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Resistance levels in Real Estate

In sharp distinction to equity markets, the behaviour of yields in real estate are much less examined. There is an understanding that yield tightening results in higher values and that yield loosening results in lower capital values, and that a snap shot of the market or an asset can be captured in the snap yield of the market or of an asset. But there is less appreciation as to the patterns, movements as well as the common 'resistance' levels either in an absolute or in a relative sense.

Resistance levels refer to the normal band of capital values in which an asset will trade. Identifying and commenting on these are the lifeblood of an equity analyst but much less so of a real estate analyst. Maybe this is because trends form much more slowly or that volatility of year-to-year income has a much deeper effect on values than these broad trends. The most basic resistance level of real estate results in the yield of a real estate asset tracking the general rate of interest. Movement in interest rate will be inversely related to the capital value of an asset. There are, however, some further filters that need to be applied to this basic model. First, there is a margin that needs to applied the yield of real estate as the cost of entering, holding and exiting it is the highest of any investment class. Secondly, a margin needs to be applied to the general rate of interest as this and the cost of borrowing are not one and the same thing – indeed the cost of borrowing to real estate in itself is a distinct cost. These two elements have an important effect on the behaviour of the real estate market.

Another major resistance level in real estate is related to sunk-cost bias. Because the sunk cost of real estate transacting is the strongest of any asset class, and hope in future upswing and the uniqueness of the asset means that people can be very loathe to trade at the level indicated by the market. This has three major consequences, the first of which is when the market starts to turn it turns slowly. Secondly, once forced selling starts 'nominal' prices fall very rapidly. Thirdly, even in a falling market such as this pricing signals can be dysfunctional – in that normal owners of assets will not trade at the indicated yield levels.

A third resistance level is the intrinsic price of an asset. Very generally, a 5% flat yield means that it will take twenty years of pure income to collect a premium (not counting costs), without strong belief in the capital value appreciation it is hard to make the case for a sub-5% purchase. Twenty years, after all, is a long time to wait for profit. At the other end of the scale if there is 10% recurring income it is hard to make the case for a sale of the asset. Whatever the exact thresholds of a lower and an upper limit there is a resulting 'S' curve meaning that availability of an asset with a yield, say, under 5% to sell is quite rare and more than over, say, recurring 10% to buy is quite rare. The resulting tradable zone of investment grade real estate assets is where risk and return is measured very carefully indeed and it is actually quite a small window from which to ascertain and secure alpha.

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