



Property – where to now?

The return from property is made up of the movement in the value of the property and the rent received (less costs). The return to an investor also depends on how much of the value of the property is funded by debt (borrowings), and how much is funded by capital from the investor.

When the property investment is made via listed property securities, the returns are also impacted by the ups and downs of the share market.

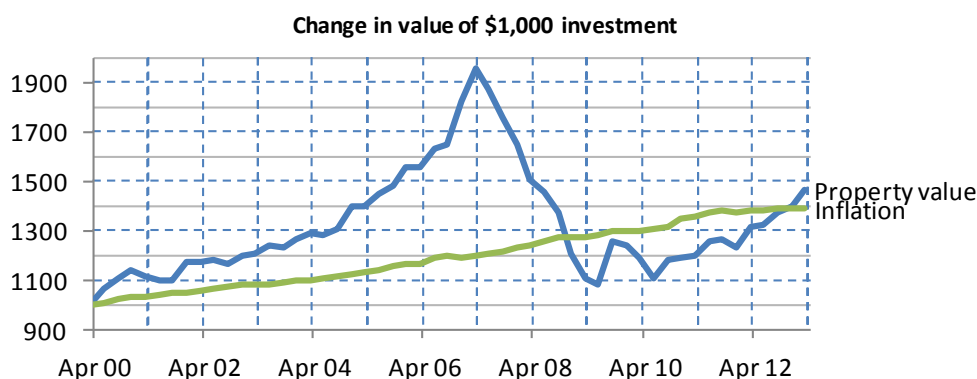
Over the last 13 years, the average annual return from listed property securities in New Zealand has been:

	% p.a.
Growth	3.0%
Dividends	<u>5.6%</u> (net of tax at 28%)
	8.6%
Inflation	<u>2.6%</u>
Net real return	6.0%

At 6.0% a year on average over the last 13 years (after-tax and inflation) most investors will have been reasonably happy with the overall outcome. The important question becomes “what will be the outcome over the next 13 years?” Is it too late to get into property?

Chart 1 shows the change in value of \$1,000 invested into the New Zealand listed property sector by an investor on 1 April 2000. It also shows the value of the \$1,000 inflation adjusted. The capital value has increased on average by 3.0% a year, which was consistent with the average inflation rate of 2.6% a year over the same period.

Chart 1

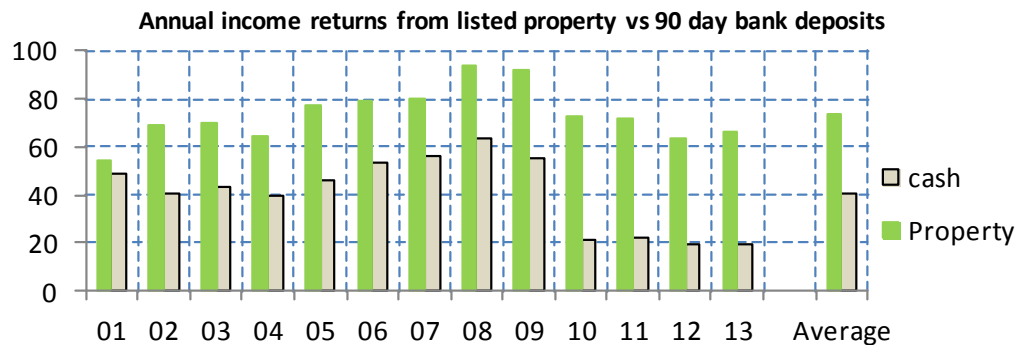


From 1 April 2000, the NZ listed property market did well until 2004. It then did extremely well until 2007, before significantly falling in the global financial crisis. Since 2009 it has recovered to be back above the inflation adjusted level.



Also relevant is the income returns from the dividends earned each year on the \$1,000 invested. The dollar amount of the dividends received after-tax, relative to the after-tax interest that would have received from rolling 90-day bank deposits was:

