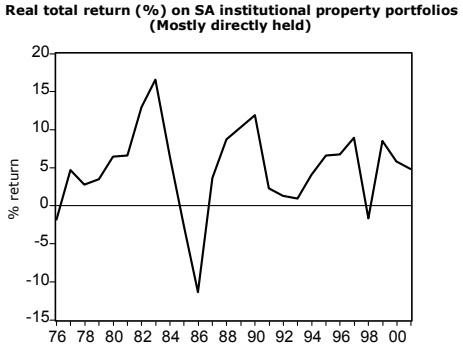
Institutional property returns set to tumble

May 2002

The nominal returns of institutional property have been in a secular downswing for the last 20 years, and the expectation is that this year the trend will continue. However, institutional property's average *real* total return of 5,2% p.a. for the last 25 years still beats the performance of both long-term gilts and cash.

The accompanying graph portrays the performance of institutional property over the last 25 years. Note how the volatility in returns has come down over the last 20 years, the result of South Africa's more stable macroeconomic policies.



Source: Rode's Database, Investment Property Databank (IPD) & StatsSA

According to a study undertaken jointly by Sapix and the UK-based Investment Property Databank (IPD), institutional property showed a nominal total return (income return + capital growth) of 10,5% for 2001, with the retail component putting in the best performance of 13,3%. In real terms, this equates to growth of 4,8% and 7,6% respectively. The retail property market's superior performance can be attributed to obstinately high consumer spending.

Sapix/IPD's analysis of property returns is based on the valuations of institutional property portfolios. Most of these valuations are done in-house, which could affect the reliability of the data over the short term. However, in the long term the average returns will become more reliable because fudging in the long run becomes unsustainable.

From 1995-2001 the data on institutional property's total return is sourced from Sapix/IPD. All the data before 1995 was sourced from *Rode's* own records.

The accompanying table compares the performance of institutional property with that of other assets over 1-, 5-, 10-, 15-, 20- and 25-years. Note how institutional property has managed to show constant real returns of around 5% over the different periods. This confirms *Rode's* general rule of thumb that property delivers real returns of 5%-6% over the long term.

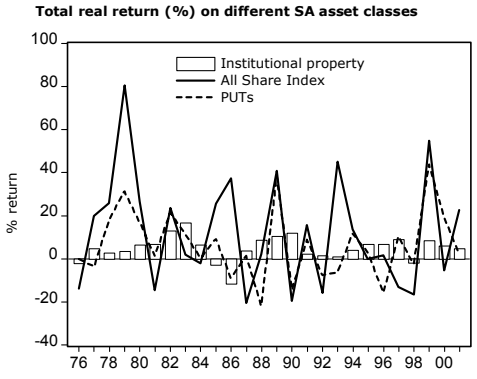
One would also expect institutional property and property unit trusts (PUTs) to show similar returns over the long term, because they have similar fundamentals. This, of course, assumes that the quality and type of property held are comparable. However, over the short term PUTs are more volatile, because they are tied to the fortunes of the JSE cycle.

Total return (%) on property and other assets

	Institutional property		All Shares		PUTs		LT gilts		Cash (BA rate)	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
2000-2001 1-yr ave.	10,5	4,8	28,3	22,6	7,7	2,0	17,7	12,0	5,3	-0,4
1997-2001 5-yr ave.	11,6	5,2	14,8	8,5	21,0	14,7	22,3	16,0	13,4	7,1
1992-2001 10-yr ave.	12,6	4,6	16,7	8,7	13,9	5,9	20,7	12,6	13,9	5,9
1987-2001 15-yr ave.	15,8	5,5	17,3	7,0	15,0	4,7	19,1	8,9	14,7	4,4
1982-2001 20-yr ave.	16,6	5,2	20,9	9,6	16,6	5,2	18,0	6,6	15,4	4,1
1977-2001 25-yr ave.	16,8	5,2	24,9	13,2	18,4	6,8	16,1	4,4	14,1	2,4

Source: Rode's Database, Investment Property Databank, StatsSA & Old Mutual Asset Management

Readers must interpret the accompanying table with caution, because the total returns could differ considerably depending on the period chosen. For example, the All Share Index showed a real return of 8,5% p.a. in the five-year period to 2001, whilst the five years up to 2000 delivered a real return of only 4,3%.

