The UK Real Estate Funds Industry - more than 10 years on from the Global Financial Crisis

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AREF
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Executive summary

Aim

The research team were commissioned to examine the evolution of the UK institutional real estate funds industry in the 10-years post the Global Financial Crisis (GFC) and then consider what is likely to happen to the industry for the next 10 years (post COVID-19). The project findings have been split into two reports. Part I of the research, "The UK Real Estate Funds Industry: 10 years on from the Global Financial Crisis," was published by AREF in 2021 and examined the quantitative analysis of fund data for the period since the GFC formed. This report, Part II, forms the forward looking, qualitative piece and considers what industry stakeholders view about the evolution of the industry in the coming 10-years.

The methodology of the research for Part II was a qualitative telephone questionnaire survey, performed by the research team in 2020, which targeted 35 real estate professionals selected from real estate fund management houses, real estate investors and advisors.The focus of the semi structured interviews largely, not exclusively, followed the experience of AREF member funds and investors. Questions included:

- Has the type/origin of investor in AREF member funds changed since the GFC?
- What are the evolving needs of these investors?
- Which real estate fund structures and strategies have been rejected by investors? Why?
- How has the industry responded to these needs?
- What are the challenges facing the UK real estate funds industry over the next 10 years?
- How is the industry aiming to meet the requirements of the next 10-years?
- What are the implications for the UK real estate fund managers?
- How has the composition of the MSCI/AREF Property Fund Indices evolved since the GFC? Why? What needs to be done to ensure the data and service remains relevant in years to come?

The analysis sought to match underlying investment trends that have occurred over the last 10 years and linking these to the behavioural observations made by the fund managers and investors where this was possible.

An important theme in the interview responses was hard-hitting feedback on the AREF/MSCI UK Property Funds Index, in particular around the need to update the data collection process, to provide greater sector disaggregation and to include more information on performance with regard to ESG and climate change.In response to Member feedback, AREF and MSCI ran a series of roundtables in 2021 to gather feedback on detailed proposals from MSCI to modernise and improve data collection to ensure the Index, and accompanying fund data provided by AREF members, is fit for purpose for the next decade. This paper therefore does not cover this theme in detail as it has been examined separately by AREF and MSCI.

Findings

The industry remains unrecognisable from the one that entered the GFC. The recriminations from the GFC has led to significantly lower leverage, an internal focus on improved governance and a period of externally designed regulation. The damage from leverage, which overwhelmed all other performance drivers, has clearly burned into the psyche of investors, with an almost universal conversion to a low or even no debt investment philosophy. The measures to improve liquidity for retail investors through new fund structures received universally bad reviews and the closure and redemption queues on some (not all) funds does suggest that the regulation has fallen short.

There was a general recognition, from both managers and investors, that governance had to be, and has been, improved. Respondents also felt that the industry had successfully implemented the raft of regulatory changes relatively seamlessly, although inevitably there is lingering resentment that the increased regulation is derived from more liquid asset classes and so is expensive, bureaucratic and excessive to implement.

Despite these changes, many larger investors now favour joint ventures over co-investment fund structures although the unlisted real estate industry has grown in the post GFC period. The proportion of industry growth from retail, UK and overseas investors is not documented which precludes any forensic examination of these investor trends. What is clear is that the number of funds in the AREF universe has not grown, with many respondents questioning the value of inclusion for the new funds that have been launched.

The merging and maturing of DB pension schemes, the bulwark of the industry's capital, understandably weighed heavily on the industry participants. Respondents varied from optimism that this capital will remain within unlisted funds, to predictions that the industry will inevitably shrink. To avert such a calamity, respondents stressed the imperative for the fund management industry, and the Government, to promote funds to existing and new investors.

However, existing fund structures were thought to be inadequate to meet the rising demand of DC schemes (or DC platforms) for daily pricing and Managed funds were seen as an impediment, not a catalyst, for future growth. The combination of a withdrawal of the considerable capital from DB schemes in unlisted funds without tapping into DC capital is judged to be an extinction scenario for much of the sector. Respondents often lamented the lack of an attractive fund structure to attract other sources of capital, such as overseas investors, hankering back to limited partnerships before the government saw fit to drive the industry offshore. There was a split as to whether in a post-Brexit world the industry should seek to come back to home shores or fall into line with Luxembourg as the new domicile of choice.

The response of funds to the structural demise of retail property, which formed the ballast in most Balanced funds and the focus of many of the surviving Specialist funds, received much criticism. How, could funds have been so naïve and slow to reallocate their capital? There was some recognition that with stamp duty so high relative to yield, that the round-trip costs of adjusting fund weights ham-strung managers. There was no mention for how useful derivatives would have been to manage the transition and almost no positive stories of any funds putting forward a solution to the problem.

Inevitably fee levels were a source of both sensitivity and concern.It was widely recognised that fees based on GAV, which rewarded value destroying excessive leverage, had not been sustainable. There was also much concern that there was a danger that fee levels have been pushed too low and that smaller investors were likely to be disadvantaged by higher fee scales than for larger investors. There was a tiny minority of optimists that thought technology would allow fees to lower: perhaps the reputation of the industry as a late adopter of technology is well-placed.

What happens next?

The burst of innovation that led to the growth of the fund management industry in the years leading up to the GFC was spurred by the demise of the previous giant in the UK commercial property market, the life funds, and the growth in retail property types too large for the average investor.

Seismic shifts in property and investment markets demand such innovation from managers. Granted they have to do this with the Government tying one hand behind their back through stamp duty rises and a deaf ear when it comes to transition relief on converting to new fund structures.

The post-Brexit landscape was thought to depend much on the outcome of negotiations with Brussels and many thought that a new fund structure was also required for the industry to thrive in the UK. Optimism was thin on the ground for either.

The shining beacon of success has been the successful recycling of capital in maturing DB schemes into Long Income funds, an accomplishment many in the industry are clearly proud of.

Other' sectors were repeatedly highlighted as having the potential to replace retail as the driver of fund growth. Opinions varied as to which will be the next growth sector, healthcare or infrastructure perhaps. Real estate sectors can grow from literally nothing, take retail warehousing and student accommodation as examples.

The elephant in the room is not new, residential is an older institutional real estate investment sector than office, retail or industrial. The market and the requirement is huge, whether the opportunity is realised will either be a footnote or centre-stage in reports on the industry fortunes in another ten years from now.

Respondents were clear that the new, will not look like the old, with operational property expected to increasingly replace passive leases. This has significant ramifications for the reported portfolio metrics.

ESG is another potential opportunity to launch new funds, which creates another information challenge to all funds. It was referred to as a 'must-have', not a 'nice-to-have' and unlisted funds should advertise their progress-to-date - at the very least to avoid becoming a pariah asset class.

It is a truism that if unlisted, co-investment vehicles offer value-for-money to investors then they have a future, in whatever wrapper that may be. If fee levels are too high, the industry will not offer value-for-money, and will not thrive. A transparent, comparable, fee measure is long overdue and linked to transparent performance reporting will ensure that fee levels across the industry are appropriate for the performance delivered.

There is a palpable fear that fee levels are on a race to the bottom, as for index-tracking equity funds. But real estate funds are not passive and if activity is value-adding to performance then investors should be willing to pay a fee.

Part II: The survey

Background

The GFC marked a significant turning point for the global investment industry. It came at a time when managers and investors had enjoyed a long period of strong performance and a feeling of optimism that this high would continue long into the future. Few soothsayers predicted the over-heating of markets and the period of significant market stress which followed.

The ramifications of what sometimes feels like reckless investment behaviour, from both managers and investors, has led to much introspection and regulation in order to change the way the investment industry behaved in the preceding 10 years. Recriminations have led to significantly lower leverage, a focus on improved governance and a preference from some larger investors for JV arrangements. The post-GFC economic recovery has not been strong and there have been set-backs along the way. Interest rates have remained low and investors have favoured real estate as a source of yield rather than growth.

Capital sources

“The day of Balanced funds financed by DB pension schemes is at an end.”

As a rule, managers have not observed a significant change in the composition and number of the investors in their AREF funds over the last 10 to 15 years. Investors tend to be dominated by DB (Defined Benefit)/DC (Defined Contribution) corporate schemes, local authority pension funds and multi-managers. The comments below are representative of the conversations we have had:

“There has not been a major change in the investors in the AREF funds they are predominantly UK DB/DC corporate pensions and Local Authorities”

"The AREF universe has a pretty stable investor universe of UK domiciled DB and Local Authority pension funds. Our AREF fund hasn’t taken on new UK clients in the last five years…”

“I would say that investors in AREF funds are predominantly large UK institutions and the multi-managers.”

