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SENTIMENT IN PROPERTY INVESTMENT DECISIONS: A BEHAVIOURAL PERSPECTIVE

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Sentiment in property investment decisions: a behavioural perspective

Introduction

The limited literature available to describe property investment decisions (Anderson and Settle, 1996; Miles *et al*, 1989) portrays the process as an exercise in rational analysis, evaluation and choice. Typically, prospective investments, after identification, are compared with benchmark criteria and decisions made on whether the attributes of the property will enable achievement of those criteria. These decisions are informed by forecasting models that vary in their degree of theoretical rigour, informed by and to a degree reflecting different levels of data richness. In this latter respect, the property market is characterised by unevenness in the quantity and quality of its data. In particular, there is frequently a constraint on the extent to which individual investors can fully access available information. This constraint may arise partly because of a lack of transparency in market transactions. It may also exist because acquiring certain kinds of data, such as demographic information relating to underlying demand or supply factors, may be too costly for some investors to justify. In some situations, therefore, property investors may have a deficiency in either, or both, the quantity or quality of information ideally required to make judgements in line with their investment model.

Lacking direct evidence of what the market is actually doing, property investors may turn to indirect signals in the form of "market sentiment" or "investor sentiment"[1]. This paper discusses the relevance of sentiment to an understanding how property investment decisions are taken. In so doing it seeks to differentiate between the interpretation of sentiment in financial markets and in property markets, drawing attention to the lack of understanding of how sentiment is formed in the latter and calling for empirical work to investigate this deficiency.

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[1] The term "investor sentiment" is used more widely than "market sentiment" in the literature on financial markets and is generally adopted in this paper. The issue of how this differs from market sentiment - something perhaps of more relevance in the property market - is not pursued in this current paper.

Investor sentiment in financial and property markets

The efficient market hypothesis that underlies conventional explanations of finance market behaviour assumes that investors are fully rational and will make decisions that reflect all available information. Investor sentiment in the financial markets is conceived of as expectations or judgements that are not fully justified by available information on market fundamentals. Investors who rely to some degree on sentiment are termed "noise traders", who by definition misprice investments in relation to rational expectations (Shiller, 1989; De Long *et al*, 1990; Shleifer and Summers, 1990). Examples of investor sentiment-in-action include reliance on general market commentaries and the adoption of trading strategies, such as trend chasing, that are unwarranted by fundamentals. More generally, sentiment is manifested in the use by investors of "popular models" (Shiller, 1990)[2]. Investors' willingness to rely on sentiment may also be facilitated by excessive subjective certainty about their judgement ability (e.g. overconfidence, see Ayton and McClelland, 1997).

The proponents of the noise trader school argue that the impact of this activity on the market is neither transient nor unimportant. Shleifer and Summers (1990), for example, maintain that underpricing or overpricing by noise traders will not be quickly corrected by the trading interventions of rational investors because of limits to their willingness or ability to perform a perfect "arbitrage" function. They also contend that, in addition to being more than transient, the effect of noise trading matters because it is unlikely to be random. They attribute this to the non-random incidence of psychological biases, which they suggest may underlie much of noise traders' reliance on investor sentiment.

If investor sentiment is significant in explaining financial market behaviour, to what extent is this also true for property markets? Is there any reason, for example, to expect that property investors are fundamentally different from other investors? Given the relatively larger sums required for direct property investment, it might be assumed that property investors are more sophisticated in their approach, therefore less likely to rely on sentiment. On the other hand, anecdotal evidence suggests that

[2] Shiller (1990) uses the term "popular models" to describe the models that are actually used by the broad masses of economic actors to form their expectations, in distinction to the models used by economists that assume these expectations are formed rationally.

property market sentiment is frequently perceived as a very material consideration. Another, perhaps more crucial factor that may lead to differences in the impact of sentiment is data availability in the two kinds of market. In the financial markets, information is generally regarded as being more complete and accessible than in property markets (although, as Gale (1997) points out, the availability of data does not necessarily lead to its efficient use by all investors).

Property investment decisions

The extent to which sentiment influences property investment decisions is part of the wider question of how these decisions are made. There is, unfortunately, a paucity of studies of investor behaviour that have addressed the wider context within which decisions are made, the use of information or the rationality of this behaviour. A recent exception to this is the study by Clark (1998) of investment decision making by trustees of UK pension funds He highlights the uncertainty trustees are confronted with and the unreality in assuming, as mainstream finance theory does, that they are purely rational utility-maximisers applying conventional risk-return calculations. In particular, he discusses the importance of the influence of habits of prudence (which may include behavioural traits such as regret and loss aversion), rules of proprietary conduct (e.g. fiduciary duty) and the norms that govern trustees' relationships with consultants and investment managers (i.e. reliance, reciprocity and mutual respect). This analysis does not develop the issue of investor sentiment, although contained within Clark's habits of prudence is an analogous "preference for similarity", whereby trustees prefer to have an investment strategy more like other funds even if similarity means lower potential returns.

Ball (1998) also stresses the importance of acknowledging the complexity of influences in the property investment decision-making environment. He reviews the principal methodological approaches to exploring the British property development process[3] and points to the limits of traditional economic analyses in failing sufficiently to acknowledge the role of institutions. Although participants may display behaviours that differ from those implied by rational profit-maximisation, Ball cautions that interpretations of the rationality or irrationality of participant behaviour

[3] These are: mainstream economics; institutional power; and Ball's own structure-of-provision approach

may depend on the standpoint of observation. As an example, he cites the well-publicised preference of financial institutions for investing in central London (as opposed to UK provincial) offices. Viewed from one perspective ("behavioural institutionalism") this may be explained as an irrational preference by the agencies in question for "things London". Seen from a different perspective, such preference may be a rational response to institutional rules that dictate what are allowable levels of liquidity or risk from investments.

