Due Diligence Forum Research Paper

AUSTRALIAN RESIDENTIAL PROPERTY - INVESTING ON SOLID GROUND

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Residential property is the largest asset class in Australia, it has delivered historically attractive returns, and has very promising fundamentals going forward. In Australia, residential property is an inefficient market, with assets predominantly traded by amateurs who may only ever transact a few times. Over a 20-year period, residential property has produced above average total returns as compared with other asset classes, and with lower volatility than Australian shares. This research paper examines the evidence backing these assertions and demonstrates the benefits of taking a professional approach to residential property investments, as well as the benefits available for investors of including residential property in a diversified portfolio.

Today's investors have many options available to them and so, the battle over property versus shares rages on. Yet what many investors have overlooked in the past is the fact that residential property is the largest asset class, in its own right, in Australia. Historically, as this research paper will demonstrate, residential property as an asset class has delivered attractive returns, yet often when developing a wealth creation strategy or constructing a financial plan, this asset class is not included. This research paper will also consider the current fundamentals underpinning the residential property sector, explore how a residential property portfolio will add value to a diversified portfolio, and conclude with a new approach to accessing this attractive asset class via a managed fund.

AUSTRALIAN RESIDENTIAL PROPERTY – ATTRACTIVE FUNDAMENTALS FOR INVESTORS

Why should residential property be considered for investors' portfolios?

In June 2009, economic forecaster BIS Shrapnel published a report[1] arguing that demand in residential property from investors and "upgraders" was growing and would more than make up for any slowdown if first home buyer activity started to slacken off later in 2009. BIS Shrapnel expects prices to continue to rise, but that price movement will be slow until unemployment peaks early in the 2010/11 financial year. It is forecasting a return to double-digit growth in residential property prices in the 2011/12 financial year. Interestingly, the group is forecasting that Sydney house prices will increase by a total of 19% over the three years to June 2012. Examined below are some of the facts and figures about the residential property asset class in Australia that are key to assessing the benefits of this sector.

[1] Source: BIS Shrapnel's Residential Property Prospects, 2009 to 2012; Report published June 2009.

Fact 1: Size

Residential property is the largest asset sector in Australia (Figure 1). By not having an investment grade exposure to this asset class, investors are potentially missing out on exposure to a major source of Australia's overall growth in wealth and hence will possibly be at a potential disadvantage in their retirement.

Figure 1: Market size of major Australian investment sectors (as at March 2009)

Market Segment	Size
Residential Property	\$3.2 trillion
Commercial Property	\$0.4 trillion
Shares	\$1.0 trillion
Fixed Interest	\$2.0 trillion

