CONTRASTING INFLUENCES ON THE VALUATION OF IRISH EQUITIES AND PROPERTY

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Components of Asset Return

The absence of any simple relationship between year to year returns on assets and inflation is not surprising. In the case of long gilts, an increase in inflation which leads to an increase in long term interest rates will cause a fall in the capital value of gilt holdings. Similarly, a rise in inflation and interest rates would tend to increase dividend yields and thus reduce capital values for equities. Finally, one might expect a rise in inflation and interest rates to lead to an increase in rental yields and hence a decrease in property values. Over time, however, inflation should lead to an increase in nominal dividends and rents which would tend to increase capital values thus counteracting the initial negative effect of higher valuation yields. These hypotheses are considered in the remainder of this article.

Gilt Yields and Dividend Yields

Long gilts and dividend yields are plotted against inflation in Figure 1. In the case of gilts, the redemption yield for a hypothetical twenty year gilt is plotted at the end of each year. The inflation series is based on the change in the Consumer Price Index to mid-November of each year. Dividend yields are those shown on the Goodbody-Dudgeon combined index of industrial and financial shares at the end of each year.

It is readily apparent from Figure 1 that the three series have moved very much in line with one another over the period 1965-85. In fact there was a strong correlation between inflation and long gilt yields (0.85); also between dividend yields and both inflation and long gilt yields (0.74 and 0.77 respectively).

Rentral Yields

No published statistics are available for rental yields in Ireland. The accounts of the Irish Pension Fund Property Unit Trust were analysed for the eleven years 1975-85 and an estimate made of the average annual cash balances of the trust. These balances were assumed to earn the average

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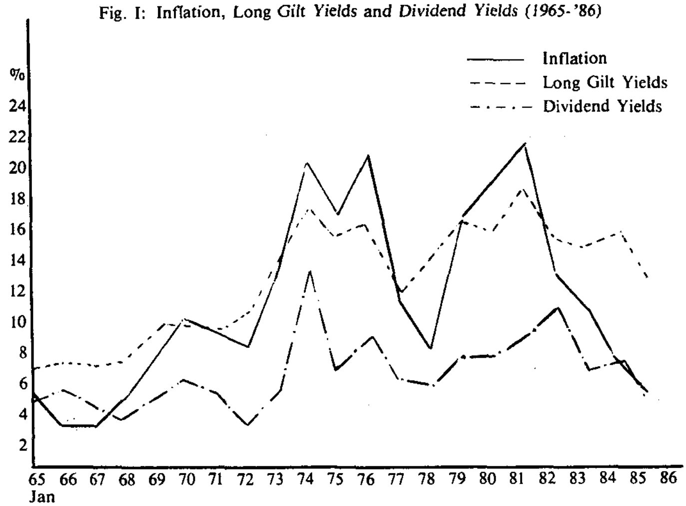
Fig. I: Inflation, Long Gilt Yields and Dividend Yields (1965-'86)



return on one month money. Adjusting the total income for the weighted cash return, a rental yield was derived below:

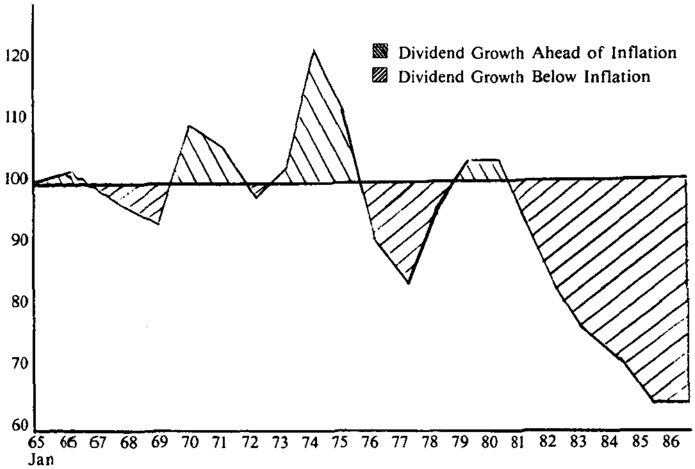
Year	Irish Property Rental Yield %
1975	6.1
1976	7.4
1977	7.3
1978	5.9
1979	6.9
1980	7.4
1981	5.7
1982	7.0
1983	6.3
1984	6.8
1985	7.1

The main feature of the data is the extraordinary stability of rental yields. During the above period the mean yield was 6.7% and standard deviation 0.6%. Over the same period long gilt yields ranged from 11.5% to 18.4%. Unlike dividend yields, rental yields appear to have been relatively immune to changes in long term interest rates.