“This is a very difficult time for AREF funds they are highly skewed to multi-managers and these are a dying breed, along with the LGPS’s move away from Balanced funds to direct ownership the investor universe is getting smaller.”

Since the GFC there has been a significant move towards consolidation in the pension industry.The pooling and possible future merger of many local authority schemes, the maturing of the DB schemes and the increase in partnerships/clubs has led to a certain level of hysteria in the fund management industry. If the pension fund investment universe begins to dwindle then there is expected to be a reduction in the number of investors who will commit to the AREF funds.

“Sources of capital are consolidating and getting bigger. This has a very big implication for AREF member funds – investor cheque sizes are growing and, in some cases, this is limiting the ability to invest in funds as ticket sizes are too big.”

“The Balanced open-ended funds are still driven by the same type of corporate and local authority investors though this is problematic for them as these sources of capital are maturing and we will see reduced inflows over time.”

“The move toward JV/ club type arrangements will have a big impact on the AREF universe going forward as these vehicles will not comply with their requirements.”

As the pension pools get larger the option to manage their own direct property portfolio becomes more realistic. As one investor confided, “….diversified core is now done via our direct portfolio team – we much prefer to go with a specialist value-add managers”. In these situations, investors will look for managers/advisors who will offer specialisms that they cannot provide in-house. This then begs the question, do investors want Balanced funds? The answer seems very much to do with size of fund. Clearly some funds will be too small, or less inclined, to take on the management role and so they will remain committed to these funds.

“Smaller investors will still need the exposure that the funds offer, but do the larger institutions?”

“The larger investors will be looking for greater control from in-house teams, the medium sized schemes are splitting their allocations between direct investment managed in-house and then the indirect allocation will go to a multi-managers and global funds.”

Other people we spoke to said that there is no threat to the AREF fund universe and investors will still want exposure to funds within the benchmark.

“I don’t believe that the LGPS funds will divest from the AREF funds I think there will be a re-allocation providing the funds are actually doing what they should.”

However, this came with a caveat – a number of interviewees stressed that a massive effort is required to raise the profile of the AREF funds as well as ensuring the legal structures and tax arrangements are as investor friendly as possible. The fund management industry and the UK Government need to be seen to be promoting the UK as a go to investment destination for domestic and foreign investors. Several people mentioned the Managed funds with their UK pension fund only investor restrictions as a negative and confusing feature of the AREF universe.

“The Managed funds do explicitly limit certain investor types which clearly does not help the expansion of the investor base.”

“Some of the AREF funds can only accept UK pension money – this is very limiting for them and it is off putting for global investors who may be interested in investing.”

Pension schemes

"DB pension schemes will largely be gone in 10 years; what investor group will replace them?"

When people were questioned about the type and domicile of the investors in the AREF funds, it became very clear that the vast majority of funds relied on UK pension fund investment and more specifically DB corporate and local authority pension funds. The DB pension funds have relied on the UK Balanced funds to provide their exposure to UK real estate since the early 1970s when the indirect real estate funds were first created.

When questioned on the future of DB investment many interviewees expressed a concern that the funds could face a significant reversal of investment flows. With many DB schemes having closed to new pensioners and so adopting a more mature, shorter term investment strategy, and other schemes being replaced by DC schemes, the return requirements of a significant portion of the UK investor universe have changed and their investment allocations will naturally evolve to meet these future requirements.

"DB schemes are dying a slow death as sources of capital as they start winding down or combining to create LGPS's".

The evolution of the investor universe will undoubtedly have a very real impact on the investment funds industry. An impact which some interviewees felt the industry was woefully unprepared for; "……the migration from DB to DC; the industry must adapt structures to allow managers to bolt together solutions to manage client risk". The issue is twofold; how to offer the investors (DC schemes) a real estate solution to suit them and, two; how to ensure that the real estate funds themselves are not left to deal with declining in-flows of capital.

"As the UK DB schemes are now practically all closed to new pensioners, they will all migrate to Long Income funds to de-risk and manage their long-term liabilities."

The pooling, and possibly the eventual merger, of local government pension schemes (LAPS's) is seen by many people who took part in this research as potentially one of the most fundamental threats to the UK real estate investor universe and by association the AREF fund universe. As the LGPS's work together to rationalise their investments, in the pursuit of reduced costs and

and maximised returns, fund managers are waiting to see whether this will bring about a major exodus of capital from the open-ended funds as larger pension pools invest directly under the direction of in-house teams.Whatever the outcome it is clear that these pools definitely have *"far more bargaining power now than they did before"*. The power of the LGPS's, is discussed later in the report.

"...certain LGPS's are firing their advisors and are planning to manage their real estate investments internally. This will be a slow process as many schemes don't have the experience. However, it is inevitable that the open-ended fund universe will see a reduction in its client base."

"...the decline in the number of DB pension funds will be pronounced over the next 10 years and they will be replaced by the LGPS's. This isn't necessarily a direct replacement as the bigger pooled LGPS funds are likely to have very different investment strategies."
"LGPS's are likely to exit most Balanced funds over next 10-years and then they are most likely to go direct relying on Specialist funds to cover areas where there is no-house expertise."

DB Schemes – Long income funds

The creation of Long Income funds has been one way in which the industry has attempted to meet the changing needs of the maturing DB schemes and this has subsequently led to the significant growth in these vehicles as investors attempt to manage their liabilities.

“The rise of the Long Income funds has been one of the biggest changes [since the GFC] at a time when interest rates and gilts are at their lowest. Corporate pension funds have an increased appetite for fixed income as this helps them with their liability matching as they mature.”

“DB investors are increasing their allocations to Long Income funds which have become increasingly important.”

“There has been a rise of alternative Long Income funds – intended for DB pension funds because they offer secure inflation linked returns”

“Over the next 10 years I think we will continue to see a greater allocation to Long Income from the liability matching perspective. …… we particularly favour government backed income so it is relatively secure.”

DB Schemes – daily liquidity

DC pension schemes have to offer greater flexibility to their pensioners which has as a result resulted in them being more tightly regulated than their earlier counterparts.One of the most controversial regulatory controls is the requirement for them to have at least 20 percent of the fund held in capital in order to manage the liquidity demands of their investors.There is a serious lack of understanding in the industry as to why this liquidity is required or even how the fund administrators should manage it.

“…frustrating inability to mix DB and DC money in the AREF funds. DC schemes cite the need for daily liquidity. Why? Why have the FCA pushed this requirement for daily trading? It is not clear whether there is a real need? It puts unnecessary pressure on funds to deal with redemptions.”

“DC funds demand liquidity, but do they really need daily liquidity?”
“Why do DC schemes require daily liquidity? If there was more flexibility with this then there would be more security for the UK open ended industry.”

“DC schemes are caught between what the market wants and what legislation will permit. Legislation is likely to be cautious. DC funds are constrained – encouraged to go into authorised funds so real estate needs to be authorised.”

With the rise in popularity of REITs several people commented that there is an increasing possibility they will appeal to DC investors who are after the liquidity they can offer.

Overseas investors

The majority of interviewees confirmed that they had not really seen a major change in the domicile or type of investor in AREF funds over the last 10 years. With threats of declining investor numbers and the knock-on impact this will have on funds, managers have been trying to broaden the funds' investor base. D`espite their best efforts, foreign investors tend to invest directly, this is especially true of Asian and Middle Eastern investors who are attracted to the UK market as investors in London based trophy assets, US investors are more likely to invest via a private equity style Specialist fund or via a JV or separate account.

"We have had interest from largely European investors with some interest from Asian and North American institutions, but this is focused on specialist strategies e.g. London trophy assets. AREF funds aren't appealing."

"There has been a rise in the take up by some European investors especially from northern Europe and the Nordics, but these are usually targeting larger more prominent fund management houses..."

"More needs to be done to promote the UK real estate investment to foreign money and make investment as easy as possible. If we don't do this then we will lose out to massive pan-European funds which will have some exposure to the UK built in."

"Efforts have been made to attract foreign investors, but we have not seen a massive change in the situation. The returns from the Balanced funds are just not attractive enough to encourage foreign investors in contrast the Specialist funds have attracted some foreign investment."

"We are seeing some international investors come to the UK, especially in recent years. They have come from Asia and the Middle East, both HNWI and Sovereign funds. Prior to that we had the Australians, Canadians and Northern Europeans."

Transparency and a full understanding for the AREF universe would help many people as one person questioned "I am not sure how many AREF funds can actually take foreign capital – would be really interesting to know". Further highlighting the confusion and lack of understanding that often surrounds the composition of the AREF universe.

