PROPERTY'S PLACE IN YOUR PORTFOLIO

GREENRIDGE
REAL ESTATE INVESTMENTS

November 2017

As property people we often find it difficult to look beyond our love for the asset class and accept that property is just part of many investor's multi-asset investment portfolios. However, sometimes it is worth stepping back and looking at why an investor should (or shouldn't) invest in property, and where commercial property assets sit in the increasingly large pantheon of other asset classes on offer.

Traditionally property is seen as sitting somewhere between equities and bonds in terms of both its investor characteristics and its performance. This is certainly true over the long term, at least on a simple visual measure such as the chart below.

Indeed, taken over this very long term the average annual total return from the three main asset classes is remarkably similar, with gilts showing 8.41%pa, equities 9.5%pa and property 8.50%pa. The simple extrapolation of these returns to a portfolio strategy would be to have a quarter of your wealth in each, with the final quarter being in cash. However, the latest global asset management poll from Reuters shows that typically investors have 47% of their portfolio in equities, 41% in bonds, 6% in alternatives, 5% in cash, and only 1.3% in property. So, what is it about property that makes it so different to the other asset classes? The short answer is liquidity and lot size.

Dealing with liquidity first, all the asset classes apart from property are at least theoretically tradeable at any time that a suitable exchange is open. Property however is less liquid, and typically the length of time between deciding to trade and actually completing the trade is around six months (IPF 2004). Illiquidity is not unique to property, indeed it is commonly discussed in both the bond and equity markets when they are falling and investors are unable to sell their assets due to lack of demand, but it is structurally more common in property than any other asset class.

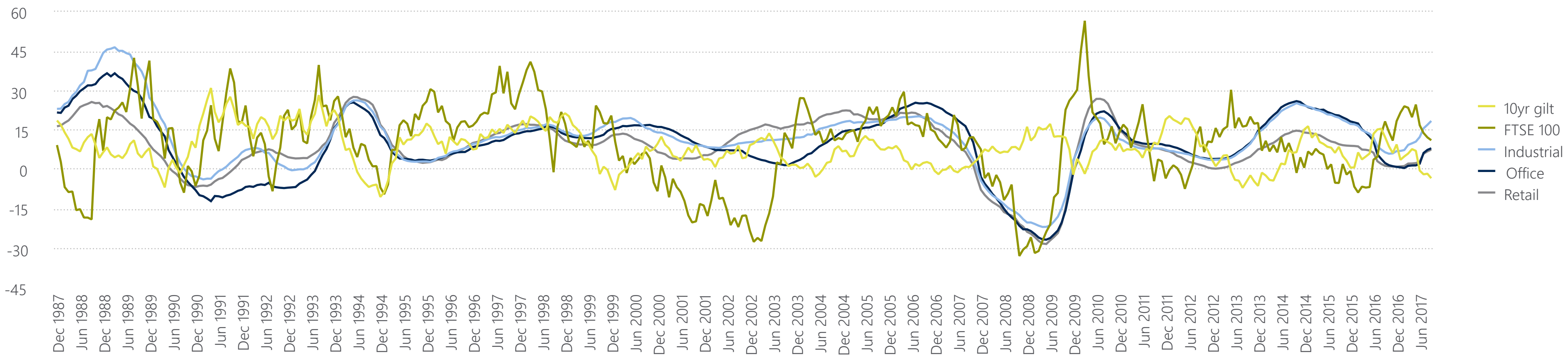
There is a host of academic research that suggests that there should be an illiquidity premium for any asset class that is less liquid than another. However, most studies conclude that the illiquidity premium on real-estate is broadly the same as that in the equity market, and much higher than that experienced in the very low risk bond markets.

Whilst many potential investors might shrug off, or not even attempt to understand, liquidity, lot size is definitely a major barrier to entry into commercial real-estate for many investors. Indeed, we believe that this is probably the major reason why portfolio weightings to real-estate are so much lower than the potential returns might suggest they should be.

