



Residential Property

How it can help hedge against inflation

Usage statement This document is only intended for use by investment professionals in the United Kingdom.

Overview

- UK inflation running at 3.7% and could reach between 4%-5%
- Negative effects of the £200bn of QE are likely to start filtering into the economy
- Property can offer a hedge against both expected and unexpected inflation
- The degree of insurance depends on how and which type of property asset is used

Why should investors be worried by inflation?

The Bank of England has to date purchased £200bn in assets and while there is debate as to the risks of the Quantitative Easing policy, consensus is building that one of the negative outcomes will be an increase in the levels of inflation.

The Bank of England's inflation target is 2% but is currently running at 3.7%. If we factor in the increase in VAT and commodity prices, coupled with a weak sterling adding to the cost of imported goods some economic commentators have suggested that inflation could reach between 4%-5%.

During periods of sustained high levels of inflation the real value of money erodes. So if we have an inflation rate of 3.4%, £100k today will be worth in real terms £97k at the end of the year (Table 1 illustration). Therefore investors need to invest in an asset that offers a net return that matches the inflation level in order to stand still.

	Year 1	Year 2	Year 3	Year 4	Year 5
	No Hedge				
Capital	£98,600	£97,220	£95,859	£94,517	£93,193
Income	£2,000	£1,972	£1,944	£1,917	£1,890
	Hedged				
Capital	£103,400	£106,916	£110,551	£114,309	£118,196
Income	£2,500	£2,585	£2,673	£2,764	£2,858
	Effect on income				
Income difference	-£500	-£613	-£729	-£847	-£968
% Loss	25%	31%	37.5%	44%	51%

Table 1: The effect of inflation at 3.4% has on £100,000 on cash earning 2% vs. Hedged investment

With UK government debt currently at £863.1 billion¹ a sustained period of inflation is actually an effective method of reducing it. It could be argued that there is little incentive for them to get inflation back on target quickly.

With this in mind investors should evaluate whether their current asset allocation sufficiently protects or hedges against inflation.

How property can help to hedge against inflation?

If we view property as an asset whose price is interpreted as the discounted sum of future cash flows (Campbell & Shiller 1987²), it provides a hedge because the cash-flows (income generated) are often linked or indexed to inflation. An example of this is the UK IPD All Property Returns which have averaged 11.7% pa since 1971 compared with inflation of 6.8%.

The asset class is principally split into commercial, which includes offices and retail space, and residential property. For the most part institutional and individual investors tend to invest in commercial property via real estate equities or Real Estate Investment Trusts (REIT).

However the degree of insurance depends on the ability to precisely forecast inflation and the ability to frequently renegotiate the rental contract to adjust for current and future inflation.

Empirical research

A recent study by Demary & Voigtanger (2009)³ from the Cologne Institute of Economic Research entitled "The Inflation Hedging Properties of Real Estate: A Comparison between Direct Investment and Equity Returns" offers a more comprehensive and clearer insight.

The research applied the Fama & Schwert⁴ regression⁵ methodology to a larger and more comprehensive data set than previous studies. It included property equities, Real Estate Trusts (REITS) and direct property investment. Additionally it compared commercial (Retail & Office) and residential property across Australia, Canada, Finland, France, Germany, Ireland, the Netherlands, Sweden, UK & USA.

The conclusion was that property did provide investors with a hedge against inflation (Table 2). However there were different degrees of protection depending on whether the investment was made directly or indirectly, and in which sector of property it was made.

