The Other Side of the White Picket Fence

By Robert Bridges with Michael Kianmahd

The Home as House

At the risk of heaping more misery on the struggling residential property market, an analysis of home price and ownership data for period of the last 30 years in California - the golden state with notoriously golden property prices – shows that the average single family house has not been a particularly stellar investment. Over that period, a typical homebuyer would have been wise to learn a thing or two about disciplined investing, and would have been better advised to consider putting his or her money elsewhere if the goals were to build net worth and financial security. The popular misconception that houses are always great investments has wider economic implications as well, as our society becomes increasingly concerned with providing generally for retirement security and housing affordability. Excessive public policy emphasis on owner-occupied housing for social objectives, and reliance on homebuilding as a provider of short-term economic stimulus, may also cause capital to be diverted from more productive investments, and misallocate increasingly scarce public resources. Even if the recent crash is ignored, a house, despite our government's herculean efforts to give all of us a chance to buy one, may not have been the greatest place to put one's hard earned money.

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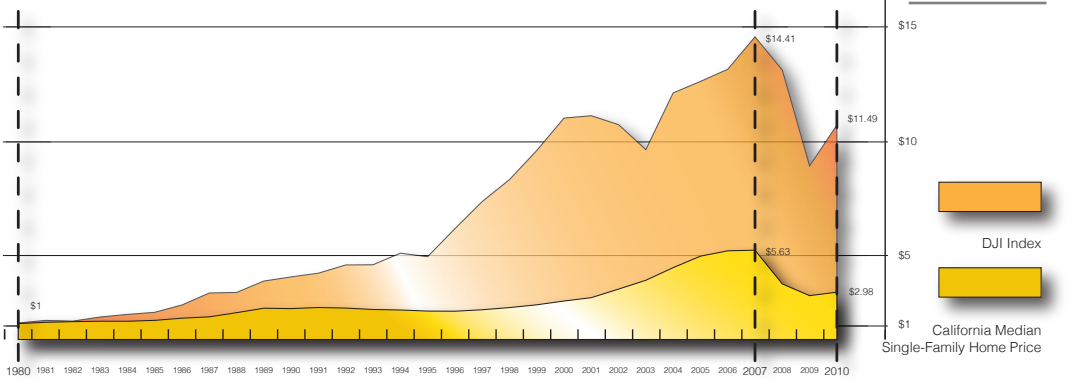
Exhibit 1



Growth of $1 Invested in 1980 in a California Median Single-Family Home, Versus a Similar Investment in Dow Jones Industrial Average Equities

The purpose of this article is not to argue that home ownership is less than a critically important aspect of American life, nor is it an argument in favor of renting over owning. Notwithstanding the sanctity of home ownership, why do people assume that a house purchase comes with a guarantee of profit?

