Q1 2015 Investment Report

For professional investors only

Schroders
The London Borough of Tower Hamlets Superannuation Fund

Investment Report
Schroder Real Estate Capital Partners

Schroders

Q1 2015

Schroders

The London Borough of Tower Hamlets Superannuation Fund

In this report

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Overview

Portfolio Objective

To achieve a return of 0.75% pa net of fees over rolling three year periods above the AREF/IPD UK Quarterly Property Funds Indices - All Balanced Funds Weighted Average (benchmark).

Portfolio Valuation

Value at 31 Dec 2014	GBP	119,210,385
Net cash flow	GBP	-
Value at 31 Mar 2015	**GBP**	**122,202,426**

Performance Periods to 31 Mar 2015

Total returns GBP	3 months %	12 months %	3 years % pa	5 years % pa
Portfolio (gross)	2.5	16.2	8.6	7.3
Portfolio (net)	**2.5**	**16.0**	**8.4**	**7.1**
AREF/IPD UK Quarterly Property Fund Index All Balanced Funds Weighted Average	2.8	16.6	9.4	8.4
Difference	**-0.3**	**-0.6**	**-1.0**	**-1.3**

Breakdown of performance				
UK Investments (Gross)	2.7	18.0	10.2	8.9
European Investments (Gross)	1.6	-8.1	-9.8	-7.9

Source: Schroders & AREF/IPD UK Quarterly Property Fund Index, 31 March 2015.
The portfolio's returns are calculated on the basis that units in open-ended funds are valued at their mid price and closed-ended funds at their NAV price.

Summary

The current combination of UK GDP growth running at 2.8% and zero inflation is probably as good as it gets in the short-term. Schroders expects inflation to increase to 1.5% by the end of 2015, as the fall in oil prices drops out of the calculation, and for GDP growth to slow slightly to 2.6% this year and to 2.0% in 2016. Part of the deceleration in growth will be due to a gradual increase in interest rates – we expect the Bank of England to make its first move in November – and part will be due to a tightening in fiscal policy after the general election. In addition, the housing market appears to have lost momentum following the introduction of new rules on mortgage lending last year.

The latest IPF (Investment Property Forum) Consensus Forecast suggests that commercial real estate could achieve total returns of 12% in 2015. Our view is that total returns in 2015 should probably be closer to 15%, although the more yields fall this year, the greater the risk of a potential correction in the future.

The portfolio returned 2.5% over the first three months of 2015, which was 0.3% below the benchmark. Central London and industrial specialist funds have been positive drivers of performance, while cash and reinvestment costs associated with a high volume of transactions over the reporting period (£5.8 million) have temporarily held back returns.

The UK portfolio (97% portfolio value) continues to perform well, outperforming the benchmark by 1.4%, 0.8% pa and 0.5% pa over the past one, three and five years respectively. The portfolio's Continental European holding produced positive performance over the past quarter (10.9% q/q in Euros) but remains a drag to total returns in aggregate over the past five years in particular.

Portfolio Strategy

We have been recycling cash received from selling down part of the portfolio's central London exposure to existing balanced fund holdings where capital exposure can be diversified across all mainstream property sectors.

In the past few quarters we have focused on positioning the portfolio for income. To that end, we have increased the portfolio's exposure to industrials by acquiring a further stake in Ashtenne Industrial Fund.

Alternative real estate sectors also remain favoured, in particular those sectors which deliver attractive yields and relatively resilient income streams

UK Property Market Summary

Economy

The current combination of UK GDP growth running at 2.8% and zero inflation is probably as good as it gets in the short-term. Schroders expects inflation to increase to 1.5% by the end of 2015, as the fall in oil prices drops out of the calculation, and for GDP growth to slow slightly to 2.6% this year and to 2.0% in 2016. Part of the deceleration in growth will be due to a gradual increase in interest rates – we expect the Bank of England to make its first move in November – and part will be due to a tightening in fiscal policy after the general election. In addition, the housing market appears to have lost momentum following the introduction of new rules on mortgage lending last year.

Occupational Market

While office rental growth in the regions is a long way behind that in central London (+11% in 2014), there are some bright spots. Brighton, Cambridge, Cardiff, Edinburgh, Reading and Manchester all saw office rental growth of 3% or more in 2014 (source: Investment Property Databank (IPD)). The main impetus has come from professional services, IT and bank back offices. We expect office rental growth in the regions will probably continue at 2-4% a year through 2015-2016, and 1-2% a year from 2014-2019 (see chart). We are cautious partly because some cities still have quite high vacancy rates and partly because there are likely to be further cuts in public sector jobs after the general election.

