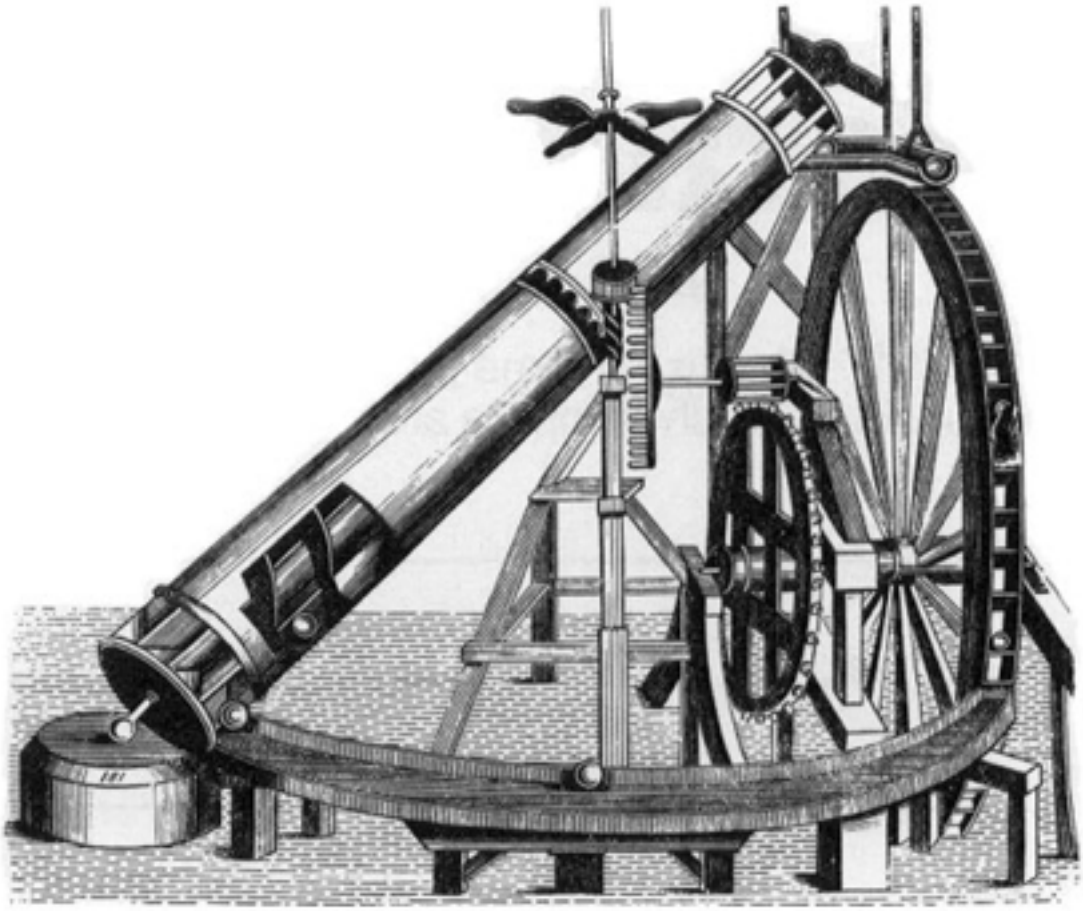
John Forbes

CONSULTING LLP

Designing real estate funds for DC pension investment

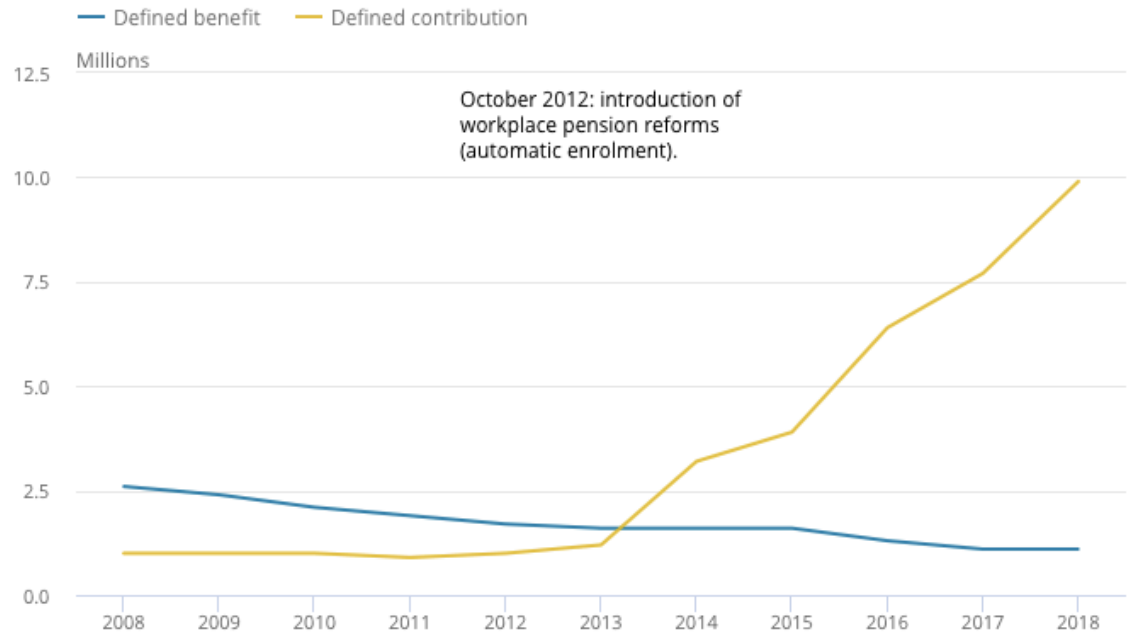


July 2020

This paper on designing real estate funds for DC pension investment is based principally on a presentation by John Forbes to a webinar for the Institute and Faculty of Actuaries on Thursday 9 July 2020, *Challenges of Including Illiquid assets in DC Pension Funds*, plus some elements covered in earlier presentations including *Illiquid assets in a world of electronic trading and platforms* by John Forbes of John Forbes Consulting LLP and Rob Martin of LGIM Real Assets at the Investment Property Forum 30th Anniversary Symposium in 2018.

Background

Recent years have seen a dramatic growth in the number of individuals in UK occupational defined contribution (DC) pension schemes. The following chart as at 2018 is from the most recent Office of National Statistics Occupational Pension Scheme Survey published in June 2019. The next update is due to be published in September 2020.



