The Absolute Return Letter — February 2005

Summary

This month we will revisit the outlook for house prices around the world, exactly one year after we did an essay on the U.K. property market (you can find our February 2004 newsletter on www.arpllp.com). Why is this particularly relevant again now? Well, there are several macro-economic indicators which provide valuable information regarding the outlook for house prices in the medium term.

In summary, we conclude that falling interest rates are a primary reason for the property price appreciation we have experienced in recent years and that it will probably also be interest rates that will have to take the blame when the trend finally reverses itself. In fact, prices have already started to fall in some places, most notably in London and Sydney.

We go on to suggest that in the short to medium term, the euro-zone offers the best protection against sharply falling property prices, because anaemic economic growth in this part of the world is likely to keep interest rates under control.

Finally, this month we are including property in our model portfolio for the first time with an allocation of 7%. Given our relatively cautious view on property prices, our decision to include it at this stage may surprise you. The truth is that we have been looking to add property to our model portfolio ever since it was established, but poor liquidity in most property funds has put us off.

We have finally found a property manager that offers acceptable liquidity terms. More importantly, though, we have actually found a manager who is quite bearish on property. We think he can make decent returns, even if property prices start to fall and even better returns, should the bull market continue. That is the sort of manager we like to invest with.

Do not despair if you enjoyed our December article "What Exactly Is It that You Guys Do?". Mads will return next month with part two of his series of articles.

The Property Market Revisited

Last week, we attended an alternative investments conference here in London sponsored by Lehman Brothers. One of the sessions focused on property, and it was suggested that European insurance companies and pension funds are planning to raise their allocation to property quite significantly. The presenter suggested that the average European pension fund will increase its allocation from 4-5% of total assets at present to about 10% within the not too distant future.

Now, that is a big commitment to property and will result in billions and billions of pounds, euros, kroner, etc. going into property over the next several years. However, European pension funds invest mostly in commercial real estate, and this essay focuses exclusively on residential property. But the projections got us thinking.

Commercial property is at a much earlier stage of the business cycle than residential property. Across Europe, there are still millions of square metres of vacancies, in particular in retail and office space. Rental increases are now starting to creep back in, though. If you invest in property on a speculative basis, and not because you need a place to live, the commercial space is probably the place to be, but that is an entirely different story from the one we intend to share with you today.

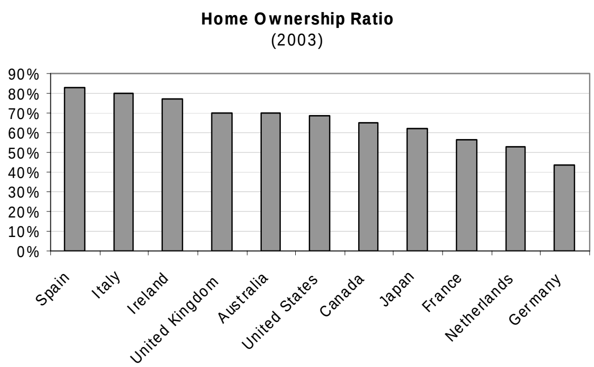
Home Ownership

Let's go back to the residential market and look at why house prices are important. There are two reasons. Firstly, they provide a topic for dinner party conservations. At least here in the U.K., everyone seems to have a view on property prices. The nation is obsessed with property.

The second, and perhaps more important, reason is that house prices have a profound effect on the economic climate by affecting consumer sentiment, household wealth and the capacity to borrow. At the same time, changes in the economic climate have an effect on house prices. The two feed on each other, which helps to explain why house prices are so important to the economy.

House prices are, in fact, much more important to the economy than share prices. It is still a puzzle to many people why the equity bear market of 2000-02 did not do more damage to the economy than it actually did. The (main) reason is that shares are held by a relatively small number of households, whereas home ownership is high in most countries (see table 1).

Table 1:



Source:
IMF World Economic Outlook, September 2004.
Selected countries only.

In the United States 68% of all households own their accommodation, whilst only 52% own shares. Even more telling, the poorest 80% of U.S. households own 17% of all stock market wealth, but they control 51% of all home equity[1]. In other words, the broad middle classes that set the tone for the economy are far more sensitive to changes in house prices than they are to changes in share prices.

The picture in Europe is similar, although home ownership varies considerably from country to country. Meanwhile, equity ownership across Europe is lower than it is in the United States.

The Importance of Interest Rates

So how expensive are property markets around the world? We have looked at the Economist's house price index, and we have used data from the IMF measuring the price-to-rent ratio to put these numbers into perspective. The price/rent ratio for property is very much like the price/earnings ratio for shares, i.e. it measures how much you are paying for property relative to how much that same property can generate in income.

