

Local Authority Pension Fund Property Investment

Introduction

This note sets out the basis for the current approach local authority pension funds have to investing in direct property and the main reasons for maintaining these arrangement.

Investment Rationale

Local authority pension funds have a significant exposure to property. According to the independent StateStreet performance measurement service 8% of assets were allocated as at 31 March 2015. The main reasons for investing in the asset class were:

- Diversification away from equities.
- As long term investors local authority pension funds can manage the illiquidity of the asset class and be paid a premium for this.
- Scope for growth in capital value.
- Long term income streams which match the long term liabilities funds have.
- Ability to select asset managers who can add value though skill.

Case Study-Kent County Council Superannuation Fund

In 1995 KCC appointed what is now DTZ Investors to manage a £60m property mandate. 20 years later the direct DTZ portfolio is worth £450m and the Fund has other property investments in secondary pooled funds bringing the total allocation to around £600m.

During the period 1995-2015 the Fund has added additional capital of £215m and has seen capital growth of £145m. Additionally there is an income yield of around 6% per annum.

Over the 20 year period there has been an average return of 10.8% per annum.

The Kent Fund has regularly won property industry investment awards where its performance has been compared predominantly with private sector funds.

The Fund has a portfolio of around 30 strongly performing assets which if sold into the market would have a hefty premium attached to them.

The Fund does not wish to sell but to derive returns to pay current and future pensions from the income stream of rents and benefit from long term capital growth.

Why maintain the current approach to direct property?

The main investment reasons for maintaining the current approach are:

- Funds have built up their direct property portfolios over a long period. Scarcity of supply for high quality assets and the huge amount of due diligence needed to support a purchase means that direct property portfolios take considerable time and cost to build up. If a Fund has invested in the due diligence and incurred the substantial purchase costs (e.g. stamp duty and legal fees) it needs to hold the assets and receive the financial benefits over long periods. A Fund passing its assets into a pooled fund would have these financial benefits seriously diluted to its detriment financially.
- By running its own portfolio the Fund also has control over liquidity i.e. it is not in a position where it could be forced to sell good assets to balance the needs of other investors. By the same token, it is not under pressure from other investors to buy into the market at times when high quality stock is not available at sensible prices. As an independent scheme, the Kent Fund has been able to avoid sales and purchases at injudicious prices during market cycles and instead taken a measured approach which has resulted in better investment decisions.
- Each asset is unique and has been purchased for specific investment reasons. So unlike equities where a stock in a particular company is the same for all the investors no two properties are the same from an investment perspective. A pooling of the assets from different local authority funds means that the benefits of the expertise in selecting those assets will be lost.

Case Study- Battersea Park

The Kent Fund owns two properties in Battersea Park, one used for car servicing and one as a cash and carry. The December 2014 valuation was £23.5m but DTZ have already started working with Wandsworth Council on an ambitious scheme to build approximately 300 flats on the site. The potential value of this opportunity depending upon whether Kent develop the scheme itself or sell to a developer is a multiple of the £23.5m, easily double that value but quite possibly a lot more.

Clearly the Kent Fund would want to benefit in full financially from the development of its asset and not pool this benefit with others. The fiduciary responsibility of the Kent Fund is to its current and future pensioners and the employers who contribute to the scheme.

Again, pooled investors might have different maturity or risk profiles which would make this harder to achieve.

- Investment manager skill is a major determinant of returns. This skill applies in the first place to the identification and bidding for a property but at the right price. Once an asset is acquired then the investment manager will use their expertise to add value. For example the Kent Fund owns a retail outlet centre in Doncaster. DTZ are adding to value by using existing car park provision to add additional retail and food outlets thus giving additional income and adding to the capital value.
- Adding value requires significant resource. DTZ Investors use substantial resource from across what is now Cushman & Wakefield. This takes the form of class-leading market research, advice on market trends, dealing with occupiers and buildings, reporting and financial management.
- Valuation of assets would be a contentious issue. If an investor wants to invest in a high performing pooled investment fund then they will be required to pay a premium to get into the fund. Local authorities would similarly want a premium, which would have to be negotiated, for their assets.
- There would be substantial transaction costs such as stamp duty (stamp duty on purchases of commercial property over £500,000 is 4%) and very substantial legal costs.
- Costs of setting up an investment vehicle.
- Availability of high quality investment managers for such a large mandate.

Conclusion

Whilst the failure of some local authority funds to effectively manage their equity investments is clear and needs to be addressed the larger local authority funds which have been able to build up highly successful direct property portfolios have demonstrated skill both internally and through their selection of external managers to justify these assets continuing to be managed locally.