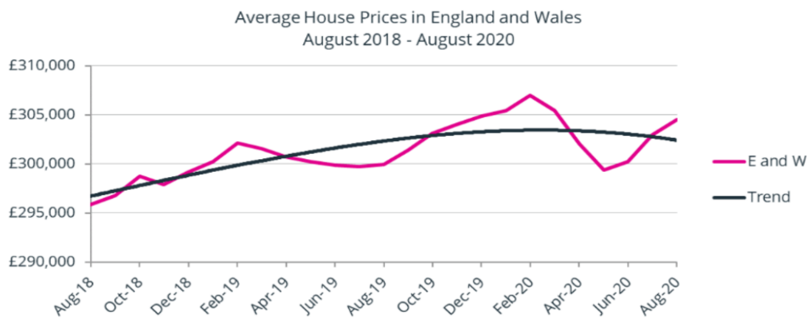
Hearthstone Investments: A positive Q3 for UK residential property and the TM home investor fund

UK residential property market



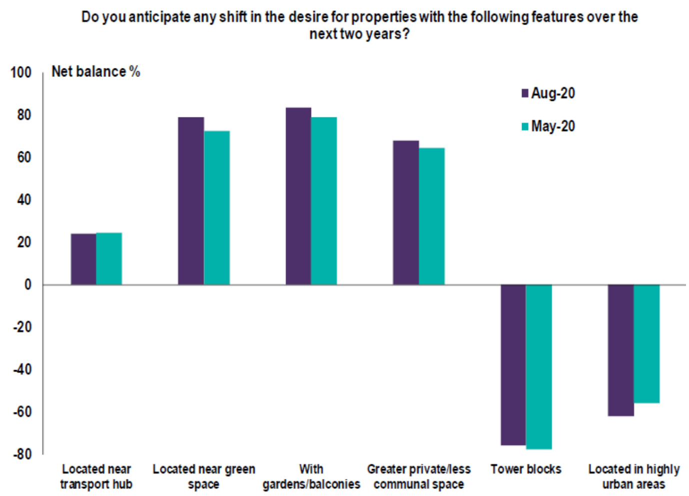
Source: e.surv (LSL Acadata)

The UK housing market continued its rebound in September with demand, inventory, and sales agreed all up year to date (YTD) versus 2019. Since the housing market re-opened in May house prices reverted to growth. A combination of buyers' pent-up demand following the UK-wide lockdown and the introduction of the Stamp Duty Holiday led to a Q3 performance few expected back in Q2 when the market came to a sudden standstill. According to Zoopla, demand is currently up 39% YTD with supply up 10%. This is fuelling a continued positive housing market in the UK, with their index stating that prices are up 2.6% annually.

Source: Hearthstone, Google Maps

Underneath the headline figures we are carefully monitoring regional trends. A recent FT article, quoting data from the Centre for Cities, listed the Top 10 cities with the biggest increase in unemployment benefit claims and the highest proportion of people on furlough. Some of these are due to significant exposure to one sector (such as Sunderland or Slough), whilst others are due to recent regional lockdowns (Leicester or Blackpool, for instance).

Our investment approach can, and does, avoid areas that rely too much on one sector, but we cannot do anything about regional Covid-19 lockdowns. What we can do is build a regionally diversified portfolio to avoid being overly exposed to a single town or region. Diversification is a critical component of our Investment Philosophy. Currently, the TM home investor fund holds 204 mainstream houses and flats spread over 55 different locations. Our largest allocations include holdings in Greater London and the London Commuter Belt, as well as Bristol, Birmingham, Manchester, and Edinburgh.



The housing market really is being driven by a "once in a lifetime" re-evaluation of housing needs, with changes in working patterns having a direct impact on housing demand. The latest RICS survey confirms a trend first identified in May, where "83% of respondents foresee demand increasing for homes with gardens over the next two years". e.surv (who provide the Acadata benchmark to Hearthstone) observe "a trend towards larger homes with private outdoor space" coupled with relocation from city centres to suburbs and more rural areas as commuting times no longer have the same emphasis on choosing a location as previously. The TM home investor fund portfolio is ideally positioned to benefit from this trend having largely avoided high density locations including Central London.

The Consensus forecast collated by the Treasury remains broadly unchanged from last month. It is worth pointing out that the range of forecasts remains quite wide, reflecting a high degree of uncertainty. Likely, we will see a repeat of mini-Covid-19 cycles over the coming months with infection statistics worsening - followed by more restrictions, followed by more economic stimulus (as seen in March and now again in September); and the same cycle in reverse (as seen between May and August). The current market is very much determined by Government policy, more so than usual, which is fluctuating constantly. However, being such a key part of the UK economy, who is to say that the SDLT holiday won't be extended past March 2021 in order to support the housing market?

