nerej
EST. 1963 | CELEBRATING 55 YEARS

Appraisal: Common Sense

April 23, 2015 - Spotlights

A lot of economic behavior takes place based on a lack of knowledge and judgment and over-reliance on habit, benchmarks, or other factors founded in laziness or incompetence. Real estate behavior is no exception.

Technology and human nature makes for a potent combination in producing illogical and incorrect results. Feed enough data into a program and something is bound to result to make sense to somebody.

Somewhat like walking around outdoors but using the Iphone to tell what the weather is. Real estate markets are dynamic and changes are subtle, slow to change, and changes often are not immediately apparent. The foundation of more than one real estate bust has been built on accepting input from machines and ignoring obvious signs on the street.

Investment real estate markets are long term. Assets lack the immediate liquidity that is available in the stock and bond markets. While that may be a good thing, it also means that investments should not be entered lightly; getting in is easier than getting out, most of the time.

Given relatively long horizons of real estate, it's easy to interpret short term signals as definitively and definitely indicative of the future. And beware of the insidious effects of seemingly small compounding resulting in large future outcomes over long investment analysis holding periods. The future doesn't always work out as modeled: a rosy today doesn't guarantee blues skies forever.

The best investors seem to be those who understand the asset, its quality, and location and who are willing to pay a fair price. Once the decision is made, the crowds of analyst can punch up the appropriate scenarios.

It's the less sound investments that require great motivation to buy and to justify prices being paid. Currently, investors decry the lack of quality investment alternatives and then use this shortage to justify paying first class prices for second rate assets.

In this low return era, commercial real estate represents the opportunity to make outsized profits. But, having made decisions to invest, there are a lot of moving pieces, plenty of places for things to go awry. Good investors turn down far more deals than they accept.

Low rates won't last forever. Rising rates can upset cash flow, especially if cash flow is based on overly optimistic assumptions. Asset values are moving targets based on seemingly firm assumptions about uncertain futures. Ignoring fundamentals and chasing uncertain appreciation outcomes may create big winners, but, just as easily can make a lot of losers in due time, often slowly, imperceptibly.

Much optimism abounds in real estate and the economy. We are well into a cycle and it may be a good time to consider downside risk. So take care about those compounded optimistic