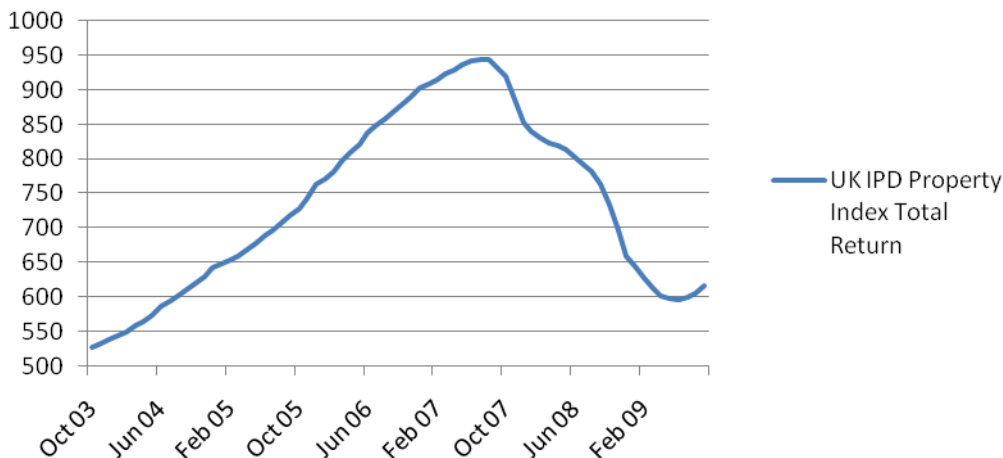


IPS View: Property - short term gain, long term pain?

We remain glad that we managed to sell our open ended property portfolio by the end of 2007. Since then we have been waiting for the right time to return to the market. The chart below shows the total returns from the UK commercial property as measured by the IPD total return index. This makes tempting reading, right?

Tempting?



We think now is a good time to start re-building property exposure but (there's always a but) we don't think property will re-trace its highs anytime soon. As we discuss below, the short term outlook is good and we expect to see a sharp bounce in prices from the lows seen in June as yields compress. However fundamentals (particularly rents and void levels) are weak and we do not see them being any stronger in 2010, thus the recovery will take some time. This will keep a lid on any bounce. Also, remember this was a bubble market driven by cheap and plentiful mortgage credit. We think a lasting impact of the credit crunch is that mortgage lending will stay expensive and leverage remain restrained. Our base case scenario is therefore for capital values to plateau over the next 2-3 years (after the technically driven rally we are currently in). In this scenario our returns would come from the attractive real yields still available on the assets plus we would own any upside if and when the market finally recovers.

Rising demand for property...

We are struck by investors' ongoing love affair with UK property. "Treat them mean to keep them keen" was probably the single worst piece of romantic advice I received but it could be the motto of the UK property market. Unlevered investors are down around 34% on a total return basis from the peak. Any levered investor who bought after 2005 with, say, an 80% loan-to-value mortgage has (on a mark-to-market basis at least) lost everything. Property also remains an illiquid asset at a time when flexibility to adapt to a changing economic climate remains important. Yet, if our investor

interactions are anything to go buy, property remains the number one or two area of potential interest. Add to this foreign (particularly Asian) buyers and we think the demand side will remain robust in 2010.

...is meeting limited supply

Negative equity was the story of the residential market in the early 1990s bust. It is also the dominant theme of the current commercial market. Banks effectively now control a large part of the market. They don't like to foreclose if they don't have to (this keeps their non-performing loan ratios in check). Nor are they happy to see properties sold if they don't get repaid in full. The banks are therefore not forcing asset sales. This means there is a limited supply of new properties coming on to the market. For example, Savills estimate that there is about £530m of property currently for sale in London versus potential demand of around £7.5bn.

The exception to this is non-income producing assets (e.g. half-finished developments, un-let buildings) where the banks are choosing to take their losses. There is a genuine investment opportunity here but it is probably too high risk/high return for us at IPS.

How to play the opportunity

- **Listed opportunities:** equity markets have already priced in too much good news for us. For example the FTSE REIT index is up 92% in the last 6 months. In spite of the obvious benefits of staying liquid, we prefer the risk/return opportunity of the physical market.
- **Open-ended funds:** we like the fact that these funds give access to the physical market with reasonable liquidity. We value the ability to get out if markets look expensive, which closed end funds do not provide. For this reason open-ended funds are currently our preferred route to market, however careful analysis is vital. Large in-flows to any fund would give us concern though: the limited supply in the market right now means it would not pay for anyone to be a forced buyer.
- **New closed end vulture funds:** for the reasons set out above, we think the opportunity has passed for the new vulture funds. The forced selling is over and demand is growing. We think it will be hard for these funds to achieve their 15% plus promised returns without excessive risk. Less ambitious, lower risk/return new funds would work for those who can live with the illiquidity.
- **Direct investment:** For those with the funds, direct investment into solid high quality income producing assets makes a lot of sense to us. However, we are advising our clients to look outside London for the best value to avoid competing with the strong foreign bid for high quality, income producing London assets.

Chris Brown
Co- Chief Investment Officer
21 October 2009

The content of this email does not constitute investment advice and should not be relied on as such. Specific advice should be sought about your individual circumstances. We should remind you that the value of investments and the income from them can go down as well as up, and investors may not get back the full amount originally invested.

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