

# Property Market Update

## The Investment Case for Residential Property



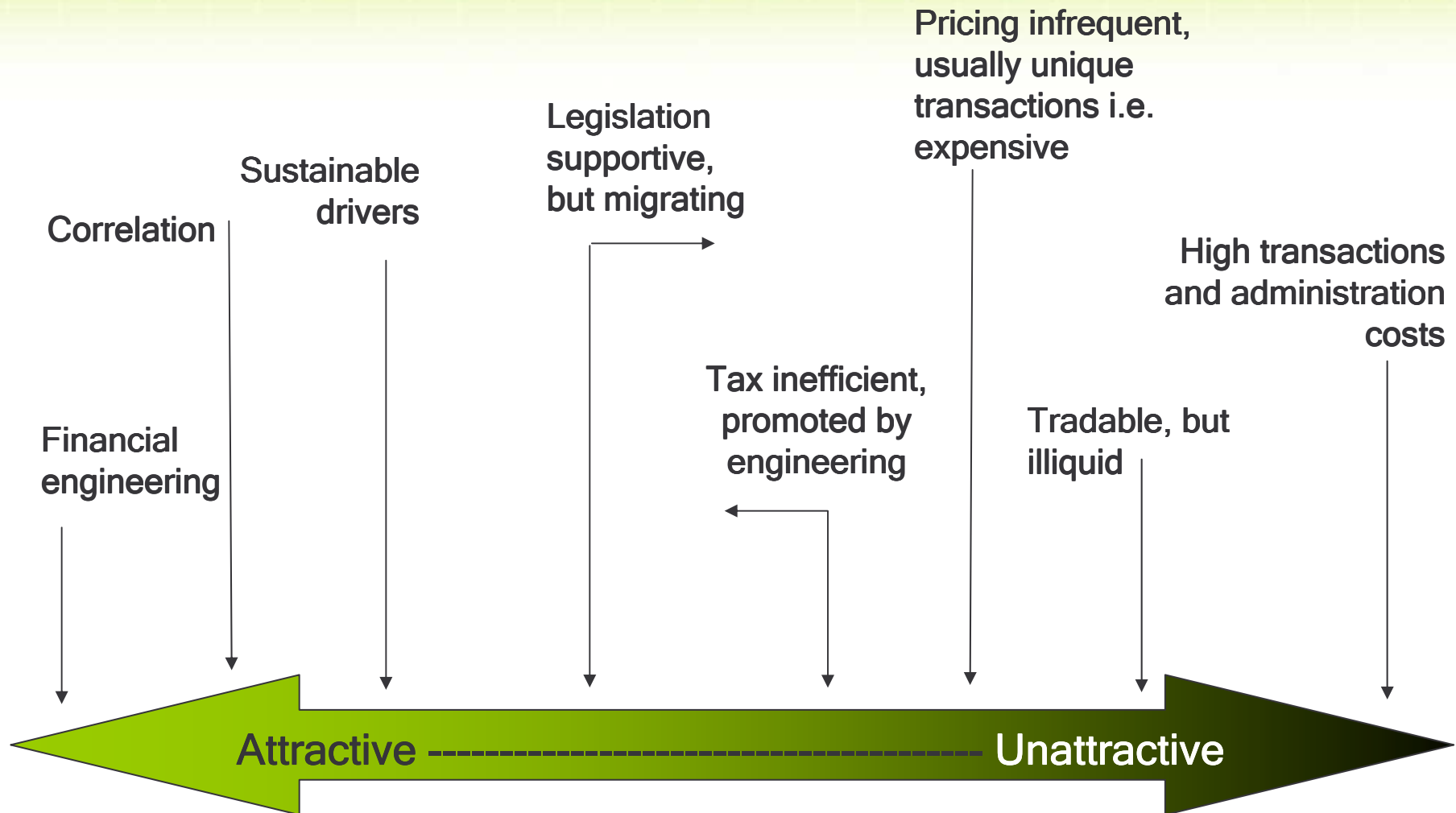
Dr Adrian Saville  
Chief Investment Officer  
May 2005

  
cannon asset managers  
PEOPLE GROWING WEALTH

# Asset Management Perspective

- Desirable features of an asset class:
  - Tradable (liquidity preferred).
  - Regular, accurate and inexpensive pricing.
  - Tax efficient (not critical - bonds, cash, property).
  - Sustainable drivers (structural events require impeccable timing).
  - Financial engineering (such as leverage).
  - Low correlation.
  - Low transactions costs and administrative burden.
  - Supportive environment (legal framework and relevant institutions).

