

Property in financial planning – some thoughts after the bubble

(An excerpt of this paper was first published in the Business Times on 16 January 2004)

Except for a bounce after the Asian Financial Crisis in 1998-1999, the Singapore property market has been weak since 1997. It has been a cruel shakeout financially and mentally. Financially, many are suffering negative equity in their homes. Mentally, it has impaired the long-held belief that property could only appreciate given land scarcity in Singapore.

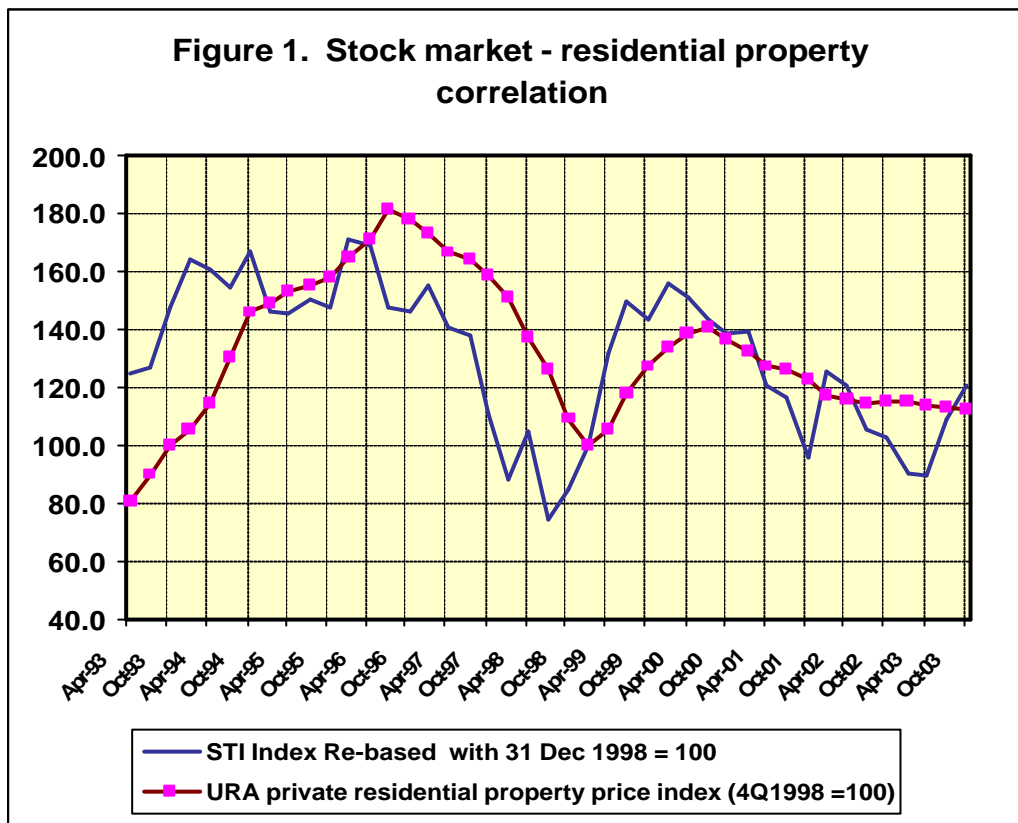
Do your sums

Another myth that was prevalent then and still pitched to homebuyers by lenders and sales folk today is that “any time is a good time to buy a property if you are buying to stay”. Generally, we are advocates of owning your residence but watch the price you pay. Overpaying by \$100,000 on your property means other needs such as retirement or your children’s education would be short by \$100,000 plus the compounding effects of interest payments. This could be the difference between a Spartan and comfortable retirement. So, do your sums, research and remember to bargain.

Is this a good time to buy?

One question that we are often asked is whether this is a good time to buy property. We wish we knew 100% for sure. Indeed, that is all we need to know once with 100% certainty in order to meet all our financial needs! Unfortunately, investment advisors can only work with the balance of probabilities based on relevant statistics and fundamental analysis and judgement.

