

Property: Back to Fundamentals

After 14 years of positive returns, the UK commercial property market went into sharp reverse in the second half of 2007. The speed of the market decline in the fourth quarter was unprecedented, and has moved real estate pricing rapidly closer to fair value. In this article, Rob Martin, Head of Research for Legal & General Property, considers the causes of the recent correction, examines the role that property plays in an investors' portfolio, and looks at whether we may now be approaching a turning point for the sector.

The recent dramatic repricing of property has surprised many commentators and concerned those that have invested in property for stability. There are two key considerations for investors going forward from here: first, to understand the causes of the current market correction and second, to consider whether the fundamental reasons for investing in property over the medium and long-term remain intact.

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What are the causes of the current market correction?

A number of previous reversals for property, including the events of the late-80's/early-90's, were driven by broadly similar events; strong economic growth leading to increased occupier demand and a response from property

developers who commence building; the cycle is then unhinged by slower economic growth or even recession, which weakens occupier demand and leads to substantial oversupply of property.

The current property market decline has been driven by a significantly different set

DRIVERS OF PROPERTY RETURNS: 1995-2007

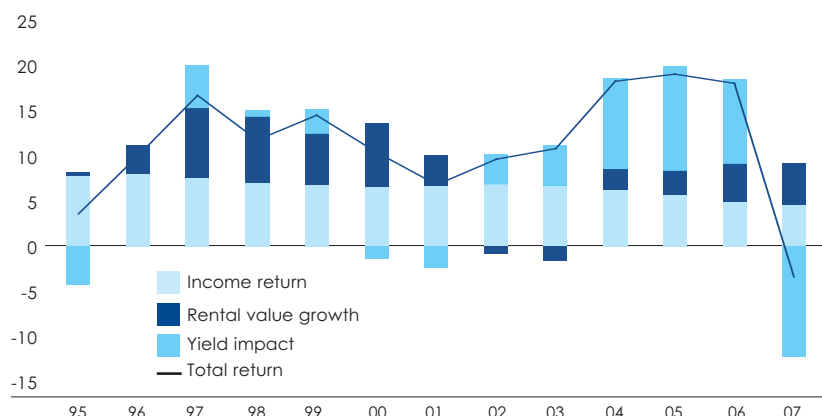


Figure 1

Source: Investment Property Databank (IPD) Annual Index

of events. In this cycle, the shape of total returns reflected swings in the demand for property as an investment rather than the underlying occupier markets. To understand the drivers of the rapid decline in values that started during the second half of 2007, we first need to consider property market performance in the preceding years.

In the wake of the losses experienced by many investors in equity markets in the early part of this decade, there was an increasing focus on ‘alternative’ asset classes, particularly those with strong and secure income streams. Property yields compared well with those offered by other asset classes, particularly gilts or cash, which attracted a large volume of capital into the sector. This included demand from overseas investors, who were major buyers of UK property during these years, reflecting the UK’s status as one of the largest and most liquid property markets in the world. In addition, there was strong demand from debt-backed investors, which reflected a ready supply of financing, offered on favourable terms as banks sought to increase their lending to the sector. With strong demand for property as an investment, but only a finite supply of investment-grade property assets, the result was rising property prices; capital values rose by 41% during 2004-6. This pattern of rapid growth in prices is set out in figure 1, which separates the drivers of return.

Capital growth can be decomposed into two elements: rental growth and yield impact. A rise in market rents, all other things being equal, will result in a higher future income stream and consequently a higher value. Yield impact is the part of capital growth that is not due to changes in future income and so reflects trends in investment markets; it is analogous to a change in the price-earnings ratio for equities. Although 2004-6 saw good levels of rental growth for property, it was yield impact that was the principal driver of returns, reflecting investor appetite and confidence in the sector. As prices rose

