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In Search of Truth

The Housing Bubble and Me

A Financial Odyssey

by David B. Moore

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I keep reading that despite record high Price-to-Rent ratios (the ratio of the median home price in an area to the average rent for a two bedroom apartment in that area) and Price-to-Income ratios (the ratio of the median home price in an area to the median income in that area), there is no housing bubble in the U.S. in general and San Diego – where I live – in particular.

Well, this may indeed be the case. But, just for pure entertainment, follow along with me, dear reader, on my own personal odyssey of buying and selling a condominium in the San Diego area. Perhaps something instructive will be taken from the journey.

I moved to the San Diego area in October 2000 and, after looking at homes in San Diego's North County Coastal region, I came to the conclusion that prices were, in aggregate, slightly silly. Nevertheless, wanting to be a homeowner and determining that it was somewhat cheaper than renting on an after-tax basis, I decided to try to put as little money at risk as possible and buy the least over-valued two bedroom/two bathroom condominium I could find within a reasonable distance of my firm's office in Rancho Santa Fe (which, incidentally, has the dubious distinction of having the highest median home price of any city in the country).

I settled on a 1230 square foot condominium in La Costa, about a mile from the La Costa Resort and roughly three miles from the ocean. I paid $188,000 for a second floor (the top floor) unit on a hill with a great view over La Costa. The couple from whom I purchased the unit had paid $87,000 for the unit three years earlier and had put an additional $30,000 in upgrades into the condo. So, over the course of three years, the value of their home had increased (after adjusting for the upgrades) by 61%, or roughly 17% per year. Not too shabby, I must say.

With understandable trepidation – after the heady price run-up of recent years – I forked over $188,000 (actually, I put $45,000 down and the bank forked over the rest) and proceeded to put about $8,000 of additional upgrades into the unit (including a $4,500 "special assessment"). To keep the math consistent, let's just assume I put $45,000 down and financed the remainder plus the upgrades for a total mortgage of $151,000. So, after all was said and done, I ended up with a monthly mortgage payment of $1,102 (8% 30-year fixed), home owners' association dues of $200, and property taxes of $172, for a total monthly outlay of $1,474 (and $961 tax-adjusted for the deductibility of mortgage interest at my marginal tax rate). What was worrisome about all this at the time – to my way of thinking, at least – was that rents for units like mine in the same complex were running at about $1,100 per month. Clearly, this is not the sort of math that made Sam Zell a billionaire.

Now, to back up for a moment, let's perform the same financial analysis from the standpoint of the sellers of my condominium at the time of their purchase. Once again, to make an apples-to-apples comparison, we'll assume they bought the place with the upgrades already in place for $117,000. With a down payment of $24,000, this leaves a mortgage of $93,000. So, at the end of the day, this fine couple was left with a monthly mortgage payment of $715 (8.5% 30-year fixed), home owners' association dues of $200, and property taxes of $107, for a total monthly outlay of $1,022. At the time they bought the condo, rents in the complex averaged around $1,000 per unit. Now, this is math

I can understand. Had they held onto their unit as a rental, I figured, they could've raised the rent 3% or so per year and the value of the condo could reasonably be expected to climb another 3%-5% per year. Factor in 5 to 1 leverage (i.e., 20% equity) and you're looking at an IRR somewhere in the 15%-25% range, depending on the vacancy rate, costs associated with upkeep of the unit (repairs, painting, new carpet, etc.) and refinancing issues. In any case, again, I liked the math from their perspective. But, as it happened, they needed the money to use for a down payment on a larger home. And that, of course, is where I entered the picture.

Fast forward to September 2003. Three weeks ago, my neighbor was updating me on recent sales in our complex and I decide to get a printout to see the information first hand. Following were the sales statistics for virtually identical units (varying upgrades notwithstanding, of course):

April	**1 unit sold**	**$242,000**
May	**1 unit sold**	**$246,000**
June	**1 unit sold**	**$291,000**
July	**1 unit sold**	**$295,000**
August	**1 unit sale pending**	**$305,000**

Well, I just couldn't take it anymore. In five months, prices had increased by almost 26%. I listed my unit and it sold in five days for $306,000. (I know, I know – with hindsight, I probably left $5,000 on the table.) I had purchased the condo hoping not to lose money on it and here I am, three years later, having netted almost $100,000 on the unit after commissions and expenses. Do I feel smarter for the experience? Not a whit. Do I feel lucky? Unequivocally so.

