December 2009
PIMview

Iain Scotland is Deputy Head of our Managed Funds team. For our final PIMview of 2009, Iain looks at commercial property as an asset class, which is one of his areas of expertise. We have reintroduced this into many of our clients' portfolios and so we thought it would be a good time to delve into it in more detail, and explain our reasons for this move.

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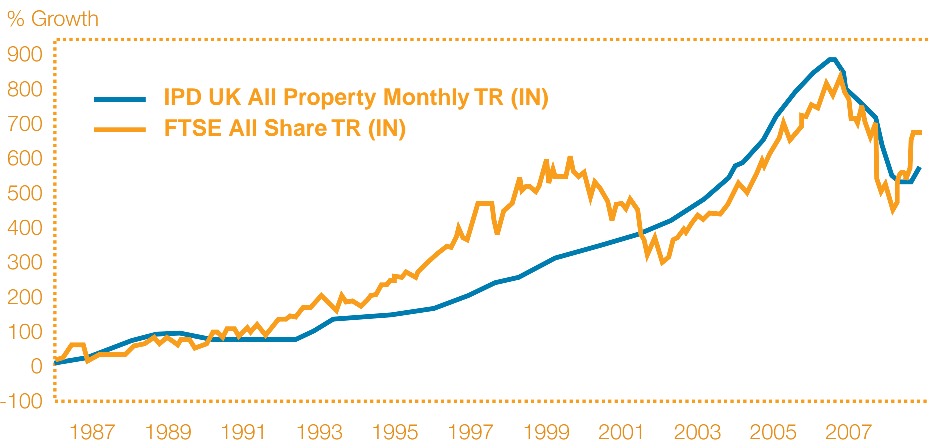
Iain Scotland IMC
Deputy Head of Managed Funds

Iain joined Principal in 2004, having previously gained 14 years' experience in direct equity fund management. Most recently he was Head of UK Smaller Companies at Insight Investment (formerly Clerical Medical), where he was responsible for some £600m in assets under management. In this role he led the development of a distinctive and successful research-driven investment process, recognised by external fund ratings services such as S&P. Prior to that, he was a smaller companies fund manager under some of the most well known names in the industry, at Gartmore Investment Management.

Investing in Commercial Property

"Buildings and land used for the performance of business activities. Commercial property can include single offices, office buildings, government offices, shops, warehouses, factories, restaurants and hotels."

Percentage Growth Total Return
from 31.12.1986 to 30.11.2009



Source: Lipper

Commercial property has delivered very attractive returns over the past couple of decades. An increase in value of 532% since the start of 1987 (as shown in the chart opposite) is slightly less than the return achieved by the FTSE All Share index but the return profile has been much less volatile. Certainly investors who held commercial property from 1987 to the beginning of 2007 would have been sitting pretty, and by that time commercial property had started to be seen as a 'must hold', even for private clients.

Two years later, we can see how a classic bubble had developed:

- By 2007 yields on prime commercial property had fallen to below the level of government bonds.

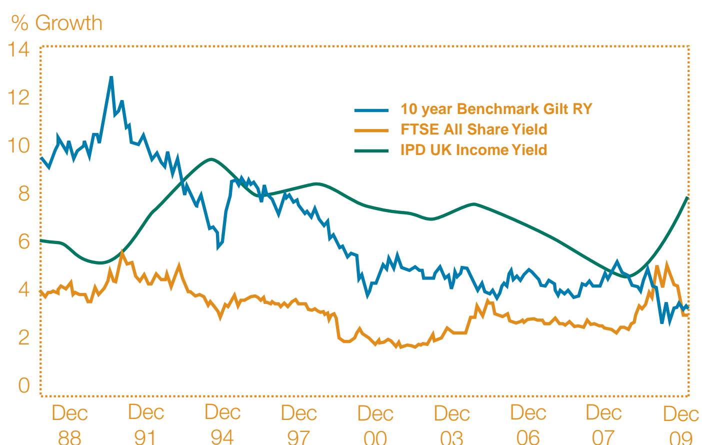
- This meant that, to justify valuations, there must have been an expectation that rents would increase further from already elevated levels.

- Commercial property funds were seeing very strong inflows and banks were keen to lend to property investors, further inflating the demand. Inevitably this contributed to the inflation of the commercial property price bubble.

- At the same time as the demand for property investment was peaking, the first signs of trouble that would eventually lead to the near-collapse of the global financial system were appearing in the US sub-prime mortgage market.

Almost inevitably, this confluence of events led to a very sharp correction in property values. Economic slowdown reduced demand from occupiers of property and the availability of lending for new investment from banks dried up. The first reaction of the lending banks was to try to recover their debts by selling property. However, as the financial system reached crisis point, no fresh lending was available and property transactions dwindled to negligible levels. This added a new concern for property investors. If no transactions were taking place, then valuations could not be made on an open market basis. So property values were marked lower as forced sellers had to accept very low prices, whilst transactions were still possible.

Gilt, Property and Equity Market Yields - 31.12.1987 to 30.11.2009



Source: Lipper

By early 2009 sentiment among investors and owners of commercial property was at a low point: rental yields on (the few) prime property transactions were up to 10%. The refinancing of the UK banks in early March marked the low point for commercial property. Some shrewd property specialists had started buying prime property in early 2009 and now accelerated their investment, taking advantage of property owners who still needed to raise cash to meet funding requirements.