If we look at all the commercial property investment transactions across the UK since the start of 2012, the average capital value is £20.5m. This is heavily skewed upwards by properties in London, however even if we exclude London from the analysis the average lot size is still £10.6m. Of course one person's barrier to entry is another's bonus, and many investors are actually attracted to real-estate because of the ability to deploy large amounts of capital in a single trade. This is particularly

UK 10y bond, FTSE 100, IPD main sector total returns (YoY % change)

Source: Thompson Reuters Datastream



true of the recent explosion in global real-estate investment by sovereign wealth funds, large family offices, and other risk-averse institutions. Indeed, the argument is often made that the level of research and due diligence required on an investment of £10m is not dramatically different from that required for an investment of £100m.

Another lot-sized based argument for the attractions of investing in real-estate is that it reduces competition. While the smaller investor who wants access to the sector has an increasingly diverse list of real-estate equities and indirect property funds that they can invest in, the pool of investors who are able to invest directly in property is comparatively small. This reduces competition, and at least theoretically ensures a higher degree of professionalism and 'right-pricing' than in a more liquid market.

Property also has a number of other reasons to recommend itself to the professional investor. These are well summed up in the Investment Property Forum's regular publication "Understanding UK Commercial Property Investments", which is as close to a Peter & Jane (or Biff & Chip for younger readers) guide to the strengths and weaknesses of the sector as there is. This guide takes the investor on the journey of deciding between direct, indirect or not investing in the asset class and sums up the Pros and Cons of commercial property as an investment as follows:

Pros	Cons
Physical asset	Heterogeneous
Relatively stable income return	No central trading exchange
Capital growth potential	Large lot size
Diversification benefits	Valuation, not market prices
Risk/return profile	Transaction and management costs
Inflation protection	

Rather than examine every one of these Pros and Cons in this newsletter, we have picked out those that we feel are most relevant to the Greenridge philosophy.

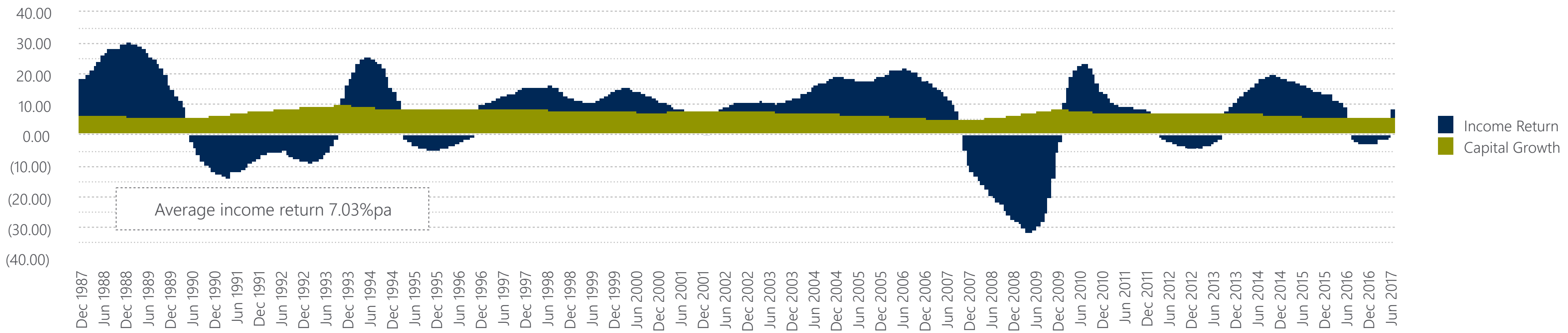
The physicality of real-estate has always been one of its primary attractions to investors. It is tangible, and in most jurisdictions the amount of land is finite. The quantum of development is usually restricted by some kind of planning system, and this in turn reduces the risks of long term oversupply. The flip-side of this characteristic is that being a physical asset (as opposed to an electronic one) there are costs and skills associated with managing these assets, and investors may consider these too much effort, or choose to outsource them to a professional manager.

