With a raft of second-line local stocks offering growth upside and higher yields, should investors be adding to the shares they already own - or with interest rates at historical lows - is buying residential property a better strategy?

WHERE TO INVEST – property or shares?

BY MARK STORY

With residential property investments being highly street and market-specific, making sweeping conclusions about this asset class is problematic at best. But owing to the near moribund nature of our equities market since the global collapse of 1987, residential property investments have outperformed local shares by a country mile.

The 10.4% rise in last year's national house price index compares favourably with a 5.3% drop in the NZSE40 Capital Index. In the year to June, the official house price gain as calculated by Quotable Value NZ was 14.2% - inflation over the same period ran at only 1.5%.

A longer-term view paints a similar picture. In fact, since late 1996 national house prices have risen 17.2% while the NZSE40 Capital Index has fallen 17.6%. Even factoring in Gross Index returns (including distributions) the stock exchange has still underperformed house prices in Wellington and Auckland since late 1996.

Over-exposure

Not surprisingly, Kiwi investors have considerably more exposure to residential property than their global counterparts, and Westpac household wealth statistics reveal just how much. Since 1989 the value of residential housing increased by $79 billion to $191.8 billion, while the total value of the share market rose by $18.9 billion to $41.5 billion.

But as any client advisor will tell you, a bullish economic environment typically provides the strongest leverage to equity market growth. So with the New Zealand sharemarket beginning to look much healthier over recent months – it's worth asking whether the property argument (over equities) still stacks up?

There's a real danger in trying to differentiate between a cycle and a sustained trend. But if more recent figures are any proxy, the cycles could be turning. Residential property prices

"RESIDENTIAL PROPERTY INVESTMENTS HAVE OUTPERFORMED LOCAL SHARES BY A COUNTRY MILE"

increased by 16.2% in the year to August. Interestingly enough, over the same period the NZSE40 delivered a (gross) return of 15.5% (NZX50 16.8%) - while the return from listed Property Index was around 10.5%.

Cycles turning?

Full year comparisons will make for interesting reading, and if we're interpreting market signals correctly, we could see a rotation out of property. What history teaches us about cycles is that within bull markets, yields compress. Conversely returns from equities, in a good year of economic growth, will outperform property as a subset.

So with most brokers reasonably bullish over the economic outlook, and global recovery gaining pace and breadth - especially within the US and other countries like Japan - would it be better to take a punt on local (or offshore) shares or plough more money into property?

With so many investors disenchanted with the share market and other financial instruments, local appetite for residential property is hardly surprising. And as Kiwi investors are more likely to invest in the flat around the corner than listed property, the rise in the proportion of housing stock owned as rental properties also comes as no surprise.

Warning signs

From where Mark Brighouse sits as CIO with Arcus Investments it's unclear whether the future global economic climate favours equities over property. But with equity markets expected to benefit from strong earnings, he says residential property could be the first market to cool.

Adding to a cautionary air on residential property, the Reserve Bank Governor Dr Alan Bollard recently warned investors that a better performing share market, together with higher debt-to-income ratios - plus slowing net immigration - could severely staunch the "bull-run" in residential housing.

While that's true, Brent Procter investment advisor with PriceWaterhouseCoopers says the sentiment being expressed by many economists and banks - that the housing boom will keep rolling for a while yet – is making it hard for his clients to look beyond residential property. Given the buying frenzy we're currently witnessing – which saw Barfoot & Thompson deliver the highest sales for any September on record – investors can be forgiven for doubting the residential property party is coming to an end.

Not surprisingly, bank appetite for residential housing lending doesn't seem to be letting up either. In fact, in the 13 months to 31 July, bank housing loans rose by $8.7 billion – that's an additional $30 million every working day.

"IT'S BETTER TO HAVE A LITTLE BIT OF MEASURE EVERYWHERE THAN PUT ALL YOUR MONEY INTO PROPERTY"

Slowing demand?

The figures are yet to confirm it, but anecdotal evidence coming out of the country's largest market, Auckland suggests the demand for residential property could be slowing. Talk on the street suggests developers are currently witnessing a notable downturn in demand for residential rentals, especially within the apartment market.

But there's a danger, argues Derek Howarth with Christchurch-based broker, Lawrence Milton and Howarth in assuming property is one generic market that always moves in unison. For example, while the heat might be coming out of the Auckland market, Christchurch is doing gang-busters – thanks somewhat, says Howarth to Australian investors. He suspects what's luring Aussie buyers is the return yield, cheap money and no capital gains tax. "It's better to have a little bit of measure everywhere than put all your money into property," says Howarth. "Nevertheless, I expect the property market to continue trending up for at least the next 12 months."

What could herald a warning on the residential property front, flags BNZ chief economist Tony Alexander is a 4.8% drop (to $327) in the average rent for places freshly let for September, and a 4% decline in the number of properties freshly let during the same month. Adding to this warning sign, hints Alexander is the REINZ house price data that finds the ratio of annualised rents to selling prices at a record low (for the series) of 5.7%.

What would trigger a moment of truth for residential property investment, argues Brighouse is interest rates gravitating back up

LISTED PROPERTY VALUES - PUBLISHED RATINGS

	Price Target	Price Gross	Forecast Yield
OUTPERFORM			
Calan Healthcare Properties Trust	$0.83	$0.97	9.6%
NEUTRAL			
AMP NZ Office Trust	$0.80	$0.85	8.6%
Capital Properties	$0.88	$0.90	10.2%
Colonial First State Property Trust	$0.98	$1.02	9.5%
Kiwi Income Property Trust	$1.05	$1.04	8.2%
National Property Trust	$0.92	$0.96	9.7%
Property for Industry	$0.95	$0.91	7.5%
Urbus Properties Ltd	$0.90	$0.91	10.0%
Urbus Properties Ltd (CN)	$0.89	$0.89	9.6%

Source: FNZC estimates

to around 9% or beyond. “Interest rates are a big driver and you shouldn’t assume they’ll always stay low,” says Brighouse.

