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ECONOMIC BEHAVIOR AND ATTITUDES
OF RENTAL PROPERTY OWNERS

BY

MARIAN F. WOLFE

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ECONOMIC BEHAVIOR AND ATTITUDES
OF RENTAL PROPERTY OWNERS

By

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California, Chancellor's Patent Fund, the Center for Real Estate and Urban
Economics, and the U.S. Department of Housing and Urban Development.
Introduction: Statement of the Problem

The determination of profitability in residential real estate is based on several key financial indicators, such as capital gains and after tax income. Investors are assumed to follow professional management and investment strategies, designed to generate maximum levels of after tax income (including tax shelter). A recent survey of one hundred rental property owners in Alameda County, California, casts doubt on this assessment of profitability and associated investor strategies. In spite of low levels of after tax income, most owners interviewed felt that their investments were profitable. Furthermore, survey responses covering management and investment strategies, reveal that few investors are professional "profit-maximizers."

It is important to expand our understanding both of owners' perceptions of their investments and the strategies they practice in owning and managing their properties. Perceptions of today's market are influential in formulating expectations of the future market. These expectations, in turn, affect sales prices and development decisions. According to George Katona, economists have traditionally glossed over the importance of market perceptions, since objective data on them were impossible to obtain.1 Secondly, insight into economic behavior is necessary to project investors' responses to policy or market changes. Most analysts assume that owners are professional, profit-maximizers. This simplification then permits analysis of investor sensitivity to changing market conditions. A good example of this is projections of investors' responses to changes in tax laws. Since market analysis is based on assumptions of investor behavior, improving our knowledge of attitudes and behavior is critical.

In the late 1970's and early 1980's, housing analysts discussed the profitability crisis in existing rental housing. The majority view held that there
was a crisis; the minority position stated there was not. It would be helpful to determine whether owners, themselves, felt there was a profitability crisis. It is reasonable to believe that investors differentially evaluate investment performance of their properties. For example, although many properties generated negative cash flows in the early 1970's, it is possible that not all owners saw this situation as undesirable. For example, someone who purchased for capital appreciation would not be as disappointed by negative cash flows as would be the individual who purchased for income.

Another reason why we need to understand investors' attitudes and investment behavior is to know how they might realistically respond to changes in tax laws or rent regulation statutes. Assuming that there is a profitability crisis, it is possible that the public sector will intervene in the market to improve the level of profits. If policies are based on projections of idealized investors, the outcomes of intervention may not be in the direction originally intended. With more accurate models of behavior, public sector policies might be more effective. Although this paper does not actually posit alternative models, it does raise questions about the use of the "rational economic actor" model and encourages further research in this area.

To explore these issues, this paper will first review other models of landlord behavior for a comparative framework. It will then examine investment strategies and rent raising policies within this framework, by analyzing responses from in-depth interviews conducted in 1981 with over one hundred property owners in four Alameda County cities (Berkeley, Hayward, Oakland, and Fremont). The properties owned by these respondents are located in middle income rental markets which face strong, effective demand. Finally, this paper will analyze respondents' perceptions of the financial performance of their properties and compare these impressions with actual profit components, such as cash flow and appreciation.
Models of Landlord Behavior

There are two major models that explain landlord behavior. The first utilizes assumptions of profit maximizing, rational behavior from neoclassical economic theory to describe landlord characteristics and responses. Explanations for the current crisis in rental housing profitability frequently are based on the outlook of this professional investor, who compares the competitive financial advantages of multifamily housing and concludes that "the multifamily structure, except under unique circumstances and unique locations, (is) a relatively riskful, noninflation-proof investment."

Some of the owners interviewed in this study fit the professional investor model, as illustrated by the following example of "Jack Miller," an Oakland property owner.

Jack Miller, head of the Jack Miller Property and Investment Management Company, owns a twenty-eight unit building with five partners in a limited partnership. Jack is the general partner, and his company manages the property. He and his partners had originally purchased the land in 1969 and constructed the building. Consequently, they take a double declining balance method of depreciation.

The building has a net operating income ratio of .46, reflecting fees paid both to the off-site management company and a salary for a resident manager. Additionally, over six thousand dollars was paid in 1980 for advertising, legal, and accounting fees.

Jack and his partner developed the property originally for appreciation, and, in fact, the actual appreciation rate has exceeded original expectations. They had intended to hold onto the property for about ten years, but now feel they may own it for more time, since to "maximize sales price, we would have to sell to a condo converter. We were in negotiations with one, when the moratorium against conversions was declared in Oakland." Also, they had intended to refinance the property, but waited too long and "missed the boat. We should have known better. We waited for interest rates to go down." Jack would like to sell the property because he is sick of it. "If we could get a decent price when the capital gains law changes, it would be a good business decision to sell."

Jack Miller earns between $150,000 and $200,000 adjusted gross income per year, has assets between three and ten million, and owns six other residential income properties, totaling 575 units.
The second landlord model is based on empirical studies of owners of low income rental housing and stresses the nonprofessional motivations of landlords, which indicate satisficing, not profit maximizing, behavior. One Canadian study said these owners constitute "the other economy." Solomon and Vandell refined this concept and developed it into a theory of housing markets in declining areas, referring to it as the "dual theory." Discussions of the current crisis in the rental market do not entirely ignore this second model. For example, Anthony Downs explained rent practices of owners by saying that they are "turn-over-minimizers" and not "profit-maximizers." This is an illustration of nonprofessional economic behavior.

