

INVESTMENT RESEARCH

Investing in property

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“It’s tangible, it’s solid, it’s beautiful. It’s artistic, from my standpoint, and I just love real estate.”

- Donald Trump, business magnate, socialite, author and television personality

“I’ve never lived in a building without my name on it.”

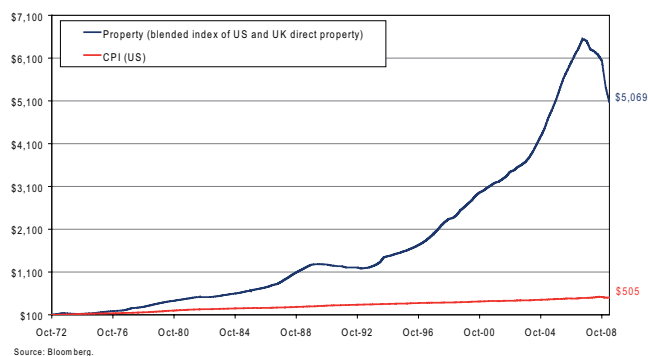
- Ivana Trump, former Olympic athlete, socialite, fashion model and former wife of business magnate

Why invest in property?

Frankly this is a silly question to ask New Zealanders. They can easily out trump the Trumps in their love affair with property. Be it through their house or through investment properties, New Zealanders are acutely aware of the wealth that property investing can create.

It is worth stressing that property is a particularly strong performer during periods of inflation. Most people can remember how it soared in value through the inflationary 1980s. This was driven by rising building material and labour costs, as well as rental increases. If inflation does re-emerge over the next couple of years, property should once again perform strongly. In the meantime, the bricks, mortar and land should still produce attractive and transparent cash flows from the ongoing stream of rental income. Both of these characteristics are aptly demonstrated by the long-term returns generated by property assets, as shown in the accompanying graph. Not only was considerable wealth created, but property handsomely outperformed inflation over the entire 36-year period, growing investors original \$100 into \$5,069 fortune.

Property performance versus CPI



New Zealanders’ affinity with property can, however, lead to an over allocation to this asset class that may be detrimental

to their wealth. While it is indeed a distinct and attractive asset class that performs strongly during inflationary episodes, it should be one allocation among several within a balanced, well-diversified savings plan because property can suffer from sharp and unexpected drop in value. It is also important that, in due course, savings can be drawn upon as needed in retirement. This requires that with a moderate notice period, any property exposure within a savings plan can easily be converted to cash – in other words, the assets remain liquid regardless of the market environment.

Listed property dominates direct

Direct property and listed property are two approaches to gaining exposure to the same underlying asset. Indeed, the two could in theory be exact replicas – they could own the same buildings, have the same management and the same capital structure. But they would be different.

Direct property delivers stable returns but has uncertain liquidity. Listed property, on the other hand, has constant liquidity but may have volatile returns. Direct property vehicles tend to value their properties using the valuations produced by registered valuers. These tend to be historic and transactional-based assessments that move slowly, producing stable returns in line with those expected from property. On the downside, direct property vehicles have no mechanism to provide investors with reliable liquidity. In fact, many direct property structures have had to freeze redemptions in recent times. The inability of individual investors to cash up their direct property investment, often when it is most needed, can not be underestimated.

It should also be noted that the various types of direct property structures can have other risks that listed property trusts are not exposed to or are less vulnerable to. These risks stem from limited property management skills and a lack of diversity (owning only one type of property). At its most extreme this can be a private individual purchasing a commercial property. One building with one tenant means that the investor is only exposed to one type of property in one location without an expert managing the rent review and renewals. This is a recipe for a volatile and disappointing property experience when things go wrong.

“Location, location, location.”

As listed property has risen to prominence, another major point of differentiation with directly held property has

emerged. Because listed property trusts are on the whole larger than private property trusts, the listed property trusts have become owners of the best property assets in the best locations. To coin the old adage, "Only three things matter with property... location, location, location." Or to adapt another sage piece of property advice, "What could be better than owning a fraction of the best building on the best street?" And that is exactly what the best listed property trusts can offer smart property investors in London, New York, Tokyo, Paris, San Francisco and Edinburgh. For listed property investors, quality and diversity is assured.

Listed property dominates direct investments in property in almost all respects except one. When a high quality property portfolio is listed on the share market to enable investors to buy and sell with ease – it also becomes subject to the volatility of global shares. But what if investors could land an investment which offered all the benefits of listed high quality property without the share market volatility?

