For UK institutional investors and consultants

Finding a home for property in DC pensions

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Executive summary

Property is often under-represented in DC strategies	Property is often not considered for inclusion in the investment strategies of defined contribution pension schemes. Where schemes do allocate to property, allocations are often considerably smaller than for defined benefit schemes.
Property has an attractive risk-return profile	UK property has - on many measures - offered a superior risk-return profile than equities and demonstrates good long-term protection against inflation.
Property offers long-term downside protection	Using long-term asset-liability modelling, we see improved downside and average pension outcomes by replacing 10% of the equity allocation in an example lifestyle strategy with UK direct property.
Direct property vs. listed property	Direct property has many risk-return advantages over listed property, such as lower volatility and lower correlations with equities.
Active Beta DC Property Fund	Liquidity is often mentioned as a reason DC schemes do not invest in direct property. Building on the success of the Aegon Active Beta Property Fund, we launched a DC version of the strategy in 2020 which offers the same benefits, but with daily liquidity.

Introduction

Despite the rapid growth in defined contribution (DC) pension assets they often remain the poorer cousins of their defined benefit (DB) counterparts when it comes to the variety of asset classes they offer. This is certainly the case with property, which is successfully used to diversify the investment strategies of many DB pension funds and improve their risk-return profiles. Property is, however, seen much less in DC pension default strategies.

This article looks at the potential benefits for DC pension schemes of introducing non-listed property to their default strategies and introduces a new investment solution which overcomes the issues of allocating to a less liquid and heterogeneous category.

Property in DC pensions

According to a research paper from the Investment Property Forum[1] around 1.8% of DC pension assets in the UK are invested in property. This compares to 4.7% of assets for DB pension funds[2]. Given most DB pension funds are maturing and likely to be de-risking, this suggests DC pension funds, with a longer average investment horizon and so a higher expected allocation to growth assets such as property, are very much underweight property compared to their DB counterparts.

This article considers the advantages of investing a proportion of DC pension portfolios in property, the methods of investing and why non-listed property has advantages over listed, before lastly considering how to overcome some of the issues inherent in property investment for institutional investors.

[1] *Real Estate Investment in UK Defined Contribution Pension Schemes, 2018*
[2] *Pension Protection Fund Purple Book 2021*

The advantages of adding property

Property is an asset category that has historically enjoyed high long-term returns, meaning it can hold an important place in a DC investor's growth phase, when they are focused on building capital over the long term. The fact that property generates a higher proportion of its return from income than equities and that the income is often contractual and predictable means it usually has steadier returns than equities. Income from real assets like property also usually has an implicit or explicit link to inflation meaning returns are usually a good hedge against long-term inflation. Table 1 demonstrates some of its favorable risk-return characteristics versus equities.

Table 1: UK property versus equity return characteristics (period 31 December 1989 to 31 December 2023)

Attribute	MSCI World	FTSE All-Share	UK Balanced Property
Annualised return	8.3%	7.6%	5.8%
Quarterly annualised volatility	15.8%	14.9%	6.5%
Return/risk ratio	0.53	0.51	0.89
Maximum drawdown	-46%	-41%	-39%
Quarters with UK CPI outperformance	92/136	89/136	99/136

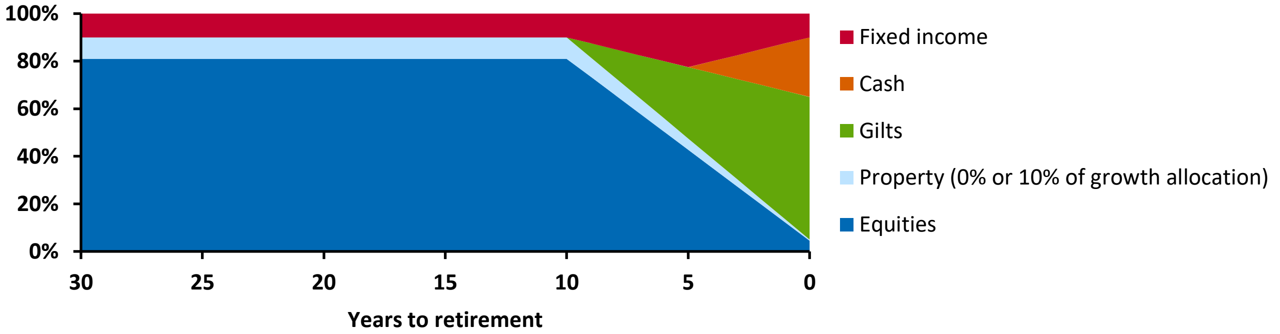
Source: Bloomberg, MSCI/AREF UK All Balanced Property Fund Index, ONS, Aegon Asset Management. Quarterly returns from 31 December 1989 (first UK Balanced Property Index data) to 31 December 2023.

