OAK INVESTMENT MANAGEMENT GROUP

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Agency Theory and Real Estate

Though agents or brokers are all prevalent in real estate, 'agency theory' relates to a specific economic hazard for an investor when investing. This hazard relates to misaligned objectives of an investor to an appointee or agent endowed with carrying out their will. In principle, the wishes of a capital provider and an executor of their wishes should be straightforward and aligned. However, aligned incentives sounds easy enough in theory it is only when it comes to practice does this worthy goal become more and more elusive.

A real estate agent is paid either on the buy side or the sell side for a completed transaction. In the UK (though crucially not some other European countries) it is illegal to be paid by both sides to a transaction. Either way, an agent in real estate is not bothered (rightly or wrongly) whether the price is too high or too low. Arguably as advisors to the buyer or to the seller respectively both should argue restraint *against* a deal. A buyer's agent in particular should flag up all the risk factors as well as reasons why the price should not be so high. A seller's agent should be sure that it is the right time in the cycle to be selling and that they getting as high a price as possible.

The real world, however, does not work like that – in practice all advisors (whether professional, legal or other) will intuitively seek a deal rather than to abort a transaction. This bias is not necessarily a bad thing – it is much harder to do something than not to do something. Business people of action will tend towards eliminating the road blocks to getting something done. But where such 'will to act' does not reflect the intention or the wishes of the capital provider, that is agency theory in the classical economic sense. This is prevalent in real estate by virtue of a great deal of participants who earn their living as pure deal agents.

How is the classical economic agency problem mitigated in real estate? The first method of dealing with agency theory is to recognise that it exists. In many ways this is the most important factor to consider. If one appreciates that interests are not aligned one can adjust behaviour, actions accordingly and mitigate any pitfalls. The second method is to cultivate an appreciation that real estate is an iterative interaction that is usually embued with long termism as well as a long memory. Unwise advice can be remembered for a much longer time than other asset classes. The third is to ensure that the prime mover of executing a transaction is based on fundamentals of the deal – agents control information and that information is powerful used in the right way, but they and that knowledge should not *per se* be a driver in the deal.

The best mechanism by far to keep people aligned is to keep them accountable and ready. At Oak Investment Management we believe wholeheartedly in using the best agents in the industry – but also in challenging their assumptions, their opinions as well as their suggestions. This is how we defeat misaligned objectives. Only with this level of oversight can a team be created that makes wise and profitable investment decisions.

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