Despite strong consumer spending, large parts of the retail property market remain in the doldrums. While certain retailers are expanding (e.g. discount stores and restaurants), this growth is outweighed by store closures (e.g. banks, bookmakers, fashion and phone shops), reflecting the rapid increase of mobile banking, internet gambling and online sales. Online clothing and footwear sales jumped by 17% in 2014 (source: ONS). Moreover, the recent U-turn in the expansion plans of the major supermarkets, which are now closing or sub-letting space in their big stores, will add to out-of-town vacancies. The Javelin Group of retail consultants estimates that the amount of space in hypermarkets and superstores could shrink by 25% over the next five years.

In the industrial sector, most regions are now seeing steady rental growth of 2-3% a year. The market is benefiting from both the growth in express parcels generated by online retailing and a cyclical recovery in small and medium sized enterprises (SMEs). The number of SMEs has grown by 10% in the last three years (source: Department for Business Innovation & Skills). In addition, the amount of space in standard industrial units has fallen over the last decade as estates have been redeveloped for housing, particularly in London and the South East.

Investment Market

The investment market was very busy in 2014 and the total value of real estate transactions at £63 billion matched the previous annual record set in 2006 (source: Property Data). Central London offices were once again the most liquid part of the market, but last year also saw a pick-up in shopping centre and industrial transactions, along with a number of deals in student accommodation and healthcare. Although the fall in oil prices means that interest from Middle Eastern and Russian buyers is likely to wane in 2015, we expect that Japanese and Taiwanese pension funds and Chinese insurers will become more active.

As a result of strong competition in the investment market, the IPD all property initial yield fell to 5.3% at the end of February 2015, its lowest level since early 2008. On the one hand, this looks reasonable in the context of 10-year gilt yields at 1.5% and given prospects for steady rental growth over the next few years. Our pricing model suggests that the gap over gilts could narrow to 1.5-2.0% without putting real upward pressure on real estate yields. On the other hand, we are aware that certain parts of the investment market have got ahead of occupier fundamentals (e.g. prime West End offices, shopping centres and distribution warehouses). We are therefore tilting our portfolios towards those assets and sectors (e.g. alternatives and multi-let industrials) which should be relatively resilient if investor sentiment turns.

Outlook

The latest IPF (Investment Property Forum) Consensus Forecast suggests that commercial real estate could achieve total returns of 12% in 2015. Our view is that total returns in 2015 should probably be closer to 15%, although the more yields fall this year, the greater the risk of a potential correction in the future.

The other immediate uncertainty is the general election and the risk that business confidence will be shaken, either by the prospect of an EU referendum, or by large increases in corporation tax and the minimum wage. The former could be problematic for London, given it is a hub for international financial and business services, whereas a jump in the minimum wage would particularly affect care homes, hotels, leisure, pubs and retailers.

Continental European Property Market Summary

Economy

After a pause in the middle of last year, the eurozone economy is gathering strength. All the major economies except Italy grew in the fourth quarter of 2014 and the recent rally in business confidence suggests that companies are coming to terms with the Ukraine crisis and the risk of Greece leaving the euro. Schroders expects the strongest levels of growth from Spain and Germany at 2% per annum through 2015-2016. Conversely, growth in France and Italy is expected to be weaker, at 1% and 0.6% per annum, respectively. The collapse in oil prices and low inflation has boosted households' real incomes and most eurozone governments have now completed or eased their austerity programmes. In addition, the start of quantitative easing (QE) has cut borrowing costs in southern Europe and triggered a sharp depreciation in the euro versus the dollar and sterling, which will benefit exporters.

Occupational Market

Office markets in continental Europe fall into two main camps. In the big German cities and Stockholm, employment in finance, business services and new media & IT has been growing steadily since 2011, vacancy rates have fallen below equilibrium levels and office rents are rising in most locations. Conversely, in Brussels, Copenhagen, Madrid and Paris, a lot of recent lettings have involved occupiers rationalising their space in order to cut costs, resulting in vacancy rates above their long-term averages. However, even in these cities there are attractive sub-markets with low vacancy rates (e.g. southern Paris, the Centre and Leopold districts of Brussels, and Madrid's central business district) and we expect them to lead the upswing in rents as demand recovers later this year.

