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Appreciating the House: Housing as an Investment

by Miriam Wasserman

A house is both a provider of services that its occupants consume and a long-lived asset that can fluctuate in value. Although homes offer both consumption and investment benefits, most prospective homebuyers give priority to a house's consumption aspects. As Miriam Wasserman points out, for many, buying a home represents the fulfillment of a lifelong dream. Homes become the stage for daily routines and major life events; they give families a sense of achievement and the hope of a secure future. However, the problem with buying a house is that you can't buy a small share of it. A house is an all-or-nothing deal whose value often dwarfs that of any other single investment. As an investment, economists find that housing is less volatile than stocks, but more so than Treasury bills. In this article, Wasserman discusses the ways in which one's home constitutes both a consumptive good and a long-term, sometimes risky investment. She also explores the future of housing investment, where it may be possible to own residential real estate without facing the same level of risk that homeowners do today.

Prospective homeowners today tend to focus on the neighborhood and the building's characteristics, giving priority to the "consumption" over the "investment" side of the house.

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The United States is a nation of homeowners. When the early settlers came to America in search of the opportunities denied to them in Europe, they saw owning their homestead as a sure basis of power, a status symbol, and insurance against bad fortune. Today, that dream is a reality for more Americans than ever; from being a nation mostly of renters in the 1940s, over two-thirds of U.S. households now own. However, this also implies that a majority of Americans assign a considerable share of their wealth to a risky asset that is highly illiquid and hard to diversify.

Houses can play both Dr. Jekyll and Mr. Hyde in their owners' lives. They are the stage for daily routines and major life events. Houses furnish roof and roots, a place to raise children, and access to the schools, parks, and social networks of an entire community. Homeownership gives families a sense of achievement and of psychological stability, as well as the hope for a secure future. As an investment, buying a house is a way of accumulating wealth, financing their children's education, and saving for their retirement.

But the ideal home to live in may not make an ideal—or secure—nest egg. Houses are the largest single investment most people make. The homestead represents over one-third of the average household's assets and weighs even more heavily in the finances of the less wealthy. Yet, one need only look back a decade to see that buying a home entails considerable financial risk, and housing prices can fall as well as rise.

So far, there are no ways for families to reduce their exposure and no way to buy any insurance against housing market downturns. Home equity loans may lessen some of the liquidity constraints in housing, but only at the expense of increasing the risk of losing the house if the price dips. Yet, many households—older ones in particular—are overinvested in residential real estate and are foregoing potentially more lucrative opportunities by having their wealth concentrated in housing equity. Although they may not view their house primarily as an investment, they cannot avoid the financial implications of ownership.

There is a dichotomy in the very nature of housing, which affects how people view it. A house is both a provider of services that its occupants consume, and a long-lived asset that can fluctuate in value. While both facets are present in people's minds, they are not often integrated. Today, prospective homeowners tend to focus on the neighborhood and the building's characteristics, giving priority to the "consumption" over the "investment" side of the house. "I don't hear people coming into our offices today talking about real estate as an investment," says Robert W. Leighton, Jr., President of Coldwell Banker Leighton Realty in Gales Ferry, Connecticut. "They are talking about the American Dream, about a home for their family, for their lifestyle."

For Leighton, his clients' attitudes have a simple explanation: A decade after the real estate bust, single-family housing prices in Groton, Connecticut, are still off the peak by about 25%. "Would I be talking of the stock market as a great investment if for the past ten years it had been flat? Of course not," he says. "That's why we are now talking about warm, fuzzy things: pride of homeownership and the American Dream. Buying a house always was that. But tomorrow, if house prices start going up at 20% a clip, it's going to be a great investment again."

A STOCK TO LIVE IN

To integrate the consumption and the investment views of a house, consider the sources of housing's returns. Houses resemble stocks in certain respects. Stocks give investors both a capital gain and dividends. Similarly, housing offers two sources of returns: the house's appreciation in price and the daily stream of services the house provides. Increases in the price of the house make up the capital gain portion of the return. The value of the stream of housing services resembles income from stock dividends. No flow of money is involved in the second portion of the return, but its value can be estimated as "implicit rent"—the amount of rent a homeowner could charge by leasing the home.

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The implicit rent "dividends" are what make one's home a castle, but people place their hopes of accumulating for the future on the capital gain. Whether these hopes play out depends partly on the quirks of the housing market. Because of the delays involved in construction, the supply of new houses responds with a lag to growing needs. Thus, in the short term, house prices are particularly sensitive to changes in housing demand. Growing population, increasing incomes, low interest rates, and low unemployment levels will push prices up. Individual house prices can vary within general housing market swings. The value of a particular building also depends on the upkeep, additions, and "sweat equity" that its owners vest in it—as well as on its surroundings, since the price of the house reflects the characteristics of neighborhood and town: school quality, crime rates, and adjoining landscapes get capitalized in the price.

