Nottinghamshire County Council Pension Fund

UK property investment briefing (Paper 2)

27 January 2014

Aberdeen

Contents

Nottinghamshire County Council Pension Fund

Property can deliver a range of possible features and outcomes. In the two papers presented here we will describe these features, question some of the accepted wisdoms regarding property investment and look at the potential outcomes.

The paper titled "What can property offer an institutional investor" outlines the features of property as an asset class and also some of the features that certain types of property assets may offer.

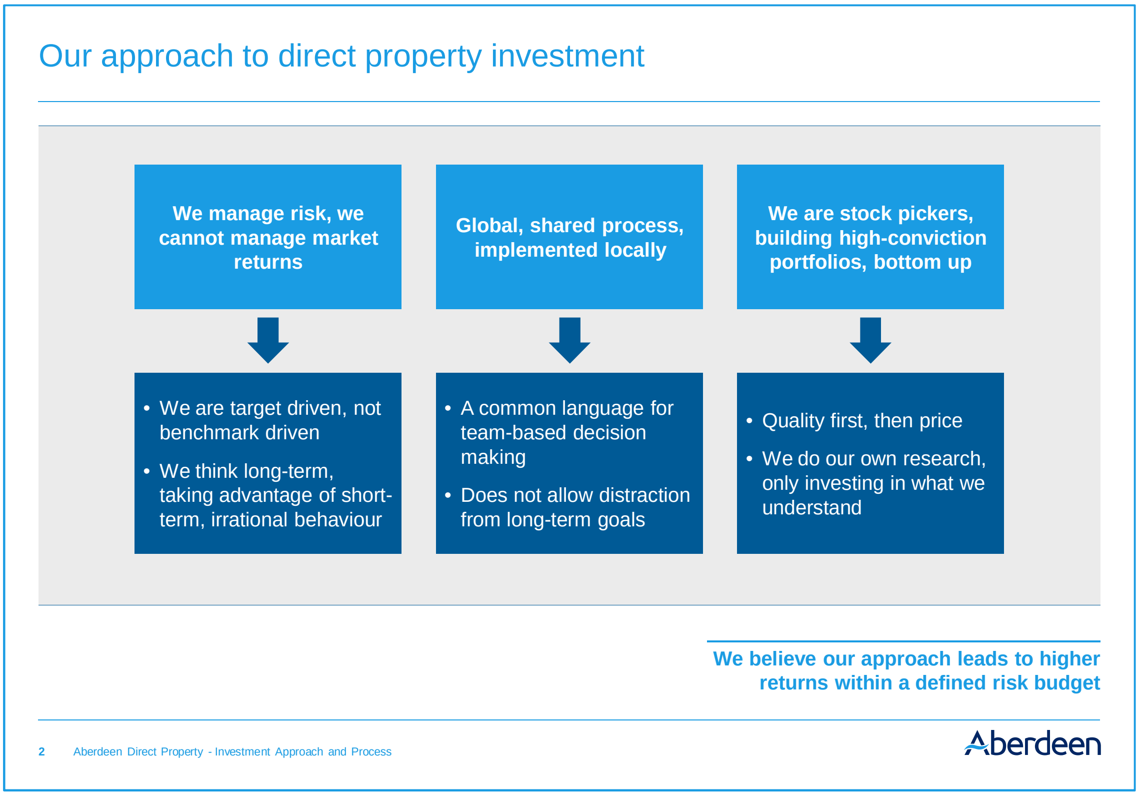
This paper will set out how the Aberdeen process seeks to secure the best long term returns for our clients, offering the lowest risk and volatility and how we would suggest this is specifically applied to the Pension Fund, in line with its stated strategic aims for property within a multi-asset portfolio. Finally, we will set out two different risk profiles that could be adopted by the Pension Fund and specify the risks inherent in each.

The Aberdeen process

Having established the theoretical arguments for property in "What can property offer an institutional investor", we now explain how the Aberdeen process is designed to take advantage of some of the misconceptions regarding property and how it seeks to exploit market mispricing arising from those misconceptions.

