

Colonial First State Global Asset Management

Property derivatives: A potential end user's perspective

Presentation at PIR Forum 2008

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Outline

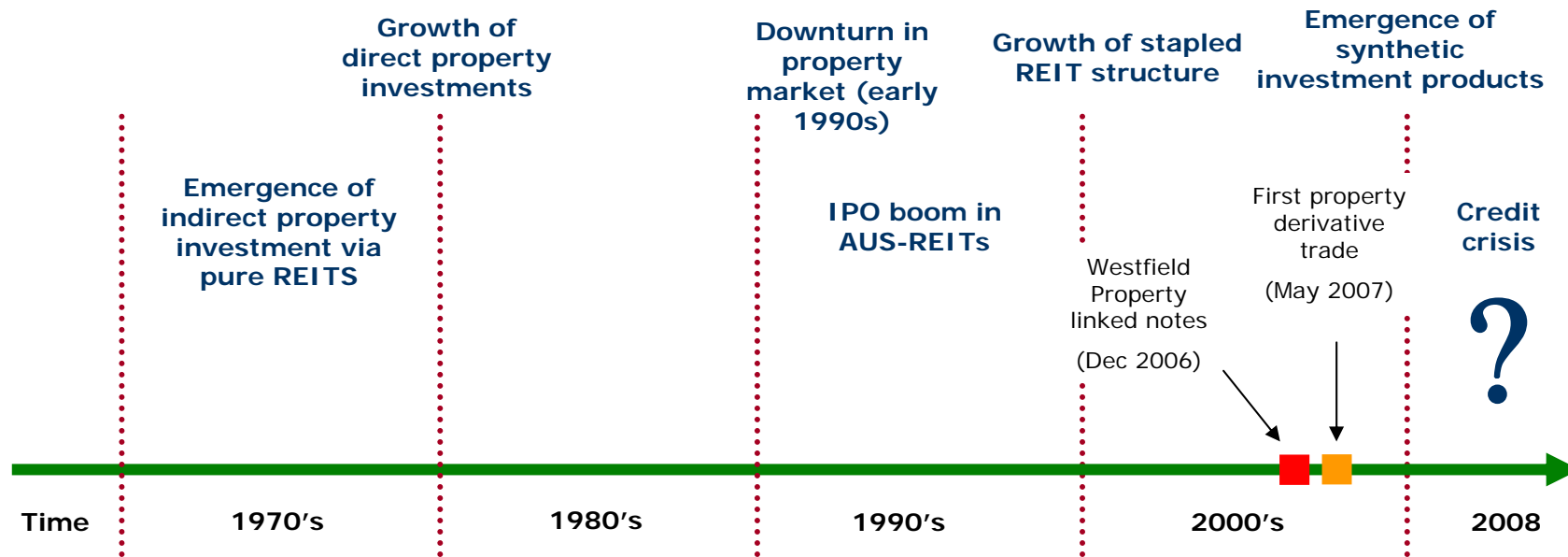
- ① The Australian experience
- ② Potential end users & strategies
- ③ The Australian commercial property market
- ④ Outstanding issues

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The Australian experience

- evolution of a maturing asset class



- AFMA has established a working group comprised of industry stakeholders to help promote and develop the concept.
- Property industry is interested; however, to date there has been more talk than action!
- Will there be a shift away from indirect property investment with the current turmoil caused by the credit crisis?

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Possible players - strategies for risk management

