DOI: 10.31357/fmscmst.2014.00186

A Comparative Analysis of Inflation Hedging Characteristics of Real Estate and Financial Assets in Colombo

Dissertation Submitted to the University of Sri Jayewardenepura as a Partial Fulfillment for the Requirement of the Final Examination of the M.Sc Estate Management and Valuation (Special) Degree

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Dates of Submissions
For evaluation : 10.03.2014
Corrected final report : 22.07.2014

The work described in this dissertation carried out under the supervision of Dr. P D Nimal and any content on this has not been submitted in whole or in part to any university or any other institute for another degree/examination or any other purpose.

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Hereby, I certify that Mrs **Gardi Hewa Kankanange Nimesha Sakurangani Wickramaratne**, REMV 93 duly completed the research titled A Comparative Analysis of Inflation Hedging Characteristics of Real Estate and Financial Assets in Colombo under my supervision.

Also it is declared that, this final report has been completed according to the instructions and suggestions made by the board of examiners.

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Signature of the supervisor

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Signature of the 2 nd examiner

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Signature and the official stamp of the Head

Acknowledgement

This Dissertation would not have been possible without the guidance and the help of several individuals who in one way or another contributed and extended their valuable assistance in the preparation and completion of this study. It is a pleasure to convey my gratitude to them all in my humble acknowledgment.

First and foremost, I offer my utmost gratitude to my supervisor Dr. P D Nimal, The Head, Department of Finance, University of Sri Jayewardenepura, for his supervision, advice and guidance from the very early stage of this research as well as giving me extraordinary experiences throughout the work. Without him this dissertation would not have been completed or written. I am indebted to him more than he knows.

I gratefully acknowledge Prof. R G Ariyawansa, The Coordinator, M.Sc. in real estate and Valuation degree program, University of Sri Jayewardenepura, for his valuable advice and coordination to this dissertation. His involvement with his originality has triggered and nourished my intellectual maturity that I will benefit from, for a long time to come. Sir, I am grateful in every possible way.

Many thanks go in particular to Mr. Amila Wickramasinghe, Lecturer, and Department of Decision Science for his valuable advice, guidance and constant support for statistical analysis of this study for which I am eternally indebted.

My sincere thanks goes to all Senior Lecturers of the Department of Estate Management and Valuation, who gave me highly valuable suggestions for which I am eternally indebted.

I am heartily grateful to Top Management of the Department of Valuation, for giving me a tremendous support by giving property value details to make this task a success.

Last but not the least I would like to thank my husband, parents and sisters for their unending support, encouragement and prayers. Without their support this work would not have been possible.

Finally, I would like to thank everybody who was important to the successful realization of this Dissertation, as well as expressing my apology that I could not mention personally one by one.

ABSTRACT

The general objective of this study is to comparatively analyse the inflation hedging characteristics of real estate and financial asset in Colombo. Three specific objectives were stated to achieve the above objective. First objective is to examine the inflation hedging ability of the real estate against actual, expected and unexpected inflation. Second is to examine the inflation hedging ability of the financial assets against actual, expected and unexpected inflation. Finally compare the inflation hedging ability of real and financial assets. Residential and commercial properties are taken for real estate and treasury bill and stock are used to represent the financial assets. Fama and Schewert 1977 framework and regression analysis is employed to analyse the data. The results support that residential properties are performed as good hedgers than commercial properties against actual inflation. Among the financial assets t-bills are performed as good hedgers than stocks against actual inflation. Since regression coefficients of all assets except stocks are less than 1, all assets are partially hedge against actual inflation. When expected and unexpected inflation are concerned t-bills are performed good hedgers against expected inflation while residential property plays best against unexpected inflation. Stocks are not hedgers against both expected and unexpected inflation.

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CHAPTER ONE

Introduction

1.1. Background of the Study

One of the objectives of holding an investment portfolio is to protect the purchasing power of investors and provide investors with a continuous positive real rate-of-return. However, it has been observed that during inflationary periods certain financial instruments not only protect the investor, but actually perform as a perverse hedge, i.e., decrease in value as inflation increases (Rubens *et al*, 1989) hence the need for both individual and institutional investors to determine the hedging potential of an asset before investing their money on assets.

According to the above paragraph, in an inflationary time periods long term investors face a regular problem about how to maintain the purchasing power of their assets over the investment time period and how to produce the maximum real return to achieve the investment objectives.

Barkham *et al* (1996) stated that the ability of an investment to protect against the erosion of real return due to increase in prices is vital in many ways. Further they are explaining that, for an individual, maintaining the real value of savings is important in order to protect the purchasing power for future needs. In a related way, it is important for investment managers to understand the ability of investments to hedge against inflation.

Maintaining economic and price stability of country has become one of the core objectives of Central Bank of Sri Lanka as in many other developing countries.

The concern with maintaining price stability stems not only from the need to maintain overall macroeconomic stability, but also from the fact that price stability forms a better environment for investment, output, and employment etc. Over the decades, experience of many countries suggests that price stability promotes economic growth. Therefore policy makers believe, when inflation crosses a reasonable limit in the economy that can adversely affect other macroeconomic variables and in turn undermines its steady level of the economy (Kesavarajah, 2011).

Further Kesavarajah (2011) stated that recent years, experiences in both developed and developing countries have shown that rise in the price of essential commodities; particularly food and oil items affected almost all the countries in the world. Hence every country was under pressure to control the inflation level and the Central Banks of these countries have taken various measures to maintain the price stability. Sri Lanka's economy is not exceptional with respect to this issue since it heavily depends on these two items. Following the economic liberalization, the expansionary economic policies followed by the government and the Central Bank of Sri Lanka resulted in improvements in various macroeconomic indicators including economic growth, which remained above five percent. At the same time, continuous rise in the general price level in the economy has emerged an important macroeconomic problem all over the country.

It is evidenced that the short-run effects of price increases may seem small and negligible, but the long-run effects of inflation can be substantial. Long-term investors therefore prefer to invest in assets that provide some protection against increases in the general price level – especially pension funds, whose liabilities usually rise with inflation. To circumvent this financial catastrophe, regulators and policy makers experimented with unconventional tools, such as quantitative easing and stimulus packages, which might help overcome the recession but also are likely to instigate inflation.