

UK Institutional Investment Strategy



PASSPORT
TO
BETTER PERFORMANCE

Introduction

Welcome to the St Bride's Managers UK Institutional Investment Strategy report in which we set out our views as to where, how much and what UK institutional investors should be investing in...and of course, why.

The world has changed. The UK has changed. Investment strategies that have been appropriate for the past 50 years are almost certainly now past their 'sell-by' date.

After the Second World War, the UK needed to re-build itself both economically and physically. We've done it and we now don't need any more offices or industrials or retail outlets. We have more than enough for the foreseeable future. Whether they are in the right place of course is subject to much debate!

On top of this, the world has just seen the arrival of the 7 billionth person. Substantial growth is projected across Africa, Latin America and Asia, whilst Europe is the only region showing negative growth. But more challenging is the fact that urban populations around the world are going to continue to increase dramatically over the next 35 years. The move towards urbanisation is also strongest away from Europe. These demographic changes, coupled with the growing strength of the emerging markets, will play a big role in the performance of property. In our view it is pretty obvious where property investment is most needed.

In light of all this, we at St Bride's Managers believe that some fresh thinking is required by our institutional investors and the whole 'where, what, how, when' conundrum needs to be re-addressed. Hanging on to traditional strategies and / or hugging inappropriate benchmarks will ultimately prove misguided.

Overseas Property Investment

Some UK institutional investors already have a global exposure to property. However not many have a meaningful exposure. Global mandates are common across other asset classes but not property which currently barely moves the dial. Overseas equities, for example, now represent over half of pension funds' share portfolios.

We believe this will change and that institutional property investment should take on much more of an international flavour over the coming years.

With overall weightings to the sector now averaging an absurdly low 7%, it would seem to us that this should be funded out of additional allocations to the sector.

World Population Growth

Region	Total Population 2014 millions	Total population 2050 millions	Urban population 2014 millions	Urban population 2050 millions	Urban Change %
Africa	1,138	2,393	455	1,339	194%
Asia	4,342	5,164	2,064	3,313	61%
Oceania	39	57	27	42	56%
Latin America	623	782	496	674	36%
North America	358	446	292	390	34%
Europe	743	709	545	581	7%
World	7,243	9,551	3,879	5,988	54%

Source: UN 2014 Revision

UK Pension Fund Weightings

	1970 (%)	1980 (%)	1990 (%)	2000 (%)	2013 (%)
Equities					
UK	50	46	52	48	16
Overseas	2	8	18	23	32
Total	52	54	70	71	46
Fixed Income					
UK	34	25	11	16	30
Overseas	0	0	2	4	4
Total	34	25	13	20	34
Property					
UK	10	17	9	5	6
Overseas	0	0	1	0	1
Total	10	17	10	5	7
Other / Cash	4	4	7	4	13
Total	100	100	100	100	100

Source: 1970-2000 UBS Pension Fund Indicators 2006
Hymans Robertson, The WM Company

So why go global?

Greater opportunity to diversify. Basic portfolio theory suggests that the broader the diversification the more stable the returns and the more diffused the risk.

Market inefficiencies. Some overseas markets are less efficient than our domestic market and provide better opportunities to add value through active management.

The world order is changing — property portfolios need to be rebalanced. Performance targets are often based upon historic benchmarks that are not relevant to the rapidly changing world economy.

Removes barriers constraining access to new stock. Opening up the markets that you invest in, allows for greater choice.

The case for investing globally is compelling. But where do you start?

The St Bride's World Cities Model

The world is a big place providing plenty of opportunities to invest in real estate. Our view is simple. You need to remain focused and understand the markets in which you are invested. To this end we have constructed the St Bride's World Cities Model. This identifies the cities – not countries – that we recommend for investment over the coming years. It is our aim to “de-mystify” overseas property investment and to encourage investors to focus on key cities rather than a catch-all countrywide approach.

The St Bride's World Cities Investment Model is a risk management tool designed to identify the most secure destinations for long term overseas investment. It does not seek to promote the prospects for property returns, but rather to offer a clear pathway for investors to achieve a controlled exposure to overseas investment.

The model is based around a series of themes which we have weighted according to importance: Constitution, Business, Property, Economy, Knowledge, Access, and Living. The selection of these themes provides a rounded picture of the issues that will be of concern to an international investor. Each of the themes is weighted in order to reflect the fact that some issues are more important to investors than others.

