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Interest rates are rising. Income growth is uncertain. What's a real estate investor to do?

Did you know that the percentage of U.S. households that now own, rather than rent, is at an all-time high nearing 70%? This is great news for households pursuing the American Dream, but may be not so great if you are a rental real estate investor. And, given that real property values – nationally – have run up so much, I can only imagine that households that are still renting might be considering kicking themselves right about now. As well, I am willing to bet all you can think about is how much money you would have made if you had “stuck your neck out” or “stuck your neck out further” on purchasing some real estate. Well, that sort of thinking sounds dangerously like the investors in 2000 who thought they were losers if they hadn't jumped on the technology stock craze. And we all know how that story ended!

As mentioned in our prior newsletters, we strive to provide articles on various aspects of wealth management to assist your understanding of why planning for the present and for your future has importance. Yes, we also promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

With the rumor that interest rates have bottomed out and will be heading higher in the next few months, panic over this phenomenon has begun to make an impact on the minds of people across the nation. It has many investors looking for a “safe haven” and mistakenly seems to be feeding the housing craze right now.

In this letter we won't try to make any “crystal ball” predictions about the real estate market, but we will discuss some of the economic and demographic forces that will drive the housing market in coming years, and how you can navigate them to your advantage. And, as always, we will finish with an update on our investment activities.

The Housing Market – It's Been A Great Run!

In the past five years, home prices nationwide have climbed more than 41%, according to the Office of Federal Housing Enterprise Oversight (OFHEO) – and far greater in the District of Columbia (93%), Rhode Island (80%), California (77%) and Massachusetts (76%). For comparison, the Commonwealth of Virginia enjoyed 49% home price appreciation and 51% was the reward in Charlottesville. Homeowners have tapped that equity to take vacations, buy second homes and build up their nest eggs. They have counted on rising home prices to bolster their future – and shore up their present.

But now homeowners may have to face a new reality – the party can't last forever.

Over the next five or 10 years, economists and analysts say, home prices are likely to yield a less-impressive return, while the market slows to catch its breath.

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For homebuyers, that prospect presents a new set of challenges. In the recent past, diving into real estate was a no-brainer. Interest rates were low, and there were precious few other ways to safely invest money. It was hard to go wrong no matter where you bought. Now, some of the forces that made housing so attractive have faded. The stock market has improved, and home-price appreciation has slowed across the country.

"This moderation in the growth of house prices is welcome because continued price jumps like those of the fourth quarter last year (3.7% nationally) would raise the potential for declines later on," said Patrick Lawler, Chief Economist at OFHEO.

Interest Rates

Perhaps no other factor has pushed home sales and home prices higher in the past decade than the long-term decline in interest rates. In 1981, the interest rate for a 30-year, fixed-rate loan averaged 16.63%. The monthly payment for a \$200,000 mortgage then was \$2,800 a month. Today, the average rate is about 6.25%. For the same \$200,000 loan, the payments are less than \$1,250 a month. It should hardly be a surprise that Americans bought more than one million new homes last year, up from just 436,000 in 1981.

The problem now is that interest rates are more likely to rise than fall. The economy is rebounding, inflationary pressures are beginning to appear, and the federal budget deficit is growing. All of these forces suggest rates will climb over the next few years.

Of course, no one expects rates to return to anything remotely close to the levels seen in the early 1980s. But even a slight rise in interest rates could knock some buyers out of the market. If rates go to 7%, that would add \$1,000 or more annually in payments on a \$200,000 loan.

Also, as interest rates rise, more Americans will likely choose to rent their homes rather than buy. Yet, real estate agents will tell you that a rise in interest rates will be offset by an improved economy, which should inspire more buyer confidence and more home sales. That may be true, but only to a point. As the recent business cycle proved, housing can rise to new heights during a downturn, and it needn't boom during an economic rebound. Prices were nearly flat during the first several years of the rebound in the 1990s.

For buyers, one way to mitigate the pain of higher rates is to apply for an adjustable-rate loan that starts with an unusually low rate, then adjusts higher later if interest rates keep climbing. But that increases your risk later.

Income Growth

From 1980 to 2001, median incomes in the U.S. rose 138%. Home prices rose almost exactly the same amount –136%. Mere coincidence? Hardly. Over time, home prices move in lockstep with incomes, because incomes help determine how much a consumer can spend on a home. The relationship isn't always so clear in the short term because builders add more supply if demand rises, and hold back if demand falls. But in general, if home prices grow faster than incomes, houses will then become unaffordable, and that will force a slowdown in price appreciation until the market balances out.

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That's what homeowners could face in the next several years. From 1996 to 2003, incomes rose 22%, while home prices climbed 47%. In some cities, the gap was even wider. In Boston, for example, incomes rose 40%, while home prices shot up 120%. In San Diego, incomes rose just 31%, compared with a 142% run-up in home values.

Also, low interest rates have helped mask the problem by lowering homebuyers' mortgage payments. But sooner or later, incomes will have to catch up, especially if interest rates rise.

What should homebuyers do in the face of an income gap? If you're a short-term investor with plans to buy a home and sell it again in a year or two, you should steer away from cities where the gap between incomes and prices is widest.

Does this mean you should necessarily target neighborhoods that have high average incomes? Not necessarily. What matters is the rate at which incomes are rising, not the amount of wealth that's already there. After all, income growth can easily stagnate in posh parts of town when an economy goes south. Often, the best investments are made in transitional neighborhoods that were once economically distressed but are now enjoying rapid income gains due to new investments and new jobs in the area.

