

Property

Property has been the darling of UK investors for the last 10 years or more. This article looks at the advantages and disadvantages of property as an investment, and how it might fit in to an overall investment portfolio.

This article is primarily concerned with commercial property. Many of our clients hold residential property sometimes because they need somewhere to live and also often in the form of buy to let arrangements. Commercial property can offer both substantial capital growth and significant income in the form of rental payments. Like all other investments property has advantages and disadvantages.

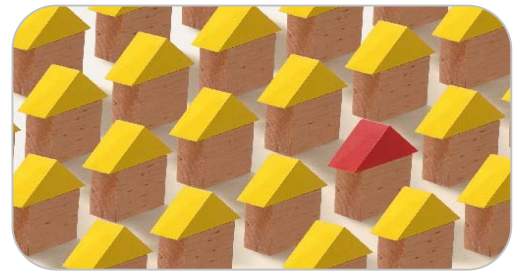
Disadvantages

Data

It is difficult or impossible to find reliable data on commercial property. Most commentators refer to the Investment Property Databank, which produces detailed data on many aspects of commercial property, both in the UK and worldwide. The data is useful but is appraisal based data. I have a nervousness of appraisal based data – virtually all of the other data we use is transactional. RICS also produce a lot of interesting data. Be wary of qualitative data or research masquerading as quantitative data. Property is heterogeneous; this may be an advantage for the property professional but makes valuations and appraisals complicated.

Liquidity: Most listed shares can be sold in the twinkling of an eye or the click of a mouse. Disposing of property is normally a much lengthier process than disposing of a stock or a gilt. In a falling property market, property funds can usually suspend dealing in their funds for a period of several months.

Buying and selling costs: The cost of buying and selling property can be very high compared to other assets.



Size of unit: £10,000,000 could with care produce a reasonably well diversified portfolio of UK shares. Through diversifying in this way investors hope to reduce the risk of picking a duff investment. £10,000,000 may not be enough to buy one large office building. We therefore exclude many property funds as potential investments because they are just not big enough to achieve any worthwhile diversification.

Confusing labelling: Property funds in the UK cover two distinct approaches. They can invest in either property itself or in the shares of property companies. These are quite different propositions. Investment in the shares of a property company is fundamentally an equity investment rather than a property investment. It might be supposed that the share prices of property companies are closely linked to the state of the property market but this has not proved to be the case.

Irritation: Owning and managing property can be a time consuming and frustrating experience. Many of our clients choose to gain exposure to property via property funds rather than through direct ownership.

Maintenance costs: Maintenance costs are higher and less predictable than for other investments. Most investments have running costs in one way or another but it is important not to be seduced by high headline yield numbers without investigating further.

Advantages

More secure capital than equities: The price of property in the Western world can and does fluctuate but it is extremely unusual for the value of a property to become nil, but this is a real possibility with equities.

Good income producing asset: Generally high value and high quality properties are let to tenants on long term leases often with upwards only rent reviews. This can provide a fairly secure flow of rental income. The yield on commercial property funds has historically been higher than the yield on equity funds.



Good capital growth potential: In the medium and long term property prices have risen more quickly than price inflation.

Poorly correlated with equity markets: Generally the performance of property markets is not strongly (positively or negatively) correlated with the performance of equity markets. There have been times when both have declined in value but this is rare. This means that the addition of property to a portfolio can help to reduce volatility.

REITs: New legislation encouraging the formation of Real Estate Investment Trusts on tax advantageous terms may give a boost to commercial property

How much to invest in property

Each of our clients decides individually exactly how much to invest in each asset class. We offer advice and analysis. If we were to use only the widely available mathematical models to produce efficient frontier portfolios (these are portfolios that would historically have produced the desired return with minimum volatility consistent with this return objective) then we would typically have weightings in property of between 20% and 60%.

In fact, we generally recommend that clients hold between 0% and 15% in property. There are several reasons for this advice. The design of model portfolios based around asset allocation is at last becoming very popular. This is an excellent trend. But none of these models are panaceas. As well as our strong relationships with the academic community we also look closely at where institutions are investing their money. Most very long term institutional investors have a 15% or so cap on property investment. Over the 90s property became less and less fashionable. Large pension schemes gradually reduced their exposure to property as it started to seem obvious that shares were a one way bet. As it became clear that shares were not a one way bet, and after years of reducing property exposure, in the last few years pension schemes are piling back into property. We prefer to select a mid ground. 5% to 15% is sensible for many clients. Some large pension schemes with a low tolerance for risk are altering their investments radically. Some might have expected a shift from equities into property; in fact the shift has been from equities to fixed interest securities. This has much to do with schemes attempting to match their investments to their liabilities.

In the very long term we believe that equity markets will deliver the highest returns for investors. To this we add fixed interest, cash and property to reduce volatility. In general we are nervous of very high exposure to property for the reasons listed above. Many clients are however not nervous. Each client is different.

We see property as an asset class and would rarely recommend any gearing. Geared property investments should be left to the professionals. Borrowing to invest is too high a risk strategy for the bulk of our clients.

You will be used to seeing a lot of data in the papers that we produce. However, in this case, there is very little. This is because of the appraisal nature of the data. The IPD website (www.ipdindex.co.uk) shows that returns from all UK property have averaged 12.8% per annum over the last five years. This comfortably beats all other mainstream asset classes. To their great credit the following warning is published next to the data. "The IPD Index is neither appropriate or authorised for use as a benchmark for portfolio or manager performance."

The RICS site (www.rics.org) is packed with interesting information about property and associated matters.

WM and CAPS also produce good reports on asset performance but these are subscription publications.

There is broad consensus that over the last 10 years property has been the best performing asset of the mainstream asset classes returning approximately 12% per annum.



Conclusion

Scientific data on property is hard to track down. Despite this difficulty economic theory suggests that the long term return to investors on property should be substantially better than that available from gilts, bonds or cash deposits. Investors will demand a premium for the various disadvantages that property suffers from. This premium is likely to be less than the very long term premium on equities because total loss of capital is very unlikely, and therefore the asset is less risky than equity investment. Property often produces an attractive yield.

Property has a place in most of our clients' portfolios.

Ben Sherwood - Partner
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