Investment Property Forum

INVESTMENT PROPERTY FORUM Educational Trust

Disagreement and Uncertainty in UK Property Market Forecasts

Executive Summary

Summary Report

January 2006

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The IPF Educational Trust and IPF Joint Research Programme

This research was commissioned and funded under the auspices of the IPF Educational Trust and IPF Joint Research Programme.

The three-year programme supports the IPF's wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class. The initiative provides the UK property investment market with the ability to deliver substantial, objective, and high quality analysis on a structured basis. It will enable the whole industry to engage with the other financial markets, wider business community and government on a range of complementary issues.

The programme is funded by a cross-section of 16 businesses, representing key market participants. The IPF Educational Trust and the IPF gratefully acknowledge the contributing organisations:

Capital & Regional, Donaldsons, Grosvenor, GVA Grimley, Investment Property Databank, KPMG, LaSalle Investment Management, Land Securities, Lovells, Morley Fund Management, Nabarro Nathanson, Prudential Property Investment Managers, Quintain Estates & Development, Scottish Widows Investment Partnership, SJ Berwin and Strutt & Parker.

Disagreement and Uncertainty in UK Prperty Market Forecasts research team

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The Project Steering Group

The IPF, appointed a project steering group to guide and assist the Research team. They gratefully acknowledge the contribution from: Matthew Ryall (LaSalle Investment Management) - Chairman, Russell Chaplin (UBS Global Asset Management), Andy Schofield (IPD), Morgan Angus (Arlington Property Investors) and Charles Follows (IPF).

Preface

Introduction

The IPF Consensus forecasts further the objective of the Investment Property Forum to improve the efficiency and transparency of the investment property market. The IPF is extremely grateful for the continuing support of the contributors as noted on the quarterly publications, as the publication of Consensus Forecasts is only possible thanks to the provision of the individual forecasts. The IPF has published consensus forecasts since 1999.

Property market forecasting is an important component within the property investment decision-making process for institutional investors, supporting asset allocation, property fund strategy and stock selection in a mixed-asset portfolio. This has taken on increased importance in recent years with the closer alignment of property and the capital markets and increased application of modern financial techniques to property investment decision-making. Property forecasts are of increasing interest within the burgeoning property derivatives market. However, uncertainty is inherent in any forecast model or process, the input variables and the output forecasts.

Research that contributes to understanding the reliability of property forecasts will enhance the knowledge and understanding of property as an investment asset class, both to property professionals, and to those outside property and contribute to improvement in the functioning and efficiency of the property market.

Objectives

The project investigates the extent of disagreement among individual organisations' forecasts of UK commercial property markets and analyses whether disagreement provides market signals. This project involves investigation of the IPF's data set of forecasts to examine variations in forecasts (performance) between individual organisations. The research proposes to analyse patterns in and the information content of the distribution of the individual forecasts and to assess variations in the performance of the forecasting organisations contributing to the IPF's quarterly survey. However, no individual forecaster will be identifiable from the findings

The IPF congratulates the Research Team on an excellent project will help inform users of the IPF Consensus Forecasts and property forecasts more generally.

This report is the executive summary extracted from the full research findings, which is available as a separate report from the IPF (contact details below)

The IPF invite comments on the findings and the recommendations for future research. Please address comments or suggestions to Charles Follows, Research Director, IPF 3 Cadogan Gate, London SWIX 0AS. cfollows@ipf.org.uk 020 7695 1649

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Background and Objective

Property forecasts are an integral part of the property investment process at the strategic, tactical and stock selection levels. This study investigates the nature, extent and patterns of disagreement and uncertainty in the forecasts of UK property investors and their advisors. From the outset, it is important to be clear that uncertainty is inevitably associated with all forecasts and that a set of forecasts will contain some degree of disagreement. Market structures and relationships are never completely stable and even a perfect model could not account for (by definition) unforeseeable 'shocks'. Property market forecasts also rely upon forecasts of the market drivers which are typically obtained from macro-economic forecasting organisations. Different forecasting organisations then apply different model specifications to these inputs, interpret the information in different ways and, inevitably, produce different forecasts.

Data and Approach

In order to examine uncertainty and disagreement in property market forecasts, we analyse the Investment Property Forum's consensus forecasts from 1999-2004. The forecasts of individual property forecasting organisations were made available to the researchers on an anonymous basis. In addition, we compare the results from the property forecasters with non-property forecasters predicting an array of macro-economic and capital market variables. We then apply a range of standard measures of accuracy to the forecasts. An interesting feature of the IPF forecasts is that, although the target remains fixed (IPD All Property Rental Growth, Capital Growth and Total Return for end of calendar year), each forecaster makes a number of forecasts at different times in the preceding 24 months.

Main Findings

- An interesting finding of the analysis is the extent to which property forecasting organisations agree with each other. This may be caused by a combination of the use of common forecasting methods, obtaining 'driver' forecasts from similar sources and an element of herding among forecasting organisations.
- Although most property forecasting organisations tend to have similar expectations, the consensus forecast often contains significant forecasting uncertainty. This suggests that forecasting organisations should not draw too much comfort about being close to the consensus.
- Given high levels of agreement and high levels of uncertainty in the consensus forecast, uncertainty in the property forecasts of the individual organisations seem to be primarily generated by common factors rather than by the individual forecasting organisation itself. This is not a unique feature of property market forecasters and non-property forecasters display similar patterns.
- A key source of uncertainty in the property market forecasts of capital and total returns may have been due to problems of forecasting yield shifts. The fact that capital growth tended to 'mirror' rental growth indicated that forecasters' expectations of capital returns were generally a product of rental return expectations. This may reflect the generally acknowledged increased difficulties of modelling yield shifts relative to rental growth. Alternatively, it may result from the aggregation of individual sector and regional forecasts into a forecast of the index.

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- The analysis suggests that there are inefficiencies in property market forecasts. When market performance was improving, total returns tended to be systematically underestimated. Conversely, when performance was deteriorating, total returns tended to be systematically overestimated.
- We find little evidence of consistent superior or inferior performance among individual forecasting organisations. When comparing the performance of individual forecasting organisations, very few individual forecasting organisations stand out. Again, this is true of both property and non-property forecasting organisations.
- At a group level, property advisors and fund managers tended to be marginally more accurate (in terms of absolute error) in their property forecasts than equity brokers.
- In specific years, across the three performance measures, the "best" individual forecasters were property advisors (45% of years), fund managers (20% of years) and equity brokers (35% of years). However, most individual forecasters were generally unable to repeat the performance in other years. Most evidence of forecasters being able to repeat strong performance was for rental growth.

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