AGENDA ITEM: 7 Page nos: 8 - 24

Meeting	Pension Fund Committee
Date	21 March 2011
Subject	**Property Portfolio**
Report of	Deputy Chief Executive
Summary	This report asks the Committee to note the recommendations regarding the property portfolio and agree to liquidate the property portfolio.

Officer Contributors	John Hooton, Assistant Director of Strategic Finance Karen Bannister, Interim Treasury Manager
Status (public or exempt)	Public
Wards affected	None
Enclosures	Appendix A – Property Investments
For decision by	Pension Fund Committee
Function of	Council
Reason for urgency / exemption from call-in (if appropriate)	Not applicable

Contact for further information: Karen Bannister – Treasury Manager Tel: 0208 359 7119

1. RECOMMENDATIONS

1.1 That the Committee note the recommendations and agree to liquidate the property portfolio.

1.2 That the Committee delegate to liquidation of property portfolio to the Deputy Chief Executive.

2. RELEVANT PREVIOUS DECISIONS

2.1 Council – 11^{th} September 2007 – Minute 64.

2.2 Pension Fund Committee – 26 March 2008 – Dec. 1 – Exempt

2.3 Pension Fund Committee – 10 September 2008 – Dec 11 & exempt.

2.4 Pension Fund Committee – 4 February 2010 – Dec 6

2.5 Pension Fund Committee – 15 September 2010

3. CORPORATE PRIORITIES AND POLICY CONSIDERATIONS

3.1 To ensure that the pension fund is being invested prudently and to the best advantage in order to achieve the required funding level. Effective monitoring of the Pension Fund will provide support towards the Council's corporate priorities in providing better services, with less money.

4. RISK MANAGEMENT ISSUES

4.1 The primary risk is that of poor investment performance. Fund manager's performance is monitored by the committee every quarter. If fund manager performance is considered inadequate, the fund manager can be replaced.

4.2 The value of the pension fund assets at any point in time is determined by the market and a large movement in the markets could have a significant impact on the surplus or deficit of the fund.

5. EQUALITIES AND DIVERSITY ISSUES

5.1 Ensuring the long term financial health of the pension fund will benefit everyone who contributes to the fund.

6. USE OF RESOURCES IMPLICATIONS (Finance, Procurement, Performance & Value for Money, Staffing, IT, Property, Sustainability)

6.1 The property portfolio as a whole has under performed the specified benchmark over the longer term. JLT Investment Consulting are therefore recommending that we liquidate the property portfolio.

6.2 Whilst there will be costs involved in liquidation of the portfolio this, in part, would be offset against the risk of further underperformance.

7. LEGAL ISSUES

7.1 None other than contained in the body of the report and appendices.

8. CONSTITUTIONAL POWERS

8.1 Constitution – Part 3 Responsibility for Functions – Section 2 – Responsibility for Council Functions delegated to the Pension Fund Committee through the Pension Fund Governance Compliance Statement.

9 BACKGROUND INFORMATION

9.1 History

9.1.1 The Superannuation Act 1972 makes provision for local authorities to operation pension funds for their employees and employee of other employers who have either a statutory right or an admission agreement to participate in the funds. The London Borough of Barnet's Pension Scheme Fund (The Fund) is set up under the Local Government Pension Scheme (Administration) Regulations 2008 (SI 2008/239); (ii) the Local Government Pension Scheme (Benefits, Membership and Contributions) Regulations 2007 (SI 2007/1166); and (iii) The Local Government Pension Scheme (Transitional Provisions) Regulations 2008.

9.2 Property Investments

9.2.1 The recommendations of The Fund's investment advisors, JLT Investment Consulting are attached at appendix A.

10. LIST OF BACKGROUND PAPERS

10.1 None.

Legal: TE
CFO: AT

Property Investments

London Borough of Barnet Pension Fund

JLT INVESTMENT CONSULTING

Executive Summary

The London Borough of Barnet Pension Fund ("the Fund") has an internally managed property portfolio internally which makes up around 4% of the Fund's assets; this property portfolio has historically underperformed its benchmark.

