Chapter 1 Supplement: Real Estate as an Investment: Efficient and Inefficient Markets, Market Perfection, Real Estate and the Capital Markets

Marshall, a famous economics buddy from the olden times, noted that in a perfect or an efficient market, the price of a good should be close to its value. An efficient market is one in which the terms of exchange broadly reflect all relevant and publicly available information. A perfect market is one where there are no "structural" impediments to the transacting of business.

Apple's price may seem high relative to its current earnings, but investors expect earnings growth, honest management and a lack of government interference and the stock price reflects all of these factors. The stock is said to be "efficiently" priced.

I. R/E markets are much less efficient than the market for stocks and bonds.

How are R/E markets inefficient?
What market imperfections lead to these inefficiencies?
Imperfections leading to inefficiencies can be classified in at least 6 areas…

1. Information flows in R/E vs. the capital markets…

2. Government controls in R/E vs. the capital markets…

3. Transaction costs in R/E vs. the capital markets…

4. Numbers of buyers and sellers in R/E vs. the capital markets…

5. Product heterogeneity/homogeneity in R/E vs. the capital markets..

6. Product liquidity….

II. The use of strict financial models in evaluating real property is likely inappropriate as R/E violates some of the underlying assumptions of those models. The assumptions include, echoing the inefficiencies above: homogeneity of products traded, limited transaction costs and limited government interference, large number of buyers and sellers, and unobstructed information flows.

III. Are R/E markets becoming more or less efficient? Of items 1-6 in number I above, only government controls in number 2 are getting "worse." All of the other items, 1 and 3-6, are getting "better." Details in the text and in class….

IV. So, given all this, why invest in real estate? **Advantages**? Three main reasons: Use of leverage, tangible asset, pride of ownership. **Three cash flows**? Income, capital gains (hopefully) and tax shelters. **Disadvantages**? See the imperfections above, and recall especially the illiquidity of real estate and the management requirements if it is directly owned.