MJ HUDSON Allenbridge

# Surrey Pension Fund Committee

Manager Review Meeting Minutes

**3rd August 2022**

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## Attendees

Lloyd Whitworth, Head of Investment and Stewardship
Neil Mason, Assistant Director – LGPS Senior Officer
Anthony Fletcher, Independent Adviser

## Background

The purpose of this meeting was to receive an update from CBRE on the performance, activity and outlook for the UK and Global property funds managed on behalf of the Surrey Pension Fund. And to receive a progress report from BCPP on the development of their investment solutions for global and UK property.

# CBRE



David Inskip - Head of Research
Shamaan Malik - Deputy Portfolio Manager
Nahid Abdin - Intern Analyst

Akash Shivashankara - Deputy Fund Manager: CBRE Global Alpha Fund

*Mandate Summary*

Property Fund-of-Funds with holdings valued at £340.5 million in 30 underlying funds at 30th June 2022. The Portfolio of funds is made up of 75% invested in a range of UK funds and 25% in the CBRE Global Alpha Fund.

*Performance*

CBRE provided separate performance data for the UK and global funds due to accounting period differences. The Global Alpha fund's return was reported to 31st March whereas the UK fund's return was calculated to 30th June 2022, each fund also has a different performance objective.

The total return of the UK property fund over 12 months to the 30th June 2022 was estimated at 22.4% in GBP, which was 1.4% behind the performance objective's return of 23.8%. Over 3 years the estimated return was 8.3% p.a. in GBP, compared to the performance objective's return of 9.7% p.a. The performance objective for the UK fund is to outperform the MSCI/AREF UK QPFI All Balanced Property Fund Index + 0.5% p.a. over a rolling 3 year period.

The total return of the Global Alpha fund over 12 months to the 31st March 2022 was 16.7% in local currency terms, well ahead of the funds 9% to 11% performance objective but behind the market comparators (MSCI GPFI) return of 20%. Over 3 years the fund delivered 8.6% p.a. in local currency terms, compared to its objective of 9% to 11% p.a. over a rolling 3 year period.

Over the 12 months to June 2022 CBRE's attribution analysis estimates that currency made the largest positive contribution to overall returns followed by the global alpha fund which slightly outperformed 2 of the specialist core industrial/logistics funds in the UK portfolio. From a sector perspective Industrial/logistics and long income remained top performing sectors for both funds, with retail and hospitality continuing to suffer from structural headwinds made worse by covid.

In the UK the Industrial, funds produced the largest sector returns and the retail sector the lowest. In terms of the individual funds, the Nuveen UK retail warehouse fund was the best performer delivering a +80.7% return, whereas Nuveen's UK shopping centre fund delivered -38.6%. Only 6 of the portfolio's individual funds matched or outperformed the 23.8% performance objective over 12 months. There was a long tail of funds which underperformed the objective, 11 of which delivered a total return of less than 10%, but only 2 delivered a negative return, Palmer Capital development fund III, which is in "wind-down" and returning capital to investors and as mentioned above the shopping centre fund.

The largest contributor to the performance of the global fund over 12 months was currency. The global fund's performance is stated in local currency and with more than 95% of the fund's investments denominated in currencies other than GBP, changes in the value of the GBP can have a big influence on the total return. Regional performance was also denominated by the strength of the US dollar but the aggregate return on investments in Europe and Asia Pacific did outperform those in the UK. At the sector level contributors and detractors for the global fund were similar in to those of the UK fund, while logistics funds were 3 of the top performers, the greater sector diversity of the global fund also had a US residential fund as a top performer and a hotel in Europe as its worst performer.

*Current Positioning*

As would be expected from a property portfolio over the year there has been no significant change to overall portfolio positioning; the main themes remain unchanged overweight core and defensive strategies including Long Lease property and underweight opportunistic. Both funds are focussed on resilience of income, they are overweight industrial/logistics and in the global fund residential, underweight and reducing office and retail, neutral alternatives. In the office sector where they have maintained exposure it has been focussed on prime properties with high ESG

15 ratings and lower impact from “working from home” because they offer a broader experience for employees. In the last 12 months the UK fund has made only 2 outright purchases and 1 outright sale. Most of the investment activity in the UK fund has been through the return of capital from funds that are in “wind-down” or drawdown of already committed capital. The global fund made 3 sales and purchases of roughly similar size and due to strong positive cashflow from investors made new commitments to invest the equivalent of 7.5% of the funds NAV. The % turnover of the global fund was roughly double that of the UK fund.

