International Review of Business Research Papers
Vol.5 N0. 2 March 2009 Pp.121-131

Views On The Allocation Of Listed Property In A Retirement Fund Portfolio In South Africa

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The primary purpose of this research is to present views on the allocation of listed property in a retirement fund portfolio in South Africa. Empirical data is collected by means of a detailed questionnaire which highlights the actual allocation of listed property in the South African retirement fund portfolios, and the fund managers' perceptions on the optimal allocation of listed property in a South African retirement fund portfolio. Results show that most South African fund managers allocate 0% to 2% of their total portfolios' funds to listed property. Reasons cited, among others, for including listed property into their portfolios includes inflation-hedging, risk diversification, and consistent cash inflows. Results also show that low liquidity and small size of the listed property sector contribute to these low allocations of funds to listed property.

Field of Research: Equities, Portfolio Management

1. Introduction

Property is amongst the oldest forms of investment. Property provides a capital base from which an economic unit can maximize wealth and also provides the owners with rental income from those who lease them. Property, as a form of investment, has grown over the years. As Hartzell and Webb (1988: 38) observe, property has become "an important investment category that offers the investor unusually good risk-reducing characteristics". According to Ibbotson Associates (2001), property investment trusts have become a major factor in the United States commercial industry over the last 10 years.

Portfolio managers are consequently evaluated on how they perform, that is, the total return they achieve for the investor, given the level of risk. Therefore, an overriding objective of a portfolio manager is to maximize returns and, at the same time, weighing carefully the obvious trade-off between risk and return.

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Even though the portfolio manager might be aware of the risks, the returns from listed property have been more difficult to quantify, especially because it is not a well-researched and sizable sector in South Africa. As pointed out by Maritz and Miller (2004), academic research on the role of property in investment portfolios has received scant attention, both internationally and locally. Therefore, it could be implied that listed property is a neglected asset class.

When it comes to the asset allocation decision of listed property in the portfolio, portfolio managers are faced with a number of considerable challenges to overcome. The first challenge is that portfolio managers must address a question that involves the treatment of listed property in the investment decision process. For example, portfolio managers need to decide on whether listed property will be classified as a separate equity class or as part of equity. According to I-Net Bridge (2006) database, there is a strong correlation between the income yields of listed property and bond yields. Following from this statement, the second challenge involves managers deciding on substituting listed property for bonds in portfolios. The third challenge is about deciding on the rand amount of retirement fund portfolio to be allocated to a listed property. The latter challenge stimulates this study which looks at the asset allocation decision relating to the optimal exposure to listed property shares in portfolios. Listed property will continue to be regarded as a neglected asset class in the institutional investment arena as long as this asset class is poorly researched and understood. The purpose of this research is to present views on the allocation of listed property in a retirement fund portfolio in South Africa.

2. Literature Review

Maritz and Miller (2004) note that listed property is a growing sector on the JSE Securities Exchange South Africa (the JSE). They argue that total assets value and liquidity of the property asset class has grown tremendously over the past ten years. The growth in size of the sector was followed by the increase in liquidity of the sector as more direct property portfolios were securitized (Maritz and Miller, 2004). The following table shows the growth of the listed property in South Africa over a decade ending December 2004 as measured by the total assets of the listed real estate sector. Table 1 (below) shows that the role played by listed property in a portfolio in South Africa is reduced from 72.59% to 23.30% in 2001 and 2004, respectively. Implications are that portfolio managers attach little value in listed property assets. This could mean that theoretical benefits associated with this class of asset are not appealing to portfolio managers as yet.

Table 1
Growth in total assets in the listed property sector in South Africa (1995-2004)

Year	Value of total asset of the listed property sector in South Africa (Rmillion)	Growth in total assets of the listed property sector in South Africa (%)
1995	3463	n/a
1996	3952	14.12
1997	4890	23.74
1998	7296	49.26
1999	7909	8.40
2000	11547	46.00
2001	19929	72.59
2002	25238	26.64
2003	34668	37.36
2004	42746	23.30

Source: I-Net Bridge (2006) database

According to Gelter and Rodriguez (1997), liquidity refers to the ability of the seller of the asset to quickly and inexpensively convert the asset held into cash at or near the current full-market value of the asset. Listed property shares on the JSE had previously been characterized by low liquidity. However, some authors argue that things have started to change as the sector's market capitalization and returns have outperformed other asset classes. This statement is contradictory with the actions of portfolio managers because table 1 (above) shows that these managers are decreasing the weightings of property shares in a portfolio since year-2002.

