



Investment Insights

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Navigating the Real Estate Bubble

Unless you've been a participant in "Survivor 12: Lost in Space", you've undoubtedly read about or heard about the incredible appreciation in real estate over the past few years. In the minds of many respected economists (including Federal Reserve Chairman Alan Greenspan), a "bubble" exists in the real estate market, particularly here in the Bay Area. In addition to skyrocketing prices, many are also concerned about the risky loans buyers are now using to afford these high-priced homes. Here are some eye-popping facts:

- prices of homes have risen 60% in the past four years in Alameda County
- affordability is at all-time lows, with median home prices 12 times the average Californian's income
- in the first quarter of 2005, 60% of all buyers in California used "interest-only" loans, despite rates on traditional fixed mortgages being near 30-year lows
- despite the boom in home prices, rental prices in the East Bay have actually fallen in the past four years

Whether or not you agree with the notion of a bubble in real estate, it's hard to argue that great value exists in today's market. Will prices continue to rise? Or will we see the bubble burst, much like in the technology stock boom of the late 1990's? Obviously, no one knows, and in time that question will be answered. In the meantime, here are a couple of strategies to help you keep a level head and make smart decisions in today's real estate market.

Buy for the right reasons

Ask many buyers why they are buying a home now, and one of the top reasons is fear of missing the market. These buyers have watched prices rise 30-40-50%, and the pain of being out of the market is now greater than the fear of overpaying for a home. They are emotionally being drawn into the market, capitulating by buying regardless of the economics. This was prevalent in the late 1990's in internet stocks, when investors paid up to own the Yahoo's and Amazon's of the world, readily admitting that prices were inflated, but afraid to wait on the sidelines for more reasonable prices (and we all know how that ended).

In contrast, the smart buyer today is buying not for immediate emotional or financial gratification, but instead as a part of a long-term plan. This is the buyer who admits that

although the price they are paying may be a bit high, they can afford the payments, and are not depending on rising prices to continue, but rather believe in the long-term value of owning a home. They expect to be able to live in the home for a long time, and the lifestyle impact of buying over renting is a big plus for them.

To find out which camp you might be in, ask yourself this question: **if I knew the price of this home would be unchanged 10 years from now, would I still buy it today?**

Don't overextend yourself

Right now, mortgage loans are like credit card offers: “0% down!”, “1.5% introductory interest rate!”, “Pay what you can afford every month!”. If you have a pulse and any income, you can probably find a lender to give you that \$600,000 for the two-bedroom fixer-upper. In fact, Fed Chairman Greenspan recently warned major mortgage lenders about the risky loans they've been making. These risky loans are allowing some buyers to make purchases that are well outside their means. As the saying goes, “If you want to hang yourself, they will give you the rope to do it!”

Amazingly, the use of creative financing comes at a time when interest rates on traditional fixed-rate mortgages are near 30-year lows. Of course, there are sometimes very valid reasons to use adjustable-rate mortgages, but is it the best solution for 60% of buyers? Or is this creative financing being used to (temporarily) make the purchase affordable?

Also overlooked by many home buyers is the fact that maintaining the investment (taxes, maintenance, insurance, etc) can often add up to tens of thousands of dollars a year, and are not optional (and, importantly, don't exist for renters). If buyers are strapped to make mortgage payments, where do funds come from for these additional costs?

If you choose to use something other than a traditional 15- or 30-year fixed mortgage, ask yourself this question: **could I afford this home if I did use a 30-year fixed mortgage?**

Much like the internet stocks in the late '90's, I'm sure you can easily find opinions to validate any point of view, from bargain to rip-off, of real estate today. Frankly, only time will tell who is right. It is especially important at times like these to not get caught up in the emotion of the moment, but to make logical, informed decisions based on your own situation. Take time to think about the two simple questions I presented above: the answers you get are probably worth far more than the forecasts and opinions of the market gurus.

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