

C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENT

U.K. Property: Attractive, But Pricey

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U.K. Property

Attractive, But Pricey

Investors may be surprised to learn that property has outperformed equities and bonds over the last 16 years. Since 1987, the Investment Property Databank's (IPD) U.K. All Property Index has posted an average annual compound return (AACR) of 10.4%, compared to 9.4% for the FTSE All-Share and 10.1% for FTSE British Government Nominal Bond Index (see Table A). Proving that the tortoise can beat the hare, property owes its strong performance to net income, which comprises 53% of IPD U.K.'s total returns. While net income's annual returns averaged 6.2% since 1987, rental and capital values have returned an average of 3.4% and 2.7% annually (see Table B).

Within the IPD U.K.'s All Property Index, the industrials sector has outperformed retails and offices, posting AACRs of 13.2%, 10.1%, and 9.4%, respectively, over the last 16 years (see Table C). Industrials, which consists primarily of light manufacturing warehouses, has been buoyed by consistently higher yields and relatively higher capital value growth. However, the sector that wields the largest impact on the aggregate index is retail, accounting for 47.8% of the total, compared with offices, 31.9%, and industrials, 19.4% (see Table D).

The decline in interest rates since 1990 has been a boon for property. While ten-year gilt yields have fallen from 13.1% in April 1990 to 4.1% in May 2003, yields on the All Property Index have been far more resilient, shrinking from 9.1% at their peak in April 1993 to 6.7% currently. Among sectors over a similar period, industrial yields have slipped to 7.7% from 10.4%, office to 7.4% from 10.0%, and retail to 6.1% from 7.9% (see Table E).

Lower Volatility and Enhanced Diversification

Property also appears to have performed well on a risk-adjusted basis, although the variability of returns is understated by the appraisal method of property valuation.¹ The annual standard deviation of monthly returns for government bonds has been 5.7 percentage points since 1987, for the FTSE All-Share Index, 17.1 percentage points, and only 2.8 percentage points for the IPD U.K. Index. Of course, property's illiquidity means that investors incur risks they do not incur with traded securities, and they also face substantially higher transaction costs.

¹ IPD was originally established by surveying firms and agents, who continue to hold a minority stake in the company. IPD produces independent monthly and annual indices, collecting data directly from institutional investors, which include property unit trusts, pooled pension schemes, and unit-linked insurance funds. The IPD U.K. monthly indices account for about 10% of the value of assets in the institutional real estate market, while its annual index represents about 75% of the total property assets of U.K. institutions and listed property companies. The annual index contains more large portfolios and high-value properties, such as shopping centres and Central London offices, than the monthly indices. IPD indices are appraisal-based, which tends to smooth fluctuations in capital value relative to indices based on market-traded equities. The total returns are comprised of capital and income components, with properties appraised each month. The capital component is calculated net of all capital investment for the month and is expressed as a percentage of the capital employed. The income component is based on the rent receivable/accrued over the month, net of all irrecoverable revenue expenditure directly attributable to delivering the income stream but gross of portfolio management costs. As of year-end 2002, 9.3% of the All Property Index was located in Central London, 14.9% in Suburban London, 21.6% in Rest of South East, 16.4% in Eastern and South East, 14.9% in Midlands and Wales, and 22.9% in the North of England and Scotland.

Property has helped to diversify portfolios against the risk of equity downturns, with 36-month rolling correlations of returns between the IPD U.K. Index and FTSE All-Share averaging -0.1% since 1989. However, property returns have had low correlations with RPI inflation, averaging 0.1% over the last 13 years (see Table F).

Rich Valuations

Although property has performed extremely well over the last 16 years, investors should not expect to earn 10%+ annual returns in the foreseeable future. Weighing on property are risks of a further slowdown in economic fundamentals, as well as lofty rental values and overextended capital values. On the positive side, however, property should continue to provide a steady source of income, with trends in each sector playing out differently as the business cycle turns.

