

Brexit reveals the dangers of property trusts

Unlisted funds are expected to stay frozen for months

JAMES KIRBY
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Just when they had regained their mojo — if not quite their respectability — a frisson of fear has run through the Australian property trust sector as news filters through from Britain of the spectacular effect Brexit has triggered on that country's property trusts.

Inside a week a remarkable 50 per cent of retail funds in the British commercial market have been frozen as investors rush to take money out of Britain.

In what must now seem like a recurring nightmare for overseas investors, some of the biggest names in property funds—including Standard Life, Henderson, Aviva and a string of related operators — have simply “gated” their funds and they are expected to remain closed for months.

This is the second time this has happened in less than a decade.

There is no evidence yet that the Brexit drama has spread to Australia... and why should it?

Our market is very much isolated from the prevailing weakness in Europe.

But there is evidence once more that property trusts — especially trusts not tradeable on the stockmarket, such as unlisted trusts and mortgage funds — are fundamentally risky.

No less a figure than the governor of the Bank of England, Mark Carney, emerged this week, warning of what he called “a liquidity



Bank of England governor Mark Carney has warned of “a liquidity mismatch” in property funds

Fifty per cent of retail funds in the British commercial market have been frozen

mismatch” in property funds. First and foremost the British crisis shows just how rapidly a property fund can get into trouble.

If a crisis erupts a property trust simply cannot sell buildings as fast as the rate at which redemptions may come in the door.

Nor can it raise rents or find other ways to raise sufficient cash ... the only choice, then, is to freeze the funds.

And though it is illiquid funds that are once again in the frame, it is fanciful to think the listed property trusts are immune from wider

industry problems. Indeed, companies often have interests in both listed and unlisted property securities.

In Britain major groups such as the listed company British Land have seen falls of more than 30 per cent.

Henderson — a diversified fund manager with significant property interests — is listed in Britain and Australia. On the ASX Henderson has fallen from \$5.00 to \$3.50 in the three weeks since the Brexit surprise.

To put some numbers around

the issue, unlisted property trusts in Australia hold about \$25 billion in assets. That makes it perhaps one-sixth the size of the so-called A-REIT sector representing listed trusts, which has held steady over the last week.

Unlisted property trusts, from groups such as Charter Hall, Cromwell or Sentinel, have become popular again in the local market. They are offered by both financial planners and fund managers as a “non-correlated” choice for retail investors to get into property without the high demands of direct property or the volatile nature of A-REITs.

But the perennial problems presented by unlisted property trusts never go away.

Here's why:

1. They are illiquid — when things go wrong you cannot get your money out.

2. The manager of the fund — if worried about property conditions — may “freeze” the fund — this is not possible with listed A-REITs, which tend to stay tradeable on the market, but possibly with a sliding share price.

3. When unlisted property trusts are frozen they can remain so for months and often for years.

Dugald Higgins, a senior investment analyst at Zenith Investment Partners, says: “The surprise out of the UK this week is not the funds have had to freeze,

but there is evidence again that people are shocked when it happens.

“I am continually concerned that private investors who go into unlisted property trusts do not understand the nature of the product.

“They underestimate the risk of this very scenario playing out in the market for whatever reason.

“We saw it in 2008 when there were huge problems with mortgage funds and unlisted trusts ... people need to be told exactly what can go wrong here.”

Meanwhile, the Australian unlisted property trust sector finds itself in the uneasy position of being one of the very best asset classes in recent times — beaten only by listed property trusts and gold stocks in recent months. Since the GFC the Australian unlisted property trust sector has returned about 9.5 per cent annually to investors.

The majority of that return has been made up of income yield, which is running at about 7 per cent.

But with investors underpinning the funds, which continue to bid up commercial property in order to access those income yields, new fears are emerging that the Australian sector is once again getting overpriced. That concern, rather than ripples from Brexit, will be the one that matters most locally.

Property can only produce modest returns

ROGER MONTGOMERY



As mortgage interest rates in Australia have declined from more than 18 per cent in the late 1980s to just on 4 per cent today, house prices have become more expensive relative to incomes.

The apartment oversupply — combined with failed settlements — convinces me that it will be developers trying to move unsold stock to meet their own debt obligations that will cause lower apartment prices.

And while reports of mothballed development applications have hit the headlines, it seems construction is continuing almost unabated.

According to my friends at investment bank UBS, Australia's residential crane count has surged 165 per cent since September 2014 to a record high 525 units, with the biggest lift occurring in Sydney. That's a more than doubling of the number of cranes operating in the residential sector in just 21 months.

Dwellings under construction as a share of GDP at over 3.5 per cent is now at all-time highs and more than double the percentage observed in 2000.

Moreover, most of the dwellings are multi-story apartments, rising from a total of \$5 billion in 2001 to \$40bn today. And if you don't believe that is sufficient to cause a foreseeable oversupply, consider that commencement data suggests completions will continue on a near vertical growth path for at least another six months.

The simple rule to remember when investing is the higher the price you pay, the lower your return. If interest rates stay where they are, it means the high prices paid will ensure the best return that can be expected is the income produced by the asset with little or no capital gain.

If interest rates rise, you shouldn't be surprised to see asset values and prices drop, and perhaps even sharply.

