund level return**

| Denominator                                      | Numerator                                       | Return                  | Difference from previous row        |
|--|---|-------------------------|-------------------------------------|
| Direct portfolio value                           | Portfolio income + change in portfolio value    | Direct portfolio return | n/a                                 |
| ...plus investment value of indirect investments | ... plus indirect investment returns            | Total investment return | Impact of indirect investments      |
| ...plus cash                                     | ... plus interest received                      |                         | Impact of cash                      |
| ...less debt                                     | ... minus interest on debt                      |                         | Impact of debt                      |
| Net Asset Value                                  | ... minus fund costs fees                       |                         | Impact of costs                     |
| Net Asset Value                                  | ... minus fees                                  |                         | Impact of fees                      |
| Net Asset Value                                  | ... plus premiums / discounts on net new issues | Total investor return   | Impact of bid/offer price mechanism |

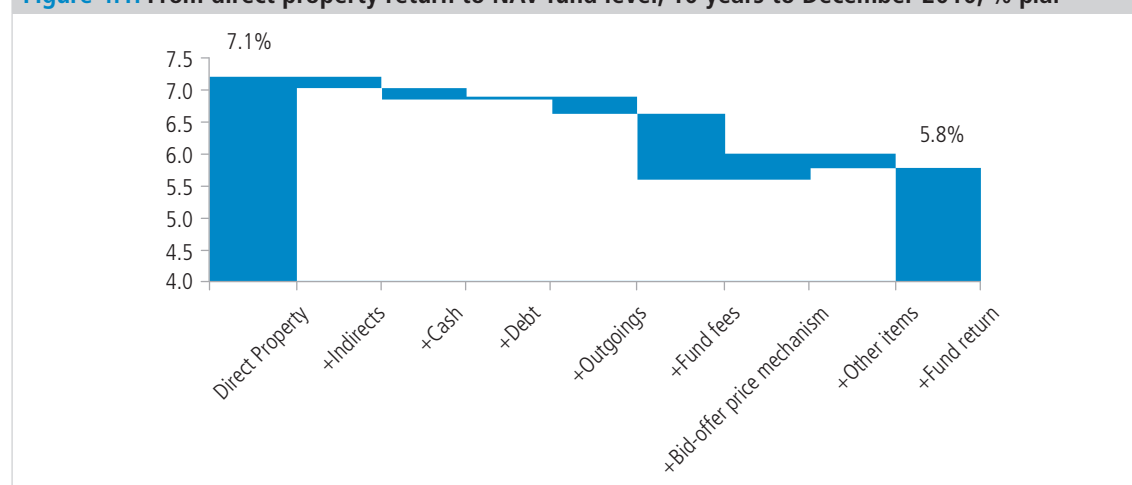
Whilst every effort has been made to identify all the drivers of changes to NAV it has not been possible to precisely quantify all of the data items. Therefore, in Figure 4.1 there is a final category for the balancing item where the change in NAV could not be fully allocated between the categories.

## 4. HEADLINE RESULTS

### 4.1 A Decade of Indirect Fund Returns

Over the 10 years to December 2010 the contribution of other investments, cash, debt, costs and fees reduced the return from pooled fund vehicles from a direct property return of 7.1% p.a. to a fund level return of 5.8% p.a.

**Figure 4.1: From direct property return to NAV fund level, 10 years to December 2010, % p.a.**



The 7.1% p.a. return is calculated as the total return on direct property assets over the total value of the direct portfolio. Adding the return from and the capital employed in holdings of other indirect vehicles, equities, derivatives and joint ventures reduced fund returns by 0.10% p.a.

Cash is a drag on fund performance when the return on cash is lower than that of real estate. Over this period cash reduced fund returns by 0.19% p.a.

Debt reduces the capital employed in the fund so leverage amplifies fund capital returns if capital growth is positive. If interest payments on the debt are below the rent received on the real estate portfolio this further enhances total returns. On balance, over the 10-year period, debt marginally increased returns by 0.03% p.a.

Fund outgoings and fees are a direct reduction from the return delivered to investors. Fund outgoings lowered returns by 0.26% p.a. and fund and performance fees reduced returns by a further 0.99%.

Investors are charged a premium to invest in a fund over NAV to compensate existing investors in the fund for the acquisition costs already incurred on the existing portfolio – the bid–offer spread. The premia or discounts from trading in units on the fund increased returns by 0.37% p.a.