The following story of a widowed owner in Oakland provides an example of the nonprofessional owner:

This owner is a widow who is 75 years old. She has owned her 1922 duplex since 1941. The mortgage is completely paid off. She lives downstairs and rents out the upstairs, which is a one bedroom for $130/month. (The median rent for a one-bedroom apartment in the Oakland sample was $275.) She says that expenses have increased faster than rents, because she chose to keep rents low. One woman lived there for eight years and didn't have a single rent increase.

She and her husband purchased the property originally, just as a home for themselves. They had intended to live there until the War was over, but decided to stay since her husband liked the house and didn't want to move. When asked what policy could increase profits the most in rental housing, she said "I am not enough into any of these things to form an opinion."

She owns no other property, but does have some stocks, bonds, and savings totaling $150,000. Her 1980 adjusted gross income was under $10,000.

These case stories illustrate extreme variation among owners. One very apparent difference is whether the property is used for economic purposes. Although the widow receives income from her duplex, she also lives there, so that ownership provides nonpecuniary benefits. On the other hand, Jack Miller owns his apartment building for very specific investment goals.
In order to explore variation among owners, Figure 1 presents a comparison of professional owners with nonprofessional owners. Although it is possible that any individual owner could be completely professional or wholly an amateur, most owners fall somewhere in between. Of central importance to this study is the way in which management practices and investment strategies vary among owners along this continuum. The two case stories above showed that investment goals varied greatly. On the one hand, Jack Miller is aware of ways in which the investment should be handled to maximize profits. He uses a double declining balance method of depreciation, considers refinancing at the appropriate time, and projects a specific holding period at the time of acquisition. The widow, on the other hand, purchased her rental property originally as a home. She had not articulated economic goals beyond that. In regards to financing, the widow has not leveraged the property, but owns it free and clear, while Jack Miller realized he "missed the boat" in not refinancing his property sooner.

This polarity continues in the area of management practices. Jack Miller runs a professional company, which manages the property. There are high direct management expenses, including some which a small scale owner would not even incur, such as advertising and a salary paid to a resident manager. In contrast, the widow does not raise rents, in spite of rising operating expenses. Perhaps since she lives downstairs from the rental unit, she wanted to retain a good tenant. One can see that these two examples highlight some of the differences indicated in Figure 1.

So far most of the empirical works on landlord behavior have looked at owners of low income rental property and in many cases have provided evidence of the prevalence of noneconomic landlord behavior. The applicability of this model to owners of middle income rental housing has not yet been documented. Do owners of middle income rental properties attempt to maximize profits or do
### Figure 1
Comparison of Professional with Nonprofessional Owners

<table>
<thead>
<tr>
<th>Characteristics of Buildings</th>
<th>Professional (Profit Maximizing Owner)</th>
<th>Nonprofessional (Satisficing Owner)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Newer, Larger</td>
<td>Older, Smaller</td>
</tr>
<tr>
<td>Lives off-site, possibly</td>
<td></td>
<td></td>
</tr>
<tr>
<td>out of area. Large scale,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>sophisticated.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Resident owners, part-time,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>small-scale. Unsophisticated,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>own time considered a free</td>
<td></td>
<td></td>
</tr>
<tr>
<td>resource.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Management Practices:**

<table>
<thead>
<tr>
<th>Tenant-Landlord Relations</th>
<th>Arms length, businesslike often through paid staff. Contractual obligations.</th>
<th>Face-to-face contact, absence of formal lease. Few evictions.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent Levels</td>
<td>Competitive, level determined by supply and demand. Regularly scheduled increases.</td>
<td>Below market rents out of desire to preserve tenant satisfaction. Lack of articulated rent raising policy.</td>
</tr>
<tr>
<td>Management and Maintenance</td>
<td>By paid staff or contracts.</td>
<td>Self taught, own input, hired labor minimized.</td>
</tr>
</tbody>
</table>

**Investment Strategies:**

<table>
<thead>
<tr>
<th>Investment Goals</th>
<th>Profit maximization. Aware of competitive nature of alternative investments.</th>
<th>Complex, not always articulated, possibly nonpecuniary in nature.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing for Acquisition or Improvements</td>
<td>Economic use of mobile capital. Search for lowest interest rates and high degree of leveraging.</td>
<td>Low level of leveraging. Does not like using borrowed funds.</td>
</tr>
<tr>
<td>Assessment of Investment Performance</td>
<td>Professional assessment, based on analyzing all components of profit.</td>
<td>Minimal or none.</td>
</tr>
</tbody>
</table>


they pursue other goals? Since much of the "crisis in rental housing" literature relies on a neoclassical economic model of landlord behavior, it is important to know to what extent this accurately describes owners in middle income submarkets. Although this present study is too limited in scope to answer this question, it can provide insight into the issues.

Investment Strategies

Investment strategies describe the motives and considerations that property owners have that guide their investment behavior both before and after property acquisition. Frequently, when analysts project investors' responses to changes in income tax laws or rent regulation, they use a professional investor model. For example, if a change in tax laws penalizes short term ownership, then investors are expected to hold onto their properties longer, because they are assumed to be sensitive to the tax consequences of selling. Additionally, by accepting a professional model of behavior, one can then assume there is consistency between goals and actions. If an owner purchases a building for the purposes of appreciation, then this owner would project an appreciation rate over an intended holding period and consequently acquire a piece of property meeting those objectives.