A perfect hedge against inflation is formally defined as "an asset where the nominal returns perfectly co-vary with inflation" (Tarbert, 1996: 77). Historically, investing in commercial property has been perceived as providing a hedge against inflation. Research into the qualities of real estate, relating to inflation, has been carried out in a number of countries. Hoesli (1994) argue that most results show that property seems, in the long-run, to provide a better hedge against inflation than shares. This is found by authors to be particularly true for the unexpected inflation. According to Fraser, Leishman and Tarbert (2002: 354), one might expect "a low correlation between conventional gilts and property, as the former is inflation prone and the latter is generally viewed as an inflation hedge".

The role of commercial property in mixed asset portfolios has been the subject of extensive research over recent years. Existing studies provide conflicting results regarding whether property investment trusts effectively optimize and diversify institutional portfolios or not. Some research papers document that the benefits of diversification concentrate at the macro level since asset allocation determines the majority of return variability (Brinson, Randolph-Hood and Beebower, 1995).

These could be reasons South African portfolio managers reduced the role played by property assets in a portfolio as from year-2002 (refer table 1 above). McBride (2004: 66) maintains that “the investment universe, both internationally and locally, has changed over the last 15 years”. A wide array of new instruments is available and offers most combinations of risk and expected return that are required to achieve the objectives of a fund (McBride, 2004). Therefore, a retirement or insurance fund manager can invest in many other diversification assets other than property. For examples, a fund manager may invest in, but not limited to, international debt and equity, emerging market debt and equity, private equity, venture capital, high-yield debt securities, commodities, or derivatives (McBride, 2004). As a result of this array of choices, McBride (2004) argues that the uniqueness of property as a deliver of diversification has been diluted.

Webb and Rubens (1987), in support of Hartzell, Hekman and Miles (1986), concluded that property should comprise 20% to 30% of a diversified portfolio. In the late 1990s, a decade later, Ziering and McIntosh (1997) found that property should still form significant part of an overall asset portfolio. However, according to Pensions and Investments annual survey of the 200 largest pension plans in the United States of America (USA), allocations to property for defined pension funds have averaged between 4% and 5% over the last 10 years (Fidelity Asset Management, 2004). This is very low compared to what is suggested by Webb and Rubens (1987), and Ziering and McIntosh (1997). Implications are that the ability of listed property to provide diversification benefits may have been weakened.

In South Africa (SA), very little research has been undertaken to conclude on the allocation of funds to listed property. In a report by Maritz and Miller (2004) for the Cadiz Financial Strategists, it was suggested that the allocation to listed property in historical minimum variance and optimal portfolios is between 6% and 13%. However, according to the Alexander Forbes Large Manager Watch (2004) survey, the average asset allocation to listed property in the SA Best Investment View category declined from 1.50% in year 2000 to 1.308% in 2004. Implications are that South African property portfolio weightings are below international norms. The only limiting factor in South African portfolios is the size of the listed property sector, which makes up to 1.82% of the JSE (I-Net Bridge (2006) database).

3. Research Design

To achieve the purpose of this research and meet its objectives, a questionnaire was designed to collect data. Empirical data, by means of a questionnaire, highlights the views on and actual allocations to listed property in South African retirement fund portfolios. A sample of ten investment managers across the investment management industry, representing the insurance, retirement funds and pure investment managers, were sent questionnaires to participate in this research.

As the value of the listed real property is relatively small when compared to the value of all the listed securities in South Africa, so is the number of important market players in the listed property sector. The selection of sample was undertaken by means of stratified random sampling to include all the relevant variables of practice. The sampling was also affected on a deliberate basis to ensure inclusion of the major market players in the South African listed property sector. The ten randomly selected institutional investors are those with substantial investment in commercial and industrial real estate either owned directly or through related entities and listed property funds. They also represent the larger retirement fund investment managers in South Africa. The particular institutions selected to be included in the sample have played an important and active role in growing and developing the listed property sector within the South African capital market.

Of the ten investment managers who were sent a questionnaire, only 60% of them responded. This 60% response rate is found to be acceptable, as the respondents represent a major portion of investment houses that have an exposure to property. For example, the sample of investment managers that participated in this study control approximately 50% of the investment grade property in South Africa through listed property. The questionnaire was developed to elicit information on South African property market practice and respondents' views about what they construed to be pivotal concerns and possible solutions to perceived problems. Their responses are important in order to achieve a broad base of opinions from the major JSE market players in the listed property sector.

4. Research Results

4.1 Asset Under Administration

Assets under administration range from less than R1 billion to over R50 billion. Fund managers, that administer assets of less than billion, constituted 17%. Another 17% are fund managers that administer assets between R1 billion and R3 billion. Those that administer assets between R3 billion and R10 billion, constitute 33%. A group of fund managers that administer between R20 billion and R50 billion, and another group of fund managers that administered assets more than R50 billion, constitute 17% per group.

