

REAL ESTATE NEWS



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Fine Homes



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Rents are Cheap Relative to Home Prices!

(or Home Prices are Expensive Relative to Rents)

Is the Real Estate market overpriced? Is it headed for a crash? These are questions I continually see answered for us in the pages of financial newspapers. Recently, an article in Investors Business Daily stated that there is no bubble. Yet next week in Barron's, I read that their might be a housing bubble.

What is the informed and intelligent purveyor of financial information to believe? Even if the financial analysis is correct, it does not mean that a prediction will happen in reality. There are too many variables and uncertainties.

Just because a market is overpriced or underpriced by historical standards does not mean that it will not become more overpriced or underpriced. But relative valuation can direct you toward a general bias of accumulation or holding your ground.

With that in mind I would like to share with my readers one simple ratio that I have found helpful. It is the comparison of the house payment (after tax breaks) to the rental value of the same home. This is the same analysis that a buyer makes. "Should I rent or should I purchase?". "How much more will I have to pay to own this home versus if I rented the home?"

While we are certainly comparing apples and oranges, we can make some assumptions to simplify the comparison.

Let's assume the following:

- 1) Appreciation to be flat (a BIG assumption).
- 2) The cost of owning a home, after tax breaks is 75% of PITI (principal, interest, taxes and insurance).
- 3) The benefit of paying off the mortgage is at least initially offset by the cost of maintaining the home.
- 4) A 10% down payment.

So not including the emotional factors of owning vs.

renting, what is the real financial benefit to owning? Certainly over the long haul, it is the knowledge that you will pay the home off. But in the shorter term of 10 years or less, it is the future appreciation that an owner experiences that is the real incentive to owning.

A buyer's real financial motivation to pay more than the going rental rate for a home is based upon how much appreciation the buyer anticipates. But because we are human, people tend to overweight the recent past when anticipating the future and often don't consider the possibility that real estate might not appreciate at 20% per year just because it has for the last 5. In fact, a period of slower growth or perhaps depreciation is always possible.

During times of extreme appreciation, such as we have had, ownership will often exact a premium. This makes sense when assuming the immediate future will bring more price appreciation. Why should I not pay \$1,000/month (after tax breaks) MORE to own a home than rent? Because compared to the \$50,000 in anticipated annual appreciation this \$12,000 annual "ownership premium" is insignificant. But trees don't grow to the sky and during periods of flat to declining Real Estate prices, this ownership premium can seem like throwing good money after bad.

How do today's prices relative to rent compare to past peaks and troughs? Let's take a look at some guesstimates from the past. I will choose the most recent past peak of 1990, 1996 as the trough, and compare that to the present.

Previous Market Peak - 1990

In 1990 I bought a home for \$430,000, an expensive home by the days standards. This home would have rented for about \$1,800 per month and interest rates

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were about 10% for fixed rates but adjustable rates of around 7% were more of the standard.

What type of ownership premium did I pay?

1990 Example $\$430,000 @ 7\% 2575 + 448 + 60 = 3083 * .75$ (to eliminate tax benefits) = 2312

Ownership premium would be $2312/1800 = 1.28$ or a **28%** premium to own.

Other examples might include a typical Los Altos 3 bedroom, 1.75 bath home. In 1990 this home sold for about \$250,000 and would rent for around \$1,200. Using the same calculations as above ($PITI * .75 / Rent$) yields $(1807 * .75 / \$1,200) = 1.13\%$ or a **13%** ownership premium.

Note: In the above example the more expensive home brought in less rent compared to the value. This is not abnormal. Tenants pay for utility and will not pay as much as an owner for the amenities of a higher end property.

Market Bottom - 1996

In 1996 I had a home that I rented for \$1200 that would have sold for around \$190,000. At the time interest rates were about 7% fixed.

1996 Example - $\$190,000 * .9 @ 7\% = 1138 + 198 + 50 = 1386 * .75 = 1040$. $1040/1200 = 87\%$. The ownership premium was **minus 13%**. Meaning that it was **13% cheaper** to own in 1996 than to rent.

Today - 2005

Today that same 3 bedroom, 1.75 bath home in Los Altos rents for around \$2,200 per month, but would cost around \$625,000, while interest rates are around 6%.

