FUND MANAGEMENT DIARY

Meeting held on 2nd October 2018

Why is property so often the source of trouble?

- The property sector is large, with the total value of global residential and commercial property equivalent to over 1.5 times the size of global gross domestic product
- The combination of property's tendency towards big booms and busts, and its links to the economy, explains why it has been at the root of many recessions in the past
- Although property markets have been responsible for multiple national and regional crises, it is highly unusual for property to spark a global crisis as it did in 2007/08

Property's importance to the global economy

It is now ten years since the global financial crisis, a key trigger of which was the property market. Indeed, property has been associated with financial crises and recessions throughout recent history. There are many reasons why property has the potential to have such an important bearing on the global economy.

First, it is, quite simply, a very big market. At $200 trillion, the total value of global residential and commercial property is almost double the size of the outstanding stock of debt securities (i.e. government and corporate debt), around 2.5 times the size of the value of outstanding equities and is equivalent to over 1.5 times global gross domestic product. The sheer size of the market is certainly part of the reason why property is such an important determinant of the health of economies and financial sectors.

Property has a number of links, direct and indirect, with the economy. It directly affects the economy via the construction of buildings and through related supply chains. In addition, it affects confidence as rising prices boost the confidence of property-owners while denting sentiment for would-be home-owners. The value of property also affects the amount of collateral households and firms can borrow against to fund spending and investment. And crucially, it also affects the health of the overall banking sector of an economy because many property purchases are financed by debt.

Second, property tends to be a major influence on the economy due to its cyclical nature – with a propensity to experience periods of boom and bust. It is common for global house prices to fall in real terms (i.e. adjusted for consumer price inflation) during a downturn but rise on average by over five per cent a year during an upturn.

This tends to magnify all of the effects of property on the economy, on both the way down and on the way up.

This cyclical nature is a feature of the property market that goes back centuries and did not begin in recent decades, when mortgage finance became more prevalent. The big swings in prices are partly because the supply of property tends to adjust more slowly than the demand for property. The resulting periods of mismatch between supply and demand may explain why the sector seems to be especially vulnerable to swings in sentiment and speculation, which can accentuate price cycles. Finally, the borrowing that finances much of property demand means that leverage can magnify underlying property market cycles.

Property has been at the root of many recessions

The combination of property's tendency towards big booms and busts, and its multiple links to the economy, explains why it has been at the root of many recessions in the past. For example, there have been twelve burst housing bubbles in the G7 economies since 1960 and eleven of those have been followed by a recession within three years.

In addition, burst housing bubbles have been more likely to result in recessions than burst equity bubbles. This makes sense because of the greater value of property and because households are more heavily invested in property than in stocks and shares; mortgages also make up a large proportion of bank assets. What's more, the cumulative loss of output from a residential property-related recession is around three times greater than a typical recession[1].

Leverage explains why property downturns have often resulted in banking crises and recessions. Research by the International Monetary Fund shows that of the nearly 50 systemic banking crises in recent decades, more than two thirds were preceded by boom-bust patterns in house prices[2]. One of the most dramatic examples of property being at the root of a crisis is the recent global financial crisis of 2007/8. Because of the way that American mortgage debt had been sliced and diced, securitised and sold throughout the world, the downturn in the United States property market led to the global credit crunch.

Given that purchases of commercial property are typically bank-financed, it clearly has as much scope as residential property to cause serious downturns. However, it is rare to see a downturn in the commercial property market without one in the residential market too. Accordingly, commercial property tends to magnify

[1] Andrew Haldane, *Speech: The Commercial Property Forum twenty years on* (Bank of England, London), 2013.
[2] Min Zhu, *Opening remarks at the Bundesbank/German Research Foundation/IMF Conference: Housing Markets, Financial Stability and the Economy* (International Monetary Fund, Washington, D.C.) 2014.

downturns, rather than cause them in its own right. Commercial and residential property prices tend to move fairly closely together, given that they share common drivers such as lending standards and interest rates.

