PART ONE

A RECENT HISTORY OF THE REAL ESTATE ROLLER COASTER

CHAPTER 1

The Big Bang: The Post-2000 Real Estate Explosion

Between 2000 and 2006, mortgage interest rates in the United States fell in half. That started a feeding frenzy, which sent housing prices to dizzying heights.

An investment bubble is just what it sounds like: a pocket of air, rising upwards until it bursts. In real estate, just as in other financial arenas, bubbles occur when demand for a product pushes its price well above what is rational. A kind of investment fever sets in, with one buyer selling to the next, until the final fool has paid the final inflated price: the time when the music stops and someone is left standing without a chair.

When the bubble pops, people can never quite believe they bought into the mass hysteria that drove prices so high. They come to their senses, as if waking up from a collective dream. They remember saying to themselves: *It can't be this easy to make money.* But they ignored those thoughts and kept going. Well, they were correct. It's not that easy.

The great real estate bubble that rose between 2000 and 2006 was not the first of its kind. History is littered with the wreckage of past buying stampedes. From today's vantage point, many seem ludicrous, if not downright frightening. Even a cursory student of history is aware that the Great Depression followed that enormous bubble known as the Roaring Twenties, capped off by Black Tuesday and the collapse of the wildly overblown U.S. stock market.

Perhaps the most bizarre bubble in history was the tulip bulb craze of Holland, from 1634 to 1637. In retrospect, it is astonishing. At its peak, when the price of already expensive tulip bulbs rose 2,000 percent in one month, Dutch citizens were willing to trade their life savings, their land, even their homes for a handful of these unborn flowers.

Real estate bubbles do not seem quite as perverse, if only because at the end of the day you are still at least holding onto tangible property. And their causes seem more logical. The Florida real estate frenzy of the 1920s, for example, was predicated on a thriving U.S. economy combined with Florida's burgeoning popularity for people who were sick of being cold. The state's population was growing rapidly, and housing could not keep pace. By the mid 1920s, houses were quadrupling in value in less than a year. Condolike properties were going for more than $4,000,000 in 1925. And these are not adjusted prices!

The U.S. real estate bubble of the 2000s bears remarkable similarity to the Florida land boom of the 1920s. Back then, credit was easy to find, and people took on huge mortgages. Houses were trading hands like poker chips, and everybody was jumping in, even

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people with little money. Big capital was poured in as well, developing large residential tracts, golf course communities, retirement villages, and so forth. In one unique barometer of the boom, the *Miami Herald* was so jammed with real estate ads that in 1922 it became the heaviest newspaper in the world.

In the case of the great real estate bubble of the 2000s, the trigger was the availability of credit. The prime rate for the majority of top U.S.-chartered commercial banks, which had hovered at 8 percent or better for the last half of the 1990s, hit 9.5 percent in 2000. The rate then swiftly declined, sliding from 9.5 percent on Jan. 1, 2001 to 4.75 percent on Jan. 1, 2002. By mid-2003 the rate had bottomed out at 4 percent.

This fall in the prime rate—the interest rate charged by banks to their most creditworthy customers, including mortgagees—was the result of a parallel drop in rates by the Federal Reserve. This rate, officially the Federal Funds Target Rate, is the short-term, overnight rate at which banks can borrow money from the Federal Reserve. Its fall was even steeper, tumbling from 6.5 percent on January 1, 2001, to 1.75 percent on January 1, 2002, bottoming out in mid-2003 at 1 percent (see Figure 1.1).

The Federal Reserve lowered its interest rates partly in reaction to the dot-com bust and the consequent economic slowdown at the end of the roaring 1990s, a bust many believed was caused by too much tightening of Fed rates in the final years of that decade. The Fed wanted to restimulate the economy, and it did. Its 1 percent rate from mid-2003 to mid-2004 opened the door to massive liquidity in the marketplace. The rate climbed back to just over 5 percent by 2006, but by then the cat had been let out of the bag.

The cat, in this case, was a huge increase in purchasing power for home buyers, and it unleashed a buying fever that sent home sales soaring. And what a fever it was.