7 Themes to assess World Cities



Source: Ramidus / St Bride's Managers

The results of our research have London leading the list, followed by New York, Singapore, Tokyo and Paris. The 20 cities are spread around the 3 main investment regions.

St Bride's World Cities

St Bride's 20 World Cities (London = 100)		
Rank	City	Score
1	London	100
2	New York	99.4
3	Singapore	89.4
4	Tokyo	88.2
5	Paris	85.1
6	Hong Kong	85.1
7	Chicago	79.5
8	Los Angeles	79.3
9	San Francisco	78.6
10	Sydney	78.0
11	Toronto	76.7
12	Boston	76.0
13	Washington D.C.	75.1
14	Geneva	74.9
15	Amsterdam	74.6
16	Vancouver	73.6
17	Seoul	72.9
18	Melbourne	72.8
19	Stockholm	72.6
20	Berlin	72.5

Source: Ramidus / St Bride's Managers

For more information on the St Bride's World Cities Model please refer to our publication of May 2011 titled 'World Cities: Delivering Discipline to Global Property Investment'. A copy of this publication can be found on our website – www.stbridesmanagers.com

Including an allocation to St Bride's World Cities will change the structure of most UK institutional portfolios. We are recommending that a realistic target weighting for overseas property investment is 30-35% and in an ideal world this should come from a fresh allocation to property.

Investing in London

London topped the St Bride's ranking as the most secure destination for long-term investment. However UK institutions have historically been cautious about investing in their own Capital. This attitude needs to change.

The IPD Universe (All Property) Index shows a sharp decline in UK investors' holdings in London over the last 30 years from over 50% to barely a third today. This trend may reflect the fact that domestic investors have sold assets to overseas players – who do not contribute to IPD. Even more distressing is that most balanced funds have only between 10-20% of their assets located in the Capital.

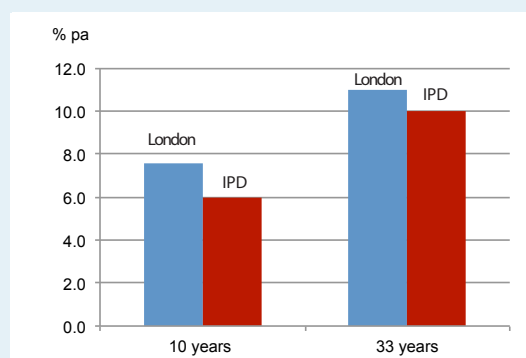
Concerns over volatility, pricing, performance and competition from overseas investors have been the principal historical deterrents. However, from a risk management standpoint, London features first or second in three of the seven risk management themes analysed in our research. Only New York, Singapore and Tokyo got anywhere near London.

London is the world leader in international finance and business services. It is at the heart of the world's financial markets and is a vital asset to the British and European economies. Financial and professional services generated a trade surplus of \$51 billion in 2012 and in 2011 the financial services industry accounted for 9.6% of UK GDP and 12% of UK tax receipts. London's total economic activity GVA is substantially higher than any other UK region, accounting for 22% of total UK GVA. Between 2010 and 2020 London is estimated to create 315,000 net new jobs.

London's population is also predicted to continue to grow robustly. In fact the majority of the UK's population growth over the next 20 years will be concentrated in London and the South East. The Capital's population is set to expand by 1.5m to top 9m by 2031. For investors, the positives of this population growth are huge. Population growth is the most fundamental and dynamic driver behind the real estate market. It increases demand for goods and services. More people inevitably mean more demand for housing, more jobs and therefore more demand for property, more retail spending and more shops, and more demand for social infrastructure, such as schools, colleges, universities and healthcare. Adding this many people to the city will create intense competition for land and is expected to drive strong performance in the future.

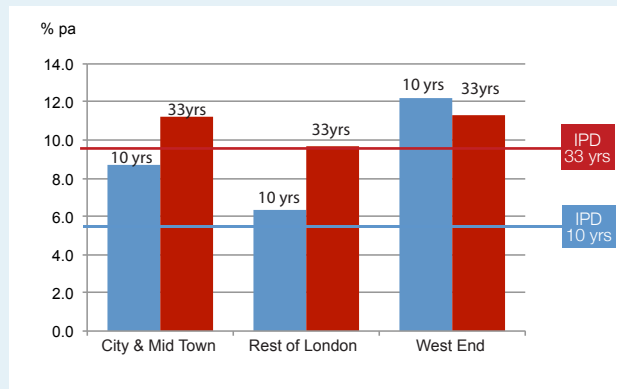
The perception of the performance of London's property market has consistently been negative but the statistics show that this perception is wrong. London has produced significantly better long term returns than the IPD average in the industrial and retail sectors over every time horizon. In fact, London Industrials have been the best performing industrial sub-market over the last 10 years by way of total returns.