Manager	Schroder Exempt Property Unit Trust (SEPUT)	Hermes Property Unit Trust (HPUT)	Rockspring Hanover Property Unit Trust (RHPUT)	BlackRock UK Property Fund (BUKPF)
Valuation of Fund's holding as at 31 Dec 201	£5.926m	£8.667m	£2.383m	£6.007m

As investment advisors we have not previously been asked to comment on these assets, and whilst the performance of this portfolio has only a very marginal impact on the Fund performance as a whole, it is now appropriate to consider this property allocation. This is because the Fund's recent Diversified Growth (DGF) mandates will mean that Fund's managers, Schroders and Newton, will make active property allocations within their respective DGFs. Therefore it could be argued that a separately managed, internal property portfolio is no longer required.

In this short paper we discuss the property asset class and comment on its relevance for pension funds in general, and then detail the individual property managers held by the Fund. We then discuss some specific considerations for the Fund and make some recommendations.

Contents

Section One - Introduction

One of the distinguishing features of property is that it exhibits both equity and bond-like characteristics.

The income stream from rental payments on property investments is a similar feature to that of coupon payments received from bond assets. Hence, property investments can also be used by pension schemes, in conjunction with income from bonds, to pay cash outflows such as pensions in payment.

The returns on property investment are real, due to rental growth being correlated to economic growth, with long-term return expectations tending to be greater than other yield-returning asset classes such as gilts and corporate bonds. As a result of the correlation between rental and economic growth, property can also be used to match active liabilities as part of a pension scheme's growth assets. Property exhibits equity-like characteristics with a reduced level of price volatility from one month to the next due to the infrequency and subjectivity of valuations.

Property investments can also be used for diversification purposes, with only modest correlations exhibited between property and equities or bonds.

Illiquidity

One of the main disadvantages of property investments is its illiquidity. The process of buying and selling property can take a long time, meaning it is difficult to sell holdings in property at short notice at a fair price. Also property investments are discrete buildings and so the cashflows from asset transactions are, by their very nature, "lumpy" and can lead to significant cash holdings.

Should there be a sudden investor sentiment to sell out of the asset class, investors within a pooled fund may not be able to immediately relinquish units, as the manager would have to sell properties to raise cash. This may lead to the managers being forced to sell properties for below fair price.

In order that the manager can sell properties at a fair price, they can put in place a notice period, whereby investors have to give advanced notice of their intention to sell. Further, it may be that a redemption queue exists until disinvestment can take place, providing the manager sufficient time to sell out of properties (or, more cynically, allow the manager to retain assets for longer).

This was the case for most pooled funds in 2008, with investors unable to realise their assets in a period where property returns were sharply negative. We then saw the opposite effect during 2009 and the first half of 2010, with subscription queues forming with managers looking for suitable properties to purchase as the market started to pick up.

