Always look on the bright side of life

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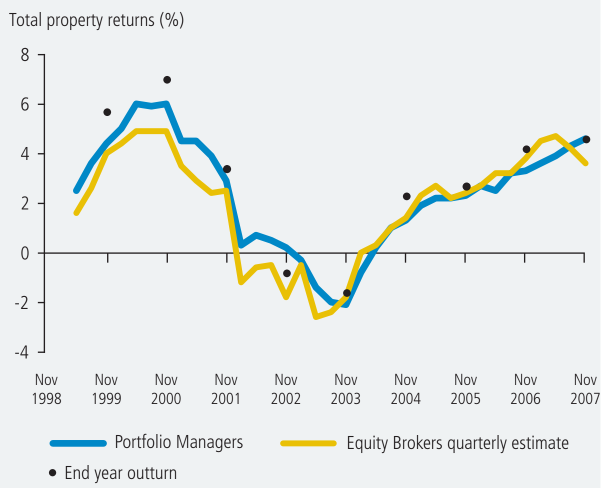
Much has been written on behavioural biases in forecasting, especially on the tendency of forecasters to huddle together. They share common data and very similar techniques, so perhaps it's not surprising that similar results are produced. Also there may be significant perceived risk in being both different and wrong.

But are real estate forecasters so risk averse? This article compares the IPF's consensus forecasts of rental growth by industry specialists (portfolio managers) and 'outsiders' – equity brokers against actual outturn as recorded by the IPD for the 1998-2007 period. It also looks at equity houses' accuracy in forecasting equity earnings growth.

The analysis suggests that there is behavioural bias in forecasting. It seems that forecasts underestimate the volatility of both return and rental series and forecasters have an aversion about forecasting negatives in their own asset class.

Figure 1: Consensus forecasts of rental growth

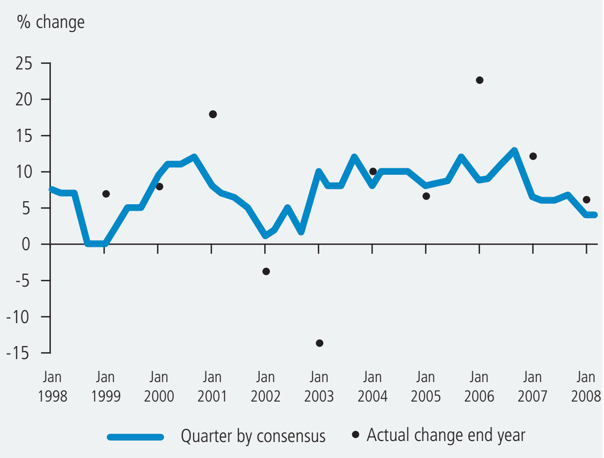


Source: IPF

Figure 1 looks at rental growth forecasts (consensus mean) by fund managers and equity brokers. The solid blue and yellow lines are quarterly forecasts of rental growth over the same calendar year from the IPF Consensus forecasts and the black dot is the outturn. The graph shows property fund managers underestimated rental growth 1999-2001, missed the negative outturn in 2002, underestimated recovery in 2004-07 and finally got it right in November 2007. As a result, I conclude forecasts underestimate future volatility which may then explain the divergence between the consensus total return and the implied returns from the derivatives market. It also suggests that risk analysis based on the consensus forecast may be under estimated. Since the end of 2007 consensus forecasts have corrected slowly downwards.

We see a better predictive performance on rents from the equity brokers, albeit a smaller group. Like fund managers, they underestimate the upside but they were better predictors of the 2002 negative outturn and, interestingly, they went negative in 2008, earlier than real estate managers (not shown on the graph).

