Buy cheap, sell dear

– the importance of timing

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LEIMDÖRFER

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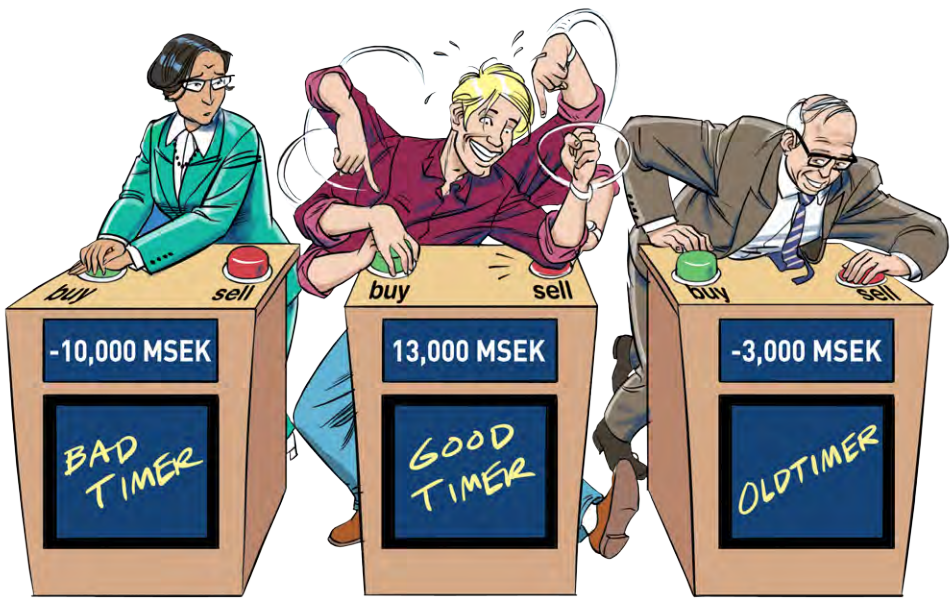
Is timing the market possible, and if so; which investors have succeeded in buying in a bear market and selling in a bull market? Why have some investors performed better than others? This report aims to shed light on these issues by looking at a decade of transactions on the Swedish property market.

Since the beginning of commerce, savvy tradesmen have tried to 'buy cheap and sell dear' in order to make money from a perceived superior ability to time the market. Methods for predicting market movements range from simple rules of thumb to more elaborate scientific approaches.

But forecasting the future is difficult – some would say impossible – and often the modern marketplace is described as instantly pricing new information, making it very difficult to benefit from information advantages. Nevertheless, such impediments have not discouraged people from trying to look through the veil of the future.

On a market with a limited number of infrequently traded unique assets, timing the market may however be more feasible than on a market where assets are homogenous and traded very frequently. This report studies the direct property market and different investors' timing of transactions.

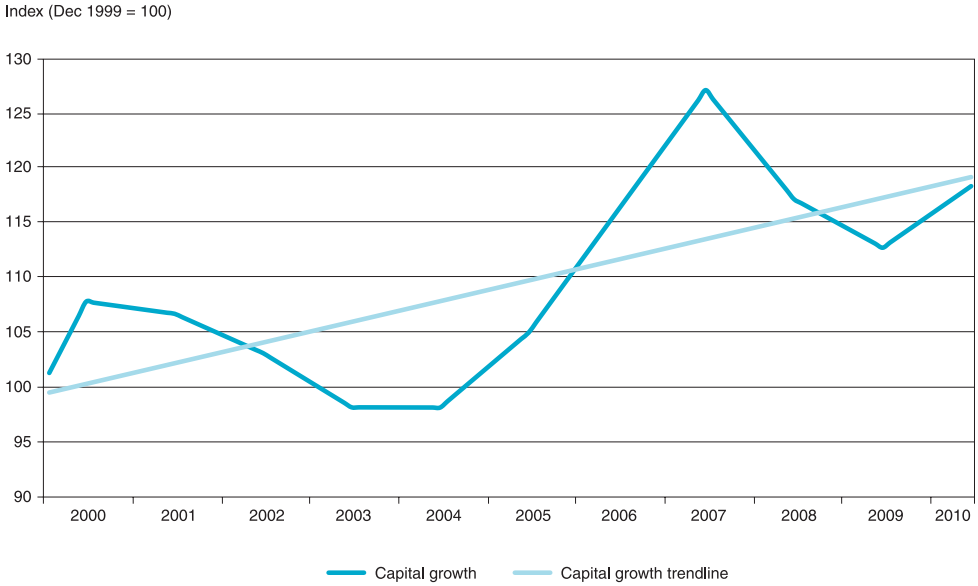


Analysing timing

To evaluate timing, it is necessary to disregard the characteristics of specific transactions but focus instead on the point in time at which a transaction is made. The chart below shows capital growth [1] on the Swedish property market and its trendline. Obviously, it is favourable to acquire properties when the capital growth line is below the trendline, and to divest properties when the capital growth line is above the trendline.

