

The Benefits And Pensions Monitor Interview

Real estate appears to be capturing more and more Canadian pension fund investment dollars. In recent months, we have seen OMERS, the CPPIB, and the Ontario Teachers' Pension Plan announce major real estate investment deals abroad. Even HOOPP made a splash announcing its first foreign real estate investment.

Benefits and Pensions Monitor recently had an opportunity to explore the attraction of real estate to pension funds with Russell Chaplin, chief investment officer for the property business, and Jon Lekander, global head of indirect property, for Aberdeen Asset Management.

Here is that conversation.

Benefits and Pensions Monitor: What is the consensus in terms of liquidity returning to the market?

Russell Chaplin: There is liquidity returning to the markets. There is a lot more liquidity than there was two or three years ago. It was coming in various different forms including the public and private debt markets.

There is considerable potential for a lot of capital to be deployed into property over the coming few years. Though people in the industry are also concerned about the downside risks associated with refinancing of real estate debt in the next two or three years which was underwritten through banks and CMBS in 2005, 2006, and 2007.

BPM: Where are the best spots for real estate investment these days?

Chaplin: We are private equity players who look across the whole globe. We are buying and selling properties on behalf of institutional investors, pension funds, insurance companies, sovereign wealth funds, etc. The parts of the market that we are looking at are really more the core markets. That would be the U.S., Canada, the Americas, Europe, the UK, Australia, Japan, and Asia. From our view, there are some strong opportunities in the north of Europe, the Nordic countries, France, Germany, the Netherlands, and also in the UK. Although the UK has recovered quite early in the cycle, many of the assets there are the best assets and they are quite heavily priced.

The U.S. is going to offer opportunities as well in the coming two or three years off the back of refinancing of debt.

In Asia, we are probably more biased towards Australia at the moment than Japan, but within that market, as well, there are a whole load of emerging markets China, India, etc., which we do cover, but not in the core business. It is covered through the fund of funds where we invest in unlisted vehicles.

Jon Lekander: Japan does not look particularly appealing compared to other markets in Asia. However, it is a big and deep market so there are also opportunities there. Australia turned a corner about a year ago and is doing well. It is still a market that we are looking at. I think we are at the part of the cycle where the difference between markets is larger and the opportunities are wider spread than you would normally think.

BPM: Some managers, when they invest in Europe, just focus on certain sectors of major cities such as London. Is that starting to change?

Chaplin: You need to rewind a bit to where we have been in the last two or three years which has been a big unwinding of the rise in capital values across the globe, driven by excessive debt in the market. We have been through some strong falls in markets. Markets like the UK have fallen 50 per cent in capital value unleveraged.

BPM: What type of excess debt are we talking about?

Chaplin: Leverage applied to real estate, the relatively low interest rates that were available in 2005, 2006, taking on debt to finance real estate purchases. A lot of the major markets and the very good properties actually saw a strong downturn in values during 2006, 2007, and 2008 and, as a consequence of that, prices fell a long way. The potential returns on those looked very attractive. Those who were looking to invest in property over the last year to 18 months have really been targeting those properties with good fundamentals, good leasing, and good locations with good tenants, properties that will re-lease relatively easily. Most of the money that was waiting to go into property went on hold in 2007 and 2008. When it started to come back in, it all went into those markets. It would be going into markets like London or Paris or the major capital cities because that is where those assets are. That still exists. We are still seeing that flow of capital into those markets.

There is a beginning of a sense that people are starting to look further than that, looking outside capital cities and properties which are maybe in less prime locations, with not as good tenants, and so on. One of the concerns for us is that people may be doing that too early in the cycle. The economic cycle which drives the occupier markets which ultimately drives the growth in property values is actually somewhat weak, as opposed to the rest of the economic recovery so the property recovery is going to be relatively weak as well. We are concerned that people might be stepping into those secondary markets a little bit too early.

BPM: It seems that some of the major Canadian pension funds are at the vanguard of looking into property. Is this one of the few cases where the Canadian funds are ahead of the curve?

Chaplin: Canada is an interesting place because if you look at the ratio between the size of the pension fund market and the available property within the domestic market, it is relatively high so there is a lot of pension fund capital chasing relatively few assets. The market seems to be relatively tightly held with very few transactions and in that kind of structure you typically find people looking outside of their domestic market.

I would not say that Canada would be abnormal in that. There are other markets with that kind of characteristic as well. Some of the Nordic markets Sweden and Norway have very high pension levels, but not a great deal of real estate. It is automatic that you would start to look beyond your borders.

For a relatively small market in a global context, Canadians have certainly been looking outside of Canada. The very biggest can do that by going and buying properties across the globe. My sense is there are not many that can play that game. There is the potential for the smaller pension funds to need to go outside of Canada as well. They need to choose a different approach to those of the bigger players.

BPM: Is that where fund of funds come in?

Lekander: That is one of the things that we are thinking about, either the money going directly into funds which might be targeting a particular geography or a particular sector so perhaps taking a step into Europe and going into a fund which is invested in retail, office, or industrial property across Europe or the UK.

The other route is to go in through a fund of funds type of route where you have exposure to more funds from more managers and, underlying that, much more domestication in terms of the number of properties you would be exposed to. There are various different routes into that. It feels to us as though either the single unlisted funds or fund of funds route looks like the most appropriate for Canadian pension fund clients.

