St. Bride's Managers

Prospects and Challenges

A Dove and Hawk Discussion

July 2013

General UK Outlook

Dove and Hawk attended St Bride's Managers recent investment seminar at the Magic Circle. They weren't too sure what to expect!

Dove: Have you recovered yet from their Annual Seminar? You looked a bit startled when we left.

Hawk: Yes, just about. The magician at the end of the seminar was absolutely amazing wasn't he? It was worth going just for that. I'm afraid I slept through most of the property stuff though. Our youngest had kept me up all night...

Dove: Then you missed some really interesting things.

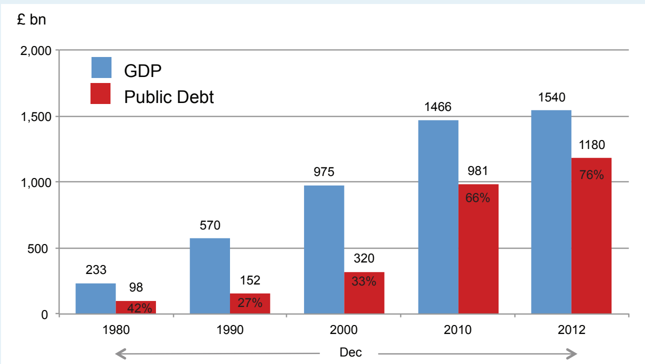
Hawk: Well, when the old fella started off by saying that it's all going to be doom and gloom, I thought… 'come on… give us a break'. I think that's when my eyes started to close.

Dove: He had a point though. Actually, he had ten points and put together, I found it all a bit scary.

Hawk: Yes, but you are easily scared. So what did he say?

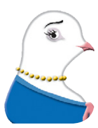
Dove: Firstly, the ratio of public debt to GDP is dangerously high and getting worse. At the end of 2012 it was 76%. Perceived wisdom is that 90% is the high water mark. Anything above that would really freak out the markets - and there is every chance that will happen!

UK GDP and Public Debt



Source: ONS

Hawk: Yes, but Mr Osborne is on the case. All his austerity measures will sort it out, surely?



Dove: No… I don't think so. We really are going to need much higher growth than is forecast and Government spending is still rising and they are frightened to death of cutting the pensions, health and education budgets. Between them, those three sectors represent about 49% of the annual spend and the OBR forecasts that this will rise to 53% within the next couple of years.

UK Government Spending (£ billions)

	1980	1990	2000	2010	2012	2015 (est)
Pensions	0	0	66	115	127	150
Health	12	29	50	118	121	133
Welfare	24	53	59	110	115	116
Education	12	25	43	88	92	103
Defence	14	23	28	43	46	44
Other	42	71	92	186	187	183
TOTAL	**104**	**201**	**338**	**660**	**688**	**729**

Source: ONS / OBR

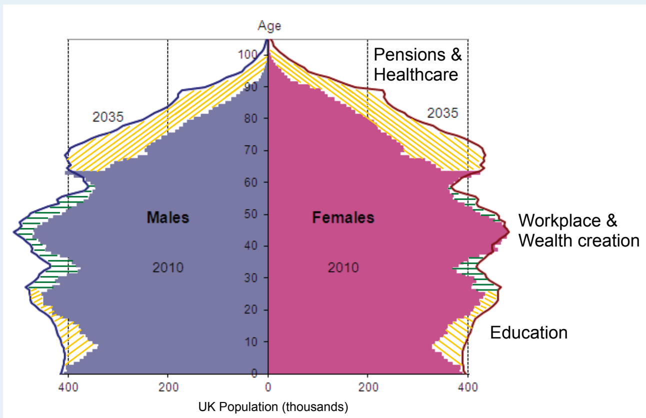
Hawk: Holy schmoly! Let's get this straight. Are you saying that the Government will be spending £150 billion a year by 2015 on pensions alone? What the heck is going on here?