*Outlook*

CBRE’s macro-economic outlook was pretty bearish, they are expecting a recession in the UK, although not as bearish as the Bank of England’s very next day forecast of stagnation in 2023. CBRE expects inflation to fall quite quickly next year as “base effects” from this year’s high energy prices and a weakening economy, caused by falling household incomes (cost of living crisis). They also see higher bond yields as having a twofold negative technical impact on property. The first being a higher cost of debt and increased yields required to attract investment. The second a portfolio effect caused by the negative returns from bonds causing property weights in pension funds to become overweight leading to forced sales of property assets to re-balance overall asset allocations or at least reducing demand for the asset class. This second impact is of particular importance to corporate pension funds, which are typically closed and have a very high proportion of assets invested in bonds and property.

CBRE presented evidence that higher interest rates and bond yields, and a weakening outlook were already having an impact on the property market with markedly falling capital growth in all sectors in the second quarter of 2022. They also pointed to falling investment volumes and a big negative swing in sentiment. As a result, they are forecasting rising yields and falling capital values in 2023 and 2024 leading to very low total returns from the market over the next two years. In May they reduced the 5 year annualised total return expectation for the asset class to 4.8%, with 4.6% coming from income, this is the second downward revision this year, their last expected return published in February was 5.5% p.a. The weakness is widespread with CBRE expecting the total return from all sectors to be lower over the next 5 years.

The global team seemed to be more optimistic about the returns from property but they do have a much broader set of market sectors and countries in which to invest. Regionally they see the best opportunities in the US and Asia and are least comfortable with continental Europe, mainly because of the war between Russia and Ukraine and the uncertainty around how long the actual conflict lasts but also because of the longer-term implications for security. They could see post covid opportunities in both office and retail and stated that the global fund had “dry powder” in the form of increased cash commitments from investors, but they also suggested that the second quarter of 2022, could have been the last quarter of strong returns for a while.

***Adviser View***

This was a much more confidently presented and clear meeting than the last time we saw the CBRE teams. I have no concerns with the team or how they are managing the portfolio on Surrey’s behalf. However in future I believe we should ask CBRE to report the performance of both the UK and Global funds over the same period.

**(Hold)**

# BCPP

Alistair Smith - New Head of Real Estate
Paul Campbell – Portfolio Manager
Milo Kerr – Head of Client Relations

Surrey's pooling partner BCPP is in the process of designing their property offering for Global and UK. The Global offering will be similar to the CBRE approach of gaining indirect access via a mixture of property funds, but the UK approach will involve migrating away from funds to a property portfolio that will be predominately made up of direct property investments.

The process of designing the new fund offerings has been very slow and drawn out and was not helped by the departure of the last Head of Real Estate in the second half of 2021. BCPP have now appointed a new Head of Real Estate, Alistair Smith, Alistair's background is in property surveying and valuation and for the last few years has led the team that consolidated Abrdn's various legacy property offerings into one new platform. As a result, he has gained considerable experience of the intricacies of consolidating a complex portfolio of indirect and direct investments from a range of managers.

Some progress has been made on the provision of the Global Property offering with Aon Townsend appointed to be the investment adviser to the Fund in July 2022. Northern Trust has also been appointed as Third-Party Administrator and Depositary for the whole of BCPP real estate offering. Paul Campbell who has been involved from the beginning will be the BCPP Global Property Investment Manager. There will be two indirect global property funds with different performance objectives, which can be combined to meet the needs of each partner fund. The property team will be working with partner funds to establish a plan for transition of legacy assets from each LGPS to the Pool. Some work needs to be done to finalise the exact requirements for each partner fund including the balance of risk and return and the potential need for currency hedging and income distribution. BCPP will be seeking commitments from partner funds later this year with a view to launching the global offering in the 1st half of 2023.

The UK offering is going to be a much more difficult solution as some of the partner funds already have established portfolios of direct holdings and others like Surrey have existing portfolios of indirect funds all of which need to be transitioned in such a way to keep the very high transaction costs to a minimum.

***Adviser View***

This transition is potentially the most expensive and complicated task that BCPP has undergone. Nonetheless I believe it is the right choice for Surrey to take, provided it can be delivered at a lower price than the Fund's current property solution provided by CBRE. The global element is a fairly straightforward substitution of CBRE as fund selector by the team at BCPP. I believe the real savings will be achieved by the substitution of UK indirect property funds by direct property investments in the UK. In my experience, bearing in mind past experience will not always play out in the future, direct property investment delivers better risk and return outcomes at a much lower price, with much lower volatility and not much less liquidity.

In determining the balance between Global and UK property investments, Surrey needs to decide exactly what it wants the property allocation to do in the Strategic Asset Allocation. If it's more about growth than income maybe a higher weight to global property, if however, it's about certainty of income maybe a higher weight to UK property should be considered.

**Anthony Fletcher – Independent Adviser to the Surrey Pension Fund**

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1 Frederick's Place, London, United Kingdom, EC2R 8AE | +44 20 7079 1000 |