Now, let's look at my condo as an investment from the perspective of the new owners. They're putting $61,000 down, leaving a note of $245,000. Consequently, they'll be left with a monthly mortgage payment of $1,549 (6.5% 30-year fixed), home owners' association dues of $220, and property taxes of $281, for a total monthly outlay of $2,050. For context, rents currently average roughly $1,250 a month in my complex. To say that this math is problematic from an investment standpoint would be an understatement.

Now, I realize that the after-tax cost for the new owners will be roughly $1,450 per month (assuming a 35% marginal tax rate), which is only $200 greater than average monthly rents. Nevertheless, the mean value to which condominium values have historically reverted is their value to a rational investor, not the tax-adjusted value to an owner that plans to occupy the property. Given current rents and interest rates, the *maximum* amount that a rational investor would pay for my condominium is roughly $200,000. Assuming a 25% down payment (a 25% down payment is standard for non-owner occupied properties), this would leave the investor with roughly $1,350 in monthly outlays (6.5% 30-year fixed mortgage, HOA, and insurance) and $1,250 in monthly rental income. The property would be cash-flow negative for roughly eight to ten years until rents were raised enough to cover the monthly expenses (mortgage, HOA, and insurance), vacancy periods, and upkeep. (Most real estate investors expect an investment to be cash-flow neutral *at worst* from the start, so I'm being generous here.) Nevertheless, assuming 3% rental increases and 3%-4% annual price appreciation, the IRR on the property would be in the low- to mid-teens using a 10-year time horizon. Using these same assumptions with a $306,000 purchase price yields an IRR in the low single digits. *And this assumes that the purchase price is a legitimate base from which to continue the price appreciation. If we assume that the property is overvalued to some degree at the time of purchase, the IRR turns negative.*

To be fair, however, the value of the condo to an owner that merely wants to keep his total after-tax cash outlay equivalent to a comparable rental is approximately $250,000 (assuming a 35% marginal tax rate and a 6.5% conforming fixed-rate 30-year mortgage). Importantly, however, this is not particularly good way to view a property from an investment standpoint.

In August of last year, MSN Money published an interview with UCLA economist Ed Leamer. At the time, Leamer thought that much of the nation, and Southern California in particular, was in the midst of a housing bubble. He based this observation on the fact that in many cities across the country, the

Price-to-Rent and Price-to-Income ratios were at all-time highs, eclipsing their highs of the late-80s, immediately preceding the last housing decline. He also acknowledged, however, that he couldn't forecast when home prices would peak. "The nature of a bubble is to feed on itself," he noted, "with rising prices convincing more and more investors that prices can only continue to rise." When it ends is, to some degree, a matter of pure speculation.

For my part, I think we're clearly in a housing bubble. The fact that so few agree with me is, in a way, further evidence of the bubble. After all, bubbles form because the masses are consistently and heavily on one side of a trade. The bubble is a reflection of the masses' opinion. The bubble begins to deflate only when the marginal buyer decides that prices have gone too far, which is hard to predict. But, once prices start to decline, most buyers step back, thinking, "Hey, let's see how far they fall." And they fall and fall and fall…until the marginal buyer thinks prices have gone too far in the other direction.

History has taught us that the final value to which prices decline in these situations is often well below that which a rational investor would consider an "equilibrium value." Which is just another way of saying that values before and after a bubble tend to be somewhat symmetrical – overvaluation on the upside is almost always followed by undervaluation on the downside.

In the final analysis, where the housing market is concerned, the music appears to have stopped, but there are a lot of people still dancing. I, for one, plan to sit out the next few numbers. Eventually, after all, the principal is going to show up, take away the spiked punch, and shut the dance down for good. And by that time there won't be many seats left. To be sure, hangovers will ensue.

To quote philosopher and former basketball player Charles Barkley, "I may be wrong… but I doubt it."

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