PORTFOLIO MANAGEMENT

Spring 2015 Newsletter

SPRING NEWSLETTER

PROPERTY CONTINUES TO OUTPERFORM

Australian housing is again one of the best performing investments in these challenging financial and economic times.

The growth in values since the global financial crisis has been remarkable, supported by low interest rates, strong population growth and an increase in demand from international investors. We see continued long term growth from this safe-haven investment sector.

Property ownership has been the critical driver of wealth for many families and households in Australia, as well as an asset class many love and understand.

This year, however, we expect mixed results from residential markets. Like so much of the economy there is a wide variation in performance based on geography. Although the headlines tend to focus on the rising fortunes of Sydney and Melbourne, there are other pockets around the country that are buoyant, with values increasing to record levels. However, there are also areas with the opposite issues, slow demand and prices struggling to hold the levels of previous years.

Overall, however, there remains unprecedented interest in property investment. This is reinforced by the presence of Asian investors who are very alert to the good buying opportunities created by the slump in the Australian dollar — as well as the tax advantages offered to investors in Australia.

SYDNEY SETTING A FAST PACE

A fast pace is being set in Sydney. Prices in many suburbs have rebounded to record levels, particularly at the expensive end of the market. Sydney continues to have a large shortage of housing stock, although this is being progressively eradicated by new construction and renovation, which is reaching record levels.

Rising prices in Sydney also reflect the popularity of the current state government and confidence in it's leadership. NSW is now reporting the strongest economic growth in Australia.

The city has been the stellar property performer recently, albeit coming off a low base. However, some areas have risen excessively and there is the potential that prices in some suburbs could fall by up to 10 per cent this year.

Overall, Sydney prices were up a staggering 18.4 per cent during 2014-15 — a growth level that we believe is not sustainable.

THIS ISSUE:

— Sydney, Melbourne & Brisbane

— Mixed Review For Rental Markets

— Historic Lending Conditions

— Superannuation Investors

FINANCIAL CONTROLS TURNED UP

Recent attempts to control investment activity by the government regulator and the banks could temper the speed of price rises in the immediate short term, however, this is unlikely to be a long term issue.

These controls have included:

- Tighter monitoring and restraints on lending to international buyers.
- Tighter monitoring and restraints on investors.
- Increased deposit requirements for investors.
- Potentially higher principal amounts included in repayments.
- Increased interest rates for investors.

MELBOURNE'S RISING STAR

Melbourne prices were up 11.5 per cent during the year, the second biggest capital city increase behind Sydney. However, more recently Melbourne has overtaken Sydney in price growth. During the last quarter Melbourne prices increased 6.1 per cent, compared with Sydney's 5.4 per cent increase during the three months.

Generally, Melbourne continues to forge ahead with average prices also at peak levels, albeit almost 30-20 per cent lower than Sydney averages. Steady growth has been a feature of the Melbourne market for several years, despite expectations that prices will slow.

Melbourne has a good balance of supply and demand and is much further along in the construction cycle of new high-rise apartments than other cities.

BRISBANE PRICES IN RECOVERY

Brisbane values have been complicated by two major floods since 2011 and the downturn in the resources sector. Indeed, residential values in some areas are only now returning to the levels of five years ago.

Average values in Brisbane are about 20 per cent below Melbourne and about 40 per cent below Sydney. During the year, Brisbane prices still managed a 3.9 per cent increase in the past 12 months.

It is interesting to note that the two major impacts on the Queensland economy are tourism and resources - both are cyclical and both depend on growing demand and investment from Asia.

There has been a slightly belated lift in housing construction in recent times, including a new wave of high rise apartments mainly close to the Brisbane CBD. These projects are expected to hit the rental market over the next 15 months.

In contrast to the strong demand elsewhere, Brisbane's auction clearance rate is currently around 55 per cent, compared with between 75 and 80 per cent for both Melbourne and Sydney.

MIXED REVIEW FOR RENTAL MARKETS

The typical yield from tenanted property in Sydney is 3.2 per cent, slightly higher than Melbourne's 3 per cent returns. Lower yields, however, largely reflect the recent sharp increase in capital values, not falling rents -- which is good news for total investment returns.

However, rents edged up just 0.9 per cent during the past year, which were among the slowest recorded annual increases we have experienced but still good for the current market. The downward pressure on rent rises is largely due to the surge of new apartment units entering the markets. We think it will be some time before rentals start rising at a faster pace but quality detached and semi-detached properties will be first to benefit.

