What can property offer an institutional investor?

UK property investment briefing (Paper 1)

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Aberdeen

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Property can deliver a range of possible features and outcomes. In this paper we will describe features, question some of the accepted wisdoms regarding property investment and look at the potential outcomes in terms of volatility, inflation hedging, diversification, etc.

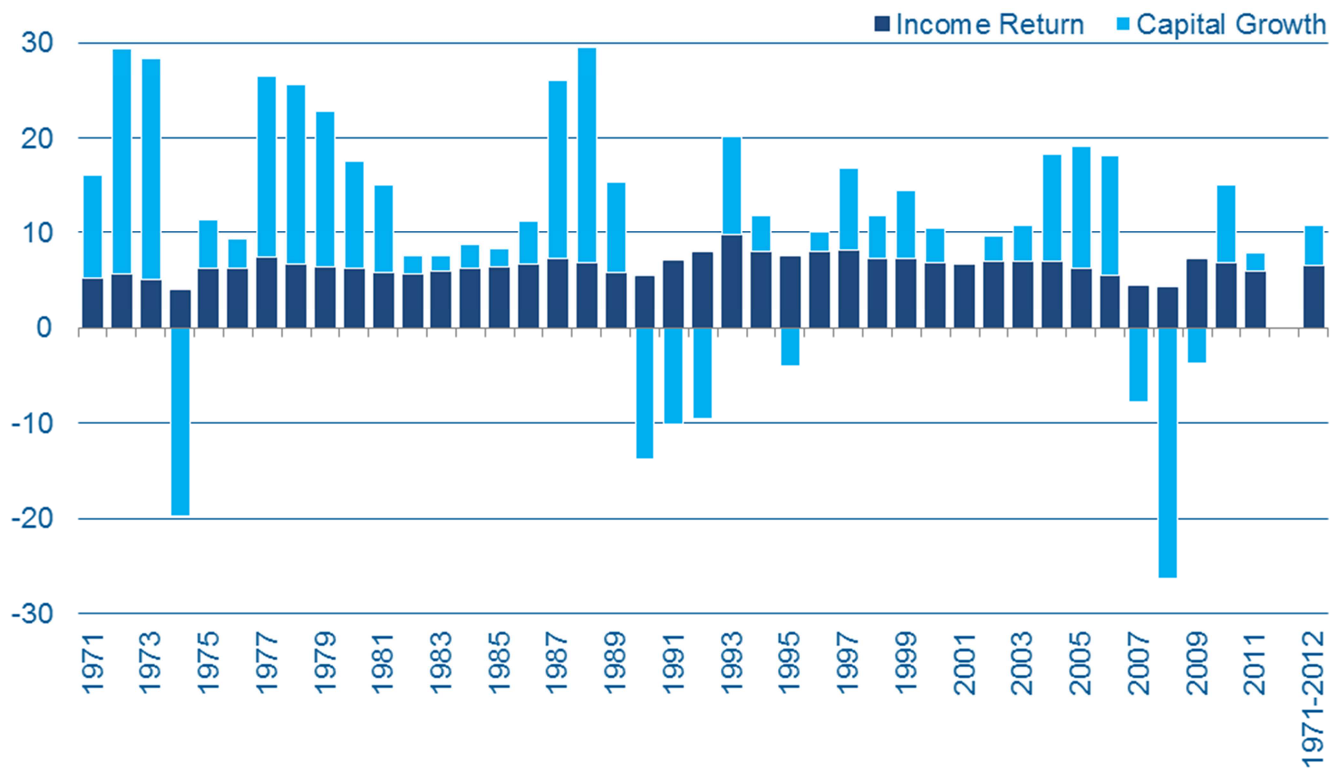
This paper outlines the features of direct property as an asset class. When investors think of property and describe its features as an asset class, they most often mean direct (assets directly owned by the investor), unleveraged property investment in the domestic market. It is important to emphasise that the characteristics of property investments that do not take the "purest", direct form are quite different. It is a common perception that indirect property (assets owned through a structure such as property unit trust) investment in property gives equally, or more, effective exposure to the underlying market. This paper will therefore conclude by highlighting why this perception is incorrect and demonstrate that the different "entry points" strongly influence the nature of the investment.