# A Dating Game



# But Unsexy Doesn't Mean Unattractive

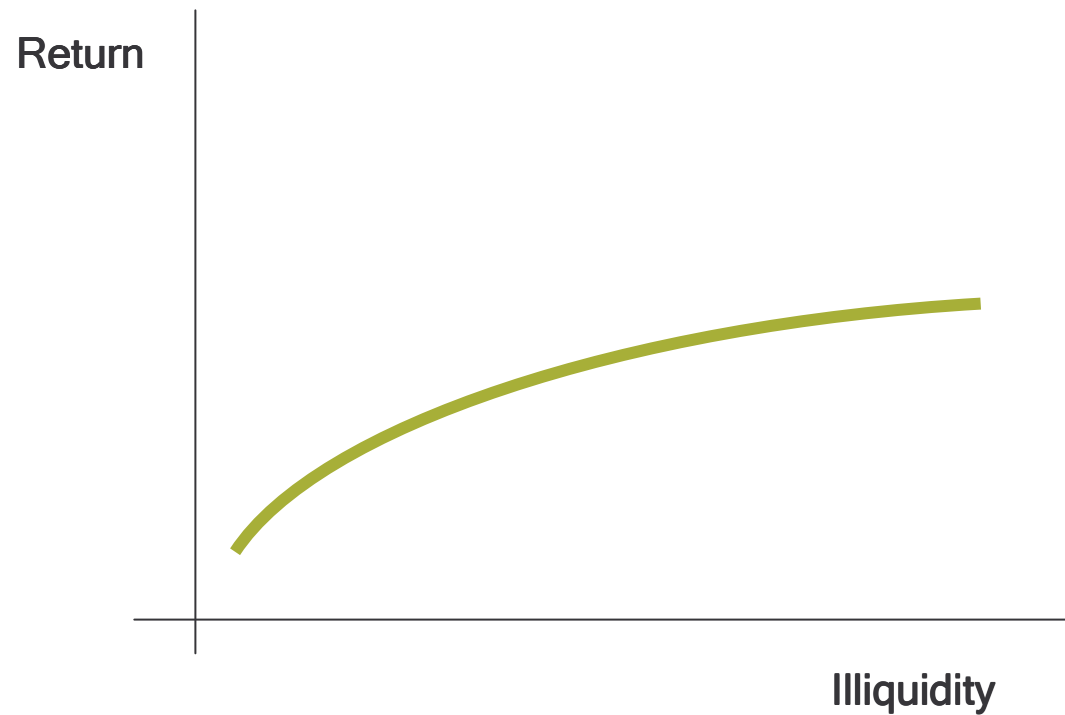
If you wanna be happy for the rest of your life  
Never make a pretty woman your wife  
So for my personal point of view  
Get an ugly girl to marry you

*Jimmy Soul, If You Wanna Be Happy*

(1963, Le Grand-SPQR Records)

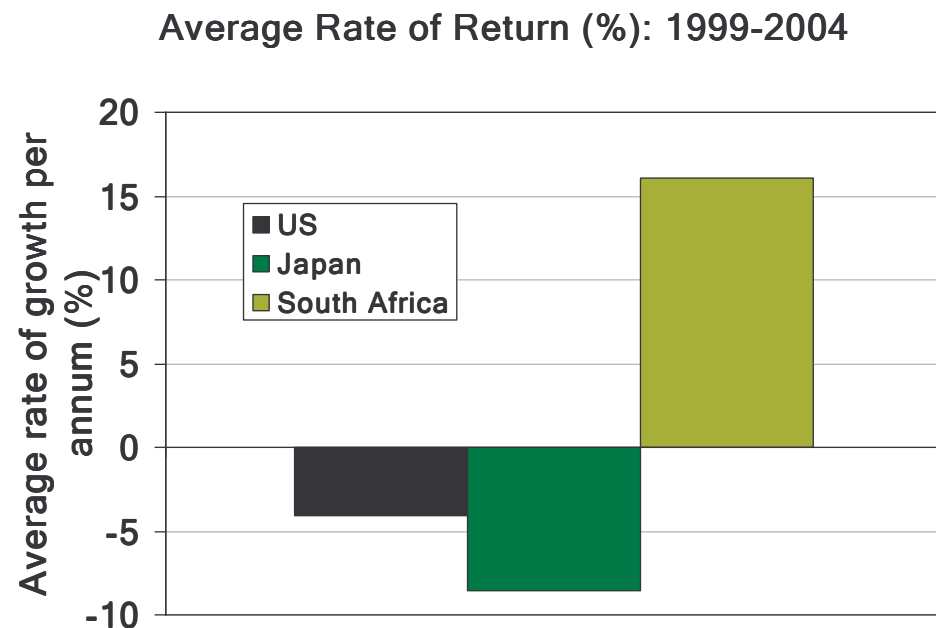
# Value in Ignoring Rules

- Investors rewarded for assuming illiquidity (risk).
- Inflexion - 3-5 years (varies by market, asset class and across time).
- Venture capital, private equity, some hedge funds, art & unlisted real estate.



# Investment Case

- Regardless of structural desirability, there has to be an investment case.
- *“Price is what you pay, value is what you get”.*



Desirable investment traits offer no guidance on returns. This is a valuation issue.