The heterogeneity of property is for us actually one of its major strengths. Within this asset class there are a huge variety of subsectors, and within those an even larger variety of assets. Each asset has its own characteristics, and the key to out-performing the market is understanding those characteristics. Again, this is where a professional asset manager can add value, particularly since the market as we have already discussed is relatively illiquid, and not as transparent as the bond or equity market.

However, the biggest attraction of commercial property for us is the fact that real-estate has the capability to deliver both income returns and capital value growth. Arguably the sector has something to offer both risk-embracing and risk-averse investors, with the chart below demonstrating this very well.

The components of the Total Return on UK commercial property (YoY%)

Source: MSCI, UK All Property Index



The risk-averse investor will always be attracted to UK property by the income return, which in a global context is comparatively stable due the long leases and upward only rent reviews that are available in the UK. Another characteristic that is relatively unique to the UK commercial property market is the fact that the majority of the costs of occupying a property are the tenant's rather than the landlord's problem. This means that the owner really only has to pay the costs of acquisition of the asset, and then those of a property manager to collect the rent. The cost of repairing and insuring the property is the responsibility of the tenant, as is the cost of returning that asset to the landlord at the end of the lease in a suitable condition. This makes owning property in the UK a relatively 'fire and forget' investment.

The risk-embracing investor is often attracted to property by the volatility of capital values, and the desire to buy at the bottom and sell at the top. Given the aforementioned liquidity and transparency issues of the asset class this approach requires a high degree of experience and immersion in the market, and this is another area where we believe that Greenridge can add value. Out-performance can come from a variety of areas, ranging from simple market knowledge to experience in asset management, refurbishment or redevelopment of assets.

So, where is the UK commercial property market now in relation to other asset classes? As the chart shows, returns are pretty much where they should be, sitting around the middle of the spectrum between equities and gilts.

While capital value growth on property fell into negative territory in the nine months immediately after the UK's referendum on EU membership, average capital values are now rising on a year-on-year basis. This means that according to IPD/MSCI, UK commercial property has delivered an attractive total return of 8.43% over the 12 months to the end of July 2017, with industrial property showing a return of more than 15% over the same period.

Industrial property (and more specifically logistics focused warehouses) is currently heavily in vogue domestically and internationally, and as such is experiencing steady income growth and stronger than normal capital value growth. Office and retail property returns are primarily income driven at the moment, with out-performance on the capital value front only being delivered by asset management, refurbishment and development.

Looking ahead, we expect that the strong global appetite for income-producing assets of all types will continue to support investor demand for UK commercial property. The ideal asset for most of these risk-averse investors will be 'prime' and 'secure', and thus the best opportunistic strategy for an investor looking at the UK at the moment would be to buy short income and turn it into long income. Real-estate returns will continue to sit between equities and gilts on the risk/return spectrum, and as ever out-performance will come from local market knowledge and looking beyond the received wisdoms.

Asset performance, 12 months to end July, GBP (%)

Source: Thompson Reuters Datastream

ABOUT GREENRIDGE

With a track record of over twenty years of strong performance, Greenridge ("GIM") is a boutique real estate investment manager that thematically invests its own capital side by side with its investor partners.

Considering increased geo-political and other risk factors, GIM only deploys capital into lower risk assets outside Central London that are let on long leases to the UK Government or other Investment Grade tenants. Strong relative returns can still be generated in this conservative asset class but as always, prudent asset selection is key.

GIM targets a double-digit IRR and distributed cash on cash returns of over 8% pa net of all costs, all within a conservatively leveraged capital structure.

Potential investors who share our views on risk and return are welcome to get in touch to discuss potential participation into one of GIM's conventional or Sharia investment programs.

Greenridge Investment Management Limited
84 Brook Street, London, W1K 5EH
+44 (0) 20 7486 8778
deals@greenridge.co.uk
www.greenridge.co.uk