Volume 20 //

Acuity

The greatest wealth is **your peace of mind...**

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WEALTH MANAGEMENT

Global commercial property: as safe as houses?

> Real estate cannot be lost or stolen, nor can it be carried away. Purchased with common sense, paid for in full, and managed with reasonable care, it is about the safest investment in the world
>
> Franklin D. Roosevelt

Global commercial property can, potentially, offer valuable diversification benefits to an investment portfolio. Many investors exclude it because they own residential property investments, or small commercial units. Are we talking about the same thing or is it entirely different? In short, it is different and rational investors should consider its inclusion in portfolios.

'I've already got all the property I need!'

The British (along with the Americans, Australians and the Hong Kong Chinese) have had a long-standing obsession with property. Many people have a material proportion of their net worth tied up in it, either through their principal home, second homes, buy-to-lets, or perhaps a small office block in their personal pension plan. House prices are currently rising fast again – particularly in London and the South East – and the false premise of 'easy money' from property is in danger of returning.

Inevitably, that does lead to the question as to why investors would want any incremental exposure to global commercial property in their investable assets portfolio. This volume of Acuity aims to provide some perspective on why it does makes sense for most investors and explores the valuable attributes it delivers in a well-structured portfolio.

An aide memoire on residential property

There are a few points of note that are worth reflecting on when it comes to residential property (homes and buy-to-let investments).

- A home is not an investment unless the owners have a plan to downsize at some point. Even then, the investment is only the excess capital realised.
- Property is a depreciating asset that requires love and attention, as any homeowner knows only too well.
- Buy-to-let investment is not the next step up the investment risk spectrum from deposits, but a leap to the other end of the risk spectrum, being a highly geared business venture with a concentrated play on the direction of the value of each specific property.
- Residential property prices can and do fall: from 1989 to 1993 property prices in the UK fell by around one third in value after inflation; they also fell by a similar magnitude from 2007 to 2009[1].
- Leveraged losses can wipe out all of the equity in the property and more, resulting in negative equity (where the debt is greater than the value of the property).
- Managing buy-to-lets is time consuming and net income is far lower than many new to the game perhaps realise: headline gross rental yields of around 5% end up as net yields of around 2%, or less, once all reasonable costs are taken into account[2].
- Commercial property is driven by different dynamics to residential property and their return patterns are not the same.

What is global commercial property?

The remainder of this volume focuses on the commercial property asset class and how it can be effectively incorporated into portfolios.

First things first: it makes sense to define what we are talking about. The commercial property market is made up of three principal sectors: retail space, such as shopping malls; offices; and industrial buildings, such as warehouses and factories. It also includes hotel/resort/leisure, healthcare, storage and specialty assets to a lesser extent. The global stock of investable commercial property - sometimes referred to as 'real estate' - was estimated[3] as being worth around $26 trillion at the end of 2011, which was a shade lower than the total market capitalisation of listed companies of $27 trillion.

That's a big number, yet few individual investors hold anywhere near as much commercial property in their portfolios as might be expected. On the other hand, institutional investors, such as pension funds, endowments, sovereign wealth funds and ultra-high-net-worth families have long held material allocations to this asset class. In fact, one third of the assets managed by the world's 100 largest asset management companies focus on property[4].

The chart below provides an overview of the distribution of commercial real estate value globally, which is split quite evenly across the Americas, Europe and Asia.

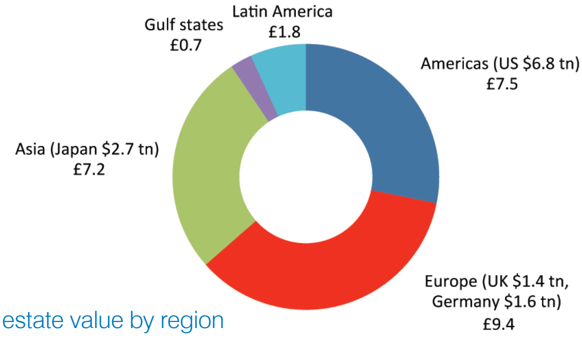

Figure 1: Commercial real estate value by region

Data source: Pramerica Real Estate Investors (2012) – refer to endnote[3]