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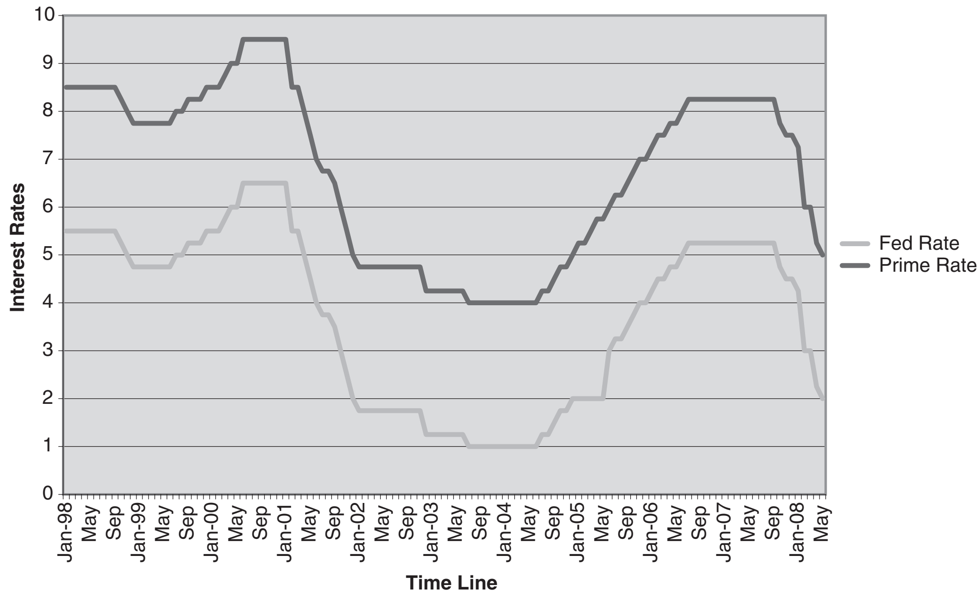

Figure 1.1 **Fed and Prime Rates, 1998–2008**

Source: Federal Reserve

Sales of new homes in the United States had remained fairly steady for decades prior to 2000, rising gradually as the twentieth century came to a close. In 1965 a total of 575,000 new homes were sold in the United States; ten years later the number was similar, at 549,000 new homes sold. By 1985, annual new home sales had inched up to 688,000, staying at that level for more than a decade; in 1995 the total was 667,000, for example.

But when the prime rate dropped and people could borrow money at much lower rates, all hell broke loose. In 2002, the number of new homes sold in the United States reached 908,000; by 2005, at the peak of the real estate boom, 1,283,000 new homes were sold. In other words, after increasing less than 20 percent over the three decades from 1965 to 1995, annual sales of new homes then doubled by 2005.

A similar rise took place in new home prices. While the average new home in the United States cost about $100,000 in 1985, and climbed to about $158,000 in 1995, by 2005 the average price of a new house came in at just under $300,000. By 2006, with the momentum still rolling, the average price had reached $305,000.

The median price for single-family homes in the United States—the combined price for new and previously owned homes—also rose at a good clip. Between April 2000 and April 2005, the median U.S. home price rose 55 percent to $206,000 (it would cross $230,000 in 2006). (See Figure 1.2.) Key urban markets climbed much faster, at blistering paces: up 135 percent in Los Angeles, 132 percent in San Diego, 117 percent in Las Vegas, 128 percent in Miami, and so on (see Figure 1.3).

