

## Party past midnight with impunity

**Guest Column**  
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We are where we are.

Most everyone I know who's made a career out of investing in real estate wishes we were somewhere else. Not physically, but in time.

Everyone wants to climb into their TARDIS (a time machine, for those without kids weaned on Dr. Who) and move back or forward a few years. Back to take better advantage of what, in hindsight, has been a re-rating and re-pricing of our asset class not likely to be seen again for a long time. Forward to take advantage of the inevitable correction ahead.

Unfortunately, it's too late to take advantage of the 15% plus annualised returns (ungeared) enjoyed by our asset class since 2002. Many of us were smart enough to be long during that period; few were smart enough to be as long as they now wish they'd been.

More importantly, however, it's too early to take advantage of the next downturn. We all know it's coming, we just don't know when. We call it cycles. Finance gurus call it "mean reversion" – the tendency for markets to return to their long-term averages.

Don't ask me what will make the cycle turn. I still struggle to put my finger on what turned the last cycle, and I was

there. I'll leave that to other commentators, either smarter or more self-delusional than I. I've got a more mundane issue to focus on – how do I invest successfully until then?

Firstly, I do invest. Calling the top of the market too early earns no investor kudos. Remember Phillips & Drew's Tony Dye, who predicted a stock market collapse in the mid-1990s, at least four years before it arrived, wiping billions off the funds he managed?

I invest, but I change my game plan. I take advantage of the fact that I've seen this movie before. Amongst the principles that guide me in the sunset years of this great cyclical upswing are the following:

**If you're going to overpay, overpay for quality.** Property yields have fallen across the board in recent years, but not uniformly. Yields on prime assets have fallen much less (in absolute terms) than yields on sub-prime assets. This mirrors the behaviour of bond markets when yields are falling: spreads between investment and sub-investment grade paper narrow as investors compromise investment criteria in an effort to maintain yield.

People can rationalise this all they want (I could fill this article citing rationales I hear for overpaying for crap assets), but it's delusional. By sweeping up secondary assets late in the cycle I'm making two bets:

one on the general movement in property yields between acquisition and disposition (this I can't avoid), and a second on the *spread* between prime and sub-prime yields. I'm worried enough about the first risk; having to win on both has the makings of an accumulator bet. Drain some liquidity out of the markets and let's see how long tertiary offices in Germany trade at 6% yields.

**Shorten your investment horizon, unless you can hold for a very long time.** My grandfather started investing in property in New York in the 1940's. Today, everything he bought is worth more than he paid for it – proof positive that if your time horizon is long enough in real estate, eventually you'll make money. Problem is, few of us can wait fifty years for a bad investment to come good. Timetables are forced upon us, and expediency overcomes experience. That means the winners, when the market turns, will be those who can clear their chips off the table fastest.

"Clearable" assets will not be complex ones – ask the banks who survived the early 1990's how easy it is to trade out of a spec office development, in a buyer's market, when you're just laying the first floor. Clearable assets will be quality assets (see point 1), with simple stories (i.e. "next year's cash flow will probably be something like this year's"). Dreams die hard when

the cycle turns, and "hope value" – a key component of many property trades today – evaporates in a hurry.

**Bet on occupier markets, not investment markets.** Strong European economies are underpinning strength in occupier markets. When the turn in the cycle comes, the catalyst, whatever it is, will come from the capital markets, not the occupier markets. For me that translates into greater comfort betting on positive outcomes in micro issues (e.g. finding someone to fill a void a year or two down the road) than macro issues (e.g. sustainability of current investment yields).

Micro issues I can influence through asset management; macro issues are largely out of my control. If yields move out fifty basis points, capital values will fall – unless you can grow income to match it. That's tough to do if you're holding a portfolio of dry stock that you planned to break up and sell fifty bips sharper than you bought it. Working your tail off in a falling market to break even isn't fun, but it's better than the alternative.

**Learn about beta (and alpha).** Usually a stock market term, beta is about correlation. The correlation I worry most about is exit route correlation. Since I see the turn coming from the investment markets, my worry is holding a portfolio where all my assets will be similarly affected by a shift in

sentiment amongst the investor groups I'm likely to sell to.

Offices, retail, industrial and student housing may all have different drivers of asset level performance, but the dominant buyers of these asset classes are increasingly the same. That worries me, because my exit options will all dry up the same day. To mitigate this risk I look to "alpha assets" – assets with clearly differentiated investment market performance drivers and exit routes. An example is residential (owned). Whatever your view on sector fundamentals, there's no doubt that property fund managers and home buyers dance to the beat of different drummers.

So there you have it. How to party past midnight and not wake up with a hangover. Because we are where we are. Prices are high, but the short-term outlook for the sector is positive and investors are generally happy (if a little nervous). Trouble isn't lurking around the next corner, but if trouble comes I want to be ready – not by calling the top of the market too early, but by deploying an investment strategy that's robust and realistic enough to survive the onset of the storm, whenever it comes.

Because forecasting is an inexact science, and we never know where we are until we're there. And then it's too late.