QUILTER CHEVIOT

Our expectations for investment trust boards

Phase Three - Property collectives: Open-ended funds versus REITs
November 2024

SPECIALISTS IN INVESTMENT MANAGEMENT

Approver Quilter Cheviot Limited 13 November 2024

Contents

3 **Property collectives: Open-ended versus close ended funds**

3 **Executive summary**

4 **Overview**

4 Introduction and scope

4 The three factors

4 Initial assessment and escalation

6 **Introduction to asset classes**

6 What is real estate?

6 **Close-ended vs open-ended**

8 **Board composition**

8 Skills and independence

8 Succession planning

9 Diversity

10 Recruitment

11 Over-boarding galore

11 Summary: Board composition

12 **Board effectiveness**

12 Who does the board work for?

12 Skin in the game

13 Board evaluations

13 Summary: Board effectiveness

14 **Responsible Investment disclosures**

14 Different levels

14 Climate change

15 Ratings, certifications, and frameworks

16 ESG integration

16 Not in my backyard – Social issues

17 Where to disclose

17 Summary: Responsible investment disclosures

18 **Other issues: Addressing the discount**

19 RAG rating

20 Does size matter?

20 **Our expectations**

22 What is next?

Property collectives: Open-ended versus Closed-ended funds

Executive summary

This report, focused on Real Estate Investment Trusts (REITs), completes the initial phase of the long-term investment trust thematic engagement that started in 2022. Within this report we include three open-ended property funds as a comparator. We have surmised that REITs provide much better disclosure and transparency regarding governance oversight compared to open-ended funds. This exercise is viewed as an opportunity to verify or cast doubt upon this assumption.

As with the previous reports we have not looked at the entire REIT market, focusing only on holdings within our centrally monitored universe. In this instance, this means eight REITs[1] , plus three open-ended property funds which we selected from the funds we have under coverage. The combined value of these 11 holdings was £125m, as of the end of September 2024.

The aim of this engagement is to evaluate the current standing and set future expectations for each board against three factors:

- board composition
- board effectiveness
- responsible investment disclosures

1 We excluded one REIT undergoing strategic review, and another undergoing a merger. The eight REITs that we included in this report are part of the centrally monitored universe.

Overview

Introduction and scope

In May 2022, Quilter Cheviot initiated an engagement focused on investment trusts, an area we have significant exposure on behalf of our clients. There are fundamental differences between an investment trust and an open-ended fund. When we invest in an investment trust, we become shareholders of the company and, as such, our expectations for the governance of that company are higher than they would be for an open-ended fund. An investment trust is a listed company and, like other listed companies, has a board of non-executive directors (NEDs) whose job is to ensure that the investment adviser (manager) is acting in the best interest of the shareholders. The board appoints the manager to run the day-to-day operations of the investment trust.

During the third phase of this engagement our attention has been on the property sector, where we have engaged with eight REITs and three open-ended property funds. We have only included REITs that are managed externally. Internally-managed REITs are run more like operational companies, making direct comparisons difficult.

In the case of the REITS, we met the chair and occasionally the Senior Independent Director (SID); and for the open-ended funds, we met an investment committee member or a Non-Executive Director (NED) from the Authorised Corporate Director (ACD) managing the fund. While we generally provide an overview of the meeting agenda, we chose not to supply specific questions beforehand because we favour having a discussion over receiving rehearsed responses.

The three factors

The objective of this engagement is to improve corporate governance practices and responsible investment disclosure in the investment trust sector. There are three primary focal points:

Factor	Detail
Board composition	We expect a board to be independent, diverse and have the right skillset. With regard to independence there are two areas of consideration: first, we do not believe it is acceptable for an investment trust to have a board member who has been appointed or is employed by the investment adviser. Second, we believe that tenure impedes independence. We expect boards to adhere to the nine-year rule unless there are mitigating circumstances. Boards should also meet the FCA diversity guidance. The board's skillset should be appropriate to challenge and support the investment adviser, as well as representing shareholders.
Board effectiveness	The board's function is to represent the shareholders and act in their best interest. Therefore, we expect boards to have the ability to challenge the investment adviser where necessary. Furthermore, boards should be prepared to engage with shareholders and remain open to their feedback.
Disclosures	We see responsible investment disclosures as pertinent to the investment trust and its holdings. That said, we acknowledge that disclosure levels will vary depending on the asset class(es) invested in. For equities we expect trusts to disclose their voting actions on holdings (when applicable) and provide the rationale behind the most significant votes. Examples of how the manager has engaged with the holdings as well as clear examples of ESG (environmental, social and governance) factor integration are encouraged for all asset classes. It is also good practice to report on the board's role in managing these ESG risks.

The first phase of the overall engagement is to evaluate each investment trust against these three factors and to set expectations with each board for the future.

Initial assessment and escalation

We have RAG rated[2] the three factors for each of the meetings, and for the REITs we have set expectations for future reference. These will vary depending on the RAG rating. This will be an ongoing engagement programme, and where necessary we have established our specific escalation plans, including:

- Voting against the chair or other NEDs
- Voting against adviser representatives

Quilter Cheviot will always advise the board of its voting intentions. We have decided to anonymise investment trusts within this engagement framework.

Our escalation approach differs with open-ended funds. Our fund research team maintains regular communication with the managers we invest in and if governance or disclosure fails to meet our standards, we directly engage with the manager or the ACD board. While we typically do not vote on open-ended funds, we can do so in specific situations.

Our goal is to collaborate with boards to foster improved governance and disclosure. We believe that, in most cases, disclosing names would not significantly contribute to this effort.

2 Red, amber, green (RAG) rating

Introduction to the relevant asset classes

What is real estate?

Real estate, both direct and indirect, tends to attract income investors and long-term investors looking for steady cashflows. However, real estate can be difficult to sell quickly, making it an illiquid investment. REITs provide an attractive avenue, as they offer permanent capital and do not need to manage investor redemptions. However, open-ended funds are vulnerable to liquidity risk. During periods of volatility, if several investors decide to sell and redeem their shares, the fund may not have enough capital to pay investors. In such a scenario, the fund may need to sell some assets at a lower price, which may not be feasible and result in the fund being suspended.

