The Centurion

COUNSELOR

Vol. 14, No. 1, July 2005

UNDERVALUED SECTORS (CONSIDER!)

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- DIVIDEND STOCKS
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OVERVALUED SECTORS (AVOID!)

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- CALIFORNIA MUNICIPAL BONDS
- JUNK BONDS

Real Estate Is More Popular Than Sex

It is difficult to have a client meeting these days without the subject of Real Estate coming up. Most realize that it is overpriced but, in the same breath, mention a relative, a friend, hairdresser, or barber who is making a killing in Real Estate. This reminds us of the hype and breathless speculation during the dot.com bubble; what Alan Greenspan appropriately referred to as “irrational exuberance.” Think we’re exaggerating? Try googling “sex” and “real estate”. To our amusement (but not surprise), the word “Sex” had 79.1 million hits; “Real Estate” had 108 million. Using advanced ciphering, we conclude that real estate is currently 36% more popular than sex. For bubble comparisons, It’s important to note how this overzealousnous has translated to the financial markets. In 2000 during the dot-com boom, REIT stocks traded at 1/3 of the price-earnings ratio of the S&P 500. Today, they trade at the same multiples. For most of the past 40 years, the cap rate on income producing real estate was in the 8 ½ to 10% range while today, it is under 6% and, in areas like Southern California, under 5%.

The Federal Reserve is attempting to use the bully pulpit to reign in both residential and commercial speculative real estate lending. Last year, we concluded in a report that housing wasn’t in a bubble but could become one in some markets. We now confess to being concerned about a bubble, due in part to the information above but more so by some troubling statistics regarding investor behavior. In this article, we rely on a report written by James Montier whose prior book ‘Behavioural Finance’ detailed investor psychology. Mr. Montier believes that “the increase in sub prime lending (lending to those with blemished credit histories or unusually high debt to income ratios) has seen a meteoric rise.” Currently, sub-prime lending accounts for nearly 17% of all home equity lending. Interest-only home loans are nearly 40% of all loans written today. This is very similar to the increase in margin lending during the stock market bubble. Investors at that time felt that the use of high leverage was nearly riskless.

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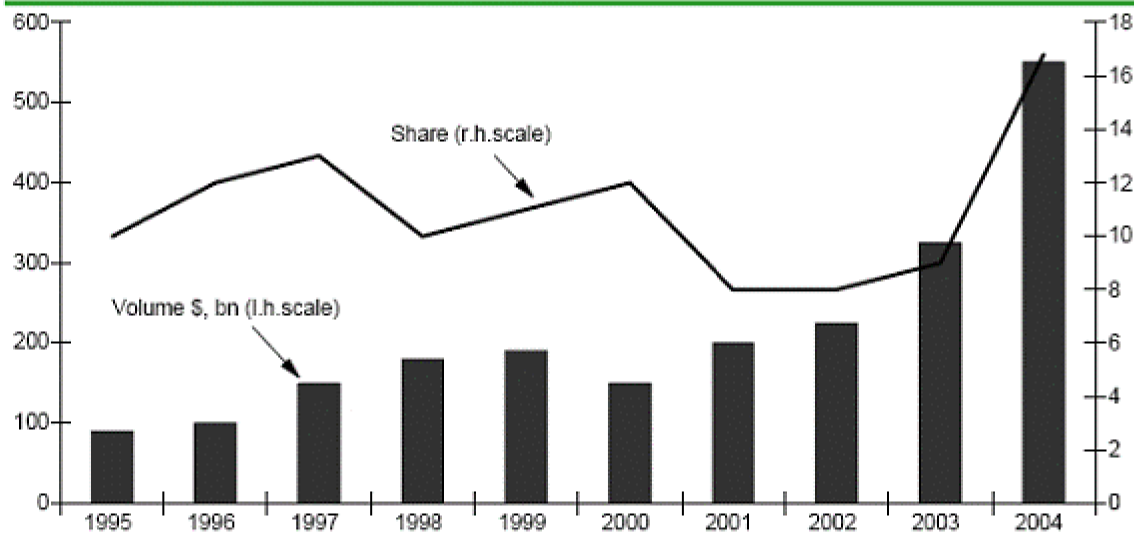
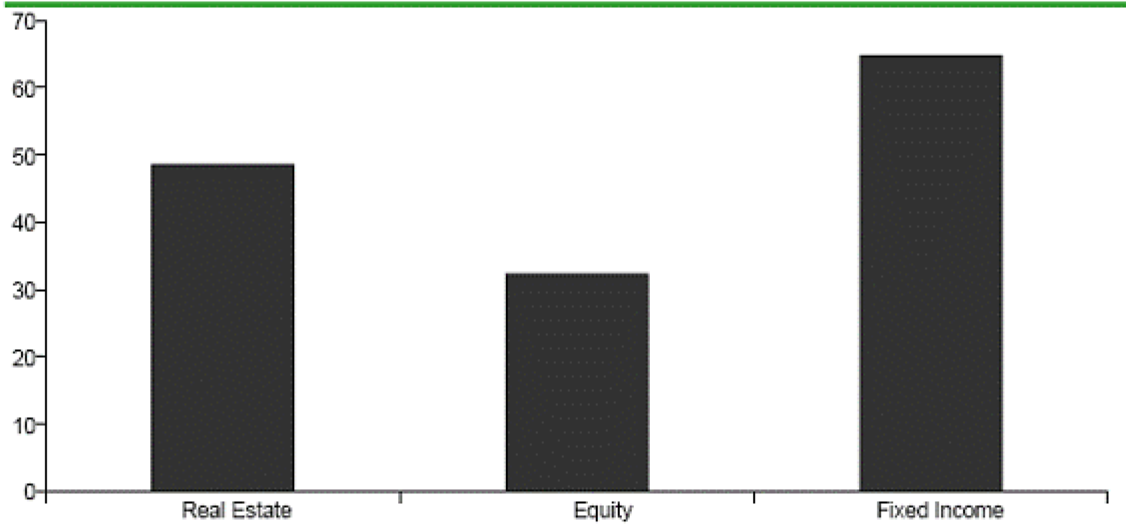


