The Highs and Lows of Real Estate Investing

Last month I discussed the pros and cons of real estate investing and how these stacked up against investing in the stock market. At the time, historic data on the real estate market in Trinidad & Tobago was not readily available and I was forced to draw conclusions based on the analysis of house prices in other markets, namely the United States.

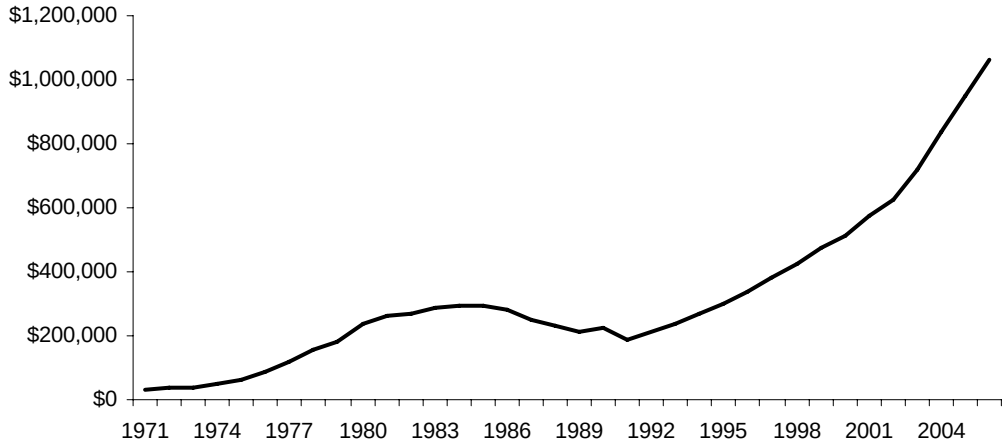
As if by magic, the Central Bank recently published a third pamphlet in its public education series, entitled “The Residential Mortgage Market in Trinidad & Tobago”. The pamphlet included provisional estimates of median residential housing prices using data supplied by the Association of Real Estate Agents (AREA) and private sector valuators.

The result is an annual house price index that tracks the average growth/decline rate of house prices across the country since 1971. Prices are based on a typical three-bedroom residential property and are adjusted for extreme market values on both the upper and lower ends of the market.

Although the data is not official, it provides the best estimate currently available and an opportunity to revisit the topic with new data relevant to our local market.

It comes as no surprise that house prices have more than doubled since the turn of the century, equating to an average annual return of 13 per cent. In fact, residential house prices have been increasing by an average of 13 per cent per annum ever since the recession in the latter half of the 1980s (see Figure 1).

Fig 1. Trinidad & Tobago: Residential Median House Prices (1971-2006)



Source: Central Bank of Trinidad & Tobago

The sheer magnitude of the current house price boom has prompted the natural question of its sustainability and whether house prices are significantly overvalued. The question of whether the nation’s housing market is a bubble at risk of bursting is not an easy one, even for economists, since real estate prices are influenced by several macroeconomic variables such as interest rates, GDP and unemployment.

The booming housing market in Trinidad & Tobago has been attributable to everything from an increase in personal incomes to the rise in construction costs. Even the recent decline in local stock prices is argued to have encouraged people to take their money out of the stock market and purchase real estate which many believe to be a more reliable investment.

It is not unreasonable to assume that once stocks fell, real estate became the primary outlet for the speculative frenzy that the stock market had unleashed. There is clearly a speculative element in home buying now. People are buying in the face of sky-high prices because they

have seen so many of their friends or relatives make a fortune in real estate. Besides (they tell themselves), everyone knows real estate prices never fall.

As with the stock market during the tech bubble, many are basing purchasing decisions not on underlying economic value, but on what they think they can sell a property for in the future—the very definition of a speculative bubble. It is precisely this overconfidence in the inevitability of continuing price appreciation that can lead to instability and eventual declines.

In world markets, house price crashes are being experienced in America and Spain, while falling rents in the UK may also lead to a reduction in property prices. Japan experienced the biggest ever house price bubble and crash to date. House prices in Japan today are still below the average for 1990, some 17 years before.

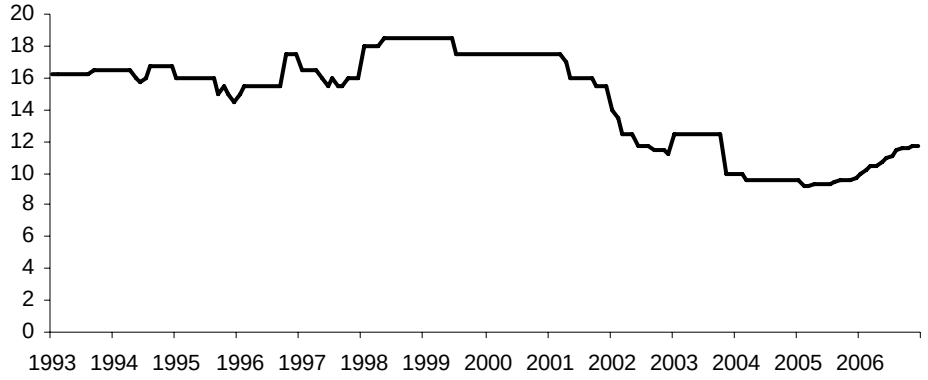
At home, the slump in oil prices in the 1980s led to considerable balance of payments difficulties and eventually forced a cut in public sector salaries. The resulting recession and high interest rates produced a sharp fall in property values and a significant increase in mortgage delinquencies.