Sometimes, if fueled by emotions, prices can stray far from the fundamentals. In the roller-coaster of the 1980s, New England house prices soared to unexpected heights and many buyers feared that if they didn't buy immediately, they would never be able to afford a house. Some people knowingly paid high prices speculating that a "greater fool" would come who would accept an even higher tag. Eventually, developers responded with a building splurge. The increase in construction employment in three years in Massachusetts alone was of the order of 50,000 jobs: the equivalent of 10 Big Digs, says economist Karl Case, of Wellesley College. By 1989, the market was glutted—especially with condominiums—and prices had dropped by as much as 56% in places like Lowell. During this pronounced boom and bust, it was hard to predict when the ride would turn. Indeed, even brokers got burned.

Moreover, the houses that had the most spectacular price increases in eastern Massachusetts were those that had the lowest initial values and were located in neighborhoods with the lowest incomes, the worst schools, and the highest crime rates, according to Case and economist Chris Mayer, of Columbia University. They speculate that this was partly because house prices rose faster than incomes and people who were priced out of the upper end of the market bid up prices at the bottom. However, when the boom turned to bust, prices in less desirable areas dropped further, with much slower recoveries.

GOOD IN THE LONG RUN

House prices do not stray far from fundamentals forever, and housing has been a good investment over the longer haul. Since house prices have tended to rise by at least as much as other prices when the general price level goes up, houses have been seen as a way to protect wealth from inflation.

The appreciation of single-family housing has, on average, exceeded the return to Treasury bills, but has been lower than the return to stocks. William Goetzmann, of the Yale School of Management, found that house prices in Atlanta, Chicago, Dallas, and San Francisco rose at an annual nominal rate of 8.6% between 1971 and 1985. This was less than the S&P 500 stock index (12.1%) and more than Treasury bills (8%, a historically high rate; T-bills more typically gain about 3.5% a year).

However, these results omit the "implicit rent" part of the return altogether, and don't take into account other costs and benefits of homeownership. On the cost side are the time and the money that homeowners must spend to fix a leaky roof or broken dishwasher. Moreover, buying and selling a house entails closing costs, moving expenses, and broker fees which can add up to about 10% of the value. These high transaction costs can wipe out the gains, even when the market is strong, especially for people who live in their house for a short time (the average stay is about seven years).

On the uncounted benefit side of the ledger, homeownership is favored over other asset holdings by the U.S. tax code. Mortgage interest payments and property taxes can be deducted from other income (but losses in a home sale are not deductible). Although most people see the mortgage-interest deductibility as the major tax benefit in housing, what is more important is that the value of the stream of housing services—implicit rent—is not included in taxable income, and up to $500,000 of the value of a house can be excluded from capital gains taxes.

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A PARCEL OF RISK

While housing has yielded positive returns in the long run, swings in the market make owning a home risky. If the price bounces around a lot, people may be forced to sell at a time when the prices are low. Economists find that housing is less volatile than stocks, but more so than Treasury bills. While stock returns tend to vary in a range of 20% above or below their average return, houses tend to vary by closer to 13% around their average return, and Treasury bills by less than 5%.

Leverage amplifies the risk. Most owners shoulder significant debt when they purchase a house. In an appreciating market, leverage allows the owner to use someone else's money to achieve a greater return. If a family puts down, say, 20% of the house value, it still captures the full appreciation of the house. On the other hand, if house prices drop enough, the family could end up with a mortgage greater than the property's value. Accounting for leverage, Goetzmann found that the returns to housing were more volatile than the S&P 500. For example, between 1976 and 1986, properties with an 80% mortgage in San Francisco had an average return on equity of 37% per year, but the return ranged from 118% in one year to a drop of -42% in another. These figures probably still underestimate the risk. Houses cannot be traded as easily or as quickly as stocks. If house prices are falling, homeowners may be forced to take larger losses than current prices would indicate.

THE HOUSE IN THE PORTFOLIO

Beyond its individual risk and return characteristics, housing is part of a larger portfolio of assets held by a family. Families can increase their overall investment risk by taking this into consideration. The potential advantage stems from the unrelated movements of housing and stock prices. Over the past four decades, housing prices have shown a slight tendency to rise when stock prices fell, and vice versa. Economist Marjorie Flavin, of the University of California at San Diego, speculates that this is the end result of two opposing tendencies. On the other hand, stock and house prices tend to move together when the overall level of wealth in the economy is changing: As people become richer, they tend to buy more of both. But stocks and real estate are also substitute assets. A disturbance—such as a belief that houses are about to rise in value—would cause households to sell other assets, including stocks, in order to buy real estate. Another reason could be inflation since, in the past, houses have done better than stocks under high inflation, and stocks have had better returns when inflation is lower.

