Quarterly investment briefing
Quarter 1 2017

First Actuarial LLP

QAS Institute and Faculty of Actuaries® Quality Assurance Scheme

Regulated in the UK by the Institute and Faculty of Actuaries in respect of a range of investment business activities.
First Actuarial LLP is a limited liability partnership registered in England & Wales. Number OC348086.
Registered address: First Actuarial LLP, Mayesbrook House, Lawnswood Business Park, Leeds, LS16 6QY.

Is now a good time to invest in property?

UK commercial property funds suffered in the aftermath of the EU referendum. There was large demand for redemptions from retail investors and six UK core commercial property funds suspended dealing[1]. Property funds with a largely institutional client base did not have to close their gates in this way, but many reduced the price of their funds to discourage disinvestment. The largest such price adjustment was a 15% reduction.

However, by the close of 2016, suspended funds resumed trading and also lifted their price adjustments. Jan 2017 saw inflows of £434m into European property which was a turnaround from £695m outflows from the previous month. The majority of these flows were to UK-centred property funds[2]. The weakness of Sterling as compared with pre-referendum results led to significant interest in UK property from foreign investors[3].

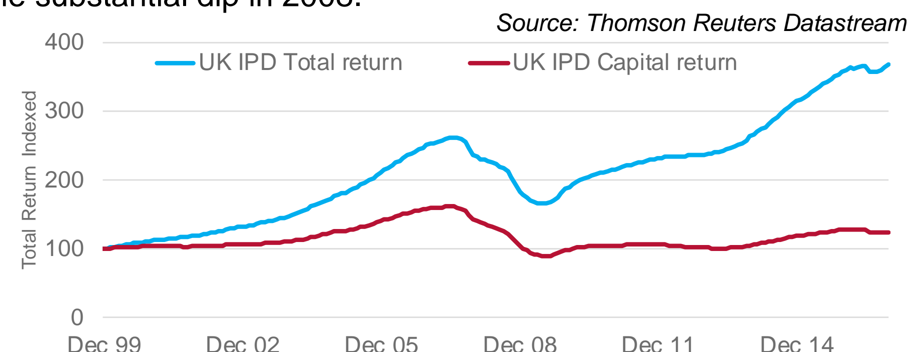
Property consultants and valuers, Knight Frank, provide a summary of the market outlook for UK property. Out of a total of 39 property sectors surveyed, the market outlook for 20 was 'stable', 13 as 'positive' and 6 as 'negative'.[4]

But property has performed strongly over recent years, does this mean it is due for a crash?

Performance

The total returns in the IPD index (a well-recognised measure of the performance of the UK commercial property market) are plotted below. This confirms that property performance has indeed been strong since the turn of the millennium. Indeed, the average rate of return has been around 8.5% per annum over the period, despite the substantial dip in 2008.

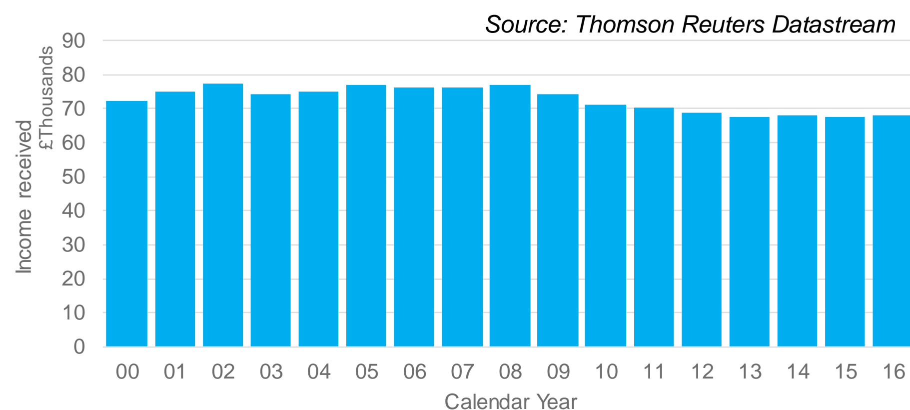
Source: Thomson Reuters Datastream



However, the IPD capital return index, which measures the performance of the capital values of the same properties, has only grown at around 1% pa over this period. This shows that the returns on property have been largely driven by rental income.