Dove: Three things. You've got the state pension. Secondly, a lot of Government pensions are unfunded and they have to be paid out of the current account. And thirdly, there are going to be millions more oldies to look after. Basically people are just living longer.

It's impacting on health costs too.

And to add insult to injury, there is going to be a burst of new kids too. Those poor people in the workplace whose job it is to create the nation's wealth are going to find the going very tough indeed.

Shape of Population 2010 - 2035



Source: ONS

Hawk: Aaaak! I'm in that group and I don't have any spare cash at the end of the month even now. My mortgage costs and credit cards are killing me. I can't afford any more.

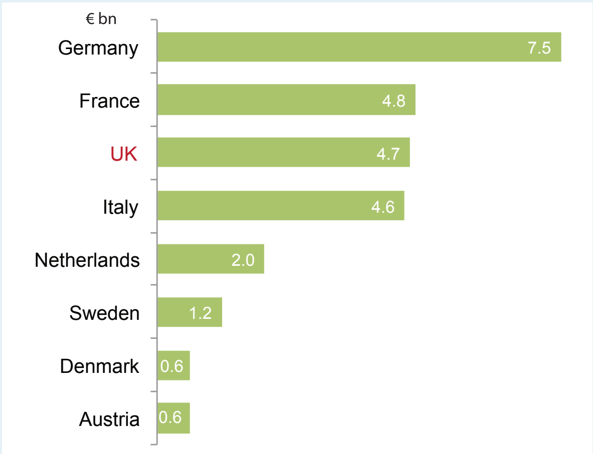
Dove: Yes, but when interest rates go up, it will be even tougher.

Hawk: When? Surely you mean 'if'?

Dove: No… I mean when. When the US starts to reduce their quantitative easing, their interest rates will go up, and we will have to follow suit. Otherwise we won't be able to attract investors to take on our Government debt.

Hawk: Well, thank heavens we're not in the Euro. That would be double trouble. We simply have to get out of there. It's costing us an arm and a leg each year.

Net contributions to the EU Budget 2011



Source: European Commission

Dove: Actually, it isn't. Our net contribution in 2011 (latest figures) was just €4.7 billion, made up of:-

- National contribution €11.3 bn
- Less rebate €3.6 bn
- Less receipts €3.0 bn

A net contribution of €4.7 bn is tiny in the whole scale of things.

Hawk: This is all a bit disconcerting isn't it? What else did the old bloke say while I was in the land of nod?

Dove: He raised three issues surrounding infrastructure.

Firstly that we are running out of energy and fast. Most scarily though, the Government seems completely incapable of making long term commitments to any essential infrastructure… airports, schools, hospitals, let alone energy.

Secondly, given the fact that the UK population is expected to grow by 11 million by 2035, we are going to have a massive shortfall of homes… unless something changes rapidly; and

Thirdly, with 2.5 million people unemployed, plus other financial and social pressures, civil unrest is a possibility. We all caught a glimpse of what could happen in the 2011 riots.

Hawk: Didn't he say anything about property?

Dove: Yes, of course he did. He made the point that property bank debt hasn't gone away, and nor is it going to any time soon. £42 billion is completely under water (more than 100% LTV). A further 15% fall in values would see another £30 billion go completely under too!

Outstanding UK Property Bank Debt

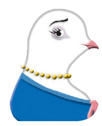
LTV	Outstanding Bank Debt	% of Total	Status
Over 100%	£42 bn	20%	Under water
86-100%	£30 bn	14%	At serious risk
71-85%	£35 bn	16%	Dangerous
51-70%	£78 bn	36%	Uncomfortable
0-50%	£29 bn	14%	Comfortable (ish)
Total	**£214 bn**	**100%**	

Source: Bank of England, De Montfort University

Hawk: Wow! But by my tally, that's only 9 dangers. What was the last one?

