A Blueprint for Buying—or Renting

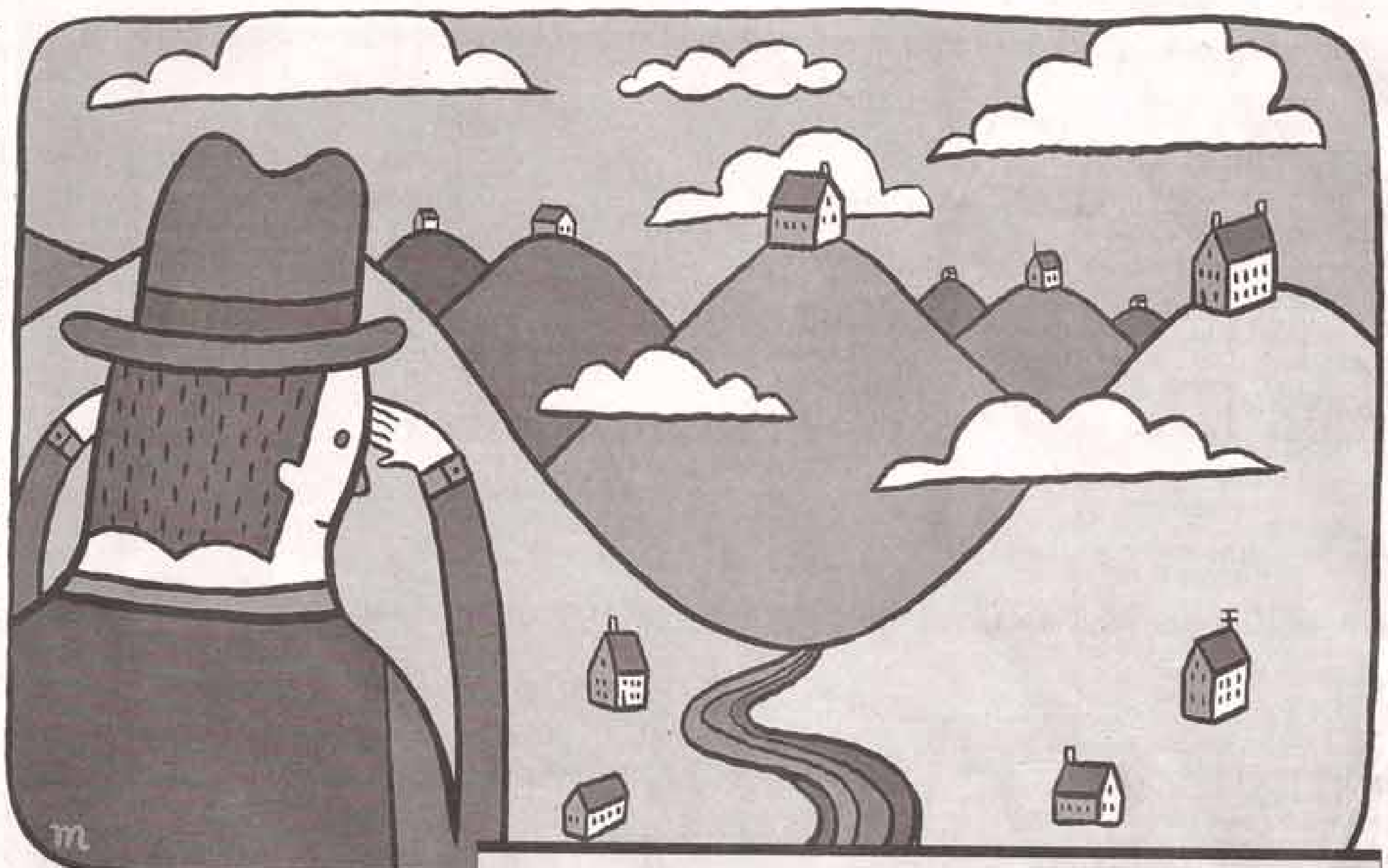
Act Today? Tomorrow? Never? Book Helps Gauge Effects Of Rates, Demand, Taxes

By June Fletcher

TO BUY OR NOT TO BUY?

That is the question facing homeowners all across the country as overall home prices reach yet another record, mortgage interest rates reach a six-year-high, and construction workers and supplies are diverted to the hurricane-ravaged Gulf Coast.

