Property Funds
(an investment in a commercial property fund)

Introduction

We encourage all types of investors to **include an element of investment into a commercial property fund** as part of their overall investment portfolio, whether their attitude to risk is 'very cautious' or 'very speculative'.

This is because **property is an asset-backed investment** and can therefore **provide long term protection against inflation**.

At the 'very cautious' end of the spectrum, where most of their money should be held in cash and gilts, **this might be just 5% of their total investments**. For 'cautious to moderate' investors onwards the percentage invested in commercial property **should be more like 10% to 15%**.

Why Commercial Property?

In our experience **most investors**, be they individuals or large pension funds, **are seriously underweight in this sector**. For our part, the dramatic fall in the value of equities and our increasing use of model portfolio tools, have combined to encourage us to make more use of commercial property funds.

Until the development of stock markets, property was virtually the only reasonably dependable form of investment. Today it provides **a way of diversifying the assets** in investors' portfolios, offering a different mix of risk and return.

Commercial property is particularly useful in an investment portfolio as **its volatility is similar to that of bonds** (ie fixed interest investments) but **it has very little correlation with either equities or bonds**, making it a very good alternative asset within a well diversified portfolio.

In **locations where businesses flourish** and people live, demand for property rises and with it rents and land values. Commercial property values **only follow business profitability in very general terms** and the property cycle is likely to be different to the business profit cycle. Tenants of commercial property have to pay their rent even when they make a loss.

Under the heading 'Property more prominent', James Smith wrote an article in the pensions section of *Investment Week* of 12 July 2004, from which we quote the following:

> The following is a quotation taken from 'Property more prominent', an article by James Smith in the pensions section of *Investment Week* - 12 July 2004
>
> Two thirds of pension fund managers are anticipating both a short and medium-term increase in their overall allocation to property, according to a study by PricewaterhouseCoopers (PwC). Although the average pension fund's allocation to property decreased significantly from the 15% to 20% highs of the mid-1970s to about 5% by 1999, this figure has begun to climb back up towards 10% of late.
>
> The move away from property for much of the 1990s is particularly glaring considering figures showing if pension and insurance funds had continued to hold 20% of their portfolio in the asset class, as in the early 1980s, they would be cumulatively wealthier by around £14bn today. A figure of this magnitude would have meant significantly lower deficits in the majority of pension funds, according to PwC. Historical evidence shows property has low correlations with equities and bonds; meaning the asset class brings twin benefits of diversification and reducing the volatility of the scheme's funding level. With that in mind, the optimal allocation to property is often in the region of 25% to 30% for a pension fund, significantly above that currently held in the majority of portfolios.

We would highlight two points raised by the article that could affect your own investment planning:

- Although the article was concerned with the level of commercial property investment in pension funds, **the need that such funds have to outperform inflation and meet future income liabilities** is not dissimilar from the needs of many investors, particularly those who have already retired or are close to retirement.

- Any move by large pension funds to increase their percentage investment in commercial property **is likely to be a positive factor in holding up values** in that sector.

The Types of Property Investment

There are many different types of property investment available. In the commercial property arena the three main sectors are **office**, **retail** and **industrial**.

Established in 1985, **Investment Property Databank (IPD)** has produced, on an annual basis, a summary of the performance of the commercial property market from 1971. The analysis of returns shows that, in the 24 year period to December 2004, **the annualised rate of total return from investing in the commercial property market was 10.8% pa**, split between an income return of 7.1% and a capital return of 3.7%.

The split between the three sectors over the same period shows the following:

Annualised returns 1980 - 2004	
Retail	11.8%
Office	9.1%
Industrial	12.0%
Sector as a whole	10.8%

Investors should bear in mind that, as with all investments, property values can fall as well as rise and that past performance of the commercial property market is not necessarily a guide to future performance.

Investment Vehicles to Use

It is, of course, **possible to invest directly into a commercial property** either on your own or with others. For this you would typically need to invest or borrow hundreds of thousands of pounds, or even millions. This is not something on which we are regulated to advise you.

