FACETOLOGY

October 2020

The gate escape

"The conventional view saves us from the painful job of thinking".
J K Galbraith

The conventional wisdom among the investment community is that diversification of portfolios is key to positive long-term returns. At FACET, we are enthusiastic advocates of this approach and it has helped to underpin our benchmark-beating returns for over 10 years. However, sometimes, one has to take a critical view of the long-term assumptions of some asset classes. Not much stays the same forever.

A one-size-fits-all approach to investing is not a good long-term strategy and simply having a static portfolio invested in a diversified mix of asset classes will not work in all market conditions. One must think strategically and be able to recognise what kind of market we are in. With the benefit of hindsight, the years following the dot.com and 9/11 stock market crashes of the turn of the century, were followed by 5 years of almost unbroken stock market appreciation before the Great Financial Crisis in 2008 brought stocks back down to earth.

But from that market low, there followed an even bigger bull market from 2009 until 2018, the longest in history. The USA's S&P 500 index rose five-fold. This rise was hardly without incident, however. Since 2008, investors have harboured deep concerns on any number of issues hanging over the market. The increasing importance of quantitative easing or regulatory change, like Dodd-Frank putting a squeeze on the financial sector. The impact of interest rates falling to near-zero around the world. Trade wars. Brexit.

In addition, there was the occasional crisis such as the Greek debt crisis, computer flash crashes or the terrible tragedy of the great Japanese earthquake and Fukushima nuclear power plant meltdowns.

During these times, having a diversified array of investments helped to preserve the wealth of one's portfolio because not everything is correlated. Difficult periods for stocks has often been met by central banks cutting interest rates, which in turn raises the value of bonds. Sterling weakness, following the Brexit referendum in 2016, was offset by having investments in other countries in other currencies.

One asset class, property, has long been regarded as a safe bet in almost all market conditions. Prime investment property is stable financially and legally and is easy to own. It has also been profitable for years; underpinned by economic growth, low interest rates and relatively constrained supply.

However, there is one downside to owning bricks and mortar property which isn't the case with stocks, bonds and currency, and that's liquidity – in this case the ability to trade at least daily.

In the commercial property sector, this has been done most successfully by property managers investing in a number of commercial properties from which they derive a steady stream of rental income and capital gain through natural appreciation or, more commonly, enhanced development and renovation.

So far, so good. However, the advent of near-zero interest rates has, over time, attracted an ever-increasing number of investors to the high rates of income relative to stocks, bonds or cash. This would be fine if these new investors were undertaking a long-term investment commitment. Some do, of course, but many don't.

A sizeable minority of investors are often to be found “dancing near the door” while invested in property funds, presumably content with the fact that their investment is secure, stable and, like the other assets classes they own, daily traded.

The problem arises when events, let’s say a spike in inflation causing markets to raise their expectations for interest rates, can lead short-term investors to seek to exit from property. That is to say, the prospect of falling property prices outweighing the long-term attractions of continuing to collect a stable yield.

The selling of units in a property fund which, in normal times, would be funded by cash, runs into problems if sufficient investors relinquish their holdings simultaneously in response to a common event. The cash buffer held by the managers can be quickly reduced, leaving the managers having to sell real properties to meet the cash demands of unit redemptions. Property, of course, is not that easy to sell. It is not, as we all know, daily traded.

At times like this, it has become fairly common for property funds to close their funds to sellers. This is often referred to as “gating”. It is quite a drastic step for managers to take and not taken easily. It is bad for PR, business and distressing for investors unable to get their money back. It is also detrimental to the value of the fund. And typically, once one big fund gates, almost all the others follow and the whole sector can be in lockdown for weeks.

This has happened at least four times in recent years and one contributing factor is what amounts to a little bit of herd mentality across the industry. In a volatile world, investors want to be able to move quickly. This is understandable but it is hard to reconcile illiquid assets, property, with the need for units in the fund to be daily traded. The conflict is obvious.

The industry and the regulators have been trying to address this issue and there have been some novel proposals. However, policy and changing regulations are difficult to measure and, therefore, the impact of them is hard to quantify if you are a portfolio manager trying to build predictable returns into your investment strategy.

For this reason, we have taken the decision to sell all property exposure from retail client portfolios. There is much to credit the property sector and the attractions remain. But the practical considerations outweigh the perennial problems that exist.

Property has been an excellent diversifier of risk over the years and we may well return to it one day. We will continue to watch it closely in these volatile times but, for now, must prioritise wealth preservation for client portfolios.

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