Whilst every effort has been made to allocate all changes in NAV to a category, a reconciliation error of -0.20% p.a. remains.

## 4. HEADLINE RESULTS

**Table 4.1: Summary, 10 years to December 2010, % p.a.**

|  | Denominator                       | Numerator   | All Funds   |
|--|-----------------------------------|---|-------------|
| Portfolio returns                          | Direct portfolio value            | Portfolio income + Change in portfolio value          | 7.1%        |
| Impact of:                                 |                                   |   |             |
| Indirect, listed & derivatives investments | ... plus Indirect portfolio value | ... plus indirect investment returns                  | -0.10%      |
| Cash                                       | ... plus cash                     | ... plus interest on cash                             | -0.19%      |
| Debt (including marking debt to market)    | ... less debt                     | ... minus interest on debt                            | 0.03%       |
| Fund outgoings                             |                                   | ... minus fund costs                                  | -0.26%      |
| Fees & performance fees                    |                                   | ... minus fees  | -0.99%      |
| Bid-offer price mechanism                  |                                   | ... plus premia / discount on unit issues/redemptions | 0.37%       |
| Other items                                |                                   |   | -0.20%      |
| <b>Total return</b>                        |                                   |   | <b>5.8%</b> |

The different fund types experienced contrasting investment performance and also differing impacts from cash, debt and fees. Specialist Funds generated by far the highest return. Much of this extra performance was structural, with strong performance in the sectors in which the Specialist Funds concentrated, predominantly Retail Warehouses and high-yield industrials. The strong investment performance meant that leverage was accretive to the performance of Specialist Funds but not to the Balanced Funds. Fund outgoings were highest on the Specialist Funds: a result that is in keeping with these funds holding stock requiring more active management than the more balanced fund types. Managed Funds had the highest impact of cash but the lowest fund fees.

**Table 4.2: Summary by fund type, 10 years to December 2010, % p.a.**

|  | Managed Funds | Other Balanced Funds | Specialist Funds |
|--|---------------|----------------------|------------------|
| Portfolio returns                          | 6.8           | 6.5                  | 7.8              |
| Impact of:                                 |               |                      |                  |
| Indirect, listed & derivatives investments | -0.09         | -0.07                | -0.06            |
| Cash                                       | -0.44         | -0.19                | -0.09            |
| Debt (including marking debt to market)    | 0.00          | -0.19                | 0.90             |
| Fund outgoings                             | -0.17         | -0.22                | -0.34            |
| Fees & performance fees                    | -0.49         | -0.86                | -1.35            |
| Bid-offer price mechanism                  | 0.81          | 0.38                 | 0.12             |
| Other items                                | -0.20         | 0.07                 | -0.85            |
| <b>Total return</b>                        | <b>6.6</b>    | <b>5.4</b>           | <b>6.2</b>       |

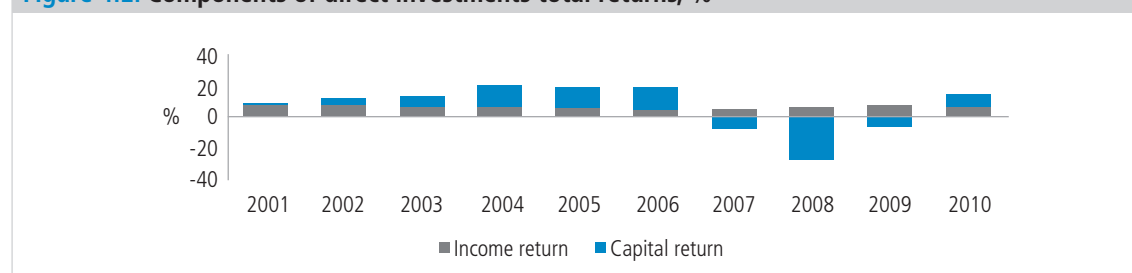
## 4. HEADLINE RESULTS

### 4.2 Direct Investments

The average capital employed in the directly held real estate assets of Pooled Funds in this study was £24.2bn and the surplus generated by these assets was £35.0bn.

The performance of the properties accelerated from 2001 through to 2004 and returns remained strong through 2005 and 2006. From December 2000 to the peak of the market in June 2007, the direct property in pooled funds had turned £100 into £248. By June 2009 this had reduced to £157 but a strong rally left £100 invested worth £199 by the end of the 10-year period, a 7.1% p.a. return, 5.9% p.a. from income and 1.1% p.a. from capital.