Fundamentals rule

Before tossing up between equities and property, he urges investors’ to return to time-honoured fundamentals. For example, given an investor’s age, need for income and appetite for risk, what asset classes should they be looking at? With so much of their total wealth invested in their home, Brighouse believes many Kiwis would be better served paying down more of their mortgage than investing elsewhere.

If you’re paying your mortgage off at 7%, you’d have to be getting a total return of 11.5% elsewhere to be doing better. Paying off your mortgage doesn’t increase your exposure to property. But Brighouse says it certainly makes the investment easier to hold through difficult times. “Take care not to re-leverage yourself just because you have made some inroads into your mortgage debt.”

Procter shares similar sentiments, he says many investors over-capitalise on the family home with the mistaken view they’ll one day unlock capital gains. “It’s not uncommon to find couples in their early to mid 40s who have a big mortgage and little or no savings. There’s a lot of talk about cashing-up the family home years down the track and reinvesting surplus cash, but I seldom see it happen,” says Procter.

Portfolio approach

Once investors have made a sizeable dent in their mortgage is an ideal time, according to Brett Wilkinson client advisor with Direct Broking to start diversifying assets. Taking a portfolio (or diversified) approach should adequately balance an investors exposure to any single asset class. But determining the right split, he adds depends on risk and return inputs. “Investors need to think of a share portfolio in much the same way as property produces income and capital growth over time, and keep their hands off it.”

So assuming investors take a portfolio approach to investing, how much exposure to property should they really have? From

STOCKS RECOMMENDATIONS

Source: Macquaire Financial ServicesYield portfolio

Company	**Forecasted CPS**	**Gross Div yield %**
Contact Energy	21.8	6.8
F&P Appliances	74.0	7.6
Capital Properties	9.0	10.2
Powerco	16.0	9.4
Steel & Tube	25.5	10.4
Average Dividend yield	**8.9**	

Value portfolio (As at 12 September)

Company	**Under valuation**	**Forecast 2003 PER**
Fletcher Building	30%	9.4
Fletcher forests	24%	34.8
GPG	18%	n/a
Waste Management	16%	13.6
Powerco	5%	10.1
Telecom	36%	11.4
Average under valuation		**22%**

Wilkinson's perspective, this will vary depending on the investor and the property exposures they already have. As a general rule, he says someone without any property exposures, other than a family home or who's over 50 might have anything from 10% up to 25% exposure to property shares.

Riding the dips

It's likely over the long-term that every asset class will have its day in the sun. For example, Procter witnessed renewed investor interest in shares when the market started rallying earlier this year. Nevertheless, he says too few investors are prepared to break with their existing comfort-factor and gear-up (borrow) on equities – even when they're looking undervalued.

There are signals, Procter adds that last April's swing to equities could be coming off the boil. With residential property having distracted funds, it's hardly surprising that NZX turnover in shares has been down. "While most investors feel pretty good about their recent returns from shares, there's a feeling that equities are looking fully valued at current levels."

So with both equity and property sectors looking over-heated, individual stock and property picking is harder than ever. That's why Brighouse believes investors should be prepared to ride the dips, spread risk, and not get too hung-up on short-term technical issues that drive capital market sentiment.

He believes investors will only discover the right asset allocation once they've assessed their own individual requirements, the need for income versus a leverage into growth assets, and the time-frame they're investing for.

Long-term approach

Here are some obvious considerations. As timing markets and cycles is something even "so-called" experts struggle with, he suggests investors take a long-term approach to both property and equity assets. Step one for investors', he adds is to start marrying both short and long-term income needs with the underlying fundamentals that each asset class offers. "Any asset is only worth the income it generates over time, and the cash-flow it earns," says Brighouse.

“INVESTORS WILL ONLY DISCOVER THE RIGHT ASSET ALLOCATION ONCE THEY’VE ASSESSED THEIR OWN INDIVIDUAL REQUIREMENTS”

It’s realistic to expect the long-term income streams from either property or shares to grow faster than inflation. The key question though is by how much? Shares probably have good leverage to nominal GPD growth, whereas property is strong related to disposable income growth. But given that Kiwi investors are much more willing to mortgage property than shares, the leverage element from property is more common.

Liquidity factor

That’s true, but Wilkinson says the liquidity-factor associated with (most) shares makes it considerably easier to partly sell-down when there’s an unexpected need for cash. “While you can sell a parcel of shares overnight, you just can’t sell the front porch within a property investment to pay for a family holiday or to upgrade the family car.”

Meaningful comparisons

To ensure investors make meaningful comparisons between asset classes, Wilkinson says it’s important to understand the time-frame a return was delivered within, and always take a total return view to ensure you’re comparing apples with apples. For example, beach front properties have been an outstanding performer over the past three years, showing an 18%-plus compound annual growth. “This is hard to beat, but a comparison with the average price over a ten year period shows equities can perform well, particularly when dividend income is added to the equation,” says Wilkinson.

LPTs

Like Wilkinson, Procter and Brighouse agree that one of the best ways for smaller investors to get good exposure into property– with strong liquidity, better diversification by both tenant and property mix - without needing a significant capital outlay is through listed property trusts (LPTs).

As a yield-play (offering nominal growth upside) the listed property sector is now off the boil. Broker, First NZ Capital expects the sector to continue struggling against the broader market. In fact, of the nine LPT’s covered in its recent property report, the broker has an outperform recommendation on only one (Calan Healthcare). But even at between 7.5% to 8% the average yield still outperforms the average dividend yield of all NZ stocks, currently fractionally over 5%.