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Investing in a low growth environment.

The Investment Report.

Global Listed Property Securities

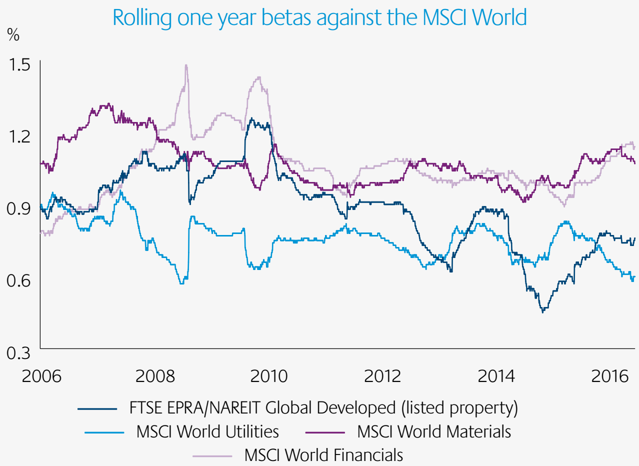
The global property market is behaving like a runaway train... Again

The global property market can be likened at present to an out of control passenger train. While other listed equity sectors are struggling in a low growth environment, property securities are being powered by ever-lower interest rates and the train is hurtling along a track with values hitting all-time highs. So if you are not on board already is it a good time to climb on? We think not. If you have missed this train then move on, it is moving too fast, in our view, to safely pick up more passengers. And we all know how this is going to end. We saw the same thing happen in the months leading up to the Global Financial Crisis (GFC). The difficulty is knowing what to do about it. As our mandates do not allow us to move fully into cash (the equivalent of jumping off), we really have to continue on with the journey, even though potential disaster approaches. However, we are adjusting the portfolio even more towards the type of stocks that will prove resilient in a downturn.

The tearaway property market – how much longer a defensive?

Historically, listed property has been considered one of the more defensive sectors within equities. The steady stream of rental income that property securities generate give them bond-like characteristics – similar to other defensive equities sectors like utilities. Chart 1 demonstrates that this defensive nature has resulted in both listed property and utilities generally having lower betas to the broader MSCI World Index than their 'cyclical' sector counterparts such as materials and financials.

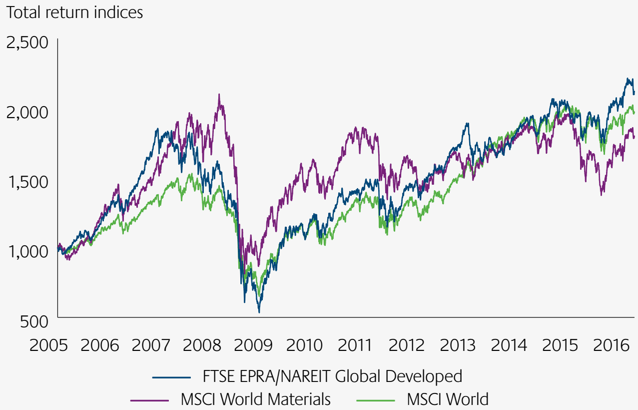
Chart 1: Listed property appears defensive today ...



Source: FTSE EPRA/NAREIT and MSCI.

So in periods of strong market performance, the cyclical sectors have tended to outperform the market and the more defensive 'boring' sectors have tended to underperform. During periods of low or even negative market returns, however, the defensive sectors have traditionally come into their own and outperformed the broader market as the cyclicals struggle. Yet, as shown in Chart 2, during the GFC in 2008, listed property securities failed to provide the defensive characteristics that some were expecting. What happened?

