The great Indian obsession with real estate investments

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In recent years while working on various investment portfolios, there have been many instances seen of increasing allocations to real estate as an asset class. As the real estate investments are usually big ticket, purchase of a real estate investment usually means that an otherwise balanced portfolio will become lop sided or overweight real estate. Of course when we talk to investors, investors do retort that this is that next big idea which is going to double their net worth in a few years. So what therefore are the reasons why Indian investors are obsessed with real estate? Also, it is important to understand how this over exposure could have pitfalls for investors in some cases.

Bigger emotional connect with physical assets - Usually we find behaviorally that there is a bigger emotional connect that investors have with physical assets such as real estate and gold as compared to financial assets. This may stem from the fact that in India real estate investors have not seen prices of property go down. The usual thing one hears people say about property investments is that "What if it doesn't grow, this real estate investment will never go down".

Remember that there are two kinds of corrections that assets can undergo - price correction and the time correction. What the real estate markets are experiencing currently is a time correction, where values have remained same over a long period of time, giving investors an impression that the valuations of their holdings are intact. To know more of this, one could ask investors about the 90s when real estate prices remained flat for many years.

An emotional connect can therefore come in the way of investors making rationale decisions to exit investments in real estate and hence could prove a hindrance.

High absolute values – Many a time we hear people narrate stories as to how the property their father bought in the 70s has grown and multiplied to worth crores of rupees. Little do they understand is that if one calculates the growth rate for this investment made in the 70s today, the rate of return would be in the range of 10-12% pear year. For example a friend who bought a residential property in a posh locality in Juhu, Mumbai, in 1980 for Rs. 10 lakh, is now worth Rs. 4 crore. On doing the math, one understands that the rate of return is only 10.5% per year.

Assuming a similar long term horizon of 30+ years in the Indian stock markets or even simply in the BSE Sensex, one could have got much better results.

Considering liquidity as an important parameter in investment decisions, the fact that real estate investments are high value and big ticket in fact leads to illiquid assets. This may mean not being able to use funds even though investors may have a high net worth, mainly due to illiquid nature of this asset class.

Taxation impact creating more real estate investments - The tax rules currently mandate the capital gains made from sale of property to be reinvested in real estate and/or capital gain bonds. Due to human nature of avoiding taxation, gains from sale of property usually flow back into buying more of the same, thereby creating a continuous exposure of investor portfolios into this asset class. The other option of capital gains bonds offers a 6% rate of return which is unattractive to investors, thereby pushing them back to real estate.

This does not mean that exposure to real estate as an asset class is bad; the only disadvantage of this is that it does not allow portfolio rebalancing to happen from one asset class to another. For investors that are planning rebalancing from real estate to debt or equity may find that they may be in a fix after exiting from real estate as they either need to go back to real estate or to debt in the form of capital gain bonds.

Easy availability of leverage – With the lowering of interest rates and attractive financing schemes, Indian investors are finding it easier to fund real estate purchases. As buyers usually have to put down only 20% of the cost, the balance 80% being funded by lenders, property purchase has become easier for investors.

Although this is favorable for investors, what investors need to be aware of is that since this is an unregulated market currently, they should not fall for any false promises and /or funding schemes which they do not understand. This may lead investors to get into a negative cash flow situation especially if the EMIs that they have committed to are high. As under construction projects may not be completed in time, there may not be any rental inflows and hence the burden of EMIs may not be comfortable for investors.

In line with the above, our view is that investors should have real estate in their portfolio, but in moderation. As Shakespeare had once written "Can one desire too much of a good thing?"

Shalini is a member of The Financial Planners' Guild , India (FPGI). FPGI is an association of Practicing Certified Financial Planners to create awareness about Financial Planning among the public, promote professional excellence and ensure high quality practice standards.