Players

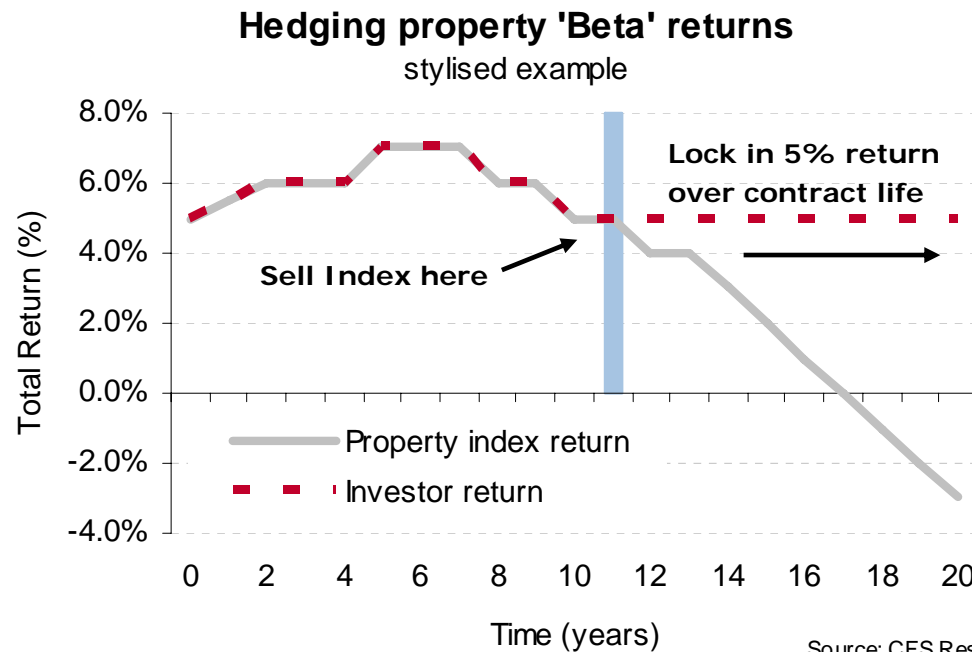
- Asset investors
 - Super funds
 - High net worth investors
 - Hedge funds
- Asset managers
 - Fund management companies
 - Property companies
- Asset creators
 - Property developers
- Asset transactors
 - Real estate agents / valuers
 - Investment brokers

Strategies

- Long / short property 'beta' exposure
 - Hedge an existing property investment / position
 - Manage entry and exit decisions in regards to property holdings
- Diversification (in relation to the index)
 - Between sectors (sector rotation)
 - Across geographic regions
- Alpha transfer (portable alpha)

Investment strategies

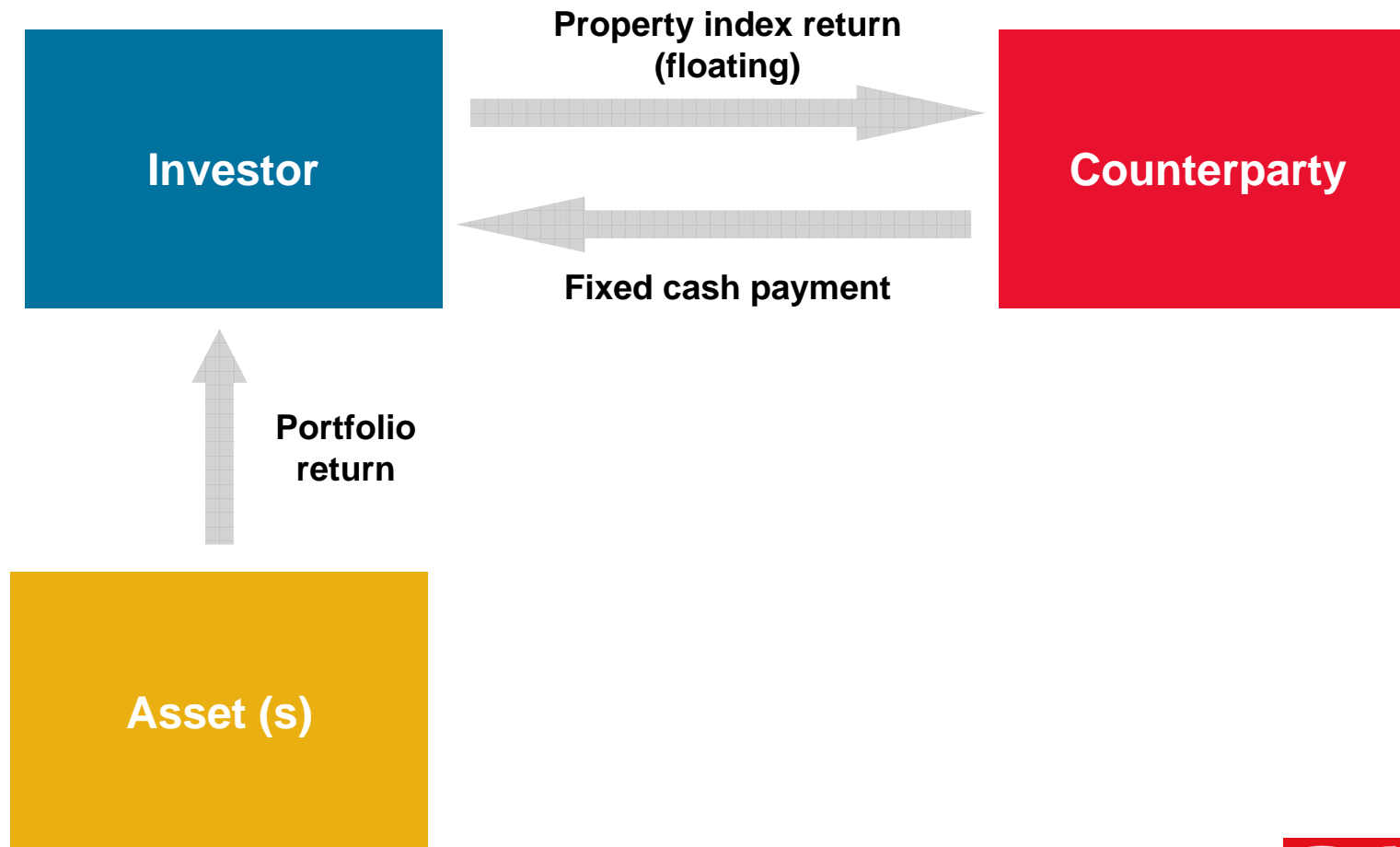
- go long / short property 'Beta' exposure



