Schroder's Property Fund of Funds mandate

Addressee

This paper is addressed to the Officers and Pensions Committee of Suffolk County Council as administering authority for the Suffolk County Council Pension Fund ("the Fund"). The paper considers the style of management and performance of the property fund of funds mandate managed by Schroders.

Background

Schroders commenced management of a fund of property funds mandate on behalf of the Fund at end March 2001. The mandate value at end June 2012 was approximately £156 million, 10.3% of aggregate Fund value. The benchmark allocation to property is 10%, all of which is managed within Schroders' mandate.

The benchmark allocation to property was 12%, prior to 31 March 2011, when it was reduced to 10%. The Fund's prevailing allocation to property had been significantly lower than 12% over the period between mid 2007 and mid 2009, when prices suffered a major setback. In mid 2009, the allocation was 7.3%.

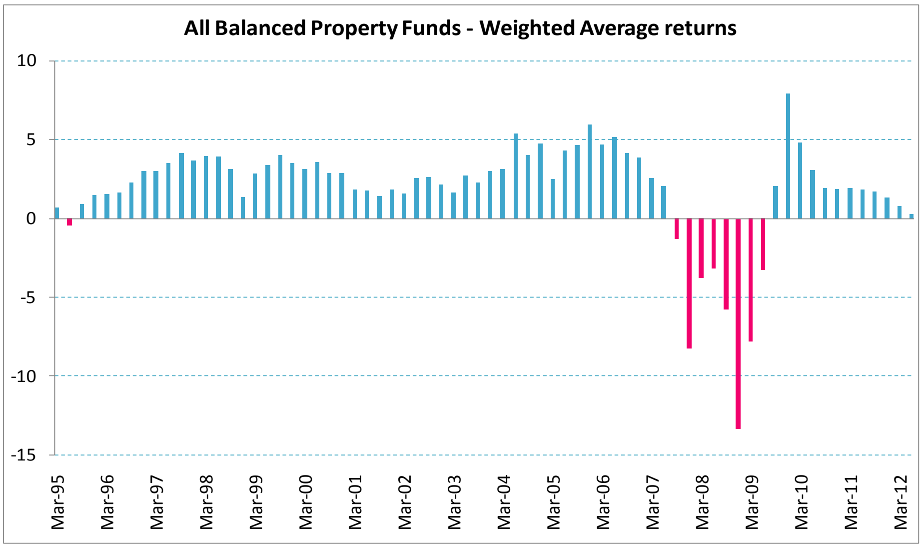
History of UK Property returns

UK property suffered a significant setback in the late 1980s and early 1990s. The market bottomed out at the end of 1992. From this point, property delivered continuous positive returns quarter on quarter returns until and including Q2 of 2007. One reason is that a significant proportion of property returns come from rental income. Another reason is that property trades infrequently and valuers determine capital values by reference to other properties, so the inherent volatility of prices is dampened by the valuation process. [This differs markedly from listed equity prices which trade minute by minute throughout the day and so reveal the inherent volatility.]

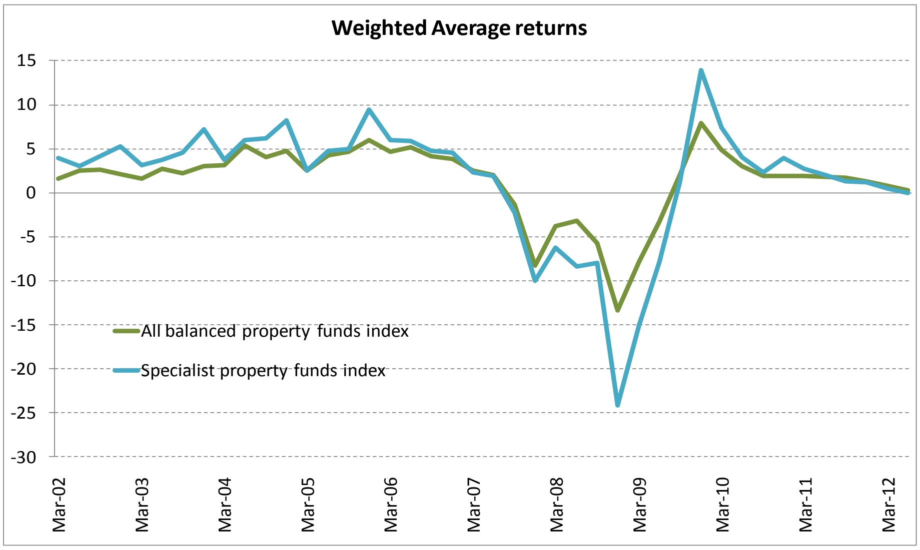
Over the long period from end 1992, property prices were supported by falling bond yields. This carried on until the mid 2000s. By that stage, investors had become so used to the steady pattern of returns that they began to become complacent. By this stage, rental yields had become quite compressed. Nevertheless, new investors continued to buy. This included well-off individuals who invested in syndicates with highly leveraged positions. This propelled the final stages of the property bull market in 2006 and 2007. When leverage became problematical in 2007 and 2008, a significant amount of forced selling took place, driving prices sharply lower.

