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And then there were four…

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Wind-down of M&G Property Portfolio leaves just four retail funds – how did it come to this?

M&G launched its retail investor fund in 2005 as a growing crowd of retail investors clamoured to grow their exposure to the booming real estate market.

The fund, among others, promised real estate linked returns and daily liquidity in a new investment model that allowed everyone access the sector – and potentially opened it up to billions in new cash.

Despite the global recession three years later the retail funds continued to grow and in its heyday the sector's top 10 funds (depending on definitions) had more than £20bn under management.

But getting on for two decades on from its launch, M&G Property Portfolio is now to be wound down – leaving just four UK open-ended property funds for retail investors present in the market and many speculating that the sector has had its day.

A history lesson

Retail funds as we know them today in an open-ended structure were born off the back of reforms to wider property fund structures following the 1990s recession.

The idea behind them was sound: giving people access to real estate without the ups and downs of the equity market or the need to fork out the millions required to buy a single asset.

Of course, the issue that has been at the heart of their troubles in recent years was present from the very beginning: demanding daily liquidity on an illiquid asset. However, in a less high-tech era, liquidity issues were more manageable.

The sector grew rapidly as the property market recovered following the financial crisis. PAIF legislation was (re)launched in 2012 with the aim of allowing investors to receive gross income from investments alongside preferable tax treatments.

Then there was Brexit – and the beginning of the end.

As markets reeled, there was a run on one of the funds which made the news. This in turn sparked a wider panic and more and more investors demanded their money back. Problems that had not emerged in the aftermath of Lehman Brothers were suddenly far more acute, creating a downward spiral in confidence.

Without the cash reserves to cover the growing number of redemptions, first one then another fund suspended trading.

This in itself was not exceptional: the funds had been designed so they could suspend trading to have time to sell assets at the best possible price. Only one tried to meet liquidity requirements immediately – Aberdeen – and assets were sold at heavy discounts. It famously sold 10 Hammersmith Grove to Brockton for £89m in the wake of the crisis, who then flipped it for £103.5m a few months later to Tai United, who then sold it to Blue Horizons for £112m less than 12 months after that.

Listed REITs are the most obvious alternative to open-end property funds but many investors have gone elsewhere

The crisis of confidence shook the sector to its core and, despite the subsequent years of attempted reform, many saw it as the death knell for the

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sector. Some funds never really recovered. The Aviva Investors UK Property Fund, which remained suspended the longest after the EU referendum, shrank from £1.8bn at the time of the vote to less than £400m by 2020.

When the funds were suspended again during the Covid-19 epidemic – due to a technicality in valuation uncertainty rather than the volume of outflows – any remaining confidence evaporated. A stream of outflows became a torrent.

M&G's fund shrank in size by over £950m or 45% in a little less than 12 months.

Since then another six funds have announced closures or mergers, winding down and selling off assets. Excluding funds that are being wound down, just £3bn remains across four funds.

Reform

The years of decline gave ample opportunity for reform.

Following the 2016 crisis the FCA consulted on improvements, though this did not always help. It was the new FCA regulations that forced funds to suspend trading during the Covid pandemic – as they had breached rules which now said trading must be suspended when there was material uncertainty over the value more than 20% of assets.

Its current proposal, outlined in 2021, is for mandatory notice periods of 180 days for redemptions.

The suggested reforms proved unpopular. According to independent consultant John Forbes, they are a "one size fits all". One of the biggest issues is that investment platforms are currently not set up to handle notice periods.

Almost as unpopular as the proposals themselves is the fact that the FCA hasn't followed up on them, effectively leaving the industry in limbo. Fund managers are stingingly critical of the FCA and believe it shoulders a lot of the responsibility for the torrent of outflows in recent years. Most do so privately, but Columbia Threadneedle did so publicly in a recent update to investors.

"The FCA's consultation around a proposed introduction of a 90-to-180-day notice period for investor redemptions has been met with adversity. A formal announcement from the FCA is still awaited and this uncertainty continues to influence outflow."

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The FCA failure to act has not been helped by indecision between regulatory departments themselves, with what Forbes describes as a Mexican stand-off between the FCA, HMRC and Treasury about ISA rules. As the rules currently stand, open-ended property funds would no longer be permitted in ISAs were notice periods introduced.

Getting money back (into funds)

Even with reform, the challenge is in tempting retail money back into the market. The only other option open to investors is the REIT market, and as we explore elsewhere today, it has benefited to some extent although a lot of money has gone into other asset classes.

There is still a place for funds that give investors access to real estate without having to contend with the volatility of the stock market.

One potential avenue is creation of LTAFs – or Long Term Asset Funds – which, since launching earlier this year have been the great white hope of the sector – with Aviva, Schroders and BlackRock all taking the plunge. These open-ended vehicles have at least 50% of their assets in long-term, illiquid assets, but still offer some liquidity to meet trading requirements, notably for the defined contribution pension funds. The FCA is opening up access to retail investors, but, because LTAFs have notice periods, they are not currently eligible for ISAs and run into the issue of platforms demanding daily liquidity.

End of the road?

The reality is daily liquidity for illiquid assets does not work. Unless investors, regulators and platforms can embrace new models that give daily pricing, daily subscriptions but fixed or deferred redemptions then the remaining funds will continue to decline, and billions that could be invested via ISAs and pension pots will go elsewhere.

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