BEYOND THE BUBBLE

How to Keep the Real Estate Market in Perspective—and Profit No Matter What Happens

MICHAEL C. THOMSETT and JOSHUA KAHR

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Michael C. Thomsett
***and* Joshua Kahr**

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—Michael C. Thomsett and Joshua Kahr

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Beyond the Bubble

INTRODUCTION

The Nature of Real Estate Bubbles

In 1973, I purchased my first home in Marin County (just north of San Francisco) for $29,400. My father was appalled at seeing me spend so much for property. He predicted that I would never make a profit. But sixteen years later, in 1989, I sold the home for $325,000. Virtually all of the increase in value happened in the local bubble between 1987 and 1989.

What caused this dramatic surge in housing prices in Marin County over such a short period of time? There were a couple of key factors at work. First, long-term drought conditions caused Marin County to impose a water moratorium for several years, which prevented virtually *all* residential-home building. When the moratorium was lifted in 1987, prices for existing houses skyrocketed. Second, many large employers left San Francisco proper and relocated in the surrounding areas after the city passed a payroll tax. Fireman's Fund alone brought tens of thousands of jobs to Marin County in a single year, placing even more demand on local housing stock.

The Marin County bubble could have been predicted if you knew what to look for: a mostly fixed number of houses in the area, the likelihood that water restrictions eventually would be lifted, and the sudden influx of a large number of potential home buyers. This is a typical example of the kinds of factors that cause real estate bubbles. The person quoted above didn't see any appreciable increase in the value of his house for almost fourteen years. But consider someone who bought a house for, say, $35,000 in 1985 and sold it four years later for over $300,000!

Bubbles can be extremely profitable or very dangerous. Prices rise and prices fall, inevitably, so bubbles cannot continue forever. This book examines the bubble phenomenon in real estate and the rest of the economy. It explains what factors create bubbles, shows how you can predict them if you know what to look for, and provides suggestions for dealing with potential sudden changes in valuation.

THE BIG PICTURE

Beyond the Bubble explains and examines the real estate bubble in a context of a larger investment market and the overall economy. This is important because it helps to understand how and why bubbles emerge and, historically, what has happened to earlier bubbles. Once you study the broader markets and bubbles in this context, you will be able to develop an awareness of key market drivers affecting real estate prices, both economic and noneconomic. As a result, you will be better able to evaluate markets and predict the rise and fall of prices.

The book also examines real estate by specific type, because it is important for you to view residential and other types of real estate as entirely different markets. Just as regional factors dictate how bubbles act, the different kinds of real estate perform based on vastly dissimilar economic and market forces.

REGIONAL FACTORS

When there appears to be a nationwide real estate bubble, there is a widespread belief or assumption that when the bubble bursts, it will do so universally. This is highly unlikely. Real estate valuation tends to respond to regional and local influences; there is no single real estate market.

Clearly, there are vast differences between the markets in Los Angeles, Phoenix, St. Petersburg, Sioux Falls, and New York City. All of these markets have specific characteristics, but they are different in each place. The levels of jobs, commuter trends, college-aged population and retirees, local economic forces (industry versus farming, for example) and dozens of other factors define those regional markets. You have to know what's going on in your market and with the type of property you're investing in.

Some books propose drastic measures in preparation for the "coming crash" in real estate. But this presupposes that your house is going to lose value no matter where you live. The alarmist approach to real estate is not as realistic or as sensible as studying the factors in *your* region and then deciding whether or not you are exposed to an actual bubble. Generalized advice on how to protect yourself before the bubble bursts is not relevant if, in fact, you have low exposure to a real estate bubble. If you do have high exposure, you may want to take drastic action; but the first step should be to study your local market.

When the bubble does burst in any one region, it will occur for very exact reasons relating to the local market. Those cause-and-effect situations are not universal, so the Sioux Falls market will not react in the same way as the markets of New York, Florida, or Arizona. There is no such thing as a single bubble, and even in the regions where prices have risen and bubbles have emerged, the future changes in value will not occur at the same time or for the same reasons. The Marin County bubble burst in 1989 when the earthquake hit; property values fell over the next six months. However, after this slump, housing prices rebounded with a vengeance. And as of 2006, a longer-term bubble in the area made San Francisco one of the fastest-growing regions in the country.

ROOT CAUSES

A bubble in real estate or any other commodity does not occur without reason. This book examines the root causes of bubbles, and how those causes are likely to change in the future. For example, one cause for rapid rise in residential prices in many areas is the trend in interest rates. As rates move lower, larger segments of the population are able to qualify for financing. As a result, there is increased demand for housing, which drives up prices. Eventually, as interest rates rise, those prices are likely to stop growing and remain flat, or even to fall.

Another root cause involves the location of housing and the people who want to move to those locations. The greater Phoenix and central Florida areas have become favorite retirement centers, and as a result a lot of construction has occurred.

But there are consequences. For example, Phoenix used to be known for its clean air and safe living conditions. Today, it is one of the most smog-polluted cities in the country, which may surprise people who remember past reasons for migration to Arizona.[1] It is the size of that migration and the related increase in the use of autos that have, in fact, changed the situation. The attraction of an area can lead to its loss of that very attraction. Phoenix has also experienced increases in crime rates and is now among one of the most dangerous places to live.[2] Changes have occurred in other cities as well. For example, in Las Vegas, *the* hot property market only a few years ago, property values have recently declined more than 20 percent.