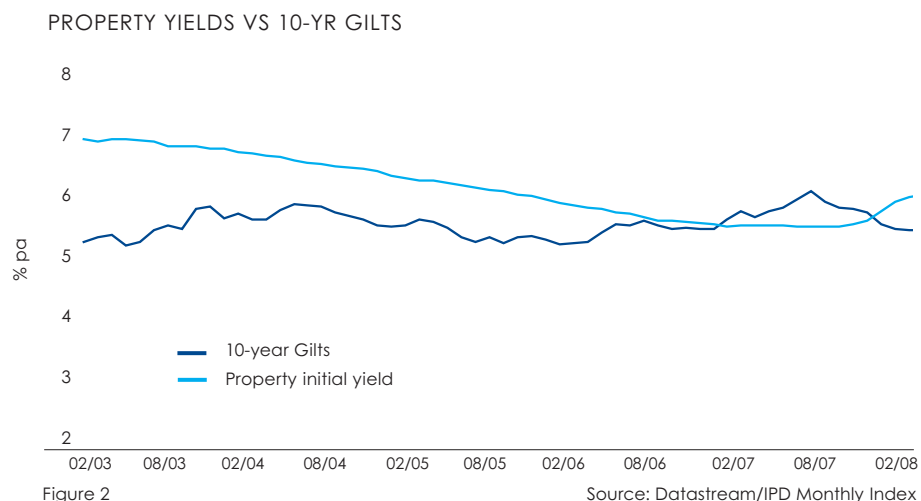


Figure 2

Source: Datastream/IPD Monthly Index

much faster than rents during this period, the yield on property fell. By the middle of 2007, the fall in property yields and rise in gilt yields had completely removed the yield margin offered by property, and indeed produced a negative yield gap (figure 2).

This created the potential for an upward correction in property yields, which was then ‘triggered’ by the credit crunch. The major impact of the credit crunch on property was to prompt a general reduction in risk appetite amongst investors that affected a number of asset classes as well. Although it also impacted on demand from debt-financed investors by sharply increasing the cost of debt as well as severely curtailing its availability except on very restrictive terms, such investors had largely been out of the market for some time. The effects were

felt rapidly in the property market during the summer of 2007; investment demand weakened and property prices fell back.

Although some people had highlighted the potential for a correction, the speed with which it took place took almost all commentators by surprise. One of the key reasons behind the speed of correction was that over the past decade the asset class has been opened up to a much more diverse investor base, making it more sensitive to changes in overall investor sentiment. The credit crunch was a phenomenon that moved sentiment sharply for all major asset classes over a very short period of time. The effect on property was clear; for the calendar year 2007, property capital values fell by -7.7%, with the majority of the decline taking place in Q4. Yields rose from a low of 4.6% in June 2007 to 5.2% in December.

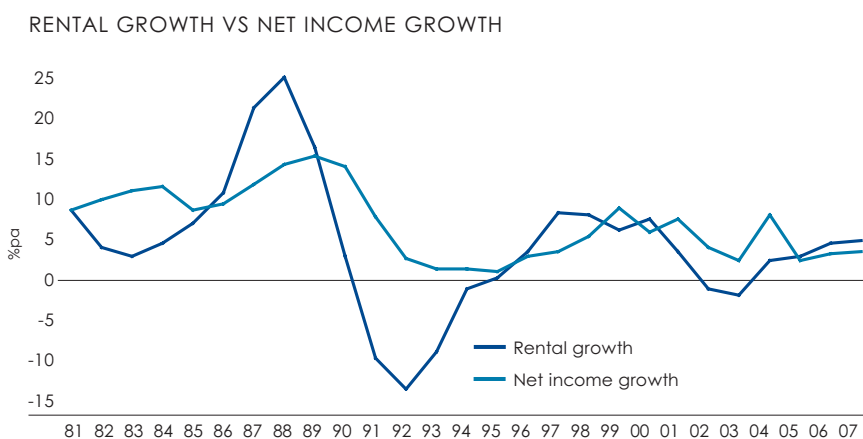


Figure 3

Source: Investment Property Databank (IPD)

