Research Programme 2006-2009

Large-scale Investor Opportunities in Residential Property: An Overview

Research Findings

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November 2007

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LARGE-SCALE INVESTOR OPPORTUNITIES IN RESIDENTIAL PROPERTY: AN OVERVIEW

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LARGE-SCALE INVESTOR OPPORTUNITIES IN RESIDENTIAL PROPERTY: AN OVERVIEW

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The case for residential investment

This report sets out the case for residential investment. It identifies the huge scale of residential as an asset class; explores the characteristics of the housing market, concentrating on the UK for simplicity though many of its features can be found elsewhere as well; highlights the exceptionally high historical returns that have been made from housing over the past 20-30 years; investigates the pros and cons of residential investment for investment funds; and examines the range of residential-related investment options.

History until recently has been unkind to large-scale private residential investors. Amongst other factors, they were squeezed out of UK housing through years of strident government action. Most notably, this occurred through the strict regulation of the private rented sector until as late as the 1990s, with some rent control still lingering on even now. In addition, most low-income rental housing provision was removed from private endeavour during the twentieth century into a 'social' sphere – formulated and run on non-market principles – from which private investors were excluded and still are to a great extent.

When making a case for a greater interest in residential investment, instead of trying to identify some great market failure, the point needing to be made is that both the housing and financial worlds are changing. It is within these axes of change that justification can be found for greater interest in residential investment by large institutions.

On the finance side, today in contrast to 50 years ago when institutional investors were last relatively large-players in residential, there is greater scale, diversity and flexibility in the investment community. There is also a far wider range of investment options and vehicles. Moreover, transactions and monitoring costs – though still relatively high in real estate – have fallen dramatically due to a wide variety of technical and organisational innovations.

On the housing side, there is a similar story of altered markets. There now exists a large and successful private rented sector, which has grown to maturity over the past decade. Uncertainty about re-regulation has also diminished. Although grumblings for more state control occasionally win through, the private rented sector seems likely to remain a relatively free market for the foreseeable future. Governments are now wise to the huge costs of disrupting rental market process. In addition, the surge of small-scale buy-to-let within the private rented sector may now be peaking and the rental market is now maturing, after almost two decades of rent liberalisation. These features, plus other developments considered later, suggest that opportunities for large-scale investors may be growing in residential markets.

An expanding private rented sector

Private renting is growing. Two and a half million English households lived in the tenure in 2006 (12% of all and almost a fifth of Londoners). The number of tenancies has risen by 25% since 1999 and is forecast to grow by 3% yearly over the next decade. This growth rate is less than in recent years but is still strong. Furthermore, rents did not rise much during 2000s but they are now starting to increase and are likely to continue to, especially as rents tend to lag house prices over the housing market cycle.

Most of rented stock is in southern England, particularly when measured by value (60%) and half of that share is in London alone. Moreover, it is even more concentrated in terms of investment options for large investors, as they are likely to be primarily interested in large blocks of private flats which are located mainly in parts of London and other major cities.

Portfolio diversification benefits

There are considerable diversification benefits in terms of the correlation of returns between residential and other asset classes. For example, the correlation between real capital growth in UK residential and commercial property was 0.64 between 1991 and 2006. In addition, regional house price cycles vary in timing and cross-country house price cycles differ too, offering further diversification possibilities. Residential markets also have similar relatively low volatility characteristics to other property markets.

Residential offers strong long-term capital gains

Real UK house prices rose on average by over 4% pa in real terms between 1981 and 2006. This growth was far greater than the lacklustre capital returns for commercial property. This disparity in capital returns is likely to continue in the future on a trend basis. Historically, residential price upswings in the UK have been stronger than in commercial property and periods of falling real values weaker.

The weight of wealth is in residential

Residential property represents over two-thirds of the market value of all UK assets, whereas commercial property represents around a tenth. Even so, there is no evidence of a long-term shift of asset value share towards housing but, instead, there are relatively small cyclical shifts in share depending on contemporary price performance for specific asset classes. Household net financial and net housing wealth has grown broadly in tandem on a trend basis over the past decade and a half.

Justification for large investor interest in residential cannot be made simply by reference to the scale of the asset class and general increases in housing wealth but, rather, arises from residential's return and diversification benefits as an asset class.

The gains from investing directly in residential

Returns have been good since the mid-1990s and average rental returns are likely to remain attractive on a trend basis. Direct ownership offers full information benefits. Specialist management skills in particular add value, where they matter. Large investors have tended to do particularly well in specialist residential niches associated with student, health-related and older person housing plus high quality and serviced accommodation.

The problems with investing directly in residential

A variety of issues arise. Some of the most important are associated with high transaction, management and maintenance costs and greater tenant turnover and vacancy rates compared with equivalent investments by value in commercial property. Furthermore, vacant property has a market-premium discouraging the holding of new built property, and homeowners and small-scale landlords are often willing-to-pay more for specific residential properties than valuations based on expected returns warrant for large-scale investors.

There is some concern over potential threats to firm reputations through being associated with managing residential properties. However, the experience of mortgage lenders suggests that such fears can be exaggerated.

Large value residential property investments tend to trade in illiquid, thin markets, which may raise problems for exit strategies and valuations. Further disincentives arise for investors that focus on matching income flows with potential liabilities and, so, under-weight capital returns.

The multiple ways of investing in residential

Apart from direct investment, there are a variety of alternative routes to investing in residential property. They include indirect investment in companies and funds owning, managing and, possibly, developing and trading in residential assets.

Other means are associated with housing finance via mortgages and their derivatives and equity release and sharing, although these markets are already well served, offer hybrid exposure to residential and capital markets and, in some cases, pricing and reputational risks.

Residential land investment and investing in housebuilder shares are further options although they are more general investments in equity markets and the specific returns of the development and building industries than exposures to residential property itself.

Another area is currently small-scale but has potential for considerable growth, namely, house price derivatives and spin-offs from them. Derivatives markets would help encourage large-scale investors in residential, both as traders and holders of housing related derivatives and as direct and indirect investors in housing assets. Asset holders and other market agents could hedge risk using derivatives and, thereby, market liquidity would be increased and risk lowered. However, there is a need for a large market in derivatives for the full benefits to be realised. The problem then arises of how scale can be achieved.

The problem of the scale of investment

Currently, several features that would encourage more large-scale investors into the residential market are lacking. There is a need for more residential property firms that funds and others could invest in. This requires the creation of good quality residential management teams, which are currently in short supply. In order to encourage such activities there needs to be enhanced investor interest.

Therefore, the residential market for large-scale investors faces somewhat of a chicken-and-egg situation. If there were more quality options for investment and if there was a stronger derivatives market, plus a variety of other ifs, then the scale of investment might be far larger than it currently is. But how is it possible to move to that scale for the current situation? It may be that the market has settled into a relatively low activity equilibrium.

Overall, the prospects and opportunities for large-scale investor involvement in residential seem stronger than for some time. Yet there remains a need to fill key institutional and other gaps in order to encourage the market to expand significantly.

1. INTRODUCTION

Why is there such a huge disparity between the financial sector's holdings of residential and non-residential real estate? In an ideal market economy, the principle of arbitrage, profiting from buying cheap and selling at a higher price, would suggest that the risk-adjusted returns from different asset classes should be pretty much the same over the long-run. Yet, as will be shown below, residential investment hardly features at all in many UK funds' portfolios and residential on most measures is a relatively low risk asset. So, why are financial institutions uninterested? This apparent bias against residential, it should be added, is common around the world, apart from countries where there are exceptional regulatory pressures or tax breaks that encourage investment funds into housing.

This report sets out the case for residential investment. It identifies the huge scale of residential as an asset class; explores the characteristics of the housing market, concentrating on the UK for simplicity though many of its features can be found elsewhere as well; highlights the exceptionally high historical returns that could have been made from housing over the past 20 to 30 years, despite the arbitrage principle mentioned above; investigates the pros and cons of residential investment for investment funds; and examines the range of residential-related investment options.

History until recently has been unkind to large-scale private residential investors. Amongst other factors, they were squeezed out of UK housing through years of strident government action. Most notably, this occurred through the strict regulation of the private rented sector until as late as the 1990s, with some rent control still lingering on even now. In addition, most low-income rental housing provision was removed from private endeavour during the twentieth century into a 'social' sphere – formulated and run on non-market principles – from which private investors were excluded and still are to a great extent.

When making a case for a greater interest in residential investment, instead of recourse to trying to identify some great market failure, the point needing to be made is that both the housing and financial worlds are changing. It is within these axes of change that justification can be found for greater interest in residential investment by large institutions.

On the finance side today, in contrast to 50 years ago when institutional investors were last relatively large-players in residential, there is greater scale, diversity and flexibility in the investment community. There are also a far wider range of investment options and vehicles. Moreover, transactions and monitoring costs – though still relatively high in real estate – have fallen dramatically due to a wide variety of technical and organisational innovations.

On the housing side, there is a similar story of altered markets. There now exists a large and successful private rented sector, which has grown to maturity over the past decade. Uncertainty about re-regulation has also diminished. Although grumblings for more state control occasionally win through, the private rented sector seems likely to remain a relatively free market for the foreseeable future. Governments are now wise to the huge costs of disrupting rental market process. In addition, the surge of small-scale buy-to-let within the private rented sector may now be peaking and the rental market is now maturing, after almost two decades of rent liberalisation. These features, plus other developments considered later, suggest that opportunities for large-scale investors may be growing in residential markets.

Housing demand has burgeoned and will continue to do so in the future. It roughly doubles every 25–30 years with economic growth, even without the impacts of immigration and other demographic factors. Rising incomes and the desire for more space and living amenities associated with them perennially stoke up the pressure of demand. Paradoxically, as housing demand has risen, the amount of land used for housebuilding annually has fallen

1. INTRODUCTION

dramatically. This has helped to push up house prices significantly on a trend basis. Worsening housing affordability, in turn, has altered the choice between owning and renting for millions of households and changed living patterns, leading to a greater role for the private rented sector and more emphasis on rental accommodation in large blocks of flats.

