With unemployment falling throughout developed markets and interest rates remaining at rock bottom levels (for now) the slow but steady recovery in these markets continues. **This month we focus our attention on commercial property**, an asset class which is often seen as a barometer for the general health of the global economy and which tends to correlate with fluctuations in GDP.

**With income hungry investors flocking in ever increasing numbers to the sirens' call of high yield debt, we consider whether property can be considered as an alternative source of income to these ever riskier fixed income investments.**

As developed market central banks have increasingly turned to quantitative easing as a way of artificially stimulating growth the **yields on conventional fixed income products (bonds) have been squashed** to levels that are no longer attractive to many of those seeking income. Income hungry pension funds and private investors alike continue to move out of lower yielding fixed income securities such as US treasuries, UK gilts and investment grade credit into higher risk junk bonds, leveraged loans and "covenant-lite" bonds. This is justified to clients as "moving along the yield curve" or in simple terms taking more risk to obtain higher yield, often described as "chasing yield". **This general shift has made other sources of income in other asset classes more attractive and commercial property is an obvious consideration**.

So is this the right time to invest?

**Firstly it is important to mark the differences** between residential and commercial real estate. For one, **commercial property yields are higher.** The IPD All Property Index – the main benchmark for performance of commercial real estate in the UK – shows average yields close to 6%, contrasting with closer to 3% for the Halifax residential property index. Secondly **investors tend to buy commercial property as a yield play rather than expecting capital growth**, which is more the domain of the residential property investor**. Thirdly** because the lease terms of commercial property tend to be shorter and because it is businesses that use commercial properties, **they tend to be more sensitive to the fluctuations in the UK economy than residential property**.

Most of our clients not only have significant personal exposure to UK residential property but in many cases this is also leveraged through the use of a mortgage. In addition, it is difficult to obtain efficient exposure to residential property without actually buying the "bricks and mortar". We are therefore interested in commercial rather than residential property as a way of diversifying risk and also as a way of generating higher income for our clients.

So given our earlier assertion that commercial property tends to reflect the general economic outlook, **clearly we want to consider buying commercial property when the economic signals suggest that a recovery is well underway**. **This is certainly the case in the UK,** as our more than smug chancellor is only too happy to point out. In 2013 the UK posted some of the strongest growth figures of any of the G7 countries and unemployment continues to fall. The IMF even announced yesterday (8th April 2014) that UK growth for the next year is expected to reach 2.9%, the best of the world's major economies. **Economic growth translates into increased demand** for office space, strategic corporate expansion, new start-ups and lower default rates. **This increase in demand should force rental yields to increase and may also push prices higher.**

**So what decisions should govern the selection of one commercial property investment over another? Yield is of course the first consideration** - the income component (rather than capital growth) is the main source of return for commercial property investors, although capital growth is of course very welcome.

**But what governs that yield?** Like all investments the return profile should be a direct reflection of the amount of risk taken.

The following variables contribute to that "picture" of risk and return:

**Sector** - "retail" (eg shops) is often considered riskier than say " office" (eg financial services) and "industrial" is often considered riskier than retail. Higher risk translates into higher yield.

**Quality of tenant** - Tesco is a better quality tenant than HMV as it is less likely to default on its rental obligations. Therefore Tesco should pay less than HMV.

**Length of lease** - A longer lease often attracts a more competitive (lower) yield as it provides surety of cash flow for the investor.

**Geography** - South East Vs North East. Typically South East, London centric property is considered lower risk than the North East.

**Quality of the building** itself - will maintenance be a major cash drag and what are the costs of running the building including service charges?

These are just some of the important variables that an investor should consider and the construction of a property portfolio will be governed by such decisions.

**So assuming that enough due diligence has been undertaken to warrant an investment in the sector, how do we buy it?**

Premium commercial property changes hands for hundreds of millions of pounds and transaction costs can be in excess of 5%, not to mention the considerable expertise required to manage such property and to build a diversified portfolio of investments.

Therefore **investing directly into commercial property is a step too far for most investors. However there are many different types of vehicle** that we can use to provide our clients with access to commercial property.

Below we consider some options:

**Real Estate Investment Trusts (REITs).** These companies issue shares to raise funds in order to make property purchases. These **can include direct stocks, direct real estate** purchases **and mortgage securities**. The shares are typically publicly traded and so provide high levels of liquidity. They do not pay corporation or capital gains tax at company level and so they are tax efficient and the headaches of dealing with expenses or being a landlord is not borne by the underlying investor.

**However being forced to pay out 90% of their income** to comply with REITs rules **means that they are less able to take advantage of strategic growth opportunities** (i.e they can't reinvest much of their income into other properties). **Also** as they are listed securities **they have historically had much higher correlation with global stock markets** as they form part of the FTSE 100 index and so offer less diversification than investing in property direct. British Land and Land Securities are examples of direct companies that have converted to being REITs.