Source: Office for National Statistics - Occupational Pension Schemes Survey

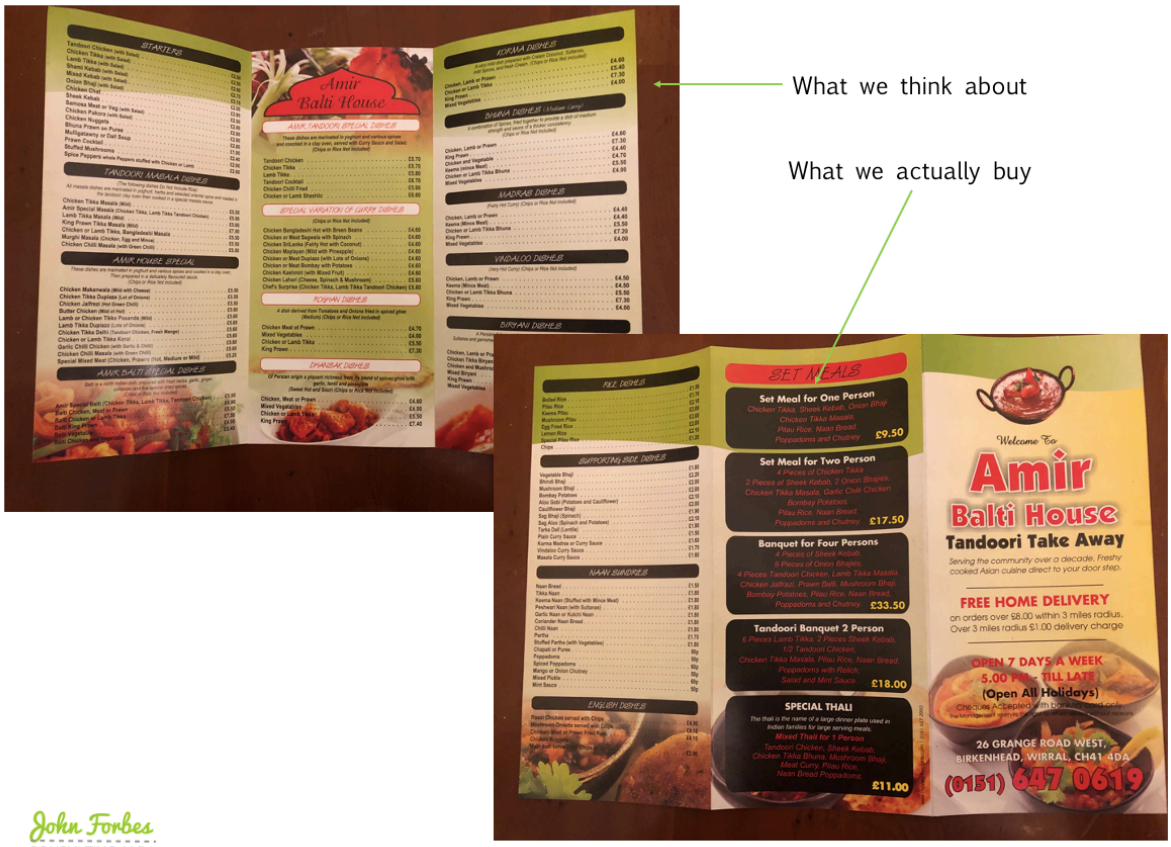
The development of the UK occupational DC market took a huge step forward in 2012 when auto enrolment into workplace pensions came into effect. The introduction was phased from October 2012 to February 2018. The National Employment Savings Trust (NEST) was set up as a trust-based, DC pension scheme for smaller employers unable to establish their own schemes. The ability of employers to pool their approach, but not the calculation of individual liabilities, also

moved forward with the development of “master trusts”, which were defined in the Pension Schemes Act 2017.

The individual nature of the assets and liabilities of current DC schemes, including master trusts, is an important one in considering illiquid assets and contrasts with the proposed treatment of collective DC, referred to in legislation as *collective money purchase schemes* and covered in the current Pensions Bill awaiting its second reading in the House of Commons at the time of writing this paper.

In current DC schemes, each individual member is regarded as holding their own individual assets. This is a key driver of the perceived requirement for assets to be priced on a daily basis and liquid on a daily basis, although as discussed further in this paper

In DC schemes, members can opt for the “default fund” or for “self select” investment options. In presentations for seminars, we like to illustrate this point with the menu from our favourite Indian take-away….