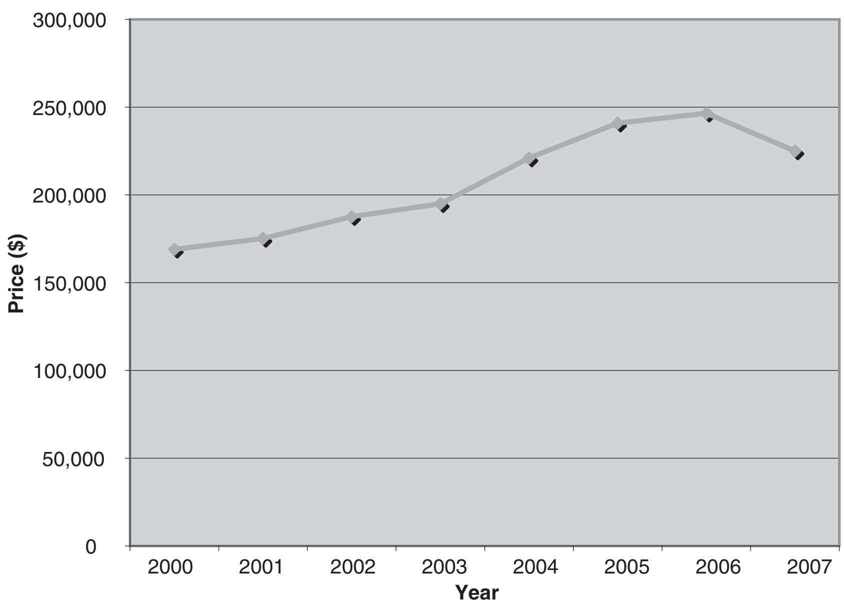

Figure 1.2 **Median Price of U.S. Homes, 2000–2007**

Source: U.S. Department of Housing and Urban Development

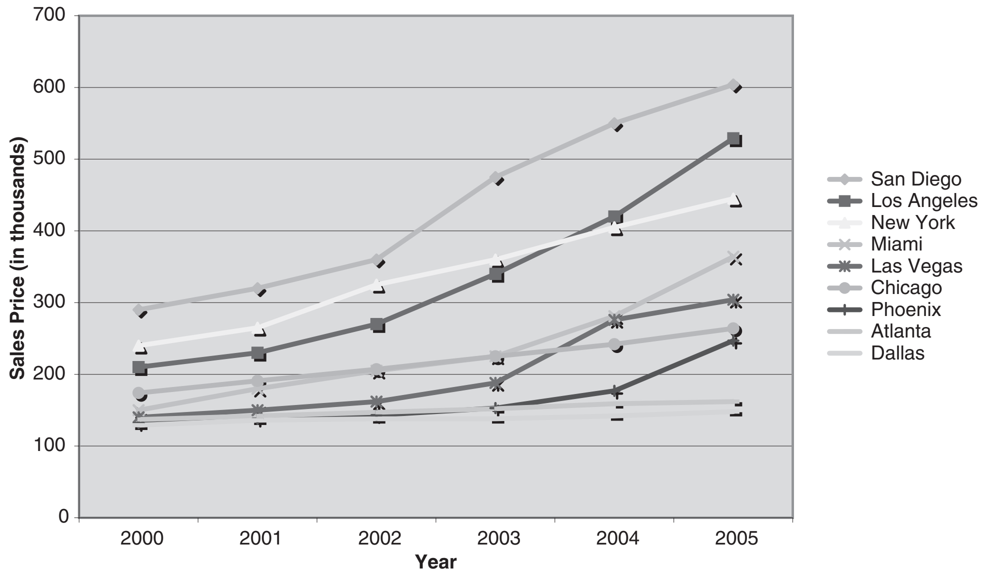

Figure 1.3 **Median Prices in U.S. Cities, 2000–2005**

Source: National Association of Realtors; S&P/Case-Shiller® Index

This paints only part of the picture, however. Not only were average and median prices rising, but the quantities of more expensive new homes were also soaring. At the beginning of the house buying frenzy, in the year 2001 for example, 75,000 new homes were sold in the United States for less than $100,000, while only 25,000 new homes were sold for more than $500,000. By 2005 the ratio had flipped. In that peak year, only 33,000 new homes sold for less than $100,000, while 144,000 homes sold for more than $500,000. The quantity of midpriced new homes that sold had escalated as well: The total number of homes selling for between $300,000 and $500,000 jumped from 110,000 in 2001 to 315,000 in 2005. Americans were trading up, and they were doing so with a vengeance.

There were other indicators, too, of how Americans took advantage of the lower interest rates to fuel their new buying mania.

Back in 1988, when the U.S. Census Bureau first started keeping comprehensive records of such things, 676,000 new homes were purchased. Of those, 62,000 were paid for with cash, 44,000 with Veteran Administration guarantees and 127,000 with FHA-insured loans—the rest were purchased using so-called conventional mortgages, larger loans that were not government insured.

