Research Paper Number 26

Hedging Housing Risk

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Date:
December 2000

This paper has now been published and is no longer available as a part of our Research Paper Series. The reference to this paper is:

Englund, P., Hwang, M., Quigley, J.M. (2000): "Hedging Housing Risk". The Journal of Real Estate Finance and Economics, Volume 24, Issue 1, Article 8.

Abstract:
An unusually rich source of data on housing prices in Stockholm is used to analyze the investment implications of housing choices. This empirical analysis derives market-wide price and return series for housing investment during a 13-year period, and it also provides estimates of the individual-specific, idiosyncratic, variation in housing returns. Because the idiosyncratic component follows an autocorrelated process, the analysis of portfolio choice is dependent upon the holding period. We analyze the composition of household investment portfolios containing housing, common stocks, stocks in real estate holding companies, bonds and t-bills. For short holding periods, the efficient portfolio contains essentially no housing. For longer periods, low risk portfolios contain 15 to 50 percent housing. These results suggest that there are large potential gains from policies or institutions that would permit households to hedge their lumpy investments in housing. We estimate the potential value of hedges in reducing risk to households, yet yielding the same investment returns. The value is surprisingly large, especially to poorer homeowners.

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