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Why are some current real estate investors willing to take higher risks for lower returns?

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How much risk can you stand? These days, if you are like most, it's more risk than a few years ago, and, for smaller return. Why do we tolerate more risk: false optimism, greed, desperation? Read on.

"Risk on" or "risk off" phrases are typical ways stockbrokers comment on participation in equity markets. Simply stated, these phrases imply that investors are either taking on, or moving away from, risk. Real estate investors have been" risk on" for at least five years, and they have piled more money in while being aware of potentially lower yields each year.

In doing some research for this article, I was surprised to see so many articles, over so many recent years, discussing this "desperate" search for yield. Every year since around 2010, writers have been discussing and sometimes warning of potential problems of investing with excess risk for too little return. Barron's magazine in 2010 talked about buyers "lining up" for office buildings. The Financial Post in 2011 talked about investors desperate for yield. CBS News in 2013 continued the discussion.

What they say, of course, is that the Federal Reserve has kept the federal funds rate low in order to stimulate the economy. In 2006, that rate was over 5%, but since then the Fed has reduced it ten times, lowering it to zero or .25%. This of course has had the expected effect of providing available and cheap money to people like real estate developers. But it also has lowered return rates to investors looking for income. Low interest rates have pushed returns down on money markets, CDs, Treasuries and bonds to near zero. Investors ultimately dig deeper into the asset class pile, usually finding riskier investments. The result is lower rates of return, and lower related cap rates, reflecting higher prices of assets. The better properties are bought, and while supply increases as has recently been the case, investors will also seek properties in riskier markets, with weaker tenants.

Back to the parallel of the stock market, some believe stock prices are higher mostly because yield is not available in typical money markets. Similarly, investors have moved into junk bonds in search of higher yields, but at the expense of higher risk. In a Barron's magazine article, Howard Marks summarizes this problem well. He says that investors face two risks: 1) they have too high expectations and thus lose money; and 2) they have too low expectations, don't invest, and then miss out. These days, the fear of losing money seems to have receded, while the fear of missing out has increased. Once again, staying out has been partially caused by expectations of the Fed raising rates, which has not happened. Thus, those who stayed out of the market are regretful, and may thus be piling in now, unfortunately at a point nearer the top of the market.

I don't believe we are at the top; nor do I believe there is a fully inflated bubble. However, it seems reasonable to parse and distinguish between at least two types of bubbles. First class properties, bought by world class investors, with huge staying power, will survive a downturn. But, those who piled into lower quality assets, will face a different bubble in lower quality markets, with greater potential for deterioration. When the music stops, as it inevitably does, the savvy and financially strong investors will be sitting in the chairs, and the ones late to the party will be standing all alone.

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