The Long-Term Value of Home Ownership in the U.S.

Updated November 2010

NATIONAL ASSOCIATION *of* REALTORS®

REALTOR®

Introduction

Housing is shelter first and foremost, but under normal circumstances it also is a proven sound long-term investment. Abnormal swings in recent years have distorted those perceptions, and for many people the reality as well. But a closer examination of the underlying fundamentals shows housing will continue to be a good long-term investment in the future – as long as we don't tamper with basic policies which promote responsible and sustainable home ownership.

Beyond the factors of shelter and investment, buying a home generates a pride of ownership and commitment to community, which comes with achieving this key part of the American Dream. Combined, these factors contribute to the quality of life in communities across the country – inspiring our nation to be described as the "best housed nation on earth."

The goal is sustainable home ownership which contributes to the vitality of communities. People who are not ready for the responsibility and challenges of home ownership should not pursue it, particularly if they have short-term time horizons of only a few years, limited resources or poor credit.

Home Ownership Rates

Over time, during most of the past 50 years, roughly two out of three households in the U.S. have been home owners, while one-third have been renters. According to the U.S. Census Bureau, the home ownership rate accelerated in the 1950s with strong household formation following World War II. By 1965 it rose to nearly 63 percent, and has hovered fairly close to the 66 percent range since 1979; it currently resides at 66.9 percent (third quarter 2010), which appears to be a sustainable level based on fundamentals that will be further explained.

The Modern Housing Era

For all intent purposes, the modern housing era began after World War II when the G.I. bill made the 30-year fixed-rate mortgage widely available. In the 1930s and 1940s, it was far more common to pay cash or finance a home with a 10 year mortgage and a 50 percent downpayment; consequentially, home ownership rates were much lower – in the range of only 45 percent – before the housing market heated up in the 1950s with the Baby Boom.

The 30-year fixed-rate mortgage is the cornerstone of home financing, offering safe and stable payments. Alternatives, including adjustable-rate loans and various hybrids, make sense for buyers who would be comfortable with a worst-case higher payment adjustment or plan to sell before the first adjustment period. However, preservation of the fixed-rate loan is critical to a stable housing finance system that has worked well for over 60 years – any tampering with that model could have dire consequences for the overall economy.

Favorable Tax Treatment and Economic Benefits

Congress has long recognized the intrinsic values of home ownership, and consequential economic and social benefits, and has offered tax incentives for home owners since the inception of the Internal Revenue Code with the Revenue Act of 1913. Most important is the mortgage interest deduction, which reduces the tax burden for home owners. The use of itemized deductions grew notably during the 1950s and 1960s as home ownership increased.

Borrowers may increase the number of federal tax withholding deductions to increase their net pay, which helps to make monthly mortgage payments more affordable. In addition, state and local property taxes are deductible.

Today, home owners pay 80 to 90 percent of the income taxes in the U.S., and among those who claim the mortgage interest deduction, nearly two-thirds are middle-income earners. In the mid-20th century, the deduction became a key component in how the housing system works in the U.S., stabilizing communities while helping owners to accumulate long-term wealth. That, in turn, provides confidence for consumers to spend and stimulate other economic activity.

For each home purchase, nearly $60,000 in direct and indirect spending occurs in the economy. Besides the services directly tied to a home purchase, other sectors benefit from the demand for related goods and services, including carpeting, furniture, appliances, window treatments, landscaping, home improvement, etc. In total, housing and related economic activities account for more than 20 percent of Gross Domestic Product in a typical year.

Social Benefits

Home owners have a stake in their community, and various studies* show they are more likely to vote and are less likely to move. Long-term residents are more prone to volunteer and participate in civic activities. In essence, many studies show home owners make better citizens – they have higher educational achievement (as do their children), lower crime rates and help to maintain a community. Some studies also show home owners are happier and healthier with higher life satisfaction, higher self-esteem and perceived control over their lives.

Owner-occupied housing generally is better maintained than renter-occupied housing. Higher levels of home ownership lead to more stable communities by being imbedded in the same neighborhood and community for longer periods. For example, nearly 30 percent of renters moved during 2009, while only 5.2 percent of home owners moved.