The approach to investment in property reflects the general approach that Aberdeen adopts across all asset classes but is adapted for the particular needs of property. At its core are the following aspects:

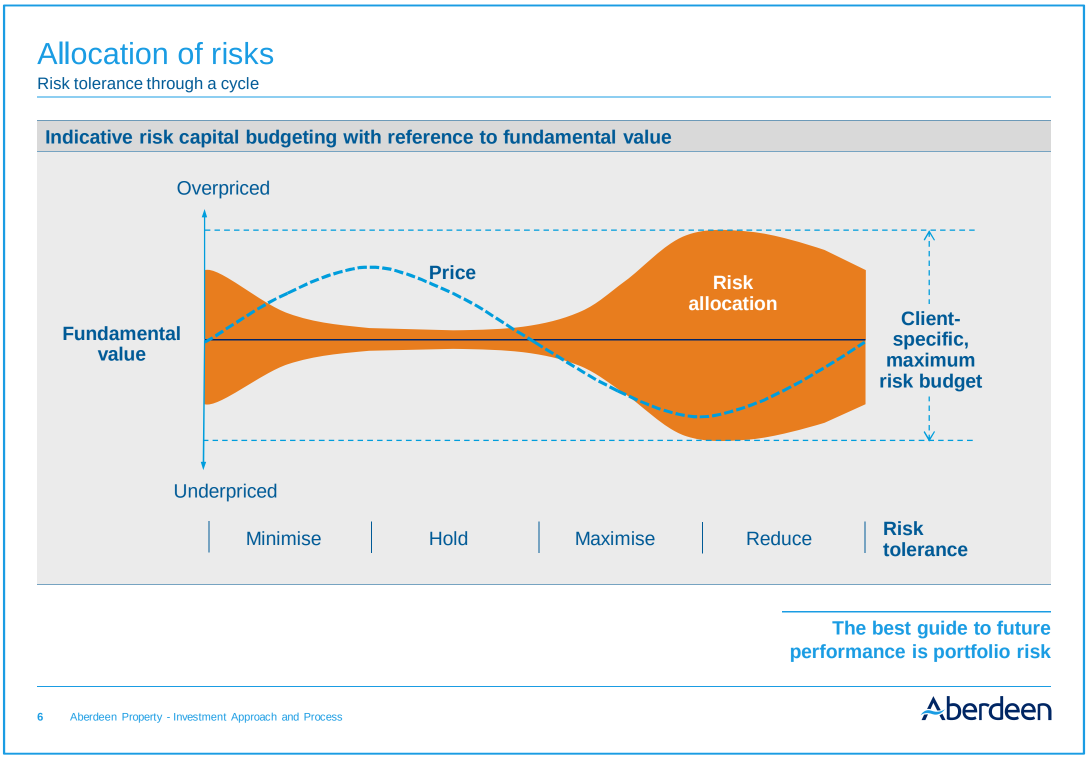
- We can manage risk, we cannot manage market returns
- We follow a process which does not allow distraction from long-term goals
- We build high-conviction portfolios, bottom up
- We invest on the basis of quality first, then price
- We believe that our approach will lead our investors to earn higher returns, within a defined risk budget, in the longer term.



Accordingly, we recognise that:

- Risk can be consistently mispriced by the market
- By adopting an absolute value approach to investment, our investors will be rewarded when we hold the right types of risks at the right point in the property cycle
- A focus on short-term return seeking or benchmark-based decisions is likely to lead to style drift and deliver inferior longer term outcomes

At the core of our processes are the concepts of risk tolerance and risk budgeting and their use to define the extent of the risks which should be taken at different points in the cycle, within the context of our clients' objectives. This can be broadly described within a framework of dynamic risk allocation and is summarised in the diagram below.



