THE COMPASS CHRONICLE

Highlighting important financial planning and investment issues *Fall 2005*

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A client-focused financial advisory firm dedicated to providing objective advice to individuals, families, and retirement plans.

Our financial advisory services include:

- Investment Management and Consulting
- Retirement Planning
- Education Funding
- Family Budgeting

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Housing Bubble: Fact Or Fiction?

The stock market sell-off from 2000–2002 was the first time investors had experienced three consecutive annual declines in the S&P 500 since 1941 (a total decline of 47% from the peak). This drop came subsequent to a significant run-up in the stock market from 1995–1999, the first time the U.S. market had ever experienced five consecutive calendar years of 20% or greater gains in the S&P 500. While the 2000–2002 sell-off is termed a bear market and not a bubble, technology stocks are widely considered to have experienced a bubble and a subsequent deflation. In fact, the NASDAQ Composite Index, comprised primarily of large-cap technology-related stocks, fell more than 80% from its peak during that time frame.

While stock market investors suffered at the beginning of this new century, owners of residential real estate generally enjoyed remarkable appreciation. Has residential real estate experienced a bubble similar to technology stocks in the late 1990's and, if so, when will the bubble burst?

Home Prices From An Historical Perspective

Home prices generally increase in line with personal income, since income determines how much a homeowner may spend on housing. According to national data from *The Wall Street Journal*, median income increased 138%, while home prices increased 136% from 1980 to 2001. However, more recently, home prices increased much faster relative to income on a national level. From 1996 to 2003, home prices jumped 47% versus a 22% increase in income. In some regions, such as the Northeast and California, this disparity grew much larger.

Based on similar data released recently by Standard & Poor's, the average U.S. home price is approximately 3.1 times the average household income, more than the average of 2.6 times since 1960 and its highest level ever. S&P found that on both coasts, specifically the Northeast, Florida, and California, home costs have increased at least 30% above the normal home price-to-income ratio. Many of these areas have experienced annual appreciation of 10–20% in each of the last two years. These are the areas that are most at risk of a housing correction.

A Beneficiary Of Low Interest Rates

A primary reason for such appreciation has been historically low mortgage rates and, more recently, a slew of new mortgage types, including interest-only mortgages. Lower rates and interest-only mortgages have allowed both marginal buyers to purchase their first

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home, as well as existing homeowners the ability to trade up to larger homes without increasing their mortgage payments.

Most At-Risk Markets

In early June, Federal Reserve chairman Alan Greenspan stated that a nationwide housing bubble is improbable, but warned of "froth in some local markets."

Based on data since 1968 from the National Association of Realtors, the median sales price of existing homes has advanced at an average annual pace of 6.4% over the past 36 years and has never suffered from an annual decline on a *national* basis. The slowest price increase since 1968 was 0.22% appreciation in 1989.

Local markets have occasionally suffered setbacks, however. One of the hardest hit housing markets in recent memory was California. After reaching a peak in 1991, the median sales price declined for five consecutive years, although only a 12% drop in value from the peak was experienced. Even this drawn out decline could hardly be considered a housing bubble.

According to analysis released by PMI Mortgage Insurance Co. in July, the country's 50 largest housing markets have, on average, a 21.3% chance of experiencing a price decline over the next two years. PMI's study incorporates each market's home price appreciation, home price acceleration (a measure of whether the rate of growth is increasing or slowing), employment growth, unemployment rate, and home affordability to determine the likelihood that a particular market will see a price decline within two years. Six housing markets have a better than 50% chance of a price decline based on PMI's analysis, with Boston leading the pack, followed by Long Island, and several California cities.

At-Risk Ranking	Metropolitan Area	Likelihood Of Price Decline Within 24 Months
#1	Boston-Quincy, MA	55.3%
#2	Nassau-Suffolk, NY	54.0%
#3	San Diego, CA	52.8%
#4	San Jose, CA	51.3%
#5	Santa Ana, CA	51.2%
#6	Oakland, CA	50.9%
#7	Cambridge-Newton-Framingham, MA	46.9%
#8	San Francisco, CA	45.9%
#19	Washington, DC-Arlington-Alexandria, VA	20.9%
#39	Philadelphia, PA	7.6%

Source: PMI Mortgage Insurance Co., *Summer 2005 Newsletter*

What's Next?

The housing market, in general, is not experiencing a bubble, although the pace of appreciation is unsustainable. The most likely scenario is that home price growth will decelerate or even stagnate, allowing personal incomes to in effect "catch up" to home prices. However, the coastal regions referenced above are at greater risk of suffering from a drop in prices, as referenced by the PMI data.

Another factor that will impact home prices is mortgage interest rates. As interest rates rise, the affordability of real estate declines due to the resulting higher mortgage payment. This places downward pressure on home values. But unless mortgage rates spike upward, the housing market is unlikely to suffer a sharp price drop.

What You Should Do

What can you do? If you are able to view your primary residence as a long-term consideration, somewhere that you are comfortable living for at least five to ten years, you avoid the pressure of having to sell during a period of weakness. This is analogous to a buy-and-hold strategy used with stock investments. If you plan to stay in your home long term, the value of your home in the short term should be of little consequence to you unless you plan to leverage the equity in your home through borrowing.

If you have an adjustable rate or interest-only mortgage and plan to stay in your home past the point where your monthly payment is likely to escalate, consider locking in a fixed rate while rates remain near historical lows. Contact our office with questions or if you need a referral to a reputable and knowledgeable mortgage broker.