The key features of UK direct property investment

1. A relatively high and stable income return.

Over the long-term, direct property, as measured by the Investment Property Databank (IPD), has offered a relatively high and stable level of income return (yield) compared with UK bonds and equities. Chart 1, below, shows this feature back to 1971. IPD essentially represents a very large portfolio of property investments (measuring c£140 billion of mainly commercial property in the UK), giving sufficient diversification of income streams to show very little volatility. However, for most investors of any reasonable size it is not possible to replicate this stability in full.

Chart 1: Income and capital returns, IPD Annual Universe, 1971 - 2012



Source: IPD, March 2013

Chart 2 shows that during the 42-year period since 1970, UK property has delivered an average annualised income return of 6.5%. This compares with an average income return on UK equities over the same period of 4.7%.

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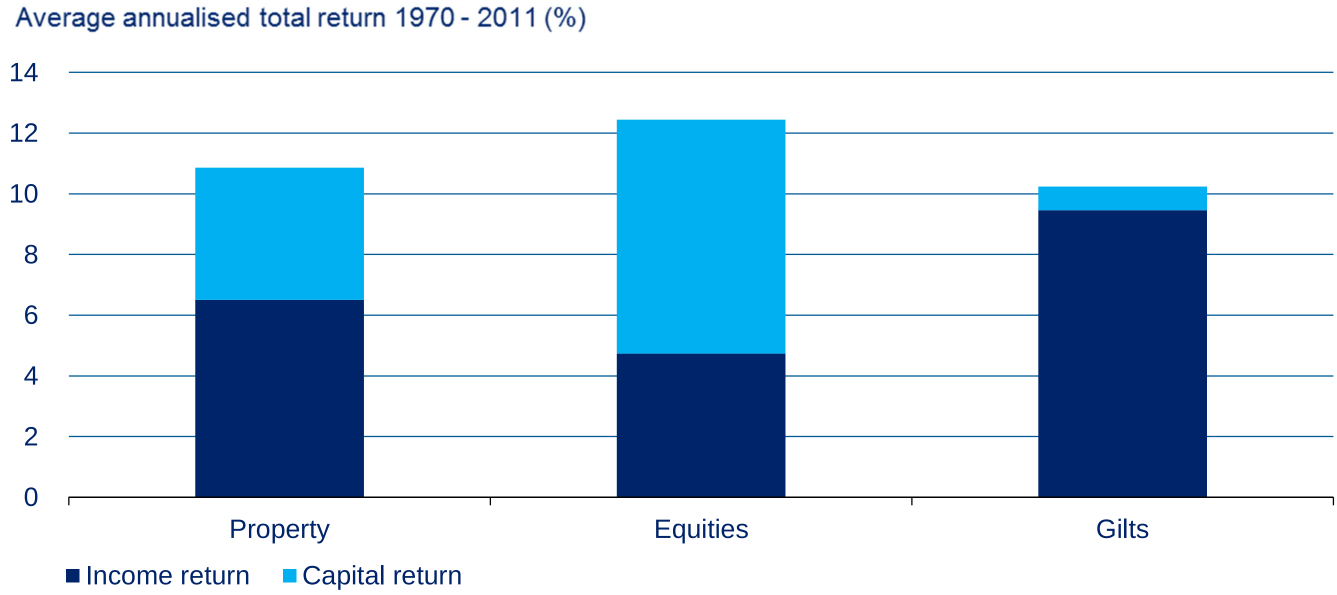
Chart 2: Property's income and capital return versus equities and gilts



Source: IPD, March 2013

In this way, property does tend to deliver a relatively high and stable level of income return.