¹ Office of National Statistics 21st Dec 2010

² Campbell & Shiller (1987) "Cointegration and tests on present value models" Journal of Political Economy Vol. 95

³ Demary & Voigtanger (2009) "The Inflation Hedging Properties of Real Estate: A Comparison between Direct Investment and Equity Returns"

⁴ Fama & Schwert (1977) "Asset Returns & Inflation" Journal of Financial Economics Vol 5

⁵ Regression is a statistical measure that attempts to determine the strength of the relationship between one dependent variable (usually denoted by Y) and a series of other changing variables (known as independent variables). Regression is often used to determine how much specific factors such as the price of a commodity, interest rates, particular industries or sectors influence the price movement of an asset

	Expected Inflation	Unexpected Inflation	Realised Inflation
	Direct Investments		
Residential	1.33	-0.30	-0.10
Retail	3.82	1.16	2.58
Office	-0.11	1.41	0.88
	Real Estate Investment Trusts		
Residential	23.02	70.15	73.65
Retail	23.49	70.16	74.34
Office	20.64	63.74	67.31
	Equities		
Equities	20.98	180.47	181.91
Real Estate Equities	16.93	96.59	98.95

Table 2: Demary & Voigtanger - Test on Perfect Inflation Hedging

The study found that while investments in equities/real estate equities (inc. REITs) did give investors exposure to property, it did not provide a hedge against inflation. The reason for this disconnect is that although returns are connected with the underlying property asset, greater weighting is given to the performance of the company actually managing the building.

This is further supported by Larsen & McQueen (1995) whose research showed that while an investment in gold can be used as a hedge against inflation, assets connected to gold are not able to protect against inflation.

Additionally, in general equities are not highly correlated with macroeconomic factors since market expectations and corporate news are more relevant.

Therefore direct investment was found to offer a hedge against inflation, but as stated previously is sector dependent.

Retail property was the poorest performer because landlords would find it difficult to increase rents at a time when their tenants were coming under increasing pressure to reduce costs.

This is supported by a report from Cushman & Wakefield⁶ entitled "How Occupiers can reduce costs and release value by re-gearing their leases" which concluded that with an increasing number of landlords in distress, the negotiating power is firmly with the occupier. Furthermore Cushman & Wakefield's own data showed that average UK retail rents had fallen 9% in 2009 with some locations falling by as much as 25%.

Office space was found to provide a partial hedge due to the reduced ability to renegotiate rents during periods of unexpected increases in inflation. Commercial property rental contracts tend to be between 5-20 years in length. Increases are usually indexed to past inflation which provides a hedge during periods of expected inflation (low) however are not renegotiated often enough to keep track of unexpected changes in inflation (high).

Residential property was found to act as the best hedge against inflation due to a number of factors. Rental contracts are typically short in duration, usually 12 months. This enables the landlord to renegotiate rents regularly so therefore can adjust for inflation. Secondly the research found that residential property had a low level of substitution meaning that tenants had little choice but to pay the increase as it would be difficult to find a similar property in the same location for less.

⁶ Cushman & Wakefield – Business briefing 2009 How Occupiers Can Reduce Costs and Release Value by Re-Gearing Their Leases

This appears to be borne out by data from the Royal Institute for Chartered Surveyors⁷ (Lettings - Oct 2009) which showed that rents were increasing at the fastest level since Q4 2008 and members in Prime London seeing a 9% increase in rents during 2010.

Conclusion

The negative effects of inflation are no longer a threat, but a reality. As such it would be prudent for investors to consider allocating a portion of their portfolio into direct residential property.

We would go further as to state that not all residential property investments are equal and that in order to maximise the benefit derived from such an investment, investors should focus on assets that are located in areas of high demand and low supply such as Prime Central London.

Institutional and individual investors keen to utilise this strategy will find significant challenges (regulatory and/or financial) in investing directly into residential property. Therefore the best vehicle would be an unquoted residential property fund.

Unlike quoted vehicles these funds offer all the benefits of a direct investment because returns are only correlated to the performance of the underlying asset. At the same time they are able to maximise exposure and minimise risk in a similar fashion to quoted vehicles.

For further information contact:

Joe McTaggart

+44(0)20 7340 8677

⁷ Royal Institute of Chartered Surveyors - Residential Lettings Survey Great Britain Q3 2010