The Association of Real Estate Funds

Submission for the Autumn Statement 2023

Executive Summary

AREF represents over fifty UK commercial real estate funds responsible for over £50bn of pension fund investment into UK commercial property.

Following on from the Chancellor’s statement at the 2023 Spring Budget and the more recent Mansion House Speech, this submission outlines proposals to further support the unlocking of productive investment from defined contribution pension funds and other sources. The proposals are in five areas:

1. Maintaining the current universe of daily-traded commercial real estate funds
2. Encouraging or mandating third-party DC platforms to hold non-daily-traded assets.
3. Encouraging or mandating smaller DC funds to merge to create funds with scale.
4. Moving DC funds from an Individual Account model to a Collective DC model.
5. Addressing the correct gatekeepers and incentivising them to take managed risk.

We hope these proposals are useful and will be happy to discuss them further. We look forward to the Autumn Statement building on the Spring Budget and the Mansion House Speech.

About the Association of Real Estate Funds (AREF)

AREF is the trade body that represents UK commercial real estate fund managers, those firms that support them and the end customers that invest in commercial real estate funds. Our membership includes over fifty funds spanning the leading commercial real estate fund management houses in the industry, through to smaller specialist boutiques, with a collective net asset value of over £50bn in the UK.

Autumn Statement Submission

AREF noted with pleasure the following in the Chancellor's statement at the 2023 Spring Budget: *"… we need to build a larger, more diverse financing system, where the benefits of investment in high growth firms are available to more investors. So I will return in the Autumn Statement with a plan to deliver that. It will include measures to unlock productive investment from defined contribution pension funds and other sources …"*.

This paper makes a number of suggestions to help unlock that investment. In line with the agenda of the Government-convened Productive Finance Working Group (PFWG) and in support of the levelling up, regional generation and growth agenda, AREF takes "productive investment" to include that in commercial real estate and infrastructure, as well as other illiquid assets such as venture capital, private equity and private debt. Given AREF's expertise, the thrust of this paper is focused on facilitating investment from UK Defined Contribution (DC) pension funds into commercial real estate and measures which can then be generalised to facilitate investment into other illiquid assets.

Common solutions are possible across these productive asset classes because there is one problem common to them all: liquidity.

The Challenge

The commercial property industry as a whole has been concerned for some time about the decline in investment from Defined Benefit (DB) schemes as they close to new investment and increasing numbers are bought out by insurance companies. This decline in investment has been exacerbated by the recent liability driven investment (LDI) crisis and the rise in gilt yields. Commercial real estate funds are seeing high levels of redemptions and, as well as a loss of investment, we are seeing a loss of jobs.

The problems preventing DB investment being replaced by DC are not of a lack of desire on the part of the DC funds, or of regulation - they are operational and structural problems. While the PFWG has done much valuable work in the development of the Long Term Asset Fund (LTAF), for these operational and structural reasons take-up has been slow. In our view there are **five areas** which remain to be addressed in order to open the tap on DC investment. These are:

1. Daily-traded commercial real estate funds: don't turn the remaining tap off
2. Platforms
3. Pension fund scale
4. Collective DC and Defined Ambition
5. Addressing the correct gatekeepers and incentivising them to take managed risk

1. Daily-traded funds

Currently the only route into commercial real estate investment for most UK DC funds is to invest in the small remaining number of daily-traded open-ended funds. These funds provide daily liquidity for the majority of the time through holding relatively high levels of cash, with rare suspensions under extreme market conditions. Technically DC funds can also invest in listed Real Estate Investment Trusts (REIT) and Real Estate Operating Companies (REOCs) but these provide an undesirably high level of volatility and low level of diversification against other listed equities.

Following the suspension of the Woodford Equity Income Fund in 2019, the liquidity mismatch has come under greater regulatory scrutiny from the FCA, who concluded that they would not impose notice periods until the PFWG had addressed the operational barriers represented by the platforms, referred to in the "Platforms" section below.

This work has still not been done and although notice periods have not yet been imposed, fund managers and their investors have seen "the way the wind is blowing" and have taken their own pre-emptive action. The result has been the withdrawal of pension fund capital from the sector with the closure of a number of the largest daily-traded funds, the loss of over £20bn of investment from UK sources into UK property, and the large-scale transfer of ownership to overseas private equity players who focus on short term value extraction rather than long term local placemaking.

Our recommendation here is simple: do not close off the only significant avenue for DC funds to invest in illiquid commercial real estate until other avenues have been opened.

2. Platforms

This is the fundamental obstacle to most DC funds investing in UK commercial real estate - it is structural and operational, not regulatory. In the absence of a solution to this problem, new regulatory structures such as the LTAF will not really help.

