BUSINESS MANAGEMENT **4 min read**

Why is Commercial Real Estate underrated in public discourse?

EHL

WRITTEN BY
EHL Insights

Excerpts from our recent research paper: Das, P., Füss, R.; Hanle, B. & Russ, I. *"The Cross-Over Effect of Irrational Sentiments in Housing, Commercial Property, and Stock Markets",* in Journal of Banking and Finance.

Residential Vs Commercial

People stare in amazement when a PhD in "Real Estate" is mentioned (one must be nuts to over-invest in a doctoral program just to sell more or bigger homes!). Admittedly, a lot of real estate research is geared towards the housing sector which is undoubtedly an interesting area of study, especially due to its relationship with the national economy. But it's interesting to note that a growing amount of real estate research is linked to Commercial Real Estate (CRE), although with a relatively smaller audience.

The reason why residential markets get all the attention can be easily explained. Compared to a roughly $30 trillion housing market in the US alone, commercial real estate just about represents half. Besides, unlike CRE which only "wealthier" and institutional investors are interested in, almost every household from poor or ultra-rich has some form of association with the housing market. Yet, for too long, the CRE topics have not been the favorite in public discourse on financial markets and policymaking.

Before we investigate why, let's digress a bit – with a good reason – towards an ultra-concise primer on behavioral finance.

The rational market with the invisible hand is dead

Neoclassical economics believes that investors termed as "Homo Economics" are inherently rational. This rationality is like an "invisible hand" And the famed "Efficient Market Hypothesis" (EMH) assumes that the Homo Economicus is able to spot the right information, interpret it perfectly and then make the right investment decision. What if some investment decisions still, somehow, end up being biased and wrong (e.g. buying assets when it is best to sell or selling them when it is best to buy)? EMH believes that individual biases in opposite directions eventually cancel each other out.

A different group of researchers (the "behavioralists") do not necessarily subscribe to EMH. Starting from the fringes of the economic paradigm they have increasingly become mainstream in recent decades. Behavioralists successfully showed that the biases may be ubiquitous and systematic, and cannot cancel each other out to be zero in aggregate. Thus, some assets may be overpriced and some may be underpriced.

EMH provides a counter-argument: if the biases cannot cancel each other out, then a group of smart investors ("arbitrageurs") will notice it and take advantage of the situation. For example, they will sell the overpriced assets and increase their supply. If the supply increases, the asset price will fall and eventually reach their fair levels. In some markets with liquidity (i.e., the ability to quickly buy/sell assets), such as stock exchanges, the "arbitrage" argument does hold ground. The machine-driven, high-frequency trades (often) bring the stock prices to their "rational" levels.

Due to the "climate change" in finance research, our understanding of investment has been increasingly overtaken by behavioral finance. Behavioralists showed that not only the markets may be biased at the aggregate level, but that many of these biases are predictable. Beyond being prone to biases, investors are limited in their ability to make sense of the available information. Now, we courageously acknowledge that investors herd like sheep and overreact to panic like wild animals.

Arbitrage opportunities require (1) availability of an adequate amount of cash and (2) an ability to execute a transaction quickly. Both of these are a luxury in big-ticket real estate markets. One cannot instantly raise capital to buy assets or find an investor to sell assets at the current prices. Of course, one cannot easily take a 'short'-position on real estate in most markets (i.e., betting against increase in prices). Hence, if real estate prices are irrationally high (or low), they are likely to remain so for some time. The Homo Economicus cannot survive CRE markets for too long.

If the prices are irrational, the role of sentiments may creep into markets. In this context, sentiments are those beliefs about the market conditions that we cannot explain by facts. No wonder, a large number of studies show the role of sentiments in pricing homes, CRE and stocks.

Smart Vs less smart investors

Being the same "animals", all investors are prone to behavioral biases, but some are more biased than others. Increasingly aware of their potential biases over time, sophisticated investors tend to (or, at least, *pre*-tend) to behave more "rationally." The finance literature often shows that big-ticket institutional investors (corporations, funds, etc.) are more sophisticated than private, individual investors.

The three markets in question: housing, CRE and stocks, differ in their fundamental structure. Unlike stocks, housing and CRE markets witness much fewer trades and lack transparency. Besides, while housing markets are dominated by individuals (or households), CRE are characterized by institutions (funds, corporations, partnerships) and stock markets by both types of investors. As a result, one should expect sentiments to play the least role in CRE, the most in housing and modestly in the stock markets.

CRE is a bit special

Our main interests were in examining the cross-over effect between sentiments in one market versus sentiments (and returns) in another. Our findings are revealing: housing and stock market sentiments significantly impact each other. However, while the stock market sentiments respond carefully to the housing sentiments, the housing sentiments get carried away by the stock market sentiments. This finding is not particularly surprising as households are expected to be more irrational. House prices, too, get excessively influenced by stock markets, while the opposite is not true.

CRE, however, is special. CRE sentiments have a more significant impact on returns in both housing and stock markets than the sentiments developed within these two markets internally. In other words, stock returns are not associated with the stock market sentiments, but they are impacted by CRE sentiments. It is the same for housing markets too, as they get carried away by CRE sentiments.

Interestingly, neither the sentiments, nor the returns in CRE markets are affected by the other two markets. In fact, CRE sentiments and returns are sensitive to their own past and are immune to housing or stock market movements.

So what?

Although housing and stock markets play a significant role in the economy, they are inter-connected with each other. Therefore, from a policy standpoint, it is challenging to allocate resources independently to either market.

Beyond the performance (i.e. returns) of these markets, the policy and investment strategies must also be watchful of sentiments. Sentiments in different markets determine future returns in their respective markets, but also exhibit a cross-over effect on returns in other markets.

In particular, commercial real estate sentiments and returns have significant effects on sentiments and returns in other markets, but the opposite is not true. In other words, commercial real estate markets, although of a smaller size, are dominated by more sophisticated investors. These markets provide unique information about the future movement of the overall economy, a fact that has been broadly ignored in public discourse on the economy. Our findings suggest that both housing and stock markets look up to the opinion of commercial real estate investors, whether it is qualified or not.

The verdict: CRE is more important to the economy than we had previously thought. We'd be wise to track the development in CRE markets more closely for policy and strategy purposes in the future.

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