- A property derivative allows an investor to short the market – first time that this has been possible.
- In the event of a market downturn, traditional property investor would have only two options:
 - Hold, riding out the downturn and taking the performance hit
 - Sell asset (s) at a potential loss
- Via a derivative, the same investor can lock in a guaranteed return – even if market the falls further.

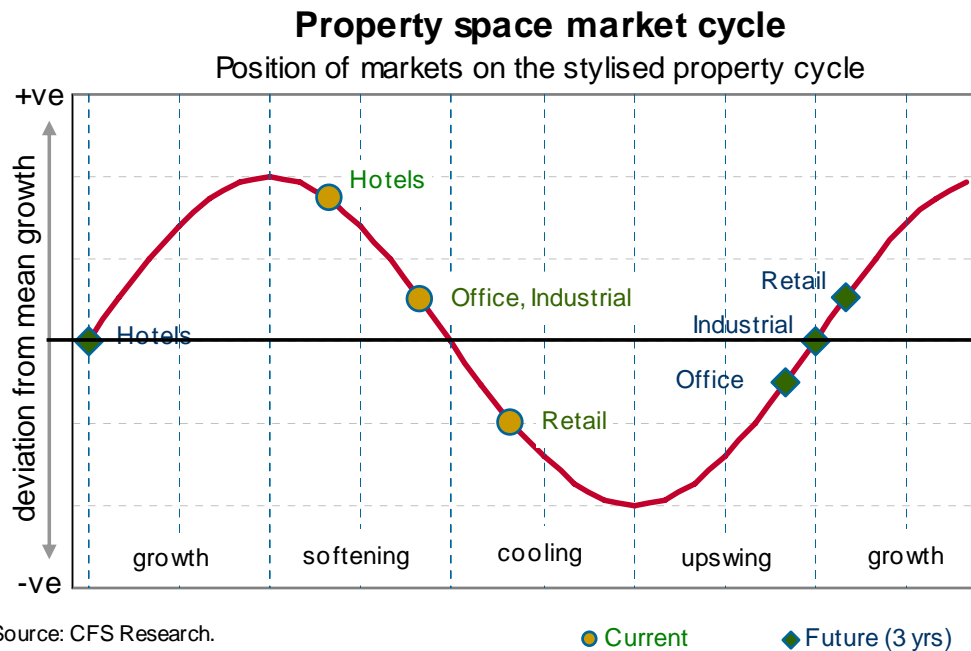
Hedging beta exposure

- sell floating return for fixed return



Investment strategies

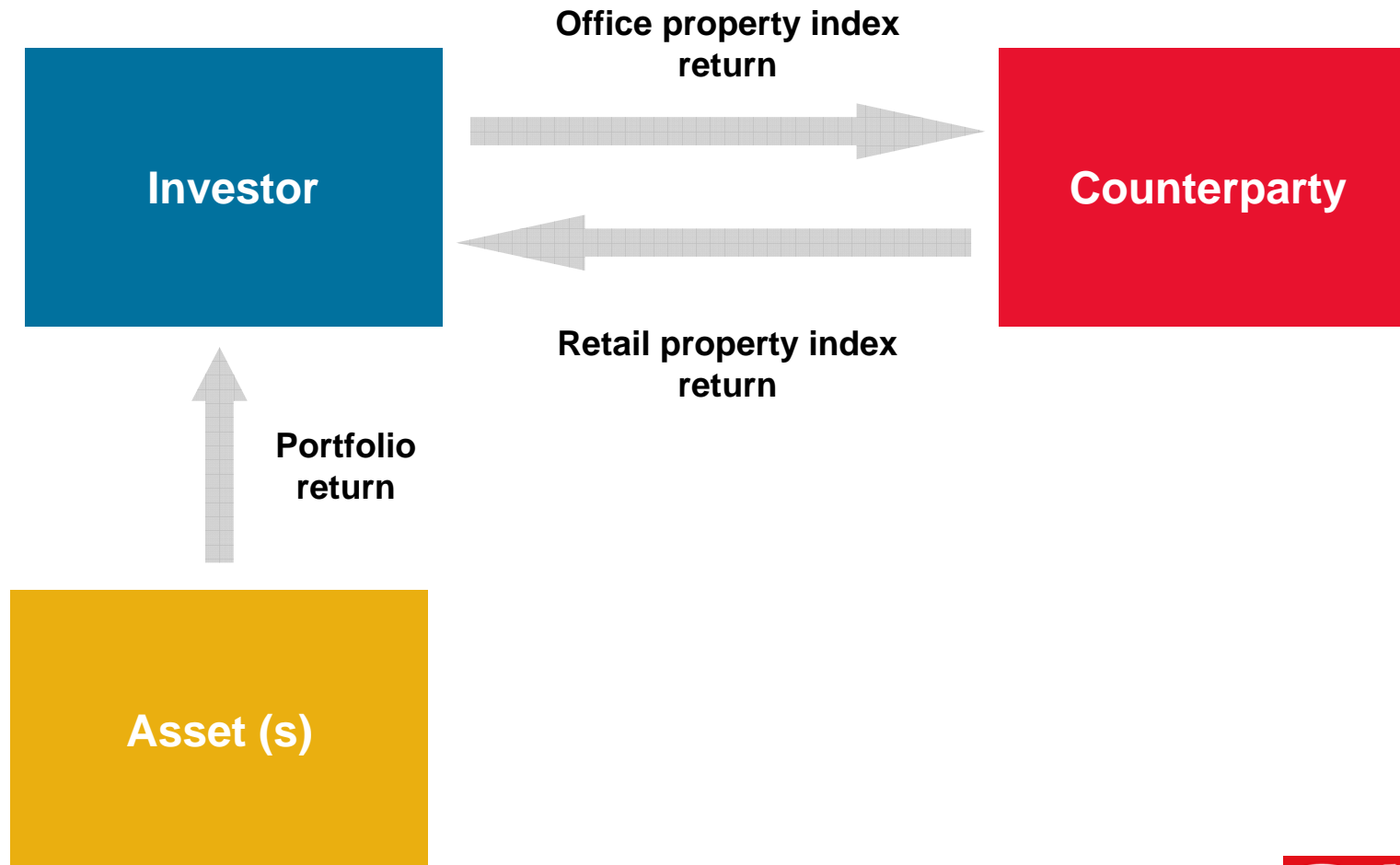
- rotating portfolio property sector allocations



- ➔ Commercial property sectors tend to be at different stages of their cycle at any one point - presents opportunities for diversification.
- ➔ Sector rotation: consider the present and expected future stage of the sector cycles in Australia. One strategy could be:
 - to short the Australian Office sector
 - go long the Australian Retail sector
- ➔ Highlights the importance of forecasts.