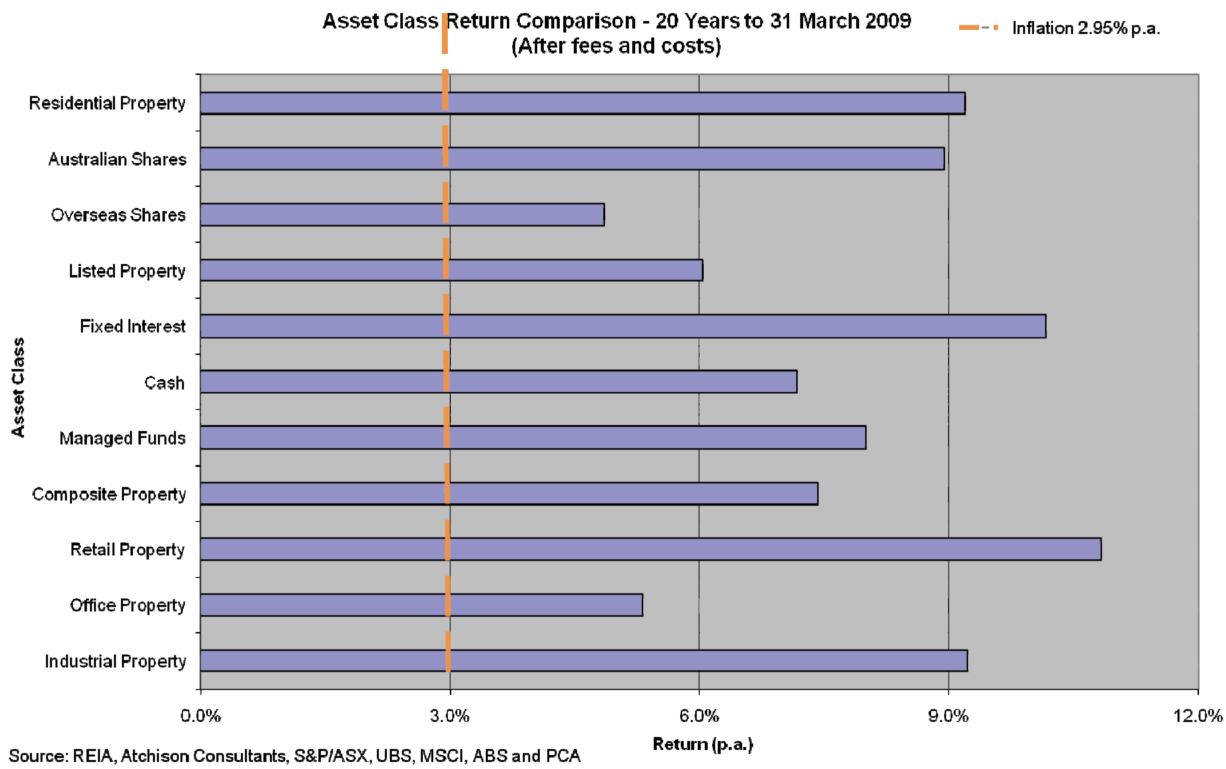
Source: Estimates by Atchison Consultants, Standard & Poors, PIR

Fact 2: Inflation hedged investment returns

Residential property has provided an average return of 9.2% per annum over the 20 years to March 2009[2], 6.25 % over the average annual inflation rate of 2.95% over that period, providing an excellent hedge against inflation (Figure 2).

[2] When determining returns an Index for each asset class is has been used (see Endnote for details) and assets are marked to market as follows: Australian Shares – monthly; International Shares – monthly; Australian Listed Property – monthly; Residential Property – quarterly; Direct Property – quarterly; Managed Funds – monthly; Australian Fixed Interest – monthly; International Fixed Interest – monthly; Cash – monthly.

