AJBell Investcentre

The current operating environment for open-ended UK direct property funds

What just happened?

There is a strong sense of déjà vu right now following the announcement that the M&G Property Portfolio and its feeder equivalent fund have had to suspend trading on 4 December 2019. This is a replication of what was witnessed following the EU referendum vote in 2016, when many open-ended UK direct property funds were forced to suspend due to liquidity issues.

We don't see this as an isolated case – unlike with Neil Woodford's funds – but much more of a sector issue given the majority of UK direct property funds have experienced heavy outflows during 2019. Once one large fund suspends, it often raises concern among investors, who then in turn search for liquidity, which can put pressure on the remaining open funds, and so the vicious circle commences.

Cash is king! Or is it?

The very nature of direct property exposure in an open-ended fund structure creates a huge mismatch between liquidity and access. This arises due to the fact that an open-ended property fund trades daily (providing investors with the ability to buy and sell daily) whilst the underlying assets (bricks and mortar) are extremely illiquid: it can take many months to complete a disposal of a commercial property. Therefore, in order to allow these funds to remain open and offer daily liquidity, they typically operate with substantial cash positions, usually somewhere between 15–25% in normal market conditions.

The cash exposure aids flow management as fund units are bought and sold each day, thereby allowing the fund manager to offer daily liquidity without the need to transact highly illiquid and expensive assets each time an investor wishes to redeem their position. However, when this cash exposure dries up, funds usually need to suspend trading so that they are not forced sellers and can engage in a managed disposal programme. Unlike 2016, when this came as a shock to investors, it has now broadly been well publicised that these vehicles can and should suspend when liquidity is an issue in order to protect the interests of long-term fund holders. Indeed, the FCA has effectively said so in its recent update on these type of funds following its review of the 2016 suspensions.

The table below demonstrates the range that currently exists between the cash positions in a number of well-known retail property funds.

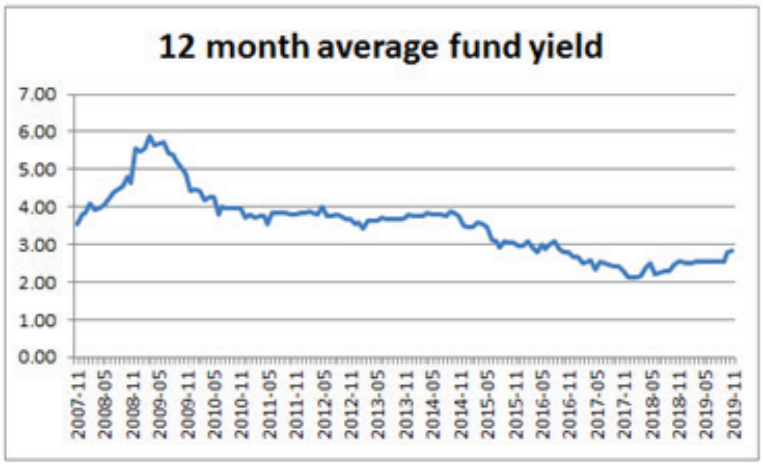
Fund name	Cash exposure (%)
L&G UK Property	25.20
M&G Property Portfolio	5.00
Aberdeen UK Property	11.54
Aviva Investors UK Property	30.90
Janus Henderson UK Pty PAIF	16.70
Threadneedle UK Prpty Authrsd Investment	6.30

*As at end of October 2019.
Source: Fund group factsheets

Cash is certainly not the perfect answer to liquidity, as it doesn't protect funds from suspending in times of distress and in strongly performing property markets the cash acts as a substantial drag on returns. Additionally, yields are also impacted and fees become more expensive as fund groups do not exclude the cash exposure from their charging structures.

AJ Bell's tactical asset allocation view on UK direct property

For some time now, AJ Bell has held a negative outlook on UK direct property through open-ended funds. At launch in February 2018, our managed portfolio service took a tactical asset allocation decision to not to be exposed to any open-ended UK direct property funds at all. This centred on the belief that yields have been driven to such low levels that they appeared unsustainable, meaning the asset class could become overly reliant on income with capital growth being challenged.



*A simple average of a basket of high profile retail property funds (Aberdeen, Aviva, Janus Henderson, L&G and M&G).
Source: Morningstar Direct

At these yield levels, investing in UK direct property was not justified for the AJ Bell active growth portfolios (launched in February 2018) or the AJ Bell Pactive portfolios (launched in February 2019). The rationale for the zero-weighted exposure was: firstly, there seemed poor value in the asset class; and secondly, the liquidity consideration. Simply put, potential total returns were not attractive enough to warrant exposing the Managed Portfolio Service to the liquidity risks of an open-ended UK direct property fund.

Instead, absolute return has been used in order to provide diversification benefits in a similar vein to that of UK direct property but without the liquidity challenges and structural headwinds that UK commercial property currently faces. This exposure currently comes from the Janus Henderson UK Absolute Return fund. While this tactical position detracted value in 2018, it has worked well during 2019 as the realisation of the Brexit risks increased and the resultant uncertainty caused the UK economy to slow. We were alert to these risks increasing and wrote about it in February 2019 with the title 'Is the liquidity of open-ended UK property funds about to be tested again?'.

While we don't get much satisfaction from being right about investors not being able to get their money back when they want it, this shows the importance of being on top of the issues and having your clients invested in an investment solution that has the flexibility to tactically adjust the portfolio positioning when we see a fundamental mispricing in the market.

For further information, please see the following article written in February 2019:
https://www.investcentre.co.uk/articles/liquidity-open-ended-uk-property-funds-about-be-tested-again

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