june 2017

investment bulletin

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Institutional Investment in Property

July's Markit Business Outlook indicates that UK business optimism fell in June, led by weakest service sector confidence for seven years. Fragile business sentiment is linked to Brexit-related anxiety, domestic political uncertainty and squeezed consumer budgets. Service providers reported the least optimistic outlook for corporate profits since 2011 and expectations for service sector business investment over the next 12 months are subdued. This Service sector view is at odds with Manufacturing optimism based on gaining sales in overseas markets arising from a weaker pound. Manufacturing sector business investment intentions are now well above the post-referendum low seen last year

MSCI data indicates that All Property prices continued to grow in Q2 and have now risen for the last 9 months in succession. The rate of capital value growth as measured by the MSCI Monthly index accelerated from 0.9% in Q1 2017 to 1.1% in Q2.

Institutional investors bought commercial property in Q1 2017 acquiring property assets worth £1.64bn and recording sales of £1.37bn. Net investment in Q1 of £279mn compared to net disinvestment of £1.32bn in Q4. In the 12 months to March, net investment by institutions amounted to £664mn compared with net disinvestment of £2.1bn in the 12 months to December 2016.

In the first quarter, **pension funds** invested a further £276mn compared to a net investment of £99mn in Q4 2016. Total investment by pension funds in the 12 months to March amounted to £899mn compared to £740mn in the 12 months to December 2016 and £224mn in the year to March 2016. **Life companies** continued to sell property. Net disinvestment in Q1 amounted to £25mn compared to net disinvestment of £167mn in Q4 2016. Total disinvestment in the 12 months to the end of March amounted to £475mn compared to £504mn in the 12 months ending December 2016 and net disinvestment of £703mn in the year to March 2016. **Property Unit Trusts** disinvested £232mn in Q1 compared to disinvestment of £1.50bn in Q4 2016. Net disinvestment in the 12 months to the end of March amounted to £1.27bn compared with net disinvestment of £3.59bn in the 12 months ending December 2016 and disinvestment of £1.30bn in the year to March 2016 (National Statistics, 2017).

In Q2 2017 total investment in UK commercial property by all domestic and overseas investors decreased by 12% to £11.3bn from £12.9bn in Q1.

Investment in Central London offices in Q2 decreased by 34% to £3.3n from £4.9bn in Q1. This key market segment made up 29% of all transactions in Q2 compared to 38% in Q1. Shopping Centres benefitted from strong levels of investment in Q2 but investment decreased for Rest of UK offices and Retail Warehouses compared to Q1. (Property Data, 2017)

Investment by UK institutions and property companies decreased by 13% in Q2 to £5.3bn from £6.1bn in Q1. Money into commercial property from overseas investors decreased by 11% to £6.0bn from £6.8bn in Q1 and overseas investors share of the UK investment market remained unchanged on 53%. (Property Data, 2017)

The largest deals of Q2 were the acquisition of The Grosvenor House Hotel for £600mn; and Hines sale to Deka of the Cannon Place office building for £485mn. Other notable transactions in Q2 included a 13 asset portfolio providing 6,500 student beds; and a Factory Outlet portfolio.

Total institutional investment in Q1 turned positive for the first time since last year's referendum. Net investment amounted to £11.6bn compared to net disinvestment in Q4 2016 of £16.9bn. Investors, however, continued to reduce their exposure to risky assets. Institutions made net disinvestments in Q1 of £16.2bn in UK equities and in £7.2bn in Overseas equities but increased their holdings in Cash and Other Short Term Instruments, UK gilts and property. (National Statistics, 2017)

UK real estate and factor investing

Increasingly, investors are switching to "factor" investing or "smart beta".

Conventionally funds have allocated money to mainstream asset classes such as bonds and equities and to alternative investments like real estate, commodities and hedge funds. Allocations have been made in some cases quite arbitrarily in proportion to market value. A European equity fund might weight its holdings in the manner illustrated by table 1. In a similar way a UK private real estate fund might seek to weight its holdings in proportion to the capital value of each segment in its MSCI benchmark.

