Rather bonds than property

This article is an update on a paper that was read by Erwin Rode, CEO of Rode & Associates, at the Rode Conference in Johannesburg in 2000.

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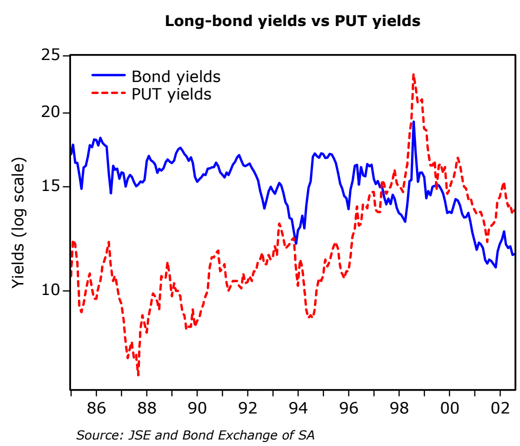
August 2002

It is hard to believe that 15 years ago, the market rated listed property far superior to long bonds, a situation that has since been totally reversed. The question is why?

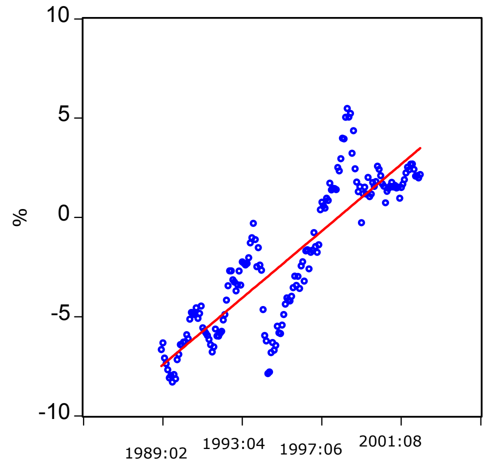
In the 1980s, the income yield of property unit trusts (PUTs) was significantly lower than that of long bonds. No doubt the reason was that investors were expecting significant earnings growth from PUTs, compared to the flat income of bonds. Hence they were prepared to buy PUTs at a lower income yield. However, as the accompanying graph shows, since 1988 this yield gap has been closing progressively, and since 1999 PUT yields have actually exceeded bond yields. Fortuitously, this is also the time from which a correlation developed between the income yields of listed property and long bonds. So what the market is telling us is not to expect income-stream growth from listed property, i.e. listed property has become a direct alternative to bonds, albeit with a slightly higher risk.



Note that we use PUTs as a proxy for listed property in this article. We could just as well have chosen property loan stocks, which are subject to the same forces as PUTs and therefore follow similar trends. For long-term bond data we use 20-year bonds ex the Bond Exchange of South Africa's yield curve.

The next graph portrays this yield spread (PUT income yields minus bond yields) since 1989. It shows the progression in the gap — from PUT yields being lower than bond yields, implying a higher relative market rating for PUTs, to PUT yields being higher (from mid-1997) than bond yields. This means that since 1989 the market has become progressively more negative towards listed property relative to bonds. No doubt the Reserve Bank's battle against inflation through a strict monetary policy from 1989 onwards played a major role in the rerating of bonds.

PUT income yields minus bond yields (% points)
1989:01 - 2002:08



Source of data: JSE & Bond Exchange of SA

A really dramatic narrowing of the gap occurred from the last quarter of 1994 (-7,8% points) to the end of 1998 (+5,2% points). Possible reasons are:

- Institutions' disillusionment with property after a decade of mediocre performance and the concomitant shift into other asset classes, including offshore investments.
- Coupled with this, the growing interest in SA bonds by foreign investors.
- Furthermore, the market started believing in the possibility of lower inflation for SA, which of course was positive for the lowering (strengthening) of bond yields.

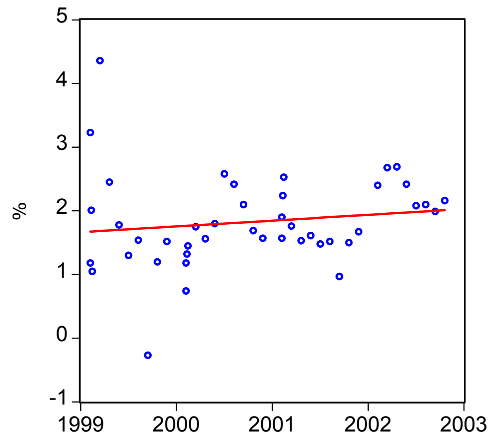
Until now we have discussed the long-term rating trend of bonds relative to PUTs. But what about the more recent trend? Our analysis from 1999 (see last graph) shows that the yield gap is still increasing — albeit at a much flatter slope — implying that the market rating of bonds is still becoming more favourable relative to PUTs.

The reasons for the current yield spread, and the further gradual widening thereof, can probably be explained as follows:

- Property funds' greater risk relative to bonds. It is also possible that this risk differential is perceived to be increasing because of the current cyclical oversupply of property.
- Poor short-term prognosis for property cash flows. In fact, this sector's cash streams are already moving sideways.
- Bonds' greater liquidity relative to PUTs. This allows foreigners to buy SA bonds from time to time — something that the listed-property sector yet has to experience. The big stumbling block here seems to be that listed property counters are tightly held by SA institutions.
- Supply. The supply of listed property counters is growing steadily. On the other hand, in a weak equity market, the demand for bonds has picked up, whilst the issuing of new bonds

has been limited owing to the government's prudent fiscal policy. So it is a moot point whether the supply of bonds or listed property has been most constrained.

PUT income yields minus bond yields (% points)
1999:01 - 2002:08



Source of data: JSE & Bond Exchange of SA

An analysis of the above postulated reasons for the yield differential brings one to the conclusion that they all tend to be cyclical or temporary. There is little doubt that the property oversupply will disappear in about two years' time, thereby boosting cash flows; and there is no doubt that more and more institutions will list their directly-held properties, thereby increasing the size and quality of existing funds and their tradability. Hence we do not expect that the current worsening trend of PUT yields relative to bond yields will continue ad infinitum. ■