Forecast

Fund managers look to emulate success of core open-end funds in US

The launch of AXA CoRE Europe Fund this week is a sign of the times as investors look to diversify and seek out secure sources of income

BY ANDREW DON

AXA IM – Real Assets has joined a growing band of fund managers to have launched a core pan-European open-ended fund.

AXA said on Tuesday that it had raised €500m (£387m) for the AXA CoRE Europe Fund and was looking to grow it to €3bn-€5bn over the long term.

It is the latest in a series of fund managers to have targeted the space in recent years, including the likes of Schroders and M&G, and others are now planning to follow suit. TH Real Estate is launching its European Cities Fund imminently and Cornerstone is also believed to be close to launching a fund.

So why are so many managers pouring in now and what sort of growth prospects can their new funds expect?

The two key catalysts of the recent flurry of activity have been domestic market conditions and strong funding levels. Investors in North America, Asia or Australia have seen domestic returns slow at the same time as their allocations to real estate are growing.

"Many are looking to make allocations to Europe for diversification, and simply to deploy capital," says TH Real Estate fund manager Andrew Rich. "Core open-ended products with reliable managers are a great route to market for them in regions where they don't have on-the-ground expertise or large enough allocations to justify specific strategies."

Core funds – which employ low-risk strategies by focusing on well-let, high-quality property – are particularly attractive to pension funds and insurance companies. Such investors don't want to take big risks and are currently struggling to achieve the returns they need to match liabilities from bond investments because of low interest rates. They are looking for steady income over the long term and open-ended structures are a way to park money without having to worry about redeploying capital at the end of a fund's life.

"We believe the timing is good for prospective returns"

Tony Smedley, Schroder Real Estate

Searching for yield

Rainer Suter, fund leader for AXA CoRE Europe, says that in an environment in which institutional investors are continually searching for yield, core investment offering "visible long-term income is a compelling proposition".

There is currently "a big positive yield gap between bond and real estate yields", adds Tony Smedley, head of European real estate investment for Schroder Real Estate. "Fund managers naturally prefer to launch funds when the timing appears good for prospective returns. We believe the timing is good now."

There is still a view among some non-European investors that when investing in Europe, they should be targeting high returns to compensate for the risk implicit in investing in countries with different currencies to their own, although this is becoming less prevalent as more investors see the benefits of diversification by geography.

Pursuing higher-risk strategies also needs more monitoring and market understanding, which is hard for all but the biggest players.

Tall order: France's highest tower, Tour First in Paris La Défense, has been acquired for the AXA CoRE Europe Fund

"Opportunistic strategies would generally be a better fit for the biggest investors, who have the resource and ability to identify the right strategies and managers," says Rich. "Global investors who just want access to European real estate don't have this capacity, and look for sensible core strategies with stable established managers."

Fund managers frequently point to the US to illustrate the potential of pan-European core funds.

There are only about 15 truly pan-European core open-ended real estate funds as measured by the

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Top US funds

JP Morgan Asset Management	$28bn
UBS	$18bn
Prudential	$17bn
Morgan Stanley	$15bn
RREEF	$8bn

Source: NCREIF ODCE Index

IPD Pan-Europe Property Fund Index – which launched in March 2011 – and together they have close to €15.7bn of assets under management.

By contrast, in the US, which has a slightly smaller overall commercial real estate market than Europe, there are about 20 funds with more than $1bn (£703m) of assets under management, and some are substantially bigger than that. JP Morgan Asset Management is the largest, holding $27bn of property, followed by UBS ($18bn), Prudential ($16.4bn) and Morgan Stanley ($15bn).

The main reason the US funds are so much bigger is that they have been around for much longer. JP Morgan AM launched its fund in 1970, whereas in Europe the first funds only launched in the past decade, following the launch of the euro in 1999 – before then it would have been virtually impossible because of the risks associated with investing in so many different currencies.

However, there is now a widespread belief that Europe will start to catch up with the US.

"We are starting to build similar funds in Europe, and have been building a good track record since recovery for about five years," says Richard Everett, a managing director at CBRE Global Investors, which has one of the biggest and best-established pan-European core funds. "The longer this goes on, the more investment should flow into the core sector."

Rich is also bullish about the future, predicting "a universe of pan-European core open-ended funds totalling €50bn within 10 years," while Mark Clacy-Jones, MSCI vice-president and head of applied research for real estate, sees the potential for double the current number of funds in the next decade.

Barriers to growth

However, there are barriers to the market's development that may prevent the same number and diversity of funds launching in Europe as in the US. To build a credible platform, managers need to establish a presence on the ground in the main European markets. Relatively few managers have this today, and creating it from scratch is an expensive proposition.

The other difficulty for new entrants is building critical mass. Investors want to invest with larger funds because they are more likely to be able to take their money out when they need to.

"This may create a small group of larger core funds by a limited few institutional managers who can seize a position in the market, and this could act as a barrier to entry to smaller or newer entrants in the sector," says Steven Cowins, real estate partner at King & Wood Mallesons.

Furthermore, the web of different countries in Europe brings other challenges related to "the practical implications of building a network of people, with different languages, local tax rules and planning differences", says Tony Brown, chief investment officer at M&G Real Estate, which is behind the M&G European Property Fund and recently launched the M&G European Secured Property Income Fund.

One such challenge is on the investor side. European pension funds and other investors are conscious of duplicating their domestic market, but this can be unavoidable for fund managers. "When you are running a pan-European fund you are trying to appeal to all the investors, so what you can't do is exclude the Dutch market for Dutch investors and the German market for German investors to avoid duplication on their own portfolios," says Danny McHugh, head of continental real estate at Standard Life Investments.

However, judging by the size of AXA IM's initial capital raise, these challenges are far from insurmountable. Others do not seem to be unduly worried either. With investor demand for core pan-European strategies growing, 2016 could well be the year the US phenomenon crosses the pond and takes off in Europe. ■