• Theme O: Real Estate Finance & Investment
  
  Session: O-3
  
  Time: FRIDAY, 26.JUN.2015 09:00-10:30
  
  Location: Taskisla Room 109

• Has anyone seen my neo-cortex? I’m sure I left it here somewhere.

• Behavioural biases among real estate investment decision makers
- Consider these in the context of real estate investment markets

- Suggest ways to reduce the possible impact of this behaviour

Q&A to follow
A framework for understanding our biases

Thinking *Fast*: System 1
- Quick, automatic, intuitive and emotional.
- Default option for information processing.

Examples:
- Detecting hostility in someone’s voice.
- Judging which object is more distant

Thinking *Slow*: System 2
- Slow, conscious, more deductive and logical.
- Deliberate effort required means we often defer to System 1.

Examples:
- Parking in a narrow space.
- Multiplying several numbers.

Understanding the decisions we make
Knowing how our brains work might make us better investors

Investors are prone to a range of systematic errors and psychological biases.

These decision-making errors help to create inefficiencies in financial markets.

They also help to explain irrational booms and busts like property crashes.

Human psychology can have a big impact on investing.

We make ‘cognitive’ errors on a routine basis by using rules of thumb and oversimplifications.
### Examples of biases

<table>
<thead>
<tr>
<th>Self-deception</th>
<th>Simplification</th>
<th>Social</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Confirmation bias</td>
<td>and nudging</td>
<td>- Herding</td>
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<tr>
<td>- Hindsight bias</td>
<td></td>
<td>- Priming</td>
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<td>- Narrative fallacy</td>
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<tr>
<td>- Overconfidence</td>
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<td>- Cognitive dissonance</td>
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<td>- Information overload</td>
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<td>- Illusion of knowledge</td>
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<td>- Hyperbolic discounting</td>
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*Let’s focus on FIVE key biases and how we can address them*
ANCHORING
Clinging to an irrelevant piece of information such as a number

SUBSTITUTION
If a hard question cannot be answered quickly, an easier related one is found

FRAMING
Considering issues based on how they are formulated (framed)

LOSS AVERSION
Responding more strongly to losses than to gains

HERDING
Doing what everyone else seems to be doing
• Local real estate agents were taken to a house and asked to appraise it
• Each group of agents was given the same information packet about the house
• Just one key difference - different groups were given different asking prices
• Most participants stated that asking price should be irrelevant
• Appraised values were positively related to the anchor, the asking price

<table>
<thead>
<tr>
<th>Apparent Listing Price</th>
<th>Appraised Value</th>
<th>Recommended Selling Price</th>
<th>Reasonable Purchase Price</th>
<th>Lowest Offer</th>
</tr>
</thead>
<tbody>
<tr>
<td>$119,900</td>
<td>$114,204</td>
<td>$117,745</td>
<td>$111,454</td>
<td>$111,136</td>
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<tr>
<td>$129,900</td>
<td>$126,772</td>
<td>$127,836</td>
<td>$123,209</td>
<td>$122,254</td>
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<tr>
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<td>$125,041</td>
<td>$128,530</td>
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<tr>
<td>$149,900</td>
<td>$128,754</td>
<td>$130,981</td>
<td>$127,318</td>
<td>$123,818</td>
</tr>
</tbody>
</table>
Example of a hard question

- What is the true nature of this real estate investment?

Easier related questions

- Which familiar asset class does it resemble?
- How did this property fund perform against its peers recently?