On a positive note, there are no signs that deflation is leading consumers to defer purchases. Eurozone retail sales grew by a healthy 3.7% in volume terms over the 12 months to January. However, demand for retail space remains tepid because many retailers are focusing on their online offering and improved logistics. Online accounted for 10% of German retail sales in 2014, up from 4% in 2010, and this trend is echoed in many other eurozone countries. The strongest parts of retail real estate are big dominant shopping centres, major tourist destinations, small shopping centres with a strong food offer and big "boxes" in towns with good population growth and active housing markets.

After a prolonged period of oversupply, the logistics market has got back to equilibrium. Take up in western Europe rose by 10% in 2014, as retailers and logistics operators reconfigured their supply chains and prime rents rose slightly in Dusseldorf, Frankfurt and Rotterdam. Looking ahead, our real concern is that speculative development will bounce back quickly, given short lead times. We therefore favour mid-sized warehouses close to big cities, where supply is restricted.

Investment Market

The total value of investment transactions in continental Europe rose by 10% in 2014 to €145 billion (source: RCA) as liquidity rippled out from the core markets of France and Germany to Benelux, Italy, Portugal and Spain. The majority of capital invested was equity, but the last year has seen a definite increase in real estate lending, as finance costs have fallen further to rates of 1-2% and new entrants, such as insurers and debt funds, have come into the market.

The weight of capital means that prime office and shopping centre yields have fallen to 4-5% in most major cities in western Europe, while yields on prime logistics-related properties are down to 6%. This might look rational in the context of 10-year government bond yields at 0.2-1.25%, but investors are increasingly concerned that pricing of prime assets has become indiscriminate. We see better value in central business district offices that have short leases, or which can be repositioned, offices in mixed-use areas with a good range of amenities, convenience retail, mid-sized warehouses around big cities and certain alternative types (e.g. hotels). Yields on these assets are typically 0.5-2.0% above those on prime assets and we expect them to outperform over the medium-term, assuming the eurozone economy continues to grow.

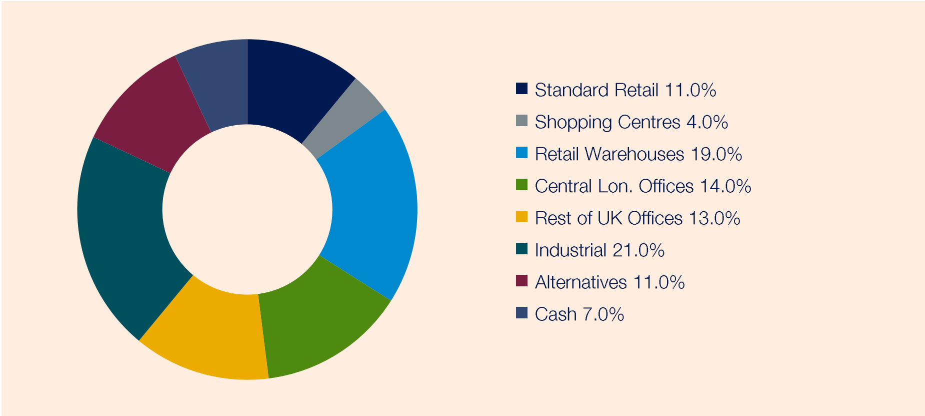
Outlook

We forecast total returns on average investment grade European real estate will be 7-9% per year between end-2014 and end-2018. Total returns and capital growth are likely to be front loaded, benefiting from yield compression in 2015-2016 and rental growth from 2016 onwards.

