Summary
• Private rental sector is growing all the time, with one in five households currently renting, expected to grow to one in four. Rents are increasing by 0.9 per cent annually.
• Pension funds have been showing increasing interest in this niche market.
• Stable income and long-term investments, which can potentially ride out volatility in the residential property market, are among the main draws.
• But maintenance costs, potential turnover of tenants and illiquidity must be taken into account and carefully managed.

Safe as houses?

Sandra Haurant considers why pension funds should be looking at private rental investments

The property or pension question is one that private investors have posed to themselves for many years. For many, faith in bricks and mortar remains firm, while the fluctuations of the stock market can be off-putting. The latest Office for National Statistics (ONS) *Wealth and Assets Survey,* published in August 2018, asked non-retired people which was the safest method of saving for retirement. Employer-backed pensions came first with 40 per cent of the vote, but investing in property came a strong second with 29 per cent. Among the self-employed, property was the most popular choice, with 42 per cent of people voting it the safest method of saving for retirement.

For pension schemes, though, the private rental sector (PRS) is an area that did not command quite so much interest. But things are beginning to change. Continuing low interest rates, poor bond yields and a need for regular income are driving the quest for reliable investments, and some believe that private rental investments can provide a promising mix.

As PiRho Investment Consulting's director, Phil Irvine, says: "Many pension schemes are looking into secure income assets, which includes rental housing, sometimes in specialist niches such as student accommodation, social housing, and so on."

Going up?

There is certainly growth to be seen here; according to the Office for National Statistics, tenants in Great Britain saw rents rise by 0.9 per cent in the 12 months to August 2018, an increase which had remained steady since the previous month. In England, private rental prices rose by 0.9 per cent, in Wales by 1 per cent, and in Scotland by 0.5 per cent, while in London increases were smaller at 0.3 per cent.

Local authority pension schemes have been putting more than a toe in this particular water lately. Derbyshire Pension Fund, Nottingham Local Government Pension Fund, and Staffordshire, Teesside and West Midlands Pension Funds recently became key investors in a closed-ended institutional housing fund run by Hearthstone Investment Management, known as Hearthstone Residential Fund 1 (HRF1). The local authorities invested £100 million into the 10-year fund, which has bought properties, including two Manchester apartment blocks.

Meanwhile, the Universities Superannuation Scheme (USS) announced in May that it was entering into a £330 million joint venture agreement with Places for People, investing in the UK private rented sector. Core funding for the partnership comes from USS, with Places for People's investment arm, PfP Capital, acting as asset manager, and Touchstone, its specialist property management business, taking on the day-to-day management of the property portfolio.

Ways in

Pension funds wanting to invest in residential property typically do so through pooled investment vehicles managed by real estate fund managers – and there are a number of funds that have been specifically established with institutional investors, including pension funds, in mind. "Some of these pooled vehicles are specifically Build to Rent (BtR) focused," says JLT Employee Benefits' senior investment consultant and head of manager research, David Will. In other words, buildings that are specifically built with the rental market in mind.

Asset attraction

So what is it about private rental that appeals to the pensions sector? Will says: "As pension funds are maturing and becoming cashflow negative, the UK PRS offers a number of features that they are seeking, namely stable, predictable income streams, diversification from other traditional asset classes that they invest in, such as commercial real estate, equities and bonds, defensive characteristics, including capital preservation and inflation linkage, and technical support from the long-standing structural supply and demand imbalance." And, he adds: "Last but not least, support from the UK government, which sees the PRS and BtR in particular, as a means of creating better quality and professionally managed housing stock for rental on a large scale."

For PfP Capital managing director Chris Jones, pension funds investing in the rental sector is, on many levels, a question of common sense. "The trend over the past decade or so has been owner occupation falling and rental accommodation continuing to rise and we see that trend continuing into the future," he says. It's an assertion that is backed up by research published in 2017 by estate agent Knight Franks, which showed that some five million households, or 21 per cent of the total, currently live in private rented accommodation, a figure anticipated to rise to 5.79 million by 2021.

For pension schemes, then, the private rented sector may offer the opportunity of a dependable income with good prospects for the future. As Will says: "The main benefits to pension fund investors are robust, stable income streams from an asset class that is supported by a long-standing supply and demand imbalance in the UK housing market, low correlations with other asset classes and the sector's defensive characteristics."

After all, as he says: "People always need somewhere to live, and the rental market has been robust during economic downturns, potentially resulting in lower capital falls from the rental market compared to the sales market." And Jones agrees: "The rental sector can often ride out the vagaries of the residential property market."

The rewards, then, can be stable and relatively generous, in the right climate. Will says: "Expected returns from the pooled vehicles that pension funds can use to access this sector are typically in the region of 6-8 per cent net of fees."

Risks

But there are, of course, risks. While, as long-term investments, private rental sector funds may absorb the worst of the property market fluctuations over time, residential property, by its nature, can be a relatively illiquid asset, and a need to sell at a low point on the chart could spell significant capital losses.

There are other considerations too, Irvine says: "Investment in rented property for pension schemes has typically been popular on the continent, but less so in UK. One of the advantages of this sector is that these are investments in real assets that have inflation characteristics," he says. "On the disadvantages side, these have historically been relatively small investment lots with quite high cost in terms of monitoring, repairs and collection of rents."

Anyone who has ever been involved in the upkeep of a property will know that there are inevitably costs involved. Maintenance can be onerous, and with rental properties, there is always a degree of 'churn' to manage, with tenants coming and going over time. For Jones, this is why choosing the right investment is essential: "I think one of the key risks for investors in this sector is the ability of the manager to manage the portfolio over the life of the investment or fund," he says. Jones claims that PfP is able to manage a portfolio in a way that ensures the operational costs are kept as low as possible, and at a level where the firm is able to ensure "appropriate asset management is undertaken, and that we are providing a quality service to the customer". After all, as he says: "A happy customer is one who will remain in the property and continue to pay their rent."

And, of course, a tenant is not simply a customer; when the investment is somebody's home, there are many important dimensions to be taken into account. As Will says, the fact that "people always need somewhere to live" makes rental property a relatively future-proof asset, on the face of it. But, adds Will: "There are […] some caveats for pension funds to consider. Most importantly, there is the moral question. Could this be viewed by pension scheme members and other beneficiaries as exploitation of the people who are unable to purchase their own property or who choose to rent?"

The counter argument is that properly, professionally managed properties provide good quality homes for those who rent. And with a private rental market, which looks set to continue its upward trajectory, like the age-old pension versus property question for private investors, it is unlikely pension schemes will shut the door on this sector any time soon.

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