



Unlike our pay-to-view reports, **RODNEY'S RAVINGS** and chapters of **The Real Housing Market Story** booklet are free. You can sign up for them and notification of forthcoming **Property Research** reports on our website – <http://www.sra.co.nz/lists/>.

## **The Real Housing Market Story** **Essential insights for investors and would-be home owners**

### Chapter One

#### **It is real house prices that matter**

In this, the first chapter of a booklet on the housing market I look at the importance of real or inflation-adjusted house prices and shed light on the question of whether it is time in the market or market timing that matters most for housing investors. The booklet will be delivered in instalments over the next few months. When completed, the booklet will provide investors and people choosing between buying and renting with practical and easy to understand insights into issues critical to their decisions.

Why am I writing this booklet? Partly to help market our housing report (see <http://sra.co.nz/housing.html> for information on the **Housing Prospects** reports). As our Whos Who of clients can attest, these reports offer the best available insights into housing and section market prospects (e.g. advanced warnings of when upturns and downturns are coming), whether housing offers good, bad or indifferent investment prospects and how, at the national level, housing stacks up in terms of the decision to buy or rent. The reports cover the national market and 24 cities/districts. In the past we have only sold annual subscriptions to the **Housing Prospects** reports that are produced 11 months per annum, but we will soon also be offering investors and would-be home buyers the option to buy one-off reports.

I am also partly writing this booklet because I have a desire to improve economic literacy among investors and would-be home buyers. Despite housing being the single largest component of household wealth there is a lack of quality analysis of housing market prospects both nationally and at the district and suburb levels. Producing **The Real Housing Market Story** booklet is our first step in filling this void. The second step, to be taken soon, will be offering investors and would-be home buyers the option to purchase one-off copies of the **Housing Prospects** reports that will incorporate an enhanced assessment of housing as an investment option and a more detailed assessment of the merits of buying versus renting.



Rodney Dickens  
Managing Director and Chief Research Officer  
Strategic Risk Analysis Limited  
[rodney@sra.co.nz](mailto:rodney@sra.co.nz)  
[www.sra.co.nz](http://www.sra.co.nz)



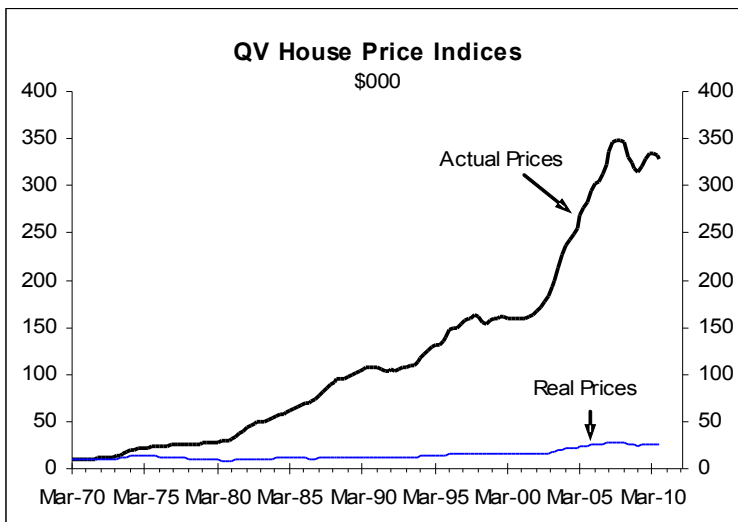
### It is real house prices that matter

The fall in house prices in 2008 will have dealt a blow to the myth that house prices never fall much, but it only scratched the surface of the real issue. In economics there is a focus on real or inflation-adjusted prices and I doubt that there is sufficient understanding of the importance of real prices.

If an investor buys a house the critical issue should be how the house price and rental income perform relative to prices in general. If over the lifetime of the investment the house price goes up 200% but prices in general increase 300% the purchasing power of the money invested in the house will have fallen 25% (i.e. when the investor sells the house the proceeds will buy 25% less goods and services than the money used to buy the house would have purchased). Equally, if rents on the house go up 200% while prices in general increase 300% the purchasing power of the rental income will have fallen 25%. The question of what happens to rents relative to house prices is relevant to the decision between buying and renting and will be addressed in a future chapter.

