Real Risk In Real Estate

The opinion expressed here two weeks ago, that the time to start thinking about inflation is before it becomes a problem has produced a raised eyebrow or two in polite financial company. So what? Any change from the more than two decades of secular disinflation in the broad economy and outright deflation in certain sectors and in places like Japan will be so profound and so persistent that it will color every investment decision you will make for the next quarter-century.

For this reason, and with worries whether residential real estate is in a bubble acknowledged, let's take a look at real estate as an investment class. It still deserves a place in everyone's portfolio, but it is far riskier than most of us realize.

Your Home Is Your Castle
Real estate is a unique investment in several ways. First, let's distinguish between the real estate services you consume, better known to you as your house, and the real estate in which you invest. One of the crueler aspects of inflation is it creates the illusion that you have actually profited from your residence. Once you add in all of the holding and maintenance costs associated with putting a roof over your head - taxes, utilities, repairs, foregone investment returns elsewhere - and the replacement costs associated with selling your property and moving somewhere else, those returns get pretty skinny on an inflation-adjusted basis. In addition, the transaction costs on real estate are high enough to make a New York Stock Exchange specialist blush.

Any homeowner understands soon enough that the physical structure cannot appreciate in value net of maintenance costs unless it is an architectural masterpiece. Land can acquire a scarcity value, but this is a two-edged sword: The desirability of neighborhoods rises and falls in unpredictable long-term cycles. Land, like gold, should go up in price when the expected holding costs are less than the expected rate of inflation; this phenomenon no doubt accounts for much of the recent strength in real estate markets. Property owners, like bond investors, simply have capitalized the effects of lower interest rates.

By the time you are through analyzing your house in financial terms, you have a mess: It is a bond imperfectly indexed to inflation with a floating yield equivalent to the imputed rental value less the holding costs. Like a high yield bond, you are long a call option on credit upgrades; you benefit along with your local market if it becomes more attractive. However, you are short a number of call option: On taxes to your local government, on the deductibility of mortgage interest to Uncle Sam, on energy prices to whomever, on interest rates.

In addition, you are exposed to both general macroeconomic conditions and to the fortunes of a locally dominant industry. I know this last risk firsthand from living in Houston during the oil-price collapse of the mid-1980s. Still, you have to live somewhere, and as Ibbotson & Associates have demonstrated, only common stocks have outperformed real estate over the long run.

Someone Else's Pad
Investment real estate is capable of generating significant returns, albeit with significant risks. Each and every parcel of real estate is by definition unique. Unless you are swinging office buildings, hotels and shopping malls around by yourself and are willing to rub elbows or other selected body parts with Donald Trump, you are probably best off sticking to real estate investment trusts (REITs).

REITs must distribute 95% of their rental income back to their investors each year. This distribution accounts for much of the return of a REIT. Over the past five years, the 100-member S&P REIT index has outperformed the S&P 500 by 10% on a price-only basis; non-trivial to be sure, but considering how the S&P 500 has fallen 19.3% in price terms over the past five years, unspectacular. On a total return basis the gap expands to a 48.1% outperformance by REITs. Once again, this outperformance coincided with a horrendous bear market in stocks and a historically aggressive Federal Reserve campaign to lower borrowing costs. The odds of these being repeated in the near future are low.

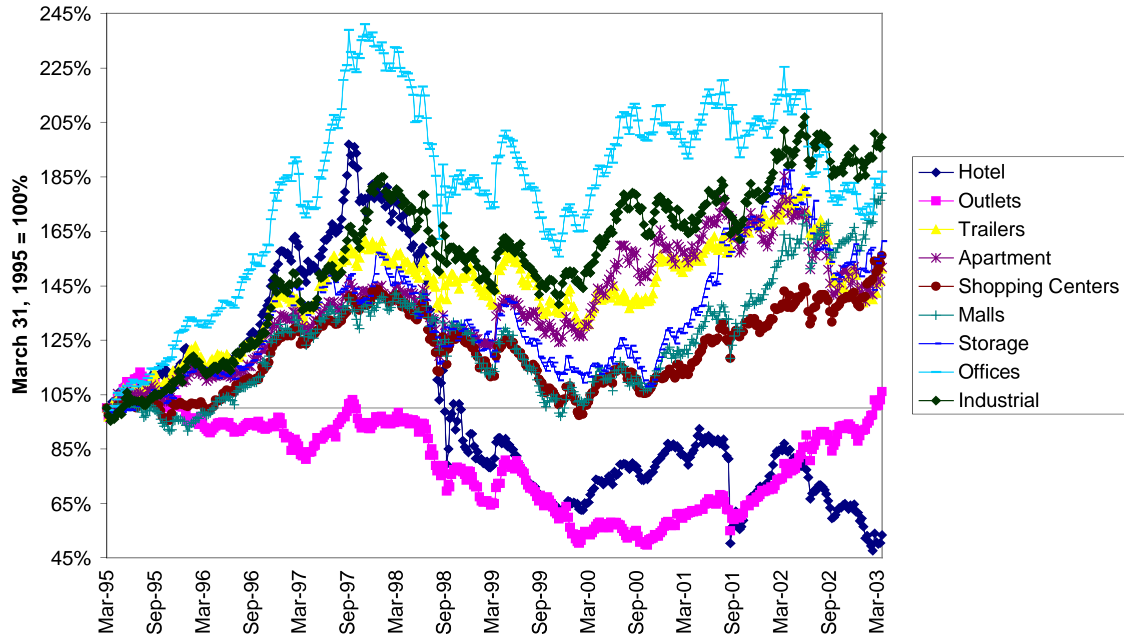
Should the administration's dividend tax plans pass in all or part, the relative attractiveness of REITs will increase too. As this plan has been on the table since the start of the year, it is a fair bet that its effects have been discounted in the prices of REITs.