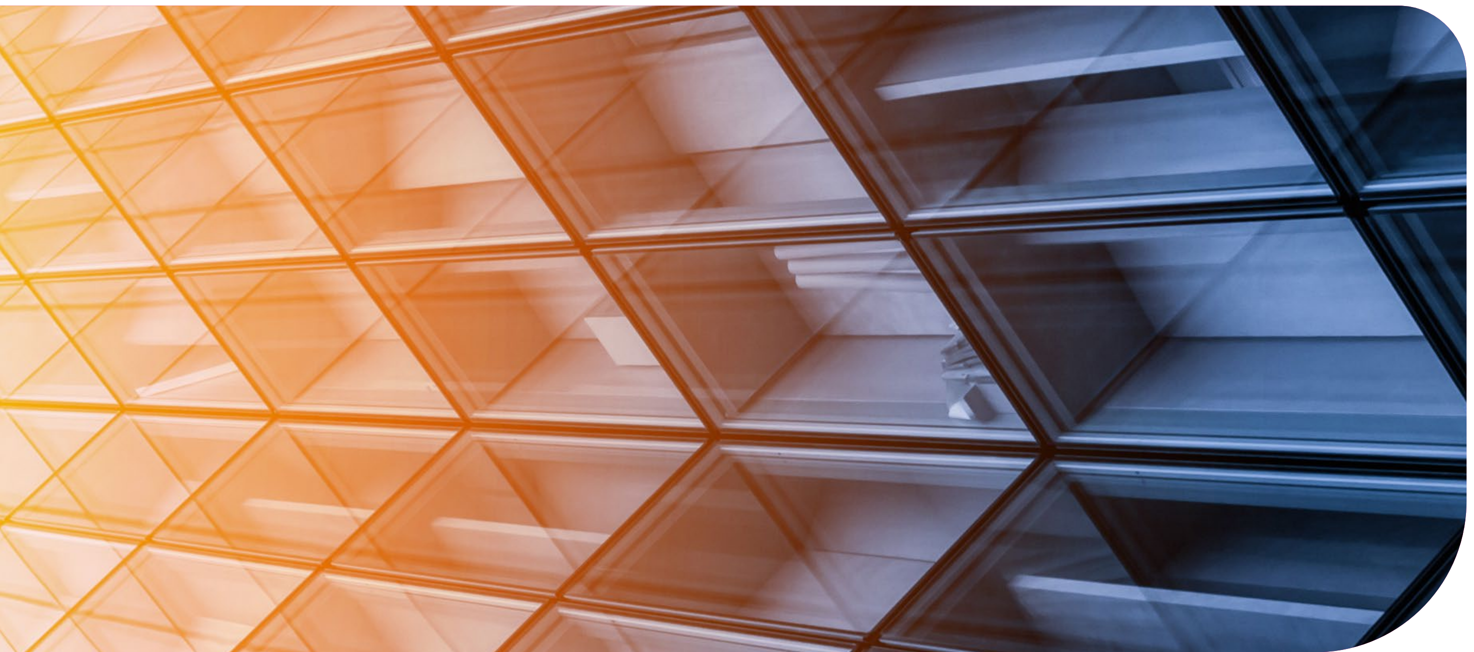
Closed-ended versus Open-ended

We will explore the different types of characteristics and governance structures that make up these funds.

Real Estate Investment Trusts: The last two letters in the acronym REIT stands, for investment trusts. REITs are listed on the stock market and their shares are traded in the secondary market, which means that shares are not created or cancelled by shareholder transactions. This feature is called permanent capital, and it is one of the reasons why investment trusts are a suitable vehicle for holding illiquid investments such as property. Investment trusts are listed companies, and like any other company, have independent boards of non-executive directors. The non-executive board has the responsibility to ensure the trust is managed in the interest of shareholders. Like any other investment trust, REITs may use internal or external managers. For this report, we only considered REITs that have external management.

The board outsources the day-to-day running of the fund to the investment adviser that it oversees and has the authority to replace, if it is deemed to be in the best interest of the shareholders.

Open-ended funds: The most common type of funds in the UK. Open-ended funds do not trade in the stock market. Instead, the investment adviser buys or sells stocks from investors in the fund. The key difference is that when an investor purchases a share, a new share is created in the case of an open-ended investment trusts (or unit in the case of unit trusts), thereby



increasing the total number of shares (or units). The reverse applies for sales. If a significant number of investors decide to sell, the investment adviser may be compelled to liquidate the fund's assets to generate the necessary funds to pay out. As property is an illiquid investment, it may take a long time to sell at fair value. Therefore, the combination of the open-ended structure and illiquid holdings can, under some circumstances, lead to problems such as the suspension of trading (this is called gating) and the sudden closure of funds. This explains why daily-dealt, open-ended property funds increasingly falling out of favour.

The two main types of open-ended funds are:

- **Open-ended investment companies (OEICs):** Open-ended investment companies (OEICs) are also known as investment companies of variable capital (ICVC)[3]. OEICs have an authorised corporate director (ACD) responsible for the management of the fund. The Financial Conduct Authority (FCA) has indicated that 25% of the members of the ACD board (or two people, where there are fewer than eight people) must be separate to the ACD. The directors are proposed by the ACD and approved by the FCA, unlike the directors of an investment trust which are elected by shareholders[4].

The non-independent directors must:

  - Possess sufficient expertise and experience to be able to judge whether the ACD is managing the fund(s) in the best interests of investors.
  - Be required to provide effective challenge of the ACD's processes, including the challenging of potential conflicts and their management.

- **Authorised unit trusts (AUTs):** Are governed by an investment committee or a board of trustees; usually the governance structure is less opaque. Unit trusts have a bid and an offer price, whilst OEICs have a single price.

3 unit_trusts.pdf (clarityglobal.com)

4 ACD Model Explainer_proof29 Jun.pdf (theia.org)

Board composition

As previously mentioned, our expectations on board composition will vary depending on the structure. However, we seek boards that have directors with relevant experience in the assets their structure holds, regardless of the open- or closed-ended structure. Additionally, we expect boards to consider diversity and adhere to the highest standards.