Whether the favouring of London offices actually *is* rational behaviour can better be determined by discovering if the actual choices made by investors align with expectations generated by their institutional investment rules. In other words, is central London actually a less risky or more liquid home for office investment funds than alternative UK locations, or is sentiment or some other factor playing a part? This question has been pursued by Rowley and Henneberry (1999). They confirm that the distribution of new office development *is* skewed, with London attracting substantially more than its comparative level of office-based economic activity would suggest. Because this situation does not appear justified by the historic performance of these offices they ask whether socially based perceptions and conventions, bred within the "London property nexus", shape investment decision-making. One of their concerns is that these perceptions may be ill-informed and they proceed to illustrate this by comparing the actual performance returns of London and provincial offices with the sometimes at-odds perceptions of these returns that they obtained from interviewing key decision makers in the "nexus". They discover, however, that certain property characteristics (e.g. greater availability in London of properties above a certain lot size) may help to explain the London bias. Rowley and Henneberry's interpretation of their data is that the irrational behavioural characteristics that they uncover, and that may militate against office investment outside London and south-east England, are localised and not prevalent throughout the market. The implication is that where information is well sourced and reliable, decisions are more likely to follow rational models.

Gallimore *et al* (1999) investigated investment decision-makers but confined the study to small to medium UK property companies. They found that though normative models provide an "ideal world" view of investment, the diverse nature of the

property market appears sometimes to preclude rigid decision-making strategy and accordingly, medium- and small-sized company's investment decision-making does not follow normative models either prescriptively or subscriptively. They also report upon a firmly held belief held by some of their decision makers that they could judge accurately the stage of the property cycle (and its trajectory beyond the present). This judgement about trend may have been based on prior analysis of market fundamentals, although this seems unlikely, since these decision-makers were selective in the information they accessed. They seem more likely to have been using a representative heuristic[4]. To this extent these investors may be a variant form of noise trader, relying on "insights" into the market trend.

No-one has investigated noise trading effects in UK direct property market, although Barkham and Ward (forthcoming) explore noise trading as an means of explaining the difference generally observable between the share price of UK property companies and the market value of their underlying property assets. This difference, which generally sees share price trading at a discount to underlying value, is associated by Barkham and Ward to non-property-related indicators of confidence. They conclude that sentiment significantly determines the discount to net asset values in UK property companies.

The foregoing studies suggest that aspects of property investor behaviour may be based upon perceptions of sentiment, or other surrogate indicators of behaviour; that whether this behaviour is or is not rational is a complicated question, influenced at least in part by the framework of analysis; and that the likelihood of rational behaviour may increase with the quality and quantity of information available.

Investor sentiment in property markets - rational or irrational?

Reliance on investor sentiment in financial markets - making judgements not justified by available information on market fundamentals - is not seen as rational behaviour[5]. Noise traders eschew reliance on available information in preference to some biased proxy for this. Since they prefer to swap primary data for some dubious surrogate

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4 "Representative" thinking involves the neglect of base-rate information (i.e. the actual likelihood of an event) in favour of information that conforms to certain stereotyped groupings.

5 "Rational" is used here to describe behaviour that conforms to normative optimising models.

they are deemed irrational. Similar irrationality in behaviour may of course be exhibited in property market investors who rely on signals of sentiment. Property market investors, however, are much less likely to have access to all available information. Their dataset may provide only a partial view of the market's activity. In fact, the size of whole dataset itself may be uncomfortably limited in informing decision making, such as when few market transactions occur (though this may be more a problem to valuers than to investors). When, for whatever reason, information is limited, property investors may turn to consider signals of sentiment, not so much to usurp the value of hard data but to augment what limited information is available. In such markets, where information is less than full, investor sentiment takes on a different character. It ceases perhaps to be wholly informational noise and its use may become more justifiable than in financial markets.

In property markets, therefore, whether reliance on investor sentiment is rational or not may depend in large part upon the extent of information available. Even where information is copious, however, paying some heed to sentiment may still be justified as rational, on the basis that other market participants, less rational in their decision making, may still influence prices. Investors who can "..guess better than the crowd how the crowd will behave" (Keynes, 1936, 157) may still come out ahead. What currently remains unexplored is what information property investors use to gauge how the crowd is guessing, including the process by which these impressions are formed and the informational content of these perceptions of investor sentiment.

Conclusion

Property investment decisions are reliant upon information. As well as hard evidence on market activity, investors may utilise their perceptions of sentiment. In finance markets, judgements based on investor sentiment are generally characterised as irrational. In the property market this conclusion may not always hold and it may or may not be rational for property investors to consider investor sentiment. Whatever the case, it will only be sensible to use information on sentiment, if the means of its apprehension and comprehension provide reliable representations of how other investors will act. However, apart from the studies by Rowley and Henneberry (1999) and by Gallimore *et al* (1999), neither of which directly address this issue, little is known of the processes by which property investors evaluate sentiment, how

they use this information in their decision-making and how rational or otherwise this behaviour is. This paper lays a basis for the empirical investigation of these issues.

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