Multi-managers

The final significant type of investor in the AREF funds are the multi-manager/ fund of funds. With only a few managers running this type of mandate the universe is small but significant in value. This type of investment vehicle is one which many interviewees believed has had its day, investors can be charged double fees i.e. a fund of funds management fee coupled with the fund management fee charged by the underlying funds. This model is often regarded as stressed and not appropriate for the larger investors which can afford to rely on their own in-house expertise to do the same job. The newer and smaller pension funds/family offices on the other hand can't afford to go it alone so there is an opportunity to expand investment from these types of investors.

During the interviews, several managers expressed a frustration that the multi-managers required specialist treatment, requiring their own due diligence questionnaires to be completed rather than relying on the standard and approved AREF one. They justified this because of the size of the investment they represented.

"There is a dominance of multi-managers in the AREF funds. Global multi-managers are bringing in some foreign money – Australians and Swiss – but this will only have an impact at the margins, they will not replace the declining UK DB schemes."

"Multi-managers are not at the vanguard of thought leadership – they have rested on their laurels, there has been a lack of innovation/thought leadership."

Portfolios

The first five years post GFC were focused on a recovery play, the next five years began to see significantly weaker performance in the retail sector and the rise of the alternatives like student accommodation, PRS, education and social infrastructure in a search of alternative sources of income.

Many interviewees also talked about the meteoric rise of industrial/logistics as the "go to" asset class of the post GFC years.

Other managers talked of changing their fund allocations "Post GFC…*we sold all our shopping centres early on and were early movers to logistics and out of town retail"*.With industrial/logistics assets continuing to help to bolster fund returns at this turbulent time there seems little likelihood that the sector will see a drop in investor appetite in the near future.

The switch has not been swift enough or gone far enough for some in the industry, *"There is now a fundamental weakness with many funds holding too much retail and too little in alternatives"*

It is clear from the interviews that the economic recovery has heralded the move away from the traditional real estate sectors and fund portfolios which were largely split 50:30:15:5 (retail: office: industrial: other) to one which has morphed into an almost equal split where retail assets account for a much less significant percentage of assets and industrial and the other category are equally as important. We are not far from seeing a complete switch between retail and alternatives in fund portfolios especially in the most recent vintages.

Alternatives assets such as student housing, education, healthcare, storage and PRS are now seen as vehicles which offer investors the opportunity to deliver non-cyclical returns, potentially more secure, and longer-term leases and the exposure to operational assets where investors can receive additional returns from access to operational businesses and hidden income streams. As some people put it "…real estate can no longer be viewed in isolation" and this is especially true for alternative/social infrastructure assets where tenant satisfaction is key. Managers will increasingly need to maintain good relationships with their tenants and follow their needs to maintain that crucial "hidden" income flow.

Retail

“Retail was once regarded as the ballast in a balanced portfolio, it is now often regarded as toxic.”

The above quote, though quite extreme, is representative of most of the people we spoke to as part of this research. In the years before the GFC managers of the large balance funds which experienced significant inflows of capital used to buy big retail centres in a bid to invest their cash. A move which has left many struggling to manage lumpy and obsolete assets which have had a negative impact on fund performance and potential viability. The collapse of the retail sector has been coupled with the collapse of many retail businesses which have been unable to compete with more internet savvy operators who have embraced online shopping and click and collect with a far cheaper and more efficient order fulfilment model.Some managers believe the industry was too slow to see the writing on the wall and the rotation out of certain retail assets should have started straight after the crisis. Instead many only started to de-risk their retail portfolios in the last five years leaving many funds with high retail exposure struggling in the current crisis.

“We are still in a position where some managers still have over 30% of their Balanced funds invested in retail – how can this be? Is it a herd mentality – this is not active management. Portfolio construction should have some intelligence behind it, not complacency.”

A number of interviewees did try to explain quite understandably that the rotation out of retail has been impeded by the rise in stamp duty, which in some cases means that the round-trip costs are more than the equivalent of 2-years of income.When faced with trade-offs like these it is not difficult to see that “herd mentality and complacency” one interview talked about may not be the whole story.

On a more positive note many investors did point out that it would be short sighted to turn our backs on retail investment in general. The sector is far from “toxic” with retail warehouses and food shopping out-lets proving particularly resilient to the ravages of the impact of Covid-19 on the sector. We need fund managers and real estate investors think differently about how we can use retail in a post pandemic world and look at projects which will offer an alternative life for struggling assets. There is a role for retail both within a balanced portfolio or a specialised fund it just needs to be a different one for the one it has historically played or perhaps the actors need to be changed.

ESG

A key change in the 10 years since the GFC lies with the adoption of Environmental, Social and Governance (ESG) practices and the material impact these will have on the performance of the industry. ESG is designed to enhance industry wide thinking, whilst trying to draw out potential risks and opportunities going forward. The integration of ESG factors can be used to enhance traditional financial analysis by identifying potential risks and opportunities. The expectation that all decisions made by both managers and investors should be made in the light of how they incorporate these three objectives will continue to have a significant impact on the way the real estate industry has operated in the past and crucially how it will operate in the future. Fortunately, most people we spoke to agreed with this.

"ESG is so fundamental we should not treat it as a special add on – it should be at the heart of the business"

"ESG is a massive thing for investors and this will continue into the future – it will no longer just be a box ticking exercise."

"….expect to see this embedded into all investment strategies"

"Environmental issues were the first to be addressed and we are now starting to deal with the social part. Investors have changed the way they look at funds and managers, managers must prove they are doing their job properly and they have excellent governance."

"ESG is massive now and has grown over the 10 years since the GFC. Despite this there are not that many sustainability/green investment funds in the market. The need to produce a measure of impact has possibly held progress back."

Reservations were expressed as to how effective ESG investing is when more and more ESG and Impact funds are being launched with a nod to ESG requirements and expectations.

"We now have to be weary for "green washing" and the consultants/advisors/investors will have to weed out the genuine funds from the phoneys. The availability of a benchmark/index which would take into account ESG criteria should be a no brainer"

"ESG, though very much needed, is turning into a box ticking exercise"

Impact investing

Impact investing increases the pressure on managers to quantify the positive impact they have made through their investment strategy, which ideally will have a societal or environmental benefit. Being able to provide investors with quantifiable evidence of the impact of their investment strategy in relation to their target returns is important, it is even more important in this low return market. It appears this impact measurement tool is some way off but the adoption of the ESG ethos and impact investing is firmly embedded in the vast majority of fund managers' code of conduct.

"The need to produce a measure of impact has possibly held progress back"
"With the move to ESG/Impact are people prepared to give up return for impact? – Can managers provide both with the same vehicle?"

Leverage

As part of the research the respondents were asked about the post GFC years and what, if any, changes to real estate strategies, allocations and structures they had witnessed. The most frequent response to this question was the recognition of the immediate loss of appetite for high levels of leverage in funds, even in Specialist funds. The pre GFC years were very much characterised as a time when managers embraced the use of higher levels of debt – even in a low risk core fund. Leverage was often used to increase fund size, which would have a knock-on effect on the GAV based management fees, inflate returns and of course, potentially achieve higher performance fees. Practices which will be discussed later in the report.

The debt driven global financial crisis led to the very quick rejection of highly leveraged funds.On the whole this is regarded as a positive move with some people we spoke to still feeling that there is still too much debt employed in some of the specialist core fund universe. The failure to de-leverage has left funds struggling in the current market.

Governance

The survey participants were quick to highlight the dramatic increase in the use of investment industry wide regulation, improved governance, compliance, and risk management in reaction to the excesses associated with the pre-crisis years.The realisation dawned that the needs and interests of investors, and their ultimate clients the majority of whom were UK pensioners, were neglected in favour of higher manager fees.

"The GFC happened at a time when there was too much supply and too much leverage. Leverage was used to bolster returns and assets were acquired with little scrutiny and process."

"....blind pool funds were popular, investors had little control, managers bought assets not necessarily in-line with their mandate and they took on increased levels of debt to do this."

The increased reliance on blind pool funds, at this time, provides further examples of the erosion of investor control. Unlike seeded funds, where investors knew what assets were in the fund, blind pools left investors as they had no control over the properties managers were acquiring.

A consistent theme running though out the conversations is the recognition that the needs and requirements of investors often received little consideration and in the immediate years after the GFC regulatory bodies across the globe endeavoured to come up with checks and balances which would give investors the confidence to take more control of their investments and hold their managers to account. Some believe these controls are now excessive, expensive to manage, and inappropriate for the real estate industry as they were designed for more liquid and tradeable asset classes.

