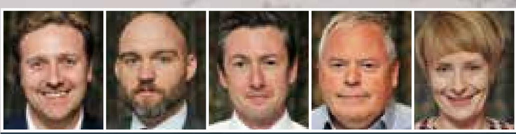
Property

Real returns



Matthew Abbott | Oliver Hamilton | Martin Towns
Duncan Whitfield | Lucy Williams

NOVEMBER 2018 | PORTFOLIO INSTITUTIONAL ROUNDTABLE

Property: Real returns

Property is an important asset for long-term investors. The right home, shop, office, pub, hotel, call centre or warehouse in the right location could provide regular, inflation-protected income that beats the current return offered by UK government debt.

It is also a diversifier, a benefit that has been highlighted during the on-going depression in gilt yields and the recent sell-off in London-listed equities.

These are just two of the reasons why many pension schemes have put serious investment to work here. RPMI Railpen has around £2bn tied up in property, while 20% of Southwark Council's £1.5bn retirement scheme is in bricks and mortar.

Alongside being a regular income payer, the asset class could also improve peoples' lives and even help save the planet.

Residential is now considered an institutional asset class thanks to fund managers solving the sector's lack of scale problem by funding projects that build at least 100 flats for rent. It is projects such as this that are helping to ease the UK's housing crisis.

They also tick the environmentally-friendly box on investor wish-lists as properties can be built to be energy efficient and thus cut a scheme's carbon footprint.

One of the reasons why this is possible is because, unlike with equities and bonds, those investing in real estate directly have more control over the assets.

So with real estate paying a regular income, protecting the environment and increasing the housing stock, what's not to like? Well, like all assets, property does carry risk.

The lack of a tenant is one such issue that has hit the headlines recently. Some of the landlords owning large high street retail units are looking for new tenants after department stores Marks & Spencer and House of Fraser announced store closures this year. With huge units to fill it doesn't sound an easy task.

I wonder how many more high street shops or restaurants have been saved from the brink of closure by a landlord agreeing to lower the rent and, therefore, their income.

Then there are those that warn that the wrong type of Brexit deal could lead to exodus of companies from offices on these shores. The same warning came after the UK voted to leave the EU and it came to nothing.

Commercial and residential property could be sold for more than the original investment, but there is no guarantee that this will happen. Who wants to be a forced seller at a time when prices are depressed?

Despite these risks, property should be an easy sell to pension savers. They understand it better than they do most other assets. They live in a property; they do the weekly shop in one and probably work in one.

Another benefit is that you can see and even touch what you have invested in. That carries more weight than a piece of paper with "I.O.U." written on it.

From the discussion that follows in this supplement, it seems that property has cemented its place in a pension scheme's investment portfolio; just don't call it a bond proxy.

Mark Dunne

Editor, *portfolio institutional*

Contents

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M&G Real Estate

Lucy Williams
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M&G Real Estate

Duncan Whitfield
London Borough of Southwark
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"In terms of diversification, lots of real estate reacts differently to market conditions. It is a massive opportunity."

Matthew Abbott, Mercer

PI: How strong is sentiment for property among institutions?

Lucy Williams: It is fairly positive.

Martin Towns: We have seen quite strong in-flows into the sector over the past few years. Clients generally view it as being attractively priced with the spread between UK real estate and bonds at an historical high. The UK also looks attractive on an international basis. A lot of overseas markets have continued to get more expensive, whereas the UK has stood still since the EU referendum.

Supply and demand, which influences rental incomes, generally looks quite positive. So that is also supporting positive sentiment towards the sector.

Matthew Abbott: My money is on a negative return in 2019. It was on a negative return in 2018 and 2017, but that is not what happened. I have been surprised at how far things have gone on the occupier side and in the investment markets. There are lots of supporting factors, like low bond yields.

Whilst we are not especially positive on UK property, we are not especially positive on anything else. Things are becoming more barbell. There is more demand for lower risk and more demand for high risk, but less demand for somewhere in the middle.

PI: What low risk property assets are you talking about?

Abbott: There is a lot of demand for long-lease real estate, anything that is going to get you inflationary income. The debt market is appealing. On a five-year view, do I want the UK property market or a whole loan that is giving me income? I want a whole loan that is giving me income.

We still have interest in the private rented sector (PRS). It is the broad IPD ‘beta-plus-a-bit’ approach that is not getting much traction at the moment. There is an argument for the value-add stuff, so taking income and improving it. So you are looking at the strong occupier markets and buying into that.

One thing I would note is that, from the data I have seen, expected supply for the next five years in Europe has had a massive uptick. That is concerning.

Towns: I agree with the point about value-add. In the UK there is a degree of investor risk aversion as we get towards March next year and uncertainty around the Brexit outcome. That is pushing more people into core real estate, so secure assets with secure income streams. It means there are more assets around which are being labelled ‘non-core’ or ‘value-add’ as people are worried about taking leasing or vacancy risks. What we are finding on the ground is that occupier markets are relatively strong and we are picking up some pretty good assets at attractive prices because of that.

There is a mismatch at the moment between investor risk aversion versus what we are seeing on the ground in terms of supply and demand in the occupier markets. That is an interesting opportunity.

PI: What assets look particularly attractive at the moment?

Towns: There is increasingly a divergence between the performance of the underlying sectors. The obvious one is retail versus industrial and logistic properties. As more retail sales move online, increased demand for industrial and logistic property has led to strong rental growth, whereas retail is under pressure for the same reason.

But you cannot generalise and say that all industrial property is good and all retail property is bad; very selectively, there are still some interesting deals to be found in retail. Likewise, with logistics you have to be cautious about projecting forward the rental growth that we have seen in the past few years.

PI: Duncan, 20% of your scheme is invested in property. Why are you so bullish?

Duncan Whitfield: From a local government grassroots point of view, it is a three-dimensional position. Southwark is all about regeneration, so we have a keen and acute local understanding of property, the land market and, indeed, housing. Where you have that intelligence within an organisation you are more likely to have your funds seriously looking at property.

There are now two aspects of property. There is the traditional retail, commercial, logistics part of the business, but now there is the emerging housing side. Even within the housing side you have the private rented sector and you have politicians, who are highly influential in local investments, who want to do social housing.