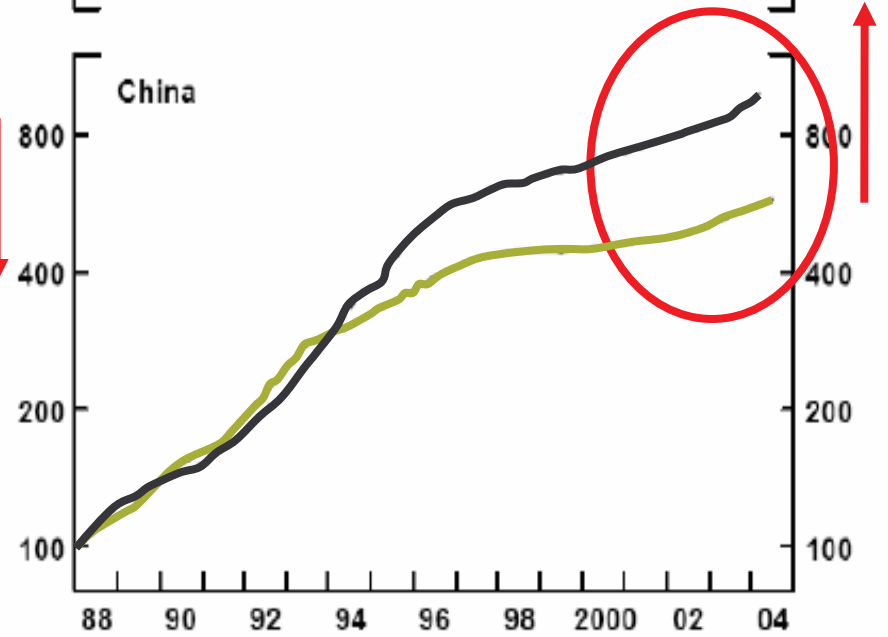
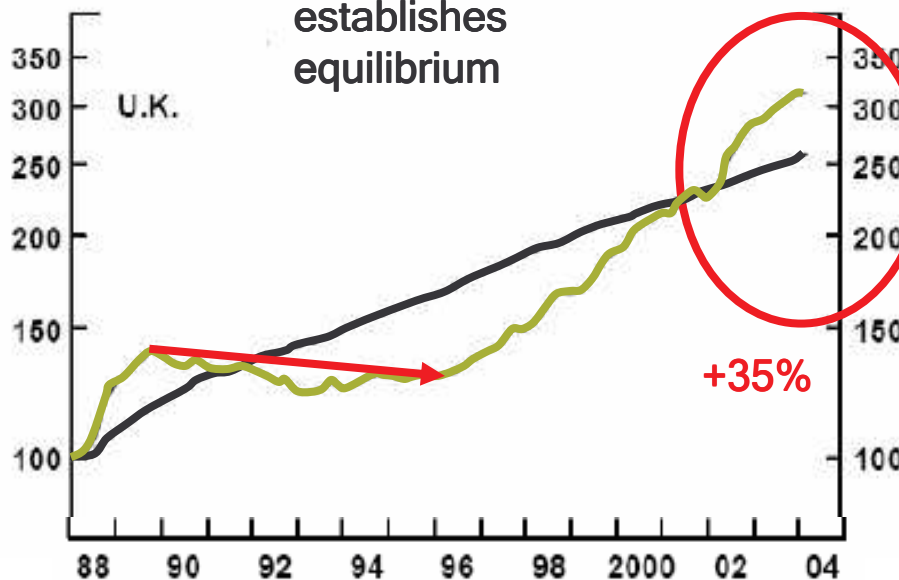
# Investment Case

- Valuation case for residential property - simple nominal gross domestic product model.
- Powerful (simplicity) with widespread application (international).
- High explanatory power ( $R^2$  of up to .85).

# A Model of Residential Property Valuation

- Driver of house prices an amalgam of:
  - Economic activity; and
  - Price inflation.
  - Nominal GDP records growth in current priced GDP.
- Assume a base price of 100, if nominal GDP climbs by 10%, then fair value of housing rises to 110, and *vice versa*.

