THE COMPASS CHRONICLE

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A client-focused financial advisory firm dedicated to providing objective advice to individuals, families, and retirement plans.

Our financial advisory services include:

- Investment Management and Consulting
- Retirement Planning
- Education Funding
- Family Budgeting

In This Issue . . .

Housing Bubble: Fact Or Fiction?

The stock market sell-off from 2000–2002 was the first time investors had experienced three consecutive annual declines in the S&P 500 since 1941 (a total decline of 47% from the peak). This drop came subsequent to a significant run-up in the stock market from 1995–1999, the first time the U.S. market had ever experienced five consecutive calendar years of 20% or greater gains in the S&P 500. While the 2000–2002 sell-off is termed a bear market and not a bubble, technology stocks are widely considered to have experienced a bubble and a subsequent deflation. In fact, the NASDAQ Composite Index, comprised primarily of large-cap technology-related stocks, fell more than 80% from its peak during that time frame.

While stock market investors suffered at the beginning of this new century, owners of residential real estate generally enjoyed remarkable appreciation. Has residential real estate experienced a bubble similar to technology stocks in the late 1990's and, if so, when will the bubble burst?

Home Prices From An Historical Perspective

Home prices generally increase in line with personal income, since income determines how much a homeowner may spend on housing. According to national data from *The Wall Street Journal*, median income increased 138%, while home prices increased 136% from 1980 to 2001. However, more recently, home prices increased much faster relative to income on a national level. From 1996 to 2003, home prices jumped 47% versus a 22% increase in income. In some regions, such as the Northeast and California, this disparity grew much larger.

Based on similar data released recently by Standard & Poor's, the average U.S. home price is approximately 3.1 times the average household income, more than the average of 2.6 times since 1960 and its highest level ever. S&P found that on both coasts, specifically the Northeast, Florida, and California, home costs have increased at least 30% above the normal home price-to-income ratio. Many of these areas have experienced annual appreciation of 10–20% in each of the last two years. These are the areas that are most at risk of a housing correction.

A Beneficiary Of Low Interest Rates

A primary reason for such appreciation has been historically low mortgage rates and, more recently, a slew of new mortgage types, including interest-only mortgages. Lower rates and interest-only mortgages have allowed both marginal buyers to purchase their first

continued on page 2

Housing Bubble: Fact Or Fiction?

continued from page 1

home, as well as existing homeowners the ability to trade up to larger homes without increasing their mortgage payments.

Most At-Risk Markets

In early June, Federal Reserve chairman Alan Greenspan stated that a nationwide housing bubble is improbable, but warned of "froth in some local markets."

Based on data since 1968 from the National Association of Realtors, the median sales price of existing homes has advanced at an average annual pace of 6.4% over the past 36 years and has never suffered from an annual decline on a *national* basis. The slowest price increase since 1968 was 0.22% appreciation in 1989.

Local markets have occasionally suffered setbacks, however. One of the hardest hit housing markets in recent memory was California. After reaching a peak in 1991, the median sales price declined for five consecutive years, although only a 12% drop in value from the peak was experienced. Even this drawn out decline could hardly be considered a housing bubble.

According to analysis released by PMI Mortgage Insurance Co. in July, the country's 50 largest housing markets have, on average, a 21.3% chance of experiencing a price decline over the next two years. PMI's study incorporates each market's home price appreciation, home price acceleration (a measure of whether the rate of growth is increasing or slowing), employment growth, unemployment rate, and home affordability to determine the likelihood that a particular market will see a price decline within two years. Six housing markets have a better than 50% chance of a price decline based on PMI's analysis, with Boston leading the pack, followed by Long Island, and several California cities.

At-Risk Ranking	Metropolitan Area	Likelihood Of Price Decline Within 24 Months
#1	Boston-Quincy, MA	55.3%
#2	Nassau-Suffolk, NY	54.0%
#3	San Diego, CA	52.8%
#4	San Jose, CA	51.3%
#5	Santa Ana, CA	51.2%
#6	Oakland, CA	50.9%
#7	Cambridge-Newton-Framingham, MA	46.9%
#8	San Francisco, CA	45.9%
#19	Washington, DC-Arlington-Alexandria, VA	20.9%
#39	Philadelphia, PA	7.6%

Source: PMI Mortgage Insurance Co., *Summer 2005 Newsletter*

What's Next?

The housing market, in general, is not experiencing a bubble, although the pace of appreciation is unsustainable. The most likely scenario is that home price growth will decelerate or even stagnate, allowing personal incomes to in effect "catch up" to home prices. However, the coastal regions referenced above are at greater risk of suffering from a drop in prices, as referenced by the PMI data.

Another factor that will impact home prices is mortgage interest rates. As interest rates rise, the affordability of real estate declines due to the resulting higher mortgage payment. This places downward pressure on home values. But unless mortgage rates spike upward, the housing market is unlikely to suffer a sharp price drop.

What You Should Do

What can you do? If you are able to view your primary residence as a long-term consideration, somewhere that you are comfortable living for at least five to ten years, you avoid the pressure of having to sell during a period of weakness. This is analogous to a buy-and-hold strategy used with stock investments. If you plan to stay in your home long term, the value of your home in the short term should be of little consequence to you unless you plan to leverage the equity in your home through borrowing.

If you have an adjustable rate or interest-only mortgage and plan to stay in your home past the point where your monthly payment is likely to escalate, consider locking in a fixed rate while rates remain near historical lows. Contact our office with questions or if you need a referral to a reputable and knowledgeable mortgage broker.

Did You Know . . . Cashier's Checks

Cashier's checks, historically considered to be among the safest means of payment because they are drawn on a bank's own account, are now one of the most counterfeited. Counterfeit cashier's checks are being used with increasing frequency as payment at online auctions and shopping Web sites. Even U.S. Postal Service (USPS) and retail money orders have been counterfeited. To check the validity of USPS money orders, hold them to the light and look for Benjamin Franklin's watermark and the security thread with "USPS" running from top to bottom. To validate cashier's checks, contact the issuing bank.