MJ HUDSON Allenbridge

Surrey Pension Fund Committee

Manager Review Meeting Minutes

25th July 2023

Attendees

13

Neil Mason, Assistant Director – LGPS Senior Officer
Lloyd Whitworth - Head of Investment and Stewardship
Mel Butler – Investment Strategy Manager

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

Shamaan Malik - Portfolio Manager
Dugal Hunt – UK Region Head and Client Director
Isabelle Brennan – Senior Director, Client Solutions

Mandate Summary

CBRE manage a Property Fund-of-Funds with holdings valued at £292 million in 30 underlying funds and a further £13 million in cash. On 31st March 2023, the portfolio's asset allocation was 72.6% in a range of UK funds and 27.4% in the CBRE Global Alpha Fund. The performance objective for the total mandate is to outperform the MSCI/AREF UK QPFI All Balanced Property Fund Index + 0.5% p.a. over a rolling 3 year period in GBP terms. Surrey appointed CBRE in April 2004.

Performance

Although the meeting was held on the 25th July and some estimated performance data could have been available as of 30th June 2023, in order to be consistent across both the UK and Global portfolios, as requested last year CBRE provided performance data to the 31st March 2023. The internal performance objective of the Global Alpha Fund is different to the UK portfolio of funds, but CBRE have used Surrey's performance objective as the comparator to measure the total return.

On this basis the total return of the CBRE portfolio was -9.3% compared to -14.5% for the benchmark over 12 months. Over 3 years the total return was +2.8% p.a. compared to the benchmark return of +2.6% p.a., while ahead of the benchmark by +0.2% this outcome is -0.3% p.a. when compared to the performance objective. The total return is ahead of the benchmark and objective over 5 years at +3.8% p.a. compared to the objective of +3.0% p.a. However, the total return since inception is +4.6% p.a. -0.9% p.a. behind the Surrey performance objective and -0.4% behind the benchmark.

Over the 12 months to March 2023 CBRE's attribution analysis estimates that the 5 best positive contributions to performance came from; the Global Alpha fund, followed by Fiera Fund 5, Currency, Unite Student Accommodation and Fiera Fund 4. The 5 funds with the largest negative contributions were M&G Secured income, Standard Life, Long Lease, Schroders UK Real Estate, Industrial Property Investment fund and Airport Industrial Property Unit Trust. CBRE cited a fall in capital values as the primary reason for negative performance driven by sustained macro-economic volatility. The distribution yield of the portfolio was 3.4%.

In terms of absolute return 7 funds achieved a positive return, with a long tail of negative absolute returns from -4.1% to -57%. Within this there were 8 funds whose total returns were below the benchmark return of -14.5% and some of these were last year's best performers including several industrial and logistics funds. But once again the largest negative return was achieved by Nuveen's UK shopping centre fund which delivered -57%, after achieving -38.6% in the previous year. This was mainly due to continuing issues with it's largest development project, the St James Quarter in Edinburgh.

Current Positioning

In the last 12 months in anticipation of the launch of BCPP's Global and UK property fund solutions Surrey instructed CBRE to place the portfolios on "care and maintain" instructing them to make no new investments into closed ended property funds for the UK segregated portfolio. The last new commitment to the Fiera Real Estate Logistics Development Fund of £10 million was made in 2q 2022. Although there will have been some changes in the Global Alpha Fund, where Surrey does not have a segregated investment, the Fiera Logistics investment was the last new discretionary asset allocation decision. In total there were £5.74 million of drawdowns to funds with outstanding commitments namely £4.99 million to CBRE's UK Affordable Housing Fund and £746,000 to the Fiera Logistics Development Fund. These drawdowns were broadly matched by £ 5.34 million from the return of capital received from 6 different closed end funds in the UK portfolio.

Regardless of Surrey's care and maintenance instruction, CBRE believed that market conditions have been so poor

13

over the last 12 months that they chose to pause and re-confirm their investments, and to maintain their key themes of a focus on resilience of income, and quality. In the UK portfolio they remain committed to industrial/logistics especially in the South East where land is scarce and in both UK and Global portfolios, residential both affordable and private housing, student accommodation and new health care / nursing homes. Residential is an area where they believe there is structural under-supply of good quality assets. At the sector level CBRE remain underweight and continue to reduce exposure to office and retail, except where they can find opportunistic high quality, prime assets, with high ESG ratings and resilience to changing trends in user behaviour.