Dove: He saved the hairiest until last. He reckons that UK secondary property valuations, especially in the regions, haven't yet been fully marked down to market prices. There may be 10% or more to go. However, compared to Continental Europe, UK valuations are positively 'saintly'. Over there… well, frankly they are a complete joke.

Hawk: So he's pretty bullish then?



Dove: Hmmm! This is as gloomy as I have ever known him. He reckons that UK-wide property total returns will only average about 4% pa over the next 5 years, which is way below the IPF consensus average of 7-8% pa.

But remember, he was the guy who said back in November 2007 following the collapse of Northern Rock that we were faced with ten years' of misery. Everyone laughed at him then, but do you know what... he may yet be proven to be right.

The Global and Domestic Picture

Dove and Hawk heard how the US and Asia-Pacific offer stronger growth prospects, how Europe will remain in the doldrums for some time and how the UK is a mixed bag.

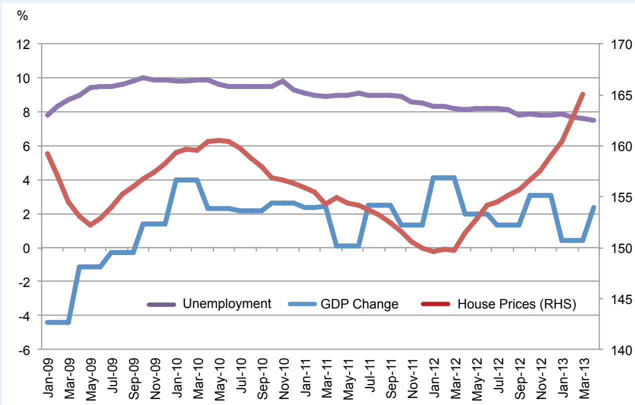
Hawk: So what did you make of their global picture round-up? I remember being awake for some of this! I was expecting them to tell us how bad everything was.

Dove: So had I, but the US economy is apparently growing again at 2-3% pa and unemployment is falling. Encouragingly, they have managed to bring their corporate and personal gearing down whilst house prices are rising again too. As home owners feel a bit wealthier, so they will probably start to spend more and this should add further fuel to their economy. The US is looking pretty healthy.

Hawk: I just love the yanks' 'can-do' attitude. When everybody thought they were down and out they pick themselves up again. Why can't we do that?

Dove: Because we don't have the dollar on our side and we are in danger of losing our national mo-jo. We really need to shape up.

US Economic Signals

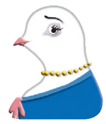


Source: BEA, S&P Case Shiller Index, National Central Banks

Hawk: But we're better off than Continental Europe, surely?

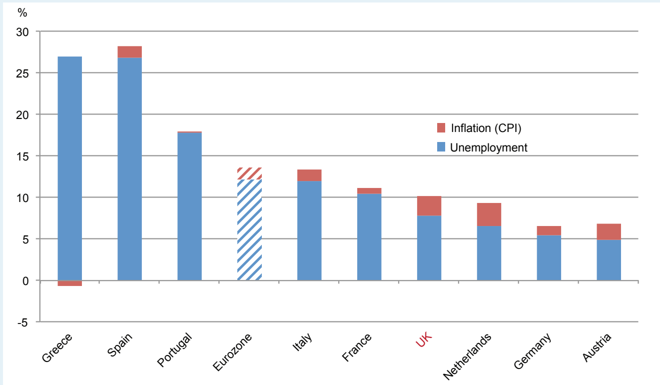
Dove: Sort of. Along with the Scandinavians, being outside the European Monetary Union has allowed us to control our currency a bit. This is showing through with some early signs of economic growth. On the other hand in the Eurozone the economy has contracted for six quarters in a row! St Bride's don't see much prospect of a significant turnaround in the near term either.

Hawk: Yes, I heard that unemployment in the Eurozone is now 19.4 million. How miserable is that?



