Inside Highlights

Productivity increases have "allowed the credit expansion to proceed apace without triggering inflation and hence warning that Fed policy" has been too loose.

—observation by Roger W. Garrison, professor of economics at Auburn University, Barron's, January 28, 2002.

Happy Holidays!

Tax and Financial Strategies

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Wealth Creation Strategies

The Real Estate Bubble, Part IV

A worldwide boom

Overvaluation of real estate appears to be a worldwide phenomenon. Until recently, prices were skyrocketing in areas as diverse as London and Sydney. The net yield on single-family residential rentals, assuming an all cash purchase, recently averaged less than 2% in Australia. Locations that we'd never dream could increase in value have joined the party. Prices in Baghdad have surged by as much as 600% in the last three years (which strongly suggests that conditions in Iraq are not as bad as the media would have us believe). While pent-up demand could explain the explosion in values in the Middle Eastern kingdom of Abu Dhabi, which recently freed up its property market, prior artificial restraints can hardly explain an initial public offering of Aldar Properties, which was 472 times over-subscribed, or the sale of 290 unbuilt villas in less than one hour.

Prices have doubled in South Africa—an entire country—in barely three years. In the last year, Bulgarian prices have increased by 50% and more than 100 lots and homes have sold for over $1 million in southern Baja, California. Prices in Shanghai, China which now has almost double the number of skyscrapers (defined as 18 stories or higher) as New York City (4,000 vs. 2,000), exceed $5 million for super-luxury apartments. Chinese builders are putting the finishing touches on 4.7 billion square feet this year alone. Granted, the Chinese have some catching up to do. However, with real estate fairs mobbed and speculation rampant, a case can be made that it's become more than a bit overdone. Fueled by 5% mortgages, average prices for 1,000 square foot homes in Shanghai have almost doubled since 1998. At $70,000, they sell for 35 times per-capita annual income of $2,000, or 35 years of income not counting mortgage interest. The conventional thinking on housing—that prices are driven by local factors—seems to have been proven wrong with worldwide monetary expansion and easy credit conditions rooted in a mass psychological belief that real estate (except for housing in Japan and Germany, where annual declines in value have become the norm) is the perfect investment.

A worldwide bust

A burst in the housing bubble could have enormous repercussions in the world economy. The aggregate value of housing is far greater than that of the stock market and fluctuations in prices may have a much greater effect on consumer spending. Ignoring Socionomic theory (which posits that economics are determined by mass psychology), such spending is unlikely to drop by nearly as much when share prices decline 20% as when house prices plunge by a similar amount. Worse, owners more frequently borrow cash against increasing home values than increasing share prices because of the perceived stability of house prices and the ability to borrow far larger amounts relative to value. As a result, borrowing against home equity as a share of disposable personal income has skyrocketed from less than 1% in 1993, to 3% in 2000, to 6.92% in 2005. Net borrowings doubled in the 2nd quarter of 2005 vs. the same quarter in 2004 and are now 16 times the average rate of the mid-'90s. This shows an enormous—and unsustainable—dependence on borrowing against homes to fuel spending and reflects a view held by some that they are sleeping inside piggy banks. The repercussions when that trend reverses could be a sight to behold. Due to households' perceptions of wealth, some argue that house prices do not need to fall at all for borrowing and hence consumer spending to slump.

A safe haven

Yet there are some relative safe havens in the United States. Values in the country's heartland are, in some cases, compelling, providing impetus for a net migration from the coasts. While so far most of that migration has flowed to nearby states, prices in many of those areas have roughly doubled in just three years. Emigrants are beginning to look further to find value. Trend watcher and futurist Joel Kotkin, writing in the *Wall Street Journal* ("Hinterland Ahoy!" Sept 27, 2005) suggests environmental and insurance restrictions in coastal areas post-Katrina may be an added inducement to such emigration. While the libertarian policy prescription of eliminating federal flood insurance and other subsidies to those who choose to build in dangerous locations is not expected, the likelihood of fewer subsidies has increased and could go far in driving migration inland.

Recent newsletters mentioned the median house price to median household income ratio in various locations. The medians in California are now roughly $569,000 and $50,000 respectively, for an unheard-of ratio of over eleven to one. In Pittsburgh, where the medians are closer to $110,000 and $45,000, the ratio is less than two and a half to one. Now that's relative value.

