Schroders

Thought Leadership

Property: a firm foundation for pension scheme derisking plans

The strong run in property values over the past few years is likely to have boosted the funding levels of those pension funds with reasonable-sized allocations to real estate. The temptation may now be to sell out while the going is good. We can understand the urge, but wonder whether trustees and governance committees will find anything quite as suitable for their needs in the current climate?

03/06/2016

Given the continued trend by pension funds to reduce the risk of their investment strategies, we would argue that real estate offers some good cashflow matching characteristics for schemes' lengthening liabilities.

Yields of around 5% are highly attractive compared with other assets, particularly long-dated gilts, where the current yield gap of between 3% and 3.5% is high by historical standards.

Moreover, UK real estate has been an excellent asset for pension funds to use to offset – or beat – inflation-linked liabilities.

It has outperformed index-linked gilts by about 2% a year since 1982. This return is markedly better than the average rate actuaries typically use to discount pension liabilities, which is the yield on gilts plus 1% according to the Pensions Regulator.

But it goes further than that. Real estate also has surprisingly good matching characteristics for pension scheme cashflows,as we demonstrate in the chart.

Here we have shown typical cashflows from a hypothetical property over a succession of 10-year leases. The cashflows are discounted and compared with the cashflow requirements of a typical pension scheme.

The match is generally pretty good. Rising rental values help to offset increases in pensions in payment due to inflation.

It is true that the liability cashflows tend to be somewhat longer, but only three ten-year leases have been assumed for the property.

In practice a property's cashflows may well be longer if the building is regularly refurbished. This should ensure that it doesn't become obsolete and continues to be able to attract new tenants at higher rents.

While the income from real estate can be a good match for inflation-linked liability cashflows, it is fair to say that the match for interest rates is somewhat weaker. In mitigation, it needs to be said that, firstly, this tends to be the case whatever asset is used to match pension scheme liabilities, with the exception of gilts.

Secondly, the property-related assets typically used to help match long-dated cashflows – for instance, infrastructure debt, ground rents and long lease property – have a somewhat weak interest rate match and are typically lower yielding than mainstream commercial real estate.

We would argue that schemes seeking broad cashflow matches from property need to be willing to widen their investment net and give their manager the flexibility to pick buildings where they see value to help deliver performance.

Of course, many schemes have carefully constructed de-risking plans in place that will prompt them to switch out of growth assets as funding level targets are hit. Typically, these plans involve replacing “riskier” assets, including property, with bonds.

We believe that approach would actually risk losing the very valuable – and rare – growth and matching characteristics of real estate in the de-risking process.

In fact, real estate can cover both sides of this equation: growth and liability matching. This means that when schemes are thinking of moving out of risky assets such as equities, real estate should be on their list of replacements.

Not only does it offer a better cashflow match, but its higher income can add stability to returns and provide some useful diversification with other assets as pension schemes de-risk.