ORER LETTER

Volume One, Number One

Summer 1987

Are Real Estate Markets Inefficient?

Markets may be inefficient in the sense of providing opportunities for earning above normal profit. The search for such opportunities in the stock market has led researchers at the University of Illinois and elsewhere to look for anomalies in the form of substantial regular seasonal fluctuations in rates of return. Having found these effects in stock markets, researchers are now looking at real estate markets.

There are two fundamental questions that need to be answered if seasonal rate of return anomalies are found. First, what causes them? Second, what allows them to persist? It is this second question that is at the center of the market efficiency debate. \Why would speculative activity be restrained from leveling the rates of return across months? The knowledge of an impending high or low rate of return month would cause individuals to speculate. The speculation should have the effect of driving the price up prior to an anticipated high return month and driving it down immediately afterward. Speculative activity would lower the rate of return in months with predicted above normal rates of return and raise the rate of return in months with predicted below normal rates of return. In this way, an efficient market results in self-defeating prophecies.

Answers for the first fundamental question (what causes seasonal effects?) are accumulating for the stock market anomalies. However, these answers may not ultimately prove to be correct. For example, there is a tax selling hypothesis which attempts to explain high January rates of return, the *January Effect,* in common stocks. This hypothesis is losing favor in the face of evidence that the January Effect is found in countries with markedly different tax laws. There is another hypothesis that attempts to explain the January Effect by asserting that mutual fund managers move into riskier-smaller stocks in January in order to increase the expected return on their portfolio and thus increase their expected compensation which is based on the performance of their portfolio over the calendar year. Later in the year, it is said that these fund managers tend to move into safer-larger stocks in order to lock in portfolio returns and their own compensation. Therefore, the January Effect is seen as a consequence of a problem with the decisions of agents, the fund managers, potentially diverging from the interests of the principals, the fund owners. This is called an *agency prob1cm.* This agency problem hypothesis is capable of explaining a January Effect in small stocks purchased by fund managers. However, it provides no explanation for similar anomalies found in other assets such as real estate.

The answer to the second question (what allows the anomalies to persist?) is that markets are inefficient. Perhaps access to information is unevenly distributed. This is a bit hard to argue concerning the stock market's seasonal anomalies which have been widely known for at least four years. However, information problems have been asserted to exist in real estate markets for a long time. Thus, it may be less surprising that the real estate market exhibits inefficiency than that the stock market exhibits inefficiency.