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Can property get back in the mix?

Adam Lewis, committee chairman and associate editor, Fund Strategy

Welcome, to the fourth Fund Strategy Investment Committee. This week we are joined once again by Keith Wade, Schroders' chief economist and strategist, as well as a new member to our panel, North Investment Partners' John Husselbee.

A recent cover story in *Fund Strategy* ("Can property raise the roof again?", 15 May 2013) examined whether there was a case for returning to the sector, once known for its safe haven status. Indeed, between January 2006 and July 2007 the asset class was so popular among retail investors it led the IMA's Specialist sector to be the top seller in net retail terms for 17 consecutive months. I remember receiving a snow globe with London's landscape in the background, marking the New Star Property Trust passing £1 billion in assets under management.

Then things went awry. Between 2007 and 2009 returns dived by about 45 per cent and several funds had to take emergency action to stem outflows. The diversification argument for the asset class seemed to evaporate as everything, bonds and equities included, correlated back to one following the onset of the financial crisis.

Those in favour of the asset class say these falls, while painful, were a blip and the crisis has run its course. They say the sector has returned to its long-term profile of having a low correlation with equities and bonds, while in addition providing an attractive level of income.

So the main question I ask the panel is this: Is the UK commercial property sector on the way back to regaining its place in as a genuine diversifier in investor portfolios and, if applicable, how are you gaining exposure to the asset class?

Mike Deverell, investment manager, Equilibrium Asset Management

"Property remains a genuine diversifier away from bonds and equities in normal times. However, it is important to remember that commercial property is highly linked to economic growth. In economic crises such as 2007 to 2009, it will not provide protection against falling prices any more than equities will.

With economies apparently stabilising, commercial property is starting to look attractive again. Bonds appear expensive, and after a strong run in equities investors will look elsewhere for returns.

Commercial property prices have been falling, but this is now showing signs of slowing. With the rental yield on the IPD index well over 6 per cent we only need to see stable capital values for this to look an attractive asset class. Those who believe in the "great rotation", where investors will sell bonds and buy equities, should also look at property. The factors that are supposed to be bad for bonds and good for equities are also a positive for property.

We have recently invested back into property and expect to increase this soon. We prefer bricks-and-mortar funds such as Swip UK Property Trust, but are also looking at ways to track the IPD index using derivatives. We think this could beat most traditional funds.

Jonathan Davis, managing director, Jonathan Davis Wealth Management

"We have never accepted that commercial property is a diversifier in investment portfolios. During the 30-plus year bond rally, equities also rallied, as has, of course, all forms of property. Diversification? What happens when, eventually, both lending stops and interest rates rise? We tend to invest in areas we can understand most easily. Commercial property is complicated for us in that it is multifold. Is it prime office, less prime office? Prime retail or out-of-town less prime? And the same for factories and warehouses. We do not have the expertise to understand the intricacies of these markets.

Overall we see an economy that is improving due to £100bn per year government spending over tax receipts (aka a deficit). So, in the short term this is positive for commercial property usage and therefore for mutual fund investing. Also, as there remains a huge demand for income, which will continue as interest rates are kept down, then even paltry yields, last seen at the peak of the bubble in 2007, will be attractive for institutions.

All in all there is scope for commercial property funds to hold up for a while, though longer term I take you back to my first question: What happens when, eventually both lending stops and interest rates rise? We have no such funds in our portfolios.

James Calder, head of research, City Asset Management

"Within our multi-asset approach, commercial property is considered as a separate asset class. Historically, the reasoning was that this sector is a source of diversified return and provides an attractive yield. Unfortunately, before the financial crisis commercial property became highly correlated with equities and therefore failed to satisfy the diversification criteria. In addition, yields fell as capital values increased, the result being that the sector lost its safe haven status. After the crisis commercial property values fell and investors were left feeling rather bruised.

Our current investment strategy ascribes a weighting of almost zero to commercial property, although we have made a small move back to the asset class through a specialist property vehicle. We remain concerned about the outlook for capital values.

With regard to fund selection, one must be very careful over where fund managers have positioned themselves in terms of asset split (office, industrial, retail high street and geography). Rental yields within the fund are also of great importance.

We still have concerns over the risk versus return profile for general property, but the outlook is changing and a move back to the asset class by the first quarter of 2014 would not be far-fetched.