**Figure 4.2: Components of direct investments total returns, %**



The performance of the direct property held by Specialist Funds was higher than in the more diversified Managed Funds and Other Balanced Funds. As a rough approximation, about half of this outperformance is due to the strong performance of Retail Warehouses and Industrials, segments in which the Specialist Funds had a higher weight (although the largest holdings of Specialist Funds are Shopping Centres, which underperformed the All Property average over this period).

**Table 4.3: Direct investment returns by fund type, 10 years to December 2010, % p.a.**

|                   | Managed Funds | Other Balanced Funds | Specialist Funds | All Funds |
|-------------------|---------------|----------------------|------------------|-----------|
| Portfolio returns | 6.8           | 6.5                  | 7.8              | 7.1       |

### 4.3 Cash

Over the past 10 years cash levels as a percentage of GAV on indirect funds have averaged 4.2%.

Cash balances depend upon portfolio turnover decisions, some of which will be driven by the manager's view of the future direction of property prices. For open-ended funds, cash balances also depend upon the investment flows into and out of the fund. Managers of open-ended funds are required to keep a degree of liquidity in the fund in the form of cash and, as new money is invested in the fund, this translates into cash balances (rather than being drawn down by the fund manager as is often the case with closed-ended funds).

## 4. HEADLINE RESULTS

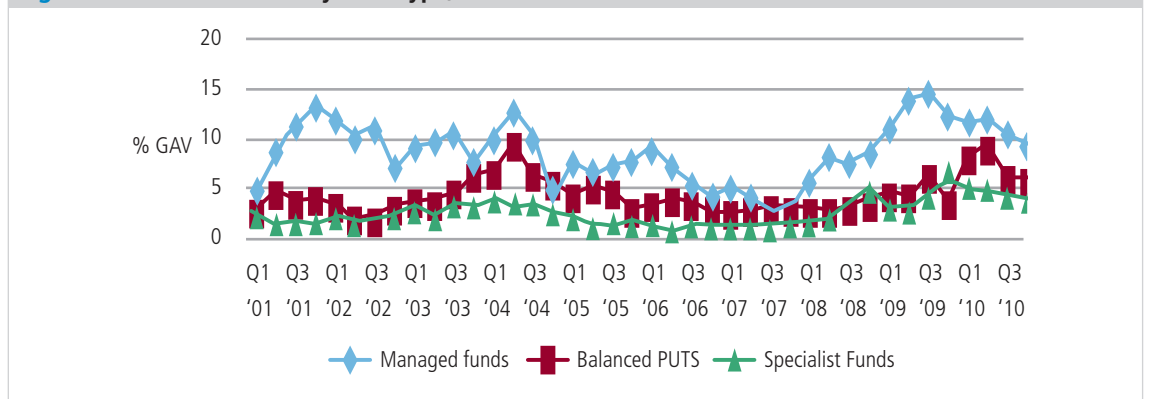
**Table 4.4: Average cash balances by fund type, 10 years to December 2010, % of GAV**

| % Average GAV | Managed Funds | Other Balanced Funds | Specialist Funds | All Funds |
|---------------|---------------|----------------------|------------------|-----------|
| Assets        | 91.5          | 95.8                 | 98.6             | 96.4      |
| Cash          | 8.5           | 4.4                  | 2.5              | 4.2       |
| GAV           | 100           | 100                  | 100              | 100       |

Cash balances were significantly higher on Managed Funds, which, as well as being open-ended, do not distribute their income, averaging around 10% of GAV until September 2004 then after December 2008, and 6% between these dates. Cash balances on Other Balanced Funds averaged around 4% of GAV until 2010 and then peaked at 9% in the second quarter of 2010.