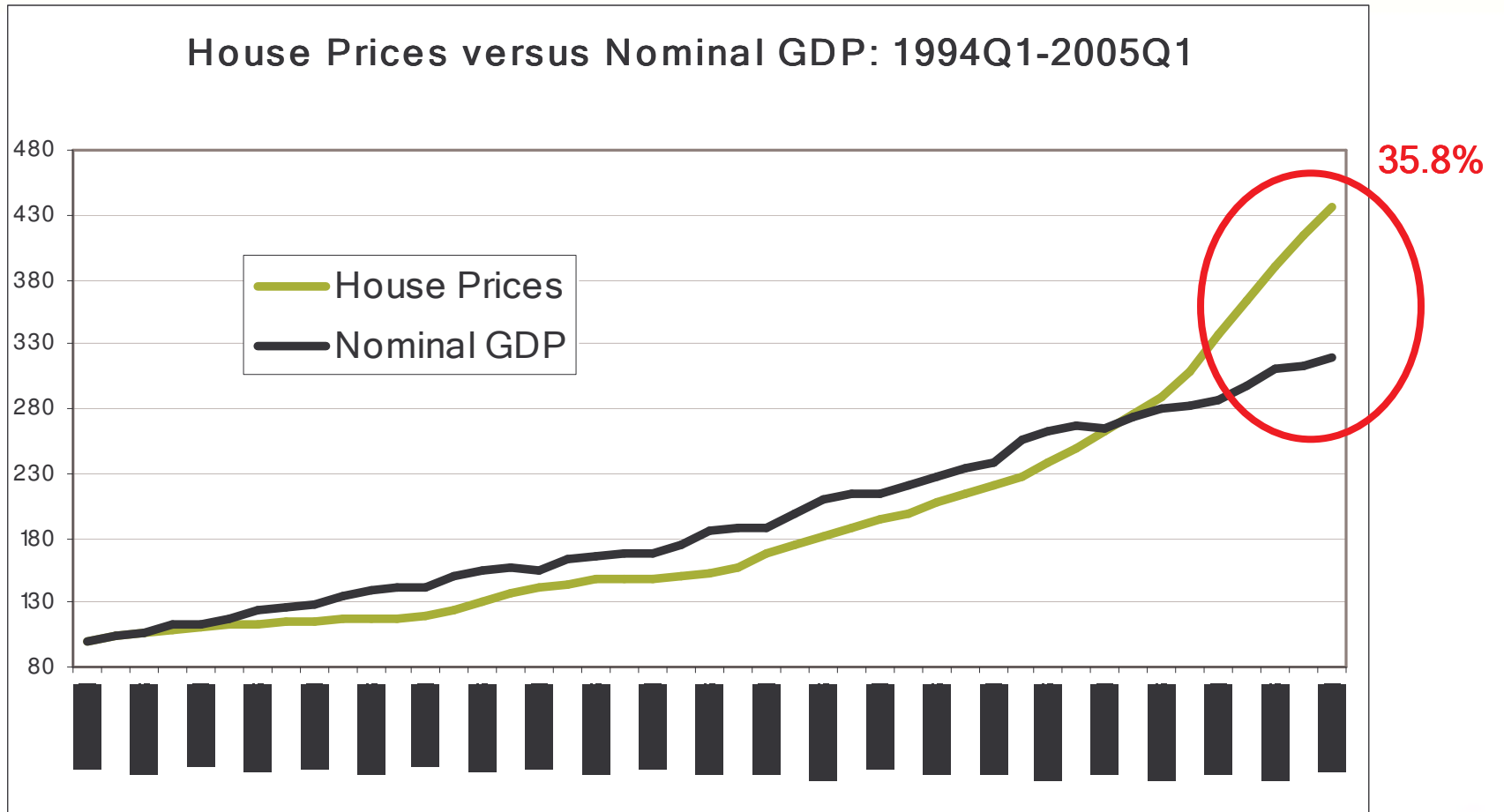




Few negative runs

Low volatility

# South African Residential Property

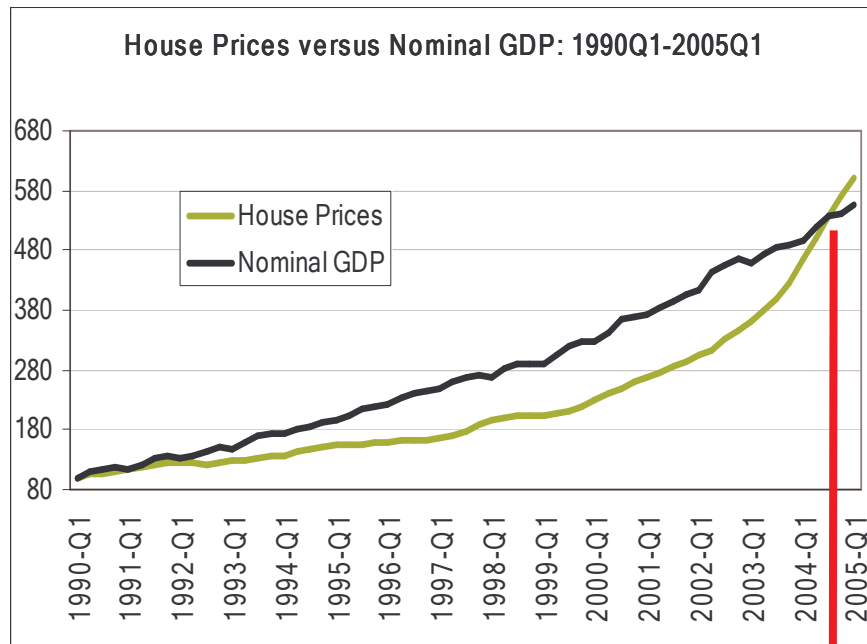


# So, Is This a Bubble?

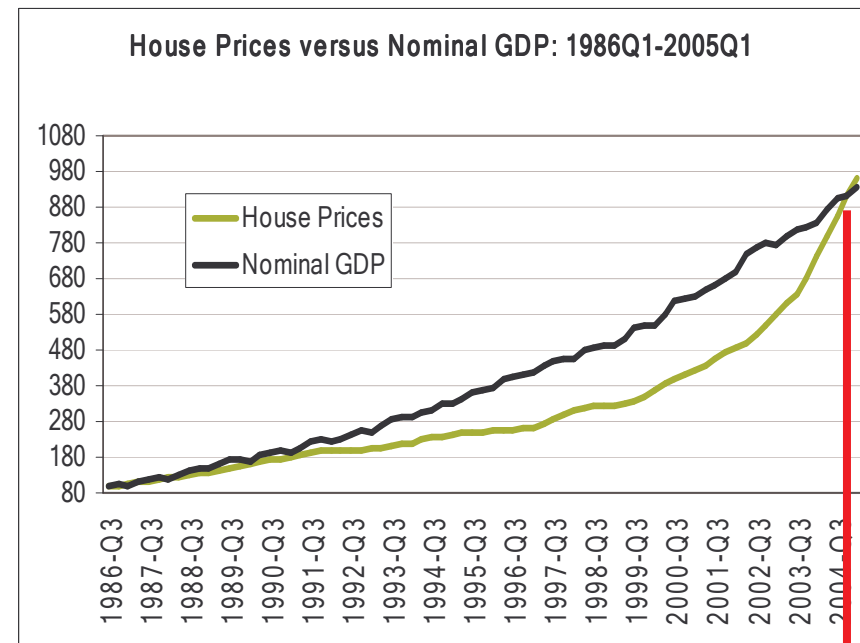
Even a dime, held close enough to the eye, can blot out the sun.

