This Christmas, relax and bank on the yield

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Remember Clive Dunn, star of BBC post-war sitcom Dad's Army? His character, Lance Corporal Jones, would descend into a state of hysteria at the first mention of Hitler. "Don't panic, don't panic", he would shout at his card-playing comrades, embodying the reaction he was urging them to avoid.

Markets are a bit like that, capable of switching from calmness and optimism to anxious pessimism in an instant. Panic selling is often the result.

The challenge for investors is in establishing whether the change in mindset is warranted. If it is, caution should prevail. If not, the lower prices pessimism brings are an opportunity.

For property trust investors in Australian Real Estate Investment Trusts (AREITs) at least, we'd argue in favour of the latter. In this sector, it is the perception of risk rather than the reality of it that has changed.

Let's dismantle the myths driving the recent outbreak of panic.

Conventional wisdom states that higher interest rates push up debt servicing costs and push down AREIT share prices - as bond yields rise property trust dividends become relatively less attractive.

One of those arguments is true but overstated, the other, the data suggests, is altogether false.

At 26%, AREIT gearing is at its lowest level since 1999[1]. A prudent approach to debt management has resulted in the sector's average debt term exceeding 5.5 years, almost double that of the pre-GFC era. Debt sources have been diversified to reduce future funding risk and hedging has been steadily increased.

These factors offer higher levels of cashflow protection if and when rates rise. The sector simply doesn't have the debt exposure many investors believe. The influence of rising rates on debt servicing costs is correct but overstated.

As for the connection between rising rates and lower AREIT share prices, the historical data suggests otherwise.

In the last five interest rate tightening cycles[2], the S&P/ ASX 200 AREIT Accumulation Index achieved an average annualised total return of 7.5%[3].

That's not only reassuring, it makes intuitive sense. Interest rates are more than numbers on an analyst's spreadsheet. Rising rates are usually an indicator of low unemployment and inflation and high business and consumer confidence. Those things are good for AREITs.

The final interest rate conundrum concerns the expectation of future rate rises. The US Federal Reserve began increasing rates in late 2016 but the local situation is quite different.

The Reserve Bank has held rates at 1.5% for a record 28 consecutive months and the 10-year bond rate is currently below where it was at beginning of the year. In other words, property trust investors have been worried about something that didn't happen in 2018 and probably won't in 2019.

The threat of online retail to shopping centres, which has dominated discussion in the sector this year, is a more sustainable argument. Lower quality retail centres and shops on High Streets are showing signs of stress. Flat wages growth and declining residential housing prices in Sydney and Melbourne, meanwhile, add to the fear that the glory days of shopping centres are over.

Again, the data suggests these fears are overdone. Retail AREITs continue to maintain high occupancy rates of 99% with no rise in tenant defaults. And shopping centre productivity (the amount of sales a centre gets per square metre of space) grew by 3.1% over the 2018 financial year, suggesting that Amazon isn't having the impact on bricks and mortar the market thought it would.

The implication is that too many investors are ignoring the success of many retailers in developing their omnichannel experience.

Retailers like Apple, Nespresso and Mecca offer a shopping experience that cannot be replicated online. Meanwhile, the space vacated by shrinking department stores is being taken up by supermarkets and retailers like H&M, CottonOn Mega and Daiso. All of whom pay more rent (per square metre).

It is an often-forgotten fact that Australia has some of the world's best shopping centre landlords. They have been busy shifting the tenant mix towards a more experiential theme. All the evidence suggests it's working, which is why we're confident the sector will continue to deliver attractive, reliable yields in the years ahead.

Panicking is never a good thing in investing. Decisions should be made on a rational assessment of the facts rather than an emotional response to doom laden shot term forecasts and media headlines.

If you're an investor in Australian property trusts (assuming you're not over-exposed to those with residential development activity) you have less to worry about than you probably think.

This Christmas, rest easy, put your feet up and when you get frustrated by the crowds at your local shopping centre, just think of the yield. Right now, it happens to be one of the more reliable, predictable things in finance.

1 JPMorgan research.
2 Tightening cycle defined as a period of consecutive rate increases or where multiple rate increases have been punctuated by a period of no change.
3 APN article: "Conventional wisdom is wrong. Rate rises are good for property trusts" 15 May 2018.

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