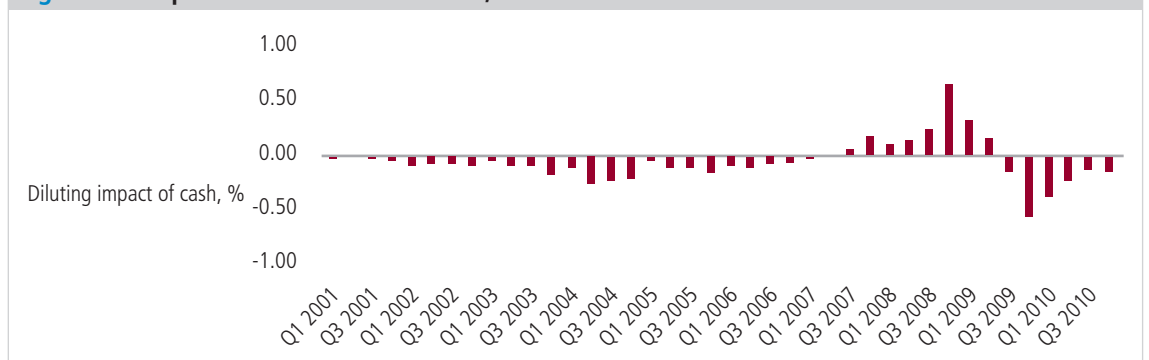
Most Specialist Funds are closed-ended, where cash balances are not impacted by regular investment flows and portfolio income is treated separately in the balance sheet to the NAV calculation. Cash balances on Specialist Funds rose significantly after June 2008, averaging 1.9% before and 4.2% afterwards. The rise in cash balances was predominantly due to a diversion of income in an effort to resolve breaches of loan-to-value covenants.

**Figure 4.3: Cash balances by fund type, % of GAV**



Cash dilutes returns in an upswing but enhances returns in a downswing. Until the downswing began in late 2007, cash was consistently a drag on fund performance as interest earned was below the return of the real estate market. In the sharp downswing cash offset some of the negative portfolio performance, before diluting performance once more in the sharp recovery.

**Figure 4.4: Impact of cash on fund returns, %**





## 4. HEADLINE RESULTS

Over the cycle, cash reduced investment returns on average by -0.19% p.a. Managed Funds, with their higher cash balances, experienced the greatest dilution of fund returns due to cash. Specialist Funds with their higher cash balances in the downswing and lower cash levels in other periods experienced the lowest dilution from cash.

**Table 4.5: Impact of cash on fund returns by fund type, %**

|                     | Managed Funds | Other Balanced Funds | Specialist Funds | All Funds    |
|---------------------|---------------|----------------------|------------------|--------------|
| Investment returns* | 6.7           | 6.4                  | 7.8              | 7.0          |
| Plus cash           | 6.2           | 6.2                  | 7.7              | 6.8          |
| <b>Impact</b>       | <b>-0.44</b>  | <b>-0.19</b>         | <b>-0.09</b>     | <b>-0.19</b> |

\* Investment returns = Portfolio returns + Indirects, etc.

The scope for managing cash balances by funds is arguably very limited, especially open-ended funds where the decision to invest or disinvest is taken by the investors. Unsurprisingly, there is, therefore, a fairly direct relationship between the average cash balance and the drag on fund performance for the Managed Funds and Other Balanced Funds.

### 4.4 Leverage

Leverage is the use of debt within a portfolio. The measure of leverage used in this report is the stock of debt divided by GAV. Some funds mark the value of this debt to market. Managed Funds and most Other Balanced Funds are unleveraged whilst two-thirds of Specialist Funds are leveraged.

Leverage was significantly higher on Specialist Funds over the 10-year period, averaging around 33%. Debt balances on Other Balanced Funds averaged around 7%. The unweighted average of Other Balanced Funds that utilised debt was 16%.

**Table 4.6: Average leverage by fund type, % of GAV**

| % Average GAV | Managed Funds | Other Balanced Funds | Specialist Funds | All Funds |
|---------------|---------------|----------------------|------------------|-----------|
| Debt          | 0.0           | 6.7                  | 33.2             | 18.9      |

