



# JUMPIN' ON THE LAND WAGON

By Charles E. Gilliland and David Carciere

**T**exas land markets are exceptionally robust. The accelerating market of the past five years has driven returns to levels approaching the historic highs of the 1970s. Average returns for short- and medium-term investments from 2000–05 increased a full percentage point or more compared with averages from 1995–2005. The increase in returns on 2000–05 long-term investments exceeded 3.25 percent.

Market participants and observers increasingly speculate that the Texas land market cannot sustain the lofty prices posted in the past several years. Pointing to the past 35 years, they note first the moderation and then collapse of returns that followed the heady 1970s. Some fret that markets will break like they did in the mid-1980s.

Pundits are being urged to predict when prices will recede and prosperity vanish. To understand today's land market, it helps to have a historical perspective.

## Past Drives Present Market

The end of the 1960s saw inflation ratchet up. Investors discovered the power of leveraging to magnify returns in an inflationary environment. Early in the 1970s, agricultural prices and exports soared while an oil embargo escalated energy prices. Farmers, landowners and those in the energy industry found their pockets bulging with profits.

In mid-decade, inflation allowed borrowers to repay loans with cheaper dollars. Buyers who acquired land pre-inflation reaped the greatest returns. After the initial spurt, net-of-inflation returns settled to moderate levels that continued into the 1980s.

Government officials took action to end the high rate of inflation, and energy prices came under pressure. Inflation abated, and the strengthening dollar priced farmers out of the world market. Oil price growth slowed and then collapsed in mid-decade.

At the same time, changes in income-tax policy reduced returns on real estate investment. Financial leverage began to work against borrowers. The recession following the oil price collapse in 1986 led investments financed with borrowed funds to default.

This financial storm caused demand for land to evaporate dramatically, dropping prices and swelling lenders' inventories of properties. Those who purchased land in the 1980s would not see positive returns again until the end of the decade.

The impetus for both the run-up in the early 1970s and the collapse in the 1980s came from shocks outside normal market forces. Changes in oil pricing policy, tax policy, monetary policy and agricultural policy induced shifts in market profitability. Extensive borrowing first fueled prosperity and then deepened declines following defaults. This suggests that clues to future economic changes lie in societal conditions and changes, not in analysis of the market's track record.

Market trends reflect recent social and economic events. Many of today's buyers lived through the 1980s real estate bust and subsequently viewed land as a dangerous investment. The 9-11 attacks and the continuing securities fraud scandals have biased many investors in favor of tangible property. Money remains relatively cheap, and lucrative investments are scarce.

In this environment, demand has become an investment-based driving force for a market teeming with buyers. Tax advantages gained from reinvestment in a 1031 exchange reduces effective prices for those cashing out investments in other properties. High energy prices are proving lucrative for royalty owners and others in the industry. The result is a land market with assets held in strong hands and few attractive properties for sale.

The current market is characterized by a prevalence of cash investments, which was not the case in the 1980s. Most landowners will not face the prospect of loan default in the event of an economic downturn. Unlike the 1970s, inflation