As a picture is worth a thousand words, it's one thing to read about price differences but another to see it. A recent investigation of a small slice of the hinterland, parts of Tennessee and Tulsa, Oklahoma, provided a graphic illustration that existing price disparities are unsustainable.

Arbitrage the price disparity

While disparities between inland and coastal areas have persisted for decades, the imbalance has increased substantially over the last five years. In a period during which prices in many interior areas have barely budged, they have more than doubled in many coastal and nearby coastal states, including California. The potential for arbitrage—selling the coast and buying the interior—has never been greater.

Five years ago, you could sell one California house and purchase two similar ones in comparable areas in the interior of the country. Today, you can sell one and buy four or five such houses. It's not that we want or need so many houses. But consider what the freed-up cash can do.

While we'll compare what I know, we'd find similar numbers in many other areas, including parts of the Carolinas, Georgia, Pennsylvania, Texas, Ohio, Illinois, Indiana, northeast Utah, and many other mid-Atlantic and upper mid-Western states. Obviously, numbers are approximate and would vary depending on management skills as well as local factors and vacancy rates.

Sell high, buy low and invest the difference

A typical 2500 square foot house in the San Fernando Valley on a half-acre lot in a good area north of Ventura Blvd. sells for about $850,000. The same house in a similar area in Jackson, TN sells for $150,000. If you made the move, you could invest the $700,000 in risk-free 10-year Treasury Notes at about 5% and earn $35,000 per year. You could also invest it in seven $100,000 rentals in Jackson, TN and take home $40,000 to $50,000 after expenses, or in commercial real estate and earn $50,000 to $60,000 in a decent year, with fewer management headaches. And it would be state income-tax-free, since TN has no state income tax.

An average 1600 square foot home in Granada Hills now sells for an amazing $500,000. The price for the same home in a comparable area of Tulsa, Oklahoma is $100,000. Property taxes are about $6,500 on the former and $1,050 on the latter. The interest payment on a $100,000 loan at 6.5% is equal to the cost of property taxes on the Granada Hills home. While the $500,000 house might rent for $1800 per month, the $100,000 home will go for $800. Although at those prices finding good tenants may be a challenge (why don't they buy?), you could purchase five and take home as much as $3,000 monthly after expenses. Or, sell California, buy Oklahoma and invest the difference in Treasury Bonds, taking home over $1,600 monthly relatively risk-free or up to $2,400 with greater risk but with some potential for appreciation in four single-family homes.

Even more unfathomable are current market values in areas like Manhattan Beach and Santa Barbara, where prices have rocketed by a factor of ten in just 25 years. A typical $1.5 million home in either area a block or two from the ocean is worth about $300,000 to $400,000 on a lake (not a block or two away—on the lake) in the hinterland. Without taking into account the tax consequences of what may be a large capital gain, the net return on $1.1 million invested in risk-free and hassle-free Treasury Bonds is about $55,000 yearly. The net return on commercial property might be $77,000, with potential for appreciation. The obviously greater risk can be reduced with proper diversification, which would be easy with that amount of money. While many people are perfectly happy living in moderate $1.5 million homes next to the California coastline, owners should ask themselves if it's worth forfeiting the income that could be earned on the equity, given their particular situation.

While moving isn't right for everyone, there are many for whom it makes sense. While my wife and I have decided not to make such a move, tempting though it may be, we have shifted some of the chips onto other tables by exchanging two of our three vacation rentals in Mammoth Lakes for commercial property in Jackson, Tennessee. Unfortunately for those of us who still own property in overprices areas, it only takes a move at the margin—in other words, a few per cent—to cause dramatic price changes in a downward direction. Recall that by the close of the market on Black Monday, 1987, investors trading only 2% of outstanding shares agreed that stocks were worth 20% less than they were the preceding Friday. While it takes far longer for a crash to occur in housing, the principle is identical: our hopes and wishes do not determine prices. The market, which is set by buyers and sellers at the margin, do.

