



The Millionaire down the Street Was Right, But Now What's in Store for Real Estate?

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For many across the U.S., the real estate market has been the latest get-rich-quick craze. Indeed, hordes of homeowners and investors *have* become wealthier as they watched their home values increase or their investment properties sell for multiples of what they paid for them just a few years ago. But the run-up in real estate may be ending. Federal Reserve chairman Ben Bernanke last month said the housing market is "cooling."

Around the same time, former Fed chairman Alan Greenspan told the Bond Market Association that the U.S. housing market's "extraordinary boom" is over.



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While few would dispute these assessments, what's in store for real estate is difficult to predict. "I don't think there's a widespread bubble in housing markets in the U.S.," says [Joseph Gyourko](#), a real estate and finance professor at Wharton and director of the school's [Zell/Lurie Real Estate Center](#). He acknowledged that 2005 was "frothy" and that "in niche markets like condos there are crashes absolutely waiting to happen." He sees no "great collapse" on the horizon, though. In Gyourko's view, local economic factors -- such as job growth and supply restrictions on residential real estate -- justify the hike in real estate prices in many cities, particularly on the coasts.

Robert Shiller, an economics professor at Yale University and the author of *Irrational Exuberance*, which anticipated the stock market crash of 2000, disagrees. In his view, the recent, unprecedented spike in U.S. home prices reflects the damp, invisible hand of investor psychology. What's been driving up the price of single-family homes, he notes, is "like the psychology of the stock market in the 1990s -- and it is probably very unstable."

Both men delivered these comments at a conference earlier this month on Innovation and Risk Management in Real Estate Markets, organized by the [Wharton Financial Institutions Center](#) and Mercer Oliver Wyman, a financial services strategy and risk management consulting firm. Gyourko and Shiller spoke on a panel about price dynamics in the real estate market, along with Gordon DuGan, president and CEO of W.P. Carey & Co., a firm that provides corporate real estate financing to companies, and Richard Saltzman, president of Colony Capital, a large hedge fund that invests in commercial real estate. The latter two focused on the commercial real estate market, which has changed dramatically since the early 1990s, the last major downturn in real estate.

Regarding residential markets, Gyourko argued that "local and not national factors are driving house prices." Local trends have caused a divergence in both median home prices and home price growth in different U.S. markets, with coastal markets benefiting the most. Home prices have appreciated more than 500% since 1980 in Washington, D.C., California, New York, Massachusetts and Rhode Island, according to the Office of Federal Housing Enterprise Oversight. More recently, home prices in vacation hot spots have soared. In the last year alone, home prices surged by more than 30% in Southwest Florida, including Naples and Cape Coral, and Phoenix and Flagstaff, Arizona. Many metropolitan markets across the U.S. are also at historic peaks in terms of price-to-income and price-to-rents.

Investors have benefited from the housing boom because of record low interest rates in the wake of the

Nasdaq stock market implosion of 2000 and the economic recession. After lowering its key overnight lending rate to 1.00%, the Federal Reserve, starting in June 2004, has gradually raised the rate to 5.00%. But by historical standards, interest rates have remained low.

Over the long haul, interest rates and house prices have not been correlated. When interest rates rise, there has typically been no dramatic fall in house prices, even though mortgage debt service payments increase, and vice versa. One reason that house prices may continue to increase despite rising interest rates, Gyourko suggested, is that homeowners might expect to refinance their mortgages at a lower rate.

Growing Rich People

Gyourko indicated that the most important factor driving housing prices is on the demand side: income. "Basically we've been growing rich people in the U.S.," he said. In 1940, less than 1% of families earned \$100,000 in today's dollars. By 1970 that income level applied to about 5% of families. By 2000 it applied to about 12% of families.

In Gyourko's view, the rich want to live in only a few metropolitan areas, primarily those on the coasts. In the San Jose, Ca., metropolitan area, about one-third of households now earn \$100,000 or more, he said. In Washington and San Francisco, a quarter of families earn more than \$100,000, while in Chicago one-fifth do. In addition to increasing demand for pricier homes, supply has been constrained. In San Francisco, Los Angeles and New York, the housing supply (reflected by the total construction permits relative to the housing stock) has decreased in recent years. Detroit and Minneapolis, on the other hand, are neither growing rich people nor restricting supply -- and that means recent housing price appreciation in those markets could be a harbinger of trouble, Gyourko said.

While Gyourko focused on supply and demand factors for the rise of residential real estate prices, Shiller focused on speculative investor sentiment. He noted that since the early 1990s the rate of growth for median housing prices has risen every year. This has created an investor psychology that "the millionaire down the street is really right," he said. And just as legions of investors dove into the housing market in recent years, seeking to profit from a low interest rate environment and rising home prices, those same investors could just as suddenly rush for the exits.

For Shiller, the larger economic concern is that the bulk of most homeowners' wealth is tied up in their home. Even if the housing markets in different geographies face different prospects over the near term, many investors run the risk that their real estate investments -- and hence their financial well being -- could decline.