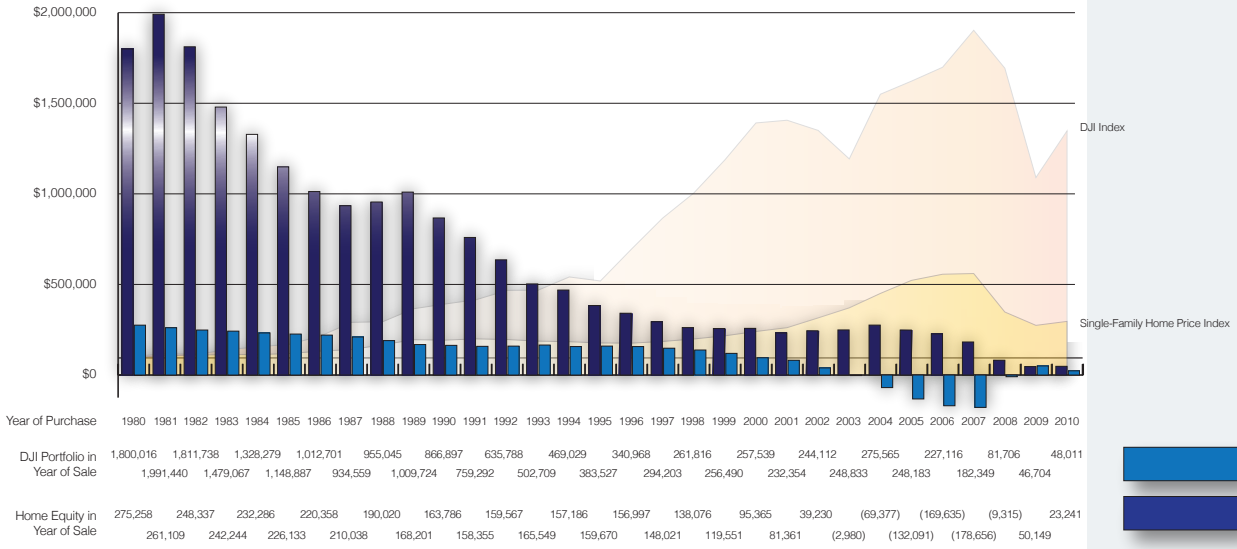
According to data on historical median house prices, mortgage interest rates and rental rates in California published by the California Association of Realtors, Freddie Mac, and the US Census Department, between 1980 and November of 2010, the price of an average single-family house has risen only by an average of 3.6% per year – from $99,550 to $296,820.[1] Even if it is assumed that a home was sold at the most recent peak of 2007 – the point at which houses in the index reached a peak of $560,270 – the average annual price growth over the 28-year period between 1980 and 2007, is just 6.61%. A dollar used to purchase a median

[1] Interest Rates Source: Freddie Mac

single family home in 1980 would have grown to $5.63 in 2007, and to $2.98 in 2010. But the same dollar, invested in a portfolio mirroring the Dow Jones Industrial Index would have been worth $14.41 in 2007, and $11.49 in 2010. (Exhibit 1)

A principle of basic finance is that unless the overall return of the investment exceeds the cost of borrowing, the borrowed money actually reduces the overall investment's profitability. This "negative leverage" has been one of the factors at work in typical home purchases over this period - despite massive intervention in the form of government guarantees and pricing backstops in the mortgage industry. With growth in rates for houses in these low ranges and mortgage interest rates typically higher than rates of return, the impossible challenge for a purchaser over this period has been to borrow money at a cost that is not detrimental, given the need for financing to supplement the small down payment that usually is a part of these purchases.

Exhibit 2



Year of Purchase	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
DJI Portfolio in Year of Sale	1,800,016	1,811,738	1,328,279	1,012,701	955,045	866,897	635,788	469,029	340,968	261,816	257,539	244,112	275,565	227,116	81,706	48,011	1,991,440	1,479,067	1,148,887	934,559	1,009,724	759,292	502,709	383,527	294,203	256,490	232,354	248,833	248,183	182,349	46,704
Home Equity in Year of Sale	275,258	248,337	232,286	220,358	190,020	163,786	159,567	157,186	156,997	138,076	95,365	39,230	(69,377)	(169,635)	(9,315)	23,241	261,109	242,244	226,133	210,038	168,201	158,355	165,549	159,670	148,021	119,551	81,361	(2,980)	(132,091)	(178,656)	50,149

Exhibit 2: Home Equity Versus DJI Equities Portfolio for Purchases in Years 1980-2010, Assuming End of 2010 Year of Sale

The story continues to get even less cheerful when the normal costs of ownership are included in the calculation: If it is assumed that the average purchaser in 1980 secured an 80% loan at the time of purchase, made payments for 30 years, paid taxes and insurance, and paid a modest amount for maintenance, that owner in 2010 would have had a paid-off home with equity of $296,820. The annual rate of return on the down payment and the cash spent along the way would be a disappointing, if not tragic, -3.47%.

