

BOTTOM LINE WITH RESIDENTIAL ESTATE

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You would think that people would learn from disasters. The stock market bubble of the late 90's is long forgotten by many, and has been replaced by residential real estate fervor. This is very concerning. Myths are circulating that echo sentiments of tech investors a mere 4 years ago. Many homebuyers believe there is no risk in real estate, that the returns are attractive, and most problematically, that the recent rise in home values will continue indefinitely. Sure, home prices have risen dramatically, but only in the last few years.

To address the homebuyer's assumption of attractive returns on residential real estate we point to a study performed by Ibbotson & Associates and Bloomberg. The study found that there were three factors that practically negate actual "bottom line" real returns for residential real estate.

TAXES - Taxes usually effect all investment decisions one way or another. For residential real estate this includes real estate property taxes and capital gains taxes that can occur at the point of sale.

INFLATION - From 1926 through 2003 inflation has averaged 3.03% per year. Without tax, an investment had to return 3.03% compounded annually just to stay even with inflation. (For the last twenty years inflation has averaged 3.07%; for the last 10 years, 2.45%.)

EXPENSES - All investment returns must be adjusted to include expenses. In the case of residential real estate we must included brokerage commissions which average 6% for both transactions; the buy and sell. In addition there is mortgage interest, property taxes, insurance and miscellaneous costs. This study did not include routine maintenance expenses for the homes.

To make the study complete and for comparison purposes, Ibbotson & Associates and Bloomberg applied the same three factors against other classic investment types over several investment periods to come up with the following "bottom line" results.

HISTORICAL INVESTMENT RETURNS ADJUSTED FOR TAXES, INFLATION AND EXPENSES

Holdings Period	Inflation	S&P 500 Index	DJIA Index	Muni Bonds*		U.S. Treasury		
				"A" Long	T-Bills	5-Year Notes	Long Bonds	Single-Family Homes
77 Yrs 1926-2003	3.03	4.94	0.74		-1.02	-0.40	-0.04	
40 Yrs 1963-2003	4.42	3.48	0.37	1.77	-1.49	-0.99	-0.78	
20 Yrs 1983-2003	3.07	7.20	6.84	3.45	0.15	0.95	1.38	0.57
10 Yrs 1993-2003	2.45	5.66	7.45	2.99	0.15	0.89	1.43	0.20

Source: Ibbotson and Associates and Bloomberg. * Income data not total return.

Blue chip stocks, as measured by the S&P 500 Index, show positive returns during all holding periods shown above. But even the bull market of the 1990s only boosted the last 20 year average annual "bottom line" return to 7.20%. Municipal bonds returned approximately 85% of the income (before taxes) of long U.S. Treasury bonds, however, federal income tax rates the last 20 years for an investor in the top tax bracket have averaged 40%!

Treasury bills provided a negative bottom line return in every holding period except the last 10 and 20 years. Five-year Treasuries and Long-term U.S. Treasuries provided a negative bottom line return except for the last 10- and 20-year holding periods when interest rates had their most dramatic decrease, providing capital gains we cannot expect in the future.

On the other hand, single-family homes provided a bottom line return of 0.20% and 0.57% for the last 10 and 20 years. Obviously, home owning, even excluding maintenance costs, has not been the investment we might have desired or believed. If the \$250,000 (\$500,000 per couple) exclusion from capital gains tax is factored in, results improve; however, the returns remain unattractive for 10 and 20 years at 1.04% and 1.48%, respectively.



Financial planning must adjust for inflation and apply appropriate tax rates to the interest, dividends, and/or capital gains. If a portfolio cannot earn positive returns over time after taxes, inflation, and expenses, it is losing wealth.

Most of the time, taxable fixed-income securities only make sense for the persons in the lowest tax brackets, or for tax-exempt or tax-deferred investing, such as 401(k), pension or profit-sharing plans, charitable organizations and state and local governments.

Although studies and their statistics do have limitations, we are comfortable saying that the broad view of bottom line returns - after inflation, taxes and expenses for the different classes of investments - is clear and indisputable. The next time a neighbor claims he doubled his money on his house because he bought it for \$200,000 ten years ago and it is now worth \$400,000, remember that he is probably ignoring the ten years of interest, taxes, insurance, and maintenance he has forked out. He is also probably omitting the commissions, fees, tax stamps and other closing costs he paid and would pay again upon the sale. Let's not forget that adjusted for 3% inflation; the purchase price is more like \$270,000.

Real estate can be a good investment, but it is neither an extraordinary one nor a low risk one. The stories of being sold swamp land and of "hot" development going cold have been plentiful for centuries. When you hear these stories, think about the recent tech stock bubble and you may notice what we have been noticing a lot (though not as much since the hurricanes ripped through here) --- the most enthusiastic real estate investors are using the exact same language to describe the joys of real estate as tech investors were using in the late 1990's. As people pay ever higher prices, thinking they will find someone else to buy from them at even higher prices, all we can counsel is, "buyer beware." You don't want to be one of the many unbelievers at the end of that chain.