Sector rotation

- sell office exposure and buy retail exposure



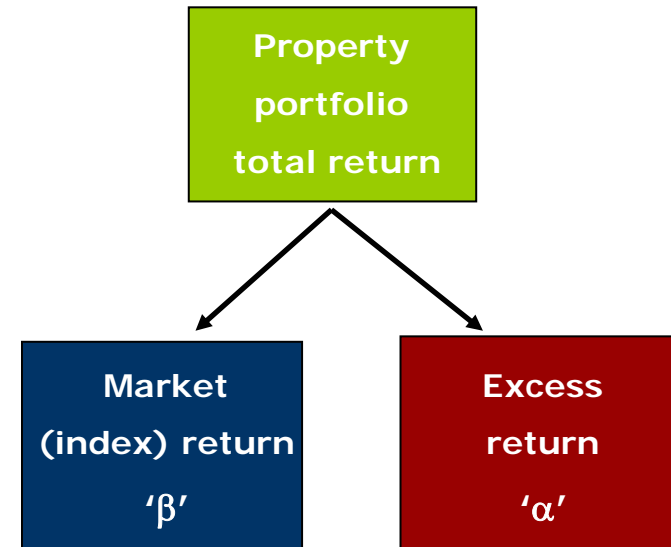
Investment strategies

- portable alpha

➔ Portable alpha

Is simply the process of separating the 'alpha' return from 'beta' return and then adding the alpha component onto another portfolio.

- ➔ It is 'portable' because alpha can be applied to any asset class or benchmark through the use of synthetic overlays to achieve the desired market exposure.