In this article, commercial transactions of Swedish properties from January 2000 to June 2010 are analysed. This sample represents a total property transaction value of more than SEK 1,000 billion.

Capital growth [1] with trendline, 2000-2010



[1] Based on IPD Sweden annual figures

Method

A 'capital growth index' for the period January 2000 to June 2010 is constructed based on IPD Sweden annual figures.

IPD capital growth is based on annual property valuations. Since they rely heavily on comparable transactions, which may be announced not at the time of signing but some time thereafter, property valuations tend to lag the market. Furthermore, a substantial number of comparable transactions have to take place before there is market evidence of a new yield level, contributing to this lag in property valuations. For this reason, the capital growth index is adjusted six months back in time. After having made this adjustment, the movements in the capital growth index closely follow those of the Carnegie Real Estate Index, which is the most commonly used index when tracking the Swedish listed property sector's performance.

A trendline representing an 'average' performance from a timing perspective is derived from this capital growth index. It should be noted that the capital growth index, and thus also the trendline, shows general market development as reflected in the IPD figures.

All transactions included in Leimdörfer's proprietary database involving Swedish properties between January 2000 and June 2010 are grouped by the following investor categories:

- *Listed property companies* – publicly traded property companies in Sweden or abroad whose main business activity is property.
- *Non-listed property companies* – property companies that are not listed but are either privately held or subsidiares of a listed group whose main business activity is something else than property.
- *Institutional investors* – asset managers of institutional capital, i.e. insurance premia or pension contributions, including public compulsory savings schemes such as national pension funds.
- *Core property funds* – funds investing primarily in income producing investments using low leverage and with no or very low development exposure. Generate a high proportion of total return through income return. Low to moderate return requirements. (1)
- *Value added property funds* – mainly closed ended funds with moderate leverage which deliver returns from a balance of income return and capital growth. May allocate part of investments to development projects and typically also invest in forms of active management such as letting, repositioning and/or redevelopment of properties. Moderate to high return requirements. (1)
- *Opportunistic property funds* – mainly closed ended funds using high leverage, which may have high exposure to development or other forms of active asset management, and deliver returns primarily in the form of capital growth. High to very high return requirements. (1)
- *Bond issuers and equity syndicates* – companies whose main financing source is either equity from small or medium size private investors or the high-yield bond market.
- *Construction companies* – companies whose main business activity is constructional development.
- *Government and municipalities* – companies controlled by a central, regional or local government body.
- *Other investors* – including but not limited to tenant owner associations, renting companies and owner-occupiers.

For each investor category, and for acquisitions and divestments respectively, a monthly timing 'score' is calculated by multiplying the monthly share of the investor category's total transaction volume with the percentual difference between the capital growth index and the trendline as per that month.

This exercise baselines all investor categories and produces a positive or a negative monthly score, for acquisitions and divestments respectively, for each investor category, indicating how well investors within each category have timed their property acquisitions and property divestments in relation to the general, 'average', development of capital growth (the trendline).

A total score for acquisitions and divestments, respectively, is calculated by summing all monthly scores over the time period January 2000 to June 2010. A grand total score per investor category is finally calculated by summing the acquisition and divestment scores. The percentage score can be converted into SEK by multiplying the percentage score with total investor category transaction volume.

It is important to point out that this analysis ignores any movements in income return levels as it is solely based on the capital growth element of the IPD index and the timing of transactions in relation hereto.

(1) Partly based on European Association for Investors in Non-listed Real Estate Vehicles (INREV) definition.

Jumping on the bandwagon

Transaction activity tends to be higher when prices are comparatively high. In terms of value, a majority of all transactions has taken place at such times when the capital growth index is above the trendline. In particular, January 2006 to September 2008 stands out as a period with exceptionally high transaction activity with almost 40 per cent of total transaction volume of the examined decade. In June 2007, prices peaked at 12 percent above the trendline.