It is a mixed bag, but Southwark’s commitment to housing is about our knowledge of property as a business and over-ridingly we have, maybe fortunately, an experience of property continually gaining value. You may have to take some hits along the way, there will be periods where it all turns backwards, but take the long-term view that property, if it’s the right property, will gain value over time. Our fund is going to be around for a hundred years and more so why should we fear those blips in the system when we see a bit of a shortfall?

From a sector point of view, politicians are particularly nervous about Brexit. That is probably holding a lot of funds back in terms of their investments in property, but I’m not necessarily seeing that in the private rented sector. The housing crisis across the country means we have to build houses and a lot of that is private and private development brings with it affordable homes. I’m sensing from my colleagues that the private rented sector is alive and active.

Williams: There are a lot of mandates from local government pension schemes across the UK. They have existing exposure to core balanced funds and so they have residential property alongside as a diversifier.

Abbott: On the residential side, it is almost time to start asking 'why not?' as opposed to 'why?' In the US, most portfolios have a quota in all sectors – industrial, retail, office and residential. The market is less mature here, we have to build it out and the risks are different, but if you are not considering residential you need to ask yourself, 'why not?'

I remember being on a panel about five years ago and saying: "This will be an institutional asset class within 10 or 15 years." I said it facetiously and there was a groan in the room, but we are five years on and it's not as though everyone is getting onboard with it, so there needs to be a big push there. I want next year to be a big year for institutional investment in the private rented sector. Brexit might be good for that because you might see it falling in value, so the yields might look a bit more attractive in the next six to nine months.

We are seeing different types of residential, whether it's social housing, homelessness housing, student housing, senior living or shared ownership. There are so many strands of residential and, quite frankly, we haven't got our heads round most of them. We have got our heads round PRS but there is so many intricacies in the other parts, not least government policy.

Williams: It is not just about investing in funds. We have seen many of our larger pension scheme clients investing through co-investments. They are clubbing together to invest in a larger asset, having more control and paying less fees. That is a trend definitely for the LGPS pools going forward.

Oliver Hamilton: Do your clients see property debt as property? Most of our clients are not putting it in a property allocation; they are putting it somewhere else such as in fixed income or view it opportunistically. That has actually been easier for them because some are at their target property allocations.

Abbott: It depends on what kind of real estate debt. If you have senior Libor plus 3%, then that sits somewhere else.

Clients are slowly moving away from buckets, which I'm delighted about because there used to be a feeling that if something doesn't fit in a bucket then clients don't do it.

There is also a mantra that anything above a 10% in real estate is not the norm. Your 20%, Duncan, is the highest I have seen in LGPS or corporate. I don't know if it's a herding mentality, but, given that real estate does lots of different things, 10% is arbitrary and there is a lot of merit in going above that, whether it's debt or in something else.

Towns: We see clients increasingly reaching or targeting that 10% threshold. If you look back over a much longer period you find that it has historically been over that level. Since the global financial crisis you have seen people gradually up-weighting to real estate.

There has been an internationalisation of real estate exposure as well. People are not just concentrating on their domestic markets. There is also more money going into so-called 'alternative sectors' like PRS and student housing.

To Lucy's point, people who once focused on investing in funds are now looking at separate accounts and co-investments. It depends on their specific circumstances and what they are trying to achieve from real estate.

PI: Is property a bond proxy?

Whitfield: No, I see it as an alternative.

Towns: At some level for most clients property pricing is connected to bond pricing. From an asset allocation perspective, that is a driver of the relative value of different asset classes. But property behaves differently to bonds. If you look at the diversification benefits from adding real estate to a wider portfolio you can see that. You can see the correlations and you can see the impact it has on risk-adjusted returns. That tells us that it is not just a bond proxy.

Also within real estate you can make it behave more like a bond or more like equity, depending on the strategy you deploy. If you go into a long-leased product, where the majority of return comes from income and you may have an investment-grade tenant, then it is going to behave a bit more like a bond. If you go into value-add real estate you are taking more capital risk, but you have more upside potential and so it is more of an equity exposure. So real estate is not just a bond proxy; allocations to real estate are connected to bond pricing, but it behaves differently.

Abbott: There is an important difference between total returns, diversification and income. We have a lot of clients doing inflationary income-type real estate as a bond proxy. However, you have to go into it with your eyes wide open. I have major problems with people talking about long lease as a gilt substitute because in 2008 yields went up 20% and long-lease real estate funds went down 20%. With a 40% performance differential they are not a bond proxy.

In terms of wanting diverse steady inflationary income, I can see that argument. The other bit is looking right down the risk curve at things like ground rents and income strips where the water gets muddied even more.

PI: What yields is property offering?

Whitfield: As a product it is volatile. In the past couple of years we have been right up at a 10% return, but post-2008 our returns were closer to 5%.

There is the issue of valuation in the property world. I am cautious about the conservative nature of valuation. We put into our scheme valuation how much we think our property is worth, but it is actually worth a lot more because the valuers will, quite rightly, give a prudent view.

Abbott: You have got to factor in that valuations are backward-looking, so they might be worth less. The housing market's average discount-to-asking price last year was 20-odd percent. Valuations of residential houses mean absolutely nothing in today's market.

Property is far more volatile than everyone thinks it is, but at the end of the day you only get the price of the value that you record. There is no daily pricing like there is in an equity market. If there was then the pricing mechanism would almost drive the volatility.

Hamilton: That is also an issue if we start looking at various strategies, whether they are value-add or closed-ended funds. Some of the assets are being valued in different ways. Different parts of the world use different valuation methodologies, so do managers. So it's just being aware that it is something to pay attention to if you are going global.

Towns: As a generalisation, valuers in the UK are perhaps better at adjusting valuations as per market conditions. Some other countries have a methodology which can create a smoothing effect.

We have had a strong price appreciation in most parts of the property market over the past few years. Most people believe we are getting to a point where it is going to be much more about income going forward, which is why it is important to be thinking about which parts of the market you are investing into. Alternatives are a good example of where you could have a reasonably strong belief in supply and demand fundamentals and therefore an expectation of some continued rental growth over time.

Abbott: The other interesting bit on yields is that the UK is changing dramatically; industrial sector yields are lower than retail yields. Mean reversion is a statement that can come under loads of scrutiny. Will yields ever mean revert to what they used to be or is the world just a different place now? Industrial yields could well be below retail yields for the rest of time. I have no idea. On the valuer's side, ask if they are taking into account retail sector weakness in their valuations and I suspect the answer would be 'no'.

