

REAL ESTATE

OVERVIEW

Cash pours into the property market

But with record sums being invested in the sector, Jim Pickard says those seeking the highest returns need to weigh up several options

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Despite fears that some parts of the market are over-heating, many pension funds are upping their exposure to the sector. Some pensions advisers are suggesting funds should hold as much as 15 or 20 per cent of their money in real estate - a significant jump on today's average holding.

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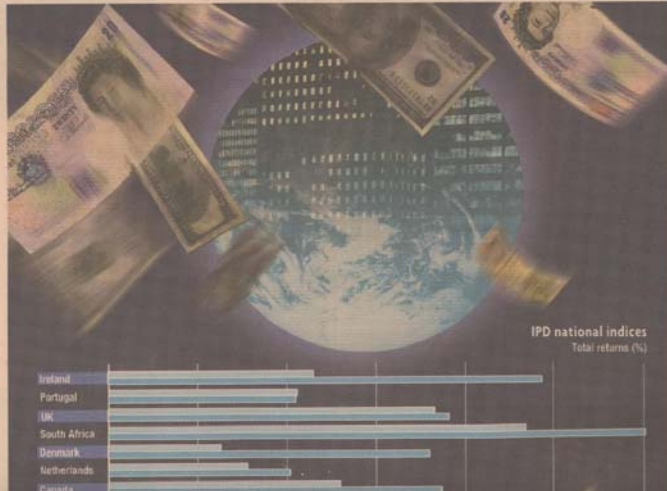
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On top of this, investors can buy stakes in funds of funds, which hold units in both listed and unlisted vehicles. AME Capital has suggested there are now more than 100 global securities funds specialising in real estate, half of which are focused exclusively on Europe. Of these, 35 were launched in 2006.

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Real Estate Cash Pours Into The Property Market

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It is not only institutions that are buying into property. Retail investors have shown huge appetite, too, as the property funds topping the best seller tables testify.

In the UK, retail investors poured a record £1.1bn (\$2.1bn, a, -1.6bn) into open-ended property funds in the last quarter of 2006, about 30 per cent of all investment. The pattern was similar for closed-ended funds, with more than a third of the £2.7bn raised by new issues in 2006 going into property.

This trend has prompted the Financial Services Authority, the UK's City watchdog, to warn in its 2007

Financial Risk Outlook that retail investors could be 'adversely affected' if there was a significant correction in the market.

For now, however, it seems that few investors - institutional or retail - are paying much attention to such warnings.

For pension fund trustees, the sheer choice of product must sometimes seem overwhelming.

According to Property Funds Intelligence, there are 62 global real estate funds, a portion of which are targeted at Europe. Then there is an array of Europe-focused funds. According to Inrev, the body representing the unlisted European property sector, there are 449 vehicles, excluding German open-ended funds.

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One attraction for investors is that such funds can invest in difficult, far-off markets - such as Japan, Hong Kong or India - without the time-consuming process of buying direct real estate.

Overall, however, it is not hard to see how this array of product could prove confusing to many investors.

The lack of consistency among vehicles is underlined by a recent report by the Association of Real Estate Funds, which represents the UK unlisted property sector.

According to AREF, the range of returns over 2006 was at its widest for more than three years. One fund delivered annual returns of over 60 per cent, while others were far from impressive.

Should pension funds invest in core funds or opportunity funds? Do they stay in domestic markets or venture overseas? Do they buy direct property, stakes in indirect funds, or property equities such as Reits? How much attention should they pay to fee structures, which with some funds can prove expensive?

There is no easy answer. But investors should be aware that each of these choices will involve different factors as the property cycle progresses.

Take Reits an investor may think that he is gaining direct access to the property market by buying shares in one of these listed property vehicles. In theory, yes, a Reit's value should rise and fall with the success of the real estate market in which it operates. But its share price will also be subject to the ups and downs of the stock market. In correlation terms, Reits may track other equities almost as closely as they do property markets.

Investors should be increasingly aware of the wider backdrop to the market. In the UK, for example, a sharp jump in interest rates means that yields on the typical building are now far below borrowing costs. For a typical pension fund, with an aversion to gearing, that may not seem to matter. And many experts believe that yields could fall even further under the huge 'weight' of demand in the market.

But if leveraged investors drop out of the market it could mean that wider sentiment will eventually send pricing into reverse, with implications for everybody involved. Even a small upward shift in yields (which signify rents as a proportion of the price paid for a building) could equal a significant drop in value - just as the reverse has been true during the recent bull market.

Yet many experts are sanguine about the possible end of the UK boom. Duncan Owen, chief executive of Invista, the property fund management group, says it would be too simplistic to say that real estate is overvalued. 'This is a diverse asset class, and while parts may be overvalued, others are not,' says Mr Owen. 'Property returns may well surprise on the upside in 2007 and may yet break 10 per cent.' Richard Kirby, manager of the F&C Commercial Property Trust, says there is little sign of investor appetite waning.

Yet he agrees that total returns should moderate in 2007, after three years of total returns in the high teens. He suggests that a period of 'single-digit returns' is in prospect for the next few years.

On balance, most fund managers are predicting stronger growth on the continent than in the UK over the next few years because there is still a positive margin between borrowing costs and yields in eurozone countries.

At the same time, investors should bear in mind that listed property stocks on mainland Europe are trading at much higher premiums to net asset value than those in the UK, making them relatively expensive.