Trusted Advisor

August, 2004

By Gary E. Miller, CFP™

Contact Gary Miller at 949-249-2057
E-mail: Gary@trustedfinancial.net

Vol. 3, No. 7

Question for a Nervous Market:

Which was a better economic move:
1. Purchasing a home in September 1987 or
2. Purchasing an index of stocks?

Those who recall the "Crash of '87" will be inclined to choose a home as the better economic investment. After all, between the end of September of that year and the low close of October 20, the average stock gave up some 32% of it's value. At the time observers wondered if we had seen the highs for the stock market for decades to come. But within eighteen months the market averages completely regained what had been lost. Even after almost five years without significant upward progress, the major stock market averages are valued at nearly three times their level prior to the 1987 crash, adjusted for inflation (See table below).

With nearly all your neighbors gasping about recent selling prices for homes in your neighborhood, real estate would appear to have been the logical place to put your money. Not so fast. Using statistics recently published by Harvard's Joint Center for Housing Studies, we compared inflation adjusted returns on single family homes with those for the Standard & Poor's 500 stock index, widely considered a useful measure of average performance. The results were startling. Between 1987 and 2003 the real median price for a new home rose only 5%, adjusted for inflation. Considering that the size of the average home grew from 1755 square feet to 2126 square feet, a 21.1% increase, it can be said that on a per – square - foot basis, the value of a single family home actually declined!

"Nonsense", any Orange County California homeowner will exclaim, noting how prices have changed in their neighborhood. "National averages never fully reflect the dynamic growth we see here on the West Coast!" True, agreed. To improve the relevance of this study, I took

Year	National Single Family Homes Median Price	Orange County CA Sngl .Fam. Median Price	S& P 500 Stock Index	% Chng Homes	% Chng Stocks
1987	$ 185,292		448		
2003	$ 195,000		1112	5.2%	148%
1990		$ 406,000	431		
2003		$ 489,100	1112	20%	158%

Sources: *Harvard Center for Joint Housing Studies, "State of the Nation's Housing June 2004"*
Yahoo Finance, "www.yahoo.com"
St. Louis Federal Reserve Bank

Notes:
•HCJHS figures are an index adjusted to 2003 dollars
•Standard & Poor's 500 Index has been adj. for inflation using Implicit GDP Price Inflator, St. Louis Federal Reserve Bank
•The effect of dividend reinvestment is not factored into pricing for the S&P Index

Certified Financial Planner™

Gary Miller is in his 31st year of providing financial guidance to individuals and pension plans. He is a Registered Investment Advisor and a Certified Financial Planner ™ Practitioner. Gary holds a Certificate in Personal Financial Planning from the University of California, Irvine and has served as a Board member of the Financial Planning Association, Orange County Chapter.

For information about attending one of Gary's seminars please call 949-249-2057 or e-mail gary@trustedfinancial.net

statistics specific to Orange County California, our home base, from the same Harvard study. Because this more specific data only reaches back to 1990, we must accept a slightly different time period, 1990 to 2003. The comparison proves that indeed, Orange County housing values have outpaced the national averages. But what the numbers clearly suggest is that the stock market, in general has far outpaced housing.

The apparent explosion in Southern California housing prices in the first six months of 2004 is not factored in to this study, but even if an estimated increase of 20% per year to date is approximately correct, this would still leave residential home ownership as an inferior investment to common stocks.

Why then, do so many people feel that their home has been their best investment?

For one, people don't jump in and out of their nest like they do with stocks. With stock prices quoted daily on radio and television, and a brokerage industry whose survival depends on frequent trading, there is tremendous pressure on investors to think short term. In contrast, one's home is usually purchased with a long term horizon. Many people spend their entire married lives in the same bungalow. This allows the inexorable forces of inflation and rising population to push selling prices upward. During periods of depressed housing prices, such as the five year slump we experienced in the 1990's, most people are unaffected. They like their homes and they have no inclination to sell them and move elsewhere. If only this attitude were more prevalent among stock investors, they might feel better about equities as another path to prosperity.

There's another reason why homes seem to be the better investment: *leverage*. Even people who consider themselves extremely conservative will think nothing of buying their home with a mortgage. This is equivalent to buying stocks on margin, but no one thinks of it that way. Borrowed money when applied to an appreciating investment, creates improved returns. By putting 20% down, if your home grows 5% in a given year, your original down payment has earned better than a 20% return[1.]

In contrast, most stock investors, the careful ones at least, do not employ leverage. This makes the apparent return on investment far less exciting. Measuring one's home vs. one's stock portfolio is something of an apples to oranges comparison. A home, after all, provides non-economic benefits like security, warmth, great neighbors and a lawn to mow! In addition there are great tax advantages to owning real estate. By contrast, stocks are just ownership interests, certificates with boring pictures of people like Alexander Graham Bell or Walt Disney engraved upon them.

Still, the numbers don't lie: long term holding of good quality stocks is a superior economic investment to residential real estate. Let's face it- both investments make sense for most people. Individual circumstances dictate how to allocate your financial resources.

When asked for advice, I usually recommend that younger people focus on owning their own home. Once this nest egg has been secured and surplus investment capital becomes available, usually in middle age, a diversified portfolio that includes common stocks, bonds, and alternative instruments makes sense.

Warning: In a hot housing market like the one in which we seem to find ourselves, it is tempting to invest in single family rental properties. Seductive reasoning tends to extrapolate recent trends, like soaring home prices, forever into the future. Inexperienced investors willingly buy a rental that produces negative cash flow, under the delusion that continuing price increases will allow for the sale of the property at a profit, 18 months down the road. As with high tech stocks five years ago, speculative thinking of this sort is likely to lead to financial disaster. If the single family home landlord runs into a cash squeeze (perhaps from a job loss), she may be unable to cover the spread between rental income and mortgage+taxes. With tech stocks, you lost money, but with a bad rental situation you lose money and get to put up with an annoying tenant to boot! A better alternative might be investment in Real Estate Investment Trusts (REITS), although most of these, too, appear overvalued right now.

