Homer Hoyt Institute

Capital Market Research Project

Interim Report

April 2003

AN INTERIM REPORT ON THE REAL ESTATE CAPITAL FLOWS RESEARCH PROGRAM

The purpose of the Homer Hoyt Institute's Capital Flows Research Program is to identify and quantify the sources and cost of funds available for real estate investment during various phases of the economic cycle. This study is part of HHI's continuing effort to gain a better understanding of the system and in order to help improve the quality of decisions. The program addresses the long-term problem that the real estate industry experiences with over and under supplies of capital as the economic environment changes. These changes in the flows of funds have, at times, exacerbated space market imbalances, leading to overbuilding and extreme price volatility. At other times, the changes have led to a devastating shortage of funds. During the real estate debacle of the late 1980s and early 1990s, properties lost approximately 30% of their values on average, while many properties suffered losses of 50% or more. Through research, we can get gather data that will contribute to better results for those who participate in the process and for society as a whole.

Phase One of the capital markets flow of funds program include sponsored research that focused on three projects designed to provide a common base for ensuing studies. These included:

- A review of the literature providing a report on the state of the art in related research.
- Development of a conceptual framework as the context for ensuing research.
- Development of a database of data sources for flow of funds research.

The first phase also included an initial collaborative research project involving teams of industry representatives and academics. That project, a study titled "The Dynamics of REIT Capital Flows and Returns," is in the first of the five areas selected for research support: the public equity sector of the "four quadrant" classification. Research support will continue in that sector in Phase Two of the program. The publicly traded debt sector may be added, depending on the availability of support.

Domestic

Public Equity	Public Debt
Private Equity	Private Debt

International

The officers of the Homer Hoyt Institute are:

Dr. Maury Seldin, Chairman
Dr. Ronald L. Racster, President and Treasurer
Dr. Ron M. Donohue, Executive Vice President
Dr. Halbert C. Smith, Secretary and Chairman of the Hoyt Fellows

Phase One of the Real Estate Capital Flows Research Project

The Literature Review

The review of the literature by Jim Clayton providing a report on the state of the art in related research in a project titled, "Capital Flows and Asset Values: A Review of the Literature and Exploratory Investigation in a Real Estate Context," has an abstract that follows:

> "This paper reviews the existing general finance literature on capital/investor flows and asset pricing with specific emphasis on the implications of the findings for real estate. The paper reviews the key elements of important papers within a framework that carefully synthesizes and ties together the main findings and real estate implications for both private and public market valuations. The papers surveyed here examine the linkages between flows & returns as well as measures of sentiment and deviations of price from fundamental value and differ in their asset market focus (domestic equities, international equities, closed-end fund, foreign exchange), frequency of data (monthly and daily) and time periods covered. Based on the review and synthesis of results the conclusion reached here is that at most times there is not a direct causal link between flows and returns (or asset values); they simply respond to the same fundamental economic news and provide a barometer of market liquidity. However, in certain "extreme" environments capital flows are related to mispricing of assets that is related to the interaction of uninformed traders and limited arbitrage. This is quite consistent across different asset markets."

The paper is organized under the following major headings:

- Introduction and Background
- Flows and Asset Values: The Issues and Theoretical Consideration
- Does Uninformed Demand Affect Stock Prices? Studies of the Price Pressure Effect
- Flows, Sentiment and Deviations in Price from Fundamental Value

Additionally, the literature is reported in a series of tables organized as follows:

- Table 1. Studies of the Link Between Fund Flows and Stock Returns
- Table 2. Studies of the Link Between Order/Investor Flows and Exchange Rate Dynamics
- Table 3. Studies of the Link Between Trading Activity, Liquidity and Stock Returns
- Table 4. Studies Directly Relating Investor Sentiment Proxies to Asset Pricing

Studies are summarized as follows:

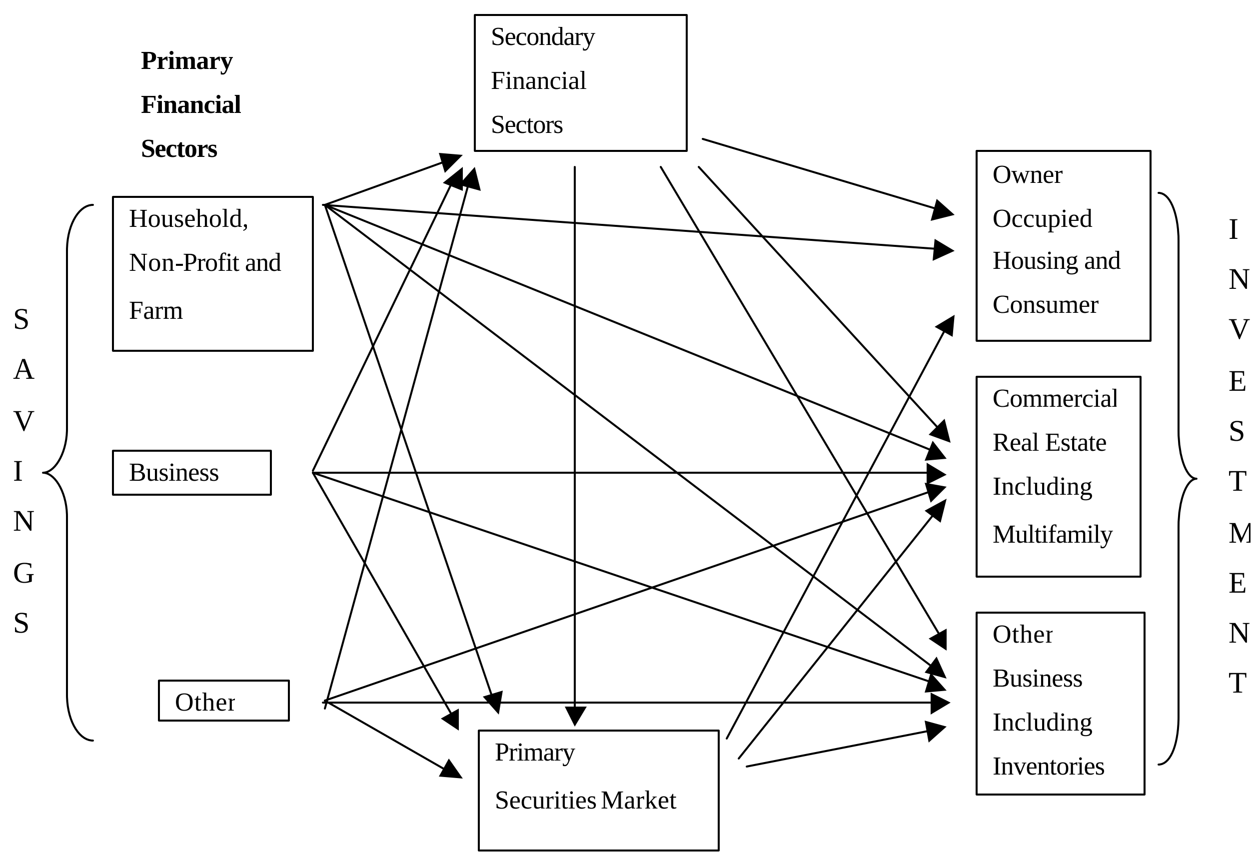
- Authors
- Title/Source
- Aim/Motivation
- Time Period/Data
- Method/Approach
- Main Findings

A Framework for Analyzing the Flow of Funds into Real Estate

Overview. A framework for a flow of funds analysis in the Hendershott-Donohue project is shown as Figure 1. Figure 1 can be thought of as a pipe system with water flowing in on the left and out on the right. The left represents saving in the economy and the right represents investment in real (non-financial) capital. As measured, these saving and non-financial investment flows are equal. Each of these flows consists of a number of component parts, which we will consider momentarily.

In some cases, saving flows directly into non-financial investment. For example, households can channel funds directly into houses, and businesses can put retained earnings directly into plant and equipment (other structures and other business, respectively). However, most saving first flows into primary securities (stocks and bonds, broadly defined) and secondary securities (debt of financial intermediaries), and then into non-financial investment. For simplicity, Figure 1 contains a single primary security market and only one financial intermediary class. Thus saving flows either directly into non-financial investment, into primary securities, or into financial intermediaries. Funds going into financial intermediaries flow into either non-financial investment or into primary securities. In the end, all the saving channeled into primary securities finances non-financial investment, and all saving channeled through intermediaries finances non-financial investment.

Figure 1
Flow of Funds



We know that different sectors save for different reasons. We are interested in the funds flowing into one component of investment, namely, commercial real estate. Therefore, we partition total saving into household or personal, business, and government plus foreign (henceforth called "other"). We consider three kinds of non-financial investment – owner-occupied housing (and consumer durables), commercial real estate, and other business (industrial plant and equipment and changes in inventories). Commercial real estate is defined broadly to include multifamily housing.

We also know that numerous different financial intermediaries exist – banks, thrifts, REITs, insurance companies, etc. – and that these have different proclivities to invest in commercial real estate either directly or indirectly.