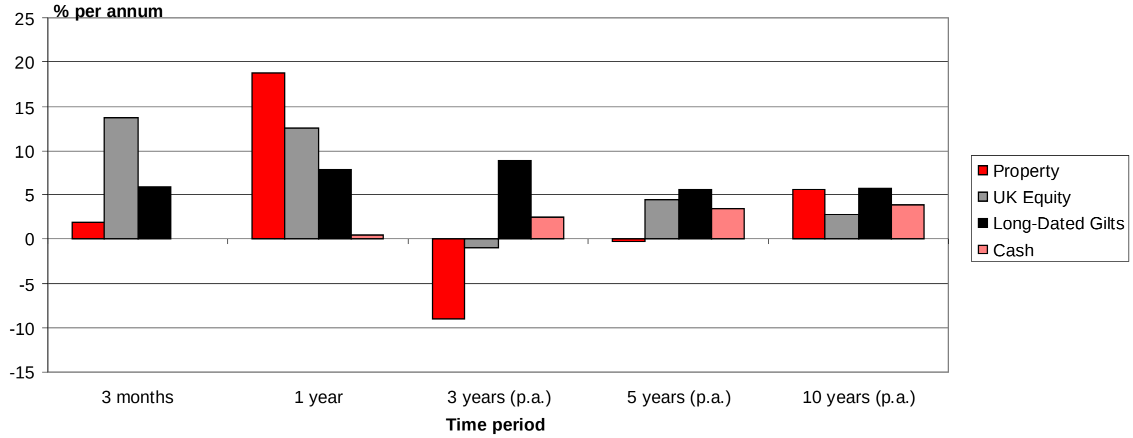
Transaction costs

Another disadvantage of property investment is the transaction costs involved. The typical bid/offer spread on a pooled property fund, i.e. the difference between the price paid to buy units and price received when selling units, is significantly higher than that of investing in equities or bonds (which are much less than 1%). Typical bid/offer spread on property funds are approximately 6% - 7%, the vast majority (4%) of which is stamp duty. For the above reasons, pension schemes should consider property as a long-term investment, with a low expectation of having to regularly manage cashflows in and out of the asset class.

However, when there are investor inflows into property funds there is the potential that sales of property fund units could be "matched" against an investor entering the fund. This is where the fund managers matches the disinvestment against an investor purchase and the value of the sale is calculated at the (higher) mid-price.

Section Two - Current Market Conditions

The chart below shows the performance of property, together with equities, gilts and cash, over various periods to September 2010.



Source: Thomas Reuters, Investment Property Databank (IPD), JLT

In recent years, property values have been falling sharply, with many investors seeking to exit positions they held in the asset class. However, following an uptick in the last half of 2009, one year returns for property are now positive, over the last 10 year period it has outperformed equities and cash.

The improving economic confidence and wider rebound in financial markets have helped sentiment and seen demand for property increase. This was initially largely driven by overseas investors, with UK institutions becoming increasingly active in the market towards the end of 2009. There is much debate amongst commentators as to whether the recent upturn in commercial property values has been driven by fundamentals or from the large flows into the asset class by mainly overseas investors taking advantage of the weakness of sterling. The property market historically has tended to lag the wider economy as the upturn in an economy takes time to feed through to occupier demand and rental growth.

Outlook

The consensus forecasts that we are currently seeing from investment managers suggest that property returns will be relatively modest over the next 12 months, with capital values flattening (or even falling in some areas), and any return coming through income, with average yields close to 6.5% (though the actual return would be expected to be lower, once voids, cash holdings, rental tax and other factors are taken into consideration. There are likely to be disparities between different regions, with City offices holding up very well, with extremely limited office space following the freeze on any developments over the past few years. In contrast, "secondary" markets such as in Northern England, and other areas particularly reliant on the public sector may well suffer as government cuts are made.

The returns that are being seen in the market for property derivatives can also give us some good information about how the market is expecting property to perform in the future. The returns implied by property derivatives suggest that 2011 returns are expected to be low, with returns in 2012 and 2013 expected to be stronger.

