



Safe as Houses?

Unfortunately the old adage does not always ring true.

Early in 2010 we identified the UK property market as one which potentially offered some compelling shorter term investment opportunity. Historic low interest rates, collapsing property valuations and a growing need for higher yield began to put property back in play. Our cautious outlook for low risk fixed income return rekindled our appetite in this market area. We therefore re-entered this sector after a significant absence! However, we now believe it is once again a time to withdraw our commitment for clients to this sector and have outlined our reasons below.

We identified commercial property as an appealing and risk adverse sector of the market and thus focused on this rather than venturing into funds exposed to residential property or those buying the shares of property, and property related, companies. The recovery in UK commercial property since, which has seen values rise steadily in the past thirteen months as some confidence returned, has translated to solid returns from our investments.

From a pure investment perspective we believe that much of the 'easy' gains in the sector have been realised. Massive inflows and the value increase already observed have eroded many valuation discounts and pushed yields down towards 3% which, when considered against current equity income yields of near 5%, do not appear overly attractive. With commercial rental rates down nearly ten percent over the last two years and increasing vacancy rates our medium term outlook is not as encouraging as before. Several property fund managers with few commercially profitable projects on their books, are finding it difficult to source new opportunities (some running over 25% cash balances) and are struggling to maintain the yield in their portfolios.

We believe there are further headwinds on the horizon; more than £160 billion of commercial property debt matures over the next five years with concerns now surfacing regarding how the industry will refinance itself given the still stagnant credit conditions. With the severe cuts to public-sector property spend also in the government's recent Comprehensive Spending Review one must ponder where future demand and growth will emanate.

Our fears also relate to a repeat of the debacle that occurred in late 2008. Falling property values combined with investor redemptions led to liquidity issues for a number of property funds, increasing bid/offer spreads (or instigate redemption penalties) in an attempt to dissuade investors from asking for their money back and protect remaining investors. One will never know if there was an element of "profiteering" – a point we highlighted at the time. In more severe cases funds became 'locked' offering little or no liquidity to investors still invested. Frighteningly, some of these funds are still locked to this day. It was reported last month that Aberdeen Asset Managers had made the decision to dissolve their €1.3 billion European property fund rather than risk reopening it to a frenzy of share redemptions. Fortunately we had exited all our property investments before this situation deteriorated in 2007.

We do not wish to be branded fear mongers, nor are we suggesting that property does not offer investment opportunities for many investors in a diversified portfolio. However given our role to protect our clients' liquidity we believe it prudent to err on the side of caution and take the gains generated by our current holdings at this time remembering dividend payments have also been made during the year.

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