Aberdeen favours a style that provides a consistent, secure income stream; a policy of buying/selling risk when it is being consistently mispriced by the market; a policy of buying and holding long term with limited trading; avoiding assets that will show higher than average volatility in capital returns: and seeking assets which can provide a degree of hedging against inflation.

This is represented as a policy of quality first, then price.

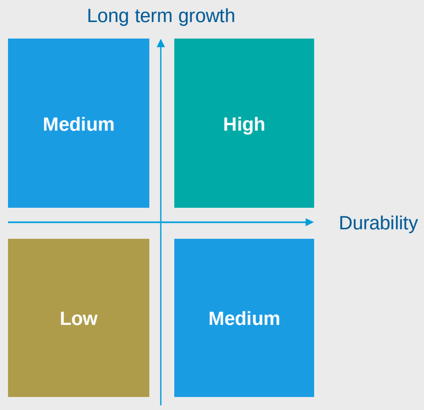
In our analysis, when buying, selling or holding assets, we will calculate the long term fundamental value of each asset compared to the market price or latest valuation. The discrepancy between price and fundamental value is a strong indication of whether we buy, hold or sell that asset.

Quality is defined as the ability for a property to deliver a durable income stream with the potential for growth. Factors influencing this are shown in the following chart. We do not define quality as a brand new building in a prime location. Properties must be fit for purpose in their market and be able to generate a durable income stream with the potential for the long term growth of that income.

Nottinghamshire County Council Pension Fund

What is quality?

Quality



Durability (of income and building)

- Ability to deliver income over a long period
  - Long lease
  - Series of shorter leases
  - Minimal downtime / void
- Low obsolescence risk
  - Functional
  - Physical
  - Economic
  - Social

Long-term growth

- Derived from a long-term mismatch between supply and demand
- Supply restricted
  - Institutional support
    - Planning/zoning system
  - Locational support
    - Monopoly locations
- Demand push
  - Demographic
  - Consumption and Production Trends

We do our own research, only investing in what we understand

16 Aberdeen Property - Investment Approach and Process

Aberdeen

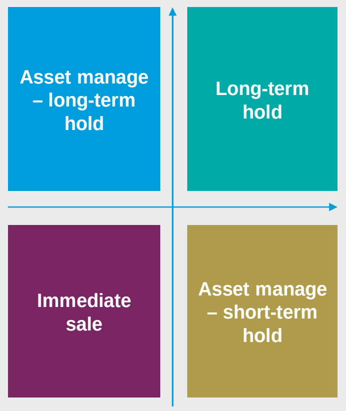
Over time, good quality, low risk assets should show less volatility, should not suffer as much in a downturn and should recover more quickly in the upturn.

Application of the process to the Pension Fund

At purchase and throughout ownership, assets are categorised according to the schedule in the following chart. This broad categorisation allows us to design and monitor the “shape” of the portfolio.

How we manage a direct property portfolio

Categorisation of assets



Long-term hold (5 years +)

- Held regardless of market environment or potential short-term relative performance
- Focus on quality
  - Durable income
  - Potential for growth

Asset manage – long-term hold

- Manufacture of long-term hold assets
- Adding value to core assets

Asset manage – short-term hold

- Tactical, value-added strategy for assets not to be held in the long term
- Assets requiring asset management prior to sale

Immediate sales

- Assets no longer fulfilling a strategic or tactical role in the portfolio
- Sale possible now at a price which realises the value of unexploited opportunities