Figure 2: Equity brokers' UK equity earnings forecast



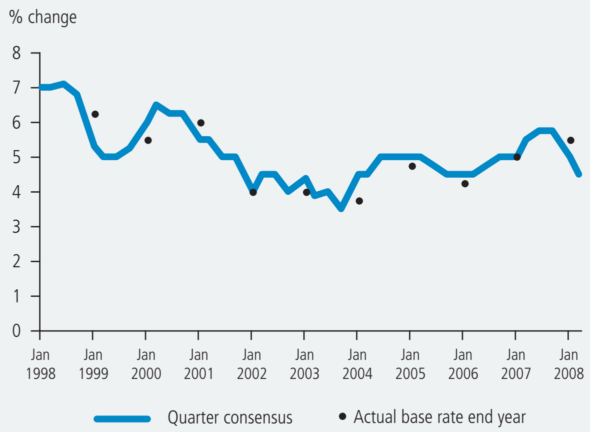
Source: Legal & General

Are we seeing a reluctance to report bad news? Figure 2 takes this further by looking at brokers' consensus forecasts of equity (FTSE 100) earnings growth 1998-2007 – these were available monthly from Legal & General – for simplicity half yearly forecasts are shown. The graph confirms the hypothesis. Consensus earnings forecasts are without exception in positive space over the 10-year period despite negative outturns in 2001 and 2002. Even after 2001 they remained optimistic. It took till 2003 for the tide to turn and then the earnings forecasts remained over optimistic till the unexpected spike in 2005, which of course they failed to predict.

Equity brokers are much better at predicting the more value neutral base rates (Figure 3). The average tracking error is much lower than earnings forecasts and significantly errors are both negative and positive implying less behavioural bias. Perhaps the existence of a mature derivatives market for interest rates helps guide them. In which case, there is hope for property forecasters, provided they can calculate implied returns!

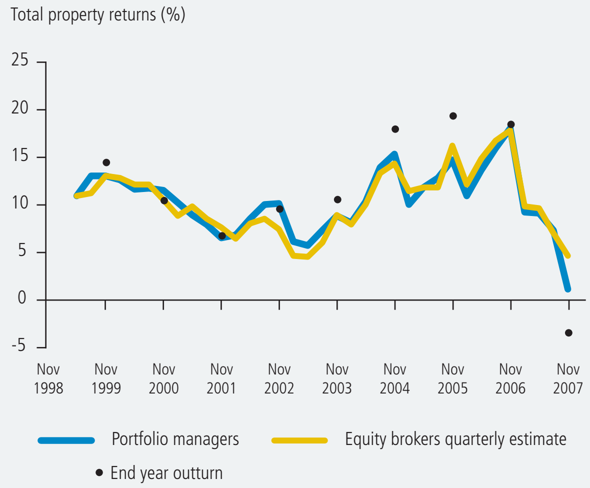
Figure 4 looks at total returns to the IPD 1999-2007 from IPF consensus data. Property managers underestimated returns in 1999, 2003, 2004, 2005, and 2006. Both they and the brokers failed to call the negative outturn of 2007. The interesting period here is 2000-02 when both groups were pretty close although fund managers were predictably more optimistic overall. This was a period when yields hardly moved (+10bps, +20bps,

Figure 3: Equity brokers' forecasts of end year base rate



Source: Legal & General Fundamentals

Figure 4: Consensus forecasts of total returns



Source: IPF

-20bps). Later on in 2003-06 they fell (-30bps, -70bps, -60bps, -60bps). It seems that both forecasting groups failed to anticipate the full extent of yield compression, even in its fourth year, hence leading to successive underestimates of return. Of course in 2007 the reverse happened.

This would imply that there is more error associated with consensus yield forecasts than rental ones. Looking at IPD data one finds that, of the three components of return over the long run, yield shift has delivered virtually no return and at considerable volatility. Perhaps there might be demand for a derivative to hedge yield shift as it seems to be a major cause of forecasting error and a considerable source of volatility that over the long run goes unrewarded.

On the basis of past behaviour we can expect the IPF Consensus forecasts to move further into negative space through 2008 led by the equity brokers. Eventually when an inflection point is reached at the bottom of the cycle it may well be an unexpected fall in yields that starts the process, followed by a slow revival in rental growth expectations that underestimates the actual strength of rental recovery.