As safe as houses?

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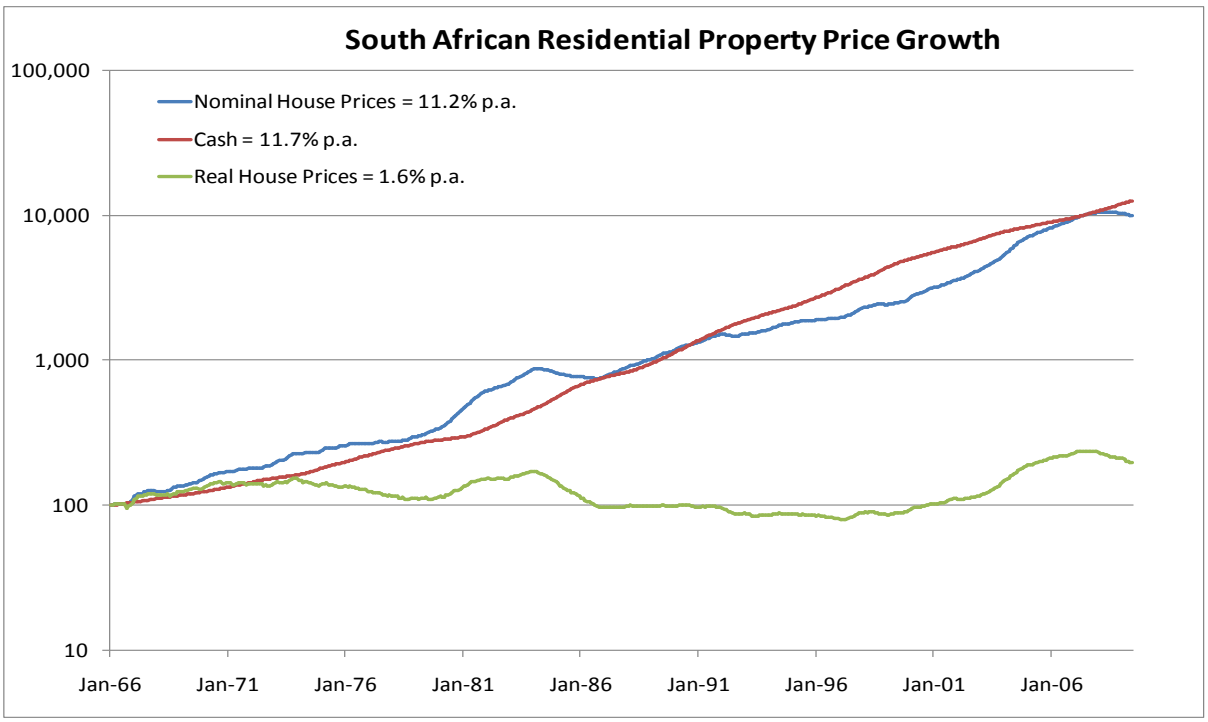
An investment in residential property represents the cornerstone of most families' wealth. Given the financial importance of property to most people, it is worthwhile trying to understand the characteristics of this asset class better.

The ABSA House Price Index, charted below, shows that the value of South African residential property (blue line) has increased at a rate of 11.2% pa since 1966. With house prices now 100 times higher than they were in the 1960s, it is understandable that homeowners often relate with pride the safe and steady returns that their properties have generated. Compare that return to cash (red line), which has produced a similar - albeit slightly higher - return of 11.7% pa. In other words, house prices have not quite kept up with cash in the bank.

The story becomes far more interesting once we strip out the effects of inflation. *Real* (ie after inflation) house price growth has only averaged 1.6% pa over the past 40-odd years (green line), significantly lower than many might expect. And even this may be an overstatement because the average house has gotten bigger and its quality has improved. You may well be getting more house for your money now than you did back in 1966.

Of course, there has been a fair amount of volatility in house prices over the period. For example, the period from 2001-2007 was spectacular – real house prices grew by nearly 250% in the space of only seven years. But over the 35-year period from 1966-2000, house prices did not grow at all in *real* terms.



Source: ABSA House Price Index & Nedgroup Investments, 1966-2009. Log scale

Can we then deduce that house prices grow broadly with inflation over the long term? In their paper '*The Inflation hedging properties of real estate'*, Markus Demary and Michael Voigtlander conclude (by regressing residential property prices against inflation), that residential property is indeed a very effective hedge against both expected and unexpected inflation. Logically, rental growth (and, therefore, house price growth), cannot grow faster than inflation indefinitely because rental growth must form an important part of inflation itself - either directly through your monthly rentals or indirectly through your cost of living.

Another fascinating study completed in 1994 by Piet Eichholtz, entitled *'The Herengracht Index, 1628-1973*' lends further weight to this hypothesis. The *Herengracht Index* is an ultra long-term study of the prices of property in the Herengracht district of Amsterdam. Records dating back to 1628 give us nearly 400 years of data to work with. The houses on the Herengracht are well suited to a long-term study, because they have largely remained unchanged (although well maintained) over the period in question. The Herengracht area has preserved its status as the finest area in Amsterdam in which to reside. This is important, because it means we are analysing an area that has retained its value relative to properties in other areas. The results of the study over the entire period, and broken down per century, are provided in the table below.

Real Price Growth of Properties of the Herengracht, Amsterdam:

	Dates	Real Price Growth (pa)
Total Period	**1628 – 1973**	**0.5%**
17th Century	1628 – 1699	1.3%
18th Century	1700 – 1799	-0.2%
19h Century	1800 – 1899	1.0%
20th Century	1900 – 1973	-0.2%

Source: Eichholtz; the Herengracht Index, 1628-1973.

It is remarkable that real house price growth has averaged only 0.5% pa over the entire period. The results are fairly consistent over each century too; the lowest real growth of -0.2% pa being in the 18th and 20th centuries and the highest real growth of 1.3% pa being in the 17th century. Over shorter periods of time the real growth rate varies far more dramatically, with real price changes in excess of 50% over any ten-year period common.

It seems optimistic to expect residential property to increase at rates significantly above inflation over the long term. Naturally, the interest rate cycle and market dynamics will ensure that this is only the case over the very long term, and property values are likely to vary vastly from normalised levels over shorter time periods.

The analysis thus far has ignored the other crucial component of property returns, namely rental income. To calculate the total *real* return from a property investment, one should add the net rental yield (or rent saved by living in your own home) to real capital growth. As rental income is likely to grow largely in line with property prices over time, the prospective *real* return from property can, therefore, be simplistically approximated by the current net rental yield.

Residential property can be viewed as somewhat similar to an inflation linked bond; with a coupon (being the net rental yield) that grows with inflation and a capital value that also escalates with inflation over time. Take comfort from the fact that your investment in your home is likely to maintain your spending power, but be careful of expecting capital growth that far outstrips the inflation rate or money in the bank.