Investing into Residential Real Estate in Lithuania - Value Drivers and Risks for Individual Investors

Dr. Ieva Augutytė-Kvedaravičienė
ISM University of Management and Economics
Abstract

• Real estate investments become more and more popular form of investing in Lithuania. Prime reasons for this are relatively cheap financing, growing income of residents and growing economy in general. Investments into residential real estate represent the most popular type of real estate investment among individual investors. When buying a residential unit with the purpose of value appreciation and income generation, individual investors often overlook major value drivers for real estate investments in a long run. Overconfidence, normalcy bias, expectation bias, bandwagon effect and other cognitive biases in decision making may lead to overvaluation of particular investment, general growth of demand and, finally, prices of real estate. The paper discusses major value drivers of residential real estate and major risks when investing into residential property, with special attention to low financial literacy of market participants, major cognitive decision making biases and limited knowledge how real estate market operates in general.
What is investment? What are the reasons to invest?

- Investment involves the sacrifice of current consumption for future benefits.

- The ultimate goal of investor is the maximization of the investment for a given amount of risk.

- Income maximization
- Value appreciation
- Hedge of inflation
- Minimization of rental expenses
Why real estate is unique investment object?

- Immobility / portability
- Uniqueness / homogeneity
- Constant management / no management needed
- Impact of minor shareholder / minor investors can not affect quality
- Expensive, not clear process to determine the price / simple price mechanism
- Low liquidity / high liquidity to agreed price
- High / low transaction costs
- Sensitive to state regulation / no special regulation
- Special taxes / no special taxes
- Physical existence / loses value if eminent does not meet obligations
Decision-making biases when investing into RE

• **Confirmation bias** – tendency to listen only to information that confirms our preconceptions.

• **Availability heuristic** – people overestimate the importance of information that is available to them.

• **Bandwagon effect** – the probability of one person adopting a belief increases based on the number of people who hold that belief, this a powerful form of groupthink.

• **Normalcy bias** – the refusal to plan for or react to a disaster which has never happened before.

• **Overconfidence**

• **Recency bias** – the tendency to weigh the latest information more heavily than older data.
Decision-making biases when investing into RE

• **Selective perception** – allowing our expectations to influence how we perceive the world.
• **Ostrich effect** – decision to ignore dangerous or negative information.
• **Outcome bias** – the tendency to judge a decision by the eventual outcome instead of based on quality of the decision at the time it was made.
• **Choice-supportive bias** – the tendency to remember one’s choices as better than they actually were.
• **Experimenter’s bias** – the tendency for experimenters to believe, certify and publish data that agree with their expectations for the outcome of an experiment, and to disbelieve, discard and downgrade the corresponding weightings for data that appear to conflict with those expectations.
• **Illusion of control** – the tendency to believe that one can control or at least influence outcomes that they clearly cannot.
Common errors in analysing RE markets

• Not clear investment goal
• Unspecified research direction
• Statistics without explanation
• Misspecification of supply and demand
• Failure to correlate supply and demand
• Inattention to economic indicators
• Ommition of primary data
Value drivers

• Socio-demographic factors
• Economic factors
• Property related factors
What are major factors investing into RE?

- Demographic and social indicators
- Income level, credit market
- Supply factors
- Trends in economics and real estate cycle phase

- Micro factors related to the property itself: location trends, physical characteristics of the property, net operating income, brake-even point, debt-coverage ratio, fixed costs related to the property...

- Personal biases affecting our decisions
Thank you

Ieva Augutytė-Kvedaravičienė

ieva.kvedaraviciene@ism.lt