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Commercial Real Estate and the Managed Funds Industry

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Foreword by Stuart Johnson, Chief Economist

Commercial real estate (CRE) has become an important alternative asset class for fund managers, and has come to be seen as a relatively low-risk investment option within a diversified portfolio. However, last year the global CRE market started to show signs of stress. Increased interest rates and changes in usage patterns driven by the COVID-19 pandemic, especially around second-tier office buildings and retail investments, were driving down valuations. By early 2024, transaction volumes had decreased, causing some overseas real estate funds to limit or suspend redemptions. This situation can be challenging for investors unable to access their money.

In New Zealand, KiwiSaver funds are particularly important because of the large number of New Zealanders who entrust their retirement savings to fund managers. In considering this issue, we were most concerned about retirees or those on the cusp of retirement potentially being unable to access a proportion of their retirement savings due to redemption limits or suspensions. We also had a similar interest regarding access to funds for first home buyers looking to withdraw part of their KiwiSaver to purchase a home.

We are less concerned about the decreasing asset valuations in CRE. In a well-diversified portfolio some investments will rise, while others fall. Decreasing investment values are not in themselves a conduct risk. But poor diversification or poor communication of the potential investment risks certainly are conduct concerns.

In May/June 2024, we spoke to ten fund managers about CRE investment, including the role of this asset class in their overall investment strategy, their recent performance, and their approach to risk management. These conversations have been largely reassuring. Based on the information that fund managers shared with us, most have good practices in place to identify and manage the risks across their CRE positions. Most fund managers have taken a conservative approach to CRE investments, and the majority of managers reported being underweight in the sector against their investment philosophy. In most cases the risk to New Zealand investors seems to be recognised and reasonably moderate.

However, fund managers should not just be aiming for “good enough”, and there are several areas where some firms could look to improve their risk management practices. These include: overreliance on the listed nature of CRE and other assets for managing liquidity risk; inaccurate and infrequent valuation of CRE positions; and high exposure to unlisted REITs without a good understanding of their leverage and funding situations. A greater focus on these issues, along with good communication between managers and customers – particularly those nearing redemption – would provide greater confidence that fund managers are well-equipped to understand and manage risk.

Providers often tell us they want to know what is happening across the industry. We hope they find this report helpful in understanding some high-level themes across the industry and specifically our comments on risk management in section 4. While these findings relate specifically to CRE, the discussion of liquidity, valuation and communication risks and how to manage them is relevant to all investment classes.

Executive summary

Commercial real estate (CRE) has become an increasingly important asset class in the past few decades. Its ability to provide both steady income and growth potential makes it well suited to a diversified investment portfolio. However, interest rate rises and the changing nature of working and shopping have caused major downturns in many overseas CRE markets, with severe refinancing stress and significant falls in asset values. This, combined with the assets' illiquid nature, has forced some overseas funds to temporarily suspend or limit withdrawals.

In this context, and after discussions with international financial regulators, the FMA consider we should increase our understanding of the exposure of New Zealand managed funds and KiwiSaver to CRE in order to better understand the risks in the New Zealand context. Using a combination of desk research and focused interviews with fund managers, this paper examines the exposure of New Zealand investment funds to CRE and how that exposure might impact customers. It also considers how fund managers manage the key risks associated with CRE and communicate those risks to customers.

Our discussions with fund managers were largely reassuring. We heard many examples of good practices around risk management. However, some still have work to do. In section 4, we discuss both the good practices and potential areas for improvement, focusing on the management of liquidity risk, valuation risk and the communication of risk to customers, especially those who are expected to redeem soon for retirement or to purchase their first home.

Despite the issues with CRE and managed funds overseas, this report should provide KiwiSaver customers some comfort that they are unlikely to face such challenges here. Overall, most of the exposure to CRE in New Zealand is through listed real estate funds, also known as real estate investment trusts (REITs), which are publicly traded on the market. Decreases in the value of CRE investments are common due to the market downturn. The fund managers we spoke to have no major concerns about these decreases, as REITs' portfolios are generally well-diversified. For example, the performance of prime/A-grade office space or subsectors such as data centres and logistics was able to counteract the downturn in other parts of the sector (notably B/C-grade office space, which is the most affected type of CRE so far). However, we are also aware that many CRE investments (both internationally and domestically) will need debt refinancing in the next 2-3 years, and this may negatively impact the investment value given the situation with the debt markets.

Losses in value are not the only type of risk that fund managers should worry about. Liquidity can also be a material concern, especially for funds with significant holdings in a single REIT. Even if the loss in value is well-contained, a related liquidity issue (such as a trading halt in one REIT) could severely affect a fund manager's holding. Liquidity risks can be amplified by concentration in a single subsector or location. For our local funds, while most of the underlying assets are in New Zealand and Australia, portfolios are also exposed to the US, European or Asian markets on a look-through basis. Due to potential differences in how REITs operate in these markets, it is important that fund managers fully understand the risks and manage them well.

Some funds also have investments in unlisted REITs. These come with a different set of risks, and it is important that these risks are properly communicated to customers. Liquidity risk associated with unlisted funds can be heightened as these units are not publicly traded, meaning funds may struggle to find buyers willing to transact at a given price. Concentration and leverage risks are also relevant as unlisted funds usually have single-class, single-asset portfolios, high gearing ratios, and limited alternative funding options. Asset valuation can also be an issue due to the low level of market transactions during a downturn. Fund managers should pay close

attention to examples of overseas unlisted funds struggling to meet redemption due to cash flow or valuation issues.