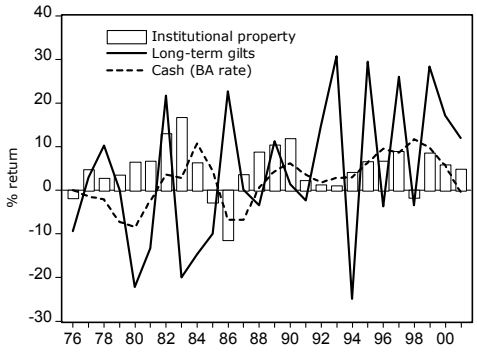


Source: Rode's Database, Investment Property Databank (IPD), StatsSA & Old Mutual Asset Management

The accompanying graphs also show the lower volatility of institutional property returns compared to that of the All Share Index, PUTs and long-term gilts. The first graph portrays how PUTs have followed the trend in the All Share Index.

Institutional property returns and the total returns on cash (BA rate) have followed a similar trend from 1984. The exception, however, was in 1998 when the real total return on institutional property dropped to –1,7%. This huge drop could have been the result of institutions writing off capital losses accumulated over the previous years — in other words, they did a reality check in the wake of the Asian crisis. We can say this because the capitalisation rates on directly-held properties rose consistently from about 1995 to 1999 (see graph below), thereby negatively impacting on capital values. Hence one would also have expected the returns on institutional property to have declined over this period, which was not the case, except in 1998, when the "correction" was made. Furthermore, because of the relatively low volatility of property's income streams and/or market rentals, one would normally not expect such a drastic change in institutional property returns, but rather a gradual decline or increase over time like in 1983-1990 and again from 1990 to 1997.

Total real return (%) on different SA asset classes

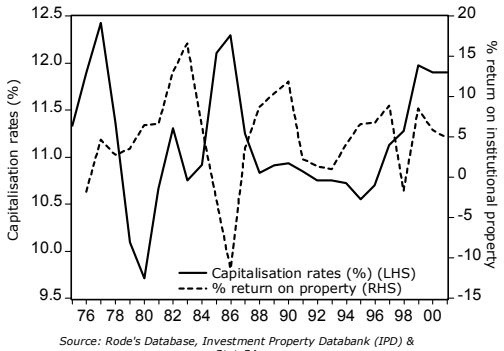


Source: Rode's Database, Investment Property Databank (IPD), StatsSA & Old Mutual Asset Management

Capitalisation rates and property returns have an inverse relationship, because *lower* capitalisation rates lead to *higher* capital values, which push up total returns — holding all other factors constant — and vice versa.

LHS and RHS in the accompanying graph stand for left-hand scale and right-hand scale respectively.

Real total return (%) on SA institutional property portfolios vs Central Witwatersrand industrial leaseback capitalisation rates



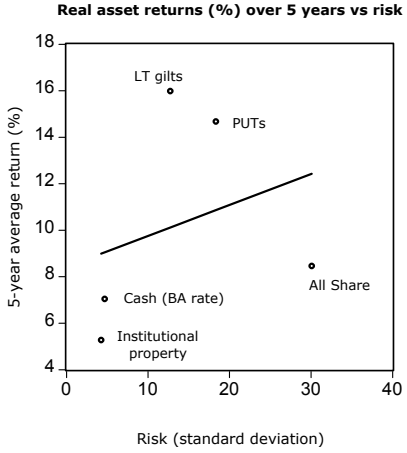
Source: Rode's Database, Investment Property Databank (IPD) & StatsSA

The next set of graphs correlate the real total returns on different asset classes over 5, 10, 15, 20 and 25 years with those of their respective risks, as measured by the standard deviations. Readers must be cautious in comparing the different asset classes over the short to medium

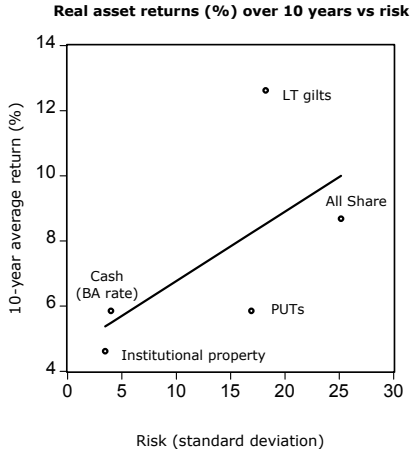
term (5-15 years), because of greater volatility. The longer term (20-25 years) gives a better indication of the relationship between the return on assets and risk. Also note that these comparisons are not the be all and end all of the relationship between returns and risk, but are merely used to give an indication of the relationship.

Standard deviation is a statistical measure of the distance a quantity is likely to lie from its average value. In finance, standard deviation is applied to the rate of return of an investment, to measure the investment's volatility, or "risk".

