5 Reasons Renting Still Beats Buying

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This weekend I'll throw $1,100 down the drain. That is to say, I'll pay my rent. Pop-finance pundits have long used the drain cliché to describe how renters like me waste money, while homeowners with mortgages "pay themselves" and "build equity."

In April 2007 I argued something different: Renting Makes More Financial Sense Than Homeownership. Basically, houses produce poor returns over long time periods while stocks and other investments produce good ones, and the outlook for houses is especially poor now, so I'd rather rent cheaply and funnel my extra cash into something other than a house.

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Even though house prices have plunged and I have enough money to buy one, I'm still not nearly tempted. In what follows I'll give five reasons. (The first two form the core of my original argument.) Before all this starts to sound too self-congratulatory, I'll also explain the one big thing my essay got wrong.

Reason 1: Houses produce lousy returns, while stocks produce good ones

Houses looked like smart investments in 2007. They had returned 9.3% a year for a decade, while stocks had returned just 5.9%. This year, with investors fleeing both houses and stocks, both probably look like a waste of money. But be careful about succumbing to what psychologists call recency bias — the tendency to form beliefs based largely on the most recent observations in a long series of data. For U.S. investors, reliable data on stocks and houses goes back well further than 10, 20 or even 50 years.

Stocks returned 7% a year for 200 years ended 2004, according to Wharton professor Jeremy Siegel. That's after subtracting an average of 3% a year for inflation, or the gradual rise in prices of ordinary goods. The plunge in stock prices over the past 16 months makes me all the more sure that shares are poised to deliver good returns over the next decade or two. Houses returned 0.4% a year over 114 years ended 2004, according to Yale professor Robert Shiller, co-creator of the most widely used index for house prices. That number is suspiciously close to zero. Indeed, it might have been zero, reckons Shiller, if not for two periods of aggressive house buying, one spurred by government incentives following World War II and another created by the Federal Reserve's drastic interest rate cuts in 2002 and 2003.

A zero return for houses might sound odd. An editor who re-published my original essay at another web site stuck the word "virtually" before zero, I suppose to soften the message. I made him take it out. If you think about it, zero is the only logical answer, so long as

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we're talking about a single-family house and not, say, a rental building built to maximize income. Inflation, recall, is the gradual price rise of ordinary goods. What's a house if not an ordinary good? Houses don't spend their days thinking about ways to make themselves more valuable. They just sit there. Subtract inflation from their long-term price increases and there's nothing left.

Apply heaps of leverage to the numbers if you like, but the outcome only worsens. Mortgage rates now are about as low as they've ever been, thanks to more government efforts to, among other things, spur house buying. But you'll still pay 5.2% to capture long-term price increases that merely match inflation. And today, you'll tie up a bundle of cash with a down payment. I'd rather pay cheap rent instead of an expensive mortgage and put the monthly cash I save into stocks and other investments. And rent is still plenty cheap, because . . .

Reason 2: House prices have further to fall

Price matters. Few stock investors would think about buying shares of a company before looking at some measure of how expensive it is relative to the value it creates. They might look at the price/earnings ratio, for example. Houses have a price/earnings ratio of sorts — the ratio of their price to the yearly income they could generate if rented out. In April 2007 I noted that price/earnings ratios for stocks were only slightly above their historic average, while price/rent ratios for houses were double their average.

Stock prices were the thing I got wrong. The price/earnings ratio I gave was correct, but the earnings on which it was based were far from ordinary. The fierce housing boom was ringing cash registers at furniture stores, employing heaps of real estate agents, padding the profit statements of lenders and, thanks to home equity loans, puffing up buying power for just about everything. I should have realized that America's corporate profit was close to a third above normal levels as a percentage of gross domestic product. Profits have reverted to average levels, and stocks have fallen to around 14 times earnings. I recently cautioned readers that, even though stocks are fairly priced, it's natural to assume that after a long period of above-average prices we can enter a few years of below-average ones.