1. Introduction

Commercial real estate (CRE), at a high level, consists of four main categories: office, retail, industrial and multifamily. While some of the assets can be used for residential purposes (e.g. multifamily), CRE as a financial asset class is quite different from the owner-occupied, mortgage-supported residential real estate sector, which receives significant attention in New Zealand. Over the past few decades, CRE has become an increasingly important type of alternative investment for fund managers. Its ability to provide both steady income and growth potential makes it well suited to a diversified investment portfolio. However, interest rate rises and the changing nature of working and shopping have caused major downturns in many overseas CRE markets, with severe refinancing stress and significant falls in asset values. This, combined with the assets' illiquid nature, has forced some overseas funds to temporarily suspend or limit withdrawals.

In this context, and after discussions with international financial regulators, the FMA was concerned this may become an issue for the New Zealand managed funds and KiwiSaver industry. Using a combination of desk research and focused interviews with fund managers, this paper examines the exposure of New Zealand investment funds to CRE and how that exposure might impact customers. We also want to understand how fund managers manage the key risks associated with CRE and how they communicate those risks to customers.

This report sets out the findings from these discussions. The next part of section 1 provides some background information on the importance of CRE as an alternative investment class and a summary of the current CRE market conditions overseas and in New Zealand. Section 2 describes the FMA's approach to producing this report. Section 3 talks about the exposure of New Zealand's managed funds and KiwiSaver industry to CRE, how CRE as an asset class has performed over time, and fund managers' outlook for the future. Section 4 includes discussions of the key risks associated with CRE investments and how fund managers identify and manage them both in normal times and under challenging market conditions. Section 5 concludes and provides a summary of the good practices we have seen and areas where we think improvements are needed.

1.1 Commercial real estate as an alternative asset class

CRE has long been a positive asset class for fund managers looking to build a balanced, well-diversified portfolio. There are many reasons why investors choose to invest in CRE. CRE investments can provide a steady source of income as business leases tend to be long-term, tenants are professional, and rents are inflation-linked. It can also be a good source of diversification against more traditional assets such as equities due to the lower volatility, lower correlation with other assets (JLL, 2024), and ability to provide inflation-hedging options (Luby et al., 2023). According to Preqin – a UK-based data company specialising in alternative asset markets – since the Global Financial Crisis (GFC), CRE has become increasingly popular among institutional investor funds. From 2010 to 2020, the number of public and private pension funds with investments in CRE has nearly doubled, while the average fund under management (FUM) allocation has grown from 7% to nearly 10% (The Economist, 2020).

REITs dominate the CRE market.[1] These funds raise capital from retail and institutional investors and combine it with debts from banks or other (non-bank) financial institutions (e.g. investment funds, insurance companies) to acquire commercial real estate. They are also in charge of finding suitable tenants, maintaining the buildings, collecting rents and paying out dividends to investors. They can be listed or unlisted. Examples of some of the largest REITs in the world include Blackstone REIT (BREIT) and Starwood REIT (SREIT), which are run by private equity firms.

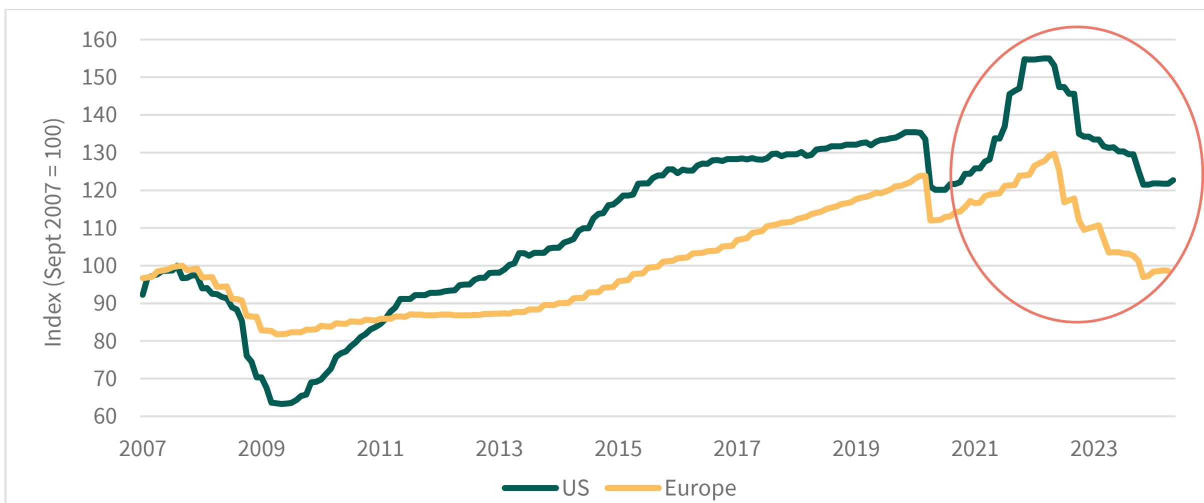
CRE investments come with risks (like all investments), including concentration, liquidity, valuation, and leverage risk. Some of these are more relevant and require closer attention from fund managers than others during a market downturn. A more detailed discussion of these risks and how New Zealand managed funds identify and mitigate them can be found in section 4.

