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Actually the return on investment of bying quality stocks in 1960 or purchasing a home would be about the same (3% above inflation). However for the latter one also had a roof over one's head - paying only municipal taxes and maintenance costs. - cjk

Are the benefits of home ownership overstated?

The perpetual debate over the pros and cons of home ownership reached new heights last week when writers from The New York Times, Forbes magazine and The Economist all took a kick at the can.

BY VANCOUVER SUN MAY 17, 2014

The perpetual debate over the pros and cons of home ownership reached new heights last week when writers from The New York Times, Forbes magazine and The Economist all took a kick at the can.

It started with Times writer Josh Barro, who argued that buying food the way we buy houses would be crazy, which probably seems obvious to most of us. But his analogy scored some solid economic points. Consider that a mortgage is, in effect, a long-term contract to buy housing services from a lender. If food buyers did the same - that is, bought a contract for the right to a stream of future food, food owners would benefit from rising food prices and would support policies that restricted the supply of food to keep pressure on prices. Some might buy food contracts for food they didn't intend to eat but rather to sell later at a profit, leading - if history is any guide - to a food bubble.

This, said Barro, mirrors the housing market where buyers take long-range equity positions in their homes and can profit from restricted supply, inflated prices and speculation.

He lamented that rather than investing in a balanced portfolio of stocks and bonds, homebuyers bet on the riskier proposition of a single property in a particular market where a 20 per cent decline could wipe out their equity entirely.

If homebuyers thought of housing as a consumption good, like food, rather than an investment, perhaps we'd avoid all that unpleasantness.

The counterpoint came from Adam Ozimek in Forbes who declared, quite reasonably, that housing is not food. If carrots represent five per cent of the household budget and the price of carrots doubles, he said, it doesn't mean the household budget must increase by five per cent. It's easy enough to switch to a cheaper vegetable - think parsnips or rutabagas.

But if the cost of housing increases, substitution is far more difficult when you factor in transaction fees, the need to place children in different schools, the loss of social contacts and so on.

What's more, households are less likely to see a significant increase in their basket of food than in their housing. Housing supply is relatively inelastic, Ozimek explained, in part because of the time lag between price changes and the supply of new properties available in the market. Food, on the other hand, is usually produced in what he called a nearly perfect competitive market in which supply can be quickly increased to prevent price hikes.

Another difference, he said, is that food, being a non-durable good, is consumed in most cases right after purchase so there is no risk of its value declining between store shelf and table. Housing, however, is durable so carries the significant risk inherent in owning any asset long term, mainly that inflation could outpace and erode investment returns in time.

Of course, any investor who has experienced the volatility of so-called "softs" on the NYMEX might challenge Ozimek's benign view of food. But that's another story.

Into this fray waded Ryan Avent, The Economist's economics correspondent, who posited that people overestimate the benefits of home ownership.

"One is typically renting either way," he wrote. "Homeowners simply choose to rent capital rather than housing."

Leverage is the force that shifts the housing market into overdrive. Avent asked us to imagine a city in which the average price of a home is $100,000 and the average down payment is 10 per cent. One household uses the $10,000 to buy units of a REIT which owns a portfolio of representative homes in that market. In the next five years, home prices rise 10 per cent a year. Here's what happens.

At the end of five years, the value of the average home will have risen a little more than 60 per cent. The household that invested in a REIT will have turned its $10,000 into $16,000 - not a bad return. But a household that bought a home will have seen a return of more than 600 per cent on its $10,000 down payment and can use its $70,000 in equity to buy a more expensive home.

"In a leveraged world, any sustained uptick in prices quickly risks becoming a speculative boom," he said. "If those that bought can cash out and buy new homes at prices vastly above the average, the average price starts to rise faster."

New supply can't come onto the market fast enough to keep prices down, partly because builders might wait to see if price increases can be sustained before committing to construction, and cities may be slow (or hesitant) to free up land for development.

Weakened credit standards and money from investors outside the city anticipating continued price appreciation can keep prices rising faster than increases in rents and incomes for a long time, Avent said.

He suggested two measures governments can take to prevent this vicious cycle: to "maintain a liberal planning regime" and to tighten credit as prices rise - measures he acknowledges would be unpopular among rich and influential people with a financial interest in maintaining high housing prices.

In his conclusion, Avent raised a provocative question. While there are clearly advantages in owning homes, "is home ownership a good thing overall?" That discussion is probably already underway somewhere in the twittersphere.

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