

# Reassessing the case for indirect property investment



## Introduction

One remarkable feature of the most recent international property boom was the explosive growth in indirect property investment: taking stakes in listed and unlisted property funds, rather than traditional direct ownership of the underlying real estate. The subsequent sharp reversal of fortunes, as property values collapsed against a backdrop of financial market turmoil, has changed investors' priorities and altered perceptions of different forms of property investment. Against these different conditions, it is appropriate to reassess their role in a portfolio.

This paper focuses specifically on the role of unlisted property funds, which have taken an increasingly prominent share of institutional property investment portfolios, both large and small. We explore the rationale for indirect investment in the light of the market turmoil linked with the credit crisis, consider the lessons to be learned, and set out some guidelines for investors and fund managers for the future.

## Has the underlying case for property changed?

There is a substantial literature showing property's contribution to risk diversification in multi-asset portfolios, as its correlation to bond returns has typically been negative. While there are technical debates about the statistical contributions from valuation lag, smoothing and the distribution of asset returns, this fundamental tenet is supported by the fact that property tends to be a late cycle performer, while bonds (a purely financial asset) perform better in the earlier stages.

However, the pricing of property assets has undoubtedly become more integrated with the wider capital markets as the asset has become more transparent and accessible. The unusually synchronised collapse in asset values across asset classes and international property markets in the wake of the Lehman crisis bears witness to this effect.

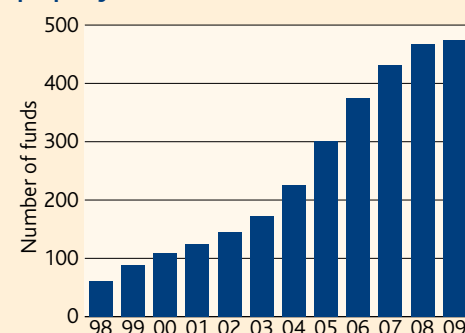
Whilst we believe that correlations with other asset classes will be higher in the future than in the past, it would be wrong to assume that the experience under the extreme conditions of the last two years will be a reliable guide, as markets normalise. Pricing will re-connect with local rental growth fundamentals, improving the scope for diversification. Property's illiquidity will continue to smooth market volatility, and investors will be attracted to the asset class by its relatively stable cashflow characteristics, and the ability to add value after purchase through active asset management.

## Why invest indirectly?

The revival of interest in property as an asset class in the late 1990s, against a relatively stable backdrop of low interest rates and low inflation, spawned an upsurge in interest in indirect property investment through unlisted funds. This was supported by demand for access to larger assets, a drive to achieve operating efficiencies, interest from smaller investors wanting to enter the market, and increased appetite for cross-border investment. In the case of the last of these, some investors had painful experiences with direct foreign investment in the late 1980s boom-bust cycle, and saw pooled funds as a way to access better diversified portfolios with expert, local management.

The indirect property model addressed all these requirements simultaneously. Accordingly, capital flowed into property funds. Many smaller investors, institutional and private, whose ability to own commercial property assets outright is limited by "big ticket" lot sizes, were attracted to these funds. Some large investors also moved to an indirect investment platform, perceiving it as more efficient. At the same time, the growth of the market was accelerated by the use of debt, enabling fund managers to build larger and more diversified underlying portfolios. While property's income stream comfortably covered the cost of debt, which was the case in most markets until 2006, investors found the banks to be enthusiastic lenders. Meanwhile, investors were able to benefit from the leveraging effect of capital growth on these enlarged portfolios, which offered an attractive performance boost.