*--- Anon*

# So, Is This a Bubble?

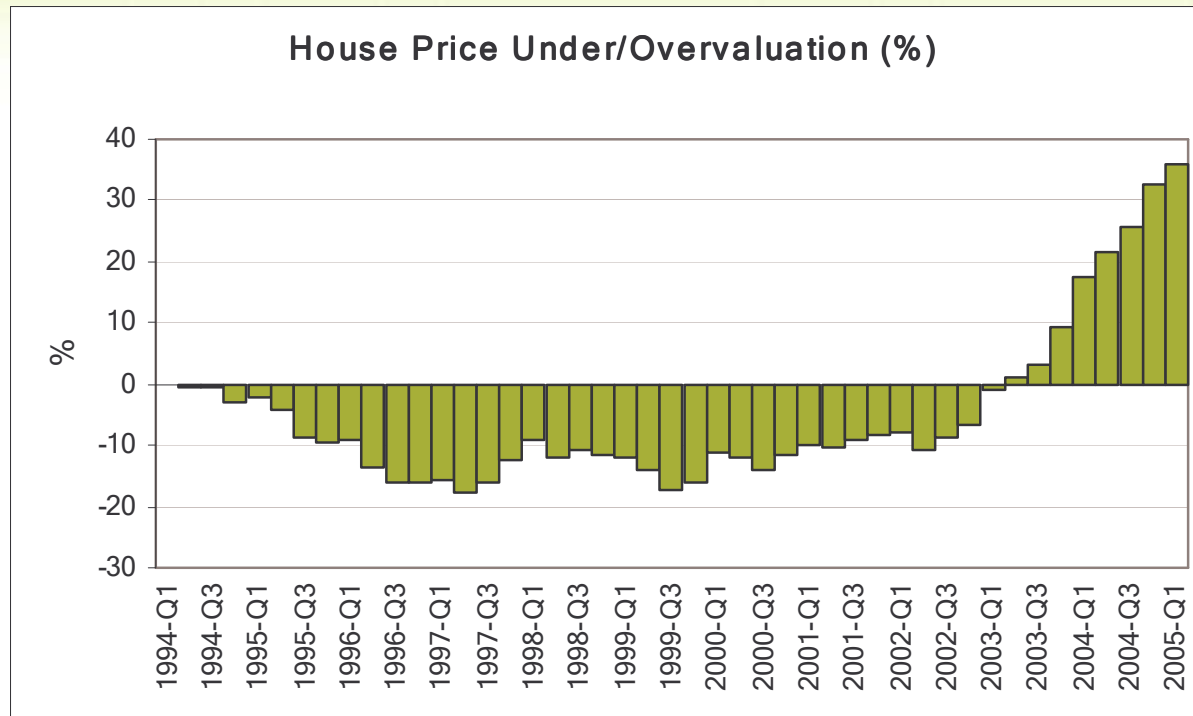


8.1%



2.2%

# Overshooting



- In itself, overshooting not a concern.
- All markets grope for equilibrium.
- Accompanying factors concerning.

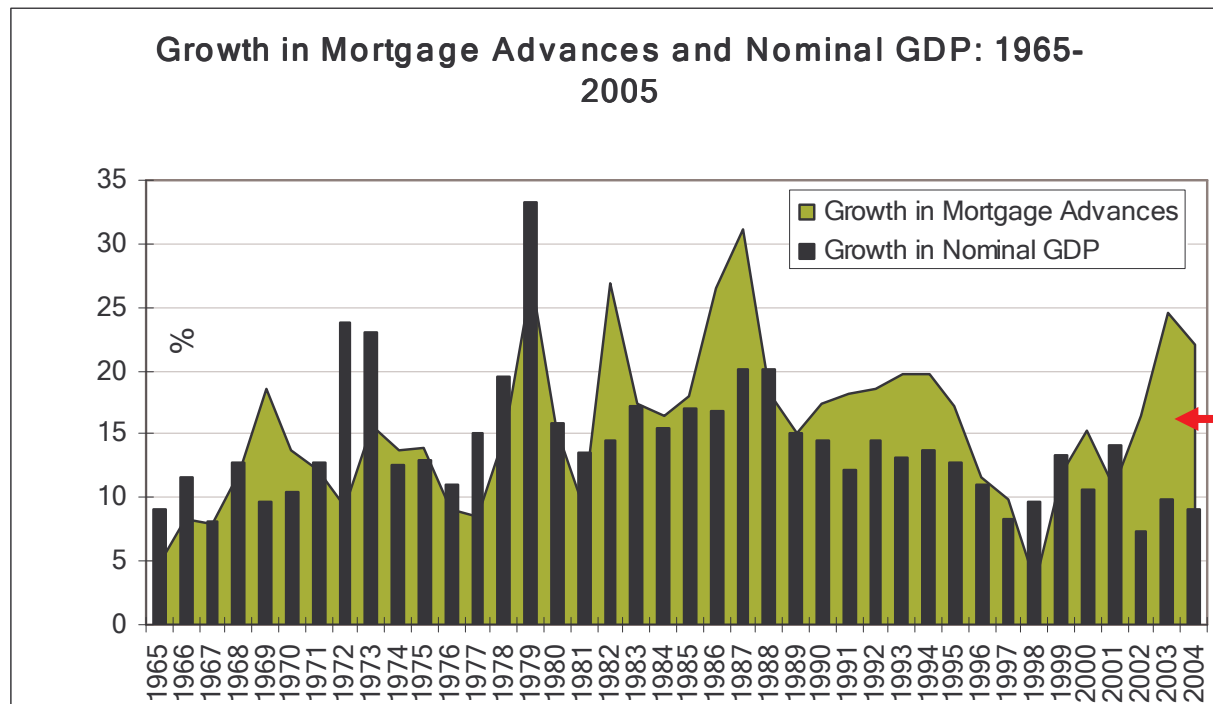
# Other Factors

Five factors evident in price bubbles:

- Ample Liquidity
- Increased Use of Leverage
- Increased Turnover
- Democratisation of the Market
- New Supply

