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What is the True Value of Desirable Real Estate?

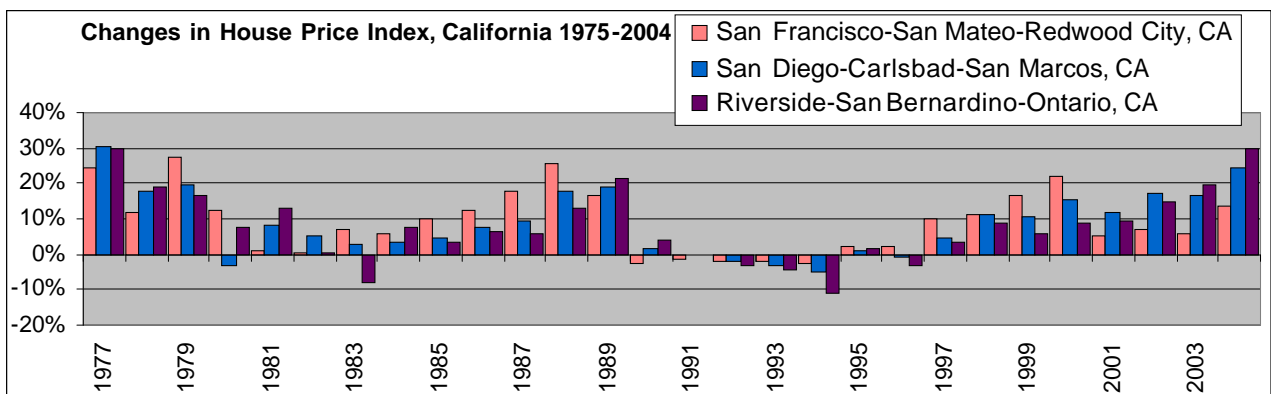
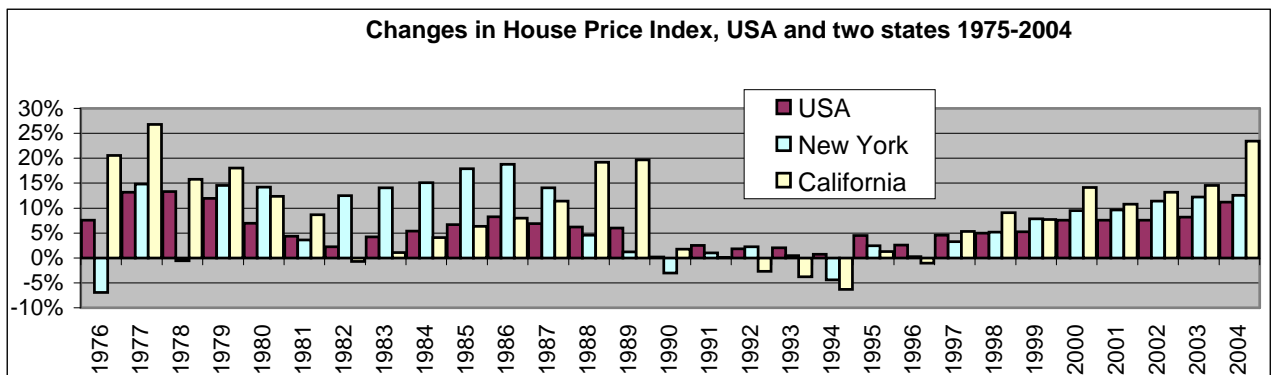
By Gil Hanoch, March 7, 2005

We have all heard about people that purchased properties 5 years ago and doubled the value of their homes. Some of you are in this group of lucky people. If you have any money to invest today, you might be asking yourself: should I jump on the bandwagon and double my own money in the next five years? Is this the new face of real estate or is the bubble going to burst?

After getting many requests to write about real estate as an investment (not as your primary place of residence), this article will look at residential real estate, with specific attention to desirable locations. It will start with a historic perspective, and then offer my personal observations.

Data

Growth. Below is the growth of real estate from 1975 to 2004. The first graph presents the US as a whole, California and New York. The second presents 3 locations in California.



Source: Office of Federal Housing Enterprise Oversight (OFHEO)

The average long-term growth and growth in the last year are presented below.

Location	USA	California	New York	Riverside-San Bernardino-Ontario, CA	San Francisco-San Mateo-Redwood City, CA	San Diego-Carlsbad-San Marcos, CA
Annual Growth 1975-2004	5.9%	8.2%	7.5%	7.37%	8.77%	8.42%
2004 Growth	11.2%	23.44%	12.6%	29.58%	13.77%	24.41%

Historically, real estate grew at an annual rate of about 6%-9%, depending on the location measured. In 2004, the growth rate reached 11%-30%.

