Is Real Estate Undervalued?

Every so often it makes sense to look at the matter of real estate values and at least mention that when it comes to numbers, homeownership routinely comes up short.

We live in an era of numbers. If you want to "prove" something, just find the right study to support your view -- and there's always a "right" study.

Think of global warming. Is it here? Not here? Will it cause worldwide flooding? Or will it produce longer growing seasons so more people can eat and warmer weather so we consume less fuel, cut pollution, and gain political independence? There are endless studies to support whatever view you prefer.

I raise this matter because we see, according to NAR, that 2001 was a record year for existing home sales -- 5.25 million were sold.

In addition, NAR "expects the national median existing-home price for 2001 to be $146,600, an increase of 5.5 percent over 2000."

Given the performance seen during the past two years on Wall Street, and given the rate of inflation, a price increase of 5.5 percent is very nice indeed.

Alas, we will now see endless reports that real estate is a good investment because property values rose 5.5 percent in 2001. That's true, sort of, but hardly the whole story.

Imagine that you put $138,975 in the bank and get 5.5 percent interest. With a touch of rounding, at the end of the year you would have $146,600.

Let's also say that you acquired a property for $138,975 and sold it a year later for $146,600. Yup, the value went up 5.5 percent:

Or did it?

Let's ignore selling costs, taxes, inflation, the future value of money, and other complexities for the moment.

To get that 5.5 percent from the bank you had to deposit $1 38,975. If you put in $13,975 -- one-tenth the amount -- you can absolutely bet that the bank would not have paid 5.5 percent on money it did not hold, the balance of that $138,975.

There's no leverage in a savings account, but that's not true with real estate.

Of the 5.25 million homes bought last year, how many were purchased for cash? Some, certainly, but most required financing, another way to say that real estate is typically purchased with leveraged dollars.

So if you bought a home for $138,975 and put down 10 percent, you would need cash worth $13,897 to purchase your property. And if the property's value rose to $146,600, then after a year you would have additional value worth $7,625.

Now comes the interesting part.

Was the down payment the entire cost of the purchase? No, there may have been closing costs and also there is a mortgage and monthly payments. But is real estate similar to a savings account or bond, just numbers on a page? Again, the answer is no. You can live in a home or rent it.

Imagine that you put $13,897 in a savings account and at the end of the year earned interest worth $7,625. The bank would have a huge sign in the window saying, “Bring us your money, we pay 54.87 percent.”

So is real estate growth is understated? Of course. That 5.5 percent appreciation figure is extremely conservative because it does not account for leverage and it says nothing about the utility of real estate, the fact that property can be used for something.

Does real estate always increase in value? No, and when property prices fall you can get large percentage decreases relative to your initial investment.

For it’s part, NAR might want to change future news releases to at least include a few pithy sentences touching on the matter of leverage. I can see the release now....

In Washington today, the National Association of Realtors announced that existing home prices rose 5.5 percent in 2001 to a median level of $146,600. A typical individual buying with 10 percent down at the beginning of the year -- investing just $13,897 --would have seen the value of his or her property rise $7,625 during the past 12 months, an increase of 54.87 percent when compared with the down payment. Of course, not everyone obtains median results. Property prices appreciate more in some areas, less in others, and sometimes real estate values decline. In addition, as they say on Wall Street, past performance does not guarantee future results....

By Peter G. Miller