The office sector has been extremely weak in Central London over the last three years, while rental values in other parts of the United Kingdom have been more resilient. Since 2000, the sector's total returns have fallen sharply, from 14.9% in 2000, 8.2% in 2001, and 5.9% in 2002. Not only have rental values in downtown London and the M25 area dropped sharply since 2000, but the overhang of supply will take time to be absorbed, and rental growth may actually fall into negative territory.

During economic slowdowns the retail sector has been a defensive play, offering lower volatility, longer leases, and links to domestic rather than international economic factors. However, this sector will be hard pressed to repeat its stellar performance in 2002 when it returned 14.0% after 5.7% in 2001. It has been buoyed by recent strength among out-of-town retail warehouses relative to in-town retail centres, due to the government's tightening of planning guidelines, which has limited supply, but is obviously leveraged to consumer spending.

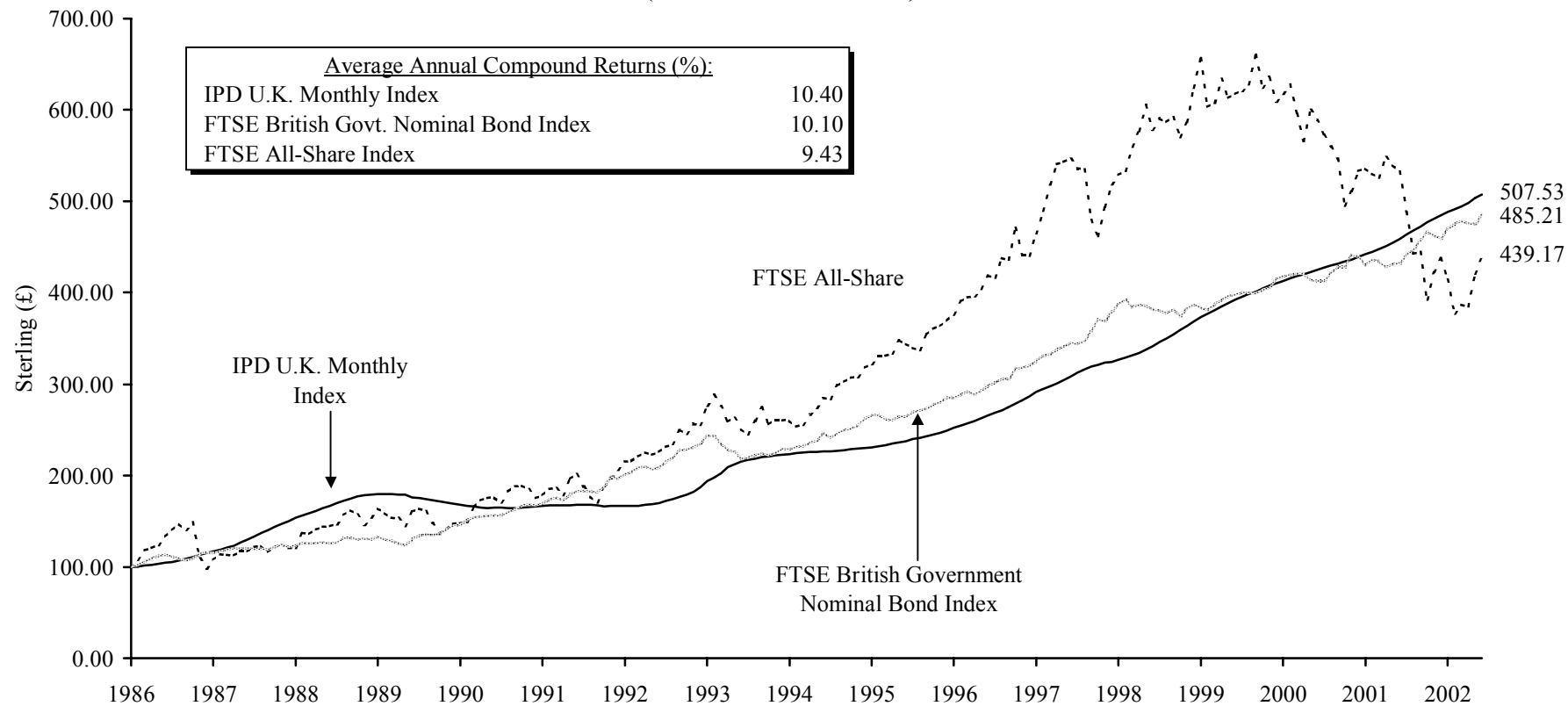
Industrial rents have held up relatively well over the last three years, as they did during the recession in the early 1990s. To the extent this sector's performance is driven by yield differentials, however, its near-term prospects may not be as attractive as they were a decade ago. Industrials outperformed since 1995 largely due to the drop in interest rates, which provided a substantial fillip to its already high income rates. However, industrial yields have shrunk from 9.4% in 1995 to 7.7% currently, narrowing its yield differential with offices and eroding its risk premium.