So, what determines the flow of funds into commercial real estate? We begin by concentrating on the composition or distribution of non-financial investment among owner-occupied housing, commercial real estate, and other business investment. Possibly the most important determinant is tax law. A second important determinant of the composition of non-financial investment is the perceived risk of the different types of investment. The last factor of relevance is the total supply of savings – the size of the inflow on the left. Various government actions affect private (household and business) saving, foreign saving, and government saving itself.

Some Measurement Issues: Attempting to document the impact of these factors on actual flows of funds to real estate is a formidable task. The main difficulty is that other factors are likely to be far more important. To illustrate, let us say that someone wished to identify the impact of home mortgage securitization on housing. One would, in effect, need to come up with an estimate of what the increase in the housing stock would have been in the absence of securitization and then obtain the securitization impact by subtraction. This would entail accounting for demographic changes over time, as well as changes in real income, in household marginal tax rates, etc.

And what about the impact of the REIT tax-exemption status? One would need estimates of the impact on the REIT industry's share of savings and of how much the increase in this share fuelled commercial real estate investment, since most of the increase likely just replaced investment that would otherwise have been financed by some other sector.

The impact of changes in tax depreciation allowances should be a simpler matter because all one needs to know is how the tax depreciation affected the user cost for investment and how investment responds to such changes. (In fact, however, the steep recession of 1982 limited the impact of more generous allowances.) Given the work on estimating business investment functions, this is relatively straightforward. This also makes the point that the further the tax/regulatory intervention is away from the end non-financial investment, the more difficult the measurement will be because we have to account for more other factors.

This project and the next two projects are supported by the Homer Hoyt Institute and supplemented by generous gifts from:

Mr. William Newman, Chairman, New Plan Excel, a Hoyt Fellow
Mr. Robert H. Gidel, Liberty Partners, a Hoyt Fellow
Dr. Joseph T. Williams, Professors Capital, a Weimer School Fellow

Data Sources for Flow of Funds Research

The "Guide to Real Estate Capital Flows Data Sources" was developed by Glenn. R. Mueller. The abstract is as follows:

> "A thorough understanding of real estate fund flows will greatly enhance the capabilities of the real estate analyst. While the need for real estate capital markets data is critical to the success of such an understanding, as yet no database specifically and exclusively tracks real estate fund flows data. The purpose of this annotated bibliography is to list the 100+ sources that exist."

<u>Introduction</u>

Financial data and capital flows are a large and growing component of the broader data reporting industry. Most aspects of publicly traded companies are tracked and stored in databases accessible to the investment professional. Unfortunately, the real estate industry has yet to develop such data sets. This annotated bibliography begins the process of listing available sources and contains descriptions, purpose, accessibility, and fees for existing real estate databases. While no specific source addresses all of the data needs of the real estate professional, when used together these sources may provide a data set that begins to compare to coverage found in public equities databases.

<u>Data Categories</u>

Nature of Asset. Capital flows data may be classified according to the nature of the asset. Typically, assets are divided into debt and equity. Another typical division is publicly traded securities and privately traded assets. The matrix created by combining these two classifications is so widely used that the consortium being formed to further the research used this quad, or four-celled, approach to group industry representatives and academics by primary focus of research interests. The data sources are keyed to these four types of capital. The key words for the types of capital are: Public Equity, Private Equity, Public Debt, and Private Debt.

These four classifications are only used for domestic flow of fund. The data on international flows is so limited that a single category for international is used. Naturally, that category includes the four-quad classification. While key word search may indicate those sources with the characteristic, no specific effort is being planned to further the data development on that basis.

Investor Specific. Investor specific categorization may be made as follows:
- Fund / Investor Size
- Planned Allocations
- Planned Acquisitions
- Planned Construction
- Capital Issues
- Capital In-flows and Out-flows.

A key word search on these phrases will identify the relevant data bases. The searches may be done in sequence within the quad classification (public equity, public debt, private equity, and private debt) or as the initial sort.

Property Specific. Property specific information is categorized at the following levels:

- Transactions – buyer, seller, price, financing
- Building Information – square feet, floors
- Lease Information – occupancy, rent, tenants, lease terms, available space
- Ownership

Comparable Sales. The database may also be searched using these property specific characteristics. This is a generic structure that may be used for a variety of purposes including, but not limited to, flow of funds projects.

