Investment Tutor Surgery

Janet Measom, product specialist – UK real estate, Aviva Investors considers property's place in the asset mix and **Dr Steve Waygood**, head of sustainability research, Aviva Investors, looks at the extent to which Environmental, Social and Governance (ESG) issues should impact the investment decision making process

Does property still have a place in the asset mix of defined benefit pension schemes?

In 2008 the fall-out from the global credit crunch and the banking crisis began to spill-over into the whole economy and commercial property was not immune to this. The collapse of Lehmans in September resulted in a massive increase in risk aversion and a deterioration in lending conditions, which had a substantial knock-on effect on property. The last quarter's return was –13.6 per cent, bringing a dreadful year to a close. December was the worst month, Q4 the worst quarter and 2008 the worst year in the Investment Property Databank UK monthly index (IPDMI) history.

Does that mean that trustees should write off the asset class for the foreseeable future? It is worth noting that UK commercial property is not the only asset class which has suffered reversals of late; it doesn't necessarily make it any easier but it is salutary to note that UK commercial property was still outperforming UK equities over one, three, five and ten-year periods at the end of March 2009 according to IPDMI.

Property offers a yield which has historically tended to be higher and more stable than that of other asset types; it can also offer valuable diversification qualities due to its limited correlation with other asset types.

The opportunities for investing in property are increasing all the time – balanced and sector or geographically focused funds, UK and overseas funds, open- and closed-ended funds, geared and ungeared funds, funds investing in bricks and mortar and funds investing in listed assets. There are funds that are specifically designed to help pension fund trustees of defined benefit schemes manage their liabilities by specialising in lower-risk, long-lease properties with top-quality tenants that should help to ensure a good income stream.

Finally we are observing, if not actual green shoots, at least some tentative signs of yield stabilisation in some sections of the UK real estate market. While we are forecasting negative returns in the short term, we see signs of improvement in investor sentiment and levels of transactional activity. As a consequence pricing has stabilised somewhat for prime properties with long leases and strong covenants. Yields look attractive relative to those offered by gilts and cash suggesting that there is potential for yields to move lower once the worst of the occupier market downturn passes. We expect that 2010 will see stabilisation in UK property values and that returns can recover robustly thereafter.

Should trustees bring Environmental, Social and Governance (ESG) considerations into their investment decision making?

The most effective document for promoting the integration of ESG issues into investment is arguably the "Freshfields Report", published in 2005. This report was asked to consider:

"Should integration of environmental, social and governance issues into investment policy be voluntarily permitted, legally required or hampered by law and regulation?"

Freshfields concluded that "…integrating environmental social and corporate governance (ESG) considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions".

This conclusion clarified the legality behind whether pension schemes could consider ESG issues. However, while the report contributed to the debate, there was little guidance for trustees seeking to implement their responsibility in this area.

How precisely can a trustee go about delivering on any ESG fiduciary responsibility? Trustees do not routinely get involved in company meetings, stock picking or portfolio construction – often delegating this to their asset managers.

Schemes can include ESG clauses in Investment Management Agreements (IMAs), and require fund managers to periodically report on their performance. For instance, being a member of the United Nations Principles for Responsible Investment (UN PRI)* requires that "where consistent with fiduciary responsibilities" signatories should commit to integrating ESG issues into investment analysis; to being active, responsible owners by promoting good corporate practice in these areas; and to reporting on what actions they have taken.

Choosing to embed UN PRI membership into global investment management agreements will help clients hold their managers to account for delivering on this important aspect of fund management.

The UN PRI monitors delivery of these principles via a questionnaire. This benchmarks signatorys' performance in relation to each principle. This analysis is then shared with signatories, most of whom do not share it with the people whose money they are managing – and they are not required to.

This is a missed opportunity. As trustees have a fiduciary duty in this area, their agents should be required to make this information available to them at no additional cost.

** For further information on the UN PRI see http://www.unpri.org/principles/.*

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