Commonality in Liquidity and Real Estate Securities*

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Abstract

We conduct an empirical investigation of the pricing and economic sources of commonality in liquidity in the U.S. REIT market. Taking advantage of the specific characteristics of REITs, we analyze three types of commonality in liquidity: within-asset commonality, cross-asset commonality (with the stock market), and cross-asset commonality (with the underlying property market). We find evidence that the three types of commonality in liquidity are priced in REIT returns but differently depending on market conditions. We also show that commonality in liquidity is mainly driven by demand-side factors. Finally, we find that REIT returns are sensitive to shocks in the REIT and stock market liquidity but relatively immune to those in the private real estate market. Overall, these results suggest that the liquidity advantages of investing in REITs are somewhat overstated.

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Executive Summary

Liquidity is a key element in investment decision-making. In real estate investing, REIT shares are often considered as a popular liquid alternative to direct investments. Although more liquid than direct investments, a REIT share's liquidity could be correlated with the overall REIT market liquidity and, given the hybrid nature of REITs, also with the liquidity of stocks or of private real estate (i.e., there could be commonality in liquidity). This would have notable adverse consequences during bad market conditions. This paper analyzes how such a risk can impact asset prices. We analyze three types of commonality in liquidity: within-asset commonality, cross-asset commonality (with the stock market) and commonality with the underlying real estate market. We use U.S. REIT data for our empirical investigations.

We first analyze the patterns of commonality in liquidity. We find that the within- and cross-asset commonalities in liquidity are relatively important and unrelated to firm size and liquidity. The commonality in liquidity with the underlying asset is generally low, although we observe a sharp increase during the subprime crisis. In addition, we find that the liquidity of larger and more liquid REITs tends to comove less with the liquidity of the private market.

We then test whether the three types of commonality in liquidity represent priced risk factors in REIT returns. Our empirical investigation relies on a conditional approach where the impact of commonality in liquidity on REIT returns is hypothesized to vary according to the state of the economy. We find evidence that the three types of commonality in liquidity are priced in REIT returns but differently depending on market conditions. More specifically, the within-asset commonality in liquidity and the commonality with the underlying asset liquidity are significant risk factors only in a high-risk state of the economy, while the cross-asset commonality is significant only in a low-risk state. Investors are thus willing to pay more for REIT shares which allow them to exit positions at a relatively low cost when the liquidity of the overall REIT market, that of the stock market or that of the underlying real estate market declines. Thus, the liquidity advantages of REITs should be nuanced.

Finally, we seek to identify the economic sources of the within- and cross- asset commonality in liquidity, testing both supply-side (i.e., credit availability) and demand-side determinants (i.e., correlated trading activity and investors sentiment) of liquidity. Our findings favor a demand-side explanation and challenge therefore the ability of the popular funding liquidity theory to fully explain commonality in liquidity.

Our empirical findings offer interesting insights to real estate investors. Although more liquid than direct investments, real estate securities embed a particular risk as materialized by commonality in liquidity. Furthermore, we show that commonality in liquidity has several dimensions which influence REIT prices. Our paper is the first one highlighting the importance of such risks. Investors should be aware of such risks and avoid making decisions based solely on the liquidity level of the assets; they would benefit from holding assets whose liquidities are not correlated, in particular during stressful periods.