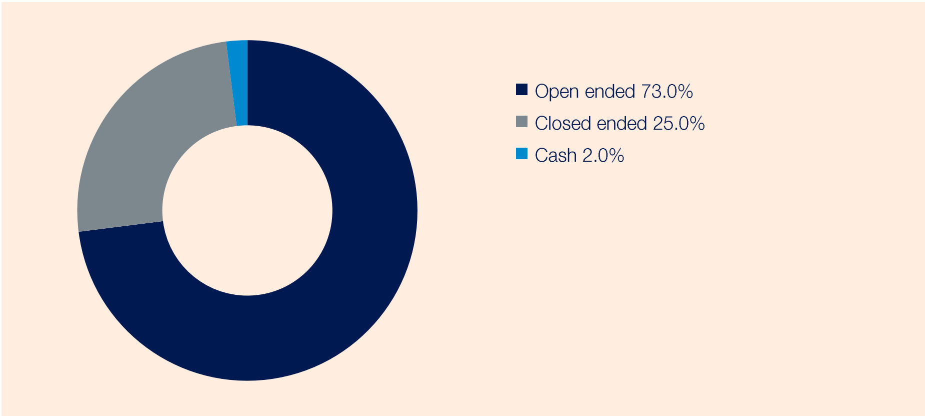
The main upside risk is that the low financing costs and the weight of money targeting real estate triggers an even bigger fall in yields through 2015-2016, boosting total returns in the short-term. The main downside risks are increased uncertainty surrounding the stability of the eurozone following a potential Greek exit of the euro and elections in Spain, or that deflation becomes entrenched.

Portfolio Analysis

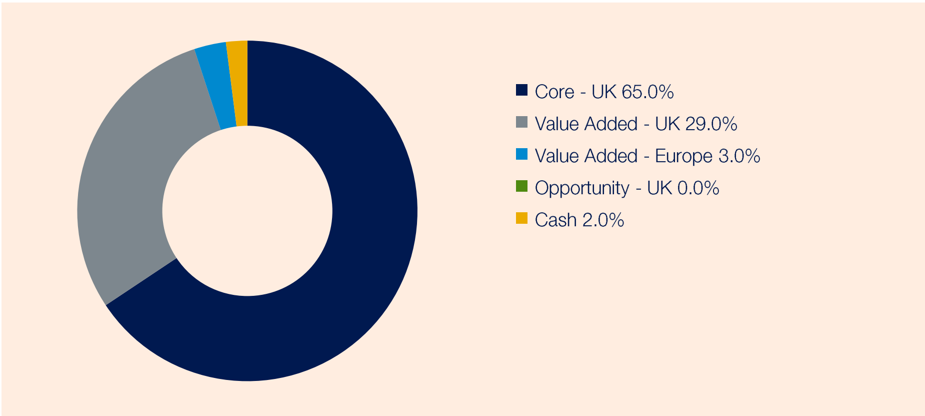
UK Portfolio sector exposure (including cash held by underlying property funds)



Open/closed-ended exposure



Fund style exposure



Source: Schroders & AREF/IPD UK Quarterly Property Fund Index, 31 Mar 2015. Totals subject to rounding. Cash included looks through cash in underlying holdings in the top chart.

Largest Stock Positions

at 31 Mar 2015

Largest Positions	Style	% of NAV
BLACKROCK UK PROPERTY FUND	Core	13.2
SCHRODER UK REAL ESTATE FUND GBP I INCOME (GROSS)	Core	12.7
STANDARD LIFE POOLED PENSION PROPERTY FUND	Core	10.3
HERMES PROPERTY UNIT TRUST	Core	8.6
AVIVA INVESTORS PENSIONS	Core	8.4
MAYFAIR CAPITAL PROPERTY UNIT TRUST	Core	6.9
INDUSTRIAL PROPERTY INVESTMENT FUND	Value-added	6.3
SCHRODER REAL ESTATE REAL INCOME FUND A UNITS	Value-added	5.8
METRO PROPERTY UNIT TRUST	Core	5.3
HERCULES UNIT TRUST	Value-added	4.1

Full details of holdings can be found in the Appendix

Performance Review

The portfolio returned 2.5% over the first three months of 2015, which was 0.3% below the benchmark. Central London and industrial specialist funds have been positive drivers of performance, while cash and reinvestment costs associated with a high volume of transactions over the reporting period (£5.8 million) have temporarily held back returns.

The UK portfolio (97% portfolio value) continues to perform well, outperforming the benchmark by 1.4%, 0.8% pa and 0.5% pa over the past one, three and five years respectively. The portfolio's Continental European holding produced positive performance over the past quarter (10.9% q/q in Euros) but remains a drag to total returns in aggregate over the past five years in particular.

The portfolio's industrial, west end office and alternative real estate exposure have been key positive drivers to performance over the past quarter, one and three year periods. The Industrial Property Investment Fund has benefitted from increasing occupier demand as economic conditions have improved, in addition to strong investor appetite for the sector given its relatively high income return. Similarly, WELPUT has benefitted from strong rental growth to the extent that we have sold down some exposure to lock in profits and move the portfolio modestly under-weight to central London offices. In the alternative sectors the Real Income Fund has benefitted from increasing valuations in the student accommodation sector.

