

Friday, 21 December 2007

Friday, 21 December 2007 was for most people the last working day prior to the Christmas break and, coincidentally, two companies chose this date to release bad news relating to their property funds.

The first piece of news was not particularly surprising as Clerical Medical finally announced that they had been forced to “reprice” their property fund which saw it fall by 6% in value. If you read our previous bulletins it is clear that this is something we thought was inevitable, and we were surprised that Clerical had waited for so long.

However, within the same announcement they confirmed that they had also “down valued” their fund by 11.7% making a total fall of 17.7% overnight!

This total loss is shocking when you consider that their fund is classed as low risk. This fall in one day is greater than the biggest one day loss ever suffered on the UK stockmarket.

Friends Provident announces a block on withdrawals

Our previous bulletins had been suggesting it was possible that if the commercial property downturn continues then fund managers would be forced to stem the outflow of money from their fund by putting a block on anybody wanting to withdraw their cash. Whilst we always knew that it was a possibility, we still felt that it would be highly unlikely to happen in reality.

The news that Friends Provident had actually done so was a big surprise and it is difficult to predict how investors will react.

Whilst these two announcements have little impact on the assets that Applewood manage, as we have very little money left in either of these funds, it may have a knock on impact on other property funds where we have clients invested.

What is the outlook for property?

One of the fundamental Applewood principles is that “we cannot predict markets”, but unfortunately in this case not only can we not predict markets, but we cannot work out where we are currently at.

The valuation of a property is a matter of opinion rather than fact until the property is actually sold and the proceeds are turned into cash. As Invista Real Estate Management (the former Halifax Insight property team) explained in their recent trading update “the sector is going through a difficult period, with very little market activity on which to base definitive trends”.

Unfortunately we have not been able to find a single fund manager or commentator predicting positive returns in the near term, and it is our opinion that returns could vary anywhere between 0% over the next 18 months and a capital loss of 20%. A capital loss of 20% would equal approximately a 12.5% loss after the rental income has been offset.

What is the outlook for property funds?

In some cases, the share based property funds have already seen falls of 40% and many people believe that these are now oversold. We would recommend retaining 100% of share based property funds, which includes all property unit trust funds.

The UK bricks and mortar property funds could unfortunately become “forced sellers” and perform worse than the market overall. In a buyers market they may be forced to sell their best properties within the best sectors and retain their worst. It is currently impossible as an adviser to recommend the prospects of one company’s fund over and above another, as we have no up to date information on the amount of redemptions they are receiving or their current approach to valuing properties.

The situation for overseas property is different and we do not recommend reducing your holdings in international property funds.

Will other funds stop encashments?

All funds within the bricks and mortar property sector have the right to stop encashments and we think that many will be forced to. The unknown is how will investors react?

We are fearful that if investors are told that they cannot have their money back for six months, then even those that previously did not want their money back will put in a request just in case. This could exacerbate the downwards spiral that companies are hoping to avoid by imposing notice periods.

What does Applewood recommend?

As long as you have reduced property in your overall portfolio to no more than 10%, then we would recommend retaining this holding, as we fundamentally believe in holding money in all areas at all times.

Property is an excellent diversifier that, if held for the long term, should provide good stable returns. Many clients have seen excellent returns over the past few years and for the most part we have been able to crystallise these gains by switching out before the funds suffered large falls.

Even if we switch out now and for example property falls another 5% it is unlikely that we will accurately spot the bottom of the market to switch back in again. It could be that we switch out now to see the market fall 5% and then rise 7.5% again before we get back in, meaning that we would have been better off doing nothing.

However, we appreciate that these are unusual times and some clients would be more comfortable switching out of commercial property entirely. If you would prefer to have no commercial property exposure for the time being then we are happy for you to switch out of these funds.

If you would like to switch we suggest the funds be held as cash on deposit until you have had a chance to talk this through thoroughly with your adviser.

What next?

If you would like to switch out of property then the relevant forms are attached and we would suggest that you forward these directly to the insurance company. Please let us know if you have done so.

We will, of course, keep you up to date with developments as and when they unfold, as we do believe that there will become a time when property would have fallen further than it should have done and we can then take advantage of the rebound by switching back in.