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Is a House a Good Investment?

Whether it is a penthouse in New York City, a beach house in Corolla, NC or a farmhouse in central Virginia, owning your own home is a significant part of the American Dream. The financial reality is that a home is the single largest investment most people will ever make. For many, it becomes their most profitable investment; for others, it can be a financial and emotional disaster. In fact, movies like "Pacific Heights" or "Duplex" might provide you some extreme examples of disasters.

How can we tell whether a house is likely to be profitable or not? Residential real estate is usually valued by looking at "comps" – the prices paid for recent transactions involving comparable homes. Comps can help us judge whether the price of a particular house is high or low relative to the prices of other houses in a given neighborhood, but they tell us nothing about whether housing prices are high or low in an absolute sense.

Some clients ask questions about housing prices. First time buyers might ask if now is a good time to buy; while clients who already own may ask if trading up is a good investment or if downsizing is a good financial move. We have also had clients ask if we are in a "housing bubble" and if they should sell their houses and rent until sanity returns. All of these are great questions. In fact, shouldn't a transaction this large be analyzed with at least as much care as other investments?

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.

This month's letter will discuss some critical questions to ponder for anyone considering buying, selling or remodeling a home and a methodology to help guide you toward making better decisions. Lastly, and as always, we will finish with an update on our investment activities.

The Rent Versus Buy Alternative

Most real estate experts realize that renting is an alternative to buying a house, but often they simply list the pluses and minuses of buying versus renting rather than help guide your decision to buy or not. So how do you decide what to do?

The best way to answer the question of whether a house is a good or bad investment is to think of houses the same way we think of stocks. When financial analysts consider buying stock, the proper question is not whether it is a good company, but whether the stock is cheap or expensive. Is it worth the asking price? When we consider buying a house, we

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should ask the same question – not whether it is a good house, but whether the house is cheap or expensive. Again, is it worth the asking price?

It is widely believed that the intrinsic value of a stock depends upon its expected future cash flows. The same holds true for a house, with the wrinkle that one of the financial benefits of owning a home is not having to pay rent to someone else. Therefore, the primary cash flows from owner occupied housing is the rental payments a homeowner would otherwise have to pay.

In this letter we will discuss a well established procedure that is widely used to value bonds, stocks, business projects and commercial and industrial real estate transactions. It can also be used to value owner occupied houses.

One effective way of addressing this issue is to determine the net present value of anticipated cash flows from owning a house. The intrinsic value calculations for a house are a little involved, but lets begin to walk through some of the considerations.

A Simple “All Cash” Scenario

Consider the unlikely case where you pay cash for a house, similar to how you might pay for a stock. Just like a stock, your rate of return consists of both income and capital gain. The income from a stock comes from the dividends. If you pay \$100 for a stock that currently pays an annual dividend of \$1, the income is 1%; if the stock price increases by 6%, your total rate of return is 7%.

For a house, the income is the rent you would pay reduced by the expenses associated with owning it. For example, as a renter, lets say you would pay \$33,000 a year – or \$2,750 per month – for a particular house. Home ownership would implicitly provide \$33,000 that you would otherwise pay someone else. On the other hand, as a homeowner, you will have to pay real property taxes, insurance, maintenance and some utilities that would ordinarily not be paid by a renter. If these expenses are \$15,000 per year, then your annual net cash flow is \$18,000. If the house is priced at \$450,000, then your return on net cash flow provides a 4% return ($\$18,000 / \$450,000 \times 100\%$).

Now lets consider the capital gain component. To make this simple, assume that housing prices will be expected to rise commensurate with inflation. If inflation is expected to grow by 3% per year, then you might assume that housing prices will rise by 3% a year too. Adding a 3% capital gain to the 4% income gives a total return of 7%.

Although this analysis is for a single year, it works year after year if income and home prices increase at the same rate. However, since over the last five years housing prices have risen substantially higher than net cash flow (income), we might actually expect that either housing prices will grow at a much slower rate or rents must rise at a faster rate going forward. Maybe it will be some combination of the two.

For many, it is hard to assume that anyone would purchase a home without taking out a loan (using leverage) and incurring mortgage payments. We will soon discuss how this impacts the analysis. The general rule for using leverage is that your financial success depends on whether your investment return from the house – income plus capital gain – is greater than the mortgage rate. If it is, the extraordinary leverage involved in most home purchases can

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make a house the most profitable investment you will ever make. If it isn't, it can be one of the most costly mistakes you'll ever make.

The Bigger Picture

We've now discussed two issues that are crucial to understanding the financial implications of home ownership: (1) the return on your home is the net rental savings plus the capital gain, and (2) leverage works in your favor if the total return is greater than the mortgage rate.

