AUSTRALIAN INVESTORS' ASSOCIATION

Email Bulletin

Investors Helping Investors

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PROPERTY

Table of Contents

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COORDINATOR'S MESSAGE

By Adrian Vorbach

The May Property Bulletin comprises of an article by Phillip Anderson, Director of Economic Indicator Services and Author of "The Secret Life of Real Estate". He describes "Ricardo`s Law of Rent" which is now known as the value of "Location, location, location". He also devised the "Real Estate Clock" which may be helpful in predicting changes in property cycles.

AIA member Brian Cordiner provides a review of Phillip Anderson's title "The Secret Life of Real Estate". This provides a valuable summary of the "Real Estate Clock," referred to in Anderson's article.

Finally, ABN AMRO Morgan Analyst, Fiona Buchanan, reviews the recent downturn in the REIT (Real Estate Investment Trust) sector (the old LPT sector). Buchanan suggests only a few REITs may offer some value to investors.

Adrian Vorbach is a Councillor of the AIA.

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THE CURRENT GFC IS PROOF THAT THE MARKET IS *WORKING*

By Phillip Anderson

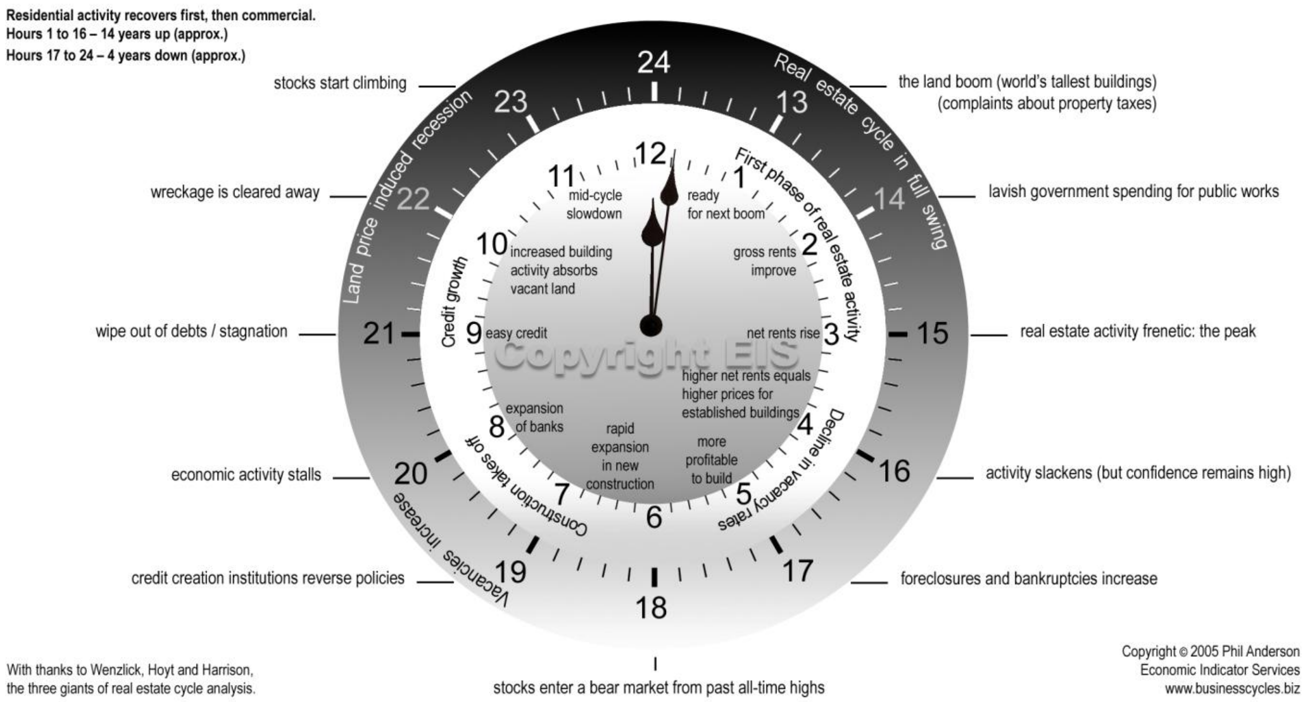
Economists delight in recalling the Dutch tulip mania of 1636, the South Sea bubble of the 1720's, and in current times the internet investment bubble of the 1990's, because it involved colourful characters in what turned out to be awesome booms that turned quickly to bust. These were random events, responses to either luck (such as the alleged discovery of gold) or invention (money-making schemes of fertile imaginations). They could not have been predicted using the standard tools of the economist.