Are we in a bubble? Should I sell and rent? Will I be able to use the value in my home for retirement?

OFHEO Chief Economist Patrick Lawler notes, "Last year's rise in borrowing rates may have stimulated fears of further rate increases, causing some prospective purchasers to move more quickly to buy than they might have otherwise last Fall. That sense of urgency apparently diminished last quarter after rates stabilized. It will be interesting to see what the effects of more recent interest rate increases are in the future."

Let's see if we can put housing prices in some inflation-adjusted perspective. If you bought a \$75,000 home in 1980, if it merely kept up with inflation, the home would sell for about \$180,000 today. Whereas, the national average applied to that home bought in 1980 now sells for \$232,000. Thus, roughly two-thirds of the average rise in housing values is simply from inflation.

However, if you lived in Massachusetts, your \$75,000 home is now \$462,000; in Virginia, \$243,000; and, in Rhode Island, \$346,000. California home values have risen to \$311,000, although in such a vast state, there is quite a difference in price increase between a San Diego beachfront property and the desert, to be sure.

But it is not all sweetness and wealth. If you lived in Louisiana, a small bubble might be a thing to be desired. Housing values in Louisiana have not kept pace with inflation. The average \$75,000 home from 1980 has only appreciated to \$144,000. Yet, if we look further northwest to Oklahoma, the state with the smallest rise in the US, homes have risen to only \$130,000. That means their home values rose slightly more than half the rate of inflation. In fact, from the OFHEO study, I count 16 states that have seen home values rise less than inflation over the past 24 years.

Recently, I read a story about the Los Angeles residential real estate market, which is "on fire". The story focused on a "30-something" couple that was hoping to buy a home for \$600,000. They experienced frustration through bidding against another couple that wanted

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the same home. They lost because their offer of \$500,000 had been far from sufficient. The real estate agent commented that houses that were \$600,000 last year are selling for \$1.2 million this year and anyone who didn't buy last year was locked out today.

If I were there, I would have advised them: 'Run for your lives! Rent! Move to another city! Don't sign that contract!' Of course, I would have cheered to the sellers, 'Way to go! Take the money and run!'

Is a \$1.2 million home necessarily a bad investment for that couple? Maybe and maybe not. If they expect to flip it in 2-3 years, they are taking a significant risk. They are buying after a large run-up in home values. Looking through the OFHEO tables suggest that run-ups are followed by softer periods.

But if it is their dream home - the place where they want to live for the next 20 years - and if they have the ability to make the payments in that time, then inflation and the long-term affect of paying down the mortgage should overcome the ups and downs, assuming they do not have to sell during the next recession. If California is where they want to live, if it is where they make their living, then housing is part of the cost of doing business in California.

What have we learned so far? Housing is not simply an investment decision. Parts of the housing equation are the desirability of your local market, local economic conditions, your ability to stay the course, the length of time you intend to live in your home and your own psychology.

Hoffman, White & Kaelber Financial Services Investment Performance Update

As we had advised last month, we consider the probability of rising interest rates to be more certain and expect the Fed Funds rate to continue climbing gradually over the next 24 months from the current 1% to a more normal range of 3% to 4%. We consider this a major economic event and have positioned both taxable and non-taxable client portfolios to accommodate this view. For our clients, we continue to focus on minimizing investment risk while in pursuit of seeking reasonable returns. The economic landscape may change, but our philosophy remains the same!

For the month ended June 30, 2004, our one-month performance is up 0.43%, our three-month return is off 5.33%, our one-year return is up 8.68%, and our average annualized return since inception is up 12.53%. Over the last sixteen months, we posted negative returns only once. Our (since inception) risk profile has begun its recovery from April's unexpected downward spike and edged lower to +/-7.31%. This risk level remains conservatively low and is consistent with our strategy. With an up month and a lower risk profile, our Sharpe Ratio remains a very respectable 1.58.

About Measuring Risk and Sharpe Ratios

Investment pros borrow a tool from the statisticians—standard deviation—to measure investment risk. It shows the **range** of returns that investments are likely to earn over a given period of time and it has two sides, the out-performance and the under-performance of an average rate of return.

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The Sharpe Ratio is a commonly used measure of portfolio earnings quality. In short, the Sharpe Ratio is a measure of return achieved per risk taken. Sharpe ratios can be better than just looking at performance because it incorporates the issue of risk. Some would say it is a measure of a manager's ability to perform consistently. The number by itself, however, is hard for many to understand without comparing it to something.

Let's take a look at the S&P 500 Index for a quick comparison. The Standard & Poor's 500 Index is usually considered the benchmark for US equity performance. As the name suggests, the S&P 500 consists of 500 companies from a diverse range of industries. Contrary to popular belief, the S&P 500 is not a simple list of the largest 500 companies by market capitalization or by revenues. Rather, it is 500 of the most widely held US-based common stocks, chosen by the S&P Index Committee for market size, liquidity, and sector representation. For the last ten years, the Sharpe Ratio for the S&P 500 is less than 0.40 and it doesn't look much better when looking over the past thirty years.

Are you familiar with Morningstar, Inc.? They are a Chicago-based, global investment research firm, providing information, data, and analysis on the mutual fund industry. They say that a Sharpe Ratio of over 1.0 is "pretty good" and outstanding funds achieve something over 2.0. Using this "yardstick", we are more than pleased with our accomplishment to date.

For most investors, the Sharpe makes good intuitive sense because they not only hate to lose money but they often compare the returns to risk free investing. You owe it to yourself to understand and consider this measure when making investment decisions.

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