Thus, housing has historically provided a hedge against financial market fluctuations and reduced overall risk for households that also hold stocks. But investing in both at the same time is not easy, and that is where perhaps the biggest problem lies. It is hard enough for a young family to save the money required as a down payment for a house, let alone attempt to build a diverse portfolio at the same time.

Furthermore, all the family's money is now in a single building. If a waste dump is built next door, the value of the house will drop, regardless of conditions in the broader real estate market. This is akin to owning all your stock in the same company. And homeownership inevitably links a family to the fortunes of a specific location. Homeowners who live and work in the same area become quite vulnerable to regional downturns, since house prices tend to be closely linked to the fate of the labor market. When local employment deteriorates, house values generally suffer as well and families find that when their luck turns, they receive not one blow but two.

The people of Groton, Connecticut, know this well. The end of the Cold War led to the downsizing of Electric Boat—a designer and builder of nuclear submarines—and threatened the closing of the local submarine base. This compounded the local free-fall of house prices during New England's real estate bust and left many homeowners unemployed. They faced a stark choice: either endure bankruptcy and foreclosure or settle for a lower-paying job (or two) in order to remain in the area. For renters, it was much easier to pick up and go in search of a better job elsewhere.

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OPTIONS IN THE WORKS

The problem with buying a house is that you can't buy a small share of it; a house is an all-or-nothing deal whose value dwarfs that of any other single investment. It is subject to market swings, and it is highly concentrated geographically. For those who are uncertain of their employment or who anticipate having to move in a short time, renting may be best. But, in the future, it may be possible to own residential real estate without facing the same level of risk.

One way of doing this would be through institutions akin to housing market mutual funds. Real estate investment trusts (REITs) raise funds in the stock market and from bank loans to invest in commercial and industrial real estate nationwide. They offer the opportunity for diversified investments. No such thing exists on a large scale for single-family homes.

Something like it could work in housing, but only if you could get households to rent from REITs on a long-term basis. Under such a scheme, people could invest as much or as little as they desired in a geographically diverse portfolio of single-family homes that would have less risk than outright ownership of a particular house. Families with preferences for big houses would not be obliged to also invest heavily in residential real estate; they would have wider options for renting. However, the upkeep of the properties would be a problem since tenants would have no incentive to maintain the value of the house.

Another option recently proposed by a group of experts in the book, *Housing Partnerships*, would create a system whereby homebuyers would reduce their mortgage costs and financial risks by selling a portion of their house to institutional investors in exchange for a percentage of the eventual sale price. In this scheme, people would not give up all their ownership rights over an individual house, but the size of their investment would be more manageable. The homeowner would be the managing partner and the investor—as the limited partner—would have no liability from ownership of the property, enabling the limited partnership to be sold or securitized. To be sure, it would be complicated to trace out the boundaries of ownership between the household and the investors, and determine how to motivate the daily upkeep of the property.

A third proposal would create a new type of insurance policy to ensure the price of a home on resale. One of the reasons no such policy currently exists is the problem of moral hazard; homeowners may be tempted to neglect their properties because they no longer would suffer the consequences of devaluation. Economist Robert Shiller of Yale University and Alan Weiss of Case Shiller Weiss (which specializes in the research and analysis of residential real estate), have proposed an insurance policy that could be settled on an index of home prices, so that homeowners would have the incentive to take care of their properties yet be protected from market downturns. Although these schemes may seem farfetched, so did the thirty-year mortgage when it first appeared.

And even if no such changes are made, most homeowners still make a reasonable return. While the risks are considerable, there is good reason to believe that the returns to housing are greater than economic studies measure. The reason lies in the value of the housing services that owners receive—the consumption "dividends." An owned house and a rental unit feel very different. People want a place they can call their own. They want the freedom to fashion their habitat to suit their desires. Because of this, the shelter provided by a home they own may well be more valuable than what they get from one they rent. It's the difference between what people can charge for their houses in a rental market and what one would have to pay to convince them to go live somewhere else.

However, a house is not a passive investment. While buyers may be purchasing a sense of freedom and independence, they are also buying a stake in a particular community. Having traded their mobility for a sense of stability, they are now bound to ensure it remains a place they want to live in. And, if they work to preserve or better their neighborhood, society as a whole gains from their investment.

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