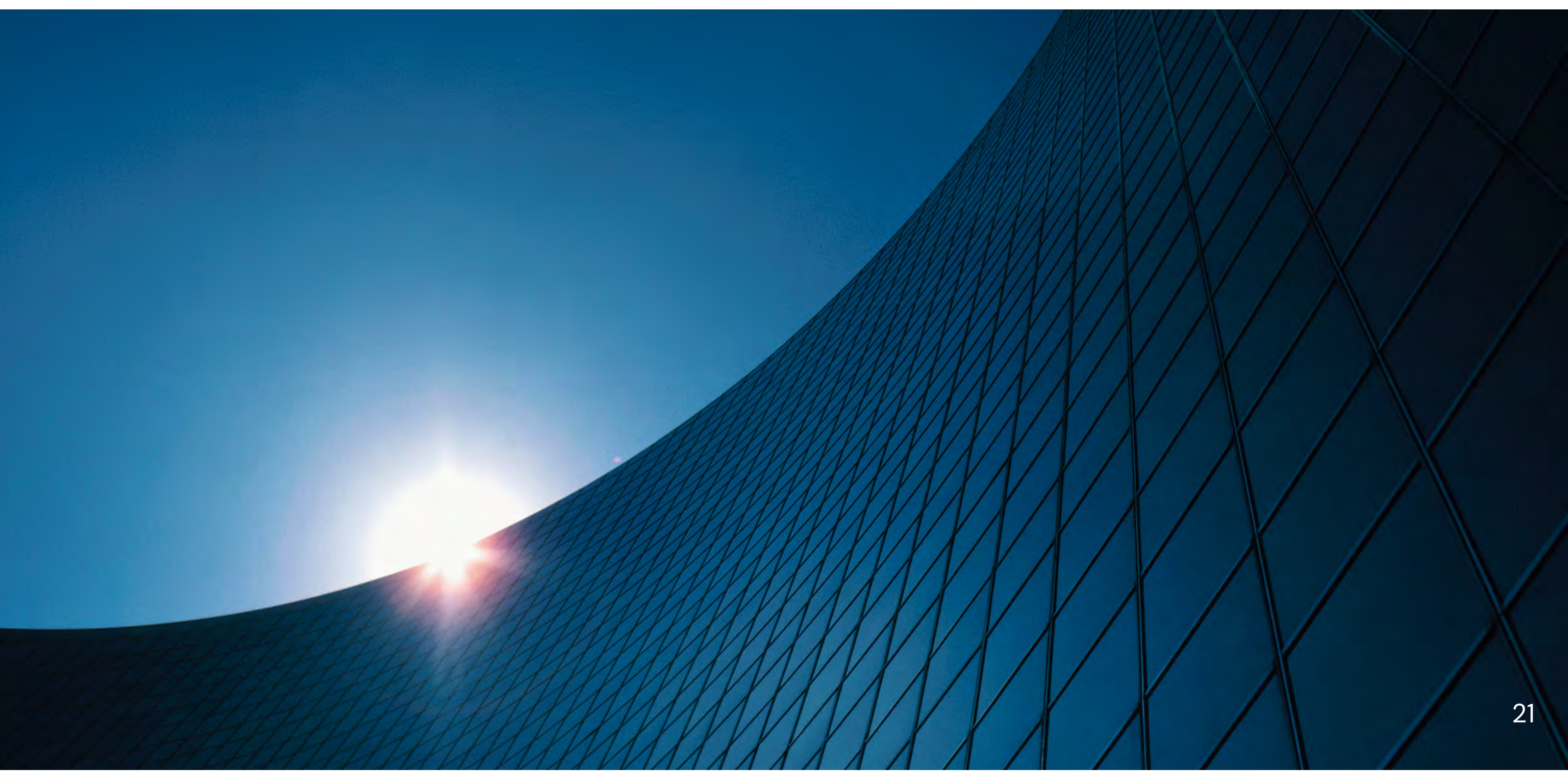
"We have transitioned from a period of unregulated growth pre GFC to one of excessive regulation where real estate investment is being shoehorned into being a desk top asset class."

"Personally, I don't think increased regulation is a positive thing. It has been imposed by a regulatory body which does not understand real estate and how it works."

"We are dealing with tough regulations which don't really fit our industry. They should be replaced by a principles and ethics approach to investment where the market is given a chance to operate more freely."

"Investors have demanded more and better governance from managers resulting in the rise in the number of investment committees and independent directors – sometimes these don't add much value – depends on the quality and conscientiousness of the members/independent directors"

"Pre GFC there was an arrogance/old school attitude within the market. Since then the industry has had to become more professional, transparent and investor friendly. The number of people working in relationship management has massively increased."



It is clear that improvements have been made from the investor's perspective. Many mangers talked about the need to improve communication with their investors, the employment of increase numbers of investor relations specialists, the expectation that funds have independent supervisory boards often with investor representation are all clear and positive examples of where progress has been made. Another area where managers have been held to account has been with the use of manager co-investment to align manager and investor interests, this is especially true of, but not exclusive to, the closed-ended opportunistic/value add strategies.

> *"....managers need to prove alignment of interest by having more "skin in the game."*

Leasing

When discussing the changes in the real estate industry over the last 10 years the evolution of leasing structures was one which was mentioned within the context of the Brexit uncertainty and COVID where occupiers have required flexibility and avoided being tied into long leases. The rise of flexible offices offering monthly rentals has helped fuelled the push to shorter leases within the office sector. Managers and investors are now faced with sacrificing the lease length in order to attract and keep tenants despite this going against traditional asset management strategy.Leases have increasingly become more operational as the users of property have become far more engaged with their environment and the service providers.

> *"....the post GFC period followed by Brexit have been challenging times. Now we have COVID-19 and more Brexit, the market is stretched. ...leases have shortened, and retail needs re-purposing. There is a clear threat to passive players i.e. core funds/managers."*

> *"The traditional variables such as vacancy rates, WALTs, income expiry need rethinking as lease lengths are getting shorter, WALTS are no longer needed and many managers are now dealing with operational properties which will have their own issues and complexities."*

What is becoming abundantly clear from the interviews is the fact that the way we view and use real estate is changing. The successful managers and funds will be the ones which embrace this and become innovative.The growth in demand for funds that invest in alternative assets, as discussed earlier in the report, have increased the use of operational strategies where partnerships with specialist operators are becoming popular. Relationships with tenants, co-investment partners and asset managers are essential to ensure rent is paid and on time.

> *"Sector and geography are no longer enough. Leases are now crucial – too many managers have overlooked the importance of the relationship with tenants, how they use space and how important rent collection is!"*

Performance challenges ahead

Over the last 10 years we have witnessed many structural trends in the industry. We have returned to a lower returning, lower yielding environment. With the collapse of retail, managers are pinning all their hopes on industrial and social infrastructure which now have some of the lowest yielding assets.

Brexit has clearly had an impact on the market going back to the referendum in 2016. Since then, we have witnessed significant market uncertainty and interviewees were in two minds as to whether the UK real estate funds industry would benefit or suffer from the split.

"Brexit has now made the UK even less attractive to an overseas investor"
"Pricing in UK is less competitive than other international markets due to Brexit"
"Brexit is going to hamper future market stability for a good few years."

"....if we come out of Brexit badly the opportunity for the UK will decrease when the global investment universe is getting bigger."

"The UK is seen as less international due to Brexit, for last 5-years the UK has been on the watch list."

"Brexit – needs sorting urgently. UK is seen as a bit more volatile than other European countries at present. We don't look stable enough to overseas investors"

What is clear is that if the UK is to benefit from the split from Europe it will need a lot of support from the Government to create an inviting investment market and tax efficient investment funds where foreign capital can invest.

"Tax is an important factor and the outcome of the Brexit negotiations will have a massive impact on the UK real estate industry. Brussels wants us to fail and they are making things difficult but if we can navigate through this process we could have a big opportunity."

"Brexit is still a big concern the UK could end up being like Switzerland with a much reduced marketplace but if things go well and we move closer to Europe we could become more involved in the global market."

"I am certain that [foreign investors] will continue to invest in the UK after Brexit – we still offer transaction security, liquidity and good Governance – which is important."
"Once Brexit has been finalised there is a chance for the UK to become a significant domicile but for this to happen, we need to have stability"

“Once Brexit has been finalised there is a chance for the UK to become a significant domicile but for this to happen, we need to have stability”

“Post Brexit uncertainty is an opportunity to create the right regulatory environment”

Not only does the UK real estate funds industry need to cope with Brexit and its impact, it has also dealt with the deepest recession since the GFC brought on by the global COVID pandemic. The impact of COVID on the way we live our lives has had many implications for the real estate around us; from the homes we live in; to the way we shop; to how and where we work, how we travel and where we spend our leisure time. The industry has been forced to deal with market frictions which have materialised now rather than some time in the future.The answer to all this is innovation, flexibility and the placing the real estate user at the centre of the investment offering.