Demographic factors, particularly an ageing population, have set in motion further developments with a new stress on the housing needs of the elderly. Many older households also have large amounts of housing equity locked up in their existing homes, though may be income poor and reluctant to trade down to smaller accommodation.

In such a changing terrain, new investment opportunities are arising in residential. Unfortunately, research into the implications of such change for the large-scale investor has tended to lag behind real world events. So, the point of this report is to map out the terrain rather than to provide definitive views on the places where investment may best be directed, although general pointers are provided. It reveals an interesting set of options. Overall, it seems likely that institutional investment in residential is likely to grow in the future, especially if policy is benign towards it, though it is unlikely to become the dominant force within rental housing provision nor lead to a reduction in the share of owner occupation.

2. A BRIEF OVERVIEW OF THE UK HOUSING SYSTEM

2.1 Tenures and finance

Most Britons are homeowners, with 70% households owning their own home (Table 1). In many parts of the country, the share is even higher but in the big cities, especially London, it is much lower with a greater preponderance of renting from both private and social landlords. Roughly 30% of owners own their homes outright and the other 40% have a mortgage, of the latter many have substantial housing equity especially after such an extended period of rapid price rises as has recently occurred.

The private rented sector is home to around 2.5m UK households – roughly 12% of the total. In addition, a further 3.7m households live in social rented housing.

Table 1: Housing stock and tenure 1951 to 2001

Great Britain

	Total housing stock millions	Addition to stock in past decade (m)	% Owner occupied	% Rented from -		
				Private landlord	Registered social landlord	Local authority
1951	13.7		30	52		19
1961	16.2	2.5	43	31		27
1971	18.8	2.6	50	20		30
1981	20.0	1.2	56	11	2	31
1991	23.0	2.0	66	10	3	22
2001	24.7	1.7	69	10	7	14
2005	26.2	-	70	11	8	11

Source: Communities and Local Government

Owner occupier and buy-to-let mortgage loans are generally of the variable rate type, adjustable at the discretion of the lender rather than set to some rate marker – though typically changes follow the pattern of Bank Rate. Mortgages are often fixed for short-periods but the use of long-term fixed rate products, where interest rates are only revised on a five yearly or longer basis, is minimal in contrast to experience in the USA and some countries in continental Europe (eg Germany).

Homeownership remains the dominant social preference, with 78% of respondents to a CML survey in 2007 indicating it as their preferred tenure in two years' time. So, when looked at on a life-cycle basis, the UK housing system is centred on owner occupation, with a mixture of income-related subsidised housing and rent allowances offered to many of those unable to afford it.

Much higher numbers of UK households are home owners at some stage in their life times than the cross-sectional tenure share data suggest and renting is often a transitional phase for, typically younger, households on the path to owner occupation. Private tenants also move frequently, being 7.5 times more likely to move in a year than are owner occupiers, according to government survey data.

The expectation is that the share of owner occupation will continue to rise gradually over time. The current government aspires to increase the share to 75% of all households over the next decade – though affordability considerations make that a hard target to achieve without substantial increases in housing supply. Government is strongly committed to increasing the supply of new housing[1] but whether the proposed increases in supply will be achieved is a matter of speculation. Similar doubt is cast over whether the targets, even if successfully met, are sufficient to lower affordability constraints rather than dampen further housing cost increases.

The high price of housing, in particular, creates entry barriers that deter younger households and the homeownership rate has levelled off in recent years as a result. So, without major improvement of the supply side, further expansion of owner occupation is only liable to occur through the consequences of an ageing population and continued social housing sales. Renting is likely to continue to grow, although at a more moderate rate than in recent years, and rents are likely to rise at a similar pace to house prices over the long run in order to make this expansion in renting feasible.

2.2 Taxation

The tax terrain between home owners, personal and corporate residential investors is uneven, complex and varies with market conditions. There are three important variables in the comparison: the respective tax treatments of interest costs, capital gains and rental income (in its imputed form for owner occupiers).

Owner occupiers can claim no tax relief on mortgage interest since gradual abolition of that tax-break during the 1990s – the rump of it finally ending in 2000. However, capital gains from house price rises are tax-free as is imputed rental income.

In general, investors are liable to pay tax on net rental income (in the corporation or income forms – depending on tax status); face capital gains tax on rising property values; but they can offset the interest costs of borrowings against rental income. The interest deduction encourages leveraged operations.

UK tax rules may not always be an issue. For larger UK or overseas investors, there is always the option to set up investment vehicles in tax-favourable jurisdictions, as has occurred extensively in commercial property.

For UK assessed entities, the relative mix of tax breaks generally favours owner occupiers. This is especially the case during eras of falling or low interest rates and rapidly rising house prices, which has been the experience of the past decade. However, the relative tax advantages of owner occupiers weaken during periods of higher interest rates and lower rates of price change, which may be the situation in the years to come. Recent reductions in capital gains taxation have also favoured rental investment.

Transaction costs in UK housing, though high, are relatively low compared to many other countries – though agent, legal and other fees are probably proportionately higher than on commercial property.[2] There is a Stamp Duty on all property transactions, which rises in value steps up to 4%. After each threshold price, the whole of the purchase price incurs the new higher rate, so the tax creates pricing and transaction anomalies around the thresholds. For residential property, the anomalies are greatest for purchasers of large blocks of residential property. In such

[1] Housing Green Paper 2007 *Homes for the future: more affordable, more sustainable,* Communities and Local Government.

[2] The evidence base is weak on these issues.

situations, although individual units in the portfolio may easily fall into lower tax bands, the transaction as a whole is still classified as being in a highest one for the investment as a whole.

There is no VAT on new housing, common elsewhere in Europe, but home improvements and extensions are subject to VAT at the normal rate of 17.5%.

2.3 House types

The majority of dwellings are single-family houses. In England in 2000, 82% of households lived in houses, 16% in self-contained flats and 2% in bed-sits and other non- self-contained accommodation.[3] This pattern of housing is radically different from most of continental Europe. There, living multi-family residential buildings represent over 50% of all accommodation in most countries (eg France, 43%; Germany, 54%; and Italy, 75%); whereas it represents less than a fifth of housing in the UK, with much of it in social housing. In the private rented sector, the picture is similar, with over 60% of properties houses, while a further 20% are flats in conversions of single family houses. A strong preference for a house and a garden is deeply embedded in British culture.

The nature of the UK residential stock presents problems for large-scale investors because there is a limited supply of tradable tracts of blocks of flats, which are the easiest built form for them to invest in. Such buildings are also concentrated in a limited array of locations, especially city-centres plus regeneration and social housing districts.

The housing stock, furthermore, is relatively old in comparison to many other European countries – with 41% built before 1945, another 45% between 1945 and 1984; and only 13% since the mid-1980s. Conversions and modernisations of the existing stock also play a major role in qualitative and quantitative improvements to housing conditions. Again, these characteristics are not particularly attractive for large-scale investors, because they increase property management costs.

2.4 Regional and tenure variations

There are substantial differences in housing market performance between the regions and countries forming the UK, reflecting local economic, demographic and housing circumstances. London is, by far, the most expensive place, for example.

Regional housing market cycles also vary in their timing. If the correlation coefficients between house price growth in London and those in the East Midlands and Scotland are examined over time, they show weakly correlated markets. For the period from 1994 and 2006 were respectively 0.27 and -0.16.

The year-by-year changes for these regions are compared in Figure 1. It can be seen that in the post-1996 era of housing market boom, London and the South East experienced a substantial upswing in the 1990s; whereas the boom did not really start until the 2000s in many other regions, with Scotland lagging England.

These cyclical variations make it misleading to compare inter-regional performance on a short-term basis. They also indicate that substantial portfolio pooling benefits can be had by having a regionally diversified residential investment strategy.

[3] Survey of English Housing, Communities and Local Government.

2. A BRIEF OVERVIEW OF THE UK HOUSING SYSTEM

For large-scale investors, the options for residential portfolio diversification are restricted by the spatial distribution of the value of the housing stock. Spatial concentration is particularly high in the private rented sector (see Table 2). Many privately rented properties are in London and its suburbs. In fact, almost half the total value of the private rented stock is located in London and the South East (in the latter mainly in towns within commuting distance of London). Other concentrations are in cities like Leeds and Manchester.

Figure 1: Regional differences in house price cycles illustrated: E Midlands, London, and Scotland, 1994 to 2006

Source: Communities and Local Government

Table 2: Value of the stock by tenure and region

	ENGLAND	North	Midlands	East	London	South East	South West
% of owner occ.	100	22	16	12	17	21	11
% of private rented	100	18	12	10	29	19	12
PR value as % total England value	13	2	2	1	4	2	2

* Privately rented sector dwelling prices are assumed to be 10% less than the average for all dwellings.
Source: Own estimates based on Communities and Local Government data

If rental investors are only interested in blocks of flats, the options narrow down even further to parts of London and a handful of other cities. Focusing on such a narrow spread of spatial locations is probably inevitable, if a very widely spread residential portfolio – and its attendant high management costs – is to be avoided.

2. A BRIEF OVERVIEW OF THE UK HOUSING SYSTEM

The principal argument for the significance of housing in the asset allocation strategies of investing institutions is the sheer scale of the sector. Measures of the value of different parts of the economy vary, depending on the source and the methodology used. IPF itself has published estimates for the commercial sector.[4] When comparing residential and commercial property, the most useful source in the annual national asset wealth survey undertaken by the Office of National Statistics, because it uses a common methodology across the various property asset classes.