Skills and independence

Our view is that boards of investment trusts should be fully independent, as this creates the best structure to defend the interests of shareholders. We prefer boards that do not include manager representatives; this is acceptable when they are executive directors of an internally managed funds otherwise we see that as a conflict with our interests as investors.

During one of our engagements, we encountered a REIT board with a non-independent director who was a manager representative. We discussed with the chair the merits of having such a director on the board. The argument in favour tends to be the experience and value that they provide to the board. Whilst we understand this argument, we believe that the investment manager representatives should be available to work with the board without being members of it. We believe that maintaining the independence of the board will result in the best outcome for shareholders.

After the engagement, we wrote formally to the board reiterating our preference for a fully independent board. Working with the board is always our preferred approach, although if we do not see progress or the board is not receptive, we might escalate to voting against certain directors.

Succession planning

We also expect directors to adhere to the nine-year tenure, as dictated by best practice. Furthermore, we suggest that directors announce in advance when they are due to step down. This transparency regarding the director retirement schedule is also considered best practice.

Diversity

"I'm not scared of women...." [5]

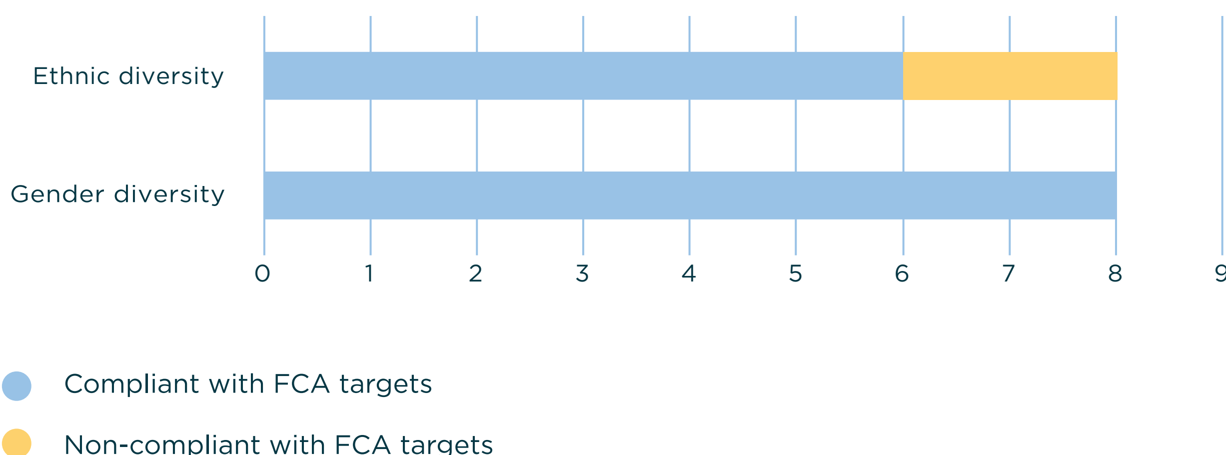
When assessing diversity on boards, we follow the FCA guidance,[6] which takes into consideration the FTSE Women Leaders Review and the Parker Review:

1. At least 40% of the board are women.
2. At least one of the senior board positions (Chair, Chief Executive Officer (CEO), Senior Independent Director (SID) or Chief Financial Officer (CFO)) is a woman.
3. At least one member of the board is from a minority ethnic background (which is defined by reference to categories recommended by the Office for National Statistics (ONS)), excluding those listed as coming from a white ethnic background.

Amongst the REITs included in this report, the average female directorship representation was 46% compared to 41% of investment company directorships in 2023, according to an AIC report[7]. Only one REIT did not comply with the ethnic diversity guidelines.

Open-ended funds did not disclose the ethnic composition of their boards or advisory committees. However, two out of the three boards that we engaged with had at least 40% female representation.

The chart below indicates that all the REITs involved in this engagement met the gender diversity goals, but two boards lack ethnically diverse directors.