“Lies, damned lies and statistics”, said one famous wag. When using statistical correlations, it is important to ascertain causality. For example, there is a correlation between the size of ships and the age of their captains but the relationship is not causal! However, one correlation, which we believe is causal, is the one shown in Figure 1, the local Singapore stock market performance and the residential property market. It is causal as it is driven by the nation’s economic performance. We re-based the STI index to 100 points at end 1998 in order to compare with the URA residential properties index. The stock market apparently leads the URA residential properties index by six months, Hence, if the correlation holds true and the stock market bottomed in 2Q 2003, then the forthcoming property market data should show a bottom in 4Q 2003 or 1Q 2004.



Most of the punditry agree that the stock market has bottomed but where is it going? This appears important if we believe that the stock market leads the property market.

We believe that global stock markets in the past 9 months have appreciated primarily as a result of excess liquidity (courtesy of G3 central bankers) and a reduction in investors risk aversion (observable declines in equity and credit risk premia). This is manifested by the expansion of price-earnings ratios globally. For example, the PER on the S&P 500 has expanded from 16 to 19 times in the past 8 months. We believe that in 2004 both short and long-term interest rates will stay low because of outsourcing to China et al. China is not only a prodigious supplier of cheap labour (driving inflation down) but also an indirect supplier of capital to global manufacturing through her high saving propensity (driving real rates down as well).

This notwithstanding, we believe that excess liquidity will no longer be expanding as liquid balance sheets are converted into inventory and investments in new equipment i.e. Significant PER expansion is not likely. We believe that better corporate earnings (bigger "E" in PER) will drive the markets forward in 2004.

What to buy?

Even if one believes that this is a good time to buy a property, what type should one opt for? Our preference is for prime freehold dwellings in general. Within the prime area, an older, but well-maintained dwelling with a low allowable plot ratio could very well preserve its value best going forward.

We arrived at this conclusion from an explanatory model which we developed (details of the NI Property Model are published on <http://www.ni.com.sg/newsletters.asp>). We emphasize that this is an explanatory macro model and not a predictive micro model. Eventual appreciation of residential property is still very much subject to government land supply and zoning policy, the effects of adjacent developments and other dwelling-specific factors.

Essentially, when buying a residential property, one is purchasing two elements: the building and the land beneath. Generally the building would have a useful life of 30 to 50 years. That is, the value of the building will depreciate. On the other hand, (freehold) land tends to appreciate at a rate of nominal GDP growth per capita¹. Based on this fundamental assumptions, our model delivers some interesting predictions.

The value of a property (P_0) compared to the value of land (L_0) on which it sits is a good proxy as to how suburban it is. The bigger the ratio ($R_0 = P_0 / L_0$) the more suburban the property is likely to be. Figure 2 is the prediction of what would happen if nominal GDP growth per capita, g , averaged 6% over the next 20 years.

¹ In simplified form: nominal GDP growth per capita = real GDP growth + inflation rate – population growth. Assuming that new household formation is balanced with land supply, and barring systemic changes, prices should rise in tandem with nominal income growth or what the population can afford.