UK commercial property lost its safe haven status with poor returns during the financial crisis. Our panel considers whether the asset class has recovered enough to be an effective diversifier

THE INDEPENDENT VIEW

Keith Wade, chief economist and strategist at Schroders

UK commercial property has historically been an intermittent diversifier from bonds and equities. In a traditional "occupier market cycle" property returns are coincident to the economic cycle, moving independently of equities. Property returns are driven by changes in open market rental values, which should reflect the strength of the underlying economy. Thus between 2000 and 2002 when the dotcom bubble burst, property continued to deliver about 8 per cent a year because the UK economy continued to grow, thus offering diversification from equities.

The period 2003 to 2007 can be classified as a "capital markets cycle", a period in which property returns were driven by the huge increase in the availability of cheap debt, not a change in the underlying fundamentals. Investors bid the UK all-property initial yield down from 6.7 per cent to 4.6 per cent, causing capital values to rise by 49 per cent. When the debt taps were turned off, demand collapsed and values fell by 44 per cent.

With bank debt now in short supply and investors exercising more caution, we believe a return to the debt-fuelled volatility of the last cycle is unlikely. We anticipate that the bulk of returns from UK property will be derived from an income return of about 6.5 per cent.

The yield gap between UK commercial property and gilts is as large as ever, while property yields also look fairly priced relative to other asset classes. We expect to return to a period where property returns are driven by the occupier market. This suggests that returns on UK commercial property should again follow the economic cycle and thus regain its diversification benefits from bonds and equities.

John Husselbee, chief executive officer, North Investment Partners

"Diversification is at the heart of our investment approach and our portfolios are constructed on a multi-asset, multi-manager basis. We would consider commercial property as a long-term diversifier but we currently have little exposure to it.

Part of the challenge is finding a suitable vehicle to access bricks and mortar. Most of our mandates offer daily liquidity, which is not suited to gaining the best long-term diversification benefits offered by this asset class. If we were to buy an open-ended fund then typically to offer daily dealing these are at best 80 per cent invested in property, with the balance in cash and short-term deposits. This is a result of the experience of some funds which came under significant pressure at the end of the previous cycle, where excess redemptions led to suspended dealing. This option gives us neither the full capital nor income exposure to commercial property.

The alternative is to invest via closed-ended investment companies where there is market liquidity. However, here the challenge is pricing, which can often trade at a discount and rarely at a premium to net asset value. This route increases portfolio correlation to equities, which reduces any diversification benefit.

Tim Cockerill, head of collectives research, Rowan Dartington

"For an asset class to be a diversifier suggests the correlation between it and another asset class should be low or, ideally, negative. But correlations change and an asset class that worked as a diversifier can suddenly become correlated with another.

The key is whether an asset class is fairly priced, cheap or over-valued. If it is over-valued the chances of a correction are higher. Going into the financial crisis, property had become over-valued. The conversion of property companies into real estate investment trusts drove share prices of companies such as British Land to high levels. On the back of this and other factors commercial property prices rose, supply grew and with it a rash of property trust launches which were highly geared. Everything was set for a correction.

Today the excesses have gone from the property market and broad valuation measures indicate the sector to be "good value". Demand varies, but where there is demand then rental income is likely to rise. Activity has picked up and secondary property is being bought with a view to upgrading it – the next property cycle seems to have started.

Property funds have again been offering an investment with strong diversification qualities. Returns have varied between the types of investment vehicle, but the asset class looks set to work as a diversifier for the next few years.

Lee Robertson, chief executive, Investment Quorum

"It is our opinion that attractive income returns are bringing investors back to property as an investable asset class. From the circa 40 per cent falls we saw during the crisis, with redemptions and gatings aplenty, we seem to have come a long way forward and we feel that the latest IMA figures showing net sales of £98m in April alone show we are not alone in this view.

Our clients are often looking for a real return on their portfolio and with yields falling on bonds in particular the search for income has turned to UK commercial property and global Reits, among other classes. We have found that quality managers such as Ainslie McLennan, who runs the Henderson UK Property Unit Trust, Gary Hutcheson at Ignis and Gillian Tiltman of M&G are getting good yields from industrial and logistics-style operations from quality properties mainly in the south east.

Other decent managers such as Threadneedle and F&C appear to be following the same styles of investment and are finding that the pickings are there. Even with these managers looking towards the same types of buildings for the same yields the space does not yet appear crowded. On a five-year view, we feel that there are returns to be had, particularly from a yield standpoint.