

U.S. Structured Finance Newsletter

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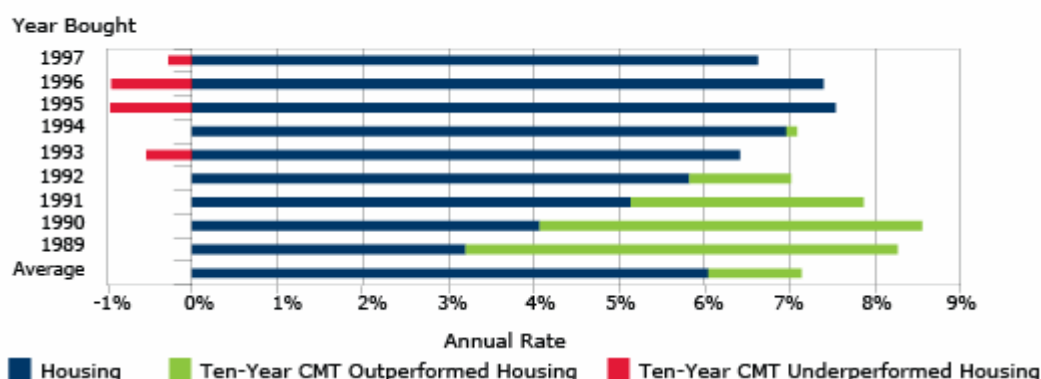
THE EXTRAORDINARILY SHORT LIFE OF EXTRAORDINARY RETURNS ON HOUSING

As mortgage interest rates began a three-year-long fall to historically low levels in 2000, the U.S. residential mortgage market experienced a tsunami of mortgagors demanding access to mortgage credit and mortgage lenders willing to oblige, inflating a housing bubble that has since collapsed. The first wave of mortgagors were prime borrowers seeking rate and/or term refinancings, taking advantage of low interest rates. The second wave were new entrants, including first-time homebuyers; subprime borrowers qualified under “expanded” underwriting guidelines; homeowners investing in real estate for profit, either by renting or flipping properties; and borrowers who would serially take cash out of their properties through refinancing.

Demand for mortgage credit exploded because borrowers, first-time buyers and refinancers alike believed three things. First, mortgage borrowing would never be cheaper. Second, home prices would only continue to increase in the future. Third, one could never lose money on residential real estate. To their dismay, many borrowers (lenders and investors) now recognize that home prices sometimes fall and one can, in fact, lose money on residential real estate. A review of the Fiserv Case-Shiller Indexes (CSIs) of home prices highlights extraordinary but short-lived housing returns of the mid-2000s.

Imagining that a borrower sold his or her house exactly ten years after it was bought, a ten-year rate of change was calculated every month for 34 large metro areas covered in the CSIs and averaged by year. Typically, any homeowner who held a house for exactly ten years could expect to sell it for almost twice as much as the original purchase price – about 180%. This is equivalent to a 6.1% annual return over the full ten years. This average, however, represents a barbell distribution, with small returns at the beginning of the time series and extraordinary returns in the recent past.

Average Annual Rate over a Ten-Year Holding Period



The annual return for a borrower who bought a home in 1989 and sold it in 1999 was a minimal 3.2%, even though in 1989, the ten-year Constant Maturity Treasury (CMT) averaged 8.3%. Buying in 1994 and selling in 2004 returned about 7.0% a year on average, similar to the ten-year CMT, which yielded about 7.1%. However, borrowers who bought their houses in 1995 and 1996 and sold them ten years later reaped huge rewards, garnering annualized returns of 7.4% and 7.5%, respectively. These are two of only four years when housing represented a better investment than ten-year CMTs.

The market continues to view home ownership as a reasonable long-term investment, with an average annual return of 4.6% since 1990. This average includes the boom years of 1998 to 2005 (6% to 10% annually) but is expected to decrease as mortgagors who sell in the near term recognize losses.

For questions or comments, please contact Susan Kulakowski at skulakowski@dbrs.com.