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Dazzling returns divide the experts

Unlisted funds Top performers are delivering 10 per cent returns, but some warn they could be dangerous, writes **Duncan Hughes.**

Top-performing unlisted commercial property funds are returning about 10 per cent a year, or about four times one-year bank term deposits and Australian 10-year bond yields.

That makes funds with strong and sustainable yields an attractive investment for those seeking income, particularly in an era of increasingly volatile equity markets, say certified financial advisers.

Real estate rents, which are also a popular alternative source of income, are falling in many postcodes because of oversupply and fewer people heading off to mining centres such as Perth and Darwin.

Residential property yields (annual rental income as a percentage of the value of the property) are averaging just over 4 per cent in Australian capital cities for apartments and around 3 per cent for houses. That slips about two percentage points after the deduction of costs.

"I'm feeling very comfortable with commercial property [funds]," says David Bryant, chief executive of Australian Unity, which has more than $7 billion under management, about prospects for the sector.

Australian Unity's HealthCare Property Trust, which invests in hospitals, clinics and other buildings associated with health, last year had a yield of about 7 per cent and capital growth of more than 5 per cent.

Fears that rising supply and softening demand will slow growth in unlisted commercial property funds are misplaced, says Shane Oliver, head of investment strategy at AMP Capital, because total new office supply is expected to peak.

Slowing economic growth and falling interest rates will benefit the sector because they will strengthen demand for yield, Oliver says. AMP, which has about $156 billion under management, predicts the Reserve Bank of Australia will cut official interest rates to 1.75 per cent in the next six months.

"I think recent global developments – such as big falls in major bourses – have added to the case for another RBA cut," Oliver says. "If there is to be a recession, it would be different – but I think a recession will be avoided."

Adrian Harrington, managing director of Folkestone Funds Management, says investors need to focus on total return (a combination of yield and capital growth).

He says investments need to be carefully chosen so they continue adding value to the fund as economic conditions change.

"The current focus on yield may not entirely compensate investors for loss of capital down the track if yields blow out, or a specific property has tenancy risks if it becomes uncompetitive due to age, location or amenity," Harrington says. "When asset prices are being driven by unprecedented liquidity being injected into the financial system, rather than underlying real estate market fundamentals, we are in uncharted territory. Investors need to be cautious."

The unlisted sector includes core and non-core funds. Core funds offer lower risk, with constraints like a 20 per cent limit on development property and a 50 per cent limit on gearing (borrowing to invest).

Total core fund return for the year was more than 7.6 per cent, according to the Property Council of Australia/IPD Unlisted core Retail Property Fund Index.

Non-core funds are unrestricted by these investment conditions. Total return for 2015 on the sector's $2 billion of assets was more than 15 per cent, according to the index.

Long-term investors in the sector saw their fund performance take off before the global financial crisis in 2008 and then come down like a high-rise demolition, with prices crashing by more than 20 per cent.

Regulators analysing the shakeout found fault with many funds' pricing of assets, excessive borrowings and poor communication with investors. The Property Council of Australia claims the lessons have been learnt and that transparency, disclosure and strategies required to achieve high performance are continuously disclosed.

Upbeat: Australian Unity chief David Bryant, left, and Warren Ebert, managing director of Sentinel Property Group. PHOTOS: JOSH ROBENSTONE, GLENN HUNT

Brendan Shannan, a certified financial planner and director of JP Wealth Management, has worked with investors seeking redress for losses caused by trust collapses and frozen assets. Five property funds with nearly $400 million remain frozen after the GFC, according to regulators.

Shannan says investors need to remember that a trust is a complex legal structure with a potentially conflicting relationship between its manager/administrator or responsible entity and asset manager.

"There are several cases where investor interests have taken the back seat to the managers," he adds.

Shannan says investors need to seek independent expert guidance as well as check the fund's constitution, regulatory authorisation, manager's record and asset allocation. Investors also need to consider their risk tolerance, particularly as property is "essentially illiquid".

"It is usually the unsecured investors that are unprotected when property values fall," Shannan says. "That means investors have little option but to ride it out and hope for the best since fund withdrawals, by this stage, are usually frozen."

Folkestone's Harrington says: "It is imperative that investors identify and qualify the risk in their property portfolio. Factors such as supply and demand, strength of lease covenants, duration of leases and rent review remain fundamental to the assessment of risk. Answers to these will be critical in the investment decision to either buy at this point in the cycle or sell assets to take advantage of investors who are becoming increasingly aggressive in their requirement to deploy capital."

He recommends gearing of no more than 50 per cent based on loan-to-value ratio covenants from a lender of 60 per cent, which provides flexibility in a market downturn.

"A priority for all investors is a well-diversified portfolio. Bought well, non-residential property has a key role to play in a mixed-asset portfolio."

Investors should also look for a clear investment strategy, a structure they understand, transparent and fair fees, quality assets and high levels of disclosure, Harrington says. Some managers have big borrowings, which investors need to be aware of before committing.

People who criticise [high gearing] are dickheads.
Warren Ebert, Sentinel Property Group

Warren Ebert, managing director of Sentinel Property Group, has six of the 10 unlisted non-core retail property funds showing the highest performance in the 12 months to the end of December. The flagship Homemaker Trust returned about 130 per cent. Fund gearing is between 50 per cent and 65 per cent.

"I love it and it makes sense," Ebert says about borrowings.

"People who criticise [high gearing] are dickheads."

Ebert claims the important numbers are cash flow – which comes from rents – and interest cover, which is how easily a company can meet payments on borrowings.

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