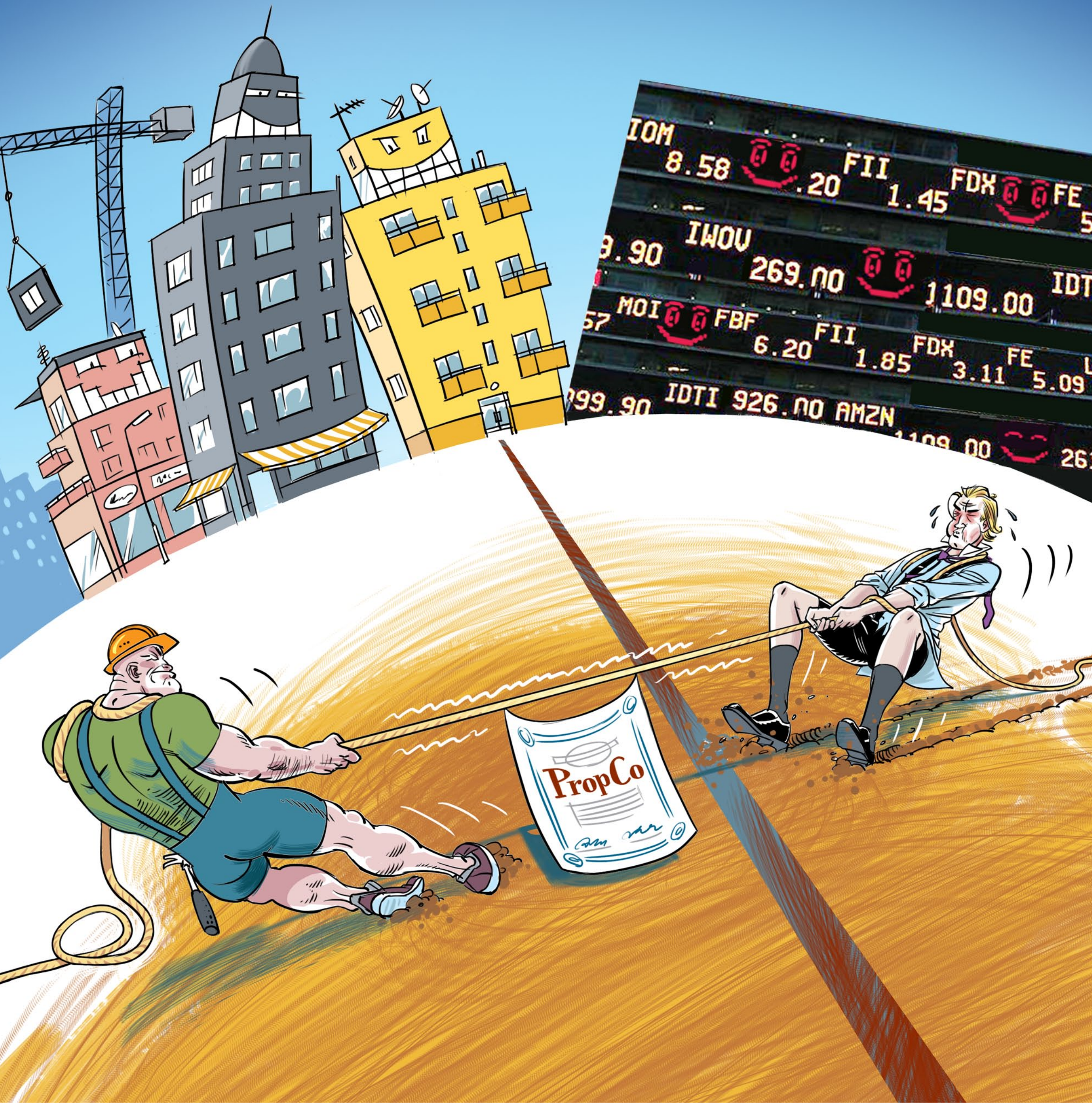
Property shares

– property or shares?



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Property shares – property or shares?

What is the nature of property shares? Do they bring property market exposure or do they simply follow equity markets? Does it make sense for institutions to hold property shares in order to diversify away from equity markets or do property shares behave just like any other shares? Could property shares effectively replace direct property?

It is common wisdom among institutional investors that property contributes to beneficial diversification vis-à-vis other asset classes held by investors. Common wisdom also dictates that 'true' exposure to property is primarily achieved through either direct ownership, non-listed real estate funds or the latest vogue; joint ventures and club deals. Listed property companies have been the ugly duckling and have been left to the equity departments since 'they are mainly an equity markets exposure'. This article penetrates the subject of whether property shares should be viewed as property exposure and/or equity markets exposure.