The survey obtained information from property owners on several aspects of investment strategies:

- Main reason for acquiring the property;
- Whether the owner considered other investment options;
- Anticipated holding period;
- Projected rate of appreciation, and
- Use of financing.

Figure 2 compares the responses of the surveyed owners with the model of the "professional" investor in each of these five areas.
<table>
<thead>
<tr>
<th>Investment Strategy</th>
<th>Professional Investor</th>
<th>Survey Sample (n=103)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Main reason for acquiring property</td>
<td>Will vary in relative emphasis among economic goals, such as appreciation, tax shelter, and income.</td>
<td>Two-thirds purchased for economic reasons (one-fourth for tax shelter, one-fourth for income, one-sixth for appreciation). One-third of the sample purchased for noneconomic reasons, primarily as a home for the owner or relative of the owner.</td>
</tr>
<tr>
<td>Consideration of other investment options</td>
<td>Will consider other investment options, both in and out of real estate to satisfy him or herself that selection of a particular investment will maximize profits.</td>
<td>One-third of sample did not consider any other option, either in real estate or outside of real estate. Two-thirds considered other options (one-half looked only at real estate and one-sixth considered both real estate and investments aside from real estate.</td>
</tr>
<tr>
<td>Ability to consider and estimate holding period</td>
<td>Estimation of holding period is used in projecting profit from property prior to the time of acquisition. This estimate is often based on the period of maximum tax shelter advantages.</td>
<td>Two-fifths of the sample projected a holding period (median was five years). Two-fifths thought they would hold the property indefinitely, and one-fifth did not think about it.</td>
</tr>
<tr>
<td>Ability to estimate appreciation over holding period</td>
<td>Estimation of appreciation rate is used in projecting profit from property prior to the time of acquisition. This estimate is based on careful market analysis.</td>
<td>One-half of sample did not know what appreciation rate to expect at the time of acquisition.</td>
</tr>
<tr>
<td>Use of financing for property acquisition, property improvements, or other investments</td>
<td>If feasible, owner will use leveraging as much as possible in initial acquisition. If owner plans on holding onto property for an extended period of time, then he or she will refinance to pull out equity. Major improvements will be paid for with borrowed funds.</td>
<td>Eighty-six percent of the sample properties have outstanding mortgages. One-quarter of the properties were refinanced.</td>
</tr>
</tbody>
</table>

Source: Figure 1 and Investor Interviews.
What motivates an individual to acquire property in the first place is a very basic consideration. The professional investor acquires property for economic reasons, which may stem from individual circumstances (need for income tax shelter or relative liquidity) or from market and institutional conditions (changes in tax statutes or market strength). Property owners interviewed in this study primarily cited economic reasons for acquiring properties. Figure 2 shows that tax shelter and income were the two most frequently mentioned financial reasons. However, one-third of the sample said they acquired their properties for nonfinancial reasons, either to provide a home for themselves or a relative or for other reasons that have little to do with standard investment strategies.

Table 1 presents the distribution of purchase reasons by when the property was acquired, size of project, and owner's 1980 adjusted gross income. Given the nature of the late 1970's rental market, one would assume that investors acquiring property at that time would be more likely to purchase for appreciation than for income. In fact, thirty-eight percent of the owners of the sampled properties that were purchased between 1976 and 1980 said the main reason they bought was appreciation, and only fourteen percent of that group cited income. Small multiples appeal to owners who are interested in living in one of the units. Table 1 shows that owners who said they wanted a home or who gave other personal reasons were more likely to buy small multiples. This purchase reason shows the strongest relationship with size of project, whereas the other reasons are more evenly distributed across project sizes. Finally, one assumes that a higher income individual would be more interested in tax shelter and less interested in living in his or her rental property. This relationship is supported by the information presented in Table 1.
Table 1

Owner's Reason for Purchasing Property by When Purchased, Size of Project and Owner's Income

<table>
<thead>
<tr>
<th>Main Reason for Purchasing Property</th>
<th>Tax Shelter (n=19)</th>
<th>Appreciation (n=26)</th>
<th>Income (n=24)</th>
<th>Home or Other Personal Reason (n=34)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year Purchased</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1975 or earlier</td>
<td>47%</td>
<td>38%</td>
<td>75%</td>
<td>71%</td>
</tr>
<tr>
<td>1976-1980</td>
<td>53%</td>
<td>62%</td>
<td>25%</td>
<td>29%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Size of Project</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1-4 units</td>
<td>32%</td>
<td>31%</td>
<td>21%</td>
<td>70%</td>
</tr>
<tr>
<td>5-19 units</td>
<td>47%</td>
<td>38%</td>
<td>37%</td>
<td>24%</td>
</tr>
<tr>
<td>20-49 units</td>
<td>21%</td>
<td>31%</td>
<td>42%</td>
<td>6%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td><strong>1980 Owner's Adjusted Gross Income</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$20,000 and under</td>
<td>24%</td>
<td>23%</td>
<td>24%</td>
<td>33%</td>
</tr>
<tr>
<td>$20,000 to $40,000</td>
<td>29%</td>
<td>45%</td>
<td>38%</td>
<td>53%</td>
</tr>
<tr>
<td>$40,000 and over</td>
<td>47%</td>
<td>32%</td>
<td>38%</td>
<td>13%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>99%</td>
</tr>
</tbody>
</table>

Source: Investor Interviews.
Another issue is whether investors considered other investment alternatives at the time they acquired their properties. A professional investor would consider other options, evaluate returns and risks associated with each option, and then select the opportunity that maximizes profits, given the risk level. In the survey of property owners, two-thirds of the respondents reported that they had considered other investment options, primarily real estate. However, one-third of the sample did not consider any other option. (See Figure 2.)