**Figure 1 Strong growth in European property funds**



Source: INREV

**Figure 2 Total return correlations 1986-2009**

|                             | European direct real estate | US direct real estate | World equities | US equities | European equities | World government bonds |
|-----------------------------|-----------------------------|-----------------------|----------------|-------------|-------------------|------------------------|
| European direct real estate | 1.00                        |                       |                |             |                   |                        |
| US direct real estate       | 0.45                        | 1.00                  |                |             |                   |                        |
| World equities              | 0.37                        | 0.21                  | 1.00           |             |                   |                        |
| US equities                 | 0.17                        | 0.20                  | 0.89           | 1.00        |                   |                        |
| European equities           | 0.47                        | 0.26                  | 0.94           | 0.87        | 1.00              |                        |
| World government bonds      | 0.24                        | -0.09                 | 0.23           | 0.19        | 0.23              | 1.00                   |

## Key Points

- The global financial crisis has affected investors' risk appetite
- This has in turn affected preferences for different forms of property investment
- In this context it is appropriate to review the case for indirect investment

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The number of pooled fund launches burgeoned (see figure 3), and a number of high profile investors sold their direct property holdings and moved to a purely indirect model.

Many funds were structured as closed-ended vehicles, with a short capital-raising period, a finite life, and with assets to be liquidated on expiry. Increasingly, however, open-ended vehicles were developed, offering the promise of ongoing liquidity. As the number of indirect investors grew, so did the scope for secondary market trading of units in unlisted funds, although so far the UK has been the only country to have seen this develop in any depth. A secondary market gives the opportunity to trade units in otherwise illiquid funds, and increases the scope for active management of indirect property holdings, further adding to their appeal. The ability to trade units quickly, and often more cheaply than the underlying real estate, means that in a normal market indirect property holdings are often more liquid than direct property.

There are two broad models for indirect property investment:

**Pooled funds:** a single fund structure for multiple investors. A wide choice is available: balanced and specialist; single country and international; open- and closed-ended; institutional and retail. Within these categories, investment styles range from "core", income-driven portfolios through actively managed "value-added" products to highly opportunistic, deal-driven and often development-based vehicles.

Pooled funds are a simple solution for investors looking to get exposure to a target market for which a particular product offers a good proxy. A product is selected to fulfil the investor's requirements. Some investors use pooled funds as their sole property holding (typically selecting a balanced fund consistent with their chosen strategy), while others may target specialist products to supplement their direct property holdings.

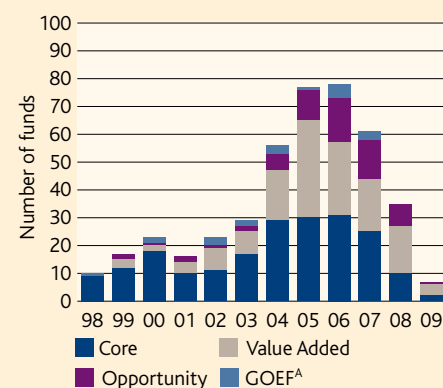
**Multi-manager:** a portfolio of different pooled funds, constructed to exploit the benefits of holding (and perhaps trading) a mix of available products. This category can be further split into segregated multi-manager portfolios, designed specifically for individual investors, and "fund of funds" structures, which can accommodate multiple investors. The multi-manager model of indirect investment emerged as the choice of available products grew to bewildering proportions.

The multi-manager approach, like a pooled fund, offers an investor the advantage a single point of contact for the management of its property portfolio. However, in this case the investor delegates the task of selecting and monitoring the underlying funds, including the often onerous process of due diligence, to an expert multi-manager. The multi-manager can provide a strategic overlay to customise the portfolio more closely to the investor's performance objectives and risk profile, and may offer a degree of active management of the portfolio, to adjust it as market conditions and investment needs change. Multi-manager investing typically supports a more customised approach than investing in a single pooled fund, with greater risk diversification.

The conventional wisdom on the advantages of indirect investment is as follows:

- Indirect investment can offer scale benefits from a pooling of resources with other, like-minded investors. This enables costs to be spread, and can boost buying and negotiating power.
- In particular, it overcomes the practical obstacle of large property lot sizes, especially for smaller investors. By pooling their capital, investors can gain exposure to assets and portfolios that would otherwise be unaffordable. The ability to access a broader investment universe of property types and markets increases choice, and offers potential performance benefits.
- Buying units in funds also offers more flexibility in the amount to be invested, as it avoids the "lumpiness" of individual property assets, which are usually indivisible. Holdings can be traded in volumes unrelated to the lot sizes of individual assets, giving greater flexibility.