Stock and Flow. Another way of looking at the data is to use a classification of stock and flow. The vision for the database is to quantify the flow of funds charts that show, for specified periods, the sources and destinations (uses) of funds, and to show holdings of the assets. These holdings represent the stock of the asset by the nature of the asset classification discussed above, i.e., the quad classification. The stock data base may also contain investor and property specific information.

The flow data shows the quantity of funds flowing during the relevant period, i.e., the time span between the two stock snap shots. The level of detail may vary by type of asset and/or by source of funds. But a series of flows, tracked over a period of time during which significant changes occurred in exogenous forces, may indicate some explanations for the paucity and surplus of funds that flow to real estate assets from time to time.

The next step in data development, which potentially is in phase three of this project, is to fill gaps in the areas of greatest concern to industry and to generate research by academics as well as industry to provide a better understanding of the system as well as to enhance the level of understanding. This process will significantly improve the quality of real estate decision making.

The entry format is shown in the accompanying box.

Publication Title:	Title of the publication.
Web Site:	Publication's website.
Publisher:	Publisher of publication
Format:	Format of publication. Typically this is a database, newsletter, or magazine.
Types of capital:	Types of capital covered by the publication. This is usually a combination of public equity, private equity, public debt, and private debt.
Categories of Data:	Equity or debt.
Capital Flows Data:	Information in the publication that specifically covers fund flows in the real estate capital markets.
Other Data:	Other data covered by the publication that may be useful to the real estate professional.
Frequency:	Frequency of publication for a newsletter or magazine. Frequency of updates for a website or database.
Cost:	Cost of publication denoted in US dollars. Time period of subscription can also be found here.
Link to Data Sample:	URL to any data or articles published by the source that may be available free of charge.

An Invitation to Participate

The research projects described in Phase One have initiated a Real Estate Capital Flows Research Program that was conceptualized at a symposium cosponsored by HHI with a grant to the Johns Hopkins Center for Capital Market Research. The symposium was held at Johns Hopkins University's Washington, D.C., center in December 2000.

The mission of the program is to improve the quality of real estate decision making through the collection, creation, and dissemination of real estate capital flows data and analysis. The real estate capital flows research program will operate primarily through a website that will contain downloadable data and other publications, as well as directions to other sources, some of which may be proprietary. Research projects, such as those described in this interim report, also will be put on the website.

The symposium roundtable in Washington, D.C., reached a new level in this groundbreaking effort through a new organizational structure involving a coalition of industry leaders and academicians. Five capital market areas of interest were identified: Public Equity; Public Debt; Private Equity; Private Debt; and International Capital Flows. The symposium participants decided to proceed with a World Wide Web-based consortium of all interested parties.

The Homer Hoyt Institute is moving forward with this initiative, and is actively seeking new participants to support and assist in the development and execution of a comprehensive research agenda. Leading academic researchers are being asked to submit proposals for projects that will fit within the general scheme of the overall research concept. Leading practitioners are being asked to identify critical research areas, lend their expertise, and provide support.

The Homer Hoyt Institute is committed to seeking funding for relevant real estate capital markets research. Donors may indicate the area of research of greatest interest. Donor participation in research design, provision of data, and determination of relevancy also is requested.

Together, we can create an understanding of the sources and flows of funds to real estate investment and their impacts on real estate markets. As results become available, they will be distributed to supporters and participants, including the Hoyt Fellows, Weimer School Fellows, real estate professionals, and other interested parties, firms, and potential researchers.

For more information about the Real Estate Capital Markets Research Program and the Homer Hoyt Institute, please visit our website at www.hoyt.org or contact:

Dr. Ron M. Donohue, Vice President, Homer Hoyt Institute
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This invitation is extended by the Directors of the Homer Hoyt Advanced Studies Institute:

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Dr. Ronald L. Racster, The Ohio State University, Emeritus
Dr. Halbert C. Smith, University of Florida, Emeritus
Dr. Jeffrey D. Fisher, Indiana University
Dr. Norman Miller, University of Cincinnati
Dr. Kerry Vandell, University of Wisconsin-Madison

Phase Two of the Real Estate Capital Flows Research Project

What are the institutional arrangements for the flow of funds to real estate? The first part of the answer to this question is represented by a series of flow charts. The project is an immense undertaking requiring an ongoing effort to develop the detail. Furthermore, it faces severe data problems. Our best approach is to consider the overview flow of funds diagram as a mosaic, with different parts of the diagram refined to selected levels of detail. By selecting the areas of greatest interest, and using those with acceptable data, we can refine the holistic view in order to get the most practicable relevant perspective.