Forecasts for the UK economy

Comparison of independent forecasts, month by month

		March	April	May	June	July	August	Sept
2020	GDP	0.6	-5.8	-8.6	-9.2	-9.1	-10.1	-10
	Inflation RPI, Q4	2.2	1.4	1.3	1.2	1.4	1	1.2
	Unemployment, Q4	4.2	6.9	7.7	7.9	8	8.3	8
	House price inflation, Q4	2	0.5	-3.0	-3.8	-3	-2	-2
2021	GDP	1.3	5.0	6.2	6.5	6.6	6.5	7
	Inflation RPI, Q4	2.9	2.7	2.6	2.5	2.7	2.9	2.8
	Unemployment, Q4	4.1	5.5	6.3	6.6	6.5	6.6	6.5
	House price inflation, Q4	2.5	2.5	2.8	3.0	3	2	-0.2

Source: HM Treasury

GDP, RPI and unemployment rate - average of latest forecasts

House price inflation - Q4 on Q4 a year ago. Median

To a degree, the housing market is likely to follow these ebbs and flows over the coming months. It is reassuring that the housing market has entered this crisis on a stronger footing compared to the two previous major recessions. Employment was at a record high and the housing market did not experience exuberance in terms of lending or house price growth over the preceding years. Importantly, housing supply remains flexible in case of prices weakening. Owner-occupiers who do not need to sell simply stay put, and housebuilders can slow construction. This creates downside protection for house prices, with Zoopla expecting little change in the Housing market to the end of 2020, although demand might fall off slightly during Q1 2021 as applications for the current Help to Buy scheme wind down.

TM home investor fund

The increasing market activity mentioned above has again been reflected in the Fund's property portfolio which increased in value again in September, following increases in June, July, and August. Month-end valuations for September were up 0.02%, giving a cumulative increase of 0.36% over the last four months. The Fund's Standing Independent Valuer, CBRE, increased the value of our holding in Minster, Kent this month, and is continuing to scrutinise the strength of market activity across other regions. CBRE has expressed optimism regarding the momentum of house prices in many of the regions in which the Fund is invested, including Colchester and Haywards Heath, which has incidentally also seen a 'surge' in rental activity recently.

As mentioned repeatedly, the Fund's performance has highlighted the resilience of the Residential sector versus Commercial - not least, in terms of the strength of rent collection. September has seen this continue, with the Fund collecting 96.5% of rent demanded – broadly in line with our long-term average of 99%. In stark contrast, commercial landlords are reported to have collected just over 22% at quarter rent day on 29th September, with the UK retail sector fairing worst at just over 12% of rent being collected for the quarter.

The Fund's high rent collection is driven not only by the quality of the Fund's tenants, but also the processes put in place early in the Pandemic in so far that although some tenants did fall into financial difficulties, they have been able to obtain Universal Credit and maintain payment of their rent, demonstrating that residential rental income is very crisis-proof. We are also seeing the number of vacancies within the portfolio slowly fall, with occupancy now back up to 97% from a low of 90% at the height of the pandemic, resulting in the highest monetary rent collection for 2020.

The following table contains the latest performance metrics for the Fund:

TM home investor fund

Key Performance Metric	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20
Total return, C-Class Acc, month	-0.14%	-0.28%	-0.07%	0.07%	0.14%	0.00%	0.21%
Total return, C-Class Acc , 1 year	1.48%	0.98%	0.70%	0.70%	0.77%	0.70%	0.70%
Property valuations, as % of property portfolio	-0.22%	-0.38%	-0.14%	0.06%	0.21%	0.06%	0.02%
Distributed Income, C-Class Inc	n/a	Launched 20/04/2020	2.41% gross *	2.41% gross *	2.41% gross *	2.41% gross *	2.41% gross *
No of voids (vacant properties), end of month	17	23	21	17	24	17	13
+ Completed Acquisitions / - Completed Sales	+ 0 / - 3	+ 0 / - 0	+ 0 / - 0	+ 0 / - 0	+2 / -1	+0 / -0	+0 / -0
+ Move ins / - Move outs	+ 9 / - 5	+ 0 / - 6	+ 3 / - 1	+ 10 / - 6	+2 / -8	+9 / -2	+13 / -9
Rent collected as % of rent invoiced	99%	96%	98%	95%	102%	98%	97%

* estimated annual yield, based on Class C Acc historical yield

Stuart Springham

Fund Manager

5th October 2020

Important information

Past performance is not necessarily a guide to future performance and future returns are not guaranteed. Investors may get back less than the amount invested.

Residential property values are affected by factors such as interest rates, economic growth, fluctuations in property yields and tenant default.

Property investments are relatively illiquid compared to bonds and equities, and can take a significant amount of time to trade.

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