4.2 Investment Style

All fund managers consider their investment style as value-oriented. This is expected because listed property shares have more characteristics of value than growth shares. Value shares are characterized by higher dividend yields, where the valuation of the income stream generated is not reflected in the market price of the underlying share. In other words, value shares are usually bought at a discount.

4.3 Asset Classification

More than 83% of the fund managers consider listed property shares as a separate asset class different from other shares, with only 17% of them treating it as part of equities.

4.4 Valuation Of Listed Property

Most fund managers (66%) valuate listed property shares using listed property yields relative to bond yields. Other fund managers (17%) valuate listed property shares on the basis of whether the market value is at a discount or premium to the net asset value (NAV) of the underlying portfolio of properties. Another 17% of fund managers valuate listed property shares on an earnings yield growth trade off, that is, the higher the yield, the less the earnings growth expectation, and the lower the yield, the higher the earnings growth expectation, which is expected to compensate for the lower yield.

4.5 Investment Constraints

Most fund managers (66%) feel that liquidity of the listed property shares is a major constraint in investing into the listed property sector in South Africa. According to 17% of fund managers, the small size of listed property sector is a constraint to investing into this sector. Another 17% of the fund managers feel that it is neither liquidity nor size that makes it difficult for them to invest into listed property sector, but there are other reasons. These other reasons were not specified by them.

4.6 Benefits From Listed Property

According to 33% of fund managers, inflation-hedge characteristic of listed property entices them to invest into this sector. Another 33% of fund managers invest into listed property sector in order to diversify their portfolio risk. The rest of fund managers, that is approximately17%, feel that they invested into listed property in order to receive consistent cash flows.

4.7 Allocation To Listed Property

Only 83% of the fund managers answered questions pertaining to asset return mandates (ARM). Most fund managers (80%) indicate that the current exposure to listed property is between 0% and 2%, whilst only 20% of the fund managers say that their current exposure to listed property is more than 2% but below 5%. In terms of optimal exposure to listed property, most fund managers (80%) suggest that the optimal exposure to listed property in absolute return mandates should be between 0% and 2%, whilst others, that is 20% of fund managers, feel that the exposure should be between 10% and 15%.

Most fund managers (67%) responded that the current allocation to listed property in asset allocation mandates (AAM) is between 0% and 2%. The other 33% of fund managers state that their current allocation in asset allocation mandates is between 5% and 10%. In terms of optimal allocation, 67% of fund managers feel that the optimal allocation to listed property in asset allocation mandates should be between 0% and 2%. Other fund managers (33%) feel that the optimal allocation to listed property in asset allocation mandates should be between 5% and 10%.

Only 83% of fund managers responded to questions pertaining to total return mandates (TRM). All fund managers (100%) state that the current exposure to listed property in TRM is between 0% and 2%. Again, all fund managers also indicate that they are at optimal exposure levels in terms of TRM. In terms of both direct and listed property (balanced exposure), 83% of the fund managers responded that the current exposure in balanced mandates (BM) is between 0% and 2%. The rest of fund managers, that is 17%, disclose that their current exposure, in terms of BM, is between 5% and 10%. In terms of optimal allocation with respect to BM, 67% of the fund managers feel that the optimal allocation to BM should be between 5% and 10%.

5. Discussion And Conclusions

5.1 Characteristics Of Listed Property

Table 2 (below) summarizes the responses of fund managers relating to characteristics of listed property.

Table 2
Characteristics of listed property

Brief description of question	Percentage of respondents (%)
Valuation method	
Relative to bonds	66
Based on NAV	17
Yield-growth trade-off	17
Characteristics	
Inflation-hedging	33.3
Diversification	33.3
Consistent cash flows	33.3
Constraints	
Size (Market capitalization)	17
Liquidity	66
Other	17

In addition to results summarized above, 83% of fund managers feel that listed property should be treated as a separate asset class from equities. In other words, a majority of fund managers differentiate listed property shares from other equities. When asked about the method they use to valuate listed property shares, 66% of fund managers state that they use listed property yields relative to bond yields method. This high percentage of fund managers who use this method of valuation confirms a strong correlation between the income yields of listed property shares and bond yields that was suggested by I-Net Bridge (2006). Other fund managers (17%) valuate listed property based on whether the market value is at a discount or premium to the NAV of the underlying portfolio of properties. Another 17% of fund managers prefer to valuate listed property using earnings growth/income yield trade-off.

When asked to comment on the characteristics of listed property, fund managers' defined listed property as an inflation hedger, a risk diversifier and a consistent cash flow producer. These results indicate that fund managers invest into listed property sector in order to achieve different objectives. However, there is nothing that can prevent a fund manager from realizing more than one benefit. These findings are in line with Hoesli (1994) who argue that most results show that property seems, in the long run, to provide a better hedge against inflation than equity. This is, according to Fraser *et al.* (2002), due to the fact that property is generally viewed as an inflation hedge. Although McBride (2004) argue that the uniqueness of property as a deliver of diversification has been diluted, results of this research show that approximately 33% of South African fund managers continue to invest in listed property for diversification benefits. Results also show that approximately 30% of fund managers invest in listed property in order to receive consistent cash flows or to hedge against inflation.