A Conceptual Framework as the Context for Ensuing Research

The purpose of this presentation is to provide an overview of the theoretical framework for an ongoing research program in flow of funds. The overview starts with a series of charts that outlines a conceptual model for the flow of funds into commercial real estate (see Figures 1-6). This simplified conceptual model will be expanded upon as the research program moves forward.

> *Figure 1*: Figure 1 (page 4) has been developed in the Hendershott-Donohue project, "A Framework for Analyzing the Flow of Funds into Real Estate," previously described on pages 4 and 5).

We know from Figure 1 that there are five potential ways that funds may flow into commercial real estate, i.e., from the three primary sectors, from the secondary sectors, and through the primary security markets. To describe the characteristics of the flow of funds into commercial real estate, we need to think about the various components of the commercial real estate market. There are several different ways in which one might segment the commercial real estate market. A common method is the "Four Quadrants," which segments commercial real estate by ownership characteristics: Private Equity, Public Equity, Private Debt, and Public Debt. One might also consider adding international real estate as another sector of interest. For our purposes, we select one quadrant, Public Equity, as an example and provide a conceptual model for flows into that sector.

> *Figure 2*: An alternative method of segmenting commercial real estate is to think about the physical character of the assets, i.e., property type. Figure 2 provides a listing of the various types of commercial real estate. For our purposes, we separate commercial real estate into Core and Non-core, with Core property types being those property types where the primary business is leasing commercial space, without significant operating responsibilities. The performance of Core property types is dependent on fairly well known economic relationships that exhibit known supply-demand relationships.

For purposes of this analysis, Figure 2 identifies Office, Industrial, Retail, and Multifamily apartments as Core property types. Non-core property types include Hotels, Health Care, Net Lease Facilities, Self-storage, Specialty Retail, Recreational Facilities, Manufactured Housing Parks, and Timber and Raw Land.

Figure 2
Commercial Real Estate

CORE	NON-CORE	
Office	Hotels	Health Care
Industrial	Self Storage	Net Lease
Retail	Specialty Retail	Recreational Facilities
Multifamily	Manufactured Housing	Timber and Raw Land