Annualised 1970-2007 % nominal pa	Direct UK Property IPD UK All Property	UK Equities FTSE All Share	Gilts 5-15 Year
Total Return	12.10	13.90	10.30
Capital Growth	5.50	9.00	0.40
Capital Growth as % of Total	46.00	65.00	4.00
Volatility (Standard Deviation)	10.40	30.00	14.10
Return / Risk Ratio	1.16	0.46	0.73
Annualised Correlations			
Property-to-Equities / Gilts	N/a	20.00	5.00
Equities to Gilts		62.00	

Figure 4 Source: Investment Property Databank (IPD)/FTSE/Barclays Capital/LGP Calculations

Total return for the year was a negative -3.4%. But it is important to highlight the fact that the underlying occupational market remained largely healthy in 2007; indeed rental growth was 4.6%, the highest figure since 2000 (figure 1).

The events of the past 6-9 months have blown the 'froth' away from the property market and left it to establish a level based on fundamentals. This leads us to reflect on whether those fundamentals which investors have historically focused on remain in place.

Has the "case for property" been undermined?

Property plays a key role in multi asset portfolios, principally owing to its "different" performance characteristics, making it a "low correlation" asset class; its price is a combination of the rent that a tenant pays to occupy it and the value that an investor places on that income stream.

Rents reflect the demand for and supply of property. In the UK, a growing economy and relatively limited new supply has led to long-term growth in rents broadly in line with inflation; according to the Investment Property Databank (IPD), rents grew by an average of 3.9% pa between 1980-2007 compared with RPI inflation at 4.2% pa. But market rents are subject to cycles. So there is an

additional factor to consider; the contracts used to lease space. The typical UK lease has a long duration (9.8 years long in 2006/7 Source: IPD) and upward-only rent reviews every 5 years. So landlords benefit from any growth in market rents but equally the 'upward-only' clause gives protection against a decline. So as an asset class, property combines much of the security of a bond with the potential for growth offered by an equity; while rental growth has averaged 3.9% pa, the downside protection offered by leases has allowed net income to grow by 6.3% pa (figure 3). This provides an effective hedge against inflation and has been seen as particularly useful for pension schemes and other investors looking to match indexed liabilities.

Another distinctive feature of property comes with the potential to add value to the underlying asset, through physical refurbishment or redevelopment as well as the restructuring of contracts with tenants. This offers the prospect of boosting performance for an investor's portfolio beyond that which would be delivered by the market alone.

The secure income base has formed the foundation for property returns over the long-term; income has accounted for a little over half of the total return from property, compared to around a third for

UK equities (figure 4). With the inclusion of capital growth, total returns to property have been between those of equities and gilts, but with a lower volatility than either. A particularly strong characteristic of property is that its correlation with equities and gilts is much lower than their correlations to each other; 20% and 5% respectively compared to a correlation of 62% between equities and gilts. So the inclusion of property has been an important source of diversification in a multi-asset class portfolio and has helped to deliver improved risk-adjusted returns.

What does 2008 hold for the market?

There are still several headwinds facing the sector. In the short term, a substantial volume of investment property remains on the market, particularly from retail funds. We may also see a number of debt-backed investors disposing of assets in what is likely to remain a much more restrictive financing environment. Currently, investment demand for property is patchy and likely to remain so for some time yet, particularly given evidence that 2008 will be a challenging year for the UK economy, which will temper investors' expectations for rental growth. We expect this balance of supply and demand for investment property to lead to further falls in capital value in the first half of 2008.

But the valuation of property relative to other assets has already improved substantially, with the yield margin over 10-year gilts standing at 0.9% in February 2008 compared to a long-run average of 1%. We forecast that despite slower economic growth, rental growth will remain positive in 2008. With property prices falling further, this will raise the property yield and in the absence of a sharp rise in gilt yields, the yield gap will move above the long-term average. We expect a growing number of multi-asset investors, including pension funds, to see this as a signal that the market offers value, particularly given the blend of

equity and bond-type characteristics that property's income stream has displayed historically.

