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# Unlisted funds - lessons from the crisis

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The last decade has been an unprecedented period of volatility for real estate markets. A period of boom, globalisation and the ascendency of the blind pool fund model, followed by financial crisis, economic downturn and a collapse of real estate markets, causing investors to question their fundamental assumptions. Property remains an attractive asset class, but the arrangements via which capital is deployed has been the subject of intense scrutiny by investors, consultants, investment managers, academics and more latterly, regulators. Against the backcloth of this turbulence, The Association of Real Estate Funds in the UK 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. The report, "Unlisted funds: lessons from the crisis" was published in January 2012. Following are some of the highlights of the report, comments on its relevance to markets outside the UK and what, if anything, has changed in the year and a half since it was published.

There is one inescapable fact that underpins the report. Real estate is an illiquid asset and creating a real estate fund is an exercise in managing compromises as well as being able to pick good assets. There is a trade-off between liquidity, volatility, performance and risk.

There are three broad areas of concern that arise from this

Firstly there are inherent conflicts and non-alignments of interest that that are difficult to minimise and manage.

Secondly managers' efforts at improving transparency and engagement are solving some problems but are creating others.

Finally there are investors in funds that are unsuitable for the purpose for which the investor has selected them.

There are three important areas of non-alignment of interest.

The first and most obvious is between the investors and the manager, with instances arising in both the open-ended and closed-ended fund model.

The second area of non-alignment of interest is between investors themselves - there was a lack of alignment of interest between different types of institutional investor at crucial points during the period of volatility, in particular:

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.

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 third area of non-alignment is between those responsible for the raising of funds and those responsible for deploying the capital once raised. One of the paradoxes apparent from the report is that the top of the cycle is the easiest time to raise funds but the most difficult to spend it wisely. 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.

The second broad area of concern is that managers' efforts at improving transparency and engagement are solving some problems but are creating others. Fund managers have made very significant steps to meet the demands of larger investors for greater access to the manager and greater influence through investor committees. However, the unintended consequence of this is that smaller investors are starting to feel disenfranchised. Keeping smaller investors engaged and attracted to the fund concept is essential for the viability of the business model. Larger investors are able to negotiate fee rebates that are not available to smaller investors. It is therefore such smaller investors who contribute most to fund manager's profitability. In the current environment of fee pressure and rising costs, this could be crucial.

The final area of concern is that there investors for whom currently available funds do not deliver what they need. Many investors are attracted to open-ended funds because of the ability, at least in theory, 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. 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. There are investors who are invested in open-ended funds who are paying a high cost for liquidity that they do not need.

This creates an opportunity for product development, as does the possibility for investment managers to address the specific points for improvement highlighted in the report. There are other factors that also push in this direction:

a) The increased importance of cross border-investors and in particular the rise in capital from Asia as the increasing Asian middle classes provide for their old age.

b). The nature of separate accounts changing with new players entering the market, the increased number of multi-managers and development of fund-of-funds.

c). 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.

d). Regulatory changes creating new investment vehicles that have not previously been available. Examples include amendments to the rules for Property Authorised Investment Funds and the introduction of Tax Transparent Funds in the UK and the new limited partnership in Luxembourg.

e). Changes to tax rules and their interpretation is eroding some of the advantage of the traditional pan-European fund relative to a fund of fund or separate account model investing in tax efficient local funds such as PAIFs in the UK, OPCIs in France and SGR managed funds in Italy.

There are a number of key areas covered in the report that the association of real estate funds has flagged up for further work, and indeed AREF has initiation further dialogue between investors and managers on a number of these points. However there is no need for managers to await or need formalised best practice in these areas. Indeed with the diversity of views amongst investors it is questionable whether a homogenous approach is even a desirable outcome. Investors need a breadth of choice of vehicle and approach. For real estate investment managers, addressing these issues creates an opportunity for differentiation.

Although the report for AREF was produced for a UK audience, the issues are of general applicability. Indeed, although in terms of the underlying property, the volatility in the UK has been greater than elsewhere with a peak to trough fall per the IPD all-property index of nearly 50%, at the fund level, the problems were often more intractable in some other countries. The problems of the German open-ended fund industry have been well-documented.

At the time the report was drafted one major difference between the behaviour of fund managers in UK and their counterparts in some other European countries was the low impact of regulation. The report for AREF concluded that regulation had only a limited impact on fund manager behaviour. This is changing rapidly. Real estate investment managers will have to deal with the direct regulatory impact of the Alternative Investment Fund Managers Directive (AIFMD) and beyond that with the indirect impact on their investors of Solvency II on Insurance companies and IORP on pension funds.

Regulatory change is a driver for improved governance and greater transparency in funds and fund managers at a number of levels.

Firstly, it may be an explicit requirement of the regulation;

Secondly it may be a means of satisfying more general requirements of the regulation, such as the general conduct of business requirements in AIFMD;

Thirdly, it provides a framework for resolving non-alignment of interest issues that can arise from the regulatory requirements. What investors want, what managers want and what regulators demand can pull in three different directions;

Finally, it provides reassurance to stakeholders that the regulatory requirements are being met.

The most immediate change is the imminent arrival of the AIFMD. In just over two months time on 22 July 2013 the AIFMD will become transposed into local law across the EU. This will be followed by a one year transition period during which time fund managers will need to meet the locally set interpretation of the registration requirements.

The requirements of AIFMD will increase the existing commercial pressure for improved governance, greater transparency, stronger controls environment and more independent supervision. All of this will increase costs and add to the pressure for consolidation in the industry.

The commercial pressure on fund managers is also not over. 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, 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. In the case of open-ended funds, the ability of investors to switch between funds is restricted by the cost of moving capital. In the case of closed-ended funds, investors are by definition signing up for a ride of more or less fixed duration. 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 an increasing diversity of views amongst investors, with some clearly having a far more active approach to managing their investments than others.

Despite these challenges, there is an opportunity for those fund managers who are able to adapt to the new environment. Real estate remains an attractive asset class. There is an opportunity for fund managers to tap into this by bringing new funds to the market that address the concerns of investors and regulators.