**Figure 3 European property fund launches 1998 to 2009**



<sup>A</sup> German Open-ended funds reporting to BVI, the number may differ from the number of available GOEF as funds report on a voluntary basis  
Sources: Data prior to 2009 INREV/IPD, Data from 2009 INREV and BVI, Feb 2010

Indirect investment offers scale and expertise unavailable to most investors if they were to access the market directly

Buying units in funds, rather than property assets, is more flexible

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- It can improve liquidity. In the direct property market, the uniqueness of each investment, and the complexity and cost of the due diligence process, mean that property assets are slow and expensive to transact. Buying into an established fund can give instant property exposure. For open-ended property funds, which offer a measure of liquidity, units can often be traded more quickly, and sometimes at lower cost, than the underlying assets.
- It improves diversification and lowers specific risk (i.e. the influence of individual assets on portfolio performance), by giving the investor access to a potentially much larger underlying property portfolio.
- The diversification at property level can be greatly magnified through following a multi-manager approach, which also serves to diversify product and manager risk, and enables the best managers in each market to be selected.
- Indirect investment enables investors to outsource investment activities to expert, specialist teams with the resources to construct and maintain portfolios. This can be particularly important to cross-border investors looking to access unfamiliar markets.

While these advantages can seem compelling, in deciding whether to follow this route, investors also need to consider the following:

- Indirect investment, by definition, means delegating control over the day-to-day running of the portfolio to the manager, although investors can sometimes participate in its governance through representation on investment committees and unitholder advisory committees. The manager has a duty to balance the needs of different investors, which may not always be aligned.
- Fund fee regimes can vary widely, and they may or may not be aligned to investors' interests. Administrative costs will often be higher than for a separate account mandate, so fees will usually be higher too.
- The multi-manager model incurs a second layer of fees, in addition to the underlying fund fees, to cover the multi-manager's services, such as fund selection, due diligence, transactions, financial administration, compliance, portfolio monitoring and reporting. The multi-manager's fee will normally be much lower than the fees on the underlying funds, and a good multi-manager will also be able to achieve compensating cost savings and more favourable terms for investors through their scale and expertise.

### How has indirect property investment been affected by the downturn?

The credit crisis and resulting recession have prompted a reassessment of investment processes and portfolio composition across all asset classes. There has been a marked shift away from leveraged investments and debt instruments, and a significant reduction in risk appetite. At a practical level this meant a retreat from investments in hedge funds, commercial mortgage-backed securities, corporate bonds and emerging markets generally. It has also dented the reputation of pooled property funds, and the fund of funds model.

Indirect investment returns have fallen well below those for direct property and many investors have found themselves locked into crisis-ridden funds, unable to reduce exposure to assets previously regarded as long term holdings. This poses the difficult question of whether with hindsight the non-listed fund model is fundamentally flawed, or simply suffering an inevitable correction after an unprecedented market boom. How can an investment model that was supposed to promote diversification and risk reduction have become so tarnished?

On closer inspection, the fundamental arguments for indirect investment remain sound, but it can be seen that the strategies and structures of individual funds were not well placed to withstand the sudden change in the investment climate. In particular, the interlinked effects on debt and liquidity lie at the heart of these concerns.

In normal circumstances, a key benefit from investing in a pooled fund or fund of funds is

Indirect Investment can offer more liquidity than the underlying market

Pooling capital with other investors enables larger, more diversified portfolios to be developed

Conversely, disadvantages can include reduced control and higher running costs

The downturn has hit property funds hard, mainly through the negative effects of leverage

Performance and liquidity have been adversely affected

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diversification, with the ability to access a much larger pool of underlying property assets than would be possible for each individual investor. The current market climate has not changed the fundamental case for constructing well-diversified portfolios to reduce specific risk (for example, by property type, location, tenant profile, lease structure and balanced lot sizes). If anything, increased risk-aversion has reinforced the need. Investors in multi-manager portfolios benefit from access to an even larger pool of underlying assets – the combined strength of all funds in which they have a stake. This offers both product and manager diversification. Although investing across a range of products and managers in present circumstances means there is likely to be some exposure to troubled vehicles, there are benefits in not having 'all eggs in one basket' where these problems occur.