“There will be lots of change post COVID everyone is looking for the future driver of change.We need to refocus the industry, look more closely at how building users and consumers use real estate, be very aware of structural obsolescence”

“COVID seems to have encouraged people to question whether they want to be decentralised rather than urbanised – no longer want to live in overcrowded cities dependent on public transport”

“COVID will lead to some structural changes with a further increase in online retail further killing off the high street, logistics will continue to grow in desirability. Retail is a challenging environment but there are opportunities with planning and reductions in business rates. We will see some flexibility in offices in the next 3-5 years with the increase in home working. However, I don’t believe this is the end of the office – just the re-imagining it.As always prime locations will do well and there will be weaker demand and lower rents for secondary markets.”

“The industry suffers from short-termism and this needs to be addressed – post COVID what are the plans, themes for the future? Tenant covenant, location and re-letting prospects are going to be key.”

“COVID has led us to question how we use the physical space. Will offices ever be the same, will we be working from home, collaboration hubs, flexible offices etc What is going to happen to the high street – it needs something other than retail…”

“COVID has to be a prime factor in how managers approach the next 10 years, as is the continued regulatory pressure by the FCA around market uncertainty”.

“COVID has accelerated trends (e.g. concern over housing densities) there will be huge opportunities for managers who embrace and predict these changes”

Fund structure

"When familiarity trumps innovation"

This seems the most appropriate quote to introduce the conversation on fund structures for UK real estate vehicles.This discussion has never been far from the headlines since before the GFC with the charging of stamp duty on investor interests in Limited Partnerships. In the last 10 years the introduction of the PAIF structure was meant to revolutionise the open-ended fund market. Instead it has incurred the frustration of many managers and investors.

PAIFs

"The launch of the ACS/PAIF structures in my opinion have muddied the waters there has been no clear move to adopt these new structures"

"PAIFs are not able to offer the liquidity that they were set up to do, they also come with the added issue of cash drag. Why would you invest in a property fund and have 20 percent of the fund in cash?"

"The move from Unit Trusts to PAIFs was an attempt to move from the older JPUTs/GPUTs but institutions have been wary that these newer structures would increase daily trading and so the take up of PAIF and ACS fund structures has been low."

"Not sure the PAIF works – no one has a long track record of running these funds.

It is clear from the discussions, which have taken place as part of this research, that the lack of support from the Government and increased legal and administration costs have hampered the adoption of new fund structures or the rationalisation of the old. When the PAIF was first mooted there was a desire to switch off-shore JPUTs and GPUTs to on-shore PAIFs, one of the reasons that this didn't work was because "*... you couldn't seed the PAIF without incurring the stamp duty on the underlying assets"*. Demonstrating the "*lack of joined up thinking*" with the top level policy makers.

This poor communication between policy makes and the industry needs to be addressed to ensure the smooth adoption of any new structures such as the Reserved Investment Fund (RIF) which would introduction a new closed-ended or hybrid UK structure which could facilitate managed liquidity events.

"PAIFs are great for funds of a certain size, but has not proven so useful for the mid-market manager who is dealing with smaller pools of capital. The size of the required capital commitments also makes it more difficult for the smaller more entrepreneurial fund manager to get ideas to market."

"If you could achieve the holy grail of seeding relief and improved liquidity in a vehicle that can be managed without the material expense of offshore running costs, you are starting to create something very attractive to investors."

On/off-shore

With the exception of the introduction of the PAIF and ACS structures most interviewees said they felt that there hadn't been a huge change in the structuring and domicile of funds over the last 10 years.

"Managers still use Channel Isles and Luxembourg as fund domiciles unless something significant happens to stop this."

"We are still using Luxembourg structures which seem to be the most popular with our investors."

"...we often have to create Jersey based feeder funds to accommodate different investor domiciles.Non-UK investors don't like having to complete UK tax returns, so they prefer the feeder route."

"US investors are not after core investments and are comfortable with JPUTS/GPUTS and closed ended funds as a way of investing in the UK"

The winds of change

Some of the managers we talked to are cautious of using offshore domiciles because of the renewed stigma associated with tax avoidance. A few did say that some non-UK investors were happy with these jurisdictions, others were cautious.

"Investors are moving away from the riskier, less palatable, less responsible structures – they are doing the right thing"

"...there are concerns over offshore structures, especially Cayman, but also Jersey/Guernsey."

"Some international investors are staunch advocates for not investing in funds domiciled in a jurisdiction that can be construed as a tax haven. The question which are more frequently asked now than say a year ago is "is your fund domiciled in a legitimate place to conduct business".

The momentum may not be sufficient to lead to change with other investors quite content to continue as they have always done and rely on JPUTs / GPUTs and Luxembourg.

"The Channel Island structures are preferred by the global investors, who prefer private placement."

"Managers still use Channel Isles/ Luxembourg and something significant would have to happen to stop this."

"Luxembourg is a more acceptable route into investments for foreign investors."
"….15 years ago, Luxembourg was nothing now it is the domicile of choice for new UK and European funds"

Measures to control tax avoidance may resonate with the Government but rising stamp duty and changes to capital gains tax for overseas investors suggest the Government is more disposed to introduce measures to raise tax from commercial real estate.

"The change in the CGT has not been helpful. Definitely not an incentive for non-UK investors to enter UK funds."

With the introduction of AFIMD, UK fund managers are required to hold a passport to attract European investors to UK or European legal structure so there has been a slight decline in Channel Island vehicles and a move to Luxembourg. With the threat of Brexit there has been an increase in the move to send the administration infrastructure to Luxembourg in a future proofing exercise.

"Since Brexit, European investors prefer Luxembourg over UK Limited Partnerships."

However, there is a clear undercurrent of optimism that once Brexit happens there would be an opportunity for the UK to fight back and firmly re-establish itself as the domicile of choice, not least because of the infrastructure and capacity needed to take on the role. Luxembourg is often referred to as over stretched and limited in the ability to cope with all that is required.

In order to stabilise the UK offering a number of people stressed that the financial industry in the UK needs the support of the Government and the security to know the Government isn't going to impose crippling tax demands which will understandably destabilise the market. But if everyone pulls together then there was a definite feeling of optimism that things could be turned around to the UK's benefit.

"Tax is an important factor, and the outcome of the Brexit negotiations will have a massive impact on the UK real estate industry. Brussels wants us to fail and they are making things difficult but if we can navigate through this process, we could have a big opportunity."

"UK government/industry must work very hard to bring everything onshore"

A number of the respondents did mention the proposal to set up the Reserved Investment Fund (RIF) and many hoped that it would be recognised by the Government and the FCA, though others remain sceptical and that a fund offering quarterly or even bi-annual redemptions could still be problematic.

"The RIF structure may work but it depends if it is supported"

"If the new RIF could provide an onshore structure that is similar to a JPUT then it should be supported"

"There is a need for a better structure to create a new marketplace and the RIF could help with this"

"We need a perpetual semi-open-ended fund structure"

Another concern regarding any future developments in fund structuring was the cost of converting old structures to new, or just setting up a new fund with an untried and tested fund structure. When discussing the launch of the PAIF a lot of managers talked of the set-up costs being prohibitive, and there is no reason to believe that this will not be the case if we launch a new fund type.

"We found it very difficult to see the business case for restructuring vs the legal/accounting costs vs attracting overseas investors."

"Any change will naturally incur an increase in costs and understandably this is not popular."

"There is the move to try to bring structures onshore, but I am not sure that there really will be a financial saving to be had if we do go through the pain and cost of restructuring. The government will have to do something to incentivise the move."

"It will also take us back to a simpler pre-2004 world where direct investor ownerships in LPs are not treated for tax purposes as direct ownerships in property."

"Some international investors are staunch advocates for not investing in funds domiciled in a jurisdiction that can be construed as a tax haven. The question which are more frequently asked now than say a year ago is "is your fund domiciled in a legitimate place to conduct business".

Specialist closed-ended funds

With the migration from funds to JVs and clubs after the GFC the AREF universe witnessed a noticeable decline in the number of specialist closed-ended funds, leaving the universe dominated by the large open-ended vehicles which have continued to grow in size.

"Over the last five years there has been an increase in the number of closed ended funds coming to the market but this increase has not been carried through into increased AREF membership."