DC asset-liability modelling (ALM)

To understand the potential benefits for DC pension schemes we consider the effect on pension outcomes of introducing property into an example glide path. We use a simplified structure for a glide path in which we have four asset groupings: growth assets (equities), fixed income (UK credits, emerging market debt and high yield), gilts and cash. We then introduce property within the growth asset allocation at a weight of 10%[3], meaningful enough to make a difference to DC member outcomes. A higher allocation could well be considered, but we recognise that, for many DC pension providers considering property, this may be a first step into an illiquid category and they may therefore be wary of higher allocations.

Chart 1 shows the example glide path which is intended to be for an investor seeking to take 25% cash at retirement and convert their capital into an income (hence a high allocation to gilts). This is just an example glide path: based upon more extensive research, we believe other glide paths, for example targeting drawdown, would show similar result trends if introducing property.

Figure 1: Example glide path



Source: Aegon Asset Management.

[3] *The 10% property allocation consists of 95% bricks & mortar and 5% cash, to allow for some liquidity in the allocation.*

We take as an example member a 25-year-old, expected to retire at age 68, and with assumed pension contributions of 10% of salary. We then calculate expected pension outcomes for this member across a wide variety of stochastically generated future economic scenarios, based upon historic characteristics of returns and variability of returns and long-term future economic projections. Table 2 illustrates the real capital at retirement if the individual converts their pension to an annuity under the various scenarios considered. More details of our assumptions and the outputs calculated can be found in the appendix.

We see from Table 2 that the addition of 10% property to the growth asset allocation offers, on average, better outcomes for future economic scenarios with lower capital and pension outcomes. The analysis therefore suggests adding property leads to better protection of downside risk, particularly in the worst-case scenarios. Despite property having a lower expected return on average than equities, we see a slight improvement in the median average outcome. This is partly due to a long-term diversification benefit – rebalancing from outperforming equities to property and vice versa – and also due to the average equity returns being partly higher due to a relatively few scenarios where equities perform outstandingly. Where the addition of property potentially hurts outcomes is in the best-case scenarios, generally associated with long equity bull runs. However, DC investors would still be benefitting from much better than expected outcomes in these scenarios.

Table 2: Pension outcome statistics with and without an allocation to property

Scenario description	Percentile	Real pension outcome	
		Without property	With 10% property allocation
Worst case	5th percentile	£9,240	£9,960 (+7.8%)
Downside	25th percentile	£16,710	£17,170 (+2.7%)
Average	50th percentile (median)	£25,370	£25,400 (+0.1%)
Upside	75th percentile	£41,220	£40,160 (-2.6%)
Best case	95th percentile	£89,810	£86,610 (-3.6%)

Source: Aegon Asset Management.

Methods of investing in property

The following are the main investment options which pension providers could use to gain exposure to property.

Direct property	At least at present, buying property directly (outside a pooled structure) is unlikely to be an option for most DC pension providers, given the size of investment required for a diversified portfolio, the ongoing governance and management requirements, the property-specific risks, and the issue of pricing illiquid assets. However, as DC pension schemes grow and market norms change, this may become a solution in the future for larger DC providers.
Non-listed pooled property funds	Pooled open-ended funds investing across a wide range of properties offer investors relatively easy access. In the UK, these types of funds are a popular way to access the market. Balanced funds, broadly covering the sectors and regions of the UK, are the most common for pension fund investments. We discuss some of the issues they have, and how these might be overcome, later in the article.