5 Comment by a chair during an engagement, whilst discussing his efforts in promoting women.

6 PS22/3: Diversity and inclusion on company boards and executive management (fca.org.uk)

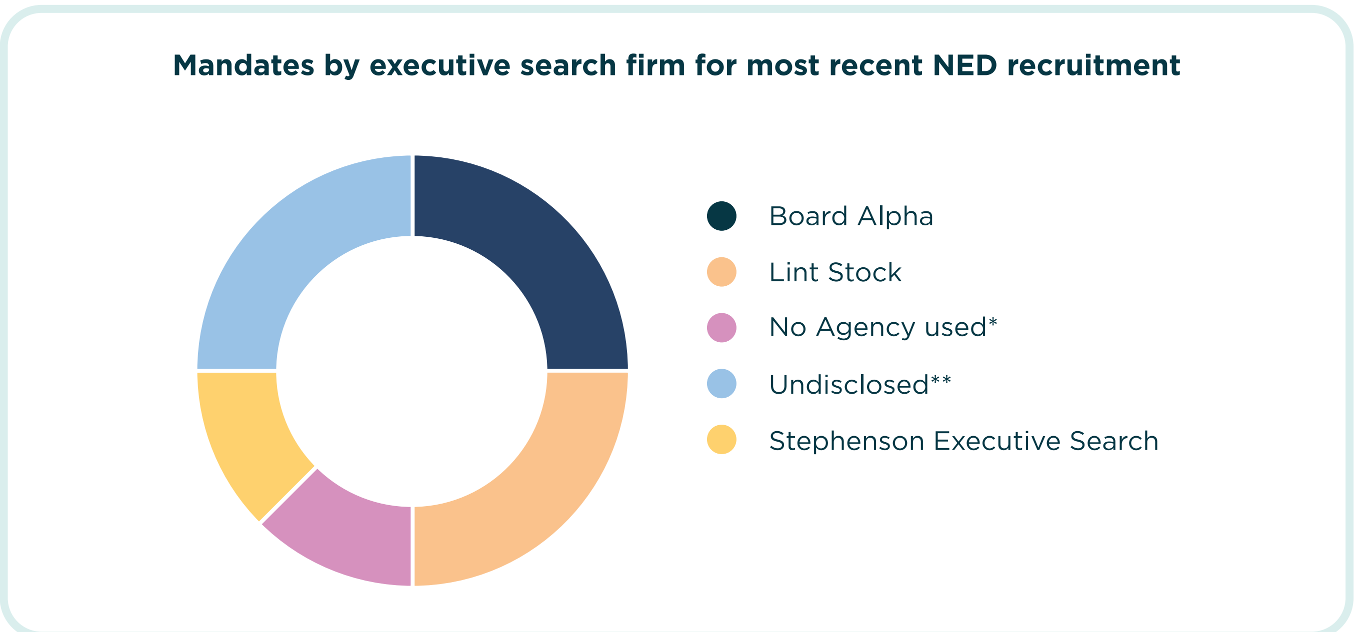
7 Go woke, not broke | News | The AIC

Recruitment

Adequate succession planning is a key responsibility of the chair. Despite this, many NEDs exceed the recommended nine-year tenure simply due to delays in finding replacements. This suggests a failure in effective planning, underscoring the importance of thorough succession strategies and clear communication. Tenure extensions should be rare, and occur only under well-explained circumstances.

The AIC Code suggests that boards use external executive search agencies to find candidates. We agree with this method as it ensures distance from the investment advisor. While the adviser can review the long list of candidates and offer feedback, the board should make the final decision. Also, we expect stricter scrutiny of any candidates recommended by the investment adviser compared to those proposed by the external search agency.

The chart below shows the most recently employed executive search firms for the engagement universe as disclosed in annual reports. This excludes open-ended trusts as they do not provide information on this:



*No agency used, refers to boards that did not use an external agency for their latest appointment or had no board changes since the initial public offering.

** Undisclosed, refers to boards that did not disclose what external provider it has last used to recruit a board member.

Over-boarding galore

As we have discussed throughout the report, there are some key differences in investor expectations between open-ended funds and REITs. One notable distinction is the role of the board. In OEICs, management is overseen by an ACD, which has a board of directors. Interestingly, an ACD can serve as the director for an umbrella fund that encompasses dozens of underlying OEICs. This means that an individual director might sit on the board of hundreds of funds. It also raises the question of whether investors in open-ended funds would benefit from an investment trust board structure, similar to that of closed-ended funds, even if it entails a marginal additional cost.

It is important to note that the role of the board of an ACD is not equivalent to that of a closed-ended fund. We were the first investors to try to meet the board for one property OEIC.

There is a structure beneath these directors that directly manages the funds; the directors primarily review documents during their quarterly meetings and approve documents rather than diving down into discussions of specific underlying assets. This setup significantly reduces the hands-on involvement of directors in the day-to-day management of the funds, which contrasts sharply with the more active roles seen in investment trust boards. This distinction is vital for investors to understand as it directly influences the governance and oversight of their investments.

When we think about the over-boarding issues in REITs, we are not as prescriptive as some proxy advisers, which tend to have a maximum limit of five positions. On the other hand, we expect the chair to be aware of the time commitments of each candidate and to have conversations with directors taking on further appointments. In our view, as long as directors can dedicate the necessary time to the trust, having multiple board positions is a benefit as it allows the director to keep their knowledge updated and relevant. This practical approach ensures that the board remains robust and well-informed, leveraging the diverse experiences of its members.

Summary: Board composition

There are three different types of board structure that we engaged with. In addition to the REITs described above, the engagement also included the investment committee of a unit trust and the board of the ACD of an OEIC.

In the first place, the OEIC structure leads to an opaque governance system, complicating board evaluation. With many funds managed by one ACD board and only 25% of members required to be independent, this setup differs significantly from what we have come to expect from closed-ended funds. With unit trusts we gain much greater transparency about the trustees and the members of investment committees. This clarity helps investors to better comprehend their independence and experience.

Board effectiveness

Who does the board work for?

When we published the first part of this report, we were concerned that it might give an unfair advantage to the boards we had not yet consulted, as they could read our expectations and prepare their responses in advance of our meeting. However, we were surprised by the reactions of two managers we spoke with who were visibly concerned about the idea of Quilter Cheviot, as an investor, accessing the board of a REIT. In one instance, the investment adviser requested two preliminary calls before granting us time with their board. After agreeing to the call, we made it clear that we wanted to speak to the board independently from the investment adviser. Regardless of our request the manager attended the meeting and was consequently asked to leave.

In another instance, a chair chose to “agree to disagree” when responding to questions regarding the discount, saying it was unrelated to governance issues and, in his view, he had been invited to have a governance related meeting.

While these examples are rare, they highlight an industry issue. The symbiotic relationship between boards and investors is the cornerstone of the sector, and for it to function effectively, open communication is essential. Managers should facilitate this dialogue and not impede it. Investors must be afforded the opportunity to have independent discussions with the board, which includes discussing the manager and their actions.

Our role is to critically support boards as part of our stewardship responsibilities to our clients. It is puzzling as to why some boards would choose an antagonistic attitude. Our only explanation for this is a lack of regular communication with investors. When extraordinary events occur that force these interactions, boards tend to become defensive. Part of the board’s role is to know its shareholders and understand their views.

We believe having skin in the game aligns directors’ interests with those of shareholders. We usually aim for at least twice the annual fees for the chair and once the fees for other directors. The personal wealth of directors varies greatly. For some, the shareholding will be insignificant. For others, they will struggle to pay for the shares upfront and will prefer to build up their position.

Regardless of the situation, unless there are mitigating circumstances, it is preferable for all directors to hold shares.

There’s no perfect link between director ownership and company performance, but a well-functioning board operates like a finely tuned engine. It’s composed of numerous elements that individually may not determine its success, but together they create an effective machine.