The Housing Boom and Bust: Aberrations

Much has been made recently about changes in the housing market since the boom, but it must be kept in mind that the market behaved uncharacteristically during this period – notably between 2003 and 2006 – largely in response to risky mortgage instruments, motivated by greed on Wall Street. In examining the correction that has taken place and any adjustments that should be made, it's important to put the information into perspective.

For example, the home ownership rate spiked at over 69 percent in parts of 2004 and 2005, and much has been made of the decline since – but it is a decline only to the long-term average. Marginal home buyers in the middle part of the decade were encouraged to buy homes by mortgage brokers recommending risky financial instruments with no down payments and low teaser interest rates. As a result, home ownership rates peaked above sustainable levels. Many borrowers didn't understand the terms of the loans, while the mortgage companies assumed no responsibilities and sold the mortgages as highly rated securities to unwitting investors.

The mortgage mess caught many other buyers by surprise, who frequently didn't understand the terms of exotic alternative instruments, or assuming that they'd be able to refinance or sell their home when the time came. A fundamental shift in the playing field had occurred, one that in hindsight should have never been allowed.

False Assumptions

The assumption of rising home values became distorted, in some areas with expectations of double-digit annual gains. Even though the national median home price had never declined in the modern housing era, people were ignoring the fact that median existing-home prices had declined in many metro areas during the 1980s and 1990s, as was widely reported in quarterly news releases by the NATIONAL ASSOCIATION OF REALTORS®.

Purveyors of toxic loans focused only on aggregate national price gains as justification for their models, not factoring what would happen with widespread introduction of lending products that lacked common economic sense and would result in numerous borrowers being unable to afford when faced with sharply higher payment adjustments.

Something of a herd instinct kicked in during the housing boom in many areas, with easy money increasing demand and more buyers chasing a shrinking supply of listings. Multiple bidding above the asking price became common in many markets, driving annual price appreciation to record levels relative to inflation. Buyers frequently ignored the advice of their real estate agents to get a professional home inspection, with many responding to "as is" offers, and often paid little attention to brochures or cautions about the risks of new lending instruments.

In the most pronounced bubble markets, where very high double-digit price increases persisted for several years, a sharp correction became inevitable. Nationally, based on annual median existing-home prices reported by NAR, that correction amounted to a 22.3 percent decline but was much deeper in some areas – particularly those with the highest percentages of toxic loans, where today we find the highest levels of foreclosures.

Buyers who bought at the top of the market in areas that experienced the largest home price gains might take more a decade to recover the equity that was lost. There were terrible personal losses for many such buyers who had to move, lost their jobs or found themselves unable to refinance. However, for the vast majority of home owners, net gains are realized when they sell their homes, and one-third of homes are owned free and clear. For people who have purchased in recent years and plan to hold for a normal period of home ownership, expectations of healthy gains are on even firmer ground for a variety of reasons.

Today's Lending Standards

It is true that lending standards are tighter today than they were prior to the boom and bust period, and to some extend this is simply the pendulum swinging in the opposite direction from the lax standards of the boom period which permitted extreme mortgage products such as "liar loans." Those loans featured no downpayment and no verification of income – something that confounded European bankers who rhetorically asked – in reference to their American counterparts – "What were you thinking?"

Even with tighter lending standards and higher credit score requirements, borrowers today can successfully find a mortgage if they don't overstretch themselves and stay within their means – something that is greatly facilitated by historically low mortgage interest rates. As bank balance sheets improve, it is expected that lending standards will gradually return to a normal sound and balanced practices.

Home Prices Trends

Since 1968 when NAR began collecting data on the median price of existing single-family homes, in most years the typical home value increased at a pace that was 1 to 2 percentage points above the rate of inflation. From 1968 through 2009, even with periods of double-digit inflation and several years of price declines that begin in 2007, the national average annual price gain was 5.5 percent.