In sum, property seems likely to post relatively modest gains over the next few years. While macroeconomic risks and relative valuations among sectors lead us to consider the asset class relatively expensive, it could be an attractive *relative* play by continuing to outperform equities and gilts in the current unsettling economic environment.

Table A

CUMULATIVE WEALTH OF THE IPD U.K. MONTHLY INDEX, FTSE BRITISH GOVERNMENT NOMINAL BOND INDEX AND FTSE ALL-SHARE INDEX

1 January 1987 - 31 May 2003
(31 December 1986 = £100)

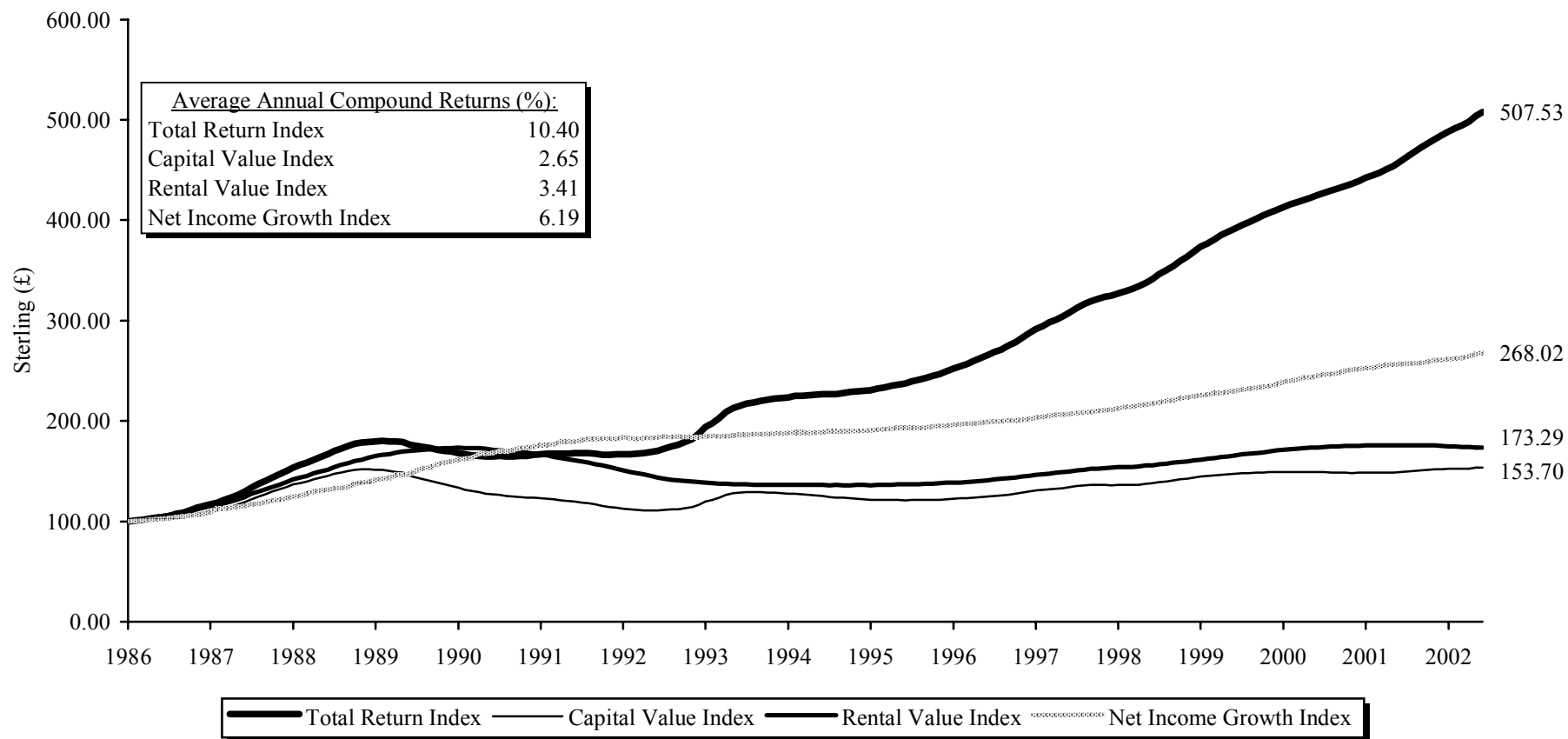


Sources: Investment Property Databank Monthly Index and Thomson Datastream.

Table B

CUMULATIVE WEALTH OF THE IPD U.K. MONTHLY INDEX ALL PROPERTY TOTAL RETURN, CAPITAL VALUE, RENTAL VALUE AND NET INCOME GROWTH INDEX

**1 January 1987 - 31 May 2003
(31 December 1986 = £100)**



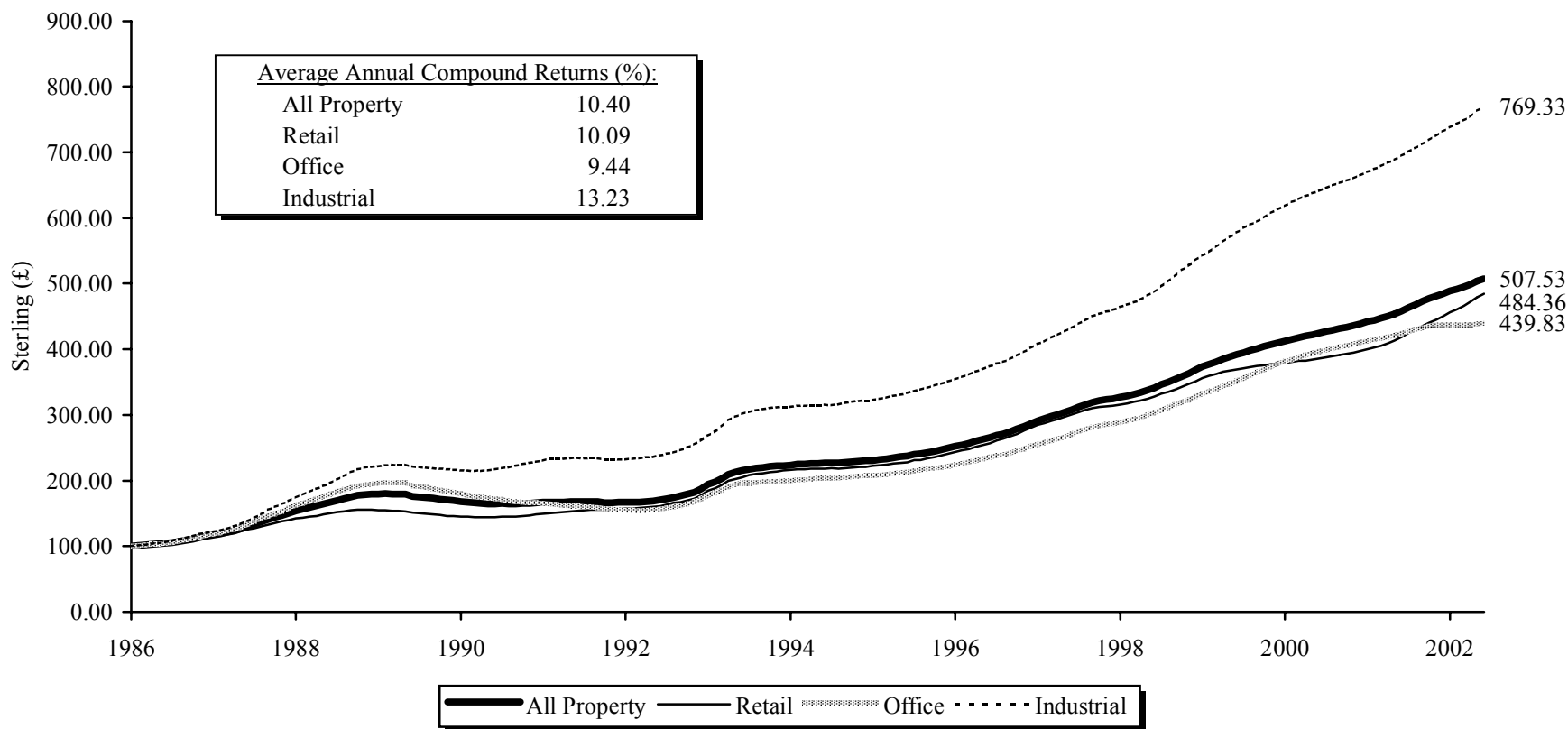
Source: Investment Property Databank Monthly Index.