Listed property vehicles	Listed property vehicles such as real estate investment trusts (REITs) are a popular method of investing in property. Their listed structure makes it easier to trade and they can allow easier access to a wider range of properties and regions than direct investing would. However, they are often leveraged compared to pooled funds and are much more closely correlated to equity markets as we see below. Listed property vehicles are also still invested in illiquid assets, meaning the listed prices of the vehicles can suffer from higher volatility and dislocations from the valuations of the underlying properties, particularly if a large number of investors want to exit or enter the same vehicle.

Table 3 sets out some of the pros and cons of the three underlying investment methods and Table 4 compares some of the historic investment characteristics of UK listed and non-listed property investment.

Table 3: Pros and cons of each investment method

Attribute	Direct investment	Non-listed pooled fund	Listed property
Required investment size	- -	++	++
Liquidity	- -	-	+
Volatility	+	+	- -
Low equity correlation	+	+	- -

Table 4: Historical investment characteristics since 2005

Characteristic	Non-listed pooled UK property	UK-listed property
Return	4.1% p.a.	1.48% p.a.
Volatility	7.7% p.a.	23.0% p.a.
Return/risk ratio	0.53	0.06
Correlation with UK equities	0.24	0.71
Correlation with World equities	0.20	0.60
Maximum drawdown	-39%	-76%

Source, Table 3: Aegon Asset Management. Source, Table 4: Bloomberg, Aegon Asset Management calculations. MSCI/AREF UK All Balanced Property Fund Index and FTSE EPRA Nareit UK Property Index used for non-listed and listed UK property. Quarterly returns analysed over period from 1 April 2005 (first available consistent data for UK listed property) to 31 December 2023.

We can see that non-listed pooled UK property has exhibited favorable risk-return characteristics compared to UK-listed property. This is partly a reflection of the way it is valued, which usually leads to smoother returns. In some cases, de-smoothing techniques can be used to analyse non-listed property returns, although there is still strong evidence that it retains an advantage from a risk-return perspective.

Non-listed UK property investment

Whilst non-listed property investment has some clear advantages over listed, there are a few of its characteristics which require careful consideration before adding it to a DC solution. Three key ones are liquidity, transaction costs and active manager risk.

Liquidity

The platforms which many DC pension providers use often require the funds offered to be daily dealt. This is not necessarily a regulatory or investment issue, since DC members have a long investment horizon and so in principle can invest in less liquid categories. The number of daily dealt UK property funds available to pension funds is limited and so simply choosing from one of these would be restrictive compared to DB pension funds which can choose from a much wider range of funds which deal less frequently.

Transaction costs

Transaction costs for non-listed property can be high, given the costs of buying and selling the underlying properties where necessary. This means switching from one property fund to another would not be an attractive option for a default DC pension fund glide path. A typical 'round-trip' cost to switch property managers on the primary market would be around 7%. A pension scheme board might therefore be understandably reluctant to switch funds, even if they had concerns over the performance of the property manager.

Schemes often want to remain invested in commercial property from an asset allocation perspective, but can find themselves trapped with an incumbent property manager that they rate poorly because of the high switching costs.

Active manager risk

Many DC default investment strategies use passive investing as much as practicable. This is partly to reduce costs, but also avoids the risks inherent in selecting active managers. With property, this risk is intensified, as disinvesting from a fund which is performing poorly may mean joining a queue and incurring high transaction costs.

In addition, selecting a single property manager for the long term in the UK is notoriously difficult. The history of open-ended property funds in the UK regularly shows that property funds that were once considered stable, attractive and popular can quickly morph into funds that become unstable, risky and illiquid. The reasons for this unpredictability are various, some related to poor management, some related to shorter-term trends in the market, and some related to investor behaviour causing managers to make decisions which are not optimal e.g. as a result of heavy outflows. However, a common result for investors is a frustration at failing to access commercial property market returns in a clean and efficient manner due to the risks of selecting active property managers.