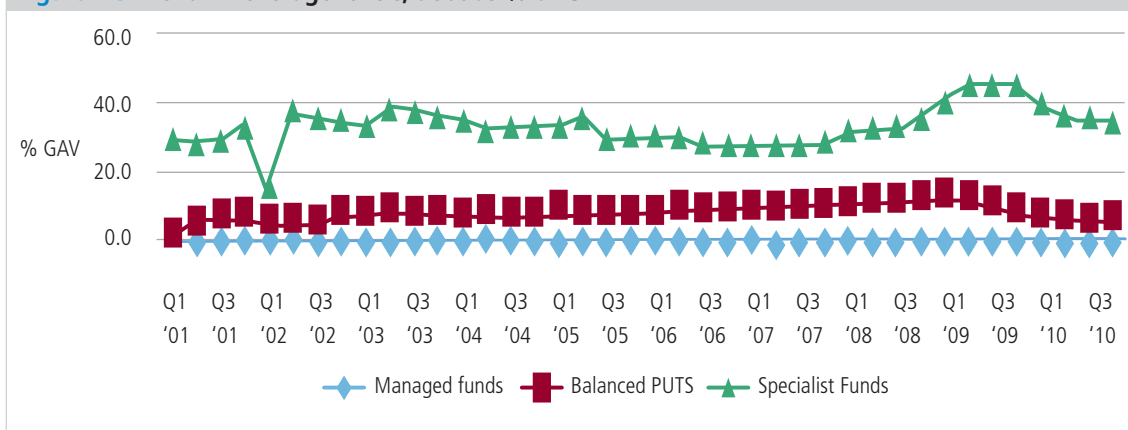
In the upswing, Specialist Fund leverage fell to below 30% from late 2006 through 2007. Balanced Funds tended to be more lowly geared prior to the upswing, only rising above an average of 9% in 2008. In the downswing, debt levels rose, reaching average levels of over 40% in 2009 on Specialist Funds and over 10% on Balanced Funds. This is evidence of the 'Black Leverage' impact. The degree of leverage naturally falls as portfolio values rise in an upswing and the leverage rises as portfolio values fall in a downswing, so gearing tends to peak in the downswing rather than in the upswing. The only way to avoid this impact is to reduce the stock of debt more quickly than the market falls – clearly, this was not easy for funds to achieve in practice.

Deleveraging by Balanced Funds reduced average debt levels to below 5% by the end of 2010, the lowest level since 2002. Specialist Funds, with a higher peak in leverage, still had leverage of 35% at the end of the 2010. The deleveraging by Balanced Funds came too late to save them from the ravages of the downswing but too early to benefit from the subsequent upswing – leverage has clearly proved tricky for indirect funds to get right.

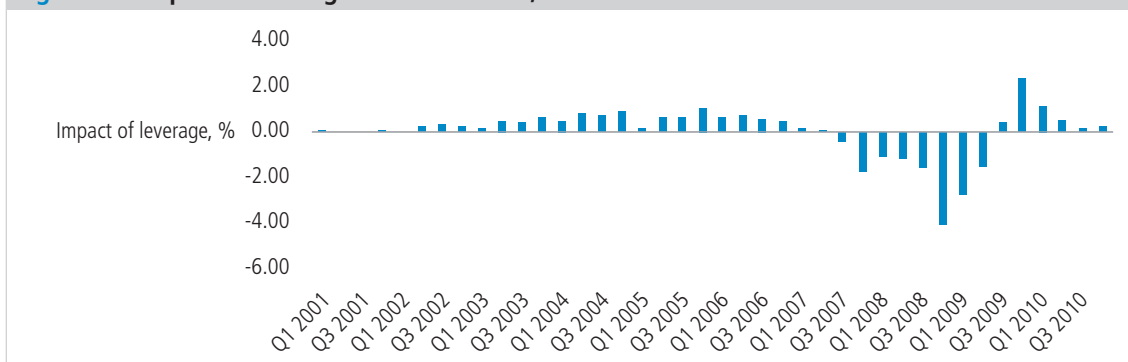
## 4. HEADLINE RESULTS

It is possible that part of the reason that Specialist Funds have not deleveraged as quickly as the Other Balanced Funds is due to the costs of breaking swap contracts that were put in place to protect them from rising interest rates (these contracts, ironically, created a problem when interest rates fell).

**Figure 4.5: Trend in leverage levels, debt as % of GAV**



**Figure 4.6: Impact of leverage on fund returns, %**



The overall impact of the 'sound and fury' of leverage through the cycle was a tiny increase in overall fund returns. Specialist Funds benefitted to the tune of 90 bps whilst Other Balanced Funds lost 19 bps.

**Table 4.7: Impact of leverage on fund returns by fund type, %**

|                              | Managed Funds | Other Balanced Funds | Specialist Funds | All Funds   |
|------------------------------|---------------|----------------------|------------------|-------------|
| Investment Returns plus cash | 6.2           | 6.2                  | 7.7              | 6.8         |
| Plus debt                    | n/a           | 6.1                  | 8.6              | 6.9         |
| <b>Impact</b>                | <b>n/a</b>    | <b>-0.19</b>         | <b>0.90</b>      | <b>0.03</b> |

The quarterly volatility of fund returns increases by nearly a third from 4.1% to 5.3% after including the impact of debt. The volatility of Specialist Funds increases by 50%.