The financial crisis that broke in 2007 is different. This crisis was pre-determined by the structure of the economy. The present crash is NOT a market failure: it is actually proof that the monopoly capitalist system is working, and working well. The instability of the system is inbuilt into the DNA of the economy. The process is underpinned by the enclosure of the economic rent, a concept first formalised by English economist, David Ricardo.

Ricardo's Law of Rent states, simply, that the economic rent is not a cost of production. A house costs pretty much the same to build, wherever you build it - wages are the same, and materials costs are the same. But the selling price will depend on the location. So builders, for example, will bid more for the best locations. That money doesn't go to the workers building the house, and nor is it spent on improving the materials used. It purely benefits the owner of the land. This bid is what Ricardo was first to identify as a 'surplus': the economic rent. Property investors know it today as locational value.

Wherever a price is put on this locational value of land, a property cycle will develop as speculators and companies chase land prices higher and higher, reducing the proportion of wealth being invested in creating jobs and investing in productive businesses. This cycle is beyond the control of central banks. The enormous credit created by banks based upon this value now gives us the violence of the property boom, then bust. This cycle has so far manifest clearly in 14 years of rising prices, then four years declining.

24 HOUR REAL ESTATE CLOCK



years ago to help guide my own investments through the cycle. From the 1955 land price low in most Western 'rent-enclosed' economies (ie where land is privately owned), the 18-year cycle has been exact: 1955 to 1973/4, to 1991/2 and now to what will most assuredly be another property low in 2010. This real estate cycle has actually been repeating since 1800 in the U.S. and since 1600 in the UK, where the cycle originated.

The current banking problems at the end of yet another 18-year real estate cycle are certainly nothing new. It is amazing to witness how quickly investors forget the previous banking panics, as land prices begin to deflate. In October 1973, the collapse of the US National Bank of San Diego was the biggest in 40 years. The bank collapsed because of the activities of its major shareholder, C. Arnholt Smith, chief fund-raiser for Richard Nixon and a major real estate speculator in southern California.

An even bigger bank failure, that of the Franklin National Bank of New York, followed twelve months later, in October 1974, also property related. The Fed chairman, Arthur Burns, when asked by a Newsday reporter what stopped the world financial system from imploding after the massive failure of Franklin bank, replied: "Luck, more than anything. We were sitting on a volcano. People were concerned in this country, but they were really scared abroad. We can't let it happen again, because we might not be so lucky the next time."

The 'next time' arrived right on que, one cycle later with the implosion of the US banking system in 1990, led by the Savings and Loans institutions. Said one staff member of the Senate Banking Committee enquiry at the time, set up to make sure a banking crisis would never happen again: "'This (banking) industry is very close to the heart of the American economy. We teetered on the edge of a major, major problem here… we teetered on the edge of a major collapse … You know, all these [financial] industries could bring down the whole economy!"

Yet we never seem to learn.

The current Australian property cycle will repeat in line with the 24-hour real estate clock. (Readers may like to refer to my last market forecast contained in the May, 2007 AIA Bulletin. Since that time, the economy has unfolded exactly as per the clock.) The UK is presently at 20.00 on the clock, the US at 21.00. Australia will follow, as it always does. Bad debts will have to be either paid off or wiped out, and the wreckage cleared away, before the economy can move on. This process will takes years, not months. In Australia, it will get slightly worse before it gets better, but the cycle will turn eventually. In 2010. Ricardo's Law of Rent guarantees it.

Phillip Anderson is the Director of Economic Indicator Services and author of 'The Secret Life of Real Estate.' A review of this title follows.

