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The long view of volatility, risks and predictions for investors and stock markets

September 03, 2015 - Northern New England

Volatility. Given recent roller coaster behavior in stock markets, have we entered a new period of volatility? Depending on when, where, and to whom you are listening, you can parse the massive swings in the stock market anyway you like.

Investors and stock markets do react to fear, uncertainty, and the prospect of the unknowable. And stock market swings can be magnified because humans aren't necessarily pushing the buttons; machines are obeying the instructions coded into them by humans.

Time to sell? Time to buy? Is it a passing phase or the beginning of cycle? It depends on who you listen to and the "products" under discussion.

Equity and bond markets tend to work on shorter and steeper cycles than real estate. Maybe. The stock market has many metrics: the Dow, S&P, NASDAQ, or something else entirely. Take your pick. Real estate is a lot harder to measure. There are fewer transactions, less uniformity, non-standardization of product, different metrics, and a lot of subjectivity out there. Long view versus the quarterly earnings target.

Surveys tells us that investors are "well capitalized, eager to place funds in the commercial real estate industry, and optimistic about the future," but that there is a lack of "quality offerings to come to market." This scarcity (a condition less characteristic of bond and equity markets) drives the current real estate markets at all levels. Plenty of cash there but not so much to spend it on. Some buyers, charged to buy at any cost, will spend their allowances on maybe not the best candy on the shelf - and then get their banker friends involved.

Volatility in investment RE markets at the equity investor (or lender) level tends to manifest itself slowly. Real estate is a long term investment: once in, it's not so easy (or cheap) to get out. So smart buyers don't always jump at a likely looking deal in this market. for fear of missing out. Or do they?

Risk. Risk is all about trying to manage the unknown and the unknowable. Some risk types are more knowable and manageable than others. The large questions, such as what the market is going to look like 10 years from now when the investor wants out, are inherently unknowable.

Risk is inevitable and investors are all about managing it in fascinating and diverse ways. Good investors try to act prudently, and good analysts try to simulate that prudence in their models, so that when bad, unexpected things happen that are counter to everyone's expectations (remember solid tenants defaulting or major investment banks failing?)there is some cushion, some fallback.

The Fed promises to be transparent and predictable. Predictable is good. Uncertainty is not. But there will be fallout from inevitable rising rates. It's hard to argue with the consequences of more taken out of NOI by debt service and less cash flow. Some may call this the next round of rate compression "less to equity cash flow" with more emphasis on "appreciation." Bad joke.

Predicting. Most real estate professionals show disdain for the idea that real estate market activity can be predicted. Anyone that's been in the business for a little while learns not to predict, but to forecast, which basically means predicting based on what everybody else thinks at that moment. If one manager does the same as another manager and the market goes bad on both, the managers aren't to blame, the market is. Enough managers acting in concert endorses the activity, even if the result is wrong.

Take Discounted Cash Flow Analyses. They are full of assumptions. These assumptions, in order to be meaningful and produce credible results, need to be backed up by support. Where does that support come from? From the opinions of managers, investors, and other market makers. Once enough people believe a trend to be true, it becomes as good as true, self-referential, tautological. At its best, when assumptions are logical and rationally supported, a discounted cash flow analysis is a powerful analytical and valuation tool. At worst, discounted cash flow analyses are filled with assumptions based on herd behavior and common rumors supporting a predetermined result.

I'm not being pessimistic. With intelligent investor activity and sound economic fundamentals in place, commercial real estate should continue to experience favorable market conditions and will be able to navigate both risk and uncertainty. That is, as long as everyone acts rationally.

A wise teacher, Bill Kinnard, used to say, "Kein Baum wächst in den Himme"- "the tree does not grow into the sky forever." This is true both for stocks and for real estate: take the long view. So, having had a bad taste of the extreme volatility that seems to be a fact of this century, where are we in both of these bull markets?

A final word. Stay away from pie in the sky discounted cash flows.

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