Debt will reduce the risk of individual funds if utilised to purchase more assets, by increasing the diversification from asset-specific risk in the fund or, for a balanced fund, to diversify the portfolio across extra segments of the market.

## 4. HEADLINE RESULTS

**Table 4.8: Impact of leverage on risk by fund type, %**

|  | Managed Funds | Other Balanced Funds | Specialist Funds | All Funds  |
|--|---------------|----------------------|------------------|------------|
| Volatility of Returns including cash           | 3.7           | 3.9                  | 4.3              | 4.1        |
| Volatility of Returns including cash plus debt | 3.7           | 4.3                  | 6.6              | 5.3        |
| <b>Increase</b>                                | <b>0%</b>     | <b>10%</b>           | <b>52%</b>       | <b>28%</b> |

Of those funds using leverage, leverage enhanced the returns by a third.

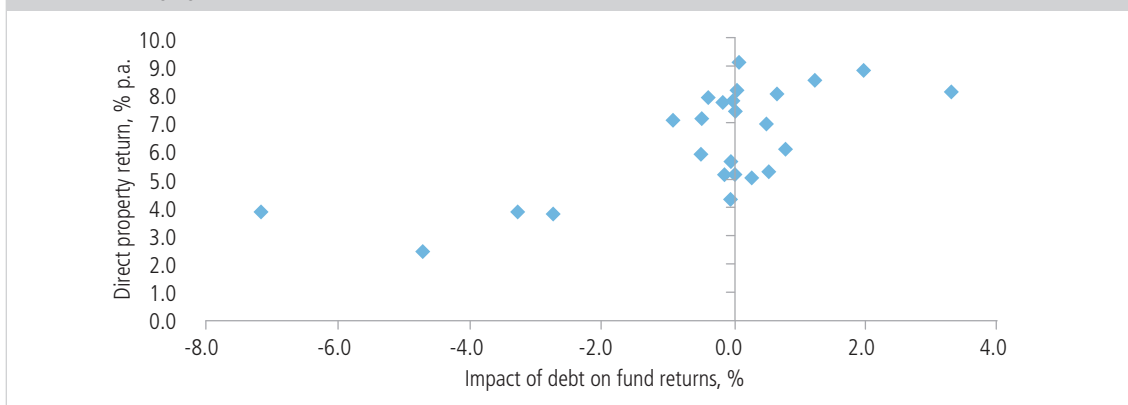
**Figure 4.7: Impact of leverage versus degree of leverage on individual funds, 10 years to December 2010**



There are two reasons why leverage can enhance returns of one fund but not another. The first is if the debt can be increased when returns are high and decreased before returns turn negative. There is evidence of this being achieved by a very small number of the funds to a limited extent. The second is to achieve strong portfolio returns. In Figure 4.8 it can be clearly seen that those funds with strong long-term investment returns were much more likely to have seen a positive enhancement to fund returns from leverage.

## 4. HEADLINE RESULTS

**Figure 4.8: Impact of leverage versus investment returns on individual funds, 10 years to December 2010**



### 4.5 Fund Outgoings, Fees and Performance Fees

Calculating actual fees paid within funds is complicated. Different charges can be applied to different investors. The list price of fees may be complex, with a sliding scale of charges based upon the size of the investor stake in the fund. Side letters, including 'Most Favoured Nation' clauses (where an investor is guaranteed to be charged the lowest fee), are not publically available. Fees can also be payable on undrawn capital, which were not possible to incorporate in calculations.

Performance fees can be also be difficult to estimate, with complex calculations (how many investors could work them out without the assistance of their Finance Director?) and accrual provisions so that, in some instances, total fees will not be known until the fund is wound up.

The ultimate fee paid by investors and received by the operator may also depend on other fee arrangements. For example, the manager may deduct the fees payable on the unlisted funds from the fees payable on the direct property mandate.

With these caveats to the estimates, fund fees are estimated to have reduced average fund performance by -0.99% p.a.