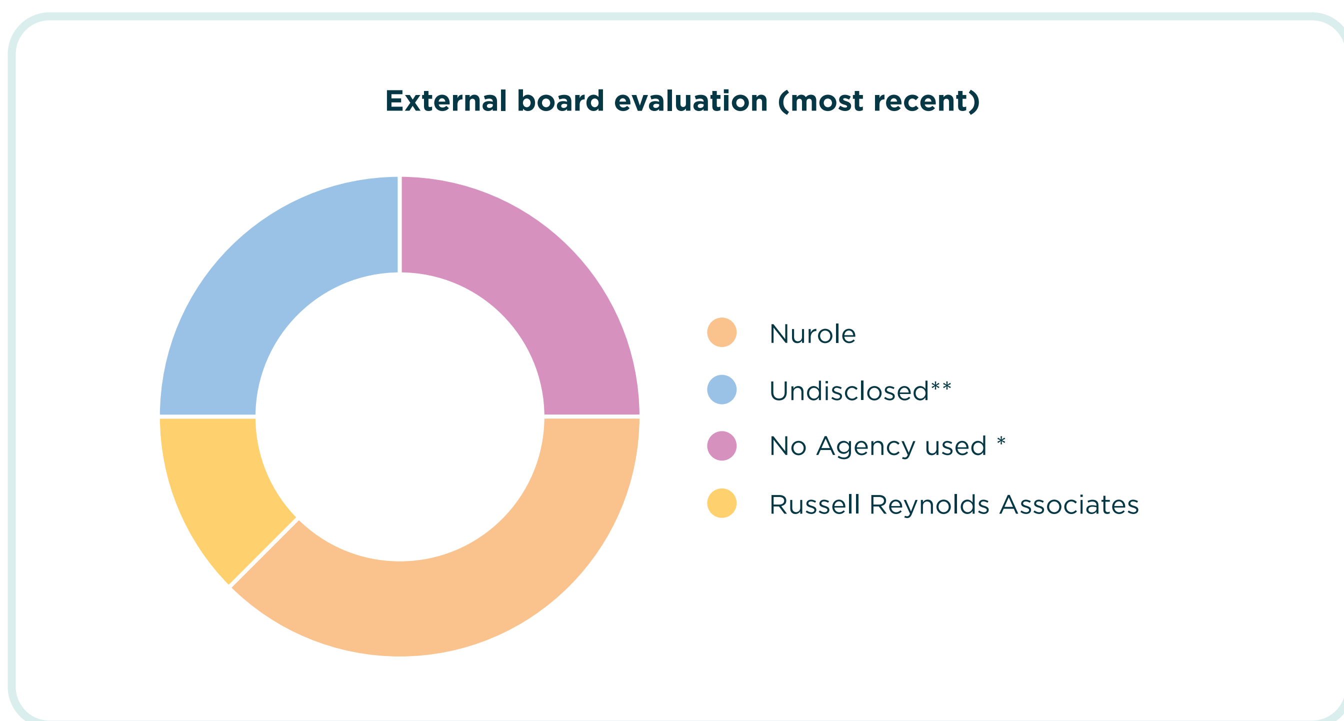
Board evaluations

The AIC Corporate Governance Code recommends that boards in the FTSE 350 undergo an externally facilitated board evaluation at least once every three years. This is in addition to an annual internal board evaluation.

This is a valuable mechanism for the board, which may not always yield groundbreaking results but serves as an essential health check. Additionally, we would appreciate more commentary on the evaluation outcomes in the annual report and any adjustments made to the board's operations based on these exercises.

The AIC Code also specifies that boards should reveal which external provider they are using, and it remains surprising to find boards failing to provide this information.

The following chart represents the external firm used to facilitate the latest board evaluation. These regulations do not apply to open-ended funds, so the chart below includes only the eight REITs featured in this report.



*No agency used, refers to boards that did not use an external agency for their latest appointment or had no board changes since the initial public offering.

** Undisclosed, refers to boards that did not disclose which external provider was used to recruit its most recent member.

Summary: Board effectiveness

Most boards are effective, but we found communication with shareholders to be an issue for some trusts. A few investment advisers were reluctant to arrange meetings with the chair without them or wanted pre-calls before doing so. These instances are rare but show that board practices and effectiveness vary. Additionally, the AIC Corporate Governance Code recommends disclosing external providers, yet some boards do not, indicating a lack of best practices in disclosure. Overall, most boards were receptive to our feedback, and we appreciate their cooperation.

Responsible Investment disclosures

Different levels

Before initiating this engagement, we believed that the disclosures available to REIT investors were more comprehensive than those available to investors in open-ended funds. There are, of course, differences in disclosure standards within the REITs. At the outset we identified the disclosures we would expect to see from this sector.

For the funds that have exposure to equities investing in property, we would expect the manager to engage and vote accordingly, to provide effective stewardship over the assets. Below, we state our expectations for funds that invest in real assets.

Climate change

> *“The built environment sector is one of the largest contributors to climate change, responsible for more than a third (37 per cent) of global energy-related carbon emissions.” (United Nations Environment Programme [UNEP] 2022[8].)*

The emissions stemming from the built environment derive from two sources: embodied carbon emissions from construction and materials, while operational emissions are from the energy used during a building’s lifetime.

Given the significant impact of the sector, it is imperative that property managers and investors prioritise responsible investment-related disclosures. This includes detailed reporting on both embodied and operational emissions to ensure stakeholders are informed about the environmental footprint of their assets.

Moreover, we expect boards to understand the trust’s climate strategy and ways to lower emissions over time. Net zero targets can either be set at the fund or trust level or be set by the investment advisor. Both methods are valid, but if the target is part of the investment advisor’s objectives, the trust must avoid ‘hiding’ behind a shared target (i.e. where its assets are included within an investment advisor’s other clients’ assets).

8 Building Materials and the Climate: Constructing a New Future (unep.org)

Regardless of the approach chosen, we increasingly expect clear annual disclosures of progress against the trust's climate strategy including current emissions (including Scope 3[9]) and planned decarbonisation trajectory. Best practice is for firms to set reduction targets through third party-frameworks like NZAM[10] or SBTi[11], covering both mid-term (2030-2035) and long-term (2040+). The trust's climate strategy should clearly outline how these targets will be achieved, with key decarbonisation levers (i.e., actions) against anticipated decarbonisation trajectory (i.e. decarbonisation milestones over time to achieve the targets).