*As tensions mount between too much demand and too little supply, many consumers are wondering if the decade-long housing boom is peaking. Should they buy now, or wait for rising rates to depress prices? **"House Poor,"** a new book by Wall Street Journal reporter June Fletcher, published by HarperCollins and in stores Tuesday, looks at this crucial question, and suggests strategies to survive a housing market in turmoil. Here is a condensed excerpt:*



APRIL AND ADAM NICHOLS are suffering from sticker shock. The newlywed New Yorkers would love to get out of their cramped one-bedroom rental in Manhattan, which costs them $2,325 a month, and buy a starter condo. But everything they've seen in their under-$500,000 price range is horrible, from a fifth-floor Hoboken, N.J., walk-up with a view of an ugly brick wall to a run-down building in the Bronx.

So what are the Nicholses planning to do? For now, nothing. "It's hard to throw money away on rent, but we're going to be patient," says Ms. Nichols. "Prices are bound to come down."

It's challenging to sit on the sidelines when every day, the airwaves are crammed with home fix-up shows, and bookstores push books on how to make millions as a real-estate investor. But the real trick to winning at real estate is to be contrarian and recognize just where you are in the real-estate cycle. When Doug Duncan, chief economist for the Mortgage Bankers Association, moved to Washington in 1988, the local real-estate market was sizzling and buyers got caught up in bidding wars at open houses. He decided to rent. Soon, the market took a nose dive. Five years later, he decided it would be a good time to buy. He paid about a third less than the previous owner, who'd lost his home in a foreclosure. "You have to use caution," he says.

Understandably, not many real-estate brokers share this opinion. An ad recently sent to

The need to uy low and sell igh

the emotions of buying a home.

clients by agents of the New York brokerage firm Prudential Douglas Elliman pushed ownership hard. It points out that real-estate prices, unlike stocks, adjust slowly, and that predictions that the New York market would crash after 9/11 didn't come to pass. It also told first-time home buyers that they have to "get in the elevator to ride to the penthouse," and asked: "Why do you work so hard? To live in a crummy rental for the rest of your life waiting for a bargain to emerge?"

But the real worry today isn't that you'll be stuck in a rental for the rest of your life, but that you'll buy at the peak, watch prices slide, and be stuck in the property for years, waiting for them to recover. To come out ahead as investors, consumers need to buy low and sell high, but this gets forgotten in the emotions of buying a home.

Honolulu's Bad Six Years

How often do busts occur? The Federal Deposit Insurance Corp. has identified 21 cities that experienced a housing bust over the past quarter-century. In the mid-'80s, the victims were cities in Texas, Louisiana, Oklahoma; in the early '90s, cities in the Northeast and California. Scattered throughout the country were other places that experienced price declines when they lost major employers or became overbuilt. After too many developers invaded Honolulu, for instance, the city had six straight years of price declines, ending in 2001.

How genuine is the danger of price declines today? Some economists like David Lereah, chief economist for the National Association of Realtors, argue that we're not in danger at all, because current long-term fundamentals are sound, including healthy job growth, tight supply, and continued demand.

And while nominal prices haven't fallen since the '30s, real home prices (adjusted for inflation) *have* tumbled from time to time, typically after a big run-up like we're seeing today. In the early '80s, real home prices fell 10%. It would take a sharp and unlikely contraction of the economy to repeat that scenario—a doubling of current mortgage rates and a halving of home sales—but if oil prices remain high, such a contraction is possible, according to Lawrence Yun, a forecast economist also with the National Association of Realtors.

Other factors are troubling, too. Americans are deeper in debt than ever before, many from risky interest-only and negative amortization loans they took out to take part in the all-night real-estate party. One big bump up in interest rates, coupled with a few local downturns, is another potential scenario. The effect could be serious. In 2000, 1% of investors controlled a third of the nation's accumulated stock wealth. Today, the top 1% of home-equity holders control only 13% of the nation's housing wealth.