London Industrial Total Returns



Source: IPD

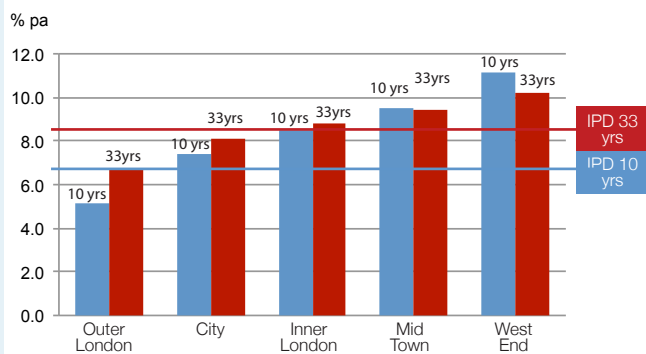
London Retail Total Returns



Source: IPD

The performance of the office sector has been more mixed. The West End and Mid-town have outperformed, whilst the City and Outer London have under-performed. However, if the IPD data is analysed more closely, one would see that out of the last 33 years, City Offices were either in the top three or bottom three sub-markets 21 times (66%). Therefore getting the timing right when investing is absolutely crucial.

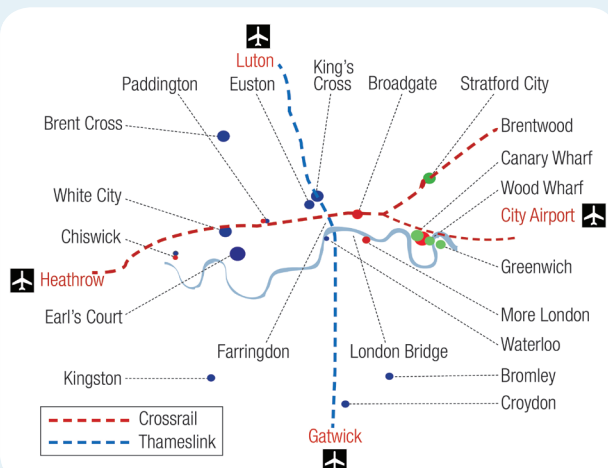
London Offices Total Returns



Source: IPD

A key feature of the London office market has been the cyclical nature of rents – rapid growth followed by rapid fall. However we envisage that the level of rental volatility will reduce as London becomes more polycentric.

Polycentric London



No longer is the London office market concentrated solely in the West End and the City. High quality schemes have emerged around the periphery of the historical core, in areas such as More London, Paddington and Regent's Place.

The shape of London will continue to evolve with the proposals for Battersea/Vauxhall, King's Cross and Earl's Court. These new emerging locations will take the sting out of rising rents and land prices and coupled with major infrastructure projects, such as Crossrail, will create interesting opportunities for investors in locations outside the traditional hubs.

Currently most investors simply focus on the West End or the City but we believe these new 'emerging' locations need to be considered.

For more information on London, please refer to our publication of September 2011 titled 'London – Number 1 World City' which can also be found on our website – www.stbridesmanagers.com

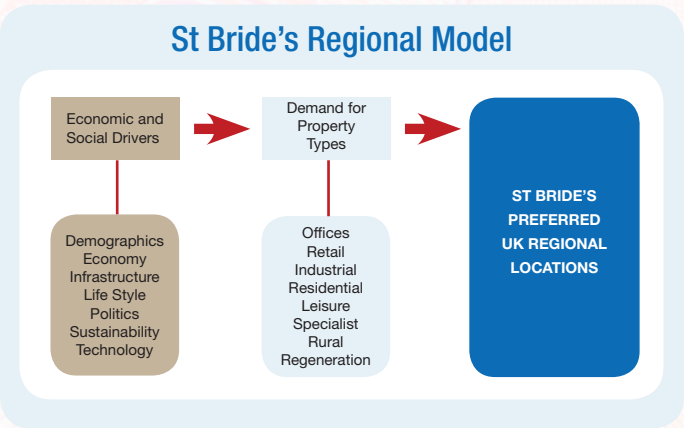
London, in our eyes, really is the place to invest. London offices, industrial, retail and residential all are worthy of investment but timing is key. As a consequence, we recommend a significant increase in UK institutional allocations to 30-35%.

