APPENDIX B

MJ HUDSON Allenbridge

Strategic Asset Allocation

A Review of Options - International Property

London Borough of Bromley Pension Fund

FEBRUARY 2020

Background

MJ Hudson Allenbridge were mandated to conduct a review into the Fund's Strategic Asset Allocation ("SAA"), which was considered at the recent PISC meeting on 3rd December 2019. This report made a number of recommendations based on the Fund's current funding level and cash flow requirements. Of these recommendations, the committee asked for further details on two potential areas for investment and a recommendation on where, if any, assets should be sold to finance these. At a further meeting on the 17th December the committee agreed the major asset weightings for an updated SAA, as detailed in the table below and requested a report focused on an investment into International Property, particularly a comparison between accessing this asset class directly against investing in US REITs. This paper looks to cover these issues.

Summary of Recommendations

- To alter the current SAA to include a new investment of 5% of the Fund into International Property to be financed by reducing the allocation in the existing SAA to global equities by 2% and Fixed Interest by 3%. The intention of the move is to further diversify the Fund whilst not reducing the targeted return. Detail of the proposed SAA is given in the table below.
- To rebalance the Fund towards the new SAA. Because the Fund is currently over weight Global Equities against the existing SAA, the entire money for the new International Property investment could be taken from global equities. Alternatively, a full rebalancing towards the new SAA could be undertaken.

MJ Hudson Allenbridge would recommend accessing International Property via a Global Property manager using a value-add strategy (explained later) and most commonly accessed via a close-ended fund of 10-15-year duration with leverage of around 50%.

Asset Class	Existing SAA	Recommended SAA	Existing TAA (30/09/19)	Assets transitioned (Estimated)
Global Equities	60%	58%	63.75%	-£64m
Investment Grade Fixed Income	15%	12%	13.20%	-£13m
Multi-Asset Income	20%	20%	18.75%	+£14m
UK Property	5%	5%	4.30%	+£7m
International Property	n/a	5%	n/a	+£56m

The transition figures in the last column are based on the Funds value at 30/9/19 and will be updated for asset movements in the fourth quarter when these figures are available.

In reality, the Committee manages the Tactical Asset Allocation (TAA) which can differ from the SAA to reflect shorter term investment views and will alter as assets move in value over time. Whilst I would not put too much weight on anyone's ability to call short term market moves, in the interest of simplicity, it may be worth realising £13m from the Baillie Gifford Fixed Interest portfolio (currently valued at £63m) and ony £57m from the two global equity portfolios and not to finance the £7m into UK property at the current time but leave this asset class marginally underweight against the new SAA with global Equities correspondingly overweight.

