

Unlisted property – not as low risk as it might seem

Investors in Australian unlisted property have done amazingly well compared to those unfortunate enough to be holding its listed counterpart over the past year.

The Mercer Unlisted Property Index gained more than 14 per cent versus a loss of around 38 per cent for the ASX/S&P 300 Property Accumulation Index in the year to June 30, 2008, resulting in a difference of an almost unbelievable 52 per cent.

So for a typical balanced fund with 10 per cent in property, the choice of investment vehicle has made around a 5 per cent difference in total returns over the past year. As a result, funds using unlisted property have had a major boost on the league tables that we regularly see in the media.

Even when you take into account differences in risk arising from such things as gearing, foreign currency exposure and property development, this divergence in returns arising from exposures to largely the same property market is, on face value, difficult to understand.

Could unlisted property be immune from the chaos we are seeing in both real estate investment trust (REIT) and equity markets? Can something as superficial as the choice of vehicle really make such a difference to the risks that investors are exposed to?

The allure of unlisted property

So let's look at some of the reasons why unlisted property appears to be such a great investment. The graph shows that unlisted property has provided investors with a much smoother ride than listed property for many years.

The appeal of unlisted property is not limited to just its smoother return history. The correlation of 0.1 between unlisted trusts (measured by the Mercer index) and Australian shares since the mid-1980s is much lower than the correlation between Australian REITs and the Australian share market of around 0.6 over the same period.

So the advocates of unlisted property trusts seem to have a compelling argument: smoother returns and a lower correlation with shares.

On face value, unlisted property trusts appear to be the answer to every investor's dreams.

Can a head-in-the-sand approach be good?

So are unlisted property trusts really so much less risky than REITs? The answer to this question lies in what you mean by risk.

There is no doubt that unlisted trusts provide a smoother return stream than REITs. The reason is that, unlike REITs, valuations are not provided daily on a listed exchange but are done on an appraisal basis. What this means is that valuers put a price on the underlying properties at regular intervals, often as infrequently as once a year.

So when property values are going up or down over time, it is not recognised in the returns of the unlisted trusts until the next valuation is done. In contrast, the values of listed trusts capture what is happening in the property market on a daily basis.

This brings me to a key point: unlisted property trusts have smoother returns largely because the investors only look at the value of their properties from time to time rather than on an ongoing basis like REITs.

So the lower apparent risk of unlisted trusts becomes much less of a positive when you realise that it occurs mainly because you are ignoring what is actually happening in the market.

Can this head-in-the-sand approach really be a better way to invest? Can it really be argued that an investment is lower risk because you value it infrequently rather than on a daily basis?

As any astute investor will tell you, taking a head-in-the-sand approach to investing is not a smart thing to do. There are many times when taking such an approach will lead to disaster.

Reminders of long forgotten disasters

As you may have noticed, there has been a recent spate of unlisted property trusts freezing redemptions.

Some of the more notable include the Macquarie Direct Property Fund, AXA Wholesale Australian Property Fund and Challenger Hybrid Property Fund. AXA has also announced moves to list its fund at the end of this year, citing the need to access greater liquidity for unit holders in the current market conditions.

The recent freezing of redemptions is a timely reminder of the disasters that occurred with unlisted property in the late 1980s and early 1990s.

These disasters showed that unlisted property can be a lot more risky than REITs.

Unfortunately, the names of unlisted trusts that closed their doors in this period like Estate Mortgage and Australia-Wide seem to have disappeared from the collective consciousness of investors.

The lessons of this period largely led to the growth of the REIT market in the 1990s.

After the share market crash of 1987, money flowed into property as a safe haven and returns remained strong for a period. But by 1989, it was becoming apparent that property was to suffer the same fate as the share market. And when that happened, the characteristics of unlisted trusts, which are now lauded by their proponents, became a major problem for investors.

The problem was, of course, the illiquidity of unlisted trusts.

When investors decided it was a good time to get out, the trusts were simply unable to meet redemptions in a market in which it was virtually impossible to find buyers. This resulted in several trusts closing their doors to redemptions temporarily and in some cases permanently. Not being able to get any of your money back is usually a risk that investors want to avoid the most.

In addition to their lack of liquidity, another major problem for investors is the inequity between investors that appraisal-based valuations inevitably cause.

Back in 1989, when it was becoming clear that property was in for a rough ride, smart investors managed to get out early at valuations that reflected a much higher market than the one that applied when they redeemed. Their gain occurred, of course, at the expense of the other investors.

This illustrates another major risk with unlisted property trusts.

When markets are falling, investors who get out early get out-of-date, inflated valuations at the expense of the remaining investors.

Alternatively in rising markets, early investors buy in at lower valuations at the expense of their fellow investors.

So when valuations are occasional, rather than ongoing, there is the risk for all investors that someone else will benefit at their expense.

The additional risks of unlisted property trusts might be worth taking if they provided an 'illiquidity premium' compared to REITs over the long term.

However, as can be seen from the graph, the opposite has been true for most of the available return history.

Choice of vehicle can't eliminate underlying risks

So for those unlisted property investors who might be feeling smug about their great returns over the past year, be aware that what is happening in the underlying property market will in time become apparent in your returns.

To suggest that an investment is lower risk simply because you only occasionally look at the underlying valuation seems like flawed logic to me.

Ultimately unlisted property trusts and REITs must reflect the risks inherent in their underlying investments.

Paul Ireland is the general manager at MLC Implemented Consulting.