Hamilton: That goes back to Martin's comment earlier about how some industrials can be over-priced and some retails can be under-priced. The risk is that someone is buying an asset and pricing in rental growth which doesn't materialise. That is when you start destroying value.

Towns: That is why you are seeing a change in the relationship between retail and industrial yields. Retail rental levels are under pressure and industrial rents are going up. The question is can you sustain some of the pricing we are seeing in industrial and logistics, because unless you get that same rental growth going forward you may not see the performance you are underwriting.

Hamilton: Mangers have adopted different approaches to acquiring industrial assets. Some focus on regional areas because the yields are higher. Others are taking keener yields in the South East because that's where they see growth and a stronger economy.

Towns: For logistics we would advocate the latter in terms of concentrating on more supply-constrained locations. The danger with some industrial logistics, for example in parts of the Midlands, is that there is more land available and we are starting to see supply coming through, whereas in the South East you have a different dynamic.

Lucy Williams

"(Larger pension schemes) are clubbing together to invest in a larger asset, having more control and paying less fees."

Lucy Williams, M&G Real Estate

Whitfield: Most of our property is now directly owned. No two properties are the same. You acquire a warehouse on the A1 for logistical purposes. You will acquire it near a regenerated transport hub, which is going to explode once the regeneration is complete. It varies from place to place. You buy a property at a deflated price in an area that will be regenerated, but you don't know when that will be. It may be five or 15 years out. The one thing you know for sure is that when it is regenerated everything that happens around that property will add to its value. So it's quite interesting when you break it down into the granular bits and pieces that make up your portfolio. All those elements are there for a special purpose and that's why you need a smart fund manager to look after it for you. It is clever work.

Towns: There is a macro story in terms of what drives money into property. You can generalise about which sectors are good and which are bad, but it comes down to the individual asset at the end of the day and for the asset manager to understand the supply and demand dynamic in a particular location.

PI: What structures are available for direct investment in property?

Towns: We run open-ended and close-ended funds as well as separate accounts and also create joint ventures and club deals.

Over the past few years we have seen increased interest in direct investment. Since the global financial crisis, investors want more control over their investment strategy and more transparency around what they are actually investing in. More control over the exact point of entry and at the point of exit as well.

Direct investments are through separate accounts or joint ventures and club deals. The strongest growth area is joint ventures and club deals where you are buying a larger asset and there are two or three investors participating. The attraction for investors is that they can see what they are investing in. They can underwrite it on day one and talk about how the governance of that vehicle is going to work.

Whitfield: They can even visit it.

Towns: That's what we do. The clients who invest in those types of transactions come with us and look at the property and we all discuss it on the ground in person.

Abbott: The difficult thing with that is it's only a certain kind of client that can do that in terms of the governance model and the amount of capital available. Most clients don't have either.

Hamilton: For some club deals and co-investment opportunities, there have been a number of our UK clients that have been interested, but to get the trustees comfortable in the time period required has been very, very difficult for them.

Towns: That is the biggest practical issue that we come across. There are a lot of investors who see the attraction of doing it, but you have to be set-up in a way that you can execute on those. You need some degree of resourcing and relevant internal expertise, but also you need to think about which managers you are doing it with. If you have a manager who has done it before they can help guide the client through that process and help manage the whole transaction in the interests of all the stakeholders.

"What I like about real estate is that it is actively managed."

Oliver Hamilton, Townsend Group Europe, an Aon company

Oliver Hamilton

Abbott: There are two points on fund structures. First and foremost, you want the best manager for the job. If you are looking at PRS you are probably going to be in a pooled fund because the separate account managers aren't as well placed as the pooled fund managers. In any given strategy, I would have a preference for a separate account because you are not impacted by other unit holders, which has been a massive issue two or three times.

The second bit is about fund structures and there are two contradictory things here. The first is that there is a lot to be said for investing with like-minded investors. The challenge there is that most fund managers are looking to diversify their investor base because they don't want a load of defined benefit (DB) pension schemes as they will have an end point. So this points to changes in structure and to bring other types of investors in. That can have a profound impact, especially if you start looking at retail investors, defined contribution (DC) investors and DB investors; how do you treat those three separately? What is the best kind of structure to diversify your investor base to protect the future of your business, but also make sure that people are still investing in it because they are with like-minded investors? That's a bit of a challenge.

Hamilton: Most of our clients, if they are going direct, go through a manager. Few of them have the resources of an internal team to build up a direct portfolio and then manage that in-house.

On the point about control, quite a few of our clients' segregated accounts are on an advisory basis and not discretionary. With an advisory mandate our clients have an extra level of control and can challenge the manager's assumptions and rationale.

In the past acting on behalf of clients and working with internal teams we have raised questions around the underwriting. For example, ensuring we are comfortable with covenants of some of the tenants, especially when you are talking about alternative properties – healthcare homes, etc – where you don't just underwrite the property. You need to be confident in the operational business in place as well. That's where that challenge of making sure that they have done the due diligence is incredibly important.

PI: Is pooling boosting property investment?

Whitfield: I am curious, but not surprised, by the pools' response to property. The pools' have difficult jobs herding all these cats and bringing things together, but the one big benefit would be big property funds within each of the eight pools. For the most part it seems to have been put at the backend of the programme of acquisition and procurement. That surprises me.

Abbott: Is it because it's difficult?

Whitfield: The pools don't necessarily understand it, so they have tended to dive back towards equities and other things that they understand.

I would have thought the bigger benefits would have come from those larger-scale alternatives. Even within our property investments there are bigger deals that we would like to undertake, but they are just too large in the context of our risk profile. If all of London, for example, had access to a pooled resource for those bigger assets then they would be immediately more achievable.

Williams: We are speaking to pools about co-investments. We are working with a scheme at the moment in terms of looking at their local area and then putting together co-investments. It will come, definitely.

A lot of the local government schemes, not necessarily in London, invest via fund of funds structures, but they will disappear because one of the drivers is reducing costs. That would be an opportunity to go direct in the UK and invest through internationally-focused pooled funds. Those are the conversations I have been having, but I agree it is at the backend. So it's equities, fixed income and then real estate.

Abbott: Putting fees aside, there is a massive opportunity for the pools to do some good things, whether it is diversification, going big on residential, going into certain debt structures, big lot sizes or taking 15-year regeneration plays. If you ask Schroders about their regeneration plays, they had a few years of absolutely dreadful performance in Bracknell, then things came back. Can you take a 15-year view? Most people can't; the pools could, especially if it's direct.