* * *

These are some of the many factors affecting the duration and movement of bubbles. As population trends cause rapid development, increases in crime and pollution follow. When you combine the effects of traditional economic factors (those falling within the realm of supply and demand) with the more esoteric noneconomic factors (so-called quality-of-life factors like climate, crime levels, and traffic), you encompass the *range* of possible influences of real estate prices. When any of the overall factors start to arise, a bubble is likely to occur over some period of time. When more than two of these influences are at work, bubbles can be dramatic, rapid, and large. For speculators, these opportunities are appealing. But the more speculators enter the market, the more their impact will be on the bubble itself. Just as pollution and crime levels affect the real estate bubble, so does the level of speculation. It is among the factors adding to and even aggravating the bubble itself.

These days, real estate bubbles have become the norm rather than the exception. Everyone who owns property or is considering buying has to ask the same questions: When is a good time to buy? Should I sell to avoid loss? How do I recognize the signs? *Beyond the Bubble* is intended as a study of these questions and a source for answers.

NOTES

1. American Lung Association, "The Most Polluted Cities," 2004, reported on www.citymayors.com.
2. The Phoenix-Mesa-Scottsdale metro area was ranked the 23rd most dangerous place out of 369 cities studied, based on a 2005 survey by Morgan Quitno (12th Annual, "City Crime Rankings"): www.morganquitno.com.

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CHAPTER 1

Real Estate and the Rest of the Economy

Only a few decades ago, the United States (and most of the rest of the world) operated on the "gold standard." Essentially, this meant that currency in circulation was backed up by gold reserves. This had the effect of keeping the economy in check, limiting growth, and preventing many economic bubbles, including those in real estate.

Under the gold standard, prices could only move up or down to a degree, and they could not run out of control or in excess of the real demand for real estate. Today, forces other than traditional "supply and demand" control the market, enabling prices to rise at incredible rates, and to bubble. The bubbles we see today—where inflated prices exist and are expected at some point to burst—are a consequence of widespread speculation in real estate. Property flipping, overdevelopment, and leveraged real estate investing all contribute to this. In addition, many areas have experienced real estate bubbles due to demographic factors, such as population migration and baby boomer retirement.

No market operates in isolation. Real estate values do not move upward or downward just because people want to own their own homes. That is a factor, of course; but there are many more factors at play. Often, these factors creating or affecting valuation lead to bubbles, distorting the value of real estate.

In order to understand real estate in general and real estate bubbles in particular, you must make a distinction between "valuation" and current "market value." These two are not necessarily the same, although the terms are often mixed up. Most people tend to think that there is no difference.

Valuation is an assessed or appraised price for real estate based on logical comparisons and costs. Thus, the cost of materials and land, comparisons between properties in similar neighborhoods, and other logical criteria are used to establish the valuation of property. In a real estate bubble, valuation may be distorted by artificial demand and other causes, leading to rapid increases in market value, which, eventually, has to be corrected.

Market value is simply the price that a buyer and seller agree to. In an orderly market, a property's market value will be based on appraisal and valuation principles. But in a real estate bubble, the principles of valuation may be suspended or ignored entirely.

HOW SPECULATION FEVER FEEDS BUBBLES

To grasp how bubbles work, it is useful to examine how speculators think, and how illogic can drive prices unreasonably high. Many books try to blame real estate bubbles on excessive credit, low interest rates, or liberal lending policies. Although all of these factors influence the bubbles, they are by no means a sole cause. Bubbles have always popped up in history, regardless of monetary policy, international trade, or other direct causes. It seems that speculators always find a way.

Analysis of economic trends can explain a lot. The U.S. trade imbalance, federal deficit, and monetary policy all contribute to the bubble. But these do not explain the periodic recurrence of bubbles and they are not as instructive as a study of human nature. Even with the economic factors in play, the simple fact is that in all sorts of economic times, *greed* drives economic bubbles. When investors and speculators see prices rising, they want to get into the market and get a piece of the action. The more speculators, the greater the artificial demand; the bubble feeds itself until it cannot grow any longer, and then it bursts.

Pyramid Schemes

Take a look at the most basic form of bubble, the pyramid scheme. The typical scheme pops up now and then in offices and plants, among friends and social contacts, or on the Internet. These schemes are illegal, but their appeal is the apparent simplicity and ease with which people are promised great riches. In fact, only the originators (and perhaps a few friends) make money, while most (usually 85 percent or more) lose all of their money.

The basic idea for the pyramid scheme is that people pay money in over a series of levels, and at each level the number of people grows. If a pyramid begins with one person collecting one dollar from six other people, he makes a $6 profit. If those six each go to six other people (total of 36), the level and the number grow. So in theory, by the time the pyramid reaches 13 levels, everyone gets rich:

Level	People
1	6
2	36
3	216
4	1,296
5	7,776
6	46,656
7	279,936
8	1,679,616
9	10,077,696
10	60,466,176
11	362,797,056
12	2,176,782.336
13	13,060,694,016