



# nerej

## **Sense of the Data - by Bill Pastuszek**

June 10, 2022 - Appraisal & Consulting



Bill Pastuszek

I know this could be construed as broad generalization, but it's up here for discussion. Many economic behaviors result from decisions based on:

1. No knowledge and no sound basis for action;
2. Limited and possibly incorrect, unconfirmed or lightly confirmed, information;
3. Selective, subjective data that confirms a preconceived idea (confirmation bias).

Real estate behavior is no exception and investment decisions are not soundly based on logic or accurate data.

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

In this digital era, it's easier to use the app on the phone to see what the temperature is, rather than step outside for a moment and have a direct experience. (Indeed, the weather app still has its uses, to be sure.)

Real estate market observation can be like that too. The data is the data but the human element – the interpretation of the data – the “last mile” in understanding markets. It's important to know what others think of the data; what is it saying to them? Considering the source is critical in evaluating anecdotal data in order) for it to be part of the empirical research? Does the source fall into any of the three categories in the first paragraph?

Real estate markets still consist of relatively sparse data points. They operate in dynamic, often slow-moving environments, and changes come slowly, and are subtly nuanced, and the results of changes that are not often immediately apparent. A large event – say COVID, the invasion of Ukraine – has plenty of potential ramifications that can be airily discussed as certainties but are really just ‘what ifs,’ “could be’s,” by media and “thought influencers.” Given relatively long horizons of real estate, it's easy to interpret reactions to short term events as definitive and definitely indicative of the future.

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 the heights of CRE markets achieved post-COVID, will growth continue in the same manner going forward, now that a new set of events – global instability, inflation, interest rates are likely affecting markets dynamics.

The foundation of more than one real estate bust has been built on running with the herd, relying on

technology driven forecasts, and overlaid by the facile conclusions of media and prognosticators. What may really be going on may have to be read “in between the lines,” reading trends and forecasts as useful data points and adding the intelligence gathered from being “on the street,” blending both big data and reliable anecdotal, primary information.

The best investors seem to understand the asset, both quantitatively and qualitatively, and are willing to pay a fair price for it. Once the decision is made, the crowds of analyst can punch up the appropriate scenarios. The best investors turn down far more deals than they accept.

With quality investments priced sky high, lesser quality alternatives abound. Investors are out there finding ways to justify paying first class prices for second rate assets. As this cycle continues to mature, with accompanying worrisome warning signs, the risk grows for the second and third tiers.

With a deflating stock market, commercial real estate continues to represent opportunities to achieve bountiful returns. outsized profits. Increasingly, there are more moving pieces, plenty of places for things to go awry.

Rising rates can upset cash flow. Also, future cash flow, if 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 continues to abound in commercial real estate. The economy is not in bad shape, even though many think it should be better than it is. Residential markets appear to be braking. On the commercial side, it's probably a good time to consider and be more aware of downside risk.

As a former appraisal teacher was fond of saying, “Trees don't grow to the sky.” (This is a German proverb: “Bäume wachsen nicht in den Himmel.” My high school German, while of some help, isn't responsible for any translation issues.) The phrase suggests that there are natural limits to growth and improvement. While the saying is attributed to companies' growth limits, it can certainly be applied to real estate. Are we in an era of diminishing returns?

So, it may be useful to revisit those compounded income growth investment assumptions over long holding periods and to review expense and reversion assumption so that a slowing market doesn't “sneak up” on the models used.

Maybe it's not entirely scientific, but common sense and critical thinking should rule in the end. Don't use that app exclusively to check the weather. Go outside. Take a walk. Enjoy the outdoors. Ask questions. Then act based on reliable data, soundly interpreted and further vet conclusions drawn from those data points by reliable sources.

(The original article was written in 2015. I came across as I was reviewing 20+ years of articles that I have written. Much of what was in the original article still makes sense today.)

Bill Pastuszek, MAI, ASA, SRA heads Shepherd Associates, Needham Mass.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540