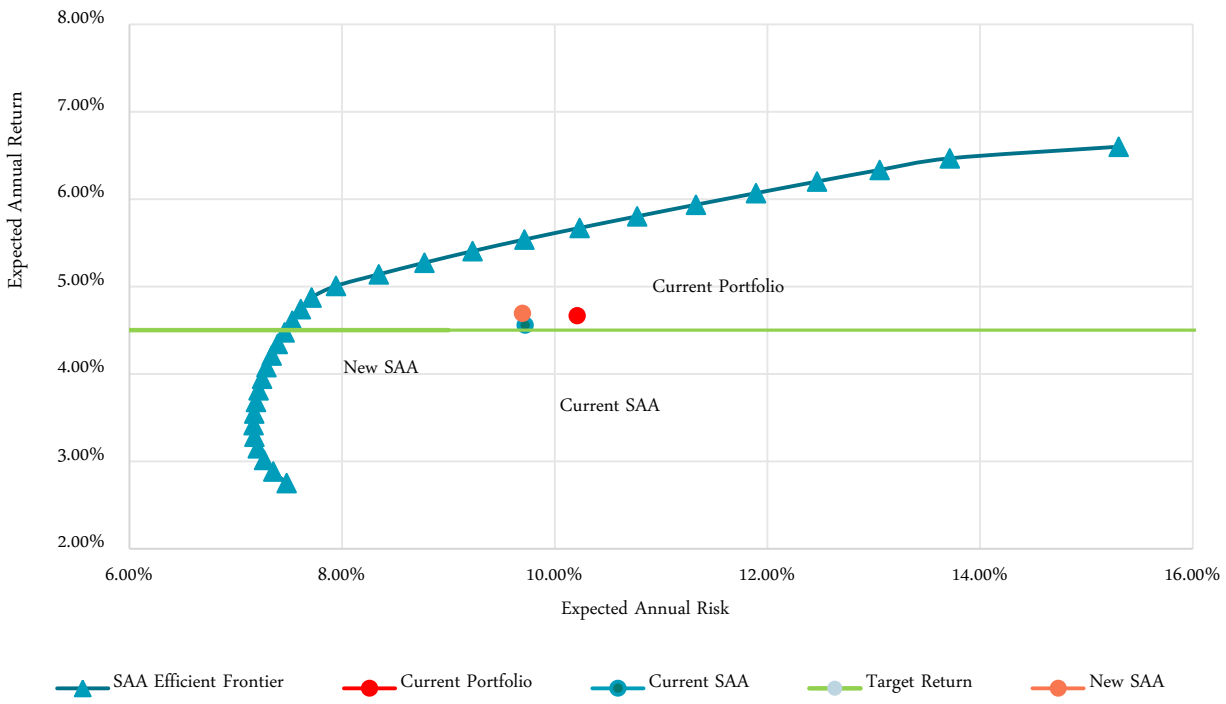
We would note that International Property as an asset class is illiquid and, as such, it will take time to deploy the capital. Current investments will therefore need to be realised as and when required, unless there is a sufficient reason to pre-

fund any purchases. We would also note that these changes involve investing into more complex asset structures, which will increase the governance burden and cost in terms of manager fees for the Fund. However, we believe the resulting SAA would add to the diversification of the Fund and better position it to deliver the required investment return and cash flows into the future.

SAA Modelling

As before, this was conducted via a mean variance optimisation model developed by MJ Hudson Allenbridge using return and volatility data from the forecasts of a number of asset managers, including those used by the Fund.

The efficient frontier shown in the chart below is the same as that used in the initial SAA report constraining global equities to a minimum of 50% of total assets but otherwise allowed to allocate freely to all asset classes.



The dots on the chart correspond to the following options:

1) Existing SAA
2) TAA as at 30/9/19
3) Proposed SAA

The current TAA is substantially overweight equities against the existing SAA and as such a rebalancing back to the existing SAA does much to reduce risk at minimal cost to forecast returns.

You will note that the risk and return of the new proposed SAA are very similar to the existing SAA suggesting limited advantage in making this move. Whilst this may be true from a modelling perspective, this quantitative approach does have its limitations, in a partial reliance on past data and, as such, we would still recommend making this change. In particular, increasing the Fund's exposure to real assets (those that should keep their value in real terms) is a consideration given some concern over a recovery in inflation over the medium term.

Our modelling calculates a Value at Risk (VaR) figure for each portfolio, this calculation uses the volatility assumptions for each asset class and the weightings of each proposed asset allocation to calculate the potential loss of value from a 2 standard deviation market event in any one-year period. This equates to a one year in twenty event. Please note that

because these figures are based on historic data the one certainty will be that the figures will be wrong but they do act as an indication of the potential scale of downside risk.

The table below details the forecast return, risk and VaR for the existing SAA, proposed SAA and current TAA portfolios.

Portfolio	Return	Risk	VaR(£)
Existing SAA	4.56%	9.7%	£128m
Recommended SAA	4.69%	9.7%	£126m
Current TAA	4.67%	10.2%	£136m

Rebalancing back to the existing SAA would mean investing more into the Fund's two existing Fixed Interest portfolios. Given the very low level of current yields in these portfolios and low return assumptions we do not recommend this as a course of action. It is because of this and a desire to reduce the concentration of the Fund's risk in equities that an alternative asset class in being recommended.

International Property

This asset class provides a good forecast investment return with some diversification from Global Equities and strong cashflow characteristics.

