

Point of View

Research I'd Like to Read

by Bernard Winograd*

The changes in the capital market for real estate in the past five years have been dramatic. As securitization has had an impact on both the debt and equity markets, a range of new investment vehicles has emerged. Institutional investors now need to assess a much longer list of possible investment strategies, and investment practice has become much more diverse in response.

In this environment, there is no shortage of new areas of research that deserve attention. Fortunately, it is also a golden age of information. As the number of public real estate companies expands, the amount of data that is freely available regarding the investment behavior of real estate is multiplying exponentially. A small army of securities analysts has been recruited to follow the industry, and the amount of work they are producing is an indication of the research opportunity that the public companies' disclosures are creating.

But the public market is not the only source of novelty in the real estate market. Institutional investors are increasingly considering overseas real estate as well as investments in the United States. In addition, there are important trends in the U.S. economy that are affecting investors' perceptions of real estate, including the increased significance of the Internet. The list of research that I would like to see covers a diverse mixture of subjects suggested by all these trends.

Begin with the issues raised by the increased public company ownership of real estate. There is no question that there is increased linkage between

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the public and private capital markets. In 1998, the third quarter saw a massive withdrawal of capital from real estate during a period of improving real estate fundamentals. The cause was a flight to liquidity in the broader capital markets, having nothing to do with real estate. But the result was one of the most dramatic adjustments in the value of real estate assets, which may have been 15% or more in one quarter—an unprecedented degree of volatility in real estate values.

There are a lot of questions raised by this increasing linkage, but the one of the most interest to many institutional investors is what it will do to the historical lack of correlation between real estate and stocks and bonds. In late 1998, the correlation between real estate investment trusts and small cap stocks jumped, after three years of decline. In the future, will REITs behave like real estate or like stocks? Perhaps more importantly, will private market real estate returns increasingly be correlated with public markets and hence with stock and bond returns? Will the volatility of private real estate returns rise? All of these are questions that need attention, and the data that will allow them to be answered are being created as the securitization of the real estate capital markets proceeds.

As data proliferates, there is also an urgent need for a price index of private real estate. The NCREIF index of private real estate returns has become widely used as a benchmark for private real estate portfolios, even though it has substantial drawbacks as a benchmark. But it is clearly not a price index. As a result, many chief investment officers find it hard to use it as a credible way of evaluating the performance of their private real estate portfolios, and its widespread use in that fashion diminishes the industry's credibility with this audience—credibility that is not all that strong to begin with. A meaningful measure of private asset values, one without the lag effects that are such a notable feature of NCREIF, would be a tremendous boost to the credibility of the industry. Given the increasing willingness to share data that the public markets are creating, this may now be an achievable goal.

The other subtle but powerful influence that the public markets are creating is an increase in the

importance of strategy as a way to create value in real estate. The justification for being in real estate having been provided by Modern Portfolio Theory, the first real estate advisory businesses often placed more emphasis on their transaction skills than on ideas about what kinds of real estate investing made sense. Diversification was the centerpiece—and often the only idea—in the execution strategy. That approach is clearly losing market share in a world that offers as many new opportunities as real estate today. Public real estate companies find themselves competing for capital by articulating their strategies and their ability to execute them. The Wall Street research community is increasingly sophisticated in their ability to assess the potential of these stories. The result is that the bar is raised for everyone seeking a mandate to invest capital in real estate.

One of the consequences of this trend is new interest in the customer. The real estate industry has often been preoccupied with capital availability rather than customers as the source of ideas for value creation, partly as a consequence of the convoluted private capital market that served it. The time has come for real estate industry leaders to devote more time and attention to what the customers for real estate, the end users of property, are looking for. There are real estate companies that do this today, and there will be more of them. Research budgets need to devote an increasing share of resources to these questions, because answering them will be one of the ways in which value will be created for investors in the future.

It is also increasingly important that the research community do more to help spread better understanding of the role of real estate in the economy. The growth of the Internet has been the source of too many glib articles predicting huge changes in the way we use land, almost none of them written with any realistic perspective on the way real estate usage reacts to economic growth or changes in productivity. Sometimes the industry is its own worst enemy. A recent advertisement promoting a REIT fund that quotes Mark Twain's satiric advice to "buy land, because they are not making any more of it" is a case in point. Why would anyone need to make more land? In the U. S., only about 3% of the surface area of the country is urban, and

there is plenty of vacant land even within that 3%. Twain's advice was meant as satire—he might as well have advised buying water for the same reason—yet it was repeated by a REIT fund sponsor as if it was sage thinking.

Surely the industry can do a better job of explaining the basics of how real estate is used in the economy. It has become a relatively less important store of wealth in the last ten years, but that appears to be a continuation of a long trend downward in its “share” of wealth since the U.S. was an agrarian society. If the Internet triggers another revolution in productivity, what can we learn about how land use has changed in past productivity revolutions that might be illuminating? And why is it that property in one part of a city can attract markedly different rents than the same property located not far away? What general theory of rents adequately reflects the complexity of modern urban landscapes? All of these questions need work in order to increase the economic sophistication with which the outlook for real estate is debated.

Finally, there is a wealth of potential insight to be gained by comparing and contrasting real estate practices and values in the U.S. with those overseas. Why is it that land is persistently a higher percentage of real estate value in other developed countries than in the U.S.? Is it because we have a federal system of government that makes land

use policy easier for developers to exploit? Or is it a direct consequence of the greater population density of these countries? How do overseas public markets differ from the U.S.? Why is it that the linkage between public and private markets appears to be very different overseas, even in countries where public real estate companies are larger and more well established? Are there lessons there about how the public market in the U.S. may change? And can we estimate whether adding international real estate to a U.S. investor's portfolio, either in public or private markets, is expected to be good for risk-adjusted returns?

Institutional real estate investing is changing in response to the growing complexity of the capital markets for real estate. For researchers in the field, this is a wonderful challenge. There are many new questions that need thoughtful attention, and new data available to draw on. Starting almost anywhere on the agenda laid out above, researchers have the opportunity to create new and meaningful insights for the industry and its investors.

Editor's Note: This edition of *Point of View* is the first in a series featuring the opinions of consumers of research. Bernard Winograd's remarks were delivered to the general session of the American Real Estate Society Meetings in Tampa in April, 1999. We believe that they are worth repeating here.