Real estate or stock: Which is the better investment?

There is no doubt that investing in property over the last few years has been a wise move. Real estate prices in Trinidad have increased substantially, fuelled by an influx of foreign investment primarily in the petrochemical industry.

The boom was initially evident in the Western peninsula but has since spread to other parts of the island, including Trinicity, Arima, St. Augustine, Chaguanas and San Fernando. While house prices in these areas have seen double digit levels of appreciation, the seemingly insatiable demand for properties in the Northwest has propelled prices to astronomical levels.

The sheer magnitude of the house price boom has prompted the natural question of its sustainability and whether house prices are significantly overvalued. While it is rare that a house will devaluate, provided it is in a reasonable neighbourhood, do not believe the dangerous myth that property will always go up in value. Hoping for – or worse, expecting – a price rise is speculation.

Although we may try to predict when the “run up” of real estate prices will come to an end – if at all – it is impossible to know when the top will finally arrive. On one hand, the outlook for the T&T economy in the short to medium term is expected to remain fairly strong which should continue to attract excess liquidity to the real estate market. But the longer house prices continue to rise, the more overheated the market becomes and the greater the risk of a sudden disruptive adjustment.

We have already witnessed a sharp correction in the local equity market where the TTSE Composite Index has lost almost 25% since its peak in mid-May 2005. And while investors continue to look for optimism in the market, there is no clear indication as to when this reversal or correction will change direction.

So, from an investor’s perspective, where are the two markets — shares and property — relative to each other? Well, shares are on a low while property is on a high, which to some may be a signal to jump on the property bandwagon and forget shares. I would argue, at this time in the cycle, the opposite is likely to be the better course.

History tells us that when everyone is doing the same thing, it’s likely that the gains have already been made and it’s time to invest elsewhere. Some expert property investors believe that now is the time to either stop investing, or even begin liquidating capital assets for profit-taking on previous few years growth and re-investing on stock market equities instead, leaving one falling wave to catch another rising.

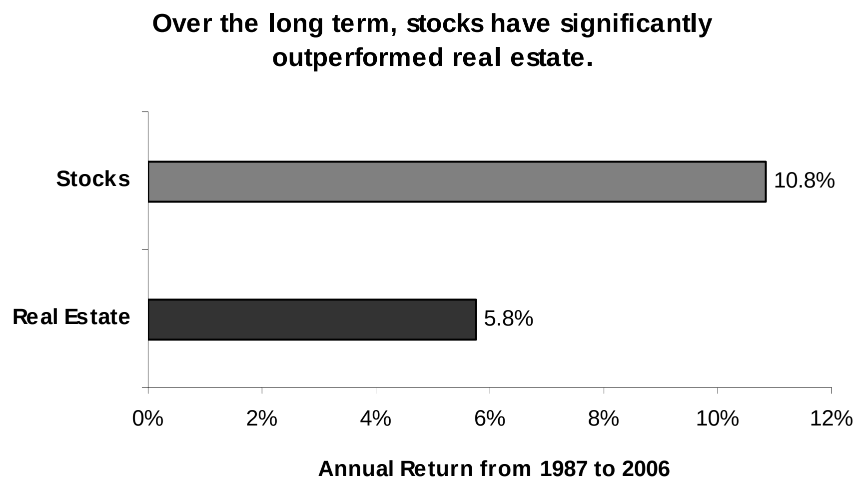
Whatever your feelings about which direction the markets will go, the lessons of investing remain the same…it is time in the market, not timing the market that yields the best returns. And for long-term investors, there is never a really bad time to buy well-located property or shares in strong businesses which pay dividends.

We know that both real estate and stocks have had their day, but the question you need answered is this: Which is the better long-term investment today?

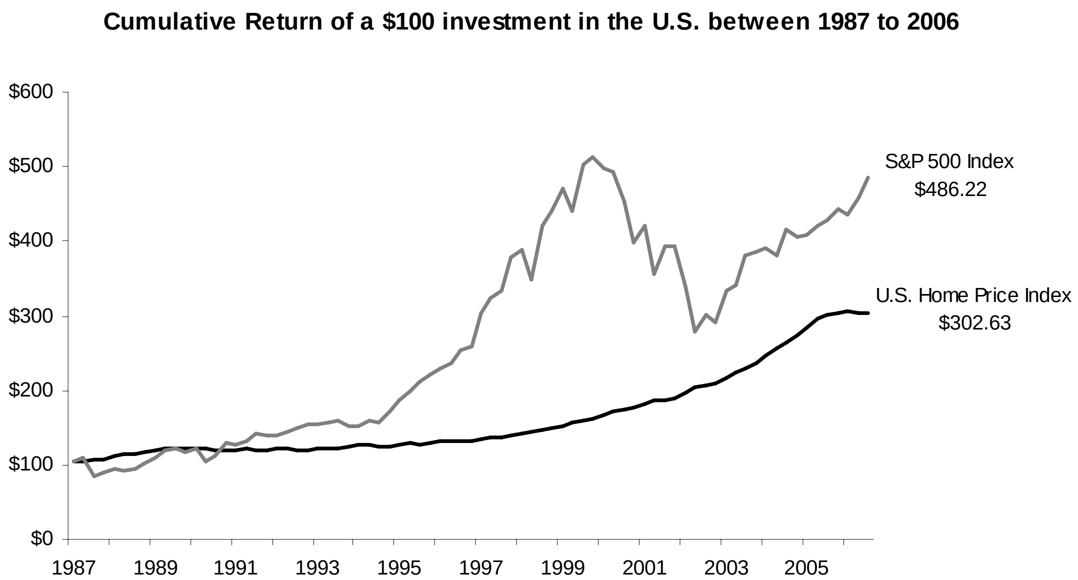
Generally speaking homes appreciate in value by approximately 4% or 5% annually, however this will vary from year to year and from place to place. Homes in fast growing areas such as cities and underdeveloped parts of the countryside can rise by 10% or more. As long as the property is not in a deteriorating neighbourhood or allowed to disintegrate, the inflationary forces at work in the housing market will make your home increasingly valuable.

