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Protect Yourself Now from the Coming Collapse of The Housing Bubble

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Because this is a much longer letter than I usually write, here is a summary for those of you who prefer a shorter version.

Executive Summary: It's now time for everyone, in California at least, to protect against an ugly collapse of the "housing bubble." There are two things everyone should do. 1. Arrange your finances so that you will not be wiped out if the value of your residential real estate drops by 30% over the next several years. 2. Have a 30-year fixed mortgage on any home you want to keep longer than 3 years. All the commentary below is in support of these conclusions.

What does a bubble look like?

I remember a conversation that I had with a wealthy, well-educated client in June of 1999. I was managing his company's 401k plan, and he wanted my opinion on his personal stock portfolio. He was holding all technology stocks, like Microsoft, Intel, Amazon, and Qualcomm. His account was up 20% in the past six months and was now worth more than $1.4 million. He was on maximum margin and buying more stock with increasing loans as his portfolio grew.

"Do you have an extra $400,000 in cash to meet a margin call if the market goes down 30%?" I asked.

"No. All my money is in the market," he said, "I want ***all*** my money to be productive."

"You do realize, don't you, that stock markets often drop 30% even in an uptrend? If you can't meet a margin call, you will lose your portfolio." He looked at me with a dazed expression. It was clear to me that he had never considered the possibility of a down market.

I decided to try a different tack. "Tell me, then, how much *is* enough?" I explained that "enough" is the amount of money that will achieve your goals. When you arrive at this figure you should change from an aggressive and risky strategy, to a conservative and protective strategy.

"Actually $1,400,000 is enough," he allowed. "It would be enough that I could feel secure that I would not have to work again."

"Then you should sell enough stock to raise at least $400,000 in cash to meet any margin calls if the markets were to drop 30%."

"But if I did that," he cried, "I would have to pay capital gains tax."

"Yes, you would," I admitted, "but didn't you tell me that $1,400,000 was enough? There is a price to pay for safety."

He pondered my comments for several minutes, and then stated reluctantly, "I don't think I am willing to pay that tax. But, I will think over what you are telling me."

"In that case," I said with mock solemnity, "I would like to explain to you your own investment strategy, which you appear to be unaware of. Your investment strategy is," I took a long pause for effect, "<u>I will invest like this until I go broke!</u>"

In fairness to this investor, he did try. He sold off some stock and covered part of his margin, but his portfolio continued to grow dramatically, so he went back fully on margin. Over the next 8 months he made an additional $800,000. It turns out I was wrong about the market going down 30%. Over the next 3 years technology stocks lost 80%. He lost his entire portfolio of more than $2,000,000 (at its peak) and ended up suing his broker. The judge agreed that his broker was negligent, but also ruled that he was a sophisticated and well educated investor so he had to be aware of the risks he was taking. In the end, the judge awarded him $25,000. I don't know what it cost him to pursue the suit.

Moral: We cannot predict with certainty what event will burst the bubble. We can, however, recognize when we are in "bubble territory" by investor psychology. Once **Cyclical Markets** are being treated as though they will never go down we know we are in dangerous territory.

What does "bubble psychology" look like?

The September 2005 *Journal of Financial Planning* contains an article that is so stupid it has to be a bullhorn warning about the top of the real estate bubble. This article tells me how to make extra money for my client as well as extra money for myself by encouraging him/her to take out a supposed "1% mortgage" on his home and invest the money with me. I invest the money he borrowed at 8% in an equity indexed annuity, which is tax sheltered, and thereby build my client's retirement nest egg. After 5 years he refinances his home and does it all again. Only a "bubble psychology" could overlook the dangerous, unexamined assumptions made by this writer. Let me list them for you.

Stupid assumption number one: You can get a loan that only costs 1%. Actually, only the payments are based on 1%. The loan is actually a variable negative amortization loan with the unpaid interest accumulating. This interest starts at 5.35% but could easily go up to 8% or more if interest rates rise. This unpaid interest is added to the loan and comes due at the end of 5 years. How can I make any money for my client if his debt is likely to increase by as much as I make him?

Stupid assumption number two: Variable interest rates will not go up in the next 5 years. Hello?! Aren't interest rates going up right now? If they do go up, my client will owe a lot more in 5 years than he currently thinks. He may not have enough equity to refinance in 5 years. Even if he can refinance, he might not be able to make the payments on a larger loan at higher interest rates.

Stupid assumption number three: Housing prices won't fall in the next 5 years. The article points out how my client can simply refinance at the end of the 5 years when the deferred interest comes due. What if housing prices drop just a little bit? If so, he may not have enough equity to fully refinance. What if they drop a lot?

Stupid assumption number four: The stock market will continue to grow by an average of at least 10% over the next 5 years. It may grow, but, then again, there could be a setback. This strategy only makes sense if we can <u>count on</u> the stock market growing more than my client's debt is increasing.

Stupid assumption number five: Equity index annuities will earn more than 8% average over the next 5 years. Even in good markets equity index annuities very seldom average 8% over 5 years. Life Insurance Company of the Southwest has one of the best equity index annuities and they publish their ongoing results for every month they have been in business since 1996. They have typically averaged between 5% and 7% over 5 year periods.

Stupid assumption number six: My clients won't sue me (and deserve to win) when this low probability, extremely dangerous investment scheme collapses. I am simply astounded that the *Journal of Financial Planning* could publish such an article without a disclaimer stating: "Warning. Following this advice could be devastating both to your client's well-being and your business future."

