# Housing as a financial asset

## Investment strategy insights

Authors: Matthias Holzhey, Economist, UBS Switzerland AG; Maciej Skoczek, CFA, CAIA, Economist, UBS Switzerland AG

- Housing is a key Longevity asset and, to some degree, an investment. However, as an illiquid bulk holding, housing is not usually seen as part of the financial asset allocation.
- First-home buyers should build up wealth with a focus on relatively liquid assets and seek to diversify their balance sheet. A well-considered mortgage strategy can mitigate interest rate risk and bolster wealth accumulation.
- The prospects for buy-to-let investments in many cities have deteriorated. Private real estate solutions are a better alternative in an environment with low yields and rental growth uncertainties.

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Housing represents, on average, 50% of households' net wealth according to the OECD[1], and it is the main asset of the middle class. Indeed, for a vast majority of households, housing is an important vehicle for passing on wealth to later generations and a crucial stepping stone on the path to reaching their financial lifetime goals. But several factors make it difficult to treat owner-occupied houses as a common asset class. Hence, this note outlines some general thoughts on home ownership and its role in the allocation of assets in times of heightened bubble risks in many cities around the world.

The UBS Wealth Way**[2]** framework helps to set the stage for this analysis. The **primary residence** is a part of the Longevity strategy, which is designed and sized to include all of the assets and resources a family plans to utilize for the remainder of its members' lifetimes. A **holiday house** fits into the Legacy strategy, which includes assets that are in excess of what the family members need to meet their own lifetime objectives. The real estate cash flow yield from **buy-to-let properties** can be an integral part of retirement funding and, as such, can be part of the Longevity strategy. However, depending on personal circumstances, such properties are often also regarded as a part of the Legacy strategy given the very long investment horizon. In the following we focus on the investment characteristics of a primary residence and its effect on the financial asset allocation in a Longevity context. In addition, we touch on the implications of buy-to-let properties. Most of the considerations apply to a Legacy portfolio, as well.

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**Housing represents a high share of households' total net wealth. Why is it not usually seen as part of the financial asset allocation?**

First, housing is an indivisible bulk asset. A first-home buyer's asset allocation could easily change from a split of 60% equities and 40% bonds to an allocation with, say, 18% equities, 12% bonds, and 70% undiversified housing. This calls into question the common asset allocation profiles, as periodic rebalancing of such a portfolio is difficult, if not impossible.

Second, housing is relatively illiquid, and the transaction costs are high. In illiquid property markets, transaction prices are affected by subjective factors and an element of chance, which opens up a wide range of possible valuations for a single property. Hence, the common risk-return optimizations of an asset allocation including housing are problematic.

Third, housing has specific non-financial features. Decisions to buy or sell a house are typically not driven by financial return considerations but rather by needs related to the size, location, and potential affordability of a particular property. It is an essential good, and homeowners who sell an owned and currently occupied home have to buy another one, especially if the local rental market is dysfunctional. Furthermore, homeownership can provide a high emotional yield.

**Should housing be considered an investment?**

Buying a home is essentially equivalent to the purchase of a stream of imputed rent. From that perspective, an owner-occupied home is an instrument with long-term bond features but an uncertain terminal value. Such a bond has some special characteristics. Living in your home eliminates the vacancy risk and therefore, to a large degree, the default risk of the bond. The payoff is non-monetary and is perceived as higher than the comparable market rents, since living within one's own four walls offers an added emotional value for many households.

*Importantly, housing is only partially an investment.* In purchasing a home, you obtain a building and the underlying land (or at least the right to use it). The land is an investment, as it captures the value of current and (potential) future rental income, excluding costs. The building itself is primarily a durable good, comparable in many ways to, for example, a car—it depreciates with use and over time. As a result, the higher the land value, the higher the share of the investment component of the total housing value. Housing in city centers typically has an investment share of more than half of the purchase price, while in rural areas housing can scarcely be considered an investment.

