INVESTMENT IN SHORT TERM LEASEHOLDS FOR PENSION FUNDS

There is in many quarters a misapprehension that short term leaseholds of property are a very suitable investment for a pension fund because of its favourable taxation position.

This misconception arises because the market price for such leaseholds is reputedly arrived at with tax paying purchase~~s~~r in mind and that therefore the necessary Sinking Fund payment is calculated on the basis of a net rate of interest after allowance for income tax. $2\frac{1}{2}\%$ and 3% were quite common rates for this part of the calculation in recent years. The fact that a pension fund can set aside this annual Sinking Fund payment out of taxfree income gives them an obvious small advantage over a tax paying purchaser.

The result of this advantage produces some very mouth-watering returns on a short leasehold.

Quite apart from the basic point that pension fund investing is a very long term operation and should therefore seek long term investments, one must not be misled by these apparently attractive yields offered under a short leasehold, but must consider what additional yield one must expect compared with a freehold investment which,being undated, fits in more suitably with the pattern of long term pension fund investing.

Where the misconception arises is the fact that the Sinking Fund calculations are made on the old fashioned basis of merely replacing the amount of the original investment. In view of inflation this concept is now surely outmoded and instead of providing a Sinking Fund to replace the amount of the original investment, one should provide a Sinking Fund to replace what the capital would have grown to had the investment been made in a freehold property.

The following table sets out the amounts of the Sinking Fund really required on the basis of replacement of capital which increases each year in line with the expected rate of inflation. That is to say, that in a ~~leasehold~~ freehold property if one assumes that the annual rate of inflation is 5% per annum, then the value of the property should theoretically increase by 5% per annum. Moreover, the following calculations have been made at a rate of interest of 10% per annum giving full (or perhaps overfull) allowance for the gross rate at which the reinvestment for replacement of the capital can be made by the pension fund, so as to understate the argument.

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Term of Leasehold	Annual amount of Sinking Fund required on above basis
5	21%
10	10%
20	4.6%
30	2.6%
40	1.6%
50	.98%

The figures in column 2 are the rates per annum by which the yield on a leasehold should exceed the yield on a freehold to make them comparable, even making no allowance for the cost of reinvestment at the expiration of the short leasehold.

* If a more conservative rate of interest is assumed (say 6%) the required S/F as shown in column 3.

① Re-investment risk if interest rates fall.

② 6% Interest with 5% Inflation is rather severe