

Market views



Stephen Elliott, Fund Manager

- Royal London Property Fund

Following strong recovery in the second half of 2009, commercial property delivered a total return of +2.18% for the year*, driven principally by capital growth of around 8% during Q4 2009 – a figure which would have been completely unexpected at the turn of the year.

Capital growth was seen in most sectors of the prime market from June 2009, with increased investor appetite boosting prime yields in most sectors, particularly in retail warehousing and central London offices. These two specific sectors have seen over 2% of yield compression in the last quarter of 2009 and the first six weeks of 2010. The retail funds managed by the majority of UK institutions are seeing positive net inflows of cash, with levels across some funds reaching relatively high percentages. Managers are very keen to avoid harming performance by having high cash weightings at today's very low interest rates leading to increased demand for prime real estate assets. As a result the market has seen a number of instances where properties purchased during late 2008 and 2009 have been placed back in the market and transacted at a significant premium to the previous sale price.

We see the recovery in capital values remaining largely limited to prime stock through the remainder of 2010. With the economy showing a steady recovery, secondary stock will continue to have its problems as the types of occupiers likely to take this space may well have a more cautious view of expansion and may indeed fail. Nevertheless better quality secondary stock should see an improvement in 2010 as investors will find it difficult to source prime stock as the year progresses. Apart from the lack of properties coming to the market, the cost of prime acquisitions will prove too painful for some investors who will seek alternative opportunities without adding undue risk. Therefore markets such as M25 offices and good secondary high streets, which have been out of favour recently, could see a greater improvement in capital values than prime stock.

We believe the capital recovery is likely to have run its course during the third quarter of 2010 with buyers pausing for breath. The downward pressure on yields will eventually reduce the risk premium between property and bonds and consequently investors may seek alternative assets. At an occupational level we do not see a vast improvement in rental growth prospects, with rents levelling out at best during the course of the year. However beyond 2010 we believe that rental growth prospects, particularly in Central London offices, are much brighter as the economic recovery continues and the lack of development leads to restricted supply.

* Source: IPD Monthly Index December 2009

Bull points

- Scarcity of prime assets, driving value
- Attraction of income yield from real estate

Bear points

- Fragility of occupational market over short-term
- Economic influences which could crystallise over next 12-18 months

Source: rlam as at 26th February 2010 unless otherwise stated.

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