Note: Total return is comprised of Capital Value, Rental Value, and Net Income Growth.

Table C

RELATIVE PERFORMANCE OF THE IPD U.K. MONTHLY INDEX SECTORS

1 January 1987 - 31 May 2003
(31 December 1986 = £100)

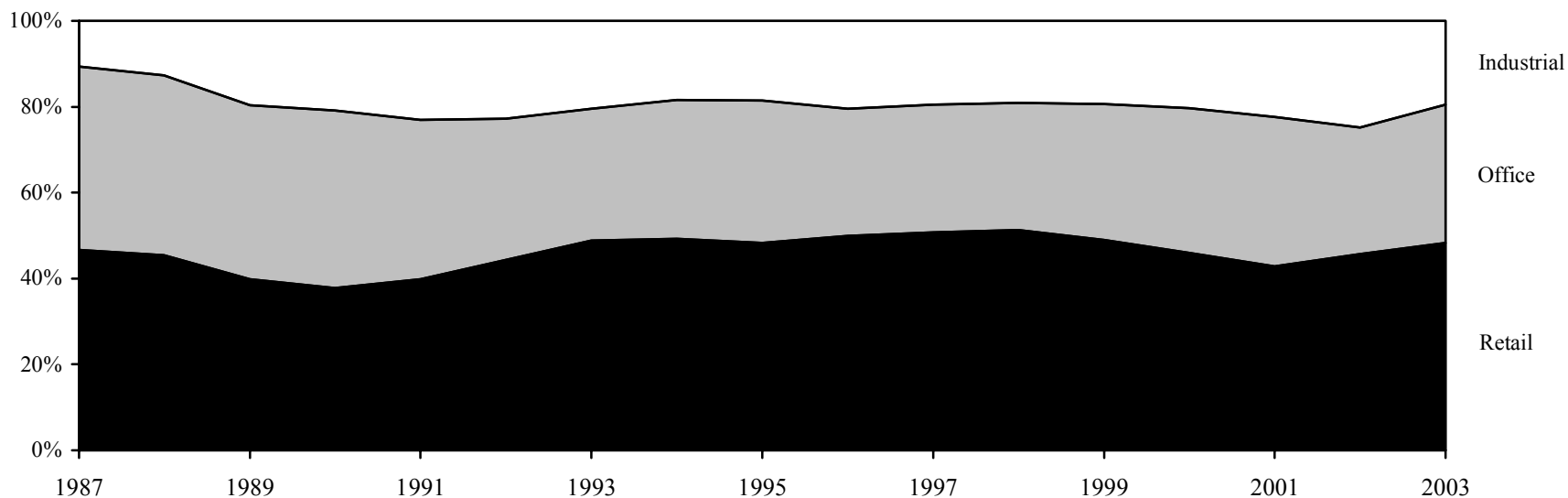


Source: Investment Property Databank Monthly Index.

Notes: Income return is the income receivable net of any property management and irrevocable costs, divided by the capital employed throughout the month. Capital growth is the change in capital value from one valuation to the next, net of any capital flows, divided by the capital employed. Total return is the sum of the income return and capital growth.