In the chart opposite, we show the quarter by quarter returns of the weighted average return of the All Balanced Property Funds index from the mid 1990s.

We can see the steady returns generated through to mid 2007, when a savage bear market occurred. Over the next 2 years, capital prices fell by 45%; the strong returns in early 2010 reflect the initial price rebound. Recently, returns have slowed and largely reflect rental income.



In the chart opposite, we compare monthly returns for the All-Balanced funds benchmark, index with returns of the index for Specialist funds. Specialist funds cover classes of property such as geographic or sector funds, and special classes such as Retail Warehouses or healthcare. Many of these funds had significant levels of gearing which provided strong returns in favourable conditions and caused problems in the market setback.



Some of the larger balanced funds had a proportion of assets invested in specialist funds, and the leverage wihin these funds also damaged the performance the performance of these balanced funds in the market setback.

Schroders mandate and approach

Schroders is one of relatively few UK managers which offer a UK property fund of funds. This approach became popular in the early 2000s. However, very few managers were able to build critical mass, so there are only four managers with significant capacity. These managers are, by order of scale CBRE (which acquired ING's fund of fund business in 2011), Schroders (which grew the business organically), Aviva (a combination of organic growth and business acquired from BlackRock) and UBS (which grew the business organically). Kames Capital (the UK investment management subsidiary of Aegon) recruited the fund of funds property team previously at ING, and is launching a fund of funds business. UBS offers segregated mandates only. The other managers offer both segregated mandates and a pooled fund of funds. Schroders offers a pooled fund called SIRE (Schroder Indirect Real Estate fund).

All of the managers adopt similar approaches, in that they aim to put together a portfolio of units in pooled UK property funds managed by a range of managers. The portfolio will include both core (i.e. balanced) funds and specialist funds. They may also include listed REITs (real estate investment trusts) and closed ended property development funds. The managers will typically hold approximately 60% in 6-10 core funds, 30% plus in 10-15 specialist funds and small amounts (if any) in REITs and closed ended funds. The allocation to cash will vary according to opportunities for selling or buying participations, amounts committed to development funds, and the managers' views of market prospects. The managers may choose to draw income from the funds, so they can re-deploy the income across their portfolio.

Why use a fund of funds?

The reasons for adopting a fund of fund approach are as follows:

1. Diversification of managers, so that the Fund is not significantly exposed to the performance of particular managers. There have been periodic difficulties with particular funds, due to personnel changes, or weak management. For example, one mainstream UK core fund has performed poorly for a number of years, precipitating large scale redemptions which has made the fund very difficult to manage, due to forced sales of underlying properties. Another core UK fund is also struggling with repeated changes of personnel and suffering widespread redemptions. It is difficult and expensive to transact in property and redemption queues result in delays and potential surrender penalties. In this context, manager diversification of a portfolio valued at more than £150 million may be considered a valuable risk mitigation approach.

2. The ability to achieve a balance of core and value added opportunities, including property developments.

3. Greater transaction liquidity because of the number of funds that can be acquired or sold at any time. To the extent that there will be a significant correlation between core fund performances, having a range of funds in which to invest or dis-invest will be beneficial, particularly when transactions costs are high. As an example, it may be possible to acquire units in one fund from another fund which is selling, whereas the acquisition of new units in another manager's fund might involve paying full UK property stamp duty (4% ad valorem) and other acquisition costs. This is also important if the Fund is seeking to raise money, because there will be greater opportunity to transact quickly, if there are several funds available.