Chart 2: But listed property was not so defensive in 2008

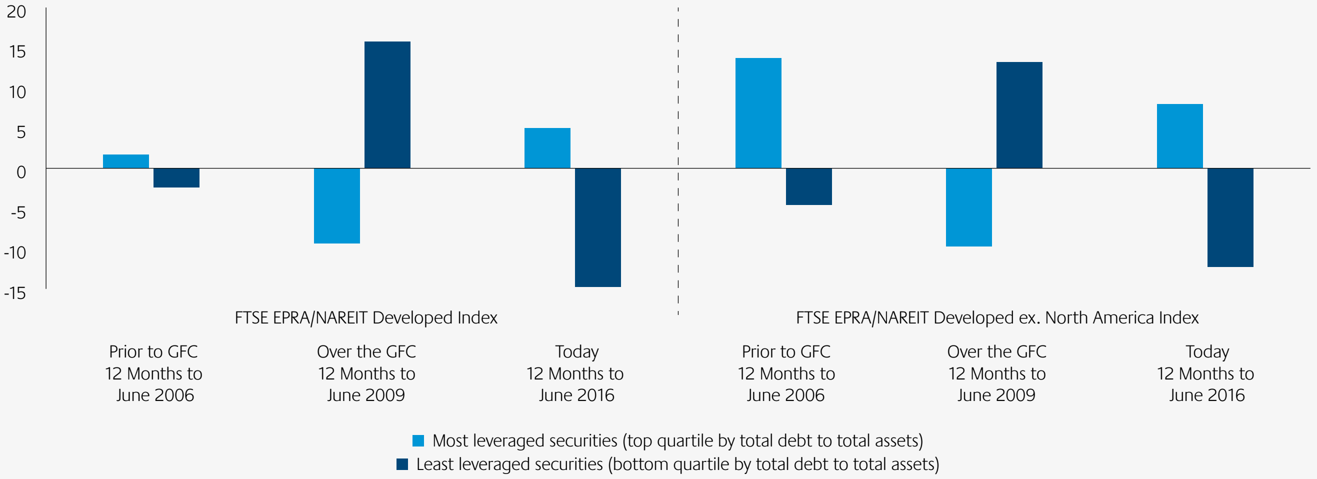


Source: FTSE EPRA/NAREIT and MSCI.

It was, after all, the bubble in developed country residential property markets that triggered the crisis in the first place. So little wonder that falling property prices were heavily correlated with plunging financial stocks and broader markets, with the FTSE EPRA/NAREIT Global Developed Property Index (in USD terms) falling almost 35% in the 12 months to 30 June 2009, plunging further than global equites over the same time-frame as the MSCI World Index fell almost 30%. However, not all property securities fell to the same extent.

As shown in Chart 3, the securities with the most highly leveraged balance sheets (the top quartile of listed property securities by total debt to total assets) underperformed the median listed property security in the FTSE EPRA/NAREIT Global Developed Property Index by around 9% in the 12 months to June 2009. This represented an absolute fall of more than 40% in USD terms. Meanwhile, their less leveraged counterparts (in the bottom quartile of total debt to total assets) actually delivered the defensive characteristics one might expect from listed property over the longer term, outperforming the median listed property security by over 16% and only suffering an absolute fall of around 15% in USD terms, slightly less than half the fall suffered in the broader MSCI World Index. So if you were seeking the defensive characteristics of listed property securities, you would have been much better off focusing your portfolio towards balance sheets with less debt.

Chart 3: Not always best to be in or out of the most leveraged securities

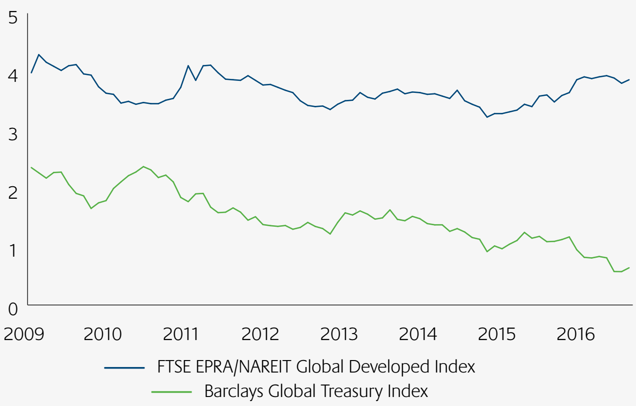


Source: FTSE EPRA/NAREIT and FactSet.

However, there is a shorter-term downside to holding the less leveraged securities. As is also shown in Chart 3, those property securities with less debt can also underperform their peers with greater balance sheet risk when the market is rising. This was the case leading up to the GFC and, if anything, the effect is even more pronounced now. On the right hand side of Chart 3, we have conducted the same analysis using the FTSE EPRA/NAREIT Developed ex-North America Index, as companies following US GAAP[1] accounting standards may overstate their total assets, compared to IFRS[2] accounting standards adopted by most other developed markets, owing to differing depreciation calculations. So even when we remove North American securities, the results are, if anything, more persuasive of the cyclical nature of the more leveraged property securities.

In the current low growth, low interest rate environment, the bond-like characteristics that have given utilities and listed property their defensive, but dull, risk/return profile have now become more attractive to investors. As central banks around the world have desperately sought to stimulate global economic growth through extraordinary and unconventional monetary policy measures, bond yields have continued to tumble, even down into negative territory. And yet the yields on listed property securities have remained high. This is influenced by a number of factors, including REITs growing their dividends.

Chart 4: Yields on listed property securites have held up as bond yields have plunged



Source: FTSE EPRA/NAREIT and Barclays.

1 Generally accepted accounting principles.

2 International Financial Reporting Standards.

The result is that investors have rushed into listed property and utilities as the availability of yield has dried up in the more defensive asset classes of cash and fixed income. While listed property securities have very secure cash flows (indeed some of the larger REITs have better credit ratings than a lot of sovereigns), they do not offer the return stability generally associated with cash or fixed income. However, they still tend to be one of the more defensive sectors within global equities, which also has some attraction to investors in these uncertain times of low economic growth and geopolitical uncertainty.