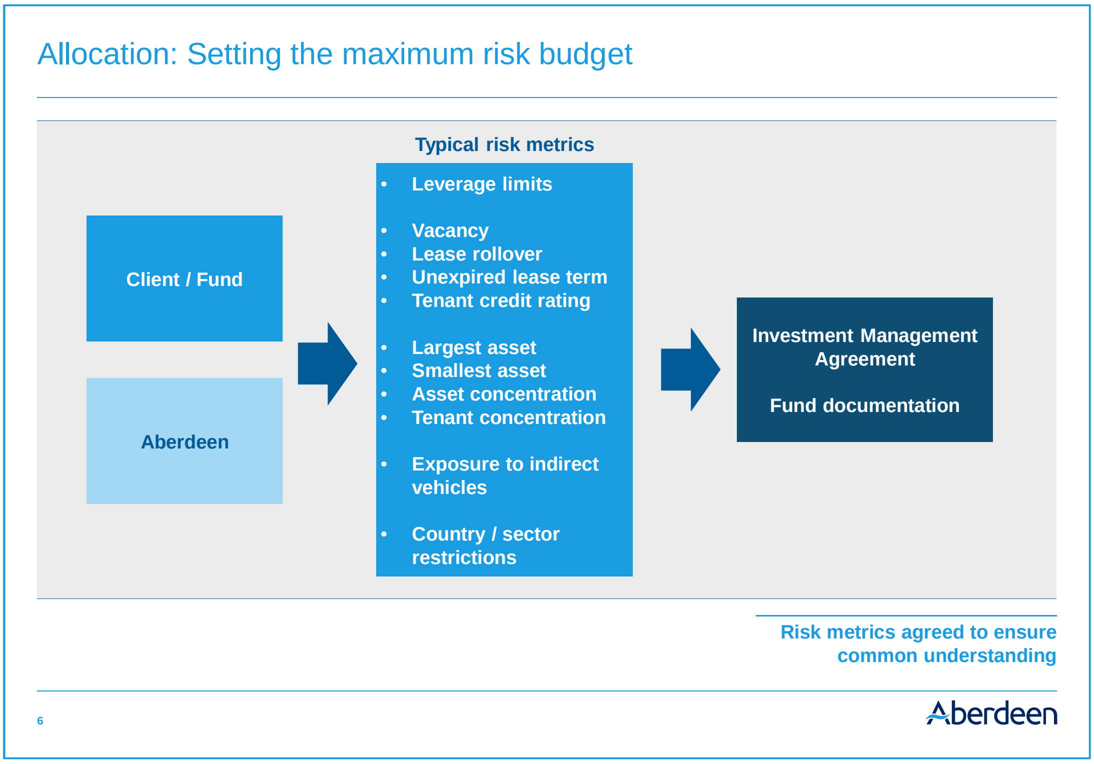
We do our own research, only investing in what we understand

15 Aberdeen Property - Investment Approach and Process

Aberdeen

The relative percentage held in each category is determined by the Fund's risk profile. A fund with a low threshold to risk would hold a higher percentage in Long Term Hold ("LTH") assets, whilst one which was happy to take on a higher level of risk (in a value-add style portfolio) would hold a higher percentage of its assets in the Asset Manage Short Term Hold ("AMSTH") or Immediate Sale ("IS") categories.

Beyond the broad "shape" of the portfolio we typically apply limits to the portfolio to control risk. These are client specific and ensure that we are managing within a risk budget at all times, ensuring no surprises for the client and a well-understood framework for us to operate within. The types of risks we typically consider are laid out in the chart below.



Alternative structures

Our investment process is designed to consistently meet our clients' objectives. Whilst these may be set out in terms of a required return, it is our role to explain, communicate and manage the risks that we believe are commensurate with such a return objective. It is therefore paramount that we understand our clients' objectives and tolerance for risk before implementing our investment process. The actual target ranges adopted for each quadrant therefore need to be determined following discussion with the Fund Trustees to reflect their preferred risk tolerance.

To facilitate that discussion, indicative ranges for "value-add" and "core" portfolio structures are set out in the table below:

Categorisation	Value-add	Core
Long term hold	0%	50 - 70%
Asset manage long term hold	0%	10 - 20%
Asset manage short term hold	60 - 70%	0 - 20%
Immediate sale	20 - 30%	0 - 10%

The percentage ranges are used as a guide to help identify risk in the portfolio and are not intended to be absolute targets, although we would normally aim for 70 to 100% above the line in the LTH/AMLTH categories. This would leave 0 to 30%in asset management/sale assets. At different points in the cycle we would aim to move the shape of the portfolio to the higher or lower end of these ranges to reflect the opportunities presented by periods of over or under-pricing. This would only be done following consultation with the Fund.

