Focus on Real Estate: Buy the Dip

By Miguel Sosa | November 2018

Buy the Dip: Noteworthy Recurring Behavior in Real Estate Markets, and How to Potentially Benefit

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Corrections occur, even in bull markets. U.S. equity markets have struggled entering into the fourth quarter. The volatility has also impacted the public real estate market, as correlations tend to increase during sell-offs (ultimately, publicly-traded REITs are part of the equity markets). [1] This has led investors to speculate whether we are entering a correction, or if it is characteristic volatility leading up to mid-term elections. [2]

We believe that, for long-term investors seeking wealth accumulation, this question is beside the point. Why? Several reasons: First, on a purely probabilistic basis, fewer than 20% of broader equity market corrections turn into a full-blown bear market (said differently, about 80% of corrections are short breaks that subsequently resume a positive market trend). Thus, the odds are for a temporary correction.

However, the more significant reasons are derived, nuanced and developed from a more thorough and insightful analysis.

Observations from Public Real Estate Markets

In the public real estate market (as measured by the Dow Jones US Real Estate Index), corrections have occurred once per year, every year, for the last 25 years.

1 A **REIT** (real estate investment trust) is a type of real estate company that mainly owns and operates income-producing real estate; some engage in financing real estate. Most REITs trade on major exchanges.

2 **Corrections** are commonly defined as a market drop of -10% to -20% following a market upswing. For this analysis, we use the term interchangeably with "sell-offs" for market drops of various magnitudes that reflect the largest losses of each calendar year.

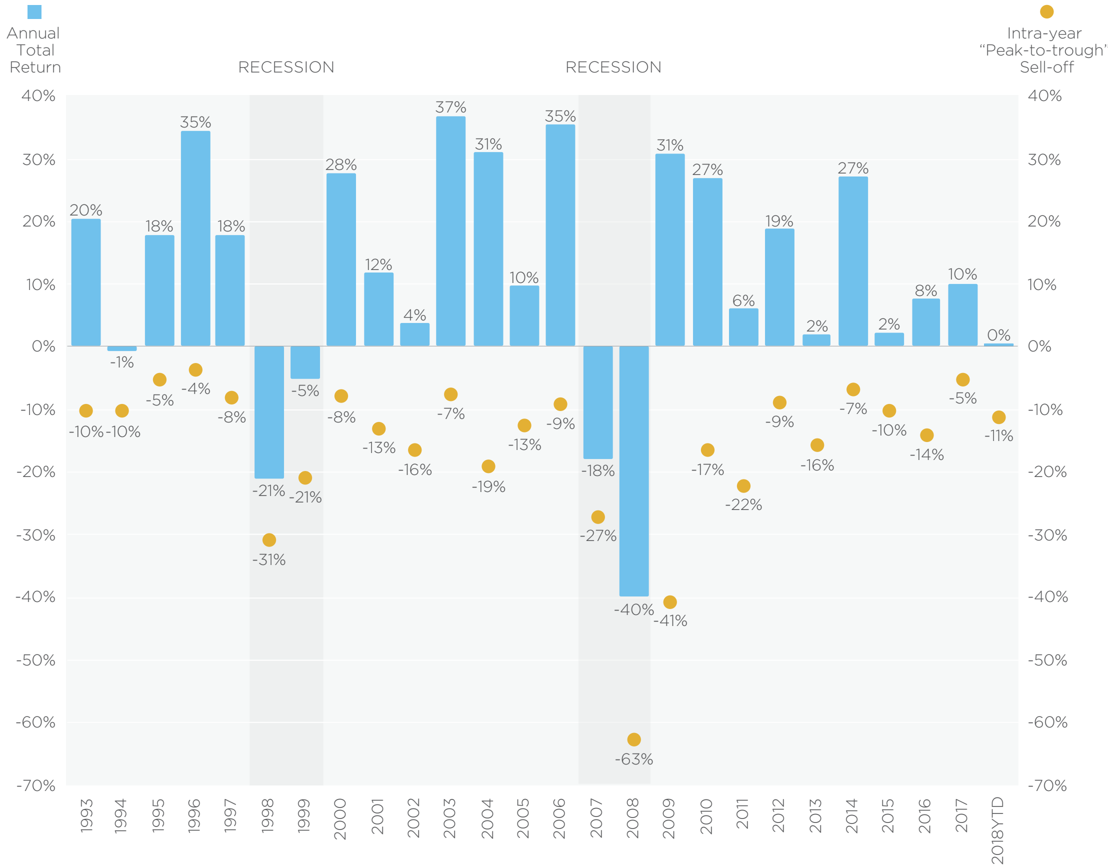
Even in years where the index's return was strongly positive or when the economy was growing, the market saw high single digit or even double-digit returns inclusive of the intra-year corrections [Figure 1].

It could be said that it is almost like one's birthday; it comes around once a year, whether you want to or not.

