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REAL ESTATE AS AN INFLATION HEDGE

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The inflation hedging quality of real estate is one of its most attractive and enduring investment characteristics. Indeed, it is the reason often given to invest in real estate particularly by those investors who need to match long-term assets to liabilities. Indeed, a number of major institutional investors have increased their allocation to real estate recently as a result of their respective house views which assume a significantly higher rate of inflation going forward. It is not just institutions. The continuing attraction of the asset class to an increasing number of High Net Worth Individuals with a strategy underpinned by wealth preservation also implies a belief that property can and does act as a suitable hedge against rising inflation.

To many practitioners in the industry, the ability to hedge through property investment has been a long held assertion. Most investors tend to be of the view that property is, or can be, an inflation hedge particularly over the long term. In the same way, most will recognise that, in the short term, local market fluctuations will tend to prevail and confuse the debate somewhat. What is clear is that the debate over the merits of real estate as a hedging tool long been raging and the evidence still remains somewhat inconclusive.

This debate will undoubtedly gather further momentum given the growing concern of a higher inflationary environment expected in the years ahead across the European market place. No doubt this growing concern will trigger a wave of new research papers on the subject which, if anything like recent ones, will shed next to no light on the issue, and succeed only in adding to the general level of confusion surrounding the subject, or at least glossing over, some of the most important characteristics of the asset class and its ability to perform successfully as an inflation hedge.

When is a Hedge not a Hedge?

The definition of what exactly constitutes a hedge is the first and, quite possibly, the most important source of confusion. An inflation hedge is often taken to mean an investment whose value is directly related to the level of inflation. In other words that there is a direct relationship between property values and some measure of inflation. So if over, say, a five or ten year period, property values keep pace with inflation, or even outperform a particular benchmark this, is not, in itself viewed as sufficient evidence that real estate is capable of performing a hedging function. For this to be the case, so the argument goes, property values have to move with, and react, to a changing inflationary environment.

Far from semantics, the use of such a definition will inevitably lead to the conclusion that commodities or even equities offer a much better hedging mechanism than that provided by real estate. After all, real estate is lumpy, there is a lack of frequent real-time pricing – quarterly data in a few markets, annual indexes in most - and that's not to say anything of the constraints imposed upon it by the landlord/tenant relationship which will vary not just between markets but over the course of the real estate cycle as well. Issues which make real estate different and which will inevitably mean that values won't be able to "react" sufficiently quickly to changes in inflation. This, despite the fact that growth in property values may well exceed inflation over a set period. In essence the conclusion that real estate is a poor hedge against inflation is often solely the result of applying a definition which is ill suited to the sector or doing so with little understanding of how the property market actually works in the real world.

The key point is that real estate provides a long-term hedge against inflation but, in order for it to do so, certain other criteria have to be met:

First whilst the real asset nature of property underpins its inflation hedging quality over the long term, buying tangible assets as a protection against inflation is sensible only if done at the right price! It's an obvious point but one that is overlooked a little too often.

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Second, properties with inflation linked leases are increasingly attractive to a broad range of investors as they are often seen as defensive in nature. However, whilst such leases can offer many attractive qualities to the investor, rent indexation does not equal inflation protection, it is not a guarantee even if some investors tend to regard them as such. The reality is somewhat different, rent indexation in the absence of pro-active management results only in over-rented assets. Such leases should not be viewed as a guarantee of an outcome but rather as a starting point in the quest for inflation protection.

Third, income growth is the key to solving the inflationary puzzle. The ability to retain a tenant in the building, maintain and grow cash flow lies at the very centre of an inflation hedging strategy. And that applies across all markets and points in the cycle.

And finally, the importance of income growth brings us to the missing link in much of this debate and that simply comes down to the ability and expertise of the asset management team. Whether in the UK with its longer leases and upward only rent reviews, in the Eurozone with its propensity for shorter leases and rent indexation, in the USA with year long leases and no indexation, or in markets such as Turkey where the length and value of a lease can be somewhat debatable, in all these instances it is the ability of pro-active asset management to deliver value which consistently shines through time and again. The bottom line is very straightforward - a bad asset manager will underperform inflation no matter what the inflationary environment might be, the point in the cycle, the holding period or the prevailing nature of the landlord/tenant relationship.

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