Furthermore, we would point out **the dangers of having 'all your eggs' in a single commercial property 'basket'**.

Commercial property does not behave in the same way as residential property and you would need vastly more experience to invest safely in a single commercial property than you would when buying a single residential property.

For the majority of investors we believe that **an investment in a commercial property fund that is set up as a collective investment scheme** is the most appropriate way to proceed. Such funds are accessible to anyone with £1,000 or more to invest.

These are divided into two general types of investment. The first would be classified as **unit trusts**, OEICs (Open Ended Investment Companies) or ISAs.

The second would be classified as **life assurance bonds**, or Property Bonds, where the only fund used is a property fund.

All of these investments provide major benefits to commercial property investors:

- **diversification of risk** through investing in a portfolio of different commercial properties or property shares
- professional **fund management**
- easier **access to your capital**
- ease of **administration**

The main difference between the general types of property funds mentioned is their tax treatment. Which is the most appropriate for you will therefore depend on your own tax position.

Investing in Unit Trusts and OEICs

When you use a unit trust, or OEIC or similar product, the tax situation is as follows:

- There is **no capital gains tax (CGT) on property transactions within the fund**. Instead you are liable for CGT when you take money from the fund.
- You have **control over when you make a withdrawal** from the fund and you may be able to adjust this to take account of your likely tax situation at any time.
- You have **an annual CGT allowance** to reduce any gain, which is currently £8,200. If you have a spouse or partner you can double the CGT allowance available to be set against any gain by putting the unit trust into joint names. Please note, however, that a transfer of half of your investment into a partner's name would raise a liability for CGT, but **a transfer into a spouse's name would be free of any CGT liability**.
- An advantage of using a unit trust is that capital gains will be **reduced for tax purposes by taper relief**.

Another benefit of using a unit trust is that the charges tend to be fairly standard, ie around 5% of the initial investment and 1.5% per annum fund based. There are **usually no termination penalties**.

A number of unit trust property funds **are now set up as offshore funds** so that the income can be paid gross.

Investing in an ISA

Following a change to the rules governing the eligibility of 'Non UCITS Retail Schemes (NURS)' on 27 December 2005, **ISAs and PEPs can now invest in commercial property**.

Although no new investments can be made into PEPs **it is a straightforward matter to transfer to a new fund** whilst retaining the tax advantageous PEP status.

When you use a PEP or ISA the tax situation is as follows:

- There is **no capital gains tax (CGT) on property transactions within the fund**. Furthermore, in a PEP or ISA you are **not liable for CGT** when you take money from the fund.
- Dividends paid by the fund are **totally free in income tax** irrespective of your tax situation. Furthermore the dividends **do not count towards the income limit** for age allowance purposes.

Investing in a Life Assurance Bond

A Property Bond is **a form of life assurance bond** and the tax treatment of these is dealt with in some detail in our Fact Sheet: *Life Assurance Bonds Explained*.

When you use a life assurance bond the tax situation is as follows:

- The underlying fund suffers **tax on investment income and capital gains under the special rate of corporate tax** applicable to life assurance companies of 20%.
- **'Chargeable gains' under life assurance bonds are** taxed as income tax rather than capital gains tax**.** The Revenue has agreed that the corporation tax of **20% suffered by the underlying fund** on its investment income and capital gains **is roughly equivalent to basic rate income tax.** Chargeable gains made on a life assurance bond are therefore **not liable for further basic rate tax** in your hands.
- An 'offshore' life assurance bond **may be a more suitable investment for a non-tax payer** as the 20% tax deducted from on onshore life assurance fund cannot be reclaimed.
- If you are a higher-rate tax payer **you will have a further 20% tax charge** on the chargeable gains from an onshore life assurance bond. You could, however, **withdraw 5% of the value of your bond each year without any higher rate tax charge at the time**, for up to 20 years.

  On final encashment of the bond the tax charge will depend on the actual gain the bond has made and your tax position at the time. If, for example, you were then no longer a higher rate tax payer because you had retired there might be no further tax to pay.