Managing share market risk

NZ Funds believes that through careful management of share market risk, listed property can provide clients with both a liquid and stable property exposure. Indeed, the results of the back testing of NZ Funds' property strategies suggest this can be achieved in a reliable manner.

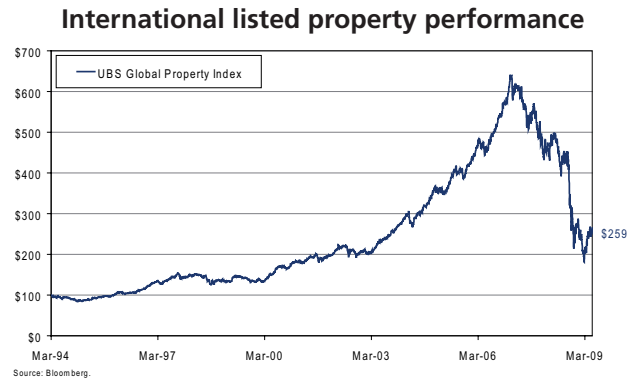
NZ Funds splits the universe of listed property into two parts, international property trusts and New Zealand property trusts, and manages their risks independently via two separate strategies. New Zealand property trusts have unique characteristics that require a different approach to that which is applied to the international property trusts.

International property strategy

The origins of listed property stretch back to the 1880s in the United States, when these investments were popular due to their efficient tax treatment. In the 1930s their favourable tax status was repealed and understandably their popularity waned. However, investors' demand for property was undiminished and after years of pressure on various administrations the favourable tax treatment was reintroduced in 1960 by President Eisenhower. The attractiveness of listed property was further enhanced with the Tax Reform Act of 1986 which allowed listed property trusts to manage their properties directly. This proved to be the catalyst for listed property trusts to become the pre-eminent property vehicle.

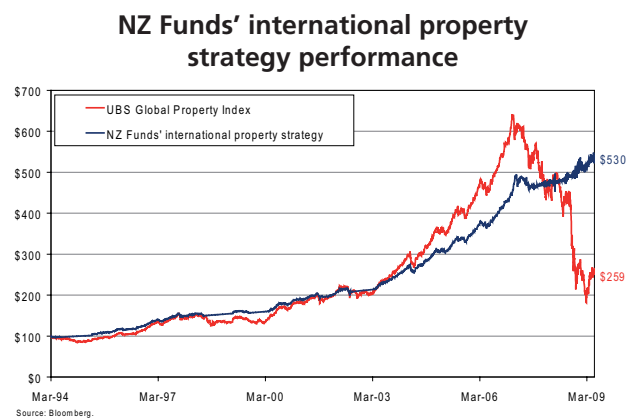
Today there are over 300 listed property trusts trading on the world's various stock exchanges. Their combined market capitalisation now stands in excess of US\$600 billion¹ and they have truly become an indelible feature of the investment landscape. They have also become a significant owner

of the skyline in every major city of the world. It is listed property trusts that have the scale required to own and run the premium office towers that are always sought after by tenants and the glamour shopping malls in which retailers need to be located. The accompanying chart shows how they have performed since the early 1990s.



This rather intimidating chart more than adequately demonstrates that share market risk needs to be managed when investing in international listed property. As such, NZ Funds investigated how effective momentum models have been in identifying episodes where performance was being driven by share market risk and not by the underlying holdings of the listed property trusts. Through this work a proprietary model was developed which over the back-testing period reliably signalled when such episodes were occurring, and that a defensive stance should be adopted to protect the invested capital.

The next stage of the research project was to develop the techniques with which a defensive position could be implemented to eliminate share market risk. Unlike the general share market, property currently lacks a liquid futures market that can be used to hedge the share market risk. In more recent times, however, exchange-traded funds have been developed that allow property investors to manage specific sector risks. One of these exchange-traded funds will be used in tandem with a cash allocation to hedge the international listed property exposure. The accompanying chart illustrates how NZ Funds' international property strategy performed when backtested over the past 15 years.



(1) Source: Bloomberg.

The allocation to international listed property will be managed by two specialist listed property trust investment managers – Resolution Capital and Challenger/Heitman. They have been selected following a thorough search and rigorous assessment of all the groups managing international listed property portfolios.