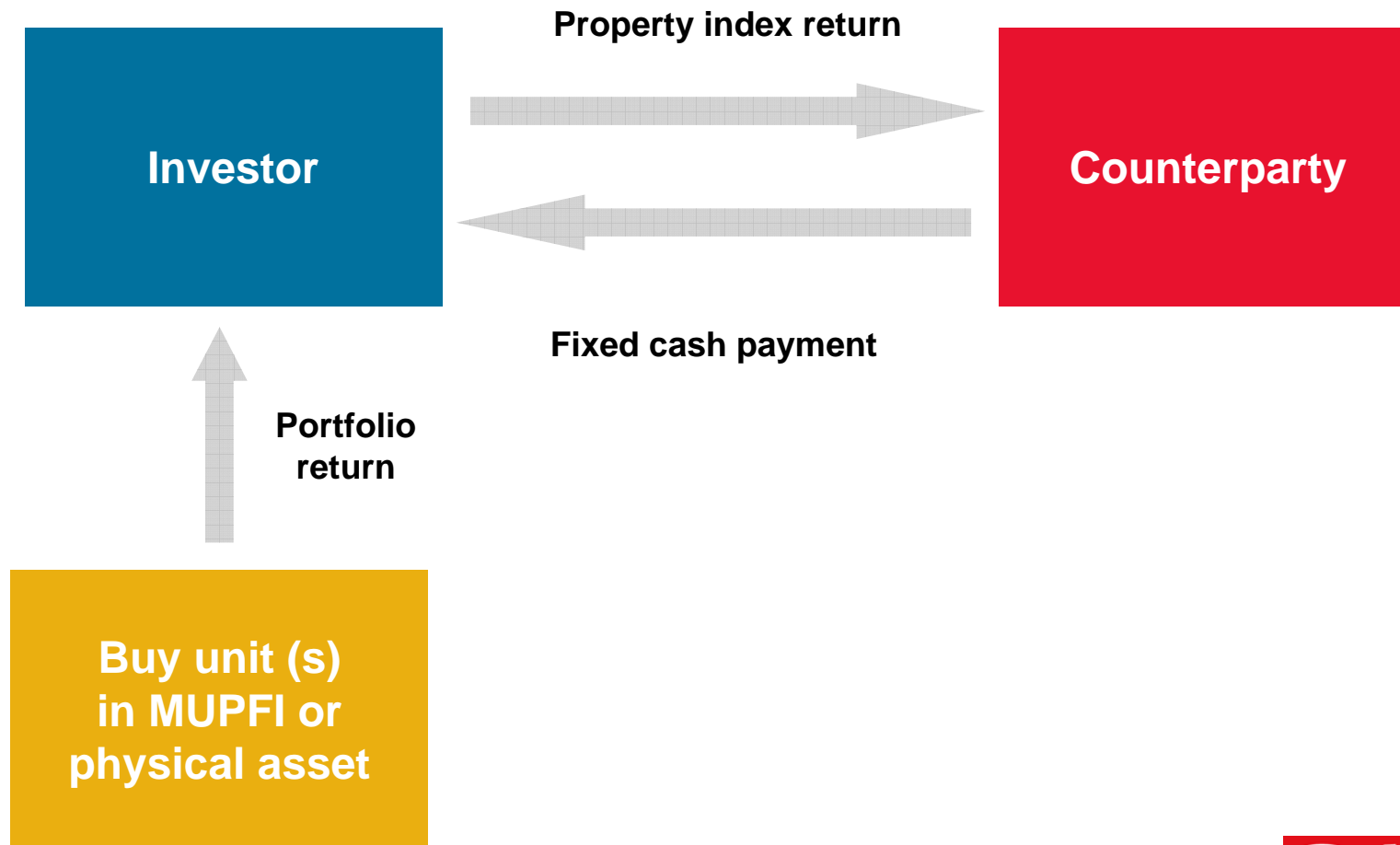


➔ Alpha can be isolated from beta by:

- Incorporating short positions directly in a strategy (e.g., long/short, market-neutral or arbitrage strategies)
- Alpha only results from market out performance as a result of superior management of property assets