Unfortunately though, diversification benefits are masked in many cases by negative consequences of carrying debt. The effects are being felt by funds of all sizes, but have particularly affected value added and opportunity funds, which tend to carry higher levels of debt.

The use of debt finance has become an established feature of the property fund market. Many managers have used capital borrowed against the security of the property assets to increase their buying power, and to offer enhanced returns through the use of leverage. With borrowing costs low, and interest payments comfortably covered by rental income, most assets were self-financing. Leverage magnifies property returns through enlarging the capital base upon which these returns are received. In a rising market, this can be highly beneficial. At the same time, however, magnified capital returns also mean accentuated portfolio volatility, and therefore increased risk (Figure 4).

As more investors looked towards indirect property as a solution for their portfolios, some relaxed long-standing investment restrictions on the use of debt in order to exploit the perceived opportunities offered by leveraged vehicles. This approach began to sow the seeds of its own destruction as money flowed into the sector, fuelling unsustainable capital growth, and forcing income yields to record lows in many markets, such that income no longer always covered interest cost. Perversely, therefore, later entrants to the market were reducing risk controls just at the point when the risks of a market 'bubble' were intensifying. Some were doing this with a view to expanding their cross-border exposure, to diversify the risk of over-exposure to their domestic markets.

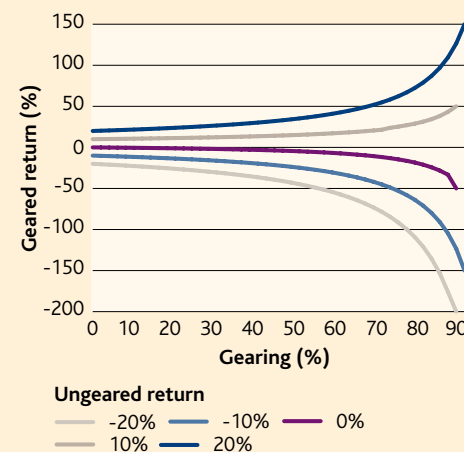
As boom turned to slump, leverage became a burden rather than a benefit. As a result, most leveraged funds have markedly underperformed their corresponding direct property markets (Figure 5 and 6).

While debt increases the volatility of portfolio returns, it does not of itself change correlations between assets and markets if applied equally. Unfortunately however, the latest global capital market crisis has meant an unusually synchronised slump in global property markets, so in this cycle cross-border diversification has offered less protection to international investors than has been the case in the past. The changed conditions have prompted a reassessment of investment processes and asset allocation generally. There has been a marked shift away from leveraged investments and debt instruments, and a significant reduction in risk appetite. This meant a retreat from investments in hedge funds, commercial mortgage-backed securities, corporate bonds and emerging markets.

With hindsight it is clear that not enough was done to reduce leverage in many property funds in the earlier stages of the recent downturn. As a result, leveraged funds have markedly underperformed their corresponding direct property markets, and will continue to do so until capital growth resumes. The unexpected speed and severity of the slowdown were, of course, significant factors in this. However, fee structures for many funds, where these are based on gross rather than net asset value, contain an in-built incentive for managers to fully utilise their debt capacity. To charge fees on GAV is entirely logical to the extent that it reflects the size and number of the underlying portfolio of assets to be managed. However, the manager will lose revenue if he or she sells assets to deleverage ahead of a downturn, which could contribute to a reluctance to do so, particularly if there is no offsetting performance fee linked to leveraged returns.