A third investment consideration is how long to own a property before selling it. The holding period is important in estimating a rate of return because it is needed to determine the nature of tax shelter benefits and capital gains. Furthermore, if one of the goals of real estate investment is to trade up, then an investor would buy with the intent to sell the property (unless he or she planned on refinancing). ¹²

Less than half of the surveyed owners had a specific holding period in mind when they purchased their properties. Of those who did estimate a holding period, over sixty percent now think they will own their properties for more time. The primary reason for this is market factors (market has slowed, cannot sell, would be hard to trade up). Another reason given by owners for wanting to hold onto properties longer is that their properties are generating profits. About forty percent of the respondents said they planned on owning their properties indefinitely, and the majority of them still feel this way. Finally, about one-fifth of the sample never thought about a holding period originally. About half of those now feel they would like to sell, and the rest still want to hold onto their properties.

Another investment consideration is appreciation, an important source of profit in rental housing, particularly in the recent past. Projecting a rate of appreciation allows an investor to estimate the amount of capital gains that a
prospective property might provide. About one-half of the surveyed owners said they had projected a rate of appreciation when they purchased their properties. (See Figure 2.) One would expect that individuals who purchased their properties more recently would be more likely to have projected an appreciation rate. In fact, owners who purchased since 1976 were twice as likely to have projected an appreciation rate as those who purchased before 1976.

Respondents who said they had not projected an appreciation rate were asked what they now thought. Many of their responses reflected little understanding of appreciation. For example, about one-third said that the property had not appreciated, since its value had gone up with inflation. Several still could not estimate appreciation, since they did not expect to have any appreciation and did not really care about it. However, there were also respondents who were now able to estimate appreciation rates on their properties and supplied a percentage or dollar amount.

Finally, an investment strategy may include the use of borrowed funds, to pay for initial property acquisition, capital improvements or to pull out equity through refinancing. Using borrowed money has two major advantages. First, it allows a greater amount of the owner's capital to be used for other investments. Secondly, since interest is a deductible expense, the real cost of borrowing money is reduced, particularly for those in higher tax brackets. Most of the respondents in this sample mentioned that there was some financing on their properties. (See Figure 2.)

The decision to refinance may reflect a more professional investment strategy, since it shows an awareness that the property has additional value beyond the income stream and appreciation "on paper." The mid to late 1970's would have been an ideal time to refinance, since properties were appreciating quickly, and interest rates had not yet risen too high. Of the twenty-five own-
ers who refinanced, twenty of them did so between 1976 and 1980. Owners who refinanced used the money for property or investment related expenditures. There were several, however, who mentioned that they used the money for personal reasons in the same way an owner of a single family house would. Those owners who did not refinance were asked if there was a reason why they had not. About half of those who had not refinanced said there was no reason. The other half said that interest rates were too high. The owners in this sample, therefore, fall into three groups: the first group refinanced in the late 1970's, the second group considered refinancing but concluded that interest rates were too high, and the third group, numerically the largest, really had not considered it.

The investment strategies in this section show that this sample contains a mixture of owners. Survey responses analyzed show that in the areas of estimating holding periods and appreciation and in the use or consideration of refinancing, at least half of the investors did not use strategies that one associates with professional investment behavior. Also at least one-third of the owners did not purchase their properties for economic reasons nor did they consider other investment opportunities.

Rent Raising Policies

One of the questions frequently raised (and often unanswered) is why owners have not increased rents more in the last five to seven years when the rate of inflation was high, and the supply of rental housing has tightened. This analysis will not be able to answer this question, but can discuss the following:

• What percentage did owners raise their rents between 1980 and 1981;
How did this increase compare with previous years' increases, and
How often do owners raise rents of existing tenants and new tenants?

Most owners raised rents between 1980 and 1981, although there were fourteen (out of 103) who did not. The median rent increase was seven percent, with a range from zero to thirty-four percent. There is a slight difference in percentage rent increases within different types of management situations; however, the difference is surprisingly small.

According to neoclassical economic theory, if demand rises faster than supply, then, the resulting market disequilibrium should lead to a rise in price. Since Bay Area rental property owners faced increased demand for their rental units, it would follow that, if they were profit maximizers, their 1981 rent increases should be higher than increases they had made in the past. Of the eighty-eight owners who reported some increases in 1981 (and who have owned their properties for more than one year), fifty-two percent said that the 1981 increase was the same as in previous years, twenty-seven percent said it was higher, and twenty percent said it was lower. Clearly, then, most owners in this sample were not taking advantage of market disequilibrium.

How do professional managers determine what are market rent levels? One key informant said he checks with other resident managers who handle properties similar to the property under question. Another approach was described by an Oakland manager as being his "rule of thumb."