Resolution Capital

Resolution Capital stands out as a leader in the field as its focus, skill and track record is second to none. Founded in 2004, Resolution Capital is a specialist listed property manager with A\$1.5 billion in assets under management. It is owned and managed by the investment team, which has worked together for the past 14 years. They are dedicated to seeking out those listed property trusts that have unique portfolios of properties, are in the strongest markets and have the best management. Their senior portfolio manager, Andrew Parsons, has twice been voted Australia's top fund manager by Reuters surveys. Resolution Capital outperformed the global property benchmark by 16% in the 12 months to June 2009 – they added a significant amount of value by being fully invested over the period and taking advantage of the extremely volatile performance of listed property.

Challenger/Heitman

Challenger/Heitman has an experienced team with real depth and a steady history of exceeding the benchmark through its systematic, active investment approach. In 2006 Challenger and Heitman formed a joint venture to manage international listed property trusts. Heitman is a Chicago-based specialist property manager with US\$19 billion in assets under management, while Challenger is one of Australia's largest financial services companies with A\$2 billion of its assets in property. The investment team at Challenger looks after Australia and Asia while the team at Heitman looks after the United States and Europe. Challenger/Heitman's international property portfolio beat the benchmark by 5% in the 12 months to June 2009.

In summary, NZ Funds' international property strategy has a constant allocation to international listed property trusts through two leading, specialist property managers. This gives the strategy exposure to the very finest properties in the best markets around the world. There is also a capital protection allocation to manage the share market risk of listed property. In doing so the stable and attractive returns of the strategy should be similar to those offered by direct property – but with liquidity, diversity and quality embedded in the exposure.

New Zealand property strategy

“I retired when I was 23.”

- Sir Robert Jones, property tycoon, author and former politician

As Sir Robert Jones wryly comments, New Zealand property investing can also deliver attractive returns. But more importantly, to properly compliment international property it needs to either have different performance, attractive tax treatment or be a low-risk investment. New Zealand property trusts tick all of these boxes and hence are clearly an attractive addition to a property portfolio. However, the limited breadth and depth of domestic listed property trusts means that they augment the majority of the property exposure which is taken through the international property strategy.

A smart-index approach is used when selecting the New Zealand property trusts that are to be included in the strategy. All the New Zealand listed property trusts are screened for liquidity and gearing to ensure they are tradeable and not burdened by debt. The remaining trusts are assigned an equal weighting within the strategy to give a well-balanced exposure that avoids concentration risks. Currently, the four property trusts included are Kiwi Income Property Trust, AMP Office Trust, Goodman Property Trust and Property for Industry.

Security	Market cap (NZ\$m)	P/E	P/B	Upside to previous high	Dividend yield
AMP Office Trust	768.2	12.6	0.8	73.6%	7.8%
Goodman Property Trust	878.9	11.6	0.9	57.3%	8.1%
Kiwi Income Property Trust	844.7	12.9	0.7	67.6%	7.5%
Property for Industry	240.3	15.3	1.0	38.4%	6.4%

Source: Bloomberg.

While New Zealand property trusts have been more conservatively structured and geared than their international counterparts, they have still experienced episodes of share market risk that would have damaged the returns of a passive, buy-and-hold approach. Consequently, a strategy has been developed to manage the risks associated with investing in New Zealand property trusts. This strategy uses momentum and valuation signals that NZ Funds' back testing showed to be highly effective in reducing volatility and enhancing returns.

The momentum signal for New Zealand property works in the same manner as for the international property strategy. The rationale behind the signal is that when listed property begins to sell off sharply, the market is no longer treating it like the stable and conservative asset that it is, ie share market risk is dominating. When this happens, a more defensive stance should be adopted which is achieved by selling half of the New Zealand property exposure and holding cash until the episode of share market risk has passed.

The second signal seeks to identify when the operating environment facing property trusts has taken a turn for the worse. When this occurs, there is a heightened danger that a share market overreaction to disappointing news may cause share market risk to dominate returns. To avoid this creating large drawdowns for the Portfolio, half of the New Zealand property trust exposure will be sold when negative earnings revisions occur.

New Zealand lacks the derivative market and the hedging devices that are used in the international property strategy to maintain a constant property exposure. Hence, the New Zealand property strategy shifts its exposure between property trusts and cash as it seeks to manage share market risk, as directed by the momentum and valuation signals.

Summary

The development of the international and New Zealand property strategies allows for the creation of a portfolio that gives exposure to the best aspects of property without any compromise. Being able to access a liquid and truly diversified portfolio of the world's premium properties (without experiencing painful bouts of share market risk) is a first for the New Zealand investment industry. In essence, NZ Funds has developed an approach to property investing that should allow New Zealanders to continue their love affair with property for many years to come.

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