1.2 What's going on in the commercial real estate market?

Overseas

Since 2023, many CRE markets overseas have been going through major downturns due to sharp, consecutive increases in interest rates and the growing trends for working from home and online shopping. In the US and Europe, asset values have dropped nearly 20% since the 2021 peak as REITs face growing vacancy rates and low yields (Figure 1). Of the four subsectors, office and retail have performed very poorly, while industrial and multifamily have managed to hold up well (CoStar, 2024). The volume of delinquent (non-performing) loans is at a 10-year high. Around US$2tn of CRE loans are due to be refixed in the next three years onto much higher interest rates, sometimes double the previous levels. It is estimated that around one-third of these loans are potentially troubled (Oliver, 2024). Refinancing of CRE debts, especially the distressed ones, is also increasingly done through private lenders as banks have started to require the infusion of additional capital when negotiating loan terms (Ramakrishnan, 2023). This can significantly add to the borrowing costs.

Figure 1: Values of CRE asset in US and Europe over time



Source: Green Street Advisors Commercial Property Price Index

[1] See Appendix Figure 1 for more details on how retail investors may be exposed to CRE through REITs.

Because of the challenging market conditions, some overseas funds are now experiencing funds deferral. For example, Starwood REIT – one of the largest in the world with a US$10bn portfolio – has recently introduced new monthly withdrawal limits of 0.33% of net asset value (NAV), compared to the previous 2%, as they are running low on credit facilities to meet redemption demands (Gara and McCrum, 2024). Blackstone REIT, which manages a US$60bn portfolio, has been facing similar pressures since 2022, and in February 2024 managed to meet 100% of redemption requests for the first time in 16 months (Gara, 2024; Gara and Indap, 2022). Pension funds can also face similarly elevated redemption risks through both their self-run real estate funds and holdings in REITs.

In the US, CRE direct loans are more concentrated in regional, second-tier banks than in large, systemically important banks. However, according to the Federal Reserve Board (2023, 2024), it is still possible that a downturn in the CRE market may lead to instability in the financial system if the number of affected banks is large enough. Some academics also share this concern. Jiang et al. (2023) showed that about 14% of all CRE loans and 44% of office loans in the US are in “negative equity”. This led to their conclusion that CRE distress can create bank run risks for anywhere from 12 to over 300 mainly regional banks in the US.

CRE risks also go beyond direct loans. Acharya et al. (2024) pointed out that large banks also provide REITs with guaranteed credit lines to help with cash flow issues. During stress, these facilities can be used extensively, which can create risks to banks’ capital positions. Increasing ties between the traditional banking sector and the shadow banking sector (which includes non-bank institutions like hedge funds, insurance providers and private credit lenders, and has become an important funding source for CRE recently) also add to the risk (Gandel, 2024; Arroyo and Sage, 2023).

New Zealand

The New Zealand CRE market is also showing signs of a downturn, albeit to a lesser extent than larger markets overseas. The non-performing New Zealand bank loan ratio for CRE has doubled from 0.6% to 1.2%, rising at a faster rate than other loan types (Appendix Figure 2). This implies there may be risks to people’s investments, especially those nearing redemption. There is also potential for global stress to spill over to the New Zealand market as global CRE prices have become more correlated since the GFC (Hilbers, 2020). At present, the issues are more individual than systemic, and the Reserve Bank of New Zealand (2023, 2024) thinks the current level of CRE stress is unlikely to cause issues for the overall stability of the financial system.

While major New Zealand-listed real estate funds have managed to respond to these risks through asset consolidation, some unlisted funds are now facing trouble meeting redemption requests and are having to introduce suspensions on withdrawals. Typical reasons for that include having to offload assets first to reduce debt and financing costs. Another reason is a struggle to maintain funding from banks due to issues around covenants, including making guaranteed monthly principal payments or retaining key tenants.

2. Our approach to producing this report

Our concerns about the potential issues facing CRE investments and funds redemption arose through discussions with several international financial regulators and observing the downturn in many overseas CRE markets. We decided to investigate this issue further in the context of the New Zealand managed fund and KiwiSaver industry.

In May/June 2024, we spoke to ten fund managers about their CRE investments, including both default and non-default funds and funds of different sizes. These discussions covered four broad areas:

- Overall investment strategy and the role played by CRE investments.
- Current CRE holdings and how these investments are performing.
- Approach to risk management of CRE.
- The suitability of CRE investments for KiwiSaver across the life cycle.

For the purposes of this report, we have taken the information firms provided in these interviews at face value and have not attempted to verify by requesting further supporting documents.

3. Commercial real estate in New Zealand's managed funds and KiwiSaver

3.1 Investment strategy and exposure

Most of the fund managers we interviewed consider CRE to be a key part of their investment strategy, both as short-term income-generating and long-term capital-growth assets. They also consider CRE a good source of diversification against listed equities and bonds. CRE investments usually take the form of holdings in listed or unlisted REITs or funds of funds with REITs holdings. Some funds self-manage their CRE portfolio while others outsource to third-party firms. On a look-through basis, several funds also hold shares in listed overseas REITs as part of their equity portfolio, or in New Zealand REITs' corporate bonds as part of their fixed interest portfolio. Other indirect exposure to CRE includes US Commercial Mortgage-Backed Securities (CMBS); however, this is rare.