The risks/rewards of holding a specific style of portfolio are set out below.

Existing/potential shape of the portfolio

It has always been understood that the Fund held property for its income characteristics, in a block of assets alongside the Fund's fixed income holdings. This has historically been interpreted as a desire to see a higher yield from the property portfolio than the property market delivers on average. This led to a propensity to acquire and hold more asset management style properties - either more secondary properties or those requiring active management to drive performance. The issue now is whether the Fund should shift from an emphasis on higher yield to one of more sustainable, durable income?

By way of illustration and to assist deliberation, we set out in the table below the relative percentages in the Fund at three different stages, categorised into the four quadrants described above. These stages are:

(1) As the Fund was in June 2008,

(2) As it was in December 2013, and

(3) How it could look, once we have completed the current round of sales and re-invested the proceeds

Categorisation	June 2008	December 2013	On completion of sales/purchases – end 2014
Long term hold	27%	41%	52%
Asset manage long term hold	23%	25%	31%
Asset manage short term hold	37%	16%	8%
Immediate sale	13%	18%	6%

The position as at June 2008 has been categorised based on a review of what transactions were actually being undertaken at the time. We have tried to avoid applying hindsight to this process so the resultant numbers should provide a good indication of how the portfolio might have looked in 2008 had it been categorised using the current Aberdeen process. The final position at end-2014 assumes all current sales complete, all monies are reinvested and the next round of potential sales (currently in the AMSTH category) are identified.

This analysis shows that in June 2008 the portfolio contained a high percentage of properties "below the line" in the AMSTH or Immediate Sale categories, at roughly 50% and with only 27% in the LTH category. This reflected the prevailing view that higher yielding stock should be targeted. Although not a value-add structure it was quite a way from being a core portfolio.

On the same analysis, the portfolio as it is today is in transition and by the end of 2014 it could be classified as a "core" portfolio, sitting close to the ranges outlined above.

Risks/rewards in adopting the Value add structure

A portfolio with this type of structure will have all its assets categorised below the line in AMSTH or Immediate sale. Such assets will tend to be assets displaying one or more of the following characteristics and by their nature, will be assets offering short term management opportunities which can be exploited and then sold:

- Poor quality location – this will make them more susceptible to voids in a weak occupier market or to changes in supply.
- Poorer, less flexible accommodation – this may require more than anticipated capital expenditure to ensure durability of income
- Shorter average lease length – potentially more voids and exposure to non-recoverable income will be experienced
- Lower quality tenant covenants - exposure to potential tenant failure
- Assets which could be sold immediately at a price which realises the value of unexploited opportunities – properties assessed as being over-priced by the Aberdeen process and which can be exited at a premium over our assessment of fundamental value
- A propensity to trade more than average, resulting in higher transaction costs and incurring a "round trip" of around 8% each time an asset is sold and those monies reinvested

In summary, assets offering opportunities for short term gain but which are generally not able to offer durable income over a longer time horizon.

This type of asset can perform well in a rising market when risk is more accepted by investors and yields are being compressed in favour of such stock. The Fund historically held a higher proportion of buildings of this type and over the period 2002 to 2007 saw returns of 0.6% per annum in excess of the IPD Benchmark. However, in a downturn this type of asset will tend to be the first to lose value as investors retreat into defensive assets; they will tend to lose more value overall; and will take longer to recover. Again, by reference to the Pension Fund's own assets, for the five years to September 2013, the Fund has underperformed -0.9% per annum relative to the Benchmark due to its greater exposure to higher risk stock over this period.

In holding a portfolio with this type of structure, an investor will require to be compensated for the risks in so doing. The Aberdeen process would advise that this is generally not achievable over the long term.