REIT Classes

But just as real estate is beholden to location, there are various classes of REITs, and they are not created equal. You can invest in apartments, hotels, industrial and warehouse properties, manufactured homes (trailers, a surprisingly good business before you laugh), office properties, outlet centers, regional malls, shopping centers, and my favorite, self-storage centers (I teach the economics of storage in a rather ghoulish way).

Industrial and office property REITs have performed strongly over the past eight years even as office vacancy rates have soared in many cities. The strongest industrial REIT performer in 2003 has been Prime Group Realty Trust, up 30.1%; the strongest office REITs have been Parkway Properties, HRPT Properties Trust and Corporate Office Properties Trust, all up just over 10%.

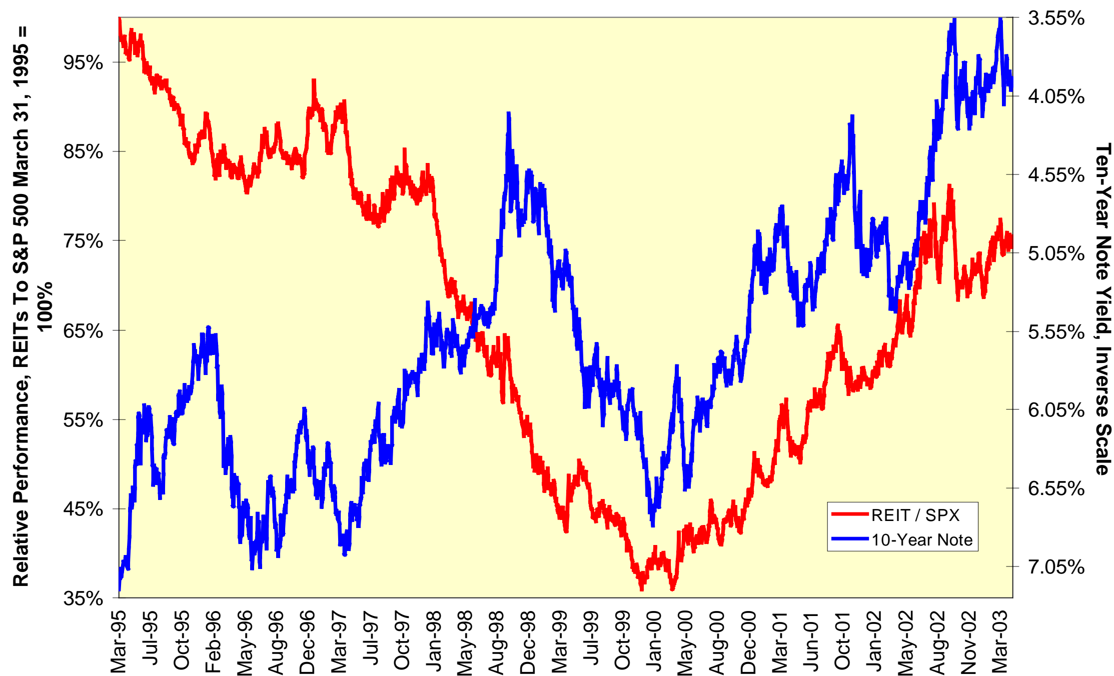
The worst performing REIT class has been the hotel group, which started to collapse in mid-1997; the obvious collapse after September 2001 was actually smaller than the once which preceded it.



What should stand out in the relative performance of REITs chart is just how volatile each of the categories has been; office properties have performed well, but are volatile and obviously suffer from a relatively concentrated market. Shopping centers and malls must be pushing against saturation limits in many markets; if my north suburban Chicago view is common, this country has no need for additional shopping centers until sometime in the 25th century, if then.

Interest Rate Risk

Real estate is famous for OPM - Other People's Money. Get someone else to put up the capital and leverage it with borrowed money. If interest rates rise, the carry on real estate falls, and so will its relative performance.



If and when the economy recovers enough to increase the attractiveness of lower yielding stocks and to persuade the Fed to start raising rates, REITs will suffer. Higher interest rates will reverse the capitalization of lower interest rates into real estate prices noted above. The market will become illiquid as people take properties off the market rather than sell when real estate gets weak, and rental increases may not be sufficient to offset the capital losses and other holding costs.

Unless you want to hedge the interest rate exposure out of real estate, and the advice here is do not try, REITs have seen their day for this cycle.