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What Does "Coming Of Age" Mean?

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The title of the lead article in our second Special Real Estate Issue in 2005 was "Why Real Estate?" The title of the lead article of this third Special Real Estate Issue is "Real Estate Comes of Age." The juxtaposition of these two titles conveys a message: a lot appears to have happened in the real estate area since 2005. Seeking some perspective on this message, I turned to a presentation I made on the subject in 1992. The occasion was a conference sponsored by Boston-based Aldrich, Eastman & Waltch, one of the earliest managers of institutional real estate.

The theme of my presentation was "real estate as a portfolio asset," a viewpoint similar to much of the content of this Special Issue. In the course of my discussion, I identified five important differences between real estate and other portfolio assets.

The first difference, and to me the most important, was what I termed kickability: "You can't kick your one-millionth share of General Motors or your one-trillionth of the national debt or the ounces of copper you have promised to deliver this coming January. But you surely can walk up to your real estate investment and give it a good hard kick—and most of us would like to do precisely that at this moment. The acquisition of kickable assets is a lot more difficult to reverse than the purchase of financial assets."

Second, real estate is "an enormously pervasive asset—ubiquitous—an asset class in which each individual piece has more specific risk and less systematic risk than the individual pieces of the stock market. Thus, a portfolio of properties can provide good diversification with many fewer positions than we commonly see in a portfolio of financial investments."

Third, the transaction process with real estate is much more complex than with financial assets: "You don't just call your friendly broker and tell him to buy you the World Trade Center or even the clapboard house on the direct road. Even the most prudent of portfolio managers typically give a lot more time and attention to the purchase or sale of their homes than they give to the purchase or sale of millions of dollars of General Electric and Genentech in their clients' portfolios."

Fourth, "When you buy a share of stock, you own a share of stock; its marketability masks the reality that you are an owner of the company. When you buy a bond, you own a bond; its marketability masks the reality that you are a creditor of the company. When you buy a piece of real estate, you own the real estate."

Fifth, with real estate, "management of the underlying asset goes along with ownership. Unlike the investor in a millionth share of General Motors, real estate investors enjoy some control over the performance of the asset they own."

Real estate may not have "come of age" in 1992, but it was clearly well beyond adolescence. Its basic character was fully developed. It is still kickable, it is still pervasive, it still requires extended negotiations to buy and sell, management still goes along with ownership, and you own the real estate when you buy it.

Then what does "coming of age" really mean? Note that I could refer to real estate as a "portfolio asset" in 1992, so that feature—although far more sophisticated today than it was then—is only a part of the whole story about coming of age. Real estate's role as a portfolio asset today is far more varied, far more significant, and far more innovative than it was fifteen years ago.

Much real estate investment today is not kickable. Marketable paper claims in a wide variety of forms have replaced kickability. In the process, this paper has opened real estate to active markets where price discovery is a benefit to homeowners as well as investors.

REITs are just the tip of the iceberg. REITs are a paper form of the old kickable asset, just a variation on the old theme of a closed-end investment trust. To a greater extent, the revolution in real estate has occurred on the liability side—the mortgage. Financial engineering is now packaging an extensive variety of debt paper, of which mortgages are only one example, into securities investors can trade instead of holding to maturity. Banks and thrifts have been transformed from create-and-hold issuers of mortgages to originators of mortgages that will soon find their way into the financial markets. The result has been a vast increase in the supply of credit, a reduction in its cost, spread of risk, and a new source of diversification for investors.

Today's headlines are full of horror stories about the financial innovations in the subprime mortgage area. This, too, shall pass. The ultimate achievement of these innovations over time will be to make the financial burden of home ownership lower as the huge increase in marketability of mortgages reduces the interest burden the homeowner will have to assume. This same process, which started with home mortgages, has now also migrated to the income-earning lending market. Thus, the coming of age of real estate for investors will become part of the miracle of markets, where assets and liabilities are priced more efficiently and trading provides investors with information about the asset that was formerly hidden.

The only qualification to those distinguishing features has developed from the introduction of the REIT, which gives real estate many of the features of common stock. But the REIT sector is modest relative to total real estate assets.

The attribute of real estate receiving most emphasis in this Special Issue—and the attribute I failed to mention in 1992—is the integration of real estate into the capital markets. Does that development demonstrate real estate has now come of age?

The answer to this question is positive if we are talking about real property. If, on the other hand, the portfolio asset is paper—a claim—rather than a real asset, the resulting loss of kickability changes the asset's fundamental character. This transformation is most important when the asset in question is a play on the liability side rather than the asset side of real estate. Recent experience with subprime mortgages suggests a reversion to childhood behavior rather than coming of age. But, if "coming of age" also implies coming into one's inheritance—including the "grown-up" world of the capital markets—then real estate must stand ready to take on all the rights and responsibilities of adulthood. Lost innocence does not prevent the need for swift market discipline from time to time. But, it may reduce the charming (or not) kickability factor that endeared us to real estate in the early days.