In order to put in this in perspective, consider an alternative investment strategy wherein a disciplined investor, who might have been considering a California median price house purchase in 1980, had opted instead to use the down payment of $19,910 and the ongoing ownership expenses to purchase a portfolio of stocks mirroring the Dow Jones Industrial Average. Because an investor in a house gets the benefit of not having to rent, to make a truly fair comparison, the cost of an equivalent rental expense must be deducted.[2] Even after subtracting the rental expense from the periodic purchases of stocks equaling the equivalent periodic ownership expenses, the value of the stock portfolio after 30 years would have been an astonishing $1,800,016 (1980 to 2010). The stocks would have been better than owning the free and clear house by a healthy net amount of $1,503,196. If the comparison would have been made in 2007, the stock portfolio would have been worth $2,186,120, exceeding the house value by an amazing $1,625,850. (Exhibit 2)

The simple story is this: If, in 1980, a disciplined investor had opted to invest in equities rather than buying a house, he or she would have been able to live rent-free for the 30 year period, later buy the house originally considered for cash, and still have enough capital left

[2] Source: US Census Dept.

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to comfortably retire, all the time having paid no more than what would have gone to a mortgage, taxes and incidentals.

Over the 30 year period of the analysis, the Dow Jones Industrial Average has risen by 10.56%[3] annually, the NASDAQ by 9.79%.[4] Median home prices have lagged these benchmarks despite spectacular efforts on the part of the government to maintain below market mortgage interest rates, expand mortgage availability, increase qualifying and loan to value ratios, and create a broadly tax-advantaged ownership climate. Policy makers have simply not been able to create guaranteed profitability.

In fairness, it should be noted that there is an 8-year period of time in which it would have been better to buy the house. If it were purchased between 1996 and 2003, and then sold in 2007, the equity in the house would have exceeded that of the stock portfolio (Exhibit 3). But if one were not so lucky or possessive of the clairvoyance necessary to pick optimal market entry and exit points, choosing the path of the house purchase might not have been the way to go.

Exhibit 3

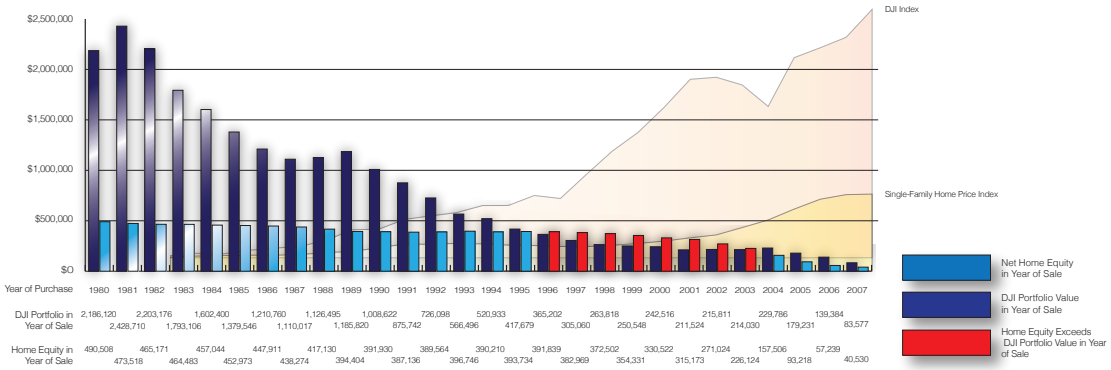

Exhibit 3: Home Equity Versus DJI Equities Portfolio for Purchases in Years 1980-2007, Assuming End of 2007 Year of Sale

In the stock investment scenario – equities being a sector of the economy that the government has never seen fit to significantly support - no debt is assumed. Although the author makes no argument in support of any public effort to aid or influence debt markets, one can only imagine the magnitude of potential capital formation if modest levels of low interest debt were available to purchasers of equities, thus allowing positive leveraging of returns for retirement accounts or other investment purposes.