Table D

IPD U.K. MONTHLY INDEX HISTORICAL SECTOR WEIGHTS



Annual Sector Weights (%)

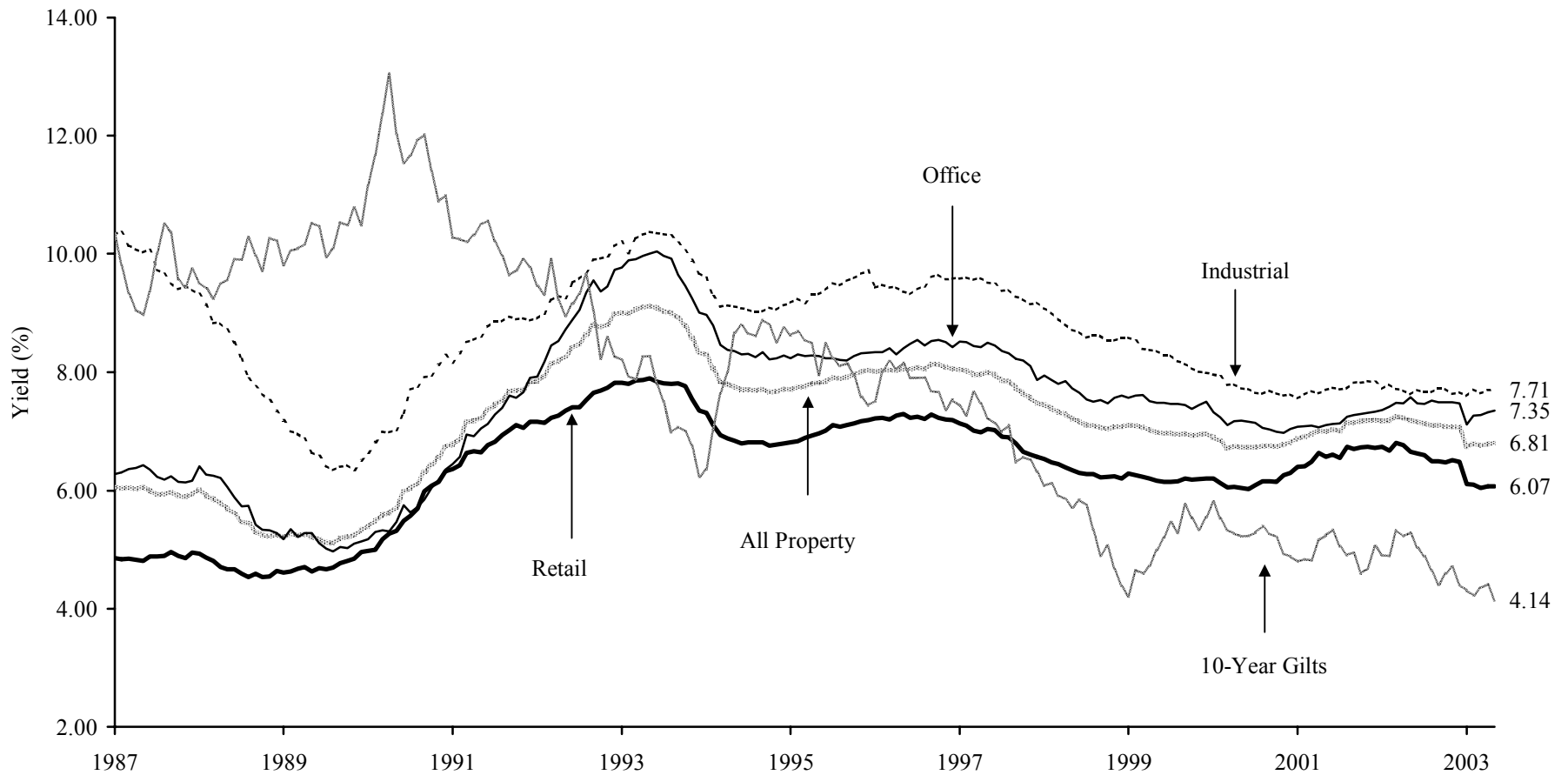
	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>Average</u>
Retail	46.61	45.40	39.77	37.73	39.80	44.30	48.75	49.16	48.24	49.34	50.27	50.76	48.19	45.31	42.24	45.11	47.81	45.81
Office	42.73	41.91	40.61	41.41	37.04	32.81	30.64	32.38	33.17	29.37	29.52	29.32	31.31	33.08	34.44	29.12	31.88	34.16
Industrial	10.66	12.69	19.62	20.86	23.07	22.79	20.44	18.39	18.50	20.20	19.35	18.94	19.02	20.04	22.00	24.54	19.35	19.44

