Alternative investments

1. Introduction

1.1. Chapter overview

For some of us property is the most familiar of all asset classes. Many people own property and are aware of the returns that can be made from property investment as well as the pitfalls.

In this chapter you will learn the factors that influence property prices and also the problems associated with property as an asset class. Because of its physical nature there are difficulties associated with property investment which are not associated with investments in shares or bonds.

Property investment can even be **indirect**; for example, through **property bonds** where you have no direct involvement in the purchase or maintenance of a property but receive returns based on the rental income generated.

Property investments will form part of any well diversified investment portfolio, and the chapter reviews the correlations between various investments.

But these are not the only alternative investments. The chapter will also cover other alternatives, such as chattels and private equity.

1.2. Learning outcomes

On completion of this module, you will:

Residential and commercial property

- 14.2.1 Distinguish between the commercial and residential property markets
- 14.2.5 Identify the risks associated with property investment, both direct and indirect

Property investment

- 14.2.2 Explain the rationale for investing in property
- 14.2.7 Identify the transaction costs associate with property investment
- 14.2.3 Identify the main investors in the commercial property market and the characteristics of the principal commercial property sectors
- 14.2.4 Explain how the direct commercial property market works with regard to: ownership and lease structures; buying and selling; costs, the valuation of property and investment performance measurement
- 14.2.6 Explain the routes to indirect property investment
- 14.2 8 Describe the role of the Investment Property Databank indices in the market

Other alternative investments

- 14.1.6 Explain the characteristics and risks of investing in ‘alternative’ investments, including gold and antiques

2. Residential and Commercial Property

2.1. The UK Residential Property Market

The UK has high levels of owner occupancy and this trend shows no signs of changing. Getting on the housing ladder is becoming increasingly difficult in many parts of the country with residential property prices rising at a rapid pace over many years.

There is an expression 'as safe as houses'. However house prices can fall as well as rise. In the 1990s when interest rates rose the property market fell in the UK and some parts of the country were faced with negative equity as the value of their homes fell below the balance of their mortgages.

2.2. Commercial property

Under the heading of commercial property we can identify the following areas:

- Retail shops
- Offices
- Industrial units, factories and warehouses
- Hotels

Factories and warehouses tend to produce the highest yields, with shops producing the lowest yields. Potential returns come from rising rental income and capital gains.

A key risk in commercial property is the level of vacancies which are termed 'void periods'. Void periods arise when suitable tenants cannot be found and so income streams stop, leaving all expenses to be funded by the owner including the borrowing costs. Commercial property is also even more illiquid than residential property. This is another major area of risk.

Table 13. Summary

	Residential property	Commercial property
Direct investment	Second homes, holiday homes, buy-to-let	Large initial outlay restricts investment to institutional investors
Tenancies	Typically short renewable leases	Long term contracts
Repairs	Landlord responsible	Tenant responsible
Returns	Rent linked to house prices	Rent linked to income potential

2.3. Features of the property market

The property market has certain characteristics and risks that differ from other financial markets.

Specifically, these are:

- The property market is very **segmented** and is comprised of a number of different sub-sectors, e.g. residential, commercial and agricultural. This is unlike the market in shares or bonds where the investment vehicle is relatively standardised compared to property/real estate
- It is **indivisible**: property is difficult to split-up into smaller 'bundles', potentially excluding smaller investors from participation

- Transaction **costs are higher** than for other investments: for example, lawyers, estate agents and land registry charges
- It is **decentralised**: there is no central market place for property, which makes it difficult for investors to compare investment opportunities in different parts of the country or across borders
- It **requires maintenance**: the costs associated with repairs and maintenance can be a significant factor in the overall cost of a property investment
- It is subject to strict **government regulation**: as well as specific legislation, e.g. Housing Act, Rent Act etc, there are also tax implications when buying/selling property, i.e. higher stamp duty, income tax on rental income and capital gains tax on the sale of an investment property

3. Property investment

3.1. Direct vs. indirect property investment

Direct property investment is buying the freehold or leasehold of an individual property and holding it as an investment. If funds allow, perhaps a portfolio of properties can be constructed in this way.

Indirect property investment is investing in a property fund such as:

- Traditional Property Fund
- Real Estate Investment Trust (REITs)

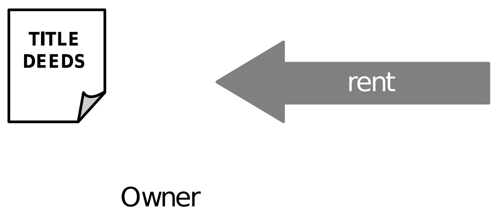
Indirect property investment has many benefits:

- Much more liquid investing in a fund rather than buying an actual property
- Achieve better diversification
- Lower buying costs than buying a real property

3.2. Direct property investment

Direct property investment means having a direct interest in the property (e.g. building and/or land) itself. Investors achieve a return by developing the property and receiving rent and capital appreciation in return.

Direct property investment:



Costs of buying, selling and owning property

As you'll know, if you've bought or sold property, it is an expensive asset to buy, sell and own. Typical costs include:

- Legal costs
- Stamp duty land tax
- Survey costs

- Estate agents costs
- Maintenance costs

Property is also very expensive so that it is hard to achieve much diversification for your investment. It can also vary in its liquidity from being able to quickly sell to taking months or years to find a buyer.