Figure 2: Asset class returns



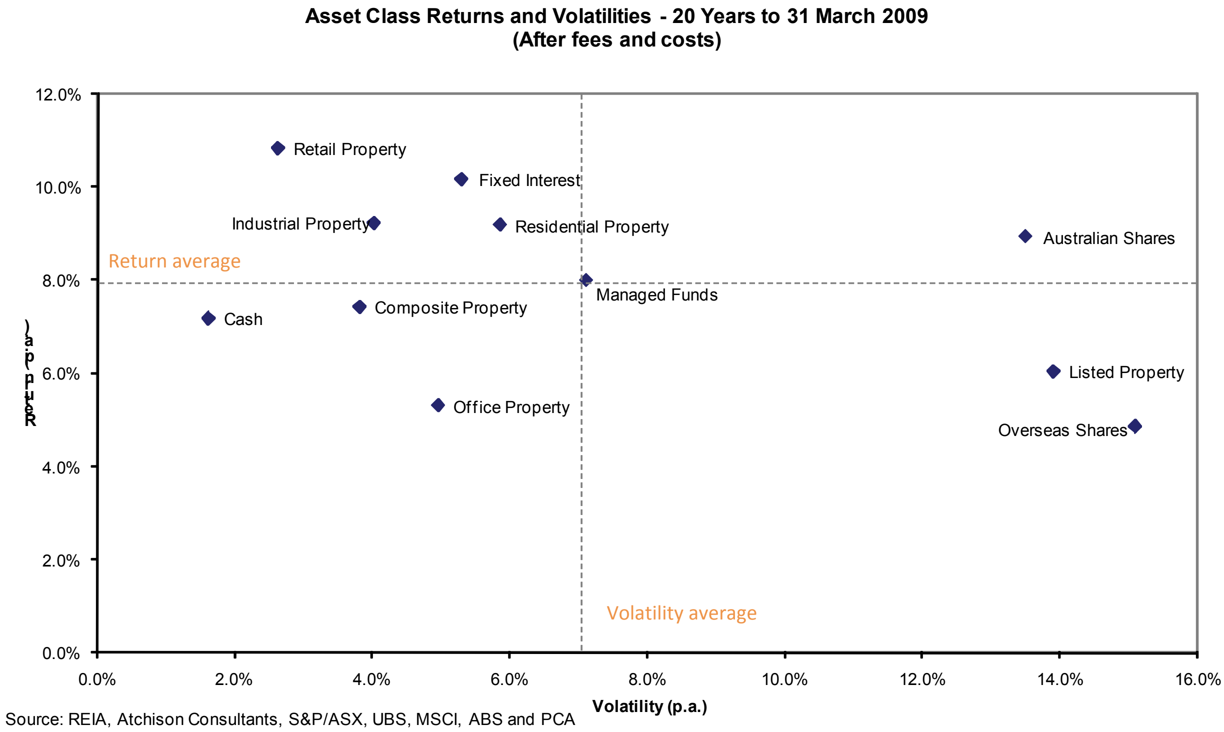
[i]Refer Endnote for Indices used in the Chart 1 above.

Fact 3: Favourable risk and return trade-off

Residential property has provided higher than average total returns (that is, income and capital growth) after all costs and fees, when compared with Australian shares, global Shares or listed property over the 20 year period to March 2009 and with lower volatility, as depicted in Figure 3[3].

[3] The ABS Housing Price Index is marked to market quarterly.

Figure 3: Asset class returns and volatility[4]



In fact, according to ANZ, "in risk-adjusted terms, residential property has delivered *vastly superior* returns to all other broad asset classes" and "In risk adjusted terms since 1984, residential property returns have *more than tripled* those of equities and more than doubled those of commercial property and government bonds."[5]

Fact 4: Negative returns less likely

The chances of having a four quarter period of negative returns from residential property has been much less through market cycles than most other asset class (excepting cash and retail property) as shown in Figure 4 which presents the rolling four quarter returns over the 20 years to March 2009 (80 quarterly periods). Residential property returned a negative return only twice over this entire period, or 2.5% of the entire sample. Investment in this asset class can provide portfolio diversification from other asset classes that produce negative periods more frequently, such as shares and listed property.

[4] Please refer to Endnote I for Indices used in Chart 2.
[5] ANZ Australian Property Outlook – January 2008

Figure 4: Frequency of negative returns, rolling four quarter periods – 20 years to 31 March 2009[6]

Asset Class	Probability
Residential Property	2.5%
Australian Shares	22.5%
Overseas Shares	30.0%
Listed Property	13.8%
Fixed Interest	5.0%
Cash	0.0%
Managed Funds	16.3%
Composite Property	16.3%
Retail Property	1.3%
Office Property	18.8%
Industrial Property	13.8%

Source: REIA, Atchison Consultants, S&P/ASX, UBS, MSCI and PCA

Fact 5: Low correlation, largely independent performance

Residential property has a very low or negative correlation with all asset classes (other than direct property) as is shown in Figure 5 below. This asset class is likely to perform independently of what is happening in other asset sectors such as Australian shares and international equities, providing excellent portfolio diversification benefits.

[6] Please refer to Endnote I for Indices used in Table 2.