Source: Investment Property Databank Monthly Index.

Notes: Data for 2003 are through 31 May. Sector totals may not add up to 100% due to rounding.

Table E

YIELDS ON IPD U.K. MONTHLY INDEX SECTORS AND TEN-YEAR GILTS



Sources: Global Financial Data and Investment Property Databank Monthly Index.

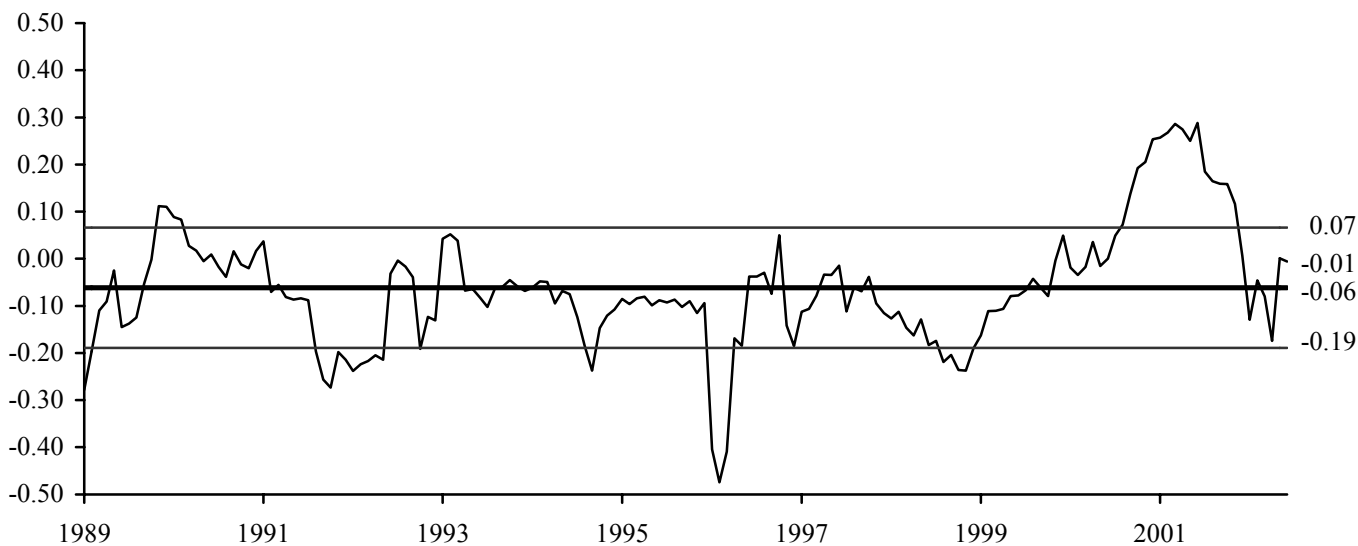
Note: Initial yield is used for all of the Investment Property Databank sectors.

