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Are you a rational real-estate investor?
By Curtis Seltzer

Economists from Adam Smith to Karl Marx believed that human beings make rational economic decisions. Both believed that each individual pursued his self-interest, though they had different ideas about where these interests lay. They also acknowledged that both individuals and groups could err in understanding their optimal economic interest. And Marxists, of course, argue that the true interests of the working class are easily manipulated by religion, advertising, nationalism and consumerism, not to mention cold beer and rock 'n' roll.

Much research has been done since WW II to suggest that the picture is much more complicated than every individual investing as an economically rational actor. We often make investment decisions with a mix of rational thinking and emotions, sometimes in balance, sometimes out of whack.

Sellers of real estate are now coached to stage their properties to appeal directly to the buyer's emotions through pleasant smells, visual cues, furniture arrangement and just-baked cookies.

Listing agents know the key that turns the buyer's lock is to get him or her to become emotionally invested in the seller's property. "I love it!" are the words a seller wants to hear from a buyer, because "love" goes a very long way to solving whatever problems may arise during the transaction. Love often trumps cold reason.

Traders of stock and commodities are supposed to be analytical and rational in their decisions so that prices of equities and goods at the end of each day reflect a true market valuation. Well, how many times have we seen traders run with the herd in a panic of fear or a blindness of optimism?

Perfectly rational decision-making is an unachievable goal over time in my opinion, but land investors should be aware of some common situations that invoke emotions at the expense of clear thinking.

Fear of Missing the Boat. When everyone you know has jumped on board a particular investment ship, you probably have missed the boat that will make you a profit. The last boat at the dock is often the one that sinks. And if it doesn't sink, the price of the ticket is way too high.

Fear of missing the boat prompted people to pay $3,000 to $4,000/acre for Southeast timberland a couple of years back when a fair price -- in my opinion -- was more in the $1,000 to $2,000/acre range. The fair price -- which was not the market price as shown through comparables -- reflected the then current value of the merchantable timber and a bare-land value for timber-producing land.

From a buyer's perspective, comparables analysis simply pegs the "value" of a target property to prices of recent similar sales; if everything is going up for no good reason, the last buyers in line always pay more than they should based on comps.

Think of this process as a chain letter: the first in line always make money; the last always lose.

This price escalation in timberland was rooted in Higher-and-Better-Use valuations that attributed second-home and recreation high values to lower-value timberland. Imputed HBU value was justified in some situations, but not all. It was based on comps and hope and a little speculation. Buyers overpaid, because they convinced themselves that future prices for the land they were targeting would be even higher than those being asked. They feared being left out.

Bubbles are fueled by fear of missing out and greed. Bubbles are emotion-driven, not fact-driven.

Greed works the up-side. Positive reinforcement occurs in investing when you make some money. Success builds confidence in what you've done, whether you've done it the right way or just lucked out.

There's nothing intrinsically wrong with finding a formula and applying it again and again. You need to keep in mind, however, that circumstances change, with the result that a formula that worked before may not work now or in the future.

The buy-wholesale/divide/flip-retail formula made huge profits for timberland investors in the 70s through the 90s when timberland was selling at low timberland prices and an immediate harvest might pay off the full acquisition price, leaving profit in the cutover land divided into retail lots. But when the get-in wholesale price rose too high, that formula became a trap, not a ladder to the stars.

Success also leads to a more cavalier attitude toward future risk. Instead of finding out something for sure, the investor tends to become less diligent in his due diligence. He thinks that he's been there before, so he thinks he knows where he is now. Confidence leads to over-confidence, laziness and mistakes.

Testosterone is a dangerous motivation in investments. Competitive people want to win. Winning to beat someone else is a potentially ruinous motive for an investor. How many times have you seen two otherwise sensible individuals in a bidding war at an auction where their final motivation has turned into beating the other bidder? Sellers love testosterone contests. I have seen testosterone play a role in small land purchases and billion-dollar deals. It's equally bad when a buyer feels he has to match testosterone with a seller.

The reward in investments is profit, not winning. The reward is the result, not the process. It doesn't make sense to win the purchase, and lose money. Beating a rival for its own sake is usually pointless and often self-defeating.

Cutting losses. People become emotionally attached to whatever they have. Stock investors tend to hang on too long going downhill. Hope springs eternal when we're faced with repudiating our own past judgments.

This emotional tendency to hang on helps a land investor and usually hurts a stock investor. Land investors rarely stick too long with land, which trends up without much volatility over the long term. Stock investors, on the other hand, may be holding on to a company that has become handicapped by technological change or mismanaged.

Companies disappear, land doesn't. Companies lose all their value; land doesn't. Patience is rewarded more with land than equities.

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