2. Volatility

Property is sometimes argued to offer stable, low volatility, total returns. In the section above we have shown that the income component of property returns is indeed very stable, according to IPD data. While capital values have been more volatile, they have historically offered lower volatility than equities. However; in property, total return measures are based on values rather than prices and these two can be very different, whereas for equities they are the same.

Research has shown that because of the way that property index measures are built, from valuation data rather than by reference to market prices, they are smoothed: they appear less volatile than they actually are. The appearance of low volatility is inextricably linked to the degree of liquidity in property markets; an unwillingness to accept volatile prices leads to a lack of transactions where two parties can agree a price. Nevertheless, given property returns in the long-term should be based principally on the income stream generated and the growth of that income stream, if the market were rational it would offer very low volatility.

One aspect of returns that brings with it volatility is the ebb and flow of occupier markets, which directly impacts cash flows, where vacancy arises and further impacts the level of rent achievable at new lettings. It is poorer quality property that generally suffers more greatly from this volatility in demand. It is also the case that, due to easier substitution, rents and occupation rates in offices and industrial property have generally been more volatile than the retail sector and other consumer-facing property types.

However, in practice, due to sentiment and the swings in investment demand and supply, it is yield-based capital movements that contribute the majority of volatility in property returns, as demonstrated in Chart 1 above.

So, whilst property appears to have relatively low volatility it is worth remembering that some of this is because the index measures valuation movements and not price movements.

3. Diversification of risk from other asset classes

Valuation smoothing of property indices not only alters the volatility of property indices but also adds a lag to the indices. This means that whilst correlations with other asset classes appear relatively low (see Chart 3), they would be higher were the index measures to be based on prices. Furthermore, even with that lag, the property market has exhibited a much closer relationship with equities over recent years, with both being severely impacted by the financial crisis. The high degree of leverage through bank loans that built up throughout the 2000s ensured that property markets were inextricably linked to the banking crisis. Property lost over 40% of its value in the period 2007-2009.

Chart 3: Correlation of UK property total returns with UK equities and gilts 1970 - 2011

	Property	Equities	Gilts
Property	1		
Equities	0.28	1	
Gilts	0.03	0.56	1

Source: IPD, Aberdeen Asset Management, Jan 14

As a property's value is based on its ability to generate a rental income stream (and the factors that influence that ability are rooted in the economic environment and the activities of businesses that contribute to the economy) you would expect some correlation with the value, through share prices, of those companies that are direct tenants. However, the relative length of lease under which a tenant occupies a building is crucial to breaking down the correlation and giving some diversification from other asset classes. Unless the tenant defaults, it should continue paying the rent and therefore the value of the property is unaffected, or at least less affected, than the valuation of the company. The income return will remain the same or increase; the capital value may fall as yields correct to reflect the strength of covenant offered.

Property does offer diversification of risk against other asset classes though the benefits are less strong than they first appear.

4. Liquidity

Property is usually described as an illiquid asset class. A liquid asset is one that can be converted into cash very quickly and vice versa, such as listed stocks. An asset which is illiquid takes longer to exchange and so during that period there is a risk that prices fall; this means that investors demand an "illiquidity premium" from property. There are in fact two sources of illiquidity in property, one of which is true illiquidity and the other which is not.

The first, true source of illiquidity is the time which it takes to trade due to the due diligence involved in assessing the quality of the investment. In normal markets this is typically two to three months, but can be longer in weaker markets or more complex transactions.

The second source of illiquidity is self-imposed: it is the lack of willingness on behalf of the buyer or seller to buy or sell at market prices. Investors tend to anchor their expectation of price around recent market evidence or valuations and are often unwilling to accept if they wish to trade then they need to do so at the market price. Being unwilling to sell at a price below valuation is not a source of illiquidity, nor is being unwilling to pay the market price to buy a property.

In this way, property can be more liquid than it appears, as long as an investor is willing to buy or sell at market prices. However, this makes property more volatile than it first appears. Liquidity and volatility are two sides of the same coin.