Portable alpha

- sell index and buy (unlisted) direct asset (s)



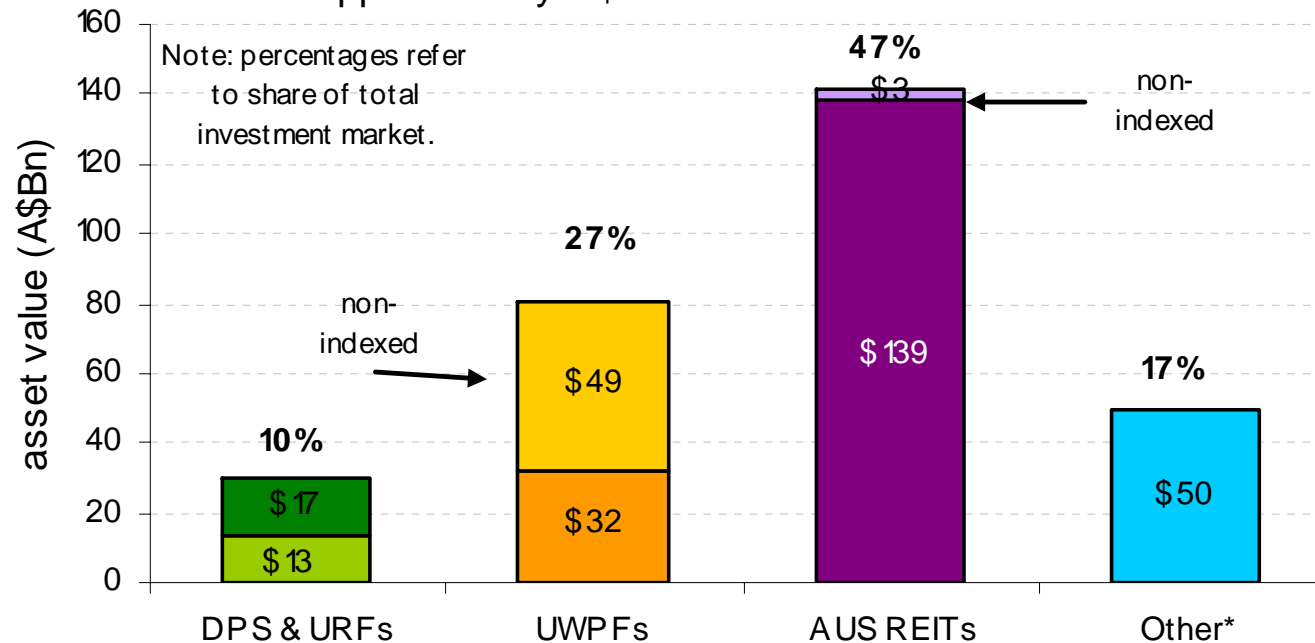
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Australian property investment market - REITs dominate investment space

