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KSAM Portfolios - Property Exposure
Want me to leave the door open or closed?

By Wayne Bishop

As an asset class, property is an important feature in model portfolios across the industry. There are a number of property fund investments available which enable portfolio managers or investors to select locations and types of property they wish to be exposed to.

From an ESG and Impact perspective both operating buildings and construction remain the largest source of carbon emissions. There have been some substantial improvements in the environmental impact of building and much of this has been driven by regulation.

Over the last decade a number of high social impact property investments have come to the market: originally medical property; then social housing for people with additional needs; quality new build rental and more recently homeless housing. For a number of years our focus has been on the more social property investments across our range of bespoke and model portfolios. Whilst the

environmental credentials of a building remain important, we consider the buildings purpose of primary importance, especially when they are addressing pressing social issues.

As with other forms of infrastructure investment, the appeal of property as an asset class has been the more stable, longer term and often inflation linked levels of income. These are offset against a reasonable level of debt, often at a fixed rate and therefore a clear and probably rising profit margin. In theory this should offer a higher, often inflation linked return than fixed income. Given its long-term nature it should also provide less volatile and risky investment than equities. Hence these investments should sit between these asset classes in terms of risk.

Investment in property and infrastructure can be either through open or closed-ended funds. Open-ended funds have variable capital meaning the number of shares go up and down as investors add and withdraw funds and the price is determined by the net asset value of the investment. A closed-ended fund has a fixed number of shares that are traded and the price is determined by supply and demand rather than the net asset value. These funds can trade at either a premium or discount to the net asset value.

The open-ended funds have the advantages of being less volatile as they are not prone to supply and demand concerns for their shares. However, where the underlying investments are illiquid (in this case this means not easily sold or purchased), then the fund needs to have a high level of cash to meet investor demand should they wish to redeem their investments, and when cash becomes short the funds are gated and investors cannot withdraw from their investments. This has happened in the past, notably in 2020, and is happening again with a number of property funds no longer able to meet redemption requests. The property funds may then be forced to sell properties to meet the redemptions, and with a number doing this at the same time this could equate to a fire sale. The net asset value of the investment may fall depending on the quality of the property the fund needs to sell.

The closed ended funds on the over hand are more volatile as the price reacts immediately and the funds trade at a large discount to their net asset value. This makes the investment more volatile, but at the end of the day the investment can be sold in the market if needed. Over time both the price and net asset value readjust.

Even before we invested in more socially focussed property, we favoured investment in closed ended funds. We prefer liquidity (meaning that the investment can always be sold) over the impression of lower volatility and performance in a portfolio. In fact, in both 2016 after the Brexit vote, as well as in the recent turmoil, we have used the weakness in the share price to add to these investments. We see the short-term weakness being created as these investments can be sold whereas some of the open-ended funds are gated, and this opportunity fits our long-term investment focus. Over time the open-ended funds will sell properties to raise cash and matters will normalise. Even where we have to own an open-ended fund with the fund based MPS models, the fund is a fund of closed ended funds and not a property fund

The downside of this investment approach is the short-term price movements, this has a further negative impact on the short-term performance of the portfolio. In the UK, closed ended property funds have a negative return of 32% for the last year.[1] Our portfolio investments have performed better than the UK market indicated above, because they are not exposed to weak areas such as retail. However, the funds we have chosen are still trading at a substantial discount to their Net Asset value (NAV).

[1] The iShares UK property ETF, source Bloomberg, 17th October 2022.

This fall in closed ended funds has clearly had an impact on portfolio valuations. The difference in recent performance between open and closed ended funds is in many cases over 30%. This reflects the difference between the reported Net Asset Values of both the open and closed ended funds and their traded price. So compared to a portfolio that holds open ended property investments the relative difference, if the asset allocation was 10%, could be as much as 3% in the short term.

Over the medium term we expect this wide gap between the share price and the Net Asset Value to close. Either the NAV comes down because of economic factors, in which case the same will happen to the open-ended funds (which investors may or may not be able to sell), or the share price of the closed ended funds we hold will rise. We expect there to be an element of both, but we have been adding to the property investments as we see them as good value in the long term. A recent article in the Financial Times expresses our concern that open ended property companies will be forced sellers and that the buyers waiting in the wings know this and are awaiting the bargains.[2]

By choosing closed end investments we have taken short term pain in favour of what we expect to be a longer-term gain, as well as favouring liquidity and more socially focussed investments. The NAV of the closed ended funds have not yet changed, so the price reflects the market rather than the NAV, but with the benefit of not being closed to redemptions.

As with all other asset classes, long-term positive investments remain our core focus. By adding to these funds in weakness, we expect that over the medium term we will have added increased value to the portfolios once the market re-establishes a sense of equilibrium.

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[2] Financial Times 18th October 2022, "Real estate investors circle as property funds offload offices and warehouses."