5. Inflation hedging

Many investors view property as an inflation hedge. An asset is an inflation hedge if its returns are protected against inflation risk (expected and unexpected inflation), that is, the returns tend to move, both in terms of timing and in terms of level, to match or exceed inflation.

Inflation hedges are not:

1) assets that deliver a positive real (net of inflation) return and/or

2) assets where the returns have a high correlation with actual inflation

So is property an inflation hedge? Our analysis has shown that, on average, UK commercial property has not been an inflation hedge. However, the picture is more complex than this and if you disaggregate the property market, it is possible to find individual markets or types of assets which better satisfy the requirements of being an inflation hedge. Some assets, such as supermarkets, have long leases where the growth of rental income is tied to inflation. However, the rental income uplifts are usually subject to 'caps' and 'collars', hence income growth may not fully reflect inflation if inflation is high (typically above four to five per cent). In addition, while the income is linked to inflation, the capital value is not.

We believe that the best way to ensure that property does provide an inflation hedge is to invest in parts of the market where the market rental growth is likely to be higher than inflation in the long term. This means identifying types and locations of assets that offer an element of structural undersupply. This occurs where "monopolies" exist. For instance, in some cases it is not possible to substitute one location for another; transport nodes are a good example of natural location monopolies. Other

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examples include locations where the planning system creates a locational advantage in so far as it is not possible to create new space which is a substitute for the existing space.

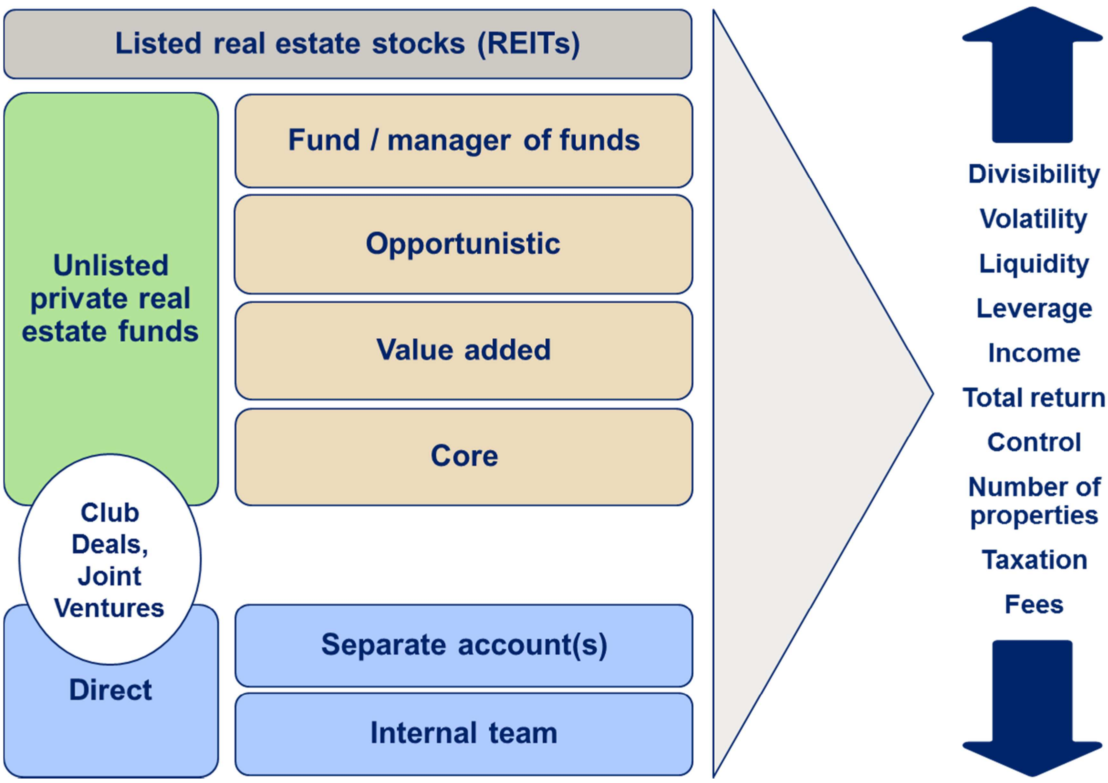
Investing broadly into "property" expecting to receive an inflation hedge is likely to lead to disappointment; if inflation hedging is a requirement then the property portfolio needs to be biased towards certain types and locations and away from others.