The regression lines in all the graphs follow a similar trend, indicating a positive correlation between return and risk, i.e. the higher the return, the higher the risk, and the lower the return, the lower the risk. An interesting phenomenon is that the regression lines over the longer periods show a better fit, i.e. a better correlation between risk and return.

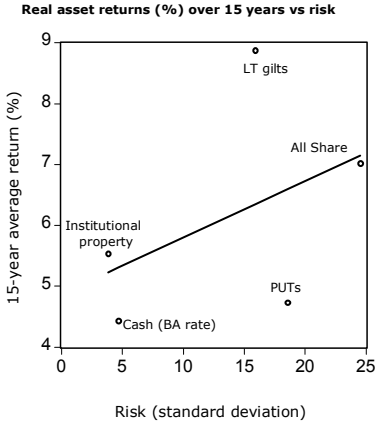


Source:Rode's Database, Investment Property Databank (IPD), StatsSA & Old Mutual Asset Management



Source:Rode's Database, Investment Property Databank (IPD), StatsSA & Old Mutual Asset Management

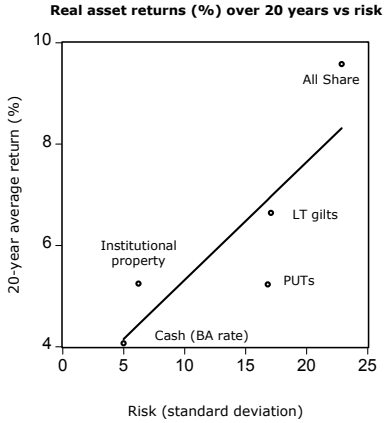
Institutional property's risk-adjusted return is higher than the average risk-adjusted return (above the regression line) over a 15-, 20-, and 25-year period. Furthermore, the graphs over these periods show that institutional property has, relative to its risk-profile, been a solid investment.



Source:Rode's Database, Investment Property Databank (IPD), StatsSA & Old Mutual Asset Management

Long-term gilts are not very comparable over the longer term (20-25 years). The reason for this is that institutional portfolios were in the early years obliged by government to hold a substantial portion of their assets in gilts, which affected the returns on this asset class. Also, in the case of cash, low real interest rates up to the late 1980s made cash, and interest-bearing investments in general, unattractive. Low real interest rates also stoked inflation during this period of course.

The All Share Index has delivered the highest returns over 20 and 25 years. However, this was also attended by higher risks compared to the other asset classes.



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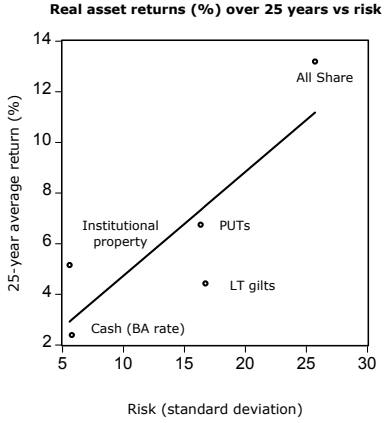
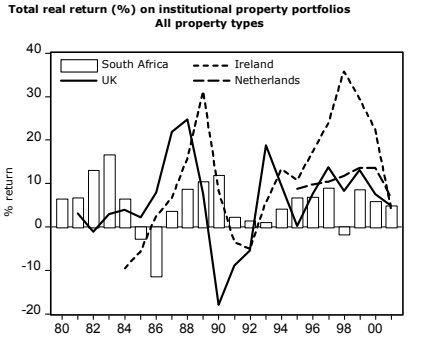


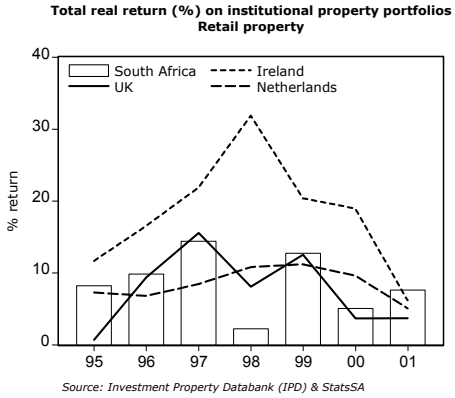
Source:Rode's Database, Investment Property Databank (IPD), StatsSA & Old Mutual Asset Management

South Africa's institutional property returns have shown low volatility over the last 20 years when compared with other countries. However, over the last six years the returns in other countries seem to have been more stable.



