Considering a Home Sweet Investment?

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The twenties and thirties are an ideal time for establishing future financial success. However, various and competing financial goals and responsibilities such as student loans, home purchases, raising children, and saving for retirement can be overwhelming. Diversified Trust has compiled a series to help guide young people toward a brighter financial future.

HOME IS WHERE THE HEART (ACHE?) IS

Once, buying a home was seen as a way to wealth. First time buyers were encouraged to stretch and renters were told they needed to get in or be forever priced out. Then in the early 2000s, the great housing run up occurred - followed by the great housing crash. Today, it is fashionable to say that owning a home is not a good investment. Recently, Investment News, Forbes, The Wall Street Journal, and Barron's featured articles explaining why housing was a bad investment. Like most every investment, it is as easy to find a success story as it is to hear a story of tragedy. But unlike most every other investment, a home has significant intangible and consumptive qualities that make it difficult to compare to the equivalent number of Microsoft shares.

Over the next twenty years, older Americans are projected to hand down approximately $70 trillion to their Millennial and Gen X heirs in the Great Wealth Transfer. Gen X (born 1965-1980) will inherit 57% of these assets, while Millennials (born 1981-1996) will inherit 43%.

HOUSES AS INVESTMENTS

With the understanding that a home is a multi-dimensional purchase and not simply an investment that can be reduced to numbers, factors, and vectors, we thought it would make sense to look at the numbers directly. The arguments in the personal financial press for not buying a home are fairly well-known: houses over a long period of time have generally increased not much more than inflation, the carrying costs of a home are far more than simply the mortgage, homes have high transactions fees in and out, etc. We find these arguments underestimate the tax-advantaged nature of the purchase, the high leverage (borrowing) levels available, and the avoided costs of renting similar accommodation.

Using the Case-Shiller Index - a repeat sales index - and looking across multiple markets over an extended time, we agree that purchasing but not using a house in the United States is a flat to negative economic proposition in absolute terms and a pretty clear loser in terms of opportunity costs. But this might not be an appropriate comparison. Would an investor ever buy 1,000 shares of Microsoft and ask that the company stop working during her ownership? Unlikely. Likewise, a house has to do some work. We characterize that work as either the rent that the owner could receive, or the rent that the owner could avoid—for our model, we assume this number to be the same.

OUR MODEL

To better understand the home as an investment, we made a number of assumptions based on historical averages. We assumed the following:

- Home purchase price $500,000 (this is about 2x the national median)
- 20% down on a 3.5% 30-year amortizing mortgage
- Property taxes of 1% of the home's value, and maintenance and up-keep of 2%, with insurance and other legal costs at .5%. We assume that these values grow in line with forecasted inflation of roughly 2% per year
- We assume a 25% marginal tax rate for the interest deduction (the average qualified purchaser of a $500,000 house will likely be in at least the 28% marginal tax rate—a higher tax bracket would increase the returns on the investment)
- Most importantly, we assume that the house grows in value at 3% and that the rent yield (or rent avoidance) is 7% of the home's value
- Finally, we assume a 6% realtor fee on the sale of the home

Under these assumptions, if you were to hold the house for 30 years, you would have an internal rate of return of approximately 11%. On a ten-year hold, the return would be nearly 15%.

SO WHAT

Again, we emphasize that an important driver of the return is the rent (avoided or received) attributed to the house. The absence of considering this factor in other analyses may explain the variety of conclusions. An 11% return at first glance is not impressive when compared against unicorn valuations and other speculative gains, but to compound at this rate over a meaningful period of time is impressive. It is particularly attractive in light of the view that many have about the future returns of the equity markets. As more capital continues to pour into equity markets, the prospect for sustaining historical rates of return appear dim. This is particularly true for the U.S. equity markets, which not only have had strong inflows, but are also at relatively expensive valuations after the post-COVID market advance.

THE TAKEAWAY

We reiterate that a house is a unique asset, more akin to an investment in a painting than in a stock. The consumptive value of a house makes its investment value hard to measure. Likewise, the piece of mind that might come from paying off a mortgage means that the financial decision is likely one that should be discussed with your advisor and considered from multiple vantage points. Finally, given that homes are often very large purchases, they can have an extremely concentrating effect on a personal portfolio. The median homeowner has over 60% of their wealth concentrated in their home. The risk of loss in any single concentrated asset is high, and a prudent strategy is to always maintain a meaningful level of diversification in personal finances. The pain from the housing crisis was real and wide-reaching. Nevertheless, prospective homebuyers should not place outsize importance on the singular events of the housing crisis. We find that housing continues to be an attractive investment opportunity, particularly in comparison to the projected returns for domestic equities.

IMPORTANT NOTES AND DISCLOSURES

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