

# Is Property Set to Benefit from the Pension Fund Crisis?

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## **Introduction**

The European pension fund market is in crisis. The state run pension fund systems throughout Europe are struggling to cope, and demographic projections for the next 45 years means the situation will only deteriorate. More and more individuals are turning towards privately run pension fund schemes to support them in their old age, as the state system buckles under the weight of pensioners. The question arises: are companies and individuals doing enough to ensure a comfortable retirement? Pension funds are focusing on their long term liabilities in their investment style, and seeking asset classes to match. Real estate has proved to be a high yield asset class, coupled with offering investors an attractive risk/return profile, compared with the broader equities market. These characteristics fit well with the current liability-driven investment approach of pension funds. But how do pension funds invest?

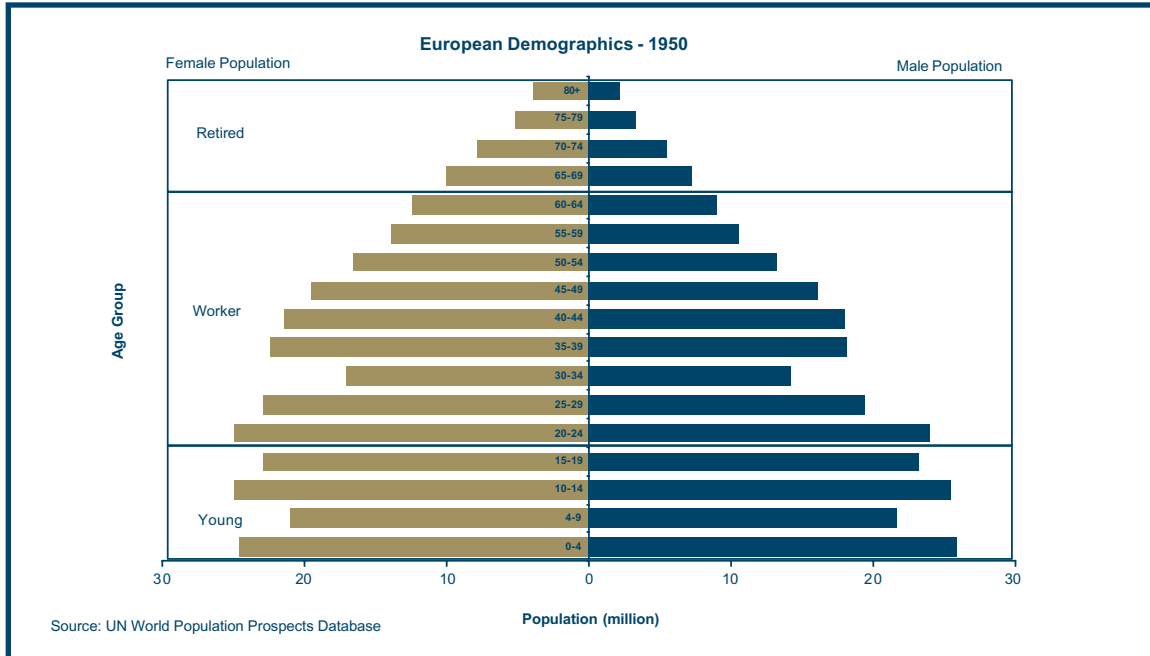
## **Demographics shift—Past, Present & Future**

It is widely discussed that populations in many of the mature economies around the world are aging. Western societies are aging for two reasons. Death rates are declining—people are living longer because of healthier lifestyles and better healthcare systems. In addition, birth rates are also declining. In Europe, on average, family sizes are decreasing. In summary, we are producing less children and living longer. Policy-makers and analysts are fully aware of the ‘time bomb’ waiting to cripple our social security system.

## **1950**

Graph 1 displays European demographics in 1950. The female population is highlighted in gold and the male population in blue. From an economic aspect, the graph is very healthy. We have a broad base of young people (the baby boomers) aged between 0-19 years, a healthy labor population aged between 20-64 years, which supports the narrow top layer of retirees aged 65+ years.

