

# WJM FINANCIAL, LLC

Fee-only financial planning and investment management

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## Real Estate, Discipline, and Behavioral Finance July 2004

The performance of real estate (as measured by real estate investment trusts, or REITS) over the past quarter provided a reminder of the importance of remaining focused on long-term goals and not overreacting to yesterday's news. In the first month of this quarter, REITS lost 15% as interest rates rose and the yield (interest income) of certain bonds had surpassed the yield provided by REITS.

The Wall Street Journal published two articles immediately after this sharp decline that made compelling arguments that REITS were overvalued and had a much longer way to fall. These arguments were based primarily on a comparison of the income yield provided by REITS relative to that provided by alternative investments. Ironically, the Wilshire REIT Index gained almost 14% from the day after these articles were published (April 21) to the end of the quarter, and those investors who heeded the advise of market pundits never participated in that gain, which was the best of all major asset classes.

This is not a knock on the journalists who wrote the articles – both of whom are exceptional, and one in particular (Jonathan Clements) should be on every investor's must read list. Nor is performance over such a short time period any indication that they are incorrect; real estate may yet prove to be overvalued.

What this is, however, is an example of how difficult it can be to predict short-term trends, and how detrimental reacting to yesterday's news can be to an investor's returns...no matter how compelling the story. Remember, there are no crystal balls on Wall Street, and the only type of information that has been consistently shown to beat the market is insider information...the kind the lands you in jail.

This is also a great example of what behavioral finance refers to as "account segregation," or the tendency to view each investment separately as opposed to viewing a portfolio in its entirety. Portfolio theory tells us that the latter, a holistic portfolio view, is far more effective since assets that are risky on a stand alone basis may actually *reduce the overall risk of a portfolio*.

Historically, real estate has been an excellent example of the diversification benefits attained by mixing multiple risky assets. Over the past twenty-five years, real estate has had lower annualized return and a higher level of risk than the S&P 500. *Lower return and higher risk*, why in the world would anyone want to add this to a portfolio? Because there is a third factor that must be considered when determining how a new asset will affect the overall portfolio: its level of correlation, or co-movement, with the other assets. A low correlation – one asset zigs when the other zags – can reduce the overall volatility. And lower volatility leads to higher compounded returns, or the amount that the investor gets to keep.

The proof is in the returns. Although real estate had lower returns and higher volatility than the S&P 500 over the past twenty-five years, a portfolio that included 80% S&P 500 and 20% real estate had higher returns and lower risk than either of the individual assets on their own.

	<u>Return</u>	<u>Risk</u>
100% S&P 500	13.55%	16.08%
100% Real Estate	13.25%	19.76%
80% S&P 500 and 20% Real Estate	13.83%	14.44%

This is exactly why it is so important to view your portfolio in its entirety, and to realize that each individual investment plays a key role in making up the whole portfolio.

We will never know the short-term direction of the market with any degree of certainty (those of us who believe we do might consider another behavioral finance topic: overconfidence), and we should not pretend otherwise. Instead, we should base our investment strategies and philosophies on objective theory and practice, and we should remain disciplined and focused on our goals and objectives instead of allowing short-term events to dictate our actions.