Since each acquisition is also a divestment of the same amount, and more transactions are executed when the capital growth line is above the trendline, all acquisitions collectively result in a total loss, whereas all divestments in total result in a gain. From a seller's perspective, divesting properties at such a time can be explained by investors as a group acting rationally. Furthermore, investors are usually reluctant to divest properties when prices are low. From a buyer's perspective, a bandwagon effect may arise as investors strongly wish to benefit from a booming market and therefore extrapolate an upwards trend too far into the future. These are the same mechanics that drive asset price bubbles.

No transfer of wealth between domestic and foreign investors

In spite of what is commonly believed, no substantial transfer of wealth has taken place between domestic and foreign investors over the examined time period. From timing alone, Swedish investors have gained less than SEK 300 million and foreign investors have lost an equal amount of money, corresponding to a mere fraction of domestic and foreign investors' total transaction volume.

For how long is the same direction the right direction?

Gains and losses from timing

Core property funds have earned close to SEK 800 million from timing alone, to the largest extent from acquiring properties at a time when prices were comparatively low. Opportunistic property funds have gained almost SEK 2.6 billion from timing, whereof two thirds are derived from well timed divestments. To a large extent, governments' and municipalities' score of SEK 2.4 billion can be attributed to the government's SEK 41 billion divestment of Vasakronan in 2008 and Stockholm municipality's SEK 10 billion divestment of shopping centre company CentrumKompaniet in 2007.

Value added property funds have lost approximately SEK 2.9 billion from timing as a result of acquisitions made above the trendline. Listed property companies have lost almost SEK 3.2 billion on timing, whereof 20 per cent is attributable to divestments and 80 per cent to acquisitions. Institutional investors have also lost SEK 3.2 billion on timing. Even though they have made money on the timing of divestments, a much larger loss on acquisitions results in a net loss.

Scores per investor category

Investor category	Score from acquisitions		Score from divestments		**Score from acquisitions and divestments**	
	%	SEK bn	%	SEK bn	**%**	**SEK bn**
Opportunistic property funds	1.40	0.85	2.74	1.70	**2.08**	**2.55**
Core property funds	1.86	0.70	1.94	0.08	**1.87**	**0.78**
Government and municipalities	-0.61	-0.24	1.97	2.64	**1.39**	**2.40**
Other investors	1.43	1.83	1.32	2.05	**1.37**	**3.89**
Bond issuers and equity syndicates	0.22	0.16	3.67	0.98	**1.17**	**1.13**
Non-listed property companies	-1.27	-3.10	0.90	1.91	**-0.26**	**-1.19**
Construction companies	-1.31	-0.24	-0.03	-0.03	**-0.27**	**-0.26**
Listed property companies	-1.09	-2.57	-0.23	-0.60	**-0.64**	**-3.17**
Institutional investors	-2.27	-3.79	0.52	0.59	**-1.13**	**-3.20**
Value added property funds	-5.17	-2.98	0.35	0.05	**-4.13**	**-2.94**
All investor categories	***-0.89***	***-9.39***	***0.89***	***9.39***	**0.00**	**0.00**

Total score per investor category from January 2000 to June 2010 distributed on acquisitions and divestments. Percentage scores are converted into SEK billion through multiplication with total transaction volume over the examined time period. Figures have been rounded while calculations were conducted without rounding. Hence, the table may appear not to add up correctly.

Income return versus capital growth

Needless to say, timing property transactions is only one among many return generating activities undertaken by property investors.

Total return is composed of income return and capital growth, and only the latter component is analysed in this report. With a long or even infinite investment horizon, timing is of less importance since a potential capital gain or loss is realised far into the future. With a short investment horizon, however, timing is central to the total return creation since the capital gain or loss arrives faster and the total income return component is smaller than for the long term investor.

Moreover, capital growth is not just a result of buying in a bear market and selling in a bull market, but may also derive from active asset management, such as reletting, refurbishment or redevelopment, successful project development and/or finding a buyer with a strong appetite for a specific asset at the time of divestment.

Although timing is one of many value creating parameters it has a substantial impact on total return. Mistiming therefore has to be compensated for by other return generating measures. The opposite also holds true; successful transaction timing may compensate for a low return on e.g. asset management or project development activities.