Cycles. In the limited history available we can see 2 real estate cycles, averaging 15 years. The recent recession in the 1990's lasted up to 10 years from decline to recovery.

Mortgages. As home prices go up, more people are using adjustable rate mortgages, in order to afford buying a home. Some mortgages allow for payments that are much lower than the accruing interest rate for the first few years. After the fixed period, the loan amount is bigger and the payments increase rapidly.

With mortgage rates near long-term lows, and the federal rate increasing, mortgage rates should go up and increase the cost of borrowing. This, in effect, raises the price of the houses and makes them less affordable.

Investor activity. Investor activity had grown in the residential housing market, as noted in the December 14, 2004 meeting minutes of the Federal Open Market Committee: "speculative demands were becoming apparent in the markets for single-family homes and condominiums". In March 1, 2005, The National Association of Realtors reported that investment home sales increased by 14.4 percent in 2004 compared to 2003.

Affordability. In recent years home prices grew much faster than income, making homes less affordable.

Supply vs. demand. According to data released on February 28th by the U.S. Department of Commerce, the supply of homes increased by 20.5% from January 2004 to January 2005. Sales in the US as a whole and in the North East declined, while they kept increasing in the West.

Change from January 2004 to January 2005			
Region	USA	West	North East
Sales	-4.2%	16.6%	-33.7%
Supply ¹	20.5%	Data Not Available	

¹Ratio of houses for sale to houses sold.

Observations

The US as a whole. In the past year, US home prices appreciated by 11.2%, nearly double the historic pace of 5.9%. There are several possible explanations for the accelerated growth in recent years. In 2000 to 2002 the stock market crashed, positioning real estate as a stable and secure alternative investment. In the meantime, interest rates reached 40 year lows, significantly reducing the cost of houses. As demand increased, house prices went up. This gave lenders the opportunity to come up with more sophisticated loans, letting people pay very little today and more in the future. These loans let people keep buying homes despite the high prices.

As the stock market is recovering, interest rates are going up, and the affordability is going down, real estate is becoming less attainable to many people. More of the buyers are investors and speculators who are hoping for continuing rapid growth, based on projections from recent history.

Based on 2004 supply vs. demand data and the other factors mentioned above, it shouldn't be surprising to see the US real estate market resume its long-term pace, or even a slower pace for a few years.

High growth areas. In high growth areas, the recent trend is much more emphasized. The 2004 growth was up to nearly 30%, quadruple historic averages of about 7.5%. Many claim that it is due to physical boundaries that limit supply in some of these areas. They say that the US market as a whole may go back to historic averages, but not places with limited supply. Good examples are the San Francisco Bay Area and the coasts.

At first, this sounds convincing, but it implies a very unique future. The price difference between the coasts and the rest of the US will keep growing. Assume half of last year's growth moving forward, or 15% compared to 6% throughout the US. With this difference in growth, the price difference will grow 3,500 times bigger in 100 years. If today a \$100,000 house in Nebraska can cost \$500,000 near the coast of California, the same house would have to cost \$1,750,000,000 in 100 years compared to \$100,000 (all in today's terms). That would give the coastal homes the same value as 17,500 homes in Nebraska, and California would be full of billionaires.

My conclusion is that locations with limited supply that become popular can appreciate faster than other places, but this faster appreciation cannot be sustained forever.

Historically, US real estate as a whole did not decline for any calendar year since 1970. The high growth areas did decline during recessions. This goes along with the behavior of investments in general: in order to achieve high returns, you have to accept high risks. Unless history is changing, a slow down in the US as a whole, could bring a bigger slow down (or even a decline) in locations that appreciated more recently.

I am not predicting anything specific, but I do claim that sustaining the recent growth has to be based on fundamental increases in home values. Below are a few recommendations that are true for real estate as well as other types of investments:

1. Invest in undervalued properties – not overvalued ones. As an investor, your goal is to make money. Don't buy a property for more than you believe it's worth. Make sure you have good reasons to expect future appreciation.
2. Do not project the future based on the past few years, especially if they are out of line with long-term historic behavior. If you think recent history is expected to continue, make sure you have a clear idea why.
3. Make sure you can afford to hold the property for a period longer than past declines. In high growth areas, the recent decline to recovery period was 10 years. In addition, there are very large transactions costs for buying and selling properties. If you can't hold the property for 15 years or more, you could end up losing purchasing power if you buy at a peak.

Note that this article refers to residential real estate investments. Specifically, buying a home as a primary residence has many additional economic and non-economic benefits, entailing different considerations.

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