How People Underestimate the Financial Risks of Home Buying

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We show that people underestimate the financial risks of buying a house. Our experiments show that even when well diversified, people judge stocks as more risky investments than homes; and people judge a diversified portfolio of homes as more risky than a single home because a home feels more tangible.

[to cite]:

[url]:
http://www.acrwebsite.org/volumes/1017656/volumes/v42/NA-42

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EXTENDED ABSTRACT
Buying a house involves serious financial risks. Volatility of home prices is one of the important sources of risk. A decrease in home prices wipes out many homeowners’ life savings. People buy homes that they would not normally consider in anticipation of increasing home prices. This often leads to losses because home price changes are not very predictable. Many potential homebuyers see that they are priced out of the market when home prices rise. A sharp decline in home prices often catch people by surprise, as it did in 2008. Between 2005-2008, home prices fell by 32% on a national basis. In 2008 alone, home prices fell by 18%. Such sharp price adjustments are in fact very common, and every time they happen, they cause great financial distress for many homeowners.

Buying a home is the biggest financial decision most people ever make. It is extremely important for household finance as well as the national and global economy. U.S. home ownership rate stands at 67.3 percent; 81.9 percent of household debt is related to residential property. If we better understand home-buying decisions, we can improve people’s lives through better informing consumer decisions and devising better market arrangements. Yet, our knowledge about bigger consumer decisions, such as home buying, is very limited.

How do people assess the risks of buying a house? The purpose of the current research is to empirically test for an underestimation of home-buying risk. Experiment 1 shows that on average people erroneously predict that the price of a particular home is less volatile than an index fund following S&P 500, which is a diversified financial asset that is tied to the U.S. market. Even when well diversified, people seem to think of stocks as more risky investments than homes. Experiment 2 shows that diversification has different effects on risk perception, depending on whether the diversified asset is a home or a stock. As expected, a mutual fund of stocks was perceived to be less risky than a single stock. In contrast, diversifying in the real estate domain via a real estate investment trust increased perceived risk. A diversified portfolio of homes feels like another intangible asset; so the perceived risk actually increases. A moderated mediation analysis with assessments of tangibility as the mediator was consistent with this explanation. In Experiment 2, people evaluated the riskiness of assets separately. We suspected that, in joint evaluations too, people would pick a single home as the safer option. Experiment 3 confirmed our prediction. When given the option to pick either a home or a real estate investment trust, people tended to pick the home when their objective was to make a safe, low risk investment. They tended to pick the real estate investment trust when their objective was to make a high return investment and they tolerated risk.

Our results suggest that people underestimate the risks involved in buying houses and the underestimation stems from the tangibility of homes. When the tangibility is lost, e.g., in a real estate investment trust, perceived risk increases even if a rational assessment requires a reduction in risk. We believe that these insights might inform the regulation of the housing markets, which are plagued by deep and frequent downturns.

The same price volatility causes higher risk for homeowners because houses are such big purchases, and as assets, houses are much less liquid than many other assets such as stocks. For instance, when the prices are going down, it is often impossible to immediately sell one’s property. This makes the underestimation observed in our experiments conservative tests of underestimation.