But it is rare for property markets to trigger a global crisis

Despite the importance of property to the global economy and its tendency to precipitate national and regional crises, it is highly unusual for property to spark a global crisis as it did in 2007/08. Part of the reason is because there is not a "global" property market. Admittedly, the peaks and troughs of property cycles do frequently coincide. But during these periods, it appears that global factors dominate and push housing markets in the same direction.

For most of the time, national property markets tend to move in different directions and at different speeds and do not appear to be that synchronised. This is because country-specific factors are most important in driving property markets, including demographics, taxes, income growth, lending practices and property supply. For instance, even during the global financial crisis, while house prices in advanced economies fell meaningfully, in emerging markets in aggregate the boom in prices halted but did not reverse.

However, a property downturn that starts off in just one country can still prompt a global crisis if that property market's connections with other countries are big enough to bring them down too. This is what happened in the global financial crisis; the United States' property market imploded and the impact on credit conditions around the world prompted the collapse of many other property markets. Nevertheless only a country like the United States, or perhaps China, is big and systemically important enough for a property slowdown to have significant spill-overs elsewhere.

Not every housing downturn in a large economy will have global ramifications though. The American housing downturn in 2007/08 sparked a global crisis because the financial system internationally was exposed to United States mortgage debt. In short, then, the circumstances that bring about a property-induced global crisis are rare.

Strategy

Future Money does not currently have any exposure to specialised property investments.

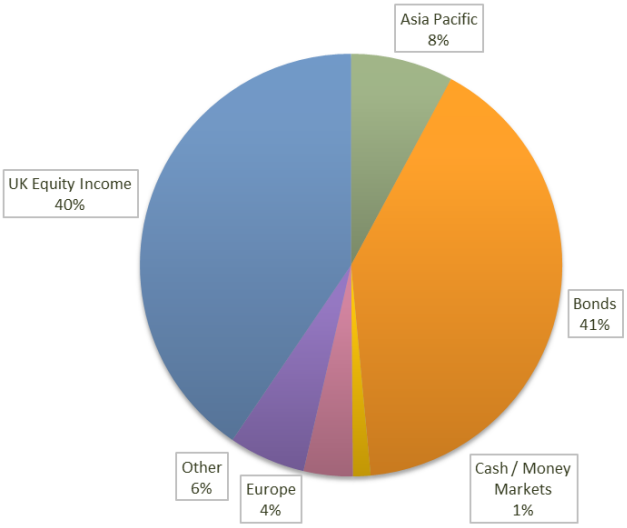
We believe that property can add diversification benefits to a portfolio in normal market conditions. However, during times of market turmoil, such as the 2008 financial crisis mentioned above, there are likely to be more sellers than buyers of property. Property transactions are typically long processes, which means that the

excess supply is likely to exacerbate price falls. The effect of this is to increase the correlation between property and other falling asset classes, which erodes the diversification benefit of a property allocation.

In addition to this, Future Money are mindful that many investors are likely to be home owners, and a substantial portion of their net assets may already be invested in property. Therefore, holding property assets on behalf of our investors could involuntarily increase their exposure to this asset class.

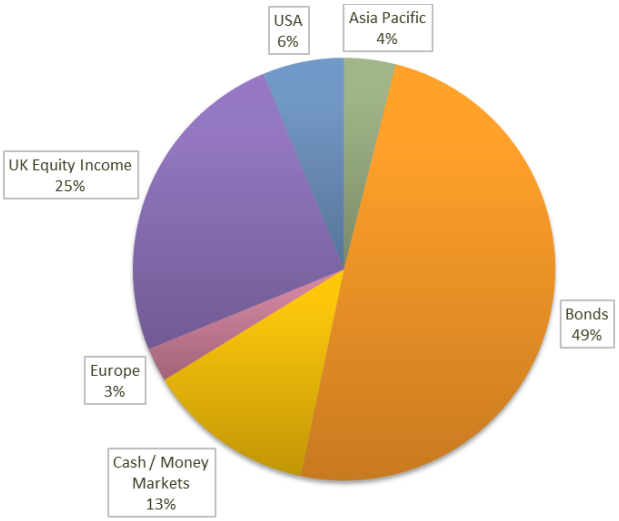
Income

The Janus Henderson Strategic Bond fund is currently under review given a change in duration exposure (sensitivity to interest rate movements). Potential replacements are being considered.



