OAK INVESTMENT MANAGEMENT GROUP

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Just like agriculture, yield in real estate is the measure of what is returned in the future for the installed assessed value today. Yield is an important comparable between different assets of how future income of each asset is performing against its value today. Correctly measured, therefore, this should be the valuation of the asset today against the assumed income from the year ahead.

Usually, however, real estate agents quote simply the current income divided by the valuation of the asset – correctly labelled this is 'trailing' yield. Measuring by trailing yield is symptomatic of backward looking bias that fails to appreciate the real dynamics of how the real estate, as a financial asset, is behaving. Measuring yield should always be a forward leaning indicator, and should include the estimated income against a hard valuation (rather than *vice versa*).

In practical terms, yield is important because it is the basic measure through which an investor can ascertain the supportable level of borrowing and hence the equity requirement for a real estate project. Generally, the discrepancy between a new and easily accessible financing facility level on the one hand and yield on the other hand will determine whether money is going into, or coming out of real estate as an asset class. Specifically, all other things being equal, a low yield in comparison to the rate of borrowing will require more equity funding and a high yield in comparison to the rate of borrowing will require less equity funding. In the former case, capital value is more important in the latter case, income value is more important to the estimation of overall value.

Of course, these generalisations can be counteracted by lending criteria that can change or can target specific sectors depending on exogenous (to real estate) factors. However, marginal changes to lending which is a non-fundamental impetus to real estate cannot last forever. At the end of such a period yields (and lending) will return to or below fundamental and sustainable values.

Yield being a percentage is an inverse exponential curve. This means that the relationship between income and capital value becomes more and more skewed the higher or the lower the yield value is. So, all other factors being equal, at a very low yield capital value is the real driver of value (the asset is likely to be very prime or to have a great deal of development value), at a very high yield income is a real driver of value (the asset is likely to be secondary or a lease length that may impair the future certainty of this yield profile). At the extreme ends of the scale, the overall value is very sensitive to yield or income movements.

General yield compression is the hope that the general market is willing to pay more for an asset over time. This is an erroneous assumption and a very dangerous investment philosophy. It only 'seems' to work when there is expansion in the overall money market. Equally erroneous is to allocate according to the average trailing yield in sub-sectors as this expresses the historical not the forward looking risk associated with each to date. Like asset allocation models, following this sort of average, immediately re-calibrating to the out-performance or under-performance of one sector, always underperforms. Yield is shorthand not a substitute for understanding a financial asset.

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