The changing role of real estate in cashflow matching strategies

At a time when interest rates are starting to rise but the hunt for yield goes on, pension funds seeking cash flow matching strategies could do a lot worse than consider real estate income, says Ian Mason, a veteran of the property fund management industry.

This may seem surprising to many who traditionally regard property as a total return asset sitting in the growth allocation of a pension portfolio alongside equities, but with 32 years' experience at Mercury Asset Management/Blackrock and Schroders, Mason noticed that the needs of UK pension funds were undergoing fundamental change and he joined AEW UK to launch their Real Return Fund.

The property fund market has responded well to the changing needs of institutional investors, developing different matching strategies. These include long leases, real estate debt and ground lease funds. However, as these have found the greatest support in the actuarially-driven world of closed defined benefit schemes, they are shaped more as bond-proxies rather than strategies aimed at delivering a real total return and preserving capital, as well as providing a high level of income. Hence the conviction that there was a need for something different.

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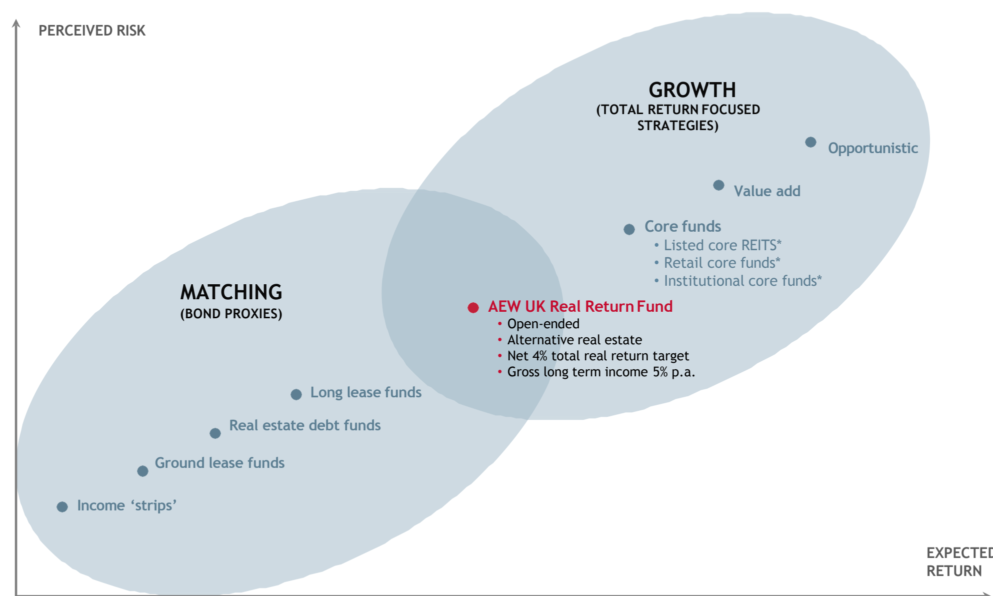
Chart 1. The property sector has responded well to the needs of investors and developed a range of new strategies; although these are mainly used as bond proxies:



Source: AEW * All typically seeking to outperform the MSCI peer group total return benchmark

The new AEW strategy focuses on the fact that whether saving for a pension via a corporate defined benefit (DB) scheme, a defined contribution (DC) scheme or a private pension such as a SIPP, most lifetime savers' underlying liabilities are linked to inflation. Real assets are therefore an excellent match for the cash flows which investors require. The issue for traditional core "growth" strategies is that they tend to focus on relative peer group total returns that produce cyclical volatility that is increasingly seen as unacceptable risk in cash flow matching strategies.