So today's ownership premium would be: $\$625,000 * .9 @ 6\% = 3,372 + 651 + 80 = 4103 * .75 = 3077$. $3077/2200 = 1.40$. For an ownership premium of **40%**.

Results

By historical standards, it is fair to say that homes are expensive relative to rental values. Today the ownership premium is 40%. This is significantly greater than the previous peak of 1990, where my rough calculations show about a 20% ownership premium.

As a side note: In Long Beach there have been a lot of investors converting apartments to condos for resale. This just confirms this imbalance between rent and price. This is basically arbitrage, where an investor buys a product in one market, in this case an apartment building, and sells it in another market, resale condos, for a profit. There have been so many condo conversions in Long Beach recently, that Long Beach has been trying to slow the process down.

Factors Contributing to the Imbalance

Why is there currently such an imbalance between

price and rents and might it come back into line by prices going down or rents going up? Disclaimer: Proving cause and effect is almost always impossible and predicting the future (without a bona fide crystal ball) is impossible as well, but that doesn't mean we can't have fun talking about the factors that might contribute.

1) **Appreciation causes appreciation.** As mentioned previously, a huge factor has been appreciation itself. Just the simple fact that property prices have gone up creates an anticipation that property prices will continue to go up. If buyers anticipate property prices to go up then ownership is worth a significant premium over rent.

2) **Greenspan bringing rates down to absurdly low levels.** Greenspan lowered the discount rate to 1.25%, in an effort to support the economy after the Dot.com bust and terrorist events of Sept. 11th. Artificially low rates inflate the value of real assets, especially assets with income streams. Who could leave money in the bank earning only 1.25%. This created a stampede to buy commercial or rental property. Cap rates (a measure of return on cash) for commercial and income properties dropped from 8-10% to 4-6%, resulting in a large increase in value per a given amount rental income.

3) **Everybody can buy a home now.** Remember the good old days when you needed good credit and 10% down to buy a home. Not today! Now there is a loan program for everyone. Even buyers with bad credit, and I really mean BAD credit with no down payment can qualify. While home ownership is a good thing, lending to marginal buyers is not. These marginal buyers are precisely the buyers most likely to be renters. This has reduced demand for rentals and increased demand for purchases.

4) **Speculation.** More people are buying 2nd homes to rent out. About 25% of the homes purchased today, are purchased as rental properties. This keeps rents affordable and raises the cost of housing.

It is logical that a combination of low rates, rapid appreciation, new alternative loan products and 2nd home speculation, have allowed home prices to get ahead of rents. But will this trend change, will rents go up, will home prices moderate?

While the "Home Ownership Premium" as calculated shows that homes are historically expensive relative to rent, it is only one piece to a very complex puzzle.

Who knows maybe the market is truly prescient and is simply anticipating the devaluing of the dollar or significant future inflation, for which real estate would be a good hedge. But to get into the inflation/devaluation discussion would require a complete novel to explore.

Has anybody seen my crystal ball?

Market Activity

The following information is from the Multiple Listing Service as of 10/6/2005.

