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Money matters: Scott Campbell's views on Thailand cont.

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Graham Macdonald
MBMG International Ltd.

Continuing our mini-series on the views imparted by Scott Campbell, the portfolio manager whose 'Growth Fund' has been judged by S&P to be the best in its sector for the last 6 years, during his first ever visit to Bangkok, last month we turn our attention, once again, to property.

I have been recommending an underweight position to global commercial property for some time now and recent research has led to a further reduce recommendation and sale within our portfolios. There are two major reasons for this strategy.

The first is the recent and imminent further rise in global interest rates. Like bonds and equities, rising interest rates off 45-year lows is not bullish for the asset class. Commercial property is essentially valued on a yield basis and as Government bonds rise, so too do the expected yield on property investments. By way of example, an office building with rental income of US\$1,000,000 is currently priced at 8% capitalisation to give a valuation of US\$12,500,000. If the expected rate of return rises with bond yields to say 10%, then the capitalisation of the building falls to US\$10,000,000 or a fall of 20%. Of course, leveraged commercial property investment vehicles will fall even further with a 50% gearing example in the example above causing a fall of 32%. A blow out in interest rates to 12% means a fall to US\$8,333,000 or 33% un-gearred. Valuations by directors and independents of commercial property funds are using historically low capitalisation rates and this is the time to start reducing rather than increasing exposure. The income yield will be swamped by the fall in capital value.

The second reason is the behaviour of listed property funds in recent times. My experience of listed commercial property trusts is that they tend to lead property unit trusts or other collective vehicles with physical property assets at director valuations by 6 months. The market tends to discount the expected moves in interest rates in advance in much the same way as they do earnings of industrial

and financial companies. The Real Estate Investment Trust Index (REITs) in New York price 200 day moving average has been broken in April.

The decisive breakout in April on interest rate concerns is a lead indicator for physical commercial property assets and funds. This index is obviously US focused but the same concerns and price action is happening in the entire developed world. Rising interest rates in the Western world are not indicative of a time to be overexposed to commercial property there regardless of location, location, location?

Residential Property - Bubble?

Led by articles in the FT last weekend and various features in the Economist over the past 18 months, is the housing bubble. Since 1956 UK house prices have risen, in real terms, at a trend rate of 2.1%pa. This has made housing an excellent investment but prices have gone through huge cycles. At their peak in 1973, prices were 43% above trend and in the 1988 peak they were 36% above trend. At the end of last year they were 37% above it. Tony Dye, of past fame for losing his job at Phillips and Drew for calling the Tech bubble in 1999, says UK house prices could fall by 30% over the next five years to bring prices back to trend. The usual argument of "affordability" dynamics have changed does not wash according to a study by Andrew Farlow of Oxford University. In Sydney the problem is even worse and Reuters noted in the weekend that properties have doubled in the past six years and now only offer yields of 2.5% and it now takes in excess of 30% of family income to service the debt. All this at 45 year low interest rates and expectations are that rates will only increase over the next 30 year life of the mortgage. The Western world housing market is definitely in a bubble, you only need to ask Japanese, Hong Kong, and most Emerging Market property investors about their yields, debt servicing and large falls in capital value over the past few years.

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