Figure 5: Correlations by asset class – 20 years to 31 March 2009[7]

	Australian shares	Overseas shares	Listed property	Direct property	Residential property	Au fixed interest	O'seas fixed Int	Cash
Australian shares	1.00							
Overseas shares	0.56	1.00						
Listed property	0.56	0.35	1.00					
Direct property	0.13	0.04	0.20	1.00				
Residential prop	**0.14**	**-0.01**	**0.16**	**0.29**	**1.00**			
Au fixed interest	-0.05	0.13	0.14	-0.45	**-0.23**	1.00		
O'seas fixed Int	-0.11	0.12	0.07	-0.32	**-0.21**	0.81	1.00	
Cash	-0.06	-0.01	0.02	-0.17	**-0.26**	0.44	0.36	1.00

Source: REIA, Atchison Consultants, S&P/ASX, UBS, MSCI and PCA

Fact 6: An inefficient market creates opportunities

Australian residential property is a fundamentally inefficient market. This is evidenced by the following:

- At approximately 70%[8], Australia has a strong rate of home ownership (owner occupier), and individuals' participation in residential property investing is also considered high. As an asset class, the sector is highly fragmented and controlled mainly by individuals/amateurs.
- Most individuals who own property will only transact a few times in their lives and are therefore not highly skilled at research and analysis, selection, negotiation, finance, management, etc.
- There is often an emotional component to trading property assets, which can be in conflict with achieving the best investment outcome.
- Various life events can result in forced or unplanned sales (death, divorce, financial hardship for example), often with compromised outcomes from an investment perspective.
- Professional buyers can benefit from information and experience advantages; this can be as straightforward as full access to (and knowledge of) professional search tools, or non-public information such as 'off market' properties or vendor situations.

Fact 7: Compelling fundamentals going forward

[7] Please refer to Endnote I for Indices used in Table 3.
[8] Housing Occupancy and Costs, Australian Bureau of Statistics 4130.0.55.001 2005-2006

The fundamentals of the Australian residential property market are very compelling. For some time, the gap between underlying housing demand and housing supply has been widening. ANZ is currently forecasting "that by mid-2010 Australia will have an *unprecedented* underlying housing shortage of 250,000 dwellings."[9]

The following points are a summary of those made by Dr Alex Joiner and colleagues in the June 2009 ANZ Housing Snapshot[10].

- Australian house prices have been resilient... price momentum has improved on the back of the government assistance for first home buyers and significant interest rate cuts.

- The first home buyers grant has assisted in stabilising the market. Any post-grant market adjustment is likely to be overwhelmed by ongoing and additional stimulus from recent and prospective interest rate cuts.

- Population growth is running at its highest level in four decades, providing an unprecedented call on national dwelling stock. This is being reflected in increased house prices.

- The supply side has been inhibited by high development costs, land availability and financing uncertainty for developers. This has created a supply/demand imbalance which is likely to intensify upward price pressures.

Fact 8: ASX Residential Property Index

The ASX has recognised the importance of the residential property sector by announcing last year a deal to develop residential property index derivatives. These have the potential to allow individuals and institutions to access index-linked exposures to the $3.2 trillion residential property asset class and may become a useful tool in hedging residential property investments.

Fact 9: Tax effectiveness

Residential property can have tax benefits for an Australian investor's portfolio. As an income producing asset, current legislation allows an investor to claim deductions against their income. While most rental property deductions are actual expenses incurred (property management, insurance, interest etc) some are non-cash deductions due to the decline in value of the improvements (building, plant & equipment); effectively providing a tax benefit now with the cash expense (maintenance or replacement) deferred.

Like most other investments, capital gains are only taxed when realised (i.e. the property sold) and, if the asset has been held over 12 months, typically attract a 50% capital gains tax discount.

[9] ANZ Australian Property Outlook March 2009
[10] ANZ Housing Snapshot June 2009

These nine facts make a compelling case for considering residential property for inclusion in a portfolio, and lead to the conclusion that investment in residential property should be seriously considered as an addition to any modern portfolio construction armoury.

PORTFOLIO CONSTRUCTION – BENEFITS OF AN ALLOCATION TO RESIDENTIAL PROPERTY

There are three key areas that have been examined when assessing asset allocation benefits for investors by including residential property in a diversified portfolio.