Of course the median single-family house cited in the CAR data exists as a statistical construct. Individual real property transactions, at different pricing levels and in different local markets will always have very different results. People generally don't stay in houses for 30 years, and all transactions have different market entry and exit timing points and produce very different outcomes. Many owners create value by rehabilitation and repositioning and by good fortune, things the illusory statistical median does not neatly capture. The profitability of real estate investments are highly variable due to the complex set of economic, locational and physical conditions that underlie their unique circumstances. But from the broadest perspective - most importantly from the perspective that should be adopted by public policy makers at a time when tax revenue is increasingly scarce – a hard look should be taken at the wisdom of continuing the diversion of extraordinary amounts of public resources that have been squandered in past attempts to prop up property markets.

Home ownership is an integral part of American life, it is the anchor that signifies a stake taken in the community. It has become a synonymous with the American dream, it is an important recognition of economic achievement and is the very embodiment of having skin in society's game. These truths are unassailable up to the point when houses become unhealthy objects of speculation, and when assumptions of profit and expectations

[3] Source: Dow Jones, Inc.

[4] Source: Nasdaq, Inc.

for financial security are unrealistically projected on them.

From House to Recovery

Homebuilding, the currently elusive activity that is apple of the eye of today's politicians in their desperation to turn the economy, can also be an extremely beneficial activity, but again, up to a point. It creates significant local spending and employment in a burst of income generated from the near immediate creation of objects of significant value in geographically localized clusters of subdivisions or other development projects. Equity, coupled with significant amounts of debt capital from external sources, are funneled quickly to local materials and equipment suppliers and labor pools, generating great wealth for the period of construction, often reversing the crushing effects of previous busts. But the positive effects are often transitory if the construction workforce finds itself in need of new work because local economies have insufficient permanent employment to justify a constant level of demand for new housing stock. As with most things, too-good-to-be-true benefits often come with a sobering caveat: Homebuilding is great as long as there isn't too much, too fast.

It is no wonder that politicians are quick to recognize upticks in housing starts, and seem to embrace robust levels of homebuilding. There are few alternative types of economic activity have such direct, intense and immediate impacts. The problem, however, becomes what to do with the workforce once the party is over.

Yet another important principle in finance is that there is an important distinction between productive and non-productive investments. Productive investments include those made in manufacturing, trade, or income-generating real estate, among other businesses. These businesses create employment, innovation, competition, trade, demand for material and services, and generate profits that are funneled back into the communities in which they are located. Owner occupied houses do not fall into the productive investment category.

A house, once constructed, does little to sustain local employment, nor does it contribute significantly to the local or wider economy when compared with most other business activity. Housing does create a modest demand of service and maintenance employment, but these jobs are a far cry in economic terms from the numbers and wage levels of those in new construction or in the long-term employment found in ongoing businesses.

The occupant of the house is most often saddled with significant mortgage and insurance tax payments, and therefore has a reduced disposable income. Even though the home may gain value over time, home equity is locked-in until the home is sold. Homes are typically sold for profit when owners perceive market conditions to be favorable for a move up, or to harvest the profits by selling or refinancing. When the house is sold, the pent-up appreciation is released, causing a significant stimulative effect, but this most often occurs at times when the market is strong and many sales occurring at the same time serve to exacerbate market upswings, resulting in what historically have been unsustainable booms. The other side of the equation is when sales of troubled assets or outright defaults occur in weak market conditions: The dumping of properties deepens the trough, as we have recently seen in the disposal of foreclosures and the damaging effects this has had on prices, home equity and bank assets.

Residential real estate markets may be forever doomed to cyclicality, but governmental activities have certainly been complicit in adding to the amplitude of those cycles and thus bear responsibility for their negative effects. Policies that stimulate new construction or home purchases by the various means of tax subsidies, financing subsidies, reduction of qualifying incomes, buyer credits, mortgage backstopping, preferential zoning and permitting, along with a multitude of other forms of intervention only create and intensify these highly cyclical effects. Policies designed to lower costs and make ownership more

"Policies designed to lower costs and make ownership more accessible only make housing generally more expensive."

accessible only make housing generally more expensive. Recent efforts to resuscitate residential markets by reducing loan balances, creating special rescue programs and other measures have reduced the security of loans and eroded the enforceability of contracts. Although not a recent event, it is somewhat jarring to realize that fourteen states in the United States do not even allow recourse provisions in residential lending contracts. The sanctity of mortgage obligations has become the rough moral equivalent of the 55-mile per hour speed limit.