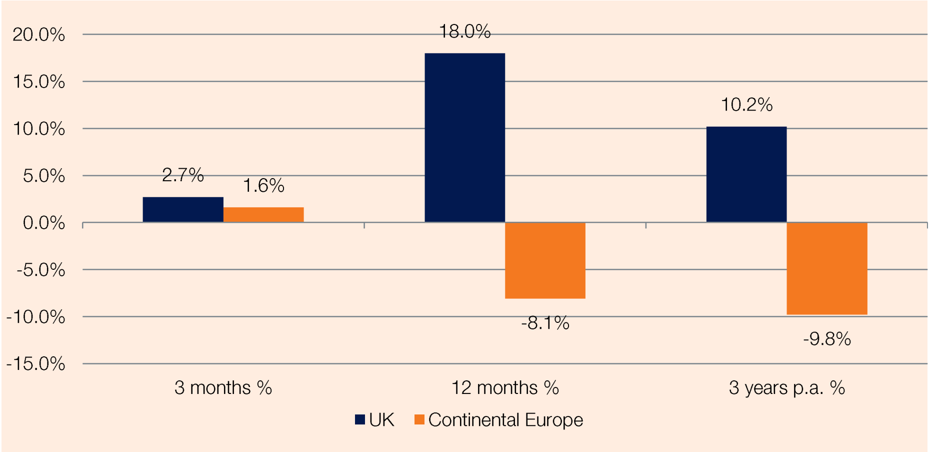
Hercules Unit Trust has been the largest negative contributor to performance over the past three months, whilst cash and transaction costs have also been dilutive to performance. However, this impact will reduce as the level of investment activity within the portfolio moderates from the high levels seen over the past six months.

In Europe, the Continental European Fund I (CEF I) produced a positive return of 10.9% in euros in the first quarter of 2015. This has been driven mainly by the sale of CG Malls above valuation and valuation uplifts in AXA European Real Estate Opportunity Fund II, NREP Logistics and Immobiliare Grande Distribuzione. However, a reduction in Euro/Sterling of 6.8% over the quarter served to offset some of these gains.

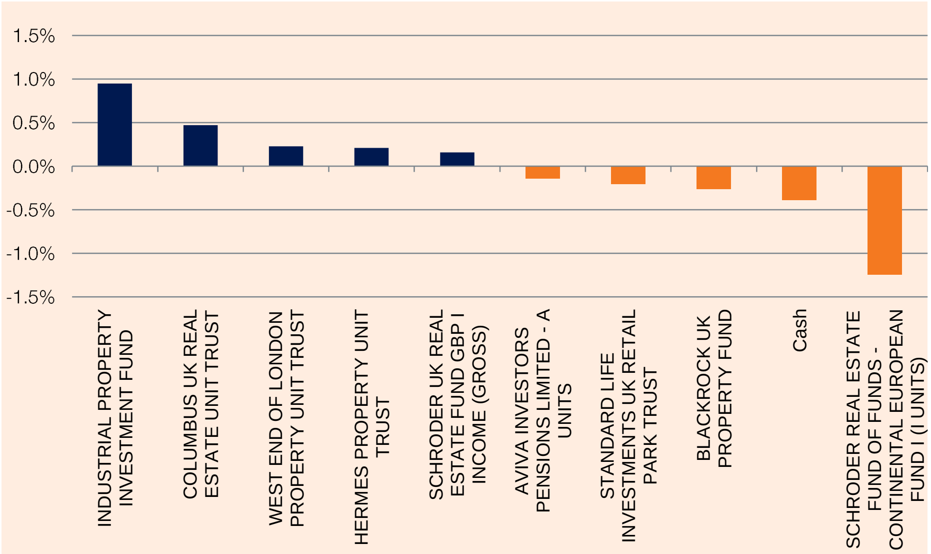
The charts overleaf illustrate the key drivers of performance in further detail.