If the unit is priced at the market rate, then one out of five people looking at the apartment will submit an application for it. If ten people look at the unit, and if the unit is located in a decent area, and if no one wants it, then the rent level is too high. You can't ask more than the market price. The tenant knows better than that. If I try to squeeze that extra fifty dollars, I've got to weigh this against the costs of not renting the apartment right away.
In setting rent raising policies, many managers give preferential treatment to existing tenants. Lowry has called this practice, the "length-of-stay discount."\textsuperscript{17} Tenant turnover provides an ideal opportunity to increase rents; consequently, one would assume that a professional owner would increase rents for tenants at that time. Professional managers interviewed during the key informant interviews follow this policy. They indicated that they practice a dual rent policy in order to retain tenants, while at the same time, they do not let rents get too much below market levels.\textsuperscript{18} Over one-half of the owners interviewed said they automatically increased rents for new tenants, and one-third said that they keep the rent at the same level that prevailed for the previous tenant. (However, this is not entirely a market response, since many of the respondents falling into this latter group own property in Berkeley, where rent regulation policies preclude increasing rents on new tenants.)

Owners were also asked in the survey how often they increased rents for existing tenants. Of the ninety-five owners who increase rents on existing tenants, two-thirds follow some schedule in how often rents are increased, which is what one expects of professional management. Following a schedule in rent increases also resulted in a higher rate of increase from 1980 to 1981.

The rent raising policies of owners described so far cannot be categorized easily. In many cases, owners pursue policies that are professional, e.g., regularly scheduled rent increases. There are also some examples where owners deviate from a professional approach. For example, most owners did not raise rents more in 1980 than in previous years, and many do not automatically increase rents for new tenants where it is still allowed. These findings suggest that there is a great deal of diversity among owners. Furthermore, even individual owners display inconsistencies in their own behavior. The following case stories illustrate this latter point. The first two are owners who gave no
rent increases in 1980 to 1981, and the second two are owners who gave increases
that were among the highest in the sample.

Three couples own an eighteen unit building in Oakland together
as joint tenants. They purchased this modern building in 1978 pri-
marily for appreciation and have both a first and second mortgage on
the property. They manage the building themselves. They did not
increase rents at all in 1980 to 1981 and generally do not increase
rents on existing tenants since "it's awkward." However, they do
increase rents up to market level on new tenants. Overall, however,
the average rents charged in this building were below the median
level for the Oakland sample.

"Mary Smith," now retired, once worked in an elementary school
cafeteria. She purchased a Fremont duplex in 1970, primarily to move
to a better neighborhood where her son would have a "different class
of kids" to run around with. She owns the property free and clear.
Mary lives in one unit and rents out the other. She originally
wanted to charge her previous tenant $400 per month but raised it to
$435 after the tenant encouraged her to raise the rent. Then when
the current tenant moved in, the owner decreased the rent to $425,
since the tenant waters the lawn. Even though Mary Smith sees her-
self as not pursuing a rigorous rent policy, in fact, the rental
amount of $425 that she charges is among the highest in the Fremont
sample.

Six partners own a forty-six unit building in Hayward that is
managed by the general partner's property management company. They
purchased the property in 1976 primarily for tax shelter and have a
first and second mortgage. Because they remodeled the building's
bathrooms and kitchens, the general partner increased rents about
twenty-two percent between 1980 and 1981. This was higher than their
usual yearly rent increase which has averaged twelve percent over the
last several years. The management company increases rents on exist-
ing tenants twice a year, and in addition, increases rents on new
renters by an additional two to three percent. Not surprisingly,
rents charged at this building are higher than the median for the
Hayward sample. These rent policies violate Hayward's rent regula-
tion ordinance. Yet, the general partner said that they are doing
less basic maintenance now than in the past, since it "costs too
much. Can't afford to. Can't recover costs because of rent
control."

A retired secretary owns a converted, large house with a cottage
in the back in Oakland. She paid cash for the five unit property in
1957 and purchased it to earn income. She lives in one unit, rents
out the other four, and pays for all her tenants' utilities. In 1980
to 1981 she increased rents by an average of seventeen percent, which
was higher than in the past, since she normally did not increase
rents at all. However, a real estate man told her that her rents
were way too low and she is "trying to get them up." This explains
the size of last year's rent increase, which violates Oakland's rent
ordinance. (However, she is unaware that such an ordinance even exists.) In spite of the seventeen percent increase, her rents are still below the median rent levels in the Oakland sample.

In the first story, the owners feel personally awkward in raising rents on existing tenants, yet they are aware of and use the concept of market rent levels to guide their behavior. In the second case, "Mary Smith" has close relationships with her tenants, does not see herself as increasing rents very much, yet receives a high rent for her unit. In the third case, the professional management company has aggressive rent raising policies and ignores the existence of rent regulation in Hayward. However, the general partner said that they have reduced basic maintenance because they cannot recoup their expenditures through increased rents. This directly contradicts what the company did in 1981, when it raised rents by twenty-two percent to cover costs of remodeling kitchens and bathrooms. Finally, the retired secretary charges very low rents and only increased them substantially in 1981 because a "professional" gave her advice.

The purpose of this section was to analyze rent raising policies of a sample of rental property owners. Based on the available data, the analysis shows that owners cannot be easily categorized as either "professionals" or "amateurs," since within this sample, there is evidence of both professional and nonprofessional behavior.

Owners' Attitudes About Their Investments

Most analysts writing about the rental housing crisis do not explore the question of attitudes about the rental market independently from actual investment performance. It is assumed that negative attitudes toward rental housing investment stem from its low financial return relative to other investments. If owners do form opinions based on commonly held financial criteria, then such an
assertion is valid. However, since we have already seen diversity among owners in the areas of rent raising practices and investment strategies, we may want to question this. It is possible that, in forming attitudes about their investments, this sample of owners does not use profit maximizing criteria. In fact, results from this survey do show a different trend. Owners, in some cases, do not realistically assess property performance and have (or at least report having) a more positive attitude towards their properties than may be economically justified. The following section will explore this issue.