Overseas investors are also likely to be an important source of investment demand – in addition to the structural factors that have attracted them in the past (ie a large, liquid and transparent property market), the UK now appears fairly priced or even cheap in comparison to many international property markets. There have also been a number of 'opportunity' funds launched specifically to take advantage of a repriced UK property market. While some of these funds are using debt to a greater or lesser extent, we do not expect debt-backed investment on anything like the scale of recent years; its use is likely to be focused on higher-risk/higher-return strategies.

So 2008 is expected to be a year of two halves: the first half of the year is expected to remain weak as prices continue to come under pressure, but in the second half we see the potential for a much healthier picture, as yields stabilise and total returns move back into positive territory.

What are the risks?

At Legal & General Investment Management, despite adopting a reasonably cautious view on the UK economy in 2008, we are still expecting rents to rise, albeit more slowly than over the past several years. Were the economy to turn down even more sharply than we are expecting, or even to go into recession, this would undermine the short-term prospects for rental growth and raise the yield required by investors to compensate for the risks of investing in the asset class, putting further pressure on prices. However, even under this scenario, we would expect the bond-like characteristics of a property's income stream to make it more defensive in a downturn than other real asset classes in particular equities.

What will be the new opportunities in the sector?

In the yield-driven market of the past 3-4 years, the fundamentals of income and rental growth have accounted for a relatively small proportion of the overall return. Going forward, we expect that to change. Targeting assets with good rental growth prospects requires an understanding of the dynamics of occupier markets. At the same time, with a more

even balance between buyers and sellers, there will be opportunities to purchase assets where specialist managers can mitigate risks that have been unduly discounted. There will also be an increased focus on activities such as physical redevelopment of assets, which add value but require project management expertise. All of these factors point to an environment in which there is likely to be much greater differentiation between the best and the worst property fund managers.

Summary

Up until the middle of 2007, property experienced a phase of exceptional returns. This resulted from a greater appreciation of the asset class but eventually led to it becoming overpriced and suffering a sharp correction. While this has led to negative short-term returns, it does also provide opportunities for long-term investors in the sector, particularly given that we may now be approaching a turning point. Furthermore, recent events should not obscure the fact that the key characteristic of the asset class, a secure and rising income stream, remains in place. And in a more discerning market, the relative performance of specialist property managers that are able to build on these foundations is likely to be stronger going forward than we have seen in recent years.

Market Overview

Commodities shoot up

February proved tough for equity markets as they stagnated with rumours of more write downs flying left right and centre. Opposite to this, commodity markets took January's 125bp cut in the Fed Funds Rate positively. Problems with the supply of energy in South Africa forced mines to cut output and a cold snap in China sent metal prices soaring. Palladium and Platinum had the biggest gains, up 52% and 31% respectively. Other commodities were also buoyed by the move in metals and crude oil managed to close for the first time above \$100. Wheat moved intraday (during one single day) in a range of \$4 (or 24%) as fraud was found at a clearing broker. This movement of \$4 was similar to the value wheat traded at only one year ago. This move in commodity prices helped the Basics Resources, Oil and Food sectors outperform other industry groups. The ECB kept interest rates unchanged helping the euro to move to new all time highs against the dollar.

London

High Street disappoints

The UK equity market posted a positive total return in February with the All Share index 0.8% ahead. A moderate increase in risk appetite saw mid and small cap indices post stronger gains, returning 1.9% and 4.3% respectively. At the sector level, Mining continued its strength driven by higher metals prices and ongoing corporate activity. Oils were another strong feature with the crude oil price breaking through the \$100 per barrel level. A continuing stream of bad news on the high street saw Retailers come under further pressure. Telecoms were also weak after both Vodafone and BT Group disappointed the market whilst Pharmaceuticals continued to be a weak feature. Corporate activity continued with FKI and Expro International receiving approaches. We expect markets to remain volatile in the short term with increased evidence of slowing consumer spending and difficult credit markets impacting on corporate profits.

