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A TALE OF TWO HOT TUBS

It is an ever-fading memory that two weeks ago I was in Maui, getting away from routine life. However, as so often happens to all of us, my life followed after me like a well-trained Dachshund.

I was sitting in a poolside Jacuzzi on the evening of July 23rd, in a light mist of rain. I don't usually sit in spas of any kind, on principle more than anything, but there I was. Of course, we all compared professions. I was an investment advisor. My girlfriend was a realtor. We were an instant power couple. I shudder to consider what must happen when doctors or lawyers go on vacation.

And of course there was the question. "What do you think of investing in real estate right now?" asked Janine from Portland, Oregon. Janine looked like a go-to kind of person, in her florescent orange bikini and pre-cancerous mocha tan. She looked a lot like Kathy Lee Gifford with better hair and a mai-tai.

I looked at my very patient girlfriend, a realtor of sagacity and honesty, and at first I could say nothing. She flashed her best "I dare you to go ahead and tell us what you really think!" smile through the steam. Still I remained speechless. I had been here before.

In 2000, while vacationing in Maui, I stayed for a week in this same condo complex on the northwest shore. In the evenings, just before bed, I would go down to this same poolside Jacuzzi, slip into the warm bubbling water, and gaze up at the stunning Pacific stars.

Of course, other tourists had the same idea. Inexplicably, American tourists are able to share in animated, intimate discussions with perfect strangers wherever they are.

It turned out, back in 2000, that my fellow soakers were obsessed with the NASDAQ. We were travelers in a tropical paradise, and yet our discussions centered on the happenings in Silicon Valley and the latest miracle Internet public offering. My fellow travelers were often totally invested in technology, with some individuals borrowing heavily to buy more, more, more technology stocks.

Here I was, five years after my former visit, back at the same spa. This group of soggy occupants were as frenzied as the spa's former denizens had been. The mania of 2005 was about real estate and real estate financing techniques. Many of the enthusiasts had recently invested everything they had, and everything they could borrow, on real estate they did not inhabit. Everyone was interested in buying a condominium in the complex.

For a mere \$675,000 you too can own a 300 square foot room with termite damage and a view of the ocean. The current owner of this unit has held it six months.

I have gone to Hawaii and witnessed two manias five years apart. It's worth remembering what happened to the first mania, the technology stock craze which ended in 2000.

When I went to Hawaii in 2000, the world presumably belonged to technology. The July 5th, 1999 Newsweek issue featured a cover stating "Everybody's Getting Rich But Me!" and it certainly felt that way. Prior to 2000, visiting the stair machine at our local YMCA became a traumatic exercise for me, as fellow enthusiasts would, from the safety of stationary bike or treadmill, clamor in favor of their latest dot-com.

Pundits on television or radio gravely analyzed the possibility of a bubble, or perhaps even of a bubble bursting, and gravely concluded, “This time is DIFFERENT!”

But of course it was not different. The Internet stocks imploded in 2000, the NASDAQ dropped over 70% until 2003, and the S&P 500 index declined over 50%. My clients avoided the worst of it because we largely escaped to value stocks. But many other investors have not regained their wealth to this day, and some will never be made whole again.

According to the U.S. Department of Housing and Urban Development, the current real estate bull market shows no signs of abating. Between March 2004 and March 2005, home sale prices in the Salinas metropolitan area increased 30%. Nationally, new home sales rose to an all time high in June. The boom is uneven: there are many places in rural or central states where real estate markets are not rising rapidly.

At least in Salinas and in Hawaii, this is a classic financial bubble. The trouble with bubbles is that you can identify them but you cannot tell when they are going to end. This could go on for years, or it could end within months. The bubble will end when something, such as higher interest rates, triggers a decline. The size of the current real estate bubble makes the 2000 technology bubble look small.

But how could I say that to Janine? As always, I could take refuge in statistics. I could tell her that between 1989 and 1995, house prices in Silicon Valley fell by about 30%. Or I could tell her that in Honolulu, between 1991 and 2001, the average price of a house fell by 23%. Or, I could ease her cognitive dissonance—the gap between facts and beliefs—by emphasizing the fruits of the current bubble. They are quite real, of course. Real money has been made.

Instead, I mumbled a bit about, “Of course it will be okay if you hold it long enough,” and “Wow, sounds great. Avoid ARM’s.” Then I dipped my head into the foaming water. My girlfriend’s eyes were still laughing when I came up for air.

What will happen? I don’t know that either. In 2000, everyone was convinced down to their toes that tech stocks were made of granite, that they would never deteriorate; yet many stocks were exterminated in the route which followed. Given the tremendous price inflation we have witnessed locally in recent years, it is reasonable to expect that some price decline in real estate may occur.

Meanwhile, we can learn another lesson from tech stocks. In 2000, we survived by going to unloved value stocks. Where are the unloved value investments in this real estate market? Study the HUD report: many of the unappreciated areas of the U.S. seem more attractive to me now.

Something to think about: this bubble may not break. Real estate may merely go dormant and sideways for a half-decade or so. But what if it doesn’t? What if it breaks like an oak tree in a windstorm?

Answer: there are going to be world-class bargains out there, waiting for us, if we can raise enough courage and cash to buy.

And what about the hot tub? My girlfriend and I have learned to take moonlit walks on the beach instead. The sand crabs haven’t got a plankton bubble going....yet. 🐞

“Listen up. I’ve paid a painful slug of money to learn this, so pay attention. I’m about to share my best piece of investment wisdom:

When America’s talking stocks, buy real estate; when America’s talking real estate, buy stocks.”

---Rich Karlgaard
Publisher, Forbes magazine