The problem is that DC funds mostly invest through third-party platforms ("fund supermarkets") which will only take daily-traded assets, making it impossible to invest in fund structures such as the LTAF which hold unlisted assets such as commercial real estate, infrastructure, private equity and private debt (in other words most assets falling under the definition of "productive finance"). The PFWG is aware of this and issued a call to action in "Investing in Less Liquid Assets – Key Considerations" but has so far been unsuccessful in addressing the problem.

We believe that there are two ways forward:

1. Mandate platforms to take illiquid assets, through regulation or legislation.
2. Encourage the development of alternative DC scheme structures, such as Master Trusts, which do not need to invest through platforms or who can use custody-only platforms.

3. Pension fund scale

Real assets such as infrastructure and commercial real estate are large, indivisible and illiquid. In order to construct a properly diversified real assets portfolio, which must be at least around £100 million, a pension fund must therefore itself be of significant size, probably at least £1bn. We therefore support DWP initiatives to encourage smaller DC funds to merge, which should increase the capital available for illiquid assets, and also the quality of the resources available to the teams managing such capital.

The model on which Australia has settled, of a number of very large superannuation funds holding large portfolios of illiquid assets, is one to aim at.

4. Collective DC and Defined Ambition

At the moment most UK DC pension funds operate on the Individual Account model, whereby each saver owns a piece of every asset in the portfolio. Thus if a saver decides to transfer to another scheme, their share of every asset has to be sold, meaning that all assets have to be liquid. This eliminates the use of illiquid assets. Under a Collective DC (CDC) structure, a saver owns a share of the value of the fund as a whole. If they decide to leave, their share of the value is paid to them out of the liquid assets (cash, equities, listed fixed interest) and the proportion of illiquid assets in the portfolio rises a little.

Again, Australian superfunds use this structure and are a good model, owning around 20% of illiquid assets and allowing that proportion to fluctuate between, say, 15% and 25%. They are some of the largest owners of commercial real estate and infrastructure in the world and, as HMG will be aware, some Australian Super Funds are opening London offices to coordinate their UK and European investment programmes, including real estate, illustrating the potential that scalable DC schemes could have in the UK market.

Some UK Master Trusts are developing in this direction and this needs to be further encouraged.

5. Gatekeepers

In recent years the focus of regulatory developments has been on retail investors and on the "democratisation" of investment. This has obscured the fact that the vast majority, over 90%, of savers in DC pension schemes do not untick the default portfolio box, so the portfolio allocation decision is left to the fund management company. In other words, the archetypal DC investor is in reality not an individual, but an institution. Therefore efforts to encourage investment in illiquid assets do not need to be addressed to individuals, but to institutions and their advisers. This means investment consultants, the in-house teams of the very large DC schemes and the remaining large DB schemes (in particular local authorities).

A shift in emphasis was signalled in the Chancellor's Mansion House Speech where the Mansion House Compact was announced, committing many of the UK's largest Defined Contribution (DC) pension providers to the objective of allocating at least 5% of their default funds to unlisted equities by 2030. We look forward to this change in emphasis continuing.

The importance of AREF's recommendations to the Levelling Up agenda

If DC investment in illiquids does not grow to fill the gap left by the decline of DB investment, there will almost certainly be profound consequences.

Levelling up will be more difficult to finance, as will addressing the housing shortage and financing the net-zero agenda through retrofitting. UK pension funds are the traditional large investors in the UK regions. The other large source of investment, overseas capital from pension and sovereign wealth funds, tends to focus in the larger conurbations and their cost of capital is higher.

Anecdotally, as DB funds redeem their holdings in property funds, we have seen commercial property assets being sold to overseas High Net Worth individuals who will be more likely to focus on short term value extraction rather than long term local placemaking. In these circumstances *the returns from investment leave the UK*, rather than going to UK pensioners, and, in the absence of demand from UK pension sources, *commercial property values will fall or rise less than they otherwise would have*.

There will be consequences for the pension system too. Including illiquid assets in pension fund portfolios lowers portfolio risk through diversification against equities and bonds and, depending on the type of commercial real estate activity, offers a high level of capital growth or a high level of income. If DC pension funds are unable to access these asset types then we believe that their long-term risk/return levels will be worse, to the detriment of UK pension savers.

Although there are other sources of investment such as charities, private individuals and overseas institutions, in our view UK DC pension funds are the most important source of investment in productive assets in the UK. The sector dwarfs the others in size, with compulsory auto-enrolment it is constantly growing, it has a long-term investment horizon and is thus very "sticky", it is willing to invest in regions of the UK where international investors may not venture, and its cost of capital is lower than that of overseas investors. It is therefore crucial to the UK pension system and the growth of the UK regions that DC investment into illiquid assets is unlocked.

AREF
The Association of Real Estate Funds

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