As of December 2023, KiwiSaver funds allocate around 3.2% of their over NZ$100bn portfolio to CRE, of which 2.6% is listed and 0.6% is unlisted. This allocation is relatively low compared to other growth assets and falls below the average target allocation of 3.1% in listed and 1.1% in unlisted. Most managers feel this is appropriate given the current economic conditions. Overall, fund managers' outlook for the CRE market remains positive as they believe the market has likely bottomed out and interest rate cuts will soon begin to stimulate market activity. Some also note that workers continuing to return to the office can alleviate the vacancy issue and lift asset values, despite being mindful of the implications of softening economic growth for the demand for CRE. Some fund managers also indicated that they are planning to increase their CRE investment in the future to take advantage of the market recovery.

In terms of funds' risk profile, we know that, on average, KiwiSaver funds hold around 5% of their assets in CRE (4% for Balanced and 10% for Growth funds; see Appendix Figure 3 for more details). Most KiwiSaver funds allocate CRE across their funds this way, i.e. lower CRE exposure in the lower-risk funds which are more likely to be held by customers nearing redemption. This seems to be a prudent approach as long as the risks associated with CRE investments are properly managed. However, there are also cases where funds allocate more CRE to their conservative and balanced funds because of the solid long-run returns provided by the asset class. While we understand there are good business reasons for both approaches, we expect funds to be able to clearly articulate these reasons and properly communicate them to their customers. From our interviews with fund managers, most were able to do so. See Section 4 for further discussion on this.

3.2 Performance

For listed REITs, Table 1 shows the total annualised returns of four main indexes in New Zealand, Australia, the US and Europe, which funds usually use to benchmark their portfolios. Note that the S&P Eurozone Property Index may not be perfectly comparable to the others as it also includes some real estate operating companies (REOC) which operate in both residential and commercial real estate.

In the short run, there is a lot of variation across markets, suggesting that location can be a good source of diversification. In contrast to the short-term volatility, overall CRE investments have delivered solid returns of around 5-10% annually over the last ten years. This reinforces the importance of maintaining a long-term view when holding CRE assets while still ensuring that liquidity needs can be met in the short term.

Table 1: Total return on CRE assets

Index	**S&P NZX Real Estate Select**	**S&P/ASX 200 A-REIT**	**Dow Jones U.S. Real Estate Index**	**S&P Eurozone Property (EUR)**
Market	New Zealand	Australia	US	Europe
Number of entities	8	21	72	47
	Annualised total return (price + dividends)			
1 year	-2.38%	24.11%	8.63%	37.97%
3 years	-6.70%	7.52%	-1.85%	-8.26%
5 years	-0.80%	5.17%	3.01%	-4.22%
10 years	6.33%	9.22%	5.68%	2.50%

Source: S&P Global.

On the other hand, returns on unlisted CRE investments vary greatly. The funds we interviewed that have holdings in unlisted CRE had experienced significant value drops (10-12%) over the past year despite long-run solid yields of 5-6% annually. There are several potential reasons for the difference in returns between listed and unlisted CRE investments. Generally, as unlisted REITS have a lower level of diversification in their portfolio, they are more susceptible to value falls in the short term. Some fund managers also mentioned that there is a difference in the type and quality of underlying CRE assets held by listed and unlisted REITs. Differences in valuation practices can also contribute to the variation in returns. We will address this topic in more detail in section 4.

4. Risks associated with commercial real estate investment

Along with long-term solid returns, investments in CRE also come with risks. In this section, we will discuss the four primary sources of risks associated with CRE and how New Zealand fund managers identify and mitigate them.

4.1 Liquidity risk

Liquidity risk refers to the difficulty that funds may face when converting holdings into cash to meet their financial obligations, e.g. debt repayments or redemption requests. Liquidity risk can become a major issue

during a market downturn. This is the main reason causing some overseas funds to limit or suspend redemption currently. In the context of KiwiSaver, this also applies to customers switching funds or withdrawing funds early. Liquidity risks differ according to the nature of the investments. The *Liquidity risk management guide* (FMA, 2024) includes the FMA's latest guidance on managing liquidity risk.

Unlisted REITs

Liquidity risk is more acute for funds that run their own unlisted REITs. This is due to the illiquid nature of the underlying CRE assets and the time it may take to complete a CRE transaction. Funds with holdings in unlisted REITs need to manage liquidity risk carefully. These units are not frequently and publicly traded, so it can be harder to find buyers willing to trade at a given price. Irregular or inaccurate valuation of unlisted CRE assets can also exacerbate this issue and limit fund managers' ability to liquidate their positions when needed.

Listed REITs

Even though holdings in listed REITs are more liquid as these are publicly traded on the market, we still expect fund managers to maintain a good understanding of how long it would take to liquidate their positions and how they would expect the price to move in those scenarios. Many fund managers could confidently explain how long it would take them to liquidate a particular position, normally communicated in days and some expectation of the forecast drop in price over this time. While the latter is exceptionally difficult to predict, it was reassuring to hear that firms had a clear expectation of how long it would take to exit positions and had at least a strategy for predicting price falls.