In effect, rapid price gains in many areas during the housing boom had borrowed from future appreciation. However, in some areas home prices have over-corrected because homes in many markets have been selling for less than the cost of replacement construction.

Net Wealth Accumulation

Home owners accumulate significantly more net household wealth than renters. The Federal Reserve Survey of Consumer finances shows this clearly over time. The most recent periodic study in 2007 showed the median net wealth of home owners was $234,200, which is 46 times that of a renter's net worth of $5,100. Although there has been a loss of household equity since the most recent survey, it stabilized in 2010 and home owner equity today most certainly remains significantly larger than renter equity.

Long-term home ownership is a form of forced savings. With a fixed-rate mortgage, those costs become more affordable over time in comparison with rent, which generally trends up.

Favorable Home Price-to-Income Ratio

The national price-to-income ratio is back in line with historic fundamentals, while mortgage rates have fallen to historic lows and housing affordability is near a record high. In 2005, the typical family purchased a home costing 3.3 times their income, but the ratio declined to 2.4 times income by 2010, which actually is below a longer-term trend of about 2.6 times income from 1985 through 2001.

Record High Housing Affordability

The relationship between median family income, median home price and average mortgage interest rate is hovering at the most favorable level dating back to the beginning of NAR's Housing Affordability Index in 1970. The index is relative, with 100 defined as the point where a median-income family can afford a median-priced home, with a 20 percent downpayment and 25 percent of gross income devoted to mortgage principal and interest. For first-time buyers with comparable income but making a small downpayment, affordability levels are roughly 80 percent of the index level.

Any housing affordability index over 100 is considered favorable. 2009 set a record high with the index at 172, meaning the typical family had 172 percent of the income needed to purchase a median-priced home. For 2010, NAR projects the index to remain around that level, meaning there's never been a period in American history when home buyers had more purchasing power than they do today.

Abnormally Low Housing Construction and Household Formation

There is a clear relationship between household formation and housing starts. The U.S. population is growing by about 3 million people a year, which would normally result in 1.0 to 1.4 million additional households being formed each year, but it's been weak for the past few years and totaled only 398,000 in 2009. On the supply side, we lose about 300,000 old housing units per year through obsolescence and demolition, which translates into a long-term underlying demand for 1.3 to 1.7 million housing starts per year.

We clearly overbuilt from 2002 through 2006, but have fallen notably below historic averages since 2007. In fact, construction activity in 2010 is only one third of the long-term average demand of about 1.5 million. The construction slowdown will help to support home values, which will become very clear once the available housing supply eventually diminishes to more normal levels.

Ironically, if construction doesn't return to normal levels within a few years, we could be looking at future housing shortages and abnormal pressure on home prices. In the meantime, household formation is constrained with kids moving back home, never leaving home in the first place or doubling up with roommates. Much of the slowdown in household formation is tied to weak confidence resulting from insufficient job creation, which impacts both home sales and apartment rentals.

Shadow Inventory

Understandable concerns have been raised about the level of "shadow inventory," homes that are delinquent in mortgage payments and ultimately may be repossessed and enter the market. There is much confusion over this issue; for example, the number of foreclosure notices is three times as large as the number of homes that are actually repossessed and placed on the market. Depending on the state, anywhere between two and four notices are issued before a home can be repossessed.

The estimates for shadow inventory range from 1.7 to 12.5 million, in part due to the confusion between notices and repossessions, but also due to assumptions regarding home value. For example, a projection of net housing worth based on selling prices in 2009 would be exaggerated because 36 percent of sales that year were distressed, typically sold at a 15 percent discount relative to traditional homes in good condition. Just over 5 million out of the 75 million owner-occupied homes in the U.S. were sold in 2009; most of the remaining 70 million properties are not distressed properties; they are in good condition with higher overall values.

Although NAR estimates shadow inventory at 2.5 million, the fact is foreclosures have been entering the market at a steady pace since peaking in the middle of 2008 (with some temporary disruption in late 2010 tied to the foreclosure moratorium). With stable home prices, it's expected we'll work through the mess created by toxic loans over the next couple of years. Unless there are additional changes to the pattern that has persisted for nearly two years, the market is expected to continue to steadily absorb these properties.