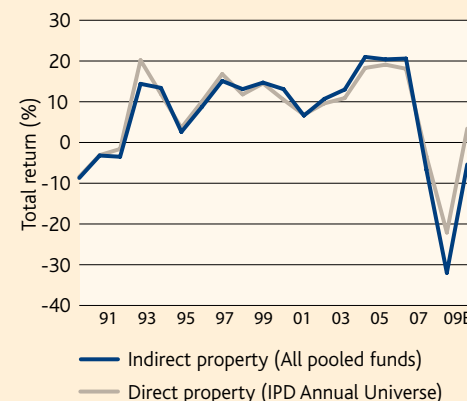
Falling asset values have left many property loans in breach of loan-to-value covenants,

**Figure 4 Impact of leverage on ungeared returns**

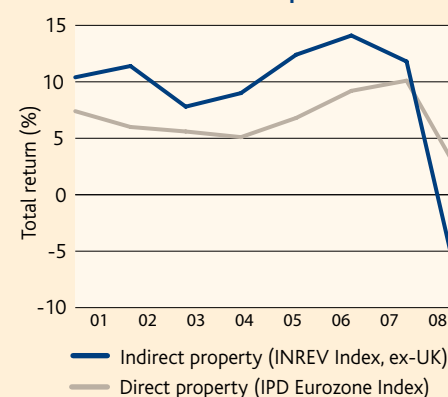


Source: Aberdeen Property Investors

**Figure 5 Direct property and pooled fund returns: UK**



**Figure 6 Direct property and pooled fund returns: Continental Europe**



Source: IPD, INREV, Aberdeen Property Investors

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whereby the asset no longer provides the required security for the borrowings. At the same time, caps on the use of leverage in the constitution of many property funds have been challenged or exceeded. This has already caused some spectacular write-downs in fund net asset values, and fund insolvencies, particularly in the UK, where capital values dipped to an unprecedented low in 2008. The problem subsequently transferred to other markets, which saw the worst point in the performance cycle in 2009. However, lenders are mindful of the risk of triggering asset sales at the bottom of the cycle. Often, these funds still generate enough income to easily cover interest payments. Where this is the case, banks are tending to take a longer view, supporting managers' efforts to weather the crisis.

The difficult market environment has had a marked effect on investor preferences and strategies. In particular, it has prompted a round of deleveraging, a retreat from developing markets and riskier, more opportunistic investment strategies, and a search for different holding structures offering the investor more control. These issues are explored further below.

### Deleveraging

Unsurprisingly, given the impact of leverage on returns, as asset values fell investors sought to reduce the effect of debt in their portfolios by shunning leveraged property investments of all kinds. The contribution from leverage changed from being a boost to performance to a major burden.

The pressure was on for fund managers to deleverage and stabilise their portfolios to address breaches of loan covenants. Unfortunately, in a weak or falling market, this is particularly difficult to achieve. There are five broad options, all of which have drawbacks:

- Selling assets, but buyers are in short supply in a falling market. Where forced sales occur, they tend to set low prices, exacerbating the problem of falling values.
- Refinancing, but although the position is now improving banks have shown limited appetite for property lending, and with high margins over central bank rates being sought, this is a costly solution despite steep falls in base rates.
- Raising new equity, but there has been a dearth of buyers, who have been reluctant to commit while asset values are still falling, and are themselves starved of finance. Existing investors in a troubled fund will be wary of throwing good money after bad.
- Suspension of dividends, but this is unpopular with investors, who see a steady income stream as a key reason for investing in property. Furthermore, the typical level of dividends is too low to make much impact if significant changes are needed.
- Suspension of capital investment, which can be reasonably straightforward to achieve, but may be insufficient, and comes at a cost of lost opportunities to enhance asset and portfolio performance.

The lesson from the downturn is that it is very difficult to take remedial action to deleverage once falls in values have become entrenched, and when liquidity evaporates. There are signs now that a degree of normality is returning, with values in most mature markets now stabilising or improving, and signs of improved levels of turnover. While pressures are easing, banks will inevitably remain cautious lenders to the property sector for some time. There is a risk that if deleveraging is initiated too late, managers will still be lowering debt at the point in the cycle where capital growth resumes. As markets stabilise and the re-pricing runs its course, the moment for deleveraging will pass. As capital growth reasserts itself, the use of debt will help to recoup losses, and there is a risk of being left fighting yesterday's battle as values recover.