To protect their financial health, Shiller argued, homeowners need a way to hedge the risk that home values in their area will change -- or to diversify their exposure to real estate in other markets. Shiller beat the drums for MacroMarkets, a company he founded with two colleagues that aims to help investors do this. Among other things, the company licenses the Case-Shiller Indexes, a series of housing price indexes that measure the average change in home prices in 10 U.S. cities. In late May, the Chicago Mercantile Exchange launched futures contracts on the S&P/Case-Shiller Home Price Indexes, offering a hedging mechanism tied to changes in the value of the indexes.

The contracts saw negligible trading in their first couple of weeks, but the exchange is hoping the market will develop. A liquid futures market for residential home price risk could open the door for additional hedging products such as housing-related swaps, index-linked notes, home equity insurance and new types of mortgage contracts, Shiller said. Expanding the residential real estate market's investment and hedging products could also alter the real estate cycle, he added. "Futures could make home prices more efficient. This could be fundamentally important to the business cycle because the business cycle is substantially a real estate cycle."

The Commercial Side

While real estate markets are often treated as a block, there are many different sectors within these markets, and commercial real estate is very different from residential real estate. The commercial market has been completely transformed since the early 1990s, said Colony Capital's Saltzman, and now operates under different rules than it did in prior economic cycles. What has changed most dramatically is the interplay between the public and private markets, he added. Colony has \$5 billion in equities under management, representing about \$16 billion in assets across North America, Europe and Asia.

DuGan, W.P. Carey & Co.'s CEO, noted that prices in the commercial real estate market are influenced primarily by two factors. The first is the increase in equity market capitalization of U.S. REITs, or real estate investment trusts, over the last 15 years, which has injected more liquidity into the market. From 1991 to 2005, the U.S. REITs market went from less than \$9 billion -- "really nowhere," as DuGan put it -- to \$318 billion, reflecting a 26% compound annual growth rate. Indeed, the overall securitized market for real estate passed \$1 trillion at the end of 2005, according to the National Association of Real Estate Investment Trusts and the Commercial Mortgage Securities Association. In addition to REITs, this includes \$683 billion in CMBSs, or commercial mortgage-backed securities. CMBSs are securities collateralized by commercial mortgages that have been aggregated and packaged for investors interested in different levels of risk.

The other factor influencing commercial real estate prices has been the record low 10-year Treasury rate, DuGan said. He noted that massive capital flows into commercial real estate in recent years were linked to both low interest rates and the concomitant lack of investment alternatives in the market. It was a "Goldilocks scenario," he said, noting that it's hard to imagine events aligning as well in the near future. DuGan added that developments in commercial real estate make it difficult to predict how the market will now respond in a rising interest rate environment.

Saltzman agreed that interest rates have been a primary driver in commercial real estate over the last five or six years, but added that the relationship is now shifting as fundamentals in the commercial market improve. After the Nasdaq bubble burst and people started looking at the risk/reward tradeoff in different asset classes, they saw that real estate had performed well. Interest rates then became a "huge driver" for people coming into the commercial real estate class in search of yield, Saltzman said. Even with interest rates rising and leverage becoming neutral, and then slightly negative, the asset class has continued to do well because people are now anticipating growth in rents, which could get their leverage back into "positive territory," he added.

But the real story that explains how the commercial real estate market has changed goes back two decades. In the 1980s, investors bought real estate with negative leverage, in which the initial yield on real estate was typically lower than the cost of the debt they were taking on, Saltzman said. They did it as a hedge against inflation or for diversification. As a lot of new supply entered the commercial market, the correlation between real estate and inflation changed. Then, in the late 1980s and early 1990s, the combination of a bad economy and significant overbuilding around the globe caused the real estate market to tank. And for much of the 1990s, the commercial real estate market paid the price.

What changed since then, however, is that in the aftermath of the savings-and-loan bust in the 1980s, the financing of deals in commercial real estate shifted from private to more public markets. In terms of transparency and governance, real estate in the late 1980s and early 1990s was the "poster child for how not to do things," Saltzman said. "There was no transparency. They were totally private markets with virtually no stringent requirements in terms of ratings." After the real estate market crashed and the traditional source of capital in the market disappeared, securitization saved the day. The first debt securitization came out of the federal government's Resolution Trust Corporation, which was formed in 1989 to acquire billions of dollars in non-performing mortgages for commercial properties from failed savings-and-loan and thrift institutions.

The RTC tranced, or segmented, and then sold the credit risk of the bad debt sitting on its books from failed S&Ls. That kickstarted the commercial securitization market. The growing world of publicly traded real estate securities eventually ushered in more transparency and disciplined reporting. "Real estate, which had been very provincial from a capital markets perspective in the last decade of the twentieth century, finally converged into the mainstream of capital markets," Saltzman said. "Now real estate is the poster child for how to do it right."

All this has potentially altered the commercial real estate cycle. In the past, the real estate cycle was "almost biblical," Saltzman observed. The market usually went up in a straight line for seven years, then dropped for a few years. That's no longer the case. Investors can see price changes for CMBSs and REITs every day and react to the changes immediately. "We haven't eliminated cycles, but what we've done as a function of having introduced public markets and all this information is we have reduced the amplitude of the cycle," he said.

If Bernanke and Greenspan are right about the real estate markets, the next couple years will surely put this idea to the test.

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