Outlook

CBRE's UK macro-economic outlook in July 2023 foresees a stagnant economy in 2023, with growth picking up, but only slightly in 2024. They also see inflation as higher for longer driven by higher wages and persistent core inflation, leading to higher base rates and that rates stay higher for longer than the market expects. As a result, they see capital values remaining under pressure and most of the future return coming from the resulting higher yield.

They seemed to be presenting a picture of a market approaching a turning point with better returns expected in the future. However, their evidence showed that while UK property yields had experienced the fastest increase in the last 35 years, it also showed that yields were still below where they were prior to the GFC meaning that the spread over government and non-government yields is still relatively quite low. When asked about investor flows, they suggested that redemptions had already peaked and that the negative influence was already in the price. They also suggested that the UK market tends to be more volatile and moves faster to price in bad news, even suggesting that UK logistics looked cheap in absolute and relative terms to the rest of the world. Their latest forecasts suggest that the 5 year annualised total return for UK property could be 6.4% up from 4.6% last year. They predict UK Industrial and Residential to outperform, delivering 7% and 7.2% p.a. respectively, with most of the total return coming from income growth rather than capital gain.

Just as last year the global team are more optimistic about the returns from property but they do have a much broader set of market sectors and countries in which to invest. They continue to see better opportunities in the US and Asia and are least comfortable with continental Europe. They see long term structural growth driven by demographics and technology advancements outweighing higher interest rates and inflation. Interestingly when you look at their chart of regional property yields, the UK looks relatively the highest yielding, in marked contrast to the period prior to the GFC.

Adviser View

CBRE's macro-economic outlook In July 2022 turned out to quite prescient. They highlighted the potential for revaluation due to higher interest rates and bond yields and the denominator effect leading to outflows from property assets owned by closed corporate pension funds, but I don't think they expected the magnitude of those pressures and the lasting impact they would have on UK Property valuations. While they point to sticky inflation and higher for longer interest rates and inflation, they are in my opinion too optimistic about the market being at a turning point. I do not believe markets have fully priced higher for longer and they have not fully experienced the magnitude of redemptions from the denominator effect and how much closer corporate pension schemes are to "buy out". I do agree with CBRE that over the next few years total returns will be driven by income rather than capital but this is the result of lower asset values. If this is an accurate forecast then from a global relative yield point of view UK property looks more attractive than Global.

CBRE, gave a very clear presentation, incorporating the requested improvements from last year, to use consistent reporting periods and valuations. I remain confident that they have the resources and the skill to manage Surrey's Property allocation. Even though I do not share their near term optimism, over the medium term their expectations are well thought through and appear reasonable.

(Hold)

BCPP

Alistair Smith - Head of Real Estate
Paul Campbell – Global Portfolio Manager
Nick Moore – UK Portfolio Manager
Hannah Hammond – Assistant Portfolio Manager
Milo Kerr – Head of Client Relations

13

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. As time has moved on the requirements of the partner funds have changed and the landscape for property investment has also changed. This is especially true in the UK, where valuations have been more significantly impacted by the change in interest rates, inflation and bond yields. An additional factor that has potentially changed specifically for the UK is, investor demand for the asset class.

Market Background

One of the impacts of the "Fiscal Event" in September 2022, is that closed corporate pension schemes which have historically been large investors in property, became forced sellers to meet short term liquidity requirements elsewhere in their portfolios. These short term flows have caused property funds to become illiquid, and "gated" while the large volumes of sales from investors are realised. This has caused the NAV of many property funds to move from trading at a premium to trading at a discount, a good opportunity if one is a buyer. But this change in valuation caused by the volume of sales, has discouraged many forced sellers which means there remains pent up liquidation demand in the short to medium term. A second longer term impact for corporate pension funds is about 40% of these schemes have seen their plans for buy-out shorten from around 10 years to around 5 years. This means that this group of investors will remain sellers of property and once they have moved into buy-out will have no requirement for property in their portfolio, thus eliminating a significant pool of long term investment capital for the asset class.

A third and more universal factor has been the "denominator effect" as the negative daily mark to market impact of listed equities and bonds caused the total Pound value of pension funds to fall, the Pound value of those less/illiquid alternative asset classes with less frequent valuations, (like property and private market assets) became larger in % terms, resulting in higher/overweight allocations, which also may lead to portfolio rebalancing. Because alternatives are less liquid, they could not be sold, so the response from investors has been where they can, to stop investing new money into alternative asset classes.

