

INFLATION HEDGING STRATEGIES FROM PROPERTY.

PROPERTY RESEARCH REPORTING FROM LEGAL & GENERAL PROPERTY.



LONG TERM PROPERTY RETURNS

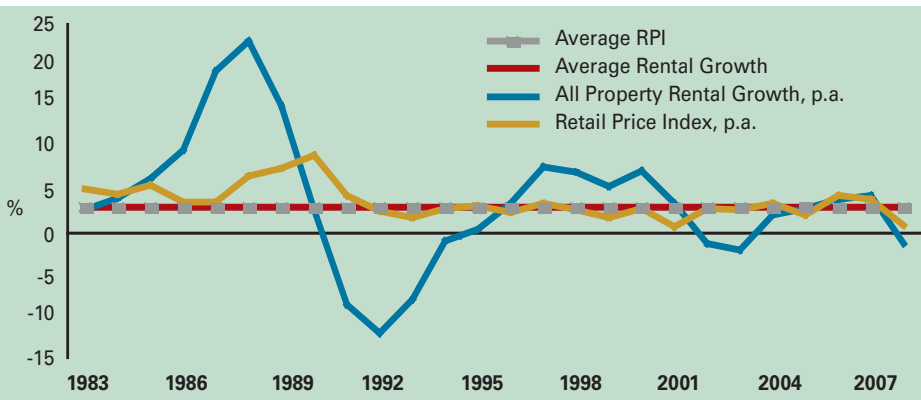


Figure 1. Source: Investment Property Databank (IPD)

As the UK economy looks to emerge from recession, future inflationary pressures have resurfaced as a concern for pension funds, requiring strategies for a more volatile inflationary environment that incorporate sufficient inflation protection. The downside to this approach is that many suitable investments are expensive, with pricing of index-linked bonds and inflation swaps both pushed up by demand. During the recent downturn in commercial property, L&G Property has designed solutions to meet this client requirement, whilst seeking to enable them to benefit from a broader market recovery.

THE LINK BETWEEN PROPERTY INCOME AND INFLATION

Rising property incomes are primarily driven by growth in rents. Figure 1 plots rental growth against RPI inflation over the past 25 years: a typical lease length for inflation-hedging properties. As the chart shows, between 1983 and 2008, rents grew by an average of 3.05% per annum, within a few basis points of 3.13% pa for RPI inflation.

As the above shows, historically rental growth over the long term has closely matched long term inflation. But as Figure 1 also illustrates, the property cycle is alive and well! Rental growth has been more cyclical than inflation, and at times has deviated quite sharply; two examples being the late 1980's and the early 1990's. These deviations pose potential problems to investors who seek to derive inflation protection from investing in a conventional property fund.

The principle of rents fundamentally matching inflation is a straightforward one: rents are a function of the relative demand for and supply of property. Demand comes from growth in the economy and supply from the delivery of new and refurbished space. The two periods mentioned above when rental growth showed a particularly different pattern to that in RPI coincided with major swings in the economy: the UK experienced the classic 'boom-and-bust' which led to a long recession during 1990-91. But it is also clear that there is a substantial lag between movements

in the economy and movements in rents; while in the early 1990s economic growth bottomed out in 1991, rents took a further year before they hit their low point.

FORMALISING THE LINK

Whilst the link between inflation and income growth certainly exists within commercial property, the relationship can become a little strained at times. But property is a diverse asset class, with differing lease lengths, varying tenant risk profiles, and most importantly for investors seeking inflation protection, there are a variety of approaches to contractually structuring growth in rents within leases.

This opens up the opportunity to take commercial property investing one step further than traditional property funds, delivering a return profile similar to very long-dated index-linked gilts or secure index-linked corporate bonds but with a potentially higher income return. The typical UK investment property lease already has upward-only rental clauses, which protect against

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reductions in rent for the length of the lease. Even in the depths of the early 1990's recession, Investment Property Databank (IPD) data shows that the movement in property income remained in positive territory, despite the sharp reduction in market rents, reflecting this downside protection. In addition, Property also offers the ability to structure rental growth to rise in line with inflation over the length of a lease. Such clauses may also include a cap at, for example, 5% per annum, which combines with upward-only clauses to provide an ideal match with a pension fund liabilities' exposure to Limited Price inflation (LPI). So this would mean Retail Price Inflation between 0% and 5% pa.

