



BALTIMORE CAPITAL MANAGEMENT

575 South Charles Street
Suite 506

Baltimore, Maryland 21201

Phone: 410-727-4480

Fax: 410-783-7917

Email: agraham@baltimorecapital.com

www.baltimorecapital.com

"I NEVER LOST MONEY IN REAL ESTATE"

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A few weeks ago when the stock market looked shaky, I had a conversation with an investor who said what I have been hearing all too often lately: "I never lost money in real estate." This echoes some of the comments I heard during the tech bubble in 1999 and 2000, statements like "I have to own internet stocks because the internet is the future." Well, we all know how that ended.

It is clear today that real estate prices in the U.S. have probably peaked, and are possibly declining, depending on the region of the country. The well-known Yale economist Robert Shiller is predicting that residential real estate prices will decline 20 to 30% over the next 10 years. According to an article in Barrons, Shiller forecasts that they will decline by 2% a year. While I may be less negative than that, I recently read that land prices in Japan rose for the first time in 16 years during 2006, and the increase was only .1%. So those who think real estate prices can only go up should understand that, while this has been true in the past five years in this country, it certainly has not held true internationally or, for that matter, historically. Remember that as recently as the 1970s, we had declining real estate and related bank problems in this country.



In analyzing real estate, most home owners compare what they paid for a home, say, 20 years ago to what it "could" sell for today. The truth is that the actual sale price today isn't known until the seller has an offer in hand, and many sellers are finding that offer elusive. Moreover, most investors would be surprised to calculate what that 20-year return really is on a compound basis. And the return is probably lower if one includes money spent improving and maintaining the property over 20 years. The number shrinks even more once interest paid is added to the calculation.

While I am a firm believer in owning your home if you can afford it, I also think that a reality check is needed when analyzing how well a property has done over time. During the last few years, we have seen speculators buy homes as investments, facilitated by very easy financing which seems to be drying up at present. All this ties in with the numerous problems we are seeing in the subprime lending market. The rippling effect in the economy does not bode well for the next year. In my view, a larger problem will only be averted by the Fed lowering interest rates sometime this year.

You may ask how this ties in with our investment strategy. The answer may surprise you, but it relates to the stock market serving as a mechanism that discounts events prior to their occurrence. For example, homebuilding stocks have become way oversold, and some now look attractive to us. We are also seeing some financial institutions with very depressed prices, that will survive and benefit from the marginal or more aggressive financiers leaving the market. Where we are not seeing opportunities is in the Real Estate Investment Trust (REITS) market. These stocks remain way overvalued and not of current interest.

As usual, controversy creates opportunity in the stock market. It will be no different this time as the real estate situation develops further.