Why People Don't Trust Real Estate Agents Part 2

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A few years ago, Dr. Stephen Levitt, an economics professor at the University of Chicago authored a book called ***Freakonomics***. ***Freakonomics*** deals with, as he puts it, *the hidden side of everything.* What he means by that is that nothing is really what it seems, that you have to dig under the paint to really see what's hidden there.

Probably my favorite chapter in the book deals with real estate and real estate agents. He doesn't start out by saying he's going to discuss real estate agents; he says that he's going to discuss how we rely on experts to guide us throughout our lives. And his example happens to be real estate and real estate agents, since that's the area he researched. Without including the entire chapter, what it boils down to is, when we sell our home, we normally rely on the expertise of others, others who happen to work in the real estate industry. And we usually enter into that relationship believing that ethically, the expert, in this case the real estate agent, is going to make recommendations to us based on what is in our best interests, not the buyer's, and certainly not his, the agent's. Dr. Levitt shows us that may not always be the case. In fact, I've observed that often, very often, the experts we rely on to help us make decisions in our lives actually offer recommendations to us, particularly if there is a conflict with their own interests, that are contrary to our best interests. That is, very often the expert offers us a recommendation that is purely in our best interest only when the expert himself has "no dog in the fight", eg., some financial interest. Economists have a term for it, incentives, and we all have different incentives. Incentives are what motivate us to perform, not to perform, to underperform, etc.

> *We expect the professional to do the "right thing". We expect the professional to be our advocate. We expect to pay the professional a fair amount for his efforts and we assume that if the professional agrees to that and if he agrees to represent us, to work for us, to advise us, that our interests, as they are represented by him, will come first.*

To summarize, Dr. Levitt describes a situation whereby a seller of real estate, say a home, contacts a reputable real estate agent, an expert on whom the seller may rely for advice in selling his home. And in his example, the real estate agent uses his research tools to recommend to the seller that he should set the selling price of his home at $300,000. His tools include knowledge of the market such as the selling price of comparable homes, valuation of comparable homes for tax purposes, etc. As well, the expert relies on his position in the community to predict the behavior of potential buyers. And just as important, the agent has knowledge of the seller, knowledge such as family conditions, children in college, illnesses, etc., that is not readily evident to potential buyers. To illustrate, see the following chart.

Option 1. We've assumed that the commission rate is 6% though the rate itself is unimportant. The concept remains the same. We've also assumed that there are no other closing costs to be paid by the seller. You can see from the chart, Option 1, that if the seller gets his price, $300,000, he nets $282,000, after paying $18,000 to his expert, the agent.

Option 2. The seller gets his price but the buyer also has an agent. In this case, the commission must be split although 50/50 may or may not be reasonable. For purposes of this analysis, let's say it is. In this case, the seller still pockets $282,000 but now his agent only makes $9,000, a 50% pay cut for the same amount of work (assuming the buyer would have found this house without the aid of his agent).

Option 3. On the advice of his agent, seller reduces the selling price by $20,000 to $280,000. As a result, the seller's net on the sale is reduced by $18,800. But the real estate agent's net on the sale is only reduced by $600 each. So, the agent's incentive in this case is to speed up the sale and pocket his commission of $8,400 as quickly as possible.

		Sales Price	Agents Commission Rate	Agent 1 Commission Dollars	Agent 2 Commission Dollars	Net Distributed to Seller	Difference Net Distributed to Seller
(1)	Buyer gets his price, one agent involved	$300,000.00	0.06	$ 18,000.00	$ -	$282,000.00	$ -
(2)	Buyer gets his price, buyer has an agent and seller has an agent.	$300,000.00	0.06	$ 9,000.00	$ 9,000.00	$282,000.00	$ -
(3)	Buyer reduces his price by $20,000, buyer has an agent and seller has an agent.	$280,000.00	0.06	$ 8,400.00	$ 8,400.00	$263,200.00	$ (18,800)
	By recommending option (3) each agent sees a decrease in commissions of only $600. But each agent will, if the seller accepts the $20,000 lowering of his selling price, not have to spend anymore time trying to sell the property.						
	If the agent saves only 8 hours, what he would spend on an open house on a Saturday, he's actually "making" $75 dollars per hour, hours he could spend selling a different house.						

Now normally, in order to sell properties, a real estate agent must spend some time on weekends, after hours, etc., showing the properties. And the time can be considerable. So if an agent shows a property over a period of a couple of months, with no hits, even though all his research points to the selling price he originally recommended, at some point during the process, he will begin to recognize that his hourly wage, when the home finally sells, is shrinking.

In his research, Dr. Levitt determined that in order to move the property and collect his commission now rather than later after putting more time into the effort, the agent will recommend to the seller that he, the seller, take a lesser offer. The chart shows what would happen in that event. Now, we don't really know that the agent thought this through and came to this decision. What we do know, as Dr. Levitt describes, is that the real estate agent "keeps her own house on the market an average ten extra days, waiting for a better offer, and sells it for over 3 percent more than your house". And the question here is, would the agent have sold his own home at this time, at this reduced price?

Clearly, this is not what the seller had in mind when he chose to hire an expert to assist him. What he thought would happen, and what should have happened, is that the expert would put aside his own personal incentives and assume the role of "seller's advocate", even if he (the real estate agent) may be impacted negatively. Does this really happen? Yes, it happens more often than we'd like. Does it always happen? Of course not. This is just an example, based on Dr. Levitt's book and research, of how some, not so ethical agents, choose to operate.

What does all this have to do with CPAs, Dentists, Auto Repair Shops? Everything!