**Ideally we want exposure to direct "bricks and mortar" (real buildings) but with high enough liquidity** and with a portfolio large enough to protect against any one specific property investment failing. **This is possible through an Open Ended Investment Company (OIEC)** which shares some characteristics of a REIT but the mechanics of which are very different. In contrast to REITs which are finite "pools" of capital, when investors buy an OIEC they are effectively buying a "claim" on the assets held within the fund, just as when buying a fund that invests in equities.

With a typical fund holding 80% of its portfolio in direct property, **these funds offer diversification** and they also provide a hedge against rising inflation as they invest in real assets.

However because investors into OEICs have greater access to their capital and since the underlying investments (actual properties) are not easily tradable, **one major risk with OEICs is that if there are a large number of redemptions, the fund manager may be forced to sell distressed assets** to meet the exit demands of investors and if they can't sell then they might need to shut the fund temporarily.

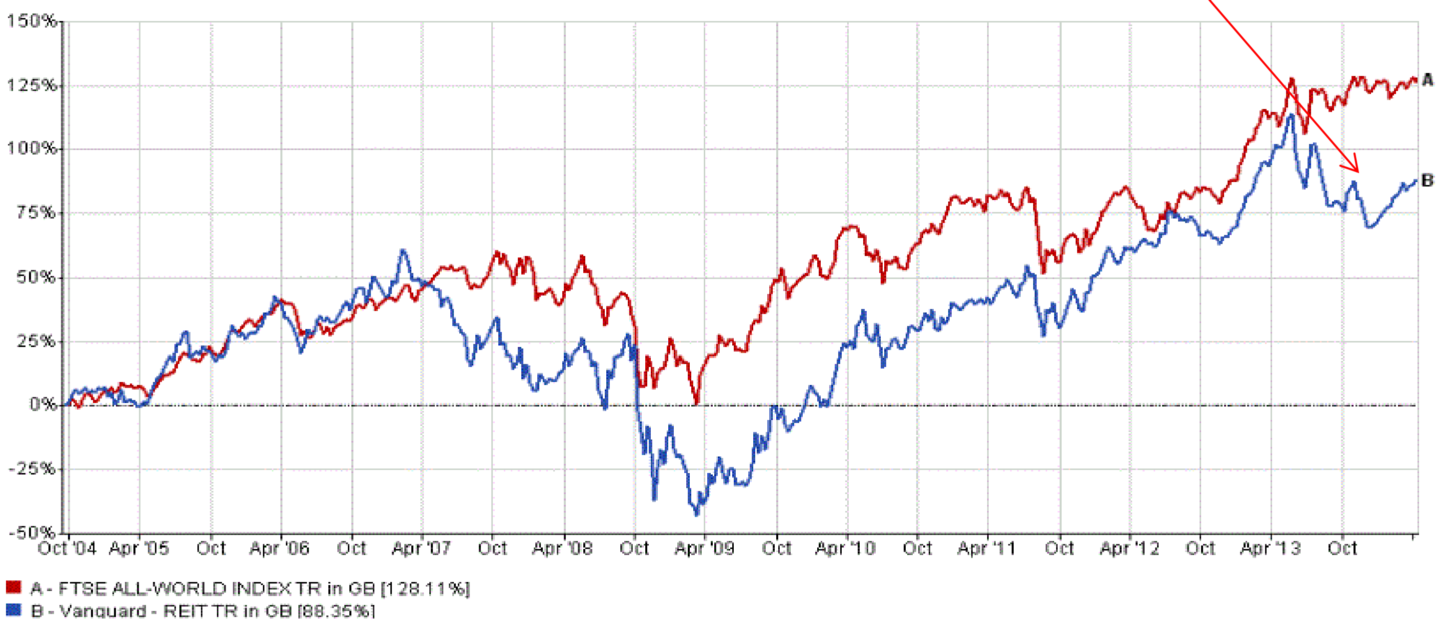
History is littered with open ended funds that have had to temporarily close. **The key therefore is to find a big enough and liquid enough fund to be able to weather these storms.**

The other option is to **consider an investment trust (IT)**. ITs are a finite pool of capital, can borrow to invest and are listed on the stock market just like REITs. However typically **they are not as correlated to equities as REITs** and this is major advantage. **However** as they are traded on the market **they can be volatile** and the price may not always reflect the actual value of the property investments that are in the portfolio **so careful monitoring of prices is essential**. Also, investment trusts are not always as easily tradable in large volumes and therefore **only smaller firms like ours can realistically buy enough of these vehicles to fit across their clients' portfolios without moving the price**. However there are some very good trusts out there for those that know where to look.

With the improving general economic outlook in the UK, **we believe that investors should consider adding some UK commercial property to their portfolios.** Selecting a well-managed, large, liquid, sector-diversified fund is probably the best route into the asset class and with yields of over 6% in some well-spread funds there are some good options available.

**Investing in the UK**, where yields are robust, new property supply is generally fairly limited, **where demand is increasing** and where clients need not be concerned about currency **should prove to be a useful diversifier in an environment of ultra-low interest rates and increasing risk in other asset classes more commonly associated with generating an income**. We will be considering such a move for our clients over the coming weeks.

*REITs show some correlation with equities but look much better value of late and with a considerably higher yield.*




*Source: Financial Analytics*