

Property investing: Time to look to Europe?

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UK pension funds considering a move into property investing should keep a watchful eye on Europe. While the UK property market is already showing signs of recovery, the pan-European market has not yet bottomed, giving investors plenty of time to take full advantage of the upswing, when it comes.

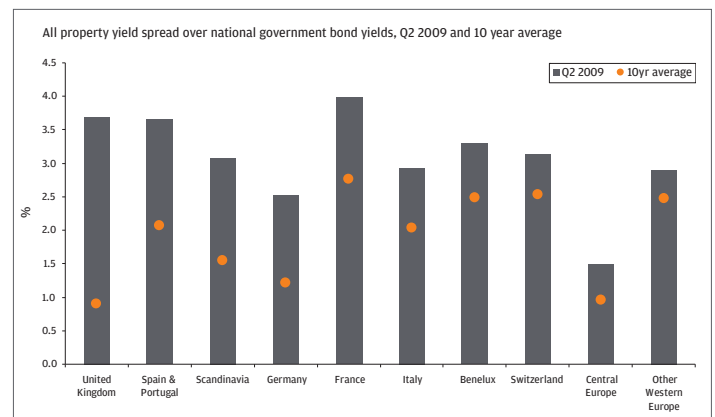
Nick Hayward
Business Development, Global Real Assets Group

There are several key reasons why we believe now is the right time for UK pension investors to consider the European property market. The first is the steady improvement in macroeconomic conditions, already witnessed in France and Germany, where growth forecasts for 2009 and 2010 have been revised upwards over the last three months, driven in part by China's strong rebound and the resulting anticipated rise in demand for goods and materials. The French economy was insulated from the worst effects of the credit crisis, and has enjoyed greater resiliency than the UK and Spain with lower levels of consumer debt and higher savings rates. Long term, property returns are driven by what is going on in the underlying economy. We are in a trough, but the lead indicators like GDP suggest we are climbing out.

Property market recovery will lag economic recovery, but a key determinant in identifying the time lag is how much space is available in any particular market. Because the supply of new space available has been lower than in previous cycles, we believe any improvement in occupier demand is likely to translate more quickly into rents and property performance. Current office vacancy in London, Paris and Frankfurt is significantly lower than it has been in the early 1990's. Depending on the market recovery in occupier markets could be between 6 months and 18 months from where we are today.

Current property pricing reflects the capital market shocks, which has created a recession leading to reduced occupier demand. In turn, rents have fallen significantly, particularly in office properties, where the peak to trough fall in headline rents in the City of London have fallen from c. £65 per square foot and seems to have bottomed out at under £45 per square foot before incentives. So why the cause for optimism? And headlines like the one in the Financial Times yesterday (October 6, 2009) that "Lenders flood back to property". The answer lies in the second reason for considering property - namely the strong yield advantage offered by property over gilts. At the peak of the market, property yields were down to around 4% or under for prime property in Europe's best capital cities. Today, however, investors are able to obtain a yield between 5.5% and 6% from relatively low-risk core property investments - properties in prime locations, occupied by high quality tenants on long leases (Source for rent and yield figures quoted: DTZ Prime Market Indicators, Q3 2009). With interest rates around the globe at or near record lows, spreads over bond yields are far above their ten year average (see chart). These factors are tempting investors back into the market.

Today's property yields look attractive compared to long-term average



Source: DTZ Research; J.P. Morgan Asset Management.

Compelling long-term growth potential

The long-term case for property investing is also persuasive. As many pension investors know, property can provide compelling long-term capital growth opportunities and has frequently performed differently from other asset classes, thus providing a degree of portfolio diversification.

The moderate volatility of property returns and its historic low correlation with other asset classes can also be attributed in large part to the fixed and regular rental income (between rent reviews), which can give property investments bond-like investment characteristics. The property market also reacts more slowly to economic change, which makes property returns less likely than equities to be subject to substantial variations over any 12-month period. This moderate level of volatility of returns means the asset class can help pension funds better match assets with long-term liabilities.

Property also offers two sources of return, adding to its appeal as an investment in all market conditions. When property markets are rising, investors choose property for capital appreciation, while in more difficult market conditions property becomes attractive as a source of yield.

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Don't follow the crowd

So where should investors look for value? Instead of following the crowd into the UK market, investors may benefit from a pan-European approach. As we've seen, the economic recovery looks increasingly sustainable, particularly in the heart of Europe. While there may be some near-term headwinds, we are confident that the property market will ultimately follow the economy into recovery.

Once the recovery is underway, investors in European property funds can further benefit from the diversification provided by exposure to differently performing economies. However, to profit from the best opportunities, it is, of course, important to find the right manager. Pension investors should look for well diversified pan-European property funds run by managers with the experience and resources to differentiate between European markets and seek out the most attractive property investments.

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