Figure 2. Projected Price Appreciation for varying Po/Lo at g=6%

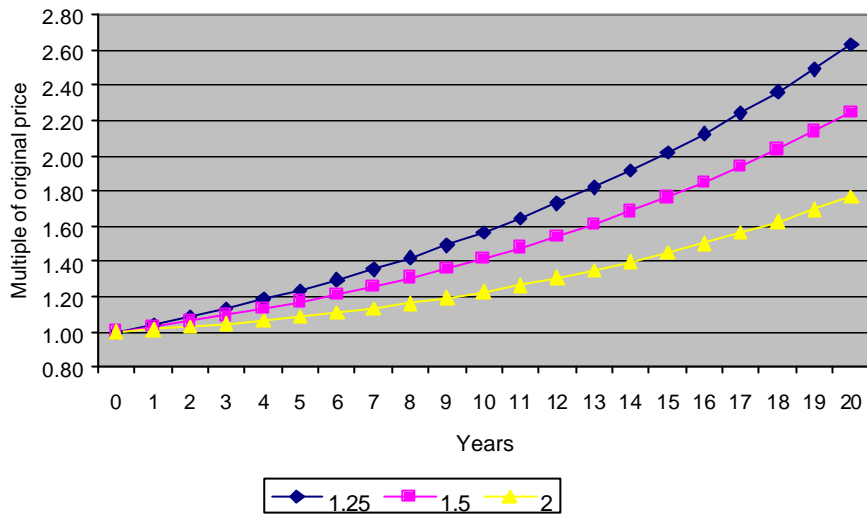
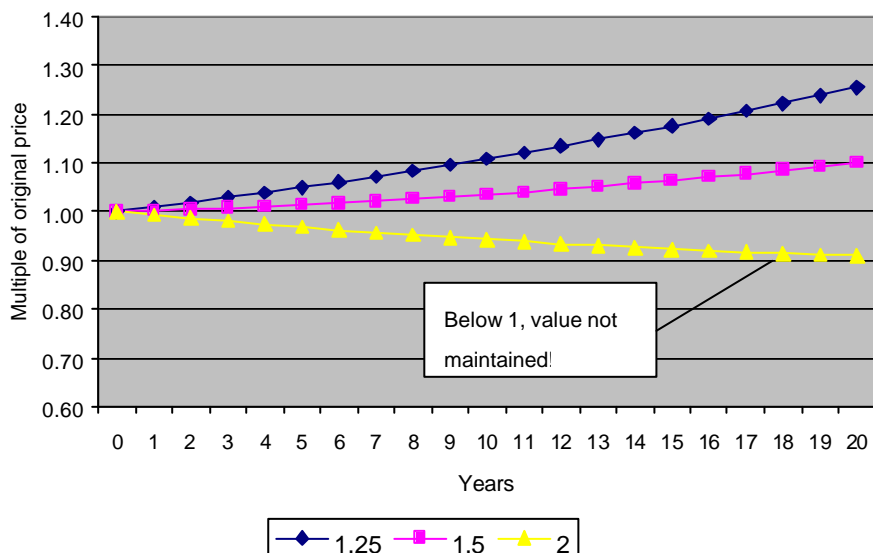


Figure 3 is the prediction of what would happen if nominal GDP growth per capita, g, averaged 2% over the next 20 years.

Figure 3. Projected Price Appreciation for varying Po/Lo at g=2%



In both Figs. 2 and 3, it is clear that, notwithstanding being freehold, the most suburban dwelling ($R_0 = P_0/L_0 = 2$) is predicted to do least well. Indeed, if economic performance is poor ($g=2\%$ only) one could suffer an actual decline in the value of one's property. This also possibly explains why deflation (when g is less than 0%) is so devastating to property values.

Diversification abroad

Properties in certain desirable areas in the US, Europe and Australia have appreciated over the past few years. However, one difficulty with diversifying abroad is that property is essentially a local game and it requires a considerable portfolio size to achieve adequate diversification. Most institutional property investors will kick the tires; check the lay of the land and the laws governing foreign investment before they commit anything. It is unwise to buy something on the basis of a glossy brochure.

However, one new phenomenon which targets retail investors is "land banking". We understand that many retail investors have invested in "undivided interests" in rural land in North America in the hope that it be re-zoned for productive use. However, how many are aware that such investments are not regulated by any regulatory body in Singapore? We believe it should be, especially when retail investors are targeted. Moreover, we believe that Singapore law does not apply in the event of a dispute – how many retail investors are familiar with foreign statutes?

The ownership structure of land banking appears to be a hybrid of land ownership, REIT and unit trust. Just because it does fall clearly under one does not mean it should not be regulated. We believe that if this were regulated under the FAA and SFA, the disclosure and compliance regime would have made investors more careful. Indeed, in the case of one land-banking company they would have had to explicitly disclose that financing was being provided by a related mortgage company. Interestingly, rates charged by the captive financier appear relatively very high. Also, if regulated, could the land-banking company advertise the projections of high returns with buy-back capital guarantees? Especially if the capital guarantee is an unrated one?

I wonder if the authorities would allow such an investment scheme to be marketed if someone tried this with raw land at the edges of Singapore.

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New Independent