Section Three - The Fund's Property Managers

Manager/Fund	Schroder Exempt Property Unit Trust (SEPUT)	Hermes Property Unit Trust (HPUT)	Rockspring Hanover Property Unit Trust (RHPUT)	BlackRock UK Property Fund (BUKPF)
Fund Manager	Ian Mason	Chris Mathew	Neal Shegog (Fund Director) Mischa Davies (Fund Manager)	BlackRock (Channel Islands) Limited
Years at manager/ in the business	Fund Manager since April 2008. 26 years industry experience	8 years at Hermes and 15 in the industry.	Neal - 16 years at Rockspring, 22 year in the industry Mischa - joined Rockspring November 2010, 12 year of industry experience	1988 inception.
Size of Fund	£1.2bn	£723.6m	£422.1m	£1,957m
Size of total funds run by the property team	Total property assets under management as at 30 September 2010 was £9.3 billion (Source: Schroders, 30 September 2010)	£4.8bn as at 30 September 2010	£422.1m	$13.4bn
Performance target (net of fees)	to provide a return of 0.5% per annum (net of fees) above its benchmark (Investment Property Databank UK Pooled Property Fund Indices – All Balanced Property Funds Median) over rolling 3 year periods.	To outperform the IPD Balanced PUT Index by 0.5% per annum on a 3 year rolling basis (net of fees).	The Trust seeks to beat its benchmark (IPD Balanced Property Unit Trust Index Median). (net of fees)	To out perform the IPD All Balanced Fund Weighted Average. (net of fees)
Number of properties in the fund	58	Direct 45 Indirect 4	37 direct properties + 4 indirect fund investments	83
% of fund in top 5 properties	24.2%	29.0%	37.5%	36.6%
Number of tenants	761	266	2292	880 (approx.)
% of fund in top 5 tenants	16.1%	19.0%	16.2%	13.2%
Number of investors	393	128	111	435

Manager/Fund	Schroder Exempt Property Unit Trust (SEPUT)	Hermes Property Unit Trust (HPUT)	Rockspring Hanover Property Unit Trust (RHPUT)	BlackRock UK Property Fund (BUKPF)
% of fund held by biggest investor	3.5%	8.8%	8.0%	2.0%
Level of Gearing (and max allowed)	9.9%. The recommended range for on and off balance sheet gearing is 0-20% of NAV, although we target 0-10% gearing.	1.9% / Max 40% of gross asset value	13.6% for direct and 18.4% including indirects. 50% gearing level permitted	8.6% of GAV at YE, max of 33% allowed.
% of fund held in indirect investments (and max allowed)	19.8%. Expect the indirect exposure to be 10% or less in the medium term following the repositioning of the portfolio.	11% / Max of 30% of gross asset value to be held in investments alongside other investors, and of this, not more than 20% of gross asset value to be held alongside other Hermes clients.	18.03% Not more than 20% of Net Asset Value may comprise units in an individual collective investment fund.	16.1% of NAV at YE, 50% allowed
% of fund held in speculative developments (and max allowed)	0%. Maximum is 15%	0% / Max 10% of gross asset value.	1.3% Not more than 30% of Net Asset Value may consist of property which is undergoing speculative substantial development, redevelopment or refurbishment.	0% (25% Max)
Void Rate	6.7%	4.9%	13.3%	5.2%
Yield	Net Initial Yield - 5.8%	4.7% Calculated using NAV	6.5%	4.1%
Level of Cash holding	5.7%	5.0%	1.7%	7.9%
Average lease length	8.0 years	8.2 years	9.5 years	8.6 years

Section Four - Performance of the Fund's Property Managers

	Q4 2010	1 year	3 years (p.a.)	5 years (p.a.)	10 years (p.a.)
Schroder	2.5	12.9	-8.1	-2.6	n/a
Benchmark	2.1	12.3	-4.2	0.0	n/a
Relative	*+0.4*	*+0.6*	*-3.9*	*-2.6*	-
Hermes	3.0	13.7	-4.3	0.9	n/a
Benchmark	2.0	12.1	-7.1	-1.9	n/a
Relative	*+1.0*	*+1.6*	*+2.8*	*+2.8*	-
Rockspring*	2.7	10.1	-9.8	-3.2	4.6
Benchmark	2.4	12.9	-5.8	-0.4	5.6
Relative	*+0.3*	*-2.8*	*-4.0*	*-2.8*	*-1.0*
BlackRock	1.4	11.5	-5.4	-0.4	6.1
Benchmark	1.9	12.2	-5.7	-1.1	5.5
Relative	*-0.5*	*-0.7*	*+0.3*	*+0.7*	*+0.6*

Source: Investment managers, net of fees. *Unaudited figures.