Investing in the UK Regions

The average weighting of UK balanced funds to the UK regional markets is currently 81%. Given their broad economic, political and demographic prospects, we believe that this allocation is far too high! This weighting must be radically reduced, and now.

In order to allocate most effectively, investors need to understand what is going to happen to the UK's economy and society in the coming years. They also need to understand the underlying demand and supply trends that will influence future requirements for property.

With our research partners, Ramidus Consulting, we have identified our Top 20 UK Preferred Cities based on the economic and social drivers of the next 20 years.



As part of our research process we reviewed seven strategic demand drivers, namely:

- Demographics and economic trends.
- Infrastructure refers to proposals for projects that might change investment opportunities (such as Crossrail).
- Lifestyle refers to changing patterns of leisure and spending and to changing attitudes towards work.
- Politics is important due to the influence that both national and European decisions will have on demand for property.
- The Sustainability agenda is key in terms of its influence on jobs growth and investment in innovation in areas such as energy.
- Finally, Technology will continue to influence the nature of work and it is important to assess how the geography of jobs might shift.

With these demand drivers analysed and understood, the results can be overlaid across each of the principal asset classes to identify prospective winners and losers in terms of locations.

UK Preferred Regional Cities

In order to support a sector-by-sector analysis of long-term investment prospects, we measured and ranked 65 towns and cities according to 12 criteria (listed in the table below). The criteria were selected to help form a picture of each location's economic vitality and therefore its attractiveness as an investment proposition. We have termed the collective 12 criteria as 'our demand proxy'.

Demand Proxy Criteria	
Population size	Qualification levels
Forecast population growth	Business density
Gross value added	House prices
Finance and business services jobs	Commercial property stock
Job seekers	Office stock growth
Weekly pay	Rental growth

All of the centres have in excess of 100,000 people and have at least 12,000 Financial and Business Services jobs. Smaller towns and cities are deemed (in our eyes) to offer limited liquidity.

Each town and city was scored between 1 and 8 for each of the twelve criteria. Therefore the highest score a location could get is 96 (12 criteria x 8).

This approach, as with our World Cities Model, allows the results and tables generated to be updated on an 'as and when' basis if there are changes to the social, political or economic landscapes. This is also in keeping with our long term city approach rather than a 'catch-all' regional one.

Results

The top regional city is Edinburgh which performs well across all 12 of the criteria but particularly strongly in the GVA and House Price criteria.

Other notable trends to emerge from the results are as follows:

- 6 of the top 10 towns/cities are locations in the South East and which benefit from the strong economic links with London.
- 12 of the top 20 locations are situated outside the South East and there is therefore plenty of hope for towns/cities north of Watford Gap (contrary to the perception of Londoners!).
- Many of the larger, older industrial towns feature outside the top 20, but there are also some notable exceptions - Edinburgh, Cardiff, Leeds and Manchester.

We believe that this approach represents a useful screening tool for institutional investors but it absolutely should not replace detailed 'on the ground' analysis and research, not least into the supply pipeline. In short though, investing against historical benchmarks is no longer a sufficient approach. A more focused town/city approach is required.

We recommend a weighting of 30-35% is allocated to our Top 20 UK Preferred Regional Cities. This is significantly below current weightings and therefore, even though we acknowledge the high cost of transacting, this will inevitably necessitate radical portfolio reshaping.

St Bride's Top 20 UK Preferred Regional Cities

Ranking	City	Score
1	Edinburgh	100
2	St Albans	95.5
3	Windsor & Maidenhead	92.5
4=	Aberdeen	91.0
4=	Guildford	91.0
6=	Reigate / Gatwick	89.6
6=	Winchester	89.6
8	Cambridge	86.6
9	Milton Keynes	83.6
10=	Oxford	82.1

Ranking	City	Score
10=	Warwick	82.1
12=	Bracknell / Wokingham	80.6
12=	Bristol	80.6
12=	Leeds	80.6
12=	Warrington	80.6
16=	Cardiff	77.6
16=	Manchester	77.6
16=	Slough	77.6
16=	Solihull	77.6
16=	Basingstoke	77.6

Source: Ramidus / St Bride's Managers

The scoring system used to identify our Top 20 UK Preferred Regional Locations differs to the scoring system used in the St Bride's World Cities Model. Therefore like-for-like comparisons should not be made between our world cities and our UK regional locations.