Some funds have been faced with breaches of banking covenants and insolvency

De-leveraging is necessary to protect returns in a downturn, but is difficult to achieve

Early action is essential if debt levels are to be managed tactically

## Reassessing the case for indirect property investment

### De-risking

The generally reduced risk appetite from institutional investors is manifested in several ways. Deleveraging is one factor, as debt magnifies portfolio volatility. Investors and fund managers should evaluate carefully the role debt should play in running the portfolio, and whether its use is appropriate in the context of the chosen risk profile.

Meanwhile, there has also been a marked pull-back in cross-border investment activity. The globalisation of property investment, a major feature of the last few years of the recent boom, appeared to be put "on hold". Developing markets in eastern Europe, Asia and Latin America have been off the agenda for many investors for some time, although there are signs that this is now changing following the significant re-pricing, and evidence that Asia in particular is emerging strongly from the downturn.

### Search for greater control

Investors have become disillusioned by the lack of liquidity that has developed in the pooled funds market. Those that have wanted to withdraw funds have, in many cases been prevented from doing so. In closed-ended funds investors are expected to commit for the life of the vehicle, but under normal conditions they may be able to trade holdings on the secondary market.

Even in the good times, the secondary market was limited in most countries except the UK. Under distressed conditions, buyers were very few, and were looking for steep discounts to net asset value.

By contrast, holdings in open-ended funds should normally be tradeable, but in practice the same limitations apply at times of weak demand. Furthermore, the need to treat all investors fairly, and to protect continuing investors against turnover costs from redeeming investors where redemptions cannot be met from cashflow, can limit the ability to cater for individual needs when differences emerge. Accordingly, many investors have not had their redemption requests met, or have suffered long delays and cost penalties. This has been a particular issue for funds catering for retail investors, where inflows and outflows of capital are susceptible to changes in short-term sentiment.

These drawbacks have prompted a search for alternative investment models. Some investors have rediscovered direct property, despite its limitations (particularly for smaller investors), as a way of reasserting control over their portfolios. Likewise, some have turned to joint venture (JV) ownership structures as an alternative to pooled funds.

Understanding these issues raises the difficult question of whether such shifts in attitude will prove to be permanent, or are just a cyclical response to the market downturn. We believe that the direct property and JV solutions will prove to be the latter, although we foresee a more balanced approach to the use of different forms of property investment in the future.

In this context, it is appropriate to consider the investment market climate and the suitability of products to meet investors' needs, and it is to these issues we now turn.

Investors are taking a more cautious approach to the use of debt

Cross-border activity has reduced, but we expect this to be temporary

Reducing liquidity in pooled funds has prompted a reassessment of other options

A more balanced approach is likely in the future, but indirect investment still has an important role to play

## Reassessing the case for indirect property investment

### Where do we go from here?

While international economies and property markets remain in a fragile state, with considerable uncertainty, some reasonable assumptions can be made about the investment environment that is likely to persist over the next few years. In particular:

- While property yields once again look enticing relative to other asset classes, most markets will have to wait some time before rental growth reasserts itself.
- Lending conditions will remain tight for some time, and in this cycle there is unlikely to be a return to the ready availability of debt finance for property investment that helped to propel markets to their recent peaks.
- Investors may seek to exploit property's yield advantage in the short term, but will focus on longer term income security and growth prospects to drive their asset allocation decisions in the long term.
- As liquidity and confidence improve, cross-border investing will be back on the agenda for many institutions.
- Likewise, there is likely to be a reduction in risk aversion, which will mean emerging markets will attract renewed attention, but these are likely to be subjected to greater scrutiny than before.
- While leverage increases portfolio volatility by magnifying positive and negative returns, it does not change the timing of the return cycle, so diversification benefits are not affected.

