How to predict (and hedge against) falling housing prices

Is the real estate market heading for a fall? A study by IESE's Carles Vergara-Alert says an informed look at trading in real estate investment trusts (REITs) can let you know if there will be a decrease in housing prices in the following month.



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What if you *knew* we were in a housing bubble in 2008? Amid ample evidence of a financial and economic crisis, many predicted that real estate prices were coming down.

But selling your own home (or another property) in a downturn isn't easy. On top of the transaction costs, it can take months and months to close a deal, disrupting life in the

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meantime. Housing is famously an illiquid asset, after all.

So, what about real estate investment trusts (REITs)? REITs can offer shares that trade on stock exchanges, and thus, like other stocks, they can be shorted. That is to say, investors can borrow shares of selected REITs, sell them at the current market price, and then buy them back at a lower price. If there is a downturn in the housing market, shorting REITs can be a hedge against real estate assets dropping in value — one that doesn't involve closing costs, agent commissions, inspections, or moving vans.

This is one of the takeaways from a study by IESE's Carles Vergara-Alert and the University of Cambridge's Pedro Saffi. Examining REITs in the United States from 2006-2013, they find that an increase in short-selling activity predicted decreases in housing prices in the following month, especially in areas that had just experienced a property boom. This predictive power can be useful for investors or for regulators to help implement policies to prevent real estate bubbles, among other things.

REIT Between the Lines

Unlike the direct purchases of properties, REITs provide a structure for investing in real estate trends that is highly liquid and has low transaction costs. REITs trading on the stock market react quickly to market conditions, via traders buying and selling... and shorting.

By comparing REIT trading activity with regional house prices in the U.S., the authors find that increased short-selling activity on REITs effectively forecasts downturns in the property market, under certain conditions. In the study, the co-authors divide the U.S. property market into four main regions: Northeast, Midwest, South, and West. In the Northeast and West, the connection between REIT speculation and decreasing house prices was strongest. This was the case because these areas had just experienced housing booms, with big run-ups in pricing. Specifically, the authors find that a one standard deviation increase in the fraction of shares on loan of REITs with properties in housing boom areas (e.g., in the West region in the U.S.) forecasts a 0.52 percent (0.74 standard deviations) decrease in house prices in the following month.

By connecting the demand for shorting financial instruments with declines in real property asset prices, this study suggests new ways for both investors and regulators to understand the housing market. Market participants can effectively use REIT short selling as a tool to hedge against future price decreases, while regulators can improve their forecasts of housing prices and consider the best policies to prevent housing booms and busts.

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Methodology, Very Briefly

The authors examine U.S. equity lending data from real estate investment across four U.S. regions across the period 2006-2013. By comparing REIT equity lending activity with the Federal Housing Finance Agency (FHFA) House Price Index each month, for distinct geographical regions, the authors show that REIT short selling activity has been shown to forecast a reduction in house prices the following month, especially in a downturn situation preceded by a housing boom.

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