

Market Commentary

Bubbles and Leverage

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Imagine it is March 2000 again. Tech stocks are running wild and there is seemingly easy money to be made. You decide to take advantage of this boom by buying tech stocks equal to 2 times your available capital by borrowing 50% of the money (the maximum allowed).

This sounds pretty risky. In hindsight we know the NASDAQ declined about 80% from its March 2000 high. Your savings would have been completely wiped out if you couldn't have quickly sold out. There were a lot of people who lost a lot of money when the tech bubble burst even if they did not utilize any borrowed money. Certainly there were some valuable lessons learned from the tech stock implosion. The question is whether they really were learned.

Let's look at something more current – real estate. Most investors view borrowing money to buy stocks as quite speculative. However practically everyone borrows money to buy real estate. In fact, borrowing 80% of the value of a home is considered standard practice and there are many instances in which people manage to borrow even higher percentages. Additionally, as residential real estate has gone up in value, it has become much more common for people to borrow more using home equity loans.

During the tech stock boom it was common to hear people talking about how much money they made in the latest hot stock. Now, particularly in places that have seen an explosion in real estate market values, the chatter is about how much homes are worth.

Whether this is a bubble or not, it is informative to look at the reasons for the substantial increase in price of residential real estate. Most analysts think the rise in housing prices has been fueled primarily by low interest rates and a number of new mortgage structures which have enabled more people to buy more expensive homes. There are two factors which limit home buyers. One is the down payment and the other is the amount of the monthly payment. If because of low interest rates or innovative mortgage structures people are able to borrow more money, it is clear they can buy more expensive homes. Thus the number of potential home buyers increases. Basic economic theory dictates that prices will rise if demand increases faster than supply. If there is a feeling on the part of buyers that prices will

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continue to rise, there is an urgency to buy now and pay whatever it takes to get into the market before it goes higher. This supply-demand imbalance does seem to exist in the most desirable housing markets.

Does this mean housing prices are an un-sustainable bubble? We think at a minimum it presents the seeds of a problem. It was argued in March of 2000 that the old rules for measuring a stock's value didn't apply in the new economy. As we found out, they most certainly do. Whether this is the top for housing prices, we don't know. However to argue as some have that real estate prices only go up defies the rules of gravity and economics.

What are the consequences if housing prices decline? Because housing is such an integral part of the economy what happens with it reverberates throughout the economy including things such as home furnishings and appliances, home improvements, construction, and employment. Since many people have tapped their home equity for purposes other than home improvements, it also has ramifications for consumer spending. Thus even a relatively minor adjustment down in housing prices could have a very significant impact on the economy as a whole.

We're not suggesting that people should sell their primary residence because there might be a bubble. While your home has some investment characteristics, its primary function is as a place to live. Because a home is a place to live it is important not to overstate the investment characteristics of a personal residence. A home which has gone up in value may make you feel prosperous, but that prosperity is hard to realize without a substantial change in life style. Additionally using a home equity loan to finance current consumption is a very risky proposition. It is one thing to borrow against a capital asset to improve the long term value of a home. It is quite another to borrow against a home to pay for a vacation which, while enjoyable, has no lasting investment value.

It's time people realize that real estate like tech stocks in early 2000 is not the ticket to a free lunch.

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