Since one of the concerns of this study is the perception of profitability, the survey included questions that assessed an owner's satisfaction with his or her investment. One of the last questions asked was whether ownership of the property had been profitable. Eighty-one percent of the owners said they thought it was profitable, but this probably overstates respondents' satisfaction. It is necessary, therefore, to go beyond a single question to analyze satisfaction in more detail.

Respondents were asked whether they would still buy the property, and seventy-four percent said they would, again reflecting a high level of satisfaction. When asked if they would like to sell their properties, about half said they would. However, many of the reasons provided for wanting to sell do not reflect disenchantment with the rental market. Of the forty-nine owners who said they wanted to sell, fifty-one percent gave reasons that were either personal or reflect a standard investment strategy. The other three response categories (hard way to make money, rent control and returns are not enough), show dissatisfaction with rental housing investment.

The survey also examined satisfaction with specific profit components. All respondents were asked whether their cash flow was more, the same or less than anticipated. Two-thirds said it was the same or more than anticipated. A simi-
lar question was asked in regards to tax shelter, and seventy-one percent said it was more or the same as expected. Finally, of those respondents who were able to estimate an appreciation rate at the time they purchased their properties (about one-half of the sample), approximately eighty percent thought it had appreciated at the same or a higher rate. This pattern of responses adds support to the finding that the owners in this sample are satisfied with their investments.

Working Paper 83-66 ("Investment Performance of Existing Rental Housing in Selected San Francisco Bay Area Communities") demonstrated that it was possible to detect variations in levels of investment performance by disaggregating the data. Does a disaggregate approach also provide insights in analyzing owners' perceptions of profitability? Table 2 presents a disaggregation of owners' responses to the five survey questions discussed above and indicates that there are differences within groups.20 The following list summarizes some of the key differences among owners:21

- **Size of Project:** With the exception of tax shelter, owners of small multiples show the greatest level of satisfaction. The desire to sell significantly increased with project size, and owners of medium-sized properties were the least satisfied with before tax cash flow.

- **Type of Management:** With the exception of tax shelter, owner-occupants are the most satisfied. Owners who live off-site and manage their own properties are the least satisfied, particularly in regards to cash flow.
Table 2
Satisfaction With Investment Performance Within Different Operating Situations

<table>
<thead>
<tr>
<th>Size of Project in Units</th>
<th>Type of Management</th>
<th>When Purchased</th>
<th>Main Reason Why Property was Acquired</th>
<th>City Location ¹</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Owner Occupant</td>
<td>Off-site</td>
<td>Tax Shelter</td>
<td>Berkeley</td>
</tr>
<tr>
<td>Percentage</td>
<td>Non-Occupant</td>
<td>Professional</td>
<td>Appreciation</td>
<td>Hayward</td>
</tr>
<tr>
<td>of Owners Answering</td>
<td>Professional</td>
<td>Professional</td>
<td>Income</td>
<td>Oakland</td>
</tr>
<tr>
<td>that:</td>
<td>Professional</td>
<td>Professional</td>
<td>Reason</td>
<td>Fremont</td>
</tr>
<tr>
<td>(n=43)</td>
<td>(n=36)</td>
<td>(n=20)</td>
<td>(n=19)</td>
<td>(n=19)</td>
</tr>
<tr>
<td>Ownership is profitable</td>
<td>83%</td>
<td>78%</td>
<td>79%</td>
<td>66%**</td>
</tr>
<tr>
<td></td>
<td>91%</td>
<td>75%</td>
<td>85%</td>
<td>91%</td>
</tr>
<tr>
<td>Would still buy</td>
<td>81</td>
<td>69</td>
<td>67</td>
<td>83%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>76%</td>
</tr>
<tr>
<td>Do not want to sell</td>
<td>63*</td>
<td>53</td>
<td>26</td>
<td>47</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>50</td>
</tr>
<tr>
<td>Tax shelter is more or</td>
<td>74*</td>
<td>46</td>
<td>40</td>
<td>77</td>
</tr>
<tr>
<td>the same as expected</td>
<td></td>
<td></td>
<td></td>
<td>76</td>
</tr>
<tr>
<td>Cash flow is more or</td>
<td>72</td>
<td>82</td>
<td>80</td>
<td>77</td>
</tr>
<tr>
<td>the same as expected</td>
<td></td>
<td></td>
<td></td>
<td>81</td>
</tr>
</tbody>
</table>

¹ City location is a proxy measure for stringency of rent regulation. Berkeley is the most stringent, followed by Hayward and Oakland. Fremont has no rent regulation.

* An asterisk indicates that the relationship between the row variable and satisfaction measure is significant at the .05 level based on the chi-square statistic.

** A double asterisk indicates that the relationship between the satisfaction measure and city (comparing Berkeley with the other three cities) is significant at the .05 level, based on the chi-square statistic.
• When Property Was Purchased: There is not much variation according to when the property was purchased. However, those who purchased properties before 1976 are somewhat more positive, reflected in satisfaction with cash flow and in not wanting to sell.

• Main Reason Why Property Was Acquired: Owners who purchased their properties for income reasons were the most displeased with the level of before-tax cash flow. Investors who purchased for appreciation are the most interested in selling, while those who purchased for home or other reasons are the least interested in selling.

