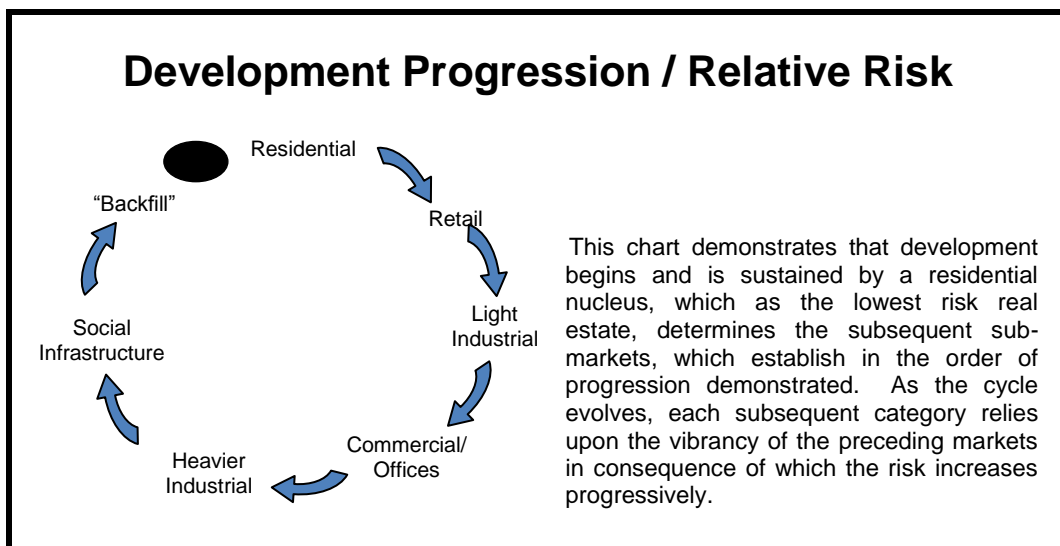


**Property Investment - Diversification and Risk
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Although property, and other forms of investment, particularly equities, may, over a long period of time produce similar returns it is important to appreciate that nonetheless, they behave very differently along the way. The reasons can be varied but during this past GFC, property in direct ownership with managed debt, performed far better than equities that had too much imbedded speculative debt. Diversification therefore can ensure that interim performance across a portfolio is balanced to an acceptable average and allowing, if necessary, a stronger asset to support those experiencing weaker conditions. Another good reason for diversification is that directly owned real estate involves a long term commitment and is a disciplined investment strategy, not easily changed, and therefore not vulnerable to fluctuating sentiment on a daily basis. Diversification to include such a long term committed approach, balances what might be short term strategy investments.

Diversification therefore makes common sense so what are the areas of relative risk?



It is emphasised that residential real estate is the lowest risk category, being at the lowest price point, very liquid, and required by everybody, not just investors. It is the easiest real estate category within which to invest, borrow, and have some flexibility and it is strongly recommended should form the solid core of any property portfolio. Indeed, several million dollars can sensibly be committed to this classification over the medium to longer term and before there need be any thought about moving to other property classes.

When diversification moves in the direction of non-residential, retail is recommended as the next least risky category, as it suffers little from obsolescence or locational trends but rather tends to consolidate longer term to become better quality. In contrast, commercial office and particularly industrial real estate is much more affected by locational trends, and building obsolescence. For this reason, shrewd investors realise that with industrial and commercial property the higher risk requires faster amortisation of their investment for which reason property yields in these classes will always be higher than retail yields, which because of lower risk does not require as fast amortisation of the investment capital.

Unlike cash which offers only interest, but no capital growth, real estate, as with equities, offers both income and capital growth, which analysed on an annual basis, is referred to as the “internal rate of return (IRR)”. With real estate, the proportion of return from income versus capital growth, does vary, and whilst the combination of both don’t exactly equate to the analysed IRR, they can for simplicity, be summarised using the following apportionment, as a guide to differentiation between the four main property classes.

Apportionment of Investment Return

Apportionment of Investment Return (Before Tax)			
	Annual Net Income Return	Annual Capital Growth	IRR
Residential	3%	6%	9%
Retail	5%	5%	10%
Commercial Office	8%	3%	11%
Industrial	9%	3%	12%

The above summary is very simplistic, and only indicative for the purpose of differentiation, highlighting for example that residential investments are more orientated towards capital growth than net return, but that at the other extreme, industrial properties rely more on income return rather than capital growth. This concept of “IRR”, is a frequently adopted measure of analysis, and for passive investment properties as the table indicates, varies in the range 9% - 12%, although for active development investments, such as construction or subdivision, increases commensurately with the higher risk, often up to 18% - 22%. To complete the comparison, the following chart although again very simplistic, is indicative of the relative overall return, from a broad range of alternative investment options.

Simple Comparison of Relative Investment Returns

Simple Comparison of Relative Investment Returns		
	Annual IRR	Comments
Cash	6.5% p.a.	Cash only
Prime Real Estate	9% - 10%	Less Income/More Capital Growth
Secondary Real Estate	12%	Higher Income/Less Capital Growth
Prime Equities	12%	Income and Capital Growth
Active Development Investments (Construction/Subdivision)	18% - 22%	All Income Returns/No Capital Growth

In Australia, particularly its capitals, and especially Melbourne, the medium to longer term investment prospects are very good. This is due essentially to strong population growth, which notwithstanding the diversity of views and Government Policy from time to time, is assured to remain strong. Returning to the first chart in this article, strong residential growth not only creates housing demand, but drives the subsequent retail, industrial and commercial office markets. Our research has determined that a new dwelling is required for every two new head of population, and that in the non-residential sector, every new head of population growth generates a need for 1.5 square metres (sq.m.) of retail accommodation, 2.1 sq.m. of office accommodation, and up to 18 - 20 sq.m. of various industrial, warehouse, factory, logistic and high tech accommodation. Unlike many countries overseas all of these classifications, due to the lack of speculative construction during the GFC period, are at very low vacancy levels, there being excellent prospects within all these categories, subject to careful choice, for strong rental growth and therefore capital performance during the next decade. A broad study of population growth and trends recognising preferred growth areas and the effects of demographic change assists selection of a good investment property and is available through appropriate consultants.