Institutional Investment in Residential

Residential is a word that has historically sent shivers down the back of UK institutional investors and their respective fund managers. We accept that there used to be prohibitive legislation and pension fund trustees have never liked the idea of tenants phoning them up at the weekend when things went wrong. However the changes in political, economic and demographic trends have convinced us that it is madness for investors not to be investing in this sector.

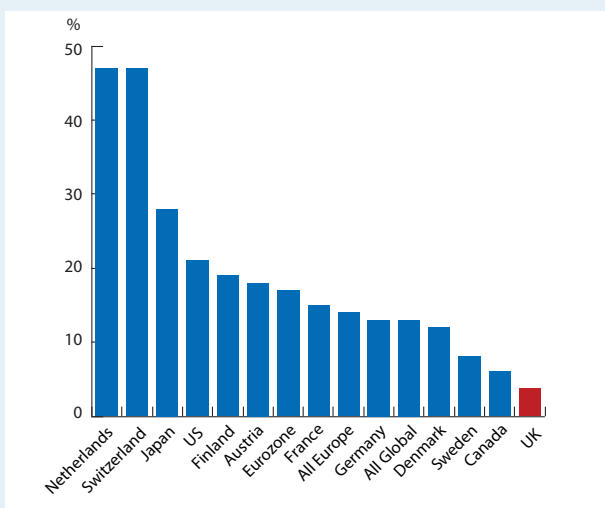
At St Bride's Managers we believe that residential needs to be embraced as a key asset class and that the erroneous myths that have plagued this sector historically must be dispelled once and for all. The time for investment is now.

Myth 1

The first common myth is that no-one else invests in residential. This could not be further from the truth.

Most other countries across the world have a significant institutional residential investment market. The IPD global average weighting is 13% and the All Europe Average is 14%. Some countries, like Switzerland and Netherlands, have nearly 50% of their total real estate investment portfolios (by value) in residential. The UK weighting figure is only at 3.8%, a ridiculously low figure that just has to change.

Institutional Residential Weightings



Source: IPD/KTI, 2010/2014

Myth 2

A second common myth is that the UK is currently experiencing a housing bubble. Rents and house prices should however hold up whilst the existing high demand / low supply ratio remains.

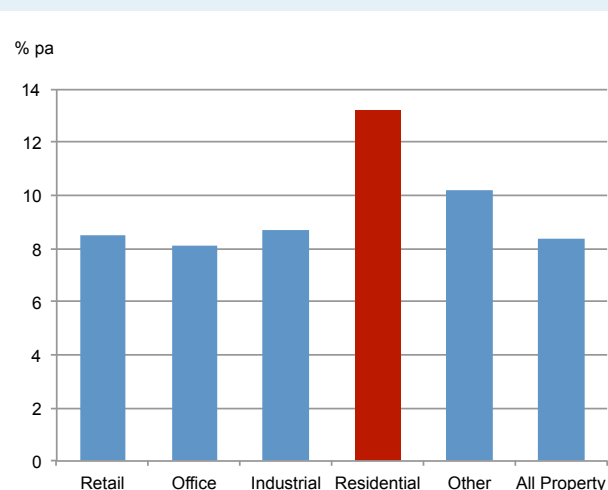
The UK is facing a growing housing crisis with an estimated shortfall of 750,000 homes by 2025. The largest shortfall (but the greatest demand) over the next 15 years is expected in London where land is at a premium.

On top of this, the UK is also anticipating significant population growth – an extra 9m people by 2037. We believe therefore that price and rental growth will continue given that demand is outstripping supply. Recent forecasts published by Savills suggest London will see 25% house price growth in the next five years.

Myth 3

A third common myth is that the Residential sector does not perform strongly. In fact, Residential has significantly outperformed the other sectors since IPD records began.

