

Friday, February 8, 2008

[Sell, sell, sell!!! Oh no, you can't.....](#)

After several years of very enticing double-digit returns and massive inflows of private investor money, the UK commercial property sector is now seeing huge numbers of investors attempt to take their money out. I say 'attempt' because many popular funds have imposed long notice periods for withdrawals in order to stem the flow and many people are finding that commercial property unit trusts are not the liquid investment they were claimed to be or were sold as.

One of the main selling points of unit trusts is their liquidity. Property is traditionally a highly illiquid asset class. It takes time to buy and sell a physical property, much longer than it takes to buy or sell a share for example. Therefore, property unit trust managers are usually obliged to keep a certain amount of available cash in their fund to satisfy redemptions when they were requested. However, funds don't want to hold too much cash because this can dilute overall returns. The problem in the last few months has been the sheer volume of investors wanting to redeem at the same time as there hasn't been enough cash in most funds.

New Star Asset Management had one of the most successful retail property funds, advertised on billboards across the country last year and valued at £2.2bn. However, after large markdowns in its net asset value, it recently announced that around £500m has been withdrawn from its flagship fund. That is quite a chunk of money to find in a short period of time. Many funds have been forced to sell properties into a weak market to raise cash. When a sale is forced, and valuations are falling, the extra property coming into the market just pushes down prices across the board. Now the big employers in the City of London are starting to reduce headcount and the demand for office space is dwindling.

There are still plenty of new construction projects under way, due to the long interval between getting the green light for the project and the final completion, which means that the supply of offices and shops is increasing at a time when demand is falling. The explosion in new 'landmark' construction projects such as the Shard in London will seem like a familiar sign to anyone who watched the Canary Wharf saga unfold at the end of the last property boom and to more seasoned investors it is surprising that we have seen the property boom continue for so long. There has been a huge amount of new construction in recent years as small, old buildings have been torn down to make way for higher and more modern properties. And when you regularly see fully functioning businesses bought and closed down so that their buildings can be turned into apartments or offices, you realise that the business of property, itself often a necessity of business, has become the tail that is wagging the dog.

Property cycles come and go but this one was the mother of all property cycles, both in the UK and in many other countries. It is normal for cycles to end, to recede and then rise again, often even stronger than in the previous cycle, but this time the rush into property was almost frenzied and the exodus out of it was even more rapid. More than £20bn has been invested by small investors in the sector since 2002. Property has long been considered a

relatively stable asset class, certainly more so than the stock market, but there has been nothing stable about the collapse in commercial property prices and in the share prices of the companies that invest in commercial property. Many funds have seen valuations fall by more than 15% in just a few months and listed property companies have seen their share prices fall 40% or more.

However, even though this cycle may have ended more severely than past cycles, it is the behaviour of the unit trust managers running the commercial property funds that have presented the industry with their next challenge: how to convince investors to put money into funds that they might not be able to access in falling markets? Many investors have made paper gains in recent years in commercial property funds but a lot of them probably won't get the opportunity to realise those gains because they can't withdraw their money for up to 12 months. Imagine if all investors across all markets, upon discovering that asset values were falling, were told that they were not able to remove their money. The financial system would collapse.

The very name 'unit trust' implies that investors entrust their hard earned savings with the fund managers and expect them to invest it accordingly. But now any semblance of trust between investment managers and investors has been destroyed because it is only when the unit trust statement comes through the door and the investor tries to remove their funds that they realise who has control over their money. If banks suddenly imposed a 12 month notice period on formerly-accessible bank accounts then there would be widespread rioting in the high street but investment companies seem able to get away with it.

Maybe in a few months time, when more small investors have received their fund statements and after commercial property values have fallen even further, will we see more protests in the media. It's possible that we will see investors queuing outside the offices of Jupiter Asset Management or Fidelity Funds, angrily demanding their money to be returned. Or will it become the norm for investment companies to be able to increase the notice periods on funds as they deem appropriate? Will we see the same thing happen to other asset classes? Even though stocks are more liquid, it could be argued that a significant increase in withdrawal demands would increase the level of selling in the stock market, pushing prices down further. In this scenario, should the investment management industry be able to attempt to prop up the market by refusing to sell stocks and refusing to give clients their money back until markets are more calm?

Maybe these extended lock-in periods are simply a sign of the times we are living in today. It appears that many of the largest banks and hedge funds have not been pricing assets to market as they prefer to wait until markets return to 'normal'. To someone working outside the complicated world of hedge funds it sounds more like they don't want to be forced to price assets at these levels and are waiting for better prices before they go public with their losses. This kind of attitude might explain why so many of the losses that have been announced have been huge and rather out of the blue. Investors lost a lot of faith in corporate executives after the Enron debacle but it looks like some people at the top of large corporations saw it as a good example of how to cover up problems. It seems that investments are becoming less transparent and some investment managers and chief

executives are becoming a law unto themselves.

If unit trust managers start imposing longer notice periods on normal investment funds then investors would have to reconsider whether those funds are as safe as previously thought if there is a question mark over how long it will take to get our money back.

In the longer run, maybe a couple of years from now, we could find that investors distrust of investment management companies has grown significantly. If commercial property values keep falling then there is going to be greater demand for withdrawals and a greater need for fund managers to stop those withdrawals. This could easily be another financial markets scandal that the FSA will have to deal with by drawing up new legislation to regulate the industry and it could be a serious blow to confidence in the industry in general. If the economic slowdown develops into a major global recession on the scale of the 1930s depression, which is a longshot but a possibility, then there is going to be huge scramble to sell assets and the most illiquid ones are going to cause the biggest panics. I suspect we'll hear more about this issue in the not-too-distant future.