Is it doubling up for an investor to own their home versus allocating to residential property in a diversified portfolio of assets doubling up?

"Australians already own too much property – the plaintive refrain of the uninformed!"[11]

Often, amateur investors think of their own homes as an investment or an asset - and it is, in one sense.
However, a home is not an investment property because it doesn't produce rental income, and holding costs can't be claimed as tax deductions (and everybody needs somewhere to live with the associated cost be it in the form of rent or a mortgage). Most importantly, few home owners have selected their home with any consideration of investment attributes necessary to generate strong capital growth and hence many will actually underperform the average. However, it is noted that a home can be a useful source of leverage from which to purchase true investments in property.

Growth or yield?

It is important for investors to understand the characteristics of different types of property investments. It has been a common mindset that managed property investments are undertaken for the prospect of yield. This might be true of commercial property however residential property investors more frequently invest for capital appreciation. So which is best?

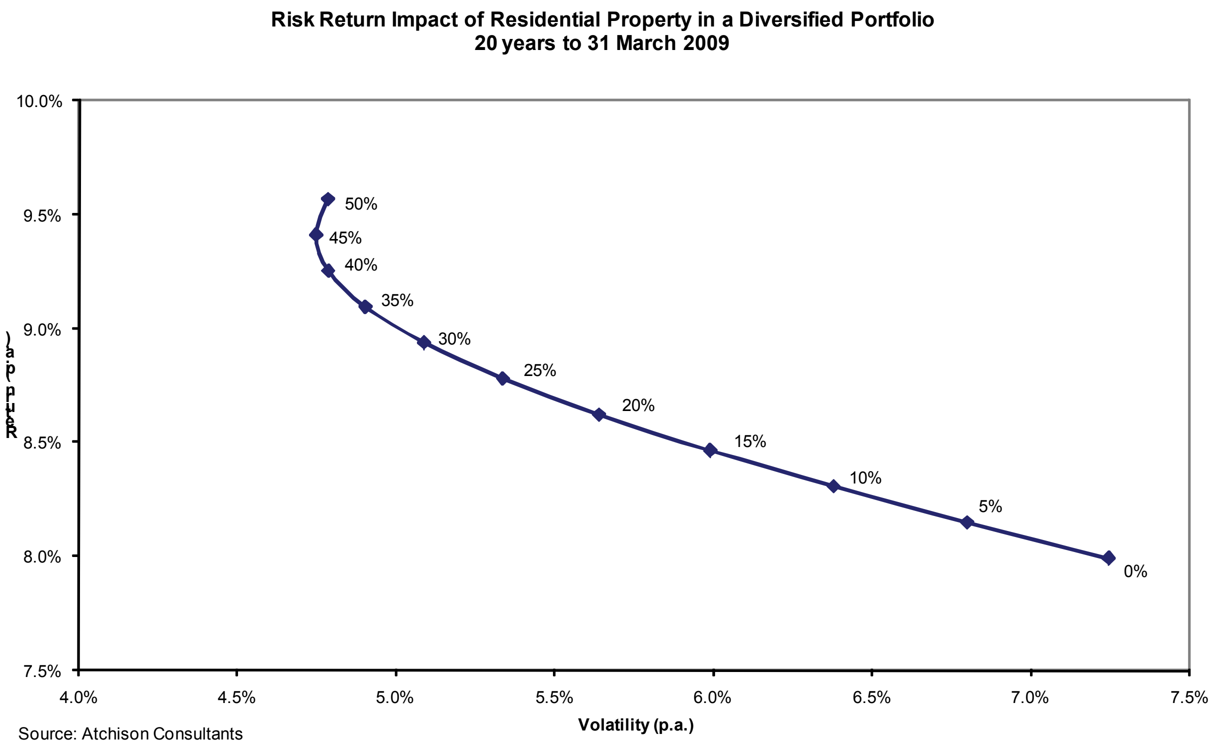
While cashflow positive residential property can be found, it typically returns lower capital growth over the longer term. Residential property with historically higher capital growth typically has a lower yield which often does not cover operating expenses (interest, rates, etc) at the gearing ratios of typical investors ("negative gearing"). However over the longer term, the power of compounded growth provides greater wealth creation and stronger cash flow. A sound and rigorous investment in quality residential property is likely to provide a reliable vehicle for capital growth and wealth creation over time.