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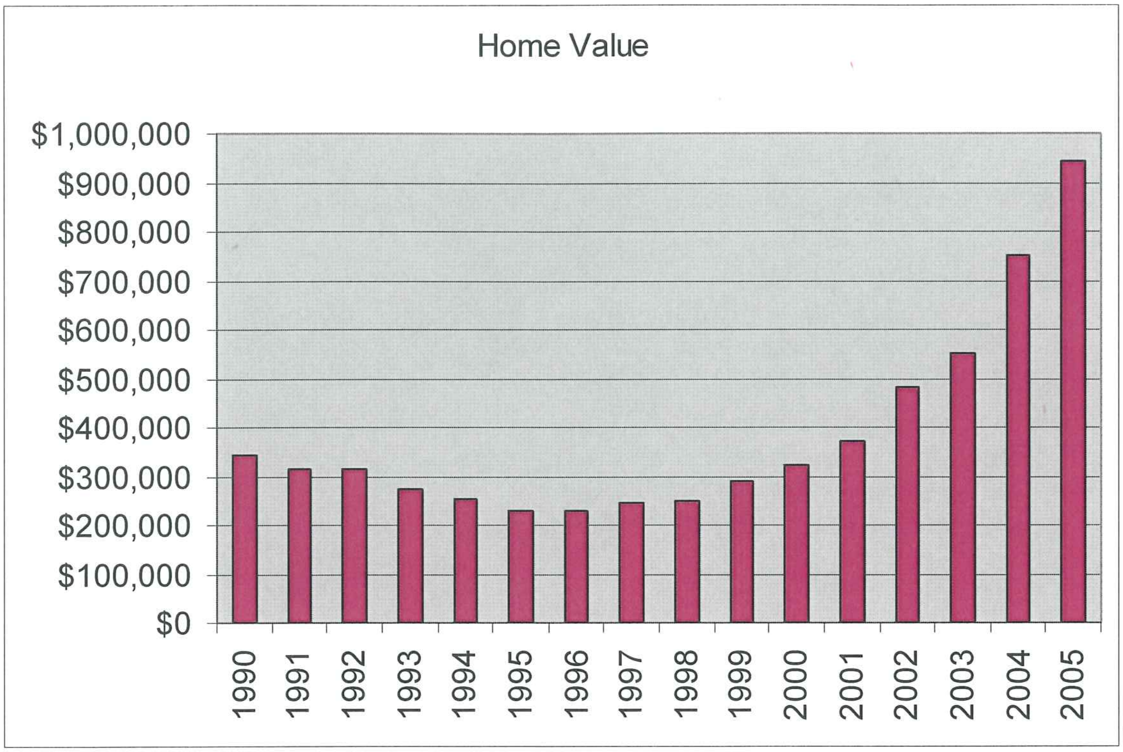
What does a real estate financial cycle look like?

One problem with financial cycles is that they typically last longer than most investors' attention spans. Let's look at the most recent real estate cycle using the value of my own home. We bought it in 1991, just after the last real estate cycle peaked in 1990. Its prior appraisal was $342,000 and we bought it for $315,000. It continued to go down in value, reaching a floor of $228,000 in 1995. (I petitioned the county and got my tax base lowered every year to 1995.) It stayed there through 1996 and then started climbing slowly back, and the county started to raise my appraisal every year. By the end of 2000, it had reached $323,000 so I finally had a $8,000 "profit" after 10 years! During the next 5 years it tripled in value. This September 2005 I got an appraisal of $942,000! See chart with the 15-year history below. Do you think the next 5 years will look like the first or the last 5 years on this chart?



What could cause the real estate bubble to burst?

Just as a bubble feeds on itself on the way up, it feeds on itself on the way down. Basically bubbles burst when something finally triggers a tipping point in market psychology. The source and the timing are impossible to predict. It can be caused by macro events such as a slight recession or a change in tax laws. It can also come from one or more of the imbalances in the market place finally giving way. Here are a few of the current indicators of a market over extended.

- 14% of California households can afford a median priced house as of August 2005.[1] Who is going to buy your high priced house?
- 63% of the dollar volume of all loans made in the second half of 2004 were non-fixed rate loans.[2] How many will have trouble when their payments increase?

- $1.3 trillion of adjustable rate mortgages face their first payment increase in 2006 and 2007.[3] This compares to only $83 billion in 2005. It represents 20% of all outstanding mortgages. How many will have trouble with their higher payments?
- 38.1% of home buyers in 2005 put down less than 5%.[4] If housing prices drop, how many of these borrowers might leave and give the house back to the bank?
- 40% of California homebuyers exceed the Federal Guidelines on home expenses.[5] The Federal guideline recommends paying no more than 30% of your pretax income to housing. The last real estate boom peaked in 1990 at a high water mark of just 36%. How many of these homeowners will get into financial trouble?
- Renting is now 50% cheaper than buying in both New York and California according to a recent study.[6] This is after they factored in the tax savings as well! If there is no appreciation in price for a while, how many people would like to cut their housing expenses in half by being renters rather than buyers?

When the real estate bubble collapses, how will that affect our other investments?

Real estate is a big factor in the economy, so it will have a temporary negative effect. However, in all of your portfolios appropriate steps have already been taken to help mitigate against an extreme market decline, such as: tactical allocation, guaranteed accounts, diversification and superior money managers who will continue to do their jobs. As always, we welcome the opportunity to discuss your individual situation. Call us any time we can be of service to you.

Sincerely,

Michael Coleman, Ph.D.
Registered Investment Advisor

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[1] California Association of Realtors. LA Times. October 7, 2005
[2] Mortgage Bankers Association. LA Times. September 18, 2005
[3] ibid.
[4] SMR Research. LA Times. August 28, 2005
[5] Public Policy Institute of California. LA Times. August 28, 2005
[6] New York Times. September 25, 2005