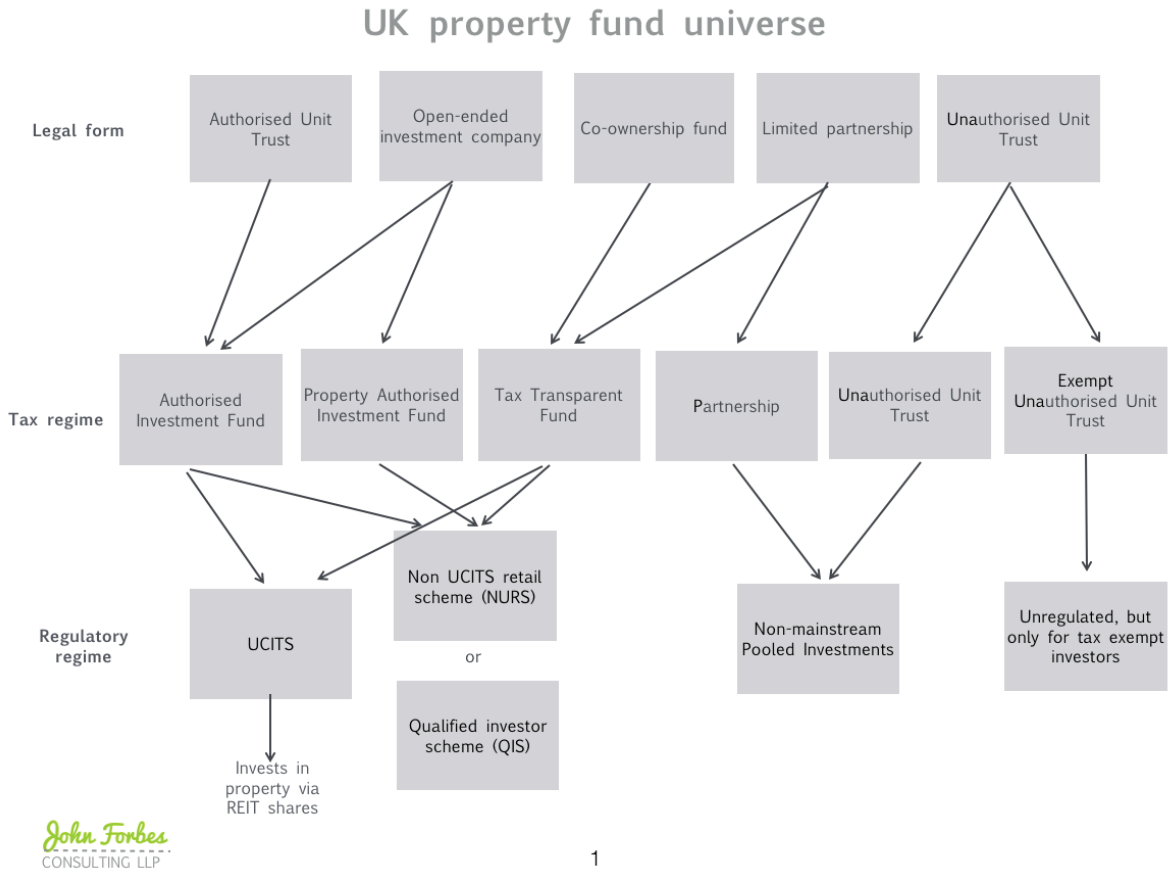


Although there are some exceptions, in the vast majority of DC schemes, almost all members pick the default option, the set meal for one. In considering investment in illiquid assets, including real estate, it is the default option that is key.

The UK property funds universe

We attempt here to map out the legal forms, tax and regulatory regimes that come together to create the UK real estate funds universe.

The apparent requirement for daily pricing and daily trading, which we return to later in this paper, drives DC investors in the direction of daily liquid models, so shares in REITs and daily traded property funds, particularly in the form of Non UCITS Retail Schemes (NURS), although this is not specifically required in regulation and has arguably become less compelling since the changes to the "permitted links" rules that came into effect in March of this year.