Whilst property will always be affected by the state of the global economy and, as an illiquid asset, can see a marked fall in value in turbulent market conditions, each individual property, by its nature, is driven primarily by local factors. Property has no known price mechanism unless it is in the process of being traded, relying on valuers to make an informed but somewhat subjective decision on the value for the majority of the time. Because of this and the inherent illiquidity of the asset class, all property investment should be considered as a long-term commitment.

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Australia 18.4%	Canada 3.7%	UK 3.5%	UK 15.1%	Canada 15.5%	Canada 14.2%	USA 11.4%	UK 17.8%	Australia 14.0%	Australia 11.9%
France 17.8%	Germany 2.8%	Germany 2.0%	USA 14.8%	USA 14.5%	USA 10.8%	Canada 10.7%	USA 11.2%	UK 13.1%	France 7.8%
Canada 15.9%	Australia 0.1%	Canada -0.3%	Canada 11.2%	Australia 10.3%	Australia 9.5%	UK 10.7%	Australia 10.6%	USA 12.1%	Germany 7.8%
USA 14.4%	France -0.9%	France -1.4%	France 10.0%	France 8.4%	France 6.3%	Australia 9.6%	Japan 7.8%	France 9.0%	Japan 7.6%
Japan 11.3%	Japan -0.9%	Australia -2.4%	Australia 9.4%	UK 7.8%	Germany 4.2%	Japan 6.0%	Canada 7.3%	Japan 9.0%	USA 7.5%
Germany 4.5%	USA -7.4%	Japan -6.1%	Germany 4.2%	Germany 5.3%	Japan 3.6%	Germany 5.2%	France 6.3%	Germany 8.1%	Canada 5.7%
UK -3.4%	UK -22.1%	USA -17.5%	Japan 0.6%	Japan 3.2%	UK 3.4%	France 5.1%	Germany 6.0%	Canada 8.0%	UK 3.9%

The table below shows the investment returns for various property markets over the 10 years to 2016.

This chart is for illustrative and discussion purposes only. Returns are shown in local currency. Source: MSCI, Pension Real Estate Association data as of 31 December 2016.

Whilst there will be wide variation around the average figure for each market, the table does show that each market has its own performance cycle reflecting more local, country specific factors. However, the low level of returns across all property markets in 2008/9 illustrates that each property market will be influenced by the global economic outlook.

Whilst investment into UK Commercial Property is often seen as a 'core' or 'core-plus' strategy, we would recommend investing into International Property via a 'value-add' strategy. This specifically targets the acquisition of assets to which the manager can add value, either by improving the quality or quantity of the rental book. This increases the focus on the local, idiosyncratic nature of each property, adding further diversification and avoids the investor making a long-term commitment to a specific geographical region which may enter a period of poor investment returns not foreseen at the present time. It is also difficult to find an institutional property manager who has truly global resources to cover all markets on a buy and hold basis. 'Value-add' does not mean taking on greenfield development risk but could involve a property requiring an element of investment post-acquisition, in order to get the best rental value going forward.

Regarding investing in the US or internationally, we would recommend the latter. As can be seen from the table, market returns will differ by country and thus having the flexibility to invest where the best medium (3-5 years) return is forecast should help maximise returns.

Whilst the US on its own encompasses a wide variety of individual, local, property markets, it will be influenced by the overall economic outlook for that country's economy. The US is later in the economic cycle than the rest of the world, having recovered earlier from the Global Financial Crisis of 2008/9 and seems to have a relatively high level of political uncertainty at present. Whilst the US may be a beneficiary of a global trade war, we are not convinced that a major breakdown in global trade is the new reality, more that global trade relations will remain more fractious even if President Trump reaches an accord with China in the run up to the US presidential elections next year. The era of outsourcing to low labour cost countries may now have passed its peak, as the level of added complexity from a global supply chain outweighs the cost savings.

There are a number of asset managers offering Global property mandates with a 'Value-add' approach, these funds tend to work with a gearing level of around 50% and are close-ended with initial investment periods followed by the return of capital over the ensuing harvesting period.

