

# Market Commentary

# NZFUNDS

## LISTED PROPERTY STOCKS SET TO SOAR

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Listed property trust shares are set to soar if New Zealand enters a sustained period of inflation.

NZ Funds senior portfolio manager Stephen Bennie says in the last couple of years investors have been focused on protecting their capital and guarding against the ravages of deflation, but the future of investing may well be all about guarding against inflation as the Government encourages the economy to expand by keeping interest rates low.

"The big lesson of the 1930's was for Governments not to raise interest rates too quickly and stifle the fragile recovery. This time around central bankers are unlikely to make the same mistake and are more likely to keep rates lower for longer. This will fuel inflation and lead to a rise in property returns."

In an inflationary environment, few asset classes do better than property. "We have spent the last year analysing the correlation between various asset classes and inflation and property ranks very high," Bennie says. Property also performs in line with a rising share market during periods of low inflation so it is a "win-win" investment. Global inflation has regularly exceeded 1-3%pa (which is the Reserve Bank of New Zealand's inflation target band). For example during the periods 1945 to 1948, when it averaged 9.6%pa, 1972 to 1982, when it averaged 8.9%pa and 1989 to 1990 when it averaged 5.6%pa.

Bennie says few people understand the devastating effect inflation can have on an individual's real wealth. "Inflation can destroy New Zealanders' savings as surely as a finance company default," Bennie says. Five years of inflation at 10%pa gives a return to investors of 62 cents in the dollar. Also, people can have short memories and forget the damaging levels that inflation can reach, but inflation hit 18%pa in New Zealand in 1987."

Inflation is also an exogenous variable for an open economy like New Zealand. "The notion that the Reserve Bank can control inflation if it is rampant in the United States, Europe and China, just because it is enshrined in our legislation, is farcical."

"For almost two years now, property as an investment has hit the headlines for all the wrong reasons, which is exactly why it makes sense to look at it now," Bennie says.

"For most New Zealanders preparing for, or in retirement, property will be an essential component of a diversified financial plan," says Bennie. Its attractive attributes include the certainty of its business model and that a large proportion of returns are derived from yield, which is relatively stable.

However, not all property will be a good investment.

"The first distinction investors need to make is between unlisted and listed property. Buying either a rental property or commercial property is not an investment proposition, it is a business proposition, and investors selling the family farm to buy commercial property are merely swapping one business for another. They are not retiring," he says.

"Investors who buy property directly or through a syndicate expose themselves to all the risks of property investing but in an illiquid and highly concentrated manner," says Bennie. The risks include tenant risk, property price risk, interest rate risk, bank covenant risk and liquidity risk.

"If anything goes wrong it might take six or more months to sell your property, or longer still if you are part of a syndicate. This means the normal risks associated with property investing get put on steroids if things go wrong," says Bennie.

Bennie believes listed property, or real-estate-investment-trusts (REITs) as they are known in the United States, will prove to be a superior investment. Globally listed REITs own everything from office buildings, to shopping malls and hospitals.

New Zealand house prices are up a mere 2.5% for the seven months to 31 July 2009, while Property Council New Zealand found that CBD offices experienced a -5.2% total return for the year to June 2009. However, since their lows earlier this year, New Zealand REITs are up 15% and global REITs are up 76%. New Zealand's three largest listed-property trusts (Kiwifund Property Trust, AMP NZ

Office Trust and Goodman Property Trust) are up between 14% and 24% from their lows earlier in the year.

Bennie expects listed property trust to continue to perform strongly in the long term. "If you look at any property market in the world, including New Zealand, the very best real-estate is always owned by a listed property trust. Who owns the A grade buildings on the Auckland skyline? It is not a private syndicate. You are buying superior pieces of property so over time you enjoy superior investment returns".

Not only is the property high quality, but by owning a portfolio of listed property trusts, investors do not become over exposed to any one geographic region. There is also the benefit of REITs' attractive tax status in most markets. For example, in New Zealand our listed-property trusts are PIEs, which means that their dividends are non-assessable income.

Most importantly, if investors wish to exit their investment, REITs are totally liquid so investors never become trapped.

However, the big downside of owning a diversified portfolio of REITs is that whenever the share market dives so does the price of listed REITs. "It is important to include a hedging strategy in a property portfolio to protect from the volatility of the share market, while enabling you at the same time to enjoy the benefits of owning a collection of world class real estate."

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