• City Location: Responses of Berkeley owners differ significantly from those of owners in the other three cities. A higher percentage of owners in Berkeley felt that ownership was not profitable and that cash flow was less than expected. There is no difference in satisfaction with tax shelter and smaller differences on the other two measures. Based on these responses, it appears that stringent regulation is more likely to cause dissatisfaction than a moderate form of regulation.

It is clear that many of these attitudes are logical, given owners' investment goals. For example, if an owner purchased his or her property for appreciation, then he or she would be more likely to consider selling the property than someone who uses it as a home.

What about the relationship between goals and actual financial performance? One would expect that individuals who purchased for income would own properties that provide higher levels of before-tax cash flow than owners who purchased for other reasons. Table 3 examines the relationship between the main reason for
Table 3

Variations in Median Levels of 1980 Before and After Tax Income and Appreciation Rates According to Why Owners Acquired Properties

<table>
<thead>
<tr>
<th>Main Reason Why Property Was Acquired</th>
<th>Median Before Tax Cash Flow Per Unit</th>
<th>Median After Tax Income Per Unit</th>
<th>Median Compounded Yearly Appreciation Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Shelter</td>
<td>$ 100</td>
<td>$-264</td>
<td>.15</td>
</tr>
<tr>
<td>Appreciation</td>
<td>$ -86</td>
<td>$-163</td>
<td>.14</td>
</tr>
<tr>
<td>Income</td>
<td>$ 387</td>
<td>$ 114</td>
<td>.10</td>
</tr>
<tr>
<td>Home or Other Reason</td>
<td>$-106</td>
<td>$-299</td>
<td>.17</td>
</tr>
</tbody>
</table>

1 One would assume that for negative cash flow buildings, after tax income would be less negative than before tax cash flow. On an individual level, this was generally the case. However, this pattern is not evident when median values are used.

Source: Investor Interviews.
acquiring properties and median levels of before and after tax income. Investors who purchased for income did earn more money per unit both before and after taxes. Those earning the lowest income per unit were owners who acquired their properties for nonfinancial reasons.

In contrast is the relationship between appreciation and investment goals. Owners who purchased for appreciation did not report having the highest compounded yearly appreciation rate; yet in spite of this, they still want to sell. (See Table 2 and 3.) On the other hand, respondents who said they purchased for home or other reasons were the least likely to want to sell, although they reported having the highest appreciation rates.

Finally, perceptions of profitability are related to actual profits. In most cases, owners correctly perceived the negative or positive nature of the property's cash flow. (See Table 4.) Secondly, the owners who said that ownership was not profitable based this assessment on financial considerations, since their properties had a much lower 1980 median after tax income per unit ($-568) than those who said it was profitable ($-90).

However, there is some evidence that owners' perceptions are not justified by the economic performance of their properties. For example, respondents who own small multiples are the most satisfied with their cash flow (see Table 2), yet these properties yielded the lowest before tax cash flow per unit. In part this may be explained by the higher incidence of owner-occupancy of small multiples. These owners, then, receive nonfinancial benefits from ownership, and consequently may evaluate their investments using different criteria than off-site owners would. Secondly, there were seventeen investors (see Table 4) who misperceived the positive (or negative) nature of cash flow from their projects.

This discussion of attitudes has shown that, although there are differences among owners, they are satisfied with their rental property investments. In
### Table 4

Comparison of Actual Before Tax Cash Flow with Perception of Before Tax Cash Flow

<table>
<thead>
<tr>
<th>Actual Before Tax Cash Flow</th>
<th>Perception of Before Tax Cash Flow:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Positive (n=62)</td>
</tr>
<tr>
<td></td>
<td>Negative (n=21)</td>
</tr>
<tr>
<td>Positive</td>
<td>77%</td>
</tr>
<tr>
<td>Negative</td>
<td>23%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Investor Interviews.
many cases, owners correctly perceive the relative financial success of their investments, although there is also some evidence of a lack of rational assessment.

**Conclusion**

This chapter has analyzed a number of areas covering economic behavior and attitudes, including investment strategies, rent raising practices, and perceptions of profitability of a sample of owners of middle income rental housing. Many of these owners exhibit professional behavior in some areas, but on the whole, they do not behave like profit maximizing investors. There is a high level of satisfaction, however, in spite of relatively low financial returns. The owners interviewed in this study do not feel there is a profitability crisis. This degree of satisfaction is surprising since other housing analysts and members of the rental housing industry have stated that rental housing is not a sound investment.

There are two possible explanations for this discrepancy. The first is that there could be a bias in the sample of owners who participated in the survey. Since the survey depended on the volunteer cooperation of landlords, it is inevitable that there is sample bias. It is possible that owners who are more satisfied would be the ones to cooperate with the interview. However, it is also possible that those owners who are the most upset with the present market would have wanted an opportunity to express displeasure. So, the bias could go in either direction.

Another explanation is that this study is based on gathering detailed information from a group of owners that does not generally express its views publicly. Many of the views that are voiced in discussions of the state of affairs in rental housing are from large scale, professional owners, who are more accustomed to political expression. Therefore, it is reasonable to assume
that, if a different group of owners is analyzed, one could arrive at different conclusions.

Given the diversity of investor behavior and attitudes, the use of the professional investor as the prototype for rental housing policies is an oversimplification. This disparity between the common wisdom and reality is critical. If market analysts and policy makers hold an idealized view of owner behavior and project from that model, and if that model is not accurate, it is likely that they will misinterpret both present and future trends in the market.