Broad categories of Property fund

Commercial property can be broadly grouped into four main categories depending on the type of asset and security of the cash flows. It is also possible to invest in a fund of funds or one targeting real estate debt. Most property funds will target one of these groupings to make up the majority of their fund and thus appeal to a particular type of investor. All real estate funds are likely to include an element of debt (leverage), either at the fund level or at the individual property level:

1) **Core**

The least risky category. Core real estate investments are fully operational buildings with high levels of occupancy usually in prime locations. Such buildings require minimal investment and management from the owner, only needing day-to-day upkeep and rent collection. The rental income from these investments generate stable ongoing cashflows. The expectation is for the assets to be held over the long term with properties revalued at least annually by an independent valuer. The price of these properties is likely to move in line with other similar assets and as such the valuer can ascribe a value to each property with some certainty. As a rough guide, at sale you would expect the realised sale price to be within 10% of the valuer's estimates under most market conditions. Bromley's existing investment via the Fidelity fund into UK commercial property is predominately of this type.

2) **Core-Plus**

Slightly riskier than the above, core-plus assets are similar to core assets but the nature of the cashflows may be slightly less predictable – for example the asset could have a low occupancy level at the time of acquisition or there may be some minor investment and alteration needed to improve the asset. Because of this, the asset can be bought at a price potentially below market and hence generate an above market capital return over the time needed to improve the property. The valuation of each property is slightly less 'known' as there may not be other properties nearby in a similar condition or with the same opportunity to add value and so the valuer will act with an element of caution. Again, each

property would be independently valued annually but the valuer may not give much value to the potential improvement in the property until this has been completed and the resulting higher rental levels achieved.

3) Value-Add

Value-add assets require substantial investment from the new owner and are considered riskier as a result. Such assets could be partly vacant or run-down at the time of acquisition; an unusual or unique purchase from a distressed seller or require change of use permits and so need a well-executed investment strategy to achieve the targeted value. Yields may be lower due to high vacancy rates and the majority of the returns will come from capital growth once the required investments have been made. Again, the independent valuer is unlikely to take into account the potential of the asset until remedial work has been completed and higher rental income achieved.

4) Opportunistic

Opportunistic property assets cover the widest variety of situations and therefore values have greatest uncertainty but can provide the greatest upside and, with each property having its own specific dynamics, the most idiosyncratic risk and least correlation to the global property market. For example, it could be purchasing a building that isn't fully constructed and then managing the asset all the way through to eventual letting and onward sale. Alternatively, these assets could be the amalgamation of a number of smaller adjacent assets where the combination is worth more than the sum of the parts.

5) **Fund of Funds**

A fund of funds (FoF) will offer exposure to multiple property managers and strategies as well as a far greater number of underlying assets than a direct vehicle would but come with additional costs due to the dual layer of fees charged by the FoF manager and the underlying managers. Typical total expense ratios for management fees for such strategies come to around 3% per annum before a performance related fee is also applied at both levels. Fee structures are difficult to compare effectively between FoF managers because they often charge different levels of fees depending on the type of transaction (primary, secondary, co-investment, etc.) and don't know the final composition of the portfolio and what kind of fees they can negotiate with underlying funds in advance. We would regard this as an expensive way of accessing the asset class albeit one that can provide instant access and immediate diversification within the asset class.

6) Real Estate Debt

Most real estate assets are acquired with a degree of debt in the transaction. Therefore, some managers invest with both equity and debt into target assets whilst there are some that just focus on debt. Real estate debt has the advantage of greater security against the asset but has consequentially lower returns. We do not see the returns from investing only in real estate debt as sufficiently attractive to justify an allocation on their own merit at the current time.

My recommendation to invest via a value-add fund rather than a core or core-plus fund may appear slightly at odds with the requirements of the Bromley Fund in that it is relying more on manager ability to add value and is higher risk without the security of a strong cash flow and yield.

This is partly due to the late stage of the economic cycle we are in which is reducing the number of under-priced assets and partly because I am not convinced that any manager can truly cover the global property market in the depth required to select strong assets in each individual property market (i.e. each major city in each major developed country). I would rather use a manager who has strong contacts with local property agents and can react to opportunities as they arise. They are not driven by a benchmark weighting to each property market or by the view that an individual property market is good value but rather by their appraisal of each individual asset.