Did You Know . . . Cashier's Checks

Cashier's checks, historically considered to be among the safest means of payment because they are drawn on a bank's own account, are now one of the most counterfeited. Counterfeit cashier's checks are being used with increasing frequency as payment at online auctions and shopping Web sites. Even U.S. Postal Service (USPS) and retail money orders have been counterfeited. To check the validity of USPS money orders, hold them to the light and look for Benjamin Franklin's watermark and the security thread with "USPS" running from top to bottom. To validate cashier's checks, contact the issuing bank.

Hurricanes Katrina And Rita: Their Impact On The Economy And On Your Bond Holdings

The devastating loss of human life and property from Hurricanes Katrina and Rita have been staggering. In addition to the hundreds of lives that were lost across several states, the economic loss from the hurricanes is astounding. According to an assessment by Risk Management Solutions (RMS), Hurricane Katrina is estimated to have caused more than $125 billion in total economic losses, of which an estimated $40–$60 billion is covered by insurance. While RMS has not released a figure for Hurricane Rita's estimated total economic loss, it believes insured losses total $4–$7 billion. And while the hurricanes' effects will be felt in the Gulf Coast economy for some time, the destruction they brought has impacted the national economy as well.

Economy

The U.S. economy was relatively robust prior to the hurricanes. For example, the economy appeared to be growing at roughly a 3.5% annualized rate (in real, inflation-adjusted terms) prior to Hurricane Katrina as part of a broad-based expansion. However, as a result of Katrina and Rita's impact, most economists believe that third and fourth quarter real GDP growth will be reduced by about 0.5% to a level of 2.5%–3.0%, depending on how long energy prices remain at record levels.

Only The Best, No–Load Funds Selected

We purchase no-load, no-transaction-fee mutual funds for our Financial Advisory Service clients through Fidelity Investments. As an independent, fee-only advisor, we are able to choose from more than 4,100 funds through Fidelity's Institutional FundsNetwork without our clients incurring any loads (commissions) or transaction fees. We are able to select the best funds from a few hundred mutual fund companies, but hold them within an account at Fidelity. Since we do not accept compensation from commissions, we can purchase funds normally sold by brokers (with commissions as high as 5.75%) with no commission at all.

The policy response from the federal government will have a large influence on the national economy's growth and inflation trends over the next 1–2 years. The federal government may spend $150–$200 billion to rebuild the affected areas, including housing and infrastructure spending. History demonstrates that the construction sector is a primary beneficiary of rebuilding efforts. Thus, the mix of economic growth will be skewed toward construction and government spending and away from consumer spending. In fact, after Hurricane Katrina consumer confidence plunged to its lowest level since March 2003, at the outset of the war in Iraq.

Consumer Impact

Prior to the hurricane-related increase in energy prices, consumers were spending 3% of their overall personal income on gasoline, fuel oil, and other energy products (not counting what consumers spend on energy services, such as electricity and natural gas), the highest level in 20 years. The latest price increases will only add to household fuel expenses, forcing adjustments elsewhere. Consequently, consumer spending growth is likely to slow to 2.5%–3.0% over the next six months from 3.5%–4.0% over the past two years.

Interest Rates

The property devastation left behind by the hurricanes may prompt the Federal Reserve Open Market Committee to raise interest rates faster than it otherwise would have, since the Fed's greatest concern is managing inflation. The disaster in the Gulf of Mexico has raised the price of petroleum products. Further, the rebuilding effort will likely add to the price pressures already impacting the tight market for construction supplies and materials. In addition to these heightened inflation pressures, once the rebuilding effort gets underway, the Gulf region's economy will get a boost. Of course, initial economic activity in the region will suffer due to worker dislocations and inoperable factories, but ultimately rebuilding activity will enhance the rate of economic growth.

Bond Market

The prospective performance of the bond market is tenuous. The Federal Reserve had already embarked upon a

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Written and edited by Louis E. Conrad II, CFA.

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path of increasing interest rates to battle the inflation threat of an expanding economy. The devastation in the Gulf region only adds to current pricing pressures and economic growth through rebuilding efforts. The federal government's plan to spend as much as $200 billion in the region will result in a larger budget deficit. Bonds generally react negatively to prospects for accelerating inflation, increasing interest rates, and an expanding budget deficit.

Consequently, we continue to maintain a cautious stance with our clients' fixed income allocations, preferring to manage portfolios for reduced interest rate sensitivity (lower risk to rising interest rates). We also seek to add value at the margin, in such areas as high quality, international bonds and inflation-protected securities. If the federal budget deficit grows, the U.S. dollar is likely to come under pressure, which would benefit non-dollar denominated bonds. An acceleration in inflation will lead to appreciation in inflation-protected securities, commonly referred to as TIPS, and our clients' portfolios have representation to this subasset class too.

Updated Web Site And Lower Fee Schedule

If you have visited our Web site recently, you may have noticed some changes. First, we introduced a reduced fee schedule that will benefit our Financial Advisory Service clients with more than $2 million under management. We also formally introduced our investment consulting services for corporate and non-profit retirement plans. If your company desires independent and objective advice for its retirement plan, please review our Web site at www.compassinvest.com for more details.

Purchase Of CDs Now Available

For clients interested in purchasing certificates of deposit, COMPASS Investment Advisors, LLC now has electronic access to competitively priced, FDIC-insured CDs offered by leading banks. These CDs can be held directly in your Fidelity Institutional account. For more information, please contact us.

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