DIVERSIFYING INTO PROPERTY

CONTINUES TO MAKE SOLID SENSE IN A LOW-RETURN ENVIRONMENT

How does property fit into an investor's overall portfolio?

The property sector offers opportunities for growth and income, particularly for investors intent on achieving stable – if less aggressive – returns on their diversified portfolios. There are specific risks and rewards in the sector – it is traditionally stable and frequently outperforms more liquid asset classes, however, it is vulnerable to sentiment and economic ebbs and flows.

Property is traditionally viewed as a tactical investment that should form the basis of a long-term strategy, often included in a portfolio because of concerns about the long-term variability of stock and bond returns. It is also seen as a portfolio diversifier and an inflation hedge.

While South African property is unlikely to reach the luck of the Irish, market indices for real estate correlate loosely with the returns on stock and bond investments, boosting the argument for including this asset class in a diversified portfolio.

Returns from property investments allow for hedging inflation, as property owners can increase their rental expectations. Similarly, property owners do not have to adjust their prices to supply and demand – they set a going rate and tend to negotiate on softer items like installation costs.

Unpacking property returns

Long-term leases may offer a lower return over time, but the returns will be stable and predictable – characteristics often sought in a volatile environment.

The property shares that pay high income returns are the ones that have high occupancy rates in attractive buildings. They are also the ones that continually grow their portfolios, with some diversifying into property abroad, as Growthpoint did when it invested in Romania in 2016, or as Redefine did when it invested in Respublica Student Living in 2015.

Investment in existing properties and diversification of risk through growing their portfolios all adds to the capital value of the share or fund.

Other factors such as timing and pricing also play a role in South African funds' performance, particularly for investors seeking to take advantage of the permitted 25% of total investment offshore. A fall in property prices, locally or in offshore markets where local funds are exposed, could lead to sudden drops in value.

What is the economic backdrop required for property to perform well?

Property fund performance tends to follow the economy. During periods of inflation and economic growth, property will offer strong returns, while it tends to stall during periods of stagnation or recession.

Performance in the property sector is also impacted by the Monetary Policy Committee's (MPC) interest rate decisions. When inflation is above the MPC's target range, the likelihood is that it will raise interest rates.

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Conversely, if inflation has peaked and is dropping because of the rand's recent strength, the MPC can cut interest rates. This will improve the capital value of properties as they become more affordable for purchase or rental, and there are less costs in the system.

However, the combination of lower inflation and a stronger rand will put earnings under pressure, and with global events having a significant influence on our market, this combination makes property look vulnerable, with a possibility of lower returns.

Real estate mirrors equity and enjoys returns in an environment seeing the greater cash flows that come with economic growth and its associated interest rate hikes, while bonds suffer in these times.

That dynamic is changing in the United States particularly, aligning with a global shift from a focus on low interest rates, or monetary policy, towards fiscal policy likely to be boosted by an accelerated increase in short-term interest rates in the United States.

This trend could see impetus if Donald Trump delivers on his intention of using fiscal policy as his main tool to increase economic growth and China also recently declaring its intentions to invest in domestic infrastructure development.

Is property overvalued or is there room for growth?
If an investor's goal is to beat inflation of 6.6%, there were four asset classes that did so by a meaningful margin in the last year: local bonds, South African listed property, North American equities and equities within emerging markets.

Listed property achieved a 10.2% total return in 2016, significantly outperforming the JSE ALSI's 2.6% for the year – although overtaken by the 14% total return delivered by bonds.

The Head of listed property funds at STANLIB, Keillen Ndlovu, expects the sector to achieve a total return of at least 8.1% in 2017, although he feels as much as 14% is possible.

While figures for 2016 are not yet available, global performance in this sector edged up to 10.7% in 2015, reaching its highest level since 2007, with Ireland leading the way with a 25% return.

Reviewing the sector over the last 20 years, listed property has yielded 19% in average annual returns – while local equities delivered 16%, bonds 12% and cash 9%.

In a similar vein, if you look back over economic trends in South Africa over the last 20 years, GDP growth has fluctuated between the positively halcyon days of nearly 7% in 2007 to nearly -3% in late 2009. However, property has bucked the various trends of that economic growth with its consistent average performance, although the global financial crisis did impact the local market significantly in 2008.

Global property has done well since the Global Financial Crisis, as interest rates have been low and yields have been attractive, if the earlier-quoted figures above are anything to judge by.

The commercial property sector was mostly resilient during 2016, despite political and economic turmoil. New shopping malls took the limelight in 2016, despite faltering retail sales, and low consumer spending and confidence.

Property owners in the industrial sector achieved above-inflation rental growth, with strong tenant retention on warehousing and logistics properties.

The laggard in the sector was office space, struggling with rising vacancies and an oversupply of rental space. Investors in this sector can expect capital growth or income from their investment, although a long-term view can yield both, as properties are bought and sold for profit, or as long-term rentals offer a steady income for the property owner, creating the potential for dividend income over time.

Risk enters the picture when leases are broken, or when there are coinciding ebbs and flows in rental cycles, with several buildings in a portfolio standing vacant at the same time. There is also risk if most of a portfolio's properties are in a single sector that becomes particularly vulnerable in certain economic conditions.

If you are building a balanced portfolio to manage the risk of a potentially low-return environment, we believe an offshore allocation of at least 25% and a maximum of 25% of the portfolio invested in property is warranted.

We are confident that local property funds and assets will continue to deliver a yield of inflation plus 6% in the coming cycle – in our view, a very healthy return. It is worth noting that global political and economic events may impact return expectations delivered by international assets.

We have already seen some impact after the Brexit vote during 2016 on the likes of Intu and CapCo. Property is a sentiment-driven game abroad, stronger in more positive economic times, but retail and institutional investors are known to get nervous quickly if there are changes in the system.
For this reason, we believe that 2017 could be a watershed year for property, particularly abroad, when Article 50 of the Treaty of Lisbon is formally triggered by the UK in its journey to exit the European Union. This is anticipated to impact London's status as the economic epicentre of the Western world.

Watershed or not – the results seen over the past decades emphasize that a long view on property, as part of a diversified portfolio, will deliver consistently positive results.