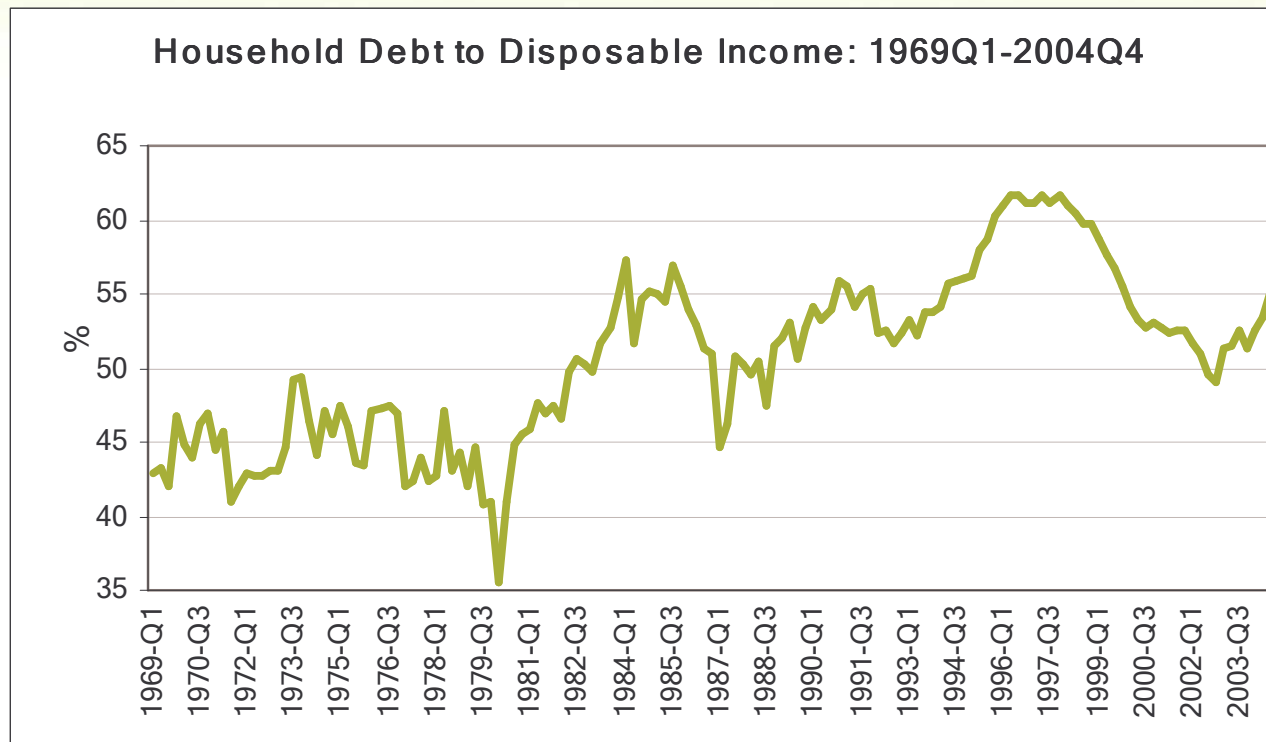
# Ample Liquidity

- Mortgage advances (3.7%) & nominal GDP (3.5%) in tandem (40 years).
- Recently broken down.
- Interest rate cycle, and structural shift in market (new entrants).



17.3%  
pa  
versus  
10.5%  
p.a.  
since  
2001

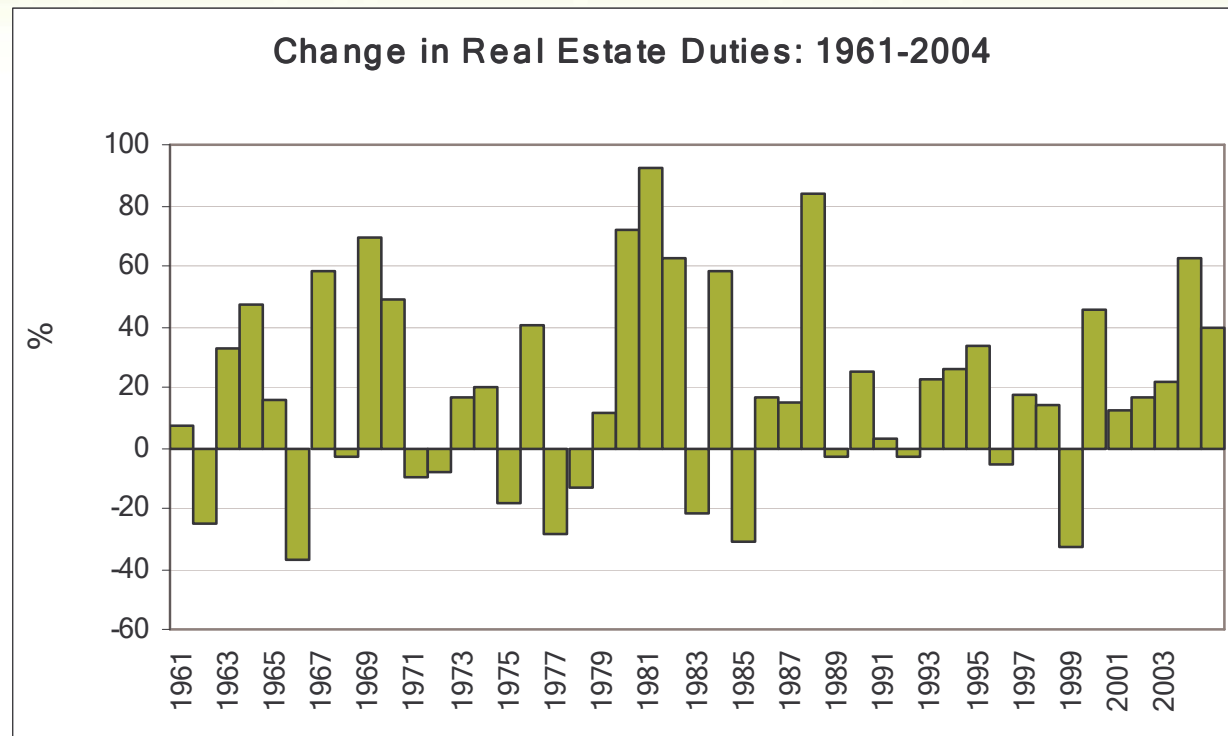
# Increased Use of Leverage



- 56.8% inside accepted norms.
- But, past decade (56.0%) and since inception (50.6%).
- Trend is up.