By 2006, a year when more than a million new homes were purchased, the breakdown of how they were financed had radically changed. Only 38,000 were purchased with cash, 25,000 with VA guarantees, and 38,000 with FHA backing. All the rest—more than twice the number in 1988—were acquired using conventional mortgages, a sign of just how much liquidity had entered the system by virtue of lower lending rates. (See Figure 1.4.)

Of course, these so-called conventional mortgages were becoming more and more unconventional. In fact, many were being made at rates that were below the prime rate—to be subsequently increased or "adjusted"—which gave buyers even more power when it came to buying their dream homes.

A lot has been written about the so-called subprime mortgages—those made to borrowers with less than illustrious credit histories—and how they have been the leading edge of the mortgage meltdown. While that is partially correct, the real problem was not so much the fact that these were subprime mortgages but the fact that they were adjustable-rate mortgages, or ARMs. If people had simply gotten a fixed-rate mortgage, at a price they could afford, then the great mortgage meltdown of 2007–2008 might have been little more than an annoying market correction to the exorbitant cost of housing.

Instead, what happened was that greed took over and clouded the judgment of both buyers and those issuing the mortgages. What happened was that lenders offered better rates to homebuyers for

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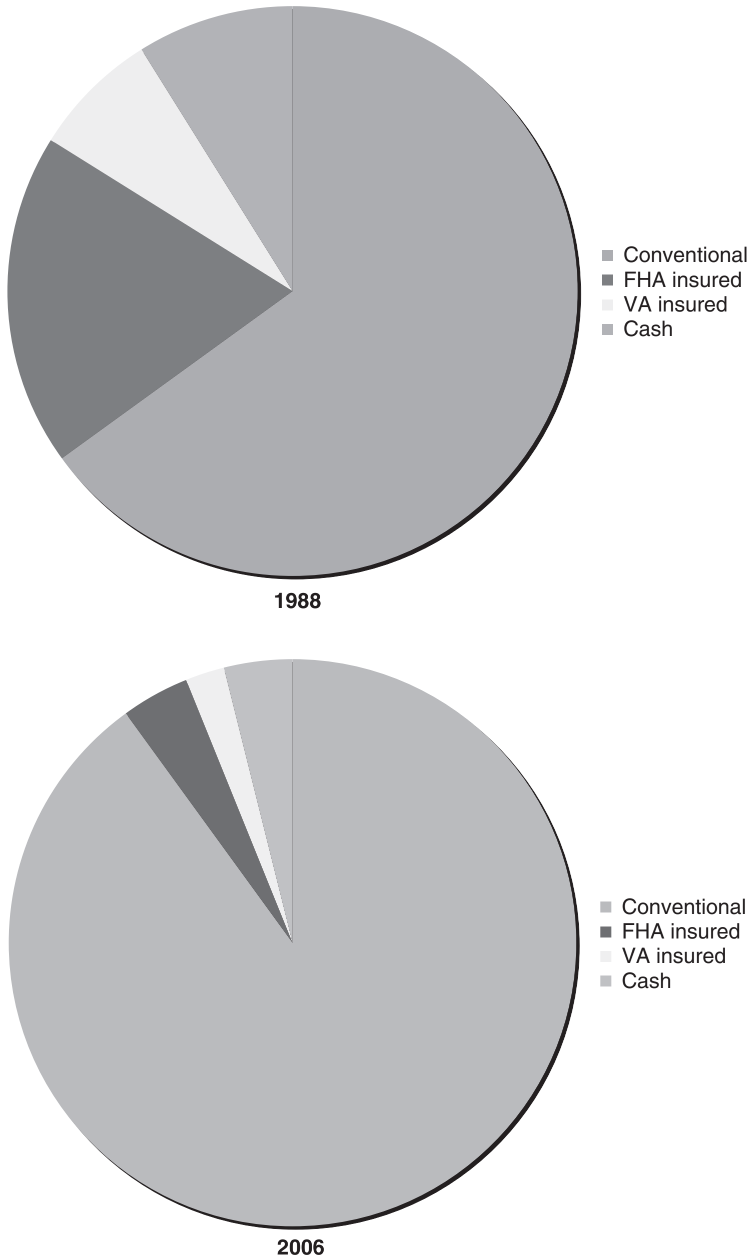

Figure 1.4 **New Home Financing, 1988 vs. 2006**

Source: U.S. Bureau of the Census

a period of time—two or three years—after which time the rates would rise. It was a great sales tool, like any upfront discounting, and buyers loved it. The consequence was a sudden surge in buying power.

