

Unlisted funds - Lessons from the crisis

Report for The Association of Real Estate Funds

January 2012

AREF commissioned PwC to undertake research into the behaviour and practices of its member funds to determine whether there are lessons to be learned from the crisis.



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1. Foreword

Background

The last decade has been an unprecedented period of turmoil for the commercial real estate markets, with the UK no exception to global conditions. Following a five-year boom phase, in the second half of 2007 the UK market went into rapid decline that persisted for nearly two years. An apparent recovery around the end of 2009 petered out and returns are slowing once again.

Amidst all this the positive net fund flows seen up until 2007 turned severely negative for a couple of years, then recovered strongly for a year or so, but have now turned neutral again.

Against the backcloth of this turbulence, The Association of Real Estate Funds (AREF) commissioned PwC to undertake research into the behaviour and practices of its member funds to provide an objective account of manager behaviour and to determine whether there are lessons to be learned from the experience.

Some of the areas that we particularly asked PwC to examine were: whether funds were constrained or influenced in any way from acting appropriately; the way in which investor flows were handled, in both directions; the pricing of units and of underlying assets; the management of debt; and communication with investors and their advisers.

Summary

Despite popular perceptions to the contrary, both the open and closed-ended fund models operated by UK-based managers have largely proved robust, although it is clear that some weathered the storm better than others.

Certainly, one of the positives from AREF's perspective is that there seem to have been significant improvements to transparency and communication, although investors still wish for more, particularly in closed-ended funds, and it is important to ensure that this continues.

That said, there are a number of issues raised by contributors that warrant further debate, to inform future product development and AREF's governance standards through our Code of Practice. These include:

- Oversight of key decisions and independent representation of investors;
- Valuation policy and practice for both direct and indirect holdings;
- Creation and redemption policy and practice;
- The need for an active and transparent secondary marketplace;
- Communication and transparency
 - at the point of investment and subsequently
 - from manager to investor
 - from investor to manager;
- Alignment of interests and conflict management
 - between investors and manager
 - between manager and capital raisers
 - between different investor types
 - between departing, incoming and continuing investors;
- Fee structures and their potential influence on behaviour;
- Liquidity
 - the mismatch between dealing frequency and property transaction timescales
 - the cost to investors of (often unused) liquidity;

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- Debt management
 - disclosure of stress testing.

As the industry voice of unlisted real estate funds, AREF will ensure that the debate takes place openly, encompassing as broad a range of interested participants as possible.

Acknowledgements

On behalf of AREF members, I would like to offer our thanks to the many people who contributed to this project: to John Forbes and his team at PwC who probably took on more than they first imagined; to all the individuals from the firms named in the Appendix who gave up time from busy schedules to answer questions honestly and frankly; and to Jenny Buck and Simon Radford who contributed so much to the steering group discussions.

John Cartwright
Chief Executive
The Association of Real Estate Funds
January 2012

2. Executive summary

Background

During the course of the last five years there has been a period of unprecedented conditions in real estate markets. The last five years cannot, however, be looked at in isolation, and much of what happened in the last five years was to a large extent a consequence of what happened in the five years before that. The period from 2002 to 2007 was marked by yield compression, rapidly rising real estate capital values and increasing capital available for real estate investment. The rapid rise in property values was already losing momentum prior to the liquidity crisis of the summer of 2007, which in turn triggered a significant downturn in both the broader economy and the property market. From the peak of the market to the trough, real estate capital values in the United Kingdom fell by something approaching 50%, according to the IPD All Property Index.

In the light of adverse commentary regarding the behaviour of fund managers in dealing with consequences of this volatility, The Association of Real Estate Funds (AREF) decided to undertake a study of the behaviour and practices of its member funds and other interested parties, to determine what lessons can be learned from the experience, how these lessons will inform industry product development in the future and whether further revisions to the AREF Code of Practice are necessary.

Methodology

The survey was undertaken by interviews with representatives of AREF member funds, members of the AREF Investor Committee and others in the industry. The interviews typically lasted about an hour. Details of those interviewed are set out in appendix one to this report.

Key findings

Despite the unprecedented period of volatility, both the open-ended and closed-ended fund models in the United Kingdom have largely weathered the storm. However, the clear perception among both fund managers and investors interviewed was that some funds and managers weathered the storm better than others. Success or failure will be determined by the market – this will ultimately be reflected in investors voting with their feet. Although the immediate crisis has passed and the normal flow of money in and out has resumed for open-ended funds in the UK, this does not mean that the process of selectivity by investors has been fully resolved. There is an inherent inertia in the movement of capital due to the cost of moving out of either open or closed-ended funds. Although investors have withdrawn funds from underperforming open-ended funds and used the secondary market to sell interests in closed-ended funds, this has been relatively limited in its extent. There have been few cases of investors acting collectively to change the manager of funds. The full impact of investors' judgement on fund managers can be expected to play out over years rather than months as investors select where to deploy new capital. Fund managers who are felt to have disappointed their investors will struggle to raise new funds. The winners and losers among fund managers will become more apparent only as new funds are raised. It was evident from interviews with both managers and investors that there is a wide diversity of views amongst investors, with some clearly having a far more active approach to managing their investments than others.

During the interviews specific instances were identified where the fund managers' ability to take the action that they felt was appropriate was restricted by the terms of fund documentation or regulation. However, in the majority of cases the key driver for the significant actions taken by fund managers, during both the boom and the subsequent crash, appears to have been decisions (or lack of them) taken by the fund managers. Investors' perception of the

behaviour of management at crucial points during the period of volatility will therefore be key in deciding the long-term winners and losers among fund managers. This perception will be determined by the wisdom of the action taken by the manager, the way in which the decisions were taken and the effectiveness of communication with investors. In view of the breakdown in trust at moments of crisis, there is an open question, discussed in more detail below, as to whether the behaviour of fund managers should be constrained further, in particular through the increased role of independent representation of investors.

There is a trade-off between liquidity, volatility, performance and risk. It was apparent from interviews with fund managers and investors that there is no “right” or “wrong” answer as to the relative importance of each. The objectives of investors vary significantly and often change over time. What will be an appropriate course of action by the manager for one will be less appropriate for another, and the manager is therefore dealing with a complex balance of conflicting demands. The greatest challenge is clearly where the conflict is between the needs of investors and the needs of the manager, for example the short-term need of managers to maintain assets under management to preserve fees. Fund managers need to provide investors with enough clarity as to strategy and the decision-making process so that investors understand the nature of the vehicle in which they are investing and what judgement the manager is exercising in balancing these trade-offs. There was also a sense from some of the fund managers interviewed that they felt as though they were being punished for doing the right thing, by investors looking for liquidity where they could find it. In particular:

- Those fund managers who did not suspend redemptions found themselves facing higher demands for redemptions as investors found their access to their capital elsewhere blocked.
- Those fund managers who had increased the cash balances of their funds in order to have working capital to meet future needs found themselves facing pressure from investors to return the cash. The investor perception of this is different in some cases, with investors accusing managers of hoarding cash that should have been returned.

In terms of the characteristics of funds, there is a trade-off between homogeneity and diversity. Minimum standards of behaviour, practice and governance can be achieved through formal regulation or through the informal regulation of the Code of Practice established by AREF. However, for many of the issues discussed in this report, there is a divergence of views. Of particular relevance is the divergence of views among investors. A number of fund managers have indicated that they believe that addressing the issues that have become apparent during the period of volatility provides an opportunity for product differentiation. Several of the fund managers interviewed indicated that they had undertaken their own exercises to identify lessons learnt from the period of volatility, not all of which they were prepared to share, as they saw this as something that would give them a competitive advantage. There is a trade-off between trying to achieve homogeneity through common standards or regulation and trying to achieve innovation and investor choice. The aftermath of the period of volatility represents a unique opportunity for product development.

Transparency between fund managers and investors is crucial to the continued prosperity of the real estate fund management industry. Most fund managers feel that they have taken significant steps to improve the quality and quantity of communication with investors, although investors feel that there could be further improvement in quality. There are specific areas where greater transparency is essential:

- For open-ended funds, the detailed workings of the timing and pricing of subscription and redemption are so fundamental to the model that a lack of transparency and lack of understanding among investors has the potential to cause lasting damage. This is a key area in which AREF can assist through ensuring greater consistency in the terminology and disclosure.
- There is a general perception that closed-ended funds are less transparent than open-ended funds. As investors’ capital is tied up for a longer period, this is a significant area of concern and needs to be addressed.

It is important that progress made in communication during the period of volatility does not regress as the market improves. There are two further areas that are more controversial and should be debated further:

- Should there be more general adoption of independent representation of investors? If so, in what form?
- Are investors equally culpable if there is a lack of transparency between fund managers and investors? How much of the blame should be laid at the feet of passivity by the providers of capital? If this is the case, how can it be avoided in the future?

Actions for the Association of Real Estate Funds

As indicated above, there are key areas to which there is no “right” or “wrong” answer. Whilst AREF could provide guidance, this seems to be an area where fund managers are keen to exploit the differences to achieve competitive advantage. It would therefore seem to be a topic that is worth further public debate amongst AREF members and others. Within this general topic, there are three areas that merit particular further attention:

- There are fundamental issues that need to be considered for both the open-ended and closed-ended fund model. The range of fund vehicles already covers a spectrum, with funds that fall between the strict open and closed-ended model. The challenges in the downturn for open-ended funds of maintaining liquidity, and for closed-ended funds of raising capital outside the commitment period to meet loan-to-value covenant breaches, may encourage greater interest in hybrid vehicles with some of the characteristics of both. There is therefore an opportunity for product development, to create new vehicles that deliver the characteristics sought by investors.
- The implications of the non alignment of interest between different types of investors should be explored further. The co-mingling of retail and institutional investors in the same vehicle (for example as Property Authorised Investment Funds, or PAIFs, become more widespread) is an

example, but there are issues even from the co-mingling of different types of institutional investors.

- The role of the fund manager in regulating inflows of capital should be looked at. There is an open question for managers dealing with both institutional and retail clients as to how far the manager is responsible for the inflow of capital, and if so how the mechanisms should be operated.

Further specific areas for attention by AREF are set out later in this report.

The importance of continuing the dialogue

Many of the issues identified in this report require further debate. It is important not only that there is a dialogue between fund managers and investors, but also that that dialogue continues into the future. Many of the fund managers and investors interviewed expressed the concern that the collective memory in the industry might be short. A continuing dialogue and debate on these matters will hopefully ensure that this is not the case.

3. Background

Outline of project

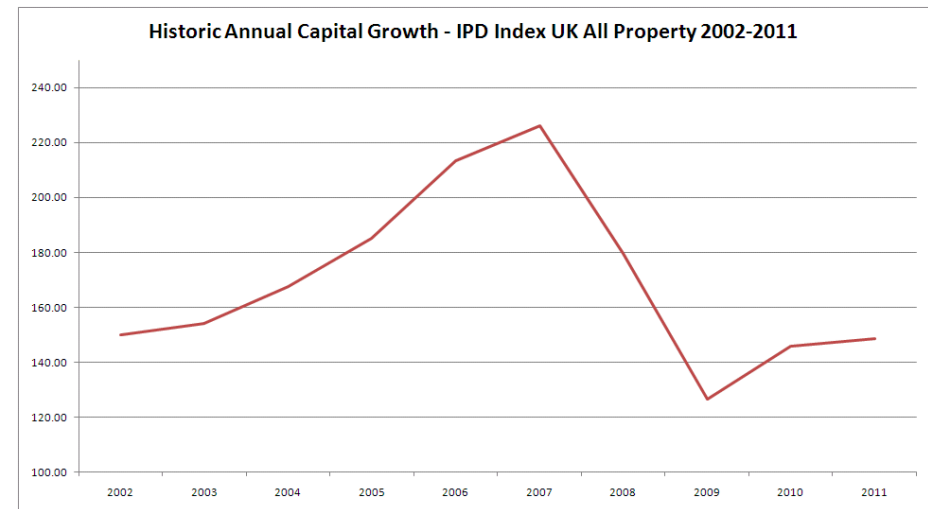
The last five years have seen unprecedented conditions in real estate markets. This period cannot, however, be looked at in isolation, and much of what happened in the last five years was to a large extent a consequence of what happened in the five years before that. Throughout the last five years, AREF believes that managers of unlisted real estate funds have been severely tested in a variety of ways, including liquidity management, investor activity, asset availability, valuation accuracy of both direct and indirect holdings, debt management and pricing, unit pricing and investor communication. All this has taken place against a backdrop of global financial and economic instability and increasingly subjective and populist media and market commentary.

In the light of some commentary, AREF decided to undertake a study of the behaviour and practices of its member funds, and hopefully some others that are not yet members, to determine what lessons can be learned from the experience, how these lessons will inform industry product development in the future and whether further revisions to the AREF Code of Practice are necessary.

The real estate and fund raising cycle from 2002 to date

The following paragraphs set out a brief commentary on the booming property market of 2002 to 2007, the impact on property of the subsequent liquidity crisis of 2007 and 2008 and the recovery of some segments of the property market in 2009 and 2010. The volatility of property values over that period is illustrated by the following graph.

Changes in real estate capital values 2002 – 2011



The booming market, 2002 to 2007

To understand the property crash following the liquidity crisis of 2007, it is necessary also to look at the five years that preceded this. The period from 2002 to 2007 was marked by yield compression and rapidly rising real estate capital values. It was also marked by increasing volumes of capital available for real estate investment:

- The period 2002 to 2007 saw a very significant inflow of funds into open and closed-ended vehicles in the UK. Details from the Investment Management Association (IMA) of inflows into fund vehicles are set out

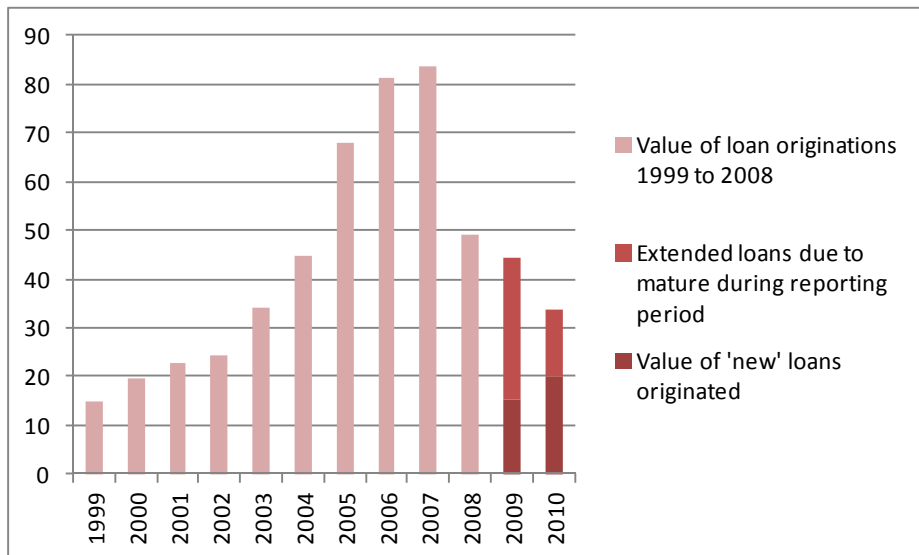
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opposite. A more detailed analysis of flows into and out of AREF member funds is set out in appendix 2.