However, to suggest that we reconsider this model of landlord behavior places us in a difficult position. First of all, the single model of profit maximizing behavior has conceptual simplicity. This simplicity permits straightforward applications which are compatible with other types of economic analyses. We do not have to puzzle too much to formulate interpretation of present or future behavior, since this model generates answers on the nature and direction of responses. To illustrate, assume we are interested in examining what change in interest rates would be necessary in order to encourage capital improvement expenditures for existing rental housing. For different rental housing situations, we would estimate the following:

- Anticipated holding period (in order to establish what role these expenditures would assume in an investment strategy);
- Increased tax shelter benefits (based on interest deductions on capital improvement loan, depreciation of the improvements themselves, and tax bracket of idealized owner);
- Present cash flow, and
- Change in debt structure.
Based on these estimates, it would be possible to derive solutions for various operating situations based on profit maximizing responses of prototypic investors.

For example, assume an owner had already paid down a property's mortgage so that amortization exceeded depreciation benefits. Furthermore, the property generates a positive before tax cash flow, and the owner intends to hold onto the property for another five years. A profit maximizing model of behavior could then project the following:

- If interest rates were either at or below the point at which the debt service required to finance the capital investments still allowed the property to produce a positive before tax cash flow, but a negative after tax income (tax shelter), the model could assume the owner would decide in favor of financing the capital improvements.
- If interest rates were above that point, then the model would assume that the owner would not undertake the expenditures for capital improvements.

However, what if owners do not consider many of these factors. For example, what about the owner who really does not know how long he or she might own the property? It becomes more difficult to determine what role capital improvements play in an investment strategy. Or what if the owner deducts the capital improvements from a single year's tax return (combining them with maintenance and repairs). Calculation of depreciation effects would not make any sense. Both of these tendencies were evident in this sample of owners. Consequently, projecting investor responses using a profit maximizing approach would not always be accurate.
Realizing that we need to forego analytical simplicity for the sake of greater realism, what model or models should replace that of the profit-maximizer? A conceptual framework which encompasses more than one model of economic behavior is not evident in real estate economics. In this respect, real estate economics is not as advanced theoretically as other branches of economics, such as managerial economics. Although the present study does not provide sufficient information with which to construct a broader theory, it does serve as a useful precursor for more comprehensive studies that need to be undertaken as a first step in formulating realistic models of landlord behavior.
FOOTNOTES


3 For a more complete description of the survey sample, see Marian F. Wolfe, "Investment Performance of Existing Rental Housing in Selected San Francisco Bay Area Communities." Working Paper # 83-67.


6 All names used here have been changed to insure confidentiality.


See footnote 1.


For example, see Ira Lowry, *Rental Housing in the 1970s: Searching for the Crisis.* Prepared for the U.S. Department of Housing and Urban Development, January 1982. (Mimeographed.)

The survey of owners asked only a limited number of questions regarding rent raising policies.

However, it is also possible that this increase in demand was not an increase in effective demand, since renters' real incomes have declined in the past five years. See Michael Stegman, "Multifamily Distress: A Case for National Action," *Journal of the American Real Estate and Urban Economics Association*, Vol. 7 (Spring 1979), pp. 77-94.

Anecdotal information on rent raising behavior was obtained from key informant interviews conducted in Winter 1981 with property managers, appraisers, and realtors.

Lowry op. cit. (1982), pg. 41.

This dual policy works in the following way: Tenants who live in their units for a period of time (usually one year), receive increases, which are relatively low. Then, when a unit is vacated, the rent is raised on that unit to the current market rent level. Of course, managers face problems if the rate of tenant turnover declines, which is the current trend, so that there would be fewer opportunities to bring up rents. In this situation, rents will lag even in projects that are professionally managed.

In addition to variations in rent levels caused by frequency of turnover, several key informants mentioned that Proposition 13 was one more factor that influenced rents in the late 1970's. After Proposition 13 passed (June 1978), they delayed increasing rents, often for a full year. Although most landlords did not reduce rents, the delay in rent increases was their way of fulfilling Proposition 13 campaign promises to renters. Landlords did not want to upset tenants, since they were concerned that if there was not some rent response to Proposition 13, there would be more political pressure for rent control.

This type of question puts respondents on the spot. If they respond that ownership was not profitable, then they are admitting to the interviewer (and to themselves) that they have made a mistake. One also finds this phenomenon in housing surveys where tenants and homeowners are asked if they are satisfied with their housing. Most respondents are satisfied, regardless of actual housing quality.

The comparison of expected rates of appreciation with actual is omitted here, since only half of the sample was able to make the comparison.
Responses summarized in Table 2 should be interpreted as follows: A higher percentage indicates that the owners in one category of a group are more satisfied than owners in the other categories. For example, if a higher percentage of owner-occupants would still buy their properties, this indicates that, at least on one measure, owner-occupants are more satisfied.

In part the size of this difference is explained by recency of purchase. A higher percentage of owners who purchased their properties for income, bought them before 1976 and so have lower debt service.

For a discussion of the need to develop "open theory" in describing economic behavior, see Harvey Leibenstein, Beyond Economic Man. Cambridge, Massachusetts: Harvard University Press, 1976.
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<th>Title</th>
<th>Date</th>
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Lawrence B. Smith and Peter Tomlinson. "Rent Controls in Ontario: Roofs or Ceilings?" November 1981.