We understand there are complexities in decarbonising assets for trusts, and fully acknowledge that progress towards net zero will not necessarily be linear. During a conversation with one of the chairs, they explained that while the REIT aims for net zero targets, a dilemma arises when their investment strategy involves acquiring older, less sustainable properties and retrofitting them to improve energy efficiency. These older assets initially lower the average Energy Performance Certificate (EPC) ratings for the REIT, giving the impression the fund is not as 'climate friendly' as others. She questioned whether it is ultimately better practice for a fund to pursue an ambitious target that could be delayed or aim for a later, less-ambitious target which better reflects the emissions challenges of the fund's older infrastructure stock. This is similar to the divestment versus engagement discussion in equities: the need for investment firms to balance ambition with practical feasibility for their holdings. We expect the board to clearly communicate to shareholders when acquiring 'improver' properties and detail their time-lined plans, and how these assets will ultimately align with the fund's climate strategy.

Ratings, certifications, and frameworks

While the Responsible Investment and Research Team use various third-party sources, we prefer primary data directly from companies. Among ratings, CDP climate data remains valuable for investors, although we focus more on the underlying data than just the CDP grading. In 2024, we engaged with one REIT as part of the CDP Non-Disclosure Campaign (NDC) to promote disclosure based on CDP standards. Another vital disclosure is EPC ratings, which are regulatory requirements impacting property lettings. Building-level ratings like Building Research Establishment Environmental Assessment Method (BREEAM) and Leadership in Energy and Environmental Design (LEED) assess sustainability, while the Global Real Estate Sustainability Benchmark (GRESB) is widely recognised for portfolio-level assessments.

Regulation

The property sector has its own set of regulatory disclosures. For example, according to the Minimum Energy Efficiency Standard (MEES) regulation, landlords must meet certain EPC requirements for their buildings. Currently, landlords are not allowed to rent any buildings that have an EPC rating below E. The government is exploring raising this EPC rating requirement to C by 2030.

Improved EPC ratings can also help in cutting carbon emissions. This supports broader environmental objectives. Additionally, these ratings promote energy efficiency, resulting in lower energy costs for tenants. This can make the properties more appealing to prospective tenants and buyers, which may lead to higher occupancy rates and increased property values.

9 Scope 3 emissions are greenhouse gas emissions that come from sources not directly owned or controlled by an organization, such as supply chain, transportation, product usage, or disposal.

10 NZAM stands for the Net Zero Asset Managers initiative, which is an international group of asset managers committed to supporting the goal of net zero greenhouse gas emissions by 2050 or sooner.

11 SBTI is an initiative that provides companies with a clearly-defined path to reduce emissions in line with the Paris Agreement goals

Building ratings

Similar to the EPC rating, there are other certifications that are applied to individual assets such as BREEAM and LEED. These are rating systems developed by private organisations, not government regulatory bodies. BREEAM is primarily used in the UK and Europe, while LEED is widely used in the United States (some investors in other countries are also using this framework as well).

Key differences between the two include geographic scope, certification process, and criteria. BREEAM uses quantitative standards for its ratings, which means it relies on specific numerical criteria. In contrast, LEED sets thresholds based on percentages, allowing for a more flexible approach to meeting sustainability goals.

BREEAM evaluates energy use, health and wellbeing, pollution, transport, materials, waste, ecology, and management process. LEED evaluates categories like location and transportation, sustainable sites, water efficiency, energy and atmosphere, materials and resources, indoor environmental quality, innovation, and regional priority.

Portfolio ratings

GRESB is an annual assessment of the sustainability performance of real estate portfolios. It rates and scores participating companies and funds based on environmental, social, and governance (ESG) performance. Whilst it is not the only standard of its kind, it is the most widely adopted.

ESG integration

When evaluating how an investment trust incorporates ESG factors into the portfolio, we do not expect this to incorporate sustainability objectives. We expect managers to consider and mitigate potential ESG risks. This applies to every fund, regardless of objectives. Most trusts claim to integrate ESG, often through engagement, acquiring properties using ESG due diligence questionnaires, and climate data requests. Notably, there is significantly less transparency around due diligence before acquiring new assets.

Not in my backyard – social issues

Properties have a significant impact on those people who live and work there. Therefore, it is essential for them to have awareness of the social impact of their assets. Through our engagements, we have discovered various community outreach programmes aimed at improving the lives of tenants and individuals living in the vicinity of the properties in the portfolio.

We have also observed investment advisers using questionnaires to understand their impact on their tenants. Implementing strong social practices is essential, not only because it is the appropriate decision ethically, but also to mitigate potential reputational damage associated with poor management of social health and safety risks.

Where to disclose

We are flexible in the format that trusts share ESG-related disclosures. We are aware that some boards are concerned about annual reports becoming lengthy. In such instances, utilising a sustainability report is a viable alternative for presenting this information.

Summary: responsible investment disclosures

While REITs have made strides in ESG-related disclosures, there remains room for improvement. The evolving nature of disclosure standards necessitates that boards continually identify and report the material ESG risks associated with their portfolios. Effective disclosure can be achieved through various platforms, with sustainability reports serving as a viable alternative to traditional, lengthier annual reports.

The social impact of property investments cannot be overlooked. By implementing strong social practices, companies can mitigate reputational risks and make positive contributions to the communities they impact. Although many investment trusts report ESG integration post-acquisition, there is a notable lack of transparency in the due diligence process prior to acquiring new assets. We found EPCs to be one of the most developed areas of disclosure; this is predictable given the regulatory requirements surrounding it.

Incorporating the GRESB or similar standards can provide a framework for assessing and improving ESG performance, although they will never be a replacement for direct disclosure. It is important to note that disclosure is a moving target, and the leader in the sector over time creates a new standard for everyone else.

With the advent of the Sustainability Disclosure Requirements (SDR) rules in the UK we will be exploring with the third-party managers we invest how this might affect their ESG related disclosures.

Additional issues

Addressing the discount

Oli Creasey
Head of Property Research
London

The property investment market —specifically those occupied by investment trusts (which includes REITs) has spent most of the last five years trading at historically wide and persistent discounts to underlying Net Asset Value (NAV). It has been a perplexing issue for many investors and boards alike;— the value of properties owned is known, so why isn't that reflected in the share price?

There are a number of theories, but when it comes to board engagement, our concern has been how to solve the problem. We have discussed the issue regularly with boards and executive teams, and, boards are well aware that the discount represents underwhelming shareholder returns, and that unwinding the discount represents an opportunity to increase those returns. However, there are also competing pressure on the boards and potential conflicts of interest.

