

THE PROGRESS REPORT

Tech Stocks Down, Real Estate Up

By Fred E. Foldvary

The shares of many technology-based companies have crashed, many to a small fraction of their peak values. Meanwhile, the prices of real-estate stocks, mutual funds, and partnerships have risen substantially this year, often by about 25 percent. What gives?

An understanding of classical economics clarifies what has happened. We begin with the basic inputs into production, which the classical economists divided into three categories or factors: land, labor, and capital goods. Land includes all the natural resources, labor all productive human exertion, and capital goods are the produced tools such as machines and buildings.

The classical economists David Ricardo and Henry George wanted to know how the wealth is distributed among the owners of the three factors. Ricardo in the early 1800s had a model where the land is divided into various grades reflecting differing productivity. Folks use the most productive land first. The "margin of production" is the least productive land in use.

As the margin proceeds to ever less productive land, wages fall and rent rises, since workers are mobile while land is fixed in place. Capital goods are also mobile, so while the return to new products can be high for a while, eventually competition whittles down the economic profits. The bulk of the gain from progress goes to rent.

Henry George in the latter 1800s added land speculation to the model. Knowing rent and land prices are rising, speculators buy land not for immediate use but to wait for higher prices. This adds to the demand for land and pushes the margin out further, depressing wages and increasing rent even more. George also introduced capitalization, where productive activity pumps up the land value. Urban land gets its value from this capitalization.

Smart investors therefore realize that eventually much of the gains from technological progress will go the owners of the real estate. One way to have profited from this was to buy selected shares in REITs - real estate investment trusts. Real-estate partnerships, mutual funds, and companies have generally enjoyed large gains this year due to the past increases in rents and land prices.

For a while, it seemed the big profits were in tech stocks and tech employment. But it was a speculative bubble, which has now burst. Shares of money-losing internet companies have crashed, and even the prices of major tech-based companies have been cut in half or more. For a while, the real-estate stocks were not sharing the gains, but economics has prevailed - this year saw the vindication of the classical theory of Ricardo and George.

George also went beyond Ricardo in discovering that the business cycle is driven by a real-estate cycle. Land values too don't go up continuously, but cycle, and eventually real-estate speculation creates a land-value bubble that also bursts. We have seen this recently in Japan and East Asia.

For most investors saving for retirement, they should not put all their money into one sector, such as technology or real estate, but should seek the safety of diversification. It's also better for most folks to avoid trying to pick individual stocks, and put their savings into broad-based mutual funds, such as those indexed or largely based on a major category of stocks.

This is called Modern Portfolio Theory (MPT). One first selects a level of risk volatility, and then for that risk level, one selects several basic categories of funds, such as large companies, small companies, international stocks, bonds, and real estate. A technology sector fund would also be suitable, so long as it is broad-based and is not too large a portion of the portfolio.

There are financial planners and funds that follow MPT. But MPT too can break down if there is a major depression. George's cycle theory can help here. Historical cycles suggest that the current real estate cycle began in 1990 and would end around 2008 if past patterns continue. That would indicate that the current decline in the stock market does not signal a coming depression quite yet.

We are now in a growth recession, but the big crash is still a few years away, if the historic 18-year cycle is still in effect. It is important to realize that there is no "new economy." The only way to eliminate the real-estate cycle is to eliminate the cause, the speculative pumping up of real-estate prices. A shift in taxation that untaxed wages and made land rent the basic source of public finance would create a new economy where the gains from progress go to the worker rather than into land speculation.

Since this tax shift is not likely during the ozos (2000-2009), most sensible investors should follow MPT but prepare to bail out into the safety of cash after the middle of this decade.