

Assessing the "Santa Claus" Approach to Asset Allocation: Implications for Commercial Real Estate Investment

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The proposed research applies state-of-the-art financial economics theory and methodology to improve our understanding of the relationship between real estate pricing and real estate investment practice. The research focuses on the cyclical nature of real estate returns and on the optimal investment strategy under such a mean-reverting return environment. The research is designed to provide a rigorous way of learning the costly lessons from the recent real estate debacle. It addresses an important question, namely, what business strategy --beside fraud and gross mismanagement-- lies behind the recent real estate problems, and what strategic changes need to be made to avoid repeating these problems in the future?

To accomplish this task, we used commercial banks' real estate investment data to address the issue of whether their poor performance in recent years has been consistent with a poorly formed investment strategy. We first employed a simple linear pricing model to derive the time-varying *ex ante* (or expected) excess returns on various real estate investment portfolios. We find the future expected returns on real estate are time-varying, generally tend to increase after a real estate market rally, and fall after a market downturn. We then document the evidence that commercial banks have been using a "Santa Claus" approach in determining the allocation of investment funds among different classes of assets. We found that their real estate investments have largely been driven by past real estate performances, i.e., they were increasing real estate investment after a good real estate market performance and lowering investment after a bad real estate market performance during the sample period. We argue that the standard loan-to-value ratio analysis used in bank loan underwriting process may have contributed to this "Santa Claus" behavior. This "Santa Claus" strategy ignored the potential negative correlation between current and past real estate returns and their future expected values. Indeed, using the Henriksson and Merton (1981) test, we show empirically that such a negative correlation is supported by available data.

Our further analysis shows that either a simple Buy-and-Hold strategy or a contrarian strategy could easily beat the "Santa Claus" strategy. In order to avoid repeating the costly mistakes of the recent real estate debacle, we propose that the backward-looking "Santa Claus" strategy should be replaced by either a simple Buy-and-hold strategy or a contrarian investment strategy of increasing real estate exposure after a market downturn and reducing real estate exposure after a real estate market rally.