

# PROPERTY AS A DEFENSIVE INVESTMENT

Although the long-standing bull-run in the UK property market appears to have lost momentum as a result of the US sub-prime debt crisis, exiting the asset class entirely would seem an unwise strategy. Nick Yeomans, Managing Director of Wilky Fund Management, asks how can investors reduce their risk?



UK PROPERTY'S 15 year bull-run has been brought to an end by the US sub-prime debt crisis and growing liquidity crunch. But,

because property remains a long-term asset and portfolio diversifier, exiting the asset class entirely may be unwise. So how can investors reduce risk?

Are indirect investments the answer? Whilst these were attractive in a rising market, the more liquid ones have demonstrated the downside risk of leveraged assets in a weakening market. For instance, REITs (Real Estate Investment Trusts) are now trading at a very large discount to net asset value.

## RECONSIDERING DIRECT PROPERTY INVESTMENT

As such, the market must reconsider the advantages of direct property investment. The standard deviation of the Investment Property Databank index over the period 1981 to 2006 (around 10 per cent) suggests that UK real estate has been less risky than gilts (14.1 per cent), and much less risky than equities (30.3 per cent). Clearly, one cannot buy the index as a portfolio of direct property.

Additionally, the specific risk of real estate assets produces considerable tracking error. Indeed, previous research by Wilky Fund Management and Property Funds Research suggests, for example, that almost £200m is needed to assemble a portfolio of London offices with a tracking error below 5 per cent.

In fact, income return has been much less volatile than capital growth. While the latter is around 10 per cent, income return volatility has been as low as 1 per cent. So, buying property for income (which many pension funds need) rather than for capital growth is a low risk strategy. For example, a 50 basis point rise in yields will reduce the value of a property yielding 3.5 per cent by 12.5 per cent, while the value of one yielding 7.5 per cent will fall by just half that. Where is such performance to be found? Yields from industrial property averaged 2 per cent over offices and 2.5 per cent over retail during 1970 to 2006. High yields will also come from many secondary retail and office assets.

## SPREADING THE RISK

Diversification also cuts risk in this regard. Better to have 20 small properties than three large ones for the same money. Smaller properties also often have higher yields, because larger investors have sold them to reduce management overheads, thus depressing market demand. They are perceived as 'difficult' because of short leases and perceived weak tenants but these can provide extra yield, whilst not necessarily creating unacceptable risk.

Hence a portfolio with low gearing and smaller assets should offer more defensive performance than 'trophy' assets. Value-driven direct property investment has been out of fashion, but its time has come again.

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