In terms of diversification, lots of real estate reacts differently to market conditions. It is a massive opportunity.

Hamilton: That's a good point. Should a core fund be investing in riskier developments? There is a limit

to the risk they should be taking. Someone has to do it and a large council pension could if they are comfortable with the risks involved.

Just out of interest, do you see a potential issue where different council pension schemes have very different requirements from the same property pools? For example, some might be focused more on income, others on capital growth. If you have that pool, how would you get together and agree on an overarching strategy?

Whitfield: I still don't know quite how to do that, but at the end of the day the pools need to be leaders. They need to be customer focused about understanding those differences. You can't be all things to all men. You have to show some leadership and say: "This is how we are going to do it. If there are significant variations, we will find multiple products that will meet the different requirements." Getting 33 agreements is not the same as getting three.

Local Pensions Partnership is probably the furthest advanced in this world, but getting the agreement of Lancashire, the London Pensions Fund Authority and Berkshire is not the same as getting 33 London boroughs to agree. It's a different trick.

Abbott: The other challenge with LGPS' is that because of the nature of their organisations they like the idea of investing in their own borough.

Whitfield: This has to be why an arm's length approach is needed. "You are the manager. You know what you are doing. You have been picked because you are a good manager, not because you are going to invest in one place."

In London you could imagine the difficulty of that because we all want the investment in our borough. If it is agnostic and the managers invest where the returns or the growth are going to come from then that actually takes some of the localism out of it.

Duncan Whitfield

"The pools open another door for investment in this world, but it's currently at the backend and that to me is curious because it should be a no-brainer."

Duncan Whitfield, London Borough of Southwark

PI: What makes a good property manager?

Whitfield: Trust, openness, transparency and performance net of fees.

Now, you can only get to the last point by making the right choice. Sometimes you will get it right and sometimes you will get it wrong. Relationships over a period of time will not be the same. The relationship with our manager has probably had three fundamental shifts during our 15 years with them and they are not the same manager now that they were when we started. We were in Europe for a while, it went badly for us, dragged our performance back for years, but that was the thing to do at the time. You had to take it through a process and actually, as with any fund manager we select, there are risks attached.

Hamilton: What I like about real estate is that it is actively managed. If you are investing in bonds or stocks the active management of that is picking a company to over or underweight, but you don't have any control over that business. With real estate somebody is going out, they are underwriting that property, taking a decision to purchase it and if they do acquire it they are managing it.

Some acquisitions will not go to plan, but the good managers are honest and can talk you through why it went wrong. They know those assets inside out and learn from the mistakes. Good managers will go through all their properties and known them by heart. It is about demonstrating how they can turn it around when things go wrong. That's a lot harder and more rewarding than passive liquid investments where ultimately performance of an individual holding is out of your control.

Abbott: It is a lot less about process than it is with equities. It is more about market access and the ability to buy flexible stock. In an equity mandate, everyone can only buy the same stuff. In real estate no one can buy the same stock, so it's about market access.

A willingness to innovate and try new things is important. I have had a change of tune. Five years ago I was a Luddite. I just wanted bog-standard retail, industrial and office stuff. Keep it simple, keep it understandable. If you think like that then you can lose pace. The market is changing to such a degree that you should be dipping your toe in the water.

It comes back to the pools. If you have a big pool of capital, do something with it that's new. Do a little bit of it. It might go wrong, but if you never do it you are never going to know. If it goes right then you are the leader of the pack. So the ability to innovate and do new things is important.

Hamilton: Before you innovate make sure that you have done your research and have brought in expertise. For example, there are a number of core funds that have jumped on the student housing bandwagon. For some, but not all, their investments haven't gone particularly well and there are dedicated student housing managers out there.

If you are looking for niche opportunities and you are a large enough investor to find a specialist, it is always better to find somebody who is experienced managing those strategies.

I have seen a number of value-added and opportunistic funds in the past make the mistake of investing in sectors or regions they are not experts in and that has hurt performance. For example, a number of higher risk pan-European managers invested in residential or Eastern European markets which in hindsight it was clear they don't fully understand them. That's where things have gone wrong for those types of funds in the past.

It is about understanding what you can and cannot do. But you also need to look for innovation and sectors with new opportunities because that's where the returns can be generated.

Whitfield: The pools are big enough to manage their own assets. We wouldn't do that, given our exposure, but with a 10%, 20% share of a £25bn pool you have the capacity to manage your own team. If you are focused particularly on your own region or area then you can bring in specialist local expertise. So the pools open another door for investment in this world, but it's currently at the backend and that to me is curious because it should be a no-brainer. It is a lot easier than trying to herd all those equity cats.

Williams: The problem is what exists now within local government schemes in terms of current real estate allocations and transition costs. That is the issue to sort first, and that's why people are putting it at the backend. Having said that, the Brunel pool has launched a long income sub-fund. That is something new that the underlying LGPS' can invest into, because traditionally they do not have exposure to long-income funds.

Towns: That model of having more resource on the client side would be consistent with what we see of other big real estate investors. If you look at big insurers, for example, they typically have a real estate team. Some of their assets they might manage themselves but they are also putting out mandates to managers who specialise in a certain sector.

They are also participating in joint ventures and club deals.

As you get a bigger pool of capital, you have more possibilities with how you invest it. To make the most of that you need some degree of resource and expertise internally.

Abbott: Do you get a feeling for how many clients are like that? Tesco and some LGPS' I know have good people, but I get the impression it is only a handful.

Towns: Some of the big pension funds and insurers in the UK have teams like that. Some of our international clients are investing globally and that's the way they work as well.

Hamilton: The Townsend Group's advisory business is almost $190bn. The average size of their advisory mandate is in the multi-billions. These are very large, sophisticated institutional investors with their own internal real estate teams. They buy real estate directly, but there are certain opportunities, especially outside their home nations or in niche strategies where they do not have the expertise in-house. In these cases they are comfortable going to an expert and trusted partner to provide advice and source opportunities.

Speaking to some large institutional investors in the past, I sometimes felt that the CIO or equivalent

Martin Towns

"Real estate is not just a bond proxy; allocations to real estate are connected to bond pricing, but it behaves differently."