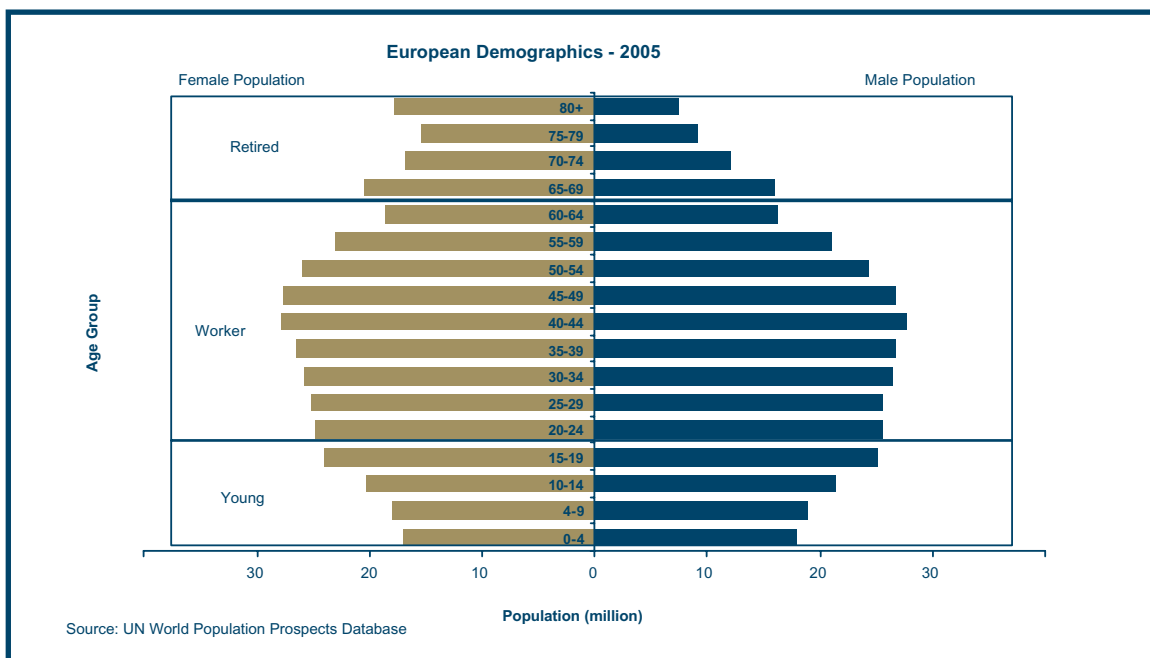
**Graph 1**



**2005**

Fifty-five years on, in 2005, the demographic picture looks a lot different (Graph 2). The broad base of the young in 1950 now comprises the rump of the worker population in 2005. The overall demographic picture is far more rounded. The young base is now narrower than the worker base, which obviously means there will be fewer workers in the future. Better healthcare and increased life expectancy has resulted in a broader retiree band, increasing pressure on the worker band to support them.

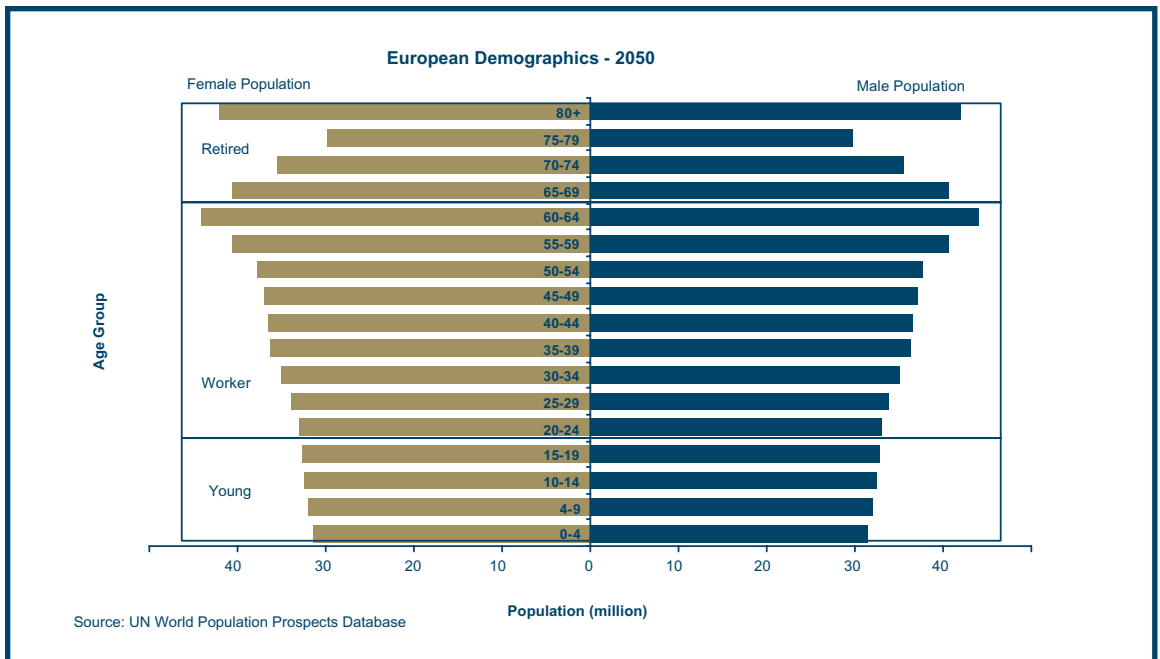
**Graph 2**



## 2050

Looking 45 years into the future, Graph 3 displays the European population estimates for 2050. Over the course of the 100 years analyzed, the demographics of Europe have almost been turned up-side-down. The retirees outnumber the young, and the aging worker band looks top heavy. The population distribution is top heavy, and as a consequence this will put incredible pressure on the worker base. In fact, the worker base is set to shrink further, as the young band narrows from 19 years down.