If house prices were purely a function of macro factors such as growth in population, etc., one would expect the price/rent ratio to remain fairly constant over time, because rents would go up or down broadly in line with prices. Yet in many countries, including Ireland, Spain, the United Kingdom, Australia and the Netherlands, prices have risen at least twice as fast as rents over the past 20 years (see table 2).

The IMF has written a very interesting essay on the current house price boom, a copy of which you can find on our web site by clicking on the following link:

http://www.arpllp.com/research_library,

They conclude that the fall in short-term interest rates explains the bulk of recent rises in house prices across most of the industrialised world. But, as you can also see from table 2, not all countries have enjoyed a strong rise in property prices. In fact, two of the largest nations have actually experienced a drop in prices, namely Germany and Japan.

Table 2:

Country	***House Price Inflation***		***Prices/Rents***
	3Q03-3Q04	***1997-2004***	***1985=100***
Ireland	11%	187%	272.45
Spain	17%	149%	249.92
U.K.	14%	139%	194.28
Australia	8%	112%	212.93
France	15%	76%	129.70
Netherlands	3%	76%	203.58
Italy	10%	69%	91.43
United States	13%	65%	136.48
Canada	7%	43%	182.59
Germany	-2%	-3%	73.07
Japan	-6%	-24%	75.23

Sources:
The Economist, December 2004.
IMF World Economic Outlook, September 2004.
Selected countries only.

Interestingly, since the introduction of the euro, countries such as Spain and Ireland with above average inflation, and hence below average real (i.e. inflation adjusted) rates, have actually enjoyed the sharpest rise in property prices. We don't think this is a coincidence. Low real rates create a perception of zero cost finance, although we all know that it is not the cost on day one that matters but the cost over the life of the mortgage loan.

Furthermore, it is interesting to notice that there seems to be a link between home ownership (table 1) and house price inflation (table 2). Those countries with the highest home ownership ratio have, by and large, also enjoyed the strongest rise in prices.

[1] Source: Freddie Mac.

We have also found a link between the nature of the mortgage system and house prices. Countries that are based mostly on variable rate mortgages have enjoyed stronger growth in house prices in recent years. Take another look at table 2. Ireland, Spain, the United Kingdom and Australia (the four countries with the highest increase in property prices since 1997) are all based predominantly on variable rate mortgages. Mortgage lenders in the United States, Canada and Germany, on the other hand, offer mostly fixed rate mortgages.

But why is it that countries with variable rate mortgages have outperformed those with mostly fixed rate mortgages? There may be several reasons for this, but we suspect that mortgage borrowers' focus on the immediate future plays an important role in explaining this divergence. Think about it. When you look to buy a new house and sit down and calculate how big a mortgage you can afford, what do you base your analysis on? Most likely, you will base it on the projected monthly cost of servicing that mortgage at the going rate. Most people ignore the potential risk of rising interest rates over the life of the mortgage.

In recent years, with short-term rates having reached their lowest levels for two generations, people with variable mortgage rates have therefore, correctly or incorrectly, felt that they could afford a bigger and better home than those with fixed rate mortgages.

The Dutch Case

Supply and demand matters in any market. Ireland has enjoyed the strongest increase in house prices of any developed country. In addition to enjoying extremely low real rates, Ireland in general, and Dublin in particular, has experienced a significant undersupply of housing in recent years. Likewise, following the reunification in Germany, there has been an oversupply of housing in parts of Germany, putting considerable pressure on German property prices.

The Netherlands deserves a special mention in the context of supply and demand. The Netherlands has had one of the poorest economic records in Europe over the past two years. House prices have hardly moved, and consumer spending has actually turned negative in the last twelve months. We have also noticed that net immigration to the Netherlands came to a virtual stop in 2003, and although we do not yet have official data for 2004, newspaper reports have suggested that the Netherlands suffered net emigration last year.

No other EU-15 country (bar Luxembourg) finds itself in a similar situation. We cannot prove it, but is seems inconceivable that negative migration trends did not have an effect on house prices and consumer spending.

Why is this important? Because over the next several decades, many European countries will experience negative population growth. One can only begin to imagine what this will do to house prices and consumer spending, but it is hardly good news. We have decided to dedicate a separate letter to this topic, as it is an important subject. Stay tuned.

Perhaps politicians should view the situation in the Netherlands as a sign of things to come, if they succumb to public pressure and freeze immigration. The truth is that we need to *increase* the number of immigrants over the next 10-15 years, if we wish for economic prosperity to continue in Europe. This may be hard for many Europeans to digest, given the strong undercurrent of scepticism towards immigrants. Maybe we should look towards the Australian model, where skilled workers find it easier to obtain a work permit than do unskilled workers.