More Indications of a Bubble

The most astonishing indication of a mass psychology run rampant in its belief that house prices cannot go down was found in, of all places, an op-ed piece in the *Wall Street Journal* September 19, 2005. In "BubbleTrouble? Not Likely," Professor Chris Mayer and associate professor Todd Sinai argued that a comparison of the cost of owning with the cost of renting proves there is no bubble. The indefensible foundation of their comparison rested on the idea that the cost of owning is "the net cash outflow required to own a house for a year...less the expected appreciation on the property." In other words, their model calls for reducing ownership costs by expected capital gains, which are, of course, extrapolated from the past. If something has increased in value, then it is always destined to increase. Using their argument, if expected gains more than offset cash outflow, it would be better to buy than to rent even if the cost of renting is zero. As Paul Jorion, a Research Affiliate of the Human Complex Systems Interdepartmental program at UCLA responded, Mayer and Sinai have "hard-wired into their model the assertion that there is no housing bubble…Translated, this means that as long as there is a bubble, prices will go up…" This is trend-following and circular reasoning at its finest.

There are numerous other flawed justifications for a new paradigm in values. One is the fact that interest rates have plummeted, making buying far more affordable. Indeed, if we are in a new permanent era of low long-term interest rates, prices of real estate should increase. However, the price gains far exceed those that can be justified because of lower interest rates alone.

Another flawed justification for specific areas such as California is, "Incomes are higher." Yes, median household income in California is $50,000, while in Tennessee it's $38,500. That would account for 30% higher prices in California, not 400%. Median income is $44,500 for the United States. That justifies California prices of 12% higher than the U.S. average, not 150%.

Clues suggesting even lenders are beginning to run scared

Numerous hints that lenders and regulators see the end of the bubble lie in actions based in fear. Among them:

1. A number of large lenders, including Washington Mutual and Countrywide, are selling most of their "option ARMS," loans that allow the borrower to defer interest.
2. Many of these same lenders are selling most "sub-prime loans" (those made to borrowers with questionable credit histories) that they originate.
3. At least one large mortgage lender, National City, has purchased credit protection on loans held in its portfolio. National City is now protected against mortgage losses that are at least twice the originally projected losses on its portfolio.
4. A number of lenders have recently announced tougher underwriting standards for new loans and a reduction in the number of interest-only loans as a percentage of total loan originations.
5. Federal Reserve Chairman Alan Greenspan recently said, "The apparent froth in housing markets may have spilled over into mortgage markets," implying that lenders may want to reduce the number of "exotic forms" of loans offered. His remarks echo the concerns of other regulators who fear that borrowers are using such loans to purchase homes they couldn't otherwise afford. Duh.

Other hints a crash could be in the offing

There are a multitude of other tell-tale signs that housing prices in many areas are approaching a peak from which a crash could occur, including:

1. According to National City, 53 metropolitan areas, which account for almost a third of the total U.S. housing market, are "extremely [over 30%] overvalued."
2. Median house prices as a multiple of median household income, which averaged about 3.3 in the three decades prior to 2000, first made it over 3.7 in 2001 and now stands at almost 5 nationwide (roughly $220,000 median price divided by $45,000 median household income). The ratio exceeds 11 in California ($569,000 median price divided by $50,000 median household income).
3. According to John Makin in an op-ed piece in the Wall Street Journal, "The ratio of home prices to incomes is two to three standard deviations above the average since 1980 in over 20 major cities, including Miami, Chicago, San Diego, L.A., Las Vegas, San Francisco, Washington, Denver and New York."
4. The price-to-rent ratio for condos (average condo price divided by average annual rent, assuming 100% occupancy) is, according to Money (September 2005), 19 in Denver and Houston, in the low 20s in Chicago and Boston, upper 20s in Los Angeles, Seattle and Phoenix, 30 in San Diego (where price increases have come to a halt) and in the upper 30s in San Francisco and New York City. Using these multipliers, the gross return on investment before expenses is 2.6% in San Francisco and 5.4% in Denver. The net return on investment is likely a fraction of 1% in San Francisco and barely over 2% in Denver and Houston.
5. The sub-prime market has increased from 5% to almost 30% of the market in just five years.
6. As we approached the late 1980s price peak in the Los Angeles area, condo prices began to appreciate at a far faster rate than detached house prices. While condos at first sold for roughly 60% of comparable houses (similar area and square footage), they ended the boom selling for about 90%

