The Irrational Residential Property Buyer

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In theory, the value of an asset, including residential property, should be closely related to the present value of the income the asset is expected to generate; now and into the future. Such income most typically comes in the form of a periodic cash flow stream and/or an expected capital appreciation. With real estate this translates to rental income and capital growth.

Economists like to point to the “rationality” of the market, which says that nobody would ever pay more for a risky asset than its risk/reward factor warrants. In general, this rule has held true for virtually all asset types, and real estate is no exception — in general.

For the institutional property buyer, purchase decisions are very disciplined and rarely deviate from narrow criteria set out at the beginning of a search. In contrast, the residential buyer will often start out with a vague idea of what he is looking for and then adjust according to what can be found on the market.

Pension funds are one of the biggest investors in real estate. And in the world of pension fund money, the actual cost of a property is virtually irrelevant as long as the income generated by that property meets a certain yield percentage. Pension funds do care about location of course. But, they don’t generally care about the color of the carpets or the color of tiles in the bathrooms. Gorgeous views and pink Italian marble are nice, but not if a cost-conscious corporation is unwilling to pay additional rent for it. In fact, the more generic, the better when if comes to commercial. That said, the view is often one of the most desirable aspects of a living space, yet one of the hardest to quantify in terms of value.

The view is one element that causes a home buyer to pay over and above what would be deemed “rational” in terms of the income such a view would generate for the investment. While a view of the castle is nice, the extra cost may not immediately translate into high rents in the current market.

The riskiness that differentiates one property from another is for the most part measured by the quality of the tenants and their creditworthiness toward covering the lease payments throughout the contract period. In the commercial real-estate market, large established multinational companies listed on a stock exchange are considered more desirable as tenants for an office property than the local Internet startup. Likewise, upper-middle-class employed families make better tenants than a pensioner or someone who is unemployed. Still, even the best residential tenants aren’t going to offer the covenant of an international company.

If real estate investment was all about rental income, then the market should demand a higher rental income yield on the investment to compensate for the greater risk that residential tenancies have by their own nature. However, this is not what we observe.

To put things into perspective, in Prague the going yields for A-class office properties with AAA tenants range around 7-8 percent, and this is net income after most costs. The yields for A-class residential properties in the more desirable areas of Prague are in the 4-7 percent range, and this is gross income *before* most costs of running the property.

The lower yield on residential property investments is in spite of the fact that most apartments are rented to individuals who don't have the credit rankings of a multinational. Why this discrepancy? Riskiness of the rental income stream isn't the explanation. Whoever would pay more for a property that attracts riskier tenants must be irrational.

In contrast to the decision-making process behind commercial acquisitions, residential property is different. There is also a different kind of competing buyer looking at residential properties for sale on the marketplace; the individual looking for that "special feeling" within their dwelling. In contrast to commercial properties where "generic" creates value, residential properties have additional value over and above their construction costs to the extent that their aesthetic qualities that appeal to making one comfortable in their own home. The Japanese garden in the atrium will rarely be the "deal maker" for an institutional buyer, but such aesthetic amenities will often serve as the core reason behind a family's decision to purchase. A pension fund asset manager who paid extra simply because he liked the Japanese garden in the atrium would be so fired his shadow would smoke.

Even though a home is a bona fide investment that should follow "rational" criteria, the "criteria" is more widely and intangibly dispersed than those laid out for the disciplined commercial or even buy-to-let investor. This is what I think makes residential properties so interesting. It's also what makes residential property valuations less volatile within business cycles.

Aspect	***Rational Institutional Buyer***	***Irrational Residential Buyer***
Investment Criteria	Highly Defined and strictly adhered to.	Loose and Vague; often adjusted during the buying process
Tenancy Risks	Low tolerance for low-grade tenants	Will often settle for anyone who pays the deposit in order to fill the property
Property Features	Generic is best	Buyers often persuaded by unique aspects of a property.
Main Investment Return Component	Rental Income	Capital Growth
Utility of Property	Functionality as a public business environment	Warmth and coziness for living and privacy