However, in some cases fund managers told us that because these assets are listed, they believe there is no issue around liquidity. We are concerned about this. It is unlikely to be true, especially for funds with sizable holdings in a particular REIT. In reality, it is not always easy to liquidate a high-value position without materially impacting the unit price, even for a listed asset.

CRE in fixed-interest portfolios

Some funds are also exposed to the CRE market through holdings of bonds issued by listed REITs, which have varying quality and risk levels. We recommend that funds have appropriate and transparent internal risk rating models in place to manage the liquidity, valuation, and default risks associated with these positions.

Issues that can complicate liquidity risk management

Regarding liquidity, the KiwiSaver industry has some unique features compared to other managed funds. KiwiSaver providers are legally required to complete customers' fund-switching requests within ten working days and to allow them to make early withdrawals for first-home deposits or financial hardship. Fund managers need to consider these when managing liquidity risks associated with CRE investments, especially during extreme market conditions.

We are also aware that some KiwiSaver funds have outsourced the day-to-day management of their CRE portfolio to third-party firms. We acknowledge that this would allow funds to leverage specialist expertise in this unique market and focus more on their core competencies in more traditional assets like fixed incomes or equities. However, this practice also comes with its own risks, including liquidity risk, valuation risk, and key person risk among others. We expect firms to manage these risks well and be held accountable for the performance of their third-party portfolio managers. We also recommend that funds put appropriate governance and reporting frameworks in place to maintain good oversight of their investments.

Approaches to liquidity risk management

Most fund managers acknowledged that the liquidity of investors' equity remains at the forefront of their investment strategy when it comes to CRE and told us that they generally follow the liquidity risk management guidance set out by the FMA (2020, 2024). Most funds also told us that they have good and continuous governance, usually at board level, of the framework regarding their approach to liquidity risk and the management tools available.

Stress testing is being conducted frequently, although the level of sophistication varies among firms, with some using dedicated products like Blackrock Aladdin or Factset while others rely on spreadsheets which are harder to scale. The FMA (2024) liquidity risk management guidance recommends that funds have a fund-specific definition of "illiquid asset" and regularly update this register. This recommendation has been followed by most funds but not all.

Overall, most fund managers told us they are comfortable managing liquidity risk with experience and learning from the GFC and Covid periods. However, we remain concerned that some managers might have underestimated the level of liquidity risk associated with both their unlisted and listed CRE assets under the current market conditions. We are also concerned about firms assuming a high degree of liquidity simply because an investment is listed.

4.2 Valuation risk

Valuation risk arises when trading prices lag or do not match the true value of the underlying assets. For example, during CRE market downturns in which assets drop in value and low levels of transactions make frequent revaluation difficult, REIT units may be traded at a premium or discount to book value. Trading at an incorrect price disadvantages investors; for example, an incorrect price above the true market value of the underlying assets creates leakage where those investors leaving the fund are receiving too high a proportion of the value of the investments due to the elevated price. Conversely, an incorrect price below the true market value of the underlying assets advantages those remaining in the fund at the expense of those trading out. Because an incorrect price creates a trade-off between an investor selling out of the fund and an investor remaining in the fund but does not directly impact the profit to the fund manager, valuation risk can be inadvertently overlooked by fund managers. The *MIS manager valuation and pricing practices* (FMA, 2017) include the FMA's latest recommendations on valuation risk.

Unlisted REITs

For unlisted REITs, where units are not traded on the market, funds should provide regular and accurate unit pricing. This information should be available to customers, especially those approaching redemption.

Due to the illiquid nature of the assets, firms should also focus on maintaining and updating their internal valuation models while also making use of external appraisals. To increase the accuracy and reduce volatility, it is important to use a combination of several valuation methodologies. Managing valuation risk must be at the forefront regarding unlisted CRE investments, especially during market downturns.

Listed REITs

Valuation is less of an issue for holdings in listed REITs as these units are frequently traded on the open market. However, the FMA's (2024) liquidity management guidance also encourages fund managers not to rely entirely on listed prices due to the risk of valuation lag.

Approaches to valuation risk management

Most funds told us they have good continuous valuation policies in place, with a combination of internal and external models. For example, in some cases, fund managers have their CRE assets valued annually or six monthly by external investment services firms like CBRE and Colliers. Another example involves firms using a desktop valuation methodology, such as discounted cash flow and comparable/recent sales, to ensure asset valuations are correct. Some firms explained how they use a multifaceted approach involving external valuation, desktop approaches and comparison analysis. These conversations were positive, and the firms demonstrated a useful approach to valuation. It was helpful to see some fund managers interrogating the approaches used by external valuation firms. As with the use of third-party fund managers, we also expect firms be held accountable for the accuracy of these external asset valuations and how that impacts their portfolio's risk profile.

However, we are concerned that this is not the case for some funds, as they rely on listed prices on the market or the policy of the underlying fund managers. In terms of market knowledge, we welcome the appointment by several funds of dedicated personnel with expertise in the real estate market to manage CRE assets. This is important for managing the liquidity and valuation risk of CRE, especially for the unlisted portfolio.