60% of the UK's net wealth, almost £4,000bn in 2006, is represented by the total value of the country's housing stock and most of that is owned by private individuals (Tables 3 and 4).[5] Financial institutions own a mere 0.04% (£1.4bn) of residential. In contrast, they own a massive £132bn worth of all other buildings – industrial, office and retail for example. Other private profit-making bodies collectively own a further £311bn worth of non-residential buildings and financial institutions may have an indirect interest in them through loans and share ownership. Yet, all those commercial buildings when taken together are worth only a little over a tenth of the value of the housing stock. Even the private rented sector by itself, valued at £450bn overall (see below), dwarfs financial institutions' holdings of commercial property and even manages to match, with a little spare, the value of whole of the private sector's holdings of commercial property.

Residential, once these numbers are absorbed, hardly constitutes a specialist (ie limited) area of property investment. Instead, that categorisation more aptly applies to commercial property. When the question is asked of what is the biggest property type in the investment park, the answer is residential!

Table 3: The market value of UK assets by type in 2006

	£bn	%
Built environment		
Residential	3,915	60
Commercial, industrial & other buildings	741	11
Infrastructure	723	11
Non-marketable tenancy rights*	545	8
Other tangible assets	843	13
Net financial	-291	-4
TOTAL NET WORTH	6,525**	100

* Associated with rental housing
** Figures subject to rounding
Source: ONS

[4] *The Size and Structure of the UK Commercial Real Estate Investment Market,* IPF research report, 2005.

[5] Non-marketable tenancy rights raise the total share of housing to over two-thirds of all net worth.

Table 4: Who owns property and other built assets?

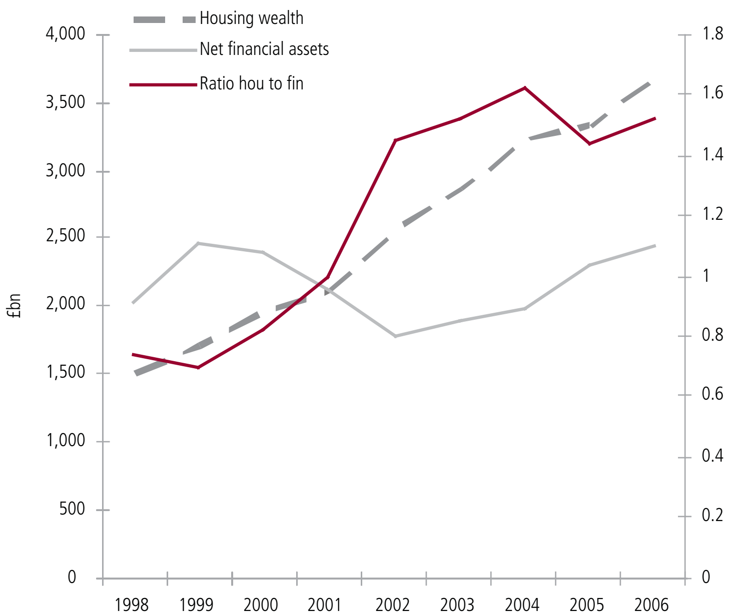
% of asset category total	Financial corporations	Households*	Private non-financial corporations+	Public sector
Built environment asset categories				
Residential	0	94	3	3
Commercial, industrial & other buildings	18	8	42	32
Infrastructure	0	0	40	60
Non-marketable tenancy rights♦	0	100	0	0

*includes non-profits serving households +includes housing associations ♦associated with social housing and small parts of the private rented sector
Source: ONS

The weight of wealth argument for investing in residential seems overwhelming. By not investing much in residential property, financial institutions seem to be missing out on a huge investment market. Even a relatively small slice of it should provide major investment opportunities. For example, a 1% share is a £40bn market and a 10% share would represent assets worth almost £400bn, not far off of the value of all the commercial and other non-residential buildings currently owned by private financial and non-financial corporations. Why should not large enterprises invest heavily in the private rented sector, say, and provide 10% of the nation's housing supply?

Figure 2: Housing wealth rising, while net financial wealth appears to be stagnating

Household sector



Source: ONS

Furthermore, on some interpretations of the data the impression can also be given that the role of housing wealth is rising, so that financial institutions may be missing the boat by not switching greater focus to housing. Overall, housing wealth has risen from being 74% of the value of net financial assets in the household sector in 1998 to being worth 152% of them in 2006 (see Figure 2). But there is a problem with this comparison, as is examined below.

3.1 Problems with the weight of wealth argument

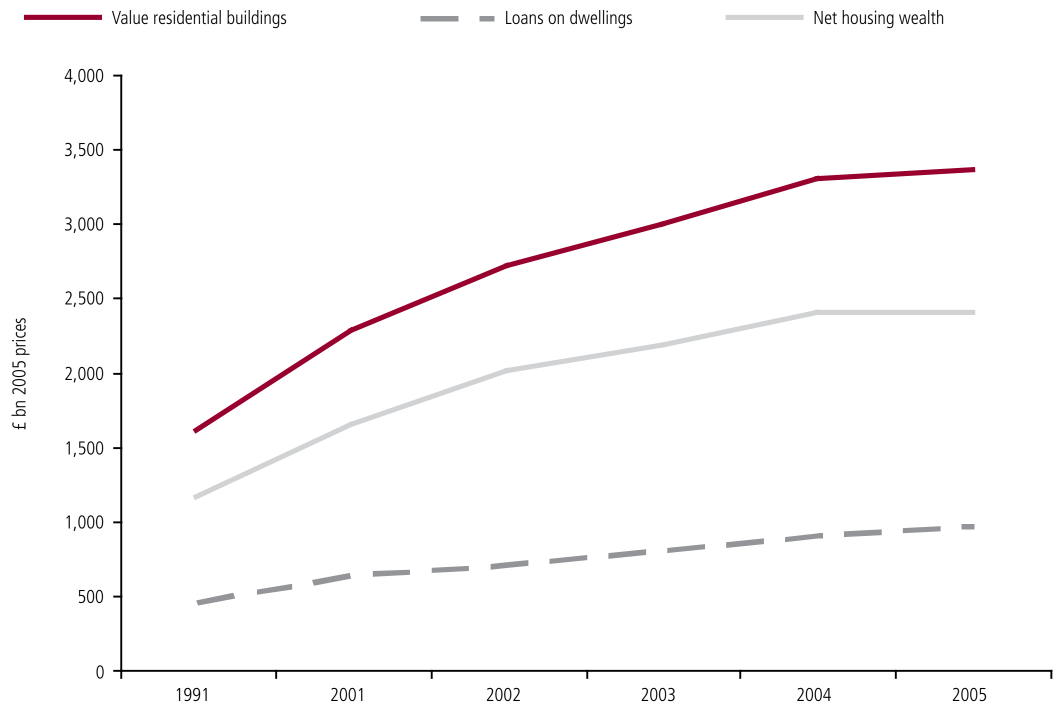
The weight of wealth argument may have merits but there are important caveats to it.

1. **Housing loans**
   Financial institutions already invest substantially in housing in terms of the loans they advance to owner occupiers, plus those to private and social landlords. Outstanding loans to the private sector alone are in excess of a £1t. Those loans, in turn, may be sold onto capital markets in the form of residential mortgage backed securities, so that the whole financial community is involved in mortgage finance not just the original lenders.

2. **Rising housing debt**
   Housing-related debt has been rising fast, so that net housing wealth has not risen as much as the gross figure (see Figure 3).

Figure 3: Housing wealth and debt

Household sector UK



Source: ONS

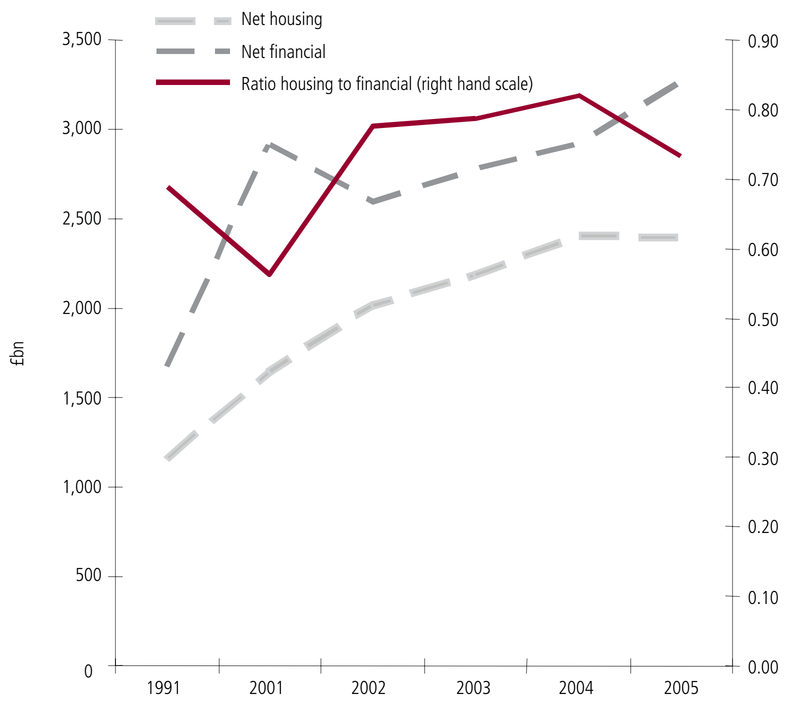
3. Financial as well housing wealth has, in fact, been rising

The data in Figure 2, which compares the change over time in housing wealth and net financial assets, is a somewhat scewed picture of the relative importance of housing and non-housing wealth because it factors mortgages and other housing debt into the calculation of net financial assets. If housing debt is deducted instead from gross housing wealth, the picture alters.

The reason is that households have been increasing their investments in life insurance, pension funds, shares and other securities and savings deposits as well as buying housing. Non-housing loans overall have also been growing at a slower rate than residential mortgages. Therefore, when the data are readjusted by dividing assets and loans into a housing and non-housing related ones, the rise in the ratio of net housing wealth to net financial assets is much lower than Figure 2 might suggest. Figure 4 shows this re-assigned distribution of asset and loans values between housing and other asset categories in the household sector. It shows that net financial assets altogether have been worth more than housing throughout. In addition, the trend growth in the two is rather similar but their cyclical behaviour depends on the relative performance of the housing market and financial investment markets.

