Opinion **Property sector**

Covid-19 prompts a rethink of the case for real estate

Asset allocation has been brought into focus for investors

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Extending homeworking means many will give up expensive city accommodation to move to cheaper suburban and rural areas

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Wealthy families with investment outlooks that span generations have traditionally followed a rule of thumb to manage their asset portfolios: one-third to stocks, one-third to art and one-third to real estate. More broadly, asset managers have been drawn to property's attractive record.

According to a study of asset performance from 1870-2015 by the National Bureau of Economic Research, real estate returned average annual returns of just over 7 per cent, compared with 6.9 per cent from equities. In the wake of the global pandemic, however, investors should ask themselves if the case for their holdings is still compelling — or should they rein back on it? In particular, three factors put the long-term value of property assets at risk.

First, the mass move to working from home has shown that remote working is viable, leading to less demand for commercial space as businesses close or scale-back offices. Already, big companies are extending homeworking beyond the autumn, with Google telling most of its 200,000 staff to stay at home until July 2021.

Extending working from home means many people will give up expensive city accommodation to move to cheaper — suburban and rural — areas, driving down residential property values and eroding returns. The shift has also accelerated digitisation, automation, robotics and the adoption of technologies that will ensure companies can operate effectively with fewer employees. This trend will exacerbate the reduced demand for physical premises.

Second, after coronavirus, governments will be looking for new sources of revenue. Stressed public coffers expose the real estate sector to higher taxes: the underlying asset (land) is immovable and politicians will favour taxing property over raising taxes on labour (income tax) at a time of high unemployment. That puts a drag on the value of real estate to the holder, again reducing returns.

Removing tax incentives for owning property would also raise funds for cash-strapped governments. The risk is that they will reverse tax relief on the interest paid on a mortgage, and restrict the scope for one generation to pass on property to the next that is currently provided by lower inheritance tax rates than is payable on other assets. This would increase the taxable base, but dim real estate's attraction.

Third, owning land and property has long been seen a good way of preserving wealth and protecting capital against inflation, because values and rents typically increase in times of inflation. However, investors today might question whether inflation will be a serious threat in the years ahead. After all, the US consumer price index has remained below 2.5 per cent from 2012 onwards, reaching a low of 0.1 per cent in 2015.

Although the huge government stimulus packages in the wake of the pandemic could be inflationary, deflationary pressures exist too. Technology is driving many costs down, for example in transport and telecommunications. The shock to global demand has led to downgraded growth forecasts; this is likely to weaken consumer demand and cap price increases. And there is no sign of wage inflation in the near-term; higher unemployment is more likely to keep it at bay.

There is a final long-term question hanging over the market — that of demographic shifts. As populations continue to age, there will be fewer economically active, younger people relative to retirees. This will leave fewer buyers for property, adding to downward pressure on prices.

The market is so broad and deep that the way price and returns play out could vary materially across geographies and sectors. But Covid-19 has thrown up many questions about asset allocation, and as investors rethink their portfolios they will have to weigh up whether exposure to real estate will protect, or erode, their wealth.