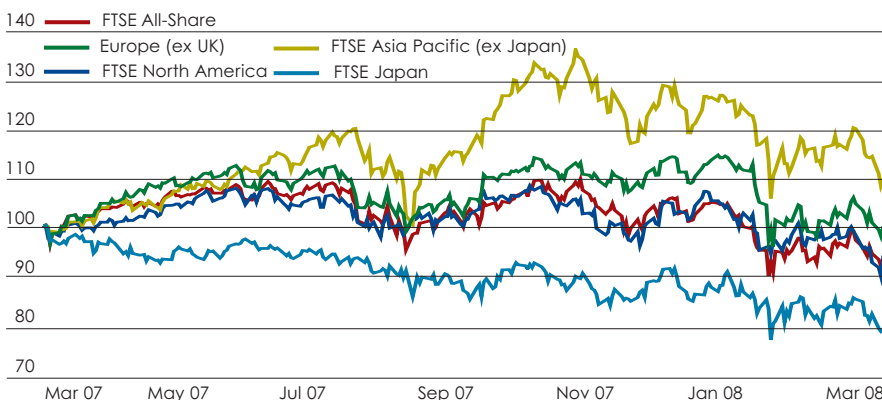
Wall Street

Microhoo!!!

The S&P 500 was down 3.5% in dollar terms in February. Energy, materials and consumer staples were the best performing sectors. Financials and telecom services were the worst performers. Economic news showed further significant deterioration during the month. The ISM manufacturing and non-manufacturing surveys remained in recession territory and non-farm payrolls shrank over the period. The consumer faced further significant headwinds in the form of higher energy and food prices. The mono-line insurance industry received much attention. A ratings downgrade of these entities would result in further asset markdowns at counter parties. These rating concerns set off a buyers strike in the municipal bond market which caused a significant spike in financing costs for many state entities. Sprint Nextel announced significant further deterioration in business trends. Microsoft offered to buy Yahoo for \$45 billion. Microsoft is a distant third to Google and Yahoo in the lucrative market for online ads.

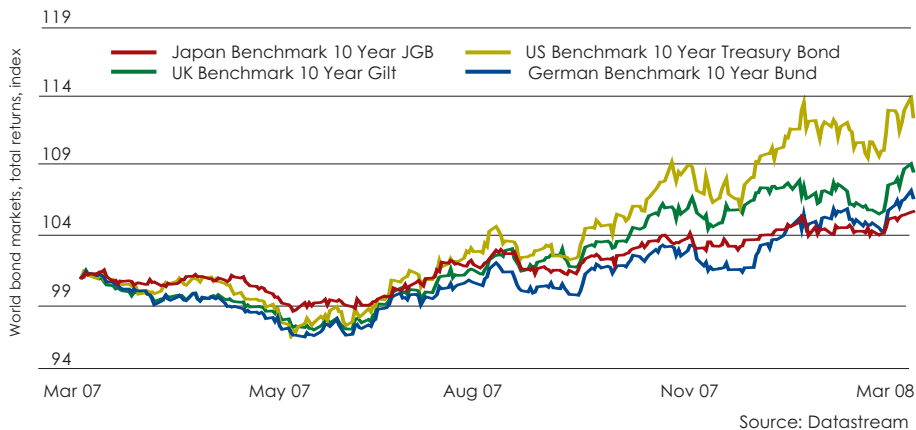
The outlook for the equity market remains challenging. Profits estimates for 2008 are likely to be reduced, as write downs from the financial sector continue and the more restricted availability of credit and ongoing correction in the housing market dampen the growth outlook.

MAJOR EQUITY MARKETS – TOTAL RETURNS £ 2007/2008



Source: Datastream

MAJOR WORLD BOND MARKETS – TOTAL RETURNS £ 2007/2008



Europe

ECB holding firm

After the turbulence in markets in the first few weeks of the year, February saw markets stabilise a little. After the heavy trading volumes of January, activity subsided a little as investors retired to lick their wounds. During the month it became clear that the Federal Reserve Board and the European Central Bank would continue their divergent strategies, the former responding to weak economic growth and the latter intransigent in the face of an accelerating rate of inflation. As we progressed through the month companies around Europe released annual earnings reports which, whilst not beating market expectations significantly, did not provide too many disappointments, the financial sector excluded. Under such circumstances it was the defensive sectors such as healthcare and telecommunications which lagged the broader market; at the other end of the spectrum were sectors where the underlying materials prices continued their seemingly inexorable rise, such as basic resources and oil and gas.