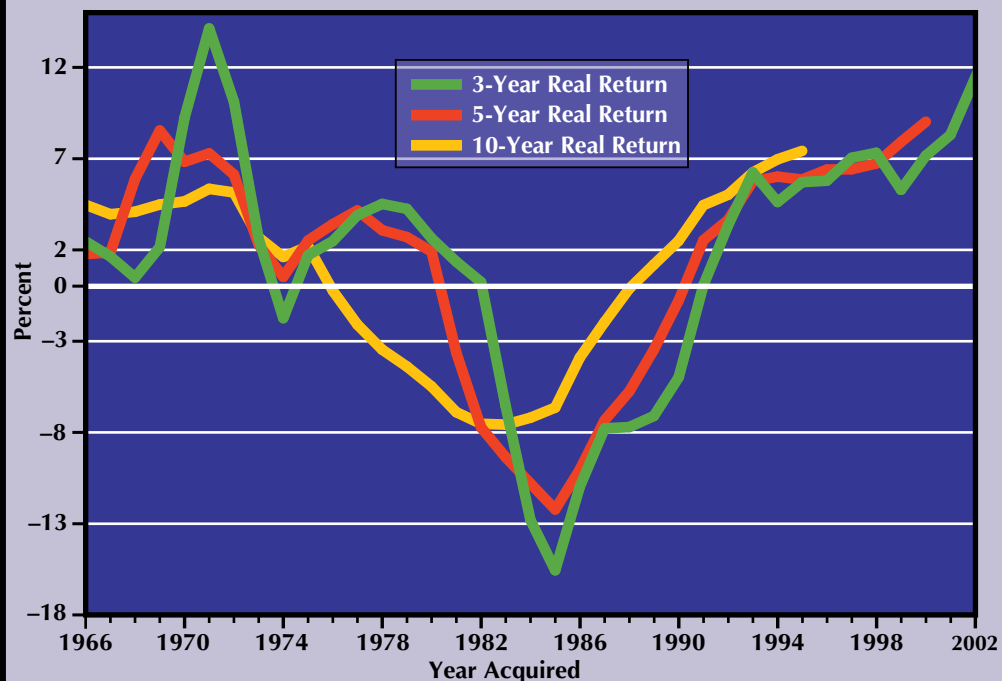
remains low today, and, although interest rates have risen, alternative investments have failed to gain appeal by becoming more rewarding.

Both the war and corporate scandals continue. Energy prices have risen to disquieting but not unprecedented levels. The energy price run-up may have taken its toll in the final quarter of 2005 as economic growth slowed. However, the economy appears to be coping without serious disruption, leading most forecasters to look for a modestly prosperous 2006 with possible slowing growth near year's end.

Without a cataclysmic shock to the economy, continued income growth along with reduced federal taxation point to a ready supply of cash seeking an investment home. Nothing currently on the horizon signals a 1980s style crash or even a marked slowdown in land price appreciation. Prospects in the near future seem to favor strong performance.

Many market observers anticipate an eventual easing of buying pressures seen in the current market. However, landowners

**Figure 1. Net of Inflation Capital Gain Returns  
Texas Land**



Source: Real Estate Center at Texas A&M University

in today's market enjoy a strong financial position, suggesting that they could avoid another foreclosure-inspired meltdown. Even though market activity may eventually slow from today's torrid pace, prices will likely continue to rise. In such an environment, investment returns on landownership would probably moderate in the long run. However, those conditions do not appear to be on the horizon.

## Updated Returns

In *Texas Rural Land Prices, 2001* (see [recenter.tamu.edu/pdf/1562.pdf](http://recenter.tamu.edu/pdf/1562.pdf)), researchers explored returns on investments in the Texas land market from 1966 through 2001. Returns were calculated for short-term (three years), medium-term (five years) and long-term (ten years) investments.

Results revealed that land acquired in 1966 for \$157 per acre could have been sold in 1969 for \$190 per acre for a 6.57 percent compound annual return. During that interval, inflation averaged 4.11 percent, resulting in a 2.46 percent net real return. Investments in risk-free three-year Treasuries during the same