BPM: Are you seeing much uptake from Canadian institutional investors in terms of fund of funds?

Lekander: The market is heading in that direction. The appetite for international property in general, whichever route it goes, is definitely here, so, yes, there is an appetite.

BPM: There seems to be an increased appetite by pension funds for real estate these days. Any thoughts on why?

Chaplin: A lot of this comes from the top down asset allocator who would be looking at the range of different asset classes that they could allocate to and typically when you look at that range of assets, when you look at property compared to equities, for instance, what you would find is that property is a relatively good diversifier for equities and bonds. Its level of income and cash yield are relatively attractive as well, but with lower volatility. What you are beginning to see is asset allocators taking away some of the allocation that they might have

traditionally had to the equities market and moving that into alternatives and property would be one of those. That seems to be a key driver. That is where you would see the overall increase in allocation to property.

Once you start to look at global property, you start to take on even greater diversification benefits because you are invested in a whole range of markets across the world. What you are beginning to see is people not only considering their domestic market in their asset allocation framework, but putting in global property. That is driven by the availability of the vehicles to be able to actually do that. It was something that five to 10 years ago you really could not do and in the last five years, you have seen a big growth in the number of unlisted funds. That means that you can actually operationalize a global property strategy without having to buy buildings. That means that pension funds can make a relatively small allocation and get good diversified exposure across the globe just as they might do for other asset classes that have been global for a long time.

BPM: The topic in investment circles these days is emerging markets. Are we starting to see more interest in emerging markets real estate?

Lekander: We have been investing in Asia, which is very much a part of the emerging markets story, for the past five years. The compelling reasons are economic growth and, in most cases, the favourable demographic profile of these countries. These make for a very compelling investment case.

The trick with emerging markets, and any asset classes, is how you handle the different transparency levels in those regions. In our experience, that comes through several different steps. One is how to access the market when the market is no longer as forthcoming with information or opportunities as you would find with other asset classes on the Bloomberg screen. That is where we have been able to fill a gap for our investors, our clients.

There is also a second level of transparency which is accessing real estate in many emerging markets where it is viewed as a strategic resource. I think the right way to handle that is being close to the market and understanding the political agenda, as well as economic agenda, of the governments.

BPM: Could you define what you mean by a strategic resource?

Lekander: Real estate is a physical asset which means in most countries it is treated with more sensitivity than corporate entities or bonds. That pertains to city planning or where that asset is located.

It is worth adding that in terms of entering more emerging markets and potentially more volatile, more risky markets, the way that you do that is paramount. For us, the key thing is about vintages of capital that you would deploy and that we would favour deploying capital over a relatively long period of time, rather than putting capital quickly perhaps into a market over a six- to 12-month period because the volatility is such in the emerging markets that you never really know whether you are at the peak of a market or at the trough. What you try to do is deploy with a constant vintage approach so that through time, you will capture the growth and you will also avoid the worst parts.

Many have chosen to enter those markets by putting a slice of capital into those markets and then seeing what happens and that could be really good or really bad. The most sensible way is to deploy throughout a period of time.

BPM: Is that the approach that a pension fund would take or are there pension funds that just bounce in and wait for it to go up and then dump it and move on?

Chaplin: Most pension funds that are looking at property across the globe are going to be after the income, the cash yield plus some capital growth.

The alternative approach is where you are using your property as a return seeking asset where you would be willing to take on more risk to achieve a return. We would suggest that is probably not the core part of a pension fund strategy, to go wholly into an emerging market strategy in real estate. If anything, that would be a satellite approach to try and capture some enhanced return over a period of time. Where you might deliver something like seven per cent from a global core property market, you might be able to enhance that up to eight, nine, 10 per cent, depending upon how much risk you are willing to take in more emerging markets with that growth.

You can blend those strategies if you wish, but it does not come without risks. The best way to minimize

the risks of investing in emerging markets is that constant deployment through the vintages to try and avoid the vintage risk.

BPM: Where do you see interest rates going?

Chaplin: Our view on interest rates is that we expect rates to stay low for a reasonable amount of time. If you look at what is implied in the yield curves, if you look at what the market thinks money is going to be yielding in five years' time, that has actually been trending down over the last couple of years as well. The market believes interest rates are going to remain relatively low for a relatively long period.

The potential risk, of course, is that you get money flowing too quickly into the economy and then you start to generate inflation. Interest rates then have to rise earlier than expected. That has been a concern for the last year or two and whilst that concern has not happened yet, there is still that potential.

As far as real estate is concerned, it tends to benefit in periods of very low cash yields because the yield on property is typically relatively high. One of the concerns there is if interest rates are going to go anywhere in the long term, we would think that they would rise. The level they are at the moment is unsustainably low in the very long term. We will see interest rates rise towards more normal levels which typically in the developed world means somewhere around four to six per cent. That seems to be some way off from the markets at the moment.

When interest rates rise, that does affect property, usually negatively on the capitalization rate. What usually comes with that is strong economic growth. That is why the interest rates are rising. They tend to work together. One is causing values to fall in real estate, the other is causing it to rise and they tend to interact and cause that stability which is what investors are looking for. ■

Benefits and Pensions Monitor's executive editor, Joe Hornyak, recently had an opportunity to talk global real estate with Russell Chaplin, chief investment officer for the property business, and Jon Lekander, global head of indirect property, for Aberdeen Asset Management.