Figure 3
Core Real Estate

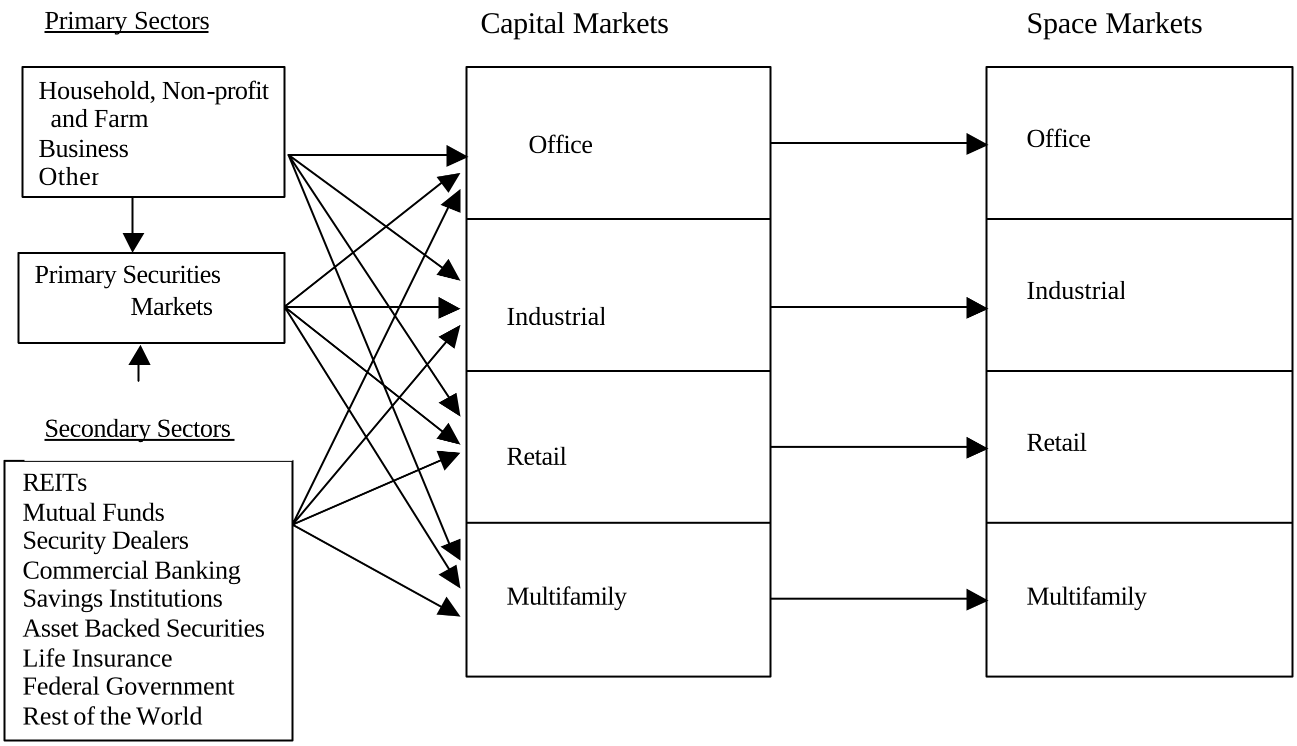


Figure 3: In describing the flow of funds into Core properties, we know that the flow comes from the three primary sectors, from the secondary sectors, and through the primary securities markets. Those funds flow into the capital market, where it is invested in existing properties and new development. Ideally, the flow of funds into any property type at any point in time is logically related to the current and expected future market conditions for that property, but that is not always the case. There is a relationship between space and capital markets, but the strength of that relationship varies substantially over time and across property types. The result is a clear notion of potential sources of flows of funds, but lack clear models that consistently explain flows.

Figure 4: To the extent that intermediaries provide flows into Core commercial real estate, they generally do so at the instruction of the primary financial sectors. The secondary financial sectors are listed in Figure 4. Unfortunately, there are no good measures of flows into specific property types through financial intermediaries. There are some aggregate measures of flows into commercial real estate in general, but no clear picture of flows into property type by financial intermediary. Over time, there are shifts in the real economic forces (population, unemployment, income, etc.) influencing property types. As a result, each property type experiences cycles. The timing and amplitude of those cycles vary substantially by property type, as well as across geographic markets. The flow of funds to these markets may not respond directly to changes in the real determinants of supply and demand. The linkage between space and capital markets is weakened, resulting in investment decisions that do not reflect fundamental supply and demand forces. This disconnect can lead to poor real estate decision making. Greater understanding of the relationships between space and capital markets may improve real estate investment and development decisions.

Figure 4
Secondary Financial Sectors
(Intermediaries)

Mutual Funds	Security Dealers	Commercial Banking, Mortgage and Finance Companies
REITs	Asset Backed Securities	Savings Institutions
Life Insurance Companies	Rest of the World	Federal Government and related

Figure 5. The decision to invest in or develop real estate involves many considerations, including the performance of other potential investments. In theory, funds should flow into real estate when it offers a superior expected risk-adjusted rate of return, and flow away from real estate when it offers an inferior risk-adjusted rate of return. As investors' perceptions of the risks associated with real estate (or other assets) change, the required rate of return changes, resulting in a change in pricing and in flows. Figure 5 outlines primary and intermediate security markets, which compete with one another for flows of funds.

