

Avison Young: The Disconnect Between Pricing and Fundamentals

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(blog by Avison Young's Amy Erixon re-published from Avison Young blog site)

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By Amy Erixon

The disconnect between fundamentals and pricing continues to be as much a topic of discussion as speculation when the US economic recovery will finally gain some traction.

In Canada, where the recovery is firmly established, **Q2 average earnings** (from same properties), as measured by funds from operations (FFO) for Canadian REITs fell 0.3%, while pricing for the same companies and properties touched all time peak levels. Everywhere you look outside traditional equities, from gold to treasury bills, new pricing peaks and yield troughs are being established.

This raises some important questions. Is this simply the weight of capital finding its way from equities to other sectors? Are we moving into an asset pricing bubble? And if so, what actions should be taken to get funds deployed in reasonable order?

Property, whose historic role in a multi-asset class portfolio is to provide steady income and stable value, is at present being buoyed by external factors such as record low interest rates and perception of relative price reasonableness (compared to investment alternatives of stocks, bonds, commodities, infrastructure, etc), driving yields to historic lows. In fact this week [Goldman Sachs](#) reported that the correlation of all "key assets" has reached the 96th percentile over the past two months, a level reached only four times in the past decade, (but three times in the last two years).

These are the characteristics of a market driven by emotion vs reason. It demands that we pay close attention to actual fundamentals, and understand how each asset class is being affected by these relative comparisons.

In my view, Real Estate's role in a multi-asset class portfolio is increasing in importance, which has and will continue to mean investors accepting lower returns. Everyone is losing patience with the volatility in the stock market. These relatively high valuations might in fact make now a good time to harvest gains on non-strategic property while being patient and careful in the deployment of new resources.

Withdrawal of governmental support such as quantitative easing combined with the inevitable need for refinancing of the overhang of maturing CMBS, FNMA and private mortgages over the next few years will permit the anticipated liquidity crunch to unfold. Investment opportunities in both fixed income and real estate spaces will improve during the upcoming years. But in the short term the weight of capital shifting may cause yields to decline further. Properties offer distinct tangible features which still serve to lower overall portfolio volatility relative to other asset classes; such as high replacement value, market barriers to entry, distinctive claim on earnings (behind taxes, ahead of other creditors), and long duration predictable cash flow characteristics. This is even true for properties located in currently overbuilt markets.

REITs offer investors a highly liquid vehicle for accessing the sector and a variety of quality operators and sector strategies. REITs are enjoying renewed appeal with both retail and institutional investors.

But historically, **REIT valuations** are on average are around 50% correlated with private property market and 50% correlated with the stock market. The problem with REIT stocks as a portfolio diversification tool is, of course, that the volatility of the stock market affects REIT volatility at precisely the time one would want it not to (over 90% currently). As global markets and all asset classes are becoming increasingly more synchronized this feature of publicly traded vehicles becomes more problematic. Additionally as the overall size of REITs as a percentage of overall property ownership grows, this volatile pricing effect spills into the private property market as well.

There is an under served market demand for a suite of private real estate vehicles that provide investors with the intrinsic benefits of property. To achieve this we need to rethink the trade-off between liquidity and pricing characteristics that are appropriate to the asset class.

Amy Erixon joined **Avison Young** in August of 2010 to develop the company's cross-border investment activities. Prior to joining Avison Young, Ms Erixon was Chief Executive Officer of IGRI, a privately held Canadian investment and development company, which she joined in 2005. While at IGRI she grew third party assets under management to \$800 million and oversaw completion of in excess of \$1 billion of investments and development.