Figure 1. **Dow Jones U.S. Real Estate Total Return Index: Calendar Year Returns and Intra-year Declines**

January 2, 1992 – November 6, 2018

Despite average inter-year drops of -15.8% (including recessions), annual returns of the DJ US Real Estate Index were positive in 20 of the past 25 calendar years and returned +11.4% per year on average.



Source: S&P Dow Jones Indices, American Assets Capital Advisers (AACA). Past performance is not indicative of future results. There is no guarantee any investment will achieve its objectives, generate profits, or avoid losses.

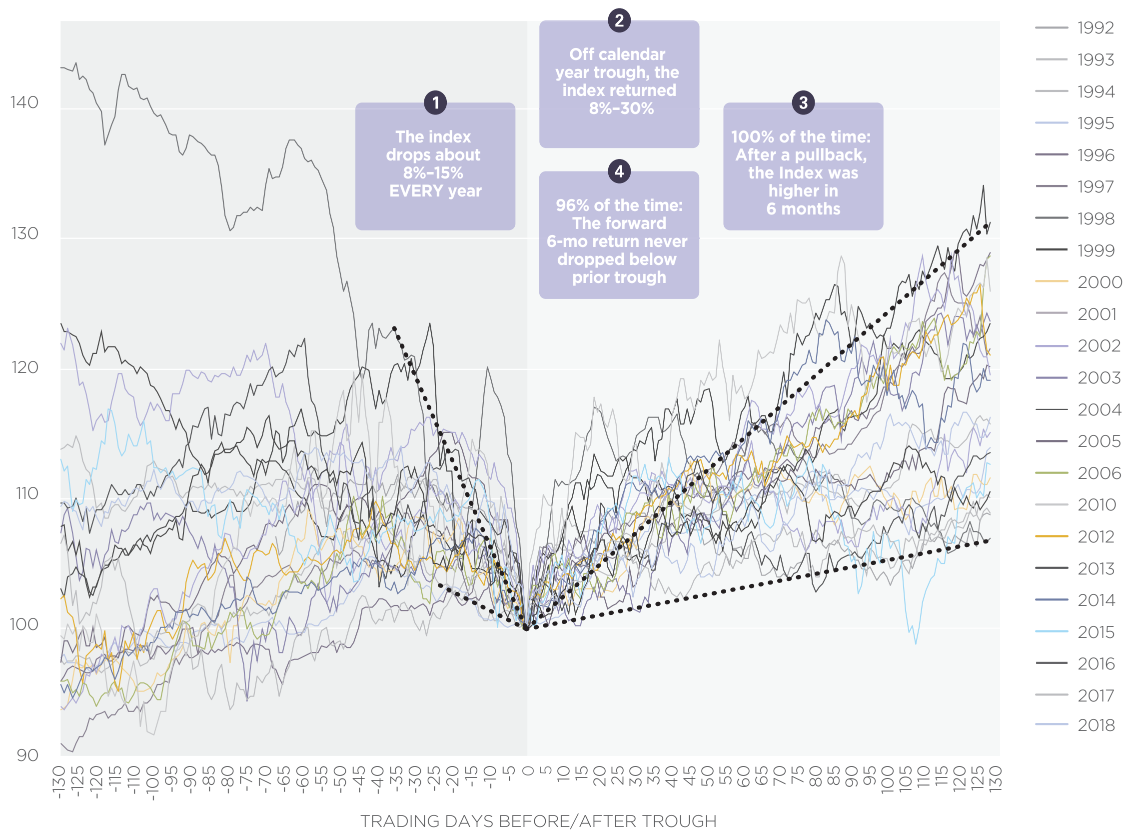
A Recurring Theme: Annual Troughs and Performance

Given that the corrections were a yearly occurrence, we decided to take a deeper, more thorough look at the performance leading into the trough and the subsequent recovery. Thus, in addition to reviewing troughs on an annual basis, we looked at the corrections of the DJ US Real Estate Index by lining up all the troughs to a "Day 0." This can help to visualize any patterns or themes that may exist both in the days preceding and following the bottom of the correction. Figure 2 does precisely this: all of the annual corrections are lined up to the same relative point in time.

Figure 2. **Dow Jones U.S. Real Estate Total Return Index Indexed to Annual Correction Trough**

January 2, 1992 – November 6, 2018 (Excluding GFC 2007, 2008, and 2009)

Annual corrections of the Index that have been synchronized (or "lined up") to a single theoretical point in time at each trough. This allows to more easily discern trends prior to or after the correction.



Source: S&P Dow Jones Indices, AACA. Past performance is not indicative of future results. There is no guarantee any investment will achieve its objectives, generate profits, or avoid losses.

