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The Case for UK Property

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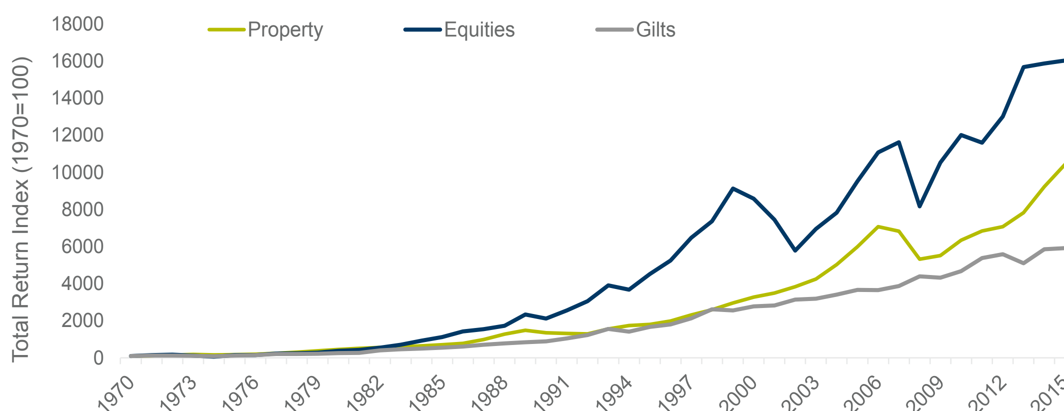
The UK commercial property market has had to withstand a considerable rise in both financial and economic market volatility since the start of 2016. First, there was the turbulence in global equity markets at the beginning of 2016, after which came the result of the UK Referendum in June 2016, with the UK public opting to leave the European Union. The political and economic climate is expected to remain highly uncertain over the course of the next two years, dampening confidence levels and growth prospects in the interim. Nonetheless, we still feel confident that UK property will be better positioned than other mainstream asset classes to deliver favourable performance for investors in the medium term to long term.

There is a well-established case for property as an asset class, and it can be summarised in the following points:

1. **Property is a risk diversifier –** the long-term correlation between real estate and equities / bonds is very low.
2. **Property is a less volatile investment –** the standard deviation (volatility) of returns is low in comparison to other assets.
3. **Property provides a high income return –** over the last ten years (to December 2015) property has produced an income return of 5.6%p.a.
4. **Property offers a hybrid investment return –** real estate combines characteristics of both equities and bonds.
5. **Property provides a partial hedge against inflation –** particularly in the UK where the nature of commercial leases is such that they can keep track with inflation and protect against deflation.
6. **Property has a residual value –** real estate is a real asset.
7. **Property exists in an established and transparent market –** the UK is also highly liquid relative to other global property markets.

Property, and its performance as an investment, must be placed in the context of the options available to investors. The following graph shows how property has performed relative to bonds and equities. In absolute terms, property has provided a total return of around 10.9%p.a. since the 1970's.

Figure 1: Property versus other asset classes - Total Return Index since 1970



Source: MSCI

One of the primary reasons for holding property is that it offers investors an opportunity to increase diversification within their portfolios, as well as reducing the volatility of their returns. The table below shows the low correlation that investment property has with both gilts and equities, as well as the lower standard deviation (volatility) of its returns. Real estate can help smooth out the performance of an investment portfolio, adding to returns without taking on additional risk.

Figure 2: Long-run correlations between asset classes, and standard deviation of returns of each asset class

Long run correlations (1971-2015)

	UK Equities	UK Property	UK Gilts	Cash (3m LIBOR)
UK Equities	100%	-	-	-
UK Property	**27%**	**100%**	-	-
UK Gilts	56%	**6%**	100%	-
Cash (3m LIBOR)	16%	**1%**	25%	100%

Standard deviation of total returns

	(1971-2015)	(2010-2015)
UK Equities	28.1%	9.6%
UK Property	**10.9%**	**5.2%**
UK Gilts	12.9%	9.0%
Cash (3m LIBOR)	4.5%	0.2%

Source: MSCI, Barclays Equity & Gilt Study

The high level of income return from real estate has proved to be a sustainable, long-term feature for property owners. An All Property income return of 5.6% over the last ten years (to the end of 2015) is consistent with the 5.2% per annum recorded over the last three years, and the 6.4% per annum recorded over the last 35 years. In such a low growth environment, investing in property is all about that income.

Unlike fixed income investments, property's hybrid characteristics mean it will also be responsive to any broader improvements in economic growth boosting property returns. Unusually, property combines the characteristics of both equities and bonds. Rents contracted under leases can be seen as the coupons from a corporate bond, while rental values can rise either through inflationary pressures or real economic growth. Historically, most of the total return delivered to investors has been through income rather than capital growth, further demonstrating the asset's bond-like qualities. That said, an investor in direct real estate can build a portfolio biased towards either equity or bond-like characteristics. Retail investing, or property development generally, for example, can provide returns that offer low dividend, high growth characteristics, more in line with equity investing.