Martin Towns, M&G Real Estate

thought that you were stepping on their toes, but this is not the case at all; it's about working together to augment the expertise in their teams.

Towns: In terms of how those big investors are running their mandates and working with external managers, we try to understand what those investors are trying to achieve. For us it is not about saying: "Here is a product, do you want to invest in it?" It is having conversations over an extended period of time about what is important to them, what they want from real estate and then coming up with an investment that gives them the exposure they want.

Hamilton: It is not about allocating in silos. What we are trying to do with our clients when it comes to illiquid allocations is to ask: "What are you looking to achieve?" Based on the answer the solution could be real estate, infrastructure, private equity, etc, but more likely a combination. The answer is also likely to change over time as market conditions and client needs change.

It's a sweeping statement but, for example, for clients looking for income, property debt is looking more attractive than infrastructure debt, but a couple of years down this might not be the case. It is important to look at the wider and more holistic picture, not just today, but keep revisiting where value is and challenging your own beliefs.

Towns: That is at the highest level in terms of when you are trying to craft a strategy, but it is vital that the manager draws on relevant expertise in the assets that they are investing in. They have a team on the ground that can proactively manage it and understand that country or sector.

It is about market access as well, about making sure you have enough of the right resource to access the best opportunities. We have quite a big business in the UK and through that we do a lot of transactions off-market. So we are accessing opportunities that are not necessarily in competitive bidding situations. We can do that because we employ a large team of capital markets professionals. All they do is look for new opportunities and buy and sell assets for our clients.

Abbott: What matters is being consistent with what you have said you are going to do. Then it comes back to trust and return targets and how you measure manager performance. It is difficult to measure that these days, clients want absolute return targets. It is difficult, but despite that you still need to look at consistency, risk profile and strategy.

I could not tell you if the building next door will outperform this one. I have no idea. What I do know is if certain buildings are consistent with your risk profile and what you said you want to do. Any manager that buys something that looks a little different is going to get questions from us.

Towns: It comes down to transparency. When a manager designs a strategy it is about being consistent and transparent about it over time.

That is a difficulty with some of the value-add and opportunistic stuff. You are giving them money and saying: "Right, I hope you go by what you told me."

"In an equity mandate, everyone can only buy the same stuff. In real estate no one can buy the same stock, so it's about market access."

Matthew Abbott, Mercer

Matthew Abbott

Hamilton: There was a manager we were looking at once, who unbelievably said: "I don't want investors in my fund asking so many questions." The transparency wasn't there and that comment ended our interest.

PI: How has the typical weighting towards property in pension scheme portfolios changed in the past 10 years?

Abbott: It has notched up, but it could be higher.

Whitfield: It's notched up slowly. In the quantum available, the change has been really at the margins.

Hamilton: In terms of the allocation to UK core property, it has not changed an awful lot. Allocations for other real estate strategies, especially value-add, opportunistic, property debt and residential, has increased meaningfully over the past five years.

PI: Where does property sit in institutional portfolios compared to other alternatives?

Hamilton: In Europe we are seeing continued demand for infrastructure, but less so for private equity, although we do have clients investing in it. Part of that is from pension schemes benefiting from improved funding positions and requiring less risky strategies. But from conversations I have had, the beauty of real estate is that people understand it and that is important to them. They work in an office, they live in a home, their children live in student accommodation, etc. Investing in private equity or private debt secured against companies is a harder conceptual leap for some. That has always been a positive for real estate.

Abbott: It sounds simple, but it is important. People understand, or think they understand, buildings and have a natural affinity to them.

Towns: We have definitely seen allocations increase for most of our clients. That is partly to do with the relative value of the asset class, but there has been a slight shift in terms of people's views about where their property allocation should sit longer term.

Some of the increases we have seen are not just because property has been relatively attractively valued. People are seeing the wider opportunities of real estate and thinking that there is a place for it in their portfolios long term at a slightly higher level.

PI: What are fees like at the moment?

Abbott: Fees are not changing for core funds and there is no reason why they should. They are a mainstay of portfolios and they have been so for a long time.

There is lots of discussion, from what I can see, around the fees charged to the high-risk strategies and how they are structured.

Two questions that we get asked a lot are, why do higher risk managers claim performance fees when the market has outperformed their hurdle? If they take a performance fee of, let's just say, 20% of returns over 8%, and the market does 15%, they have taken a big performance fee for what the market has done. That is the scrutiny that our clients are focusing on.

The other big one is something called 'catch up fees' with opportunistic managers, which are borderline unethical, in my mind.

Hamilton: One of the benefits of being a client of a large consultant like Aon, or Mercer or Willis Towers Watson is that we tend to be able to aggregate our clients together when investing in closed-ended funds to achieve substantial fee discounts. Even if you are allocating £20m, if you are part of a £300m pool then obviously you get much better fees, especially if you can go in at first close.

Abbott: It is a balance of power; the power at the moment is with the value-add opportunity managers. There will be times in the market when the power isn't with them. We are forever quizzing managers on whether they should or shouldn't charge a catch-up fee. One of them has introduced a share class where they don't do a catch-up fee, but it is just one of them. Opportunity managers need to be looking at that, but while they have a big queue of capital looking for investment why would they change it? It is about questioning the norm and, quite frankly, not enough people question the norm.

Towns: There has been a trend over the past few years for better transparency in fee structures. It is always about what the total fee is. There is definitely a trend of investors expecting managers to do more in terms of explaining what the total expense ratios are.

Hamilton: Some managers might have hidden fees, such as charging internal broker fees in the case of debt funds, and that is obviously frowned upon. So it is about understanding the headline fees and whether they are taking other hidden fees as well.

Towns: The other point about fees, or certainly this is part of our thinking, is that the fee model has got to be appropriate to the investment strategy. If you are seeking to execute something which is asset management intensive and it requires a certain number of people to be working on it, there's an expectation that's going to deliver a higher return, but also it requires additional resources to be deployed to deliver that.

Abbott: There are two aspects to that. The first is that fees for riskier strategies are going to be higher. Bringing it down to what's involved, how many people are doing what work and how much do they get paid? How much should they get paid? These are things that they should be focusing on.

Two other quick points: On the opportunistic side, if those managers underperformed would they pay you a fee out of their annual management charge?

The second is that where strategies are new and management intensive with fees that are relatively high, as those strategies develop and mature and become more stabilised the fee pressure has to be downwards.