- The same period was also marked by significant investment by overseas capital into the United Kingdom, as the years from 2000 to 2007 saw very significant increases in cross-border capital flows. The UK real estate funds industry does not operate in isolation, and at the same time that the growth in UK funds under management was driving demand for suitable assets, there was also increasing competition from other buyers.

The ready availability of relatively cheap debt to finance real estate investment was also a significant feature of the period and contributed to the boom. Details of debt for real estate are illustrated below .

Aggregate real estate lending 1999 to 2010



De Montfort Commercial Property Lending Report 2011

Available debt for real estate rose dramatically over the period, with the most substantial increase in 2004. The access to debt not only fuelled the boom that

encouraged the flow of funds into real estate as an asset class, it also contributed to the problems in the downturn of those funds that used gearing.

Funds under management – last 10 years

£m	Total	Equity	Bond	Money Market	Balanced	Property	Other	ISA
2010	578,669	350,518	107,740	4,343	53,672	12,551	49,844	105,748
2009	480,601	293,068	95,568	4,641	39,210	9,700	38,415	93,460
2008	361,686	224,867	75,000	3,200	29,643	7,715	21,260	74,366
2007	467,412	315,011	79,156	5,263	36,458	12,403	19,120	90,676
2006	409,674	293,663	58,991	3,791	31,402	12,862	8,965	90,543
2005	347,114	252,922	52,276	2,737	26,013	6,187	6,980	84,142
2004	275,641	202,975	42,027	2,188	20,012	3,100	5,339	75,310
2003	241,146	179,243	38,210	1,780	17,001	1,084	3,829	68,656
2002	194,611	143,997	30,531	1,169	14,822	955	3,136	57,571
2001	235,796	186,708	25,403	1,212	18,539	675	3,259	68,126

Data from the Investment Management Association.

A number of those interviewed for this survey commented on the fact that inflows into real estate funds mirror the underlying property cycle, increasing as the market reaches the top of the cycle. As one fund manager observed, “The top of the cycle is the easiest time to raise funds but the most difficult to spend it wisely.” The way in which managers of both closed and open-ended funds addressed this – in particular how they dealt with the practicalities of restricting inflows – varied considerably, as is discussed in more detail later in this report. The sophistication of different types of investor also varied. Retail investors continued to place capital into open-ended funds after more knowledgeable institutional investors had scaled back.

The liquidity crisis of 2007 and 2008

The rapid rise in property values was already losing momentum prior to the liquidity crisis of the summer of 2007. Although many real estate investors, fund managers and others in the industry had identified that the cycle was reaching a peak, few, if any, predicted the severity of the liquidity crisis, which triggered a significant downturn in both the broader economy and the property market. According to many estimates from the peak of the market to the trough, real estate capital values fell by close to 50%.

As indicated in the IMA figures on the previous page, there was a substantial fall in the assets under management. This was partly attributable to falling real estate values, but there were also significant net outflows from open-ended funds. As can be seen in the fund flows to and from AREF member funds set out at the end of this section and in more detail in Appendix 2, redemptions from AREF funds peaked in December 2007. In looking at subsequent outflows, it is important to note that many funds suspended redemptions, and the figures do not accurately reflect the extent to which investors wanted to withdraw their capital. Fund managers responded very differently to the circumstances in which they found themselves, resulting in widely differing behaviours. The steps that fund managers took to restrict outflows and the reaction of investors is discussed later in this report.

The liquidity crisis also saw a reversal of the ready availability of debt that had been a key feature of the preceding boom. Furthermore, the rapid fall in real estate values resulted in many borrowers breaching loan-to-value covenants. This was a particular issue for closed-ended funds as they tended generally to operate with higher levels of gearing than open-ended funds, and also, once outside the period during which the fund documents prescribe that investments can be made, did not have the flexibility to draw down additional funds from investors to remedy the breaches. Many borrowers, including real estate funds, were caught in a trap of loans maturing and loan-to-value covenants being breached as a result of falling values, at the same time as the supply of new debt to refinance dried up and raising new equity also proved to be highly problematic.

“Recovery” in market in 2009 and 2010

The “recovery” in the market in 2009 and 2010 had similarities to the boom that preceded the 2007 crash, but also significant differences. The key difference was the starkly different fate of prime and secondary property. The period prior to 2007 had seen significant convergence between the yields for prime and secondary property. In the exuberance of the boom, the risk premium for poorer quality property was eroded, such that spread of yields for properties of different quality and risk became much narrower. When property values tumbled following the liquidity crisis of 2007, values for poorer quality properties fell more dramatically, re-establishing the risk premium. The recovery of 2009 and 2010 was a recovery in prime property. Yields for poorer quality property continued to increase, creating a widening gap between the values for different qualities of property. The risk premium that had been re-established in the crash was maintained and was not eroded in the same way as it had been in the previous boom. This is significant for the purposes of this report for a number of reasons:

- The period saw very strong net inflows into open-ended funds, particularly during the final quarter of 2009 and the first half of 2010, as can be seen from the statistics in Appendix 2. Seeking to avoid recreating some of the issues that arose as a result of investments made in 2006 and 2007, the funds increasingly looked to invest only in prime assets. As in the boom prior to 2007, the weight of capital chasing a limited asset pool was augmented by inbound investment by overseas capital. As with the open-ended funds, many of the overseas investors also looked only to invest in prime assets, contributing to the over-heating of the top end of the market.
- As a result fund managers again faced the dilemma of accepting capital to invest in a potentially over-priced market. The weight of capital seeking to invest in a relatively small pool of assets created the risk of another boom. How far had fund managers learnt the lessons of the previous boom, or is this volatility inherent to the open-ended funds model?

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- Unlike the pre-2007 boom, values of secondary property continued to fall. Funds that had lowered their underwriting standards to accommodate the pressure to invest during the boom now found that some of the poorer assets were continuing to fall in value and drag down performance, even as the better assets in the portfolios were recovering significantly in value. Problems also remained, and indeed in many cases became worse, for leveraged closed-ended funds invested in secondary property.

How well fund managers dealt with these issues is discussed later in this report.

Inflow and outflow data

Detailed data from AREF on quarterly inflows and outflows from funds is set out in Appendix 2. These are summarised in the table below:

Year	2005	2006	2007	2008	2009	2010
Number of Funds at Y/E	41	57	64	67	65	65
Value (£'m) Existing Funds at Y/E	19,276	37,966	37,088	26,200	25,190	31,438
New Money Raised (£'m)	1,960	5,285	3,739	1,759	4,452	4,763
Redeemed (£'m) - Primary Market	435	814	3,546	2,968	1,283	1,845
Matched (£'m) - Secondary Market	570	1,241	884	486	429	744

In many respects, the fund inflows are more interesting than the outflows. The inflows in the boom market in 2006 and the first half of 2007 were spread over 18 months. Inflows over those 18 months were between £1 and £2 billion per quarter, with total inflows of nearly £8 billion. The boom in inflows associated with the recovery in 2009 and 2010 was much more condensed – inflows of more than £1 billion per quarter occurred for 9 months. However, within that period, the inflows in the quarter to 31 December 2009 were over £3 billion. In the quarter to 31 March 2010, although an inflow of nearly £2 billion was lower than the previous quarter, it was still higher than any of the quarterly inflows in 2006 and 2007. Total inflows in the 9 months to 30 June 2010 were over £6.5

billion. There are good grounds for arguing that it was more of a boom than the period leading up to the liquidity crisis in 2007, although others would argue that it was simply a correction of a market that had overreacted to the crisis of 2007. Whether fund managers and investors had learnt the lessons from the previous boom is one of the key matters explored in this report.

4. The trade-off between liquidity, volatility, performance and risk

Real estate is not a fungible asset. It is fundamentally illiquid and it is not straightforward to reduce a holding in a particular asset. Owning shares in listed real estate companies does create a fungible asset that allows an investor to increase or reduce their holdings as appropriate. The extent to which real estate funds approach this depends upon the characteristics of the fund. For those managing investment in real estate as an asset class, there is a trade-off between liquidity, volatility, performance and risk. Providing investors with the freedom to enter funds whenever they wish is likely to be dilutive in terms of performance. Holding more liquid assets to maximise liquidity for managing redemptions is also dilutive of performance and, depending upon the assets held (for example holding investments in real estate investment trust (REIT) shares or other open-ended funds), increases volatility. Investing in higher risk assets has the potential to increase returns, as does the use of debt, but both increase risk and volatility. Higher risk assets proved to be less liquid when the market declined sharply. It was apparent from interviews with fund managers and investors that there is no “right” or “wrong” answer. Fund managers need to provide investors with enough clarity as to strategy and the decision-making process so that investors understand the nature of the vehicle in which they are investing and what judgement the manager is exercising in balancing these trade-offs.

As indicated above, the membership of AREF has a broader representation of open-ended funds investing in the UK than of closed-ended funds or of international funds. The spectrum of funds investing in real estate is significantly broader than that represented by AREF. There are no rigid definitions of open and closed-ended in the real estate context. Lying between what would be regarded as open-ended and what would be regarded as closed-

ended, there are vehicles that exhibit some characteristics of both. Investors are attracted to vehicles with open-ended characteristics for two broad reasons:

- The ability to reduce investment and withdraw capital at relatively short notice – for example to invest at low points in the property cycle and to realise the investments at the high points of the cycle. Much of the commentary regarding open-ended funds focused on the ability of investors to withdraw capital, and in particular the suspension of redemptions by a number of real estate funds. This is perhaps understandable as retail investors are attracted to open-ended funds because of the ability to withdraw their capital when needed, but also, due to a lack of sophistication, are less likely to understand the detailed provisions that govern money entering and leaving funds. It is also worth noting that authorised funds remained open throughout the period. Institutional investors were also attracted to open-ended funds for liquidity. However, the ability to withdraw funds is not the only motivation of investors for investing in open-ended vehicles.
- Some investors were also attracted to open-ended funds because they provide the ability to deploy capital for the long term. Many investors wanting to invest for the long term are not attracted by the perceived short-term nature of the closed-ended fund model, where assets are divested and capital returned even though the investors may want to keep the capital deployed. The lack of attractiveness of the closed-ended model in this respect for some investors does not mean that such investors are attracted to the high degree of liquidity of the fully open-ended fund model either.

The distinction between the two motivations contributed to some of the non-alignment of interest and behaviour discussed in greater detail later in this report. Faced by the choice in open-ended funds of the manager selling assets to meet redemptions, there was clearly a non-alignment of interest between those wanting to redeem and those wanting to remain invested.

Sophistication and behaviour of investors

As noted above, the top of the cycle is the easiest time to raise funds but the most difficult to spend it wisely. A number of fund managers and investors interviewed as part of this survey commented that the sophistication and behaviour of investors varied significantly. Clearly there are differences in behaviour between institutional and retail investors. The events of recent years have highlighted the differences of behaviours of different institutional investors. The variety of institutional investors is also changing. Interviewees cited as examples:

- The increased importance of cross border-investors.
- The nature of separate accounts changing with new players entering the market, the increased number of multi-managers and development of fund-of-funds.
- In the longer term, the growth in the importance of defined contribution pension schemes will create a new cohort of institutional investors who are likely to behave differently from other investors.
- Even investors with similar characteristics are showing signs of a greater divergence in strategy.

This creates a driver for greater diversity of fund products, as discussed in more detail later in this report. At its most extreme level, the difference in perspective and approach of different institutional investors caused significant problems for funds. Both fund managers and investors interviewed commented on the lack of alignment of interest between different types of institutional investor at crucial points during the period of volatility.

There were two particular areas where this was cited as an issue:

- The non-alignment of interest between investors wishing to remain in open-ended funds and those wishing to redeem as the market fell most rapidly. This has been discussed above, and creates a challenge for fund managers as to whether they wish to attract both passive long-term investors and more active, and therefore more volatile, investors. In terms of those investors who were likely to adopt a more active approach, both fund managers and investors interviewed identified fund-of-funds and those investing through a multi-manager more generally as investors who were most likely to move their capital in the short term as a reaction to events. This manifested itself through redemptions in open-ended funds and through transactions on the secondary market for closed-ended funds. Both of these are discussed later in this report.
- In closed-ended funds dealing with debt issues, the non-alignment of interest between investors was in some cases a major issue. Disagreements between investors were regarded in some cases as more heated and intractable than disagreements between the investors and the fund manager. In situations where new equity needed to be raised to remedy loan-to-value covenant breaches, some investors were prepared to subscribe for new capital, whereas others were unwilling or unable to do the same. The closed-ended fund model is inherently inflexible and dependent upon timing. The risks are compounded by the use of debt. When things go well, investors benefit from the strong performance. In some cases through anticipation by the fund managers, and others perhaps more by luck, some funds were in a stronger position than others when the market turned severely. When fund managers buy at the wrong point in the property cycle and the consequences are magnified through the use of debt, the closed-ended fund model is not designed to facilitate the raising of new equity to remedy the situation. Attempts to do so varied in their effectiveness, but particularly exposed the significant differences between investors.

Several interviewees commented on the role of consultants. In the UK, consultants play a very significant role in advising institutional clients. The

views and behaviour of consultants therefore have a significant impact on the market. Many of the comments regarding the behaviour of institutional investors in this report are a reflection of the behaviour of consultants.

The reaction of consultants to events of recent years should also be noted. In particular:

- The consultants have been key drivers in changing the focus of due diligence by investors. As discussed in more detail later, there is a much greater focus on due diligence when investments are made, particularly operational due diligence on the manager and how it conducts its business.
- Some consultants are changing the nature of their business in a fundamental manner, starting to compete with the multi-managers and fund-of-fund managers. At the same time, as mentioned above, a number of traditional fund managers have been entering the separate account market. All of this is helping to create a greater diversity of investor behaviour.