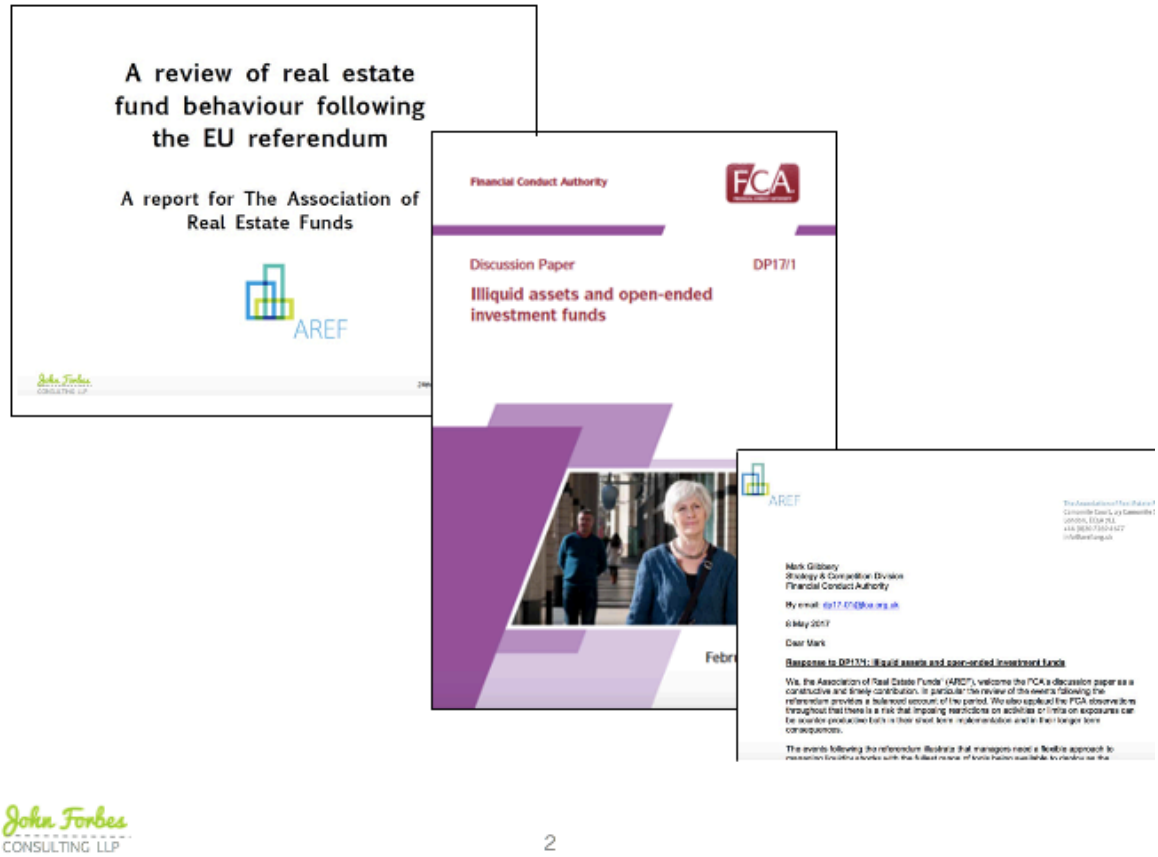


Fund behaviour after the EU referendum

In understanding the impact of the current choice of funds in the UK funds universe and the implications of liquidity and pricing, it is important to pick up some of the points that became apparent in the immediate aftermath of the EU referendum result.

Much of this was covered in our report for the Association of Real Estate Funds in 2017 looking at fund member behaviour in the aftermath of the referendum. You can find it here: http://www.johnforbesconsulting.co.uk/aref-fund-behaviour-final/

In parallel the FCA has also been conducted a prolonged process of consultations and changes to the rules for funds for retail investors, which is still ongoing.