UK Property Total by Sector



Source: IPD

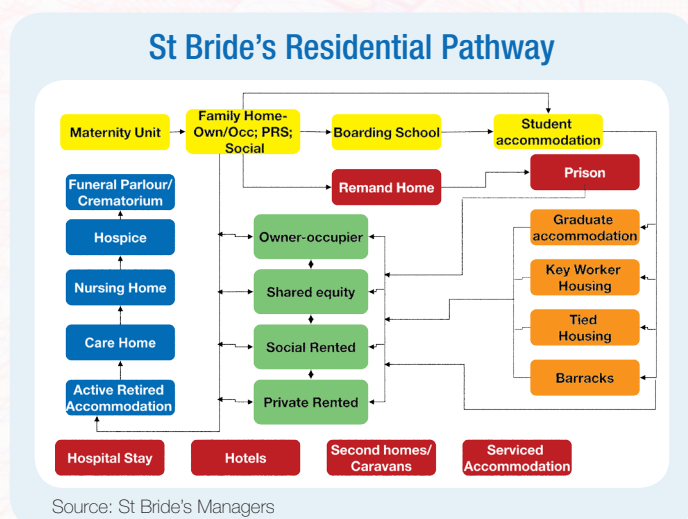
Myth 4

A further common argument institutional investors have used against investing in residential is that the leases in the sector are too short and that the income yield compared with commercial property is too low.

The average commercial lease in the UK is now 6.8 years, down from 8.7 years in 1999. Leases in the private rented residential sector are, on average, still significantly shorter than this such as, for example, one year in length for an Assured Shorthold Tenancy (AST).

With regards to income returns, historically commercial property provides a higher return than residential and has done so across every time horizon. However the gap between the two is closing. Furthermore, if the figures are analysed more closely, one can see that published commercial property rental data frequently fail to account for void periods and empty rates (as well as management costs) whereas net residential rents account for all these. If these voids and costs are correctly factored in then the income return for commercial property would fall by circa 10-15% ensuring that the difference between it and residential property is actually very small.

We believe that Residential is made up of many different sub-markets collated together. We have identified 25 residential places where ‘one rests one’s head’ on a cradle-to-grave basis. The list embraces both permanent homes and temporary accommodation. We have termed this the ‘St Bride’s Residential Pathway’.



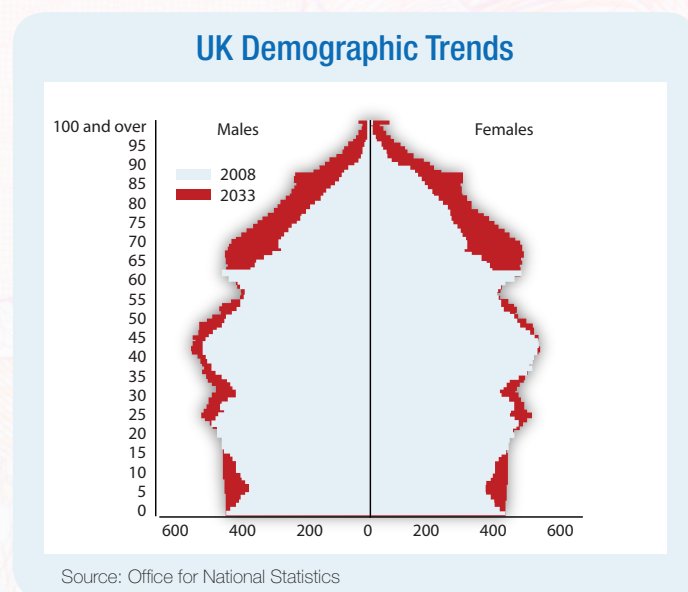
Across the top and down the right-hand side (in yellow and orange) are the accommodation options in the younger years of life, the later year options are in dark blue. At its core (in green) are four tenures that a person or family might occupy in their middle years whilst in red are the other accommodation options that an individual may require or desire during their lifetime.

Taking our residential pathway approach, we analysed where prime yields are for each of the residential sub-sectors, along with the most common/average length of lease granted.

A ‘blended’ residential portfolio can at least match the overall income and offer much better lease longevity delivered by commercial property. For instance, by combining 15% in ASTs and the remainder in ‘specialist’ residential assets, the average yield would be 6% and average length of leases of 19 years. If an investor held an exposure to ASTs of 20% (in equal measures in London and the regions) as part of a wider residential portfolio the blended income yield would be 5.5%, with an average lease length of approximately 15 years.

Whilst we strongly advocate an exposure to residential, caution needs to be applied when identifying which of the residential sub-sectors to invest in and when.

The age pyramid to 2033 shows that there will be some major bulges and pinch points in the coming years. We believe that investment and dis-investment decisions can be assisted by identifying these. For example, the age-cohort 18-20 year olds is projected to show no growth through to 2033. In fact, over the next ten years this age group is expected to fall in number by approximately 15%. This will have significant implications for the student accommodation sector.