**Graph 3**



**Table 1 Demographics Overview**

	1950	1975	2005	2025	2050
Retired (65 +)	45m (8%)	77m (11%)	115m (16%)	148m (21%)	148m (24%)
Worker (20 - 64)	313m (57%)	382m (56%)	446m (62%)	415m (60%)	334m (55%)
Young (0 - 19)	189m (35%)	217m (32%)	163m (23%)	133m (19%)	129m (21%)
<b>Total</b>	<b>547m</b> <b>(100%)</b>	<b>676m</b> <b>(100%)</b>	<b>725m</b> <b>(100%)</b>	<b>696m</b> <b>(100%)</b>	<b>611m</b> <b>(100%)</b>

Source: UN World Population Prospects Database

## What does this mean for pensions?

According to United Nations figures (Table 1), in 1950, the number of workers outnumbered retirees by seven to one. By 1975, this figure was five to one, it is currently (2005) four to one, with projections indicating it will be three to one by 2025, and two to one by 2050. This poses enormous problems. So far, different EU members favor a range of strategies to tackle the problems. These strategies revolve around three options:

- closing ‘pay as you go’ financing gaps by increasing pension contributions,
- shifting to public pre-funding of pensions by running surpluses in the public pension system over the next two decades, and
- shifting to private pre-funding of pensions.

Resolving these tensions in a forward looking way would require more focus on the third option, that is starting to build up a private pension component now so that it will eventually help to compensate for the unavoidable future cutbacks in public pension benefits without pitting younger and older against each other.<sup>1</sup>

## European Private Pension Funds Landscape

The recognition by countries across Europe that they can no longer finance current levels of state pensions has resulted in countries paring back benefits as mentioned earlier. Consequently, the pressure is on individuals and companies to take up the slack. Historically low interest rates, stock market declines and a growing number of retirees, has led to a pension underfunding crisis that is threatening the future of the defined benefit pension plan system<sup>2</sup> in many parts of the world. There is a growing consensus that pension benefits of workers throughout Europe are at risk.

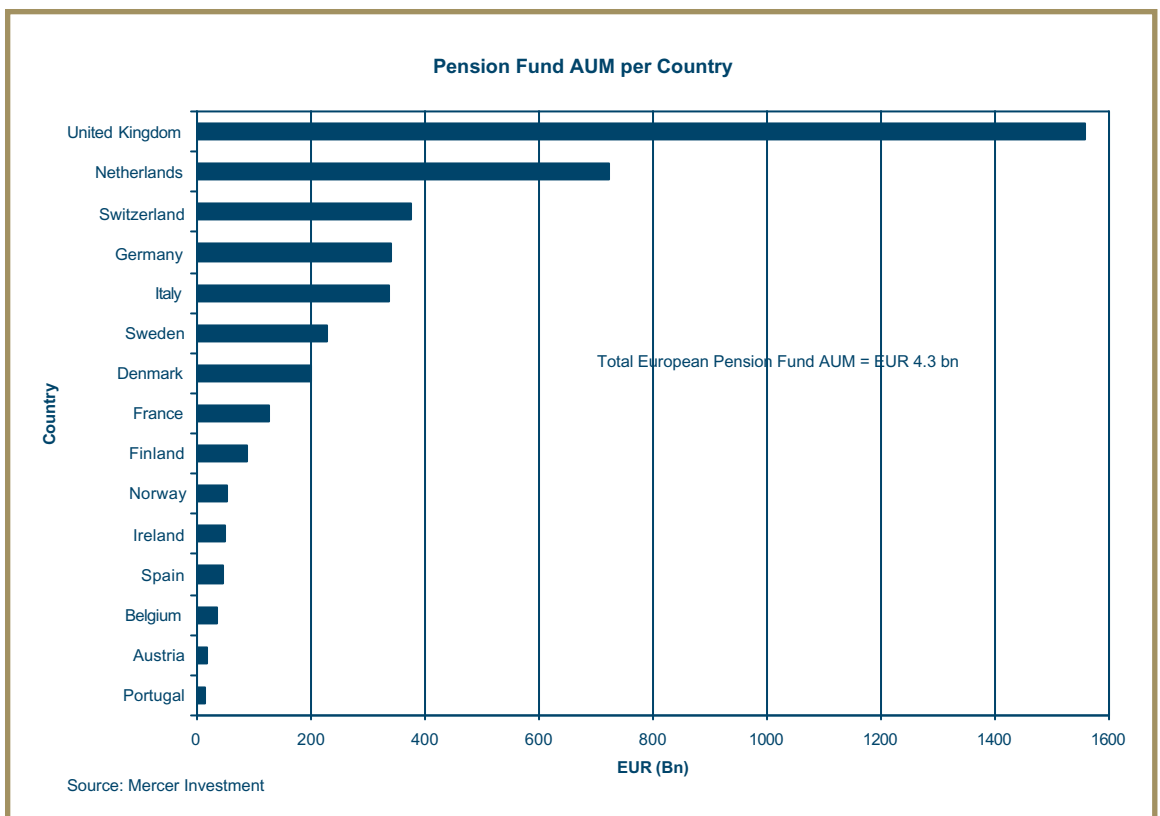
Table 2 displays the size of the private pension fund market in Europe. Total assets under management are approximately €4.3 trillion. The top 100 pension funds in Europe sit on assets valued at approximately €1.1 trillion, or a quarter of the total. The top 20 pension funds amass approximately €750 billion, with the largest pension fund in Europe, ABP of the Netherlands, just over the €150 billion mark. Looking at assets under management allocated to property investments, be it direct holdings, non-listed funds and listed property, the average is 6.5 percent.