The Outlook

Property prices vary considerably from region to region, often from one neighbourhood to the next, making it difficult to predict price changes. Location matters. Local planning rules matter. Microeconomic climates matter. I was in Dallas a couple of weeks ago, and I was astonished to see how lacklustre the Dallas property market is, considering the sizzling U.S. market (or so we are told).

Problem is Dallas was home to many telecom companies that went bust. As a result, you can acquire commercial space in downtown Dallas at about half the price you would have to pay in Fort Worth only 30 miles away. You can also buy a nice 3-4 bedroom house in the Dallas suburbs for $200,000 or thereabouts. Welcome to a non-bubble economy.

Dallas is not the only place where the property market is lacklustre. Despite official statistics showing that house prices continue to rise in both Australia and the United Kingdom, it is now widely accepted that prices in both Sydney and London are down by as much as 10-15% from the peak.

According to our friends at Goldman Sachs, once house prices start to fall, they typically undershoot their fair value [2]. Many people assume that house prices never fall. This is *not* correct. Property bear markets do not happen as frequently as equity bear markets do, but when

[2] *House Prices: A Threat to Global Recovery or Part of the Necessary Rebalancing?, Goldman Sachs, July 2004.*

property prices are in decline, they often fall for an extended period of time.

It is also of interest to note that research from the U.S. (Goldman Sachs again) suggests that market reforms, leading to easier refinancing terms for households, have increased the effect of housing wealth on consumption[3]. In other words, countries that have made it difficult and/or expensive for homeowners to refinance have not enjoyed the same boom in private consumption. Countries such as the United States, the United Kingdom as well as most Nordic countries have legislation in place that makes it much easier to refinance mortgages than do countries such as Germany, France and Italy. And guess where consumer spending is lacking…

Finally, before reaching our conclusions, let's spend a moment or two on the new interest only mortgages. During the last year, many mortgage lenders in the United States have started to offer mortgages where you do not pay back any principal in the early years of the loan. The phenomenon is now spreading to Europe, where the new loans have become enormously popular in, for example, Denmark.

The borrowers pay interest only in the early years of the loan, only to see the cost of servicing the loan go up, once they have to start paying back the principal as well. In the U.S., these loans are typically variable rate loans (in Denmark they are fixed rate loans), creating an enormous risk to the entire mortgage system, should short-term rates move higher over the next few years. With many people already stretching themselves to the limit, where is the extra money going to come from to pay principal and higher interest at the same time?

We noticed that one commentator put it the following way: *"We suspect that all the elements are in place for a perfect storm…"* (SMR Research Group).

Conclusion

Most property bubbles that have burst in the past have done so because of rising interest rates. Think Sydney and London again. Is it a coincidence that these two cities are amongst the first to see falling property prices? We do not think so. After all, the Australian and British monetary authorities have tightened more than any other central bank in 2004.

As mentioned above, property markets around the world tend not to move hand in hand, but this bull market is an exception. There are only a handful of countries in the western world that have not enjoyed a strong rise in house prices over the past 5-10 years. Some countries are already in bubble territory (e.g. Australia and the United Kingdom). Other countries appear still to be some way off a peak (e.g. France and the United States). By and large, though, this bull market is unusually global in nature.

This fact supports the notion that it is interest rates that have been the main driver, because the fall in interest rates has been very much global in nature. But that also means that when interest rates start to rise again on a global scale, there will be few places to hide. Other factors matter, but more so in the long run. *This property cycle is very much linked to the interest rate cycle. Be prepared to run for the exit when interest rates start their inevitable rise.*

Regular readers of this letter will know that we are not particular bearish on euro interest rates (neither short nor long rates). In fact, the crystal ball that we use does not predict rising euro rates any time this year. Consequently, there is no apparent reason why house prices around mainland Europe should suddenly start to fall dramatically. We actually think they could rise a bit further, as long as interest rates cooperate.

The U.S. central bank, on the other hand, seems set on taking the Fed funds rate higher this year. However, due to the structure of the U.S. mortgage system, as long as yields on long bonds do not rise dramatically, the damage to the U.S. property market will probably be limited. And the yield at the long end will not go up dramatically, unless the inflation picture deteriorates.

That leaves the U.K. property market as the most exposed in the Western hemisphere, because the damage may already be done. However, with those dreadful December retail sales figures in fresh memory, the odds of no more rate hikes have shortened considerably.

We conclude that U.K. house prices may weaken, but do not bet on a meltdown. The U.K. population is still growing at a reasonable rate. The United Kingdom is still an attractive place to come and live for many other Europeans. The U.K. planning laws are doing their job to support property values by making it difficult to build in many places. In short, the demand/supply equation provides ample support.