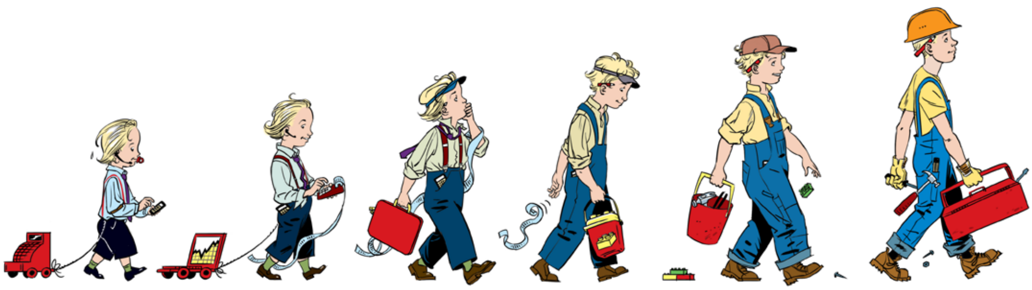
Property shares – a long term substitute for direct property

In order to analyse the nature of property shares we calculate:

a) the correlation of property shares with direct property
b) the correlation of property shares with the stock market

Instead of measuring the correlation of annual returns, we have analysed the correlations of returns of different rolling periods of time, from 1 year to 10 years.

Property shares - more like property than shares, as time goes by



From trading floor to construction site - the property share growing up to become more property than share.

The chart below shows some very interesting findings. Looking at short-term annual returns property shares and equity markets are strongly correlated (0.7) whereas property shares and property are weakly correlated (0.4). But as we increase the length of the investment period, property shares are increasingly correlated with property and decreasingly correlated with equity markets. [1] Looking at a ten-year period, the correlation between property and property shares is very strong (above 0.9!). Over the same long period property shares are negatively correlated with equity markets.

The two lines in the chart below cross at four years implying that property shares held over an investment period of more than four years are a proxy for property rather than for equities. Property investors in general, and institutional investors in particular, have an investment horizon that is longer than four years, and in many cases approaching or even exceeding ten years. For those investors, property shares constitute a very good substitute for direct property.

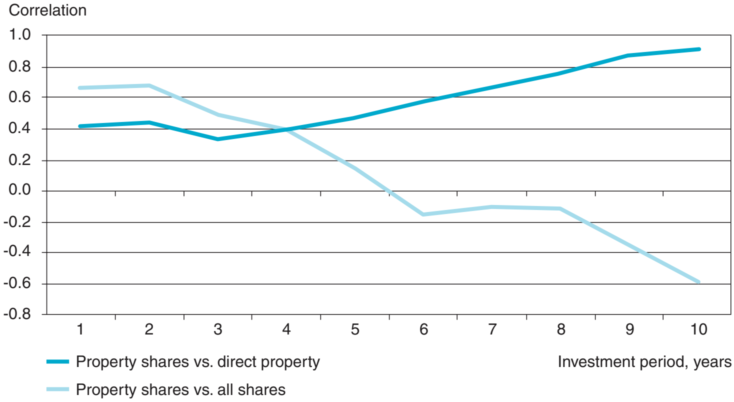
(1) Similar results for the UK market were found in the 2009 research report 'Property shares make a good proxy for direct property' by Morgan Stanley.

Method
Based on annual total returns for the time period 1988-2010, we calculate the correlations between a) Swedish property and Swedish property shares and b) Swedish property shares and all Swedish shares, for rolling investment periods ranging from one year up to ten years.

For example, the first observation in the Swedish property four-year-investment-period data series is the total return from 1988 to 1992. The second observation in the same data series is the total return if property is acquired in 1989 and held until 1993. Etcetera.

The correlation between 1) property and 2) property shares for a four-year investment period is then calculated as the correlation between 1) the series of total returns for property over rolling four-year investment periods as calculated above and 2) the corresponding data series for property shares. Correlations for other investment periods are calculated correspondingly.