**If housing has similar characteristics to a long-term bond, what are the implications for the financial asset allocation?**

It is important to consider the interest rate risk. Historically, rising interest rates have been the main trigger for corrections of housing markets. Consequently, you might want to think about reducing the duration of your financial portfolio if the bulk of your wealth is in housing.

The price-to-rent ratio is a useful indicator for assessing the interest rate risk: the higher the ratio, the higher the price dependency on low interest rates. For example, cities like Munich or Zurich are especially vulnerable to spikes in interest rates. A single percentage point increase in interest rates in these cities could reduce housing values by up to 20%.

**Housing is usually acquired to a large degree with debt. What opportunities does this create, and how does this affect investment strategies?**

Mortgaging is a tool homeowners can use to build wealth, accumulate assets, and manage liquidity. It can be worthwhile postponing the debt amortization if the expected return on financial investments exceeds the mortgage interest rate costs. The longer the financial investment horizon, the more attractive it is to keep the mortgage and invest surplus cash in asset investments. Last but not least, fixed-rate mortgages are partly a hedge against rising interest rates in a portfolio context. Overall, a well-considered mortgage strategy can mitigate interest rate risk and bolster wealth accumulation.

**In the vast majority of OECD countries, less than 10% of homeowners use their primary house as collateral for financial investments. Are the risks simply too high?**

Leverage increases the risks for your invested capital. The risk involved depends on the loan-to-value ratio and other idiosyncratic factors such as an individual's job security. In global housing markets, the average nominal price decline during correction phases has been around 17% over the past 40 years. The price corrections exceeded one-third in only 10% of cases. So, when loan-to-value ratios are less than 60%, a shortfall becomes rather unlikely. But the mortgage has to remain affordable even if the household suffers some income losses. This point is especially important since housing crashes typically coincide with economic recessions. In summary, households need financial reserves and sufficient risk tolerance to use the primary residence as collateral.

**"Don't put all your eggs in one basket" is a common investment adage, but how much direct real estate in a financial asset allocation is too much?**

The asset allocation of a first-home buyer is typically illiquid and not highly diversified given today's high house prices. So when building wealth over time, the household should focus on accumulating liquid assets to increase diversification and financial flexibility.

There's no reason homeowners should refrain from real estate investments in their financial asset allocation, as the correlation between local house prices and broad diversified real estate is generally low. But households should minimize additional real estate investments in the same economic area as their home in order to reduce their dependency on similar long-term return drivers. The same applies for buy-to-let investors. Relying on the rental income stream of a very few properties in similar locations exacerbates the vacancy risks.

Overall, the illiquidity of most direct real estate investments poses a limit to the advisable share of direct real estate within a financial asset allocation. Furthermore, the high transactions costs make a long investment horizon necessary. Taking an endowment style portfolio as a guide value, the share of illiquid assets is rarely above 40%.

**Housing has become prohibitively expensive in many cities, and the outlook is not encouraging. What action should investors take given the current market situation?**

According to the *UBS Global Real Estate Bubble Index 2020***[3],** the prospects for long-term real capital appreciation are dull in many cities. Homeowners are exposed to substantial duration risks, especially in places with very high price-to-rent ratios (i.e., low rental yields). Profit taking can be an option, as there are assets which currently provide superior risk-adjusted returns.

For homeowners seeking alternatives within real estate, we currently recommend well-managed private real estate funds that follow value-add strategies—refurbishing and repositioning underperforming assets with a significant portion of leverage. We expect them to provide better total returns compared with buy-and-hold strategies involving investment properties.

[1] *Housing, wealth accumulation and wealth distribution: Evidence and stylized facts*; OECD Economics Department Working Papers No. 1588
[2] See related report *Liquidity. Longevity. Legacy. A purpose-driven approach to wealth management,* published on 20 September 2018
[3] See related report *UBS Global Real Estate Bubble Index,* published on 30 September 2020

# Appendix

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