Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

More Bubble Trouble?

What Investors need to know about the "Bubble" in Housing Prices

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The newspapers in the United States have been filled with stories depicting the recent rise in home prices as a "bubble" phenomenon similar to the technology stock bubble of the late '90's; the implication being that current buyers could be substantially overpaying and end up "holding the bag" when the music stops. Without getting into the debate about whether there is indeed a bubble in home prices, it is important for investors in residential real estate to determine what impact, if any, this home price bubble and its potential bursting might have on their investment returns. Before diving in, let us define what we mean by a "bubble". A bubble in asset prices is said to exist when prices are driven beyond the underlying assets' intrinsic value. Investors ignore intrinsic value and bid up prices in expectation that later investors will pay even more. (I interpret intrinsic value as the discounted value of the future stream of income/benefits that go with the asset.) Thus bubbles are created by a form of speculation that relies not on expected economic events but on expected investor behavior. This is referred to as the "greater fool" theory of investing. Such a situation is inherently unstable and must eventually unravel as the pool of "greater fools" dries up.

First let us consider the effect on apartment investments of a bubble forming in single-family home prices. Normally renters of apartments buy homes and move out of the rental market once their income and savings are sufficient to afford a home. The vacated apartments, along with new construction, are absorbed by the next generation of renters; young people who are moving out from their parents' homes or new immigrants. If home prices are bid up beyond renters' means to afford them, then the renting population will increase beyond what it would have been. This will reduce vacancy rates and increase rents in the apartment market. This is unequivocally good for owners of rental properties as it boosts cash flows and thus returns on investment.

Now consider the situation once the bubble has burst and home prices are declining. In the California housing market, a reversal in prices will usually drive down volume since owners will resist selling at prices lower than what they've recently come to expect. With fewer owners willing to sell, only those buyers willing to pay top dollar will purchase houses. Unless there is a large supply of newly built homes that must be sold, asking prices will remain too high for most buyers. Over time home owners will realize that house prices are not going back to previous levels as quickly as they thought and they will reduce the price at which they are willing to sell. At the same time, normal increases in incomes (inflation) gradually raises what buyers are able to pay for houses until sellers and buyers are in agreement on prices they are willing to transact at. This process cushions the decline in prices so that the adjustment occurs gradually over time. History suggests that it can take as long as 5 years for prices to return to intrinsic values, depending on the quantity of new homes available in a given market. During this period of adjustment, rent increases will moderate as more high-income renters are able to afford houses. Eventually rents revert back to their long-term growth rate. Effectively the bubble in housing prices causes a spillover of demand to raise rental revenues until housing prices come back down. *Owners* of rental properties thus benefit even after the bubble has burst.

What about investors buying apartments during the run up in rents? Before we analyze this I will explain some terminology. In gauging the value of real estate investments, investors look at the Net Operating Income (NOI) of a property and how it relates to the asking price. NOI is basically the current annual cash flow of a property before paying mortgage payments. If we divide NOI by the price of a property, the result is called the capitalization rate or just Cap rate. The Cap rate is the current cash return on the asset before taking account of financing. Note that the Cap rate is actually the inverse of the familiar price to earnings (P/E) ratio that investors look at when evaluating stocks (Cap rate = E/P - where NOI takes the place of earnings). Thus a low Cap rate is the equivalent of a high P/E ratio and vice-versa. In the stock market a high P/E ratio indicates an expensive stock (relative to earnings) while a low P/E indicates a cheaper stock. Likewise, in the real estate market a low Cap rate indicates an expensive property (relative to NOI) and vice-versa.

Getting back to our analysis, suppose that the investment market expects that the short-term increase in the rate of NOI growth will continue for the long-term (i.e. they don't recognize that the housing bubble is only temporarily boosting NOI growth). In this case, investors will bid up apartment prices beyond the actual growth in NOI. As a result, the cash flow returns (the Cap rate) on a new apartment investment will decline without corresponding compensation from future NOI growth. Once investors realize that growth in NOI is less than expected, Cap rates will rise. Thus property appreciation will also be reduced since increasing Cap rates will tend to offset increases in NOI in determining market value (Price = NOI/Cap rate). Thus new investors will realize lower returns than they would have otherwise (if Cap rates had stayed at historical levels).

On the other hand, investors in income properties may well anticipate the pattern of rental growth induced by the housing price bubble and value properties accordingly. The key for investors is to make their own forecasts and determine whether expected returns are adequate to compensate for the level of risk in the forecasts. In other words, investors must look to intrinsic value to guide them rather than blindly buying at whatever price is prevailing in the market.

Unfortunately a decline in capitalization rates does not necessarily imply a bubble in prices. Capitalization rates may decline for sound economic reasons such as a decline in the level of interest rates or a decline in risk in a given market. Of course, a true increase in the long term rate of cash flow growth could also lead to a decline in capitalization rates while still providing investors the same expected returns as before.

Real Estate investors must carefully evaluate the prospects for growth in NOI (cash flow) in a given market and the risks associated with their forecasts. Sound investments are always possible so long as investors carefully evaluate the reasons behind declining capitalization rates and avoid unrealistic expectations driven by the home price "bubble".

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