The influence of consultants is in many cases not seen as a positive by fund managers. A number of interviewees cited the potential impact of consultants in generating a herd mentality among institutional investors. A fund might have a diverse institutional investor base but if those investors are highly influenced by a small population of consultants, and behave in practice as if they were a single investor, then the benefits of having a diversified investor base are largely eliminated. Despite this view being prevalent, the greater sense derived from the interviews was that investor behaviour was becoming more diverse rather than more homogenous.

In the same way as for consultants dealing with institutional investors, fund managers interviewed expressed concerns over the role played with retail investors by Independent Financial Advisers (IFAs).

The IFA community is currently fragmented with a large number of generally small organisations as participants. It was described by one interviewee as a cottage industry. Furthermore many may operate both as an adviser and on an

“execution only” basis. The split of activity varies considerably from organisation to organisation. The fund manager will not generally know the basis of the relationship between the IFA and its clients. The observation that IFAs are only doing what their investors want is in some cases very literally true. In others, even where the role is an advisory one, investors will often have strong views about how they want to invest. It was suggested that IFAs would be reluctant to disagree, understandably reacting to what their private clients want. It was also commented that the IFA’s ongoing engagement with their clients is often limited and in many cases the IFA is remunerated by commission for selling the product.

As noted elsewhere in this report, investors, advisers and fund managers commented on the heavy marketing of real estate funds late in the property cycle. One fund manager in particular was noted to have conducted a very high-profile marketing campaign, which was felt to have strongly influenced retail investors. The disconnect between investment teams and marketing teams is discussed elsewhere in this report. Vigorous marketing to relatively unsophisticated investors and intermediaries resulted in retail money continuing to flow into real estate as an asset class after more knowledgeable institutional investors had withdrawn. However, concerns about IFAs are not unique to real estate as an asset class.

A particular concern expressed in interviews was the quality of information flowing to retail investors. Although fund managers have made significant efforts to improve the quality of the information that they provide, it was felt that for retail investors this lagged behind the progress made with institutions. The view was expressed in interviews that this was compounded by the role of the IFA. Whilst the fund manager can control the flow of information to the IFA, it has no control over the flow of information between the IFA and the IFA’s clients. There was a widespread concern that this varied significantly in its reliability.

The role of the IFA is in any case going to change as a result of the Financial Services Authority (FSA)’s Retail Distribution Review (RDR). The FSA is proposing to ban commission-advised sales and to impose higher professional standards on financial advisers. This is currently proposed to take effect from 1 January 2013, although the Treasury Select Committee proposed a delay until 1

January 2014, citing concerns that the changes could cause an exodus from the market of more experienced advisers, who might cease to operate independently or might leave the market completely. A key element of the RDR proposals is to improve the professionalism and training of IFAs, including requirements for continuing professional education. The potential impact of RDR on the behaviour of IFAs would appear to be worthy of further investigation. More specifically the requirement for improved initial and ongoing training is an area in which AREF should consider whether it might be able to play a role.

As discussed above, it is apparent that investor views vary across a wide variety of different aspects covered by this report. These aspects are discussed in more detail in the following sections, which give rise to some general matters that are worth further debate, particularly if investors with different attributes are co-mingled, for example in Property Authorised Investment Funds (PAIFS). There is also a trade-off between trying to achieve homogeneity of approach through regulation and the setting of standards and trying to achieve diversity of product and approach from which investors can choose. The trade-off between homogeneity and diversity is a matter that arises at a number of points later in this report and is a key matter for further debate.

The challenge to the fund model

The rapid fall in real estate values discussed above following the liquidity crisis of the summer of 2007 exposed the open-ended and closed-ended fund models to a unique degree of stress. In both cases, the challenges of the model were apparent:

- In the case of open-ended funds, there is an inherent risk in providing investors with a theoretically liquid investment in a fundamentally illiquid underlying asset class. In the face of significant requests for redemptions from investors as the market declined, only a minority of fund managers were able to maintain liquidity throughout. The majority at some point suspended redemptions rather than dispose of more assets to meet redemption requests. The timing and process of suspension varied significantly between fund managers, as did the reaction of investors. Not all investors in open-ended funds have

invested in such vehicles because they want the liquidity to exit at short notice. Some are there because they want to deploy capital for longer than is generally possible in a closed-ended fund. When fund managers were faced with the prospect of disposing of assets at what they perceived to be the bottom of the market, many were reluctant to sell. As discussed later in this report, the reluctance was in many cases driven by the dilemma for the fund manager as to which assets to sell. The assets that would be easiest to sell in the shortest time were precisely those assets that the manager was keenest to continue to hold. This exposed differences between investors with different reasons for being in the funds, and between those wishing to stay and those wishing to leave. How fund managers dealt with this varied considerably. Striking the right balance between protecting the interests of investors wishing to leave and those wishing to stay is difficult. For the managers, demonstrating impartiality was always going to be a challenge in a model where there is a strong vested interest in maintaining Assets Under Management in order to maintain fees.

- In the case of closed-ended funds, the model is by definition relatively inflexible. Investors provide funding, or more often a commitment to fund, for a fixed period. The investments will also be held for a fixed period after which the assets will be realised and capital will be returned to investors. Volatility is increased by the use of gearing, increasing returns if things go well, but also increasing risk. Timing is clearly key to this model, but it is also a model where the timetable is set in advance. The downturn in 2007, and the rapid fall in real estate values, trapped a number of fund managers in situations where the timing limitations of the model prevented them taking the action that they wanted to without going back to investors. Firstly many funds breached loan-to-value covenants, but could not draw down additional capital as they were outside the investment/commitment period. Funds were also reaching the end of their lives and, as with the open-ended funds facing redemptions, fund managers were reluctant to dispose of assets at what they perceived to be the bottom of the market. In both situations, going back to investors for permission to extend in some cases exposed a significant lack of alignment between investors. The

issues faced specifically by open-ended funds are discussed in section 5 of this report below.

The trade-off between homogeneity and diversity

As mentioned earlier, in terms of the characteristics of funds and the behaviour of fund managers, there is a trade-off between homogeneity and diversity. How fund managers for both open and closed-ended vehicles behaved during the period of volatility varied significantly. Attempting to analyse this is difficult, as the situation was highly complex and the behaviour of fund managers was a judgement call. There are no “right” and “wrong” answers, with investors’ views also varying. It is impossible to set standards or lay down regulation for those areas where there is not a consensus among stakeholders as to what is important or appropriate. This is discussed further below. The key points to note are:

- The trade-off between liquidity, volatility, performance and risk is highly judgemental and fund specific. How fund managers behaved in the past and how they plan to behave in the future needs to be assessed on a case-by-case basis.
- There are some very broad questions that remain unanswered regarding the role of a fund manager in both open and closed-ended funds. In particular, is it the decision of the fund manager when to invest or simply to decide what to buy and sell? It is difficult to see that there could be a “right” or “wrong” answer, and it is more likely that it is a matter of giving greater clarity to investors so that they can make a choice.
- Views vary very significantly between investors. This is not just on points of detail, but also on matters that go to the heart of the open and closed-ended fund models.
- Minimum standards of behaviour, practice and governance can be standardised through formal regulation or through the informal regulation of the Code of Practice established by AREF. However, for

many of the issues discussed in this report, there is a divergence of views. Of particular relevance is the divergence of views among investors. A number of fund managers have indicated that they see addressing the issues that have become apparent during the period of volatility as an opportunity for product differentiation. Several fund managers interviewed indicated that they had undertaken their own exercises to identify lessons learnt from the period of volatility, not all of which they were prepared to share, as they saw this as something that would give them a competitive advantage. There is a trade-off between trying to achieve homogeneity through common standards or regulation and trying to achieve innovation and investor choice.

The trade-off between liquidity, volatility, performance and risk

As has already been mentioned above, providing absolute liquidity for investors to join when they wish increases the likelihood that fund performance will be diluted. One of the paradoxes apparent from the interviews is that the top of the cycle is the easiest time to raise funds but the most difficult to spend it wisely. Some of the processes that fund managers adopted to restrict entry to open-ended funds are discussed below. Those funds that maximised inflows and investment at the height of the market in 2006 suffered the consequences in terms of investment performance in the subsequent downturn.

There is a fundamental question as to the role of the fund manager in regulating the flow of funds in and out, particularly in open-ended funds. Should it be down to the fund manager when cash should be raised to make investments? Views differed among both fund managers and investors. At one end of the spectrum, it can be argued that it is not the role of the fund manager to restrict flows of money into the fund. In an open-ended vehicle, investors should decide when to deploy capital. It is the role of the fund manager to decide in which assets the money should be invested and to make reallocations in the asset base by disposing and reinvesting. At the other end of the spectrum is the view that it is the role of the fund manager to decide to raise capital to invest at the bottom of the cycle and to exit at the top of the cycle. Some would argue that this is the role of the closed-ended fund. This is discussed in more

detail below. Most people interviewed, whether fund managers or investors, took the view that this is in practice a compromise, with the fund manager making a judgement call as to when to introduce some form of gating to slow the inflow of cash, or simply turning off the marketing effort when the judgement is that further investment will adversely affect the performance of the fund to an unacceptable degree. A common theme from the interviews conducted was that in 2006 and early 2007, prior to the liquidity crisis, fund managers recognised that returns were diminishing and that making further investments would dilute future returns. However, they were also making a judgement call as to how much dilution would be acceptable in the trade-off between maintaining returns and raising additional capital. This raises further issues:

- If investors believe that it is the role of the fund manager to regulate the flow of funds into the fund to restrict access at the top of the market, how should this behaviour be rewarded?
- As with many aspects of the fund model, the fund manager has a vested interest in raising additional funds. A substantial proportion, and in many funds the whole of the manager's fee, is based upon Assets Under Management. The manager is making a judgement call regarding the short-term benefit of maximising cash inflows versus the long-term attractiveness or otherwise of the fund if performance declines;
- Maintaining liquidity and the ability to meet redemptions in a less active market where the rapid disposal of assets is challenging assumes the holding of more liquid assets, in particular cash and equivalents. This should reduce performance, as a real estate fund manager should be able to generate a better return from real estate than from cash, although in the rapidly falling market of 2007, this was not the case.

There is a trade-off between liquidity and volatility. Where investors are seeking to reduce their exposure to real estate as an asset class, the more liquid assets will generally be sold first. The value of shares in REITs and in the more liquid (e.g. daily traded) open-ended funds move ahead of the market in the underlying asset. It was suggested by interviewees that fund managers' reaction to the period of volatility had been to hold an increased amount of investment

in more liquid assets, including REIT shares. This would be expected to have the effect of increasing volatility. This results in a trade-off for fund managers between investors attracted by liquidity and the desire of the fund manager to attract less volatile investors. Many of the interviewees commented on changing their focus in the future to attract more "sticky" money to reduce the volatility associated with investment from "hot" money seeking to play the cycle. This would imply a greater focus on investors who see the attraction of an open-ended fund as being that the money remains deployed for longer.

There is a trade-off between volatility and performance. As indicated above, in the period during which the property market overheated in 2006 and 2007, there was a convergence in yields between prime and secondary properties. As property values fell following the liquidity crisis of 2007, the convergence reversed. The market rediscovered the risk premium for secondary property. The divergence continued in 2009 and 2010 as prime properties recovered in value, whilst secondary properties continued to fall. Secondary properties have been more volatile. Some fund managers are therefore looking to concentrate on investing only in the most prime and core of properties. Although the returns are expected to be lower, the investments are expected to be less volatile.

There is a general question about the role of closed-ended funds. As discussed in more detail later in this report, closed-ended funds typically have a fixed period for investing and a fixed life for the fund. Generally such funds have operated with higher levels of gearing than open-ended funds, increasing risk and potentially increasing returns. Success or failure is highly dependent upon timing, which raises the question as to whether such funds should be a permanent part of a fund manager's offering, or should only be raised at a time that allows them to invest at the bottom of the cycle. Some investors and fund managers commented in interviews that they expect closed-ended funds to be smaller in future, with shorter commitment periods. This potentially accentuates the issue. As with a number of other matters raised in this report, this is a matter for debate and investor choice, rather than a question to which there is a right or wrong answer.

It was apparent from the interviews that there was a particular issue for open-ended funds-of-funds investing in closed-ended funds. When the crisis hit and

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the open-ended vehicles faced redemptions, exiting from underlying closed-ended vehicles proved highly problematic. There was no ability to control what happened in the underlying funds, there was a lack of alignment of interest on key issues such as gearing and, at the bottom of the market, discounts for secondary transactions in closed-ended funds were massive. Closed-ended fund interests proved to be significantly less liquid than direct assets.

A number of the fund managers commented on a disconnect between the investment teams and the equity-raising teams at the peak of the market in 2006 and early 2007. Although the investment teams had identified that the market was reaching a peak and that further significant investment would dilute returns, this did not result at all fund management houses in an easing off in marketing efforts by the equity-raising teams. Remuneration arrangements, in their broadest sense, were cited as a major contributory factor – the equity-raising teams are rewarded for raising additional equity, whereas the investment teams are rewarded for the subsequent performance of the investments. Despite large inflows, in the words of one investor interviewed, being followed by stodgy performance, equity-raising teams are generally not rewarded for showing restraint. Furthermore, many fund managers are primarily investing capital managed by the parent business (for example some fund managers owned by insurance companies). The imperative of the parent is to raise money, and often property is the easiest product to sell. The difficulty of raising equity most easily at the “wrong” point in the cycle played out differently across the broad spectrum of investors. However, as the market over-heated, fund managers sought ways of overcoming this disconnect.

Another area that has common threads through both open and closed-ended funds was the use of independent representation. This occurred in different forms and in different situations, for example the appointment of independent representatives on boards of fund managers, investment committees or committees of investors or the use of third-party corporate finance advisers in dealing with investors in closed-ended funds in which situations arose of non-alignment of interest between investors. Views of both fund managers and investors varied as to the benefits. Generally speaking, smaller investors appear to have placed a greater value on the appointment of independent representation. From discussion with both larger and smaller investors, this distinction appears to be a function of larger investors feeling that, as a result of

fund managers’ reaction to events, they, as significant providers of equity, were much more regularly consulted by fund managers. This is discussed under “communication with investors” later in this report. As such, larger investors appear to have felt adequately represented without independents. It should be noted, as discussed also in the same section on communication, that smaller investors were more likely to feel marginalised and therefore placed greater importance on this. Larger investors, although they might be broadly indifferent to the appointment of an independent voice, did not see it as a negative feature if it did not restrict their direct access to management.