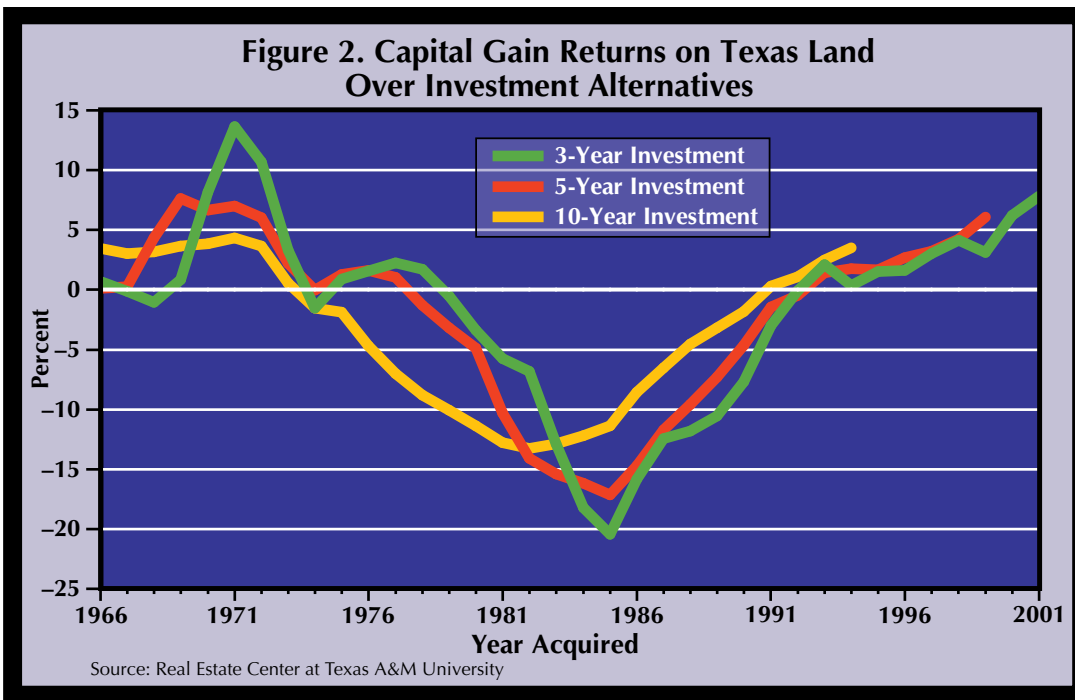
(acquired in 2000) were 9.02 percent while the long-term investment (acquired in 1995) posted a 7.42 percent return over inflation.

Unusually tame levels of inflation that averaged approximately 2 percent during the past ten years have substantially increased the value of land market investments. Net-of-inflation returns for the three investment scenarios averaged 6.88 percent, 6.02 percent and 2.73 percent, respectively, between 1995 and 2005. In the 2001–05 era, land markets posted strong returns of 7.89 percent, 7.92 percent and 6.02 percent above inflation. Short-term and medium-term investors benefited from price weakness following 9-11 while long-term

investment returns reflected the relatively low prices paid in the mid-1990s.

For the 1966–2005 period, net-of-inflation returns averaged 1.41 percent for short-term investments, 1.18 percent for medium-term investments and 0.37 percent for long-term investments. Obviously, the 1980s real estate nightmare, when markets posted persistent negative results, severely impacted these averages. Recent markets represent a completely different environment from conditions producing these historical averages.

Returns for land acquired from 1969 to 1971 reached historic peaks. Specifically, short-term returns topped out for land sold in 1974 with



time returned 5.86 percent. Compared with this yield, the nominal return on the three-year land investment provided a return of 0.71 percent above the safe alternative (Figures 1 and 2).

Graphic analysis showed that markets in the 1990s recovered from the negative returns posted on land purchased in the mid-1980s. Land acquired in 1998 and sold in 2001 produced a 7.32 percent annual real return, net of inflation. After inflation, the medium-term investment purchased in 1996 returned 6.4 percent, and the long-term investment acquired in 1991 managed 4.46 percent.

Since 2001, Texas land markets have provided increasingly generous returns. A brief bout of weak price growth immediately after the 9-11 attack was followed by a pronounced rebound that continues today. Price growth has ranged sharply higher than in the previous five years, with returns consistently outpacing both inflation and the performance of Treasury securities.

For land sold in 2005, returns net of inflation escalated to 11.45 percent for the short-term investment (acquired in 2002). Net returns for the medium-term investment

a net of inflation return of 14.13 percent, 2.68 percent greater than the 2005 result. Medium-term investments sold in 1974 returned 8.55 percent while long-term investments reached a maximum of 5.35 percent for land sold in 1981.

Moderated market price increases from 1975 to 1977 muted investment returns in the face of an inflation rate in excess of 7 percent. Surging land prices in 1978 overcame high inflation to post modest gains. That prosperity continued until 1981 when price gains slowed. The ensuing real estate bust compounded by recession led to the market collapse in 1986. ♣

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## THE TAKEAWAY

Texas land markets have returned increasingly generous yields since 2001. Capital gains for land investors during the 1990–2005 period have consistently outpaced both inflation and returns on Treasury securities.



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