Summary
• While there are connections, comparisons between the housing market and real estate as an asset within pensions portfolios are of limited use.
• Real estate can hold a variety of roles within a portfolio, but it is generally considered a long-term proposition.
• Real estate has not been immune to recent political and economic turbulence – uncertainty in the market and a 'wait and see' attitude have somewhat put the brakes on.
• Real estate is likely to continue to be attractive to pensions, offering access to a spread of sectors, and potentially providing stability and diversity in the long term.

The role of real estate in pension schemes

Sandra Haurant looks at the role real estate investment can have in pension scheme portfolios and the impact of recent market turmoil on the asset class

With Britain's current tumultuous economic landscape, homeowners across the country are paying close attention to interest rates – and the forecasts predicting how much higher they might go. Anyone with a mortgage, or anyone planning on applying for one, will be acutely aware of the upward pressure on borrowing rates, and will no doubt have read about the consequences for the market.

While homeowners tend to feel they have a good grasp on the property market, comparisons between residential housing and real estate in pensions investment are of limited use, says Mercer senior real estate investment specialist, Anne Koeman-Sharapova, noting there are substantial differences. "The first thing to say is that most pension schemes use a vehicle to access real estate," she says. Direct investment in buildings does happen – but it's not the norm; pooled investment vehicles are the standard way real estate is accessed.

"The second thing is that when people buy a house, they tend to use 80 per cent, or maybe even more, leverage *[through a mortgage]*. So, the domestic market has a much greater reliance upon mortgages and lending. But in the institutional real estate market in the UK, real estate markets are actually entirely – or almost entirely – unlevered. The related risks are far less prominent," says Koeman-Sharapova.

The risks are not the same, but the markets are not immune to knock-on consequences. DWS lead portfolio manager, Martin Zdravkov, says: "The spike in interest rates has had a chilling effect on transactional activity."

Cardano senior investment manager, Julita Perelgritz, adds: "Generally, volumes in real estate have been lower in the summer and first months of the autumn. Given the current macroeconomic uncertainty, market participants have tended to adopt a 'wait and see' approach with respect to pricing, with instances of failed transactions as buyers recalibrated their interest rate expectations. However, unlike during the early days of Covid shock, the real estate market has not shut down."

The place for property

According to Investment Property Forum research into defined contribution (DC) investment in real estate, most schemes said that "what they wanted to achieve from property investment was diversification, followed by a desire for long-term investment. Also mentioned were risk diversification and non-correlated return".

There are a variety of uses, depending

on a fund's objectives and requirements. "In recognising the multiple facets of the sector, private equity real estate can either be a growth asset or a cashflow-driven investment, if structured correctly," says Zdravkov. "Traditionally, core income-producing strategies have been used to support inflation hedging, while more development-focused ones naturally lend themselves to growth portfolios." Because when it comes to matching inflation, rents tend to rise along with rising costs, helping income keep pace in a way that cannot be done with cash, for example.

Meanwhile, Perelgritz says: "Real estate plays a role as a growth asset within pension scheme allocation. It is a compelling asset for schemes seeking to outperform their liabilities and improve the pension scheme's funding ratio. Real estate can provide stable yield or income."

However, she warns there are "pertinent risks" to be considered. "Broadly, real estate is cyclical. A lot of value can be created, or risks avoided, if real estate is acquired at an attractive basis or cost.

"Real estate can be offered through open ended investment structures that represent a liquidity mismatch between the structure and underlying assets. Since real estate investments are illiquid, this can create issues if, often in times of stress, investors decide to redeem capital in size. Therefore, an understanding of the structure for investing in real state is very important."

Properties and portfolios

Bricks and mortar are traditionally seen in the retail world as solid investments; and real estate is an illiquid asset class – something that brings advantages as well as challenges. Quickly selling up is not really an option – particularly if the market is at a standstill or if one is faced with selling at a lower price. Koeman-Sharapova says: "You can't, from one day to the next, say: 'Oh, I'll liquidate that building.'"

Real estate should be viewed, first and foremost, as a long-term investment strategy; the illiquidity premium – higher returns effectively compensating for less flexibility – is one of the "attractive features of real estate investments," says Perelgritz.

However, it is also a reason for some funds to be moving out of property, or at least adjusting. Over the past few years, Perelgritz says, there has been evidence of divestment from defined benefit schemes, which have moved away from open-ended real estate as part of wider de-risking strategies.

For some DC schemes, the lack of flexibility provides a barrier to entry. As access is generally through vehicles that are, in some cases, not well-adapted to their needs. "A lot of the access routes don't meet the requirements of DC schemes," says Koeman-Sharapova.

"Value can be created, or risks avoided, if real estate is acquired at an attractive basis or cost"

Buildings on shifting sands

The ongoing political and economic uncertainty made the markets tumble and left many equity investors unnerved. Has the real estate world been shaken, too? "Absolutely," says Zdravkov. "Real estate is a medium- to long-term investment proposition that relies heavily on policy stability. Increasing uncertainty feeds through higher volatility in currency and debt pricing, which takes the science away from price discovery." The result, he says, is a reduction in transactions and consequently lower growth in the wider economy.

Is there an argument for pensions to consider moving away from real estate? "It depends on the role of the real estate allocation within a given pension plan, and its journey plan," says Perelgritz. "Real estate can still be a valued allocation within the pension scheme investment strategy given its stable income stream, as tenants pay rent."

In effect, Zdravkov says, the real question should be: "Are current real estate allocations serving their intended purposes, and how should overall portfolios be adjusted for the uncertain environments ahead?"

What's next for real estate?

To predict what might happen next in the real estate sphere, it is worth looking at the past. Echoes of the issues faced in the 2008 financial crisis can be heard today, according to a JTC spokesperson: "The increasing distress in the credit market has historically seen the opportunistic real estate funds thrive; 2007 also saw an increase in the number of opportunistic funds come to market, along with the percentage of loan to value increasing at a lower interest rate environment than today."

The requirements for building standards in real estate are also shifting; environmental regulations, and the move towards a net-zero carbon emissions, mean that many buildings will need significant investment to bring them up to scratch.

Whatever the future holds, it is unlikely that real estate will be ruled out. There are challenges, but many argue that there are considerable benefits; not least because real estate is unusually positioned to give exposure to a huge range of different sectors.

"You can actually make a diversified basket of different kinds of properties that will have exposure to different parts of the economy," says Koeman-Sharapova. "So you can, in that way, get exposure to both cyclical and structural elements."

After all, the underlying assets within real estate portfolios are hugely varied. From giant ecommerce warehouses to physical shops in the retail sector, from companies using office space through to social housing and student accommodation, they all need a roof over their heads.

Written by Sandra Haurant, a freelance journalist