Let's say someone who bought a home in the 1990s—1995, 1996, or 1997—was paying for a $500,000 mortgage. That mortgage had a fixed interest rate of 8 or maybe 9 percent. So the homeowner was paying $45,000 a year to service the debt. When interest rates went down, in 2001, 2002 and 2003, that same homeowner could borrow at between 4 and 5 percent with an adjustable-rate mortgage. All of a sudden, the same annual expense of $45,000 could buy a much larger, million-dollar home.

People looked at the options and couldn't resist. Most figured they could get twice the house for the same payment, and that is a powerful lure. The general consensus, as well, was that interest rates wouldn't go up anytime soon. Even if they did, homebuyers could lock in their adjustable mortgage rates for a couple of years. Most thought that by the time their adjustable rates rose, one of two things would have happened: They'd be making more money themselves, so they could afford the hike, or their homes would be worth more, so they could either refinance yet again or sell and take a profit.

Add to that mix the people who went even further out on the limb with exotic mortgages. Forget about simply paying low, later-to-be-adjusted rates. New lenders were out in the marketplace—companies like Countrywide Financial Corporation—and they, unlike banks, were willing to be far more lenient about down payments and finance 85, 90, 95, or even 100 percent of the value of a home. In many cases they didn't require payment on principal, only interest, at least for a stipulated number of years. They were even giving negative-amortization loans, where not only did the borrowers not pay principal; they didn't pay the full amount of interest either. They paid some part of the interest, and the rest of it was added to the principal.

Finally, you also had the psychological impact of low-cost mortgages on people who didn't have good credit, but who now were given an opportunity to buy homes for the first time. The lower interest rates brought hundreds of thousands, if not millions, of these new homebuyers into the market. And it was not just the lower rates; it was the nature of the lenders.

What you now had were aggressive mortgage companies that did not have the same criterion as banks, with little concern about whether you could repay the loan, and no concern for the communities where they were lending. They were too busy repackaging these loans with investment bankers on Wall Street and selling them off. They just wanted to make more loans and collect more fees. And as the newly available loans released more demand, prices rose. It seemed, in fact, as though they would continue rising forever; new buyers wanted to get in on the action before their long-cherished dream of homeownership escaped them once again.

The result was that overall U.S. homeownership grew from 64 percent in 1994—where it had been for more than a decade—to more than 69 percent in 2004, its all-time peak.

To cap it all off, you had people who neither bought nor sold, but simply refinanced and cashed in on the value of their homes as prices continued to rise. In fact, an estimated 34 million households took money out of their homes 2003–2007, roughly one-third of the nation. And why not? Let's say you lived in San Francisco. Between June 2000 and June 2004, the average price of a home in San Francisco increased by almost 45 percent. If you owned a house that was worth $400,000 in the summer of 2000, by the summer of 2004 it would have been worth $580,000.

Now, to continue our example, suppose you started out with a mortgage for $350,000 at 8 percent. That's a monthly interest

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payment of $2,333 (let's forget about principal for the moment). Suddenly, with an adjustable mortgage at 4.5 percent, you could free up $180,000 in cash and pay less—about $1,988 a month—for your interest payments. Who cares if your monthly payments would rise to $2,870 a month two years later, and then climb from there. You'd be making more money by then, or your house would be worth even more, so you could refinance it again if need be.

All of this worked just fine in the context of the real estate bubble. As long as housing prices continued to rise, then these risky, exotic mortgages would be able to cover themselves. And everyone bought into it, including the investment bankers on Wall Street who packaged up these risky loans and sold them as investments—and, of course, those investors who acquired them.

