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5 Reasons Homebuilder ETFs Have Plenty Of Room For Growth

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In this Thursday, June 1, 2017, photo, builders work on the roof of a home under construction at a housing plan in Jackson Township, Butler County, Pa. (AP Photo/Keith Srakocic)

If your house caught fire and you could only take one exchange traded fund, ETF, with you, which would it be? For Daniel Beckerman, founder of Beckerman Institutional, it would be iShares Home Construction Index for the rest of the year.

iShares Home Construction Index (ITB), +24% year to date, holds 45 names related to building homes and home improvement and charges a 0.45% annual expense ratio. It holds homebuilders, D.R. Horton, Lennar, NVR; home improvement retailers, The Home Depot, Lowe's; and materials suppliers, Sherwin-Williams, Mohawk Industries.

ITB outperformed its biggest rival, SPDR S&P Homebuilders ETF (XHB) by about 21 percentage points this year. XHB, +3% year to date, overlaps ITB considerably with 35 names. But it has no exposure to ITB's biggest winner this year, Lumber Liquidators, which rocketed 136% through Aug. 31. In addition, Bed Bath & Beyond and Tempur Sealy International, which lost 31% and 10%, respectively, dragged down XHB.

Here are five reasons why Beckerman, who manages $70 million in assets in Ocean Grove, N.J., believes home builders have plenty of room for growth.

1. They're a non-disruptable industry.
Uber disrupted the transportation industry. Amazon is killing brick-and-mortar retail. Netflix put video rental stores out of business. One industry that hasn't fallen prey to digital disruption is home builders.
"It is a labor-intensive industry that is dependent on localized and specialized talent as well as the ownership and control of vacant lots," said Beckerman. "There are natural barriers to entry for a national disruptive competitor, unlike other industries."

2. Share prices have yet to recover their pre-bear market high unlike the S&P 500.
iShares Home Construction Index rallied 24% through August's end -- doubling the S&P 500's return of 11%. But if you invested when it debuted in May 2006, you would be down 33%. You would have severely underperformed the market, which rallied 86% over the equivalent period.

"It has a lot of ground to make up and I expect several more years of outperformance to come," Beckerman said. "Because of their sensitivity to issues like mortgage-interest deductibility and interest rates, investors will have to pick their entry points carefully through the year end."

iShares Home Construction Index Price Change vs. S&P 500 from 2006 to present (Stockcharts.com)

3. Homebuilder stocks are trading at bargain-basement valuations.

Beckerman believes the underlying portfolio's low valuations yet strong growth outlook makes for a compelling buy. ITB trades at 15 times forward earnings and two times book value with long-term earnings growth of 14%, according to Morningstar. By contrast SPDR S&P 500 ETF trades at 20 times forward earnings and nearly three times book value with long-term earnings growth of 10%.

"Homebuilders, on average, trade at more than a 30% discount to the average S&P 500 stock, based on their price-to-earnings ratio," said Beckerman. "The space has enjoyed strong growth and profitability over the past few years as we move closer to a normalization of a number of housing starts."

4. Low-interest rates boost affordability and demand.

Bargain-basement interest rates since the Great Recession of late 2007 through mid-2009 has made home buying more affordable against the backdrop of low unemployment rates. Rising interest rates may dampen demand. But on the other hand, that may motivate people to buy before rates go higher.

"According to data from the National Association of Realtors, housing is better than 20% percent more affordable than the past 40-year average, as measured by their Housing Affordability Index," said Beckerman.

The NAR's HAI measures the median household income needed to buy a median-priced home. A reading of 100 shows that a median-income family earns exactly enough to qualify for a mortgage on a median-priced home, given a 20% down payment. A current reading of 151 means a median-income family earns 151% of the income needed to qualify for a median-priced home. Home buying is deemed unaffordable when the monthly principal and interest payment exceeds 25% of monthly income.

Composite Housing Affordability Index

Composite Housing Affordability Index (Source: U.S. Department of Housing and Urban Development)

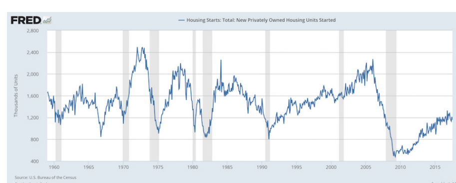
5. New housing starts have yet to recover their pre-recession levels despite higher demand and population growth.

Housing starts have rebounded from a historic low in 2009. But they remain down almost 50% from their January 2006 peak of 2.3 million units. All the while, the U.S. population grew 9% over the past 11 years from 298.4 million in 2006 to 325.6 million as of August 2017. It suggests a significant lack of supply and even a "housing depression" in the face of a severe shortage of workers. Hurricane Harvey will stall current developments in the near future. But in the long run, it could only add fuel to the proverbial fire in the housing crisis once the lost homes are rebuilt.

"The existing supply of homes falls short of being able to come anywhere close to satisfying potential demand from Millennials or the, also massive, Generation Z age group in another five years or so," said Beckerman. "I see demand picking up for homebuilders and their stocks in the years to come."

"If you live in an area with reasonable real estate prices, you could be better off buying a home versus renting in as few as three years," Beckerman added. "Millennials could provide a major tailwind for the industry since they are now the largest age group, eclipsing even the Baby Boomers."

Housing Starts 1959 to Present



Housing Starts 1959 to Present (Source: Federal Reserve Bank of St. Louis)

A Flood of Investment Risks to Consider

Construction of single- and multi-family homes fell unexpectedly in summer, totaling 1.155 million in July compared to estimates calling for 1.22 million starts. Homebuilding dipped 5.6% year-over-year as building permits declined despite strong demand. Homebuilders are struggling to find enough skilled workers and buildable lots.

American homebuilders' sentiment fell to an eight-month low in July on worries over rising material costs, according to the National Association of HomeBuilders/Wells Fargo. Builders' Housing Market Index slipped to 64 (estimate 67) from 66 in June (revised from 67). The six-month sales outlook sank to a five-month low of 73 from 75. The index of current sales dipped to 70, the weakest since November, from 72.

Building materials prices were rising even before the U.S. government imposed anti-subsidy duties on imports of Canadian lumber in April.

Hurricane Harvey will boost demand long term yet delay housing starts short term in Houston -- the second-largest market for housing starts in the country.

"A typical hurricane delays activity by four to six weeks," Credit Suisse research analysts wrote in a report Wednesday. "We believe this could be extended given the magnitude of the storm and the already tight labor market. That said, four to six weeks of lost activity would translate into 2,100-3,100 fewer starts. Assuming an average new home price of $356K, this translates into an industry loss of $743 million to $1.12 billion."

Hurricanes do not necessarily boost pricing power for home builders and building materials like roofing, flooring and wallboard, they added.

"Demand tends to come over time and can be protracted as homeowners await insurance payments and need to seek out labor and storm-related volume typically creates a pull-forward in demand—as opposed to raising absolute long-term volumes—causing some choppiness in results and year-over-year comparisons," Credit Suisse wrote.