**Table 4.9: Impact of outgoings and fund fees on fund returns by fund type, %**

|   | Managed Funds | Other Balanced Funds | Specialist Funds | All Funds     |
|---|---------------|----------------------|------------------|---------------|
| Fund return exclusive of outgoings and fees | 6.2%          | 6.1%                 | 8.6%             | 6.9%          |
| <b>Impact of fund outgoings</b>             | <b>-0.17%</b> | <b>-0.22%</b>        | <b>-0.34%</b>    | <b>-0.26%</b> |
| <b>Impact of fees</b>                       | <b>-0.49%</b> | <b>-0.81%</b>        | <b>-0.74%</b>    | <b>-0.70%</b> |
| <b>Impact of performance fees</b>           | <b>-0.00%</b> | <b>-0.05%</b>        | <b>-0.61%</b>    | <b>-0.28%</b> |
| Fund return inclusive of outgoings & fees   | 5.6%          | 5.0%                 | 6.9%             | 5.6%          |

## 5. CONCLUSIONS

Pooled Funds are at a crossroads, some have argued that they are in managed retreat.

The growth in these funds has been dramatic over the past decade. This growth was driven by both push and pull factors. Fund sponsors often created pooled funds as a means of providing liquidity to manage the reduction in the sizes of their Life Funds, whilst maintaining exposure to their prized large assets. Other investors were keen to gain exposure to these assets and multi-managers required a product to give access to both return and the diversification benefits of an exposure to commercial real estate to their investors.

This study has sought to document the impact of the dramatic market cycle on these funds and how the debt, cash and fees in these pooled funds impacted on fund returns. These impacts are being digested by the unit holders in these funds, as they determine their future investment intentions, and also by the sponsors of these plans when deciding how to structure such funds in the future to avoid some of the pitfalls experienced over the period.

In some funds, the investor base is now fracturing with no consensus as to the future of funds. Some investors, such as Sovereign Wealth Funds and European Pension Funds, have increased in size and are now seeking to either 'go it alone' or invest more through joint ventures rather than pooled funds. Many large Life Funds have had time to adjust their portfolio structures as they are run down in size – and, indeed, Solvency II may accelerate such planned reductions in direct real estate investment – and so the pooled fund has achieved one of its functions.

But, as in many financial innovations, the features of the first generation of funds will be modified to leave a solid investment product that is an excellent route for many investors to access the real estate market.

Sponsors have worked on codes, such as the AREF Code of Practice, to improve transparency in accounting and fees and many funds now go beyond these minimum requirements.

Investors understand that there are costs in running real estate funds. Fees should be fair and appropriate to the work involved and the performance delivery achieved, so as to align the interests of investor and fund manager. Suitable benchmarks are available to compare investment performance, and performance fees can be constructed that share returns between fund manager and investors fairly. With greater transparency in these costs, it is likely that these funds will attract investor cash in future.

One hopes that fund managers and investors can plan their strategies for whatever the next cycle might bring, to manage their liquidity and leverage requirements to deliver investors an attractive return for the risks that they are taking.

## GLOSSARY

1. IPD Pooled Property Funds Index (PPFI).

All of the funds included in the IPD PPFI are collective investment schemes offering indirect exposure to the UK property market.

2. Property Unit Trusts (PUTs) may be either authorised (i.e. regulated by the FSA and designed for investment primarily by private investors) or unauthorised. Many of the latter are off-shore funds. Because of their tax status, some PUTs domiciled in the UK are open to investment only by UK pension funds and charities. Unauthorised PUTs may also be either open-ended (issuing or redeeming units to meet changes in supply and demand) or closed-ended. Depending on market conditions, units in both open and closed-ended funds may be traded on the secondary market. A balanced PUT generally holds a wide mix of property assets by type and location. A specialist PUT focuses on particular types of property or on properties in particular geographic regions.

3. Exempt Property Unit Trusts (EPUTs) are not subject to capital gains tax and, as a result of this tax status, are available for investment only by other CGT-exempt funds (principally UK pension funds and charities).

4. Managed Property Funds (MPFs) are tax-exempt, unitised and open-ended funds. However, unlike PUTs, they do not distribute their income and are managed mainly by insurance companies as vehicles for investment by their occupational pension fund clients.

Limited Partnerships (LPs) are tax transparent funds incorporated under the 1907 Limited Partnership Act, and while they vary in structure, must have at least one general partner who has unlimited liability in respect of the partnership.

Common Investment Funds (CIFs) are similar to EPUTs but are designed specifically for charities. They are established under Section 24 of the Charities Act 1993, and are themselves charities and subject to approval by the Charity Commission. They do not incur stamp duty, CGT or income tax. An Investment Company with Variable Capital (ICVC) is an open-ended collective investment scheme structured as a corporation. ICVCs are also known as Open Ended Investment Companies or (OEICs).

## NOTES

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