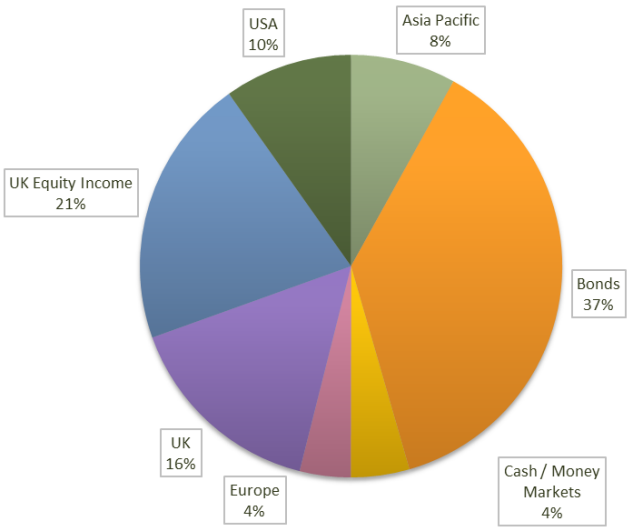
Real Value

The reduction of M&G UK Inflation Linked Corporate Bond and increase in short dated tracker funds continues this week. No further changes are currently being considered.



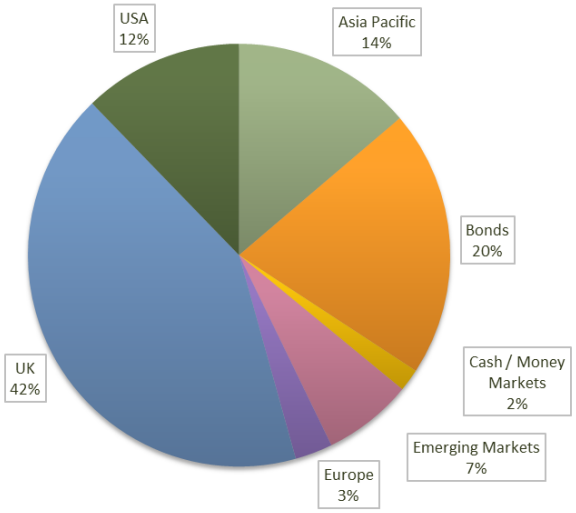
Real Growth

The move out of M&G UK Inflation Linked Corporate Bond continues this week. A decision to remove the Janus Henderson Strategic Bond fund has also been made. The fund has recently lengthened its duration, which is a move counter to our views and therefore the fund will be replaced with the BlackRock Corporate Bond 1 – 10 Year Tracker fund. Given current volatility in bond markets, this change will be made gradually over the coming weeks.



Dynamic Growth

No new changes are currently being considered for the Dynamic Growth portfolio. BlackRock Asia has experienced relatively weak performance over recent months, this appears linked to the fund manager's bullish views on the region during a time that has been hampered by negative sentiment originating from US-China trade wars. The fund is being maintained with the expectation that a recovery in sentiment will be experienced in the region in the coming months, which will in turn trigger a recovery in this fund's performance.



Important Information

Please note that the contents are based on the author's opinion and are not intended as investment advice. This information is aimed at professional advisers and should not be relied upon by any other persons.

Any research is for information only, does not constitute financial advice or necessarily reflect the views of the author and is subject to change.

It remains the responsibility of the financial adviser to verify the accuracy of the information and assess whether the fund is suitable and appropriate for their customer.

Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

For any information about the Future Money funds please contact the authorised corporate director, Margetts Fund Management Ltd, on 0121 236 2380, admin@margetts.com or at 1 Sovereign Court, Graham Street, Birmingham B1 3JR. A copy of their Terms of Business which relates to investments into the funds can also be obtained using these contact details.

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