History has shown us that a real estate crash is not inconceivable and may be a much more serious risk than is widely acknowledged. The price of oil is not the only pin capable of bursting the real estate bubble in Trinidad & Tobago. High levels of demand at high prices are simply not sustainable in housing due to the affordability constraint. As with any market, real estate goes through cycles and if houses get too expensive, people will simply stop buying them.

The decline in interest rates since their peak in 1999 has certainly made mortgage payments more affordable and real estate a more accessible and profitable investment. A drop in mortgage interest rates reduces the cost of borrowing and should logically result in an increase in prices in a market where most people borrow money to purchase a home.

Today, mortgage rates have bounced off their historic lows in March 2005 (see Figure 2), and within the last two years, the portion of new mortgage loans contracted at rates between 8 and 9 per cent has increased from 60 per cent in 2004 to 88 percent in 2006. As interest rates rise, mortgage loans become less affordable and the overheated real estate market will begin to cool.

Fig 2. Real Estate Mortgage Loan Rates (%)



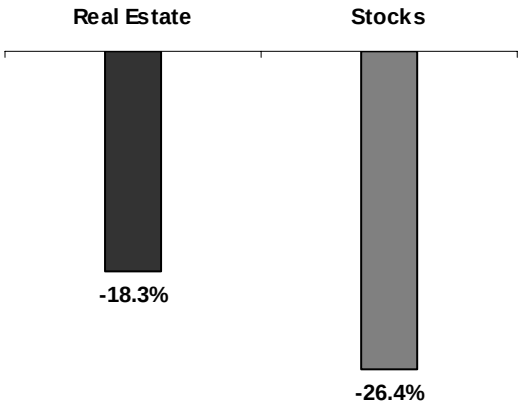
Source: Central Bank of Trinidad & Tobago

Real estate agents tell me that the number of days houses sit on the market is creeping up, and inventory levels are on the rise. Both are early warning signs that prices are poised to fall. According to Central Bank estimates, the percentage change in median house prices fell in 2006 for the first time in four years.

What conclusions can be drawn from these trends remains a matter of debate but the fact remains that the longer house prices continue to rise, the more overheated the market becomes and the greater the risk of a sudden disruptive adjustment. Do not believe the dangerous myth that property will always go up in value. Hoping for (or worse, expecting) a price rise is speculation.

The popular notion that, unlike stocks, homes do not fall in value is believed to have contributed to the current frenzy for real estate investment. While the risk of a sudden loss in capital is much higher for stocks, it is certainly possible to lose in housing, as much as 18% in one year according to historic estimates (see Figure 3).

Fig 3. Wosrt Annual Return from 1987 to 2006

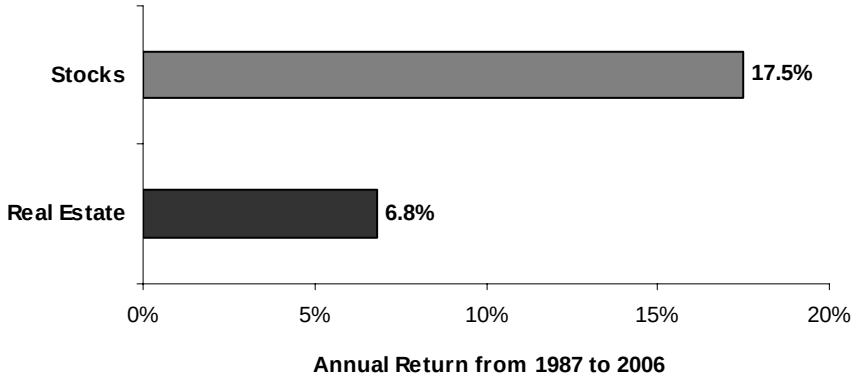


Source: Central Bank of Trinidad & Tobago, Bloomberg

Compounding the popular expectation that home prices do not fall, it is also widely believed that home values will yield average or better-than-average returns as investments. Yet history has shown that stocks will greatly outperform real estate in the long run.

In Trinidad & Tobago, housing has delivered a solid but unimpressive annual return of 6.8% between 1987 and 2006, according to Central Bank estimates. The broad equity market, however, delivered a crushing 17.5% over the same period as measured by the TTSE Composite Index (see Figure 4).