Table 1; Sample asset allocation

Exchange	Size ($bn)	Asset allocation
Euronext	3,379	27%
LSE	3,272	26%
Deutsche Bourse	1,738	14%
SIX Swiss Exchange	1,479	12%
NASDAQ Nordic Exchange	1,253	10%
BME Spanish Exchanges	833	7%
Borsa Italia	653	5%

Such market-weighted approaches overweight securities or assets with high prices and underweight those with low prices. They have also been shown to be rather concentrated in a small number of mega-cap stocks, sectors and certain market segments and hence lack diversification, which may lower their returns and increase risk During the Great Financial Crisis (GFC) seemingly efficient market weighted portfolios suffered disproportionately because the traditional asset classes are in fact correlated.

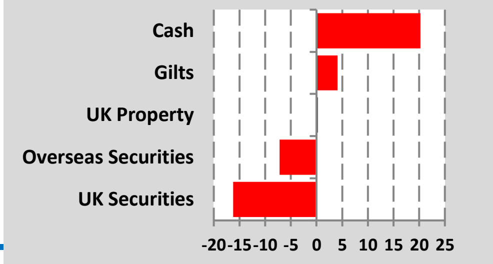
Increasingly, investors are switching to "factor" investing or "smart beta". Smart Beta attempts to deliver a better return/risk trade-off than conventional market cap weighted indices by using

Investment in UK Property
Q1 2017 (£m)

	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	592	540	512	1,644
Sell	316	573	476	1,365
Net	276	-33	36	279

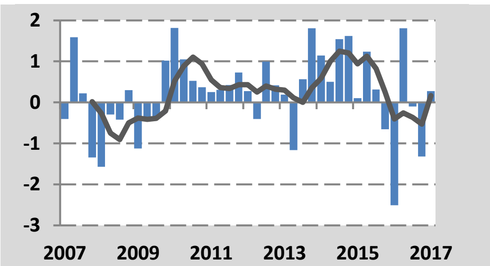
Source: National Statistics

Net Institutional Investment (£bn) Q1 2017
By asset type



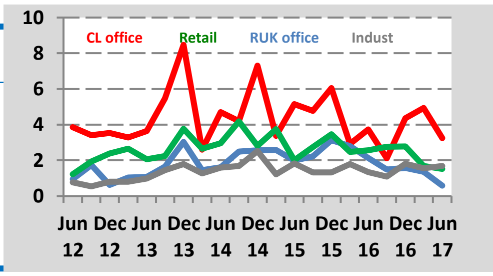
Source: National Statistics

Net Institutional Investment in Property (£bn)



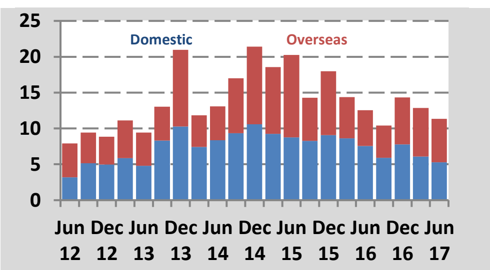
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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alternative weighting schemes based on company characteristics which have been shown to be related to future asset returns such as accounting metrics, price momentum or volatility.

MSCI[1] indicates that a factor can be thought of as any characteristic relating to a group of securities that is important in explaining their return and risk. They identify six factors for equity investing that have historically provided a return premium; namely, Value, Low Size, Low Volatility, High Yield, Quality and Momentum.

In UK commercial real estate the market has been segmented by use and geographic location. The traditional IPD / MSCI market illustration is illustrated in Table 1.

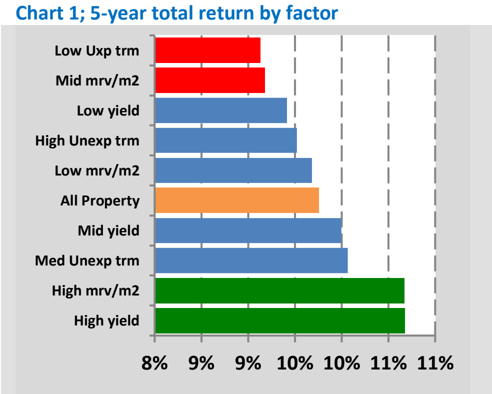
Table 2; Traditional IPD / MSCI segmentation

