

Is Real Estate a Fad?

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According to the American Heritage® Dictionary of the English Language, (Fourth Edition Copyright © 2000 by Houghton Mifflin Company), a fad is defined as: “A fashion that is taken up with great enthusiasm for a brief period of time; a craze.” Could real estate investors be subject to “a craze”? It sure feels that way.

The scene is a crowded market and all around me people feel desperate to purchase at least one of what is being sold. Am I describing my experience of buying a pet rock as a child or today’s world of investing in real estate. The answer is, in fact, both. Don’t misunderstand me, I am not really into fads: No fad diets for me or break dancing in my past. Mohawks were not for me. I don’t get up in the morning on the lookout for the latest craze, but nonetheless, the real estate fad seems to have found me.

REITs

The public REIT market is a fine example of the phenomenon I am describing. The underlying fundamentals of the market and the investment yields available do not support the valuations. The Vanguard REIT Index, an index that is thought by many to approximate the performance of all publicly traded REIT stocks, closed at an all time high recently and was yielding approximately 4.6%. The index has risen from approximately 13.5 to greater than 20 over the past two years representing 50% appreciation in value. The index was in the neighborhood of 11.75 five years ago. Add to that rise in appreciation an annual yield, as paltry as it may be, and the total return is deemed by most to be very good, especially in comparison to other investment indices.

So, what’s the problem? The problem is that it doesn’t make sense. When one looks at the underlying fundamentals of any given piece of real estate, it does not compute. The Wall Street Journal printed an article last month titled “Silicon Valley Sees Traces of Growth.”. However, the office market is reported to be 23% vacant. Over the past five years, rents have dropped dramatically and the area has lost a net of 70,000 people, presumably some of which previously filled the now vacant office space. In Boston, the story is similar. Effective rental rates have dropped dramatically and vacancies have increased. A Boston Globe article, “Make way for condos” published in June 2005 listed the current downtown Boston asking rents to be \$29.96 per square foot and vacancy rates to be 14.6% versus asking rents of \$53.85 and vacancy rates of 2.4% in 2000. Rates of returns as indicated by real estate fundamentals have decreased in many other parts of the country as well.

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Nonetheless, REIT values have risen despite the drop in underlying fundamentals. It is not due to the increase in yields, they have dropped as values have risen. So, what is to explain the value increase? Is it possibly the poor performance of the alternative investment products? Put another way, real estate is popular vs. unpopular products. It might have been Rodney Dangerfield who said: "if you want to look skinny, hang out with fat people." That sounds to me like a dubious way to get thin. It is a fad in the making. People want to buy REIT stocks to make them look skinny - if nothing else, the yields certainly are.

Housing

Housing is housing, unless, of course it is an investment. In the old days, people just bought a house to have a place to live. Now people buy homes to have an investment. I believe that most quality real estate investments generally should have either recurring income or a value-added aspect whereby appreciation in value is built in accordance with a specific plan. Then again, what do I know? These days, people just buy any old house and expect great value appreciation - and many have been right in doing so over the past five years. A Barron's article from June 20, 2005 called "The Bubble's New Home" showed housing prices in many major markets, including Los Angeles, Miami, New York, and Boston, increased greater than 50% from 2000 to 2005. It does not matter that the homes have had negative annual cash flow because appreciation cures all ills. That is, of course, until it doesn't.

Housing prices should be primarily driven by three major factors:

1. supply;
2. demand; and
3. the cost of funding.

Supply is primarily limited by barriers to entry such as a shortage of land and economic limitations such as replacement costs that are higher than building values. Demand is primarily a function of employment. The cost of funding has much to do with interest rates. If one looks at each of these elements, the one that is most dynamic, that is an aberration from historic levels, is the cost of funding. Interest rates are at historically low levels. Further reducing the cost of funding is the growing popularity in financing products such as adjustable rate loans and interest only loans.

Of these three items affecting home prices, the most dynamic of these is also likely to be the one that affects housing prices the most in the future. A rise in interest rates will likely have a meaningful impact of home values. Such a rise may not cause an immediate or dramatic drop in values because prices are sticky on the downside. It feels bad to sell at a loss and, therefore, people often keep a home and forgo a move rather than sell at a loss. However, a drop in the market is real and those who must

move could well see a loss. At best, a significant rise in interest rates will likely result in a relatively long period of stagnant prices.

In the froth of this market, the fourth item affecting housing prices is speculation. A 2005 New York Times article, “Speculators Seeing Gold in a Boom in the Prices for Homes”, listed that the National Association of Realtors indicates that as many as 25% of the homes sold last year were bought for investment purposes. That is, the primary purpose of these home purchases was not to provide a residence for the owner, but to provide a speculative investment with the hope that housing price increases will continue. Developers and regular people say that investing in residential housing is a ‘can’t miss’ proposition. Only the foolish are on the sidelines.

Conclusion

I am passing on these fads. Surely, I am a fool, because I don’t get it. If that makes me unpopular, I can always stay home, slip on my favorite mood ring, clutch my pet rock and listen to the latest “American Idol” CD.