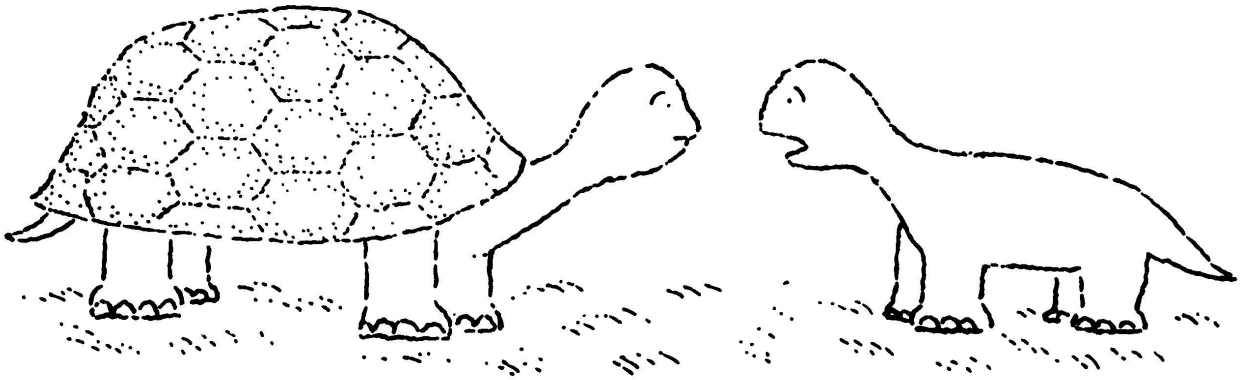
Stocks or Real Estate?

"We don't have to be smarter than the rest. We have to be more disciplined than the rest." -Warren Buffett



"Whatever you do, keep up with your mortgage payments."

My wife and I spent our early adult years moving around quite a bit together. After leaving the San Francisco Bay Area in the summer of 1997, we then lived in Miami Beach, New York City, Tokyo and finally back to the Bay Area in late 2013, where we settled down.

We've had life changing experiences along the way and made friends with extraordinary people from all over the world. But up until fairly recently, we did not own a home. We hopped from place to place pursuing our careers, renting nice apartments in desirable city neighborhoods, and lived a cosmopolitan lifestyle. These were great times but came at the expense of building up real estate wealth. Our peers, who bought homes early-on had years of a head start on us in this respect.

Many people are more comfortable investing in real estate as opposed to financial assets. The physical characteristics of land and homes is intuitive, while some people may view financial assets with suspicion, believing they have been created out of thin air. There is some truth to this, but as Warren Buffet likes to say, “Price is what you pay, value is what you get.” This statement applies to every type of investment asset, including real estate.

To me, the big benefit of purchasing real estate is not the political support home ownership receives in both good times and bad, nor the significant tax breaks applied to mortgage financing, but the ability to leverage up big time and not become subject to margin calls. For example, if a home buyer puts 20% down or $200K on a $1mm purchase, and the value of the property increases 10% to $1.1mm in one year’s time, the investor has made 50% on their $200K investment. On the other hand, there are no mark-to-market margin calls if your home declines in value by 10% or more and things don’t work out as hoped. Given the ability to leverage up without being subject to depositing additional cash makes housing an asymmetrical bet – unlimited upside potential with a good amount of downside liquidation protection.

There’s no such thing as a free lunch and almost all the decisions we make come with trade-offs. Concentrating all of one’s assets in either real estate, a business venture, or in company stock might be a good way to get rich but comes with outsized risks many people are uncomfortable taking. Also sometimes it is necessary to highlight that getting rich and staying rich are two different things…

In a recent Barron’s column, Randall Forsyth makes the case for investing in the stock market over real estate as a way of building up wealth over the long term. He may be mathematically correct, but for most of us, a balanced portfolio of stocks, bonds, real estate, private holdings, etc. is the way to go.
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The Case for Building Wealth With Stocks, Not Homes
By Randall W. Forsyth
Barron’s
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Once upon a time, a young family bought a modest three-bedroom Cape, the worst house in the best location in a prosperous suburb. Many years later, during the housing frenzy of 15 years ago and after the kids had grown and moved away, they received an unsolicited cash bid—for 20 times what they paid. That became their nest egg, which provided a comfortable retirement.

It’s all true, but it might as well be a fairy tale. Such an escalation of home prices is unlikely to repeat, especially from here after their frantic climb. Over the long term,

history shows the stock market has returned about twice as much as residential real estate. And it's done so with far fewer headaches than the attendant expenses of upkeep, which have come as a shock to many recent home buyers.

