

The Case for Unlisted Property

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Commercial property forms an important part of the investable asset universe.



Although dependent on relevance of location and the property assets in question, commercial property offers stable growth and income returns coupled with a reasonable level of inflation protection. This is due to the value of the asset (and ultimately its required rental returns) being connected to land prices and construction costs, both of which are affected by inflation.

The above characteristics make commercial property an appropriate investment for Retirement Funds, as such funds ultimately seek to provide on-going, inflation-hedged income to its members beyond their retirement. The valuations, rentals and subsequent returns on commercial property have a low correlation to other asset classes such as fixed income instruments and listed and private equity. This low correlation makes commercial property an excellent diversifying asset in a multi-asset investment portfolio, as it has the ability to provide reasonably predictable long-term returns whilst lowering overall portfolio volatility.

This statement must however be qualified, as it only holds true to the extent that investment in commercial property exposes the investor to property risks and returns (as opposed to excessive market and financial risks). Investment in the listed property

sector in South Africa over the past decade in the form of Real Estate Investment Trusts, or REITs, initially provided spectacular returns and more recently significant losses and volatility, which speaks against the very nature and characteristics of commercial property investments, namely stable and attractive risk-adjusted returns.



A closer analysis of the listed property investment class however reveals that, given the yielding nature of REITs, the investment market prices and trades these instruments similar to fixed interest instruments, which resulted in the market capitalisation of these REITs departing significantly from the combined values of the underlying properties. This peaked during 2016 and 2017 when some South African listed REITs traded at premiums of more than 40% to their underlying value.

The listed nature of REITs therefore introduces significant price volatility relative to the underlying Net Asset Values of the properties in question, which negates many of the positive characteristics and benefits related to the inclusion of this asset class. Retirement Funds should therefore consider gaining their commercial property exposure in an un-listed manner, by appointing suitably experienced property investment managers to build and manage well-diversified direct property portfolios on their behalf. Un-listed, pooled property investment vehicles will be appropriate for smaller funds, so as to ensure sufficient property diversification and benefits of scale.

Investing in commercial property in this manner will allow long-term investors, such as retirement funds, to include these investments in their portfolios at their independently valued property values, which would much better reflect the value at which the property asset can be realised. The fund in question would therefore be able to reflect in its pricing the stable nature of the distribution returns and capital growth of the asset in question, as opposed to the market values of a financial instrument such as a listed REIT, which includes substantial elements of market and financial risk.