WHY LISTED PROPERTY IS STILL A VALUABLE ASSET CLASS

2018 was a tough year for listed property in SA with allegations of share price manipulation against the Resilient Group leading the rout in the sector in 2018. Amidst the ensuing volatility, questions around the benefits of listed property investments weighed on investors' minds. However, with continued high and growing income streams, this asset class continues to play a pivotal role in the context of a well-diversified portfolio.

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LISTED PROPERTY IN THE YEAR THAT WAS 2018

Following the publication of reports on the Resilient group of companies by 36ONE Asset Management and Arqaam Capital in February 2018, South Africa's listed property sector was on the back foot throughout 2018.

However, away from the Resilient group of companies, South Africa's listed property sector actually performed quite well in the first quarter of 2018 after Cyril Ramaphosa was elected President of the ANC and succeeded Jacob Zuma as President of South Africa. Business and consumer confidence reached record high levels, while the global economic backdrop remained supportive of a recovery in SA's economy.

All that changed however when US President, Donald Trump, announced his decision to impose tariffs of up to 25% on goods imported from China and the Chinese responded with similar tariff increases on US imports. The threat of a trade war between the world's two largest economies undermined investor confidence and led to a sharp sell-off in emerging and developing markets. South Africa's listed property sector succumbed to the selling pressure and, despite a modest recovery in the prices of the Resilient group of companies, declined by 2.2% in the second quarter, 1.0% in the third quarter and a further 4% in the last quarter of 2018.

By the end of 2018, the FTSE/JSE SA Listed Property (SAPY) index had fallen 25.3% for the year, while the Nedgroup Investments Property Fund declined by 17.8% over the same period (total return with distributions re-invested). As an asset class, listed property has lost its lustre and investors are now questioning its role in multi-asset portfolios and as a cornerstone in financial plans – particularly in living annuities.

THE QUESTION OF DIVERSIFICATION

With the inclusion of a number of listed property companies in headline equity indices, the correlation between listed property and the broader equity market has increased over the past 5 years. The table below clearly highlights the increased correlation between South African REITs and the FTSE/JSE All Share index, particularly over the last 5 years.

Comparative Total Return Investment Correlation

	SA REITS	FTSE/JSE: All Share	All Bond	FTSE/JSE: Financials	FTSE/JSE: Industrials	FTSE/JSE: Top 40	FTSE/JSE: Small Cap
	Data period for upper right: December 2008 - December 2018						
SA REITS	1.00	0.28	0.58	0.55	0.42	0.19	0.50
FTSE/JSE: All Share	0.44	1.00	0.16	0.65	0.58	0.92	0.58
All Bond	0.47	0.07	1.00	0.43	0.42	0.10	0.33
FTSE/JSE: Financials	0.65	0.59	0.42	1.00	0.80	0.70	0.71
FTSE/JSE: Industrials	0.54	0.51	0.48	0.80	1.00	0.65	0.70
FTSE/JSE: Top 40	0.31	0.90	0.02	0.62	0.58	1.00	0.56
FTSE/JSE: Small Cap	0.58	0.50	0.33	0.65	0.56	0.42	1.00
Data period for upper right: December 2008 - December 2018							

Source: Bridge Fund Managers

On the face of it, listed property appears to no longer provide a meaningful diversification benefit when included with equities in a multi-asset portfolio. For this reason, some larger institutional investors and asset consultants no longer classify it as a separate asset class.

However, the data is somewhat misleading, given the composition of SA's listed property sector and the large weights in the SAPY index of Growthpoint, Redefine and NEPI Rockcastle - all of whom are constituents of the FTSE/JSE Top 40 index and tend to move in sympathy with the broader equity market.

HOW DOES THIS AFFECT THE NEDGROUP INVESTMENTS PROPERTY FUND?

The Nedgroup Investments Property Fund in contrast, which favours investments in some of the smaller and mid-sized listed property companies, continues to exhibit low correlations with the broader equity market. Since the fund was launched in August 2010, the correlation with the FTSE/JSE Top 40 index has been just 0.21 and continues to provide diversification benefits for investors looking to construct multi-asset portfolios.

THE BENEFIT OF LISTED PROPERTY WHEN IT COMES TO RETIREMENT INCOME

One of the main benefits of investing in listed property is the high and growing income stream. This is becoming increasingly more important as investors continue to retire from defined contribution retirement funds and are required to construct portfolios that provide a sustainable and inflation-hedged retirement income stream for up to 30 years.

The Nedgroup Investments Property Fund is constructed to achieve the dual objectives of sufficient income today and inflation-hedged growth in that income into the future. It is for this reason that the fund will often look different to the broader listed property sector under certain market conditions.

The table below illustrates how important this income stream can be for retirees who are drawing an income from a living annuity.

Initial drawdown	6%	7%	8%
Initial investment on 30/07/2010	5,000,000	5,000,000	5,000,000
Initial annual drawdown	300,000	350,000	400,000
Initial annual income	186,743	185,671	184,599
Initial income coverage ratio	62.2%	53.0%	46.1%
Current annual drawdown (2018)	460,111	536,796	613,481
Current annual income	868,518	799,727	730,936
Current income coverage ratio	188.8%	149.0%	119.1%
Investment value at 31/12/2018	7,149,248	6,547,817	5,946,385
Net change in unit balance (Start to end)	14.1%	4.5%	-5.1%

Source: Bridge Fund Managers. For illustrative purposes only, not a guarantee of future results.

We assume an initial investment on 30 July 2010 of R5,000,000 and a 6% per annum escalation in the annual drawdown. Regardless of whether the client initially drew 6%, 7% or 8% of their initial capital at inception, in every instance in the above illustration, the current annual drawdown is completely covered by the annual income being produced by the fund.

The long-term investor *in this example*[1] is therefore not prejudiced by the large capital drawdown experienced this year and can wait for the market to recover (as it invariably will, once investor sentiment turns more positive). If there was no income, the investor would have been selling off their capital at these low prices and their financial plan would start to unravel.

[1] For an investor who was invested since inception in July 2010. For illustrative purposes only, not a guarantee of future results.

WHERE TO FROM HERE?

While the fund's capital price fell by just over 26% in 2018, distributions fell by 2.1% in 2018 and are expected to fall by a further 3% to 4% in 2019 before resuming their inflation-beating upward trajectory in 2020. Longer-term investors in living annuities who initially drew 8% or less of their capital in the fund each year may thus be able to continue to take inflation-adjusted increases in their annual drawdowns without undermining their financial plans[2].

However, those investors who initially drew more than 8% should probably consider taking a smaller or no increase in their drawdowns in 2019.

While it is always difficult to predict what the future holds, there is no doubt that if South Africa's economic growth accelerates towards 2% or 3% in the medium-term, the sharp fall in listed property prices seen in 2018 will begin to unwind.

The current[3] one-year gross forward yield on the fund is 13.1%, offering investors an extremely attractive entry point while providing existing investors drawing an income from a living annuity, the wherewithal to withstand the current volatility in the sector. ■

[2] This statement is in the context of the illustration above for the hypothetical investor who has been invested in the Nedgroup Investments Property Fund since inception in 2010. It is not intended to constitute advice. It is strongly recommended that investors consult with their financial planner for guidance based on their specific circumstances.

[3] As at 31 December 2018.