

5 August 2008

WHAT IS HAPPENING TO MORTGAGE AND PROPERTY TRUSTS

The recent announcements by Guardian Trust, AMP, AXA and previously TOWER, to freeze or suspend repayments or redemptions from mortgage and property trusts has understandably raised many questions in the minds of investors.

The first point is that the fund managers have taken this action not because of any problems or concerns with the quality of assets or investments but purely as a defensive measure in response to extraordinary market conditions. There is no suggestion that any assets or investments are impaired.

Mortgage and property trusts are collective investment funds. Investors purchase units in these Trusts and the investors funds are used to provide mortgages to borrowers backed by quality property investments, or in the case of Property Trusts, to purchase property. Income for the Trust comes from interest on the mortgages, or in the case of property, the tenants pay rental. The interest and rent received by the fund is distributed to investors and provide a regular flow of earnings, normally by quarterly distributions.

In order to maximise earnings for the benefit of investors a high percentage of the funds are invested in quality mortgages or quality properties with a relatively small portion held in cash to accommodate requests for repayments that are both expected and planned for. In the past the cash buffer has been adequate to meet demand for repayment in normal market conditions.

The difficulty that has arisen for these funds is simply that the growing lack of investor confidence and uncertainty has resulted in a significant increase in requests for repayments as people react to market turbulence. This sudden and abnormal increase in requests for repayment is stretching the cash buffer held by the funds.

The quality of the underlying assets and the regular payment of interest on mortgages and rent on the properties has not changed. The value of the investors' interest in the Trusts is as secure today as it has always been, and the flow of interest payments via quarterly distributions is not affected.

The managers of these Trusts would normally plan on investors in mortgage or property trusts having a medium to long term outlook for their investment, perhaps three to five years minimum. The investment strategies have a similar long term objective.

If investors suddenly change their investment horizon and switch from long term to short term investors the trust cannot quickly respond as it has entered contractual commitments for the mortgages it has provided, eg, it cannot suddenly call for repayment of the mortgages it has provided, or equally commercial property is not immediately able to be realised.

It is for this reason the managers have announced suspensions or a freeze to provide time to allow the market to return to a more normal situation, as they cannot accommodate a dramatic increase in repayment requests.

What action should investors take

Clearly, investors should not panic. There is no reason to believe the value of your investment has declined or that the income stream you have received by quarterly distributions will reduce. The security of your investment in the mortgage trust or property trust has not changed. If large numbers of investors attempt to exit then a suspension or freeze is the only prudent option, but that unfortunately penalises those who have justifiable reasons for requesting repayment. If you have an investment adviser, then seek advice.

I am a KiwiSaver investor, will I be affected

The answer is no. KiwiSaver is a long term plan and these are long term investments. I believe that few if any KiwiSaver products are invested in mortgage or property funds. The freezing of these Trusts is not expected to have any effect on KiwiSaver funds.

What protection do these funds provide

Mortgage and Property Trusts are governed by Trust Deeds. The manager must at all times act in accordance with the terms of the Trust Deed. Further, the manager's actions are under regular scrutiny of an Independent Trustee whose role it is to ensure that the fund is being administered in accordance with the Deed.

Will there be further mortgage or property trusts announcing a freeze?

Possibly. If calls for repayments continue to outstrip the cash buffer available then other managers may have no option but to act prudently and limit repayments. However, this is not an indication of any market failure. As indicated above this is only a prudent reaction to a cash flow issue and does not indicate any asset impairment.

What will happen next

Investment markets will from time to time travel through turbulent times just as we are currently experiencing. However, they always come through the storm. Things will settle down and stability will return.

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