NCREIF Palm Beach

The following is the text of Bill Miller's presentation at **NCREIF**'s (**National Council of Real Estate Investment Fiduciaries**) Annual Conference in Palm Beach, Florida. Panel Members were:

- **Bill Miller** (**Appraisal Research Counselors, Ltd.**)
- **Dennis Duffy** (**Ratcliffe, Cali, Duffy, Hughes & Company**)
- **Mike Sorich** (**Integra Realty Resources**)
- **Gary Hale** (**Realty Services International, Inc.**)

Click here for a summary of **Real Estate Links** from the panel presentation.

Prophesying, Prevaricating or Posturing,
Appraisers Look into Their Crystal Balls to Answer the Ultimate Real Estate Question,
NCREIF Valuation Committee — Palm Beach, Florida, October 19, 2000

A favorite sci-fi book is **The Foundation Trilogy** by *Isaac Asimov*. The central thesis was that the future of nations, worlds and galaxies could be predicted with astonishing accuracy. Big moving things have a lot of inertia. Just eyeball the path. The models of the future could even extrapolate from the large to the small. There was absolute certainty – well, almost. An avalanche of change always begins somewhere, with someone, sometime.

Economy is an aggregate of little things

The economy is a big moving thing.   We think we can extrapolate its path. Perhaps we can. But the economy is not "a big thing" - it is an aggregate of "little things." If you drop a pebble in front of a ball, the pebble is pushed aside. If you drop a pebble in front of a ball of moving pebbles, a bunch of pebbles change course.

While we study the economy's path, the question we really want answered is what's the address of the property that's going to win – that's the one we want to own.

Real estate is a little thing. Your property is really little.

Long-term investors will often follow a simple strategy of picking an industry with a probability of winning and then picking a small number of stocks with the best probability of win, place or show. Even if the economy tanks, if they get the industry right, they might win. Even if they pick the wrong industry in the tanking economy, the winner in that industry may still do well.

We've all picked the industry – real estate. Then we pick some combination of property-type/market-location that we think will win. Then we pick the property.

In the stock market you can almost always buy shares in your pick. In real estate, the property you want to buy may not be for sale. So you buy the second, third or n^{th} choice. Now you are fully invested and fully illiquid. And your first choice comes to market!

We have a $10 trillion economy. Some of the best minds in the country can estimate what happened last quarter within about 7.5%. 2nd Quarter 2000 Advance GDP was 5.2% growth. The final was 5.6%. This like selling an office building for $100 million – and then finding out at closing that the buyer would have paid $107.5 million. Ouch.

Listen to the marketplace

The value of a generalist view is that, with thought, it can be self adjusting. Just a few years ago, who would have thought of tracking e-commerce, web traffic patterns, tech development, etc.

Today, it is the driver in some economies, but only a secondary or tertiary indicator in others.

The Five Steps to listening

1. Note that something appears out of balance.

2. Determine if the condition is perceived or real by observing related indicators. Maybe the data is flawed.

3. Hypothesize about what will happen next - will it continue out of balance, worsen or stabilize at what may become a new pattern? Why? What will cause of the next effect?

4. Observe, test and continually reassess.

5. Continually reinvent the process to make sure the facts are fresh and relevant. Tracking iron ore shipments today is not too relevant. It once was. Tracking technology shipments is.

Models are useful but reality is better.

We use national economic *estimates* like GDP growth *last quarter* to project rents and values ten-years out. Out-of-the-gate, the error rate is 7.5%. This is like trying to digitally enhance a low resolution satellite photograph of your property. You see the clarity by standing next to the property with a high resolution camera.

MLS databases are continuous-sampled economic censuses. It's factual. It's local. HMDA (Home Mortgage Disclosure Act) data has the potential to marry sales to loans to income to household occupancy. This is the future of state-of-the art fact-aggregation data. In essence, it's national raw data in a high-resolution format. The need for digital enhancement is diminishing.

Do you hear a developer or the market?

In the late 1980's, developer's wanted to either talk about themselves or their product – and why it was "the best." In most markets today, the emphasis is on the changing landscape, how there is a need to be fulfilled. This isn't puffery. It can be verified through research. The "bottom-up" aggregation of opinions from people in the market 24/7/365, verified as reasonable via research, is far better than a "top-down" analysis of macro economics – that can be misapplied to many micro-markets.