Schroders The London Borough of Tower Hamlets Superannuation Fund

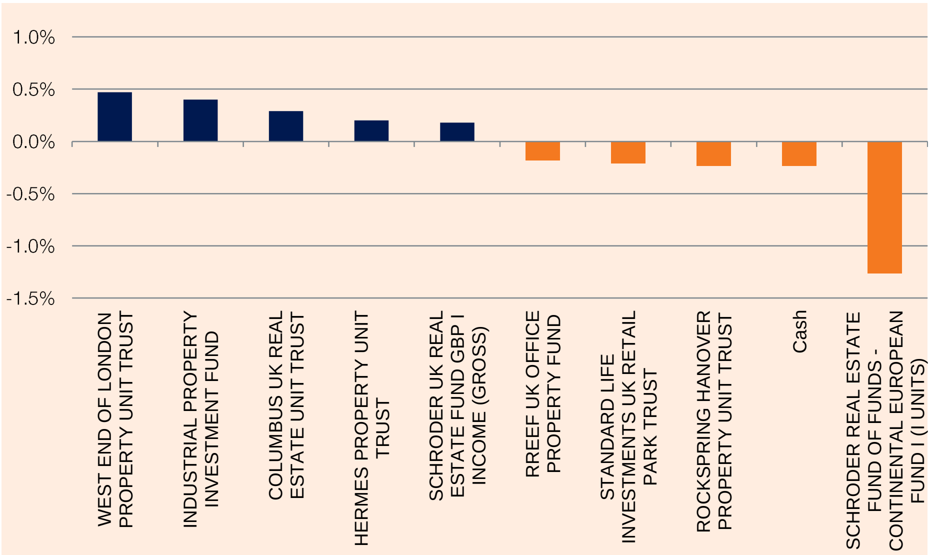
Total return by region
Periods to end 31 Mar 2015



Total return attribution relative to benchmark top & bottom five contributors
12 months to 31 Mar 2015



Total return attribution relative to benchmark top & bottom five contributors
3 years to 31 Mar 2015



Benchmark is AREF/IPD UK Quarterly Property Fund Index All Balanced Funds Weighted Average
Source: Schroders & AREF/IPD UK Quarterly Property Index
Note: Stock and fund style attribution is presented gross of fees. Periods over 12 months are annualised. Totals may be subject to compounding.

Portfolio Activity

The past three months have been active for the portfolio with £5.8m of transactions completed. Despite the volume of trades, the portfolio's uncommitted cash position stood at £0.1m (0.1% portfolio value) at quarter end. As a consequence we expect the negative impact of cash and transaction costs on portfolio returns to diminish over coming months.

Purchases

Fund	Investment GBP	No. of units	Entry cost/(discount) (%)
ASHTENNE INDUSTRIAL FUND UNIT TRUST	987,463	2,129,274.00	4.0
BLACKROCK UK PROPERTY FUND	1,503,745	38,206.00	-0.1
MAYFAIR CAPITAL PROPERTY UNIT TRUST	392,760	333.13	3.4
METRO PROPERTY UNIT TRUST	999,999	2,371.69	3.3

Sales

Fund	Disinvestment GBP	No. of units	Realised loss/gain GBP
ASHTENNE INDUSTRIAL FUND UNIT TRUST	49,322	n/a	n/a
SCHRODER REAL ESTATE FUND OF FUNDS - CONTINENTAL EUROPEAN FUND I (I UNITS)	1,105,741	n/a	-128,294
SCHRODER REAL ESTATE FUND OF FUNDS - CONTINENTAL EUROPEAN FUND I (I UNITS)	88,659	n/a	-6,599
WEST END OF LONDON PROPERTY UNIT TRUST	354,618	-484.05	212,665
WEST END OF LONDON PROPERTY UNIT TRUST	406,246	-554.53	243,627

Commentary on Activity

Purchases	
Ashtenne Industrial Fund	We added to this existing holding over the quarter by acquiring units on the secondary market at a 4% premium to net asset value (NAV). The acquisition increased the portfolio's exposure to industrials towards the level or our house view, while increasing exposure to a fund with an attractive 7.5% income distribution yield.
BlackRock UK Property Fund	Income and sale proceeds were recycled into this existing balanced fund on the secondary market at mid price.
Mayfair Capital PUT	Funds were drawn over the quarter to facilitate the purchase of two offices in Crawley and Redhill and a diverse portfolio of twelve other assets following an in specie transfer. The portfolio purchase had the benefit of increasing the fund's exposure to the industrial sector, reducing single asset and single tenant concentration, increasing the portfolio's average unexpired lease term, reducing the vacancy rate and improving the overall quality of income.
Metro PUT	Funds were drawn over the quarter to purchase a car dealership in Maidstone. The asset is let on a new 25-year lease with annually compounded RPI uplifts, reviewable every 5 years, collared and capped at 1.5% and 4% per annum, respectively.