We thought very seriously about engaging with external valuation firms to understand their approach to valuation and to understand what quality of service was being delivered to our population of regulated managed investment schemes. In the end, we decided against this approach, although we may undertake some research in this area in the future. Our primary reason for not engaging with valuation firms is twofold: we appreciate that many fund managers are accessing the best available valuation services in the New Zealand market; and the FMA does not have regulatory oversight of these entities – they are beyond our perimeter.

4.3 Leverage risk

Leverage risk arises when firms in an investor's portfolio borrow money to fund their operations or to purchase assets. When interest rates rise, firms with high levels of leverage face high borrowing costs and may need to sell some of their assets to pay for that. This can, in turn, negatively impact the value of investors' holdings. In the worst-case scenario, if borrowing costs become unaffordable and firms default on their debts, investors can lose some or all their investments as creditors take priority over equity shareholders.

Leverage risk is particularly relevant for CRE investments in the current high-interest rate environment as REITs require high levels of upfront capital and therefore are usually highly leveraged. The illiquid nature of CRE assets can also exacerbate the degree of leverage risk, as REITs may need to borrow more to meet redemption requests during market downturns.

Leverage risk in the context of CRE

Listed REITs usually operate with a gearing ratio of around 30-40%. Fund managers told us that unlisted REITs are generally more leveraged, with the gearing ratio in the high 40% to nearly 50% levels on a look-through basis. As commercial banks were faced with tighter capital requirements coming out of the GFC, they have reduced their lending capacity and therefore willingness to fund REITs. As a results, REITs have also turned more towards private credit and the wider shadow banking sector for their borrowing needs. During high-interest rate periods, this can be a concern for funds with holdings in REITs, as debt creditors will be paid out first in the case of a forced sale. The degree of loss to investors with equities in these assets would depend on how much the value has fallen. In extreme cases, they may lose the full value of their investment.

Leverage risk is a bigger issue for unlisted REITs, as they usually lack alternative financing options (e.g. bond issuance or an overseas parent firm) and need to rely on a high level of debt to fund their investments. Moreover, to reflect the inherent degree of risk, bank loans or private credit loans to unlisted REITs can also have specific covenants in place, including guaranteed principal payments or a requirement to retain key tenants. This can create significant risk during market downturns.

Approaches to leverage risk management

Overall, fund managers seem to be aware of the challenges facing REITs, with good understanding of their leverage and funding structures. Most managers told us that they are comfortable with the New Zealand listed REITs' conservative approach to debt-funding. Those with holdings in unlisted REITs also did not raise any major concerns. However, as these situations can change quickly, it is important for fund managers to maintain good oversight and regularly monitor this issue.

4.4 Concentration risk

Concentration risk refers to the potential for excessive loss arising from funds' large exposure to a single entity or a small number of entities or markets. In the context of CRE, managed funds may be exposed to concentration risks by type of CRE asset, location, market subsector, and similar characteristics.

Investment type

Most KiwiSaver fund managers we talked to focus their CRE investments on listed REITs, which are publicly traded and have a relatively well-diversified portfolio for a small country like New Zealand. In contrast, unlisted REITs usually run single-sector and single-location portfolios which come with higher levels of concentration risk. However, the highest holding of unlisted REITs among all New Zealand-managed funds is only around 5% of the total CRE portfolio.

Location

In terms of location, most of the underlying assets held by New Zealand-managed funds are in New Zealand. The most common positions are the eight largest listed REITs. Holdings in overseas CRE vary across funds, with those managing larger portfolios focusing more on this source of diversification. The most common overseas holdings are from Australia, which usually offers higher returns than New Zealand without requiring vastly different market knowledge. Some funds have an Australian arm directly managing this portfolio, with on-the-ground expertise in the market. The highest exposure to overseas markets among fund managers we spoke to was around 50% of the CRE portfolio, spread evenly across several markets such as the US, Japan, developing Asia, and Europe.

Subsector

Most funds' listed portfolios are well-diversified across subsectors, with the highest holding in retail, industrial and office space. Investments in logistics and data centres, which have been doing well despite the challenging market conditions, are uncommon. Unlisted CRE investments are more varied. While shopping centres and prime office space remain the two most common assets, there are also investments in agricultural land (vineyards, horticulture), aged care (retirement villages) or multi-unit dwellings (student accommodations, build-to-rent).

Approaches to concentration risk management

Overall, most fund managers seem to understand concentration risk well. The main reason is the greater focus on listed REITs, which usually run a balanced, well-diversified portfolio. However, New Zealand is a small market with limited investment opportunities in listed assets, which might impact funds' ability to rely entirely on this for diversification. The concentration of CRE in major cities like Auckland and Wellington can also be an issue. However, most fund managers were comfortable with how listed REITs deal with this type of concentration risk.

Investments in unlisted assets, which carry higher concentration risk, are uncommon. Except for some rare cases, conservative and balanced KiwiSaver funds have excluded unlisted CRE entirely from their portfolio. This can provide some reassurance for customers of these funds, who are more likely to be people nearing retirement or looking to withdraw funds in the near term for first-home deposits. Some managers indicated that they might increase their holdings of unlisted CRE assets in the future, as these can provide good returns in a lower interest rate environment. However, they told us they would only do so in the medium or long term once market conditions stabilise and they are comfortable managing the higher degree of risks.