Figure 4: Net housing and financial wealth compared 1991 to 2005

Households



Source: ONS

This brief review of the dynamics of the housing and non-housing wealth suggests the missing the boat thesis may be on shaky grounds. There has not been a sea-change in the distribution of wealth holdings and financial institutions' traditional relationships with the personal sector remain solid and are subject to substantial long-term growth.

The cyclical pattern of change since the early 1990s in the relationship between net housing and financial asset holdings is revealing (Figure 4). Over the 1990s, net financial assets rose actually faster than net housing wealth, with the housing market slump of the first half of the decade contributing to this result. The dotcom boom and its aftermath then affected the value of financial assets, first upwards and then down. In the 2000s, as the housing market boom spread throughout the country into all local markets, net housing wealth grew rapidly but the increase tailed-off as house price growth moderated. With stock markets again booming again in 2005, the housing to financial wealth ratio dipped once more. The long-term cyclical behaviour of the housing market and its relative lack of correlation with equities is likely to mean that the ratio between the housing and financial asset categories will continue to fluctuate in the future.

3.2 Conclusions about the weight of wealth argument

The overall conclusion about the weight of wealth argument is that, yes, housing is the largest asset class but that of itself does not mean that large-scale organisations should be trying to have major investment presences within it. What is more important is the expected return to be achieved by investing in any particular asset class. Consequently, examining the viability of residential investment is not so much a question of the size of the residential sector as one about the potential investment return benefits residential offers and the weight of wealth argument provides no answers to that.

There also seems to be no clear cut evidence that the overall distribution of wealth between asset classes is inexorably moving towards housing, away from financial assets, like pensions and insurance. Instead, current evidence suggests that the share between the two asset types inevitably reflects the consequences of a recent long-boom in house prices, so that cyclical rather than trend factors are important. Furthermore, even if such a trend shift was ever observed, it might be of little significance to the investment strategies of major institutions unless it can be demonstrated that housing offers favourable returns for them.

4. RELATIVE RETURNS: RESIDENTIAL COMPARED WITH OTHER ASSET CLASSES

4.1 Total returns

The strongest case for investing in residential property are the returns to be received from it. The evidence tends to show that they are generally good, particularly in terms of capital growth. The long-run volatility of those returns is also less than the 15-20 per cent typically experienced in equities markets.

Data

Indices on residential investment returns are not as good as those for commercial property, so it is necessary to outline the constituents of the available data sources before presenting the UK evidence on residential returns.

Investment Property Databank (IPD) has only been collecting residential returns data since the start of the century. The information gathered has the benefit of reflecting a portfolio of investment properties and takes account of capital expenditure and management costs and, as a result, gives a more accurate assessment of residential investment conditions than house price indices alone, which in any case are dominated by owner occupier transactions. However, IPD only monitors currently around £2bn of property, much of it from specialist investors; while the overall private rented sector is worth around £450bn. Recent IPD measured residential returns are broadly similar to those of the Paragon Mortgages and the Association of Residential Letting Agents (ARLA) buy-to-let indices and lower than them over the longer-term.

There are some differences in methodologies between each index. The Paragon measure takes no account of property management, capital expenditure and other costs, which can be substantial. In the IPD series, slightly over a third of potential and actual gross income was lost either to voids or to maintenance, management, insurance, utilities and other irrecoverable costs. ARLA factors in voids but not other costs into its index.

Despite their differences in construction, the three available rental property indices all show robust historic returns for residential investment. (Table 5 shows the IPD and Paragon data). They exceed substantially those on bonds and for equities over the full six year period of the IPD index (a period which included the dotcom crash). The measured returns would be higher, of course, on a leveraged basis.

Rental returns according to the Paragon buy-to-let index have diminished in the last couple of years as house price growth has slowed in many parts of the country but are still respectable. An important factor is that rents have failed to date to catch up with house prices.

Capital appreciation has played an important part in generating residential returns in the 2000s, as can be seen in Table 5. Most media reporting of private residential investment focuses on rental income returns only, rather than gross returns, and on that basis persistently forecast an impending crisis. Yet long-run capital gains in UK housing are substantial and have a significant influence on expected gross residential returns.

Detailed differences between the data are due to the factors already enumerated. For example, a reason for Paragon income returns in 2006 being much higher than in the IPD series is that it is based on gross rather than net rental income, while the variations in capital value growth between the two are likely to be mainly due to the differences in the locations and dwelling types of the properties in either series.

4. RELATIVE RETURNS: RESIDENTIAL COMPARED WITH OTHER ASSET CLASSES

Table 5: UK residential returns

IPD 2006 and historic performance over three and six years

	1 year			Annualised total return by 2006	
2006	**Total**	**Income**	**Capital**	**Over 3 years**	**Over 6 years**
Residential	16.8	3.5	12.8	11.6	13.6
Commercial	18.1	4.9	12.6	18.5	13.7
Equities	16.8		13.1	17.2	4.5
Bonds	-0.1		-5.5	4.6	4.9

Source: IPD

Paragon buy-to-let index 2003 to 2007

Average gross one year returns

	Income	Capital	Total
Jul 07	6.0	4.1	10.1
Jul 06	6.7	9.8	16.5
Jul 05	7.0	14.1	21.1
Jul 04	7.7	16.9	24.7
Jul 03	8.9	20.5	29.4

Source: Paragon Mortgages

4.2 Long-run capital gains

A major difference between commercial and residential property investment relates to long-run real capital gains. Given the strongly cyclical nature of prices in property markets, some care has to be taken over choosing periods for comparison to avoid end point biases. As commercial prices did so exceptionally well from 2004 to 2006, it probably makes sense to exclude those years from a long-term analysis, which is done here.

When the 25 year period from 1981 to 2003 is examined, valuations have fallen in real terms, according to IPD, which recorded average annual real falls of over 1% yearly – a drop in values of over a quarter during that time (though subsequent price rises have reversed some of that fall). In contrast, house prices rose on average by 4.2% in real terms over the same period, producing handsome capital returns (Table 6).

4. RELATIVE RETURNS: RESIDENTIAL COMPARED WITH OTHER ASSET CLASSES

Table 6: UK property real returns breakdown 1981 to 2003

	Capital gains		
Commercial property	Average % real change per year	Standard deviation	**Income returns Av. % pa**
Retail	0.5	7.9	1.9
Office	-2.7	10.7	2.6
Industrial	-1.7	9.5	4.5
Other property	-0.7	8.2	1.0
All Property	-1.2	9.0	2.5
UK house prices	4.2	8.6	----

Sources: IPD, NSO, Communities and Local Government

The comparison is not quite straightforward but the difference is so great that it is not essential to dwell too much on detail. However, it is important to note that the IPD capital values information is related to a *stock* of properties held by investors and an amalgam of changes in the capital values of new buildings and of depreciation in the value of buildings as they age within the IPD portfolio;[6] whereas quality-adjusted house price data relate to a *traded* mix of dwellings of all ages.

Timing may also be important in the comparison. Over the period 1981–2003, office capital losses offset positive real income returns to leave a near zero overall real return. Yet, it could be argued that this result is heavily influenced by the collapse of the commercial property market in the early 1990s – a one-off. However, housing experienced a bad crash at the same time and took longer to recover. Even taking into account the tumultuous 1970s, the Barker Review estimated the long-run real trend of house prices at 2.4% annually.[7]

As well as pointing to the empirical evidence, there are some general reasons to expect commercial property capital values to increase at relatively moderate rates over the long-run in comparison to housing. They relate to technical, economic and political factors that – taken altogether – lead to continuous improvements in the supply-side for commercial, while there are good reasons to expect housing supply to lag demand over the long-run.

1. Land is a scarce resource and commands especially high premiums at central and other desirable business locations. Yet, *technically,* it is relatively easy, regulation permitting, to create, say, more offices by increasing densities and building high. In comparison, high density living appeals only to a narrow range of housing consumers, because most of them aspire to a house and garden, as noted earlier. Commercial property tends not to be so land consuming as housing as a result.

[6] The precise breakdown between the real values of new buildings and depreciation with the existing stock will depend on additions and withdrawals from the portfolio of properties in the IPD data set at any point in time, refurbishments, depreciation rates and market prices. The decline in capital values for any individual property is likely to be worse than shown in Table 6, because of the impact of individual property depreciation.

[7] K. Barker *Review of Housing Supply. Interim report – Analysis,* H.M. Treasury 2003.

It is also easier to innovate in the construction methods of commercial buildings as well, because of the acceptable density factor and other features of this type of built structure, such as the fact that their interiors are relatively simple and standardised. This lowers building costs over time and probably at a much faster rate than in housing.

2. *Economically,* firms are always trying to limit their use of resources to produce any given amount of output and manage to do so over time. By doing so, they increase general wealth and prosperity. This spirit of economy generally includes minimising their use of buildings. Households are quite the opposite in this respect to cost conscious enterprises. Over time, for preference reasons, they want more space per person with rising incomes and, typically, lower density environments. Even when land supply is elastic, pressure is put on house prices by such demands and housing supply is highly inelastic in the UK.

3. *Politically¸* the direct relationship between the supply of commercial buildings and economic and employment benefits is widely recognised by politicians and voters. Therefore, the supply of new commercial buildings, though it faces constraints in the planning system as pointed out by the recent Barker Review of Planning, generally responds to market forces more readily than does that of residential. Of course, there are caveats to this point. Some types of commercial building may cut into politically sensitive areas. For example, out-of-town shopping centres are restricted in the UK by planning policy in the arguable belief that this will save high streets.

Together these points suggest that

- the price elasticity of commercial building supply is generally much higher than for housing. This is especially the case in the UK where housing supply is severely restricted by the planning system, as the Barker Review of Housing Supply demonstrated.
- the demand for commercial property increases at a slower rate with economic growth than does housing.