Sales	
West End of London Property Unit Trust	Proceeds were received following redemptions that were served in July 2014. It has been our stated strategy to reduce exposure to the central London office market following a prolonged period of very strong returns.

Return of Capital	
Ashtenne Industrial Fund	The fund continues to sell assets in line with its business plan and has returned capital to unitholders.
Schroder Real Estate Fund of Funds - Continental European Fund I	Distribution in Jan: CEF I continues to distribute capital in line with receipt of proceeds from underlying investments. Over Q4 2014 AXA European Added Value Fund and FREO Germany II Partners returned capital following the sale of assets. Distribution in Feb: CEF I declared an interim capital distribution of over 20% of NAV in February 2015. The distribution consisted of proceeds from the sale of IRUS European Retail Property Fund on the secondary market at a premium to valuation and a further tranche of capital received from Corestate German Residential Fund.

Redemptions Outstanding

Fund	Curr	Est. proceeds	No. of units	Date proceeds expected	Notice date
Standard Life Investments Retail Warehouse Fund	GBP	4,248,018	4327	H2 2015	September 2014

Portfolio Commitments

Fund	Curr	Initial commitment	Drawn	Balance	Latest possible drawdown
Mayfair Capital Property Unit Trust	GBP	1,800,000	392,760	1,407,229	n/a
Multi-let Industrial Property Unit Trust	GBP	1,500,000	547,274	952,726	n/a

Strategy

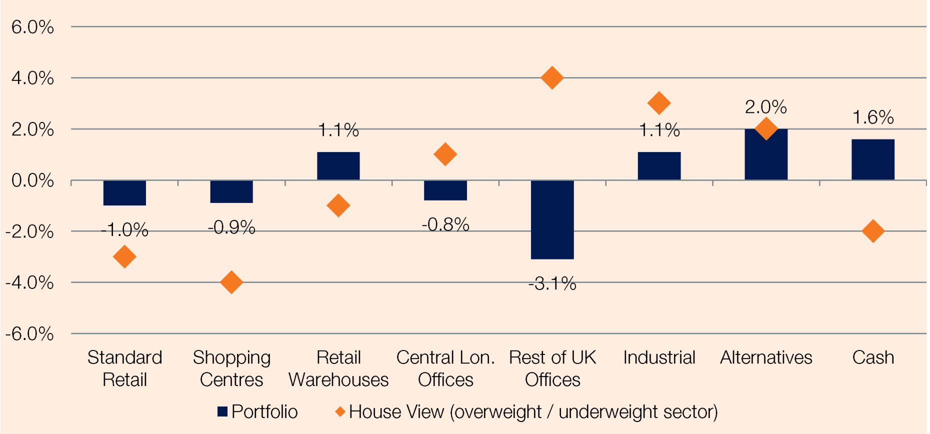
We have been allocating money returned from Central London and Continental Europe to balanced funds, where capital can be deployed efficiently and diversified across all mainstream sectors.

Investment has also been earmarked for two bespoke strategies we have created exclusively for our clients: Mayfair Capital PUT and Multi-Let Industrial PUT. Both of these investments reflect our aim to position the portfolio for income which we expect will be the key driver of returns over the coming three year period. Our preference is for industrials, where yields are attractive and where supply/demand fundamentals are positive. In addition we continue to favour alternatives where rental growth is less correlated with the performance of the economy, income yields are attractive and total returns are relatively resilient.

We are looking to increase our exposure to regional opportunities, which look set to benefit from the broadening economic recovery. This would balance the current portfolio bias to London and the South East. Our preference is for office and industrial assets.

Although retail sales are increasing, much of the growth is online. Vacancy rates remain high across many locations and the prospects for rental growth are dim. In our portfolios, our focus continues to be on local convenience retail, which is benefiting from the switch to "small basket shopping" and retail warehouses, which provide retailers with efficient and affordable space.