of the prices of similar homes. In June 2005, for the first time ever, the national median price for a condo was higher than that of a single-family home-$223,500 vs. $218,600. Condo prices appreciated 57% in the period 2001 to 2004 and 80% in the five years ending September 2005, while house prices nationally increased "only" 25% and 40% respectively. Condo prices tend to fall more during busts: in the late 1980s in Boston, for example, they dropped by as much as 50% over several years, while detached single-family house prices fell by half that. I would surmise two reasons for the late-stage surge in condo prices: (1) it's all anyone can afford and (2) condos are more susceptible to rampant speculation. Evidence for this can be found in Miami, where some condo towers are 75% investor-owned and where a broker of preconstruction condos recently launched a web site, Condoflip.com. Preconstruction condos are reminiscent of Internet companies with zero revenues launching Initial Public Offerings in 1999.

7. Properties sold within two years of purchase have recently comprised over 40% of total sales in two zip codes in Las Vegas and two in Miami. There's a supply glut of condos for sale in Chicago. Condo investors in San Diego are tossing in a months' free rent and other incentives, even as they lower tenant standards. Gross rent on a $190,000 condo in Las Vegas has declined from $875 to $795 per month. After an assumed monthly homeowners' association fee of, say, $250, property tax of $100 and average inside repairs of $100, the net return on investment for an all-cash buyer is a princely 2.18%. One owner figures that while he's losing $135 per month (due to a mortgage), he'll "more than make up for the losses when it's time to sell." One of a more skeptical persuasion might ask, "To whom?"

8. The number of single family homes available for rent in the formerly hot markets of Gilbert and Anthem, Arizona, doubled in the year ending March 2005. Average rents for these homes fell 5% and 9% respectively. House rents are down 20% in Fairfield County, Connecticut. This is a countrywide phenomenon, even if it bypasses the midsection. The number of vacant single-family homes stands at a record 1.4 million.

9. As a contrary sentiment indicator (wherein the opposite of what the herd suggests is often the most profitable course of action), the percentage of M.B.A. students enrolled in real estate related courses at three schools of business offering such classes increased from barely over 30% in 2002 to over 50% in 2004. Membership in the National Association of Realtors, which was increasing at less than a 1% clip in 2000, surged by 35% in the three years leading up to 2005.

10. Another such indicator: chief economist of the National Association of Realtors David Lereah recently said, "If you paid your mortgage off, it means you probably did not manage your funds efficiently over the years" and you are likely "very unsophisticated." Anthony Hsich, chief executive of Lending Tree Loans, used a more disparaging term: "If you own your home free and clear, people will often refer to you as a fool." While there are numerous reasons to use borrowed funds, particularly from loans against one's home, it is not categorically the optimal way to go for every person in every age bracket. I hope that someday I, too, will be considered a fool in Mr. Hsich's eyes.

The Pros and Cons of Investing in Land

Investing in vacant land is generally inadvisable for a number of reasons. Among them:

1. Vacant land produces no income.
2. Interest paid on a loan to acquire the property is typically not currently deductible.
3. Because the cost of selling land averages 10%, the land needs to increase in value by 11% before breaking even. (A $100 parcel must increase in value to $111 to pay a 10% commission and still yield $100.)
4. If using borrowed funds, the value must increase by the total cost of funds plus buying and selling costs. The average increase per annum must equal or exceed the annual cost of funds plus buying and selling costs amortized over the holding period. If, for example, the entire cost is borrowed at a fixed 6% per annum and five years later selling costs of 10% are incurred, the value needs to increase by a bit over 8% per annum just to break even, or a total of 48% compounded. This assumes the interest is deductible in the year of sale. If structured so that it's currently deductible (not always possible), the required return is a bit less; if not deductible even in the year of sale (which is possible), the required return is greater.
5. The value of land needs to increase by at least 7% per year to equal the net yield of a well-priced rental property that does not increase in value. That means there is little room for error in the selection of vacant land. Due to compounding, if the land doesn't double in value in 12 years, you probably did better with rental property that stayed flat but which earned net rents of 7% yearly. (The effect of compounding and current differences in taxation of capital gains vs. rents, which would otherwise allow a lower return on land to break even, is probably offset by holding costs including property tax and land maintenance.)
6. In real life, I have rarely seen a client make a substantial return on vacant land.

