

Let's get real with real estate

It can seem infallible but returns can be hit, as in current downturn



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For decades, real estate in the financial hubs of Hong Kong and Singapore seemed infallible. Critics of such "conventional wisdom" gave the example of the recent financial crisis, but this was brushed aside as a "once-in-a-lifetime" event that could not happen again.

But it has.

At its bottom in the recent Covid-19 crash, both Hong Kong's and Singapore's value-weighted portfolio of real estate investment trusts lost 25 per cent.

As of the beginning of the month, the Hong Kong real estate portfolio appeared to have recovered while the Singapore portfolio was still down 16 per cent.

Investors who thought real estate provided stable returns with not much risk would have been in for a double-whammy as real estate returns cratered at the same time as equity markets worldwide.

Focusing on real estate investment trusts in Singapore with residential and hotel properties shows an even starker image, with cumulative returns from the beginning of the year down over 20 per cent and 40 per cent respectively over the same time period.

REAL ESTATE RETURNS ARE RISKIER THAN YOU THINK

From January 2000 through April 2020, the worst drawdown for Singapore real estate was over 67 per cent between July 2007 and August 2012, and the worst drawdown for Hong Kong real estate was almost 70 per cent from November 2007 through November 2010. And it is not just Singapore or Hong Kong.

Similar drawdowns occurred for Japan, with over 75 per cent from April 2006 through April 2013. In fact, real estate drawdowns of the United States, Australia, Singapore, Hong Kong, South Korea, Israel, Japan and Germany were all worse than the maximum drawdown from the MSCI All-World Country stock index returns.

In addition, academic research has shown that real estate returns exhibit no outperformance relative to local and global equity market indices. In fact, the research has shown that common factors driving equity markets also drive real estate returns.

WHAT ABOUT PRIVATE REAL ESTATE?

Some may argue that this is not a fair comparison as the real estate assets considered here are real estate investment trusts (Reits), which are packages of real estate that are traded publicly on the stock exchange.

In fact, overall real estate indices, such as the SRX Property Index, have sub-components using prices from private market real estate, which show a rising trend over the long term.

The private non-landed index using data from all regions in Singapore rose from 124.9 in January 2010 to 191.1 in March 2020, a gain of over 53 per cent.

The price returns S&P Singapore Reit index over the same time period rose by 24 per cent. Taking into account Reit dividends, a return of over 103 per cent was generated over the same period.

What makes the comparison between private and publicly traded real estate difficult is that some investors also live in the home, getting a consumption flow in addition to the capital gains. This is certainly not possible with Reit investments.

In this case, the closest Reit comparison is for investors to use dividend income from Reits to rent an apartment.

Which number is the right comparison depends on whether an investor is receiving dividends on

their private property investments, whether an investor is actually staying in the private property, and what the maintenance costs of holding the property are.

For example, condos have monthly servicing and homeowner's association fees that must be considered. In addition, selling and buying private real estate involve agents who charge a commission. For example, for non-landed private property, sellers pay an average of 2 per cent commission. This will decrease the 10-year return from 53 per cent down to 50 per cent, a reduction more than the sticker amount of 2 per cent due to compounding.

Another argument from proponents of real estate investing typically argue to just hold on to the asset for a while so that no losses are realised. Therein lies a fallacy.

Just because gains or losses are not realised does not mean they do not exist. In the absence of large trading frictions, investors should react the same way to realised and unrealised gains and losses.

But in practice, this isn't true. A study in behavioural economics and finance spearheaded by Nobel prize winner Richard Thaler at the University of Chicago looks at these types of fallacies that generate predictable price patterns.

One specific example of this fallacy is the disposition effect, the tendency of investors to hold losing investments too long and sell winning investments too soon. Disciplined and quantitative traders can exploit such predictable behaviour to generate consistent returns.

So why the obsession with private real estate? One answer is leverage.

Real estate is one of the few securities that you can purchase for investment with only a 25 per cent down payment and borrowing the remaining 75 per cent in order to finance the portfolio, equivalent to a 4x leverage on the equity put into the purchase.

This means even a 1 per cent increase in the value of the real estate translates to a 4 per cent increase for the initial investment.

Seasoned investors who purchase and flip properties do not pay down the mortgage much and can maintain a high leverage ratio by rotating into new purchases and out of existing positions.

SO WHAT MAKES PRIVATE REAL ESTATE SPECIAL?

In a rational world, illiquid assets – those that cannot be quickly converted into cash – would trade at a lower price as investors consider the situation where they quickly need cash but cannot liquidate.

However, there is one situation where the illiquidity of private real estate may be beneficial.

In this world with imperfect investors who have self-discipline problems, holding on to the asset during temporary bad times and ignoring the public market signals may be beneficial. Just increasing the holding power for investors to stay invested longer is the key.

In this case, the common wisdom to hold on and avoid unrealised losses is not a fallacy as it would be in a rational world, but is indeed wisdom in a behavioural world.

However, this applies to investing in any asset. Long-term investors should also not react much to short-term market movements. But we don't seem to have such "common wisdoms" for equity markets. When equity markets lose 20 per cent, articles get written all around the world calling for people to liquidate their positions and "avoid the big one".

So, if people ask me now what makes real estate special, it seems quite obvious to me. Beyond the leverage, it is the investors.

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