A more complete analysis is complicated by several other factors:

- Unlike other expenses, fixed rate mortgage payments don't grow each year;
- Most mortgages have a finite life;
- Part of each mortgage payment includes a principal pay down – which builds equity;
- The interest portion of every payment is tax-deductible and declines each month.

Now, with these concepts behind us as the “building blocks”, you can now begin to assess whether a particular house is likely to be profitable or unprofitable – cheap or expensive. This assessment can be accomplished by calculating the net present value (“NPV”) with after-tax cash flows being discounted by the homebuyer's required rate of return. There are plenty of calculators to help you accomplish this via the internet; or if you're uncertain about going it alone, we'd be happy to offer our services to help.

In this calculation, the initial cash flow is equal to the down payment and other closing costs. The following net cash flows, until the expected sale of the house, consist of each period's rental savings net of the mortgage payments and other expenses associated with home ownership. The final cash flow is the home's expected sale price net of broker's commission, other selling expenses, remaining mortgage balance and any prepayment penalties. Because the cash flows are guesstimates, it is generally sufficient to work with monthly or annual assumptions. Don't be sidetracked by accounting labels. All we really care about here are dollars coming in and dollars going out.

The homebuyer's required rate of return can be determined from rates of return available on investments. The initial down payment ties up funds that could otherwise be invested in stocks, bonds and other assets; and, as the years pass, the net rental savings free up funds that can be reinvested elsewhere. The required return can be based upon current interest rates, but since there is considerable uncertainty about the net cash flow from a house, you may want to use a required return similar to that applied to stocks and comparable risky investments.

After you've done your NPV calculations, or had someone do them for you, you'll need to interpret the results. A positive NPV would indicate that the house is not too expensive and you should buy; alternatively, a negative NPV would indicate that the house may be too expensive and you should rent – generally. Why generally? Because a negative NPV could turn positive depending upon how long you plan on keeping the home!

Confused yet? Let me explain.

It's not uncommon for the after-tax cash flow from buying a house to be small or negative for the first few years. But as time passes, with growing net rental income and fixed mortgage

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payments, the after-tax cash flow can become positive. In addition, the homeowner's equity is growing, but can easily be dissipated by substantial selling costs if the house is sold soon after purchase. These transaction costs underlie the sound advice that most people should not buy a house unless they plan to keep it for a while.

Don't be dismayed by the fact that you cannot provide exact values for future cash flow data. We actually don't need to know input values to the last penny. The best way to handle imperfect knowledge is to try a range of values to understand your best and worst case scenarios.

What Matters Most?

For most households, emotions play a significant role when involved in decisions relating to home ownership. Yet making the wrong decision can certainly cause a significant hardship down the road.

Determining whether a particular house is a good investment can be a complex process. However, using NPV analysis as a tool can help you navigate through some of the more basic – yet significant – questions of home ownership such as:

- How do I know if I'm ready to buy a home?
- How does purchasing a home compare with renting?
- Should I sell my home and rent until sanity returns?
- Is the home I'm looking to buy a good value or too expensive?
- Is an older home a better value than a new one?
- In my locale, is one neighborhood-school district-etc. a better value than another?
- Should I renovate my existing home if I'm going to sell it soon?
- How can I keep track of all the homes I see?
- How large of a down payment should I make?

We're At Your Service

At Hoffman, White & Kaelber Financial Services, our focus is to help our clients achieve a more certain future. As such, our wealth management clients gain comfort in our conservative strategy of seeking to control risk while carefully and methodically growing their investments.

Hoffman, White & Kaelber Financial Services Investment Performance Update

According to a recent Wall Street Journal article: "To the amazement of many investors, Treasury bonds have been among the year's best investments. Despite three consecutive interest-rate increases by the Federal Reserve since June 30th, Treasury bond prices have been rising and their yields falling amid concerns about the economy's strength. One reason for the bond market strength has been that people are using bonds as a parking place for money they are reluctant to risk in the stock market." We believe this to be only so because investors see Treasury bonds as the lesser of all potential "evils". We too are positioned defensively these days, but haven't "put all our eggs in one basket".

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For the month ended September 30, 2004, our one-month performance is down 0.11%, our three-month return is down 0.18%, our one-year return is up 4.65%, and our average annualized return since inception is up 10.32%. While volatility (risk) continues to increase in most market sectors, our (since inception) risk profile has edged downward further to +/- 6.85%. This risk level remains conservatively low and is consistent with our strategy. With our expectation that this statistic gains increasing importance, our Sharpe Ratio remains a very respectable 1.35.

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.

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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