Property shares correlated to direct property in the long run



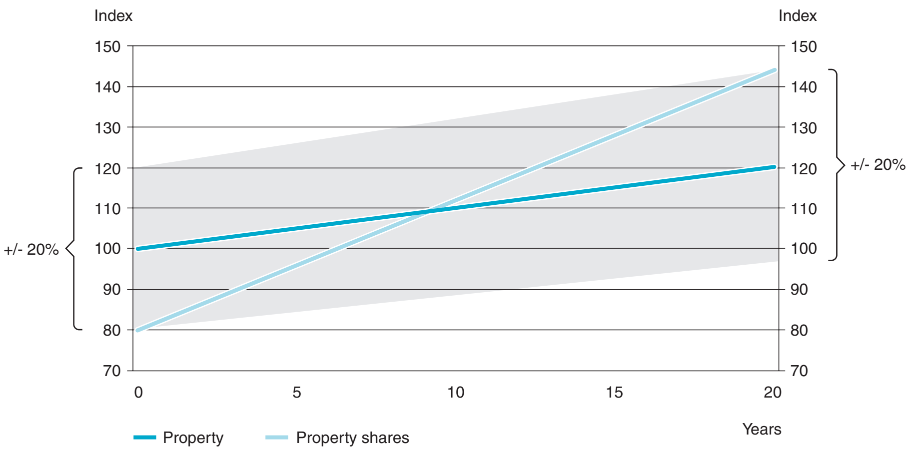
As the investment period becomes longer, property shares are increasingly correlated with property and decreasingly correlated with equity markets.

The high correlation between property and property shares in the long run is not surprising at all. Under the assumption that property shares in the long term trade in a corridor around NAV (Net Asset Value - which is based on valuations of the assets and thus reflect the direct market), the returns of property and property shares over long periods of time should be very similar. For example, assuming that property shares trade in a corridor of +/- 20% to NAV and an investment horizon of 20 years, the annual return differential between property shares (unlevered) and property would be less than 0.8 percentage points (see chart below). Given a more realistic scenario the differential would be much smaller. In other words, if we assume that property and property shares do not diverge, returns will be similar and the correlation high, in the long term.

On the other hand, the relatively low correlation, in the short term, between property and property shares can be due to various factors, e.g. that short term trading is influenced by non-fundamental factors or that investors in listed property companies have limited information about the underlying property market. It could also, to some extent, be explained by 'smoothing', which hides the true effect of macroeconomic shocks on the property market. 'Smoothing' is a measuring problem whereby, for various reasons including methodology, property valuations tend to lag and underestimate movements in the underlying markets. There is substantial evidence that property valuations suffer from 'smoothing', a subject that is left for another article.

Given the smoothing phenomenon in property valuations, it is even possible that property shares actually reflect the changes in the underlying property market better than property valuations.

Small annual return differences



The most extreme case would occur if property shares trade at a 20% discount at the beginning of the period and at a 20% premium at the end of the period (assuming 60% leverage), i.e. $\sqrt[20]{\frac{1+20\%*(1-60\%)}{1-20\%*(1-60\%)}}-1 = 0.8\%$

Should investors own direct property at all?

Owning property is, for all practical purposes, like running a business. Institutional investors are not normally 100% owners of companies outside the property sector but for some reason property is an exception. It is not uncommon for large institutions that a majority of the head count is people working with property, although property constitutes a small percentage of total assets under management. Should institutions really bother running a business of directly owned property, if they achieve a similar exposure through property shares? To answer that question we will compare property and property shares and analyse the following aspects: property exposure, costs, liquidity and risk/return.

Property exposure

As seen above, listed property shares constitute a good proxy for property exposure, at least in the medium to long run. Since institutions typically have a long investment horizon, property shares are almost as good as direct property in order to reap the benefits that property exposure brings in terms of risk diversification. In addition, a wide range of listed property companies in the Nordics offer various kinds of property exposure: retail, office, residential, logistics, warehousing, long leases, high yielding, etcetera. This universe reaches beyond the normal scope of property owned directly by institutions.

An investor in property shares does not have full control of the underlying assets; the property company could change its strategy, new shareholders can alter the agenda, etcetera. On the other hand the investor, in such a situation, can always sell the shares on a liquid market (see Liquidity below).

Costs

Assuming that property shares can substitute direct property, is this a cost efficient way to achieve property exposure?

In jurisdictions without 'REIT-vehicles', such as the Nordic countries, listed property companies suffer from a tax disadvantage compared to directly owned properties, because of double taxation. In practice though, property companies have been paying relatively low taxes. For property companies with leverage the tax shield diminishes the problem.

Regarding overhead costs, a listed property company should have about the same costs as properties owned directly by institutions, given comparable asset volumes. There is a cost attached to being listed, which at least for large companies is small, in relative terms. On the other hand this contributes to listed property companies being very transparent which makes them easy to benchmark.