Dove: That's a good point. Some bright spark called Arthur Okun invented something called the Misery Index which is the aggregate of the unemployment rate and the rate of inflation. You can see that the index is high across virtually the whole of the Eurozone reflecting lower wages (or job losses) and an erosion of spending power through inflation. But at 10% the UK is hardly in a position to gloat.

Eurozone's Misery Index



Source: Eurostat

Hawk: And I guess that Asia Pacific is still 'go-go-go'?

Dove: With the exception of Japan… yes! The total APAC population is 3.5 billion people and rising. They are young and getting wealthier. This is creating a virtuous circle. APAC is the growth engine of world.

China is rebalancing its economy so that it is less dependent on exporting and focussing more on internal consumption and investment. GDP growth at 7.5% pa still looks feasible, so that looks okay.

The only fly in the ointment is Japan. They have committed to a massive expansion of money supply, large government spending programmes and a reform of regulation and FDI rules. Japan already borrows a huge amount as a percentage of GDP (240%) relative to the other G8 countries and is committed to borrow a whole lot more. If this Abenomics programme fails, they really are in serious 'do-do'.

Hawk: So where should I be investing?

Dove: St Bride's model current favours the US and Asia Pacific and recommends an underweight position to the UK and Continental Europe.

St Bride's Managers Recommended Global Weightings

	UK	Continental Europe	USA	Asia-Pacific
Neutral Long Term Weightings	70%	10%	10%	10%
	down to	down to	up to	up to
Recommended Weightings 2013-17	65%	7%	14%	14%

Source: St Bride's Managers

Hawk: Wow. So are you really telling me that they're recommending investors take money out of the UK… St Bride's home patch? Have they got a death wish or what?

Dove: They do have an office in the US…

Hawk: Ah! Of course. No wonder they are recommending a higher weighting to the US then.

Dove: That's a bit harsh. They have an office in Madrid too, but they aren't recommending an allocation to Spain, are they?

Hawk: Well that proves it. They definitely do have a death wish. Madrid? Are they mad? The place is totally bust.

Dove: Exactly. They have set up an office there to help investors and banks work out their issues, and boy, do they have issues. But they have a top bloke there to help.

Hawk: Hmmh! So turning attention closer to home, what did they have to say about the UK property investment market? At their seminar last year they were banging on about London as 'the' investment destination. And the last thing I'd heard was that they had launched a UK regional fund – 'White something'. Are they now fans of both?

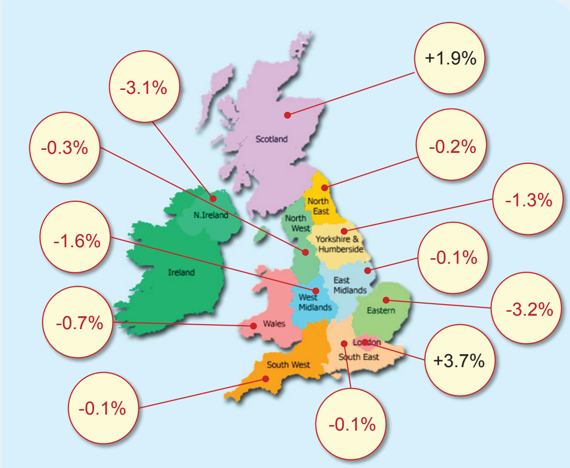
Dove: You were asleep, weren't you? What they have been consistently saying is that UK institutional investors should be much more discerning in what and where they own in the UK. Like their World City Model, they have a UK Regional City Model. Yorkshire (hence White Rose) has three cities in the top 30 – Leeds, Sheffield and York. And they are looking to do something a bit different there too. It's a sort of opportunities fund - direct, development funding & JV's etc.

Hawk: Well, I am still a fan of London. It has done me really well recently.

Dove: I am still very much a fan too, as are St Bride's, but so are lots of investors from countries I have never heard of – which normally end in 'stan'. Yields have hardened a lot and, for right or wrong, domestic investors are being frightened off.