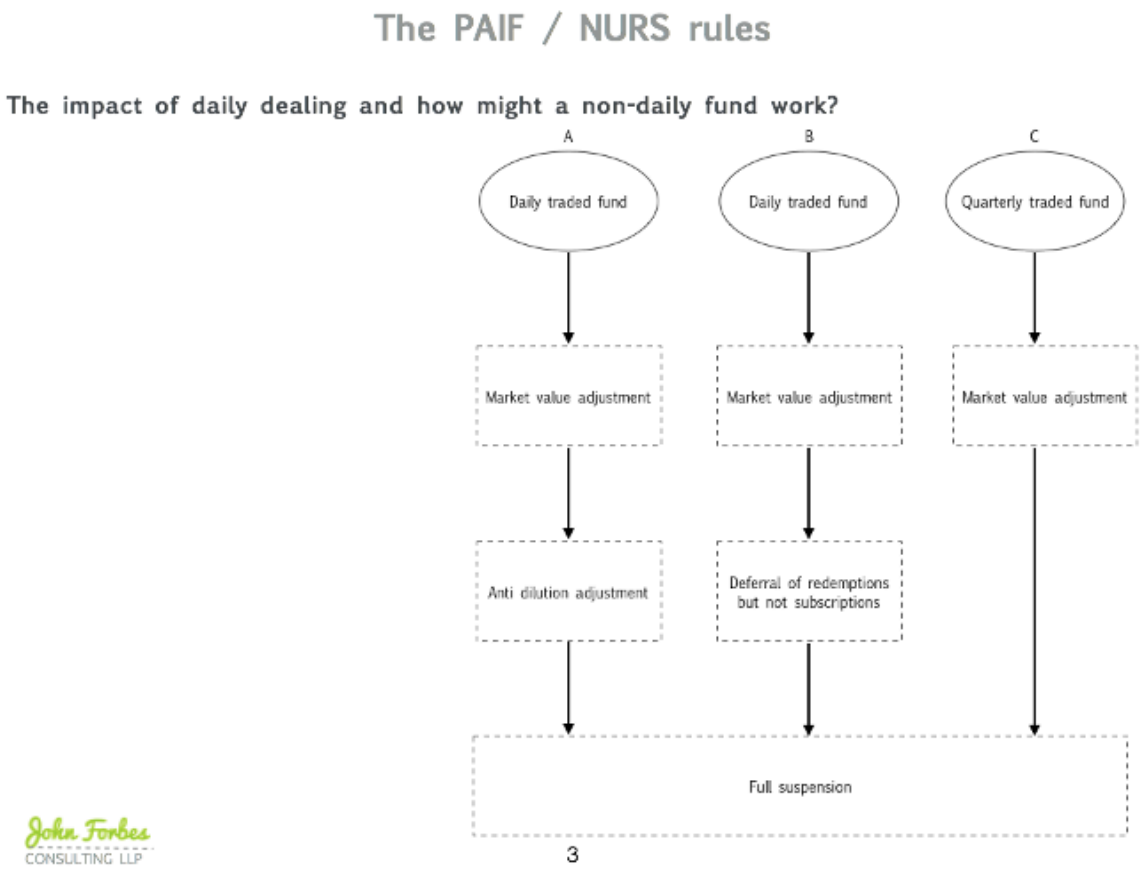
The Bank of England in its financial stability report in December 2019 had announced that would be further development of the regulation in this area by the FCA. In an online speech to the Investment Association the day before the presentation on which this paper is based, Christopher Woolard, Interim Chief Executive at the FCA, announced a further consultation. This is what he said:

While suspension is in the best interest of investors, this crisis, like the aftermath of the Brexit referendum, shows the difficulty for these funds of maintaining a promise of daily liquidity to investors when their assets are inherently illiquid.

There has been considerable discussion about how to ensure redemption arrangements offer a fair deal to those remaining in the fund as well as those who wish to exit. We will look to consult later this summer, in a genuinely open way, on whether long-term investor interests would be better served by finding a way in which these funds could safely transition to a structure in which liquidity promises to investors are better aligned with the liquidity of fund assets.

This paper does not consider the fund suspensions and pricing behaviour after the EU referendum although it is covered in detail in our report for anyone who is interested.

One of the points that is covered in our report is that the challenges for funds for retail investors are also common to unit linked insurance products and defined contribution pension schemes. The biggest shift in retail investment since the retail distribution review has been the growth in model portfolios development invested via online investment platforms. As with DC investment, the platform architecture has become the main driver of how the open-ended funds operate. The proposals for retail funds in our report on the EU referendum are, in our view, equally applicable for DC pension default funds. This is what we outlined as potential liquidity models:



This sets out three models, two of which offer daily redemptions, the third which does not. Typically, open-ended funds for institutional investors in which defined benefit pension schemes invest offer redemptions quarterly, two quarters in arrears which matches more closely the liquidity of the underlying assets. It would be entirely possible to have this for redemptions but maintain daily subscriptions and pricing.