Although there were specific instances identified in the interviews where the fund managers’ ability to act was restricted by the terms of fund documentation or regulation, in the majority of cases for the significant actions taken by fund managers during both the boom and the subsequent crash, the key driver appears to have been decisions (or lack of them) taken by the fund managers.

Were you prevented from taking steps you wished to by fund documentation or other contractual relationships?

(Source: PwC SURVEY QUESTION)

Yes	No
42%	58%

The general question of what managers were permitted to do under the fund documentation for both open and closed-ended funds, and the extent to which investors understood this, also raises questions for investors about their level of understanding of fund documents. The general question of investor sophistication has been discussed above. This is, however, also important in considering the broad question of homogeneity versus diversity that has been raised already in this report. One possible conclusion from the period of volatility is that there is greater need for standardisation and definition. For example INREV, the European Association for investors in non-listed real estate funds, has sought to define fund types and fund strategy. However, many funds do not fit easily within these definitions and, as outlined earlier in this report, the increasing diversity of investor strategies and other factors may well

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make this even more of a feature in future. The more that funds do not fit into neatly defined boxes, the more important it is that investors read the fund documentation and fully understand the characteristics of the vehicles into which they are investing.

As has been indicated already, the ultimate judgement on fund managers' performance during the period of volatility will be delivered by investors voting with their feet. However, this will play out over a significant period of time. There are obstacles to rapid changes in either open or closed-ended funds. In the case of the former, the costs of redeeming through the operation of the bid-offer spread create significant friction to the exit of capital. In the case of closed-ended funds, investors' capital is tied up for the life of the fund. Although in many cases the investors can collectively remove the fund manager or bring the fund to an end, this power has only very occasionally been used in practice. Investor dissatisfaction with individual fund managers has not translated into much short-term action. However, it is clear from interviews with both fund managers and investors that there will be a longer-term impact as investors place new capital. They will be highly selective as to the managers that receive allocations.

Fund managers of all types of fund face a more general challenge in responding to the changing requirements of investors. A number of interviewees commented that in the future investors will want:

- Lower gearing
- Lower risk
- A greater focus on income

Responding to this change in sentiment is relatively straightforward when new open or closed-ended funds are being established, but is potentially challenging for existing vehicles. How does a fund with a perpetual life go about changing its strategy? As with other aspects covered by this report, there is unlikely to be unanimity of view amongst investors. Fund managers need to find a route that treats all investors fairly. As with many other aspects of this report, transparency in decision making, clarity of communication and representation

of smaller investors, for example through independent board members, will be important.

5. Issues specific to open-ended funds

As discussed earlier in this report, for all funds there is a trade-off between liquidity, volatility, performance and risk. For open-ended funds the unique feature is that liquidity is provided by investors joining and leaving funds through the fund life, rather than by trading their interests with a buyer and seller. This exposes the manager to a much higher degree of direct involvement in the process of managing liquidity. Although much of the media and other attention has focused on how managers acted in the downturn and how they managed the outflow of funds, how managers dealt with the inflow of funds is also important.

Were changes made to the arrangements for investors entering or leaving the funds?
(Source: PwC SURVEY QUESTION)

Yes	No
53%	47%

Some of the media coverage suggested that investors were caught unawares by the suspension of redemptions by open-ended funds. Interviews suggest that institutional investors were well aware of the provisions allowing redemptions to be suspended, and indeed expected such action. It is worth bearing in mind that in considering the balance between investors wishing to redeem and those wishing to remain invested, the majority wished to remain invested. The detail of how open-ended funds suspended redemptions is dealt with below. In general when the choice was between selling assets in a falling market and maintaining redemptions, the majority of institutional investors supported suspension. The key issue for investors was generally not whether or not suspension occurred, but the individual circumstances giving rise to

suspension, the way in which the decision was taken and the way in which communication was handled.

Some managers interviewed commented that the industry could have acted more collaboratively to find a solution to some of the issues in managing the process of dealing with redemptions and the decision as to whether or not to suspend. However, others saw this as an opportunity to differentiate themselves through their behaviour, so a collaborative approach was unlikely in practice. The issues faced by funds (and how they dealt with them) were highly fund-specific, as were investors' reactions. In many ways the key question is the extent to which investors will, in future, differentiate between behaviours by fund managers in response to the downturn.

As discussed earlier in this report, there is a fundamental issue for open-ended funds in preserving fairness between investors in a fund and those wishing to leave or join. A combination of factors contributed to a sense of unfairness among some investors, in particular:

- The mechanisms used, particularly bid-offer spread, are complicated and may not have been fully understood by investors. The lack of understanding is not helped by the fact that some of the terms used are not clearly defined or are defined in a different way when applied to other asset classes. A useful exercise that AREF could undertake would be to assist in standardising terminology by producing an AREF glossary of definitions, or adapting that already produced by INREV.
- There was a perceived lack of clarity as to how fund managers took decisions, resulting in a concern among investors that arbitrary changes were being made;

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- As previously discussed, fee arrangements for open-funded funds reward the fund manager for maximising Assets Under Management. The manager has a vested interest in maximising inflows and minimising outflows. This perceived conflict of interest added to the concerns of investors.

The way in which subscription and redemption provisions operate in open-ended funds varies significantly. Fund documents set out the timing and the pricing mechanisms for investors leaving and joining funds.

- The ability of investors to switch between open-ended funds is restricted by the cost of moving capital. The cost of buying units is greater than the cost at which they can be redeemed (the bid-offer spread). There is no standard formula for calculating this bid offer spread, although in theory all fund managers were reflecting the cost of buying and selling assets, i.e. estimates of future costs of acquisition and disposal.
- In many cases investors, who did not understand the basis of calculation and were not able to compare different pricing models, did not appreciate the minutiae. As a result, investors questioned the fairness of pricing.
- The fundamental question is whether the pricing should reflect just the expected costs of disposal and acquisition, or also anticipated rises and falls in the value of assets. In a rapidly rising or falling market, there might be significant moves in asset values between the time that cash comes in and the point at which investment assets can be acquired. In most, but not all cases, this was addressed by using the value at the date at which the investor joined or left the fund. In the minority of instances where this was not the case, there was sometimes an attempt to address this through the bid-offer spread. This added to the difficulty of comparing one bid-offer spread to another, and also added to the perception among some investors that the rules were being changed in a somewhat arbitrary manner to benefit the fund manager.
- Many bid-offer spread calculations do not reflect the effect of gearing. Costs are based on Gross Asset Value, not Net Asset Value.

- Interviewees identified two situations that potentially magnified the problems of subscriptions and redemptions in a rapidly rising or falling market:

- The value at which investors are redeemed. One particular issue identified from both the manager and the investors' side was a situation where the value at which investors would enter or leave the fund would be set at the time when investors gave their notice rather than the date at which their cash was drawn or paid out. Investors joining or leaving the fund would do so at a price that is based on the Net Asset Value at the date of the request rather than the date of the redemption or issue of units. This was a particular problem in a rapidly falling market in which assets were being sold to meet redemptions. Those redeeming were being paid out at a higher value than was being received from the disposal of assets. Not only did this create a sense of unfairness amongst remaining investors, there was a concern among those interviewed that investors were more likely to redeem in this situation as they had greater certainty as to the proceeds that they would receive. The situation could therefore lead to a downward spiral of redemptions.

- The second scenario identified that would potentially magnify the problem was the use of debt to fund redemptions. Again, this would potentially result in remaining investors losing out to those exiting in a rapidly falling market in which assets were being sold to meet redemptions. If loans were taken out so that investors could be repaid earlier than the disposal of assets, then falls in value between then and the actual disposal would be a cost to the remaining investors, even though the disposals were ultimately to fund redemptions. Based upon the interviews conducted, fund managers borrowing to fund redemptions only did so in situations where the disposal price of the assets being sold to meet redemptions had been agreed, but the sale had not completed. The use of debt to fund redemptions would potentially have a significant impact, so might be expected to be a focus of attention for investors during due diligence in the future.

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- If fund managers are to adopt a more sophisticated and transparent approach to the operation of the bid-offer spread, as with other areas covered by this report, good behaviour needs to be rewarded by investors. One fund manager commented that they had spent a considerable amount of effort preparing a sophisticated pricing model, but that this was not understood or appreciated by investors.
- It is also important to note that there is a secondary market in interests in both open-ended and closed-ended funds. In the case of an open-ended fund, investors acquiring an interest through a secondary transaction will avoid the costs associated with the bid offer spread. Statistics regarding subscriptions and redemptions in open-ended funds do not therefore reflect the full amount of movement in investors. Fund managers had assisted in maintaining a secondary market in fund interests in return for charging a commission. This has reduced somewhat as new entrants have joined the market as brokers. Investment bankers and agency firms have established teams acting as brokers for interests in open and closed-ended funds.

Issues around controlling money coming in

As discussed earlier in this report, although the interviews identified specific instances where the fund managers' ability to take the action that they felt was appropriate was restricted by the terms of fund documentation or regulation, in the majority of cases for the significant actions taken by fund managers during both the boom and the subsequent crash, the key driver appears to have been decisions (or lack of them) taken by the fund managers. This appears to be particularly the case for the flow of capital into funds, as fund documentation is generally less detailed on the provisions for money coming in compared to the provisions for money coming out.

The disconnect between those raising money and those investing it has already been discussed earlier in this report. A number of those interviewed commented that the relationship between the fund manager and the investor varies across the spectrum of different fund managers and different investors. In dealing with more sophisticated institutional investors, the fund manager will often have a very direct relationship. Both the fund manager and the

investor see it as part of the role of the manager to advise as to the state of the market. Many fund managers interviewed commented that as the market reached its peak, they were advising their institutional clients that it was not a good time to invest. Where there is not that direct relationship, this is more difficult. From the interviews with managers, a number of specific issues were identified:

- As indicated earlier in this report, interviewees cited situations where there was a disconnect within the same broad organisation. An example cited was the situation of the many fund managers who are primarily investing capital managed by the parent business (for example some fund managers owned by insurance companies). The imperative of the parent is to raise money, and often property is the easiest product to sell. Some of those interviewed commented that although they were concerned about the level of capital being invested at the peak of the cycle in 2006 and early 2007, they were nervous about making the case too vociferously as it was clearly not the message that the parent company wanted to hear. There is, however, reason to believe that this will be less of an issue in the future, for two reasons:
 - The subsequent liquidity crisis and the problems encountered by open-ended funds in dealing with their own consequential liquidity crisis have focused attention on the dangers of unrestrained equity raising.
 - Perhaps more importantly, prior to 2007 many fund managers lacked formal processes for addressing volatile markets. In the crisis and, in particular, facing the issue of whether or not to suspend redemptions, many fund managers established committees or working groups with representation from a broad range of stakeholders within the organisation, including from the compliance and distribution teams, as well as the investment professionals. This created a much greater sense of collective decision-making. Although some organisations disbanded these groups when the market recovered, in others these have remained. This has helped to ensure that managers who raise concerns that the market may be overheating are supported by this being a

collective decision. A more clearly defined decision-making process assists in transparency with investors more generally. This is an important area and AREF could assist by encouraging further debate between fund managers and investors, and by providing further guidance to members.

The mechanisms by which entry to funds may be restricted or discouraged follow two broad approaches: pricing and rationing.

- As far as pricing is concerned, the general approach of bid-offer spread has been discussed above. In funds where a single price is used, the cost of transacting is reflected through swing pricing. After Net Asset Value is calculated, the amount is reduced or increased by an amount to reflect transaction costs. The direction of swing is determined by whether money is flowing in or out. If the fund is experiencing net inflows, the NAV is adjusted upwards. If the fund's dealings for the specified period generate a net outflow, the NAV is adjusted downwards. As such it is not in concept dramatically different from bid-offer dual pricing. In both cases, the detail lies in how the cost of transacting is calculated. With single pricing, an alternative to swing pricing is the use of a dilution levy. With all of the pricing methods, the key issue in terms of investor perception was not that one pricing method was seen to be inherently unfair in comparison to others, but that changes were made to the calculation of expected transaction costs. Investors were unhappy that changes were made to the pricing in the face of redemptions, in particular, as discussed above, to reflect anticipated falls in the value of assets. Adverse investor reaction was therefore primarily in reaction to the mechanism being used to discourage exit from rather than entry to the funds. This is discussed further below.
- Restriction of inflows was more widely achieved through rationing, through waiting lists to delay entry to funds, through scaling back investors' requests or by being selective as to which investors to accept.
 - The use of waiting lists raises issues regarding the behaviour of both fund managers and investors. The way in which fund managers operated waiting lists varied considerably, both in terms

of the formality of the process and the length of time which investors were held in queues. In terms of formality, it is also significant that some fund managers allowed investors to remove themselves from the queue if they chose to do so. At the other end of the spectrum, some subscription forms do not have a longstop date, such that investors were joining a queue with the prospect that the wait could, in theory, be indefinite. The uncertainty over the duration of queues and the option in some cases to withdraw encouraged some investors to join multiple queues, withdrawing once they had deployed sufficient capital. This in turn created further uncertainty for fund managers.

- In open-ended funds exclusively for institutional investors, it is possible to have investors make commitments to invest that are only drawn as specific investments are identified. This is not practical for products for retail investors (or indeed for smaller institutions where the individual investment amounts are small). In cases where a commitment basis is not operated, capital needs to be invested into the funds and held as cash until assets in which to invest are identified. Where institutions are investing on a commitment basis, it is possible for the manager to manage short-term acquisition liquidity through a credit line secured over the undrawn commitments. This is widespread in closed-ended funds but is much more unusual in open-ended funds.
- As indicated above, fund managers also scaled back investors' applications, either permanently or as part of the process of managing the queue. The decision as to whether or not to scale back and by how much was a decision by the manager rather than by set formula. In the vast majority of cases the scaling back was pro-rata, either across all investors waiting to enter the fund or across those next in the queue who had subscribed at the same point. In the latter case, the scaling back was generally a deferral.
- The issue of selectivity is a more difficult one. Generally fund managers felt that they had not been selective between investors

when scaling back investments or managing the queue. However, there were instances where managers cited challenges:

- There is a natural tendency to favour those clients with which the manager has a long-standing relationship, particularly if the investor is applying pressure to be allowed to make the full investment that they want in the fund;
- A number of fund managers commented that part of their strategy going forward is to ensure that a higher proportion of the investors in the fund are more “sticky” money that is likely to be invested with a longer time horizon. Whilst this generally means a greater focus on raising money from more passive investors rather than discouraging more active investors, it would be understandable if managers also exercised selectivity as to who was allowed in.
- One of the lessons learnt from the period of volatility is the impact that it can have on a fund if a major investor significantly reduces or withdraws their capital. A number of fund managers commented that they wished to have a more diverse investor base to address this. One fund manager commented that they had been concerned by the level of investment that an investor wanted to make, relative to the overall size of the fund. The manager discussed this with the prospective investor, who agreed to scale back their investment.

