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(IL)Liquidity of property

by Jackson Franks, Analyst

As mentioned in my previous blogs, I am an avid Watford football club supporter. Although there are some ups and (a lot more) downs, being a Watford supporter has had one positive outcome. It's enabled me to cope with the ever-changing UK political situation. Since David Cameron resigned as Prime Minister in 2016, following the UK's vote to leave the EU, there have been three UK Prime Ministers over the preceding six years, with the fourth set be announced. However, comparing this to the Watford managerial hot seat, we have seen twelve people come in as manager over the same period. Although the owners have had to absorb a lot of negativities for their cutthroat approach, their methodology has worked. Since 2016, Watford have been in the Premiere League for five out of seven seasons, the best in its history. So, although there is a limited appetite for uncertainty, I am of the firm belief that if something isn't working, then change it.

Following Liz Truss's government's mini-budget, turmoil ensued in UK financial markets. The sell-off in UK government bonds (gilts) amid concerns about monetary policy, debt, and pension funds' financial status, shook sectors including property. As with the 2016 Brexit referendum, and a period during 2019, daily dealing property funds saw high levels of redemptions. In turn, Columbia Threadneedle suspended dealing in their daily dealing property fund, bringing back the debate on whether the UK regulator should restrict retail investors from open-ended property funds.

At Momentum Global Investment Management (MGIM) we do not invest in open-ended real estate funds because of the clear liquidity mismatch of offering daily dealing on an illiquid asset such as a property. Due to the length of time it takes to sell a property, a minimum of 3 months, but in times of market stress often longer, when the sector sees an increased level of redemptions the open-ended property strategies are unable to cope with the cash demand, and therefore suspend dealing. Gating the fund enables the manager to postpone redemptions for a period of time so they can raise the cash needed to pay out to investors by selling an asset or raising further capital. This could be an uneasy time for retail investors who are wanting to reduce their exposure to the sector but are unable to do so.

Open-ended property funds are not the only way to gain direct exposure to the property market. At MGIM we gain exposure to the sector through Real Estate Investment Trusts ("REITs") and a private equity vehicle known as the Momentum Africa Real Estate Fund ("MAREF"), which are suitable for retail and qualified institutional investors respectively. A private equity style vehicle, such as MAREF, has its advantages and disadvantages for investors. Investors would be locked into the strategy for the duration of the fund's life, this gives the manager time to generate returns undistracted by the impulses of investor flows. Having said that, this style is illiquid and if the investor requires liquidity during the life of the fund (the majority are eight+ years), they cannot redeem.

REITs, similar to private equity vehicles, have a fixed pool of capital for the investment manager to invest across the sector whilst offering a similar liquidity experience to investing in publicly traded stocks. REITs are easier to understand from an investor's perspective: by leasing space and collecting rent on its acquired real estate, the company generates income which is then paid out to shareholders in the form of dividends. REITs are required to distribute 90% of their taxable income to shareholders which on average is significantly higher than other equities. However, because REITs are listed on the stock market, their share price is driven by two factors: firstly, the valuation of their underlying assets, and secondly, the broader market sentiment and buying/selling pressures. The manager never has to handle redemptions, as investors simply sell their shares in the market if they so wish.

It is critical that any investor in the real estate sector understands and appreciates the illiquid nature of the underlying asset class. At MGIM, we manage this illiquidity risk by sizing our real estate exposure appropriately and investing in liquid REITs instead of open-ended daily investment vehicles, thus avoiding the risks arising from an asset-liability mismatch. Although the listed status of a REIT introduces an element of equity market risk and pricing volatility, which is particularly evident in these uncertain times, investors can still liquidate their holdings if so required, or indeed add to their holdings at what might prove to be heavily discounted valuations. Neither of these options are available to holders of most UK open-ended property funds at this point.

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Sources: Unless stated all figures sourced from Bloomberg Finance L.P.

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