What goes for property and its ability to produce income also goes for shares or any other asset. Think about this carefully: an asset, any asset, is only worth the present value of the cash flows that can be extracted over its life. To arrive at the present value, one must discount the future cash flows back to today. This is be-

cause \$100 received in 10 years time is not worth \$100 today; it is worth something less. How much less depends on the discount rate one applies to the future \$100 to arrive at today's value. The higher the interest rate, the lower the present value.

For example \$100, to be received in 10 years time, discounted to today using a 2 per cent rate, is worth \$82. When the rate increases to 10 per cent, that same \$100 in 10 years is only worth \$38.55.

So there is an irrefutable mathematical reason for the inverse relationship that exists between asset

As interest rates go up, the value of an asset goes down

values (all assets) and interest rates. As interest rates go up, the value of an asset goes down. And it doesn't matter whether that asset is farmland, a business, shares, bonds or a commercial property. Interest rates act like gravity on the value of assets. The higher the interest rate the stronger the gravitational effect.

This can be observed in financial markets over a long period of time.

Between 1960 and 1981, interest rates in the US surged, and along with the equity market risk premium, rates rose from about 5 per cent to 18 per cent. Over that 20 year period, the S&P 500 index returned 3.6 per cent per annum. That's 20 years of low returns. Then, between 1981 and 2000, interest rates plunged, sending the combined US bond rate and implied equity risk premium back down to 8 per cent. In that 20-year period, the S&P 500 returned almost 15 per cent per annum. Twenty years of extraordinary returns. Since 2000 the combined rate has been flat and, perhaps surprisingly, the S&P 500 has returned just 2.5 per cent per annum. Another 16 years of low returns.

But I am not sharing this with you because I want to point out that it doesn't matter whether the economists who predict rising rates, or those that predict low flat rates, are right — both scenarios will produce low returns for investors.

I am sharing this with you because it seems the same “good-times-are-over” relationship can be observed between property prices as measured by house-price-to-income ratios and mortgage interest rates.

To put it simply, every way you look at it you have to expect low returns.

Know your terms before doing up DIY property

MONICA RULE



Many self-managed investors borrow money to buy properties through their do-it-yourself fund.

Some of these properties may need work, but superannuation rules are complex, so take care when considering making alterations on a property owned by an SMSF.

Put simply, there are precise definitions of what might be maintenance and what might be substantial improvements that would enhance the value of the property — investors need to know the difference. Crucially, a lot depends on the terms of any lease agreements.

Take a situation where an SMSF has acquired a residential property through a limited recourse borrowing arrangement. Soon after the acquisition, the council rezones the property for “mixed” use. Due to the rezoning, the SMSF member decides to lease the property from his SMSF to conduct his business.

But before the member moves in, the property needs some alteration work done to comply with council regulations. Let's say the bathroom facilities need to be upgraded to provide access and functionality for a disabled person. An additional parking space is also required.

Before doing any alterations, a number of questions must be considered by the trustee to comply with super law.

• Would the alterations change the character of the property?

Under the borrowing rules, the SMSF is prohibited from borrowing to improve the property. But improvements can be made using money that hasn't been borrowed as long as it doesn't alter the character of the property to such an extent it becomes a different asset. In our situation, the property acquired by the SMSF was originally a residential property and zoned “residential”.

Therefore, the alterations will change the character of the property from residential to commercial and would change the character of the property. However, if the lease agreement entered into between the related party tenant and the SMSF trustee contains “retention of ownership” and “make good” clauses, the alterations will not change the character of the property.

• Would the alterations paid for by the tenant amount to an acquisition of materials by the SMSF from the related party?

Normally an object affixed to a property will form part of the property and will constitute an acquisition of that object by the SMSF trustee.

But if the lease agreement contains retention of ownership and make good clauses, any items the tenant affixes to the property remain the sole property of the tenant, who must remove the items on expiry of the lease.

The tenant needs to ensure the property is left in the same condition at the end of the lease term as it was at the start, with fair wear and tear excepted. Provided this is done, the alterations made and paid for by the tenant will not be treated as an acquisition of assets or material by the trustee.

• Would the alterations paid for by the tenant amount to contributions being made to the SMSF?

It is stated in tax ruling 2010/1 that a contribution is anything of value that increases the capital of a super fund provided by a person whose purpose is to benefit one or more members of the fund, or all of the members in general.

If the retention of ownership and make good clauses exist in the lease agreement and the alterations are required to be

removed on termination of the lease, the alterations will not amount to contributions being made to the SMSF. This is because the capital of the SMSF is not increased by the alterations, as the tenant retains ownership of these.

Also, if the member performs any work on the property owned by the SMSF, such as painting or renovation, the member can only be paid for the work performed if the member provides the same service to the general public via their own business. If the member decides not to charge the SMSF for any work performed, then the increase in the value of the SMSF's property would be treated as the member's contribution to the SMSF.

It is important SMSF members do not try to draw up lease agreements themselves or perform any work on properties.

I recommend employing a professional to draw up a lease agreement where things such as retention of ownership and make good clauses are stated clearly in the agreement.

It is also best to employ an arm's length builder and contractors to perform alterations work on SMSF properties.

Monica Rule is the author of “SMSFs and Properties” www.monicarule.com.au



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