Size of Australian property market by segment

approximately A\$300bn as at June 2008

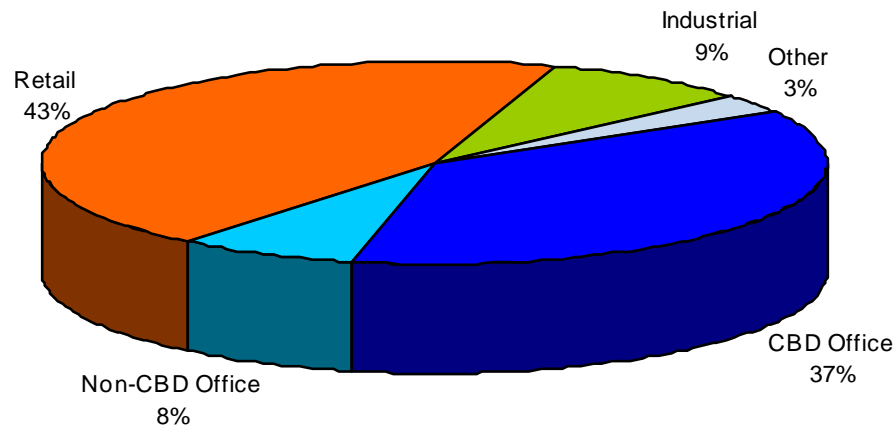


Note: "Other" denotes other private property investments.

Source: PIR, Mercer, UBS, ABS, and CFS Research.

Australian commercial property market - PCA / IPD investment index

Property sector composition of PCA/IPD Index
by value as at June 2008



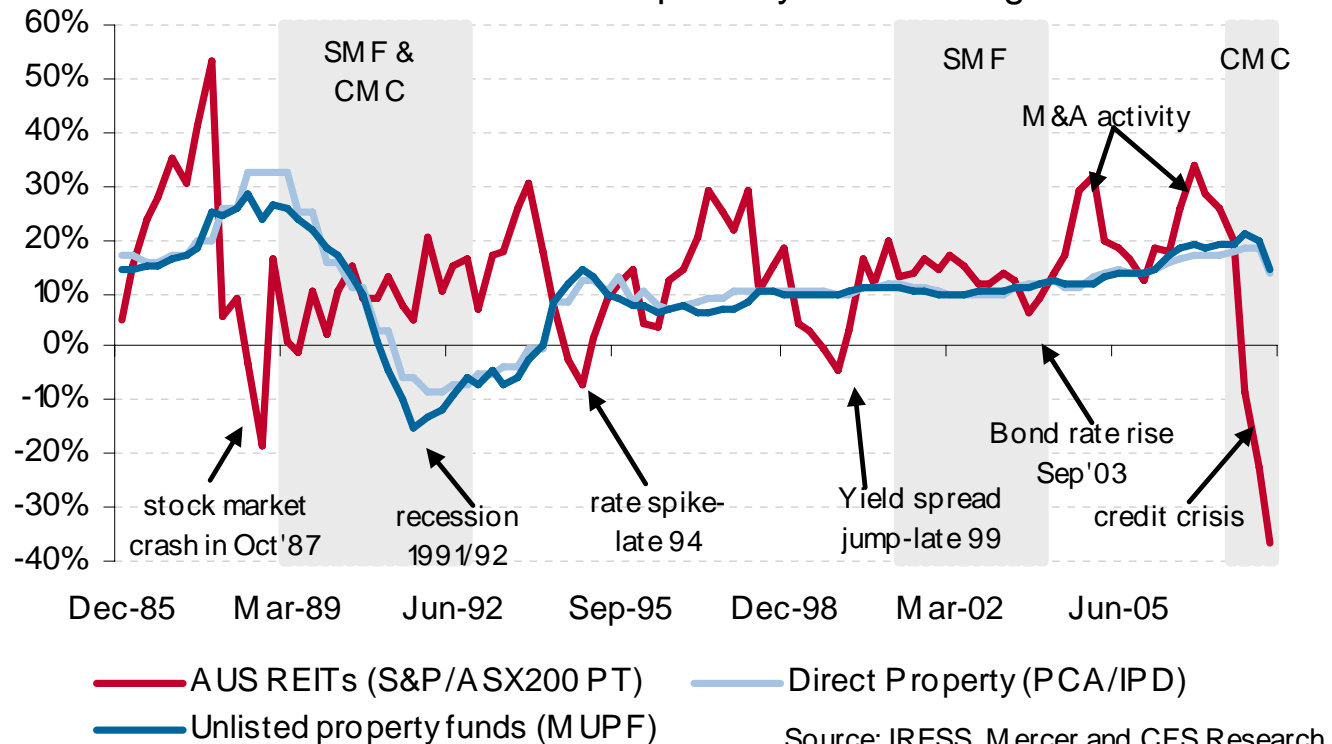
Source: PCA/IPD and CFS Research.

