How to invest defensively in property

Executive summary

- Rising property yields reflect increased risk
- Buying property for income rather than capital growth is a low risk strategy
- Short leases, break clauses and weak tenants produce higher income yields, as do small lot size properties, which will spread risk
- A portfolio with low gearing and small assets will offer defensive real estate performance – not large 'trophy' assets
- Value-driven direct property investment is back in fashion

Nick Yeomans

Property returns have been outstanding for many years. Measured over the past five, ten and 15 years it has been the star asset class. Now, though, the US sub-prime crisis and growing liquidity crunch mean an inevitable end-of-cycle feeling is pervading the UK property market.

Worryingly, prime quality assets are trading at yields significantly below swap rates for the first time since 1994 and a rise in cap rates has begun. However, property is a long term asset and a diversifier, so exiting the asset class may be neither desirable nor wise. Can investors reduce the risk of their property exposure? How can this be achieved?

Fashionable alternatives

There has been a recent fashion for indirectly investing in property via unlisted real estate funds, Real Estate Investment Trusts (REITs) and derivatives. All have appeared attractive in a rising market, and all can be used to reduce or spread risk. But all three are geared assets, and the more liquid of them have already demonstrated the downside risk involved in investing in leveraged assets in a weakening market:

- REITs, launched with a fanfare in January 2007, are now trading at very large discounts to asset value and have been highly volatile
- derivative prices have collapsed from positive margins over London Interbank Offered Rate (LIBOR) as high as 10% to negative margins of 6% (and there is a large basis risk to be suffered by those using derivatives to hedge property exposure)
- unlisted funds may soon go through a similar experience. With gearing as high as 70% in some high risk funds, rising cap rates and higher debt costs should lead to significant falls in prices

Direct property reassessed

Diving for cover may not be necessary, but the market needs to re-consider the advantages of direct real estate and the control it can provide for investors.

Available data assumes that, in addition to its low correlations (diversification) with equities and gilts, real estate is a low risk asset. The standard deviation of the Investment Property Databank (IPD) index over the period 1981 to 2006 (around 10%) suggests UK real estate has been less risky than gilts (14.1%) and much less risky than equities (30.3%).

This disguises several issues that make the relative standard deviations of asset indexes of dubious value when judging the risk of property, because:

- property is relatively illiquid but this is not reflected in the data
- real estate data is smoothed, being based on valuations rather than prices
- finally, while the index may have low volatility, this may not mean much, for investors cannot buy the index. Moreover the lumpiness and specific risk of real estate assets produces considerable basis risk or tracking error in any portfolio of a typical size

Similarly, there is little to be gained by comparing the standard deviations of different property types. It may be interesting to know that retail (at 7.0%) has been less volatile than offices (at 10.4%) and that City and West End offices have been the most volatile sub-sectors. But how many offices or shopping centres do you need to reduce your risk to this market level of diversification?

Previous research by Wilky Fund Management and our research partner Property Funds Research [Baum, 2007][1] provides a worryingly large answer, especially for offices. Almost £200m is needed to assemble a portfolio of London offices with a tracking error below 5% - see Figures 1 and 2.

Property Type	Geographic Location	Average lot value (£m)
Standard shops	UK	4.6
Retail warehouse	UK	21.5
Shopping centre	UK	39.5
Other retail	UK	5.0
Office	London	15.2
	South East	7.2
	Provincial	7.2
Office park	UK	10.0
Industrial	UK	6.4

Figure 1: average lot sizes by segment

Source: *Wilky Asset Management / Property Funds Research / IPD*

Segment \ Capital required (£m)	5% tracking error	4% tracking error	3% tracking error	2% tracking error
Standard shops	28	42	74	157
Retail warehouses	86	129	259	1,013
Shopping centres	118	158	237	434
Other retail	40	60	100	169
London offices	152	243	455	1,229
South East offices	36	50	86	172
Provincial offices	36	58	87	166
Office parks	40	60	110	210
Industrials	32	51	90	212
Total	568	851	1,498	3,762

Figure 2: capital investment required for target tracking errors

Source: *Wilky Asset Management / Property Funds Research / IPD*

1. Baum, A (2007) Managing Specific Risk in Property Portfolios, Property Research Quarterly Vol 6 No 2 pp 14-23

Finding value and low risk

It is more likely that a thoughtful asset-specific approach will be fruitful. We know, for example, that income return has been much less volatile than capital growth. Remembering the standard deviation of total return runs at around 10%, it is amazing to note that capital growth volatility is equally high while income return volatility has been as low as 1%. So buying property for income (which is what many pension funds are seeking) rather than capital growth is a low risk strategy.