We advocate that residential should represent a 15-20% allocation in a balanced UK portfolio and that this radical reshaping should start now.

Using Real Estate Securities

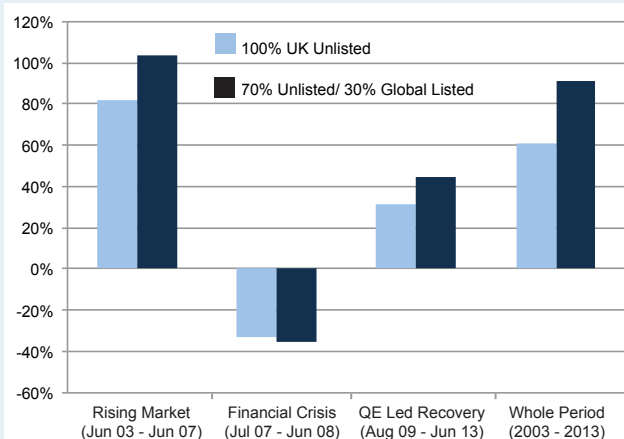
We recommend that up to 15% of a real estate allocation should be deployed in securities. Blending a securities exposure with direct investments will enhance the returns profile of a fund and make it easier to access some markets.

Many real estate markets around the world, particularly in the Asian gateway cities, are hard to penetrate by way of direct investment and in some cases buying the shares of property companies and REITs may be the only way to access the market.

Research has consistently shown that blending listed securities with direct investments and non-listed funds can enhance the returns of the real estate portfolio. The chart below shows the effect of a 30% allocation to securities within the real estate allocation. Through the long term-cycle it has a significant positive impact on returns and can be liquidated and invested daily if portfolio management requires it.

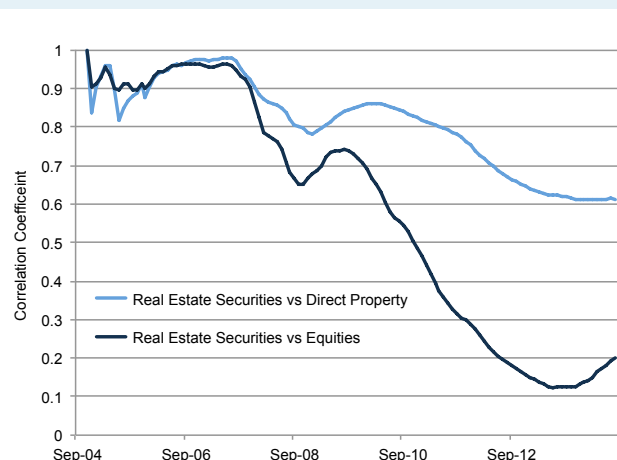
Dividend income makes up a significant portion of real estate securities' total return. In the case of Real Estate Investment Trusts boards are obliged to pass 90% of rental revenue to investors by way of dividends. The Global Developed Property indices typical yield is between 3-4%.

Total Returns through the Cycle



Source: Consilia Capital, Townsend, Bloomberg

Listed Securities are a good proxy for the direct property market



Source: St Bride's Managers, Thompson Reuters Datastream (FTSE 100, IPD, FTSE EPRA/NAREIT UK Index)

The case for investing in RES is clear - they offer strong returns, liquidity, access to hard-to-reach markets, income and diversification. But are they equities or real estate? A number of research studies support the intuitive assumption that returns from listed real estate companies mirror those of direct real estate investment - they derive their earnings wholly from real estate after all. Whilst, in the short term, RES behave like the wider equity universe, adjusting for pricing lags, they correlate closely with real estate. We believe therefore that investments in RES should be integrated with a wider real estate strategy and they form an important part of St Bride's world portfolio model.



Conclusions

We recognise that our recommendations are radically different from most current institutional weightings.

