

The famous investor, Warren Buffett voiced his opinion on how the average investor should invest their capital, "So many investors, brokers and money managers hate to admit it, but the best place for the average retail investor to put his or her money is in index funds."

An index fund is a security that aims to replicate the movements of an index of a specific financial market. Examples of index funds would be the S&P 500 and the Dow Jones Industrial Average. When you purchase an index fund, your return is directly related to the movement up or down of the index.

I have always wondered about how the returns on hotel investments compare to the returns of index funds. Would an investor be better off purchasing a hotel or one of the index funds? I decided to look into these two investment options and I think the findings will surprise you.

Each year HVS publishes the Hotel Valuation Index (HVI) which tracks hotel values in 52 major U.S. hotel markets plus the United States as a whole. The HVI started in 1987 so it now has 22 years of actual hotel valuation information for these markets. The HVI is based on local supply, demand, rate, occupancy and REVPAR data from Smith Travel Research. HVS takes this data each year and develops a profit and loss statement for each of the 52 markets using local revenue and cost components. The resulting Net Income is then capitalized into a value estimate based on an appropriate capitalization rate. The final number represents the value per room for a typical hotel in that particular market. The process is repeated each year which creates an annual valuation trend line that can then be used to evaluate the investment return.

Using the HVI we can compare the annual movement of hotel values in each of the 52 markets to the yearly change in the value of the index funds. We will utilize the two most widely used index funds- the S&P 500 and Dow Jones Industrial Average for our comparison. We will also show the movement of the consumer price index (CPI) to see how hotel investments fared against inflation. Since a picture is worth a thousand words we will illustrate the comparisons with graphs.

Insert Graphs

The first graph shows the value trends for a typical hotel in the United States compared to the three indices. The blue bars are the annual values per room starting in 1987 and continuing to 2006. I chose to end in 2006 because this was a peak year for both hotel values and the indexes. As we all know, hotel values crashed in 2008, but so did the two stock indices. In 2009 the stock market started to recover but hotel values have lagged somewhat.

The three lines on the graph represent the three indices- the red is the CPI, the purple is the S&P 500 and the green is the Dow Jones Industrial. Each of the lines starts in 1987 at the top of the blue bar for that year and continues towards the right based on the annual percentage change in the value of that index. Essentially what the graph illustrates is if instead of buying a hotel in 1987 for the value per room at that point in time you put your money into one of the index funds, would you be better off (had made more money)by 2006?

The graph for the United States shows the red CPI line initially crossing over the blue bars which means from 1990 to 1995 hotel values in the U.S. were not able to keep pace with inflation. During the hotel growth period of 1997 through 2000, growth in hotel values surpassed the CPI. Between 2001 and 2003 hotel values again lagged the CPI and from 2004 to 2006 hotel values rebounded faster than the CPI. Looking at the S&P 500 and the Dow Jones over this period you can see that at no time did hotel value growth exceed these indices. Therefore, an investor buying the typical hotel in the United States would have been better off buying one of these index funds compared to putting the same amount of money into a hotel.

Now let's look at the graph for typical hotel in New York City. As you can see compared to the annual values of a typical hotel in the United States, New York City hotel values have been very volatile with high peaks followed by very low valleys. Again during the recession in the early 1990's hotel values fell below the CPI and the two stock indexes. Starting in 1996 hotel values began to exceed the CPI, however, it was not until 2005 did hotel values overtook the S&P 500 and the Dow Jones. Therefore, an investor over this period would have done better (value wise) investing in a New York City hotel rather than an index fund.

We ran this analysis on the 52 major U.S. hotel markets and discovered that there were only five markets where a hotel investment was able to grow faster than all three indices. These markets were: Miami, Austin, TX, Omaha, NE, New York City and Las Vegas. The following table shows the percent change in value for the Dow Jones and each of these 5 markets from 1987 to 2006.

While I will admit that these findings surprised me, I am not advising my clients to go out and sell their hotels and invest the proceeds into index funds. This analysis shows only the over change (appreciation) in value of the investment (over the long term) it does not include the annual returns you receive in profits or dividends. Also the analysis is for a 19 year period which is significantly longer than the normal 8 to 10 year hotel holding period. Where big money can be made with hotel investments is by riding the cycles- buying at the low points and selling at the height. Timing the market to buy at the lows and sell at the highs will significantly increase your return.

Last but not least I find it somewhat ironic that Omaha, NE was one of the hotel markets that exceeded the index funds because Omaha is the home of Warren Buffet!