There have been periods when real house prices have increased dramatically, as was the case most recently between 2002 and 2007. But many will be surprised by how much real house prices have fallen in the past, with this knowledge important in opening eyes to what could happen in the future.

As an aside, there can be a problem with the REINZ data. It picks up the impact of money spent on improvements, which means reported REINZ house prices will overstate long-term returns. To properly calculate the returns the money spent on improvements should be added to the purchase price. I no longer have a reference to the report, but I think I am right in remembering that Massey University did a study some years ago that looked at repeat sales of unimproved houses and concluded that the REINZ house price data overstate returns by about 20%. If anyone having access to this report can provide me with a reference and remind me of the actual conclusion I will incorporate these in future editions of this chapter.

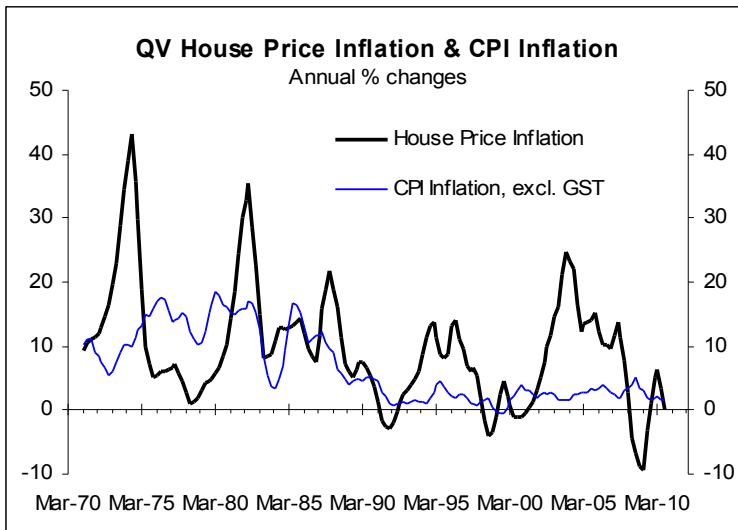


The black line in the chart shows the QV house price index, which shouldn't suffer from the impact of improvements because of the way it is composed, converted to thousands of dollars using the QV average house price in the 2006 September quarter as a base. One can't help but be impressed by the 3,492% increase in the national average house price in the last 40 years, although somewhat less impressively this converts to a compound annual average increase of 9.4%. This is partly testimony to the power of compounding returns over 40 years. But in today's era of low inflation an average annual return of 9.4% will still seem impressive.

The problem is that over the same period the consumer price index (CPI) excluding the impact of GST also increased materially. When the house price measure is adjusted to remove the impact of increases in prices in general the resulting blue line tells a much less impressive story. In real or inflation-adjusted terms the national average house price increased 176% over the last 40 years at an annual average compound growth rate of 2.5%.

Inflation can be viewed as rising prices, but it can also be viewed as the falling value of money. If prices go up 15% the purchasing power of money falls 15%. In this context the blue line shows what would have happened to house prices over the last 40 years if prices in general had not increased and the integrity of money had been maintained. If there had been no inflation the average house price (measured in terms of the value of money in March 1970) would have increased from \$9,319 in the March quarter of 1970 to \$25,766 in the March quarter of 2010 rather than to \$334,575 as actually occurred. There should be no doubt that the value of money is an illusion when inflation exists, especially when we look at periods as long as 40 years. Even if prices in general only increase 2.5% per annum over a 40 year period it would mean that at the end of the period a dollar would buy 63% less in terms of goods and services than was the case on day one. This is important because people consume goods and services, not money.

While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.