According to the REIT textbooks, companies have straightforward means to address a discount to NAV. When shares are higher than underlying values, one should sell the shares (raise new equity) and buy relatively cheap property. When the opposite is true, management should be instructed to sell the fully valued property and buy back the cheaper shares, removing them from the share register in the process.

In theory, doing so should unwind the discount, although frequent pushback we have received from boards is that in practice the impact of these interventions is not clear. It is true that opinions are divided and there is no definitive proof that share buybacks or special dividends drive shareholder performance higher.

What is less talked about is the conflict of interest that such an intervention can create.
If a board were inclined to do so, it could sell property until the portfolio was empty and return all NAV to shareholders. This would deliver an instant boost to returns but would be a one-time impact; the company would be liquidated and investors would need to look elsewhere for the next opportunity.

Widespread liquidations like this are perhaps not in shareholder interests (assuming the shareholder wishes to continue holding property in liquid securities) and are also not in the interests of the decision-makers on the boards, who do not want to preside over a shrinking company and be out of a job.

We continue to work hard reminding boards that their duties are to shareholders, not themselves or management. We also remind boards that a shareholder raising the idea of buybacks is not necessarily advocating for the wind-down of the entire company, and that raising new capital in the future in a more favourable environment is still possible.

Often, if the boards won't do it, someone else will. Consolidation and acquisitions are becoming commonplace in the UK REIT universe, with the cheapest, smallest companies representing an opportunity for private investors and larger REITs alike. Deals that take REITs out of the stock exchanges are no different than an organised wind-down from shareholder perspective.

The UK property market is navigating a turbulent period. Successive crises have severely impacted investor sentiment towards the sector, starting with Brexit, and continuing until the most recent higher rate environment. The good news for investors (and boards/management) is that there are no new headwinds on the horizon and interest rates are beginning to move in the right direction. REITs can start to look forward to a more benign environment and hope that the day of the discount won't last forever.

RAG rating

We have RAG rated each of the eight REITS and three open-ended funds based on the three factors outlined at the beginning of this report. We examined this by market cap to check for any correlation between size and RAG outcomes. Achieving a green rating is rare as we aim to set higher standards. Amber ratings will vary; some trusts require minor improvements, while others need significant work. As this is a long-term engagement and publicising names offers no benefit, we have anonymised this report.

	REIT	REIT	REIT	REIT	REIT	REIT	REIT	REIT	OE	OE	OE
Board composition	Green	Green	Green	Amber	Red	Red	Green	Amber	Red	Green	Green
Effectiveness	Green	Green	Green	Green	Red	Red	Green	Green	Red	Green	Green
RI disclosures	Amber	Amber	Green	Amber	Red	Amber	Amber	Red	Red	Amber	Amber

Green rating:

- Only one REIT obtained a triple green rating.
- Board effectiveness obtained the most green ratings.

Amber rating:

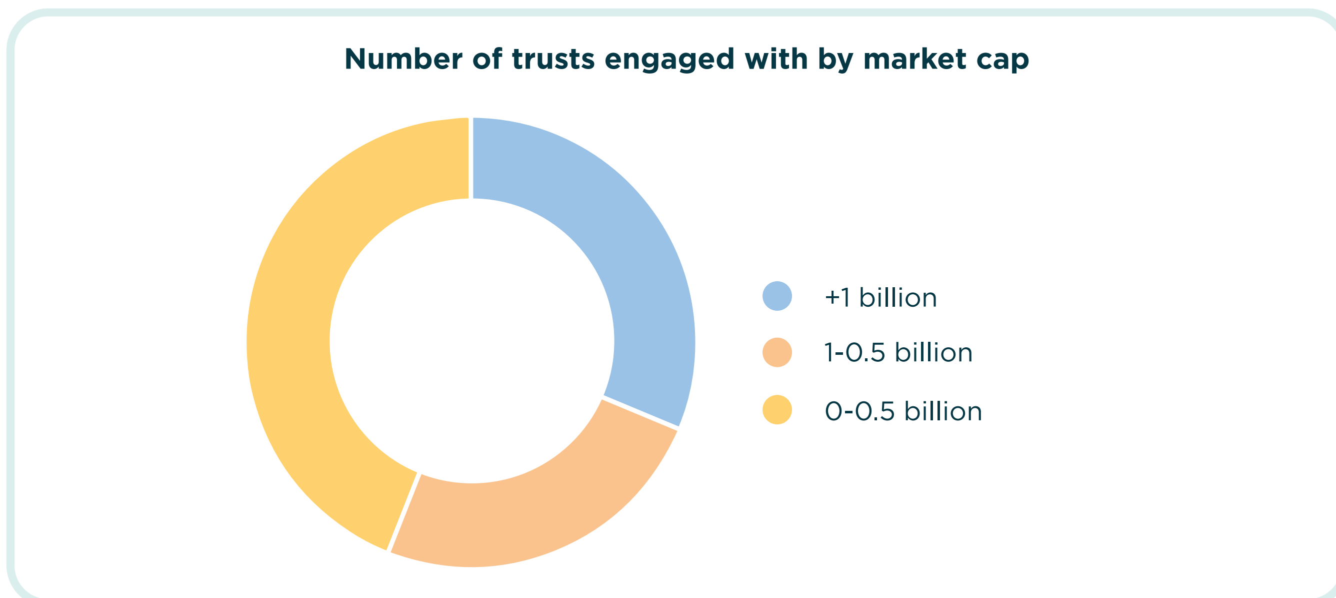
- Most amber ratings were for RI disclosures.
- No board received an amber rating for board effectiveness.

Red rating:

- One REIT and one OE fund received triple red rating.
- Three boards received a red rating for board composition; this was caused by lack of independence.

Does size matter?

This analysis covered funds exceeding £3bn as well as those below £100m[12]. Although our findings are merely anecdotal, based on the rating we can infer that smaller funds have performed worse. The chart below illustrates the ratings for both REITS and open-ended funds, arranged by fund size in descending order.



The chart below shows the ratings of REITs and open-ended funds ordered by, NAV[13] with 1 being the largest.

