

The Biggest Mistake

Hubris Versus Caution in Today's Real Estate Market

A number of years ago, the *Book of Questions* was released. This little book posed various questions to the reader. For example, you discover your 3-year-old child, whom you adore, is, because of a mix-up at the hospital, not yours. You are the only one who knows. Would you exchange the child to correct the mistake?

Or this one: By controlling medical research funds, you can guarantee a cure will be found in 10 years to any disease you choose. Unfortunately, no progress on cures for any other disease would be made during this period. What would you do?

Interesting questions. My question, however, is less philosophical and more practical. What was the single biggest mistake a real estate investor could have made in the past four years?

Was it paying \$500 per square foot for an office building in downtown Washington, D.C.? Was it putting down a 10 percent hard deposit on a retail center in California without conducting any due diligence, in an effort to pre-empt the sale of the center? Was it failing to measure the square footage of a building, only to learn the building was missing 50,000 square feet? Was it purchasing terrorism insurance that turned out to be five times more expensive than originally underwritten?

Actually, it was none of these. For many less-disciplined real estate investors, price appreciation more than made up for any of the mistakes mentioned above. The biggest mistake you could have made in real estate in the past

four years was simply that *you did not buy*.

In business, we sometimes make what Warren Buffett calls "the intelligent-but-with-some-chance-of-looking-like-an-idiot decision." In recent years, however, most real estate decisions had little chance of making you look like an idiot. You could have failed to look at the occupancy level of a property. You could have failed to examine the property's environmental history. You could have failed to do any number of things. As long as you bought a property with cash flow, you still would have been OK.

What does it mean when careful analysis of risk doesn't seem to matter anymore? What does it mean when the mere act of buying is more important than what you buy and at what price? Something is going on that relates to caution, risk and the culture of the real estate industry.

I am by nature a cautious man, but even I find myself thinking about the real estate market and wondering, "If a real estate investor had been less cautious, would that investor have made more money?"

I see a lot of hubris in the real estate market today. Who is to say the hubris is wrong? Maybe caution is wrong. At JER, we raised a billion dollars in capital last year. As we were doing this, some investors said to me, "We're going to allocate more money to real estate, but we're going to do it slowly." That could be the worst decision of all. You may lose if you do get in, but you may lose even more if you don't.

This isn't like the 1980s. What caused most of the problems then

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was that many of the real estate decisions were made not for economic reasons but for tax reasons.

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That resulted in a lot of speculation and a lot of overbuilding. That is not the case today. There is little evidence of excess supply out there. The economy is expanding. The job market is growing. Inflation is modest. We probably will experience some expected increases in interest rates, but no one sees a big spike coming. Today, a lot of money is flowing into real estate for exactly the right reason — real estate has been the best-performing asset class.

So what is going to happen next? Of course, certain catastrophic risks exist that all of us simply ignore. Imagine what would happen if terrorists hit six malls around the country or if a radioactive dirty bomb went off within blocks of the White House. Imagine the economic consequences of such an event.

But event risks such as terrorist attacks or other worst-case scenarios cannot be calculated. If you took such risks into account, you would not buy anything. We in business assume there will be ups and downs, but they will be of limited duration. We are optimists by nature.

So where should we come down on this balance of risk and caution? After the collapse of the Soviet Union, *The End of History* by Francis Fukuyama was published. The premise of the work was not that things would no longer happen in history but that democracy, as a system of government, had triumphed over the rival ideologies of monarchy, fascism and communism. The author's argument was that democracy constituted the final

and ultimate form of human government — and thus constituted the end of history. The end of history theory lasted until terrorists flew into New York City's World Trade Center. Fundamentalist religious ideology is now at war with democratic political ideology.

Similarly, a few years ago, things were going along so swimmingly that some believed economic forces in the global age were so different that we might have reached the end of the business cycle. The argument was that various global economic dynamics would smooth things out. This was written about in major magazines and newspapers.

In real estate, we now hear it argued that we are in a new "new economy" with different rules. What does it mean when real estate is seen as an alternative to the safety of fixed-income investments such as Treasury bonds?

I do not believe in the end of history. I do not believe in the end of the business cycle. And I do not believe it is the end of risk in the real estate market, although it does appear others may believe that. Today, I see a culture developing in real estate with no memory of collapse.

Someone asked me the other day why anyone in real estate would feel immune. The answer is that money managers live in silos. If your job is to invest in stocks, a bond crash does not educate you. If your job is to invest in real estate, a dot-com crash does not educate you.

Sooner or later, the innocent real estate investor out there will be educated. Never before in my lifetime has there been a period when you could not find an area of distress, an area where you could buy low and then just hold. Unexpected "shocks" inside and outside the real estate industry will continue to occur and sooner or later will create areas of distress.

I do not believe we are in a real estate bubble, but I do believe some in our industry are living in a bubble — a bubble of having known and invested in only good times. We've had the happy situation of a real estate market that has

absorbed the hubris of many of its investors. How long that will last, I don't know.

If the biggest mistake a real estate investor made over the past four years was not to buy, then

The second biggest mistake real estate investors will make is they will invest niche and narrow, not big and broad. The way to balance risk and caution in real estate is to take a broad global perspective.

what is the biggest mistake a real estate investor will make over the *next* four years? *That you do not buy.* It will be dicier, certainly. In fact, the second biggest mistake real estate investors will make is they will invest niche and narrow, not big and broad. The way to balance risk and caution in real estate is to take a broad global perspective.

I continue to believe in real estate as a long-term investment. The reason is very simple. Real estate houses the economy. As an economy grows, so does its need for real estate. If you believe the nations of the world will continue to increase in wealth, then something must house that wealth. And that something is real estate. If you believe people will continue to work hard to better their lives, then something must house the results of that labor. And that something is real estate. If you believe capitalism will continue to be the basic organizing principle of the world's economy, then something must house capitalism's output. And that something is real estate.

I believe in the risks of real estate — but I believe in its rewards even more. ♦

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