Segment	Size (£mn)	Asset Allocation
SE std. retail	14,492	10%
RUK std. retail	9,678	7%
Shop. Centres	12,328	8%
Ret. Warehse	22,758	15%
City offices	5,836	4%
WE & Mid offices	14,505	10%
Rose offices	14,117	10%
RUK offices	8,398	6%
SE Industrial	17,992	12%
RUK Industrial	11,223	8%
Other	16,202	11%

Source; MSCI

In a similar vein to the smart beta process described above we can seek to identify characteristics of real estate that drive out-performance. So far we have been able to analyse the impact of Yield, Unexpired Lease Term and Market Rental Value (see Charts 1 & 2).

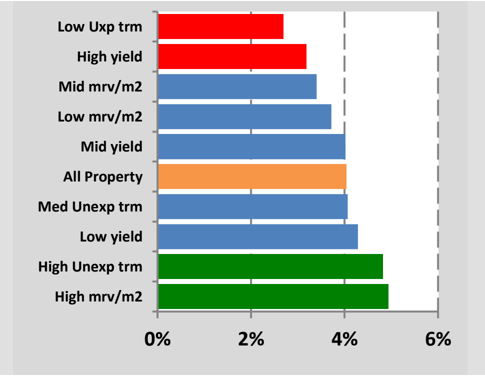
Chart 1; 5-year total return by factor



Source; MSCI & APR

Over five years to March 2017, real estate assets with a relatively high yield and high market rental value per m² clearly out-performed. Whilst equally importantly assets with a low unexpired term and low yield under-performed. During this time period real estate assets enjoyed a period of robust performance supported by a stable economy in the course of recovering from the GFC.

Chart 2; 10-year total return by factor



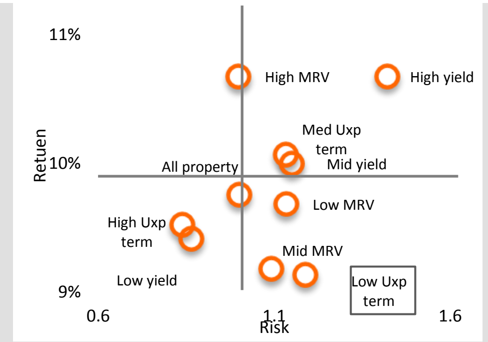
Source; MSCI & APR

Over ten years to March 2017, real estate assets with a relatively high market rental value per m² and high unexpired term out-performed. Assets with a low unexpired term and high yield under-performed. During this time period real estate assets suffered a period of volatile performance as the GFC triggered a period of great economic instability.

The difference between the analysis in Chart 1 and Chart 2 is a timely reminder that factors driving performance will change through the cycle. Sensible portfolio construction cannot be ignored and fund managers need to ensure that the appropriate factors are carefully monitored throughout the cycle.

Return, however, is only one side of the investment equation. Investors also need to know how much risk they are taking on (see Chart 3).

Chart 3; Factor risk



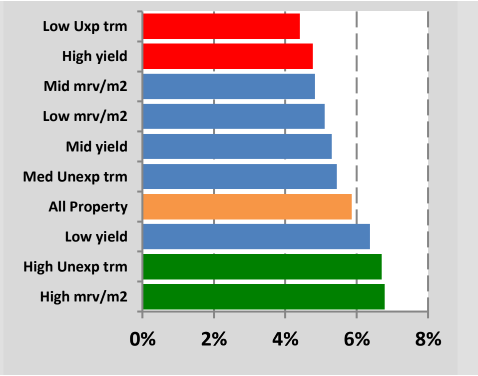
Source; MSCI & APR

Finally for now, if we adjust the performance numbers for risk we can calculate how much return a factor is generating for every unit of market risk (Chart 4).

Over five years to March 2017, real estate assets with a relatively high market rental value per m² and high unexpired term out-performed on a risk adjusted basis. Assets with a low unexpired term and high yield under-performed on the same basis. These are the same factors suggested by the analysis of 10-year performance in Chart 2; suggesting that low volatility is the key factor if investing through the cycle.

[1] MSCI. (December 2013) Foundations of Factor Investing.

Chart 4; 5-year risk adjusted total return by factor



Source; Property Data & APR

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