For similar demand pressures, a more elastic supply implies a lower long-run increase in capital values. Britain is exceptionally poor at providing new housing supply, so it is unsurprising that the long-run difference in the growth of capital values between commercial and housing is particularly high in this country. This imbalance between long-run capital growth of housing and commercial property, therefore, is likely to stay and be greatest in the strongest growth, most planning restrictive, regions, like London and the South East.

Recent housing market forecasts suggest a continuation of the upward drift of house prices. For example, a recent study by Oxford Economics for the National Housing Federation suggested that English houses prices may temporally slow in 2008 but will then accelerate again to rise by 40% over 2007 values in nominal terms by 2012.[8]

This not to say that there cannot be pockets of housing oversupply in the short-term, especially of particular housing types at specific locations. Unfortunately for large-scale investors, the UK planning system currently has a strong preference for high density, 2-bed flat developments on brownfield sites, an attractive investment type for them. For example, there is evidence at present of over-supply of this product type in some of the large northern cities. Yet, the potential scale of such temporary supply gluts is far less than those common in the commercial sector.

[8] NHF press release, 7.8.07, www.nhf.org.uk.

4.3 Capital gains volatility

By far the most volatile element of property returns is capital gains. The third column of Table 6 highlights that the volatilities of commercial and residential property capital growth are fairly similar. Moreover, both are substantially less than the average price fluctuations found in equities.

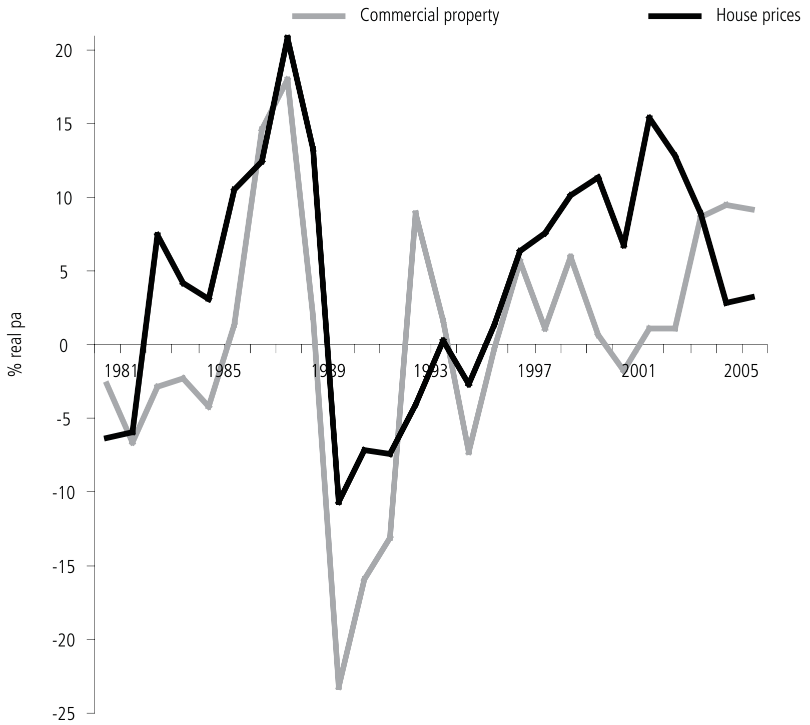
The returns between the two property sectors nationally are also imperfectly correlated. Over the years shown in Table 6, the pattern of real price change differed noticeably between commercial and residential, with a correlation coefficient between them for the whole time from 1981 to 2006 of 0.69 (0.64 for 1991 to 2006).

Figure 5 shows the period in more detail. Over the 26 years, house prices tended to have longer periods of upswing than commercial markets and in the sharp downturn of the early 1990s house prices fell less and recovered more strongly. This differential pattern of price change – with stronger price booms for housing and weaker slumps – accounts for the much higher capital growth record of residential property.

4.4 Vacancies

Residential rental vacancies have been running at around 7-8% a year over the past few years, according to both IPD and ARLA information. Vacancies obviously lead to a lower than feasible rental income and come about because of tenant turnover, important in residential, and the state of the housing market.

Figure 5: Annual real capital growth 1981 to 2006: UK commercial and residential property compared



Sources: IPD, NSO, Communities and Local Government

As the UK residential lettings market has only been deregulated for a relatively short time period and data are limited, it is difficult to develop a clear understanding of cyclical vacancy behaviour and whether recent vacancy information can be regarded as indicating 'normal' rental market conditions.

4.5 Housing market cycles

Though often unrecognised, cyclical variation in the private rented sector is different from that of the owner occupier housing market itself. These variations are caused partly by demographic, income and regional factors, as the two sectors serve distinct age and income cohorts and have varying national spreads. In addition, behavioural drivers in relation to market forces are important but quite complex in their operation.

Boom periods, when house prices are rising, encourage some households to invest in homeownership and, so, quit renting, as price expectations grow; whilst others are crowded out of homeownership by no longer being able to afford purchase and remain longer as renters than they otherwise would have. Periods of flat or falling prices have the opposite effects. For some entry to owner occupation is discouraged because of poor price prospects, yet price softness makes purchase more affordable as well. The two drivers related to price expectations and affordability thereby influence the demand for owning versus renting over the course of the housing market cycle, with each pushing in a different direction.

A reasonable hypothesis is that the price expectation effects on the demand for owner occupation are greatest during the earlier stages of an upswing and they are then increasingly outweighed by the affordability effects towards the end of that phase. In downturns, the impact on demand reverses, with price expectation effects on owner occupied demand depressing prices in the earlier stages of the downswing and affordability factors becoming on stronger factor at later stages. The demand for renting relative to owner occupation falls during an owner occupied market upswing but rises again as that market moves towards its peak and subsequently slows.

This argument has a number of implications, which are unnecessary to draw out in detail here. Instead, what is important is to simply emphasise the deduction that the demand cycles for private renting and owner occupation are unlikely to be synchronised. Moreover, when the demand for homeownership is falling strongly and affecting price expectations negatively this will raise the demand for renting.

5. COMPETITORS IN RESIDENTIAL RENTAL MARKETS

The ability of large-scale investors to operate successfully within residential property depends on the other types of landlord active there. Private individual, or 'buy-to-let', landlords are the most prominent, owning over two-thirds of all tenancies. There are also specialist property companies and other corporates – many of the latter own property for a variety of non-commercial reasons or through historical accident. Housing Associations are also increasingly involved in the development and management of 'market rent' properties.

The most pronounced trend of the past 20 years has been the expansion of the buy-to-let sector at the expense of corporates. Overall, tenancies have risen by a quarter in the past decade, primarily in the buy-to-let sector. Some corporates have simultaneously taken advantage of rising house prices to sell off their residential portfolios. The growth of buy-to-let has sometimes been characterised as a fad phenomena but, in reality, it has a basis in the dynamics of the private rented sector since market liberalisation at the end of the 1980s and the greater availability of mortgage finance from the late 1990s onwards at significantly lower rates of interest in relation to owner occupation than prevailed earlier.[9]

Small landlords are also cost competitive relative to large ones over wide portions of the rental housing stock. They do not have high overheads, can be flexible in response to market signals and even those relatively larger ones holding scores of properties can easily scatter their investments over a variety of local markets and thereby spread their risks. In particular, they can compete effectively with larger enterprises within the diverse and scattered stock of properties that constitutes most of the UK private rental stock. The majority of this housing is scattered around neighbourhoods of quite old, terraced and semi-detached houses, and flat conversions within this house type.

The predominant mix of private rental property and the costs of managing it favour small-scale landlords. New properties in blocks of flats – though often thought to be typical buy-to-let territory - are, in fact, comparatively rare with the private rental stock.

There is substantial 'churn' with properties being bought and sold by landlords. They sell to each other as well as sell to and buy from owner occupiers and, additionally but less so, from housebuilders. It is consequently impossible to identify a fixed set of rental properties but rather a changing pattern of private rental tenancies within the UK's total housing stock, albeit it one with clear characteristics. This trading pattern again is not conducive to the operations of large-scale investors. Typically, they want to hold a large block of property as a unity over the long-term.

It is sometimes claimed that large-scale landlords bring professionalism and higher quality to residential renting, though the evidence for this assertion is poor. A key implication derived from such claims is that large-scale investors should easily be able to takeover private rental provision, if only they had the inclination. This argument seems weak. In principle, the scope for scale economies and the benefits of specially trained workforces seem limited, as argued above, in the contexts predominating in UK private rental investment. Consequently, given the economics of residential landlordism, it seems hard overall to envisage large-scale investors being able to take over the core private rented sector. Small-scale investors are generally at least equally well able to operate within it and are often more cost effective for any given level of quality. This conclusion is backed up by one important piece of evidence: throughout the world the private rented sector is dominated by the small-scale personal investor.

[9] M. Ball *Buy-to-let: The Revolution – 10 years on,* ARLA, Amersham.

Such observations do not rule out important roles for large scale-investors in the core private rented sector. Instead, they suggest that they are unlikely to offer any additional value that sweeps the small-scale investor away. Yet an important implication is that when such investments are made by large-scale investors, they would be advised to mimic the flexible organisational frameworks that derive the best returns in these markets. This may involve outsourcing; a pyramid whose base is local providers; branding; or anonymity – with the idea configuration depending on the precise circumstances.

There are also segments where large-scale investors are likely to have clear competitive edges in residential investment. Such opportunities probably exist mainly when scale economies or enhanced skill sets, or both in combination, create distinctive and cost-effective rental products. In other words, large residential operators can prosper particularly well where they can take advantage of potential scale-advantages arising through branding, in purchasing, via specific forms of quality control or in other management fields.

Empirical evidence in the UK of such investment possibilities already exists and its potential for expansion is shown by the several new fields of direct residential investment developed by large-scale investors over the past decade. A number of firms and funds now exist with £100–500m portfolios of UK residential property. They have grown to be major players in such areas as accommodation for students, key workers and retirees. Other growth areas with significant potential are serviced apartments for mobile, high-income professionals and health-care related housing.