Despite these caveats, when recently consummating a tax-deferred exchange into a $328,000 commercial property in

Tennessee (a hint of value: it's 5,600 square feet), my wife and I were ending up with a small amount of taxable boot. Preferring to avoid tax on the entire amount, we thought about adding an $85,000 rental house (a darling 2 bedroom 1 bath home in a good area of Jackson, TN) with a small mortgage to the exchange, but balked at buying residential income property. We were also considering leveraging up in order to purchase another commercial property, but my wife has a lower tolerance to leverage than do I. That's when I realized that land was inherently leveraged: land is to developed property what options are to stocks. We can see this by using an example.

Let's take an area with $200,000 houses where the cost of construction is $180,000. The land value must be, therefore, $20,000.

Say the houses in that area appreciate to $300,000. In many areas with fantastic price appreciation, the cost of building the house has not increased. Therefore, the entire increase in value must be in the land. If the cost of construction remains at $180,000, the value of the land must have sextupled ($20,000 to $120,000). Yet, existing house prices have increased by "only" 50%. Even in more realistic times, if the house price went up just 10% to $220,000, the imputed value of the land doubled (from $20,000 to $40,000). In effect, if you purchase a $20,000 lot in an area of $200,000 houses that cost $180,000 to build, you are controlling $200,000 worth of real estate. That's leverage.

It's very similar to owning an option on a $50 stock for which you pay $5. Although imperfect (you might pay $5 for the right to buy the stock for $53 a year from now), the principle is similar. If the stock price increases to $100, you doubled your money by owning the stock. The $5 option on that stock increased in value by a multiple of almost ten.

Of course, like any other leverage, this all works in reverse. The economic value of land with $180,000 houses that cost $180,000 to build is zero, even if it will never (due to speculative purchases) become worthless. Hence, the caveat: because it is so easy to buy near the top of markets where the herding instinct takes hold, I have rarely seen a profit earned on the sale of vacant land. And now, speculative excesses have bid up the value of land, even in areas of the country exhibiting little speculation in housing. An isolated area of West Texas, for example, sold for $65 an acre as recently as February 2005. Buyers are now paying as much as $800 an acre, induced by Internet come-ons and seminars offered by promoters in far-off cities. The economic value of this land is zero if, as is exceedingly likely, nothing in the town of nearby Valentine (population 217) sells for more than the cost of construction. The nearest city is El Paso—160 miles to the west.

Nonetheless, the purchase of land can be viewed as a leveraged purchase without the tenant risks of a rental. A $10,000 parcel can be considered a valid alternative to a $100,000 house which, after accounting for all costs including mortgage and opportunity cost on any down payment in excess of the cost of the land, has a net loss equal to property taxes and land maintenance costs. It can also be viewed as a diversification in a large portfolio of real estate, or if low-valued, a small diversification in a small portfolio. An investor with $1 million in income-producing real estate can make a rational case for owning $50,000 in land. One with $200,000 could easily argue for $5,000 or $10,000 in land.

Oh, we bought some land. The tax cost of not buying (due to "boot" from the exchange) reduces the net growth in value required to break even to about 4% per annum. And it's in Tennessee, not California. Joining Nissan Motors, which recently announced they're moving some of their operations from California to Franklin, TN, I'm betting we're in good hands.

Oil and the Enabling of Despots

I must admit to some irritation over the demagoguery over the "windfall profits" oil companies have recently earned. The annoyance is related to a number of observations. In no particular order:

1. The median rate of return on investment for the Big Oils has been below the median return for the S & P 500 for 16 out of the last 20 years. No one railed against their meager profits during those 16 years.

2. People squawking about oil company profits are often the same who"ve supported limits on drilling for oil anywhere except the Gulf. The resistance persists despite the fact that there have been no oil spills from drilling platforms or pipelines in decades, even with category 5 hurricanes passing over them.

3. Those howling are also frequently the same pseudo-environmentalists who have done everything possible to prevent even one new refinery from being built in the United States during the last 30 years.

4. Few if any of those haranguing Big Oils about high costs fail to decry the Big Waters for the cost of water. Evian, for example, sells for roughly $21.19 per gallon.

5. Compare a person living in a $300,000 house that"s increased in value to $600,000, with the shareholder of a company pumping oil out of the ground and converting that oil to energy. How much new wealth (usable things for current consumption or investment) has each created? It"s pretty obvious. Yet, no one complains about the completely unearned profits gained in housing over the last five years, nor is any demagogue threatening to impose a "windfall profits tax" on such gains.

