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5 asset classes – and the sub-class that tops them all

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The sub class that topped them all? Read on.

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Over the past 10 years, investment returns from the major asset classes have been more modest than in previous decades, but one remains the better bet than others.

Market lore suggests the asset class that produces the greatest return for investors over time is equities. New research from advisory firm Atchison Consultants shows that over 25 years, this is broadly true.

However, the financial crisis of 2007-08 hammered share market performance over the past decade and other asset classes emerged as winners within investment portfolios. The sub class that topped them all? Office property.

Atchison Consultants' research tracks 11 asset class returns over 10 and 25 years. Here is a snapshot of five performances and why office property was in front of the pack.

1. Office property

Shane Oliver, AMP Capital's head of investment strategy and chief economist, explains that "yield compression" has played a significant role in commercial property returns. Its total return for the 10 years to December 2015 was 9.1 per cent.

Yield compression happens when investors bid up prices relative to rents – often in response to low and falling interest rates.

Oliver says that commercial real estate was sold off after the financial crisis, producing higher yields – but since investors have seen capital growth and falling yields.

Return records

Total returns for periods to December 2015

Asset class	10-year return	25-year return
Australian shares	5.5	10.2
Overseas shares	4.9	7.2
Residential property	7.4	9.4
AREITS	2.0	8.7
Fixed interest	6.1	7.8
Cash	4.5	5.5
Managed funds	5.3	8.5
Direct property	8.9	7.9
Retail property	8.7	10.3
Office property	9.1	6.6
Industrial property	8.2	9.5

SOURCE: ATCHISON CONSULTANTS

Return records: total returns for periods to December 2015

Direct property is a category containing the three major commercial property classes – retail, office and industrial assets. As at December 2015, direct property had returned 8.9 per cent a year over the past decade, and an annual return of 7.9 per cent over 25 years.

Ken Atchison, managing director of Atchison Consultants, says the income commercial property produces is mainly responsible for its returns over the past decade.

“The income component is in the order of 7 per cent of that 8.9 per cent return, with around a 2 per cent yield from capital growth,” he notes.

Atchison expects a similar situation to continue for the near future.

“Commercial property is offering a 6 per cent income return, compared with a cash rate of 1.5 per cent. This asset class is appealing to local and international investors because Australia is one of the higher yielding property markets in the world.”

Oliver believes commercial property should continue to do well, provided the economy continues to grow and Australia manages to avoid a recession.

“But performance is unlikely to be as strong as the last few years,” he says.

2. Australian real estate investment trusts (AREITs)

At the other end of the scale, Australian real estate investment trusts (AREITs) turned in just 2 per cent returns on average over the past decade, but returned a much healthier 8.7 per cent over the past 25 years.

Atchison blames the 10-year result on the effect of the financial crisis. Prior to the crisis, many AREITs were very heavily geared, which impacted returns from these trusts. At the peak of the crisis, the banks called in loans and forced AREITs to raise new capital.

“They did this in a major way and at deeply discounted prices, so the 10-year result captures that period,” Atchison explains. “It was brutal.”

In terms of future returns from this asset class, Atchison notes that AREITs have maintained more conservative gearing levels in recent times, which should help support future returns. He notes AREITs on average have gearing levels of around 30 per cent, whereas before the financial crisis gearing in some trusts was as high as 60 per cent.

“Double digit returns in the immediate future are unlikely,” he says.

“Having said that, the share market was up by 6 per cent in July, which is pretty crazy.”

3. Residential property

Atchison’s research shows residential property investments produced a healthy return over both 10 and 25 years, delivering 7.4 per cent a year and 9.4 per cent a year respectively. Residential property also experienced volatility of just 3.8 per cent over the 10 years. (Shares experienced volatility of 14.3 per cent over the same period.)

Property’s strong returns and low volatility raise the question whether investors should rethink their strategies on asset allocation.

Atchison notes the increase in migration – leading to population growth and higher demand for housing – is one reason why residential property investments, excluding owner-occupied residential properties, have done well. Nevertheless, he still expects shares to do slightly better than residential property over the next three years.

4. Australian shares

This popular asset class delivered a return of 5.5 per cent a year over the past decade and 10.2 per cent a year over the past 25 years.

Greg Einfeld, a director of Lime Actuarial, explains the poor sharemarket performance of the past decade is due in part to sector-specific circumstances.

“Banks needed to raise capital and have seen slowing credit growth,” he says.

“Miners and energy companies have seen reducing commodity prices and supermarkets have seen increasing competition from new entrants.”

Over this period, Einfeld notes discretionary retailers have also seen price deflation and new online competitors.

“On top of this, most industries are experiencing slowing economic growth, low wage inflation and therefore sluggish demand, and digital disruption.”

5. Fixed interest and cash

Bonds have performed well off the back of declining interest rates. Cash returns, however, are linked to short-term interest rates, and so have been weak.

Atchison’s research shows that over 10 and 25 years, fixed interest returned 6.1 per cent a year and 7.8 per cent a year respectively, whereas cash has returned 4.5 per cent and 5.5 per cent a year over the same timeframes.

What lies ahead?

Over the past 10 years, the returns from the major asset classes have been more modest than in previous decades.

Louise Lakomy, director of financial advice firm Crystal Wealth Partners, expects this trend to continue.

“Factors affecting the major asset class returns over the next 10 years will include a continued environment of low economic growth, low inflation and low interest rates,” she says.

Lakomy adds that low growth and low inflation will make it more difficult for companies to increase profits. “So broadly, equity markets will be challenged,” she says.

In the absence of a major economic shock, Einfeld believes overall future economic conditions are likely to be a continuation of those seen in recent years.

“Interest rates will continue to fall and large companies will struggle to grow profits,” he says.

“As a result, the outlook for most asset classes looks weaker than it has looked historically. Property may buck the trend, if rents hold up and interest rates remain low.”

“Shares in smaller companies also represent an opportunity, however only for investors who are skilled at picking the right stocks,” adds Einfeld.

“Shares in large companies, cash and fixed interest are unlikely to achieve the returns to which investors have become accustomed.”