The $2 Trillion Housing Mystery: Part Two

We looked in the first part of this blog piece how researchers from the Reserve Bank of Australia arrived at the puzzling conclusion that housing in Australia was 30% undervalued, implying a $2 trillion increase in housing values since last year. In this second part I want to have a look at the future capital gains the RBA researchers' assumed for housing.

The base case in last year's research was an ongoing appreciation of 2.4% per year. For many property owners that might instinctively sound too low. Much lower than the gains experienced in recent decades on their own properties, for example. Isn't it common knowledge that returns in real estate are made predominantly through capital appreciation rather than income?

Actually, 2.4% is the *real* gain assumed, after inflation, so it isn't as conservative as it first looks. And I'm about to argue that it is far too *high.*

The researchers have plucked the number based on the average appreciation of house prices from 1955-2014. That's a 60 year period, you would think long enough to make 2.4% a reliable estimate. But it's not, and the RBA's chart below shows why.

Rental yields in Australia, the pink line in the chart, have halved in the past 30 years. That's obviously not because rents have fallen, but rather because property prices have been rising at a faster rate than rents.

There may be some sound one-off reasons for this. Interest rates have fallen and the RBA also argues that the other ongoing costs of owning a house have too. But property prices can't *perpetually* grow faster than rents, and these factors won't be an *ongoing* source of capital gains. Like share prices can't forever outpace earnings, property prices can't beat rental growth in the long term. The two are tethered.

The decline in rent yields shown in the chart roughly accounts for a doubling in house prices. Even over a 60 year period that distorts averages significantly. In fact, it has accounted for about 1.7% of the 2.4% per year average appreciation.

The remaining 0.7% is possibly a better indicator of what you can expect capital gains, after inflation, to deliver long-term. Or, more optimsticallly, page 19 of the Reserve Bankresearch suggests rents since 1960 have risen 1.3% per annum in real terms.

Doesn't sound like much? The bad news is that you won't get that unless you pay fair value. If you overpay you'll do significantly worse. Housing isn't a risk free path to prosperity. As Charlie Munger has often asked, why should it be so easy to do something that can make you a fortune?