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The Spirit of Independence

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Should LGPS funds invest in UK housing?

With the UK government committed to deficit reduction, it is eyeing the capital managed by pension funds in the private and public sector to satisfy an investment gap in the UK economy. Media attention has focussed on infrastructure. In this paper, we look specifically at housing, where there is significant undersupply.

LGPS funds are responsible for an estimated £150 billion of assets. If Committees were to consider investing a proportion of these funds in areas such as social or affordable housing, what issues would they need to consider? Do these investments represent an attractive opportunity or are there good reasons why almost no investment has taken place in the past?

Background

There is a chronic shortage of UK housing. This can be traced back to the sell-off in Council housing stock in the 1980s, which encouraged a generation of rental householders into home ownership, with much of the remaining Council rental stock transferring to Housing Associations. Since that time, population growth has far outdistanced new home construction. Official projections estimate that the number of UK households will grow by 272,000 per year until 2033. At the same time, the supply of new homes is falling. Between 2006-07 and 2010-11 the number of new dwellings completed annually fell from 219,070 to 130,790 – a fall of 40%. This is not expected to reverse any time soon. Local authority budgets are being squeezed, and private developers are feeling the strain of tighter bank lending policies.

Houses remain unaffordable for many; the ratio of average house prices to average earnings remains high at around 4.5 times. This is particularly true for the current generation of young adults, debt-laden from university and unable to afford the quality of housing that their young families desire. The average size of the required deposit has doubled from 5-10% to 15-20% of purchase price. As a result, pressure on the rental market is increasing and average rents are being pushed higher.

Is this an investment opportunity?

Although institutional investment in residential property is common in many countries, it has never figured significantly in the UK. This is blamed on small lot sizes and tenant management issues (rent collection, maintenance), all of which are more easily accommodated in Office, Retail and Industrial properties. However, there is also a major issue, in that many stakeholders in UK housing (owners, builders, realtors, politicians) are more interested in high and rising house prices. Other things being equal, investors should be more interested in buying cheap assets on which satisfactory future returns can be generated.

Most products we have seen in this area have been relatively modest in scale and almost all depend on rising house prices as a key factor in driving future investment returns. Notwithstanding the current shortage of supply, we cannot see how prices can continue to rise when they are unaffordable for many. Further, at an economic level, rising house prices do not add to UK wealth. Instead, they result in a regressive transfer payment, typically from the poor to the rich and from the young to the old.

What would make investment in this area attractive?

For LGPS funds, we believe that returns comparable with equities are necessary (allied with no greater risk), to aid in deficit repair. This would be satisfied most appropriately by an inflation linked rental stream (net of costs) with a starting yield in the order of 4-5% p.a. We believe this would be more viable in current circumstances if the unit housing cost could be reduced significantly below prevailing prices, e.g. by making land available cheaply to pension funds (possibly re-zoning for residential use) and building condominium style (apartments) to a common (though not identical) design template. In some ways, this would mean setting up the pension fund as private landlords, almost in competition with existing regulated social landlords (RSLs), although we would anticipate that residential management would typically be outsourced to these RSLs and the pension fund and RSL would work in partnership.

There are spin-off advantages, e.g. increased housebuilding will increase local employment opportunities. Further, there is a local benefit arising from an increased supply of affordable rental accommodation available on long-lease; this should stabilise or reduce private sector rents (making housing subsidies more affordable for Councils), but competing private landlords are unlikely to be pleased. Local house prices may also stabilise, because of an increased supply of accommodation.

We have seen products which provide long-term lending to regulated social landlords (replacing the lending they previously obtained from banks). We do not believe the returns generated by these products (typically CPI + 2%) are sufficiently high to satisfy the needs of LGPS funds (CPI + 4-5% net).

Social housing has the potential to be a key area of investment for pension funds. It has low correlation with the economic cycle and provides cash flows that are well matched to pension funds' liabilities through its embedded inflation linkage from rents. However, it is likely to be attractive only to long-term investors, such as local government pension funds, due to its illiquid nature and the timescales required to realise sufficient returns.

What do Committees need to ask?

Investment in social housing could present an attractive case for those looking to address any social responsibility and localism concerns. However, the primary aim must be an appropriate risk/reward profile and there are a number of issues that Committees need to address:

- Will the investment returns be satisfactory and what are the risks?
- Can we find people with the right expertise to provide unconflicted advice to our Fund?
- How do we persuade ourselves that returns from investment in social housing opportunities in our locality are sufficiently attractive to compensate for the loss of diversification that would result from a wider investment pool?
- What additional costs (e.g. for legal advice and specialist investment knowledge) might be incurred?
- Could we work in an appropriate partnership with local RSLs?
- What reputational issues might emerge, e.g. in setting rental levels or where there are particular management problems with tenants?

Conclusion

On the surface, social housing would seem to present an attractive investment opportunity for local government pension schemes – long-term, inflation-linked cash flows that provide a steady income stream in line with scheme liabilities. There is further appeal through its 'socially responsible' nature. However, this should not be the definitive factor behind any decision making; there are significant issues of conflict of interest to take into account. Ultimately, Committees should remember that they have a fiduciary responsibility to the Scheme and their primary goal is to safeguard the interests of its members. Maximising returns for an appropriate level of risk must be a guiding factor.