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Study: Real estate best buy when inflation comes

Real estate has been the hedge against inflation and common stocks are growing increasingly weaker, G. William Schwert told about 100 University of Rochester alumni yesterday.

"I doubt that I'll tell you anything that is going to allow you to go out and make money," Schwert, an assistant professor of finance in the UR Graduate School of Management, said at the beginning of his talk on investments.

Instead he offered an easy-to-understand look at performance of certain investments over the past 22 years.

It was documented by research Schwert did with University of Chicago economist Eugene F. Fama, published in the Journal of Financial Economics.

Schwert studied the rate of return of treasury bills, government bonds, real estate and common stocks from 1953 until 1975. He compared the nominal rate of return on investments to the real rate of return: "the return in dollars minus the inflation rate".

What he discovered was a "startling picture of what's happened over the past quarter-century" as inflation rates, which hovered at between one and two percent during the 1950s and early 1960s, took off in 1968 and rose to an average of 7.1 percent between 1971 and 1975.

"Common stocks are going down as inflation is going up," Schwert said. His study indicated that common stocks, which yielded, on the average, a real rate of return of more than 10 percent between 1953 and 1967, showed a 5.5 percent negative rate in the 1970s.

Treasury bills and government bonds also showed a less favorable real return, he said.

Real estate prices, however — at least the prices of FHA-insured homes — have kept pace with inflation, he said. "Our study of the price of FHA homes throughout the country shows that housing prices have gone up with the inflation rate. On the average, they've gone up at the same rate."

The study revealed that investment in real estate produced a .9 percent negative real rate of return between 1971 and 1975. "We don't have the data to show the total return," Schwert said. "Our figures leave out the rent you would have to pay if you didn't own a home, or costs to maintain the constant quality of a home. But I can guarantee the total return would be much higher."

The study looked only at FHA-insured homes, but Schwert said he believes the findings would apply to the price of conventionally financed homes as well.

"Real estate," he observed, "is not a fixed-income asset. The rate of change in the price of housing is in the same order of magnitude as the consumer price index. House prices tend to go up at about the same rate as the prices of other goods and services."

He conceded that the study concerns only the purchase of a home, not the securing of a home mortgage, which would involve interest rates and monthly payments. "In your own investment you should consider the effect of borrowing on the purchase of a home," he said.

Unlike real estate, Schwert observed, fixed-price securities like treasury bills and government bonds are hurt by unexpected inflation. Since they will be sold at a fixed price after a certain number of years, treasury bonds and bills "cannot adjust to unexpected inflation" which eats into the real rate of return, he said.

G. William Schwert

Common stocks also take a beating from unexpected inflation, Schwert said, because firms "engage in contracts over time, written in dollar terms and specifying a fixed price. While unexpected inflation means the dollars paid out represent less, it also means that the dollars taken in are worth less.

"When firms engage in fixed-price contracts, they're anticipating the future inflation rate," Schwert continued. "If you're systematically wrong about the future, then the other party will make money off you."

Other factors that led to a dramatic drop in rate of real return of common stocs, Schwert said, were "a couple of recessions and things like the Arab oil embargo. Inflation didn't cause these things. It could be that by a fluke of history, they happened at the same time."