2004 Stats

Address	Br/Bth	Sq Ft	Lot Size	List Price
Alamitos Heights				
421 Havana	2/1	1084	3900	699,900
655 Ultimo	3/1.75	1450	6500	749,500
705 Terraine	3/1.5	1629	9100	800,000
339 Flint	3/2.5	2242	3250	865,000
535 Winslow	3/2	1589	6500	929,500
355 Winslow	3/3	2262	3250	949,900
356 Los Altos	4/3	2600	6500	998,000
739 Terraine	4/3	2936	9100	1,050,000
675 Havana	3/2	1939	6500	1,100,000
780 Havana	5/4	2692	6500	1,170,000
790 Terraine	3/3	2390	6400	1,190,000
389 Panama	3/3	3000	4810	1,499,999
425 Ultimo	6/5.5	5679	12998	1,900,000
621 Havana	4/4.5	6419	9750	1,995,000
La Marina Estates				
1620 Knoxville	3/2	1296	6720	649,000
1441 Iroquois	4/3	1980	7150	759,000
Los Altos (S. Fwy)				
2090 McNab	3/1	1054	6195	490,000
2156 Stanbridge	2/1	862	5775	525,000
5661 Los Arcos	3/1	1051	6180	559,000
2307 Heather	3/1	1134	6090	565,000
1602 Stevely	3/2	1038	5890	575,000
2370 Fanwood	3/2	1248	6000	579,900
1851 Snowden	3/1	1054	6195	579,900
2137 Rutgers	2/2	994	5775	589,000
2236 San Vicente	3/2	1506	6120	590,000
1810 Ashbrook	3/1	1200	6231	599,000
2180 Senasac	3/2	1710	6380	599,900
6920 De Leon	3/1.75	1206	5580	619,000
2249 Radnor	3/1	1297	5820	619,900
2061 McNab	3/1	1534	6380	629,000
2061 NcNab	3/1	1534	6380	629,000
2241 McNab	3/1	1568	6000	629,000
6849 Driscoll	3/2	1060	5576	629,900
1720 Petaluma	3/3	1522	6820	634,000
5337 Daggett	3/2	1430	5775	669,000
2171 Fanwood	3/2	1700	6270	679,900-684,000
2206 Gondar	4/1.75	1943	6000	689,000
2090 Lomina	3/2	2162	6090	699,000
5670 23rd St	3/2	2000	5800	699,000
2313 San Anseline	3/1.75	1399	5750	699,900
2218 Conquista	4/2	1940	7680	719,000
2136 Fidler	4/3	1859	5775	749,900
1872 Marber	3/2	1464	6044	750,000
1897 College Cir	3/3	2341	7370	829,900
2177 Radnor	3/1.75	1654	6000	699,000-729,000
2152 Fidler	5/3	2121	5775	779,000
1933 San Anseline	3/3	2535	9780	1,049,000
University Park Estates / College Park				
6821 11th St	4/1.75	1779	7695	689,000
6860 11th St	3/2.5	1754	5985	730,000
6313 Mariquita	4/1.75	2160	6436	819,000
6215 6th St	4/4	2301	6820	879,900
6231 Monita	4/4	2319	6450	899,000
461 Margo	3/2	1692	6380	950,000

(Based on closed sales from 2004 - SoCal MLS)

Alamitos Heights

Number of Sales - 45

Low Price - \$425,000

High Price \$1,350,000

Average - \$839,079

Average Sqft - 2,213

La Marina Estates

Number of Sales - 7

Low Price - 569,000

High Price - \$770,000

Average - \$665,571

Average Sqft - 1,969

Los Altos (all)

Number of Sales - 191

Low Price - \$360,000

High Price - \$749,900

Average - \$511,504

Average Sqft - 1,457

Univ Park Estates

College Park

Number of Sales - 20

Low Price - \$528,000

High Price - \$825,000

Average - \$661,720

Average Sqft - 1,776

Park Estates

Number of Sales - 24

Low Price - \$625,000

High Price \$1,425,000

Average - \$903,366

Average Sqft - 2,357

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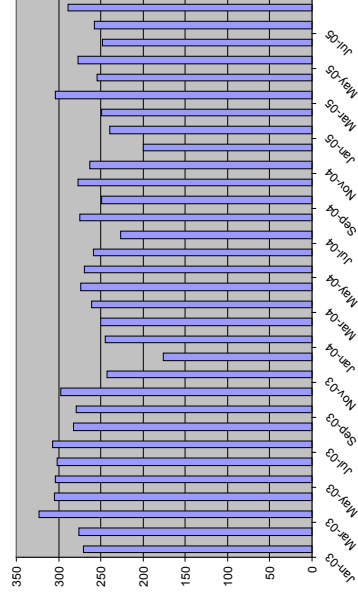
*Market Activity:
What's happening in
your neighborhood?*

*2004 Stats by Neigh-
borhood.*

Market Health

The graphs below show stable sales of around 250 homes sold per month, during 2005. Inventories of unsold homes have been increasing during this fall. The current number of homes for sale represents a two month supply.

SFR Sales in Long Beach



Unsold SFR Inventory in Long Beach

