What makes property different?

By Erwin Rode
6 February 2000

Some investors grow up believing religiously in the infallibility of bricks and mortar as an investment class, others will never be convinced. It may have a lot to do with one's risk profile and degree of ignorance.

The risk profile is self-evident. A schoolmate of mine, a few months after obtaining his driver's licence, would stop at every intersection of the *dorp* where we grew up – whether there was a stop or not. Just to make sure. Other mates would do the rolling stop at stop intersections during broad day-light – risking the ire of the single traffic cop. And on the odd occasion they would even ignore a stop street completely, especially late at night after a drink or two. Surely such differences in behaviour will be reflected in their investment preferences.

And then there is knowledge, or a lack thereof. *Onbekend is onbemind*. Property is a black box to many investors, a fact that could create lots of *angst* in the early morning hours if you happen to be a fund manager saddled with a few billion rands' worth of property. The easy way out is to dump the stuff. And this is exactly what the guys started doing five years ago.

So let's go into the knowledge factor by asking what makes property different to other investment classes.

Firstly, the fund manager's main complaint is the illiquidity of directly-held property. This is a valid complaint, because it means that you cannot trade, and you cannot play the property cycle. On top of that, many dye-in-the-wool property men that had been calling the shots until about five years ago didn't believe in selling a property once acquired. They believed an institution (or individual) had such a property – like a good wife -- for life. This is known in the textbooks as a 'naïve buy-and-hold strategy'. Hence a term like 'trophy' property. Many years ago, when I suggested to a property investment manager that a well-known 'trophy' property should be sold because the cycle was going to turn against him, he exclaimed: 'But then we will never be able to buy it back again!'. Imagine a fund manager saying that about De Beers!

The problem of illiquidity explains the present world-wide trend to list property, which is an elegant solution.

Secondly, property's risk – variability of returns – is much lower than that of non-property equity. This is so irrespective of whether property is directly held or listed. The reasons are twofold. Number one, market-rental growth is pretty predictable; number two, lease renewals tend to be staggered. Thus property's cash flow is quite stable. Because of this, the capitalisation rates of properties are also relatively stable, when compared with the dividend yields of shares. This makes for stable values most of the time. When a property portfolio is listed, this principle still applies, with listed properties' prices less volatile than those of other equities.

Thirdly, property's total returns will – in the long run – under-perform those of equities. This is so because listed businesses can do clever entrepreneurial things to boost cash flow. However, property is mostly a captive of the market. And the market is in turn a captive of inflation. In the very-long term – say 20 years -- prime rentals can only grow at the inflation rate. But since an individual property ages, such a property's cash flow cannot be expected to keep up with inflation in the absence of refurbishment (further capital injections). Obvious exceptions to the captivity theory is where entrepreneurs change the use of a property, change the tenant mix (as in the case of shopping centres), and so on. But the scope for doing these things is limited. Hence the need for playing the cycle.

Fourthly, we see there is a trade-off between risk and return. In fact, in the long run, on a risk-adjusted basis, property can be expected to deliver similar returns to equity.

Fifthly, a high proportion of property's total return emanates from the high income yield, which is of course taxable. Equity, on the other hand, delivers largely tax-free returns in the form of capital growth.

Sixthly, to counter the tax disadvantage, gearing is a distinct possibility that can boost return on equity beyond anything that is imaginable with non-leveraged equity. However, this could become a disaster when the timing of the investment is sub-optimal, thereby adding considerable risk. Structured finance is another option when the landlord is lucky enough to sign up a AAA tenant on a long lease.

To sum up, property's distinctive characteristics can considerably reduce the risk (variability) of a portfolio's returns. This is so because it partially marches to its own drum-beat. Fund managers ignore this fact at their own peril. ■