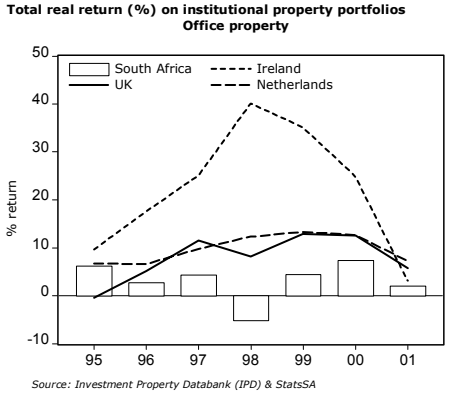
Source: Rode's Database, Investment Property Databank (IPD) & StatsSA

Ireland's property market has put in an exceptional performance over the last six years. This was caused by that country's economic boom.



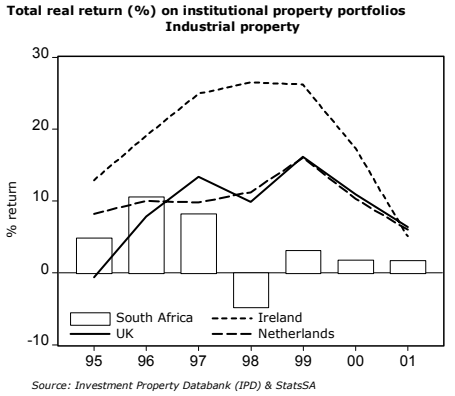
Source: Investment Property Databank (IPD) & StatsSA

When it comes to the office market, Sapix/IPD's data shows that South Africa has put on a poor showing over the last six years. The reason for this is that Sapix/IPD combines the returns of CBD and decentralised offices in South Africa. Thus, in the light of the decay most CBDs have experienced, one would expect the SA office sector as a whole to perform badly. Therefore it would be better if Sapix/IPD split the performance of the CBD and decentralised office nodes.



Source: Investment Property Databank (IPD) & StatsSA

South African industrial properties have put in a poor performance over the last four years, and have not been able to keep up with the returns seen in the UK, Ireland and the Netherlands.

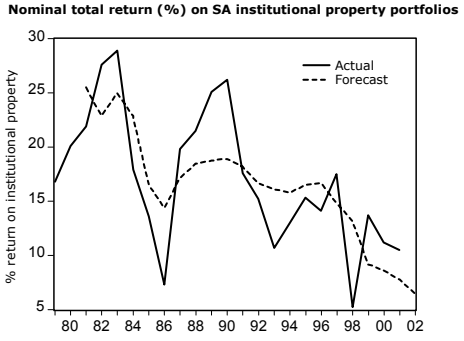


Source: Investment Property Databank (IPD) & StatsSA

The following graphs portray the actual and forecast institutional property returns until 2002. The variables used in forecasting 2002's returns are industrial leaseback capitalisation rates for the Witwatersrand and dividend streams for PUTs. Our regression model shows that these two variables explain 48% of the changes in institutional property returns, and that both capitalisation rates and dividend streams are statistically significant predictors.

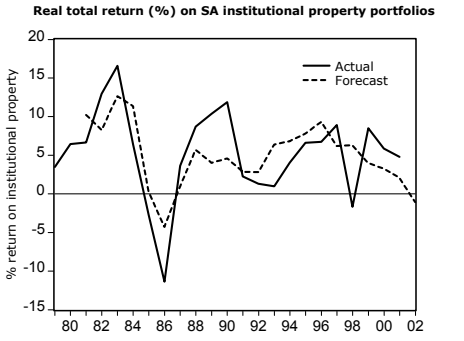
Some of the possible reasons why these variables only explain 48% of the changes in institutional property are:

- The capitalisation rates used in the regression model are for industrial leasebacks on the Witwatersrand. However, institutional property consists of different types and quality of properties, with different capitalisation rates.
- The institutional returns used in compiling the time series have over time become more representative of the whole market, whereas in the earlier years they were based on a handful of property portfolios. The same is true for the dividend streams. Today the PUT sector consists of more companies, which in turn have enlarged their property portfolios over time.
- Differing in-house valuation methods and the possible manipulation of the variables, like capitalisation rates.



Source: Rode's Database, Investment Property Databank & StatsSA

Our forecast succeeds quite accurately in explaining the secular trend in institutional property returns, which have been downward since the early 1980s. However, it fails to explain the huge fluctuations in institutional returns.



Source: Rode's Database, Investment Property Databank & StatsSA

The accompanying table sets out the forecast of institutional property returns in both nominal and real terms. The forecast real value for 2002 has been calculated by deflating the nominal value by a forecast consumer price inflation rate of 7,5%.

Forecast of institutional property returns (%)		
	Nominal	Real
2000	11,2	5,9
2001	10,5	4,8
2002	6,4	-1,1

This concludes our section on institutional property returns. ■