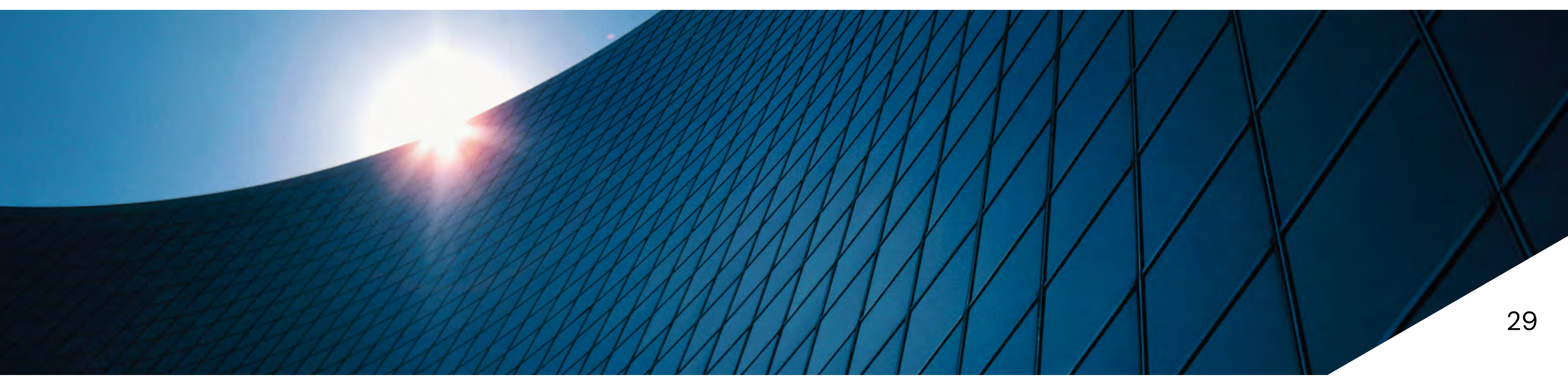
"We can see the AREF fund universe has declined especially in the sector specific category – not looking great for AREF without a change in focus."

Closed-ended funds started to return to the market several years after the GFC but when they made their comeback they came back as specialist, value-add/opportunistic funds which charge higher fees for higher returns.These funds do not naturally sit in the AREF universe. There is a disparity between the data produced by these limited life funds and the data required to complete the PFV and AREF/MSCI indexes. The closed ended funds provide little, or no data in some cases, no quarterly returns, or income distribution, like the open-ended funds, their focus is on the returns once the assets are sold and the fund is wound-up, the absolute return. They therefore don't see the value in submitting data to AREF and being included in an index with very different funds with a completely different strategy.Some managers confirmed that they had been approached to enrol their new funds as members of AREF but they confided that they could see little value in doing so.

If we see the move to more liquid closed-end funds, as many in the industry would like to see, then perhaps there will be more of a motivation for the managers to become more transparent as they will be courting different investors, like the DC pension schemes, who will require a market level of transparency in order to be confident of their long term investment.

"I think we will see a move to the launch of more closed-ended funds, ideally with some redemption windows, more JVs where the investors have more control.

"Closed-ended funds with some liquidity could be a way forward which would give some liquidity but this must be managed carefully."



Debt funds

Alongside the increased popularity of alternative funds since the GFC there has been a similar increase in the number of debt funds and in recent years, infrastructure, as the niche sectors receive more interest and investment. One respondent suggested an open-ended debt fund would be of interest to his investor clients, despite much lobbying this still hasn't been picked up by the industry.

"Despite the move to Real Asset labels – infrastructure is more likely to be dealt with separately.Debt funds have also become very popular"

Liquidity

At times of market distress and economic uncertainty the psychological need, largely by private investors, to gain access to investments even when it may not be necessary and is detrimental to long term performance, has plagued and undermined investor confidence in those funds which offer daily, weekly or monthly liquidity.Events like the GFC, the Brexit Referendum and now COVID have all triggered a rush to redeem units from the open-ended, so-called, liquid funds.

"...investors went into so called liquid funds which turned into illiquid ones very quickly forcing investors to sell direct assets which they didn't want to do."

Unfortunately, the surge in redemptions mean fund managers are overrun with requests to redeem units which they cannot manage. In order to protect funds and the existing investors managers have to gate/close the funds.

"The industry has suffered significant reputational damage from gating"

".....the liquidity offering by open ended funds/PAIFs need to change. Daily trading does not work when you are dealing with such an illiquid asset. Even proposed quarterly or bi-annual redemptions are still tight."

"liquidity was a big issue post GFC, as it is now, and this undermines the credibility and confidence in the industry. Real estate doesn't lend itself to providing a liquid unlisted product."

The constant in the discussion about liquidity is that real estate is not a liquid asset and therefore how can open-ended funds offer daily liquidity when their underlying assets are far from liquid? This issue is further exacerbated by the opening of these funds to retail as well as institutional investors. Whereas, in general, institutional investors invest for the long term, retail investors have a more short-term view and consequently panic and try to redeem their investment at a time of market crisis.

"Retail funds are shot to pieces. The credibility of OEFs has been damaged too many times, they can't carry on hiding behind uncertainty."

"Liquidity is a real issue for retail funds I can't see how they can survive unless there is a big change in regulation surrounding redemptions."

A further complexity at this time of market stress has been the addition of the Material Uncertainty clause in mid-March reflecting the RICS's statement that property valuations were reported on the basis of "material valuation uncertainty". This meant that less weight could be attributed to previous market evidence for comparison purposes. AREF echoed this by stating valuers could "......no longer make reliable judgements on value". The implications for the open-ended funds have been catastrophic. Governed by the rules laid out by the FCA applying to funds investing in inherently illiquid assets, such as commercial property, with more than 20 percent of the portfolio subject to material valuation uncertainty funds have been encouraged to suspend trading in order to protect investors.This level of control from the FCA has led to a number of interviewees complaining that the restrictions have had a detrimental impact on fund and the ability of managers to do their job.

"We need to change the valuation process we can't have the material uncertainty clause destabilising the market."

"Increased regulation has had a major impact on the industry. Current valuation caveats precipitating the closing of funds has caused unnecessary issues."

"There has been a significant increase in regulation. Personally, I don't this is a positive thing as it has been imposed by a regulatory body which does not understand real estate and how it works."

"We are left with a conflict between offering liquidity and protecting all investors. But one thing seems to be perfectly clear daily dealing in unlisted real estate funds is a disaster" .

Secondary market

The real estate fund industry does have the secondary market whereby independent brokers or the managers themselves can assist in the trading of units between a willing seller and willing buyer. Trading takes place quite regularly within a select number of funds, but this cannot compare with the liquidity offered by REITs and the listed equity market.

"The real estate secondaries market needs to behave more like private equity secondaries market where US$50-US$75 billion trades are completed per annum, compared to the US$5-US$10 billion within the real estate trades – there is no reason why this can't grow but the buck stops with the fund managers and the investors."

The process can be drawn out and it is far from where players in this area would like it to be.Several people who we talked to during the interviews expressed their frustrations that this opportunity to facilitate liquidity was not embraced by managers.

"The [secondary] market is built on trust and reputation – so managers are the foundation of any significant secondaries market. Unfortunately, the big names are reluctant to adopt it which has held the market back."

"If investors want liquidity in the real estate market then they need to accept realistic pricing to facilitate secondary trading, fighting over small pricing movements doesn't help anyone."

What seems to be key to establishing a successful secondary market is access to comprehensive, reliable, and current data and technology which will facilitate the sharing of information, the pricing and potentially the actual trade itself. Currently bi-monthly newsletters are distributed by brokers giving indicative pricing of trades that have taken place and units which are available to trade. Several respondents pointed out that AREF should take the lead and collect trading data and publish this with the rest of their information.

"Technological development is key to building the market to facilitate transparency, the problem is managers don't like to see their funds are trading. Currently tech is used as smoke and mirrors trading screens with numbers, but these are not current values or representative of deals in the pipeline."

"....there are some deficiencies in the AREF data: the reporting of secondary trading is one.The calculation of pricing policy, was it is matched or traded?"

"The secondary market suffers from the opacity of pricing and painful post-trade processing"

Clearly the issue surrounding the pricing of units is a stumbling block for the progression of this market and the interviewees acknowledge it. The secondary market already provides the discipline and creates the opportunities but we are still at the stage where an investor needs to find a manager/broker/intermediary to source units and then negotiate a price which invariably requires time.

"[we] need an equivalently simple means of buying units as buying REITs"

REITs

When discussing liquidity for retail investors, in general, most people felt that the daily priced unlisted open-ended funds failed investors and fell short of expectations.However, many felt that REITs were a much better alternative for this class of investor. REITs have also grown in popularity in the last 10 years as the number of DC pension funds have multiplied, these funds must offer daily liquidity and therefore they must have a reliable source of liquid investments. One interviewee went as far as suggesting that some open-ended funds should consider converting to a REIT structure and therefore benefit from gaining access to the increasing number of DC investors.

"There has been a significant growth of externally managed REITs due to the loss of faith in open ended structures after gating, a lack of innovation and the lack of available product in the unlisted space."

