



THE PETE ANDRESEN INVESTMENT NEWS

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THE REAL ESTATE BUBBLE

First, let me say that I think home ownership is one of the basics of financial freedom. I strongly support the concept of home ownership, and I believe that owning your own home is an essential component of growing wealth.

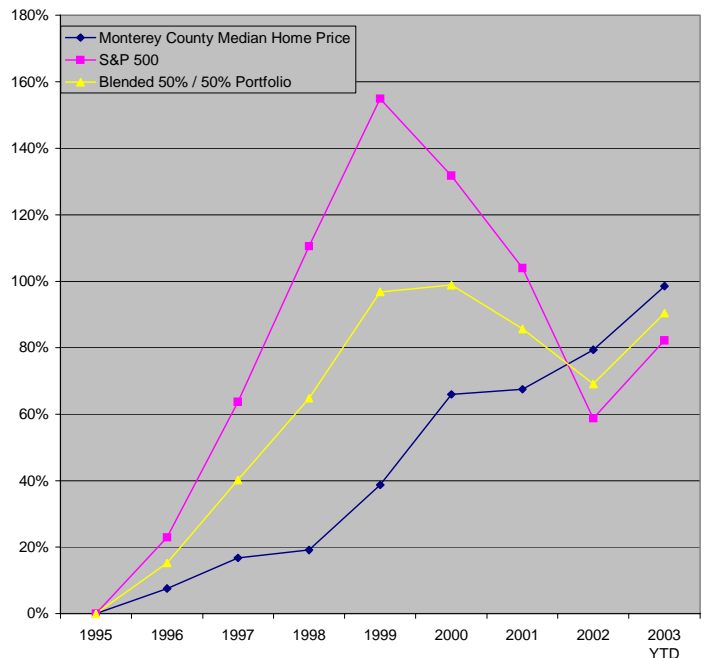
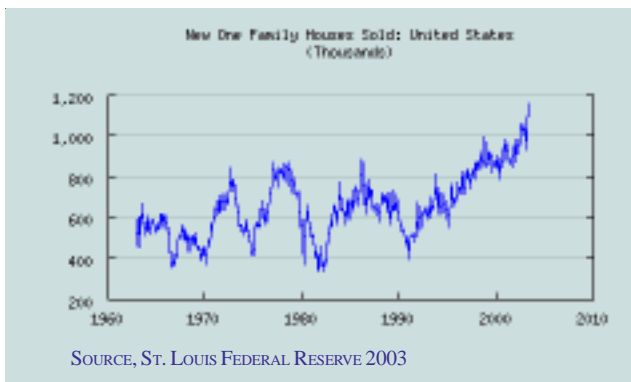
However, having said that, it looks to me like we are experiencing a runaway market in family housing which has the potential to end badly. Unlike the recent technology stock bubble, this time the market excesses are driven by the system itself. For that reason, an individual acting sensibly can still be terribly wrong.

I also believe that like all bubbles, there are several potential outcomes. Prices may continue to rise at current rates, although this is very unlikely. Home prices may ratchet up and then move sideways. This is quite possible, and in fact has been the outcome after several real estate price jumps in recent decades. Or, perhaps, prices for homes will decline for a number of years before recovering.

An even more drastic result would be fracture of the current national mortgage market. This would not only stall the housing market but would also affect the credit markets, the bond markets, and possibly even the stock markets. In my opinion the mortgage marketing system is already at risk right now. Presently we are utterly reliant upon economic improvement to avoid disaster. It is for this reason that the Federal Reserve and the White House are throwing budgetary caution to the wind and are engendering plans for such aggressive economic stimulus as even lower interest rates and immediate income tax cuts.

Housing has been a very successful investment, especially in attractive locations such as Monterey County. According to the California Association of Realtors, in one year the median price of an existing home in California has risen 14.8%. Salinas has experienced a 30% increase in median home prices in a year. In Truckee, by Lake Tahoe, the median price went up 37%, and Malibu experienced an incredible 54% increase.

Sandy Haney of the Monterey County Association of Realtors recently provided me with historical data for median home prices for Monterey County. It is interesting to note that price appreciation has not been outlandish from an investment point of view. As this graph shows, a home purchased in 1995 has grown in value 99%. The value of that home has essentially doubled. This reflects an uneven rate of appreciation, such as in 2001, when the median price of a home went up only 1%. However, we also have to take these numbers with a dose of skepticism, since they incorporate both the massive mansions of Pebble Beach and the beautiful but smaller starter homes of King City. In other words, the price performances of individual homes have differed substantially from these numbers.



During the same time period, an S&P 500 Index mutual fund increased 82%, even after the recent declines. Over the longer term, an S&P 500 Index fund has delivered results which are essentially comparable to an investment in real estate.

We have additional data going back to 1987 which shows the S&P 500 outperforming the local real estate market substantially, however we were unable to get the individual year housing numbers between 1987 and 1995. Please go to the Breaking News section at www.andresenassoc.com to see this longer term graph.