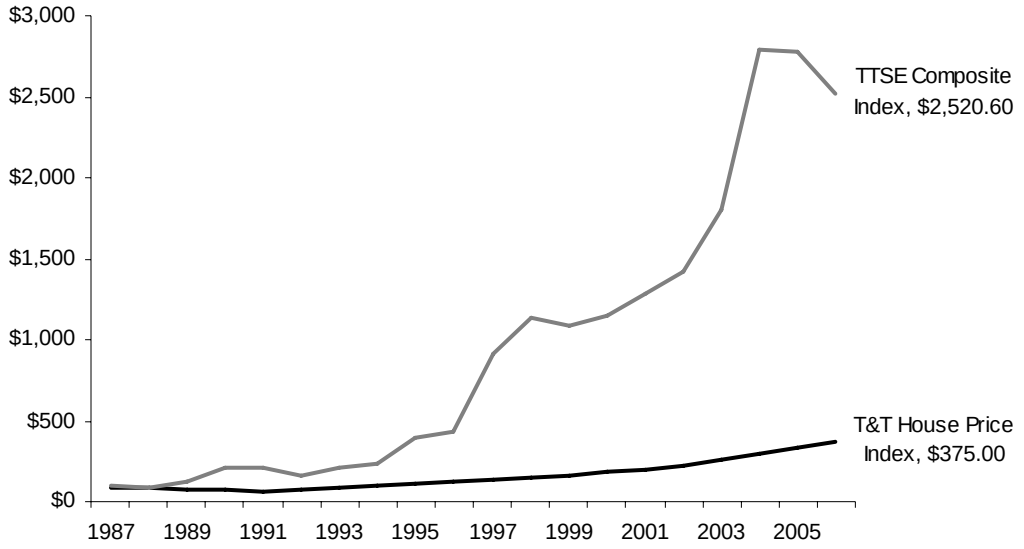
Fig 4. Over the long term, local stocks have significantly outperformed real estate



Source: Central Bank of Trinidad & Tobago, Bloomberg

In terms of cumulative returns, had you invested $100 in the stock market 20 years ago, your investment would now be worth $2,520.60 as opposed to $375.00 had it been invested in real estate (see Figure 5). Had I deducted any transaction costs that might apply when I calculated returns, real estate would have fared even worse.

Figure 5. Cumulative Return of a $100 investment between 1987 to 2006



Source: Central Bank of Trinidad & Tobago, Bloomberg

When you buy property with a mortgage, you need to pay at least 10% of the value of the property upfront to secure the agreement. You may also pay a percentage point or more of the loan to lower your interest rate. The size of the loan, the interest rate and the term of the mortgage all affect monthly mortgage payments as well as the overall cost of the mortgage.

For a 20-year mortgage valued at $1,065,000 (the median house price in 2006) with a 9.0 per cent interest rate, the monthly mortgage payment amounts to $9,582 while overall cost of the mortgage to the borrower amounts to $2,299,699. While lengthening the term of the mortgage to 30 years would result in a lower monthly mortgage payment ($8,569), the overall cost of the mortgage would also increase by $785,224 to $3,084,923.

If interest rates on the 30-year mortgage were to increase to 9.5 per cent, the overall cost of the mortgage would increase by a further $488,869 to $3,573,792. In Trinidad & Tobago, where most mortgages are extended on a variable-interest rate basis, an additional cost due to increases in interest payments over the life of the loan poses a significant risk to the borrower.

Homeowners who cannot afford the increased payments are at risk of losing their house to foreclosure while landlords risk falling (or even negative) rental yields after mortgage interest. If interest rates rise, house prices will have to fall to improve affordability and sustain the yields that have made real estate such an attractive investment.

Even investors who can afford to buy without a mortgage still risk buying at the top of the market, capturing a poor rental yield and then losing capital as house prices go through a correction. In many parts of Trinidad & Tobago, it is significantly cheaper to rent the same property than to purchase it. If house prices continue to increase much faster than underlying rents, economic theory predicts that house prices must fall.

Other costs of property investing that are often overlooked include insurance, the title search fee, the stamp duty to register the Deed of Conveyance, the stamp duty on the Deed of Mortgage, legal fees and taxes. For a mortgage of $1,065,000, stamp duty on the Deed of Conveyance alone (which allows the transfer of the property to the new owner) will cost $64,000 or 6 per cent of the value of the mortgage.

Like stocks, capital gains on real estate are not liable to tax in Trinidad & Tobago unless the individual sells the property within 12 months of purchase. Rental income, however, is liable to income tax. Individuals must pay tax on net income after operating expenses pertaining to the property (including mortgage interest).

Stocks, by comparison, are incredibly cheap to buy, own and sell. At a local brokerage such as WISE, you can expect to pay between 1% and 1.5% of the transaction value in commission while the maintenance charges, if any, are negligible. Furthermore, residents of Trinidad & Tobago who invest in stocks are not liable to tax on dividends or capital gains.

Given the lower returns, higher costs and uncertain future of the real estate market in Trinidad & Tobago, it is no wonder why some individuals have chosen to rent. By renting, they gain the flexibility of a lease and freedom from home repairs. They can also invest more money in stocks, bonds and other assets that could appreciate faster than real estate over the next couple of years.

For someone debating whether to rent or buy in a market that's experienced recent and substantial house-price run-up, it may be better to delay the home purchase and see what the market looks like a year or two down the road.