**Table 2 European Pension Funds Overview**

	<u>Assets under Management (€ bn)</u>
Total Pension Fund Assets under Management in Europe	4,300
Top 100 European Pension Funds	1,100
Top 20 European Pension Funds	750
Largest European Pension Fund	150
Average European Pension Fund Property Allocation	<b>6.5%</b>

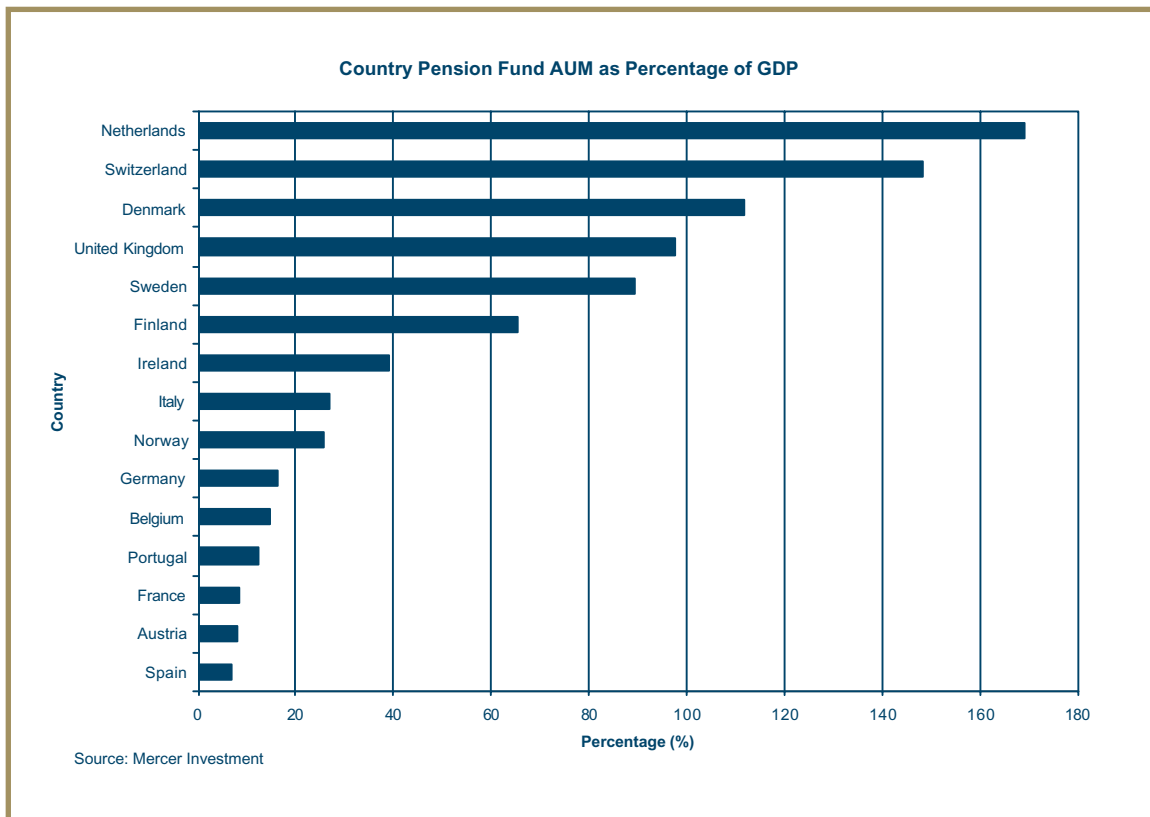
Graph 4 displays the assets under management in private pension funds in developed Europe, on a country basis. The United Kingdom is by far the largest market with just under €1.6 trillion under management. The Netherlands, second in the list, has approximately half this amount under management at approximately €700 billion. Switzerland hits third spot, with just under €400 billion under management. Not surprisingly, countries such as Germany, France and Italy that have historically provided very generous state pension plans to its retirees, are not well represented on the list. Remarkably, Spain, one of the largest countries in Europe in terms of economic power and population, lies in twelfth place, behind the small Scandinavian countries and Ireland.