If it is accepted that it is part of the role of the fund manager to control the inflow of money when the market is overpriced in a rising market, it does raise a question as to why this should not be applicable if the market is still overpriced in a falling market where the fund manager is facing redemptions. To the extent that the fund has used its available cash to meet redemptions and is facing further net redemptions, there is clearly a strong vested interest in raising new capital rather than becoming a forced seller of assets or suspending redemptions.

Based on the comments received during the interviews, many fund managers felt that lessons had been learnt from the consequences of the capital inflows in 2005, 2006 and early 2007, with the result that in 2009 fund managers took in less in cash, operated waiting lists etc. However, as indicated above, this was not universal and there were very substantial inflows at the end of 2009 in particular.

As discussed earlier in this report, whether some fund managers are regarded as having managed inflows better than others will ultimately be decided by investors placing their capital in the future. The view that large inflows are generally followed by poorer performance is almost universally held by those interviewed. Greater transparency about the process of managing inflows and how decisions are taken would help new investors to funds, but would also help to provide reassurance to the existing investors who are the ones being diluted by inflows.

Issues around controlling money flowing out

Although, as mentioned above, the provisions for money going out were generally set out in more detail in the trust instruments than the provisions for money coming in, in general the broad mechanisms were the same, i.e. through pricing and rationing as above. The pricing and queuing mechanisms discussed already switched into reverse as funds faced net outflows. However, there are two significant areas where actions taken by fund managers caused investors to question the fairness of treatment.

- In some cases fund managers changed the pricing mechanism to increase the cost to investors of exiting funds. Although the fund managers concerned may argue that there were good reasons for the changes and that they reflect dramatically changed and unanticipated circumstances, it was regarded as a source of unfairness by many investors;
- In dealing with outflows, fund managers faced the more fundamental decision as to whether or not to suspend redemptions from funds entirely. This is discussed in more detail below.

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As discussed earlier in this report, there is a fundamental issue for open-ended funds in preserving fairness between investors in a fund and those wishing to leave or join. Suspending redemptions so that investors cannot leave is the most extreme step in setting aside the interests of investors who wish to leave to protect the position of those who want to remain. It is therefore a highly contentious area for which there is no “right” or “wrong” answer. The process by which the decision was reached therefore involved the fund manager taking into consideration a broad range of stakeholders, including the affected investors. There are a number of considerations to be taken into account in trying to assess how well the manager handled this, both in terms of the decision as to whether or not to suspend redemptions and the timing of the decision.

- Fund managers were strongly motivated to avoid suspending redemptions, because of the risk of reputational damage. Because of the severity of the circumstances and the widespread use of suspension, the reputational damage at an individual level may not have been as severe as managers anticipated at the time. Furthermore, with the benefit of hindsight, a number of fund managers interviewed who did suspend said that if they had realised that they would ultimately end up suspending, they would have taken the decision to do so earlier.
- Managers entered the downturn and the significant increase in the number of redemptions with widely differing amounts of cash available to fund redemptions. The point at which they were required to start selling assets to meet redemptions therefore also varied significantly.
- There is always a price at which assets can be sold. The suggestion that fund managers could not sell assets to meet redemptions is highly questionable. Managers (and other stakeholders as discussed below) took the view that the disposal of assets in an illiquid market where the only available buyers were bargain-hunters would adversely affect future performance and the interests of remaining investors.
- As discussed earlier in this report, the fee structure for managers in open-ended funds is significantly, or, in many cases, entirely a function of Assets Under Management. The manager is therefore not in an

independent position and has a vested interest in discouraging investors from leaving the fund.

- Even at the point where redemptions reached their maximum, the majority of investors wanted to remain invested. At any given point, it was only a minority that wished to redeem their units and exit. In terms of support for the manager’s decision to suspend redemptions, the majority who were ongoing investors benefited from the decision to suspend, whereas the investors who wished to leave and found themselves blocked were a minority but were materially affected. The fact that the decision to suspend redemptions was supported by the majority of investors does not in itself mean that all investors were treated fairly. The position of the minority may in some circumstances need to be protected against the decisions of the majority.
- Conversely, some fund managers interviewed took the view that suspension was essential to ensure the continuity of the fund. If the fund was unable to meet redemptions within the timetable specified within the fund documentation, the alternative to suspending redemption was to wind up the fund. In such circumstances suspension was necessary to allow the fund to continue for those investors who wanted to remain invested. Just as the position of the minority may in some circumstances need to be protected against the decisions of the majority, the position of the majority may in some circumstances need to be protected against the decisions of the minority.
- The decision as to whether or not to suspend and the timing of that decision was highly fund-specific. It was dependent on the individual circumstances of the fund and the judgement exercised by the fund manager. As indicated earlier, the ultimate assessment of that judgement call will be made by investors and evidenced by the decision as to with which fund managers they choose to deploy their capital in the future.

Fund managers will be judged not only upon the decision reached and its timing, but also on process, in particular:

- How was the decision reached?

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- How good was the communication between the fund manager and investors before and after the decision?

As indicated above, there was a broad recognition amongst fund managers of the importance of engaging an extensive range of stakeholders in the decision-making process. Most managers engaged in extensive formal and informal communication with major institutional investors. Communication with investors is discussed in greater detail later in this report.

A reaction of many fund managers to the stresses arising from the liquidity crisis, and in particular the decision as to whether or not to suspend redemptions, has been to improve engagement with a broader range of stakeholders within the organisation. Decisions were not taken by the individual fund manager and investment team in isolation. As has been indicated previously, many fund managers established committees or working groups with representation from a broad range of stakeholders within the organisation. Composition of these groups varied from manager to manager but might include as well as investment professionals, the Chief Financial Officer and the Chief Operating Officer, and representatives from the compliance and distribution teams. The establishment of broader stakeholder groups created a much greater sense of collective decision-making.

The decision as to the timing and choice of assets to sell is in the hands of the fund manager. When assets need to be sold in a falling and illiquid market to meet redemptions, there is a question as to which assets the fund manager should sell. Prime assets with good quality tenants were expected to hold their value better in the long term, but were also more liquid and easier to sell in the short term. Valuations were regarded as less reliable on poorer quality assets, and the pricing achieved in practice reflected the lack of willing buyers.

In view of the significant difficulties experienced in managing the challenging conflicting demands of investors, and also to help allay fears of the managers' own vested interests prevailing over those of investors, greater attention should be given to the role that could be played by independent directors or advisers. Although not adopted widely, such a step would potentially help with communication, transparency and independence and provide reassurance to investors at a time when they are nervous and risk averse. At a minimum the

advantages and disadvantages should be debated in the real estate funds industry.

As indicated above, the final assessment as to whether fund managers dealt appropriately with the outflow of funds and, in particular, decisions as to whether or not to suspend redemptions, will be made by investors and reflected in where they choose to deploy their capital in future. It should therefore be assumed that investors will consider the fund manager's performance on key aspects of this:

- How well prepared for the downturn and liquidity crisis was the manager?
 - How effectively had the manager controlled inflows in the run up to the crisis?
 - Had they anticipated an increase in redemptions and built up cash reserves within the fund to put it in a stronger position to cope with outflows?
 - How liquid were the fund's underlying assets?
- How well did the manager cope with the decision as to whether or not to suspend redemptions?
 - Did the manager implement a decision-making process that ensured the engagement of a broad range of stakeholders?
 - How good was communication?
 - Did the investor agree with the decision taken?
- Did the manager learn from the experience and are the changes introduced continuing?

6. *Issues specific to closed-ended funds*

In the UK, and within the AREF member funds in particular, closed-ended funds tend to invest in more specialist property types. Outside the UK, this is less exclusively the case, and closed-ended funds with more general investment strategies also exist. In the UK and AREF context, it is therefore important to distinguish between issues that arise because the investment is in a more niche property type and those that arise because of more general features of a closed-ended product. It is also worth noting that as a function of this, investors in closed-ended funds tend to be more sophisticated institutional investors.

It is not only managers of open-ended funds who feel pressure to invest. Managers of closed-ended funds also face a pressure to invest once capital has been provided or committed. Depending upon the timing of the fund-raising this may not be the best time in the cycle. Many closed-ended funds operate on a capital committed basis rather than collecting in cash on day one. Investors commit to provide capital when requested by the fund manager during a fixed investment period. Although the trigger for calculating internal rate of return for calculating the manager's performance occurs only at the point the capital is drawn down, there is still an understandable pressure to invest within the allotted investment / commitment period of the fund, rather than never drawing the cash. Many fund managers commented on the pressure to invest from investors who had made commitments, even though in 2006 and 2007 many fund managers had identified that the market was reaching the high point.

Other closed-ended funds, particularly those with a less institutional investor base, drew funds from investors at the outset, holding them as cash and liquid investments until opportunities to invest arose. The drag on performance created further pressure to invest. Arguably, this is no different from open-ended funds. However, closed-ended funds are more likely to have performance fees for the manager based upon the time value of money, increasing the impact on the manager's return of the drag effect of holding cash.

Relatively higher levels of gearing in closed-ended funds magnified the unfortunate consequences of investing at the top rather than the bottom of the market. How funds generally dealt with issues of debt is discussed in more detail below. As has been discussed already, the weight of capital chasing available assets pushed up prices. In order to remain competitive during the boom, fund managers of closed-ended funds became increasingly dependent on maximising the amount of debt used to fund acquisitions.

The timing of raising and deploying capital is clearly key in the closed-ended fund environment. The trade-off for the lack of liquidity in closed-ended funds is the expectation of higher returns. In a more challenging environment, there is an open question as to where those returns will be found. One view expressed by an interviewee was that the closed-ended fund should not be a permanent feature of the market. Closed-ended funds should only be raised when the circumstances are appropriate. This also raises the question as to how long the commitment period for a closed-ended fund should remain open. There are arguments for both a longer commitment period and a shorter commitment period.

- The argument for a longer investment period (generally favoured by fund managers) is that this reduces the pressure on the fund manager to try to deploy capital more quickly. Generally closed-ended funds using a commitment basis of capital draw-down are investing in the higher risk, more complex assets in the value-added or opportunistic part of the investment spectrum. As such, the fund manager needs to evaluate a larger number of investments before selecting those with which to proceed, transactions are more complex and there may need to be draw-downs of capital over a period of time to complete the investment.
- The argument for a shorter investment period (generally favoured by investors) is that the success or failure of the closed-ended fund model is

very specific to the time at which the investment is made. The longer the commitment period is left open, the greater the risk that circumstances will have changed by the time the capital is drawn. The assumptions made by the fund manager may no longer be valid, and the investor may have better opportunities to deploy the capital with other managers with a different real estate strategy or indeed in different asset classes entirely. Investors are increasingly focused on the relative performance of the different vintages of their investments.

This also raises questions about the role of closed-ended funds in a market that many commentators believe may well be less strongly cyclical for the foreseeable future as the effects of a weak economy dampen recovery. If the role of the closed-ended fund is simply to buy assets at the bottom of the cycle and to sell them at the top, then the next few years could be very challenging. As indicated above, taking the view that closed-ended funds should only be raised when the circumstances are appropriate, it would be possible to argue that the next few years do not represent an attractive period to be operating a closed-ended fund. The alternative view is that the role of the closed-ended fund is not merely cyclical but provides the fund manager with a fixed period with investors' capital to exploit opportunities that require more active asset management. Those who take this view believe that the next few years will present precisely the environment in which closed-ended funds are likely to thrive. Investors will want to understand the skill-set and track record of the fund manager.

Dealing with issues of debt highlighted many of the potential drawbacks of the closed-ended fund model. As discussed above, some fund managers had identified in advance the risk of a fall in the market and the pressure that this would put on loan-to-value covenants. Some interviewees commented that they had drawn capital from investors prior to the collapse in the market specifically to be able to repay debt. The funds that found themselves in particular difficulty were those which had high levels of debt and were beyond their commitment period and therefore the fund manager could not rely on being able to draw down additional capital. Although much rarer, there were apparently also instances of fund managers who were within the commitment period but had investors who were unwilling or unable to meet their obligations.

As discussed above, closed-ended funds are inherently illiquid investments. Investors sign up for a fixed period of time, generally on a commitment basis. Funds are drawn when opportunities are identified by the fund manager and are returned as investments are realised. Although it is possible to exit a closed-ended fund by selling a fund interest on the secondary market, in practice this proved challenging. At the height of the crisis, interests in closed-ended funds could only be sold at very substantial discounts. The market has recovered significantly since then, particularly as this has become a more recognised opportunity with new investors entering the market. Behaviour of both investors and fund managers has also changed:

- Some fund managers are now taking a more active role in assisting investors to dispose of interests in closed-ended funds. As has been discussed above, fund managers in open-ended funds have traditionally assisted in secondary transactions between investors, an attractive proposition from the perspective of the investors as it avoids the cost of the bid-offer spread. Recent years have seen an increasing trend towards investment banks, agents and boutiques operating as brokers for a secondary market in both open and closed-ended funds. Fund managers are in some cases seeing the advantages in assisting investors to undertake secondary transactions, not through the desire to charge a commission, as was the case historically with managers of open-ended funds, but in order to keep investors who need to reduce their positions happy so that they will invest in future funds, and to have some input into the choice of incoming investors. As has been mentioned already, the non-alignment of interest between investors was in some cases a major issue. It is therefore very much in the interest of the fund manager to try to manage the process to bring in like-minded investors. When the market was at its lowest ebb and there were few investors in the market, this was not really possible, but as the market has recovered, some greater selectivity is in theory possible, although the primary concern of the outgoing investor will generally be price, particularly if they are selling down their entire position.
- Other steps that fund managers are taking in terms of improving governance and transparency are also making it easier and less

financially penal to sell fund interests as new buyers are able to get a much clearer idea of what they are acquiring;

- The increased due diligence process conducted by institutional investors on the way into funds, discussed in section 10 below, will also help to facilitate the exit if they seek to sell on the secondary market.

