Summary
• Observers point out that the global appetite towards residential investment is growing rapidly and that there is a rapid acceleration in understanding and demand amongst UK investors.
• Pension funds' interest has been matched by a growth in the number of funds available in which to invest.
• Industry insiders point out that the private rented sector can offer a steady real-income-generating investment.

Paying the rent

Andrew Williams considers the opportunities for pension funds to invest in social and private-rented housing

In the ongoing quest for steady returns, many pension funds are showing increasing interest in investing in social housing and private-rented housing. So, what have been the main recent trends and developments in pension schemes' investment in this market? Has there been an increase in UK pension fund interest in this area over the past few years? What are the main motivations and risks? And in what ways might pension schemes access this asset class?

Significant advancement

As Aberdeen Standard Investments' global head of investment research, Andrew Allen, explains, since the turn of the century, we have seen a rapid emergence of interest in residential generally - a trend he observes appears to reflect the 'underlying fundamentals, progression of management techniques and professionalisation and understanding of the sector.'

"One might suggest that the huge expansion of buy-to-let amongst private investors perhaps expanded the consciousness of the sector amongst investors generally," he says.

According to him, this growth includes a significant advancement of lending to social housing providers, and a nascent advancement of equity investment alongside such entities, as well as a rapid phase of growth, and arguably maturity, in the UK student hall sector (where Allen reports private-sector investment from pension funds and others is now commonplace) and early stages of progression of mainstream private-rented housing, albeit "perhaps curtailed by the lack of established and stabilised investment product to invest into".

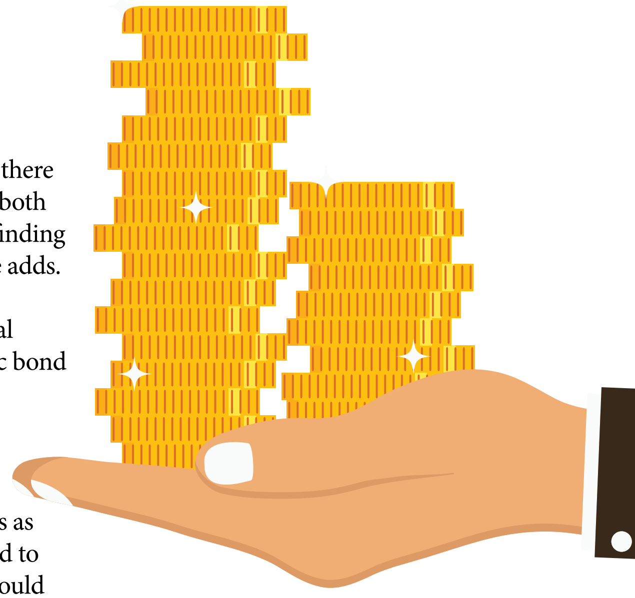
"We find it fascinating to see the differences in international perspectives in this regard. Whilst a typical US pension plan might allocate perhaps 20-25 per cent of its real estate portfolio to residential we see UK plans typically allocating between 0-10 per cent. Our experience, and recent survey evidence, of global appetite towards residential is growing rapidly. Amongst UK investors we see a rapid acceleration in understanding and demand," says Allen.

Secure income

Pensions for Purpose's founder, and MJ Hudson Allenbridge's senior adviser, Karen Shackleton, agrees that there has been growing interest in residential property as an asset class amongst pension funds, attracted by the relatively secure income stream and growth potential. In her view, this has coincided with a growing interest in impact investment, which she describes as a desire to try and deliver both positive financial returns and positive outcomes for society or the environment.

"This means that any asset class that can deliver to those twin objectives will be of potential interest to a pension fund, and residential property can do that. Pension funds' interest has been matched by a growth in the number of funds available in which to invest. Ten years ago, it was difficult for a large institutional investor to deploy capital in affordable housing. Now there are a number of funds raising capital, from large, global fund managers to niche, impact specialists," she says.

"UK pension funds have, for a number of years, been looking for alternative secure income asset classes which can act as a substitute for low-yielding gilts. This has probably been the main driver towards affordable and social housing. However, pension funds need to consider issues such as liquidity, scalability, track record, impact measurement and regulatory change to housing allowances before investing," she adds.



Elsewhere, Redington head of manager research, Nick Samuels, argues that the private-rented sector offers a steady real income-generating investment at a time when traditional equity and bond markets are looking expensive and offering relatively low income returns. In order to access the space, he reveals that many pension funds are joining forces in order to allocate money – and cites the example of seven local authority pension funds, which recently clubbed together to invest £200 million in a private-rented sector fund.

"The decision to join forces was prompted by plans to merge the investments of the UK's 91 local government pension funds (LGPS) into eight pools. Going forward, the government is hopeful that pooling will encourage more money into the sector and enable local government funds to make bigger private-rented sector investments," he says.

"Interest in social housing is also starting to increase. Investments not only provide attractive, secure inflation linked income, it also clearly makes a sustainable and distinct difference to communities across the UK. Meeting a social need in the UK housing sector is clearly appealing," he adds.

Attractive proposition

Elsewhere, M&G Investment director of fixed income, John Atkin, points out that recent regulation in the banking markets means that, from a capital perspective, it is difficult for banks to lend for long time periods, as they used to previously – but that pension funds have stepped in to meet this requirement.

"Housing associations like to have long-term financing in place for a number of reasons and they tend to plan new developments with a long time horizon. Pension schemes too have an increasing desire for long-dated assets as it enables them to hedge out their liabilities and they like the certainty of well regulated markets," he says.

"It is therefore fair to say that there has been increased interest from both sides, borrowers and lenders, in finding appropriate finance solutions," he adds.

According to Atkin, pension schemes can buy the debt of social housing associations in the public bond market or they can lend to them on a private and bi-lateral basis. Typically, he observes that most pension schemes would use an external credit manager to do this as the risks can be complex and need to be fully understood. A scheme would also "ideally seek assurance that either of these options offer good value versus other similar investment propositions, so a breadth of perspective is important".

"As pension schemes continue on their de-risking path it is likely that they will continue to have need for reliable, well-regulated cashflows, which they should buy as and when they exhibit good value. It is of course impossible to know what legal or regulatory changes may have on such a supply and demand dynamic, but for whichever entity becomes responsible for actually paying pensions, this is a potentially interesting lending market," he says.

Moving forward, M&G's associate director of corporate affairs, Rebecca Grundy, believes that a key challenge now is to ensure that PRS accommodation is of a high quality – particularly since, if the accommodation is right, renters will reward landlords with long tenures.

"On average most would expect to change accommodation only twice in a decade, which is music to the ears of institutional investors, such as pension funds and insurers, who need the income security of long-term tenants," she says.

"Through their investment in commercial real estate, pension funds are accustomed to investing extra in durable, quality buildings and facilities in order to make this happen. We definitely think this is a growth area and could be particularly interesting for LGPS in the future given that housing is in the infrastructure 'bucket,'" she adds.

Ultimately, Samuels argues that, for investors with long-term liabilities such as pension funds, both private-rented sector and social housing offer a very attractive proposition, with the yield offered by the private-rented sector currently "'very attractive compared to UK gilt rates, which have fallen and have remained consistently low over the past 10 years".

"The appetite of investors is expected to remain strong and grow over the coming years. Not only does the sector offer institutions a compelling combination of reliable income growth and robust capital values, returns have shown low correlations with those from other asset classes, making it an ideal component within a UK diversified portfolio," he says.

"Whilst the sector is still in its infancy, greater investment will come once pension funds are convinced that it can deliver an acceptable net return, without relying on unrealistic capital value increases."

Written by Andrew Williams, a freelance journalist