One potential disadvantage of using a life assurance bond is that **there will usually be an early termination penalty** during the first five years of the plan. This may not be a problem as you should not plan to invest for less than five years anyway, but it could be a nuisance in the event of a financial emergency.

Use of Fund Supermarkets

Whether you wish to invest into a commercial property fund via an investment fund such as a unit trust or an OEIC, or via an ISA or PEP transfer, or a life assurance bond, there is **a major advantage of doing so via a fund supermarket**.

This is simply that rather than using one commercial property fund **you can split your investment between a number of property funds** run by competing fund managers. This will reduce the risk that one manager will make some poor investments.

We mainly use the **Cofunds Fund Supermarket** and would be happy to let you have further information.

Be Aware of Gearing

Some commercial property funds **have an element of gearing**. This is not necessarily a bad thing but you need to be aware of it.

People use gearing **when they buy their own home with the help of a mortgage**. If, for example, you have purchased a property for £200,000 with the aid of a 75% mortgage (ie £150,000) **the gearing is said to be 1 to 3**, ie the relationship between the money that you invested in the property and the money that you borrowed is 1 to 3.

If, over time, the price of your property increases by 25% then **your gain is geared**, ie instead of being 25% of the money you invested (ie 25% of £50,000 = £12,500), **it is four times that amount** (ie 25% of £200,000 = £50,000).

By the same token, if your property falls in value by 10% **then your loss is also geared**, ie instead of being 10% of the money you invested (ie 10% of £50,000 = £5,000), **it is four times that amount** (ie 10% of £200,000 = £20,000).

If you invest £50,000 in a property fund which is geared 1 to 2 **then your investment is based on £150,000 of property within the fund**, the balance of £100,000 being made up of a loan taken out by the fund manager.

Your potential profit is therefore based on an investment in commercial property of three times your actual investment although the interest paid for the loan has to be deducted from this. **Your potential reward is increased in such a fund but so is your risk of loss**. A geared property fund will exaggerate the general gains from commercial property and also exaggerate the general losses.

Risk Factors

- The general market for commercial property may during the period of any investment in shares in the fund depreciate with the result that the value of the fund's property investment portfolio falls. The value of any individual property may fall, for example, due to the insolvency of a tenant. The monthly valuation of the fund will be predominantly based on the opinion of the valuer of the fund of the current market value of the fund's property portfolio.

- The cash resources immediately available to meet applications for redemptions of shares in the fund are limited and if net redemption requests on any subscription day exceed those resources investment properties may need to be sold in order to redeem such shares. As land and buildings may be difficult to sell on these occasions, there may be times when the shares cannot be immediately redeemed.

- Investors need to understand the possible downside effect of a geared property fund. That is, if all or part of the portfolio should need to be sold at a time when commercial property values had fallen, the banks would first be paid the money that had been borrowed from them. This could translate into a higher capital loss than the actual fall in commercial property values would appear to warrant.

- It is intended that an investment in the shares in the fund will procure regular income for the investors who should be aware that this income will fluctuate. In addition it should be noted that the tax treatment of the fund may change.

- Charges and expenses in connection with the fund are not made uniformly throughout its life and it is possible that an investor may not receive back the full amount of its investment especially if it is redeemed within the first few years.

- Redemption of the shares in the fund is at the discretion of the fund's manager and there may be circumstances in which it is decided not to permit redemption. Your attention is drawn to the provisions for redemption in the key features document or prospectus.

- An investment into a property fund is intended as a long-term investment. Where past performance is mentioned please note that the past is not necessarily a guide to future performance. The value of units may go down as well as up and you may receive back less than the amount you have invested. The tax treatment of any income payments depends on individual circumstances and tax rates and laws may change in the future.

For Further Info

If you would like to receive advice on an investment into a property fund please ask your usual Arch adviser or contact us via one of the following:

Tel: **01483 204600**
Email: **enquiries@arch-fp.co.uk**
Online: **www.arch-fp.co.uk**