The biggest risk in the U.K., as far as we can judge, is consumer complacency. The latest Bulletin from the Bank of England[4] focuses on indebtedness and financial stress amongst British households. In the report, a recent survey is quoted, where 40% of households interviewed agreed with the statement: *"My house value has*

[3] *See note 2.*

[4] *Bank of England Quarterly Bulletin, winter 2004.*

risen so much that I do not worry about other debts I may have".

Quite interestingly, though, the debt problem in the U.K. does not seem to be concentrated amongst homeowners. Again, the Bank of England leads the way: *"The evidence from the latest survey suggests that, while the vast majority of debt is owed by homeowners with mortgages, debt problems are concentrated among renters."*

It appears that strong property prices are offering a great cushion for homeowners, whereas renters are not so lucky. The million dollar question, of course, is how the debt situation will unfold when property prices run out of steam.

One final note on mainland Europe:

Export industries have been the main driver behind economic growth over the last couple of years, whereas consumer spending has generally disappointed. With a strong euro to undermine the continent's competitiveness, do not count on export driven growth in 2005. We need European consumers to spend more. Otherwise growth could stall completely later this year.

The solution stares us all in the face[5]. Lower the euro rate. We are not talking the usual 0.25%. Give it a whack. Combine it with market reforms, making it easier and cheaper for European homeowners to re-mortgage. Voila. Consumer spending will go up. Europe's growth will be re-invigorated. The U.S. current account deficit will start to shrink. The dollar will appreciate in value against the euro and we will all eventually start to worry about inflated property prices in Germany. For the moment, though, that is a nice problem to have.

Niels C. Jensen

[5] *I wish we had thought of this idea first, but I am happy to give the credit to our friends at GaveKal Research (see www.gavekal.com).*

Model Portfolio

We are making several changes to our model portfolio this month. When the portfolio was established back in January 2003, it was based on an investment philosophy of conservatism. We genuinely believed that, on the back of the great 2000-02 bear market, investors would demand very conservative investment strategies based on the principle of capital preservation.

The last couple of years have taught us a lesson in investor psychology. Whilst a minority of our clients certainly belong in the conservative camp, a clear majority prefer a somewhat more aggressive portfolio structure. In our experience, most private investors quite simply want double digit returns, and they are prepared to take a calculated and reasonable amount of risk to get there. The changes to our model portfolio reflect this fact.

The volatility (standard deviation) of our model portfolio has been quite steady around 6% since inception. Going forward, we expect the volatility to increase modestly to 7-8%.

Cash: 15% → 10% ↓

Our allocation to *Cash* has been reduced *from 15% to 10%*. Although an argument can be made for reducing the cash position further (after all, the return on cash is pretty mediocre these days), we are not bullish enough at this juncture to justify such a move.

Investment Grade Bonds: 21% → 11% ↓

We are reducing our exposure to *investment grade bonds* quite dramatically – *from 21% to 11%*. We are becoming increasingly comfortable with our view that, at the end of 2005, yields will be pretty close to current levels, leading to very modest returns on traditional bond strategies. The possible exception is Euroland, where conti-nued weak economic growth could potentially lead to further downward pressure on interest rates.

Catastrophe Bonds: 3% → 5% ↑

We are increasing our exposure to C*atastrophe Bonds from 3% to 5%*. Our manager passed the test with flying colours during the Asian tsunami crisis. Whilst a human tragedy of gigantic proportions, it was a relief to see that there was no loss of principal in our manager's portfolio. In fact, December was his best month ever.

High Yield Bonds: 5% → 1% ↓

We are reducing our exposure to *High Yield Bonds from 5% to 1%*. There is little value left after the yield spread between high yield and investment grade has shrunk to an all-time low. Significant yield enhancement is required before we can be enticed back.

Alt. FI & Equity Strategies: 22% → 30% ↑

We have increased our exposure to *Alternative Fixed Income and Equity Strategies from 22% to 30%*, as we see better opportunities in alternative than we do in traditional investment strategies for 2005. Our exposure to alternative fixed income strategies is predominantly to European managers, whereas our exposure to alternative equity strategies is more balanced.

Managed Futures: 3% → 5% ↑

The exposure to *Managed Futures* has been increased *from 3% to 5%*. We are investing further in managed futures, partly because returns are competitive, partly because the asset class offers excellent risk diversification. As we grow more and more concerned about the macro outlook, we need asset classes like this in our portfolio to deliver respectable returns.

Property: 7% (NEW) ↑

Finally, we are introducing property to our model portfolio for the first time with an allocation of 7%. Given our relatively cautious view on property prices, our decision to include property at this stage may surprise you. The truth is that we have been looking to add property to our model portfolio ever since it was established, but poor liquidity in most property funds has turned us away. We have finally found a property manager that offers acceptable liquidity terms. More importantly, though, we have actually found a manager who is quite bearish on property. We think he can make decent returns, even if property prices start to fall and even better returns, should the bull market continue.

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