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Open-ended property funds for retail investors

Last week's announcement by M&G that it was planning to close its flagship real estate fund, the M&G Property Portfolio, has once again thrust funds for retail investors into the spotlight. As ever with media coverage of this topic, quite a bit of the commentary was off target. M&G Property Portfolio is another victim of the malaise that has afflicted the sector since the fund suspensions in the immediate aftermath of the EU referendum result in June 2016.

The problems of open-ended property funds for retail investors in 2016 were highly publicised. Property fund suspensions made the 10 o'clock news. Until that point it had been unusual for news about such funds to appear outside the innermost pages of the markets section of the Financial Times.

Following the suspensions, the FCA started investigations that resulted in a series of consultations and proposed legislative changes, the outcome of which is still awaited over seven years later. The Association of Real Estate Funds (AREF) also wanted to consider what had happened from the perspective of its member funds, appointing us to prepare an independent report, which was published in April 2017 as, *a review of real estate fund behaviour following the EU referendum.*


A review of real estate fund behaviour following the EU referendum

A report for The Association of Real Estate Funds

AREF

John Forbes

24th April 2017

https://www.johnforbesconsulting.co.uk/_files/ugd/9e8725_e51031edce53419ca8e072715385e669.pdf

We remain very strongly of the view that we expressed in 2017 that there is a role for open-ended funds for retail investors. However, a combination of regulation and the UK retail investment infrastructure restricts investors to a limited, daily-traded, "one-size-fits-all" choice. The FCA is keen to reform by introducing mandatory notice periods, so a different "one-size-fits-all" option. This may be suitable for some funds, but we believe that other approaches to managing liquidity should also be available. In particular, we think in many cases a model that allows deferral of redemptions by up to six months to allow assets to be sold but also allows that investors can be paid out earlier if there is available cash, or other investors wishing to subscribe, or assets are sold sooner. It seems irrational that if there is available cash, the fund has to sit on it for 90 or 180 days before it is returned to investors.

Some commentators have again suggested that there is no reason for open-ended funds for retail investors to exist as people can invest in REITs or in hybrid funds that combine listed and unlisted real estate. This is all every well, but not every investor wants to invest in REITs. Retail investors should have the choice, as is the case for their institutional counterparts.

The “one-size-fits-all” approach previously mooted by the FCA fails to recognise the nature of “retail” investment into property funds. The proportion of investment directly by individuals without coming through intermediaries in most funds is tiny. Most “retail” investment is through fund-of-funds and model portfolios offered by FCA regulated businesses. Regulation, in particular MiFID II, recognises the difference between advised and execution-only clients and that greater risk and complexity in investment products may be more appropriate for the former.

There are well-recognised impediments to reforming open-ended funds. In particular, the architecture of retail investment platforms needs to change, which will require significant investment. Platform operators will not make this investment until there is clarity as to the outcome of the FCA’s regulatory cogitations. As the funds wither away whilst waiting, the likelihood of any investment in the infrastructure diminishes. It does not help that the FCA, HMRC and the Treasury are in a Mexican standoff over the ISA rules. For many investors, ISA eligibility is a key consideration, so a regulatory change that would make property funds no longer an ISA-able investment is a major deterrent. The huge degree of reliance on platform architecture is an unintended consequence of the Retail Distribution Review (RDR), a fundamental overhaul of financial services legislation for retail investment advice that came into effect on 1st January 2013.

All that has been achieved by the prevaricating since 2017 has been a diminished choice for retail investors. We may have reached the point of no return for property funds. Alarmingly, we may be making the same mistakes with the new Long Term Asset Fund (LTAF).

John Forbes
22nd October 2023