Pent-up Demand

Demographically, there is a pent-up demand for new households well into the future. In recent decades the market was driven by the Baby Boom generation, the 75.8 million people living today born between 1946 and 1964. Their children's generation, sometimes referred to as the Echo Boom generation, is essentially the same size – 75.0 million people born between 1982 and 1995. Considering that the median age of a first-time buyer is 30, this younger generation is just entering the peak years for buying a first home and will fuel demand in future decades.

Opportunity for Buyers

In hindsight, the current period is likely to be viewed as a golden opportunity to buy a home. Mortgage interest rates are hovering around record lows, home prices have declined and actually overcorrected in many areas, inventory is plentiful and sellers are motivated. With a growing population and housing construction below long-term fundamental demands, it is inevitable that supply will eventually come back in line with demand.

At the same time, the *2010 NATIONAL ASSOCIATION OF REALTORS® Profile of Home Buyers and Sellers* shows the typical first-time buyer plans to stay in their home for 10 years and repeat buyers expect to hold for 15 years. With that kind of a long-term view, it is likely that most buyers will see a return to normal price appreciation patterns that will allow them to build equity. Although many comparisons on home equity change focus exclusively on price, equity also is accumulated by gradually paying down the mortgage principal.

Home buyers also benefit from the power of leverage. Buyers typically use their own money to cover only a small portion of the purchase price, but the gain they realize is based on the total value of the property. Ironically, when home ownership is compared with other forms of investment, this benefit of leverage often is ignored, along with the fact that an individual has to live somewhere at some cost – similarly, an imputed rent value generally is not considered.

Typical Seller Equity

The typical home seller has been in their home for eight years and generally is seeing a very healthy gain from when they purchased, even though that period covered most of the boom-bust cycle. It demonstrates that the longer you own, the better your investment.

Even with several years of price declines, the recent NAR Profile of Home Buyers and Sellers shows the typical seller who purchased a home eight years ago experienced a median equity gain of $33,000, a 24 percent increase, while sellers who were in their homes for 11 to 15 years saw a median gain of 40 percent.

Certainly, any seller would be happier with a higher price they could have received a few years ago, but this underscores the long-term value of home ownership, even in a period that is atypical. More importantly, the lessons learned from the housing bust have virtually eliminated risky mortgage products. The loans being made today are safe and sound, with some safeguards in place and others being developed to prevent future abuses or confusion over loan terms. The caution is to not over-react, with a clear understanding of the cause and effect relationships in the boom and bust cycle.

Conclusion

Home ownership continues to be a sound investment over the long-term, providing shelter and a higher quality of life where most owners feel safe and secure. It is the primary means for most households to accumulate wealth, providing resources for a more comfortable retirement. In times of need, the accumulated equity in a home offers financial flexibility – it can be tapped for major expenses such as college education, major medical bills, or adding to the home to accommodate a growing family. It should never be used for simple consumption.

In a normal market, most families accumulate enough equity to trade-up to a larger home in three to five years, although that is longer in the current environment and conditions vary widely around the country.

Even so, 85 of recent home buyers see their home as a good investment, and nearly half think that investment is better than stocks. Even with the turmoil created by the housing boom and bust, this indicates the long-term view of home ownership as a fundamental goal and value remains sound. In fact, the single biggest reason most people buy a home is the simple desire to own a home of their own, including 53 percent of first-time buyers (findings from the 2010 NAR Profile of Home Buyers and Sellers).

When approaching retirement after a long period of home ownership, most owners have accumulated large amounts of equity which permit them to trade down to a smaller and easier to maintain home, generally with an all-cash transaction. Most renters could never dream of such options; a mortgage might last 30 years, but renting is forever.

In short, achieving sustainable home ownership truly is the greatest part of the American Dream.

###

*See *Social Benefits of Home Ownership and Stable Housing*, NATIONAL ASSOCIATION OF REALTORS®, August 2010, for a detailed analysis and references to specific studies.