When attempting to pinpoint common constraints to investing into the listed property sector, 66% of fund managers think that listed property sector is relatively illiquid. These findings contradict opinions of Maritz and Miller (2004) that listed property's liquidity has grown tremendously. With respect to size of the listed property sector, 17% of fund managers found it to be too small to offer material investment benefits. The growth in size of listed property is still increasing but at a decreasing rate (refer table 1 above). Again, Maritz and Miller (2004) may have over-estimated the average growth in size of listed property. Another 17% of fund managers argue that there were other constraints to investing into listed property sector. These other constraints were not mentioned. Implications are that fund managers can achieve similar benefits by making use of other type of assets other than listed property. For example, as put forward by McBride (2004), fund managers may use international debt and equity, emerging market debt and equity, private equity, venture capital, high-yield debt securities, commodities and/or derivatives.

When trying to ascertain any possible relationship between the size of asset under administration and the perception of listed property as a separate asset class, no significant relationship is found. But, it is interesting to find out that there is a negative relationship between liquidity of listed property and large assets. For example, fund managers of large asset under their administration indicate that listed property equity sector is relatively illiquid than other equities. It could be implied that most fund managers, that have large listed property asset under their administration, find it difficult to quickly and cost-effectively sell listed property shares at or near their market value. On the other hand, fund managers with lower listed property under their administration cite other constraints to investing into the listed property sector.

5.2 Allocations To Listed Property

Table 3 below summarizes the responses of fund managers relating to their views and actual exposure to listed property.

Table 3
Allocations to listed property

Question Description	0≤2 (%)	>2≤5 (%)	>5≤10 (%)	>10≤15 (%)
Current exposure	80	20	n/a	n/a
Optimal exposure	80	n/a	n/a	20
Current allocation	67	n/a	33	n/a
Optimal allocation	67	n/a	33	n/a
TRM (current exposure)	100	n/a	n/a	n/a
TRM (optimal exposure)	100	n/a	n/a	n/a
BM (current exposure)	83	n/a	17	n/a
BM (optimal exposure)	67	n/a	33	n/a

Table 3 shows that the majority of fund managers have a current exposure to listed property of 0% to 2%. Also, most fund managers feel that a current exposure of 0% to 2% is an optimal exposure. The implications are that a very few fund managers in South Africa believe that listed property can act as an inflation hedger, diversify risk or provide consistent cash inflows. However, other fund managers are aggressive in terms of what they believe to be an optimal allocation level. These aggressive fund managers believe that an exposure may be increased to a range of 10% to 15% of the total portfolios' fund. These results support a range of 6% to 13% suggested by Maritz and Miller (2004) in a report for the Cadiz Financial Strategists.

In terms of allocation to listed property, most fund managers' current allocation is in the conservative band of 0% to 2% and they believe that they should remain in this optimal allocation range of 0% to 2%. On the other hand, few fund managers' exposure ranges between 5% to 10% and they also feel that their allocation is optimal. However, the amount of funds allocated to listed property is, on average, 1%. These findings confirm results of the survey by Alexander Forbes Large

Manager Watch (2004). This survey revealed that the average asset allocation to listed property in the SA Best Investment View category declined from 1.50% in 2001 to 1.308% in 2004.This is contrary to a range of 20% to 30% proposed by Hartzell *et al.* (1986). The implications are that listed property has lost its unique diversifying ability.

All fund managers' current exposure in terms of total return mandates is between 0% to 2% and all of them feel that this range should be targeted in order to optimally expose a portfolio to listed property. In terms of balanced mandates, 83% of fund managers' current exposure is within a range of 0% to 2% and approximately 33% of fund managers in South Africa wish to increase this narrow band to, at least, 5% but not exceeding 10%. Results of table 3 indicates that South African fund managers of retirement funds are, on average, reluctant in investing in listed property and reasons provided for such reluctance include, but not limited, to the illiquidity nature of listed property and the relatively small size of the listed property sector within the massive JSE in the African continent.

There are a number of field of study that can be pursued in the future such as the impact of debt securitization on the performance of listed real estate companies. In order to carry that task, one may want to focus on the financing mechanisms used to purchase direct property. One may also try to determine the value that is created by the use of alternative financing methods. Given the results of this research, one may want to determine if fund managers of retirement funds in South Africa forego lucrative returns as a result of their reluctance to expose a larger proportion of their portfolios to listed property.

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