Yet despite the steady build up of equity in a home due to the appreciation value and the gradual reduction of the mortgage, history has shown that stocks will greatly outperform real estate in the long run. Although historic data on real estate in Trinidad & Tobago is not readily available, we can still draw conclusions from the analysis of the house prices in other markets. In the United States, housing delivered a solid but unimpressive annual return of 5.8% between 1987 and 2006, according to the S&P/Case-Shiller U.S. Home Price Index.

The broad equity market, however, delivered a crushing 10.8% over the same period as measured by the S&P 500.



In terms of cumulative returns, had you invested $100 in the stock market 20 years ago, your investment would now be worth $486.22 as opposed to $302.63 had it been invested in real estate.



You can make more money in real estate than the stock market if you do more than buy a house, live in it, and sell it later. Flipping properties for a quick gain or looking for tenants to manage might create profit, but such activities also introduce risk. If your rental property becomes vacant or your renovation project sits on the market for 6 months, you have to be able to continue servicing monthly expenses such as utilities, maintenance, insurance and mortgage interest.

Such regular outgoings can quickly add up, not to mention the big but irregular expenses like roof replacement, plumbing or electrics. The costs of buying the property in the first place are substantial and often overlooked. When you buy property with a mortgage, you need to pay at least 10% of the value of the property upfront, up to 10% for stamp duty and another 1% in legal fees. Sellers have to lay out a further 3% commission for their agent, prepare a place for sale and, if it's their home, pay to move. All in all, the cost of buying and selling can total about 15% of the purchase price.

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. Stocks also cost the average investor less in time and effort than property investing. Being responsible for maintenance, repairs and other disagreeable tasks – even for your own home – can be demanding.

While home ownership is not always the proverbial bed of roses, the sense of pride a homeowner exudes on the accomplishment can be second to none. A home also satisfies a basic psychological need. It is something we can call our own, decorate, add to, and even love. But the primary value one receives from it is utility. No one I know can live inside a stock. So, yes, real estate does have its advantages.

The assets strongest advantage is undoubtedly leverage, or the use of a mortgage to amplify the return on your cash. For example, imagine you make a 10% down payment on a $2 million house. After two years, the property increases in value to $2.2 million, or 10%. The return on your down payment is a staggering 100% - you've just doubled your money in two years!

What about stocks? Well, you can leverage them by buying on margin, but you can borrow no more than 50% of the purchase price. You could also play in the options market, but you risk losing your entire investment. Of course, the same risk exists in real estate where leverage can also magnify a negative return. If you are forced to sell the property for less than you paid, you not only lose your original investment but you may also end up owing money to the bank.

While it is certainly possible to lose in housing, the risk of a sudden loss in capital is much higher for stocks. Because real estate takes so much time and effort to buy and sell, it rarely soars or plunges. The S&P 500's worst annual performance over the 20 years between 1987 and 2006 was a -27.5% loss compared with a -2.8% decline in the Home Price Index.

Equity investors can easily reduce their exposure to risk by diversifying among different asset classes, industries and investment vehicles. Spreading your investments across various sectors or industries with low correlation to each other will reduce price volatility by the fact that not all industries and sectors move up and down at the same time or at the same rate. Building a diversified portfolio of individual stocks and bonds may take a lifetime of saving but purchasing a mutual or exchange-traded fund is an instant and affordable diversification solution that will reduce risk without sacrificing returns.

Real estate, like the stock market, has a variety of classes across which to diversify such as residential, commercial and industrial. If you are relying on one piece of property to build wealth that is no different than throwing your retirement savings into one stock or one narrow sector mutual fund. Unlike the stock market, however, you have to be a large investor to have the means to own the hotels, stores, apartments, office buildings, and vacant land required to achieve a properly diversified real estate portfolio.

Both real estate and stocks offer distinct advantages but as to whether one investment is a significantly better than the other depends on your personal circumstance and financial situation. One thing is for certain, however, a portfolio that has some of both is the best for most investors. The idea is not to choose one investment and ignore the others, instead spread your investments among the different asset classes. This means that if your property is down, your other investments may compensate.

There are smart reasons to invest in real estate, and then there are dumb reasons. The truth is that we can't be certain whether home prices will continue to rise or if stocks will outperform real estate over the next few years. Investing in property thinking you can use borrowed money to score big is very risky. But if you're investing for the "right" reasons - and you know your risks - chances are your investment will be a good one. It's better to regard a house as a place to live first and foremost and secondly as a long-term investment.