4.5 Communication of risks to customers

Fund managers' approach to risk communication

Most fund managers told us that they have been communicating the returns and risks associated with CRE or other risky assets to their customers frequently, especially those closer to redemption. This is done through both official documentation and regular updates. Many also have mechanisms in place to encourage customers to switch to more liquid, lower-risk assets throughout their life cycle and to avoid becoming over-exposed to CRE.

Analysis of risk communication

Based on our discussions, most fund managers' communication of CRE risks appears adequate. It seems to support customers to have control over the risk-return trade off at different points in their life cycle. It also ensures a good level of diversification for customers' retirement funds, especially when many New Zealanders' main investment is already in residential real estate, which is subjected to similar interest rate cycle risk.

We appreciate that many customers may not follow their investments closely, especially when they are unable to access them for a number of years. We considered undertaking a review of customer communications; however, that was beyond the scope of a research activity focused on CRE. In the future, we may look to examine customer communications in more detail.

We remain concerned that, in some cases, fund managers have relatively high levels of CRE exposure in low-risk funds, which are more attractive to customers nearing redemption. We are aware of at least one fund that is marketed to customers over 60 years old that holds a 7.5% allocation in CRE. While we acknowledge that there might be business reasons behind this approach, it is important for funds to appropriately communicate the risks and benefits associated with CRE to their customers.

5. Conclusion

CRE has long been a positive asset class due to its ability to provide both steady income and growth potential. Over recent decades, CRE has become an increasingly important part of a well-diversified portfolio. However,

CRE investments, like all investments, come with risks. It is important that fund managers understand and manage these risks properly.

Since 2023, many overseas CRE markets have been going through a major downturn, with falling asset values. In some cases, real estate funds have had to introduce limits or suspension of withdrawals. Risk levels are elevated, especially liquidity risk, valuation risk, and leverage risk. We are concerned about the situation overseas and wanted to understand if this appears to be a major problem for New Zealand's managed funds and KiwiSaver industry.

Overall, based on our conversations with fund managers, we have not seen anything which makes us particularly concerned that CRE markets are causing any major issues here. However, the current absence of acute risks associated with the managed funds' and KiwiSavers' CRE holding should not be taken as an entirely positive reflection of the asset class. We are aware that many CRE investments (both internationally and domestically) will need debt refinancing in the next 2-3 years, and this may negatively impact the investment value given the situation with debt markets.

Most funds appear to have good practices in place to identify and manage the risks associated with CRE. Some examples include having a fund-specific definition of "illiquid asset" and regular maintenance of the illiquid assets register, especially during periods of high volatility; regular stress testing and appropriate governance framework at the board level for the risk management approach and the tools available; combination of both external valuation services and internal valuation models; diversification across investment type, location and subsector; and a good understanding of REITs' financial situations. The use of external services firms like fund managers or property valuers is welcomed, as long as funds remain accountable for their performance. Communication of risks to customers also appears to be adequate, with some funds having mechanisms in place to encourage customers to switch from CRE to more liquid, lower-risk assets throughout their life cycle.

However, there are some areas where we think some firms can enhance their risk management practices. These include: overreliance on the listed nature of CRE assets for managing liquidity risk; inaccurate and infrequent valuation of CRE positions; high exposure to unlisted REITs without a good understanding of their leverage and funding situations; and a lack of clear communication regarding the inclusion of CRE or other asset classes in different risk-rated funds. These require closer attention and better communication between fund managers and customers, especially for those customers who are nearing redemption.

