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The Sound Investor Series #12

Analyzing Real Estate in Your Investment Portfolio

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As prices continue to climb, there is no shortage of articles about real estate these days. I do not know if prices will continue skyward, but I do have some thoughts on how investors should look at real estate within their portfolios.

First, it is important to differentiate between residential real estate, i.e. your home, and any other real estate investments you might have. Most of my thoughts in this article concern your investment in your home.

To help establish a foundation for our discussion it is important to understand the long-term investment returns of real estate. For the past 50 years or so, real estate investment returns have been higher than bonds and lower than stocks. If we accept the long-term connection between risk and return, this means real estate is riskier than bonds and safer than stocks.

Looking forward, if you think bonds will return about 5% a year and stocks around 9%, the expected long-term return of real estate is 7%. But assets go through cycles where the returns are higher than normal for a while, and then lower. We have all seen this with the stock market over the past ten years - some years had increases of 20% or 30% while other years saw declines of the same magnitude. Overall the market was up about an average of 10% a year.

The real estate market has similar cycles although usually less volatile. It appears it is currently at a point where prices are increasing faster than the long-term average and such periods are almost always followed by those where they go up more slowly than normal.

How does real estate fit into your investment and retirement planning? First, make sure you include your house when making a list of all your assets to understand your total wealth. It is easy to see why your home should be included, since for most of us it is our largest asset and will play a critical role in funding retirement. If your home equity is \$50,000 and other investments total \$50,000, 50% of your \$100,000 net worth is in real estate.

If you also have a mortgage, your economic exposure is actually higher. Assuming you have a \$50,000 mortgage, you actually have a total of \$100,000 in real estate and \$50,000

in stocks or bonds. So 67% of your investments are in real estate (\$100,000 out of \$150,000).

At the next financial planning step, when you make investment decisions for your liquid or non-real estate assets, I recommend leaving your home and mortgage out of the analysis. When we bought our homes none of us planned for them to be a certain percentage of our net worth, it just happened. We needed a roof over our head, and eventually over a larger number of heads, so we bought what we could afford.

The question of what percentage of net worth should be in home equity doesn't really make sense. I recently saw an article in a major business weekly suggesting that for investors without mortgages an ideal asset allocation strategy is 60% stocks, 10% bonds and 30% home equity. This strikes me as ridiculous! We buy houses for shelter and life-style; and if it comes out to 25% or 70% of our net worth, that's what it is, it is almost impossible to target.

By advocating a home equity target, there is the implication that investors should increase their home real estate asset allocation if their other assets increase in value. In fact, investors should try and lower housing costs. For every dollar spent on an additional room or taxes on a nicer house, you have one less dollar to invest for retirement. Remember, a dollar invested today, and earning just 5% over inflation, will be worth a real \$2.65 in 20 years. Just having a bigger house or a nicer neighborhood is not necessarily a good investment; you have to take other factors into account such as maintenance and taxes.

In summary, investors should certainly include the value of their homes and mortgages when looking at net worth and economic exposure to various markets, but when deciding how much of their liquid assets should be in stocks and bonds, leave your home out of the calculations.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal. Please contact Farm Creek for a prospectus on any of the funds mentioned.

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