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INVESTMENT STRATEGIES
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New tools provide real estate hedging

Rise of transaction-based real estate indexes helps determine changes in overall market values

When it comes to financial markets, one of the most common strategies investors use to mitigate risk and make returns more predictable is the hedge. Hedging is essentially making a modest investment in an asset or position that runs counter to your primary investment. The idea is that if the market moves in the opposite direction you anticipate, your losses will be less significant.

That useful investment strategy has generally been unavailable to direct real estate investors, however. Hedging requires transparent market pricing and a clear and predictable opposing position — neither of which is consistently available in real estate investing. However, relatively new tools and techniques make it possible for sophisticated investors to overcome those obstacles and effectively utilize hedging techniques to isolate alpha returns, protect their position, reduce market exposure and improve portfolio performance.

MOST IMPORTANT FACTOR

By far, the most important factor in making hedging a viable strategy in real estate is the rise of transaction-based real estate indexes. TBIs use actual sale prices to determine, with increased precision, changes in overall real estate market values. While TBIs may not be available in markets with lower sales volumes, they have made it possible for savvy owners and investors to effectively use hedging as part of their real estate investment strategy.

TBIs are a viable alternative to the appraisal-based model upon which real estate has long relied. Appraisals are not only less accurate, they are also less sensitive to market shifts, and often lag behind when conditions change. As a lagging indicator, they have limited value when it comes to informing investment decisions.

THE ILLIQUID NATURE of real estate makes it hard to protect the asset from market swings.

One of the reasons TBIs are so important is that hedging represents more than just a way to mitigate risk. The very nature of real estate investing makes it difficult to buy and sell assets in a timely and affordable manner. Direct real estate portfolios are highly illiquid, an unavoidable reality that makes responding to market forces a tedious and costly process. An investor can sell a stock, for example, at the push of a button and for a tiny fraction of the overall asset value.

The fees, expenses, taxes and commissions associated with selling a building, however, are dramatically higher, and the process takes time, which in itself can be costly. Consequently, real estate hedging represents not only the best, but really the only effective means of protecting your assets and hold/sell timelines from wild market swings.

The other appealing aspect of direct real estate hedging is that it allows investors to better manage the other half of the risk equation: idiosyncratic risk. Idiosyncratic risk factors, the variables that arise from different property specifics and management efficacy, are more manageable. They provide opportunities for skilled investors to profit from their knowledge, insights and relationships with property managers and advisers. Essentially, hedging reduces the uncertainty that arises from factors out of an investor's control and allows them to focus on those elements they can control. As such, investors can better assess whether excess returns are true alpha.

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DON'T OVERDO IT

Real estate investors would be wise to keep a few things in mind when making real estate hedging part of their investment approach.

First, don't overdo it. Hedging is about mitigating risk, not removing it from the equation. Some degree of uncertainty allows investors to make calculated bets and profit from their insight and strategy.

Second, when done correctly, hedging is actually the opposite of speculation. A good hedge makes returns more predictable within a defined range. Real estate owners should always have corresponding long (the direct real estate asset) and short positions.

Third, it's a good idea to secure a trusted and experienced real estate investment adviser with a proven track record and deep understanding of real estate hedging.

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