We see numerous factors weighing on markets in the near term. Even though the relative condition of domestic demand in Europe would seem to be better than in the US and the UK, there are question marks over how long this continues. Certain countries are already seeing a marked slowdown, led by Spain and Ireland, and with a deterioration in conditions in the US, a major export market for the region, it is expected that the rate of economic growth will moderate in the larger markets of the continent. Add to the mix the potential for further balance sheet impairment at some banks and the potential for sustained recovery in markets appears limited.

However, in spite of these near-term uncertainties, there is scope for support for equities from valuations: it has been especially noteworthy how lowly-indebted European companies have been able to increase dividends well ahead of expectations. Since traditional wisdom holds that the long-run rate of growth of equity markets tends towards the rate of growth of dividends plus the dividend yield, the long-term investor should derive some comfort, although such longer term trends may not prevail in the face of so many volatile cross-currents. We remain defensively positioned.

Japan

Yen show its strength

Following the turbulent start to the year February offered investors some respite, as the Nikkei remained in a trading range and ended the month up 0.1%. The stronger yen and deteriorating outlook for the US economy led a number of Japanese companies to revise down when they reported their third quarter earnings. However, a surprisingly strong GDP figure, showing that the Japanese economy had expanded at an annualised rate of 3.7% during the third quarter, helped support the market.

Investors continue to be concerned by the weakness in the credit market and the prospect of further writedowns by financial institutions. In Japan, investors await the appointment of a new Bank of Japan governor in March and any policy change that might engender. Despite the better than expected GDP figure investors remain concerned that it will be revised down, particularly as the increase in corporate capital expenditure looks to be unrealistic.

Pacific Basin

Inflation rampant in China

The FTSE All World Asia Pacific (ex Japan) Index rebounded by 4.2%, in sterling terms, in February this came after the aggressive sell off in January when the index fell by 12.2%. Asian markets remain volatile as investors turn more risk averse worrying about the robustness of earnings growth given fears of a US recession and its potential negative impact on the world economy. The leading performers were Taiwan +14.1%, Thailand +13.6% and China +11.6%. Markets in negative territory were the Philippines (-4.6%), India (-2.8%) and Malaysia (-0.4%).

Taiwan was the star performer due to the continued leadership in the opinion polls by Ma Ying-Jeou of the more China friendly Kuomintang party (KMT) in the presidential election. Investors are clearly warming up to the idea that if the KMT secures a decent majority and thus a clear mandate then it remains the case that Taiwan could continue to outperform on its improving domestic fundamentals. These are direct air links, growth of Chinese tourism, a potential boost to the property market and reform of investment limits restricting Taiwanese corporates investing in China.

Chinese equities recovered some of the ground lost in January as investors hoped that the Chinese government will ease its tightening policy after the dislocation caused by the big snowstorm in late January 2008. This contributed to a January CPI of 7.1% year on year, the biggest in inflation number in China for 11 years.

On the 5 March the National People's Congress will start. This will no doubt focus on familiar themes of the past six months: inflation and margin squeeze, energy efficiency and the environment. There is likely to be more talk about tightening, but no concrete steps taken. Rather Beijing is making a lot of noise about tightening in order to create a political environment conducive to persuading local officials who take up new posts in the first half of 2008 not to indulge in an explosion of new bank financed investment projects. Furthermore Beijing is talking tight to lower inflation expectations.

Snapshot

Will a US recession crush commodity prices? Or are high commodity prices crushing the US consumer?

The US uses around 50% more energy to generate an extra dollar of income than the UK, euro area or Japan (according to World Bank data). This probably reflects the fact that Americans drive bigger cars longer distances than their foreign peers. Given we believe the US is in recession, surely we must be expecting a significant fall in energy prices over the next year? Actually, we expect continued double-digit gains in commodity prices. Indeed, strong commodity price gains are a significant reason why we are cautious on US economic growth.

