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Preserving Home Equity Values if R.E. Prices Decline



GUEST COLUMN

By Bruce Weide

First of Two Parts

According to John R. Talbott, visiting scholar at UCLA's Anderson School of Management, in his book *Sell Now, The End of the Housing Bubble*, (2006 St. Martin's Griffin's):

"If you are trying to accumulate wealth in your lifetime, you are missing a once in a lifetime opportunity. By remaining in your home and doing nothing, you are creating paper profits, and we all know they have zero value. Profits are not real until you realize them by cashing out. If you don't cash out now, you are missing the opportunity to create real wealth of between \$200,000 and \$500,000.

...you need to know that today's high housing prices are an abnormal bubble about to burst..."

Talbott makes a pretty good case for such a bubble through one of the most complete statistical analyses I've ever seen on the housing market. He illustrates through various charts and graphs that while home prices have always grown over the long term, they have actually increased generally by trend no more than the rate of inflation over the last 100 years, except during the last 6 years - a dramatically abnormal spike at the end of a 100-year flat trend.

He concludes in part, "The flatness of the real historical price data presented here tells us another important story. Whenever a boom in real estate has occurred in the past, it was eventually followed by a bust: real prices always returned to normal levels."

Talbott also comes up with a clever formula to devise a P/E (Price/Earnings) ratio for housing markets across the country. He equates earnings as potential rental income in the local housing market, vs. the cost of housing (price), to formulate the ratio.

Just as in stocks, the bigger the spread on the ratio, (i.e. you pay more for less substance) the more inherent risk there must be in the purchase of the asset. However, if a stock

price has a high P/E ratio, your hope is that the company will eventually show higher earnings, and you in fact have bought the stock at what will eventually seem like a bargain early in the company's successful history. But I would venture to guess that P/E risk in housing is less likely to play out in severely rising rental incomes in the coming 2-5 years, than by a drop in residential real estate prices if the P/E risk ratio comes back toward earlier norms

In 2000, a home in the Los Angeles / Long Beach Metro area cost 12.3 times what you could get in rental income for that house. By 2005 the ratio had grown to a P/E of 24.9 . That's a 102.4% increase in volatility, my friends.

And just wait until the foreclosures heat up on all those Adjustable Rate Mortgages, as their annual payments climb, to see a real buyer's real estate market begin.

"But I Don't Want to Sell My House"

Look, I don't really know if real estate is going up or down in the coming years any more than the next guy with an opinion. I'm not an economist, and I'm not officially taking any position herein on what is really going to happen.

But as a middle-income homeowner and a typical Baby Boomer with a negative savings discipline, what really concerns me is this: The value of that real equity in my home, albeit "paper profits", is in fact today the single greatest asset I've yet accumulated. And whether I opt to realize my gains by retiring to Montana one day, or by mortgaging it out to invest in the next dot com mania, real estate mania, or other perhaps quite levelheaded opportunity for growth, if I don't act now to capture or otherwise preserve those gains made over the last five years by building equity in my home, that asset could well vaporize by the time the dust settles in the real estate market in the next couple of years.

New Wave in Financial Planning

This very pinch is today causing the incredibly rapid emergence of a somewhat controversial, if not remarkably contrarian new strategy for financial planners. The approach, sometimes referred to as *Home Equity Optimization*, promotes removing the maximum available equity value out of your home by means of creative mortgaging, debt consolidation, or otherwise optimizing the greatest possible tax deductibility of mortgage interest payments, and repositioning the equity values into what is referred to as a "cash" position. Now it's not really cash, because in theory the homeowner is going to get the repositioned asset to earn at a rate greater than the costs to mortgage it out.

Primarily being vanguarded by two key figures nationally; Douglas Andrew, in his book *Missed Fortune 101* by Douglas Andrew (2005, Warner Books); and Ric Edelman, on his DVD *Why You Should Carry a Big Long Mortgage and Never Pay It Off* (ricedelman.com/store/video_mortgage.asp), I guarantee that if you haven't been introduced to these concepts, you soon will be. I can also tell you first-hand that thousands of financial planners are going to these models to restructure and renew their most current advice for their clients, and whether wise or foolish, if it's sweeping inside of the industry today, it'll coming to a CPA or planner near you soon.

I'll look further in detail at the tactics taken to implement these strategies, as well as the inherent risks, in the next edition of the SFVBJ. But in the meanwhile, check out the above two references for a head start on salvaging home equity values. My opinion for now: For some – an excellent opportunity to capitalize on recent R.E. market gains. Overall – potentially dangerous without strict adult supervision.

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