In our view, the more cautious approach to the use of leverage in property portfolios seen recently is likely to mark a structural shift, driven by the attitudes of both borrowers and lenders. Even when more normal credit conditions return, it seems unlikely that the appetite for high volumes of property debt will rebound to the levels seen in the earlier years of the decade. Consequently, the balance of investor demand is likely place greater emphasis on core, cashflow-driven strategies than in the past, with rather less appetite for value-added and opportunistic vehicles.

We believe the recent retreat from indirect investment and cross-border investing will prove to be a more cyclical phenomenon, and that international activity will pick up strongly as liquidity improves.

In practice, the arguments for indirect investment remain as valid today as they were in the boom times. Investors with limited resources have access to portfolios of a size, quality and geographical spread that would be unavailable through other means. In particular, indirect investment remains the most attractive option for smaller investors, and for those seeking cross-border diversification. The circumstances that triggered a synchronised global collapse in asset values across the investment spectrum were highly unusual.

While we do not regard the model as fundamentally broken, it is equally clear that lessons need to be learned. Investors' priorities have shifted. In future, they are likely to require managers to use debt more selectively and strategically, with less reliance on "financial engineering" to generate returns, and fee structures aligned with this shift in mindset. At the same time, investors should probe more thoroughly the investment strategies being pursued by pooled fund managers, and the liquidity provisions purported to be on offer. The challenge for fund managers is to bring forward a range of products offering a clearer alignment of managers' and investors' interests. This in turn will help to maintain choice for the multi-managers, and breathe new life into the fund of funds investment model.

It is important to consider what might be done to strengthen the pooled fund model to address investors' concerns, and to develop an approach to indirect investing that will be more resilient to changing market conditions in the future.

In this context, the following issues should be re-examined in the light of recent experience:

Markets remain fragile but property yields look attractive following their re-pricing

Improving confidence will support the re-emergence of cross-border investing

Investors will favour lower risk products than in the past, with less aggressive investment strategies

Many of the arguments for investing indirectly are unaffected by the recession

However, there is a need for closer attention to investment risks, and structures offering better alignment of manager and investor interests

## Reassessing the case for indirect property investment

### Use of leverage

The use of leverage in property portfolios will once again help to boost returns as asset values recover. Nevertheless, recent experience shows that debt needs to be more closely managed, and its effects need to be better understood by investors. In particular, our research indicates the following important issues that should be taken onto account in portfolio construction:

- If debt is to be used, its effect on performance should be consistent with the fund's stated risk profile, and investment restrictions should be put in place to ensure this is embedded in the investment strategy.
- Where applied, the level of debt should be sufficient to be meaningful, but for all but the most opportunistic products it should be capped below the level that could place the fund's solvency in jeopardy in a severe downturn. Typically this would imply debt in the range 30% to 60%.
- Leverage increases portfolio risk (volatility) faster than it increases returns, so risk adjusted returns will tend to decline as debt is added.
- Increasing debt progressively increases absolute returns, up to the point where high leverage in a falling market causes the fund to go bust.
- Although using debt will enable a larger, more diversified portfolio to be assembled (by buying more assets, and larger, multi-let properties), this is unlikely to fully offset the risk added through the effects of leverage, particularly for larger portfolios.

Where debt is to be used, there needs to be a clear rationale. Since it is hard to justify any use of leverage on a risk-adjusted basis, investors should look for other benefits. Examples might include higher absolute returns (which implies the manager should be willing to adjust the level of debt tactically to protect against negative consequences in a downturn), or an ability to access large lot size assets that would otherwise be unaffordable.