Figure 5
Primary Security Markets

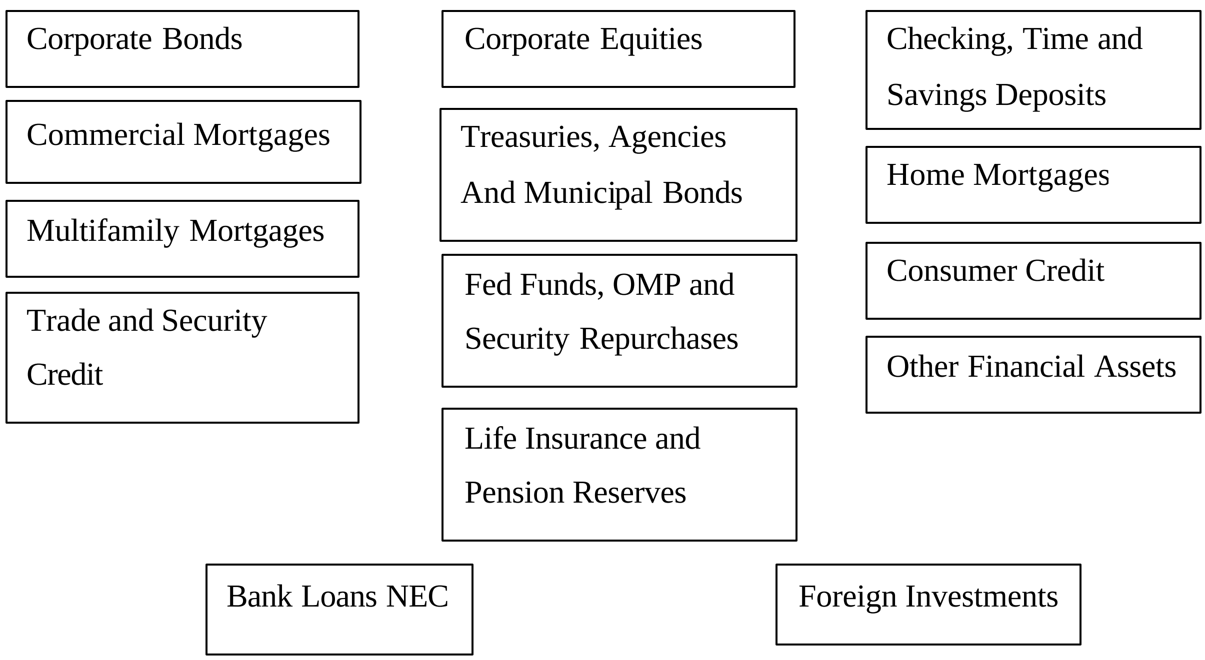
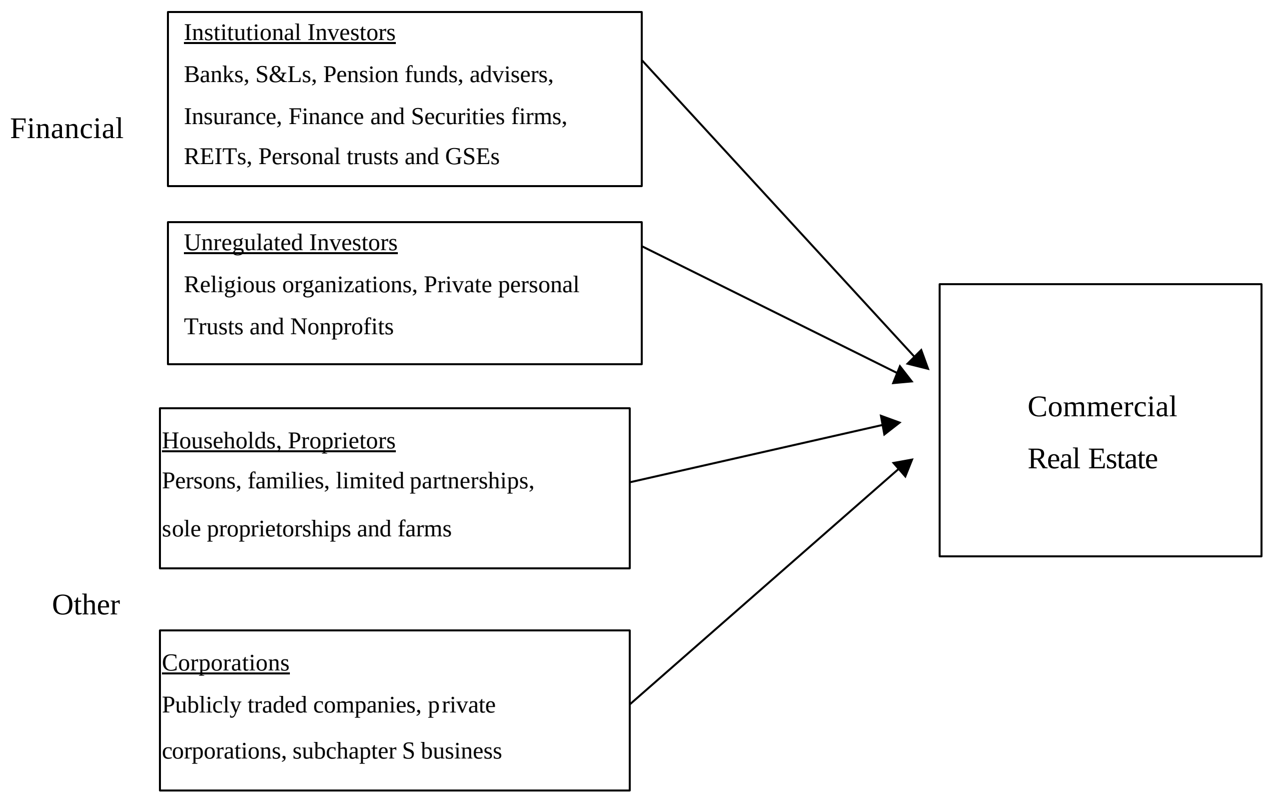


Figure 6: Real estate (in various forms) competes for fund flows. There are four major classes of investors that provide funds to commercial real estate: 1) Institutional Investors, 2) Unregulated Investors, 3) Households and Proprietors, and 4) Corporations. Figure 6 provides a breakdown of the various components of each of these major classes. We do not have good measures for how funds flow from various investors into commercial real estate. Understanding these flows would be helpful in making informed investment decisions and in avoiding some of the negative side effects that result from poor investment decisions.