The big example is residential; residential fees cannot be 90 basis points forever. When you have a portfolio that is 80% built assets and 20% development in five or 10 years from now, that fee structure has to change. So there will be some pressure on that.

Whitfield: When any fund selects a manager it will be aware of what the fee structure is. We either accept it or we don't. I have no doubt that more sophisticated fee models will arise as a consequence of the fee transparency work. We are in a world now where I don't think any fund is going to select a manager who hasn't signed up to the Transparency Code.

We expect complete openness, honesty, trust and you go in with your eyes wide shut, really. It is what it is but you have got to be careful what you wish for here because the transparency work itself may lead to more innovative higher risk alternative products that naturally come with higher fees. There is a real danger that we start rushing towards the fee rather than to performance.

I cannot take my eye off performance net of fees. If the fee is high to get that performance, then so be it. That is what fits the strategy, what fits the asset allocation.

Hamilton: That point around the best manager is important. Good quality data can be hard to come by for closed ended funds, but if you look at the performance of managers over time the difference between the best quartile and the bottom quartile is huge. They all charge the same fee, but even in the most challenging market conditions the best managers return the money, it's not what they promised, but you could get your money back. The worst managers might be wiped out. Getting access to the right assets is so important when investing in real esate. So for the sake of 20 or 30 basis points, there could be performance differential of 10% to 20% per annum. That is huge.

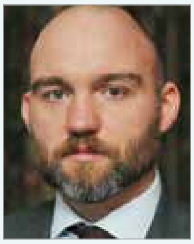
Whitfield: Can I just make one final point? It is a coincidence that we have moved into a world of having a strategy which is reducing carbon. Having foot-printed the whole of our fund, we have seen the carbon benefits of having invested in property. We have a property portfolio of direct property where all the PRS stuff is being built to the highest green standards because that is what you had to do to get value back out the other end. Our own properties, to make them valuable from return and growth points of view, need to be of the highest green standards.

So we are finding, probably by accident, that our carbon footprint is vastly improved by the fact we have such exposure to property, which is unusual but that has just been a coincidental benefit that we have come across in the last year or two.

Abbott: We have ESG ratings and if we look at our ESG ratings across asset classes, real estate ESG ratings tend to be higher than other asset classes, which is interesting. ESG within real estate is part and parcel of fundamentally how a manager has to manage a building. It is not tagged on at the end, which it can be for other asset classes.

Going global: Beyond UK property

Oliver Hamilton, principal for Townsend Group Europe, an Aon company



Historically, most UK pension schemes have focused on domestic core commercial property to gain exposure to real estate as an alternative asset class as part of their wider investment portfolio. This is in contrast to many other asset class allocations, such as equities and fixed income, which have become far more global since the start of the millennium.

Despite this, the same principles of global diversification apply to property as with these other asset classes. The UK property market is only around 5% of the institutionally-investable global property market, meaning that pension schemes with only a domestic UK property allocation are unable to capitalise on attractive investment opportunities, such as the rise of internet shopping across continental Europe, and are exposing themselves to UK specific risks.

Brexit is a topical example of such a risk and although the UK property market has responded resiliently after an initial stumble, a lot of uncertainty still surrounds the conditions of Britain's exit from the EU. This is having a significant impact on the investment decisions of UK institutional investors. We continue to see pension schemes increasing their allocations to property; however this has been by strategy or sector and in more specialist areas such as long lease, residential, healthcare and real estate debt. Very few of our clients see real estate debt as a property allocation and it sits in other parts of their portfolios which allow for greater allocation to real estate equity opportunities.

Despite increasing investments into property, few UK pension schemes have increased their non-domestic investments; the few tend to be larger schemes committing to funds at the riskier end of the risk/return spectrum. In addition, this allocation is usually a small element of a wider private markets portfolio with a different purpose to an allocation to core property. Notwithstanding this, there are compelling opportunities to invest in global core and core-plus property via pooled funds and these can be accessed by small and large schemes.

The opportunity to invest in global core and core-plus property is set against an outlook of subdued UK core property performance over the short-to-medium term. This is partly related to Brexit uncertainty and also limited capital appreciation of UK property, meaning that returns will be driven by income. Given this outlook, we would expect a global core property allocation to produce superior returns to UK property. In addition, correlations between UK property and other national property markets have been positive, albeit low, in local currency terms since 2000. This shows that investing in global core property adds diversification benefits.

It is important that an individual investor's unique objectives and constraints are carefully considered when deciding how to invest globally. Broadly, the most appropriate way for a UK pension scheme to access global property is through a fund-of-funds. If the investor is large enough, it would be beneficial to build a bespoke segregated portfolio through which they can invest in multiple funds that are combined to meet their specific needs. The alternative to this approach is investing via listed real estate, which despite being easier and faster to access can be volatile and highly correlated to equities in the short term.

Although we believe that most UK pension schemes considering an allocation to global property should focus on core and core-plus strategies, since these are the bedrock of institutional property allocations providing strong income returns with potential for capital growth, larger pension schemes with higher return requirements and risk tolerances could consider global value-add and opportunistic property funds to sit alongside a core allocation.

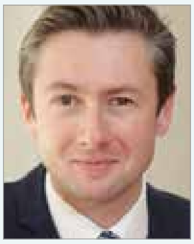
There are unique risks associated with investing in global property and important non-investment considerations. For example, currency movements are one of the main investment risks as property cash-flows are notoriously hard to hedge. Currency hedged global pooled solutions are rare and investors will therefore need to accept the risk or appoint another manager to carry out currency hedging, however this will only be an approximate.

Other considerations include tax leakage when investing in other jurisdictions, valuation methodologies (which might be materially different to the UK) and regulatory risks, especially when investing in countries which are far less transparent than the UK.

Given Brexit uncertainty and the subdued outlook for the UK property market relative to higher expected returns of global property and the diversification benefits of investing globally, we believe there is a strong case for UK pension schemes to invest in global property. The attractive stable income element and long-term nature of core property allow investors to diversify globally without materially moving up on the risk spectrum and therefore we feel investors should consider a strategic allocation to global core property in particular.

Taking a direct approach to real estate

Martin Towns, head of UK commercial and capital solutions, M&G Real Estate



Investing in real estate has evolved with changing investor preferences and rather than just accessing property through pooled vehicles, a direct approach can offer a number of benefits to institutional investors including greater efficiency, control and access to a broader range of assets.

