Global Financial Private Capital

SYNOPSIS

- A big financial misconception is that home ownership is a good investment over the long run.
- Not all assets qualify as investments, and a primary residence almost always fails to meet the conditions necessary to carry this designation.
- Homes are assets with intangible value, which offer more than just the potential for financial profit.

HOMEWARD BOUND

TRobert Shiller is an economist at Yale University and is regarded as a leading expert on housing. His analysis concludes that real estate generally keeps pace with inflation but seldom offers any return above[1].

Returns look even less appealing after factoring in repairs, maintenance costs, transaction fees, annual property taxes, insurance, and other hidden costs of home ownership. For example, a real estate broker's commission tends run around 5-6% at the time of sale.

The obvious question is why the returns from home ownership have been so shockingly poor. The answer becomes apparent when comparing the characteristics of an asset to an investment.

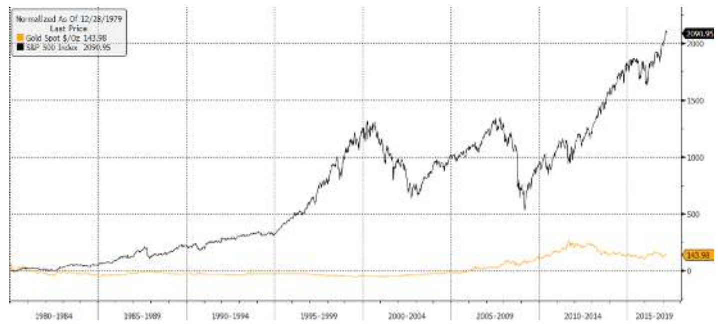
The difference between the two is that an asset is a store of value, while an investment also has the potential to generate value over time. Precious metals, art, collectibles, fancy wines, and cars are all examples of a store of value. An asset's value changes over time solely from the demand to own it and the supply available.

For instance, a piece of art hanging on a wall does no more or less than silver coins sitting in a safe. If society over time views the painting to be worth more than it was in the past, then the owner may be able to sell it for a profit.

An investment is more than a store of value because its intended purpose is to generate a return in the form of either income or quantifiable growth[2]. Bonds are investments because they pay income, and stocks are investments because companies that grow tend to see earnings rise over time.

Let's compare the two to get a sense of why some assets should never be classified as investments. Despite the fear mongers who preach its value, the chart below shows gold's performance versus the S&P 500 from 1980 through April 2017:

PERFORMANCE OF THE S&P 500 VS. GOLD



Source: Bloomberg

Investing $1 in gold (yellow line) back then would be worth $144 over this 37-year time period. That same dollar invested into the S&P 500 would be worth $2,091, which is over 14x larger than gold's return.

Making matters worse, the table below shows that gold has actually been more volatile than the S&P 500 in most instances:

ANNUALIZED VOLATILITY

	GOLD	S&P 500	+/-
DAILY	19.85%	18.23%	1.62%
WEEKLY	18.56%	16.54%	2.02%
MONTHLY	17.83%	15.30%	2.53%
QUARTERLY	15.57%	16.26%	-0.69%
ANNUALLY	16.53%	16.48%	0.05%

Source: Bloomberg, January 1980 - April 2017

A natural reaction to this data is to conclude that gold has been a terrible investment since 1980. However, I believe such a statement to be unfair because this shiny pet rock suffers from the same limitations as a home.

Gold generates no income, requires expensive storage and insurance costs, cannot compound over time, etc. Since gold does not possess the characteristics of a real investment, it should not be expected to perform like one.

Similarly, homes do not create and sell innovative products or buy rivals to grow market share. They also rarely generate cash flow, and when they do, the cash received from renting that spare bedroom rarely pays the mortgage. Hence, it is equally inappropriate to classify homes with stocks, bonds, and other investments.

> **"Investments can be classified as assets, but not all assets are investments."**

Only a select few real estate examples possess the required attributes. Landlords generating monthly rental income above their costs, and restoration experts that repair properties and sell them for a profit can certainly claim to own investments. The rest are just assets.

IMPLICATIONS FOR INVESTORS

There is an old saying that where there's thunder there's lightning, but the opposite is not always the case. Just because lightning rips across the sky does not guarantee thunder is right behind.

The same applies to assets and investments. Investments can be classified as assets, but not all assets are investments. Investors can get themselves into trouble when they are unable to distinguish between the two, and admittedly, it's not always easy.

There is also a compelling case to own both assets and investments together. For example, after years of renting in New York City, my wife and I finally purchased our very first apartment back in 2015.

Given the data above, it's justifiable to ask why we would want to lock up capital in a down payment, spend cash periodically for maintenance, and waste weekends on tasks that I truly despise, only to achieve a rate of return that may not exceed inflation.

The answer lies in what we hope to gain through home ownership. Assets often carry "intangible" value, which is importance that cannot be seen, touched, or quantified.

Within this context, we made the largest purchase of our lives for a number of reasons that had nothing to do with investing. We wanted to pick our own paint colors, customize a kitchen to suit our needs, and take a few years off from moving (few tortures in this known universe are more painful than moving between apartments in New York City).

There's no question that there was an economic component to our decision to buy. We certainly hope to earn a profit, and home ownership provides us a number of financial advantages. For example, we can write off the mortgage interest and avoid annual rent hikes in a city where prices seem to rise every fifteen minutes.

We also were very careful to buy an apartment in a neighborhood that has historically maintained is value. Leverage works both ways, so we did not want to put ourselves in a situation that would pose an outsized risk to our down payment.

However, since our apartment is not part of our investment portfolio, we maintain realistic expectations that it will not be a major contributor to a safe and comfortable retirement years down the road.

THE BOTTOM LINE is that a home is an asset and likely a great place to create memories while raising a family, but it should not be treated as an investment.

SINCERELY,

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[1] Robert Shiller, Irrational Exuberance: https://www.amazon.com/Irrational-Exuberance-Revised-Expanded-Third/dp/0691173125/

[2] There is no guarantee that any investment will achieve its stated goal, and losses are a risk associated with any investment.

Index Definitions

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not include fees or expenses. Past performance does not guarantee of results. Index returns do not reflect fees or expenses and it is not possible to invest directly in an index. The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

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