It is a hybrid between bonds and equities

In terms of the economic rationale underpinning returns, commercial property represents a series of cash flows like a bond, made up of the regular payment of rent and the residual value of the building; the more certain the occupancy and length of rental lease, and the higher the quality of the tenant, the lower the volatility of the capital value of the building is likely to be. As such, buildings with high quality tenants on long-term leases tend to act more like bonds and are less volatile as the income dominates returns. A risk exists that as leases come due they will not be renewed. This can affect near-term residual values. Properties with short-term tenancies - the ultimate being hotels - tend to have more equity-like volatility in their capital value, relying on the success of the operating company rather than the property asset. In the short-term, sentiment and supply and demand will affect the capital values. Leverage i.e. borrowing, which is often present in property investments, will also raise the risk towards that of equities, while magnifying returns, both on the up and downsides

The challenges of gaining access to commercial property assets

The low exposure that many individual investors have to commercial property exists for a number of reasons:

- Many simply make the decision that they have enough exposure to property, even if this simply means their home. Perhaps not the best reason for excluding it.
- Direct investment in commercial property tends to require large sums of capital. As a consequence, it can be extremely difficult and costly to establish a well-diversified portfolio of properties across sectors and geographies.
- It practice, it can be a hassle to manage, and if this role is subcontracted, net yields are reduced.
- Portfolios of properties are illiquid which can be problematic for investors with current and near-term liabilities and also risks concentration in property assets, as liquid assets are sold down to meet cashflow commitments.

Perhaps not surprisingly, individual investors who made allocations to commercial property in the past usually did so using 'bricks-and-mortar' unit trusts, often those offered by insurance companies[5]. These funds bought and held a portfolio of a few commercial property assets, which they, or subcontracted parties, managed. These funds were usually, but not always, ungeared. The downside was that they were often geographically concentrated, fees were high, and as investors found out during the Credit Crisis, illiquid. Fortunately the world has moved on.

Liquid access to commercial property via listed property shares

An alternative to investing in brick-and-mortar funds is to invest in the equities of listed property companies. These securities have been around for many years, providing liquid access to commercial property in a broad sense. The problem was that owning a property company could have meant anything from owning an office block that was rented out, to speculative development, holding of land banks, or the provision of property related services, such as security or property management. That meant taking on a less-than-clean exposure to the asset class.

Fortunately for investors, various tax and regulatory regimes around the world - led by the US and Australia - allowed property companies to transfer their assets into vehicles called Real Estate Investment Trusts (REITs) that conferred tax breaks at a corporate level provided certain requirements were satisfied. This new structure provides positive benefits to investors, not least the fact that exposure to property is much cleaner.

So, what are REITs?

REITs are property investment companies that pass through income to shareholders, and thus avoid corporation tax. In the UK, the profits of a REIT's property rental business are exempt from tax and investors receive income gross. One condition that must be met is that 90% of the income of the tax-exempt business is distributed to shareholders within twelve months of the end of the accounting period; in addition, 75 per cent or more of its assets must be investment property and 75 per cent or more of its income must be rental income[6]. REIT requirements vary across jurisdictions but broadly follow the same principles.

In the UK, while listed property companies have long been in existence, the UK REIT regime was only introduced in 2006, with the first REIT being launched in 2007. Examples of UK REITs include British Land and Land Securities. The development of REIT markets around the world is gathering pace as confidence in the REIT structure grows, particularly given the way in which it survived the severe market test associated with the Credit Crisis.

Are they equities or property? The answer lies in the 'Gherkin'!

One of the questions that is often raised by investors (and academics) is whether REITs are equities or whether they are property. The long and short answer is that in the short-term, REITs may be influenced, to some extent, by movements in the equity market, but over the mid to longer term, the property characteristics win through, delivering property-like returns. This is not really that surprising as prices must catch up with economic reality at some point. As such, REITs represent a fair substitution for brick-and-mortar investments.

To make this point clear, imagine that the 'Gherkin' in the City of London – a now iconic London landmark – had a twin sister. Imagine, too, that both had signed up HMRC on a 20-year, upward-only rent review lease. However, one tower was owned by a bricks-and-mortar fund, and a REIT, listed on the stock exchange, owned the other. The value placed on the tower owned by the brick-and-mortar fund would be via a monthly appraisal valuation (a rough guess) provided by a professional valuer. The REIT on the other hand would rely on the market to price it, minute-by-minute. The two valuations might be quite different on any given day, month or year, yet they are, to all intents and purposes, identical investments. Of course the two will deliver the same returns over the longer term, ceteris paribus. They have to! Recent academic research[7] supports this fact and also indicates that REITs are a lead indicator of bricks-and-mortar fund outcomes, as REITs reflect what is really going on far faster than bricks-and-mortar fund price guesses.