Real estate offers a deep pool of potential opportunities that can meet several risk and return objectives. It's important to do so not only with an asset manager that has a broad network and experience in real estate investing, but also expertise in creating these bespoke solutions for their clients.

Direct investment expands the potential opportunities, enables investment in larger assets and helps create a more efficient investment model. It also allows a higher degree of control over specific investment (and divestment) decisions.

Investing in high-quality, larger real estate assets can offer superior risk-adjusted returns potential, as occupiers seek modern, efficient accommodation with a broad range of amenities offered to better attract and retain the best staff. Such assets can offer better rental growth potential, while experience in active asset management can help maximise total returns. Through participating in joint ventures or club deals, investors can access such opportunities (alongside like-minded capital partners and managers) whilst still controlling asset-specific risk.

Execution of the strategy, however, merits some careful thought. Many investors have struggled to deploy capital efficiently, into attractive direct investment opportunities, owing to either a lack of resource, an absence of relevant in-house expertise or by not having aligned themselves with the right managers.
The latter point in itself can help alleviate internal resourcing concerns, particularly if a strategic relationship can be developed with managers which have a proven track record of identifying, structuring and executing joint venture or club deals – and importantly, experience in doing so on behalf of non-discretionary clients.

An extensive global network is essential to not only match like-minded investors with similar investment objectives, but to source superior investment opportunities. M&G Real Estate has a wealth of experience in working with joint venture partners, managing more than £3.5bn in such structures. A manager's deal sourcing network is also important; over the past three years, the majority of M&G Real Estate's transactions were sourced off-market, avoiding competitive bidding situations.

As well as through joint ventures and club deals, control over specific real estate exposure can also be achieved through a separate account, providing investors with their own preferred level of control over key investment decisions.

These can be structured in accordance with individual needs, taking into account risk and leverage appetite, alongside sector and geographic preferences. We have a long history of managing separate accounts, most notably on behalf of Prudential UK's insurance business. On behalf of Prudential, we have delivered an annualised return of 9.8% (unleveraged) since 1980, translating to outperformance of 0.6% a year relative to the benchmark.[1]

1) Data to end of March 2018

Delivering consistent outperformance requires relevant expertise throughout strategy formation, the entire transaction process and the complete asset life cycle. Scale and (off) market access is key to uncovering the best opportunities.

At M&G Real Estate, an in-house transaction management team enables us to place capital quickly, backing up the asset origination and creative deal making of our investment teams. By partnering with a manager early on in the process from strategy-setting, to execution of investment opportunities and enhancement of value throughout the asset lifecycle, we believe this creates the best potential for delivering on specific risk/return objectives.

Case study: Selly Oak

We helped a local government pension scheme (LGPS) to undertake its first direct investment through a joint venture, followed quickly by a second less than a year later.

This second deal was the acquisition in May of Selly Oak retail park in south west Birmingham, alongside another client separate account. This major regeneration development is almost completely pre-let to national retailers and set to deliver a valuable economic boost for the area, offering quality retail, improved highways and canal-side improvements.

Property: Solid returns

With low gilt yields forcing schemes to pile into bricks and mortar, *Mark Dunne* asks if the reward is worth the risk.

It has long been said that an Englishman's home is his castle; but these days it could be his pension too.

The office where he works, the shop where he buys his groceries or the warehouse that sends him the latest bestseller to read on his early morning commute could also be funding his retirement.

With the yield on 10-year UK government debt hovering around 1% in recent years, several retirement funds have turned to bricks and mortar to help pay their members' benefits. Yields range from 3.25% on offices in London's West End to 5.25% on retail warehousing at the side of motorways, according to estate agent Savills. So it is easy to understand why institutions have been lured to these assets in a low return environment.

Another reason is risk. Pension schemes have been forced to stomach more risk to generate much needed cash, but the longer-term returns offered by real estate are, on average, considered to be within reasonable risk parameters compared to equities.

One fund that has built a sizable allocation to property is RPMI Railpen. It has around £2bn tied up in bricks and mortar, or 12% of the £28bn of assets it manages.

"We certainly believe in property," Railpen's head of property, Anna Rule, says. "We are looking for new, interesting opportunities that are going to meet our target return."

She does, however, admit that this approach has been built partly out of necessity. "The strategy also reflects the need to look at alternative asset classes in light of lower bond rates," Rule adds.

CORE STRATEGY

Other funds which have turned to property include Lancashire County Pension Fund (LCPF), which has a £840m real estate portfolio, while London Pensions Fund Authority (LPFA) has £400m at work in the sector. These schemes are part of Local Pensions Partnership (LPP), a local government pension scheme pool.

Richard Tomlinson, who looks after real estate for LPP, says property is seen as an important part of these retirement schemes' investment strategies. "Both schemes are maturing and the strategy is towards cash income and property is seen as a good source of that," he adds.

Tomlinson is seeing a lot of pension fund capital flowing into bricks and mortar, which, obviously, is having an impact on pricing.

"It is a competitive market," he adds. "Prices are being bid to levels where sometimes they are hard to justify."

The rising cost of investing in real estate is not expected to ease anytime soon. Many of the schemes *portfolio institutional* spoke to about their property strategies are yet to achieve their allocation target.

Lancashire has 11% of its assets invested in property, just short of its 15% target, while Railpen has a 12% weighting to the asset class, below its 15% goal. LPFA has work to do to close the gap between the 7.5% current allocation and its 10% target.

Southwark's retirement scheme, which is worth more than £1.5bn, has a 20% allocation, or around £300m, which is invested in supermarkets, restaurants, offices and warehouses. "This is not a get in and get out strategy," says Duncan Whitfield, Southwalk's strategic director of finance and governance. "This is get in, grow the capital and get the revenue returns," he adds.

Property is core to Southwark Council's retirement scheme strategy for good reason.

"Bricks and mortar in the hands of astute managers has a great record of holding value," Whitfield says.

"It doesn't necessarily matter if it is in the middle of a city, if it is commercial, retail or housing; there is significant evidence of the certainty of value and return on property.

"Property is a key component of a wider investment strategy," he adds. "It surprises me that we don't see the same exposure in other funds."

> **"Bricks and mortar in the hands of astute managers has a great record of holding value."**
>
> Duncan Whitfield, London Borough of Southwalk

Adding real estate to a pension fund is not a new innovation. Property, to some degree, was part of many retirement schemes' investment strategy before the financial crisis forced the risk-free rate down to historic lows.