So in these uncertain times, should you buy or rent? There's no one-size-fits-all answer. Generally speaking, people tend to rent when their income is the lowest, when they're young and old, and own in-between. But that's not always true, especially today, when some young people are forgoing pricey cars and weddings to make down payments, some older people are sucking the equity out of their paid-off homes through reverse-equity mortgages, and some midcareer couples are renting luxury condos rather than buying a suburban McMansion. Let's look at the cases for owning versus buying:

The Case for Owning

Uncle Sam wants you to own a house, and gives you all sorts of incentives. Though some reformers would like to see the mortgage-interest deduction phased out, it's currently one of the biggest tax breaks most homeowners have, saving $76 billion a year, according to the Office of Management and Budget.

What's more, if you sell your house after living in it for two out of the last five years, you get a tax-free gain: $250,000 for an individual, and $500,000 for a couple.

Over the past decade, 10 million new households bought homes; now seven out of 10 American households live under their own roofs. That's certainly helped increase the average family's net worth at a time of stagnant wages and a lackluster stock market. Since the boom began in 1996, homeowners nationwide have amassed more than $5.2 trillion in home equity.

The politically sanctioned push toward home-ownership, coupled with low interest rates and easy money from lenders, has caused builders to flock to for-sale housing and neglect the rental market. The supply of rental apartments is declining, as some are demolished due to age, and others are converted into condos. Construction of new rental housing fell to a 10-year low in 2004, as multifamily builders turned in droves to more lucrative condos.

Although rents are currently a bargain in some of the hottest housing markets as supply tightens, that may soon change. It's happening already in some sizzling markets like South Florida, where condos are sprouting like kudzu, but long-term rentals are becoming as rare as jungle orchids.

The Case for Renting

For those who already own a home, have built up equity, and live in the nation's hottest and most precarious housing markets, now may be a very good time to rent.

With price increases reaching the double-digits in many metro markets, housing has become increasingly unaffordable. In some markets, the flight to home ownership, spurred by low interest rates, has left units vacant, forcing landlords to make deals. In Atlanta, for instance, it's common to see giveaways of a month's rent. In Chicago, you can get two months' free rent and a $500 signing credit.

In some of the most expensive for-sale markets in the country, rents have been falling for a long time. Rents in San Francisco, for example, have fallen 19% since 2001, to $1,300. For that monthly rent, you currently can get a one-bedroom apartment on tony Nob Hill, with hardwood floors, a built-in china cabinet and a courtyard with gazebo and built-in barbecue grill. Meanwhile, buying a similar place costs about $530,000, or about $2,366 a month at a 5.34% fixed interest rate over 30 years—and that's assuming you put down $106,000, or 20% of the purchase price.

Homeownership has other drawbacks. Because renters usually pay less, they have more money to put in the stock market, businesses and other investments. Renters also have flexibility, and can move without incurring heavy settlement costs, which typically run between 2% and 6% of the purchase price of a home.

Meanwhile, upscale owners in rising markets sometimes feel trapped in their homes by market forces. In Los Angeles, real-estate broker Anthony Marguleas says that high property taxes and limited capital-gains exclusions "severely penalize" sellers at the upper end of the market. That discourages them from listing their homes, so "inventories stay low, while demand is very high."

Buying has costs and headaches that renters don't need to think about, like homeowners' insurance, special assessments and property taxes. Even without these expenses, many families are already pushing their financial limits. A recent study by the Joint Center for Housing Studies at Harvard University found that more than one in three households spends more than 30% of its income on housing, while one in eight spends more than half.

So if you simply can't afford to buy without gambling your future, don't. "Many people are better off as lifetime renters," says Arlington, Va., housing economist John Tuccillo.

Adapted from the book "House Poor: Pumped Up Prices, Rising Rates, and Mortgages on Steroids: How to Survive the Coming Housing Crisis" by June Fletcher. Copyright 2005 by June Fletcher. Published by Collins, an imprint of HarperCollins. Used by permission.

Real Estate: Plan B (And C, and D...)

THERE ARE OTHER WAYS to invest in real estate without buying a home or condo. Some possibilities:

✓ **REITS:** Shorthand for real-estate investment trusts, these real-estate companies own and manage properties and/or real estate-backed loans. In moderation, REITs are a good asset to have as part of a well-balanced portfolio, though analysts suggest keeping the proportion under 10%.