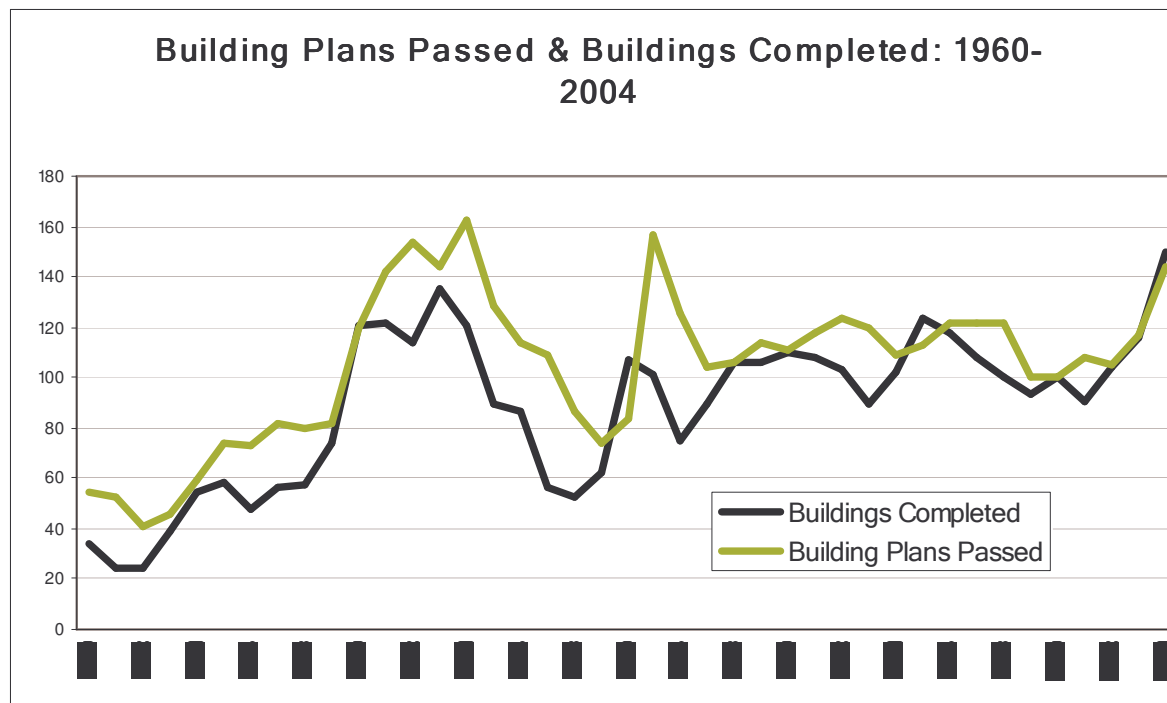
# Increased Turnover



- Average rate of expansion 10.3% p.a.
- Since 2000, 23.8% p.a. in a falling tax rate environment.

# Democratisation and New Supply

- Democratisation: anecdotal evidence (lending; agents and similar).
- Evidence of new supply more concrete.



- Plans since 2000 +10.7% p.a. (+6.2% p.a. since 1960)
- Completed since 2000 +7.8% p.a. (+4.0% p.a. since 1960)

# Back to The Long View

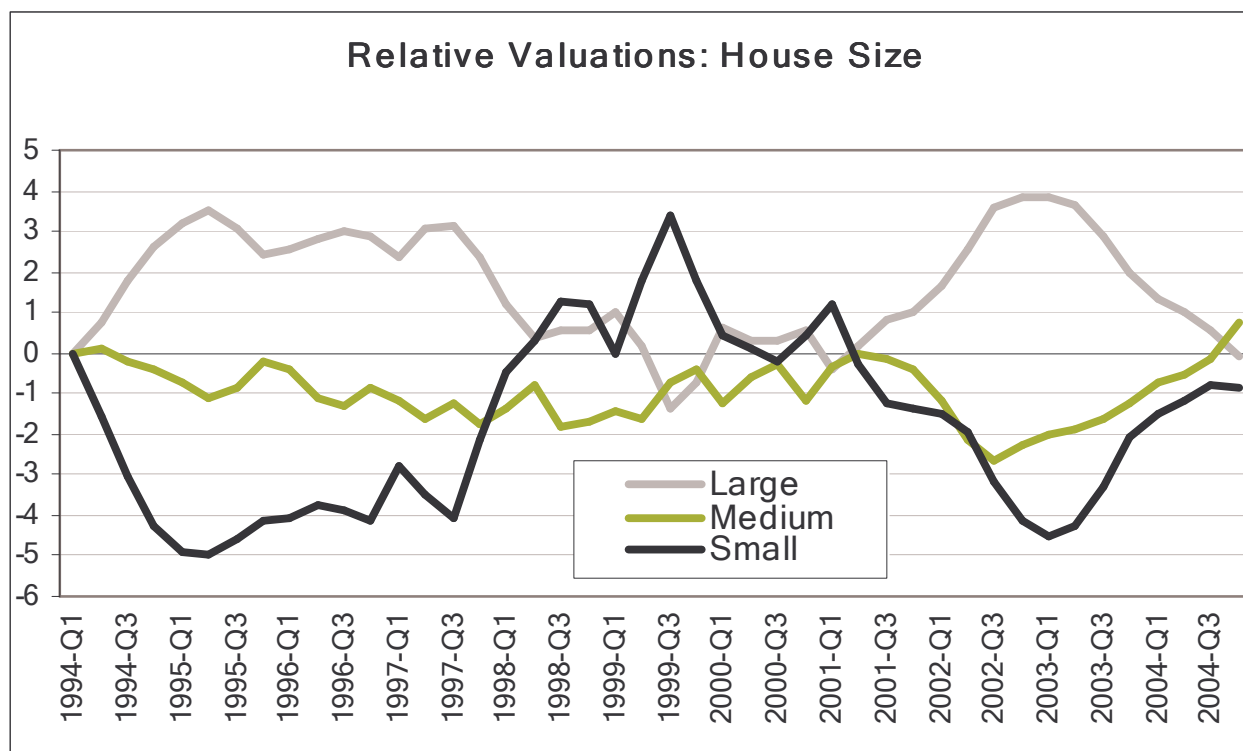
- Arguable that structural factors are evident:
  - emerging middle class.
  - lower inflation and interest rate environment.
  - easier tax regime.
- But driver is ultimately the economy.
- Valuations stretched, with evidence of 'bubble-type' factors.
- Ultimately, regress to fair value.
- In interim, asset class with poor investability characteristics and fragile investment case (yields low and prices high).