This issue was clearly highlighted during the Credit Crisis when REIT values fell steeply, quite early on, as the market recognised the problems in the debt and real estate markets. Bricks-and-mortar funds, on the other hand, carried on delivering smooth returns until they reached a point at which the pricing caught up with reality. Funds were closed to withdrawals, and remained closed for some time. The astute reader has probably already worked out that bricks-and-mortar property fund returns are falsely smooth.

What's in a global REIT portfolio?

To date, only a fraction of the global investable commercial real estate is held by REITs. In the US – probably the most developed market – REITs represent only around 10% of all investable commercial real estate. The FTSE EPRA/NAREIT Developed Market Real Estate Index, for example, captures a market capitalisation of around $1.25 trillion held by over 300 REIT companies globally. The figure below provides a geographic breakdown.

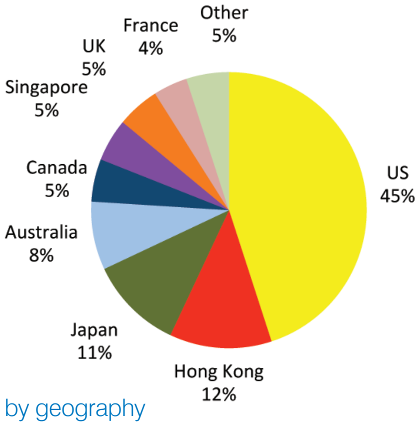

Figure 2: Global REIT exposure by geography

Data: FTSE EPRA/NAREIT Developed Real Estate Index 31/12/2012. Source: Pramerica[8]

Global property as part of a well-structured portfolio

The fact that REIT returns are driven by the underlying property assets over the mid to longer term, they should provide a diversification benefit when introduced into a basket of equities. Over the period from 1990 to 2013 global commercial property had a correlation to the UK equity market of around 0.5, which means that whilst its returns had some resemblance to those of the market, they were not that similar. It returned around 8.5% per annum, which was a shade above UK equity market returns. You can see from the chart below that it contributed very positively to portfolios over the technology stock crash in the early 2000s, did not help during the Credit Crisis from 2007 to 2009, but contributed materially immediately thereafter in helping portfolios to recover.

The expected returns sit between bonds and equities and the inherent leverage in REIT companies[9] push both risk and return up towards equity-like characteristics, at around 1% or so below that of developed market equities over time.

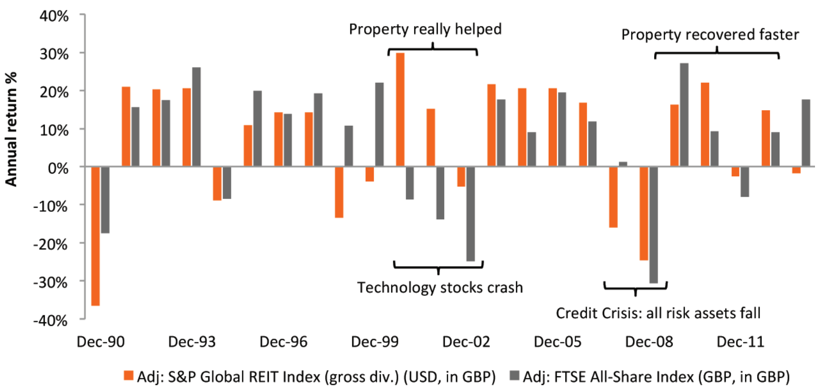

Figure 3: Global REITs vs. UK equity returns (after inflation) - 1990 to 2013

Data source: DFA Returns Program.

Property as an inflation hedge

Long-term investors always need to keep an eye on the impact of inflation on their portfolios. Property provides a strong positive correlation to inflation, as replacement costs are closely aligned to inflation (e.g. labour costs, building materials, and energy). The degree of short-term protection from inflation depends to some extent on lease structures, their maturity and the terms of the lease, which may in some cases allow for inflation-matching rental increases. Supply and demand will also impact on property's ability to provide an inflation hedge, in the shorter term.

