“Professor’s Comments”

(For the February 2009 Moody’s/REAL Index returns.)

This is a periodic commentary which will generally be posted monthly on the “RealIndices” web site, offering the perspective on the indexes of Professor David Geltner (or occasional guest commentators). Geltner was a leader of the team at MIT that developed the methodology for the Moody’s/REAL Indexes.

Notching another month in the downturn…

There was not much surprise in this month’s update of the Moody’s/REAL Index. February posted another down month, with realized transaction prices in that month down 0.63% compared to January.

While mild compared to January’s 5.5% drop, this still represents a substantial decline for a single month, and puts the realized price index now 21.5% below its October 2007 peak. This is already a bigger drop in prices than most in the industry thought, going into this downturn, would be necessary to correct the excesses of 2006-07. Indeed, it could be argued that if a 10% drop was necessary to correct for the 2006-07 froth, and another 10% drop would be necessary to reflect an economic recession, then we would be about done with the downturn in commercial property prices. But that is clearly not the case. It seems almost certain that we are still poised for major further down movement in the indexes.

In my February commentary (two months ago) I discussed the inertia in the private property market which leads one to make predictions like the one in the previous paragraph. Furthermore, at the time of that earlier commentary, we had not yet reached the bottom in general sentiment in the capital markets which occurred in early March. Only time will tell whether that proves to be “the” bottom, but as I write this in mid-April the stock market is up 25% and the NAREIT Equity REIT price index is up over 40% since early March. Keeping in mind that deals closed in February probably represent prices agreed to largely in January or even December, the February index does not yet represent prices agreed to during the February-March bottom of sentiment. And distressed sales were still only a small fraction of the deals closed in February, and will no doubt play a gradually increasing role in the transactions of the coming months.

The only bright spot in this month’s report is that the number of transactions increased in February compared to January (87 repeat-sales versus 67). But this is still a pitifully low number of transactions, below last November’s 98, and barely 25% of 2007’s average of 340 per month. Nevertheless, if January proves to be the absolute bottom in number of transactions for this downturn, then that will be the first, faint signal of the beginning of a stabilization in market values.

Transactions indexes versus the NCREIF Index in this downturn…

If there wasn’t much surprise in this month’s Moody’s/REAL report, there was some eye-opening with this month’s preliminary report by NCREIF of the ODCE Fund-level Index:

down 15.06% for the first quarter. As I write this commentary, the NPI first-quarter results are not yet available, but the ODCE preliminary report gives a pretty good indication which can be used to guess approximately what the NPI will look like. The properties in the ODCE Index are similar to the average property in the NPI, and the ODCE funds have only minimal leverage. One would expect the NPI return to be only a little less extreme than the ODCE report. This suggests that the NPI 1Q09 will be an even bigger drop than its historic fall in the fourth quarter of 2008 of 9.54% (or 8.10% by the equally-weighted cash-flow-based metric that is more comparable to the CPPI). In the traditional NPI, drops of anywhere near this magnitude never happened, especially in a quarter that was not the end-of-year close-out fourth quarter. Previously the biggest quarterly drop in the NPI was -7.01% in 4Q1991, and the previous record drop for a non-fourth quarter was -2.93% in the second quarter of 1992. Until now, the biggest absolute magnitude of any non-fourth-quarter in the NPI (positive or negative) was +3.66% in 2Q2005. This is truly unprecedented behavior in the NCREIF Index. Something has changed.

I am not on the inside of the NCREIF data-contributing membership community, so I can only speak from my perspective as a long-time analytical observer of the NPI. To me, it seems as if the fundamental structural behavior of the NPI has changed drastically during the current downturn, in particular since the summer of 2008. The nature of the change suggests to me that the traditional role and independent influence of external fee appraisers in determining the property values that are reported into the NPI has diminished significantly. My guess is that the role and influence of the investment managers and their accountants has increased. This is probably particularly true for properties held in open-end funds, but probably largely true elsewhere as well. The extreme movement in the NPI in 4Q08 and 1Q09 seems like it reflects a decision (effectively like a collective decision) to aggressively mark down property values in an attempt to catch up with the drop in the market (perhaps if necessary even to err the valuations on the low side), a marking down much faster and farther than traditional independent fee appraisal would probably have made, on average. How these new, aggressive mark-downs are being pegged, I do not know, but I suspect there is considerable influence being given to the new transactions-based indexes, as well to the REIT market and perhaps also to the NCREIF futures derivatives indicative quotes published by Markit. If my guess is right about how far the NPI will fall in 1Q09, then that index will then display nearly the same percentage drop as the Moody’s/REAL CPPI, and I can’t help doubt that would be a pure coincidence.

I am not suggesting any sort of wrong or bad behavior on the part of the NCREIF data-contributing managers or the NPI. Indeed it makes perfect sense to use indicators such as the transactions-based indexes to attempt to reflect current market values better in the property valuation reports submitted to NCREIF. Nevertheless, as a user of the NPI, I must confess to a bit of lament.

Hobgoblin or not, give me back my good-ole NPI...

The problem for users of the NPI is inconsistency. In the “good ole” NPI of before-2008, we knew the nature of its structure and behavior, and this was reasonably stable over time. There was some smoothing and lagging, yes, but we understood that and could account for it and deal with it, because it was pretty stable. At a slightly over-simplified level, if the actual real estate market was a cycling sine wave, then the NPI reproduced that sine wave with a slightly reduced amplitude and a phase-shift lag of about 3 to 4 quarters. Knowing that, we knew what the property market told us about the NPI, and what the NPI told us about the property market.

Now since 3Q2008 suddenly both the amplitude-dampening and the phase-shift seem to be gone from the NPI. But what now is governing the NPI, and how long will this new behavior last? The change in behavior occurred after the last peak, so the NPI never captured the peak of the 2007 bubble (a real peak that was really there in the market transaction prices). So the NPI is coming off of a lower peak than the transaction indexes. An equivalent percentage drop from peak in the NPI will take it lower in absolute levels than the transaction indexes. Going forward, will the NPI always smooth off the peaks but fully capture the troughs, which would give it a lower mean value than the transaction prices? Or will the NPI from now on more closely track the market transaction prices in both up and down cycles? But if so, how will it do that? Will the independent fee appraisal profession change its procedures and behavior? Or will NCREIF managers and accountants overrule independent appraisals, and if so, on what will they base their marks? In doing statistical studies and analyses using the NPI, will we have to analyze separate historical regimes corresponding to the "old NPI" and the "new NPI"?

In the movie "Last Stop Wonderland", a mis-attributed Emerson quote to the effect that: *"consistency is the hobgoblin of a small mind"* wove an amusing and central thread through the movie's plot. Maybe so, Ralph Waldo, but inconsistency in the relationship between an index and the market it tracks can play havoc with the analytical usefulness of that index. It can also be the devil for people trying to price futures contracts on that index. To me, this is yet another reason why well-constructed, statistically-based transactions price indexes, like the Moody's/REAL CPPI, provide a vital new information contribution to the commercial real estate investment industry. And none too soon, apparently.

-David Geltner, April 2009.