Hawk: I accept that yields are low, but this is hardly surprising since London's economy is still growing, which is more than you can say for the UK regions. Only Scotland has managed to stay in the black, with the north-south divide continuing to widen.

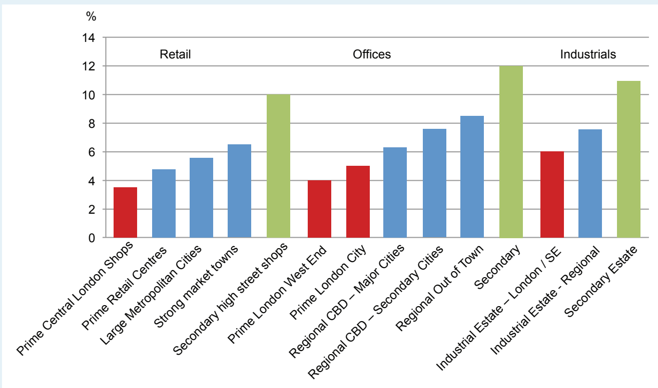
Change in GVA since 2007 (relative to UK average)



Source: ONS

Dove: I know all that, but investors are starting to be attracted by higher yields. The hunt for yield is definitely gathering pace, with the yield spread between properties in London and the regions as large as it ever has been.

UK Market Yields



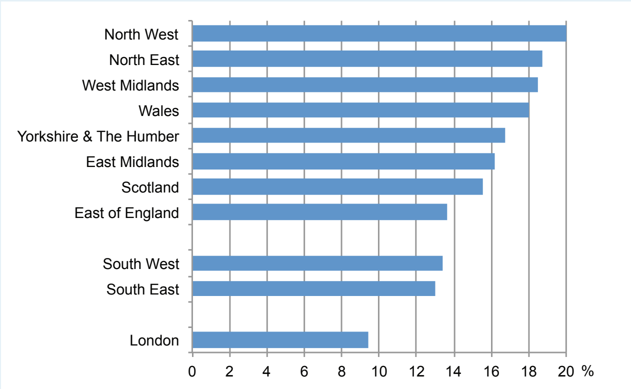
Source: CBRE

Hawk: Come on! High yields are normally high for a good reason – like the tenant's covenant is dodgy. Or the property's over-rented, or the lease term is short etc etc.

Dove: I suppose so, and I guess there's a fair bit of property currently vacant out in the regions?

Hawk: Dove my friend. The vacancy rates in the regions are alarming! At current levels there's no chance of any rental growth at all. The statistics St Bride's showed about shop vacancies were frightening - a 15% average vacancy rate and only getting worse.

Retail Vacancy Rates



Source: Local Data Company / Retail Futures

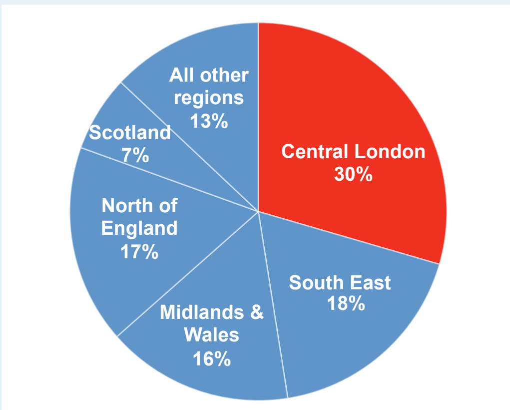
Dove: Crickey. That's worrying. But at least rents and capital values are way below the economic cost of construction. That's got to be a helpful starter for 10.

Hawk: Kind of. I accept that if someone wants a brand new glass box in Leeds, Birmingham or Manchester, they are going to have to pay £25-£28 per sq ft for the privilege. But for most mere mortals who are still minding their pennies, £12-£15 per sq ft is going to be much more their cup of tea for quite some time.

Dove: I see your point.