The most aggressively discounted of the adjustable rate mortgages were offered to people with great credit. I myself was offered a loan at 3 percent for my house in Coral Gables, Florida, with some negative amortization included. I could have borrowed $10 million. In the end I borrowed three and a half million on a home that was worth $12 million; I got a 4 percent adjustable rate mortgage fixed for five years. That way I didn't have to deal with it for quite some time, and after the five-year period the rate could rise only 1 percent a year. I figured by then I'd refinance it or pay it off with cash, plus I never planned on being there for 30 years. The important thing was that I was able to borrow almost two million dollars more while my monthly payment went up only about $1,000. Just think about that. It's unbelievable.

So these exotic types of mortgages, these creative mortgages, were available to people with good credit. And those people with good credit said it was high time to use that good credit to leverage real estate, to get more house for the money, or to start using that credit to release money to invest in other things. Billions and billions of dollars in real estate assets were made liquid, and that capital chased higher-priced housing, which of course drove values even higher.

The American public was mesmerized by the bubble—and not just for their own, primary homes. Next came second homes and vacation properties, and then properties that investors bought on spec, especially condos. As each new price barrier was broken, more investors wanted in on the act. In condo-crazed Miami–Dade County, for example, some 100,000 new condo units were on the drawing board at the height of the bubble—in a county with 829,000 households.

In the end less than half of the units planned for Miami–Dade County will ever be finished. And just as in the great Dutch tulip

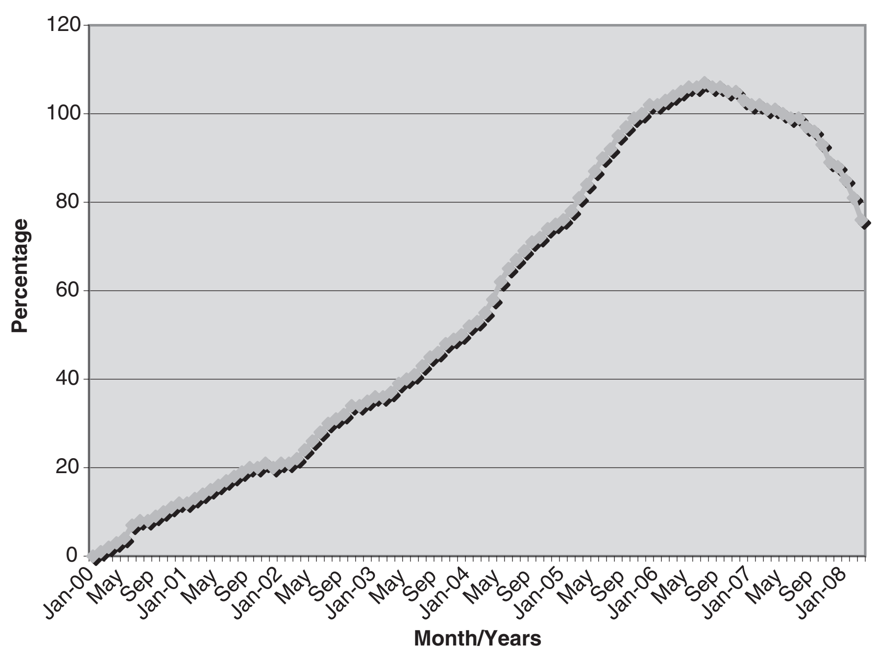

Figure 1.5 **Average U.S. Housing Prices, 2000–2008**

Source: S&P/Case-Shiller® Index

craze, the last investor caught in the cycle as it peaked will pay the price—at least the price of the down payment for that speculative condominium.

The problem with bubbles is that they are just so hypnotic; if you are not part of the action you tend to panic, to feel that if you don't jump in now you will miss out on the opportunity. In the case of U.S. housing, the bubble continued to rise year after year. According to the S&P/Case-Shiller U.S. National Home Price Index, the average price of a home in the largest 20 metropolitan markets in this country more than doubled between January 2000 and January 2006. In the hottest markets, the prices rose even faster. That kind of a bubble is hard to ignore. (See Figure 1.5.)

What you will learn in the rest of this book, however, is that if you want to make a lot of money in real estate, you must resist the herd mentality that takes place during a bubble. In order to do that you must fully understand the phenomenon and its fallout. So next we take a look at the environment that the great real estate bubble of the 2000s left in its wake: oversupply.

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