6. Between 1977 to 2004 total taxes on fuel sales amounted to over $1.3 tril-

lion, more than double the roughly $640 billion of oil company profits over that time, out of which another $200 billion plus was paid in income taxes. The question is, have you received as much value from the various levels of government levying those taxes than from the oil companies providing us fuel?

7. Who has provided you greater value: politicians touting envy for the oil companies, or entrepreneurs who, in their quest for profits, have figured out ways to drill for oil thousands of feet into the earth under thousands of feet of water and convert that oil into usable energy?

8. The Big Oils of Exxon Mobil, BP and Chevron Texaco have proven reserves of 12.9 billion, 10.1 billion and 8.6 billion barrels respectively. The state-owned monopolies of Saudi Arabia, Iran, Iraq, Kuwait and Venezuela have reserves of 259.4 billion, 125.8 billion, 115 billion, 99 billion and 77.8 billion barrels respectively. Yet, those protesting the loudest never do so about these really Big Oils. Worse, these oil companies fund and enable monarchies, oligarchies, de facto dictatorships and despots, some of whom have waged war on others. The private ones, which have never waged war on anyone, fund your pension plans. I"ll take the latter any day over the state-owned ones, with as large profits as they can reap.

Business Mileage-Rate Confusion for '05

The optional business mileage rate was 37.5 cents per mile for 2004. The IRS, which bases the rate on the average nationwide cost of operating a car, set the starting rate for 2005 at 40.5 cents per mile. Recognizing that it's difficult for businesses to shift gears in the middle of the year and get the news out to those using cars for business to take down a mid-year odometer reading, they rarely change rates part way through the year.

This year, however, fuel prices and natural disasters put too much of a strain on the economy, compelling the IRS to announce a rate increase, effective September 1, to 48.5 cents per mile. Unfortunately, we'll have to deal with the added complexity when preparing tax returns for 2005. Taxpayers who use the optional rate will have to provide us with not just the usual beginning and ending odometer readings, but also one for September 1. The trouble is, not everyone knows whether they'll use the optional rate or actual expenses of operating the vehicle until preparing the return.

The medical mileage rate, which was 14 cents per mile in '04 and 15 cents at the beginning of '05, was increased to 22 cents per mile effective September 1. The charitable driving rate remains, oddly, at 14 cents, except for those donating the services of a car in the Katrina relief effort. The deduction for Katrina relief during the period August 25 to August 31 is 29 cents per mile. From September 1 to December 31, it's 34 cents per mile. Good thing Congress knows it's supposed to keep in mind the idea of keeping things simple. The usual disclaimer applies: I couldn't possibly make this stuff up.

Year-End Planning Opportunities

There's no need to re-invent the wheel when the article in the November-December 2003 edition of Wealth Creation Strategies, "Year-End and Upcoming Tax Season Tips," which can be found on the web at www.DougThorburn.com, says it all. Among the planning suggestions that apply every year:

1. Make a note of the odometer on your business-use vehicles on 12/31.

2. Submit your 1099 data to us by January 10 for those to whom you paid over $600 in the course of operating your business or rental property during 2005.

3. Begin thinking now about how much you'd like to invest in an IRA or other retirement plan. Because deductible IRA limits for those in other retirement plans have again been increased, the opportunities for tax savings are better than ever. It may be the last year for the Low Income Savers Retirement Credit, which is one of those "no-brainers" if it's available to you. Save for the occasion.

4. Prepay any state income and property tax due if in a 25% tax bracket or higher and NOT subject to the Alternative Minimum Tax.

5. Donate your old goods to charity and make any other donations you were planning to anyway if itemizing and in a high enough bracket. Keep in mind, too, the idea of "bunching deductions" (page 3 of the Nov-Dec '03 letter).

6. Purchase business equipment now that you are planning on buying soon anyway if the tax savings is large enough.

7. Those who are usually in higher brackets should do what they can to create income to use up zero and low tax brackets. The most effective tool for this is the IRA to Roth conversion.

You may wish to avail yourself of our year-end counsel for the last five items. The idea of using up the zero-bracket, especially, is an oft-overlooked planning opportunity for which you will need our help. Call us now if you think it may apply and we will calculate the optimal amount of additional optional income production.