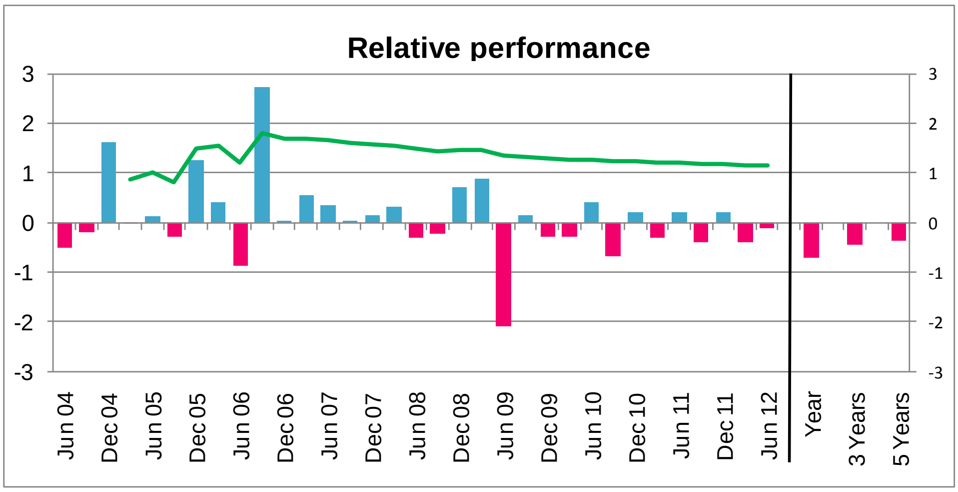
   It would be fair to state, however, that when there is a strong trend in place, some of these benefits may disappear. In 2008, when UK property prices were falling sharply, virtually every fund had a queue of redemptions. Similarly, when the market turned, there was very little opportunity to buy, because funds were not accepting cash they could not deploy in buying underlying properties as there were few sellers.

4. The fund of funds manager can manage the portfolio mix, allocating among sub-classes of properties and manager styles, according to their view of market conditions. For example, they can invest in a dedicated central London office fund, a retail warehouse fund or a student accommodation fund. Alternatively, they might select a fund targeting properties secured on long-term leases.

Notwithstanding these opportunities, it does raise the question of whether fund of fund managers are able to call timing correctly and to manage shifts between asset categories, particularly in property where dealing costs are particularly high. We can also question whether managers' portfolios are over-diversified, e.g. do they hold too many positions particularly in core funds with very similar portfolios.

Schroders' performance

The chart opposite shows the relative performance of Schroders' fund of funds on a quarter-by-quarter basis. The green line shows the cumulative annualised relative performance. All of these figures measure performance gross of Schroders' fees but net of fees paid to underlying managers. The benchmark is based on managers' net performance.



[Schroders' fee basis for fund of funds is 0.2% p.a. of the value of assets managed. Schroder do not charge a manager of manager fee on assets such as SEPUT, where they already receive management fees.]

Schroder's relative performance on the mandate has been particularly influenced by the returns in September 2006 and in June 2009. However, the performance pattern also appears to have changed between the early part of the period (bias to outperformance) and later part of the period (bias to underperformance). Nevertheless, the recent information does not provide a particularly strong signal. For example, in the last 3 years, there were seven quarters of underperformance and three of outperformance, with somewhat greater underperformance relative to outperformance.

The main reason for the performance drag over the last 3 years is likely to be the transaction costs involved in investing approximately £32 million in cash added to Schroders' mandate in late 2009 and over 2010.

Recent market background and outlook

Over the course of the last 18-24 months, property investors have focussed attention on prime property, particularly in London and the South East. Income security has also been a feature. At the same time, secondary properties have struggled, even when supported by good leases.

This polarisation in the property market is being mirrored in other areas. In government bond markets, investors have preferred safe haven bonds in the US, UK and Germany compared with bonds issued by weaker Eurozone members. In equity markets, investors have preferred large cap quality companies and higher yielding equities compared with companies which may be priced cheaply but where the earnings outlook is less certain in the near term.

The gap between the valuations of the two categories (prime / other) might continue until investors perceive greater certainty. Alternatively, if conditions deteriorate, they may continue to favour prime property, as now, although valuations already appear stretched. Void levels in some areas and classes of property are already quite high but void levels could increase further. We suspect that investors may need to see stronger evidence of widespread economic recovery before turning their focus to favouring value, i.e. cheapness, in asset prices.

Disclaimer

Conclusion

Schroders' fund of fund mandate offers significant diversification by manager and asset sub-class. In recent market conditions, when there has been significant variation in the performance delivered by different managers and styles of management, this has produced consistent performance. We believe this is a good result in what has proved to be a difficult period for property markets. We believe that the main factor affecting performance over the course of the last three years has been the drag on performance arising from investing new money added to the mandate to bring portfolio weight up to the 10% benchmark allocation.

We will be pleased to answer questions about this note at the forthcoming meeting.

Prepared by:-

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Partner

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For and on behalf of Hymans Robertson LLP

Risk Warning