[11] Streets Ahead, Monique & Richard Wakelin 2007

The impact of including residential property in a portfolio

The final and most convincing step in building the investment case is analysing the effect of adding residential property to a diversified portfolio. Figure 7 below illustrates the impact of including residential property within a diversified investment portfolio in increasing weights based on the average annual 20 year historical data[12]. The example portfolio comprises 70% exposure to growth assets and 30% exposure to income assets, with an increasing allocation to residential property within the growth component of the portfolio[13]. The return of the portfolio increases and the volatility of the portfolio decreases as the allocation to residential property increases up to around 45% of portfolio net assets.

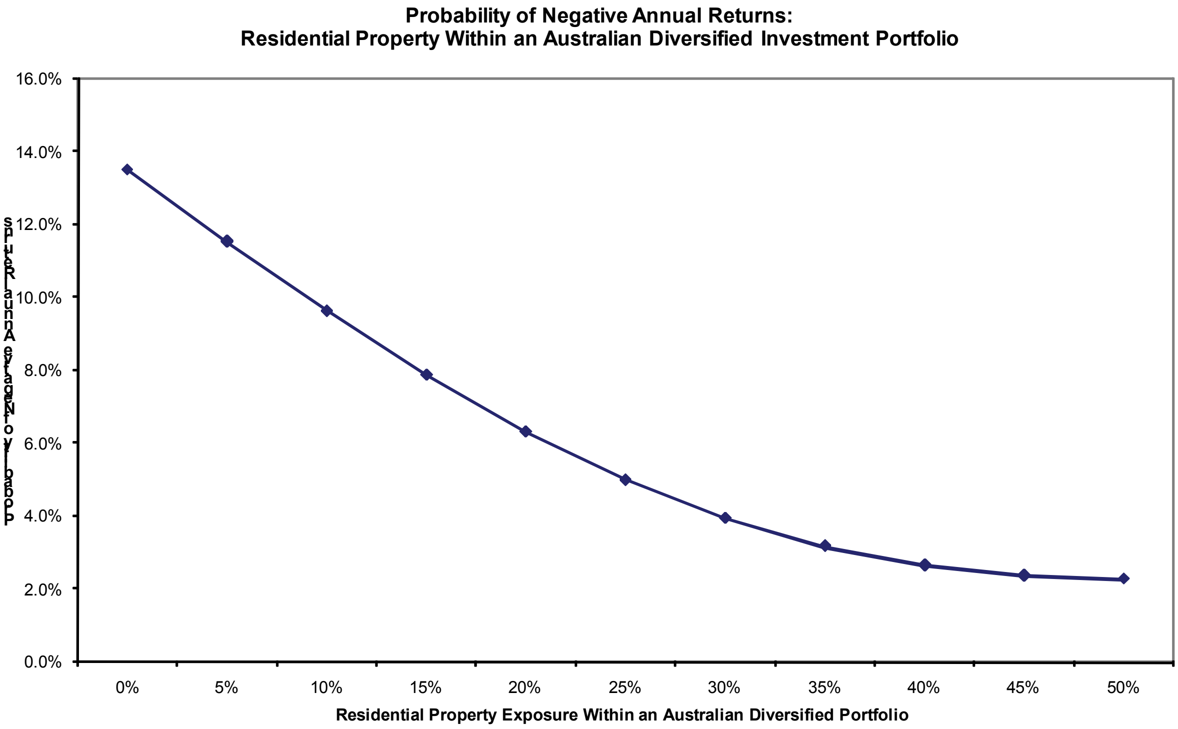
Figure 7: Risk return impact of residential property in portfolios



It is now interesting to consider again negative return scenarios for investors and how residential property can mitigate chances of this. Figure 8 below demonstrates that the addition of residential property exposure when constructing an Australian diversified investment portfolio significantly reduced the probability of negative annual returns.