Property: routes to entry

We conclude this paper by commenting briefly on the main routes to investing in property (see Chart 4). So far we have only focussed on the features of property as a direct investment.

- **Direct property**: offers a high degree of control with the potential of high income returns with low return volatility over the long term. Divisibility is low because of large lot sizes which makes assembly of a diversified portfolio very difficult.

Chart 4: Property routes to entry



Source: Aberdeen Asset Management, Jan 14

Other routes provide a trade-off across a number of attributes shown in the right of Chart 4:

- **Listed property companies and Real Estate Investment Trusts (REITs):** are highly liquid and divisible with low fees, but offer little control to investors. Pricing can diverge significantly from underlying property valuations due to wider stock market influences. The underlying assets of REITs tend to be predominately income producing and relatively low risk, but the use of leverage pushes up risk. Other property companies, such as developers, are more risky due to a relatively low proportion of income earning assets on their balance sheet.
- **Unlisted funds:** provide a balance between direct property and REITs. Unlisted funds have divisibility and moderate volatility in the case of core funds. Investors can sometimes assert a level of control but this is usually limited to expressing a view to the manager. Core fund assets are predominately income producing, but the opposite is true for more risky value-add/opportunistic strategies which tend to take on vacancy risk or development activities. Risk is increased by the use of leverage which is applied across many funds.

The most appropriate investment route depends upon the objective of the investor.

A low risk multi-asset investor should be attracted to low volatility, which is a key attribute of unleveraged direct assets; whereas the volatility of unlisted funds can vary depending upon the type of strategy. The volatility of listed property stands out as it can be very high due to the application of leverage and the public pricing of shares. Large investors taking their first step into property are likely to favour direct investment to benefit from its low risk characteristics and to achieve stronger risk-adjusted returns at the multi-asset level.

6. Conclusion

Direct, unleveraged, UK property can offer institutional investors a number of positive features:

- Property's income return is relatively stable
- Property's volatility is likely to be lower than that for equities but not as low as it appears if/when liquidity is required (when prices must be experienced)
- Property does act as a diversifier against the risk of other asset classes but the benefits are not as strong as they first appear if/when liquidity is required (when prices must be experienced)
- Property is more liquid than it first appears but investors will need to tolerate greater volatility to achieve that liquidity
- Property is not, on average, an inflation hedge. Those seeking inflation hedging characteristics from property need to be selective in the types and locations of assets which they buy and hold

Alternative routes to entry do not offer the same features. Trade-offs are necessary which compromise the main features of direct property investment but may offer enhancements in other ways.

Aberdeen's view on direct property investment related to local government pension schemes (LGPS)

Aberdeen has four LGPS clients. It is our view that investment in direct UK property is the most efficient way to access property for those able to commit more than £150m to the asset class. At this size it is possible to build a direct property portfolio of 20 to 30 assets which offer the key attributes which our clients consider important. Typically property is included in the multi-asset portfolio for the key features of delivering:

- Stable income returns
- Relatively low volatility (given a long-term time horizon for investment)
- Diversification against other asset classes' risks
- Access to an illiquidity premium, which other shorter-term investors in the asset class require, and
- Some notion of inflation hedging

It is perhaps the liquidity/volatility and inflation hedging features that create the biggest level of confusion for investors.

For those able to commit around £500m to property, it is possible to combine UK direct property investment with a global (excluding UK) portfolio of core unlisted funds. We believe that this offers increased risk adjusted returns in the long term. We would typically recommend an allocation of around 30% of that £500m to global ex UK property.