



Platform

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CHANGES IN INTEREST RATES: WHAT EFFECT DO THEY HAVE ON PROPERTY RETURNS?

While property experts want you to believe property is a stable asset class and rental increases continue into perpetuity, short-term capital fluctuations of listed property can be hard for investors to swallow. So says Paul Stewart, managing director of Plexus Asset Management.

“The returns of the FTSE/JSE SA Listed Property Index over the past five years ended 30 June 2011 show that listed property outperformed the FTSE/JSE All Share Index by an astounding 7,6% per annum,” says Stewart. “And going back to the Listed Property Index’s inception in March 2002, the outperformance is even more pronounced at 11,2% per annum.”

While this history may argue for an overweight exposure to listed property within a portfolio, Stewart says there are also times when exposure to listed property should be underweighted. This is borne out by a recent study in which Plexus Asset Management looked at listed property by taking into account the changes in interest rates (the South African repo rate) and comparing them to equity returns.

For the study, periods of returns were divided between increasing, flat and decreasing interest rate cycles. The monthly total returns (i.e. including dividends and interest) of the FTSE/JSE SA Listed Property Index (SAPY) and the FTSE/JSE All Share Index (ALSI) were then analysed over these three cycles. The accompanying graph shows the interest rate cycles as well as the SAPY and ALSI performance indexed to 100 in March 2002.

It is not immediately clear from the graph whether there is any correlation between the interest rate cycle and the performance of listed property. “However, by isolating and summarising the average returns for each stage of the interest rate cycle (see accompanying table), a clearer picture emerges,” Stewart points out.

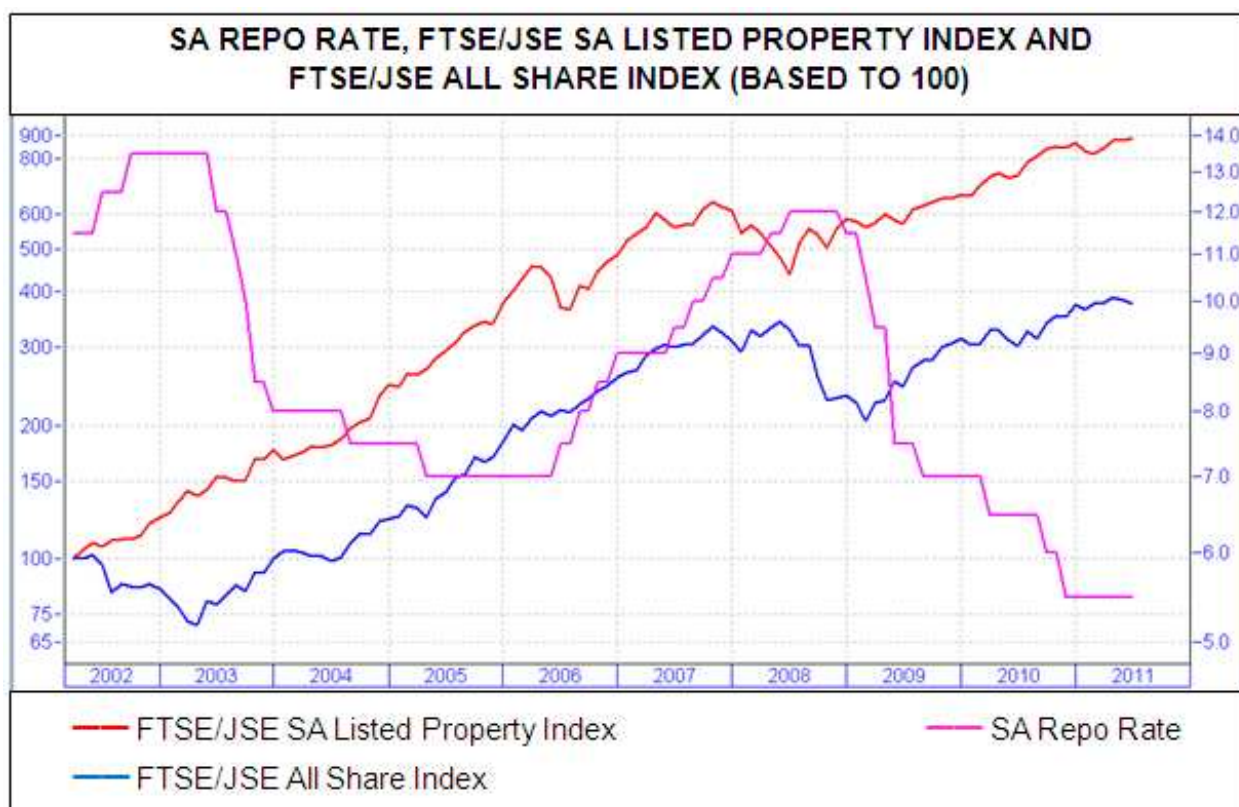
The table shows that while the average monthly return for both property and the ALSI is positive, regardless of the interest rate cycle, the minimum return over a single month can be significantly large. “It is interesting to note that listed property’s biggest down-month at -13,9% was greater than the biggest down-month for the ALSI,” says Stewart. Furthermore, it is somewhat surprising that the best period of average monthly returns for property is when the interest rate cycle is flat. “Conventional wisdom would have one believe that property would do best when interest rates are decreasing,” he says. The flat interest rate cycle also provides the largest outperformance of property over the ALSI.

It is clear that the up-cycle in interest rates is the most difficult period for property. “The average monthly performance is the lowest, the Property

Index underperforms equities and the monthly standard deviation is greatest during this cycle,” says Stewart.

Another interesting statistic is the correlation between the monthly returns of the Property Index and the ALSI. “It is relatively low over all interest rate cycles, and makes a good case for having both property and equity exposure in a diversified portfolio.

“Despite the fact that the interest rate cycle is still flat, concerns regarding increasing inflation could prove to be ominous for the property sector,” says Stewart. “While one would not want to lose the upside potential of property returns during the flat interest rate period, having an overweight property exposure at this stage could be detrimental to portfolio performance when the interest rate up-cycle starts,” he warns.



INTEREST RATES	DECLINING CYCLE		FLAT CYCLE		INCREASING CYCLE	
	Property	ALSI	Property	ALSI	Property	ALSI
Minimum	-4.52%	-9.87%	-6.58%	-13.24%	-13.93%	-13.14%
Maximum	13.42%	11.02%	18.19%	14.07%	12.70%	12.45%
Average	2.32%	1.94%	3.21%	0.65%	0.60%	1.11%
Correlation: Property vs ALSI	0.44		0.22		0.37	
Standard deviation	3.64%	4.89%	4.99%	6.31%	6.13%	4.73%