As has been mentioned above, many of those interviewed commented on the issues of non-alignment of interest in the closed-ended fund model. This was both non-alignment of interest between the fund manager and the investors and the non-alignment of interest between investors.

- As has been discussed above, timing is crucial in the closed-ended fund model, and the use of debt increases the risk associated with getting the timing wrong. Investors are highly dependent on the manager making the right judgement calls in respect of timing. Some fund managers managed to get this right and deliver very strong returns, whereas others got it terribly wrong, wiping out investors' equity. Interviewees primarily commented on non-alignment of interest between the general partner and the limited partners in the context of the way that performance was rewarded. This is discussed later in this report. There is a broader question as to whether fund managers made the wrong call because they were insufficiently incentivised or whether it was caused by a lack of expertise and judgement. As has already been mentioned, in the future, investors will pay a much greater level of attention to both reward structure and also the manager's track record on key judgement calls. In the long term, this will play out through investors voting with their feet and deploying capital with those managers who best match their expectations. What is perhaps more surprising is that despite the perceived non-alignment of interest between investors and managers, there have been relatively few instances of investors acting together to replace fund managers.
- The non-alignment of interest between investors was in some cases a major issue. Disagreements between investors were regarded as more heated and intractable than disagreements between the investors and the fund manager. In situations where new equity needed to be raised to

remedy loan-to-value covenant breaches, some investors were prepared to subscribe for new capital, whereas others were unwilling or unable to do the same. The closed-ended fund model is inherently inflexible and dependent upon timing. The risks are compounded by the use of debt. When things go well, investors benefit from the strong performance. In some cases through anticipation by the fund managers and others perhaps more by luck, some funds were in a stronger position than others when the market turned severely. When fund managers buy at the wrong point in the property cycle and the consequences are magnified through the use of debt, the closed-ended fund model is not designed to facilitate the raising of new equity to remedy the situation. Attempts to do so varied in their effectiveness, but particularly exposed the significant differences between investors.

Have you extended the investment/commitment period or life of the funds? (Source: PwC SURVEY QUESTION)

Yes	No
73%	27%

As discussed above, the key issue for closed-ended funds is timing. Both the investment period and the life of the fund are generally fixed. Gearing accentuates the importance of timing, but the more crucial point is that the model relies on buying and selling assets at the optimal time, which may be restricted by both the time limits for investing and for realisations. Extreme movements in the property cycle resulted in funds under pressure to buy at the top of the market and to sell at the bottom. To mitigate this, fund managers sought extensions to both, with nearly three-quarters of respondents indicating that they had extended the investment/commitment period or the life of the funds. As well as general extensions to the investment/commitment period, fund managers were also required in some cases to negotiate one-off increases in capital outside the investment period to deal with loan-to-value covenant breaches.

Such extensions, particularly in fund life, often had challenging fee implications. Investors generally saw a reduction of fees as part of the

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compensation for an extension in the life of the fund, at a time when many managers were facing a situation with carried interest under water and little financial incentive to continue. At the same time, some of the provisions of the extensions to fund life involved additional costs, for example from the requirement to introduce independent directors. Again, the reaction of investors varied. Matters that were referred to as positives in interviews with investors were:

- The quality and promptness of information disseminated by the fund manager. Those who discussed issues early and provided high-quality written information and presentations were praised by investors;
- Consultation, for example through a committee or discussions with investors prior to the Extra-Ordinary General meeting to take the formal decision to prolong;
- The introduction of more supervision independent of the manager, with larger investors favouring more investor representation and smaller ones more independent directors.

Although these points were generally raised in the context of managing situations outside the normal operation of the fund – extensions to the fund life and dealing with debt – they do reflect the changing priorities of investors. These are therefore likely to be points that are significant when new funds are raised in the future. The last three years have seen few new closed-ended funds raised, and therefore much of the interaction between managers and investors has been in respect of the resolution of historical matters. As new funds are raised, managers are likely to find that investors' demands in respect of governance and transparency have become significantly greater. Fund managers of other asset classes, particularly hedge funds, have made significant progress in this area, and the real estate fund management industry needs to ensure that it responds too. Investors have regarded closed-ended funds as lagging behind the institutional open-ended funds in terms of transparency.

7. Constraints to behaviour

Did remuneration structures, either corporate or individual, influence behaviour (positively or negatively)? (Source: PwC SURVEY QUESTION)

Yes	No
32%	68%

The question of what is alignment of interest and how it is achieved has been a major topic of discussion in the real estate industry, particularly amongst investors in geared, closed-ended funds. It is a contentious area and there is not a consensus of view either among fund managers or investors. Although the majority of respondents believed that remuneration did not influence behaviour, it should be noted that:

- Investors were much more likely than fund managers to believe that remuneration had influenced behaviour during the period of volatility;
- There was a view expressed by a number of investors and some fund managers that remuneration should influence behaviour. Alignment of interest between investors and fund managers would be better achieved if the remuneration structure clearly rewarded behaviour that was regarded as positive by investors. Whether or not fund managers agree with this, it would seem that a perception of lack of alignment of interest provides an opportunity for those fund managers who are able to combine a more imaginative reward structure with greater transparency in this area.

In the closed-ended fund model, it is difficult to escape the requirement that managers are rewarded based upon performance. Investors' capital is tied up

for a fixed period of time, and they do not have the option to vote with their feet and move their capital elsewhere if they are unhappy with the performance of the fund. The extreme measure of removing the fund manager has only been used very infrequently, although one of the investors interviewed for this survey had been involved in one fund manager removal and was anticipating a second. In the future, the ability to remove the fund manager without cause is likely to be one of the areas where fund managers are going to face greater pressure from investors when negotiating fund documentation.

For open-ended funds views differ. In theory, performance-related fees should be unnecessary as investors can move their capital. Capital would move from poorer performing funds to better performing funds. However:

- There are significant transaction costs on entering and leaving funds, so investors are reluctant to move capital frequently to chase better returns;
- Real estate as an investment asset may take a significant time to deliver its returns. It is difficult to identify in the very short term whether a fund manager is performing badly or well;

In an open-ended fund, performance needs to be based upon valuation rather than exclusively realisation, as is possible in a closed-ended environment. Investors interviewed expressed reservations about performance fees based upon valuation of assets.

Much of the focus of investors has been on whether performance fees and co-investment should be by the fund manager or by the key individuals. In the private equity real estate model there is increasing focus on individual co-investment. This is far less common among the real estate fund managers that are part of larger, more traditional investment management houses from which much of the AREF membership is drawn. The general view of investors in

private-equity style real estate funds was that individual co-investment was a positive feature, and ensured greater alignment of interest. In particular, co-investment is seen as ensuring that the fund manager and the individuals share in the risk of loss, to match the benefits from out-performance through carried-interest and other performance-related fees. However, it should be noted that:

- Support among investors for individual co-investment was not universal. There was a minority view that when problems arose in funds, individual co-investment by the management proved to be a distraction. Individuals at the fund manager were more focused on dealing with their own financial position than on the position of investors. This was a minority view.
- Investors expressed concern at the difficulty in separating individual co-investment from co-investment by the fund management house, particularly where the individual co-investment is funded by loans from the house. Investors indicated that they would in future be undertaking more comprehensive due diligence on individual co-investment arrangements to ensure that it is genuinely the individuals who face the exposure in the event of a loss, rather than the loss passing back to the fund management company.
- There is uncertainty as to what is an appropriate level of individual co-investment. In interviews for this project and more generally, investors have expressed the view that the target amount should not be a particular percentage, but is an amount that is material relative to the individual's personal wealth. However, there was uncertainty from both investors and managers as to what this means in practice. Implicit within this approach is a high degree of disclosure and transparency regarding both remuneration arrangements and personal wealth.
- Individual co-investment would seem to be generally impractical in an open-ended fund model – it would not be reasonable to expect individuals to have co-investment in a vehicle where it would be tied up in perpetuity.

As discussed above, there is a general question regarding the role of the fund manager in an open-ended fund. Is it the role of the fund manager to decide when to invest, or is it just the role of the fund manager to invest to the best of his or her ability at the time when investors want to invest? This question is debated earlier in this paper, but there are clearly implications for how performance is measured and rewarded. Buying assets at the top of the market in 2006 would have an adverse effect on performance measured in absolute terms, for example by reference to Internal Rate of Return, as is usual for closed-ended opportunity funds. For open-ended funds where assets are regularly revalued, the timing of acquisition should in theory have less of an impact on the subsequent performance of investments made by an investor at the same time. For performance over a year, the clock is in theory reset at the start of the year based upon valuation. There is a concern that valuations lag the market in a rapidly rising market and that assets bought in 2006 would be at a different start point to those owned and revalued in 2006.

Many of the fund managers interviewed expressed concern at the concept of a reward structure where individuals received performance-related reward based exclusively on the short-term performance of an individual fund. It would appear from the interviews with investors that it is far from clear that this is what investors want in any case. It would seem that there is an opportunity for fund managers to create a greater alignment of interest between individual employees and investors through a more nuanced approach than this. There is an opportunity to win the confidence of investors through greater transparency over how staff are rewarded and by demonstrating that individual performance is measured against a balanced score card of metrics.

What is an appropriate reward structure for both the fund manager and the individuals involved will differ for different fund styles and the risk/return profile of the fund. Although there is a clear concern among investors that reward and alignment of interest is a key question, the views of investors vary as to what the answer is – there is not a fixed view of what is the best way of rewarding behaviour. As such, what is appropriate is likely to be highly fund specific. As indicated above, this would seem to offer an opportunity for product innovation and differentiation for those fund managers which are able to combine a more imaginative reward structure with greater transparency in this area.

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The other key aspect of remuneration planning is staff retention. It was apparent from a number of the interviews with both fund managers and investors that loss of key staff from fund managers was a significant issue for some investors. Although many managers were keen to emphasise that investors should be selecting based on the fund management house rather than the individuals, this was not necessarily a view shared by investors. Ensuring staff continuity is clearly an important point, and being able to articulate a convincing history and approach would seem to be a differentiator in providing reassurance to investors.

Did regulation restrict your behaviour? (Source: PwC SURVEY QUESTION)

Yes	No
37%	63%

Although over one-third of respondents indicated that regulation had restricted behaviour, other than for Authorised Unit Trusts this was generally not considered a major issue. This contrasted with experiences of fund managers with products in other countries, in particular Germany.

In view of the well-publicised problems faced by the German open-ended funds industry, it is worth considering the German regulatory issues that have accentuated the problems. Under German regulation, funds are not allowed to dispose of assets at below book value. Unfortunately the German valuation methodology results in valuation lagging significantly behind the market. In a falling market, this resulted in book values exceeding market values. The regulations already mentioned effectively prevented German open-ended funds from disposing of assets to meet redemption requests. This inherent inflexibility contrasted with the much more flexible regulatory position of UK funds.

As mentioned above, Authorised Unit Trusts faced a more restrictive regulatory position than unauthorised vehicles. In particular, the regime limits the ability of managers to place restrictions on investors entering the funds.

A number of interviewees commented on the impending new regulations for fund managers, in particular the European Union Alternative Investment Fund Managers Directive. The consensus view of respondents was that although these will impose an additional burden on fund managers, they will not broadly change behaviour.

As discussed earlier in this report, retail investors are less sophisticated than institutional investors, a fact that is reflected in the more stringent regulatory environment for retail products. The point was raised in interviews as to whether there should be even greater regulation and protection for retail investors. As discussed previously, some additional protection for retail investors will be provided by increased regulation of IFAs.

8. Valuation

The period of volatility in real estate values has exposed the role of third-party valuers to particular scrutiny. Underlying real estate valuations play a significant role in other areas dealt with in this report. In particular:

- They feed through to fund valuations that are prepared as the basis for the issue and redemption of units for open-ended funds. If the valuations exceed the true market value, then new investors joining the fund will overpay for their units and those redeeming will be overpaid. The robustness and timeliness of third-party valuations is therefore crucial.
- Fund valuations are also relevant for performance measurement for open-ended funds and for those closed-ended funds that measure performance based on valuations rather than exclusively cash returns from realisations.
- Third-party valuations are an essential element of reporting to lenders, determining whether funds have breached loan to value covenants.

Valuers faced challenges in both a rapidly rising market and a rapidly falling market. As the market fell the challenges were magnified by the paucity of available transactions to be used for benchmarking valuations, particularly for secondary property. This was reflected in the extensive caveating of valuation opinions as the market fell most severely. With the valuation process having returned to normal, fund managers interviewed as part of this process seemed reasonably relaxed at present. However, it is worth remembering that at the time this was a huge source of concern. As indicated above, valuations are crucial to key aspects of the real estate funds model, particularly the ongoing pricing of open-ended funds. Uncertainty over the reliability of third-party valuations went to the heart of the pricing model.

Views amongst those interviewed varied as to whether valuations were lagging the market or running ahead of the market as valuers attempted to anticipate a rapidly moving market. As indicated above, valuation was particularly difficult for the most illiquid assets. Although transactions continued and recovered for very prime assets with long leases and good covenant strength tenants, this was not the case for assets of poorer quality than this. This created a significant problem for valuers in placing reliable values on such assets. According to those interviewed, when funds attempted to dispose of such assets, the price achievable on the market was found in many cases to be significantly below the most recent valuation. As discussed above, this had an impact in the treatment of departing investors relative to those investors wishing to remain.

As discussed elsewhere in this report, fund-of-funds (as well as some direct property funds) held interests in closed-ended property funds. At the point at which property values were falling most sharply, the secondary market for closed-ended fund interests proved to be particularly illiquid and fund interests were trading at a very significant discount, although pricing has since recovered. As has been highlighted earlier in this report, this was a particular issue for open-ended funds holding closed-ended funds as an investment. It was also cited in interviews as one of the areas of particular difficulty due to the lack of a standard approach, as discussed below. Closed-ended funds also typically value their assets less frequently than open-ended funds. Although less common, in some cases assets are not valued by third party valuers, or assets are carried at historic cost until disposal.

Did you change the frequency or other aspects of valuation of underlying assets?

(Source: PwC SURVEY QUESTION)

Yes	No
47%	53%

Many fund managers of open-ended vehicles increased the frequency of valuations during the period of volatility, as might well be expected. At the period of greatest instability there were instances cited of fund managers moving to fortnightly valuations. Although this was a temporary measure at the peak of the crisis, and has not been continued, the period of volatility has continued the process that was already underway of moving to more frequent valuations.

