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2005 INVESTMENT OUTLOOK -- SMART STRATEGIES

Protecting Yourself From A Housing Slump

Even if fears of a bubble are overblown, it's a good time to start thinking defensively

In many U.S. cities, the housing market looks as extravagant and top-heavy as a Dr. Seuss castle. In metro New York, the median price of a single-family house is up 78% since 1999, according to the Office of Federal Housing Enterprise Oversight. The gains are even bigger in Miami (87%), Los Angeles (97%), and San Diego (115%). For years house prices in these markets have risen faster than family incomes. The trend made sense when mortgage interest rates were falling, but rates hit bottom in mid-2003 and they're likely to rise. Put it all together, says Yale University economist Robert J. Shiller and "it seems like house prices are within a year or so of a cyclical peak."

Even if the worries of a nationwide housing bubble are overblown, it's prudent for people living in the hottest markets to prepare for the possibility that prices will flatten out or fall in 2005.

So, what should you do? In a nutshell: Pull in your horns by paying off debt and reining in spending. Also, think defensively about the housing market. It's fine to take financial risks when you know you can raise cash quickly by selling your house for a big profit or taking out a home-equity loan. But you need to behave differently if there's a chance that you won't be able to sell or borrow against your house on reasonable terms.

Preparing for a downturn is a bit like boarding up your windows ahead of a hurricane that never strikes, if you're lucky. Here's what experts advise:

-- Make sure you can cover your mortgage payments and other unavoidable expenses for six months even if the main breadwinner is laid off. That will save you from having to sell your house to raise cash in a down market, says Laurence J. Kotlikoff, a Boston University economist. One way to increase your flexibility is to arrange for the biggest possible home equity line of credit now -- while your house value is still high and banks are still accommodating. But don't actually use the line. It's there to be tapped in an emergency.

-- Save more and borrow less. Americans' personal savings rate has dropped to just 0.2% of disposable income, a near-record low. Many people feel they don't need to save money because zooming house prices are doing their saving for them. But much of that paper wealth could be blown away if house prices fall. So people need to save the old-fashioned way -- by not spending. And don't borrow against your house to invest in stocks. If the stocks tumble, you will still have to pay back the loans. By reducing debt now, you can avert having to sell your house at a loss if your cash flow dries up.

-- Treat the housing market as a risk, not an opportunity. If you're thinking of selling when prices have already soared, don't hold off in hopes that prices will soon go even higher. List your home this coming March or April, as soon as house-hunting weather improves, suggests Julie Garton-Good, an author and expert on residential real estate. Should you also delay a purchase hoping that the price will fall? That's a tougher call. It's no fun to be stuck in limbo waiting for a crash. But there's certainly no rush to buy now. Garton-Good thinks there will be many motivated sellers cutting prices by next fall.

-- Get ready to ride out a downturn. If you were planning to move next year, keep your options open in

case the market softens and you no longer want to sell. As long as you can sit tight until prices bounce back, you can afford to ignore a decline in the market value of your house. Says Yale University economist William N. Goetzmann: "The paper loss is not going to affect your life too much" because you're not losing actual cash.

In a perfect world, people would be able to insure themselves against falling house prices. Yale's Shiller has long advocated the creation of futures and options linked to indexes of house prices in specific markets. Using those instruments as hedges, insurers could offer policies that would then pay off if prices in a policyholder's neighborhood fell. On Dec. 3 the Chicago Mercantile Exchange agreed with Macro Securities Research, where Shiller is chief economist, to look into creating house-price futures. But that's a long-term fix.

ROOM TO RISE

In the short term, *BusinessWeek*'s Luxury Housing Affordability Index shows cause for concern about prices, especially in hot coastal markets. The index tracks whether upper-bracket houses are affordable to people with upper-bracket incomes, analogous to the National Association of Realtors' index for median-priced houses. Among major metro areas, the index shows, high-end housing is the least affordable in Los Angeles, followed by San Diego. In contrast, up-market properties consume a smaller share of income in Atlanta and Detroit.

The recent sharp boom in prices has caused many people to forget that in normal times, housing is a slow-growth investment. From March, 1975, through the end of 1999, OFHEO's single-family house price index rose 268% -- just a shadow of the 1,663% increase in the Standard & Poor's 500-stock index. In the short time since then, the house price index has jumped 47%, even as the S&P fell 24%. That suggests people who once speculated on stocks have turned to real estate.

Sure, there are plenty of cities where prices are reasonable and could continue to climb. David Lereah, chief economist of the National Association of Realtors, recently finished a book, due out in February, called *Are You Missing the Real Estate Boom?* He predicts that strong growth will boost incomes, mortgage rates will stay reasonable, immigration will feed housing demand, zoning laws will restrict construction, and demand for housing from baby boomers and their children, the echo generation, will remain strong. Says Lereah: "I foresee a healthy expansion."

Still, a lot of homeowners and potential buyers in super-hot markets worry that 2005 could be the year that the housing bubble finally pops. The best insurance against that is old-fashioned financial conservatism. If you keep your leverage modest and prepare yourself to sit tight, even a steep drop in prices should be manageable.

By Peter Coy