Student housing illustrates the scale and growth of such investment opportunities. Many students rent accommodation from small-scale landlords, with some neighbourhoods in university towns almost entirely used for student housing. Even so, there are over 450,000 bed spaces in student halls and over a 130,000 of them are in halls owned and run by private firms. This market was estimated to be worth £6.6bn in 2007, according to Savills, and had almost doubled in value over the previous two years. This indicates the scale of new investment taking place and forecasts point to further strong growth over the next few years. Growth is being encouraged by the over 30% increase in rents over the same period, due in part to the greater provision of en-suite accommodation.[10] The small-scale and the large investor both operate in the student housing market and the large-scale ones have been able to prosper due to an ability to differentiate their product and offer a distinctive service package.

[10] Savills Student Housing Report, 2007.

6. GAINS FROM INVESTING DIRECTLY IN RESIDENTIAL

Large investors derive gains from residential property in four main ways:

6.1 Good returns

Residential investments offer good returns, especially with rises in capital values.

6.2 Weakly correlated returns

Returns are imperfectly correlated with those from other property asset classes. Housing market returns across various spatial scales are also weakly correlated. So, portfolio diversification targets can be met through residential investment.

6.3 Specialist skills add value, where they matter

As noted above, particular housing types lend themselves to scale benefits that only large investors can provide. The range of opportunities is likely to grow in the future as living standards rise, because many more consumers will put emphasis on accommodation quality and the life-style implications to any residential package.

6.4 Average rental returns are likely to be attractive

Even if much of the private rented sector offers no special advantages to large-scale operators, they can often compete relatively successfully in many parts of the private rented sector and, so, make the prevailing average return on residential investment. That return over the long-run has to be enough to sustain investment in a market where demand is growing. The risk profile is also attractive. There is little danger of investment gluts in housing, especially in a country like the UK which is subject to severely restricted supply. Even in countries with less restrictive supply regimes, good (and relatively risk free) returns are still likely to exist, otherwise investment would fall behind the demand for rental accommodation.

7. PROBLEMS WITH INVESTING DIRECTLY IN RESIDENTIAL

7.1 Transaction costs

The costs of making an investment are relatively high in residential, both in terms of agent and other fees but also in relation to investment evaluation, decision-making and monitoring. This may create substantial difficulties for large-scale investors, lowering expected returns below acceptable levels. Individual dwellings are of low value compared to commercial properties and so the relative burden of transaction costs is particularly high. Yet, even large blocks of flats rarely match the multi-million pound deals typically undertaken by large funds when they invest directly in commercial property. Firms frequently set minimum investment amounts as guiding rules to limit transaction costs and residential property often falls way below them.

Such issues are solvable to a degree. Firms can set up special residential purchase teams or buy up portfolios of properties from others – though their supply may be limited. In any case, the general point is obvious. The high dealing costs of residential mean that it is not a perfect investment substitute for commercial properties. Firms have to take strategic views and set up cost-effective operations. Many firms may think the effort is not worth it.

7.2 Management and maintenance costs

Many aspects of day-to-day property management are borne by tenants under the terms of commercial leases but this is not the case in residential. So, property management and maintenance in residential is far more hands-on in nature and costly for investors, even when outsourced. Once again, the imperfect substitutability of commercial and residential investment is highlighted by such management issues.

7.3 Turnover and vacancy

It was noted earlier that tenant mobility is high and leases often short in the private rented sector. Re-lets require maintenance work to be done to properties and letting agencies hired. High turnover consequently intensifies management effort and costs. Furthermore, there is a risk of a prolonged vacancy when a tenant leaves. Even if another person can quickly be found, there is likely to be some void time when no rent is paid. Most commercial property does not exhibit tenant turnover characteristics to such a degree. Leases generally are long and so obviate these issues arising with residential.

7.4 The vacant property premium

Tenanted residential properties trade at a discount to vacant ones. The exact amount depends on market circumstances and valuer's attitudes, and it varies from market to market. IPD cited an average vacant residential premium of 7.5% in 2006.

It is hard to quantify why the discount once occupied is so high. One factor seems to be the psychological impact on price of any usage, even if the actual wear and tear is miniscule, akin to what happens to the price of a new car as soon as the purchaser drives it. Another is the viewing difficulties that may arise with a sitting tenant; while the six-months initial security of tenure of the typical shorthold tenancy limits some sales flexibility and there is a small risk of problems arising when a tenant is asked to leave.

Such substantial discounts on tenanted properties have the unfortunate effect for investors of generating an immediate significant capital loss when they buy a new property and let it. This phenomenon may affect large-scale investors' interest in residential.

7.5 Reputation

Few, apart from those affected, care much about tenant-landlord relations in commercial property, unless they turn nasty in spectacularly newsworthy ways. Far more headline grabbing are perceived heartless 'fat cats' out to destroy the lives of innocent victims over some housing dispute – perfect ammunition for political activists and parts of the media, no matter the justifiability of the claims. As a result, reputation fears are said to be high for major investors over involvement in housing. Such qualms can be overdone. Mortgage lenders, for instance, generally manage the media circus well and suffer limited opprobrium.

7.6 Illiquid, thin markets

There are 21m private dwellings in the UK and around 1.6m of them are bought and sold each year, so there is a deep market with little likelihood of the systematic mis-pricing of particular properties. This characterisation weakens when it comes to blocks of flats or investment portfolios of residential estates. They are much smaller in number, especially in a particular local market, and few are traded within a specific time period. As a result it may be difficult to sell them on a timely basis or to work out what is their fair market value at some points of the property cycle.

One way of improving liquidity is the intensive asset management option of asset break-up and selling off properties on an individual basis, if they cannot easily be sold as a block. Yet the transaction costs associated with that route are high; piecemeal sales take time, during which period the price of the individual properties may change for the worse if the market for them becomes temporarily saturated; and the total value of dwellings sold separately may be less than when sold as a whole.

The relatively low key, and often opaque, nature of residential investment markets has a further drawback in that they may fit in poorly with the emphasis frequently put on bench-marking within the UK property investment industry. People might reasonably think it is not in their own self-interest to invest in residential when, at best, there is no positive effect to be achieved on benchmarking criteria and, at worse, the move makes measured performance look worse.

7.7 Not a pure income investment

Many people in the residential investment business claim that some important UK funds have an implicit bias against residential because their investment aims are focused primarily on income rather than capital gains. This may be because they wish directly to match particular asset returns with expenditure liabilities (eg in the case of annuities), even when pooled asset portfolios might lead to higher expected returns. A matching of a profile of returns with those of liabilities is a weak argument for neglecting residential. A more rational strategy would be to consider the capital as well as the income side (ie total returns), because ultimately 'matching' criteria are more likely to be efficiently met by having portfolios in which income and capital returns matter.

An emphasis on income alone generally does not make housing a particularly attractive investment, especially as other types of investor (and owner occupiers!) are prepared to bid up the current price of housing in expectation of future capital gains. Therefore, income yields are invariably going to look poor. (This income return only perspective, it might be added, is regularly used to berate the buy-to-let sector and erroneously said to provide evidence that it is overheated, full of irrational speculators and about to crash).

Take the case of UK offices over the 'long' period from 1981 to 2003, shown in Table 6: the real yearly average income return of 2.6% over that time may have matched some particular set of liabilities but whoever owned those liabilities in reality received a raw deal because office's positive income return was wiped out by a virtually equivalent capital loss of 2.7% a year. The income matching strategy in this instance only beat a zero return by the average rate of inflation over the period plus a miserable 0.1% return a year. Other investments would have faired far better. Of course, it is easy to be right after the event and predictions of office returns are unlikely to have been so low at the times when those office investments were made. So, this is not an argument against offices, but rather an illustration of the pooling benefits of mixed asset portfolios and a focus on total return within them.

Of course, it may be the case that investors have other reasons for not investing in residential. The list above highlights some strong justifications for such a stance. The income matching argument might then be a polite way of saying no without having to go into the details of the argument. But, as a rational strategy, it is harder to justify.

8. THE MULTIPLE WAYS OF INVESTING IN RESIDENTIAL

8.1 Direct investment

Most of the discussion in this report so far has been framed in terms of direct investment in residential through purchasing a stock of housing and renting it out to households. There are many other types of investment vehicle, but direct investment is clearly ideal for many purposes that often parallel the advantages of direct investment in commercial property, namely:

- total control of the core asset base.
- full information about asset performance.
- an ability to gain the full benefits of the asset's investment characteristics without the intermediation of other investment forms – such as occurs when purchasing the shares of a property company, when performance is partly determined by that of equities as a whole.
- the possibility to benchmark investment performance in an unequivocal manner against some external indicator.

Against these advantages, there are several disadvantages that have already been discussed: trading sizes and volumes; high transaction, management and maintenance costs; valuation issues; turnover, vacancy and reputation factors; and potentially thin and specialist markets.

8.2 Indirect investment

Indirect involvement can be achieved by purchasing the equity of specialist residential property companies. Liquidity is improved through indirect investment and many of the extra costs and burdens associated with direct investment are borne by the residential specialist, rather than the investor. A wider range of assets and spatial locations can also be invested in for any given outlay compared to the direct route, thus offering the investor greater diversification of risk.

However, along with such benefits come the downsides of loss of control, imperfect information and a blurring of the sources of return compared to the direct investment route and a general loss of the benefits of the direct approach, as described above. Moreover, specialist firms tend to take on trading and development roles as well as holding portfolios of residential assets and those activities are more risky, which may deter investors and lead others to require a higher return than in direct in compensation.

Furthermore, given the value of most residential properties and limits to scale economies, few residential specialists are likely to be large companies and even less to merit a full stock exchange listing. The equity of smaller companies can be purchased through other routes, such as AIM listings, but the range of benefits expected of indirect investment may be diminished as a result. For example, it is easy for any given investment sum to represent a relatively large share of the equity of that firm. Subsequent trading activity may then disproportionately affect the value of that company's stock.