UK banks have substantial debt outstanding on commercial property loans. They have been slow to foreclose on the outstanding loans as there has been limited demand and, unusually in an economic downturn, property owners are still receiving sufficient cash flow to service the interest payments on their debt. How banks react to a strengthening market will be key to the medium term for property values. We believe there is a need for the banks to shrink their property loan books substantially. It is likely that they will sell into strengthening demand that current values have created. However, we do not foresee a wholesale dumping of assets that would hit the recovery in value.

Over the medium term we see commercial property as a useful diversification for clients' investments. Returns have historically come from rental income, rather than capital growth. Whilst rents may come under pressure, uncertainty across all areas of investment make the additional diversification benefits even more attractive.

However, there are still risks. The high yield available today may well be reflecting the pressure that is likely to see rents falling over the next couple of years. However, with the cushion of a 3-4% yield premium to Gilts, we believe that the value relative to other asset classes is now compelling.

How should we access the commercial property market

Liquidity remains key to making any investment. Whilst listed investment companies are traded on the stock exchange and provide ready liquidity, the premiums that the best funds currently trade at - reflecting confidence in the potential recovery in property values - make them unattractive. Therefore we believe that the most prudent way to make commercial property investments for clients is through the best-managed open-ended funds. Here unit holders buy into the assets at their current value and you also know that the prevailing asset value will also be the value at which you trade. In order to maintain liquidity for unit holders, these funds currently retain 10-20% of their value in cash. Whilst this may dilute the exposure to the underlying assets, for the comfort of maintaining liquidity it is a worthwhile price to pay.

Principal's position

Where we had discretion not to hold commercial property for our clients, we passed the peak in 2007 without any exposure to the asset class. Where clients had a specific requirement to own property we sold out of open-ended unit trusts, where the question of liquidity was then a key issue, preferring to maintain exposure through closed-ended investment trusts. We felt it was most important to minimise gearing and focus on the highest quality of 'prime' property assets. Through holdings of the defensively invested TR Property investment trust and F&C Commercial Property, clients maintained a minimal exposure to property in liquid assets that could still be traded, when many open-ended unit trusts had suspended dealing. Recently, we took advantage of its strong performance to sell the F&C Commercial Property trust at a premium to net asset value and reinvest the proceeds into the open-ended Aviva Investors Property trust.

We are now ready to add commercial property across all our client portfolios. Commercial property should primarily be seen as an income-producing investment, and valued on that basis it is currently attractive. On a historic comparison the yield premium of commercial property to Gilts has been a good indicator of value. Yield on prime properties is around 7%, substantially higher than ten-year Gilt yields. Of course, secondary property yields are significantly higher still, but do carry a greater degree of risk. We do not believe that it is necessary to take on higher risk with our commercial property investment at this stage.

If you would like any further information on this subject, please do not hesitate to contact us.

MARKET LEVELS AND MOVEMENTS TO 30 NOVEMBER 2009

UK Equities

	Index	vs Last Month %	YTD %
FTSE 100	5,191	2.9	17.1
FTSE 250	8,918	0.4	40.2
FTSE SmallCap	2,718	-2.7	46.6
FTSE All Share	2,648	2.5	19.9

Overseas Equities

	Index	vs Last Month %	YTD %	YTD (£) %
US (Dow Jones)	10,345	6.5	17.9	3.3
Europe*	140	1.0	20.9	14.1
Japan (Nikkei)	9,346	-6.9	5.5	-2.7
Pacific*	344	-1.8	49.6	43.5

*based on FTSE All-World Indices Europe ex UK and Pacific ex Japan respectively

UK Valuation Yardsticks

Market P/E	18.2	(historic, FTSE All Share)
Index Linked Yield	0.48%	(over 5 years, 5% inflation)
Market Yield	3.4%	(net historic, FTSE All Share)
Base Rate	0.5%	

Bond Yields

	Now %	End 2008 %
UK	3.6	3.1
US	3.2	2.3
Germany	3.1	2.9
Japan	1.3	1.2

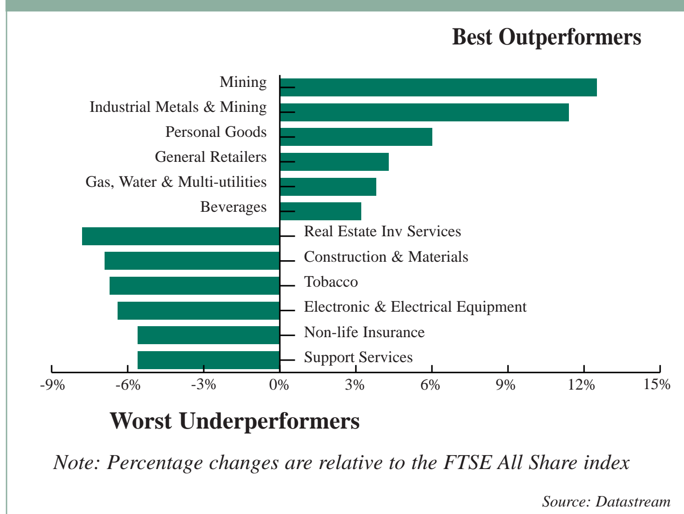
(based on ten year Government bonds)

Currencies

	Current Rate	YTD %
£ vs US$	1.6	14.1
£ vs Euro	1.1	5.7
£ vs Yen	141.4	8.5

Source: Datastream

Sectors of the Month



Note: Percentage changes are relative to the FTSE All Share index

Source: Datastream

FTSE 100 Index

Source: Datastream

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