An innovative UK commercial property solution for DC investors

For investors seeking direct exposure to the UK commercial property market, but concerned about the risk of manager underperformance, the Aegon Active Beta Property Fund provides an innovative solution. The Fund seeks to perform in line with the MSCI/AREF UK All Balanced Open-Ended Property Fund Index with a tracking error of at most 1%. It does so by investing across a portfolio of constituent funds of the index, thereby reducing manager specific risk. The active management element is limited and is intended to allow the managers to target performance in line with the benchmark after fees. It has two elements:

1. Limited active positions	Having the flexibility to hold limited overweight and underweight positions can be particularly beneficial in a less efficient market such as property. Such positions are limited to preserve the overall goal of closely tracking the benchmark index.
2. Control of costs	By using secondary market trading expertise, the fund managers can seek to minimise or even negate the transaction costs which, as mentioned, can be around 7% for a round trip transaction on the primary market. This also allows the managers to enter and exit funds more efficiently, and benefit from market inefficiencies which present themselves via the secondary market.

The Aegon Active Beta Property Fund has performed consistently with its objectives since inception in June 2017. It has delivered a 2.9% p.a. return, net-of-fees, against an index return of 2.9% p.a. with a low tracking error of 0.6% per annum since inception. This demonstrates that, for a sustained period, the Aegon Active Beta Property Fund has achieved its stated goals, providing exposure to the most frequently used UK property index for institutional investors with limited deviation.

Many of the funds underlying the Aegon Active Beta Property Fund are dealt monthly or less frequently, meaning the Fund itself can only be dealt on a monthly basis. To offer the benefits of the Active Beta approach to DC pension providers, a daily-dealt version, the Aegon Active Beta DC Property Fund, was launched in 2020.

A core allocation of 70% to 80% of the Aegon Active Beta DC Property Fund invests in the Aegon Active Beta Property Fund, with the remainder allocated to the largest daily dealt property funds and to a small cash buffer. As a result, the performance of the Aegon Active Beta DC Property Fund shares similar characteristics to the Aegon Active Beta Property Fund, whilst offering daily dealing to DC members.

Conclusion

Property can provide an attractive addition to DC default glide path solutions. It has offered high expected returns historically and low correlation with other growth asset classes. Our modelling using a wide set of projected economic scenarios also suggests the addition of property can lead to improved risk-return profiles for pension outcomes using an example glide path.

Non-listed property has several key advantages over listed property but suffers from a few key issues for DC investors, the two main ones being lack of daily liquidity and active manager risk. Aegon Asset Management's Active Beta DC Property Fund addresses these issues, with the aim of providing long-term exposure to the UK property market with daily liquidity and returns in line with the index of balanced funds.

Appendix

The asset-liability modelling performed assumes annual rebalancing and contributions. Contributions are 10% of salary and salary assumed to increase by 2% above general wage inflation up to age 40 and 1% thereafter to account for an example promotional scale. The assumed annual starting salary at age 25 is £20,000. Outcomes are measured in real terms, taking into account inflation in each scenario from now to retirement. Real capital at retirement (assumed to be age 68) is converted to a pension by dividing by an annuity factor calculated using projected interest rate curves in each scenario.

Summary statistics of long-term ALM scenarios

			Correlations							
Asset class	**Average return p.a.**	**Standard deviation p.a.**	**DE**	**EME**	**Gilts**	**Corps**	**EMD**	**HY**	**Cash**	**Property**
Developed equities	6.6%	19.0%	1.00							
EM equities	6.7%	26.5%	0.69	1.00						
Gilts	2.6%	9.7%	0.04	0.05	1.00					
UK corporates	4.1%	7.3%	0.20	0.22	0.61	1.00				
EM debt	5.1%	11.2%	0.32	0.35	0.17	0.43	1.00			
High yield debt	5.3%	13.6%	0.38	0.25	0.10	0.49	0.69	1.00		
Cash	2.6%	1.7%	-0.08	-0.07	0.24	0.26	0.13	0.07	1.00	
Non-listed UK property	6.1%	7.8%	0.26	0.26	0.14	0.23	0.19	0.21	-0.02	1.00

Source: Aegon Asset Management.

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