The problems facing open-ended property funds

It has become increasingly apparent over the last year or more that the structure of open-ended investment funds linked to real asset commercial property, is not all that well suited to the modern investment environment.

This commentary is not designed to give a comprehensive analysis of this, but a brief summary of our views and the reasoning behind them.

The core issue is liquidity. Property, whether commercial or residential, can take time to sell, especially during a difficult patch for the economy, so a fund investing in property really does need to be taking a longer-term view, and not speculating on short term changes in valuations.

However, for a range of reasons, the modern investment world has developed into one where very large sums of money are now held in arrangements, such as Discretionary Managed Funds, which habitually move in and out of investments, or on platforms that facilitate very easy and quick trading between investment funds using on-line facilities.

This, combined with some other factors, has transformed the world of investment and very significantly increased the incidence of large-scale transference of capital from one fund, or whole sector, to another.

This culture of speculation is not one which Atkins Bland endorses, as we believe equity and property markets should be used for longer term investing, and not for speculating on short term events.

However, the modern trend seems unlikely to change, and open-ended property funds, which should be an excellent investment option in terms of diversifying risk and generating longer term income and the prospect of capital growth to combat inflation, have been compromised as a result.

With an open-ended investment fund, if someone invests, then money is added and the fund manager needs to deploy this, whereas if someone sells from the fund, the fund manager has to find the capital to fund the withdrawal.

This can cause real headaches for normal equity market funds, where liquidity in not usually an issue, but managing cash flow to accommodate the sometimes-whimsical behaviour of investors is.

However, for property fund managers it is a far bigger problem, since a sudden need for a very large sum to meet withdrawal requests can cause cash reserves to be exhausted and force the need to sell property at a time when the supply and demand dynamics are very unfavourable, and securing a sale can take a long time.

Due to the increased use of open-ended property funds for money which does not seem to be taking a longer term view, these funds have been suspended on three or more occasions in the last couple of years, to manage their liquidity during a period where there has been a large scale exit.

The latest of these was, of course, during the Covid crisis.

As a consequence of the problems this causes, the regulator is likely to impose a minimum notice period for withdrawals of, perhaps, three months.

We feel that this, together with the recent history of suspensions, is likely to make these funds less and less attractive to modern day investors, who do seem to like to move quite rapidly from one strategy to another, rather than take the longer term view.

It is impossible to predict what the eventual outcome will be, but there is a risk that these open-ended property funds will find either a steady exit, or a rush for the exits, and will eventually be forced to close completely, with their assets sold and the proceeds distributed to the shareholders.

Whether or not this outcome does materialise, we feel these developments have compromised the viability of continuing use of open-ended property funds, given the obvious head winds they face and the problems they have in terms of their structures compared with modern investment behaviours.

We therefore recommend exiting these funds to alternatives which do not have the same issues.

The obvious choice is a Real Estate Investment Trust (REIT), which are closed-ended rather than open-ended funds.

With a closed-ended fund (normally called an investment trust), somebody selling their shares does so through selling them on the stock market to another person who buys them, with no impact on the assets held within the fund. This leaves the managers to get on with their job of managing the assets without the encumbrance of shorter-term speculators causing headaches with their cash flow.

However, due to the way shares in REITS are traded and the ability of managers to borrow money to “gear” the investments, these show far more volatility of value than an open-ended property fund. The actual value of the underlying assets should move in a similar way, but the shares can trade at prices which drift a long way from their actual underlying value, sometimes at a large premium and sometimes at an even larger discount.

This means a REIT is generally classified further up the risk ladder than an open-ended property fund.

As a result, moving from an open-ended commercial property fund to a Real Estate Investment Trust involves changing the risk dynamics of a portfolio, especially in terms of shorter-term valuations.

To reflect this, where this would cause a breach in the overall risk characteristics of a portfolio in comparison with an investors objectives and preferences, our advice if we are recommending withdrawing from an open-ended property fund is to redeploy some of the proceeds elsewhere than the property sector.

Our specific recommendations will obviously depend on individual objectives and priorities, and the nature of other holdings already in the portfolio.

As explained at the beginning of this document, it is not intended to provide full details, but simply an overview of the rationale behind our view that the merits of holding open-ended property funds has been compromised by recent developments, and that our advice in our portfolio reviews reflects this view.

Important notes

Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced.

Inflation can reduce the real value of capital and the income it generates.

Past investment performance is not a reliable guide to the future.

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omission excepted.

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The value of investments and any income generated will fall as well as rise.
An investor may, therefore, get back less than the amount invested.