INVESTOR'S CHRONICLE Mayad Rassam

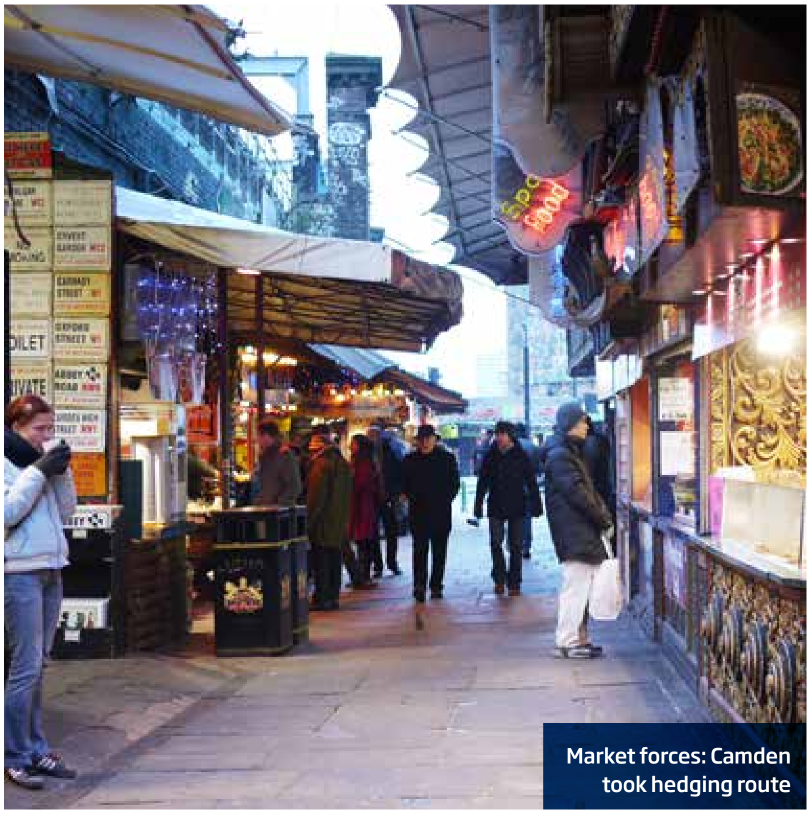
Are you a property investor or interest rate speculator?

A phrase I often hear from my clients is, "Rates are going up, so I'd better fix now." The problem is that there is no free lunch and the issue of whether to fix the interest rate on your loan, be it on a multi-million pound commercial investment or your home mortgage, needs to be considered from a wider perspective.

Financial markets price these sentiments into the fixed rate or cap premium they offer. As such, when a client fixes their interest rate because they think, like most others in the market, that rates are going up, they will not necessarily benefit from the savings they believe they will receive.

As a property investor, your main focus is on deriving maximum value from your investment. The loan facility and associated interest rate hedging should not get in the way. It should be appropriate to your property strategy and provide the flexibility required in a market that is constantly changing.

When it comes to putting hedging in place, investors should think not just about whether interest rates are going up or down, but about their property strategy. I work with my clients on understanding their business and look to use a simple toolbox of hedging instruments to achieve the main goals of hedging for property investors: a predictable cash flow and flexibility to carry out their asset management strategy.


Market forces: Camden took hedging route

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With the bad experience of interest rate hedging that many investors have endured in recent years, I do not blame clients for being wary of entering into new hedging. Some investors are still struggling to dispose of properties that have otherwise performed well but are still burdened with break costs that could be anything from 5% to 30% of the property's value. Many are also stuck in lengthy and costly litigation with banks over mis-sold interest rate hedging, with DTZ estimating that the potential cost to banks could be £5bn to £10bn.

All this inappropriate and inflexible hedging causes drag and reduces liquidity in the property market. This, in turn, affects market prices. It would be far better for the industry to get its debt and interest rate hedging right in the first place and the only way to do this is to ensure borrowers receive the right advice from someone who understands their business. Less interest rate speculating and more hedging is required.

Whether a condition of the loan facility or not, interest rate hedging is a very useful tool, when used correctly, to minimise certain risks. It may even result in a reduced interest rate cost over the life of the transaction.

However, first and foremost, interest rate hedging is insurance and as such attracts an insurance premium. Once investors understand this, they will be better off for it.

The decision on whether to hedge or not, and what product to use, will depend on cash flow projections, financial covenants, asset management strategy and the client's views on where interest rates are likely to move.

As investors, it could be difficult to know how to bring all of these factors together into a coherent debt and hedging strategy. We use our experience of investment, debt structuring and hedging to give clients workable solutions.

Working in partnership with Vedanta Hedging, we advised Camden Market earlier this year. We approached the question of whether to hedge or not by understanding the property fundamentals and loan terms and conditions.

Once the decision to hedge was taken, we turned our attention to establishing what instrument to use. It quickly transpired that the property has two quite different sides that can be viewed as separate transactions. Layering on to that the client's longer term asset management strategy, we were able to provide hedging that was cheaper and more flexible by hedging different parts of the loan in different ways.

We used only simple hedging instruments to achieve this result as we are reluctant to recommend any exotic derivatives to clients unless there is a fundamental reason to do so.

Mayad Rassam is head of structured finance and derivatives at Mutual Finance, and consultant to Vedanta Hedging