

Investing begins at Home

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Australia's large institutional investors have not invested meaningfully in the residential property market. Although analysis suggests these investors would benefit from an allocation in this asset class, product development has not been supported.

While over the past 18 months house prices have risen, the residential property market has performed very well for an extended period. As shown in Chart 1, over the past 25 years returns from residential property have been high compared with other asset classes while also being relatively stable. Rental yield over this period has been 4.5% p.a. with 8.6% p.a. capital growth. Yield which is similar to Australian shares has been lower than commercial property and government bonds. From an investor's point of view residential property should be seen as an income producing asset class with potential for significant capital gains.

Despite strong returns institutional investors have not participated in the residential market. Australia's major institutions are superannuation funds, most of which are defined contribution. According to APRA, at 30 June 2009 the superannuation market was comprised of 81% defined contribution and 19% defined benefit funds. Investment strategies vary for different types of funds.

In defined contribution funds investment risk lies with the member whereas in defined benefit funds employer sponsors bear this risk. Defined benefit funds invest more in assets which offer inflation protection as liabilities are often linked to CPI. As shown in Chart 2, residential property is attractive for defined benefit funds as rental yield has provided inflation protection. Defined contribution funds can fully exploit the long term capital growth on offer from residential property.

Another factor due to impact superannuation funds will be the growing weight of pension payments. Since the Superannuation Guarantee was introduced in 1992 the superannuation market has grown to over \$1 trillion. Pension liabilities will be higher compared with recent decades as those who have been accumulating balances under the guarantee for an extended period retire. Funds with members moving into retirement will be seeking inflation protection for pension payments. This trend has now commenced and will increase in the next decade. Where income returns are desirable residential property delivers a moderate level of rental yield while not sacrificing the potential for capital growth.

If residential property investment has met institutional investment goals historically then why has it not become an established part of their portfolios? According to APRA the default investment strategy of superannuation funds allocates approximately 10% to listed and unlisted property. The vast majority of this is in the traditional commercial property sectors of office, retail and industrial. What little residential investment there is typically is in developments, not for long term rental.

There are some key reasons why the market has not attracted institutional investment. Principally, fund managers have not been successful in structuring products which deliver an acceptable level of return. This is due to difficulties associated with achieving sufficient portfolio scale and efficiently managing the properties to maximise rent after expenses. Large scale residential asset ownership is uncommon in Australia so accumulating assets, which are usually small, can be a slow and expensive exercise. If these assets are diversely located then managing the tenants is similarly expensive. Government charges for stamp duty and land tax are also a barrier.

Overseas markets have had some success in structuring products by investing in large residential blocks which localises assets and tenants. This is most prevalent in the US where over 20% of institutional property investment is in residential property, principally multi-family units. Until such products are developed in Australia residential investment will be limited.

Concerns have been expressed about Australia being in the midst of a housing bubble which will end with a large fall in prices. These concerns are largely based around affordability, household debt and comparisons with overseas housing markets that have experienced a bubble and bust scenario. Higher prices and increased interest rates have prompted a fall in housing affordability. Nevertheless growth in employment, including salary growth, offset by interest rate increases, have resulted in mortgage repayments remaining constant at 30% - 35% of household income. On another measure, in June 2010 Ric Battellino of the RBA noted that on a nationwide basis Australia's house price to income ratio of 4.3 times was "not that different to most other countries".

While household debt levels are at historical highs the RBA has noted that available data suggests "increased debt has mostly been taken on by households which are in the strongest position to service it." The top 50% of income earners account for around 75% of outstanding household debt.

Countries that have experienced a bubble and bust in residential markets include the US, Spain, UK and Ireland. These countries have suffered from high levels of bank and government debt, excessive residential property supply and poor employment growth coinciding with their market collapse. In contrast Australia has not experienced any of these problems to any significant degree and is further supported by strong migrations flows and a shortfall in supply.

Australia's residential property is still a sound investment proposition. While investment by institutional investors has not occurred in Australia historical experience suggests that it has a beneficial contribution in portfolios.