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Appendices

Figure 1: Retail investors' exposure to CRE

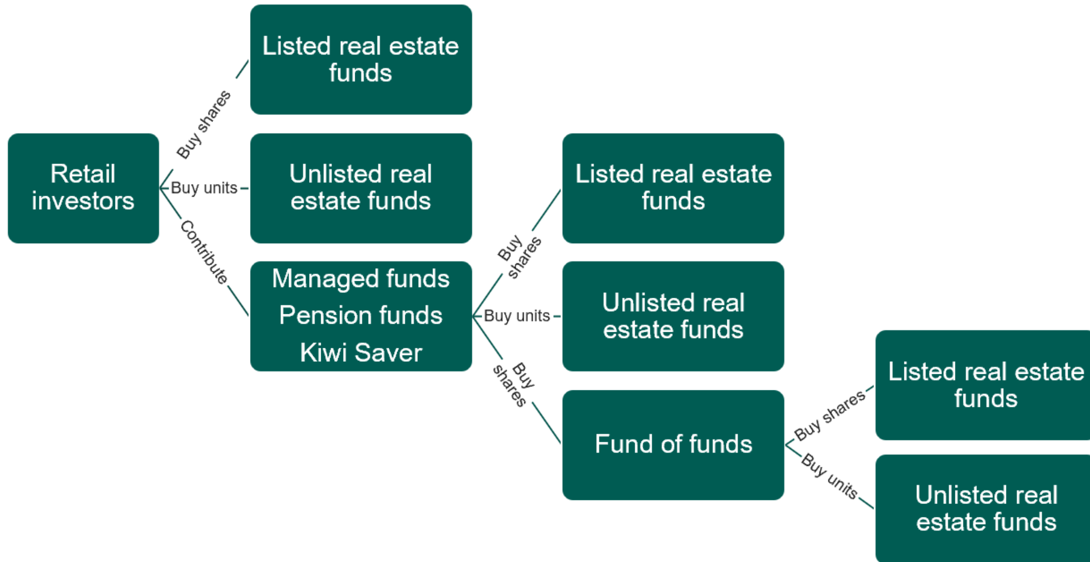
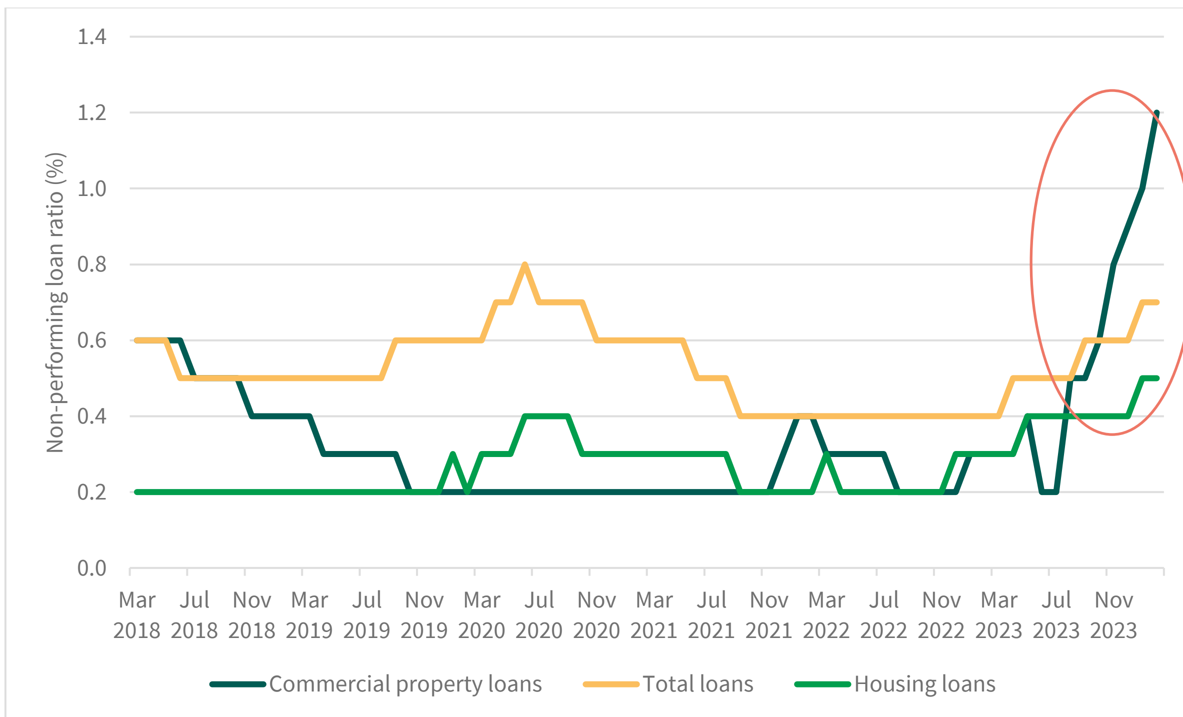
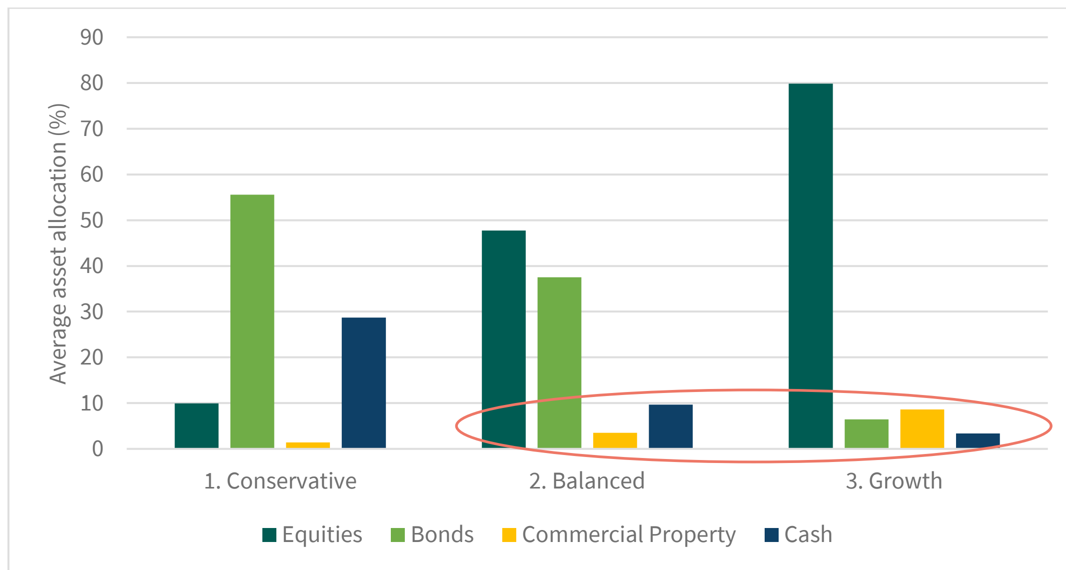


Figure 2: New Zealand banks' non-performing loan ratio – by loan types



Source: RBNZ

Figure 3: KiwiSaver funds' asset allocation (%) - December 2023



Source: Authors' calculation using disclose register data