"Retail money should go to listed REITs and equities not unlisted real estate".

REITs are not the solution to all investor's problems. They come with weakness like any other investment. In this case, as one advisor mentioned, "REITs are either too small and therefore not liquid or too large and suffer from equity noise". It is a dichotomy that REITs can guarantee liquidity but not necessarily at a guaranteed price and unlisted funds can guarantee a price but not necessarily guarantee liquidity.

REITs also demonstrate good governance with the requirement to have an external board. This was held up by many as an example of how these funds successfully protect the needs of the investors.

JVs/Clubs (not covered by AREF)

One of the very early trends to come from the GFC and the general disillusionment of the investment funds industry was the wholesale move by the larger pension funds from fund investing to a greater reliance/commitment to Joint Venture vehicles or club investments alongside a small number of like-minded investors working with a specialist manager or advisor.

> *"Post GFC investors have clearly sought control/ownership of their investments so there has been a marked increase in co-investment vehicles, JVs and separate accounts."*

> *"....in the future investors will focus more on JVs as they can remain in control [of their investments] and sell out when they want to."*

> *"[after the GFC] ....there was also a growth in JV's and more recently we have been running JVs where we supply the capital to specialist managers for a bespoke service – this gives good alignment of interest for ourselves and our JV partners."*

For investors of significant size this is and easily accessible option for them, however, smaller investors do not have sufficient capital to commit so they tend to be left having to invest via the traditional fund route. As one head of investment confirmed *"...we prefer JVs and co-investment platforms where we have more control, and this is only possible because of our size."*

Performance

When different fund performance was discussed there was a general feeling that the larger balanced funds, which had bought large lumpy assets to invest capital inflows, had not done so well in comparison to the AREF benchmark. Whilst some commentators say the industry has managed the inflows of capital in to funds much better than they did in the pre GFC years there is still doubt as to whether pressure to buy big is correct.

"The performance of the Managed Property Funds has been very poor – they are not fit for purpose"

Benchmarking

Coupled with the fund strategy has been the reliance on the choice of benchmark to measure performance or whether managers should adopt a different approach and/or benchmark more appropriate to the current times.

"Clients [are] much less interested in benchmark hugging funds especially when the benchmark relies so heavily on retail exposure"

"Many good managers are moving away from the use of benchmarks and are considering a risk and return performance analysis. Investors expect managers to demonstrate more careful thinking about specific strategies, products, and the way they do business"

"We need a new benchmark now. How long will it take to get the benchmark to reflect a more realistic current portfolio where it isn't based on 30-40 percent retail!"

"…. we need a current and relevant benchmark which reflects the activity of the day."

"Investors prefer absolute performance measures now."

"Managers need to demonstrate more careful thinking about specific strategies."

Fees

Since the GFC managers have been under pressure from investors to justify, rationalise and reduce their fees. This is the frequently recited response from practically everyone we spoke to.

A good number of people acknowledged that in some cases this was necessary as in the years before the crisis, managers had taken advantage of their investors.

"...managers pull[ed] the wool over investors eyes with elaborate fees with catchups/hurdle rates etc."

"...there were too many fees, and they were too high..."

Level

Respondents stated that fees have been on a downward trajectory since the GFC. Much of the pressure on fees has come from the LGPSs and their need to provide value for money to their members. This pressure may be increased further in the coming years due to the pooling of LGPSs which has "...given investors more strength to push for reduced fees in exchange for larger mandates".

The move from a GAV based fee to one calculated on NAV has been the most reported concession, with the rationalisation of different fees, such as management, asset management, commitment, acquisition etc coming a close second!

"Fees have dropped since the GFC but I don't think they have dropped enough. The GAV based fee (which encouraged managers to take on debt) has quite rightly been replaced with the NAV basis.

Post GFC the move from GAV based fees to NAV had a significant impact on the excessive performance fees which were common in the pre GFC years. Managers are also increasingly expected to align their fees with the performance of their funds and where performance fees are charged there is an expectation that managers have to demonstrate good governance.

"Performance fees can sometimes be more appropriate, but "US themed" catch-ups are not good for investors. Fees should be as simple as possible."

"Performance fees can be a real challenge especially where there is no claw back provision.Managers should get paid on the realisation of returns – this then gives investors comfort."

Some of the research participants are still not content that the current fee situation is at the correct level and in some cases, they feel strongly that today's fees do not reflect the fund returns received. There is some agreement that fees charged should reflect the style and management of a fund. For example, a lower risk, core, balanced fund should see a fee of somewhere around 30bps to 50bps; a separate account should be approximately 20bps and a value-add/opportunistic fund which returns over 15% can still command 120bps and they can still add significant debt.

"Fees in the real estate sector are still much higher than with other asset classes – so we will continue to see pressure for a reduction, especially in the larger Balanced funds."

"Fund strategies should impact on the fee charged: low returns should result in low fees.Managers should be charging the appropriate fee for the job."

With all this said, some people pointed out that many investors had become so preoccupied with negotiating a competitive fee schedule, and therefore value for money for their investors, that they have lost sight of the fund returns and manager performance. Some people have highlighted the perils of pitting one manager against another in a "race to the bottom" for mandates when the winner ends up with hardly enough fee to cover basic operational costs. The warnings have come loud and clear from the interviews; ....."if investors keep the pressure on fees the quality of the service and overall fund performance will suffer."

"Rightly or wrongly investors are investing with managers who have reduced fees. We need to question why should fees change and is it a good thing? The old adage "pay peanuts get monkeys" comes to mind."

"A lot of UK investors do not demand enough on performance. They seem to be more focused on re-negotiating fees and this can be detrimental to performance."

Impact on smaller investors

As the larger investors take advantage of their bargaining strength and their ability to "call the shots" with fund managers in negotiating fee agreements, the smaller investors do not have such luxury. Some managers offer tiered fee systems, but these too only reward the big-ticket investors and make no allowance for the smaller ones.

"there is less choice /negotiating power for smaller investors who do not have enough equity to invest with the bigger managers"

Reporting

Attempts have been made to standardise the reporting of fund fees in order to improve transparency for investors. The use of the Total Expense Ratio (TER) has been one of the ways the industry has sought to do this. However well-meaning the intention is, many people that we spoke to vented their frustration as to the lack of clarity surrounding the calculation of the TER.

I find it very frustrating and concerning that I can't find a manager who can calculate the net of cost return I want to get for my investment. The Industry needs a uniform process. Otherwise will lose credibility against other asset classes and the real estate industry will lose out."

This was coupled by the added complication that recognised industry bodies could not agree on a standard calculation for all their members.

"It is definitely no good for investors if two trade organisations (e.g. AREF and INREV) can't agree on the same methodology to calculate TER."

As an example of where feedback is taken on board and actioned, subsequent to the initial draft of this report AREF has aligned its definition of TER to the global TER used by INREV, ANREV, NCREIF & PREA.

Industry evolution

"There must be a degree a bifurcation in the industry between the large managers who can offer everything and the smaller, higher risk, niche boutique operations that offer a specialist product."

The consensus when discussing the industry, how it has evolved over the last 10 years and where it is headed in the next 10 years, has come to an industry which is split between the big global fund managers which tend to offer a variety of investment options, and asset classes, and the smaller niche/value add managers. Large fund management houses may also benefit from career risk in the decision makers at investors and advisors. Once respondent stated:

"...why would an investor looking for a core, diversified fund, take the risk of doing due diligence on a small less well known manager when they could go to UBS or CBRE GI, [for example]? You are not going to get fired by backing the big guys!"

Nevertheless, the majority of people we spoke to saw opportunities to be had for the smaller managers who could offer a more personalised service and still maintain a lean team with lower overheads, possibly lower regulatory requirements and higher fees than the bigger investment houses.

Managers

Since the GFC there has be a major change in the relationship between investors and fund managers with the latter recognising that they could no longer maintain the "arrogance and old school attitude" that they had cultivated in the decades prior to the GFC and the former recognising that they could no longer sit back and not take an active role in how their investments were managed.

The relationship has evolved over the last 10 years with investors becoming more demanding especially where they have to demonstrate value for money to their trustees and pensioners. Fees seem to be the area which animates managers, consultants, and investors alike and we have covered this in detail earlier in the report. Where managers have been able to drop fees; offer good performance; demonstrate excellent governance; a specialisation or just built a good relationship then investors are encouraged to remain loyal and invest in follow-on funds or ventures.

"Investors have as a rule tended to prefer to stay with a few tried and tested managers that they have a history with rather than going to lots of difference houses for the same type of product."

"Investors tend to be sticky. The flip side is that is difficult for new managers to attract new investors"

"Since the GFC many investors have taken the view that managers who can offer scale are the ones to back."