Looking at the data assembled by NYU Stern School of Business professor Aswath Damodaran, stocks (as measured by the S&P 500) returned 12.47% annually from 1972 to 2021, versus 5.41% for residential housing (based on the Case-Shiller Index, through last October), a span that encompasses inflation's liftoff after the dollar's link to gold was severed. Looking at 2012-2021, which takes in the recovery from the housing bust that precipitated the 2007-09 financial crisis, stocks returned an average 16.98%, versus 7.38% for housing.

In a new paper prepared for the Brookings Institution, Robert Shiller, a creator of the housing index, and Anne K. Thompson found 72.4% of respondents in a survey said recent bidding wars had resulted in "panic buying that caused prices to become irrelevant." That was attributed to the now-familiar story of buyers wanting more room, especially for a home office, in the suburbs. White-collar workers who could work from home were mostly unscathed or benefited from lower spending outlays during the worst of the pandemic.

Historically low mortgage interest rates further leveraged bidders' buying power. With Freddie Mac's average 30-year loan down to 3.05% in December, the monthly payment on the median-priced house of $408,100 in the fourth quarter, bought with a 20% down payment, would be $1,385. With the jump in mortgage rates, to 4.67% as of March 31, that same loan would cost $1,687 a month. The reduction in affordability is sure to slow home-price appreciation.

Shiller and Thompson found that recent buyers are realistic about near-term home-price trends, expecting some moderation, but may be "given to flights of fancy for the longer run." Damodaran's parsing of their data showed buyers at the peak of the previous bubble in 2006 didn't recover fully from the ensuing bust for 10 years. That wasn't the first time home buyers were stuck with losses. After the dip from the peak in 1989, prices didn't recover fully until 1992. And those losing spans didn't take into account transaction costs, which are huge for residential real estate.

It's axiomatic that buying high lowers future returns. In human terms, stuff happens, from better job opportunities elsewhere—especially given the ability to work from anywhere for knowledge workers—to unfortunate circumstances such as death and divorce. The ability to pick up stakes with totally portable and liquid financial assets may provide more freedom in the near term, along with greater wealth over the longer span.
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My base case is the Fed is on the road to making a monetary policy error. The front end of the yield curve has been pricing in more than eight 25bps cumulative interest rates hikes to the Federal Funds rate throughout 2022, while they have also indicated quantitative tightening (QT), in the form of pulling back open market bond purchases of U.S. Treasuries and Mortgage-Backed Securities by $95 billion per month. All this will be occurring as economic growth slows and the year over year rate of change in the inflation numbers likely begin to decelerate. The war in Ukraine along with Chinese COVID political matters threw a wrench in my and many others short term inflation projections, but once supply-side issues clear-up, I believe we will slowly begin to see things normalize in this respect. Ask yourself, if the main inflation impetus is coming from supply-side factors and are not demand-based, what use is monetary policy with respect to increasing supply? Monetary policy cannot address supply chain issues, it can only potentially seek to increase or decrease demand. If the Fed continues along this path, it becomes more likely they will break something.

As a result, the move in the bond market has been extraordinary. Interest rates have shot up over a short period of time by the most in more than twenty years. The recent liquidations over the past couple of weeks have the smell of forced selling. Once this has been cleared out, rates should begin to settle down and then start to decline. As long as the Fed continues to talk tough regarding infaltion (very political), I believe the long end of the yield curve should outperform.

Regarding stocks, we have positioned portfolio's for more defensive scenarios. Overweight equity allocations are concentrated towards large capitalization technology, real estate (REIT's), health care, and utilities. We are also overweight gold.

ASSET CLASS & SECTOR OPINIONS		
OVERWEIGHT	NEUTRAL	UNDERWEIGHT
U.S. Real Estate & Related Equities	International Developed Market Equities	Small Capitalizaton Stocks
Large Capitalization Technology	Emerging Markets Equities	Financial Services Sector
Gold & Gold Miners	Consumer Discretionary Sector	Leisure & Hospitality
Healthcare	Consumer Staples	Materials Sector
Aerospace & Defense	Communication Services Sector	Energy Related Equities
Utilities	Mortgage-Backed Securities	Leverage Loans (Floating Rate Debt)
U.S. Treasury Notes & Bonds	Local Currency EMG Bonds	Treasury Inflation Protection Securities
Investment Grade Corporate Bonds		High Yield Corporate Bonds

Sincerely,
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