This same attitude prevails in housing today. Investors were recently asked if a crash is either 'not at all likely' or 'not too likely for the following asset classes, Real Estate, Equities and Fixed Income. "As the chart below shows, investors still have tremendous faith in fixed income with nearly 65% believing a crash is unlikely. 50% think a crash in real estate is unlikely, and 30% think a crash in equities is unlikely. The high percentage of those disbelievers in a real estate crash is surprising given the immense amount of press coverage that housing market seems to be generating!"

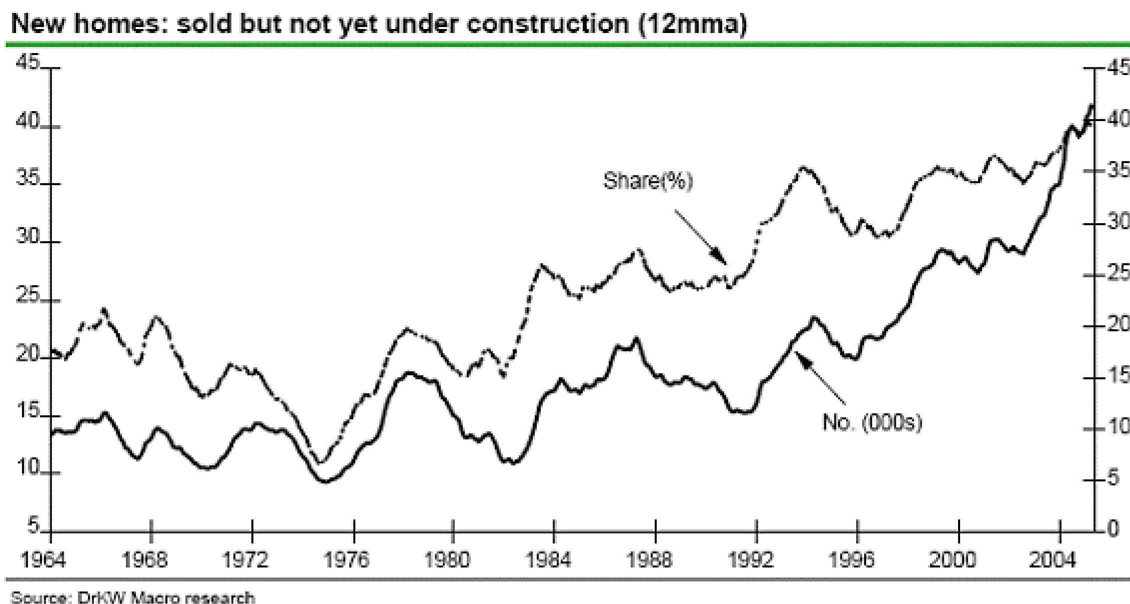


Evidence of loosening standards is also fairly typical of a bubble. For instance, investors were happy to buy firms with no track record of earnings and value them on the basis of clicks and eyeballs during the dot.com years. Within the housing market, we can find evidence of a general easing of standards. The percentage of loans with a loan to price ratio above 90% is 18% as new measures of financing have become increasingly popular. 35% of mortgages are now adjustable rates (ARMS), leaving borrowers very vulnerable to rising rates.

Other exotic mortgage types have become increasingly common. Interest-only mortgages are now commonplace. Negative amortization loans are easily available. These beasts allow buyers to pay less than the interest due, and the balance is then added to the principal repayment. Indeed 105% loan to value mortgages are also available, so buyers can cover the costs of buying!

The final characteristic of a bubble is people buying simply because prices are going up (the greater fool element). According to the National Association of Realtors, 23% of all home purchased in 2004 were for investment, while another 13% were vacation homes. They also found that 92% of all second homebuyers saw their property as a good investment. 38% said it was very likely they'd purchase another home within two years.

A simple but worrying proxy for speculative buying in the housing market can be found by looking at the number of new houses that have been sold but are not yet under construction. This category now accounts for 40% of all new home sales.



Surely this evidence amounts to a *prima facie* case that the US housing market is undergoing a bubble. The bulls rely on arguments on immigration and demographics to support their views. However, with a home ownership rate of 70%, these amount to little more than betting that prices will keep rising. Of course, bubbles can and do run for longer than everyone expects them to do. But the US housing market is looking increasingly vulnerable to any change in 'fundamentals' (interest rates and unemployment tighter lending standards) or sentiment.

