Scared of Stocks? Buy a House Instead

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Real estate may be a better — and safer — investment than I thought. This is my conclusion after reading a comprehensive study published this month titled, "The Total Risk Premium Puzzle."

To revisit our previous understanding, it has been widely accepted that equities yield real returns much higher than those of government securities. By most estimates that gap is about 6.5 percentage points; while government bonds might offer an average return of about 1 percent a year, for example, equities return about 7.5 percent a year (the precise figures depend on the data sample). Equities, however, are much riskier, and so there is a trade-off between risk and return. So far, so good.

The returns to real estate are harder to measure, both over time and across countries. One difficulty is measuring the "imputed rent" return — that is, if you buy a house you also get the pleasure of living there and don't have to pay rent elsewhere. But many analysts doubted whether the return to U.S. housing was robust over, say, the 1890-1990 period.

The authors of the aforementioned study — Òscar Jordà, Moritz Schularick and Alan M. Taylor — have constructed a new database for the U.S. and 15 other advanced economies, ranging from 1870 through the present. Their striking finding is that housing returns are about equal to equity returns, and furthermore housing as an investment is significantly less risky than equities.

In their full sample, equities average a 6.7 percent return per annum, and housing 6.9 percent. For the U.S. alone, equities return 8.5 percent and housing 6.1 percent, the latter figure being lower but still quite respectable. The standard deviation of housing returns, one measure of risk, is less than half of that for equities, whether for the cross-country data or for the U.S. alone. Another measure of risk, the covariance of housing returns with private consumption levels, also shows real estate to be a safer investment than equities, again on average.

One obvious implication is that many people should consider investing more in housing. The authors show that the transaction costs of dealing in real estate probably do not erase the gains to be made from investing in real estate, at least for the typical homebuyer.

Furthermore, due to globalization, returns on equities are increasingly correlated across countries, which makes diversification harder to achieve. That is less true with real estate markets, which depend more on local conditions. So buying real estate in different countries, if you are in a financial position to do so, is a good way to diversify, in some ways better than equities.

One implication is that the millennial generation, which is often house-shy due to having experienced both the real-estate bubble and high student debt, is missing out on a good investment. An unfortunate side effect is that access to the housing market, especially at an early age, may be helping to create and perpetuate a dual-class system in the U.S. and many other countries.

A subtler implication of this study is that, putting aside real estate, economists still don't understand very well why people don't buy more equities relative to holding cash. The old story was that equities are too risky, and surely there is something to that hypothesis. But even when risk is lower, as with real estate, a lot of people still prefer to hold the cash.

That is a puzzle, and maybe it means risk is a smaller factor shaping portfolio decisions than we used to think. For instance, there may be reasons of psychology and upbringing, or market segmentation, that many people do not deploy their money more aggressively. Furthermore, arbitrage from wealthy outside investors — who face few liquidity constraints — apparently has not been strong enough to eradicate the rate of return differentials across real estate and lower-yielding assets. Perhaps that means yet another class of real estate millionaires and billionaires will be created, as those opportunities are exploited.

So what's the catch? Well, as investors in equities are regularly informed, past performance is not indicative of future results. Many industrialized nations are entering unprecedented periods of low fertility, for example, and that could mean future housing returns won't be nearly so glorious because demand could be weak. At the same time, NIMBYism could restrict supply by at least as much.

Don't ever invest a lot of money on the basis of a single paper or study. Nonetheless, at the margin, the case for real estate just improved.

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