The reason for this is that emerging economies such as China, India and Russia use as much, if not more, energy as the US to generate an extra dollar of growth. And their economies are growing at around a double-digit pace. Our estimate of global energy demand (the increase in global GDP adjusted for energy intensity) collapsed in the early 1990s as the Soviet Union imploded. And again in 1998 as Asia crashed. But since then it has been rampant, driven by robust recoveries in domestic demand in emerging economies (Figure 1).

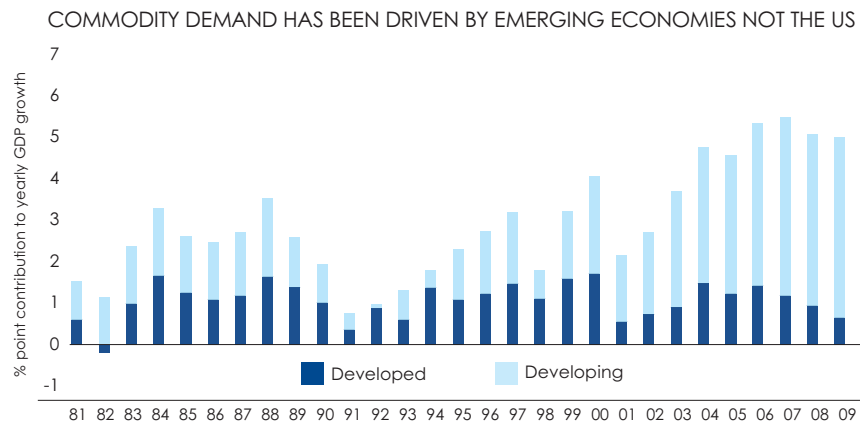


Figure 1

Source: Reuters Ecowin, LGIM, IMF

Our latest forecasts – which are much more bearish than consensus for the US – still point to buoyant commodity price growth, particularly in US dollar terms. In Chart 2 we plot our measure of energy demand against the yearly change in real commodity prices, adjusted for movements in the US\$. We do this because commodity prices are priced in dollars and can therefore change, even if demand doesn't, because of movements in the dollar. Given the likelihood that the dollar continues to depreciate, commodity prices could rise by 25% in US\$ terms in both 2008 and 2009. The downside risks are that we get an increase in supply or a sharp slowdown in emerging economic growth. But instead, we see looser US monetary policy boosting emerging markets as a lower global cost of capital is more likely to benefit emerging market economies with strong balance sheets than indebted US consumers. Ultimately, we believe these inflation pressures will prove too much for emerging economies and they will be forced to revalue their exchange rates significantly against the US dollar. This will reduce the cost of raw materials in emerging economies, but will boost the price of global manufactured goods in US\$ terms. The US consumer will therefore be further squeezed by higher import prices, increasing the odds of a prolonged recession.

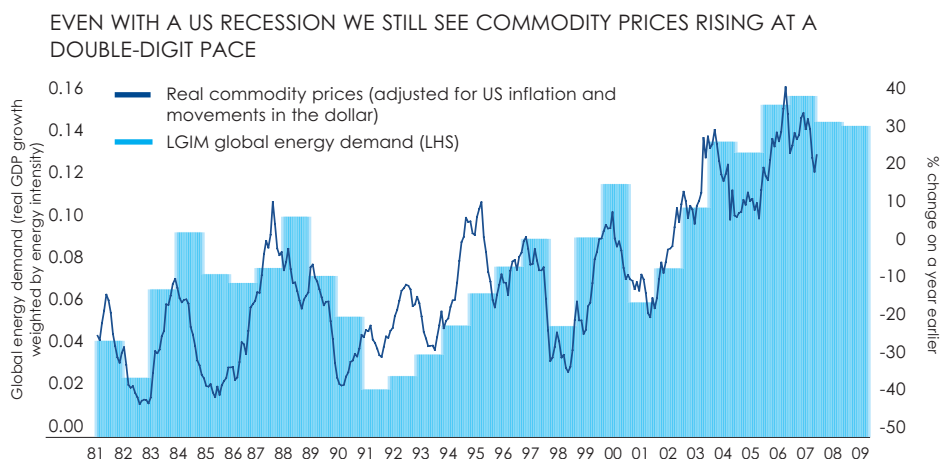


Figure 2

Source: Reuters Ecowin, LGIM, IMF

Views Commentary

Sogflation or goldilocks?