**Graph 4**



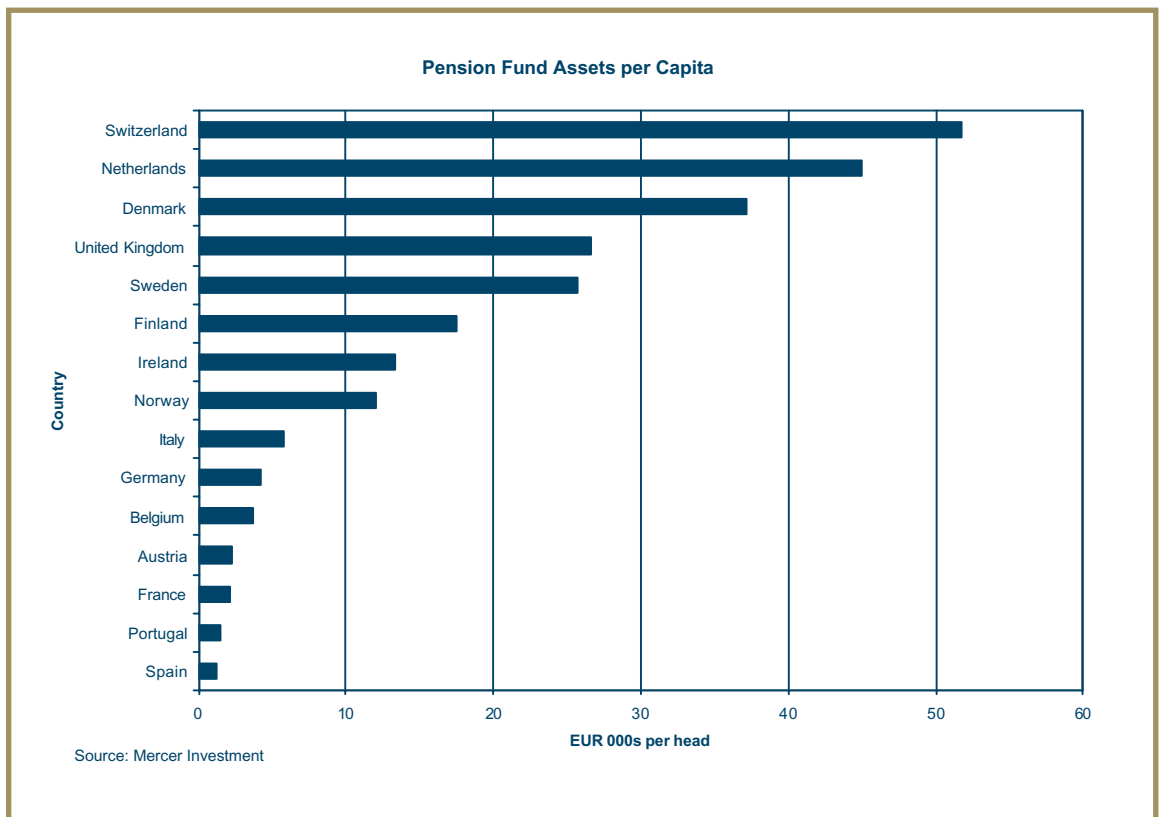
However, it is unfair to compare the countries in Europe by assets under management alone. Graph 5 compares assets under management against gross domestic product for each of the developed countries in Europe. Now the list looks very different. The Netherlands assets under management cover almost 170 percent of the county's GDP. Switzerland's figure is close to 150 percent, while Denmark is around 110 percent. The United Kingdom is just under 100 percent of GDP. Now the potential problems faced by Italy, Germany, France and Spain really become evident. Italy achieves just over 20 percent of GDP, but Germany, France and Spain all fall a long way short of the 20 percent mark. The combined population of the latter three countries is 180 million.