Liquidity

As you move from core to opportunistic property funds the focus moves from yield to total return. Hence a core fund is more suitable for an investor looking for a regular income, albeit total return is likely to be lower. It is important to remember though that this income is not instantaneous as portfolios in new closed-ended funds take several years to build. There will be the 'J-curve' effect where capital is called during the investment period and little/no income is paid out before investments start to mature and the fund can return income to investors. During this initial period, investors will be covering acquisition costs, hence the 'J-curve' of a short period of negative returns as the portfolio is being acquired.

To mitigate this problem, the alternative is to invest in an open-ended fund rather than closed-ended. I.e. purchasing shares in a fund with a fully invested portfolio already in place. The advantages of this are that income is accrued immediately and these funds are supposedly more liquid than a closed-ended fund enabling investors to divest at short notice. However, to meet this liquidity requirement, such funds hold considerably more cash and even then, redemptions could be suspended if the fund is unable to sell assets fast enough to meet redemption requests. This has happened to various funds twice recently in the UK market alone – once immediately after the 2016 Brexit referendum and then in late 2019 due to further uncertainty around Brexit negotiations.

Another important factor to consider is the base currency of the fund. For example, commitments and calls could have to be made in dollars/euros rather than sterling, leaving an investor exposed to the currency risk over several years unless the fund has the ability to also receive and hedge sterling commitments.

Portfolio of US Real Estate Investment Trusts (REITs)

A REIT is an incorporated investment trust which holds a portfolio of property assets and distributes a high proportion of its income to shareholders (a minimum of 90% for a UK REIT). As an investment trust it is a closed-ended fund and so does not suffer the illiquidity issues of an open-ended fund. The shares trade at a discount or premium to the underlying NAV (Net Asset Value) depending on investor demand. REITS are available in most developed property markets and there are a number of credible managers who offer global REIT funds (20 or so we believe).

Given the above, a manager selection mandate would still be required although the costs of this may be slightly below that of a direct property mandate due to the simplicity of the approach and relatively small number of credible providers.

Regarding management costs, a REIT fund looks cheap as the management fees only relate to the management of the portfolio of REITs and most often do not cover the underlying cost of managing the individual properties within each REIT which is born within the REIT fund. This gives a low level of transparency on costs and challenges the commonly held view that REIT funds have low management charges.

There is also the question of whether REITs perform as well as direct property funds. Over the longer term the answer is that they do reflect the performance of the underlying assets. Over the shorter term, however, because they are traded, closed-ended funds, they will be more volatile and more closely correlated with the performance of the equity market they are listed on. As an example, the correlation between a US REIT and the US equity market is usually around 0.6-0.8 over a one year period, i.e. if the US market raises 10% the US REIT rise 6-8% purely due to the rise in the US equity market with any further performance, positive or negative, relating to the attractiveness of the property assets held within the REIT.

In some markets, such as the US, REITS are not required to publish a NAV, this reduces transparency. The price is set purely by investor supply and demand with the REIT price trading at a premium or discount to the assumed NAV at any one time. At present it would seem that most US REITS are trading at a premium to their assumed NAV. This is not surprising given the strong US equity market over recent years and the late stage of the economic cycle. European REITs look to be trading on small discounts on average.

Similar to the issue above with fund base currencies, investing in US REITs would expose Bromley to the sterling-dollar risk unless they went for a hedged mandate (with its associated hedging costs) or were comfortable with investing unhedged.

I am not recommending investing via a US REITS or Global REITS fund because:

- I do not believe they provide the same level of diversification compared to a direct property fund given their higher correlation to equity markets which is the major component of the Bromley Fund. Diversification from equities is a major part of the rational for this investment decision.
- I am not convinced that they offer a cheaper investment vehicle than direct property, it is more that they are less transparent and more of the fees are hidden.
- I do not see the US market as more attractive than other global property markets and given the strength of the US economy over the recent past see it as potentially later in the economic cycle. I would prefer to invest via a global property mandate rather than purely US.

- Whilst we are forecasting a return of 5% over the long term on International Property which is similar to Global Equities, I would hope a value-add international property fund of the type detailed above to be able to achieve a higher return, potentially towards 10% per annum, I do not see the same potential for a holding in US REITS.

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