This makes sense when one notes the impact of a 50 basis point rise in yields (roughly what we can expect in the third quarter of 2007). It will reduce the value of a property yielding 3.5% by 12.5% but a 7.5% property by only half as much. Where can we find high yields? Industrial property has enjoyed average yields of 2% over offices and 2.5% over retail during 1970 to 2006. High yields will also be found in many secondary retail and office assets.

Short leases, break clauses and weak tenants are associated with difficult management and higher yields – yet weak tenants appear to be no less reliable than strong ones such as Enron or Arthur Andersen. In practice, short leases are usually renewed and break clauses not invoked.

Diversification is also a route to low risk. This provides a case for small lot size properties. Even low lot size segments (e.g. standard shops) have average values of as much as £5m and £15m is a more likely average lot size. So a £100m portfolio will buy six average properties, 20 small or three large. It is better to have 20 small properties than 3 large ones, purely to spread risk. (Figure 3)

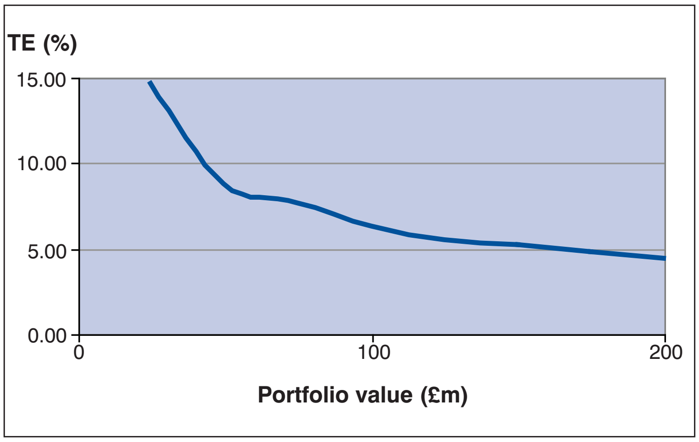

Figure 3: tracking error and portfolio value in London offices

Source: *Wilky Asset Management / Property Funds Research / IPD*

This strategy is supported by two other factors:

- small properties will often have higher yields (see above) because managers of larger portfolios have culled smaller assets to reduce management time and cost, thus depressing market demand for small lot sizes
- large lot sizes appear to be high beta assets, meaning that their value rises more rapidly than average in a strong market and falls more than average in a weak market

Why is this? Investors, catching an upward trend or flush with cash, will often wish to sink large amounts of capital fast in a strong market, while no-one wants to buy large assets in a weak market.

Finally, leverage provides an opportunity to diversify. A financial structure of 50% equity and 50% debt means that only half the required investment is needed to get the same exposure – but clearly increases risk. According to INREV[2] , high-geared portfolios hugely out-performed low-geared portfolios over the period 2001-2006 with returns of 29.9% against 10.2% respectively. Other factors may also be at work, but it almost certainly illustrates the power of leverage in a strong capital growth environment. Soon we may see that the downside can be equally dramatic.

A surprising conclusion

Hence, as we enter a new part of the cycle, a portfolio with low gearing and small, difficult-to-manage assets with short leases and 'weak' tenants will probably (and perhaps surprisingly) offer more defensive real estate performance than the 'trophy' assets sought by risk averse investors. Value-driven direct property investment has been out of fashion, but its time has come again.

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Wilky Fund Management has nearly £460m property assets under management for major institutional clients. As part of a long-established private property group, it adds extra value through energetic portfolio management strategies.

References

1. Baum, A (2007) Managing Specific Risk in Property Portfolios, Property Research Quarterly Vol 6 No 2 pp 14-23.
2. The European Association of Investors in Non-listed Real Estate Vehicles.

2. The European Association of Investors in Non-listed Real Estate Vehicles