Hawk: And on top of all this, over the next two years or so, we are going to see a ton of defaulting bank property loans in the UK regions. Of the outstanding total of £214 billion due to be repaid or refinanced, 70% are in the regions. Working this out is not going to be pretty. This bank deleveraging will constrain capital growth prospects.

Outstanding UK Real Estate Loans By Regions



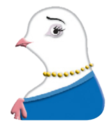
Source: De Montford University

Dove: You aren't a fan of the UK regions are you?

Hawk: I agree with that chap at St Bride's. They still tell me that there are some interesting opportunities out in the regions but that investors need to be really careful. Not everything is what it seems at first glance.

- High Yield
- Low or negative rental growth
- High levels of vacancies
- Significant over rentedness
- Banks off-loading

I haven't even mentioned probably the biggest challenge, that domestic investors are already over-weight to the UK regions. So why would they want even more?



Dove: Yes. I agree on that. On average pension funds have about 85% of their UK portfolios in the regions and only 15% in London. And hardly anything overseas.

Given the overall prognosis for the UK, this does seem pretty bonkers. The guys at St Bride's recommend:-

St Bride's Managers Recommended UK Weightings

	Regions	London	Overseas
Neutral Long Term Weightings	35%	35%	30%
	down to	steady at	up to
Recommended Weightings 2013-17	30%	35%	35%

Source: St Bride's Managers

Hawk: There is a stack of work to do then.

Dove: Yes, and not only 'where' to invest, but also 'what' and 'how'. Were you awake for the start of the session on 'Alternative Property'? I was fascinated to hear how well they have been performing.

St Bride's got that very nice young man from IPD, Mark Weedon, who heads their 'alternatives' section to tell us all about it.

Hawk: So what did he have to say?

Dove: Well, the first thing is that alternatives now account for about 10% of the IPD annual index, up from just 4% in 2003.

Hawk: Okay. You have sort of got my attention.

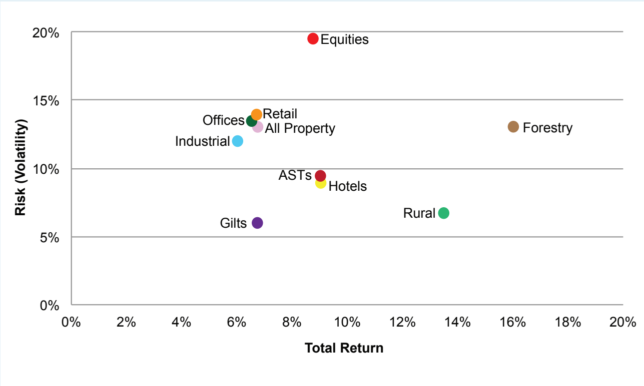
Dove: Yes, and there is quite a collection of asset types:-

Leisure 64%; Agriculture 12%; Development sites 6%;
Education 3%; Healthcare 3%; Garage & Parking 3%;

and another 9% in what IPD call 'unclassified'.

Hawk: That sounds like something out of a spy thriller. Maybe the Government have put GCHQ into IPD.

10 year total return vs standard deviation 2003-2012



Source: IPD All Property Annual Index, MSCI, JP Morgan 7-10 yr

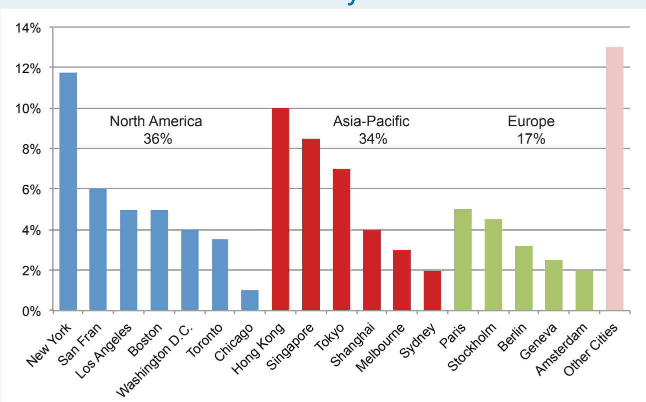
Dove: Ha ha! I think that would be 'classified', rather than 'unclassified'! But seriously, when you plot performance and risk (standard deviation) alternatives come out really well. Gilts obviously have low risk, and to be fair their average performance at 6-7% pa has been pretty good. But I think most people would reckon that they have had their moment in the sun. But look how well the alternative classes have done.

