

# Briefing Paper for F&P Sub Committee

## HDC Property Investment Fund: Performance Measures

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### 1.0 HDC objectives

HDC uses the income from its property portfolio to support revenue and to finance other Council activities. The portfolio presently delivers a net income of c£2.5m with a capital value of c£34m and a yield of c7.3%.

Current performance measures are: net income; the percentage of vacant property; and the target yield for new investments. These are simple metrics and do not convey the fund's overall performance because they do not measure total returns.

### 2.0 Total Return

Total return is the sum of the net income return and the capital return, which is the change in capital value over the period being measured.

Capital returns can be influenced by the movement in yields in the market, good stock selection and by active management to improve income and income security.

Performance measurement is the measurement of the total return on an absolute or relative basis.

### 3.0 Absolute and Relative Return Objectives

An **absolute return** target is a quantified total return over a period of time, such as *'to deliver a 5% real return after costs'*. Absolute return targets can be set to reflect the fund objective, for example, the underlying objective of a pension fund may be to achieve a target rate of return, after fees and costs, for a low risk; so the fund can meet its pension obligations.

The problem with an absolute return target is that dissatisfaction can arise when the market booms or crashes. An investor may not be happy with a 5% return if the market is delivering 20% and similarly portfolio managers will feel aggrieved if they are blamed for failure to achieve return targets made impossible because of a market slump.

To give investors comfort, property investment has moved towards **relative return** targets, which measure the performance of the fund against other funds. This allows investors to compare the performance between funds and to decide where they should invest their money.

Relative returns are measured against a benchmark of similar funds. It follows that if the index is volatile then a stable fund would have high volatility relative to the index.

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#### **4.0 Fund Management Portfolio Structure**

To perform in line with a relative return target, the benchmark would need to be considered when structuring the portfolio, to achieve a neutral position. When making purchasing decisions, the manager will take into account target rates of return relative to the benchmark and whether the structure of the portfolio is in line with the benchmark.

For an absolute return target the starting position would be an understanding of the neutral position, with different weighting positions taken depending on the attractiveness of market pricing.

#### **5.0 HDC's Portfolio Structure**

HDC's portfolio is small and was assembled over time, without an investment strategy. Most properties were retained from opportunistic direct developments.

The portfolio has a number of characteristics:

1. Geographic: The properties are all in Horsham District.
2. Sector imbalance: For example, there is a high percentage of health care – 24% of capital value.
3. The portfolio is high yielding, with an income of c7.3% compared to IPD<sup>1</sup> of 5.5% (April 2016).

The scope to change the portfolio structure is determined by the operational parameters of the fund and HDC investment objectives, which include:

1. Geographic factors – whether the fund should operate exclusively within Horsham District.
2. The amount of new money allocated to property.
3. The reality that large value markets, with large lot sizes, cannot be accessed by a small fund.
4. Timing – selling and buying takes time.
5. The degree to which it is practical or desirable to sell and the effect of transaction costs on performance.

#### **6.0 HDC Performance Measurement**

HDC does not report fund performance over time to show how the existing portfolio has performed and how it has performed relative to other assets such as equities and gilts.

In view of the fund's characteristics and because the fund is small, it is unlikely that an appropriate benchmark could be found or established, against which performance can be measured.

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<sup>1</sup> Investment Property Databank

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In the absence of an appropriate benchmark and because the portfolio is small, and therefore has individual property risk which cannot be diversified, a good approach to performance measurement would be to create a detailed annual performance report. The performance report can provide a commentary on the market, the portfolio as whole and on individual properties.

This could include the following:

1. A brief overview of the property investment market.
2. HDC property fund performance for the previous 12 months, including income return, income growth, capital return and capital growth.
3. Sector weighting with any relevant comments and/or analysis.
4. Portfolio Characteristics. This would include basic statistics such as capital value, number of properties, average lot size, un-invested cash, initial yield, equivalent yield, weighted average unexpired lease term, vacancy ratio and key tenancies.
5. A brief commentary on each property, including new purchases, with a report on what has happened during the previous 12 months.
6. An assessment of how the returns compare with returns from equities and gilts.

This would provide the level of information that would be expected by an investor in a small fund in the private sector.

A simplified benchmark report could be created for the year ending 31<sup>st</sup> March 2016, with a comprehensive report prepared for the year ending 31<sup>st</sup> March 2017.

## **7.0 Targets and parameters**

If performance targets are to be set, these would need to be appropriate to the parameters and investment objectives of the portfolio.

Brian Elliott  
30<sup>th</sup> October 2016