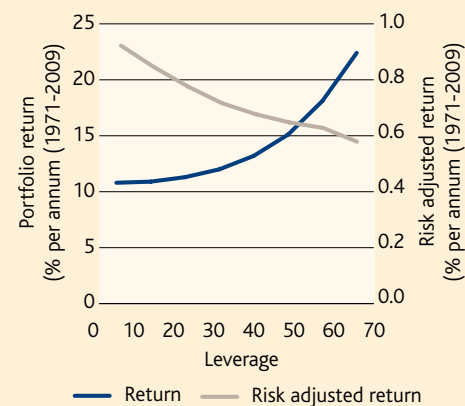
### Fee structures

There needs to be an alignment of interest between manager and investor in the setting of fee structures. Typically, fund management fees for geared portfolios have been charged on GAV. While this is logical to the extent that it reflects the scale of the overall property portfolio to be managed, it also implicitly rewards the manager for maximising borrowings at all times to acquire the largest possible portfolio. There is an in-built disincentive to reduce borrowings, even when it is appropriate to do so, as it will have an immediate, damaging effect on the manager's revenue. A better approach could be to focus on net asset value (NAV), although this would require a higher headline rate to generate the same fee. There has been some reluctance to move in this direction for fear that the higher quoted fees look less marketable, or might be compared inadvertently and unfavourably with GAV-based fees by the uninitiated. Clearly some education is needed in this area.

Where a performance fee is charged, there is also an argument to base the fund management fee on equity committed or drawn, to avoid a situation where good performance is rewarded twice. However, from a manager's perspective the logic of this approach must be considered against the likelihood of rising overheads during the fund's life.

Performance fees will be better aligned with investors' needs if they reward sustained and consistent delivery to targets, rather than short-term bursts of strong returns. In devising an incentive structure, the relative importance of the contributions from underlying asset performance and "financial engineering" both need to be considered.

**Figure 7 Impact of leverage on ungeared returns**



Source: Aberdeen Property Investors, IPD

Note: Analysis based on UK 'all property' total returns

The use of leverage should be critically examined, and appropriate risk controls imposed

Fee structures should reflect investors' performance objectives

In particular, they should not incentivise the manager to gear assets to the maximum

## Reassessing the case for indirect property investment

### Liquidity mechanisms

There are signs that the recent illiquidity pressures are starting to ease, as values in some markets begin to stabilise. As investor appetite improves, investors will seek to rebalance portfolios “frozen” by the recent lack of transaction activity. Against this backdrop, we believe that there is likelihood that a better developed secondary market for units in non-listed funds will emerge internationally as market conditions normalise.

Nevertheless, investors should recognise that while indirect investment can offer a more liquid approach to property investment under normal market conditions, in a bear market it can become highly illiquid. At the same time, managers should ensure that liquidity mechanisms are more consistent with the liquidity profile of the underlying assets, and that the stated fund terms do not make unrealistic claims that may prove impossible to deliver in a downturn.

### Performance measurement

The instability of markets and some portfolios has raised awareness of the need to better understand what drives performance in property funds – and in particular the respective contributions from the underlying portfolio and the financial structures built upon it. Reporting has tended to focus on fund level results, while the most useful property market indices in the major markets have focused solely on the direct property element. However, the position is improving as pooled fund indices become established, offering a richer source of comparative measures against which to judge the performance of individual products. This should also help to address other weaknesses: an over-reliance on absolute return performance targets for cross-border funds, and a lack of useful performance attribution analysis – both owing to the limitations of the available international benchmarks.

### Conclusion

As we have seen, the market gyrations of the past two years have put extreme pressure on established models of property investment, testing them to the limit and sometimes beyond. The root cause of many of the problems, where they have occurred, has not been the general fall in property values (although in some markets this has been severe), but the incautious use of debt to grow funds and to magnify returns. This has undoubtedly added to market volatility, and has also contributed to the recent illiquidity.

As western markets begin to emerge from recession, it is important that fund managers, investors and lenders take stock of the lessons to be learned in designing new property products, and reviving established ones. If this can be achieved, the painful experiences of recent history will not have been in vain. Without doubt most of the arguments for the use of indirect property investment as a route into the market remain intact, despite the bruising experiences of the recession. Equally clear is the fact that a better-informed approach to this segment of the market is needed, to take advantage of the developing opportunities for the future, without repeating the mistakes of the past.

As conditions normalise there is a realistic prospect that a better developed secondary market for units in funds will develop

Improved performance attribution will become possible as comparative measures improve

Debt has been at the heart of many of the recent problems in property funds; not a failure of the underlying market

The lessons learned from this experience now need to be applied

# Reassessing the case for indirect property investment

## Important information

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