Table F

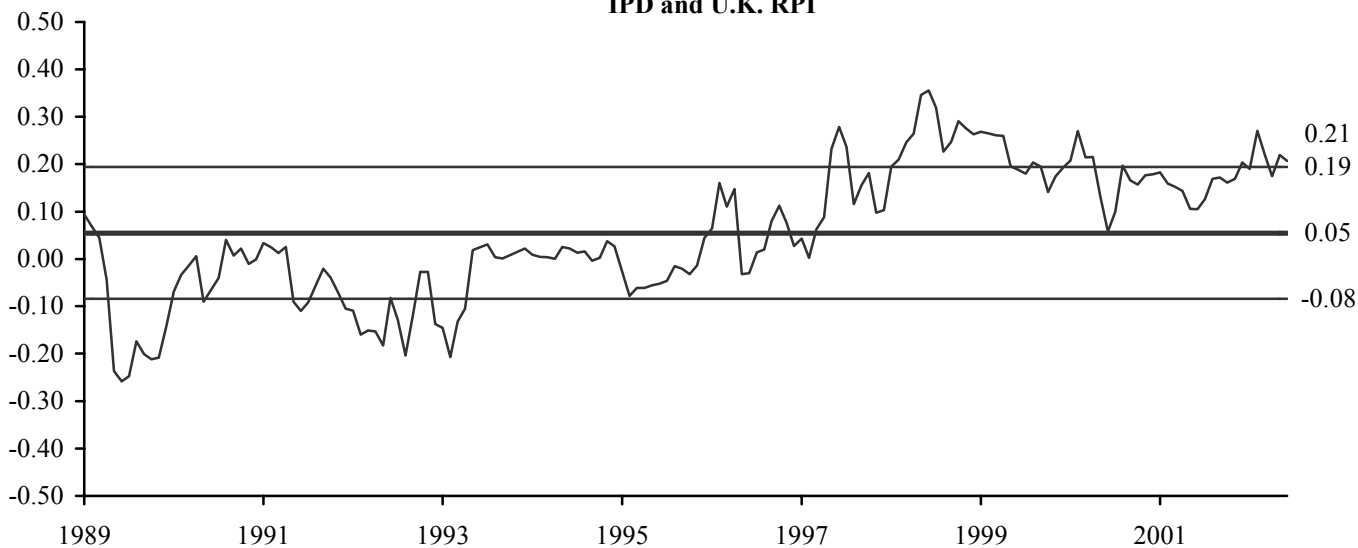
36-MONTH ROLLING CORRELATIONS OF THE IPD U.K. MONTHLY INDEX TO THE FTSE ALL-SHARE AND THE U.K. RETAIL PRICE INDEX

1 January 1987 - 31 May 2003

IPD and FTSE All-Share



IPD and U.K. RPI



—	Mean
- - -	One Standard Deviation

Sources: Investment Property Databank Monthly Index and Thomson Datastream.

Note: Inflation is represented by the United Kingdom Retail Price Index, which is published by the Office of National Statistics.