This exercise revealed a few interesting stats of market behavior:

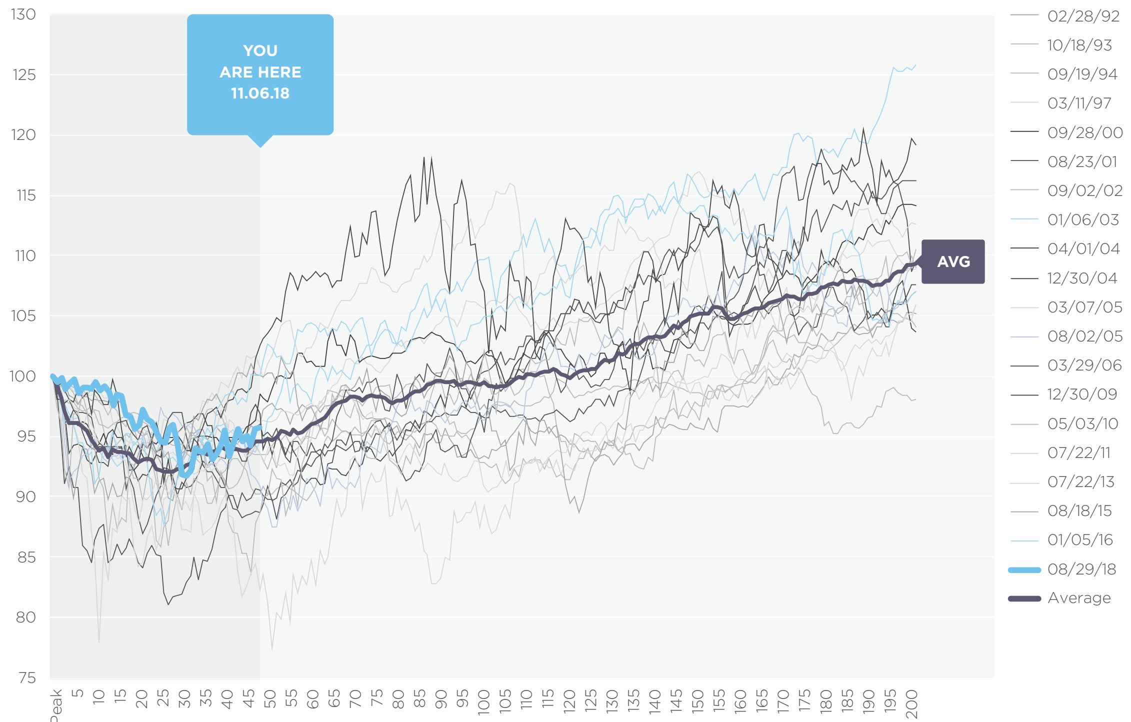
- 96% of the time after hitting a trough, the forward 6-month return never dropped below the prior trough
- After the 'yearly' trough, the index returned 8%–30% over the next six months
- At six months after the trough, the index was higher in every instance (that is, the index was not in a secondary trough)

Figure 3 shows a slightly different take; the troughs and subsequent performance have been reset so that the peak prior to the trough is "Day 0." Furthermore, the performance of the following 200 trading days has been averaged to achieve a "mean performance path," as noted by the bold "AVG" line.

Figure 3. **What Typically Happens After a Sell-off?**

Annual corrections of the Dow Jones US Real Estate Index | January 2, 1992 – November 6, 2018

Annual corrections have been synchronized (or "lined up") to a single theoretical point in time at each peak prior to the trough, and the subsequent 200 trading days. The bold "AVG" line represents the arithmetic mean of all of the performance trends.



Source: S&P Dow Jones Indices, AACA. Past performance is not indicative of future results. There is no guarantee any investment will achieve its objectives, generate profits, or avoid losses.

While the performance path is theoretical and not indicative of future results, we believe it again illustrates a consistent pattern:

- Corrections are sharper than recoveries; corrections, on average, last a bit over a month.
- Recoveries are more gradual, and (again, on average) typically take five months to completely exit the correction.
- After exiting the correction, the performance path has, on average, continued into positive territory.

An Opportunity during a Storm?

The preceding graphs have shown some repeated themes in historical corrections: they come often, occur quickly, but typically swing back and continue into positive territory.

The current correction is no different; during October, the index dropped by -6% in the middle of the month. It can understandably be challenging to take actions that may potentially be favorable for the long-term during volatile markets.

As Warren Buffett colorfully described, “the stock market is a device for transferring money from the impatient to the patient.”

About Miguel Sosa

Miguel serves as portfolio strategist where he is primarily responsible for offering support to client relationships and assisting to build the firm’s brand. He works with the firm’s analysts and portfolio managers as well as the distribution teams and their clients. Miguel helps in communicating the firm’s investment process and philosophy, as well as portfolio construction, fund positioning and related risk metrics for individual funds.

Prior, Miguel worked at Wellington Management in Boston, Massachusetts. Miguel joined Wellington in 2011 as a fund analyst, and most recently was an assistant vice president, hedge fund portfolio specialist. Miguel began his career in finance in a management development program at Fidelity Investments in Boston, Massachusetts. Prior to that, he was a Senior Systems Engineer at Raytheon Company in San Diego, California.

Miguel holds an MBA and a SM in mechanical engineering from the Massachusetts Institute of Technology. He is a graduate of the University of San Diego, where he obtained a Bachelor of Science in industrial and systems engineering.

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