Improving the return-to-risk relationship

As rational investors build portfolios, they seek incremental opportunities to improve the risk-return relationship. Adding a small, yet material allocation of global commercial property to an all equity portfolio - half in UK equities and half in world ex-UK equities – over the period from 7/1989 to 3/2014[10], did just that, as the table below illustrates.

Portfolio	Return % p.a.	Risk % p.a.	Return/Risk
50% UK eq. 50% World ex-UK eq.	7.7%	14.5%	0.53
Above but with 15% in global REITs	8.0%	14.0%	0.57

Table 1: Small incremental improvements to portfolio structure help

Data source: DFA Returns Programme

UK residential property is not a substitute

The fact that an investor owns a material allocation to residential property should not be a reason for dismissing commercial property as a valid component of a well-structured, long-term investment portfolio. This is because UK residential property is uncorrelated with global commercial property (correlation coefficient of 0.1), which – in more straightforward language - means the return pattern of one bears no relationship to the return pattern of the other. Looking at the chart below, it is evident that this is the case.

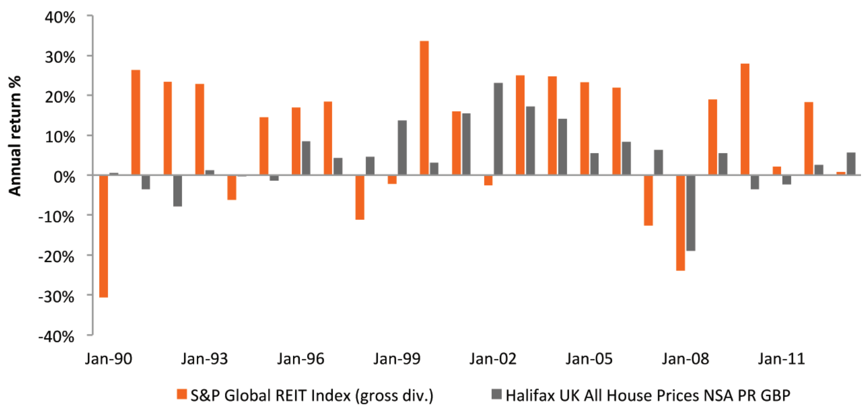

Figure 4: UK residential property vs. global commercial property 1990 to 2013

Data source: Halifax UK All House Price Index from Morningstar Encorr. All rights reserved.
S&P Global REIT Index from DFA Returns Program.

Circumstances where an allocation might not be appropriate could include investors who already hold a material exposure to commercial property, perhaps as part of their existing portfolio, through the assets of a business that they own, or because their job is directly linked to commercial property. But by-and-large it makes sense.

Conclusion

Global commercial property represents a material part of the investable asset set. Yet individual investors tend to hold low exposure to it, despite its favourable portfolio contribution from strong real (after inflation) expected returns and diversification benefits. UK residential property exposure is not a sensible reason for not considering it as part of the growth assets of a well-diversified global portfolio, as the latter is uncorrelated to global commercial property. All investors owe it to themselves to consider each individual opportunity to improve the structure of their portfolios. Global commercial property is one such opportunity. Today the tools exist to incorporate it in portfolios in a diversified, liquid, low cost manner. That's a big and useful step forward.

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End notes

1. Data source: Halifax UK All House Price Index. Morningstar Encorr. All rights reserved.
2. The detail of how this number is arrived at was covered in Acuity Volume 14: I don't need a pension plan, I've got property!
3. Pramerica Real Estate Investors (2012), 'Bird's Eye View of Global Real Estate Markets: 2012 Update', www.pramerica.com
4. Towers Watson as quoted in 'Real Estate: Investors build on the diversity of the property market', 7 July 2013, www.ft.com
5. Only a sceptic would suggest that this was an effective way to get some of the less inviting properties off their own balance sheets!
6. HMRC. Found at: http://www.hmrc.gov.uk/pbr2006/pbrn3.htm
7. Hoesli, M., Oikarinen, E., (2012), 'Are REITs Real Estate? Evidence from International Sector Level Data', Swiss Finance Institute Research Paper Series No 12-15.
8. Pramerica Real Estate Investors (2013), Global Real Estate Securities Benchmarks: 2013 Update. www.pramerica.com
9. This is usually somewhere in the region on 30% to 50%, but does vary considerably, with maximums imposed in many jurisdictions.
10. 7/1989 is the start of the global commercial property data series from S&P

Other notes and risk warnings

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