Discussion

The different funds all have different benchmarks; however, it is possible to discern that Rockspring Hanover Property Unit Trust has underperformed its specific benchmark over 1, 3, 5 and 10 year periods, and has provided the lowest absolute return over these periods too. This underperformance combined with poor performance from Schroder and marginal performance from BlackRock has led to the long term underperformance of the Fund's property portfolio as a whole.

Section Five - Recommendations

The underperformance discussed in the previous section can be combined with a number of sound reasons why the Members of the Pension Committee should consider the future of the Fund's property portfolio and reallocating the proceeds:-

- it is relatively insignificant in size and potential impact it could have on the funding position
- it takes up a disproportionate amount of officer time in its monitoring
- its diversifying role has been superseded by the Fund's DGF investments

Transactions costs

The magnitude of the bid / offer spread should be considered with respect to the timing of any planned liquidation. Currently the spread and therefore the full cost of exiting the funds is likely to be incurred by the Fund on exiting, as the outlook for property is not encouraging and therefore there may not be any incoming investors with whom to match the disinvestment.

Allocation of any property fund proceeds

The Pension Committee will have to make the decision on where to invest any proceeds from a sale of the Fund's property portfolio.

Recommendations

- We recommend the Pension committee should consider the future of its property portfolio. We do not believe there is any compelling reason as to why the Fund should have a separate, internally managed property portfolio.
- Whilst this is not a historically optimal time to exit property portfolios we would recommend that the Pension Committee does not attempt to "market-time" the exit (the potential upside is marginal and the downside risk of underperformance is much larger).
- Instead, we would recommend that the property fund managers are instructed to sell the Fund's holdings immediately, with one caveat.
- If there is the potential that this sale could be matched against an investor entering the fund then we would recommend that the fund manager has latitude on the timing of the disinvestment in order to match it against a purchase and value the sale at the (higher) mid-price.

Appendix A - Property specific considerations for fund selection

Gearing

This is the amount of borrowing within a fund. For example, a fund which is 100% geared would have twice the amount of money to invest compared to the funds it had received from investors, with the additional amount coming from borrowing. Geared funds tend to produce much more volatile returns than ungeared funds, with overstated peaks in times of bull markets and overstated troughs in bear markets. We prefer funds with no or low gearing for UK pension schemes as geared funds can be very illiquid especially in weaker market conditions.

Active management

In equity and bond investment, active management refers to the manager taking bets by holding more or less of a given stock than its weighting in the relevant index. These bets allow the manager to try to beat the performance of the index.

In commercial property, active management means the work done by the manager to maximise the value of their property assets, for example refurbishing, finding better / more profitable uses for existing properties, seeking longer term leases, seeking better quality tenants at higher rates. All managers will actively manage their property portfolios to some extent, but the degree to which this is done does vary between managers.

Amount of cash held

Managers will need to hold cash to allow them to make new purchases and to meet redemptions. Also as property market expectations change over time, then the cash holding may increase or decrease accordingly as a result of tactical decisions made by a manager.

However, in general the manager is being paid to manage property, so we would expect the cash position to be maintained at a relatively low level in the longer term.

Yield

Part of the return from property comes from appreciation of capital value and part comes from the running rental income on the portfolio. The yield of a portfolio is the ratio of the rental income to the property value, and the higher the yield, the higher the rental income relative to the value of the fund.

Void rate

At any one time, a proportion of the properties within a fund will be vacant. This proportion is the void rate, and the higher the void rate the lower the income that is being generated by a portfolio.

Lease length

Holding a long lease on a property at an attractive yield will be more beneficial for returns than holding one that is shortly up for renewal (unless there is a very strong demand in that particular sector, which would drive the rent in the re-leased property up).

Speculative investment

Speculative investments are generally considered to be those where a high level of risk involved. There are various stages in building a property from new, from sourcing the land, planning, demolition (if required) of existing property, construction, fitting out and letting. In times of rising markets, speculative development and 'new builds' gave substantial rewards. However in bear markets, the lack of potential tenants or reduced rental income from tenants has resulted in such developments being mothballed or heavily loss making.