Get the facts. Study the facts. Act on the facts.

When we use models, we often get lost in the forest by placing assumptions and facts on the same plateau. Facts have high confidence levels. Assumptions usually don't. The more you can build-up from the marketplace of facts, the better.

A client wanted to build a major residential development on the Southside – thousands of units. They could see the writing on the wall – a lot of land, cheap, close to the CBD and attitudes were changing. But the top down studies they had gave them absolutely no assurances. We suggested studying the half-dozen urban-pioneers who were building a few homes a year. Each survived –by listening to their customers.   The mystery of features, what price points would work and what wouldn't work, became apparent.   Of course, macro forces could still sink the deal. Those same forces often sink the "no-brainer" deals too.

What is the error rate?

Walton Street in Chicago's Gold Coast. 3,785 households in 1990. Vendor A shrinks the market to 3,008 in 2003, with an average income growing 2.6%/yr to $189,703.   Vendor B grows the market to 5,352 in 2004, with an average income growing 5.6% to $247,107. Wrong and

Wrong.

Fact - nothing torn down, Growth will be 315 units by 2003. Prices increasing north of 10% per year. An easy guess that buyers today have a lot more income than buyers five years ago. By the way, the vendors were two divisions of the same company!

Calibrate your assumptions with facts.

Use what you know. Fill in only what you don't know.

Find the center, search for the edges.

Find what's relevant first

A change or trend in a specific indicator like housing starts is interesting, but it becomes most reliable when there is also a related pattern of price changes, layoffs, migration, etc. As each market is specific, the related "relevant indicator" may also differ. Housing starts may diminish because of layoffs. Or, it may be due to a halt in inflow migration. Each market requires local knowledge of what data is pertinent.

Figure out what it's not.

Have you ever gotten those really wacky numbers that you know are wrong? Then you know what it's not! Every analysis starts with infinite possibilities. Finding the floor and ceiling is a huge accomplishment. Macro data may not tell us what is, but it can be very good at telling us what is not.

Combine top-down, bottom-up, supply, and demand methodology to find the sweet spot.

If the **Top down** analysis says a range of $1.1 – $1.5 million, the **Bottom up** analysis says $1.3 – $1.7 million, the **Supply** analysis says $1.2 – $1.6 million and the **Demand** analysis says $1.4 – $1.9 million, then each method indicates a spread of more than 30%.

But, the *sweet spot* is 1.4 to 1.5 – a range of 7.5%. What's the real chance it will be outside of this range? If you can approach a problem from ten sides – all the better!

Markets recover to equilibrium

Mark Zandi with RFA (now economy.com) spoke to us a few years ago. He said *"future economic growth is constrained by labor supply."* Their economic estimates were extrapolated based on this fact. This fact however, required market intervention. On October 3rd, the Senate passed legislation to raise H1b immigration quotas, set to decline to 65,000 in F2002, to 195,000. It passed 96-1.

Fact – the supply demand balance was way out of kilter. The US economy was threatened – some said by as much as 100 basis points of growth. The market tension said a solution had to occur. The market didn't know when, but something had to give. It did with a 96-1 vote. The question now is how much tension was released?

Where's the tension

Markets change when tension exceeds the constraint. It's like an earthquake. Pressure builds over the years, a quake occurs and the market landscape is changed. Big changes are not likely if there is only a little tension. Young analysts sometimes end highest and best use analyses with the conclusion that every site should be developed with a 100-story building. Market tension says that perhaps one will be built. One of the U.S. economy's chief constraints was labor supply. We just had a tremor.

One of the best specific indicators for real estate is volume. It is the balance of supply and demand. Are too many properties listed? Did a record number sell last year? How much money is available to purchase (debt and equity)? Who are the buyers? Are they tense?

What race are you running?

Benchmark your peer group. If your investment is running the marathon, don't worry about the 100-yard dash participants. They are expected to be fast. Then they rest.

© 2000 **A**ppraisal **R**esearch **C**ounselors, Ltd. ~ *October 24, 2000* ~ wmiller@appraisalresearch.com