House Not Investment Yahoo Article 2007

The Worst Investment Ever

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My fellow Fool John Rosevear considers a house to be the best investment ever. I disagree. A house is a place to live, not a road to riches.

Think about it for a minute. What characteristics do Fools look for in a great investment? Positive cash flow, low expense ratios, low transaction fees, and historically proven returns. Using these criteria, the average house falls well short of the all-time best.

Positive cash flow
If you buy a house, how much money goes into your pockets every year? How much goes out? That's right -- a house clearly produces negative cash flow. Mortgage payments, maintenance, and taxes add up to a lot of money heading out and none coming in.

This is not necessarily true for real estate as an asset class. Purchase a parking lot, apartment block, or strip mall, and you very well may find that the rents are higher than the cost of ownership. Real estate that generates positive cash flow can be a great investment. This positive cash flow fuels the dividends from REITs such as **Avalon Bay** (NYSE: AVB - News) and **American Financial Realty** (NYSE: AFR - News).

Low costs
The Fool has long advocated seeking investment vehicles with low expense ratios and transaction fees. The expense ratio is the cost of owning an investment as a percentage of its value over the course of a year. Shannon Zimmerman at the *Motley Fool Champion Funds* service searches for mutual funds with expense ratios of less than 1%.

How does this compare to housing? Costs vary significantly by location, but for urban areas, annual property taxes are typically between 1% and 2% of the current property value. Annual maintenance costs can add another 1% of the property value. If your down payment is less than 20%, you will also usually have to pay private mortgage insurance. Add property insurance, and the annual expense ratio associated with homeownership can easily reach 3% or more.

The big hit, however, arrives when you sell a property. Real estate agents will collect 6% of the selling price, while, lawyers, inspectors, title companies, and banks will collect additional fees. These fees appear as though they will remain stubbornly fixed for years to come. If you flip properties as though you are actively trading stocks, the only folks getting rich will be real estate agents. Meanwhile, transaction fees for stocks and mutual funds have plummeted in recent decades, to the point of falling below $10 per trade at several discount brokers.

Historically proven returns
The Fool has long advocated shares of individual companies as the best road to wealth, because of their inflation-crushing performance over very long periods of time. In *The Future for Investors,* Jeremy Siegel identifies several companies that have not only beaten inflation but also delivered returns far in excess of the market average for 50 years. It does not take a genius to actually buy companies like **Pfizer** (NYSE: PFE - News) or **Altria** (NYSE: MO - News), consistently reinvest the dividends, and build wealth over the decades. Over the 50 years of data compiled, Pfizer and Altria returned 16.0% and 19.8% respectively.

For any time period longer than the past few years, residential housing prices fall far behind these returns. Perhaps the best measure of housing-market appreciation is the S&P National Home Price Index. This index represents the actual appreciation of the same house over time, whereas a portion of overall housing-price increases occurs because new houses are generally much larger than old houses and people frequently spend substantial money upgrading and expanding their houses. Looking at the index, from 1987 to 2006, we see that the overall average appreciation in the U.S. was only 5.6%. Even cities showing huge gains during the final years of the housing bubble -- including San Diego, Las Vegas, and Washington, D.C. -- showed gains slightly above only 7% for the 19-year period. If we adjust these returns for inflation, we end up with real returns on housing in a range of 3%-5%. Subtract our annual expense ratio of 2%, and the return gets pretty thin.

This index is relatively new, and the data ends at the top of the final eight years of the biggest housing boom in U.S. history. Longer-term data paints an even less encouraging picture. Piet Eichholtz studied records on home sales in Amsterdam's premier Herengracht neighborhood from 1628 to 1973 and found an inflation-adjusted return of 0.2%. There were periods of rising prices and periods of falling prices, but not a continuous march upward with spectacular returns.

Final thoughts

I will agree with John Rosevear on one account -- a house is a great place to live. Fool Mary Dalrymple provides a good discussion of the issues associated with the rent-or-buy decision. Those who think renting is "throwing money away" should consider that mortgage interest, maintenance, taxes, and insurance are also "thrown away." Having a place to live costs money no matter what, and a rational evaluation of your local market should let you know which one is a better value. Before you start plugging overly optimistic numbers into the rent-vs.-buy calculator, just remember that past performance may not be indicative of future returns.