**Graph 5**



What does this mean on an individual basis in each of the developed countries in Europe? Graph 6 (on following page) takes the assets under management of each of the individual countries and divides by the total population. The figures highlighted are pension fund assets per head of population. The graph shifts again. Switzerland now heads the list with an average pension fund size €52,000 per head. Individuals in the Netherlands stand at €45,000 per capita, while the Danes hit €37,000. In the UK, the largest country for absolute assets under management, the figure is €26,000 per person. Incredibly, Italy, Germany, France and Spain all fall short of €10,000, by a long way. In fact, assets under management in France and Spain are under €2,000 per head.

Graph 6



It is clear that with state pension fund system set to change considerably in Europe to tackle demographic shifts, the onus will be placed in the laps of individuals and companies. However, looking at the current state of the private pension funds in Europe, even in the more wealthy countries highlighted in Graph 6, it is clear that the system is under-funded. In the UK, the Pensions Commission stated, “As private companies have limited access to generous pension plans, more than 12 million people in Britain—one-fifth of the population—are not saving enough for retirement.”<sup>3</sup> Unlike most of continental Europe, Britain has traditionally relied on its people to augment modest state pensions by saving for their old age through private and company pension funds. In recent years, pension funds have lost tax breaks worth some €8 billion a year, stock market declines have eroded portfolios and savings have given way to a huge surge in private debt, partly because of a booming housing market.

### Shift to Liability-Driven Management

Robert Hayes, head of Strategic Advice at Merrill Lynch Investment Management, believes that there are three major themes in pension fund investment at the moment.<sup>4</sup> Each of the themes aims to solve specific problems rather than provide sources of return. These three themes revolve around a liability-driven approach:

- use bond markets to match liabilities and reduce risk,
- re-examine equity mandates, considering the move to longer term, less constrained mandates, and

- search for additional alpha, through hedge fund investments, or portable alpha strategies.<sup>5</sup>

The move to a liability-driven approach means that pension fund advisors and investment managers need to take a holistic view of the pension fund to fully understand the problems. This requires changes to the nature of the relationship between the pension funds, consultants and investment managers. Key is the understanding of the pension fund's liability requirements.

### Added Value of Real Estate Investment <sup>6</sup>

Where does real estate fit into this liability-driven approach? The high yield focus of the property sector offers investors the necessary income stream enabling the matching of ongoing claims. In addition, low correlations with the broader equity and bond markets, provides diversification opportunities in a multi-asset portfolio. In summary, the risk/return benefits of listed real estate are:<sup>7</sup>

- enhanced diversification benefits,
- reducing correlation with stocks,
- superior risk-adjusted returns,
- strong added-value and risk-reduction benefits of property stocks in a mixed asset portfolio,
- focus on dividends, particularly REIT type structures, and
- higher REIT/LPT exposure generated greater portfolio wealth.

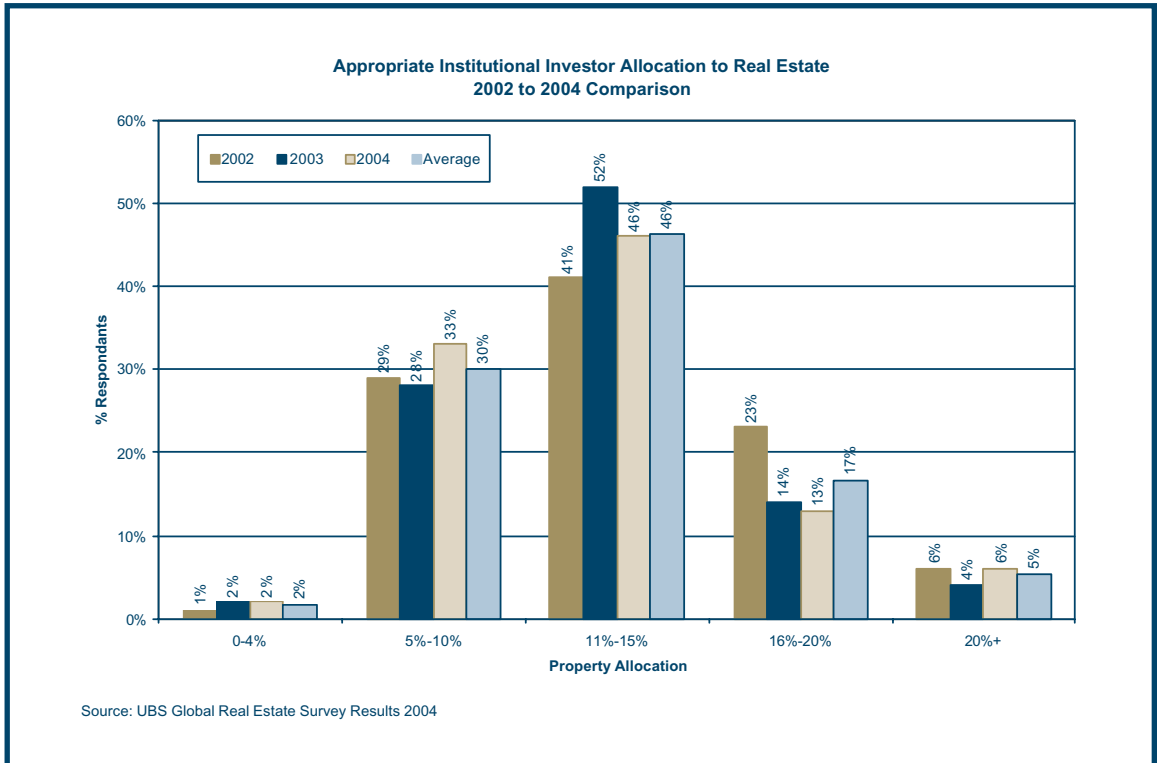
Table 3 highlights the benefits listed above of holding listed real estate portfolios over the period 1993-2003. It is clear from the table that including listed real estate in a multi-asset mix offered the investor a number of portfolio enhancements.

