Real Estate versus Financial Assets: Is it Time to Switch?

Investment Summary

- The great bull market in stocks, which began in 1982, has dramatically changed the terms of trade between real estate and stocks.
- Investors who sold real estate and bought stocks in 1982 have significantly improved their position since that time. However, if the bull market slows or ends, real estate would begin to outperform stocks.
- Real estate fundamentals, although still weak, have been improving for a year. Construction is down, vacancy rates are peaking, and the rate of inflation has passed the cyclical low point.
- We suggest that investors who are underweighted in real estate and not bullish on stocks consider increasing their asset allocation to real estate.

Introduction

Real estate equities have consistently and dramatically underperformed corporate stocks since June 1982. On a total return basis, real estate has declined by about 50% relative to stocks and by nearly 60% on a price basis alone as of the first quarter of 1987 (see Figures 1 and 2). We measure real estate returns with the appraisal-based Frank Russell Company Property Index and stock returns with the Standard & Poor’s 500. The relative underperformance obliterated the superior performance of real estate over stocks in the December 1977-mid-1982 period. As a result, real estate is trading at its lowest relative price compared with stocks in more than a decade.¹

However, because the Frank Russell Property Index is underweighted in the two strongest sectors of the real estate market — downtown office properties in the Northeast and California and regional shopping centers — a more general index of real estate performance would exhibit stronger returns. We do not believe that a more general index would alter the basic conclusions of this report, but it could affect the composition of a real estate portfolio.

The underperformance of real estate equities is attributable to a plunge in interest and inflation rates since the 1981-82 period and generally weak realty market conditions since 1984. The decline triggered a super bull market in stocks, and the weak conditions dampened the performance of real estate equities.

A similar relationship has existed between real estate and corporate bond returns since the 1981-82 period (see Figure 3). Bond returns are calculated from the Salomon Brothers Inc High-Grade Corporate Bond Index. As inflationary conditions abated, bond returns soared. The relative return of real estate to bonds has fallen by more than 44% in this period.

As relative returns changed there was a portfolio shift out of tangible assets into financial assets. However, the question now arises as to whether the shift in the terms of trade between stocks and real estate, has been large enough to stimulate a reversal of this flow.
The Improving Real Estate Fundamentals

Despite continued high office and hotel vacancy rates and evidence of overbuilding in retail properties, realty market and investment conditions are improving. Office construction peaked in the first quarter of 1986 and has since declined by about 25%. Office vacancy rates have leveled off, and although there still may be modest increases, the worst is over. Hotel construction is now plummeting, retail construction is off modestly and industrial construction remains depressed.2

These results indicate that the great construction boom of the 1980s is over and that the worst of the supply surge is behind us. Some demand problems may be on the horizon, deriving from slower employment and retail sales growth rates, but the drop in supply should exceed any potential weakness in demand.

From an investment point of view ambiguity exists. Both interest and inflation rates have risen since the second quarter of 1986. Investors now perceive that the best news on inflation is behind us and that the falling dollar will likely bring with it upside surprises in inflation. While stock prices have been relatively immune to the increase in inflation, interest rates have skyrocketed (see Figures 4 and 5). We believe that the increase in interest rates will put a ceiling on both stock and real estate prices, which will work in relative favor of real estate. Most important, stocks have outperformed real estate largely because of the bull market in stocks, not a bear market in real estate. Even with weak realty market conditions in terms of supply and demand for space, investor demand for real estate has remained strong.

An increase in the rate of inflation, however, will not immediately generate similar high real estate returns as those earned in the late 1970s, high-inflation period. Markets are considerably more overbuilt now than they were in the mid-1970s. At that time, office vacancy rates were approximately 10%. We estimate that current vacancies in central business districts and in suburbs approximate 15% and 24%, respectively, suggesting that rents will be slow to respond to even sustained periods of high inflation for many years to come. Furthermore, property owners must wait until leases expire or rollover until they can adjust for inflation in contract rents. However, at that time they may be able to increase nominal rent.

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Figure 4. Yields on 90-Day U.S. Treasury Bills and 30-year U.S. Government Bonds, 1986-Jun 87 (Monthly Data)

In addition, we believe that because the appraisal process lags actual market conditions, the current index numbers reported by the FRC Property Index represent realty market conditions of several quarters ago. Given these fundamentals, realty returns will not likely drop from this point, whereas the future course of stock returns is uncertain.

Salomon Brothers Inc forecasts that stocks will return 5% for the remainder of 1987. If an investor believes that the stock market will decline after that, then it may be appropriate to begin making the switch from stocks to real estate. A similar argument can be made for a switch from bonds to real estate if an investor expects interest rates to continue rising. The opportunity cost of increasing the portfolio allocation to real estate from levels that are currently at the bottom of benchmark ranges for most pension plans may be low. If an investor believes that a strong bull market for stocks will continue beyond year-end 1987, then stock holdings should be maintained. Nevertheless, opportunity costs may not be extremely large if there is a subsequent correction in the stock market.
A simple “trade” illustrates the dramatic change in real estate and stock pricing. In September 1985, an investor could have sold real estate and bought stock. If the investor chose to unwind the trade in June 1987, he would now own 60% more real estate than he owned in September 1985. Even if this trade were done as late as March 1986, the investor could now own 22% more real estate. Because, both real estate and corporate stocks represent an equity claim on the U.S. economy, we would expect a long-term convergence of returns. Although it still may be too early to sell stocks and buy real estate, the terms of trade are unlikely to worsen over the longer term.

Thus, given current real estate market conditions, the potential for increasing real estate returns and rising uncertainty regarding the future course of the stock market, it is time to be more constructive about investment in real estate. Institutional investors have recently held back from new real estate investments, decreasing relative portfolio shares in the asset class to levels corresponding to the low end of allocation ranges. The opportunity cost of increasing this share may be small, although it depends on expectations concerning stock market performance in the near future.

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