Prospects for Property's Performance

By Erwin Rode
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In the good old days – before inflation reared its head in the early 1970s – South African property investors didn't worry about the "performance" of their real estate. Nor did they know how to *calculate* total returns (income yield plus capital appreciation) for a specific period.

They were a hardy breed who did their viability studies on the back of a cigarette box (or so the legend goes). You could borrow money at an interest rate below the initial yield of the new development, so the property was self-financing right from the start (imagine that!). And in the long run, all you needed was a blind belief in the virtues of bricks and mortar. After all, that's how fortunes were amassed.

Not any more. Increasingly, investors see property as just one of many optional investment classes, and there has to be a reasonable prospect that it will pull its weight performance-wise before it is included in an investment portfolio. This applies absolutely to the professional fund managers, but increasingly also to sophisticated private investors. In the case of fund managers, they now also demand liquidity, that is they prefer listed property.

The owner of a large portfolio of prime properties recently asked me whether he should sell and switch to equity.

Over the past twenty years or so, ungeared prime business properties owned by South African institutions yielded an *average* real (inflation-adjusted) total return of about 4% per annum. Your average house outside the Western Cape yielded a similar return, assuming you paid rent to yourself and did not gear up (financed the house through a mortgage bond). These returns are before income tax, and seem to be international norms. And note they are *total* returns -- that is they include both the income yield and capital growth.

Compared to property, equity yielded a real total return of about 8% over the same period, thereby beating property handsomely. However, property's variability of return (risk) was significantly lower, so on a risk-adjusted basis, the returns were comparable.

This is the history. Looking into the future, it must be said that one important factor is now different: the developed world has entered an era of low inflation, with concomitantly high real interest rates. Thus interest-bearing investments have become a strong contender for your investment rand. The caveat is that a portion of this high-interest income must be reinvested to ensure capital growth.

Should the above landlord switch from property into equity, or maybe even interest-bearing instruments? Not to mention off-shore? The answer will depend on so many factors, including his specific risk and tax profile. In most instances, if the investor is in prime properties in a sound location, the answer is mostly "no", given the high friction costs (cost of switching). ■