Using the IPD total and capital return indices we have estimated the income received on a £1million investment in broad UK commercial property made at the start of the millennium. This is plotted overleaf.

[1] FCA discussion paper, Feb 2017, pg. 11
[2] FT Adviser, '*Property fund demand surges after suspension saga*', Mar 21, 2017
[3] Savills, *UK Commercial Market in Minutes*, Feb 2017
[4] Knight Frank, Yield Guide March 2017



Although income did drop following the 2008/9 recession, our analysis indicates that income levels have remained robustly high.

On prime commercial properties across the UK, rents are currently around 4-6% of capital value pa[5]. This compares very favourably with the redemption yields on gilts at around 1.5% pa and UK corporate bonds around 2.5% pa.

Property is considered to be a secure investment and, on the basis of offering a decent and robust rental yield, it looks to be an attractive asset class in the current market environment. There are however some additional risks and costs to consider.

Illiquidity risks and costs

Liquid assets such as equities and bonds can be sold quickly, in bulk, at a low cost, without much impact on the price of the asset being transacted. Property is certainly not liquid.

It can take many months or even years to find a buyer for a property at reasonable price, by which time the pricing of property may have moved significantly against the seller. That said a quick sale can usually be achieved but often only at a significantly reduced price. Additional costs such as stamp duty, estate agency and valuation fees pose a barrier to trading and, of course, individual properties cannot be traded electronically in conveniently sized trades.

This perhaps explains why the yields on property are so much higher than on those liquid assets such as gilts and corporate bonds; it needs to be higher to compensate investors for the risk and costs associated with the lack of liquidity.

However, most pension schemes, charities and endowment funds can afford to tie up a part of their assets for many years in illiquid assets. As such they have time to recover the cost of trading and benefit from the higher yields from property. In addition, without being forced to sell, they are insulated from the risks associated with illiquidity.

We feel that property is an asset class worth considering and set out what we look for in a property fund overleaf.

[5] Knight Frank Yield Guide, CBRE Yield Guide - March 2017

What we look for in a property fund

Diversification

As with all investment, diversification provides important risk mitigation. Within UK commercial property funds, we favour funds that are diversified across geographies and sectors and have a low concentration to any particular property or tenant.

Fund structure

Open ended funds are generally preferred by institutional investors as their performance reflect the cumulative performance of the individual properties held. In comparison, many closed ended investment trusts (also known as REITS) are listed on a stock exchange and their share price and performance can be impacted by market sentiment.

However, the open ended structure means the fund manager can be forced to sell property as investors disinvest from the fund. This presents the risk of being forced to sell the underlying property quickly at a significantly reduced price.

In an extreme "run" on a fund, the fund manager may be forced to sell their readily saleable, highest quality properties. Remaining investors can then be left with exposure to poor quality property.

Mitigating forced sale risk

We are supportive of fund managers having the ability to defer redemptions and apply pricing adjustments at the appropriate time. Both mechanisms can help safeguard a fund against large scale disinvestment.

We also look for a predominantly institutional investor base as these investors tend to be less flighty than retail investors.

The use of leverage can also present a risk of being a forced seller should property values deteriorate significantly. As such, we look to avoid funds with significant leverage.

Level of cash holdings

At the other extreme, excessive cash holdings may indicate that the fund needs to deal with regular redemptions. Increased cash holdings may be appropriate if the fund is used for DC pension provision, but would be detrimental to long term returns for institutional investors.

Costs

Funds with the highest costs tend to be those funds with a high turnover of properties and tenants. Fund managers need to justify these additional costs through an expectation of higher returns.

Focus on long term rental income

There are a number of funds that focus on properties with long-term rental agreements with high quality tenants. These "long lease" funds tend to offer more stable returns but potentially benefit less from a rally in the property market. As a result, they tend to suit those looking for a lower risk form of property investment.

The information contained within this discussion is for illustration only and should not be construed as investment or market timing advice. © First Actuarial LLP 2017 all rights reserved

Small print

First Actuarial disclaimer

The information contained in this briefing is, to the best of our knowledge and belief, correct at the time of writing. However, First Actuarial cannot be held liable for any errors contained herein and the recipient accepts that the information stated is provided on an "as is" basis. This briefing is for general information only. It does not and is not intended to constitute advice. Specific advice should always be sought from the appropriate professional on all individual cases.