# Do Opportunities Exist?

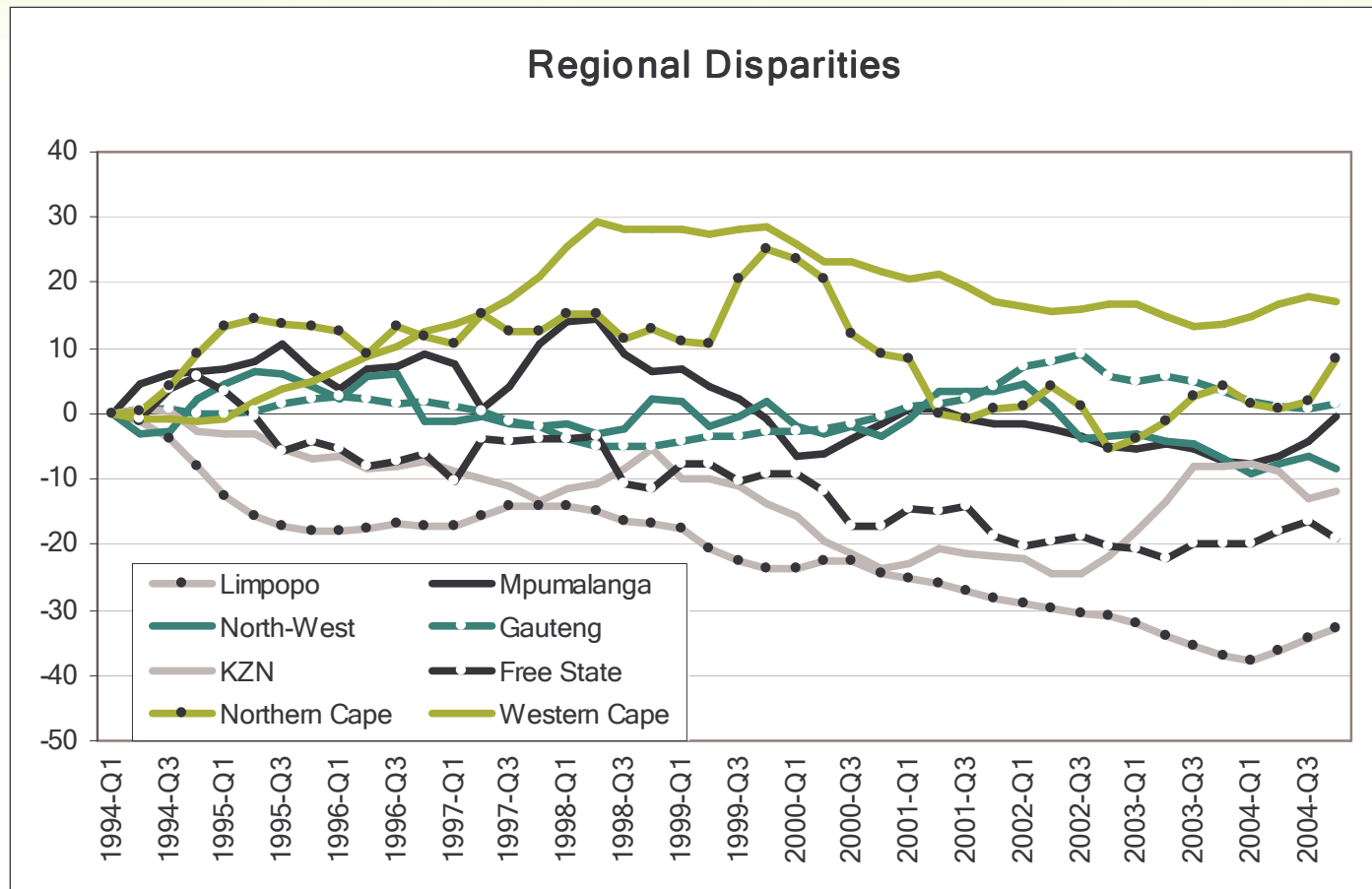
Nobody goes there anymore, it's too crowded.

*Yogi Berra*

# Size Differentials



# Regional Differentials



- Problem is arbitrage gaps are too small.

# The Short View Meets the Long View

- Asset class features not attractive.
- Expensive, mean reversion will prevail.
- Could be wrong for a long time (irrational exuberance).


The market can stay irrational longer than you can stay solvent.



Thank You

Focus and Excellence in Markets





Dr Adrian Saville  
Chief Investment Officer  
Cannon Asset Managers (Pty) Ltd

+27-11-463-3140

[adrian@cannonassets.co.za](mailto:adrian@cannonassets.co.za)

First Floor, Building 4, Parc Nicol  
3001 William Nicol Drive  
Bryanston 2194 South Africa