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BOOK REVIEW

Title: ***The Secret Life of Real Estate, how it moves and why***
Author: Phillip J Anderson
Publisher: Shepheard-Walwyn Ltd, London, UK, 2008
ISBN: 9780 8568 32635
RRP: $74.95
Reviewer: Brian Cordiner

Phillip Anderson is Managing Director of the subscriber service, Economic Indicator Services (EIS). This is his first book and in Part II, the longest section of the book, he recounts the history of land speculation and the reasons for it from the early days of American settlement through to the present era. From his research of these historical times he draws conclusions about the relationships between the rise and fall of - the financial system and banks; government policies; building and construction activity; population movements and most importantly the greed of speculators to – the rise and fall in real estate values.

Part III has the most interesting content where he summaries the lessons of Part II and develops his hypothesis of the real estate clock. The hypothesis is supported by the earlier research and includes an extensive area of graphs and charts. The conclusions drawn are that throughout European settlement in America (and some passing references to Europe, Asia and Australia) there is a reliably repetitive real estate cycle.

The author discovers that the real estate cycle repeats itself approximately every 18 years. In addition, he tells the reader the warning signs and trends that precede the various “hours” on his real estate clock. One warning about the book is that the conclusions are drawn from American data over a considerable period of time and they might not be reliable for interpreting real estate trends in other countries.

In summary, if the author’s research is reliable then we can utilise the “clock” to know when to buy and sell real estate in the future.

Brian Cordiner is a member of the AIA.

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VALUE IS THERE, BUT CREDIT CONSTRAINED

By Fiona Buchanan

It's been a tough 12 months

Profit downgrades, distribution suspensions, asset write-downs and impending refinancing obligations over the past 12 months have had a major impact on the performance of the REIT sector. Most have reported and still face falling asset values and weaker earnings. This has particularly been the case for trusts that have expanded into development, funds management and offshore investments. Consequently, this has forced funds to raise fresh capital to better manage their gearing levels, diluting their share price and shareholders in the process.

While this has been most pronounced by trusts more exposed to the riskier activities mentioned above, the more conservative vehicles have also needed to raise capital, for example, Commonwealth Property Office Fund (CPA) and Westfield Group (WDC). Unlike past years when new equity was used to fund property acquisitions, around 90% of the equity raised over the last six months was used simply to bolster balance sheets or reduce borrowings. Further deeply discounted and highly dilutive capital raisings may be necessary for some REITs given refinancing issues and asset devaluations. Deleveraging through asset sales will also be important.

Where to from here? Expect volatility to continue

All REITs are trading at deep discounts to their net asset value. Property fundamentals are expected to be tested further by softening global economic conditions, and it is likely that pressure on property valuations will continue for as long as there is global credit market uncertainty. While the recent interest rate cuts should help the sector, market volatility is likely to continue, at least in the short term. We expect to see continued refinancing pressure across the sector, along with rent deflation and capitalisation rate expansion.

Additionally, rising unemployment is a major risk for the property sector as it could lead to rising vacancy rates and lower rental growth. This would, in turn, lead to lower distributions payable to shareholders. In short, while value is evident across most of the sector, we expect there is more bad news to come. The focus is now firmly on underlying, property-based operating profit. It is now in vogue to be a property owner REIT again - being boring, simple and transparent is good. The REIT sector is returning to its roots and currently being priced relative to the value of the underlying property portfolio, the reliability of short-term earnings generated and the level of distributions likely to be paid. Despite the incredibly low market capitalisations of some REITS, merger and acquisition activity has yet to emerge. With underlying portfolios of high-quality assets and various uncertainties such as gearing and debt renewal being progressively addressed, the prospects for merger and acquisition activity is also likely to increase.

Maintain defensive bias

Looking through the current cycle, we prefer groups that are well capitalised to withstand further asset value adjustments and medium term working capital requirements. We continue to expect the sector will be plagued by re-financing issues, asset write-downs and subsequent covenant breaches. While we maintain an underweight call on the sector, our preferred picks include: Westfield Group (WDC), CFS Retail Property Trust (CFX) and Dexus Property Group (DXS). At the smaller end we prefer Cromwell Group (CMW).

Fiona Buchanan is an Analyst with ABN AMRO Morgans Limited, Brisbane.

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