Why does it feel like local real estate has provided greater returns? If you've been a homeowner during this time, you've probably used borrowed money in the form of your mortgage. You've been controlling a very valuable investment with a small amount of money and relatively small payments each month.

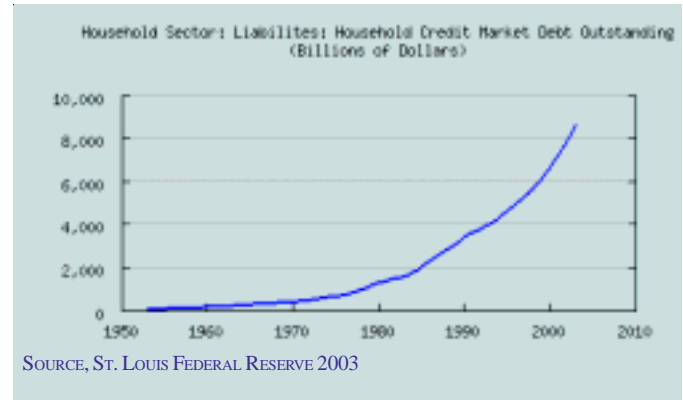
During the past year, rents for existing real estate have increased an average of 3%. Comparing rents to purchase price for real estate is analogous to comparing earnings to price for stocks. In either case you can derive a sense of relative value, a price-to-earnings or "P/E ratio". What we are witnessing is a profound rise in real estate prices without a corresponding rise in potential rental income. This is red light number one.

Red light number two is the current state of the mortgage-making system as it exists today in the US. Simply put, there is no personal consequence to lenders for making loans at maximum levels, or slightly fudging real estate loan quality. Unlike a few decades ago, most mortgages are repackaged by large, quasi-governmental agencies known by such colorful names as "Freddie Mac" and "Fannie Mae". The packaged mortgages are then sold to investors as mortgage "pass through" bonds, such as the "Ginnie Mae" bonds which many of us find in our mutual funds. As a result, mortgage brokers can arrange your refinancing at a maximum level based on the new, higher value of your home, slap on an egregiously large refinancing fee as part of your new debt, and toss the resulting mortgage to a federal institution to sell back to you as part of your 401(k). If the mortgages fail, who will do the bleeding? Not the individual lender.

You might ask why the quasi-government agencies don't do anything about this. These agencies masquerade as giant corporations in a hybrid, twilight-zone world. Their stock trades on the New York Stock Exchange just like any other private company, yet they are largely free of the reporting requirements that most corporations face. The executives of these behemoths receive stock options and giant salaries like other corporate executives. Why would they do anything to slow down any appreciation in the price of their stock? The recent investigations of "Freddie Mac", and the revelation that they are using complex financial derivatives to boost net profits, are giant wake up calls for all of us.

The third red light is our general economic situation. We are in essence living in a glorified wartime economy. Interest rates are at historic lows. As this graph demonstrates, individual debt loads are at historic highs. The economy is walking the razor's edge between growth and slumping back into recession.

Clearly something must change soon. Either the economy will begin to recover and interest rates will gradually rise to more normal levels, or the economy will not recover and frantic investing in real estate will be curtailed. Either way, there will someday be an end to the current circus. I cannot say—nobody can say—what home prices will do. All any investor can do is be careful and thoughtful, and that is what I am suggesting.



In closing, here is what I would recommend:

1. Buy "less house" than you can obtain with a maximum mortgage. Be conservative. Consider what you would do if your house fell 20% in value. Would you still be comfortable owning it? I'm not saying this WILL happen, but it might.
2. Do not use an adjustable rate mortgage, since these can go up if interest rates rise. Instead, seek out a fixed rate mortgage with minimal cash flow, even if it lasts longer. Make sure you can prepay without penalties. In this way, if your life goes well, you can always pay the mortgage off early.
3. Watch the mortgage fees! Stacking \$10,000 on the end of your refinance might not seem like much now, but after you accrue interest it's a whopper of a debt. Seek out lower fee mortgage companies. Search the loan documents for hidden fees before you sign.
4. If you must buy more real estate, buy a second rental in a geographic area where rents are still attractive. Actually there are lots of bargains out there, if you are patient and you search. Again, keep financing conservative and your cash flow high.
5. As an investor, avoid holding baskets of mortgages or Ginnie Maes as the majority of your portfolio. Right now these are attractive due to their higher yield. This attractiveness could fade rapidly if defaults increase. Stay diversified.

For more information about current Monterey County real estate, please examine the Monterey County Association of Realtors website at www.MCAR.com. You might find the MLS stats quite interesting. If studying the worst-case scenario is appealing, consider reading the book The Coming Crash In The Housing Market by John R. Talbott.

Andresen and Associates will be holding an informational seminar to discuss the possible current housing bubble on July 22, 2003 at 6:30 pm. Please call the office to confirm your attendance since seating is limited. (831) 758-1575