Can lead to misunderstandings about nature of real estate

- It’s all about capital values
- Real estate is broadly the same everywhere
- You can buy the market, just like with equity
- Good asset allocation is all that matters
Framing: “data shape” determines our approach

Why aggregate performance data by geography & sector?
FRAMING
Considering issues based on how they are formulated (framed)

Market participants view decisions through the lens of industry norms

Data made available shapes how we perceive risk and return

Consistently use familiar but unhelpful frames of reference with which to position the asset class:

1. Focus on sectors
2. Focus on geographies

“It’s kind of amazing what is not measured” – Robert Shiller

Market participants view decisions through the lens of their own career risk and social standing

1. Focus on avoiding relative under-performance
2. Hugging the peer group (managers) or colleagues (investment committees)

“...it is better for reputation to fail conventionally than to succeed unconventionally” – JM Keynes
LOSS AVERSION
Responding more strongly to losses than to gains

![Chart showing U.S. Commercial Property Prices: Relative Magnitude of Loss/Gain Pricing Effect on Price Levels (3-regime model). The chart indicates the cyclical nature of the pricing strategy of "losers" and "gainers" during the property market cycle of 2001-09.](chart.png)
Loss aversion – US findings

- Loss aversion exists in the commercial property market
- Of similar magnitude and impact as in the housing market
- Greater among larger institutions such as funds and REITs
- Behaviour carries through to:
  - Higher transaction prices (on average)
  - Longer time on the market
- The effect of loss aversion behavior varied over cycle
  - Increasing in the early stage of the peak and turning point
  - Collapsing as demand side weakness became apparent
Or why some investors sell at exactly the wrong time
Or why some investors sell at exactly the wrong time

There is some evidence that investors use a rule of three to dealing with losses:

Strike 1: They are prepared to ride out the first correction in the market.

Strike 2: They are pained by the second correction but hold on.

Strike 3: Finally, they capitulate after the third wave of selling pressure.

The irony is that property markets often correct in three downward waves, meaning investors sell at the bottom.
in real estate markets can push up the values of certain assets or sectors to extreme levels, causing bubbles.

Largely on the basis of attractive capital returns (see Anchoring)

Following the crowd can mean **buying when prices are high**

long lease strategies...Spain?

Source: FIL Limited, IPD Ireland Quarterly Index March 2015
- We have looked at five cognitive biases that interfere with rational logic
- Anchoring, framing, loss aversion and substitution fall into category of simplification
- All four can be mitigated by moving to System 2
  (Herding is different)
Possible ways to mitigate the effects

- **ANCHORING**
  Clinging to an irrelevant piece of information such as a number

- **Model income and capital values separately**

- **FRAMING**
  Considering issues based on how they are formulated (framed)

- **Ask yourself: who has shaped the question this way?**

- **HERDING**
  Doing what everyone else seems to be doing

- **Buy investments when they are lowly valued versus history**

- **LOSS AVERSION**
  Responding more strongly to losses than to gains

- **Don’t run losers to avoid ‘taking a loss’ - run the winners, cut the losers**

- **SUBSTITUTION**
  If a hard question cannot be answered quickly, an easier related one is found

- **Convert the question to a calculation, to activate System 2**
Moving from System 1 to System 2

1. Run MVO exercises, treating income returns and capital returns as separate asset classes.
2. When assessing risk-return ratios, use the coefficient of variation (risk per unit of return).
3. Estimate future cashflows, with particular emphasis on lease events.
4. List in writing the pros and cons of each choice.
5. Ignore sector and geographic data formulations ("frames").
The road towards better decisions -
ten tips for the real estate investor

1. I will forget the price I paid for an investment, to mitigate emotional anchors
2. I will analyse the income component of total return with particular attention
3. I will focus on expected returns, largely ignoring sector and geographic labels
4. I will not be seduced by top down asset allocation
5. I will strive to reduce my need for social validation, which encourages herding
6. I believe that most references to risk are really references to emotion
7. I believe that widening yields represent an opportunity rather than a risk
8. I will strive to eliminate my myopic loss aversion
9. I will resist the temptation to replace hard questions with easy ones
10. I will consistently pursue a focused asset selection (not allocation) strategy
Sources

Thinking, Fast and Slow by Daniel Kahneman

Loss Aversion and Anchoring in Commercial Real Estate Pricing by Bokhari and Geltner

Driving Emotions from your Investment Process by Tom Howard