

Are we in a Property Bubble?

Property has delivered strong performance over the short, medium and longer terms. Over the last three years in particular, property has been the best performing asset class and has helped stabilise portfolio returns in volatile times. With the significant growth in the market capitalisation of the Listed Property Trust sector, combined with the numerous unlisted and syndicate property vehicles available, the awareness of the asset class among investors has significantly increased.

During this period there has been much discussion and debate as to whether property markets can sustain their recent strong performance.



So what really drives property markets?

Before considering the sustainability of property markets, it is important to consider what drives property markets. Property markets are driven by both macro and micro influences.

At a **macro level** the influences are:

- Interest rates and the ability of investors to borrow.
- Inflation – property has traditionally been a hedge against inflation.

- Economic trends such as employment, retail sales and GDP growth.
- Asset allocation to the sector – ie. the proportion of an investor's funds invested in property.

At a **micro level** property markets can be influenced by:

- Tenant/owner occupier demand for space. As businesses expand, rationalise or change, so too will their demand for space.
- New supply of property to the market.
- Demographic change/spending habits.
- Tax benefits such as negative gearing and depreciation allowances.
- Building costs, zoning and changes to infrastructure.

The bubble debate?

There is much debate at present as to whether the property market is a bubble waiting to burst. There is evidence to support the view that we are in a bubble including:

- Rapid appreciation of house prices
- Strong outperformance delivered by listed and direct property
- Entrance of many new players to the market, for example, the increased number of highly geared syndicates

Investors however, have not forgotten the "bubble" of the late 1980's. The bubble burst in the early 1990's causing significant distress as capital values crumbled. It is worthwhile comparing and contrasting the nature of property markets in the late 80's bubble with the property markets today.

Asset Class Returns – as at 31/03/03

	1 year %	3 years %	5 years %	10 years %
Listed property trusts	13.86	14.55	9.69	11.75
Unlisted property	10.37	10.39	10.25	7.28
Australian shares	-11.93	0.87	4.74	9.71
Global shares	-33.38	-18.53	-4.04	6.44
Australian bonds	10.09	8.01	6.46	8.10
International bonds	13.39	9.42	7.89	8.93
Indexed bonds	9.86	8.89	7.73	8.23
Cash	4.91	5.35	5.27	5.81

Australian Shares – S&P/ASX 200 Accumulation Index
 Australian Bonds – USBWA Fixed Interest (All Maturities)
 International Bonds – International Bonds: Salomon Brothers World Ex Australian Government Bond Index (Hedge)
 Cash: SBC DB 90 Day Bank Bill Index
 Global Shares – Morgan Stanley Capital International World (ex-Australia) in AUS
 Indexed Bonds: SBC DB Inflation Linked Bond Index (All Maturities)
 Listed Property Trusts – S&P/ASX 200 Listed Property Trust Accumulation Index
 Unlisted Property: Mercer Direct Property Index (before tax and fees)

The late 80's bubble

Following the 1987 stock market crash investors sought the security of property income and moved overweight property in their portfolios. In addition, there were strong property investment flows from Asian investors, particularly the Japanese. As the listed property market was relatively small (less than 3% of the All Ordinaries Index versus 9%+ today) investors predominantly secured property exposure through direct property and the numerous unlisted property trusts available.

During this period, in response to the earlier deregulation of the banking industry, domestic banks, desperate to maintain market share, eagerly lent to developers. Overbuilding became a serious concern.

As supply increased and the recession took hold, property investors rushed to lock in their profits on property investments. Unlisted property trusts could not sell assets at their stated book values to fund the redemption requests and the overstatement in asset values became increasingly apparent. Values collapsed by over 50% in the direct market. With unlisted trusts unable to liquidate funds a redemption freeze eventuated. Financiers and unlisted property trusts were left with substantial amounts of property which was eventually sold into listed property trusts. This created the platform for growth in the listed property trust sector.

It is important to highlight the key market forces, which characterised the market during this period:

- historically high inflation, approximately 8% per annum
- record high interest rates, standard mortgage rates hitting 15.5%
- lack of liquidity in property markets
- high asset allocation to property

And now...

In stark contrast today, we have a market with:

- low interest rates
- low inflation
- increased liquidity provided by the listed property trust sector
- lower average asset allocation to property.

Over the last 10 years the Listed Property Trust market has grown dramatically in size from \$5 billion to \$50 billion. This market offers investors far greater liquidity and ensures perception of underlying changes in asset values can be reflected in unit trust prices on a far more timely basis than in the unlisted environment of the late 80's.

With low interest rates the yield differential between bonds and property is highly attractive. Borrowing costs are low enabling investors to leverage their exposure and drive higher returns. This low interest rate environment, combined with a genuine shortage of quality investment grade property has seen investors bidding up prices and chasing assets either offshore or via takeover as witnessed in the listed property trust market.

Interestingly however, in many cases property values have not yet reached their peak values of the late 1980's. In MLIM's own direct property fund, the Merrill Lynch Property Trust, a commercial office building at 555 Lonsdale St, Melbourne is today valued at \$39million, having been purchased by the Trust in 1998 for \$27.6m. In 1989 this same property sold for \$51m, a 30% premium to today's valuation.

In addition, investors are not overweight property to the same extent as they were in the late 1980's. Intech asset allocation figures show the total weightings to Direct and Listed Property peaked at over 16% in the late 80's. Today, total allocation is approximately 8.9%.

So...are we in a Property Bubble?

It can certainly be argued we are in a property bubble for the reasons outlined below:

- Markets are fully priced
- In the medium term there is the possibility of interest rates rising
- There is a soft leasing environment and supply issues for the office sector
- Employment growth is subdued
- It is becoming apparent, that there is an oversupply in inner city and CBD apartments
- There is a risk of asset allocation into other asset classes

However, there are a number of reasons that support our view that while markets are fully priced, we may not be in a property bubble that is about to burst:

- Values of many assets have not reached their late 1980's values
- We don't anticipate significant increases in interest rates and in the current low interest rate environment, property yields are highly attractive
- Supply and demand is in relative equilibrium (excluding office and medium density housing)
- Occupancy costs in the retail sector are not stretched, indicating a relatively low risk of tenant default
- Asset allocation in property is far lower than in the 1980's
- There is a shortage of quality investment grade property
- The Superannuation Guarantee Levy generates a weight of money that will see yields for high quality property supported
- An ageing population creates a demand for investments such as property that can generate an annuity style income

While we believe the strong returns delivered by property in recent years may not be repeated in the medium term, we don't subscribe to the theory that the bubble will burst, without a significant increase in interest rates. Despite weakness in selected parts of the property market, property yields of 7-9% on average are highly attractive from a risk/return perspective and we believe the sector still warrants inclusion in a diversified portfolio.

This document is an extract from a detailed research report prepared by Merrill Lynch Investment Managers and should be read in conjunction with that report, which is available at www.mlimadviser.com.au