



## FEATURE ARTICLE

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### **Property – Where to From Here? (Specifically - how have property funds performed over the last 12 months, and how do they compare with equity funds? What are the prospects for the next 12 months?)**

When considering the performance of property as a n investment opportunity it is of course vital to make some important differentiations at the outset.

When potentially considering investing in property using a collective investment there are basically three main investment areas, namely commercial property, residential property and property shares, that can be considered. In terms of residential versus commercial property it is worth remembering that the majority of individuals in the UK already have a substantial part of their asset allocation exposed to residential property in the form of their main residence. This means that whilst on the one hand most investors already have more than enough exposure to residential property through tax efficient owner occupation the commercial market offers diversification in the form of shops, offices and industrial property.

Having said that I have been asked in this article to consider how property investment has performed over the last 12 months, how this has compared with equity investment and what I feel the prospects are for property investment for the next 12 months.

When considering the performance of property over the last 12 months I have decided to review the Investment Property Databank (IPD) statistics and in particular the latest IPD UK Annual Property Index (up to 31 December 2010) and in addition the IPD UK Quarterly Property Index (up to 31 March 2011).



Looking at the IPD UK Annual Property Index this comprises over 11,000 properties worth over £134 billion and it includes commercial and other investment properties from 283 qualifying portfolios with externally sourced valuations.

<b>IPD UK Annual Property Index</b>	<b>Total return 1 year to 31.12.10</b>	<b>Income Return 1 year to 31.12.10</b>	<b>Capital Growth 1 year to 31.12.10</b>
<b>All Property</b>	<b>15.1</b>	<b>6.4</b>	<b>8.3</b>
<b>Retail</b>	<b>16.0</b>	<b>6.2</b>	<b>9.3</b>
<b>Office</b>	<b>15.8</b>	<b>6.3</b>	<b>9.0</b>
<b>Industrial</b>	<b>10.8</b>	<b>7.2</b>	<b>3.3</b>

(Source Investment Property Databank)

As can be seen from the table property has provided a very health return over one year to 31.12.10 and according to IPD compares with a performance of 14.5% for the FTSE All Share Index. (It is important, I think, to particularly note that a significant element of the total return for property has been generated by income.)

Looking at the data for the IPD Quarterly Property Index up until the 31 March, which covers over 9,000 properties worth over £111 billion and includes commercial and other investment properties from 238 qualifying portfolios, provides an equally encouraging picture, as shown in the table.

<b>IPD Quarterly Property Index</b>	<b>Total 3 months to 31.03.11</b>	<b>Income Return 3 months to 31.03.11</b>	<b>Capital Growth 3 months to 31.03.11</b>
<b>All Property</b>	<b>2.3</b>	<b>1.5</b>	<b>0.8</b>
<b>Retail</b>	<b>2.4</b>	<b>6.2</b>	<b>1.0</b>
<b>Office</b>	<b>2.4</b>	<b>6.3</b>	<b>1.0</b>
<b>Industrial</b>	<b>1.8</b>	<b>7.2</b>	<b>0.1</b>

(Source Investment Property Databank)

Again IPD provide the FTSE All Share returns over the same period which indicate a return of 1 per cent.

### **So why has property performed relatively well?**

There are a number of very good reasons to consider an investment into commercial property, including:

- The traditional attraction of purchasing what is perceived to be a tangible asset.
- Property has traditionally been seen as a “safe” investment not correlated to other investment classes such as equities and fixed interest – although following the credit crunch in 2008 this



argument may be seen as debateable? The argument may however still be made that certain direct commercial property investment tends to be less dependent on global economic trends (such as inflation and interest rates) than equities. Commercial property can also have its own demand and supply cycle and can be heavily influenced by local market dynamics, for example, the attraction of particular cities, or parts of cities, or whether there is a high demand for a specific property sector.

- Rental income from commercial property investments, particularly commercial properties subject to long-leases and good quality tenants, is more predictable than dividend income from shares.

The fact is that following the global credit crunch the problem for commercial property was that this raised the risk premiums across all asset classes and increased the downside risk to global economic growth. The result was that five years of growth in property values from 2002 to 2007 was wiped out in 18 months between July 2007 and the beginning of 2009.

A recovery however commenced in 2009. The reasons for this recovery may be identified as firstly the contrarian one that the commercial property market had fallen so far that it offered great value for those willing to take the risk. The value was represented by the high running yield available from various commercial properties. With the base rate at 0.5% the rent paid on the average commercial property as a percentage of the then significantly reduced property values produced a yield of up to eight per cent, which proved attractive to income seekers. With commercial property it must also be remembered that if quality tenants are in place and don't default, most rental contracts operate in the landlord's favour as they generally dictate that rents can only be negotiated up, not down, and may tie tenants in for long periods. Indeed due to upward only rent reviews income from property has risen over time more or less in line with RPI.

From here however the positives that have driven the property market up have dissipated somewhat. Indeed according to Fiona Rowley, Manager of the M&G Property Portfolio, prime properties have seen their yields recover while less-favourable sectors such as secondary offices and secondary retail properties have remained weak. Fiona's view is that it is important not to be tempted by those yields, as those sectors are likely to struggle in what is in effect a two tier recovery. In her fund Fiona is therefore focused on prime properties in good locations with strong tenants.

Looking forward and put very simply it will be the state of the economy over the coming 12 months that will be the key determinant of how commercial property performs from here as it is that which affects the underlying occupier market.



## Conclusion

When considering investment into property it is important to realise that not all property funds are the same. You have a choice of basically directly invested physical property funds, funds accessing the property market via securitised holdings, predominantly equities, and hybrid property funds combining the two strategies. From a risk perspective each category displays different characteristics in terms of volatility and liquidity and therefore must be tested against each client's investment understanding and risk appetite.

Many investors will understandably be wary of investing in commercial property. Some may have been sold the benefits of this asset class before only to discover that when they decided to encash funds imposed "exit penalties", suspended trading or introduced a notice period to stem outflows.

Ultimately property does offer good yields and these are a function of the real interest rate, rental expectations and the risk premium that investors attach to the commercial property asset class to compensate them above the risk free return.

Indeed if we go back to 2007, before the credit crunch, the Bank of England's view is that it was a reduction in the risk premium attached to commercial property at that time which was a dominant factor in driving property yields lower. The sudden repricing of risk across the asset markets as a result of the credit crunch therefore raised risk premiums for commercial property, putting upward pressure on yields.

I would argue that within a properly diversified portfolio commercial property should always have a place, although as an asset class heavily driven by its cyclic nature the degree of exposure depends on the economic conditions at the time of entry (and exit!).

Fiona Rowley at M&G believes that no significant rental growth can be expected in the short term as we move through the bottom of the rental cycle in the commercial property market but that the supply dynamics remain favourable. Looking to the medium to long term however the limited number of properties currently under development should help to support rental growth over that time frame which, for me, is a good argument to have at least some exposure to this asset class.

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