Commercial property

As mentioned earlier, under the heading of commercial property we can identify the following areas:

- Retail shops
- Offices
- Industrial units, factories and warehouses
- Hotels

Factories and warehouses tend to produce the highest yields, with shops producing the lowest yields. Potential returns come from rising rental income and capital gains.

A key risk in commercial property is the level of vacancies which are termed 'void periods'. Void periods arise when suitable tenants cannot be found and so income streams stop, leaving all expenses to be funded by the owner including the borrowing costs. Commercial property is also even more illiquid than residential property. This is another major area of risk.

Price multiples – commercial property is often priced / valued using simple price multiples of its rental income e.g. a multiple of 10 x rental income of £100,000 pa gives a value of £1,000,000. Clearly this is only a 'guesstimate' of the true value.

Returns from commercial property

In the commercial property market the rental yield is a key measure of return. Remember that the word yield just means return and is used in the commercial property markets.

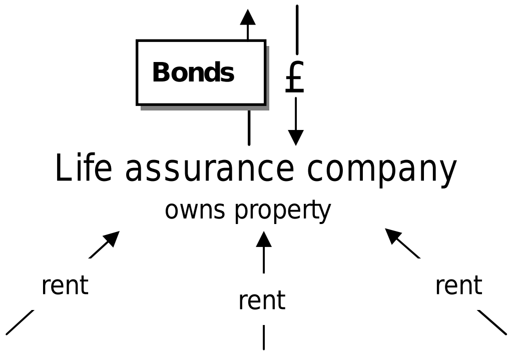
$$\text{Rental Yield} = \frac{\text{Gross Rent - Expenses}}{\text{All costs of buying property}}$$

3.3. Indirect property investment

Indirect property investment involves buying shares, or bonds, issued by a company which has invested in land and/or buildings itself.

Property bonds

Property bonds are issued by life assurance companies where the coupons are linked to the underlying value and rental income from the property in the fund.



As illustrated above, the dividends or coupons payable on property bonds are secured on the rental flows from the property portfolio.

Property income certificates

Gives indirect exposure to the income and growth of property. The certificates are often linked to a specific property.

Real Estate Investment Trusts (REITs)

Real Estate Investment Trusts have been around in the US for many years but were only introduced into the UK in 2007. They are an indirect way to invest in commercial property.

REITs are a form of investment trust and have the same characteristics, such as:

- They are a pooled investment
- They are closed-ended funds
- Their shares can fluctuate on the market, causing them to be either at a premium or at a discount to their net asset value
- They are allowed to borrow to invest i.e. to gear up

REITs do have a number of characteristics of their own to mention:

- They are a plc listed on the LSE main market or AIM
- At least 90% of their profits must be paid out as dividends (net of a 20% withholding tax)
- REITs also pay no capital gains tax within the fund

- No investor can own more than 10% of the shares
- At least 75% of assets and income must be directly related to property
- At least three properties must be owned with no single property representing more than 40% of total assets
- The REIT can borrow, but must meet an interest cover test to ensure it is not too highly geared

3.4. Property derivatives

Introduction

A property derivative is a financial contract that is typically written based on a real estate property index, which enables investors to gain exposure to the property market without having to transact in physical property and all of the problems that this may entail.

The index displays aggregate real estate market information, as opposed to an individual asset, and thereby gives a broader, more accurate representation of underlying market performance.

The most common benchmarks used for these contracts in the UK are the various indices published by the **Investment Property Database**; for example, the IPD Annual Index.

The IPD indices are also used in 15 European and 7 global markets.

Uses of property derivatives

Property investors use property derivatives much like any other derivative user because they provide the ability to:

- Gain or reduce exposure to the property market
- Hedge positions held in the underlying assets
- Speculate on the property market
- Quickly and efficiently alter the composition of a portfolio, for example switching from retail property into commercial property

4. Other alternative investments

4.1. Chattels

Chattels are tangible and moveable objects that are sometimes referred to as collectibles.

Picture for a moment the ‘Antiques Roadshow’ TV program. People bring all kinds of paintings, furniture, stamps, toys, plates and other items to be valued for the experts.

Internet markets such as eBay illustrate many of the opportunities and risks of investing in chattels.

There is typically a negative correlation between chattels and more conventional assets, i.e. they perform better when other assets perform poorly. Benchmarkes also exist for various collectibles, for example:

- HAGI indices – Historic Automobile Group International for classic cars
- SG100 – for the 100 most popular stamps
- Baldwins Coin Index
- Liv-ex 100 – Fine wine index

Capital gains on chattels have their own exemption – up to £6,000 per tax year. Gains above this are subject to capital gains tax.

5. Alternative investments: summary

5.1. Key concepts

Residential and commercial property

- 14.2.1 Distinguish between the commercial and residential property markets
- 14.2.5 Identify the risks associated with property investment, both direct and indirect

Property investment

- 14.2.2 Explain the rationale for investing in property
- 14.2.7 Identify the transaction costs associate with property investment
- 14.2.3 Identify the main investors in the commercial property market and the characteristics of the principal commercial property sectors
- 14.2.4 Explain how the direct commercial property market works with regard to: ownership and lease structures; buying and selling; costs, the valuation of property and investment performance measurement
- 14.2.6 Explain the routes to indirect property investment
- 14.2 8 Describe the role of the Investment Property Databank indices in the market

Asset allocation

- 14.1.6 Explain the characteristics and risks of investing in ‘alternative’ investments, including gold and antiques

Now you have finished this chapter you should attempt the chapter questions.