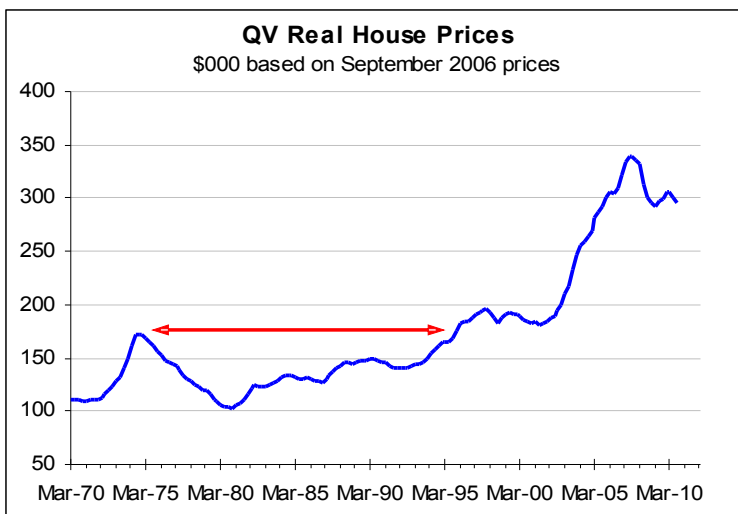
It is common for people to form expectations about the future based on their experience and the experience in NZ over the last 20 years is that house prices much more often than not rise more than prices in general, as shown in the chart. But the starting point now is massively different what to it was prior to the boom in house prices in the mid 1990s, during which the national average real house price increased 35%, or prior to the speculative bubble in prices between 2002 and 2007, during which the national average real house price increased 81%. As discussed in our **Housing Prospects** reports, the current starting point is much more like what was the case after the spike in house price inflation in the early

1970s, during which the national average real house price increased 55%.

From the peak in the national average real house price in the December quarter of 1974, the national average house price increased less than prices in general for the next five years. House prices didn't fall over this period, but because prices in general increased significantly more, the real value or purchasing power of the average house fell 40%. The fact that inflation in general averaged close to 15% per annum over this period meant that the sins of the bubble in house prices between 1970 and 1974 could be washed away over the subsequent five years without requiring actual house prices to fall. This experience will have helped create the myth that house prices never fall much. But be in no doubt about the implication of the 40% fall in real house prices over the five years after December 1974. Anyone buying a house at the peak of the speculative bubble in 1974 and selling it five years later will have lost 40% in terms of the purchasing power or real value of the money they invested. Again, people consume goods and services not dollar coins, so what really matters is real house prices.

### Time in the market versus market timing

At the end of a recent conference presentation during which I touched on housing market issues a conference delegate asked me about my view on the saying that it is "time in the market not market timing" that matters. This saying is probably partly based on the fact that actual house prices have seldom fallen much, while in the past it has never taken long for actual prices to rise above earlier peak levels. The implication is that no matter when you buy an investment property you will soon be in the money. This saying does not stack up so well when we look at the history of real house prices.



To make the numbers more relevant to today, this chart shows the QV house price index in real terms using the value of money in September 2006. It shows the 176% increase between the 1970 and 2010 March quarters discussed above. Most importantly in the context of time in the market versus market timing, it shows that it took 20 years for the national average real house price to surpass the peak level experienced in 1974. Investors that got sucked in to buying a property at the peak of the speculative bubble in 1974 would have been no better off in real or purchasing power terms for the next 20 years. I believe sayings like this, which are also used by

people marketing shares and investment portfolios, can be powerful and dangerous marketing ploys.



Between the peak in 1974 and today the national average real house price has increased 71% (i.e. around a 1.5% annual average compound return). By contrast, from the trough of the national average real house price at the end of 1980 until today the increase has been a much more impressive 187% (i.e. around a 3.6% annual average compound return). This suggests that marketing timing offers the potential for much higher returns, but market timing is not something many people are good at, including probably the people who roll out the saying in question. This is partly because many people get caught up in crowd mentality of the sort that encourages them to buy during the feeding frenzies of speculative bubbles and to sell during the depths of despair that inevitably follow. But the psychological tendency to be influenced by crowd behaviour is only part of the obstacle to successful market timing. Just as important is the fact that most people don't have the analytical skills and/or the information required to assess when an upturn or downturn in house prices is afoot.

I have most recently demonstrated my market timing skills in the share market, with my approach to timing investment in the share market discussed in an April 2009 Raving (see <http://sra.co.nz/pdf/Shares.pdf>). A similar approach can be used to time investing in the housing market and for making the decision of when to switch from renting to owning. To cater for people wanting the analysis and information required to make quality decisions regarding investing in housing and buying versus renting we will soon be offering investors and would-be home buyers the option to buy one-off copies of the **Housing Prospects** reports. More information about this option will be added to the relevant page of our website at some stage over the next several weeks (see <http://sra.co.nz/housing.html> for the relevant page on our website).