Inflation is another factor which has changed the landscape for investment in less/illiquid alternatives. The impact of last year's and this year's higher than expected inflation has shortened the cash flow horizon for many pensions funds, those that are cash flow positive, have moved closer to being cashflow neutral and even cash flow negative, which means they may need to have more liquidity and more closely manage their cash requirements.

There is also a new opportunity for investors, the rise in interest rates and bond yields means that investors do not need to sacrifice liquidity for the higher income offered by ill-liquid assets classes. Cash and short maturity bonds may not be long term solutions for pension funds due to re-investment risk, but liquid, less risky, long dated government and investment grade non-government bond yields are also providing higher income and represent competition for illiquid, more risky, alternative asset classes, which means investors need to be more certain of the return and diversification characteristics provided by alternatives such as property and private market investments.

Global Real Estate offering

Further progress has been made on the provision of the Global Real Estate offering. There will be 2 funds, the Global Real Estate Core Fund will target a return of 6% p.a. over 10 years, by investing in a range of funds targeting the Core and Core Plus property segments, the focus will be on high quality buildings with low vacancy rates, with returns dominated by Rental Income and low development risk. It is likely that these funds could have reasonable access to secondary market liquidity. The Global Real Estate Value-Add Fund will target a return of 10%p.a. over 10 years, by

investing in Value-add and Opportunistic funds, with buildings requiring improvement. Returns will be driven by capital appreciation and funds will potentially have a high degree of leverage. Because of these characteristics this fund will probably have a high allocation to Closed End funds with no liquidity.

13

Over the last year a lot has changed not just in the market as described above but also in the needs of the partner funds. Considering the feedback from partner funds BCPP have significantly changed the global offering and in light of these developments and work carried out by officers and advisers Surrey has decided to only invest in the Global Core product. Due to changes investment strategy, Surrey have also decided to stick with their 75% UK : 25% Global property asset mix rather than adopting a 50:50 mix as was foreseen a couple of years ago.

The investment characteristics of the Global Core Fund have been modified following feedback from partner funds but the level of indicative commitment to the fund has also changed its overall characteristics. The original investment case estimated size of the Core Fund would be £800 million to £1bn. At the time of writing only 4 of the original 8 partner funds that indicated an interest have firmed up their monetary commitment and this is now estimated to be around £500 million. These 4 investors have pledged to invest £265 million of cash, with 2 also contributing a further £250 million in the form of a transfer of their holdings in the CBRE Global Alpha Fund. This means the indicative target portfolio at inception will only have 6 managers, much fewer than originally indicated by BCPP. CBRE Global Alpha will make up 48.5% of this allocation, with 45% invested in 4 diversified funds, 29% in the US, 10% in Europe and 6% in Asia-Pacific, the balance will be invested in a European thematic fund, investing in Logistics. These changes in the size of the fund, in allocation and market conditions have increased the weighted average target return from 6% to 8.4%. It has also increased the expected risk of the fund with the riskier Core Plus strategies being at the top-end of their permitted allocation. On a regional look-through basis while it is well within the permitted range originally outlined it has skewed the regional allocation more towards the US. It has also increased the expected Total Expense Ratio (TER) from 1.15% to 1.33% assuming expected rebates of fees from managers can be achieved.

BCPP have outlined a phase 2 development of the Global Core Fund that is dependent on other partner funds joining at a later date. Should this happen they plan to add 3 thematic funds to the mix. The changes could reduce risk and increase diversification by adding more to Asia-Pacific and reducing exposure to CBRE Global Alpha to 27%, but there would also be a further increase in US exposure. The expected weighted average target return falls slightly to 7.9% and it could be that the TER may fall closer to the originally forecast 1.15%.

Adviser View

In my last report on the development of this fund I suggested that the Real Estate transition is potentially the most expensive and complicated task that BCPP has undertaken. Nonetheless I believed it is the right choice for Surrey to take, provided it can be delivered at a lower price than the Fund's current investment solution provided by CBRE. However, as time has gone by Surrey's needs have changed, partner fund commitments has fallen, the Global Core Fund looks more risky, less diversified, is more expensive at its inception and the resources available to BCPP to run the fund are less than those available to CBRE. With a blank piece of paper and accepting that this goes against the pressure to pool Surrey's investments within BCPP. I believe Surrey should not proceed with their commitment to the BCPP Global Real Estate Core Fund until BCPP are able to satisfy all of Surrey's necessary conditions.