There is also a chicken-and-egg situation about the existence of publicly traded residential property firms. If there were a relatively large number to invest in, institutional investors would be more likely to be interested in them. Yet until there is a significant amount of investment interest, it is unlikely that many such entities will exist. A low activity equilibrium may easily be the outcome.

8.3 Mortgages and their derivatives

As noted earlier, mortgages are a common way of investing in residential property on an indirect basis, through mortgage backed securities and their derivatives. However, the returns derived from them are linked to the cost of funds and sentiment in the capital and money markets rather than to the housing market itself. The main housing market influence is the effect on security values of borrower default risk. This is typically low but may rise sharply with negative economic shocks.

There is also a prerequisite that due diligence is undertaken when mortgages are issued and that risks are appropriately priced. The US sub-prime mortgage market has shown recently that errors can develop at both stages. However, the institutional arrangements in US mortgage finance make it more likely for such problems to arise there than is the case in the UK. Yet, the recent experience of Northern Rock in the UK and the knock-on worldwide effects of the US sub-prime crisis in 2007 highlight that mortgages and their derivatives are by no means a risk-free business.

8.4 Equity release

Equity release is associated with a variety of financial products that give owner occupiers access to part of the value of their property and those products are targeted at older home owners who do not wish to move and trade down in order to release equity. For the investor, equity release schemes offer dual exposure with returns partly related to the housing market and partly based on interest rates.

There are two main types of equity release product, with many detailed variants within each category. Only a brief outline will be provided here.[11]

The principle of the first form, *Lifetime Mortgages,* is that money is lent to an older household with little or no current mortgage debt in order to provide either a lump sum or a drawdown arrangement, releasing cash when needed. The person has a guaranteed right to live in their home for the rest of their lives and pays a fixed or variable rate loan charge, with the loan paid off from the proceeds of the house sale when the dwelling no longer remains the primary residence.

Homeowners' equity may be easily eroded by the impact of compound interest in the Lifetime Mortgage formulation. An extreme example illustrates the point: if £45,000 is borrowed in this way over a 25 year period at 9% interest, the total cost is £388,000.

Under the second form, *Home Reversions,* the owners sell all or part of their home for an agreed lump sum, or income stream, with a guaranteed right to live in it rent free to death. The loan provider then gets the proceeds of its part of the property on sale at death. The discount to current market price is typically between 35% and 60%, depending on such factors as the original homeowner's age and whether all the proceeds of future price appreciation accrue to the lender/new owner.

The potential market for equity release schemes is extremely large, with well over a £1,000bn of housing equity estimated to be currently owned by the over 65s. Rising house prices and an ageing population mean that the market is forecast grow substantially over time. The Institute of Actuaries in 2004 estimated it to be worth £2bn annually by 2010 and nearly £4bn by 2031. Growth will be strongest if the impact of an ageing society makes the pensions of many prove inadequate and if elderly people's preference to stay in existing homes remains strong.

The outstanding loans of lifetime mortgages had risen to be worth £6.3m in 2006, according to CML data, though this represents a tiny fraction of either total mortgages or housing equity. Currently, the market has 15 providers

[11] The Council of Mortgage Lenders has undertaken a number of useful studies in this area (eg *Building Confidence in the Equity Release Market*, CML, 2006) and those reports have been the prime source for the information in this section.

offering 28 products. Despite continued growth in the outstanding value of lifetime mortgages, the total value of newly advanced ones has been falling in recent years and, by 2006, the annual sum was a fifth down on the 2004 figure. However, this may be a cyclical effect as consumer expectations of house price rises moderate.

The product is by no means problem free. One issue has been that consumer confidence has been damaged by cases of unfortunate advice and pressure selling. An earlier generation of products sold in the 1980s and early 1990s failed to protect consumers from rising interest rates and negative equity. Since 1991, a code of conduct known by the acronym SHIP (Safe Home Income Plans) has been introduced in the lifetime mortgage market, which guarantees no repossession or negative equity. However, recent surveys still highlight consumer concerns about complexity, riskiness and value for money, with around a third of respondents reporting a lack of trust in equity release.

In response to such difficulties, new mortgage regulations were introduced in 2005. Both the Financial Services Authority and the Council of Mortgage Lenders continue to work on improving safeguards and the FSA is now to regulate home reversion plans as well as lifetime mortgages. So, consumer perceptions of these products are likely to improve over time.

A further difficulty for consumers of equity release products is that equity release can affect their tax and benefit positions in complex ways. They may lower the value of the expected income stream and the full impact may not be known fully for some time. As the elderly users of equity release products often have relatively low incomes many potential customers may be affected. One lender has recently estimated that 45% of lifetime mortgage recipients were in some way affected by state benefit changes.

One implication of the costs of equity release, which is of no benefit to the equity release industry, is that it brings home to consumers the true financial trade-offs of releasing equity through staying put or by trading down. Many might well conclude that trading-down is not such a bad option after all.

8.5 Equity sharing

Recent estimates have suggested that only just over a fifth of private tenants and around 5% of social tenants could afford to purchase a house at the lower quartile house prices prevailing in England without some form of mortgage subsidy or other assistance. Given preferences for homeownership, this means that there is potential demand for more affordable homeownership, known as the 'intermediate market', from 4.7m households.[12] Obviously, not all of them will try to become homeowners but the potential to offer 'affordable' products is high. Several approaches have been tried since the 1980s.

Shared appreciation mortgages (SAMs) are offered by mortgage lenders and give borrowers lower mortgage payments in return for the lender receiving a share of the value of the property on sale. During the long recent upswing in house prices lenders did well out of these and were subject to criticism. Some more recent varieties have capped the potential gain to the lender.

Developers and housebuilders have also periodically offered low cost homeownership schemes but they have tended to be limited and linked to periods of weak sales. Some developers, especially with charitable status, are focusing on utilising Section 106 agreements but overall output is small. Bodies like the Greater London Authority are currently reviewing the situation and are looking for ways of getting greater developer and property company involvement.

[12] *Report of the Shared Equity Task Force,* HM Treasury, 2006 and Housing Green Paper 2007 *Homes for the future: more affordable, more sustainable,* Communities and Local Government from which sources this section has drawn on.

Local authorities and central government have provided further initiatives and some degree of subsidy. Between 1996 and 2006, government schemes have assisted 80,000 households. Current schemes include the Key Worker Living programme and HomeBuy, which makes three shared equity products available: Open market HomeBuy, with assistance through an equity loan in conjunction with four mortgage providers; New-build HomeBuy, where purchasers typically buy 40% of the equity and rent the rest of the property; and Social HomeBuy, where social tenants part-buy at least a quarter of their existing home at a discount.

At present, the general market response to the intermediate sector has been limited to small scale bespoke schemes. Several factors seem to be holding back the market, including the absence of a recognised system for futures or options trading in housing, which would lower the opportunity costs of holding equity. The risk profiles associated with those purchasers using the equity share route are also unclear at present and there are some uncertainties surrounding regulatory issues. In addition, private providers have faced being crowded-out by subsidised Housing Associations in this area, although the Housing Corporation is drawing up protocols to reduce this.

Despite these problems, the Shared Equity Task Force has stated the government's aim over the next three years of seeing the creation by the financial community and developers of non-grant funded equity share schemes to help 35,000 to 45,000 people in England into owner occupation, which would be a segment of the housing market worth roughly £10bn.

8.6 Residential land investment

Another means of investing in the rise in house prices is to purchase land, hold it and then sell it off at a later stage or develop it. Some financial institutions are already believed to hold land for such purposes, although it is typically classified under its current use as agricultural land or as parts of future regeneration and mixed-use schemes.

Table 7: The increase in land values between agricultural and residential use

2006

	Mixed agricultural land	Residential	Potential value uplift
Region	£/ha	£/ha	£/ha
NE	6,701	2,210,000	2,203,299
NW	9,633	2,740,000	2,730,367
Yorks & H	9,159	2,330,000	2,320,841
E Mids	7,595	2,060,000	2,052,405
W Mids	11,945	2,200,000	2,188,055
E	7,739	3,615,000	3,607,261
SE	11,787	3,240,000	3,228,213
SW	10,416	2,340,000	2,329,584
Wales	9,774	2,270,000	2,260,226
Eng and Wales	10,023	2,600,000	2,589,977

Note: Uplift values are indicative only as the data are for average land values for each use in each region.
Source: Valuation Office

The value uplift for greenfield land is particularly high (Table 7); though it is still often over £1m per hectare in urban areas, including in northern English cities where prices tend to be lower than further south. Residential land values, unsurprisingly, tend to track changes in the direction of house prices quite closely. However, urban industrial values remain higher than those of residential in some parts of the South East (eg High Wycombe, Crawley and Swindon).[13]

One difficulty with strategies of holding agricultural land in the hope of winning planning permission for housing is that existing landowners will obviously want full market price for sales and existing prices will be influenced by expected future returns. The same is the case for options, which will usually have some requirement for full market value written into the final sales terms. However, even if prices do fully reflect current and future market values, the returns may still be attractive and often contain significant risk premiums for those looking for them. If some development function is bundled in with the land ownership option, the future value uplift could be particularly high.