The “market value adjustment” reflects what happens if the valuation of the underlying property assets has moved materially since the last valuation date. This is

what happened after the EU referendum result. Managers introduced market value adjustments to write down the Net asset value.

In our report, we envisaged fund managers adopting two different models to deal with high levels of redemptions, rather than moving to immediate suspension.

The first is what Aberdeen Asset management did which was to sell assets at substantial discount to market value to effect very rapid sales, but passing the impact of this to redeeming investors through an equivalent reduction in the redemption price. Those who need liquidity can get it, but with a hair cut. In the immediate aftermath of the referendum this was about the same as the hair cut suffered by owners of REIT shares who had to sell.

The second model does not guarantee daily liquidity. By deferring redemptions rather than suspending the fund, subscriptions and daily pricing are maintained and redeeming investors may be matched with incoming investors whilst assets are sold to meet redemptions. The major problem with this model is that the platform architecture cannot yet accommodate it and we are in a chicken and egg situation as to who will pay for the development.

These points are important in considering two key concerns for DC pension default schemes in respect of illiquid assets:

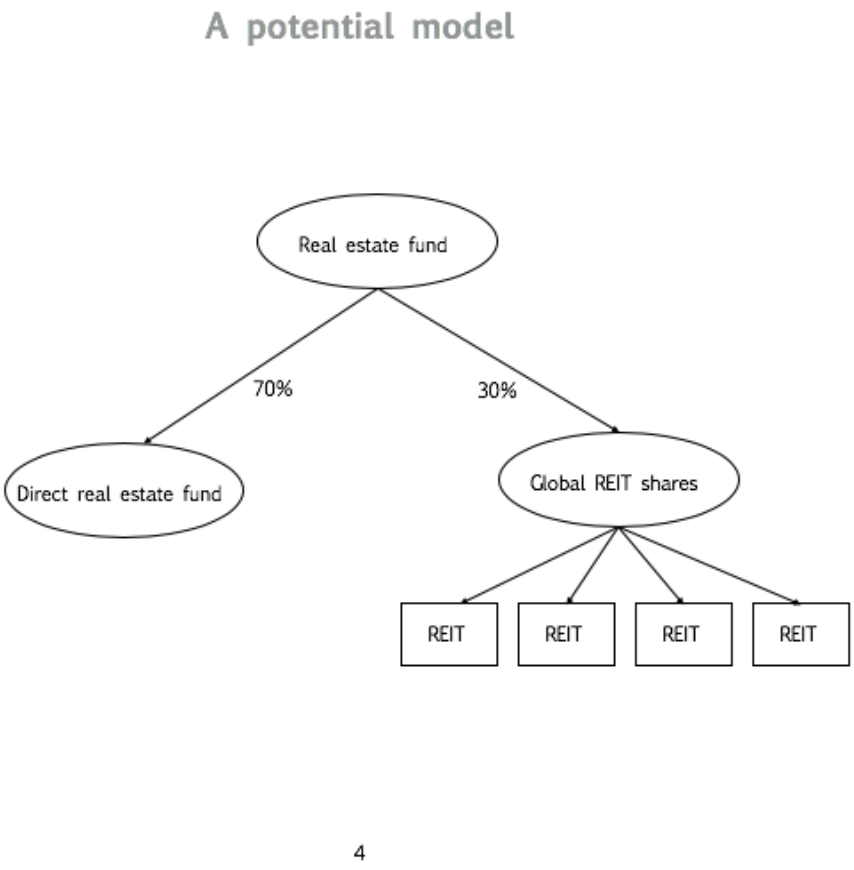
- The first is in respect of valuation. One of the major concerns of DC pension trustees is that because illiquid assets are not valued on a daily basis that members may be making contributions into the scheme or taking money out based on “stale” valuations. It is important to note that even in a daily traded fund, the valuation of the underlying property only needs to be undertaken monthly, so the quoted price at which the units can be subscribed and redeemed involves an element of stale valuation. However as set out above and as demonstrated after the EU referendum result, the fund manager has the capacity to make a market value adjustment if there is a material movement. Even if there is a “stale” price, illiquid assets are less volatile in price than liquid assets make up a smaller proportion of the portfolio. The result is therefore less likely to be material and larger and more sophisticated DC schemes are becoming more comfortable about this.