Long term versus short term investor

Consider a short term investor with a holding period of 5 years and long term investor with a holding period of 20 years. In the beginning of the first year both investors acquire a property which generates an annual net operating income (NOI) of SEK 5 million. During the holding period, the NOI increases by an annual inflation rate of 2 per cent. In the end of each investor's holding period, the property is divested at 5 per cent exit yield on the inflated NOI.

In a base case scenario, the property is acquired for SEK 100 million, providing both investors with an internal rate of return (IRR) of 7.1 per cent. In a 'mistiming' scenario, the property is acquired for SEK 120 million. In this scenario the short term investor's IRR decreases by 4.2 percentage points to 2.9 per cent, whereas the long term investor's IRR only decreases by 1.4 percentage points, to 5.7 per cent. Hence, timing has a larger impact on the short term investor's total return.

Total return attribution

Total return on a property investment is composed of

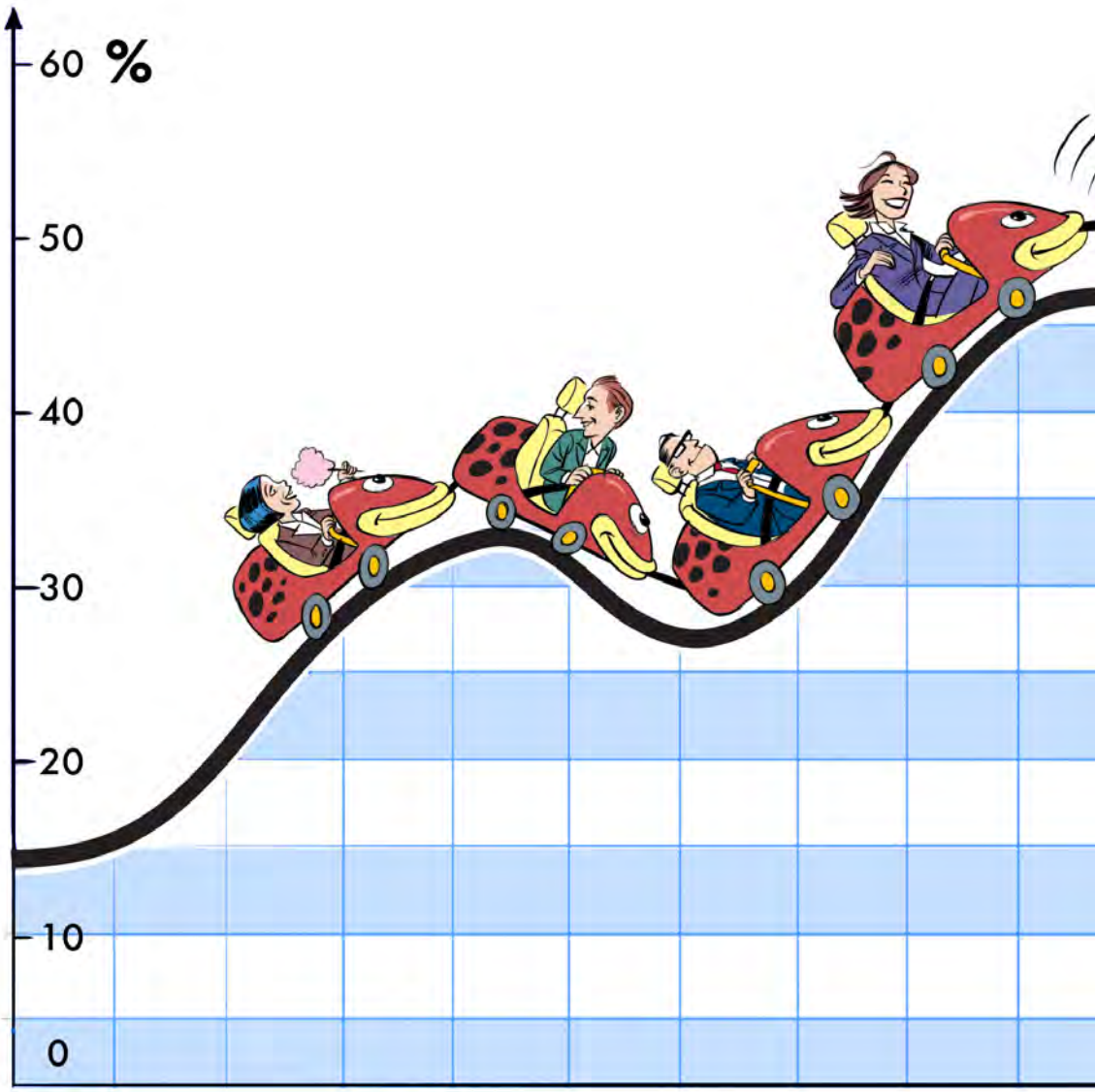
- Income return
- Capital growth

Capital growth can be further subdivided into changes in:

- Net operating income
- Property yield requirement (general property market yield shift)

Asset allocation

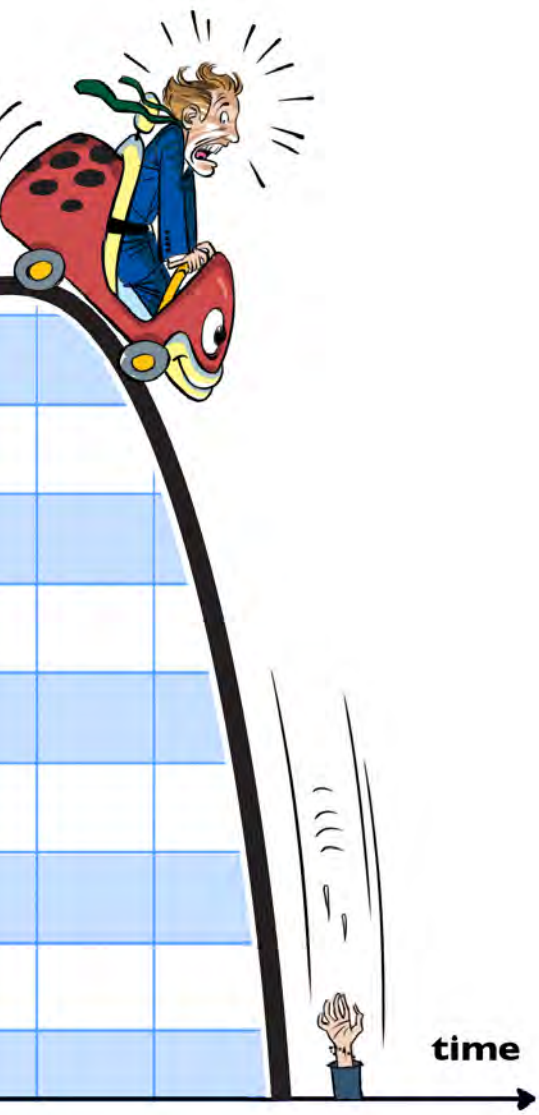
For certain investor categories, property constitute one – often relatively small – part of their total assets. This is especially true for institutional investors, i.e. insurance companies and pension funds [2]. Evaluating only the timing of property transactions, and ignoring alternative uses of capital, does not take the opportunity cost of holding properties into account. For example, in the event bonds or equities are more attractively priced than properties, a property divestment which is mistimed as defined in this article, is rational from an asset allocation perspective.



Ups and downs on the investor roller coaster

Finding the 'right' property

Some investors may simply not be able to make acquisitions when optimal from a timing perspective. For example, many institutional investors only acquires properties that meet very specific investment criteria with regard to e.g. location and building quality. Since the supply of such properties is limited, these investors have to seize opportunities as they come by. Value added property funds and many property companies need to find properties which come with a development or asset management potential. The timing of *divestments*, on the other hand, is to a much larger extent driven by the investor. This may serve to explain why the under-performing investor categories' negative scores mainly derive from the timing of acquisitions.



Summary

Investors with a very long investment horizon, such as institutional investors and many listed property companies, have underperformed with regard to timing. The same is true for investors focusing on other value-creating activities besides market timing, such as listed property companies and value added property funds. However, this is not to say that these investors have underperformed with regard to total return – only that they seem to pay less attention to timing when it comes to property activities in comparison with other investor categories, or that they find it more challenging to acquire the 'right' properties at an optimal point in time.

Investors who to some extent bet on yield shifts, such as opportunistic property funds, have shown stronger performance when it comes to transaction timing. Many core property funds are open ended, and as their transaction activity to some extent is driven by fund capital inflow and outflow, it is their investors, rather than the funds themselves, who have succeeded in timing the market.

[2] Sometimes property is bundled with e.g. private equity, hedge funds and commodities in an 'alternatives' asset class.