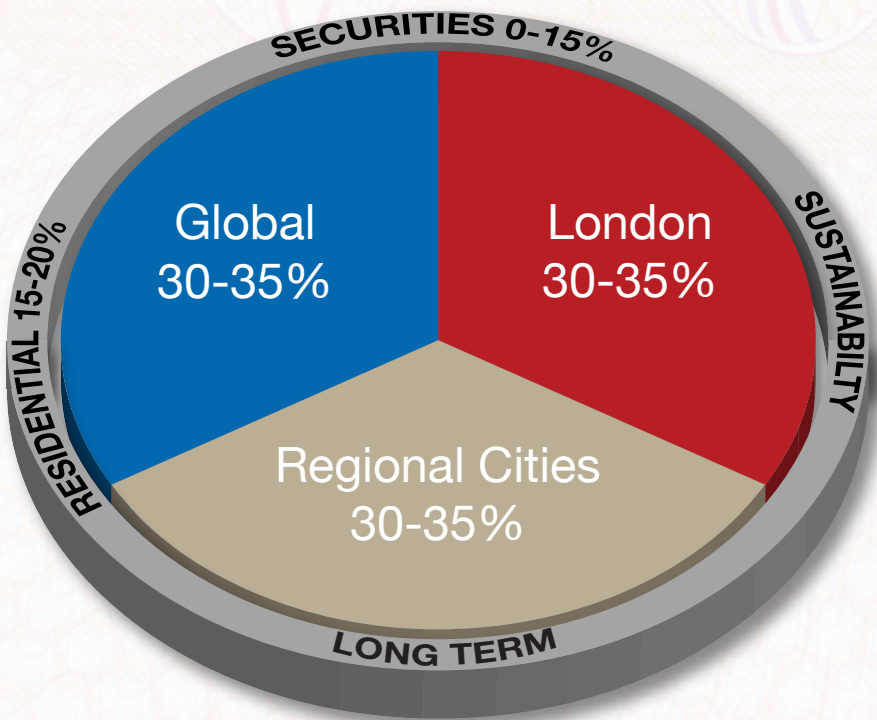
They may be unpalatable to many conservative investors who are comfortable with the status quo. Property has done well for investors in the past. However, we believe that a fresh look is needed now if property is to retain its position at the asset allocation table.

At St Bride's Managers our thinking can be summarised as follows:

- 1 **Property portfolios should be rebalanced.** They are based on historic benchmarks that are not relevant today.
- 2 **Current overseas weightings are too low.** Most UK institutions barely invest overseas. This should be increased to 30-35% and in an ideal world this should come from a fresh allocation to property.
- 3 **London ranks as the most secure destination for long-term property investment.** Here UK institutions have been cautious about investing in London. However they should have a weighting of 30-35%.

- 4 **The average weighting in UK balanced funds to the regional markets is 81%.** Given the broad economic, political and demographic prospects, this is far too high. Investors should allocate only 30-35% and then specifically to St Bride's Top 20 UK Preferred Cities.
- 5 **Residential.** The case for residential is compelling and we advocate an exposure of 15-20% in this sector.
- 6 **Listed securities and/or derivatives need to form part of an integrated investment strategy.** We believe an overlay of up to 15% is an appropriate amount.
- 7 **Sustainability and Corporate Social Responsibility.** Notwithstanding the pursuit of performance returns in this strategy, investors have an obligation to significantly improve their corporate social responsibility and approach to sustainability. Nowhere near enough is currently being done in these fields and future investment strategies should factor these issues into the decision making process.

St Bride's Managers Recommended UK Portfolio Weightings



Contact Details

St Bride's Managers

Contact Details

St Bride's Managers LLP

5 St Bride Street
London
EC4A 4AS
UK

T +44 (0)20 7078 1950

E robert.houston@stbridesmanagers.com

www.stbridesmanagers.com

St Bride's Global Alliance

St Bride's Managers LLC, Stamford, USA

E Richard Saunders - richard.saunders@stbridesmanagersus.com

T +1 203 905 6724

St Bride's Managers S.L, Madrid, Spain

E Angel Rodriguez - angelrodriguez@stbridesmanagers.es

T +34 91 395 2889

EG Funds Management, Sydney, Australia

E Michael Easson - mieasson@eg.com.au

T +61 (0)2 9220 7010

St Bride's Managers is a limited liability partnership registered in England and Wales, registration number OC350592, registered office 5 St Bride Street, London, EC4A 4AS. St Bride's Managers LLP is regulated and authorised by the Financial Conduct Authority. This document is only made available to professional clients and eligible counterparties, as defined by the FCA.

Disclaimer: This document is not intended to be distributed to or relied upon by other parties under any circumstances. This document does not create any legal or contractual obligation with St Bride's Managers LLP. The recipient agrees that this information shall remain strictly confidential. The prior consent of St Bride's Managers should be obtained prior to the disclosure of commercially sensitive information to a third party. Information reasonably deemed to be commercially sensitive and obtained from St Bride's Managers LLP should not be disclosed.