Retirement's Reckoning

In a prior issue of the Counselor (Q3-2004, available on the website), we reported on the pension problem in the city of San Diego. A recent report, entitled 'The Gathering Pension Storm: How Government Pension Plans are Breaking the Bank and Strategies for Reform' by George Passantio and Adam B. Summers of the The Reason Foundation, discuss how severe the problem is nation wide.

Most Californians are aware of San Diego's $2 billion pension deficit. This "financial mismanagement" led Time Magazine to name Mayor Dick Murphy one of the nation's three worst mayors, and eventually resulted in Murphy's resignation less than five months into his second term. If the pension deficit isn't bad enough, tack onto that our state's teachers' retirement system shortfall of around $24 billion.

Many other places are experiencing the same pension difficulties. According to Reason, the State of Illinois faces a $35 billion pension deficit. West Virginia's is $3.5 billion along with $3.3 billion in workers' compensation liabilities — these together are nearly triple that state's annual budget. According to the report, private pension plans in America are short between $400-$500 billion with Governments exposing tax payers to an additional $350 billion in unfunded pension liabilities.

Clearly, public defined-benefit programs have the intrinsic flaw in that no one is accountable for either the performance of these funds, nor the promises made to future retirees. Legislators can pile on benefits knowing that they will likely be out of office by the time the public catches on. A much better way to fund public sector retirements is to do what the private sector is doing more often: have new workers participate in a defined contribution model. From a policy standpoint, the advantage of a defined contribution system, where the government could match employee contributions to a 401k plan, is that it provides the most stability for budgeting since the contribution levels are known. Under defined pension plans, if a plan is mismanaged or unsustainable promises are made, we see the incredible volatility in what the public is asked to pay. Plus, under defined benefit plans, individuals would no longer have to worry whether those who are managing their money are using funds to fight partisan battles against corporations that have nothing to do with the secure retirement of their customers.