Houses still seem expensive, though. One recent survey by Moody's Economy.com found that the price/rent ratio in major markets had fallen to 20 from 24 three years ago, but that for 16 years ended 1999, before the house-buying spree began in earnest, it had stayed below 15.

Numbers like those should inform not only house-buying decisions, but public policy. If a citizen is being made poor by the debt they carry on the house they bought, and if a government policy keeps them tied to that house instead of separated from it into more affordable housing, are we really helping them?

Reason 3: Many houses for sale today seem designed to waste money

"Most men appear never to have considered what a house is, and are actually though needlessly poor all their lives because they think that they must have such a one as their neighbors have." Henry David Thoreau wrote that about 160 years ago in a long, somewhat preachy but also poignant treatise called "Walden," which argued against materialism and for simplicity. I'd imagine it applies to today's houses even more than to ones in Thoreau's day.

Commercial real estate investors seek to maximize the amount of use tenants can get out of a building, while minimizing the operating expenses. Single-family house buyers have lately done almost the opposite, by buying far larger houses than single families need. From the 1950s to 2006, the average American house size doubled, even as the size of

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families shrank. U.S. tax policy rewards house buyers who borrow, not renters, and not house buyers who pay cash. So naturally, Americans responded by borrowing, which inflated their buying power and ultimately caused dwellings themselves to balloon. The “dream of homeownership” became more of an entitlement to mansion-ownership. But all those mansions on the market do little for me, financially speaking. They’re expensive to heat and cool, and to fill with a respectable amount of stuff.

Reason 4: Big houses are targets for future taxes

This year, U.S. government debt will increase by the largest amount relative to the size of the economy since World War II. Assuming the country will eventually right its financial course, at least some of that money will have to be paid back. That means higher taxes in the future, and taxes come mostly from people with a proven ability to pay — people with high incomes and people with large, expensive, easy-to-find assets. There’s only muted talk of states raising property taxes now, since the federal government is working to support house prices. I’m worried that property taxes will rise sharply in coming years. Of course, renters pay taxes too, if you figure that landlords merely pass along taxes to tenants. But renters live in smaller spaces.

I might have titled this reason, "Few people truly own their house, anyway." To me, owning something is defined in part by not having to pay anymore. Condo owners are really renters, if we consider their endless maintenance fees. But house owners, too, must pay rent to the government in the form of taxes, and must pay for plenty of ongoing maintenance besides.

Reason 5: Neighborhoods are changing in unpredictable ways

In March 2008, The Atlantic published a frightening vision of what might happen to America’s suburbs. Low-density suburbs, it theorized, may become what inner cities became in the 1960s and '70s — "slums characterized by poverty, crime and decay.” I’ve no idea whether anything like that will come to pass. But the popping of America’s giant housing bubble, and a corresponding shift in where people find jobs, seems sure to reshape how and where we live in coming years. For rural folks that might not matter much. (For them, in fact, little of this might apply, since house prices in rural America have stayed pretty sane.) But anyone considering a move to the suburbs should do some careful forecasting before sinking a large portion of their wealth into a house.

I hope all this doesn’t sound alarmist. I’ll surely buy a house one day, when prices are low enough, and I’ll probably even buy one that’s a little bigger than I need. But I’ll do so knowing that I’m spending on luxury, not investing. Also, I hope this doesn’t further the anxiety of readers with mortgage troubles. The trend of the day seems to be to take an angry tone with people who’ve gotten in over their heads -- one fellow columnist referred to them the other day as “deadbeats.” But two other parties deserve a full measure of blame, and I don’t mean lenders. First, lawmakers have for decades trumpeted house affordability initiatives like tax breaks, while leaving supply in choice markets constrained. That inflated demand and ultimately produced the opposite of affordability. Second, too many people who do what I do for a living spent most of the housing boom cheerleading instead of doing math. It’s time to stop lecturing renters — and maybe to ask why public policy treats them as less-worthy citizens than buyers.

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