ATTRACTIVE RELATIVE TO OTHER SOLUTIONS

One of the key attractions to investing in a portfolio of these properties is the additional yield available. These types of funds will seek to deliver a real yield of at least 4% per annum, which compares with index-linked gilt yields of around 1.2%. On a £10 million investment, at current inflation swap pricing this arbitrage generates at least £12 million of additional income over index-linked gilts during the life of a typical 25 year lease.

Another important difference, particularly when compared to current bond-inflation swap solutions, is the residual value of the valuable underlying property asset. Whilst corporate bonds would typically estimate a recovery rate of around 30% in the case of an issuer default, the recovery rate on an equivalent property portfolio is generally twice this at approximately 60%. If a tenant/issuer goes into liquidation the landlord can take the property back to re-let to another tenant.

Linked to the residual value of the asset is the opportunity for a property investment manager

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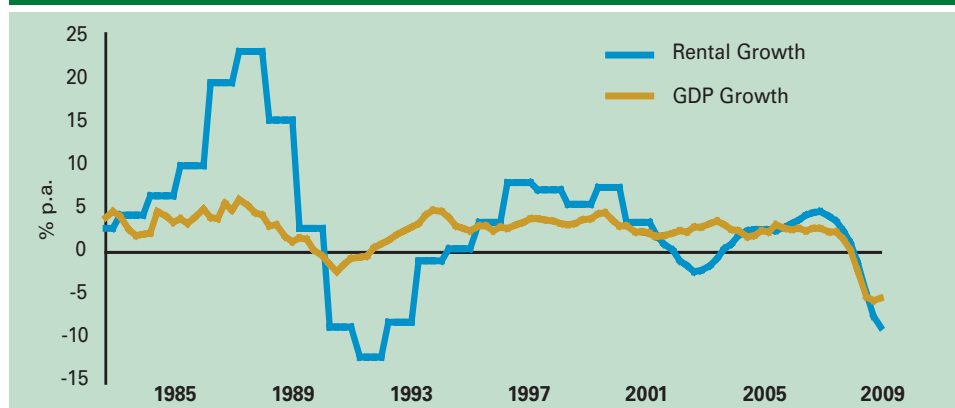


Figure 2. Source: Investment Property Databank (IPD), ONS

to generate alpha through these investments. Choosing assets in prime locations with excellent long-term residual values does not just benefit investors in the case of default.

The value of the bricks and mortar has a real impact as the lease nears its end. An adroit manager might purchase properties where there is an option to perhaps convert an office block to residential, or add a floor, thus releasing additional returns to the fund. Alternatively, it may well be in the best interests of the investors to seek to lengthen the leases to the tenant as the lease length reduces, securing additional cashflow and longer term predictable returns from an existing asset.

LPI INCOME PROPERTY PORTFOLIOS

To deliver these benefits over a long period, it is important that each benefit is carefully structured into a selection of assets. It is important that a portfolio consists of properties whose value is predominantly derived from their leases (so-called "High Lease Value" properties) as these enable an investor to access the index-linked-bond-like characteristics outlined above.

To minimise the risk of tenant default,

the properties are primarily let to government and quasi-government tenants for a minimum of 20 years. In comparison to the average property asset, the values of the assets in such a portfolio are less volatile (approximately half as volatile in fact) and have a longer duration – two characteristics a pension scheme looks for to match liabilities.

Combining these features could enable pension schemes to secure many of the benefits of investing in commercial property, whilst addressing many of their concerns around volatility and weakness in the occupational markets that might have put some off in the past. With the spectre of a potentially more volatile inflationary environment emerging, the explicit link between a portfolio's income profile and inflation gives pension schemes an extra tool in their armoury when building robust portfolios.