Market Cap / NAV	1	2	3	4	5	6	7	8	9	10	11
Board composition	● (green)	● (green)	● (green)	● (green)	● (red)	● (green)	● (green)	● (red)	● (amber)	● (amber)	● (red)
Effectiveness	● (green)	● (green)	● (green)	● (green)	● (red)	● (green)	● (green)	● (red)	● (green)	● (green)	● (red)
RI disclosures	● (green)	● (amber)	● (amber)	● (amber)	● (amber)	● (amber)	● (amber)	● (red)	● (red)	● (amber)	● (red)

Our expectations

Investor expectations evolve over time; and what was once considered good practice a couple of years ago eventually becomes an industry norm. As it stands, this is what we expect:

Board composition: Boards should defend the interest of shareholders and to avoid board compositions that may hinder this.

Independence: Perhaps the most critical feature of a board. The board's primary function is to act in the interest of shareholders. Having management representatives on the board is far from optimal. Equally, we consider shareholder representatives to not be independent. We believe that a 100% independent board is in the best interest of shareholders. We understand that manager-appointed NEDs can add valuable experience and knowledge to board's discussions, however, we argue that this experience can also be shared without being a part of the board. Additionally, we want boards to show independence of action; for example, we do not expect the investment adviser to be involved in the selection of NEDs bar a simple sense check.

12 We have used Market cap for the REITS and NAV for the closed-ended funds.

13 We have used Market cap for the REITS and NAV for the closed-ended funds.

Tenure: Best practice is a maximum of nine years' tenure. We understand that a director will not automatically become non-independent after nine years, and in some cases a limited extension of the tenure might be required to ensure appropriate succession. We expect boards to have solid succession plans in place to avoid director cliffs and excessively long tenures.

Over-boarding: NEDs should dedicate sufficient time to the oversight of the investment trust, and we expect NEDs to attend all their designated board meetings unless there are mitigating circumstances. We appreciate that being a NED of an externally managed REIT is very different to being on the board of an operating company, however, we monitor the number of board positions and will vote against NEDs where we believe there is an issue.

Moreover, boards should have the right skills and experience to be able to constructively challenge the investment adviser. An independent board without the right skills will not be able to challenge the manager and protect shareholder interests. Boards should also have access to independent advice when needed.

Diversity: Boards should be diverse and work towards the FCA diversity targets. We encourage boards to reflect on their recruitment processes and consider whether they are accessing a wider pool of candidates.

Board effectiveness: This can be harder to define succinctly as there are several qualitative elements.

Communication: Boards should be willing to engage with shareholders. This includes communication regarding the rationale behind board decisions. For example, capital allocation.

Board responsiveness: Evidenced by the board's ability and willingness to interact with shareholders. An example would be a trust that we have engaged with over several years and on a variety of issues, some of which where we and the board fundamentally disagree. The chair and the SID have always been willing to engage which is integral to our goal of acting as partners, not adversaries. While we may not always agree, having the conversation fosters a relationship and openness. This has allowed us to provide specific feedback on how the board reports its approach to responsible investment.

Director shareholdings: We believe that NEDs investing in the investment trust is one of the best ways of aligning the NEDs with the shareholder experience. However, setting a strict threshold of shares might deter NEDs belonging to different socioeconomic backgrounds from joining the board. Therefore, we encourage boards to allow flexibility in this area. We do accept that for some NEDs this is not feasible. In this instance, we expect to understand why this is the case.

Board evaluations: External board evaluations should be conducted every three years. We also advocate an interview-led approach, as we consider it to be more productive. Shareholders should also be involved as part of this evaluation.

Disclosures: When we invest in an investment trust on behalf of our clients, we become shareholders of the investment trust and not of the investment adviser. We expect the information provided to be relevant to the holdings in the investment trust.

What is next?

This report concludes the third and final report within the initial phase of our thematic engagement. Our goal was to set a new benchmark for boards of investment trusts, while raising the expectation for what it takes to be an active investor in these companies.

This engagement has strengthened our relationship with the boards of the companies we invest in. Throughout this engagement period, we met with the chairs of 76 investment trusts, and other NEDs who also attended.

The majority of these meetings have helped to reassure us of the superior governance standards that exist in the investment trust. However, some work still needs to be done, and our intention within these series of reports has been to provide a point of reference from the perspective of a long-term investor.

Through this engagement we have identified where boards did not meet our expectations, and we have been working with those boards to resolve any issues. However, nothing is static. For example, new regulations, such as Sustainability Disclosure Requirements (SDR), will have significant impacts on the way investment trusts choose to disclose ESG-related content impacting their investment. This will be the central focus of future engagements.

QUILTER CHEVIOT

SPECIALISTS IN INVESTMENT MANAGEMENT

quiltercheviot.com

Quilter Cheviot and Quilter Cheviot Investment Management are trading names of Quilter Cheviot Limited, Quilter Cheviot International Limited and Quilter Cheviot Europe Limited. Quilter Cheviot International is a trading name of Quilter Cheviot International Limited. Quilter Cheviot Limited is registered in England and Wales with number 01923571, registered office at Senator House, 85 Queen Victoria Street, London, EC4V 4AB.

Quilter Cheviot Limited is a member of the London Stock Exchange, authorised and regulated by the UK Financial Conduct Authority and as an approved Financial Services Provider by the Financial Sector Conduct Authority in South Africa.

Quilter Cheviot Limited has established a branch in the Dubai International Financial Centre (DIFC) with number 2084 which is regulated by the Dubai Financial Services Authority. Promotions of financial information made by Quilter Cheviot DIFC are carried out on behalf of its group entities. Accordingly, in some respects the regulatory system that applies will be different from that of the United Kingdom.

Quilter Cheviot International Limited is registered in Jersey with number 128676, registered office at 3rd Floor, Windward House, La Route de la Liberation, St Helier, JE1 1QJ, Jersey and is regulated by the Jersey Financial Services Commission and as an approved Financial Services Provider by the Financial Sector Conduct Authority in South Africa. Quilter Cheviot Europe Limited is regulated by the Central Bank of Ireland, and is registered in Ireland with number 643307, registered office at Hambleden House, 19-26 Lower Pembroke Street, Dublin D02 WV96.

QC00693 (11/2024)