Vacancy rates, generally, remain low, despite the increase in units across many city markets as it will be years, if not decades, before Australia's housing shortage is addressed.

Many investors have also benefited from a welcome boost to net returns during the past year from the lower cost of borrowing.

CAPITAL CITIES RULE

Not all states are as buoyant as NSW and Victoria and many areas outside capital cities are showing little growth or demand. During the year analyst CoreLogic RP Data researched the price movements between capital cities and "the rest of the state". In line with our experience, it identified a significant disparity in returns for homes outside city locations.

Soaring residential values in our two biggest cities contrasted with a flat market almost everywhere else. The price gap also appears to be getting wider between Sydney and Melbourne and the rest of the country. Rising Asian investment interest in these two cities has accentuated this disparity.

Perth housing, for example, continues to move in line with activity levels in the resources and mining sectors. During the year Perth prices edged down 0.3 per cent and we expect short term prices may decline further.

Hobart prices were up 2.5 per cent in the 2014-2015, a steady result once inflation is taken in to account.

South Australia and Queensland are somewhat of a conundrum. The median dwelling price in Adelaide is the lowest of the mainland capitals, despite prices increasing a reasonable 3.4 per cent during the year.

HISTORIC LENDING CONDITIONS

Interest rates for property loans are less than 4 per cent and at levels last experienced in the 1960s. The current low rates are tantalising for some investors and their comfort levels have been reinforced by the soaring values in our two biggest cities.

However, the big banks have effectively raised lending rates for investment purchases and increased their deposit requirements for these loans.

Their aim is to contain the growth rate for investment loans to a maximum of 10 per cent — under pressure from the Reserve Bank and the Australian Prudential and Regulation Authority. However, most of the major lenders are already at or above this 10 per cent level which implies they will now have to reduce their lending to investors to keep under the maximum.

Lenders have also been told by APRA that their capital base needs to be increased, hence the current round of major equity issues and capital raising under way. Banks are also more cautious about refinancing existing property loans and this is indicative of their reluctancy to allow borrowers to draw against their equity.

Any pause in new investment activity, however, is more likely to reflect a lack of good buying opportunities, rather than the tougher lending conditions. These lending issues are also unlikely to affect international and Asian buyers who are largely funded from domestic sources.

ASIAN DEMAND

Asia is quickly discovering Australian property - and loving what they find. Chinese buyers, in particular, have become integral to the current buoyant demand and are underpinning a lot of our price growth. Asian buyers, overall, have been both the catalyst and the price setters for Sydney and Melbourne, specifically.

Asian buyers are also more familiar with apartment style living and readily accept this type of housing. Population pressures and busy lifestyles also mean that Australians are turning to this type of dwelling, although at this stage more for investment purposes rather than owner occupation. This is being reflected in the apartment boom in many of our capital cities.

Australia's population has doubled in just 30 years and we expect that pace will continue given our migration policy and natural population growth. However, this higher demand for apartment living could open Australia up to the prospect of very intensive, high density residential developments. In particular, Sydney and Melbourne as these have much larger land masses than most Asian and European cities.

SUPERANNUATION INVESTORS

The next decade could see broader financing avenues available for investors, including greater flexibility for self managed superannuation funds and other pooled investment funds.

The cash levels within superannuation funds are high. This indicates a lot of investment money lying around waiting for opportunities to be "released" once confidence returns to the economy.

Retirees will remain a very influential group in the property market for both investment and owner occupation.

Baby boomers flush with wealth are turning to the housing market to not only downsize their existing homes but also to invest. Selling one property and buying two. This will continue to have a big impact on demand, especially for properties close to our capital cities.

The next generation of retirees will be, by far, the richest generation yet in Australia. They will be the first to retire with savings from a full work life of compulsory superannuation. With their homes paid off and their willingness to downsize, they will have many options for lifestyle, housing choice and ongoing investment.

PROPERTY – THE SAFE HAVEN

Residential property is a sound and secure long-term asset. Despite the cycles, Portfolio Management Services has achieved average growth of 10.9 per cent per annum during the past 40 years.

We've done that, through all the ups and downs, booms and busts, by focusing on properties that we can purchase below replacement value, that have solid incomes and are well located.

Despite the current uncertainties in the property market and economy, property remains a proven performer.

However, we do caution against trying to "trade" the current market and are very wary of extending gearing ratios beyond reasonable levels. Property performs best as a long term asset class.

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