Risks/rewards in adopting a Core structure

This style of portfolio will hold a higher percentage of assets in the LTH/AMLTH categories. These assets will generally display more than one of the following characteristics:

- Good quality location for an asset of its type – where demand for such an asset is likely to be strongest in the long term and one which will not be challenged by a change in supply or prime location or through social or economic factors
- Flexible accommodation – good quality buildings which will require minimal capital expenditure to retain income or which could be adapted to alternative uses
- Durable income – this can come from either a long lease or a series of shorter leases. Provided location and quality of building are sufficiently good, the ability to re-let space with minimal void exposure should be improved
- Better quality tenant covenant – less exposure to tenant failure and consequent void costs
- A lease structure offering fixed rental uplifts either by reference to a set percentage or to changes in CPI/RPI. These will provide secure, predictable income streams, often at levels of growth not achievable through the open market rent review mechanism

In summary, assets which are able to deliver durable income over the long term. It is Aberdeen's view that a portfolio adopting this style will earn higher returns, within a defined risk budget, in the longer term.

During periods of yield compression, a low risk portfolio will be likely to underperform as investors favour more risky assets. This will force yields on such assets down whilst ignoring lower risk properties, which are already yielding a lower income return. However, when the market cycle turns, it is Aberdeen's view that lower risk, more defensive stock will retain more value and will recover more quickly than higher yielding stock. The degree of outperformance at this stage in the cycle will generally more than compensate for the relative underperformance during the yield compression stage, thus providing a higher overall return over a long term cycle. This can be achieved whilst exposing the Fund to a lower degree of overall risk.

What should a core direct property portfolio look like?

Given the Pension Fund has a long term target to achieve a property return from the portfolio, we would recommend that the Fund should target the "core" portfolio ranges set out above.

With reference to the previous charts, we believe that a core direct property portfolio should have the following characteristics:

- Around 25 to 35 assets: sufficient to reduce risk in the fund but a manageable number where each asset can meaningfully contribute to the performance of the portfolio
- Low vacancy < 10% of estimated rental value
- Relatively long leases, averaging towards 10 years
- The largest asset not to represent more than 10% by value of the portfolio and the smallest not less than 2% (unless minimal asset management activity is required e.g. a long let supermarket)
- Good quality tenants
- An explicit degree of exposure to inflation index-linked leases
- No restrictions on location or sector. Good quality assets which will satisfy the fund's aims are not restricted to certain sectors or locations

- No UK indirect investment: we believe that a typical pension fund target can be met through direct ownership of assets so long as the fund is able to commit over £150m

Conclusion

From the two papers presented here, we would suggest the following lessons are relevant for the Pension Fund's portfolio:

(1) Property can offer a high and stable income return relative to other asset classes. The Aberdeen process favours holding a high percentage of core assets, those which can deliver a stable, durable income over the long term to capture this return.

(2) The capital return is much more volatile. Higher levels of volatility can be avoided by holding good quality assets. Such assets tend to offer lower volatility over the long term.

(3) The capital and total return from property have been less volatile than equities returns historically.

(4) Property can provide a degree of diversification to equities or bonds

(5) Property generally has not been an inflation hedge, but certain parts of the property market can be. Investment in properties with rent review mechanisms offering fixed increases or increases indexed to changes in the CPI/RPI can offer a degree of protection against inflation.

(6) The Aberdeen approach to investment in property reflects the general approach that Aberdeen adopts across all asset classes. The principles outlined in this paper are all designed to ensure we follow a process which does not allow distraction from long-term goals and that we invest on the basis of quality first, then price. As we can manage risk, but cannot manage market returns we must ensure that the client's approach to risk is understood and properly reflected in the structure of their portfolios.

(7) We believe that the Pension Fund should target a core portfolio structure, in line with the principles outlined in this paper.

We believe that application of this approach will lead the Pension Fund to earn higher returns, within a defined risk budget, in the longer term.