**Table 3 Benefits of Listed Real Estate**

Region	Superior Average Annual Return	Lower Annual Risk	Superior Risk-Adjusted Returns	Enhanced Portfolio Diversification Benefits	Superior Risk-Adjusted Portfolio Returns	Enhanced Portfolio Terminal Wealth
Global	✓		✓	✓	✓	✓
Europe	✓	✓	✓	✓	✓	✓
UK	✓		✓	✓	✓	✓
France	✓	✓	✓	✓	✓	✓
Netherlands		✓	✓	✓		

## Appropriate Allocations to Real Estate

Graph 7



Each year before the UBS Global Real Estate conference, UBS conducts a survey to gauge opinion on various aspects of the global real estate market. Graph 7 highlights the results to the question: what is the appropriate level of real estate for institutional investors in their portfolios? The graph shows the results for 2002, 2003 and 2004. The results are consistent over the course of the three year survey period. An average of the three years' results is also displayed. On average nearly 90 percent of the respondents believed that institutional investor allocations to real estate should be higher than the current European average of 6.5 percent; 30 percent felt that allocations should range between 5-10 percent; and nearly half cited an allocation range to property of 11-15 percent. In addition, when asked in which direction will property weightings move in 2005, 75 percent of the respondents thought property allocations would increase.<sup>8</sup> Based on the UBS survey, it is likely that institutional weightings to property will increase over time.

Nick Duff, a property specialist at consultant Hewitt Bacon & Woodrow's investment team, says the proportion of money a pension fund allocates to property depends of the profile of its liabilities and its consultant's attitude to the asset class. "We generally recommend a property allocation of 5-20 percent, so we're quite bullish. Our pension funds are looking to allocate around 10 percent in Europe."<sup>9</sup> A recent survey of 600 European pension funds by ING indicated that pension funds that currently invest in real estate expect to increase their allocations to over 10 percent.<sup>10</sup> Academic research places property allocations in the 6-20 percent range.<sup>11</sup>

## Potential Capital Inflows

If we see capital inflows into the market, what kind of figures are we talking about? Currently, with an average of 6.5 percent allocated to property, the total assets under management are approximately €280 billion. Table 4 displays a cumulative increase in the private European pension fund’s allocations in property, at one percent increases. On average, if European pension funds increased allocations to property just half a percent, approximately €22 billion would flow into the sector. If allocations increased to an average of 8 percent, a cumulative total of approximately €65 billion (the just under current market capitalization of the EPRA Europe Index) would need to find a home. If allocations hit the levels of the heady levels of the UBS survey, between 11-15 percent, capital inflows would be in the €200-350 billion range!

**Table 4 Potential Inflows**

Property Allocation	Property Assets under Management € (Bn)	Additional Investment € (Bn)
6.5% (current level)	280	–
7%	301	22
8%	344	65
9%	387	108
10%	430	151
11%	473	194
12%	516	237
13%	559	280
14%	602	323
15%	645	366

Source: Mercer Investment Consulting & EPRA Estimates

## Lack of Product

Increased investment from the pension funds is good news for the property sector, but the increased flow of capital introduces a new set of hurdles. There is increasing demand on the industry to provide investors with innovative property investment products. Nick Duff comments, “There is scope for funds of funds to be developed. If you’re a small pension fund it is difficult to get into the property sector because of the way it is structured—pro-rata it is expensive to invest. A fair bit needs to be done in the market to make property more liquid and maintain performance.” AXA Investment Management launched the EPRA EuroZone exchange traded fund in December 2004, with plans to launch a similar UK focused product in 2005. Bruno Guiot, head of EasyETF says, “the ETF series adds a number of flexible options for investors. For example, smaller pension funds, without in-house property expertise can gain cost effective diversified exposure to the sector in the form of tradable certificates.”