As a result, 'boom times' have returned to the more defensive equity sectors. Chart 2 shows that that the FTSE EPRA/NAREIT Global Developed Listed Property Index is continuing to set new highs while the MSCI World Index has more or less gone sideways for the last two years and the more cyclical sectors have underperformed.

But will listed property securities disappoint investors again as they did in 2008?

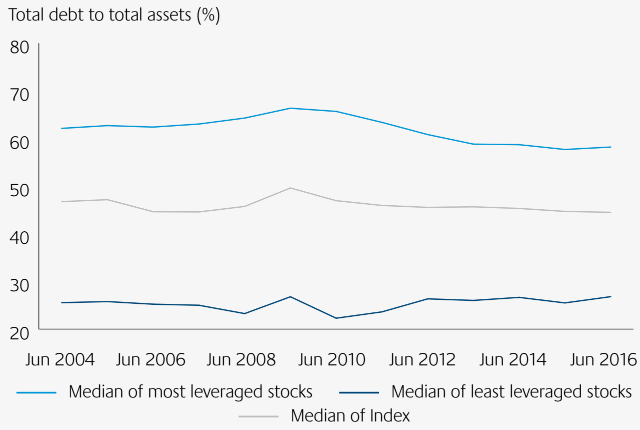
This time it is different? Surely we won't fall for that again

The extent of this price appreciation is now starting to raise concerns as we question the ability of 'bond-like' equity sectors to continue to exhibit the defensive characteristics that investors may be expecting. Have prices risen to the extent that potential capital losses might outweigh the attraction of the higher yields that these sectors offer?

We will concede that there are some differences between the property market today and the bubble conditions of 2005/06. The total debt levels of the top quartile and median listed property securities in the FTSE EPRA/NAREIT Global Developed Property Index have decreased around 11% since June 2006. And as shown in Chart 5, the level of leveraging has also fallen across the top quartile of property securities on a total debt to total assets basis. However, the median security in the top quartile of total debt to total assets remains just shy of 60%, which is not dramatically different from the levels that we saw leading up to the GFC.

More significantly, there remains a significant gap between the most leveraged companies and the least leveraged companies, where the median total debt to total assets in the bottom quartile of the FTSE EPRA/NAREIT Global Developed Property Index, at 27% is well below half the level of the top quartile median noted above. This gap is even wider if one looks at the corresponding medians in the FTSE EPRA/NAREIT Developed ex-North America Index where the median of the least leveraged securities are at almost a third of the most leveraged securities median. In short, while debt and leverage levels have fallen, the total debt to total assets remains worryingly high across those securities in the highest quartiles. Yet we are finding that there are also plenty of less leveraged (and now relatively cheap) investments to choose from if one wishes to adopt a more defensive stance. Our portfolio, for example, currently has a median total debt to total assets of 29% which is well below the median total debt to total assets of the FTSE EPRA/NAREIT Global Developed Property Index at 45%.

Chart 5: Total debt to total assets of the FTSE/EPRA NAREIT Developed Index



Source: FTSE EPRA/NAREIT and FactSet.

But is leverage really such a problem given that interest rates are so low and are only rising at a glacial pace? Surely one will have time to adjust portfolios should a crisis loom?

We are not convinced by these arguments. Few people are able to call the absolute top in markets and as the market volatility over the September quarter has shown us, many investors appear to have positioned themselves for interest rates being low forever and even the hint of a 25 basis point rise in September had security prices plunging. We think that in such conditions, investors are brave to think that they will have time to adjust before the rest of the market. As a result, we have already taken action to improve the resiliency of our property portfolio in these uncertain times.

As Chart 3 highlights, the listed property securities with the highest balance sheet leverage are again outperforming their less leveraged counterparts as passengers continue to pile onto the yield train. However, this train is now moving too fast for us. Our approach leads us towards quality securities at a reasonable price. As the market is currently favouring poorer quality stocks regardless of the all-time high values they are trading at, it is tempting to get off this train altogether. We have seen this all before in the three years leading up to the GFC in 2008. In remembering the results of that 'train wreck', it is sobering for us to think that we might be back on another runaway train. So we are focusing our security selection increasingly towards capital preservation while still delivering the level of returns that investors might think are more consistent with the defensive characteristics that are typical of listed property returns over the long-term.

This is not getting off the train – but we are steadily moving towards the caboose and insulating ourselves from the inevitable impact. This might mean that we underperform the extraordinary high returns of the index, but these returns exceed what one might typically expect of property. Furthermore, the individual highly leveraged securities driving these excess returns carry more risk than investors expect of property investments, and we are increasingly avoiding them as well.

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