Since REITs don't perform in tandem with stocks and bonds, they can help to offset losses when these markets are performing poorly. Most REITs operate with about 50% debt, so you have a bigger equity stake in properties than you'd likely have if you'd purchased them outright. But don't get too carried away acquiring REITs. Some analysts think they're victims of their own success and have been bid up too high.

✓ **REAL-ESTATE MUTUAL FUNDS:** These can be weighted toward commercial or residential rental properties, or a mix of the two. Some real-estate mutual finds hold numerous REITs. If you're a small investments without incurring a lot of commission costs, real-estate mutual funds are the way to go. Most mutual funds require an initial investment of $2,000, though some will accept as little as $250. Since commercial cycles often lag behind residential ones, you may want to switch to funds more heavily invested in commercial properties once the residential market has started to decline.

✓ **REAL-ESTATE HEDGE FUNDS:** These funds have only been around since 2000. You have to be well-off, with a minimum net worth of $1.5 million, to invest in them. But if you have the cash to invest, returns can be substantial, topping 15%. The goal of these hedge funds is to reduce some of the volatility of REITs and other publicly traded property companies. Their use of both long and short positions helps mitigate swings in the marketplace. But hedge funds are unregulated, so you shouldn't put any money in them that you can't afford to lose.

If you don't have a high net worth, you can still trade "hedgelets" on www.hedgestreet.com. Here, people gamble on the direction of mortgage rates or home prices in various major cities. The price of a hedgelet is always below $10, and trades cost a flat fee of $5 for up to 100 hedgelets, and a nickel per trade thereafter.

✓ **REAL-ESTATE-RELATED STOCKS:** Although home-builder stocks have benefited the most from the residential real-estate run-up of the past five years, from publicly traded lenders, engineering companies, material suppliers, home-improvement retailers, insurance companies, property managers, real-estate brokers and others involved in the industry. As long as housing remains strong, so should the returns of companies that make money in real estate. But if the market starts to turn, as we expect it will, so could these stocks.

details

For Halloween, Bowls That Dish

WHEN YOUNGSTERS come knocking on Rosemarie Foster's door Monday night for Halloween, she'll let her candy bowl do the talking—or at least a ghoulish, pint-sized household servant who'll snap: "Help yourself—just don't ask what they're made of."

The $60 motion-activated "butler bowl" adds a little more spirit to the holiday, says Ms. Foster. "I'm always looking for something the kids will get a kick out of."

With Halloween rivaling Christmas as a let's-wow-the-neighbors decorating spectacle, the latest element to get a makeover is the humble candy bowl. Gone are the days when anything from the kitchen filled the void. Now, it's about the bowl as statement.

Since introducing animatronic bowls in the late 1990s, Dallas-area novelty maker Gemmy Industries has tripled its offerings to 30, including severed heads and birds of prey, which retail for $13 to

$30. Giftware manufacturer Russ Berrie's new cat's head bowl, which sells for $20, plays the "Monster Mash" song when you reach in it for candy, while competitor Lenox has just introduced goody dishes in the shapes of a scarecrow and ghost. Even the fancy crystal maker Waterford is moving in: It's got a new $45 candy bowl with a checkerboard, orange-and-black pattern.

$40 Frankenstein Ornaments, Too

"There's a lot of adult entertaining.... This is one of the ways we're filling that need," says a Waterford spokesman, adding that the bowl is part of a new Halloween collection that also features Frankenstein and Mummy ornaments, sold as a pair for $40.

Halloween is an increasingly important holiday for retailers, which are trying to get consumers to spring for items from faux tombstones to giant inflatable ghosts this year. With nearly 60% of consumers saying they will do some decorating for the holiday, spending is expected to reach $3.3 billion, up 5.4% from last year, according to the National Retail Federation.

Of course, all this bowl-buying might seem a little much for a holiday where the focus—at least for children—is on those bite-sized chocolate bars, not how they're served. "I'd just prefer to get the candy," says Brad Ehmer, a 13-year-old from Palm Beach Gardens, Fla.

Still, Lorilyn Heinig, a self-described Halloween fanatic, says her $15 witch cauldron, purchased from Fright Catalog, has freed her from having to answer her door on the big night. She lets the kids help themselves, leaving her to toast the holiday inside the house with something other than candy. "I'll be serving margaritas," says the registered nurse from Cary, N.C.

—Charles Passy