For years many in the fund management industry have supported the thesis that "big is beautiful/best" and over the decades managers have merged with like-minded managers, institutional investors, and complementary businesses in an effort to chase scale. During the interviews, participants talked a lot about manager mergers and their impact on reducing the size and diversity of the fund management industry. Many questioned whether size was actually a good thing for the industry?

"The industry needs to move away from the AuM driven mind set, there should be more innovation and future proofing of funds..."

"Size ... doesn't necessarily result in managers that can deliver the service that investors want.The key to post GFC success has come down to how well a manager deals with disruption and opportunities that are presented to them. "

The consensus is that there has been a market split between the big core managers and the smaller more specialist private equity real estate managers leaving the middle-sized managers in an uneasy and vulnerable position.

"Fund managers need to be reasonably big to be considered for most mandates – size is one gauge of institutional credibility."

"The big fund managers will become bigger and the smaller niche players will do well also. I believe it will be the middle-sized managers which will struggle under the pressure of regulation and reduced fees.The big managers will be able to benefit from economies of scale and the niche operators will be able to charge higher fees on specialist products."

"The nimble specialist managers with unique skills will always be wanted, as will the large multi-asset houses which can offer a one stop shop solution. I think it is the managers in the middle ground, often dominated by a set culture, which may be in the danger zone."

".....larger managers have been able to cope with the associated burden [of regulation] better than the medium sized managers which lack the financial backing to cope with the requirements. This could have been behind some of the reasoning why there have been a number of mergers/acquisitions of medium sized firms. The smaller niche managers seemed to have been able to cope better thanks to their lean teams."

The vulnerability of the mid-sized managers was seen by many as the source of many business mergers in the coming years in an attempt to offer the market scale and a one stop shop for UK, European, Australasian and North American funds. The corporate mergers/acquisitions of the likes of Mayfair with Swiss Life; Henderson with TIAA; Tristan with Candram; Brockton with Alony Hetz and Investa with Oxford Properties are examples of real estate fund management businesses trying to future proof themselves by creating access internal sources of equity through the expansion into different investor markets to help their businesses grow and invest in new product.

"....Palmer/Mayfair/Cording/Internos have all done well to sell at the top of the market and gained access to in-house/captive funds to help grow their businesses".

"Scale will be a thing of the future we will see more mergers."

When asked what makes a successful manager the consistent message is pretty clear, a winning business is one which is at the forefront of policy and thought leadership, they are innovative in their approach to business development and have consistency of the senior team members who demonstrate good governance respecting staff and clients alike. The losers in this situation are those organisations which are complacent and therefore late to react to the market situations. Some people pointed out that good leadership crucial, if the people at the top rely on the "old boys club" for networking rather than listening to what investors want and developing good channels of communication with them then there is little hope of an entrepreneurial spark.

"....the winners will be the managers who are flexible and can innovate, who embrace technology / diversity and ESG."

"[managers] have different appetites for success, and I believe those businesses which have done well in the last 10 years will do well going forward. Track record is hugely important. Long income and secure income expertise will help, and this will still be sought in the future. I do feel that there will still be a role for small entrepreneurial businesses especially if they can attract the backing of a large source of capital."

The large multi-asset fund managers are often not seen in a very favourable light. They are considered sleepy and not relevant but other commentators see these operations as a one stop shop which could help smaller investors with all their needs. The niche managers benefit from being nimble and benefit from having good relationships with investors. People associate these managers as being specialists in their particular sector and the providers of alpha.

The inevitable comparison between the UK Balanced funds and with the larger US open-ended ODCE funds was made by a couple of people and some suggested that the only way the UK funds could aim to reach the scale of the US counter parts was for them to merge with pan-European equivalents though currency issues would have to be managed before this could progress. The merger of the UK Balanced funds would also be an option to help provide scale for managers.

"I think the big managers would like to see their UK Balanced funds merge with their pan-European ones."

"[I think the next 10 years will see] ...a lot smaller universe with the consolidation of managers all competing to produce an ODCE type fund. Competition between funds for assets will naturally lead to mergers."

When asked what traits people see in “failing” fund management houses the answer is pretty common, “…they are the managers who don’t change…”. The inability to remain relevant will be the death knell for some managers, along with the neglect of their investors and their specific needs.

“Some AREF funds were set up in the 70s and they have not changed in all this time – is it any wonder they are struggling?”

“The losers will be the large multi-asset fund managers who will struggle to remain relevant.”

“The fund management industry has been too arrogant over the years in the way it has treated investors.”

“I think it is the managers in the middle ground, often dominated by a set culture, which may be in the danger zone.”

“The UK fund industry will be a loser if we don’t change our outlook”

The future of the UK real estate fund industry will depend very much on its appetite to embrace the fluidity and fragility of the world we are living in. No longer can managers fail to acknowledge that the industry is dominated by white, middle class, males who generally have real estate degrees from the same few UK universities. Our industry must address the inequalities from the ground up, school aged children from all over the country from different socio-economic and racially diverse backgrounds should be encouraged to see the opportunities in the sector. Similarly, university graduates from disciplines other than real estate, economics and finance should receive career advice which supports and champions the sector as one which is open to everyone with a wide range of skills and outlooks. We need people who are motivated to make a difference within an industry which must embrace its role in making a positive, sustainable, and an impactful difference to our built environment and the communities which live in them.

We need improved dialogue on many different levels: with central Government; over taxation, fund structuring, housing grants and other incentives: Local government; over planning policies and localised investment: and local communities; to better understand what people want to see happen to their failing high streets or their unsuitable and dangerous homes. Industry bodies like AREF, IPF, BPF and the PIA should work with regulatory and investment bodies such as the FCA, IA and pension fund bodies to facilitate dialogue, to champion meaningful and practical research, to provide transparent and applicable data and pension fund structures which embrace rather than reject the illiquidity of real estate. All these invested parties should work together to encourage foreign and domestic investment to the UK at a time when it so desperately needs it.The next ten years should be embraced by this industry as a time of opportunity, a time of collaboration and a time of success for everyone.

Diversity

Diversity and inclusion issues have barely touched the surface especially at the more senior level.

Technology

It is clear that without technology the ability for countries all over the globe to establish lockdowns to stifle the spread of the COVID pandemic is very limited. Without technology many activities would not be possible and industries which have embraced technology have tended to flourish.Real estate has not advanced as quickly as other asset classes in the adoption of this enabler. During the interviews, the slow adoption of trading on the secondary market was held up at one of the failings by the industry in moving forward. The use of technology could not only help with more timely secondary trades but also with capital raising for new funds especially in a world where domestic travel, let alone international travel, for meetings are restricted.   The delay in the adoption of BlockChain, IMPact framework and ledger technology were all mentioned by the interviewees. The application of tokens for trading is a natural progression and one which could help speed up transactions.

“Technology will be crucial going forward especially in the way it will impact on the way we work.If we don't embrace it will be at our peril!”

“The success of an investment manager will increasingly come down to the way they deal with structural disruption like technology...”

“People who embrace change will be the winners. They need to embrace technology.”

Questionnaire

Several investors admitted that they did not rely on the AREF questionnaire when undertaking fund due diligence. The shocking response was that “....the AREF questionnaire is not fit for purpose”.Around 90% of multi-managers do not use AREF data but expect managers to complete their in-house DD questionnaires.”This revelation brings into question the whole premise of data transparency and accessibility. It appears that for certain funds, investors could receive different due diligence information on the same fund.

The whole idea behind the introduction of the AREF questionnaire was to improve transparency and the time delay in getting information out to investors. With many investors relying on their own surveys this presents questions around transparency for the industry.

Where opportunities have presented themselves, for example the inclusion of secondary trading information, AREF have not taken the opportunity to expand their coverage and become more relevant and of greater use to the industry. ESG, building quality and impact investment are all central to many investment decisions AREF should be seen to be leading the way in providing access to other data sources from the likes of GRESB, IMPact and Big Society Capital.

Reinvigorate

As the conversations with managers, investors and consultants concluded it became apparent that AREF was doing some things well and there was support from its members and general recognition that what it has built over the years is worthy of recognition.

However, the frustration with the organisation, its slowness to react to market changes, its failure to take control of its most valuable asset – the fund indexes - and make these relevant and central to an increasingly evolving industry which is embracing technological change is dangerous. AREF has the opportunity to stand with the UK real estate fund industry and help it grow in size via the provision of improved data transparency and relevance, to help with the expansion of new investment areas and the continued support of investor interest with the publication of benchmarks.

The Association of Real Estate Funds represents the UK real estate funds industry and has around 60 member funds with a collective net asset value of around £65 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the AREF Property Fund Vision Handbook.

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