	Price Inflation (HICP)		GDP (Growth)		Earnings (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro		FTSE 100
	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008	End 2009	End 2008	End 2009	End 2008
ABN Amro	2.70	2.10	1.60	1.70	0.00	0.00	-	-	5.00	5.00	2.03	1.98	0.78	0.74	5800
Citigroup Smith Barney	-	-	1.70	1.90	6.10	8.70	4.65	-	4.25	-	1.92	-	0.77	-	7000
CSFB	2.40	1.60	1.40	2.40	1.00	-	4.40	-	4.75	4.75	1.84	-	0.74	-	6800
Deutsche Bank	2.60	1.90	1.80	2.90	5.40	8.60	4.45	-	4.50	-	1.91	-	0.75	-	7200
Goldman Sachs	2.50	2.00	1.20	2.77	2.70	12.90	4.45	4.70	4.50	4.50	1.97	1.85	0.72	0.72	6750
HSBC Securities	2.00	1.50	1.00	2.40	10.00	5.00	4.50	4.50	4.25	3.50	1.79	1.73	0.75	0.75	7100
JPMorgan	3.00	1.90	1.90	2.30	-	-	4.51	5.12	-	-	1.84	2.03	0.68	0.67	-
L&G Investment Management	2.60	2.30	1.50	1.50	4.00	4.00	4.25	4.00	4.50	4.00	2.00	2.00	0.77	0.81	6000
Merrill Lynch	2.70	2.00	1.80	1.80	4.00	6.00	4.45	-	4.50	4.50	1.87	1.68	0.79	0.76	6500
Morgan Stanley	-	-	1.80	2.20	-7.00	-3.00	5.10	5.30	5.00	5.25	1.86	1.83	0.71	0.69	6300
UBS	0.23	1.60	1.50	1.70	7.10	11.70	4.40	4.60	4.25	4.25	1.99	1.90	0.73	0.70	6500
Median (ex L&G Inv Mgt)	2.55	1.90	1.65	2.25	4.00	7.30	4.45	4.70	4.50	4.50	1.89	1.85	0.75	0.72	6750
Last Month	2.40	2.00	1.70	2.20	5.50	7.70	4.55	4.65	4.75	4.75	1.96	1.83	0.75	0.72	6800
Actual end :															
2007		2.10		2.90		6.20		4.51		5.50		1.98		0.75	6453
2006		3.80		3.00		12.20		4.74		5.00		1.96		0.67	6220
2005		2.00		2.00		22.70		4.10		4.25		1.72		0.69	5618

KEY Median figures indicate change over previous month 0.00 increase 0.00 decrease 0.00 no change

*This is our estimate of fair value at end 2008, not a point forecast.

We have updated our forecasts this month. We expect the US to experience a prolonged recession. But we see a looser Fed policy stimulating growth in emerging economies. This, alongside a weaker pound, should support UK exports. But it also entails higher inflation. So we see growth below trend in 2008 and 2009 but inflation above target in both years. This is consistent with the Bank of England cutting interest rates at a moderate pace of once a quarter.

Our forecasts differ from consensus. While we see 'sogflation' (soggy growth, stubborn inflation), they see 'goldilocks', with 2.25% growth in 2009 and inflation returning to the 2% target. They also see interest rates higher (4.5% end 2009 vs our 4.0%) which in turn means they expect the pound to hold up better against the euro (though not the dollar). We continue to be more cautious on equities than consensus. We expect the FTSE to end 2008 at 6000 vs consensus of 6750.

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