- ➔ Provides investment performance for direct property – split by sector, grade, and location
- ➔ Appraisal based with annual valuation period for assets
- ➔ IPD took over management of PCA index in 2005
- ➔ PCA/IPD index uses similar methodology as other IPD global property indices (allows for cross boarder trades)
- ➔ Key information for index construction:
 - Space measures: size and vacancy rate
 - Pricing data: cap rate (yield) & discount rate
 - Income: rentals, outgoings and capex
 - Transactions: sale price, vendor & purchaser

Divergence between vehicle returns - listed versus direct property

Performance across property asset classes

annualised total returns on quarterly rests ending Jun-08



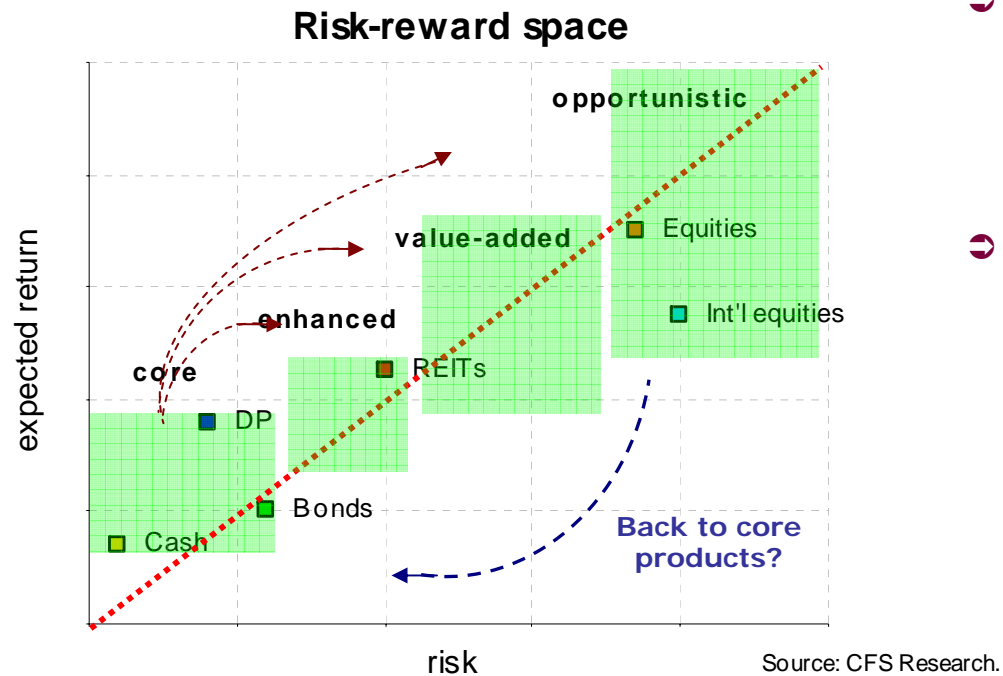
- Listed returns based on frequently re-priced market prices while direct returns are appraisal-based with infrequent re-pricing.

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- Furthermore, listed returns tends to be driven more by financial considerations (such as bond rates), while direct returns are generally a function of the real economy.

Enhance product offering

- ability to move beyond core property exposure



- A physical portfolio in direct property would position an investor in the core risk-reward space.
- A derivative overlay could be used to alter the risk-reward profile of a property portfolio:
 - adjusting the composition of the portfolio synthetically
 - one could move into a higher risk bucket by off-loading beta property exposure and replacing it with the beta of another asset class (such as equities or infrastructure)

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Outstanding issues

- index considerations

- Index is 'live' with historical values subject to revision:
 - Important as revisions could see pronounced jumps in index returns over time
- Lack of volatility in index and large serial correlation issues:
 - May result in lop-sided market with players having the same outlook
- Relative weighting in index sub-sector samples:
 - Large index constituents will have an idea of results prior to official data release
- Index versus market representation:
 - Does a derivative referencing the index truly give you market exposure?
 - Are there benefits in having more than one index?

Outstanding issues

- industry considerations

- Education:
 - raise potential end user's understanding of concept, framework and value proposition
- Regulations / Governance:
 - Do end users need to seek permission to use this structures?
- Potential market signalling device:
 - In markets with a lack of physical transactions; derivatives could help give valuers direction on asset pricing

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