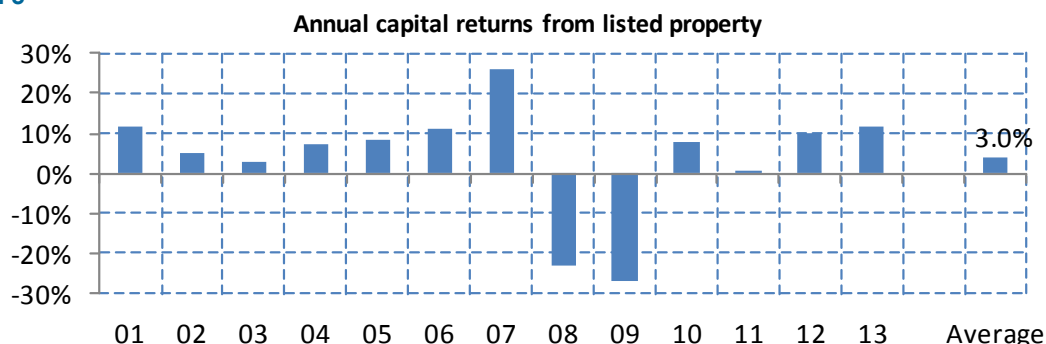
Chart 2



The average net of tax dividend distribution (at a 28% PIR) was \$/5 a year (i.e. /5% on the \$1,000). The actual level varied around the \$73 average from \$54 to \$94. Over each of the last 13 years, the net return was above the after-tax return from cash. The equivalent return from bank deposits averaged \$41 and varied between \$19 and \$63 over the same period.

When taken over the whole period, the average outcomes from property were good. The purchasing power of the investor's capital was inflation protected and the net income returns were higher than cash. However, if an investor had a shorter time horizon and tends to worry about their investments, there may have been many sleepless nights. Chart 3 shows the year-by-year changes in the value of the listed property securities.

Chart 3



In the 2007/08 and 2008/09 March years, an investor would have seen their capital decline by 17.2% and 19.7% respectively. For investors who do not like seeing \$100 become \$60 over a short period, particularly given the constant negative news in the media about the prospects for the global economy at the time, it would have been concerning. Charts 1 & 3 also show the importance of timing and whether you invest regularly or in spurts. A single investment made in the 2006/2007 year may have left an investor very unhappy with the property market.

Collectively, the last 13 years of property returns individually and as a whole, highlight the importance when investing of:

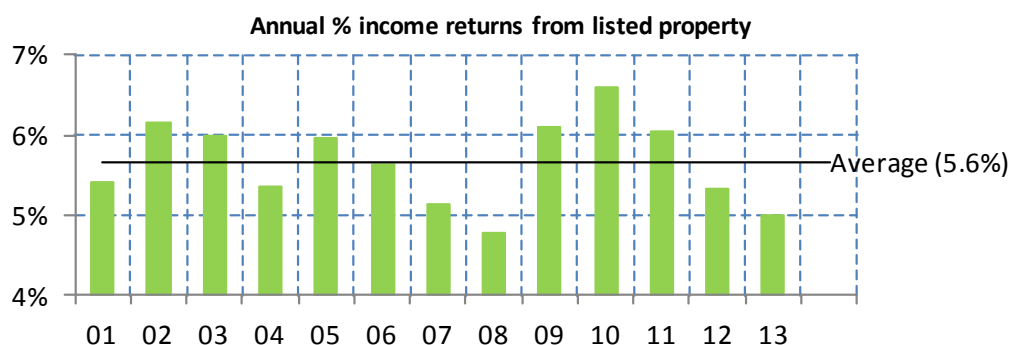
- understanding your financial goals, your time horizon and what is important to you;
- understanding the range of returns that could happen over periods shorter than your time horizon but which are part of the normal market behaviour, and
- not changing strategies (i.e. reacting) part way through the time horizon, unless there is a change in your goals.



Volatility

The volatility in the capital value of property from one year to the next was shown in Charts 1 & 3. The volatility in the after-tax annual dividend level was:

Chart 4



Property is therefore not without market risk.

The nature of returns from a diversified portfolio of listed property securities, shows that over the long term, the capital value grows in real terms, on average, but not in every year and can fall materially over the short term. They also show that the income return is volatile, but when applied to the rising capital value increases the dollar amount of dividends over time and often higher than cash returns.

What now?

It must be remembered that the performance over the last 13 years is past performance and received by the investors that owned the property securities during this period. The important question is, “will it also reflect the future, or is now too late to invest in property?”

We do not know the answer to this question. We note that property has done well in recent years but is not guaranteed to always go up. Also, in recent years the net dividend yield has declined so that today it is below its past average. As the values of the property securities have risen, the dividend yield has fallen to 5.0%.

If the current yield was to go back towards its 5.6% average, there is a risk that the current capital value of property securities decline. They would need to decline by about 12% to bring the yield back to its 5.6% average. The alternative is that rents rise across the board, which we think is less likely in the current environment.

This raises the short-term risk of property, if your time horizon is only a few years. However if your time horizon remains long-term, a 12% fall is unlikely to reduce the average return available from property over the next ten years, to below the returns available from investments like government bonds. With the current 10 year government bond yield at 3.5% (i.e. 2.5% after tax at 28%), property still looks attractive, provided that your time horizon is 5-plus years. As long as it is 5-plus years then, should the value decline short-term, a diversified property portfolio has an opportunity to recover before you need to sell them so that you can be spend your capital.

The legal stuff

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