Real estate provides opportunities to produce both income and capital growth when the economy is growing, as well as preserving value when there is uncertainty and weakness in the market. This is because UK leases are structured in such a way that they offer protection from both inflation and deflation. They are typically reviewed every three to five years, and such frequent reviews mean that income can grow in line with inflation. However, due to the "upward only" nature of UK commercial leases, protection against deflation is also provided. In other words, the overall risk and reward characteristics of real estate mean that property should be held at any time of the cycle.

Property also exhibits other characteristics which make it attractive to investors. **By its very nature, property has both an intrinsic value, as well as the ability to add value.** Even if a property is not producing income, it retains a residual value, due to the value of the land it sits on, and its potential for other uses. The same cannot be said of equities or bonds if a company goes bust or the issuer defaults.

Also, owners of property are in a unique position in that they can directly affect and improve their returns by "adding value" to their property. Such strategies might include re-structuring leases to ensure more stable, longer-term cash flows, whilst capital invested in improving the actual "fabric" of the building itself will obviously have a positive impact on its underlying value. Moreover, relative to other European markets, owners of commercial property in the UK receive better levels of income protection in the event of insolvency amongst their tenants. This is another factor which makes holding property in the UK attractive to investors.

However, it must be noted that historically there have been some negative aspects associated with property investment. Firstly, it is often said that property is an illiquid asset. It can be difficult to trade. Associated with this have been issues of a lack of information and transparency in the market, along with high transaction and management costs. Historically, some types of property (such as shopping centres and large central London offices) have proved difficult for smaller investors to invest in.

This problem has been partially resolved through the creation of indirect vehicles, although the quality of assets and managers is variable. Similarly, the issue of transparency has also been addressed to some extent, through the availability of a much wider range of market information and independent analysis and forecasts. The work carried out by MSCI / IPD, PMA and Capital Economics, for example, means that **the UK property market is the most-scrutinised in the world, enabling investors to make well-informed decisions.** Also, the development of attribution analysis in line with other asset classes, and appropriate and suitable benchmarks means that performance can be monitored and rewarded accordingly. In addition, there are now many specialist property investment managers available for fund managers who wish to benefit from investing in the sector, but who may not have the necessary specialist expertise.

So how will property fare relative to other asset-classes over the medium term?

The MPC's decision to lower interest rates, re-introduce quantitative easing and ease credit conditions will no doubt support valuations across asset classes, but return prospects across the investible universe (at least over the next five years) are expected to remain low.

The performance of equities are contingent on a continued rise in company earnings. However, with many industries revising their outdated business models to the evolving developments in technology, earnings growth is likely to be suppressed. Plus, capital gains remain susceptible to the persistent uncertainty in the macroeconomic environment. Gilts, on the other hand, offer low prospective returns for investors in the short term and increased future volatility from a subsequent re-adjustment in values over the long term.

Under such circumstances, it will be those investments that can deliver a reasonable income yield that will be more desirable to investors. This is where property looks better positioned than other mainstream asset classes. Its fundamental's still remain reasonably solid, and the income yield provided by UK property represents an attractive proposition for investors. As at June-2016, the equivalent yield for UK property, as measured by the MSCI All Property Quarterly Index, stood at 5.8%, compared to a nominal 10-year bond yield of 0.7%, and a yield of -1.5% on 10-year inflation-linked bonds. This margin over fixed income yields is in-line with property's long-run risk premium and provides adequate compensation for investors in the current world of lower investment returns.

In addition, whilst the UK's exit strategy from the European Union will continue to cloud the short term horizon, the heterogeneous nature of property, (by sector and geography) should mean that some property segments, particularly those that are supported by local business operators and have a low exposure to European firms will be more resilient to the impact of Brexit (see DTZ Investors Brexit: Impact on UK Property August 2016 for further information). Those which are susceptible (most notably central London offices) still possess good core underlying long term fundamentals. So, even if a price correction were to occur, these segments should appear better value, which could subsequently raise buying interest from overseas and domestic investors, leading to a pricing recovery, post re-adjustment.

On balance, property certainly makes a compelling investment in the context of current market conditions. Its relative price advantage (to other asset classes) combined with its inherent features, such as the scope for diversification, lower volatility, and a stable income return should make UK property a desirable asset class in a low returning, more volatile investment environment. In addition to this market return, a good fund manager should be capable of delivering an element of outperformance, as real estate is one asset class in which it is possible to consistently generate alpha.

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