It is a case of increasing their allocations to the asset rather than building a portfolio from scratch. Indeed, the London Borough of Southwark Pension Fund had a 10% allocation to property in 2005; but today it is close to 20%.

The lack of liquidity in the asset class has not deterred trustees from putting millions, even billions, of pounds to work in the sector.

The benefits stretch beyond generating a regular income stream. It also provides diversification, is a hedge against inflation and generally has a low correlation to other asset classes.

MANAGING THE ASSETS

All decisions in Southwark's property portfolio are made by its managers. "They pretty much have a free reign," Whitfield says. "They are given a target and have the flexibility to invest."

He appears more than happy to leave it to the managers, which is an attitude that he has developed during the past decade. Southwark's managers started buying distribution hubs by motorways in 2008.

At the time Whitfield wondered why they were buying big sheds by the M1, but now they "cannot build enough of them".

"That is the manifestation of the value that these low cost, high value acquisitions have," he says.

However, another scheme has moved in the other direction when it comes to making investment decisions in this space.

Anna Rule was hired by Railpen in January 2017 to manage the scheme's property mandate in-house. She hired a team of experts and soon set to work building the processes and procedures to end the scheme's reliance on third-party managers.

"We feel [bringing it in-house] is a better alignment with our overall objectives," Rule says, also pointing to a cost advantage. "It reduces principal agent issues and ultimately there is a lower cost."

LPFA's strategy has also changed. It now has a national portfolio of directly acquired properties, which has reduced its reliance on pooled funds. The downside to moving to an almost exclusively direct property portfolio is the expense.

Indeed, Southwark's property management fees doubled to £694,000 in the 12 months to the end of March 2017. "Direct property is more expensive than pooled investing, but performance is net of fees," an upbeat Whitfield says.

Tomlinson describes property fund fees as "pretty competitive" when compared to those charged for infrastructure and private equity pooled investments. "Depending on the type of manager, the fees can be competitive," he says.

THE ALTERNATIVE PATH

In the property market, housing was once seen as something of a final frontier among professional investors. Unlike its commercial counterparts, residential has traditionally not been considered an institutional asset. The issue has been a lack of scale, a barrier that institutions are removing.

RPMI Railpen has around £200m invested in housing built for the rental market. The scheme will not touch a scheme unless it has at least 100 units. It owns five assets in this market and, once they are all open for business, they should have about 1,000 beds.

"Residential is an area where there is a strong income stream," Rule says. She describes it as a burgeoning asset class that is a good hedge against inflation. LCPF kicked off its debut foray into housing by part-funding a 119-apartment building in Hayes, West London four years ago, while LPFA is building rental units at Pontoon Dock by the Thames Barrier.

"Private rental sector schemes are attractive in the major metropolitan areas," Tomlinson says. "It is hard to find the scale in provincial towns."

Southwark Council has some residential exposure through private rented sector (PRS) funds worth £15m and £20m. It also has similar sums in two opportunistic funds, which invest in distressed assets, including real estate. "These are the buy it, do it up and get out schemes, which we are not comfortable with in the other [parts of our] scheme."

Another institution benefiting from putting a roof over peoples' heads is the London Borough of Islington Pension Fund.

Islington's now former pensions chief, Richard Greening, told portfolio institutional before his retirement that residential is becoming a popular investment. "I'm pleased that we have started investing in residential property," he says. "There is such a huge need for that in London and in the UK.

"It is completely mad for pension funds not to be invested in it," he adds. "I'm pleased that we have kicked that off, although only in a small way at this point."

Islington's retirement fund has joined the London Pension Collective Investment Vehicle (London CIV) and Greening hopes that it will be taking residential investment "more seriously".

But real estate is not just about housing, offices, warehouses and shops. More alternative properties are emerging as pension scheme's chase higher yielding assets. Railpen, for example, has student housing in its portfolio.

"We believe in the alternative sector, such as retirement living," Rule says. "It benefits from strong demographics with the UK ageing at a faster rate than ever before and it also has strong anti-cyclical characteristics. We are looking to increase exposure to alternatives."

Lancashire also has student housing among its assets. Tomlinson describes the yield on student housing and elderly care homes as a "bit higher" than typical housing. Indeed, Savills puts the yield on student property at between 4.25% in London in the direct let market to 6.5% in secondary markets in the regions.

A MAINSTREAM ASSET

Despite the clear benefits long-term investors can receive from investing in property, it has been far from a smooth ride. Whitfield describes the scheme's property strategy as a "journey of ups and downs and peaks and troughs".

"We have had some downturns in our property experience, but we have stuck with it because we see the long-term benefit of capital growth from our direct property portfolio," he adds. "So we stuck with it and in the past three or four years property has been on an upturn and as we have had volatile markets, in that period, property has provided us with that steady platform that supports the rest of the fund," Whitfield says.

There is also the benefit of the natural caution that valuers tend to have on property fund valuations. "They tend to be extremely prudent, so when you come to sell you are automatically getting a little bit of value over that," Whitfield says. Value is a big part of the management of these assets.

RPMI Railpen's core investment themes include affordability, creativity and connectivity. It looks for assets and projects in areas of strong occupational demand, selects the right stock and then creates value. This typically involves lease extensions, extending the assets, refurbishment or a change of use.

"In a relatively low return environment it is key that asset management drives performance," Rule says, who believes that sustainability is a big part of managing her portfolio.

> **"Property is a key component of a wider investment strategy."**
>
> Duncan Whitfield, London Borough of Southwalk

"It is not just about delivering attractive risk-adjusted returns for our members; I am keen on investing in strong economic assets in the areas where we invest. That is a big point for me, i.e. making things better for the future generations," Rule says. "We look to invest in economically, socially and physically-relevant investments. We are all about investing in buildings and locations where people want to live, work and play."

Whatever purpose it serves and wherever it might be located, property is becoming a mainstream pension fund asset. "From what I have seen in Lancashire and London, property, infrastructure and the like are well established parts of the investment landscape these days," Tomlinson says.

Whitfield concludes that property has underpinned his scheme's investment strategy for almost 15 years and that long-term investors with a need to generate regular cash-flows could be missing out if they are not exposed to bricks and mortar.

"I would invite others to have a much closer look at and see if their property exposure is as extensive as it might be."

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