Dividend Growth

A series of real dividends was calculated for the period 1965-85 by splicing together two dividend series calculated by Goodbody-Dudgeon for the Irish equity market, one with a base of January 1965 and the other with a base of January 1972. The series is graphed in Figure 2. In the fifteen years prior to 1980, the index was never below 100 for longer than three years,

Fig. II: Trend of Real Dividends (1965-86)

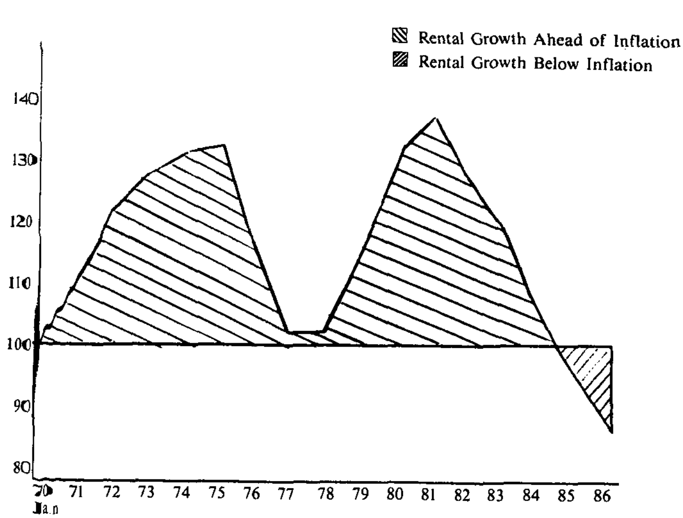


suggesting that dividends adjusted fairly rapidly to changes in the domestic price level. More recently, however, the index has been below 100 for six consecutive years, with each year showing a further decline up to end 1984. There has been a small recovery in the past year, which might indicate the beginning of a long overdue upturn.

Rental Growth

Figures for rental growth were based on Jones Lang Wooton index of estimated rental value for Irish commercial property for the sixteen years to end 1985. The index is based on a property mix: 68% offices, 21% shops and 11% industrial. Adjusting the rental index for inflation, a real rental index is plotted in Figure 3. For the fourteen years to end 1983 rents continuously outstripped changes in the consumer price index. In 1984

Fig. III: Trend of Real Rents (1970-86)



rents fell behind prices for the first time with a further deterioration occurring in 1985.

Conclusions

Since 1981, real dividends have experienced a longer and deeper fall than at any time over the past twenty one years. Wilkie (1981), while arguing in economic terms for reasonably constant real dividends, noted that in the U.K. "real dividends appear to have long runs either of growth or decline". This raises doubts about the forecasting ability of a number of sophisticated time series models, which rely on constant real dividends, and reinstates the concept of market efficiency. There appears to be a strong correlation between dividend yields and long gilt yields; hence, other things being equal, low long term interest rates enhance equity values whereas high long term interest rates depress them.

Commercial rents, which experienced very strong growth in real terms in the years 1973-75 and 1980-82, have shown a sharp decline over the past two years. Most surprising, however, has been the stability of rental yields over the past eleven years. Assuming that valuations reasonably reflect the market for prime property, it does appear that one element of the valuation process, the capitalisation rate, was relatively immune to trends in long term interest rates. This would tend to make commercial property a more attractive store of value relative to equities, which provide greater cyclical trading opportunities. Identifying the trend in equity valuations is not easy. Apart from the difficulty of forecasting real dividends, forecasting dividend yields requires a view of long term interest rates. We noted the strong correlation between inflation over the previous twelve months and the year end long term interest rate. Unfortunately there is little guidance in the literature as to how to forecast future inflation. Wilkie (1981) in his study of U.K. inflation over the period 1661-1980 concluded that "no single time series model obviously describes the progress of prices over a long period. Whatever may have been their apparent stability up to 1914, the experience of this century, and especially of recent years, makes uncertainty about the future extremely large".

REFERENCES

WILKIE, A. D. "Indexing Long Term Financial Contracts", *Journal of the Institute of Actuaries*, 1981, Vol. 108, 299-341.