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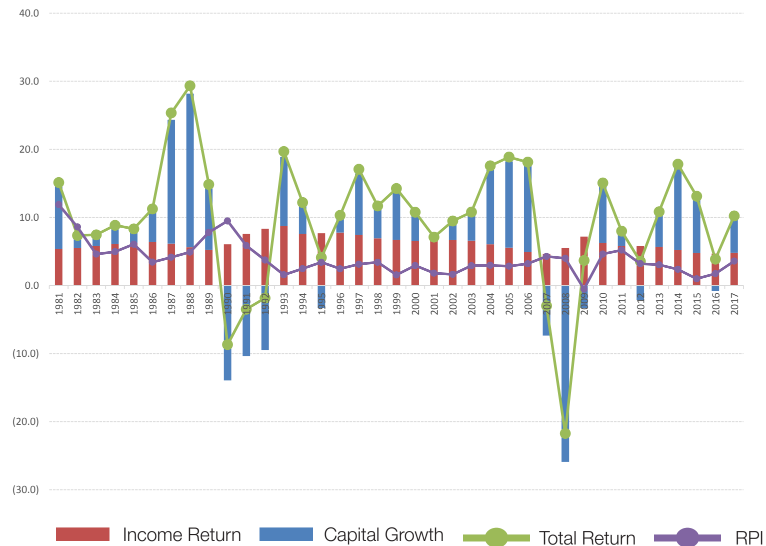
Chart 2. The volatility of property's total return disguises the fact that stable income has driven 70-80% of property's performance:



Source: MSCI

As a real asset however, property has delivered annualised returns of over 5% pa above inflation since 1980. In fact, nominal income returns alone have been more than 6% pa over the same period - ideal for cash flow matching and for inflation-linked liabilities.

So what seemed to make sense to the team at AEW was that if 70-80% of property's performance came from stable, sustainable income, then the Fund should have a core property strategy that simply focused on cash flow and income growth and avoided the traditional risks like development and leverage. After all, property is a very simple asset class; if you focus on property fundamentals and buy good quality buildings in areas of strong occupier demand, then if the market rent goes up, the value goes up. So unless you have paid a premium for the bond-proxy duration of a long lease, you get the capital growth for free.

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Why is this relevant now? Well, in the current economic environment the new dynamic which has come into the equation is the prospect of rising interest rates as monetary tightening in the USA is starting to influence policies in Europe.The prospect of higher inflation driven by growth (rather than rising costs) in the US and UK should not be seen as a threat. Indeed increasing rates are normal at this stage of the cycle and certainly healthy, especially after such a prolonged period of accommodative policy and we anticipate this should not heavily impact the macro environment that should remain very supportive of the prospects for UK growth.

However, it is natural to expect that bonds should suffer from the rising rate environment, especially those delivering a fixed coupon and those with a long duration where expected cash flows will be discounted using higher rates. And the same should be expected of property strategies which are used as bond proxies. This means that there is a lot of capital at risk from rising bond yields even on long lease strategies despite the fact that they offer a relative yield advantage. That might be acceptable in the world of actuarial valuations that assume liabilities also fall alongside valuations, but not if you are a scheme sponsor trying to plug a deficit and few schemes have the luxury of a surplus that allows capital to be eroded whilst driving cash flow off a shrinking asset base.

As usual, the main questions with rates tightening should remain about the pace and speed of rate hikes and on how central bankers manage market expectations to avoid generating "surprises". We believe that the current rates' normalisation path will continue although this does not mean the end of growth; but the recent adjustments have signaled the end to the "bonds bubble". There are, however, ways for fixed income investors to take advantage of this environment as economies rotate into a growth phase.

One of these is real estate income but it requires a strategy where returns are driven not by total returns but by the cash flow available from good quality property and real income growth from occupier demand.

The AEW UK Real Return Fund was launched 2 years ago and as at 31st December 2017 was distributing a 5.3% yield from a portfolio of 35 properties, with a weighted average lease length of over 17 years and 77% of income linked to inflation.The strategy offers clear alignment between the Fund and the needs of investors, as well as a foot inside both equity and bond camps: a real asset growth strategy with relatively high levels of sustainable income as the hunt for yield continues.

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