Based on the comments made during interviews, fund managers did not change instructions to valuers. A number of interviewees cited issues regarding the valuation of specific assets for which guidance would be desirable:

- Indirect investment in other funds;
- Mark-to-market of debt;
- Investment in property derivatives.

Of these, the treatment of indirect investment in other funds is an area that has previously been considered by an AREF working party, although at that time no definite conclusions were reached. As these issues seem to remain a concern of those interviewed, it would appear worth reconsidering both the original points and also developments since 2008.

9. Debt

The issue of debt and how fund managers dealt with it in both the upturn and the downturn is a contentious topic. As indicated earlier in this report, readily available debt was a key feature of the pre-2007 boom, and some interviewees felt that the boom was fuelled by debt. With the ready availability of debt and the competition for available assets, closed-ended fund managers in particular faced significant pressure to borrow to enhance returns to remain competitive to buy assets. In some cases, the risk of borrowing appeared not to be a consideration – the trade-off for the manager was between the amount that could be borrowed and the need to deploy capital from investors. As loan-to-value ratios increased, as did the pressure on closed-ended fund managers to borrow, the amount of investor capital deployed for each acquisition fell. Fund managers found themselves buying more and more assets in order to invest the capital committed by investors.

The liquidity crisis saw a reversal of the ready availability of debt that had been a key feature of the preceding boom. Furthermore, the rapid fall in real estate values resulted in many borrowers breaching loan-to-value covenants. This was a particular issue for closed-ended funds as they tended generally to operate with higher levels of gearing than open-ended funds, and also, once outside the period during which the fund documents prescribe that investments can be made, do not have the flexibility to draw down additional funds from investors to remedy the breaches. Many borrowers, including real estate funds, were caught in a trap of loans maturing and loan-to-value covenants being breached as a result of falling values at the same time as the supply of new debt to refinance dried up and raising new equity also proved to be highly problematic.

Some interviewees felt that over-borrowing was the fundamental problem of the crisis, and that otherwise fundamentally sound deals were undermined by the impact of excessive borrowing. Although assets that had fallen in value might have had time to recover in value had they not been submerged by debt, it is worth remembering that the impact of gearing is to magnify rather than to

change what is happening. Gearing increases the profitability of a good deal and increases the losses on a poor one. Gearing does not turn a good deal into a bad one.

There are lessons to be learnt from the impact of debt during the period of volatility, but it is more complex than a simple message of excessive borrowing. This is discussed in more detail in the rest of this section below.

*Have loans taken out by the funds you manage breached loan-to-value or other covenants?
(Source: PwC SURVEY QUESTION)*

Yes	No
47%	53%

Approximately half of the respondents surveyed indicated that loans taken out by the funds that they managed breach loan-to-value or other covenants. However, to put this into context, it is important to note that many managers of AREF funds manage funds with only relatively low levels of gearing. A more general survey of fund managers may well have resulted in a higher proportion with loans that breached covenants.

It was apparent from interviews with both fund managers and investors that some fund managers had identified in advance the risk of a fall in the market, and the pressure that this would put on loan-to-value covenants, and had taken steps to draw down additional capital from investors to pay down debt. Clearly for those who had not anticipated to the same extent or were not in a position to draw down from investors, the situation was more precarious. The extent of the problem also depended upon the way in which the fund borrowed. In some

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cases the assets were ring-fenced in separate Special Purpose Vehicles, such that lending was not cross-collateralised across the fund. In other cases loan-to-value and other covenant breaches caused a default across the whole fund. In the latter situation, the manager did not have the option of walking away from assets in breach.

In many cases, debt issues were resolved with the lenders without the need to raise additional equity. However, in situations where new equity did need to be raised, some of the limitations of the closed-ended fund model became apparent.

Many of those interviewed, fund managers and investors, commented on the lack of alignment of interest between investors when new equity had to be raised to remedy breaches of loan covenants. As previously mentioned, the key issue arose when new equity needed to be raised outside the commitment period. Not all of the investors were able or willing to provide new equity, and there was therefore a challenge in determining a fair price for the new equity that struck a balance between rewarding those prepared to fund and not diluting punitively those who could not or would not. As with many other aspects of dealing with the consequences of the volatility, transparency seems to have been key.

Some fund managers appointed independent advisers to manage the process, both in terms of raising new capital and also in leading the negotiations with the banks, as the fund manager was felt to have too many vested interests. More generally, the feedback from both managers and investors was that early and comprehensive disclosure of the extent of the problem was appreciated by investors. What is less clear is whether good behaviour in respect of disclosure will be rewarded and bad behaviour punished when new funds are raised in the future, or whether investors will just look at the ultimate outcome.

There was a general consensus among both fund managers and investors that investors had become more risk averse, and that in future funds would operate with lower levels of debt. The phrase regularly used was “modest levels of debt”. What was harder to ascertain was what investors would regard as modest, with views differing. It also raises a number of further questions that suggest that this is a more complex issue than simply looking at loan-to-value ratios:

- Borrowing is riskier at the top of the market than at the bottom. The suggestion was made by some interviewees that gearing levels should be variable across the cycle. This has potential appeal and, if it can be clearly articulated and mechanisms for operating it in practice can be devised, would seem to offer another element of product differentiation to attract investors.
- As indicated previously, closed-ended funds suffer from the inability to go back to investors to raise new equity to remedy loan-to-value covenant breaches and other issues that arose outside the commitment period for the fund. This prompted some to suggest that fund documentation should allow managers to be able to raise new capital. This, however, raises a number of other issues and starts to undermine the whole rationale of the closed-ended funds model. As views among managers and investors vary, it would seem to be an area where the best option is to allow the market to create the products. Investors will decide by deploying their capital in the funds that have the characteristics that appeal.
- There is a broad question as to the appropriateness of gearing for open-ended funds. The potential issues from the use of debt to fund redemptions were discussed earlier in this report. However there is a broader question about the use of debt in open-ended funds. The ability of investors to request the return of their equity is inherently incompatible with the management of borrowing. On the other hand, the ability to draw down new equity from investors avoids some of the issues associated with the closed-ended fund model and, as discussed above, the timescale over which investors can withdraw their capital in open-ended and semi-open-ended funds varies significantly. As with many other areas covered in this report, a variety of offering, giving investors the opportunity to vote with their feet, would seem to be the best outcome.

The overall conclusion regarding debt is that this is a complex area to which there are generally not “right” and “wrong” answers. Choice and transparency would seem to be key, such that investors can place their money in the products that most closely align to their specific requirements. As outlined elsewhere in this report, the trade-off between liquidity, volatility, performance and risk is

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an area that should be further debated. The impact of debt on this is an important aspect of this discussion.

10. Communication with investors

*Have there been changes to the frequency and/or nature of communication with investors?
(Source: PwC SURVEY QUESTION)*

Yes	No
63%	37%

Although a small minority of fund managers commented that their communication with investors had always been exemplary and that they therefore had nothing to change, the majority of managers felt that they had significantly improved the quality and quantity of communications with investors as they dealt with the stresses created by the crisis. Worryingly, this view was not shared by a number of the investors interviewed, who felt that in many cases the managers had concentrated on providing quantity rather than quality. It was commented that the volume of information provided was impeding rather than improving clarity, although fund managers could well argue that they are simply providing what investors are requesting. Conversely, investors commented that they were positively inclined towards those fund managers who were perceived as improving the clarity of their communication.

The most significant changes in communication were not in respect of formal quarterly reporting, but in other areas. There was a consensus among interviewees, both from the manager and the investor side, that:

- Institutional investors and consultants have become significantly more demanding during the due diligence process, and are asking for much more information than was the case in the past.

- There is a particular focus from investors on how the manager conducts its business, with operational due diligence becoming more prevalent. Understandably, in light of some of the problems encountered by fund managers, there is a much greater focus on risk management, governance controls etc. A number of managers interviewed commented on the role taken by INREV in this area.
- There is a concern from fund managers as to how useful the due diligence process is for investors. Extensive questionnaires and checklists are a useful way of gathering information, but to be of merit, investors and their advisers need to apply rigorous thought as to what they do with it. There is a risk of not being able to see the wood for the trees. As indicated earlier in this report, there are a number of conflicting demands that investors and fund managers need to juggle. In particular, as has been discussed, there is the trade-off between liquidity, volatility, performance and risk. As fund managers strive to meet investors' demands for transparency, it is equally legitimate for fund managers to expect transparency from investors and clarity as to how the due diligence process supports the investors' ability to make a decision on this key area of trade-off.
- Managers have increased the amount of informal communication outside the formal quarterly reporting regime. A number of managers interviewed commented that they had introduced new forms of communication with investors, such as conference calls, newsletters and such like. Comments from investors interviewed suggest that this is a welcome development, particularly where investors only had a relatively small investment in a fund and might otherwise feel excluded;

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- There is a significantly greater demand from investors for one-to-one communication. Fund managers interviewed indicated that they had made significant steps to accommodate this and were spending much greater amounts of time on one-to-one communication with investors. This is not without risk and fund managers need to take care that:
 - All investors receive the same communications (see below).
 - Smaller investors do not feel excluded by the process.
- As with many of the other areas discussed, those interviewed believed that many of the changes made during the period of volatility in respect of the provision of information to investors would be maintained, although there was a widespread view that the amount of information might diminish over time as fund managers developed a better understanding of what investors need.
- Interviews with investors suggested that this is an area that is regarded as important. One investor cited the case of a fund manager which it felt had dramatically improved its performance in this area, noting that for this particular fund manager, which the investor had regarded as previously weak in this area:
 - Property level information is now much more detailed. This is important, as this is an area where managers indicated in interviews that they were uncomfortable about where to draw the line, managing a difficult balancing act between keeping investors informed and not disclosing commercially sensitive information.
 - Fund level financial information is now excellent.
 - The clarity of disclosure had improved dramatically. The investor cited the example of disclosure of the debt position for underlying investments where, in addition to the narrative, the manager had introduced a green/amber/red traffic light presentation that made review very easy.

- From the perspective of the fund manager, the crucial question is whether the effort put into improving communication has actually made a difference to investors. Based upon the interviews, both managers and investors recognise that some fund managers have made greater steps than others in improving communication. Those fund managers that have made significant strides to improve feel that this is generally appreciated by investors, a view that is supported by the interviews with investors themselves. What is less clear is whether or not this will feed through to a change in behaviour – how far will investors move their capital to those fund managers that are better at communicating?

Were changes requested by investors? (Source: PwC SURVEY QUESTION)

Yes	No
37%	63%

The majority of fund managers felt that they had taken the initiative in improving communication with investors, rather than waiting to be pushed. This was not always a view shared by investors.

Did all investors receive the same communications? (Source: PwC SURVEY QUESTION)

Yes	No
94%	6%

As would be expected, in view of the requirements of treating customers fairly, fund managers and investors believed that in the vast majority of cases, all investors received the same communications. However, as indicated already above, in view of the increasing volume of direct communication with investors separately, managers need to take great care in this area.

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A number of managers commented on the difficulty of communicating with retail investors. In particular, concern was expressed over the flow of information through IFAs. This has been discussed earlier in this report. Potentially, the introduction of new regulation governing IFAs, and the requirement for greater training, may help. However, it was also acknowledged by some interviewed that the quality of information provided to retail investors lagged behind that provided to institutions, so there is also potentially more that fund managers could and should do.

Marketing material is also an important element of communication with investors. As discussed elsewhere in this report, the messages from investment teams were felt not always to be consistent with the messages from marketing teams. In many cases, in determining what went out to investors and prospective investors, it was felt that it was the views of the marketing teams that prevailed. As discussed elsewhere in this report, high-profile marketing to prospective investors has an impact not only on the manager concerned, but potentially on the real estate funds industry as a whole, particularly with retail investors.

11. The Association of Real Estate Funds

There are various points arising from this report that require further attention from AREF. Some suggestions are set out below. Respondents were asked two specific questions, the responses to which are set out below.

Are there areas of the AREF Code of Practice that you did not apply? (Source: PwC SURVEY QUESTION)

Yes	No
29%	71%

Generally the AREF Code Of Practice has been applied. Where the Code of Practice was not applied, in the majority of cases both fund managers and investors believed that the compulsory parts of the code had been applied, although best practice had not always been followed. One of the interesting observations from an investor was that at different points in the cycle, different parts of the Code of Practice become more relevant, and perhaps the emphasis should change. This would seem to be a good point for further discussion.

Would you have liked to have seen more guidance from AREF? (Source: PwC SURVEY QUESTION)

Yes	No
40%	60%

Generally those interviewed did not have strong views as to areas in which further guidance by AREF should have been provided. Some respondents particularly cited the decision for open-ended funds on suspending redemptions, however others saw this as a key area for exercise of judgement by

the fund manager, with those who dealt with this well achieving a competitive advantage over those that did not.

As has been discussed earlier in this report, for real estate funds there is a trade-off between liquidity, volatility, performance and risk. It was apparent from interviews with fund managers and investors that there is no “right” or “wrong” answer, with an increasing diversity of strategy and approach among investors. Fund managers need to provide investors with enough clarity as to strategy and the decision-making process so that investors understand the nature of the vehicle in which they are investing, and what judgement the manager is exercising in balancing these trade-offs. Whilst AREF could provide guidance, this would seem to be an area where fund managers would want to exploit the differences to achieve competitive advantage. It therefore seems to be a topic that is worth further public debate amongst AREF members and others. Within this general topic, there are four areas that would merit particular further attention:

- The fundamental issues that need to be considered for both the open-ended and closed-ended fund model. The range of fund vehicles already covers a spectrum, with funds that fall between the strict open and closed-ended model. The challenges in the downturn for open-ended funds of maintaining liquidity, and for closed-ended funds of raising capital outside the commitment period to meet loan-to-value covenant breaches, may encourage greater interest in hybrid vehicles with some of the characteristics of both.
- The implications of co-mingling retail and institutional investors in the same vehicle (for example as PAIFs become more widespread).
- The role of the fund manager in regulating inflows of capital. As discussed earlier in this report, there is an open question for managers

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dealing with both institutional and retail clients as to how far the manager is responsible for the inflow of capital, and if so how the mechanisms should be operated.

- All of these are important issues. The common theme that runs through them is the need for transparency with investors. AREF could assist by encouraging further debate between fund managers and investors, and by providing further guidance to members.

