

# ThinkingApplied.com

Mind Tools: Applications and Solutions

## Should You Put Your Nest Egg in Your House?

Lee Humphries

During 2001 and 2002, the S&P 500 lost one-third of its value while the median selling price of a Minnesota home rose 19.2%. But residents shouldn't conclude from this that their houses will produce a better long-term return than a broadly based stock index fund.

Minnesota's big housing gains began in 1999. The state's annual appreciation rates for 1999 through 2002 were 10.7%, 10.9%, 10.3%, and 8.1%, respectively (*OFHEO House Price Indexes*).

These rates are extraordinarily high when compared with the average rate for the twenty-three years from 1980 through 2002. Over this longer span—which includes the recent boom years—homes appreciated an average of 4.7% annually. So, the 1999-2002 increases were 2.28, 2.32, 2.19, and 1.72 times the historical average.

Over the same twenty-three years, the S&P 500 showed an average annual gain of 9.6%—despite a 13% loss in 2001 and a 23.4% loss in 2002. Long-term, the stock market enjoyed a 2-to-1 advantage over Minnesota's owner-occupied housing.

The recent house-price escalation in various parts of the US is the supply-and-demand effect of several converging trends:

- *population growth*—creating more buyers;
- *improved healthcare and increased longevity*—extending seniors' time in their homes;
- *increasing affluence*—allowing more spending on primary homes and more purchases of vacation homes;
- *retiree relocation to desirable areas*—raising demand where supply is limited;
- *historically low interest rates*—enabling more buyers to qualify for mortgages and permitting a larger mortgage at a given income;
- *depressed stock market*—causing the redeployment of invested money; and
- *fear of missing out*—motivating people to commit more of their reserves to the advancing real estate market.

But this favorable combination can't last. True, the first four trends are long-term and will continue their upward pressure on prices, but the last three have shorter lives, and their dissipation will counteract the pressure. When this happens, home appreciation will slow. (And where excessive valuations exist, price drops aren't out of the question.)

There are systemic reasons why the housing market can't match the stock market's long-term rate of return. Value has two drivers. The value of a corporation increases as: (1) the growing economy raises the demand for its products and (2) the corporation invests new capital to improve and expand those products and their markets. Similarly, the value of a home increases as: (1) the housing market grows and (2) improvements are made to a house and its property. For corporations and houses, it is capital investment that drives their appreciation above the baseline rates of economic and residential growth.

In thriving corporations, capital investment is ongoing. Thus, their improvement is virtually unending, and they can grow indefinitely at a faster rate than the economy.

But home improvement *cannot* continue indefinitely. You can add only so many rooms, Jacuzzis, granite counters, and gold-plated toilets. Eventually, no value boosters remain. Moreover, a home's maximum price is constrained by the market value of neighboring houses, regardless of the enhancements.

Improvements that accelerate your home's appreciation rate do so only in the year they are added. Thereafter, your improved home will appreciate at the rate of its local market. To generate a stock-market-sized return, your improvements must trigger an *immediate* jump in your house's price—a jump large enough to overcome residential real estate's lower average growth rate.

Unfortunately, the longer you retain your improved home, the greater that price jump must be. For retention periods of ten years or more, the required jump exceeds any markup you could reasonably expect. Using the 1980-2002 average growth rates for Minnesota housing prices (4.7%) and for the S&P 500 (9.6%), we find that each "improvement dollar" must produce an immediate price jump of \$1.57 if a house is retained for ten years; \$1.97, for fifteen years; and \$2.46, for twenty years.

Even if you do achieve the required price jump, the higher return will only apply to your "improvement dollars." Your "original-purchase dollars" will always grow at the rate of the real estate market.

These factors reduce the probability that your home's long-term return will beat the stock market. Still, that should not dissuade you from buying a better house nor from improving your present one. But don't poach your nest egg in the process.

© 2003 ThinkingApplied.com

---

**Lee Humphries**, a compulsive analyzer of many things, is president of [www.ThinkingApplied.com](http://www.ThinkingApplied.com).