UK Real Estate offering

Further progress has also been made with the UK proposition, BCPP have appointed a UK portfolio manager, Nick Moore and recruited an assistant portfolio manager, Hannan Hammond. With plans to add another UK portfolio manager in the first half of 2024 and another assistant PM in the second half of 2024. They have also appointed Knight Frank as the independent valuer. As mentioned before the UK offering is going to be a much more difficult process 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.

BCPP outlined their latest iteration of the plan for partner fund participation and timeline for the development of their investment solution. This version contains some changes which were not anticipated such as having a permanent allocation in the Gateway Fund, which previously had only been seen as a transition vehicle to maintain partner fund exposure UK property while its money was being draw down to pay for new direct physical property assets to be held

in the Main Fund.

They have estimated the size of the 2 funds at launch as £1.7bn in the Main fund consisting of all the English registered properties, currently owned by 4 partner funds. Rising to £2.5bn over 5 years as new properties are bought using cash from the Gateway fund, at a pace of £150 to 200million per year. However, they now appear to be suggesting that the Gateway fund starting at £800million could still be £750million after 5 years. The flow chart for future investments appear to suggest that partner funds could invest cash into the Gateway fund and then into the Main fund and/or directly into the Main fund. They have also outlined the net of fees performance objective for each fund as UK CPI + 4% p.a. over 10 years for the UK Main Real Estate Fund and MSCI UK Quarterly Property Index over rolling 3 year period for the UK Gateway Real Estate Fund. At the moment because any properties that are not registered in England do not qualify transfer tax exemptions, they will remain in the responsibility and ownership of the legacy partner fund.

13

Proposed future steps are to canvass firmer commitments from partner funds in 2023, "Launch" mid 2024, "Stabilisation" phase 2025 -2026 with indirect holdings liquidated and cash moving from the Gateway Fund into the Main Fund and new partner fund cash invested in either Fund, with the "growth" phase of the Main fund starting in 2027.

They outlined the benefits of this pooling solution as Opportunities of scale, Resource, Resilience and Risk management and Alignment of interests, here they noted that investors will be like minded LGPS able to execute an investment policy with a bespoke RI and ESG policies. They have also revised their estimates costs for providing this Full Service offering to partner funds. In the original business case, they expected a TER of 0.25% to 0.273% based on a total fund size of £3bn, the revised estimates are 0.219% at Launch with a fund size of £1.5bn, falling to 0.202% at year 10 if the fund has reached £3bn.

Based on information provided to BCPP they have outlined the anticipated seeding and transitional arrangements for Surrey's current holdings of UK property funds managed by CBRE. Circa £30.6 million in three funds would move directly to the Main fund as these are considered core holdings for this fund. A further £74.7 million in seven funds could be transferred into the Gateway fund. But a residual £103 million consisting of thirteen investments would remain with Surrey. These remaining assets are either Closed End funds which will return capital over time or debt and Long-lease assets that would need to be sold by Surrey or held elsewhere in the asset allocation. At launch Surrey's Gateway fund investment would be £75 million of a fund that is expected to be £552 million in total.

BCPP have also established the starting point for the Main fund based on the holdings of the partner funds with direct investments. They cited the qualities of the Main fund as being size and scale, average lot size, income growth and length of Income and diversification. They see the opportunities as larger lot size and being able to target growth sectors and locations. Over time they would look to reduce the number of smaller investments inherited into the Fund. They also detailed some of the other principles and characteristics for new acquisitions, as ESG classification, building quality and income stability.

Adviser View

The UK offering has made some significant progress over the last year and is now approaching the point where Surrey will need to express a firm commitment. Provided other partner funds are in a position to make firm commitments we will have a better idea of the size and savings that can be achieved. Unlike the Global Core offering where we are effectively being asked to replace one fund of funds manager with another. I believe the real savings in the UK offering will be achieved by the substitution of UK indirect property funds by direct property investments. 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 but with slightly less liquidity. As we have seen with the progress of the Global fund offering and other solutions provided by BCPP, Surrey will have to remain firm in its requirements to ensure BCPP stick to the plan as outlined and Surrey should not have to compromise too much in the establishment of this investment solution.

Anthony Fletcher – Independent Adviser to the Surrey Pension Fund

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