One area that could be improved without impinging upon the ability of fund managers to differentiate their products would be greater clarity over the meaning of key terms. This would appear to be particularly relevant with the impending changes for retail investors arising from the regulation of IFAs, but would also be useful for an increasingly diverse and international institutional investor base. Terms used by the UK real estate funds industry may have slightly different meanings or interpretations when applied to other asset classes, or outside the UK. AREF has a glossary of terms, but it is very high-level. A review and expansion of this would appear to be a useful exercise. INREV also has a comprehensive set of definitions as an appendix to its guidelines. It would seem sensible for any AREF review of definitions to also be used to feed in to INREV.

Further work on the impact of the Financial Services Authority's Retail Distribution Review on retail investors would appear to be useful. In particular it is worth investigating whether AREF could take a role in educating IFAs about real estate as an asset class.

Should AREF have taken a higher profile role in delivering key messages to the press? A number of interviewees commented that press coverage was unbalanced and unhelpful. This is a matter for AREF to consider and to discuss with members.

For both open-ended and closed-ended funds, there were key points where there was a perceived conflict of interest between the fund manager and the investors. This, too, would merit further discussion, to consider whether AREF guidance would be helpful, for example:

- If suspending redemptions in an open-ended fund or extending either the investment period or the life of a closed-ended fund, the manager should consider a reduction of fees as a gesture to minimise the perceived conflict of interest. Fee reductions of this nature appear to have been more widespread in the closed-end funds than open-ended ones.
- Greater use of independent representation as an important element of corporate governance. It is considered that this would help to minimise the perception of conflicts of interest. As discussed earlier in this report, larger investors are less concerned about this than smaller investors. However, ensuring that the voice of smaller investors is heard would be perceived as a positive. Exactly how fund managers respond to this should be a matter for individual decision. Investors can then decide if they like what they hear.

Appendix 1 – Funds behaviour

Interviewees

Andrew Smith	Aberdeen Property Investors
David Wise	Aegon Asset Management
Marcus Sperber	BlackRock Investment Mgt
Simon Edwards	Bradford Council Pension Scheme
Giles King	CBRE Investors
Bill Hackney	Cordea Savills
Peter Dove	Cording Group
Neil Cable	FIL Real Estate Investment Management Ltd.
Mervyn Howard	Grosvenor Fund Management
Mark Dampier	Hargreaves
Nick Evans	Henderson Global Investors Limited
Chris Matthew	Hermes Real Estate
Kevin Aitchison	ING Real Estate Investment Management
John Styles	Knight Frank
Simon Radford	Lothbury Investment Management Ltd.
Howard Meaney	LV= Asset Management

Interviewees

Nigel Smith	M and G
Rupert Sheldon	Palmer Capital Partners
Paul Dennis-Jones	Pramerica Real Estate Investors
Fiona Rowley / Nigel Smith	PRUPIM
James Petit	RREEF (UK) Ltd.
Graeme Rutter	Schroder Property Investment Management Limited
Ian Mason	Schroder Property Investment Management Limited
Mike Hannigan	Standard Life Investments
Gerry Ferguson	Scottish Widows Investment Partnership
Nick Cooper	The Townsend Group
Chris Morrogh	Threadneedle Property Investments Ltd.
Douglas Crawshaw	Towers Watson
Anthony Shayle	UBS Global Asset Management, Global Real Estate
Michael Barrie	L&G
Mark Burton	

Appendix 2 – AREF statistics



Quarter-end	Jun-98	Sep-98	Dec-98	Mar-99	Jun-99	Sep-99	Dec-99	Mar-00	Jun-00	Sep-00	Dec-00	Mar-01	Jun-01	Sep-01
Value (£'000) Existing Funds	5,213,728	5,376,310	5,576,652	5,611,407	5,924,323	6,041,037	6,073,444	6,416,960	6,681,956	6,854,199	7,095,548	7,204,606	7,222,354	7,285,697
Weighted Yield	5.93%	5.73%	5.73%	5.59%	5.52%	5.22%	5.08%	4.96%	4.91%	4.73%	4.95%	5.13%	5.57%	5.38%
Yield - High (top 1 %)	8.90%	8.90%	8.89%	8.84%	8.42%	8.09%	7.83%	7.63%	7.48%	7.58%	7.49%	7.60%	8.70%	7.77%
Yield - Low (bottom 1 %)	2.76%	2.76%	1.87%	2.31%	3.27%	3.18%	2.97%	3.33%	3.27%	3.34%	3.67%	3.63%	3.58%	3.65%
Yield - Mid	6.20%	6.13%	6.20%	5.49%	5.60%	5.21%	5.10%	5.39%	5.40%	4.93%	5.04%	5.18%	5.33%	5.32%
New Money Raised (£'000)	196,676	84,149	41,458	27,578	26,061	94,494	107,272	54,364	75,967	32,742	112,544	28,492	79,563	63,535
New Money Raised (£'000) Annually				349,861	179,245	189,591	255,405	282,191	332,097	270,345	275,617	249,746	253,342	284,135
Raised from new investors (£'000)	47,387	38,004	0	11,505	10,864	16,580	17,047	13,480	21,650	2,357	23,683	1,972	11,702	9,242
Raised from existing investors (£'000)	78,144	18,708	0	1,700	500	2,881	833	10,675	12,639	18,790	54,662	1,797	29,275	27,696
Unknown (£'000)	71,144	27,436	41,458	14,373	14,697	75,034	89,392	30,209	41,678	11,595	34,199	24,723	38,586	26,597
Redeemed (£'000) - Primary Market	7,637	93,649	67,973	69,846	9,121	3,840	29,826	64,946	100,049	86,786	62,111	35,762	46,687	42,783
Matched (£'000) - Secondary Market	23,453	32,808	27,269	100,530	46,876	66,702	37,562	28,609	159,510	85,762	141,090	86,901	105,672	131,332
Net flows	189,039	-9,500	-26,516	-42,268	16,940	90,654	77,446	-10,583	-24,082	-54,043	50,433	-7,270	32,877	20,752
Net flows annually				110,755	-61,344	38,810	142,772	174,457	133,435	-11,262	-38,275	-34,962	21,996	96,792
Number of Funds	-	-	27	25	25	25	26	26	26	26	26	26	27	27

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Quarter-end	Dec-01	Mar-02	Jun-02	Sep-02	Dec-02	Mar-03	Jun-03	Sep-03	Dec-03	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05
Value (£'000) Existing Funds	7,317,118	7,338,159	7,507,188	7,868,772	8,028,817	8,280,062	8,469,630	9,802,084	10,279,132	10,997,951	11,858,063	12,796,036	13,917,535	14,676,343
Weighted Yield	5.40%	5.17%	5.42%	4.91%	4.89%	4.86%	5.00%	4.86%	4.61%	4.75%	4.53%	4.38%	4.12%	4.09%
Yield - High (top 1 %)	7.75%	7.69%	7.50%	7.23%	6.90%	6.85%	7.56%	7.06%	7.00%	7.35%	6.64%	6.43%	6.37%	6.39%
Yield - Low (bottom 1 %)	3.98%	2.70%	3.28%	3.16%	3.11%	3.93%	3.93%	3.96%	2.38%	2.17%	2.22%	2.26%	1.79%	1.60%
Yield - Mid	5.34%	5.28%	5.35%	5.01%	5.00%	4.91%	5.06%	4.97%	4.82%	5.00%	4.77%	4.68%	4.48%	4.59%
New Money Raised (£'000)	59,385	89,611	147,008	198,807	153,020	64,620	121,661	107,805	304,903	443,921	485,309	477,447	434,615	525,482
New Money Raised (£'000) Annually	230,975	292,094	359,539	494,812	588,447	563,456	538,109	447,107	598,990	978,291	1,341,939	1,711,581	1,841,293	1,922,854
Raised from new investors (£'000)	30,080	8,346	74,969	83,245	43,442	18,442	52,745	20,010	51,128	67,831	139,269	133,128	39,841	108,072
Raised from existing investors (£'000)	10,523	17,034	61,839	56,206	49,623	14,492	35,468	71,549	198,557	201,108	146,216	148,188	134,054	91,375
Unknown (£'000)	18,781	64,231	10,200	59,356	59,955	31,687	33,448	16,247	55,218	174,983	199,824	196,131	260,720	326,035
Redeemed (£'000) - Primary Market	113,264	47,305	45,927	5,323	41,497	69,348	18,242	66,553	53,663	21,624	43,262	26,764	52,205	67,312
Matched (£'000) - Secondary Market	65,271	128,476	65,381	125,641	154,011	110,889	102,709	136,877	169,452	89,076	144,815	85,628	83,942	132,191
Net flows	-53,879	42,306	101,081	193,485	111,523	-4,727	103,419	41,253	251,240	422,297	442,047	450,684	382,410	458,170
Net flows annually	-7,520	42,055	110,260	282,992	448,394	401,361	403,698	251,467	391,184	818,208	1,156,837	1,566,268	1,697,437	1,733,311
Number of Funds	27	27	27	28	27	26	26	29	29	31	31	31	31	31

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Quarter-end	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08
Value (£'000) Existing Funds	15,280,829	13,841,620	19,276,101	27,431,649	29,756,944	36,306,787	37,966,403	43,164,374	44,222,884	43,079,389	37,088,161	34,946,918	32,912,310	30,004,146
Weighted Yield	4.06%	3.89%	3.80%	3.55%	3.43%	3.30%	3.26%	3.14%	3.09%	3.22%	3.55%	3.70%	4.10%	4.43%
Yield - High (top 1 %)	6.27%	5.89%	6.74%	6.22%	6.27%	6.30%	6.40%	7.24%	10.61%	8.38%	7.28%	8.50%	9.78%	11.31%
Yield - Low (bottom 1 %)	1.76%	2.03%	1.75%	1.28%	1.19%	0.99%	1.00%	0.64%	0.28%	0.00%	0.17%	0.23%	0.75%	1.80%
Yield - Mid	4.50%	4.40%	4.30%	3.94%	3.83%	3.70%	3.54%	3.51%	3.40%	3.56%	3.73%	3.93%	4.10%	4.32%
New Money Raised (£'000)	379,197	613,303	441,616	1,153,790	1,203,179	1,681,386	1,247,143	1,441,395	1,072,147	800,662	425,237	329,822	596,029	266,272
New Money Raised (£'000) Annually	1,816,742	1,952,598	1,959,599	2,587,906	3,411,888	4,479,971	5,285,499	5,573,104	5,442,071	4,561,347	3,739,441	2,627,867	2,151,749	1,617,360
Raised from new investors (£'000)	60,708	55,761	66,262	257,064	183,621	351,789	154,404	265,690	77,407	13,866	6,402	47,119	67,069	3,108
Raised from existing investors (£'000)	53,244	361,545	60,124	195,408	413,899	604,995	443,143	454,657	165,567	196,229	32,074	22,163	331,925	117,118
Unknown (£'000)	265,244	195,997	315,230	701,317	605,659	724,602	649,596	721,048	829,172	590,567	386,761	260,539	197,034	146,047
Redeemed (£'000) - Primary Market	65,834	52,590	249,705	200,398	297,810	181,441	134,522	324,312	631,703	939,337	1,651,022	817,621	556,808	802,469
Matched (£'000) - Secondary Market	145,792	171,439	120,468	335,169	317,269	440,517	147,586	224,607	373,154	231,525	55,128	116,402	247,515	60,326
Net flows	313,363	560,713	191,910	953,392	905,369	1,499,946	1,112,621	1,117,083	440,444	-138,675	-1,225,785	-487,799	39,221	-536,197
Net flows annually	1,604,626	1,714,656	1,524,157	2,019,378	2,611,385	3,550,617	4,471,327	4,635,019	4,170,093	2,531,473	193,067	-1,411,816	-1,813,039	-2,210,560
Number of Funds	30	28	41	52	54	56	57	62	63	63	64	63	64	66

**Unlisted funds –
Lessons from the crisis**



Quarter-end	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Value (£'000) Existing Funds	26,199,976	22,371,042	21,061,398	21,466,415	25,189,984	28,878,593	30,474,326	31,499,266	31,438,340	32,848,641	33,929,422	33,267,615
Weighted Yield	5.70%	6.14%	5.67%	5.01%	4.87%	4.60%	4.32%	4.21%	4.03%	4.37%	3.17%	2.16%
Yield - High (top 1 %)	16.61%	26.13%	16.74%	16.67%	16.13%	15.22%	13.57%	11.77%	10.63%	9.07%	9.18%	9.33%
Yield - Low (bottom 1 %)	2.62%	2.89%	0.04%	0.03%	0.12%	1.36%	0.50%	0.69%	0.82%	0.60%	0.00%	0.00%
Yield - Mid	5.33%	5.57%	5.84%	5.46%	4.89%	4.91%	4.59%	4.18%	4.03%	4.29%	3.87%	2.91%
New Money Raised (£'000)	567,269	185,589	320,397	704,401	3,241,714	1,955,261	1,368,669	752,569	686,646	412,972	609,265	470,847
New Money Raised (£'000) Annually	1,759,391	1,615,159	1,339,527	1,777,656	4,452,102	6,221,773	7,270,045	7,318,212	4,763,144	3,220,856	2,461,452	2,179,731
Raised from new investors (£'000)	49,857	82	59,258	91,837	282,965	418,059	383,579	148,499	133,454	40,056	52,726	49,765
Raised from existing investors (£'000)	337,272	28,351	60,233	138,750	364,284	321,268	352,926	151,335	180,149	63,414	145,238	221,989
Unknown (£'000)	180,139	157,157	200,906	473,814	2,594,466	1,215,934	632,164	452,735	373,043	309,502	411,301	199,093
Redeemed (£'000) - Primary Market	791,481	455,863	268,010	255,498	303,660	466,005	451,959	373,261	553,471	224,817	316,148	480,723
Matched (£'000) - Secondary Market	62,125	54,194	116,149	120,968	137,344	303,497	213,746	103,500	123,753	57,920	36,764	74,670
Net flows	-224,213	-270,274	52,387	448,903	2,938,055	1,489,255	916,710	379,308	133,175	188,155	293,117	-9,876
Net flows annually	-1,208,988	-991,463	-978,297	6,804	3,169,071	4,928,601	5,792,923	5,723,328	2,918,448	1,617,348	993,755	604,571
Number of Funds	67	67	67	67	65	66	66	68	65	66	66	64

Footnotes:

1. All information is provided on an NAV basis except for Norwich Property Trust which is on an offer price basis.
2. Cross holdings between funds have not been accounted for.



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