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Enron's Downfall Good for Real Estate?

By Charles E. Gilliland

Energy giant Enron's implosion pointedly illustrates the rationale for diversifying investments into real estate. The daily din of reports on misreported income, distorted profits, hidden losses and warnings of further revelations focuses attention on the crucial issue of who controls the destiny of invested funds.

The Enron debacle is a classic example of what strategic management specialists call the *agency problem*, which occurs when a corporation's investors and management are separate, and managers make decisions inconsistent with the investors' objective of maximizing stock price. Ultimately, Enron managers, stewards of investors' funds, put personal enrichment above all other considerations. After creating an illusion of profitability, many executives are alleged to have cashed out of Enron shares before the precipitous price drop rendered the stock virtually worthless.

At the same time, policies blocked employees from disposing of the Enron stock in their retirement portfolios. These headline-grabbing stories point out the danger of investing in an enterprise controlled by others whose activities take place beyond the view of investors.

Downside of Separate Management

Management owes a fiduciary responsibility to shareholders, and most corporate officers remain faithful to those obligations. In the worst-case scenario, however, managers seek to maximize their personal wealth and ignore the best interests of shareholders and employees. This flaw in corporate structure separates management decisions from responsibility for the consequences of those decisions.

Despite this flaw, investors flock to the corporate structure to maximize returns on investments through the benefits of specialization and economies of scale gained from pooled resources. They entrust their funds to a management team presumed to possess skills that allow them to wisely use those funds. Although they are the nominal owners of the corporation, each shareholder in the multitude of shareholders has little individual influence on corporate decisions.

To help protect investors, modern economies have devised legal structures that create a web of obligations for corporate leaders. Those legal restrictions give investors a reasonable level of assurance that corporate management will act in investors' best interests.

Corporate managers are required to report on business activities so investors can make informed decisions about whether to hold or dispose of their shares. Battered by daily concerns, investors increasingly focus on corporate earnings as an indicator of management's competence. Quarterly earnings reports are the primary measure of success or failure. Annual reports provide a more detailed accounting to those who own shares in the corporation.

Winning and Losing Trust

But as the Enron story illustrates, the system is driven by trust. Investors looked past the confusing accounting to the persons they trusted at the helm. At Enron, those managers had done well and were considered upstanding individuals possessing high levels of energy and intelligence. They had won big in the past. It seemed a sure bet they would do so in the future.

The Enron situation is not the only example of corporate management allowing socially irresponsible impulses to gain the upper hand. Each time a corporation becomes a takeover target, managers invariably devise so-called golden parachutes. The entire enterprise may not collapse in an ignominious eruption of scandals, but often top executives at the acquired firm arrange a gold-plated exit for themselves, leaving behind disappointing returns.

The temptation to use resources entrusted to them for personal gain occasionally proves overpowering. Those corrupting tendencies lurk in virtually every large business enterprise using other peoples' money. Ultimately, managers' integrity and the legal system are the last defenses against such corruption.

The disquiet settling over the stock market in the wake of Enron hearings in Congress and ongoing revelations in the media reflect a tacit acknowledgement that managerial chicanery may have infested other firms. The shock of the September 2001 attacks and the ensuing war have further heightened the perception of risk in investing in stocks.

Renewed Interest in Real Estate

In light of these misgivings, some investors may find direct investment in individual real estate projects an attractive alternative to pouring funds into equity shares of corporations, including real estate investment trusts, or even corporate bonds. The single most defining characteristic of real estate, namely location, comes with both advantages and disadvantages. Investors in real estate projects have the opportunity to take more direct control of their investments.

Because direct real estate investors can identify and see the assets from time to time, they can personally oversee the project and its managers. This places responsibility for risk management squarely in investors' hands and frees them from depending on corporate managers known to them only through glitzy annual reports or news stories.

Investors can quickly correct problems and take steps required to maximize their returns. In addition, they can share in the vision of creating projects that will help define local communities. In short, real estate investment offers more control of funds invested much closer to home than investments in corporate financial instruments, in which the only control investors have may be whether to hold or sell the security.

Real estate investments have potential disadvantages. First, the increased degree of control real estate investments offer requires greater vigilance from the investor. Second, prudent real estate investing requires study of real estate economics and local markets and a keen eye for future market developments.

Despite the increase in personal control, real estate investment carries the risk of loss. Finally, real estate investments are illiquid compared with corporate securities traded in large volumes daily.

For investors with limited knowledge of real estate markets, partnerships may offer an attractive option. Investors can create partnerships in which neophytes depend on more experienced partners to oversee projects. While ceding some degree of control, many partnerships involve circles of friends who have built trusting relationships. Personally knowing and trusting your partners gives a much greater level of control than anonymous corporate investment vehicles.

Anecdotal evidence gleaned from recent interviews with ranchland brokers indicates a new interest in buying and holding land among investors. One broker reported that a client searching for a ranch said, “With the times like they are, I want to own some land. It will always be worth something.” Others report hearing similar sentiments among land buyers. The uncertainty of the global political situation and the renewed focus on the risk of investment in securities appears to have enhanced real estate as a viable investment alternative.

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