Market forces in a climate of moderate and constant growth, rather than growth influenced or underwritten by governmental action, are the keys to maintaining a deliberate pace of new housing development that is capable of sustaining a constant level of construction employment, attract private equity investment, sustain competitive private debt markets, encourage capital growth, and ensure the lowest possible housing prices.

"Yet another popular misconception in the topic of home ownership is that paying off your mortgage is a path to retirement security."

The House of Golden Years and the Reverse Mortgage

Yet another popular misconception in the topic of home ownership is that paying off your mortgage is a path to retirement security. This logic seems to be rooted in the idea that home equity in a free and clear house is a rainy day fund, and that not having mortgage payments is a circumstance that better suits a fixed and often limited income.

While it is true that not having mortgage payments may reduce monthly expenses, holding equity in a home that is appreciating at a rate often far below other available investment vehicles is certainly not the best financial management. Funds truly set aside for emergencies should always be in the form of liquid assets, while home equity is quite the opposite. Financing vehicles to release equity are relatively expensive: Home equity loans, lines of credit, or first position loans made with low qualifying incomes often command high interest rates and costs. If the emergency is economic in nature – the loss of a job, or a business setback – it's likely that the same economic conditions creating the problem will negatively affect the value and marketability of the home, or curtail the availability of financing.

Still another misconception is that home equity can ultimately be converted to retirement income. Reverse mortgages are being peddled to an aging population, with the promise that years of saving will magically convert to stress-free income when a certain age threshold is passed. Giving a new meaning to the term "deadline," what could be a more cruel last chapter of a life than a once-zero mortgage balance growing ominously, tainting what otherwise would be the fullness of one's last years, toward a looming date certain in the not too distant future at which time one's home must either be sold, or passed to one's heirs encumbered by debt?

Unless a person intends to sell, home equity is anything but retirement security. In reality, a home is a place to live out one's retirement on other sources of income, but unless there is another place to live, its economic value it is best viewed as wealth for one's heirs – wealth that is locked-in and inaccessible except under the most onerous terms.

Just a House, After All

The recent collective cold shower taken in house prices should challenge the popular links between home ownership, investment and retirement. In its aftermath, is it wise for coming generations to continue down the road of home ownership as the cornerstone of personal finance? From a public policy standpoint, is it wise to continue the income shifts, contortions and inequities of mortgage subsidization, government backstopping and

tax breaks that have been largely unsuccessful in bringing reality to the illusion? Young people planning for retirement increasingly face a choice between house payments and meaningful contributions to retirement accounts. They can't afford both. With the specter of looming cuts in social security and other entitlement programs, or even possible systemic insolvency, the challenge for tomorrow's retirees is income self sufficiency.

At the same time, the challenge for society is in rebuilding a growing economy with abundant production, one that engages in world trade, encourages innovation as it once did, and provides high levels of well-paid and productive employment.

The solution to both goals is rejuvenating a culture of private investment and entrepreneurship. A nation of house buyers becomes captive to the economic cyclicality caused by bursts of construction activity and the limited service employment that follows in its wake. A nation of business-starters and investors that puts money behind its own ventures, or invests in our capital markets, creates long-term employment, income, exports, and the myriad technological advancements desperately needed by an expanding society as the future unfolds.

While owner occupied homes will always be the basis for healthy and stable neighborhoods, the confused and conjoined concepts of profit and social responsibility in the popular understanding of home ownership should be allowed to decouple. This will encourage the coming generations to act in their own enlightened economic interest, and to lead their leaders to the realization that houses are possessions and necessary material components of living, but not always good investments to lead them on the most the most direct and predictable path to financial independence.