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How about real estate futures?

They could offer investors high, stable returns and, importantly, a transparent benchmark of prices

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When inflation is close to 10 per cent most of the time and an investor wants to maximise returns, the nominal return should be more than the inflation rate. Typically, the stock market is considered the best bet, while government securities (GSecs) give the most conservative yield, though the relative risks are proportional. Bank deposits are somewhere in between. One area that has not been looked at closely is the real estate market.

The National Housing Bank (NHB) tracks an index called the Residex, which looks at residential housing prices over 15 centres. This has been reckoned from 2007 onwards, and is tracked on a quarterly basis. Now, there are some very interesting observations over the 4.25 years ending March 2012. First, 11 of the 15 centres gave an average compound return that was positive against the Sensex, which declined around 3.5 per cent. In fact, nine centres gave returns between 12 and 20 per cent.

Second, Hyderabad, Jaipur, Kochi and Bangalore are the centres that reported negative returns. Third, the highest return was clocked by Chennai at 30 per cent, followed by Faridabad with 20 per cent and Bhopal with 18.3 per cent. Mumbai gave a return of 16.3 per cent and Delhi 13 per cent. Clearly, this is one avenue that the investor has not seriously considered, given the capital outlay involved. These returns cover inflation adequately, which averaged 7.6 per cent on a compound basis during the period.

Against these returns, the average price volatility, which is a symbol of risk, was 42 per cent for the Sensex, while it was above 30 per cent in two cities, between 20 and 30 per cent in five cities and between 10 and 20 per cent for eight cities. Clearly, real estate appears to be less volatile than the stock market and, hence, less risky, *prima facie,* in terms of idiosyncrasy. This becomes important because it also relates to risk-return tradeoff. The GSec market, on the other hand, had a volatility of just five per cent, but gave a yield of 6.7 per cent, which does not cover inflation.

The idea that needs to be worked on is whether we can think of going in for real estate "futures" in the same manner that the forex derivative market has evolved. This will give individuals an opportunity to actually start investing in this market, ultimately helping in efficient price discovery, which is absent today. The contract will be on the Residex - which NHB announces - so the settlement price will also have to be declared by NHB. It has to be non-deliverable and cash-settled.

NEW AVENUE Investors have not seriously considered the real estate market given the capital outlay involved

Who will buy and sell these futures contracts? Individual investors can go *long* if they expect prices to move up, or go *short* if prices are expected to fall. Real estate agents and builders would also be keen to cover their risk as hedgers as will buyers of property, who can benchmark their own exposure to property with these indices. This way, they are covered as either buyers or sellers.

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The advantage for the investor or speculator would be that unlike today, when the person borrows money to invest, this will be based on a margin calculated by the commodity exchange, which will be much lower than the cost of the project. The minimum lot size could be fixed at ?10 lakh, depending on the location.

Currently, there is no way of hedging risk when it comes to property. Once a buyer contracts for a price and starts paying instalments, and the price comes down, there is an implicit loss that can be covered on the exchange now (though this has not really been prevalent in recent times when prices move only in one direction). The same holds for developers who would have actually borrowed in the unorganised market at very high interest rates.

They run a relatively higher risk given that capital investment is higher. This risk can be lowered through hedging positions on the exchange. The same holds for second-hand property, which will automatically be linked with the Residex.

The interesting part will, of course, be the daily settlement prices that have to be either polled by the exchange or declared by NHB. While this may not be possible on a daily basis, a weekly quotation can be attempted. With trading widening, there would be a tendency for the futures traded prices to feed back into the spot prices of property, thus making it more efficient, since it will be based on market forces and not on the builders/real estate companies, as is the case today. Prevailing prices today are opaque because property dealers are able to hold on to unreasonable prices at a time of a decline in the market.

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The writer is chief economist, C
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