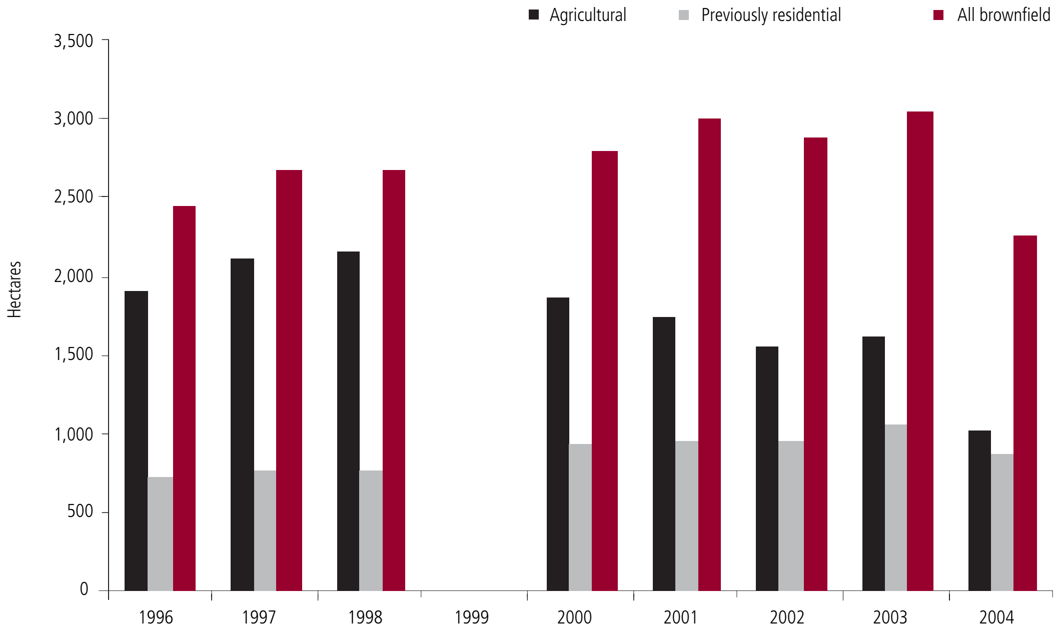
The classic view of greenfield residential development is of the conversion of agricultural land to housing. Such land transformation often benefits from large-scale land investment and development, especially when much dialogue with planners, infrastructure and 'community building' are required. Yet the amount of land subject to such change has been falling dramatically over time, especially in recent years. Figure 7 shows the situation since 1996 for England. Even total brownfield land-use has been stagnating in the 2000s and even fell sharply in 2004. Only previously residential land seems to be achieving any trend rise, especially in the South East. Much of that category relates to scattered sites and ex-gardens and so is of little interest to large-scale investors.

The government's announcements in the 2007 Housing Green Paper on increasing land supply are unlikely to lead to significant increases the amount of agricultural land being converted to housing, outside of a limited number of growth areas. The government is committed to prevailing brownfield targets and high housing densities and has made clear its lack of interest in weakening green belt constraints.[14]

[13] *Barker Review of Land Use Planning. Interim Report Analysis* HM Treasury Ch 8 provides an analysis of this issue.

[14] Housing Green Paper 2007 *Homes for the future: more affordable, more sustainable,* Communities and Local Government.

Figure 7: Agricultural and previously residential land as sources of housing land supply 1996 to 2004



Note: Data unavailable for 1999 and beyond 2004. Brownfield land totals include previously residential land
Source: Communities and Local Government

8.7 Investing in housebuilder shares

The fortunes of homebuilders tends to ebb and flow with the housing market cycle and so investing in their shares captures some of the cyclical pattern of housing market change. The correlation is obviously weakened by other general stock market influences on the performance of builders' shares, in a similar way to that considered in the indirect property investment case examined earlier.

The relationship between housebuilders' profits and long-term trends in house prices is less direct. In fact, there should be little relationship at all. The profits of housebuilders are based on competition within the industry and relative firm efficiencies. If profits rise much above typical levels, new firms will be attracted in and existing firms will expand until competition pushes returns down again.

Housebuilders clearly do gain during periods of unexpected rises in house prices because they hold stocks of land which grow in value as prices increase. However, they cannot permanently capture increased development gains because they have to pay the prevailing price for land when replenishing their land stocks. In economic terminology, increases in house prices are transmitted back into the cost of their inelastic input, land, and they only make the normal long run profits of a housing supply intermediary.

8.8 Build and own

The final option for a residential investment strategy is to be proactive and develop bespoke schemes for subsequent holding and possible trading. As noted earlier, housing associations are already becoming active in this area. Many of the market specialists in such fields as student housing also adopt this approach, sub-contracting the actual design and building work out to specialist contractors.

This approach does have the advantage to investors of them being able to specify precisely the sort of development they would like to own. But the average risk-adjusted total return is unlikely to be much enhanced above that achieved through purchasing speculative developments directly. The same argument holds for the development side of the build and own approach, as was used with regard to housebuilders above. The returns to development are only likely to be the same as those for other developers in the sector over the long-run.

In addition, residential development is a significantly more risky activity than owning buildings alone. Specialist developers, in any case, are often more skilled at site assembly and spotting consumer and market trends than are institutions with limited experience in that market place.

8.9 House price derivatives and spin-offs from them

Since the early 1990s there have been calls for the introduction of index-based futures and options markets in residential real estate in both the USA and the UK. However, little real action materialised for many years and to date only relatively minor trades have taken place, yet there is scope for substantial expansion.

The Chicago Board of Trade in summer, 2006 set up two new house price derivatives contracts, a futures contract and an option on a futures contract, based on the Case-Shiller home prices indices for a national composite index and 20 regional ones.[15] In May, 2007, the first US log-dated house price derivatives were traded. In them a boutique trading firm sold short the national Case-Shiller home price index for four and five years, with Goldman Sachs on the other side of the trade. The seller will profit if the index falls and Goldman Sachs expects the index to be at almost the same level in five years time.[16] Though neither seem optimistic about US house prices, the deal was obviously made possible because they have different expectations regarding the future of house prices.

A property derivatives market has been growing in the UK but it is currently mainly restricted to a small number of participants trading over-the-counter (OTC) products, mainly in commercial property. TFS, an inter-dealer broker that deals in swaps based on the Halifax and other European residential price indices, launched a UK future house price index at the beginning of 2007 based on derivative prices quoted in the OTC residential property market. At that time, the index rated 2007 end year prices at 4.25% higher and end 2030 prices at 93% higher.[17]

The growth of a substantial house price derivatives markets could spawn a wide variety of products, including home equity insurance and savings products for those wishing to enter home ownership at some future stage. Potential sellers of an index for hedging purposes include housebuilders and mortgage lenders, while buyers could include pension, life and hedge funds.

Several problems with such markets remain. House price indices have to be reliable; expectations have to be sufficiently broad in a market where there are marked persistence effects in prices to make hedges viable; and liquidity has to be assured, which may not be the case. When the market is deep and well-used many of these issues might be resolved. The problem is getting there.

Derivatives have grown to importance elsewhere and the expectation has to be that this market will grow in the future. Once it takes route this should also open up possibilities for large-scale investors in other areas of residential investment as a result.

[15] Economic Research, Federal Reserve Bank of Cleveland.

[16] *Financial Times,* 11.5.2007.

[17] www.tfsbrokers.com

8. THE MULTIPLE WAYS OF INVESTING IN RESIDENTIAL

This report has examined the case for residential investment. Developments in both finance and housing indicate that there are probably greater opportunities for large-scale investment in housing than have existed for many decades. The opportunities for scale economies in rental housing markets are growing and with them the possibilities for large-scale investment.

The drivers of change point to a rising significance of residential as an investment asset class. Yet there is no easy pot of domestic gold, as this report has been at pains to point out. The housing market is an efficient one, as are its associated mortgage finance ones, competition is strong and returns reflect this.

Residential as an asset class is massive, dwarfing all other types of built structure in the UK but the real justification for investment in it is the returns on offer. Historically, the returns have been good and their volatility has been relatively moderate. Real capital growth has been particularly strong, far better than in commercial property. It is forecast to be at least as good in the future, particularly in the UK which has a strong economy and a poor housing supply record. Returns are also weakly correlated spatially and, to a lesser degree, with other asset classes. So, diversification needs are also met through investing in residential assets.

Despite such features, those large investors without residential asset presences have not necessarily missed out. The attractions of residential have to be weighed up against the potential downsides.

Direct investment is ostensibly a highly attractive option. However, a series of potential negatives exist; all of which might need to be compensated for when assessing relative returns. The downsides are associated with trading sizes and volumes; high transaction, management and maintenance costs; valuation issues; turnover, vacancy and reputation factors; and potentially thin and specialist markets.

Indirect investment is another route. It has lower transaction costs and offers the opportunity to invest across a wider range of residential assets for any given sum invested. The difficulties arise in transparency; possible undesired company involvement in development activities; and the fact that share values reflect general sentiment in equities as well as housing market factors.

There are several other options. That include hybrid mixes of features. Some have aspects of loan and residential investment characteristics, like equity release and shared ownership; others focus on housing supply, such as investment in land holdings, which is potentially highly profitable but faces great uncertainties over achieving planning permission for development; and also future options that embrace residential development and trading activities. Each has its own positives and negatives. The growth of a derivatives market would also provide benefits by enabling the growth of particular residential products of direct benefit to consumers and through enabling market players to hedge positions.

Such options should not detract from the basic message of this report, namely, that residential returns derive from bricks and mortar and that is where the pure characteristics of the asset class can be found. So, unsurprisingly, the most common types of investment in residential are associated with property ownership. This is achieved either through the direct purchase of residential assets or indirectly through either the acquisition of the equity of firms that themselves hold residential assets or by buying into residential funds. Such direct and indirect investment forms are the mainstay of activity for other real estate classes as well, which is not surprising given that housing has the same broad real estate features as them.

9. CONCLUSIONS

One current problem with indirect residential investment is associated with a matching of demand and supply. The existence of firms or funds holding residential assets requires willing purchasers of their offerings and investors may be wary unless there are truly deep markets in indirect residential, which there are not at present. A chicken-and-egg situation may easily arise, leading to a relatively low level of activity. Some mechanisms may be needed to overcome such potential barriers in order to create more extensive markets in indirect residential holdings.

Finally, it should be recognised that residential is not to every investor's taste. Even so, the future role of large-scale investors in housing looks set to grow.

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