Hawk: Yes. That's pretty impressive. But I'll tell you what's troubling me. How do I get into all these new fangled assets. And if St Bride's are advocating 35% overseas, how am I going to do that?

Dove: According to St Bride's it's easy peasy. They have been modelling a 3-prong approach for both the UK and globally, a blend of direct / clubs, unlisted funds and listed REITS.

And they have been true to their city-orientated strategy too.

St Bride's Managers World City REIT Fund - City Allocations



Source: St Bride's Managers

Hawk: How so?

Dove: For the past couple of years they have been running a discrete fund made up of listed REITs whose exposure is (substantially) to their top 20 World Cities. Apparently it has done rather well and is one of the three pillars of their integrated global real estate strategy.

Hawk: Brilliant! I love it! Errrh.... what do you mean?

Dove: They are combining unlisted, listed and direct / club investments into one single strategy.

Hawk: That's great! But, of course, it won't work. Institutional investors (led by their consultants) have never been prepared to mix listed and unlisted. And adding direct holdings on top is fanciful.

Dove: Well, St Bride's are determined to get the industry to wake up and smell the coffee. They think that it's absolutely ludicrous to separate one from the other - especially when it comes to investing overseas.

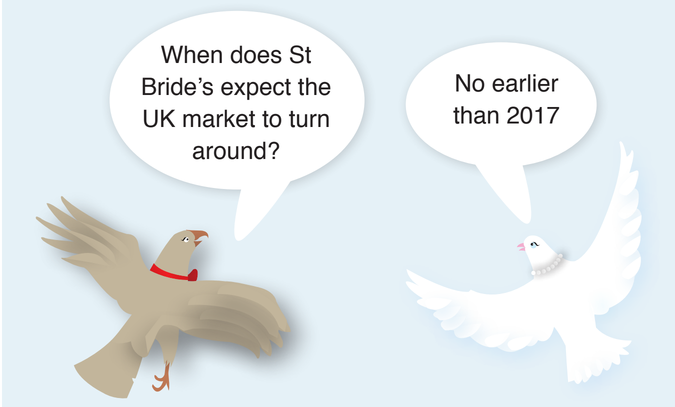
Hawk: Look, I have to fly. But am I right that in summary St Bride's are saying:

- The UK's recovery is still on a knife edge and the regions remain particularly hazardous.
- Whilst London is still a great place to have investments, rents will now have to start rising to compensate for lower yields.
- The US and Asia Pacific look attractive investment destinations, but investors should be very wary of Europe.
- Alternative property types deserve a much higher weighting.
- Strategies should be fulfilled via a blend of listed, unlisted and direct properties to achieve the right balance of risk, return and liquidity.

Dove: Yep. That's about it. Basically, they are urging investors to re-model their portfolios so that they are fit for the future. Regrettably, still far too many are focused in the past.

But overall, it is, I am afraid, still going to be tough for several more years to come.

Prospects and Challenges



ST. BRIDE'S MANAGERS

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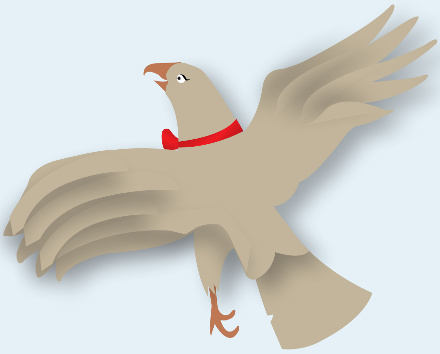

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