- The second, and somewhat related, point is that there is tendency to refer to daily pricing and daily trading as a single thing. It is perfectly possible to calculate a daily NAV even if there is not daily trading. More importantly, it is entirely possible to have daily subscriptions and daily pricing without daily redemptions. This could either be through the deferral of redemptions model described above or by having a fund with less frequent redemption days. A fund in the form of a NURS that invests in immoveable property can have redemptions up to six months apart.

A potential model

For those who believe that it is important to maintain the ability to provide daily liquidity, there are examples in the UK and the US. There are a number of products that combine illiquid real estate with liquidity in the form of REIT shares, one of which is the Legal & General Investment Management DC default fund which was also covered in the Institute and Faculty of Actuaries webinar. These typically using a global REIT share index to ensure greater liquidity.

The direct property element can be either actual direct property or property in another direct property fund.



It is possible to achieve same ends in a multi asset class fund by using other more liquid asset classes alongside the illiquid. The example cited in our report on the post EU referendum behaviour of funds is the Jupiter Merlin funds, which are a daily traded retail product. Within the multi-asset fund there is a property allocation to the Mayfair Capital Commercial Property Trust, an illiquid Jersey Property Unit Trust. The allocation to property as an asset class within Merlin rises and falls as a percentage as it moves in and out of other assets more rapidly than it moves in and out of real estate. It is nevertheless able to provide daily liquidity and daily pricing at the Merlin level. This is in a much less liquid real estate vehicle than a NURS.

Whilst the Jupiter Merlin model is difficult to envisage for a specific allocation to property, it is entirely consistent with what is being done in default funds.

Some conclusions

DC pension schemes, unit linked insurance products and retail investment products pass the investment risk to the retail member / investor. It should not therefore be a great surprise that there are some common challenges faced by all three. As discussed in our report on fund behaviour after the EU referendum, creating a better fund product and greater choice for retail investors would also potentially create a better investment option for DC pension schemes.

If daily liquidity is considered essential, there are ways of providing this. However, it is also possible to include less liquid options within DC default funds.

We think that there is an opportunity to develop a new type of fund that provides the opportunity for daily pricing and daily subscriptions without the commitment to provide daily redemptions. We believe that this has potential attractions for DC default funds, unit linked insurance products and retail investment products.

There is also a common challenge from the platform architecture which struggles to accommodate anything other than straight-forward daily subscriptions and redemptions. As mentioned earlier in this paper, we are in a chicken and egg situation as to who will pay for the development of a better platform architecture.

There is also an opportunity within the real estate investment management industry to develop new fund products for the DC pension schemes, unit linked insurance products and retail investment market.

John Forbes

CONSULTING LLP

www.johnforbesconsulting.co.uk

This presentation has been prepared for general guidance and does not constitute professional advice. You should not act upon the information contained in this presentation without obtaining professional advice. No representation or warranty is given as to the accuracy or completeness of the information contained in this presentation. To the extent permitted by law, John Forbes Consulting LLP and its members do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this presentation or for any decision based on it.

© 2020 John Forbes Consulting LLP.

John Forbes Consulting LLP is a Limited Liability Partnership registered in England and Wales. Registration number OC383809
Registered Office and Business Address: 12-14 Ashville Road, Birkenhead CH43 8SA