As a part of Phase One funded projects, our first Phase Two project investigated the interrelationships among capital flows to the REIT sector and REIT returns. The researchers found that there is positive momentum in REIT flows, but that that momentum does not persist, and even reverses over time. The results suggest that REIT investors follow momentum strategies. This suggests that capital market flows only influence pricing on a short term basis, which varies from the perspective that some market participants use in making investment decisions.

Figure 6
Commercial Real Estate Investors



Some Ideas for Additional Projects

We have made encouraging progress in understanding general flow of funds issues and in understanding flows into a specific sector, e.g., REITs. We hope to build on this progress by sponsoring additional research in critical areas of interest. The following provides brief descriptions of two additional projects for which we are actively seeking research support. We have already started on the further development of the conceptual framework project. Additional funding would help to advance that project.

We have received a proposal for a research project examining the interrelationships and short- and long-run dynamics among capital flows to REIT mutual funds and REIT Returns. The researchers will also investigate changes in REIT holdings by non-dedicated mutual funds to determine if they explain returns on publicly traded REITs. Additionally, the proposed methodology will be used to forecast returns on publicly traded REITs.

How do the demand forces in the space markets generate an attraction of capital from the capital markets? The answer seems to be “poorly.” Because the volume of construction is typically boom and bust, it indicates that too much or too little capital flows into physical development. The research questions include:

- The impact of space availability and rents on new construction;
- Cost and availability of capital, debt and equity, for new construction; and
- Alternatives available to institutional suppliers of capital.

As a partial answer to the questions stated above, a second research proposal focuses on providing an empirical explanation of the prices for commercial real estate. The standard model of rental capitalization is augmented by incorporating a flow of funds measure – new development (square feet of new construction). New development is largely funded by banks and take-out sources of finance. It is ignored in the standard valuation model (rental rates are thought to summarize space market effects for asset price determination). Data suggest that new development predicts real estate prices, often with a substantial lag, and therefore that flow of funds is a pricing factor for commercial real estate. This research will attempt to formalize this new development-asset price relation with an empirical analysis of over 25 years of time series data from the US and Japan. In order to isolate flow of funds effects, it will incorporate variables that control for capital market and rental market dynamics. It will also examine whether diversifiable risk (risk that is specific to the real estate investor) plays a role in asset determination.

Additional questions, including alternatives available to institutional suppliers of capital, open up the next sector for analyses. This deals with forces affecting other sectors of the capital market. The research questions might include:

- The rise and fall of irrational exuberance in other sectors;
- Structural influences on the flow of funds; and
- Risk and return assessments for real estate, securitized, and direct investment.

This leads us to the decomposition of risk issues. Modern portfolio theory generally treats risk as volatility. But volatility of returns may be due to a variety of factors such as interest rate volatility, inflation rate changes, liquidity problems, as well as conventional business risk. Thus, research questions might include:

- An analysis of excess returns attributable to paucity of flow of funds;
- Cap rate arbitrage generated by misallocation of funds; and
- Applicability of behavioral finance to flow of funds to real estate.

This is just a conceptual overview. The detail needs to be developed in each of the focus areas that emerged from the symposium discussion. The five main groups identified included the four included in the matrix of public/private and debt/equity plus a fifth -- international, which incorporates all four components in one category.

We believe that these are critical areas for research where improved understanding would provide relevant information and analyses that can assist investors in making better real estate decisions. This is part of a larger effort intended to create a research renaissance. Your support is greatly appreciated. If you wish to support this or other important and relevant research, please contact Dr. Ron Donohue at the Homer Hoyt Institute, (561) 694-7621, or rdonohue@hoyt.org.

The Homer Hoyt Institute is an independent not-for-profit organization established in 1967. Since 1981 it has served as the support organization of the Homer Hoyt Advanced Studies Institute which is the home of the Weimer School of Advanced Studies in Real Estate and Land Economics. Offices are located in The Hoyt Center, 760 US Highway One, Suite 300, North Palm Beach, FL, 33408; phone: (561) 694-7621.

This project is supported in part by the Hoyt Fellows of the Homer Hoyt Institute:

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Information about the Institute and the project is on our website: www.hoyt.org.