Protego Real Estate Investors, in conjunction with Barclays Capital, have recently launched a £170 million issue of Property Index Certificates (“PICs”). PICs are structured as Eurobonds which pay property linked returns set according to the IPD Annual Index. PICs are listed on the London Stock Exchange. Charles Weeks, a principal at Protego stated, “This is the largest public offering of a property derivative, based upon the IPD Annual Index series, to date. Following the recent regulatory changes as well as the clarification of the tax position of property derivatives, there are now no further structural impediments to a significant expansion of this marketplace.”

Robert Hayes, head of Strategic Advice at Merrill Lynch Investment Management, sums up the issue, “in a bid to match liabilities more closely, provide diversification and reduce risk, the demand for product innovation has rarely been higher.”<sup>12</sup>

### Conclusion

State pensions will cease as we currently know them. Europe recognizes that dramatic pension reforms are urgently required. Ultimately the onus will shift onto the private pension fund market, but that has its problems also. Contributions need to increase to provide comfortable levels of retirement for the retirees of the future. Therefore, growth of private pension fund industry is set to accelerate. The crisis has led pension fund managers to look towards a liability driven approach to management. Real estate investment fits a number of criteria in the liability driven approach, and this seems evident from the results of recent surveys, in which institutional investors envisage an increase in allocations to real estate. If allocations to real estate increase, the potential inflows could be significant. If the average allocation in Europe shifted from 6.5 percent to 8 percent, an additional €65 billion would flow into the sector. While this is good news for the sector, there still seems to be a lack of product available in investors. Developments in the derivatives market could offer investors interesting avenues to access the market, however corporate and governmental spin-offs could add supply at a fundamental level. ★

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*EPRA/NAREIT Global Real Estate Index series, and in conjunction with AXA Investment Management, he was instrumental in the creation of an exchange listed real estate derivatives market (ETFs) quoted on Euronext. He is a regular contributor to a broad range of publications, and a frequent speaker at real estate conferences. He holds a BA (Hons) in Finance and a MSc in Investment Management from City University, London.*





<sup>1</sup> “Can Europe afford to grow old?”—Alber Jaeger, IMF Finance & Development Report, June 2004

<sup>2</sup> Defined Benefit Plan—An employer-sponsored retirement plan for which retirement benefits are based on a formula indicating the exact benefit that one can expect upon retiring. Investment risk and portfolio management falls entirely under the control of the company. There are restrictions on when and how you can withdraw these funds without penalties.

This fund is different from many pension funds whose payout is somewhat dependent on the return of the invested funds. The payouts made to retiring employees participating in this defined benefit plan are determined by factors such as salary history and the duration of employment.

Defined Contribution Plan—A retirement plan wherein a certain amount or percentage of money is set aside each year for the benefit of the employee. There are restrictions as to when and how you can withdraw these funds without penalties.

There is no way to know how much the plan will ultimately give the employee upon retiring. The amount contributed is fixed, but the benefit is not.

<sup>3</sup> “Demographic time bomb ticks in Europe”—Alan Cowell, The New York Times, 27 November 2004

<sup>4</sup> ‘Learning from the past—Liability driven benchmarks’ by Jonathan Stapleton, Global Investor Magazine, July/August 2004.

<sup>5</sup> Portable alpha approach simply means that you can have a benchmark that pretty much matches your liabilities and then you can use your entire available risk budget to find sources of excess return from wherever you think they might be.

<sup>6</sup> This section is limited to listed real estate

<sup>7</sup> Diversification benefits of European Property Stocks, EPRA 2003 (period 1993-2003)

<sup>8</sup> UBS Global Property Survey 2004, page 8.

<sup>9</sup> ‘Property spans the pensions gap’—EuroProperty, November 2004.

<sup>10</sup> ‘The case for Real Estate’—Morgan Stanley research by Christian Schulte, November 2004.

<sup>11</sup> ‘Real Estate in the Institutional Portfolio, a comparison of suggested and actual weights’ by Hoesli, Lekander and Witkiewicz, indicate that optimal real estate weights for a portfolio is in the 15-20 percent range, and ‘The role of real estate in an institutional investor’s portfolio’, by Chun, Aadu and Shilling, suggest that optimal allocations to real estate lie in the 6-12 percent band.

<sup>12</sup> Learning from the past—Liability driven benchmark’s by Johathan Stapleton, Global Investor Magazine, July/August 2004