Whilst some managed funds have taken the decision to stay away from speculative development, others have the ability to allow a small degree, or to focus on refurbishments or redevelopments of existing properties rather than full new-builds.

Indirect investments

Indirect investments – i.e. investing in funds of another manager or in other property vehicles, allow a manager to get greater diversification through measured exposure to a wider range of properties, or to much larger developments such as large scale retail parks, than could be supported through their own asset base.

Indirect investments often have a higher level of gearing, and this gearing is also outside the control of the manager. Also, some of the large indirect vehicles in which managers invest have been subject to issues with redemptions recently.

Policy on redemptions

The redemption policy is the approach a manager takes when clients ask to withdraw their money.

The general principle is that it would be unfair to remaining investors if clients seeking to redeem their assets meant that properties had to be sold quickly on terms that were unfavourable. Managers therefore usually set a redemption period, whereby the client gives notice of its intention to withdraw assets and the manager pays the client the required money at the end of the set redemption period. This allows the manager to control its cashflows.

Some managers maintain a cash holding out of which small redemptions can be made without triggering a redemption period.

Size of fund and size of manager

Generally speaking, we would look for a manager of reasonable scale. This is because they will have good experience of running property funds, good processes and teams in place for managing the assets, they will have good market presence so that they have access to forthcoming deals, the ability to negotiate on prices, the ability to deal on a nationwide basis, the ability to deal with and influence nationwide tenants.

However, managers often operate several property mandates, and whilst some managers have a large property book, the pooled fund may be relatively small. There is no particular rule for assessing whether a particular fund size is preferable. A large fund is likely to be able to access a wider range and diversification of properties, and also a greater size of individual property. However, with very large funds it can be difficult to rebalance the fund from one sector to another (e.g. retail to industrial). For smaller funds, rebalancing can be achieved by the buying or selling of a smaller number of properties. Also, smaller funds can achieve diversification through investing in smaller size properties.

Use of derivatives

There are derivative investments available which provide the return, or a return over or under a given property index in exchange for an agreed series of payments.

Whilst the pooled funds we consider should mainly be seeking to make their returns from investing in bricks and mortar, where a manager believes there is an anomaly in the pricing of these derivatives, we would support their controlled use as a way of adding value.

Diversification of properties / tenants / sectors

Consider an extreme scenario - a fund had only one property - a Central London office, all held by one tenant. If the tenant goes out of business and there is no demand for the empty office space, then the fund is in serious trouble.

Generally speaking pooled funds will look to diversify their portfolio by holding a wide range of different properties, in different sectors (e.g. Industrial, Retail, Office, Central London etc), different locations, and with a wide variety of tenants.

Bid/Offer spreads

The typical bid/offer spread on a pooled property fund (i.e. the difference between the price paid to buy units and price received when selling units) is significantly higher than that of investing in equities or bonds, at around 6% - 7%. This reflects the costs of buying and selling properties, including stamp duty and legal fees.

During the recent period of poor liquidity, some property funds imposed very severe redemption penalties on their funds.

Therefore when investing in a property fund, it is important to see if matching opportunities are available, whereby a buyer is matched with a seller to minimise costs. Unfortunately, this is unlikely to be possible at the current time for any of the funds under consideration as all of the funds are seeing net inflows. This makes it unlikely that the Scheme will be able to cross units with an investor exiting the fund (therefore saving on transaction costs).

JLT Investment Consulting
St James's House
7 Charlotte Street
Manchester
M1 4DZ
Fax +44 (0) 161 253 1169

CONTACTS

John Finch, ASIP FCII
JLT Investment Consulting
Tel: **+44 (0) 161 253 1168**
Email: **john_finch@jltgroup.com**

Julian Brown PhD IMC
JLT Investment Consulting
Tel: **+44 (0) 161 253 1164**
Email: **julian_brown@jltgroup.com**