An advantage of listed property companies is that they can offer expertise in specific sectors, e.g. hotels, shopping centres and logistics. It is difficult for investors to have expertise in all these fields in-house. In this respect there are actually economies of scale.

Liquidity

If property shares are used to achieve allocation to property, the liquidity of the stock market makes it possible to rapidly change allocation to/from property, but also between different types of property and to different geographical regions, domestically and internationally. It is debatable whether direct property or property shares is the more liquid asset class. Even though the market for direct property is liquid, not least in the Nordics and particularly in Sweden, there is a lag of about three to six months from the decision to sell property is taken until the assets are actually sold. If property exposure is to be increased the time lag is much longer since it takes time to find the right assets to acquire.

One common objection against property shares is that they are liquid only in small volumes. In practice though, large blocks of property shares are changing hands relatively often and there is a liquid market for large blocks in most listed companies. Given a time span of three to six months, comparable to the time it takes to execute property transactions, it would be possible to build a book and sell almost any large block of property shares.

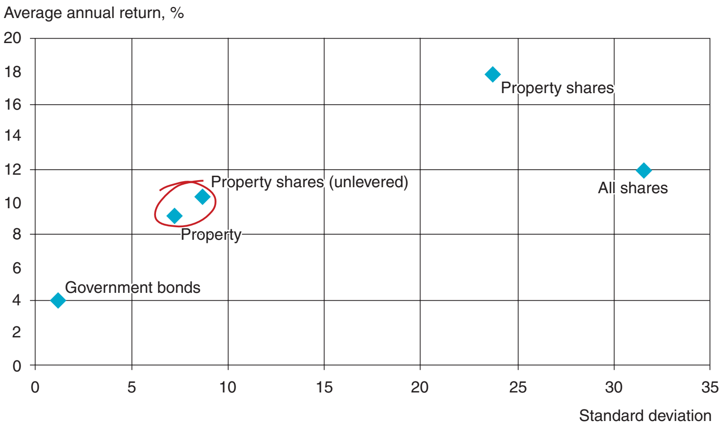
Risk/return

In the chart below risk and returns are compared for various asset classes in the period from 1996 to 2010. Returns for property shares have been much higher than for property (SFI/IPD), but this is to a great extent attributable to the effect of leverage. If the effect of leverage is removed, and risk and return are compared on an unlevered basis ('*Property shares (unlevered)*' in the chart below), property shares yield marginally higher returns compared with property.

It is worth pointing out that risk, measured as standard deviation, is underestimated for direct property since there is substantial evidence that property valuations suffer from a measuring problem ('smoothing'). In spite of that, the standard deviation for property is only marginally lower than for property shares (unlevered).

The return on property shares includes taxes and central administration whereas the SFI/IPD property return is a total return for property, excluding such costs. For the listed property companies in Sweden, the annual costs for central administration correspond to approximately 0.3% of asset value. Property shares (unlevered) yield slightly higher returns than property, while the risk is comparable or possibly, accounting for 'smoothing', even lower than for property.

Risk return matrix for property shares and property



In the chart above risk and returns are compared for different asset classes in the period from 1996 to 2010. Total returns for property shares are much higher than for property. Adjusting for the effects of leverage ('*Property shares (unlevered)*' in the chart above), property shares still yield slightly higher returns than property.

Direct property – worth the hassle?

Although this article has focused mainly on institutional investors it is worth noting that the same conclusions apply to other investors such as high-net-worth individuals.

We have shown that, in the medium to long term, property shares have a high correlation with direct property and a low or even negative correlation with equity markets. In other words, property shares could substitute direct property for most long term investors. Absolute returns and risk have been on similar levels for the two asset classes, although risk is very difficult to compare, since valuations of direct property suffer from 'smoothing' and underestimate volatility.

In addition, property shares offer greater opportunities to adjust property exposure along the way; in absolute terms or between sectors.

Summarising, investors should consider whether direct property is worth the hassle, since most of the risk diversification benefits of direct property could be achieved with property shares.

Institutional investors have owned direct property as long as they have existed. This will obviously not change overnight. There are some practical conclusions from our findings, though.

Since property shares in the long term basically offer the characteristics of property:

a) property shares can be used to achieve property exposure in markets, geographical or sectorial, where investors do not have any presence or expertise. In this way property shares constitute a very good supplement to direct property.

b) allocation to property, directly or through property shares, should be managed in an integrated way. Today direct property, property shares and property private equity are often managed by completely separate teams. This creates confusion regarding the actual total allocation to property. In addition business opportunities are missed, for instance in relation to fluctuations in relative pricing between different asset classes.