UK portfolio sector weightings relative to benchmark



Source: Schroders & AREF/IPD UK Quarterly Property Fund Index, 31 Mar 2015

Governance

Investment Resolution	Date	Voting Recommendation
None		

Appendix

Investment Restrictions

Parameters	Restriction	Current status
Max. exposure to any common investment fund (CIS)	30%	13.2%
Max. in Schroder in-house funds (Manager & Adviser)	60%	17.7%
Min. exposure to open-ended funds	45%	75.4%
Max. exposure to opportunity funds	20%	0.0%
Max. exposure to property index certificates	20%	0.0%
Max. exposure to listed property securities	10%	0.0%
Max. exposure to Continental Europe	20%	3.1%

Source: Schroders, to 31 March 2015.

Notes:

Valuation data represents value calculated as at the final business day of the quarter to which this Investment Report relates. Pricing occurs 10 days following quarter end. Accordingly, the above noted column entitled "current status" refers to the quarter end valuation data.

The Investment Management Agreement (as amended from time to time) constitutes the final record of applicable investment restrictions incumbent on Schroder Property Investment Management Limited. In the event of any inconsistency between the Investment Restrictions appearing in this Investment Report and the Investment Management Agreement, the Investment Management Agreement shall prevail.

Appendix

Portfolio Valuation

MID and NAV values

Fund	Description	Value at 31 Dec 2014 GBP	Value at 31 Mar 2015 GBP	Portfolio Value %
AVIVA INVESTORS PENSIONS	Core	10,011,486	10,264,084	8.4
BLACKROCK UK PROPERTY FUND	Core	14,461,291	16,183,538	13.2
HERMES PROPERTY UNIT TRUST	Core	10,247,420	10,468,399	8.6
MAYFAIR CAPITAL PROPERTY UNIT TRUST	Core	7,960,320	8,440,659	6.9
METRO PROPERTY UNIT TRUST	Core	5,339,001	6,420,675	5.3
SCHRODER UK REAL ESTATE FUND GBP I INCOME (GROSS)	Core	15,189,158	15,554,010	12.7
STANDARD LIFE POOLED PENSION PROPERTY FUND	Core	12,270,570	12,551,232	10.3
Sub total Core		**75,479,245**	**79,882,596**	**65.4**
ASHTENNE INDUSTRIAL FUND UNIT TRUST	Value Add	990,149	1,898,952	1.6
COLUMBUS UK REAL ESTATE UNIT TRUST	Value Add	2,245,804	2,283,788	1.9
HERCULES UNIT TRUST	Value Add	5,140,009	5,068,719	4.1
INDUSTRIAL PROPERTY INVESTMENT FUND	Value Add	7,324,157	7,664,122	6.3
LOCAL RETAIL FUND	Value Add	2,152,993	2,156,446	1.8
MULTI-LET INDUSTRIAL PUT	Value Add	525,769	542,822	0.4
SCHRODER REAL ESTATE REAL INCOME FUND A UNITS	Value Add	6,960,026	7,117,746	5.8
STANDARD LIFE INVESTMENTS UK RETAIL PARK TRUST	Value Add	4,270,433	4,248,018	3.5
WEST END OF LONDON PROPERTY UNIT TRUST	Value Add	5,628,058	5,059,567	4.1
Sub total Value Add		**35,237,397**	**36,040,179**	**29.5**
GRESHAM REAL ESTATE FUND II LP	Opportunity	11,889	13,544	0.0
Sub total Opportunity		**11,889**	**13,544**	**0.0**

Portfolio Valuation

MID and NAV values

Fund	Description	Value at 31 Dec 2014 GBP	Value at 31 Mar 2015 GBP	Portfolio Value %
SCHRODER REAL ESTATE FUND OF FUNDS - CONTINENTAL EUROPEAN FUND I (I UNITS)	Europe	4,960,812	3,807,809	3.1
Sub total Europe		**4,960,812**	**3,807,809**	**3.1**
GBP Cash	Cash	3,459,031	2,458,297	2.0
GBP Income Receivables	Cash	62,011	0	-
Sub total Cash		**3,521,042**	**2,458,297**	**2.0**
Total		**119,210,385**	**122,202,426**	**100.0**

Totals may be subject to rounding

Portfolio valuations are calculated on the basis that units in open-ended funds are valued at their mid price and closed-ended funds at their NAV price.

Source: Schroders, periods to 31 March 2015.

Notes

Responsible Investment: Schroders Socially Responsible Investment and Corporate Governance policies can be found on our website http://www.schroders.com/global/about-schroders/corporate-responsibility/responsible-investment/. We also publish regular articles on Socially Responsible Investing, which can be found on Schroders Talking Point www.schroders.com/talkingpoint.

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