[12] Atchison Consultants, July 2009
[13] Atchison Consultants, July 2009

<u>Figure 8: Probability of negative portfolio returns decreases by including residential property</u>



ACCESS TO THE ASSET CLASS

The historical evidence suggests that it is beneficial to investors to strongly consider this asset class for inclusion in a portfolio. That raises the question – how?

The statement "buy residential property" has with it a number of consequences for the direct investor:

1. The investor needs a sizeable sum or a sizeable deposit and ideally the ability to gear and the ability to service the debt.

2. A suitable location and property has to be identified and purchased. There are administrative burdens of managing the property including finance, property rates and insurance, maintenance, agents and tenants.

3. One property does not provide diversification, and the performance of that property may not match or beat the average. Even if the property asset is combined with the investors own home or several investment properties, the resulting 'portfolio' is likely to say more about the investor's emotional biases and lifestyle choices, than smart property investing.

4. Few want the responsibility of managing these activities for an investor, and often investors lack the time and expertise to achieve above average performance.

Fund Manager or DIY?

Historically, the Australian residential property sector has been devoid of investment products, however overseas, residential REITs have been around for many years.

There are numerous benefits and advantages that using professional fund managers can provide. The main advantages are outlined below - benefits and results most investors could not generate for themselves.

- A disciplined and unemotional approach with rigorous screening and objective asset selection processes.
- Professional search tools and techniques, beyond the reach, financial capacity or interest of most investors.
- The ability to identify and acquire assets with attractive long-term track records and high scarcity value, typically found in more expensive suburbs and therefore beyond the reach of many investors.
- Diversification beyond the reach of most investors. Given the relative high cost of assets, few investors can afford to own a portfolio of high quality property with true diversity; astute managers will seek to diversify across states, suburbs and types (units, houses, etc.)
- Maintenance of moderate gearing levels, lower than what many investors can afford to use as many have to gear heavily (80%+) to acquire assets. Managed funds also have the ability to re-gear and reinvest faster than the typical individual investors through the benefit of scale.
- A focus on the creation of an initial risk-buffer by acquiring assets below market value where possible, and/or with potential to add value (e.g. adding off-street parking, rebuild, quick renovation, etc.)
- Skill to recognise opportunities to add value in potential acquisition targets during due diligence phase.
- Active management of the portfolio to optimise total returns across state property cycles.
- Hassle free, non recourse exposure to the largest asset class in Australia.

CONCLUSION

Residential property investing is popular in Australia, and the managed funds industry is nothing short of prolific, with more per capita than any other country, however until recently, Australia's largest asset class was not able to be accessed through the managed fund industry. This paper has shown that, historically, the inclusion of residential property in a diversified portfolio would reduced volatility and enhances returns to investors. However, to invest in residential property alone risks emotions, finances, lack of diversification and skill getting in the way of sound and rigorous investment decision making. An investment manager that recognises that the market is fragmented and ruled by emotions, and then utilises an investment process that understands these biases and systematically exploits them, raises the probabilities of an investment in residential property outperforming the sector average.

Endnotes

[i] Indices used for each asset class for Charts 1,2,4 & 5 and Tables 2 & 3 in the paper are as follows:
Australian Shares – S&P/ASX 200 Accumulation Index
International Shares – MSCI World ex Aus Accumulation Index with Net Dividends reinvested in $A
Australian Listed Property – S&P/ASX 200 Property Trust Accumulation Index
Residential Property – REIA Index
Direct Property – PCA/IPD Index
Managed Funds – Atchison Consultants Index
Australian Fixed Interest – UBSA Composite Bond Index
International Fixed Interest – Citigroup World Govt (Hedged to AUD)
Cash – UBSA Bank Bill Index 0 + years

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