Valero L.P. - a nice income generator

Last year we traded out of Valero Incorporated (VLO), a leading oil refiner, because of the volatility inherent in the stock. We respect Valero's management, but the ups and downs of the refining business were giving me heartburn. In retrospect, this was a mistake, as the refiner's stock has nearly doubled since we exited,

exceeding our intrinsic value target. Still, the replacement security, Valero,L.P. (VLI) has not done too badly. VLI is the majority owned subsidiary of Valero Inc. that operates many of the distribution facilities associated with Valero's refineries. The stock is up about 16% since we began purchasing in mid 2003. Add the company's fat dividend yield of over 7% to this figure and the total unrealized return becomes a decent booby prize for having exchanged out of the parent company. And, as expected, VLI has exhibited far less volatility than the parent firm. The company's June quarterly earnings release showed a whopping 35.3% bottom line increase for the first six months of the year as compared with 2003.

Note: for tax sheltered accounts such as IRA's, ownership of a Master Limited Partnership such as VLI may entail some minor tax risks. While I do not believe this will be a problem, I will review our position after speaking with the company in October to get better visibility on this issue.

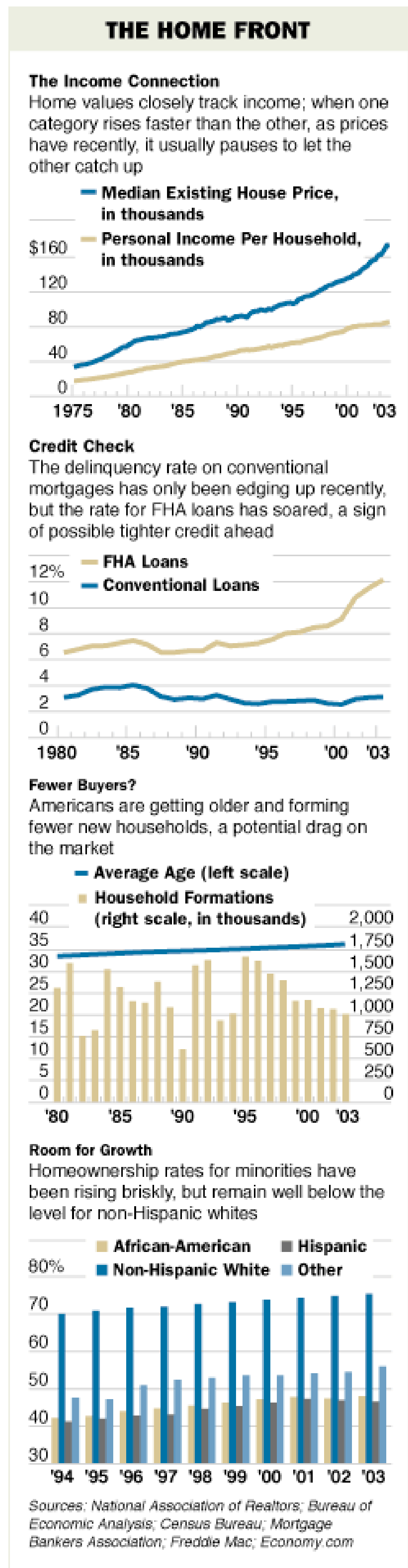
Price Legacy Preferred stall strategy seems to be working

Price Legacy (PLRE), a San Diego based real estate investment trust, owns and operates "big box" shopping centers. For example, the Costco Plaza on Doheny Park Road in San Juan Capistrano is a Price Legacy holding. We were attracted to the company's series A preferred stock in 2001, due to its attractive 8¾% dividend, and it is widely held in client accounts.

Because this preferred stock was forcing the company to pay out much of it's earnings to the preferred shareholders[2], institutional holders of the company's common stock felt shortchanged, so the firm developed a reorganization plan earlier this year. A letter from management attempted to scare Preferred Series "A" shareholders into trading in their valuable holding for the riskier common stock, or a new, less attractive preferred stock. After doing the math we demurred, and refused to tender our clients' Preferred "A" shares. As we'd suspected, a large number of preferred shareholders like ourselves refused to tender.

So, management initiated a partial call of our stock. The company only had enough funds available to call in 1 million of the 6.5 million shares outstanding in June.

By refusing to tender, clients have continued to enjoy a fat dividend. Recently, Price Legacy announced the sale of a Florida property and their intent to use most of the proceeds to call in more of our series A preferred. My estimate is that about 1/3 of the remaining Preferred "A" shares will be returned to Price Legacy by year end. Eventually, it will all go back to the company, and a profitable investment will



Sources: National Association of Realtors; Bureau of Economic Analysis; Census Bureau; Mortgage Bankers Association; Freddie Mac; Economy.com

have been retired. By delaying this day, we've garnered a dividend that is well above the norm for today's low interest rate environment. Meanwhile, we hope clients view this successful strategy as evidence that professional money management can improve their returns.

HAPPINESS

To be happy with a man, you must understand him a lot and love him a little.

To be happy with a woman, you must love her a lot and not try to understand her at all.

ANNOUNCING FINANCIAL WORKSHOP SCHEDULE :

Gary Miller, CFP™ will be conducting investment workshops this Fall. Please mark your calendar and alert friends or family who may benefit from attendance:

Financial Independence for Women

Gary Miller, CFP™ will be teaching a class called *Financial Independence for Women* at Irvine Valley College, Irvine California Wednesdays October 6, October 13 and October 20, 2004 6:30PM to 9:00PM. To register, visit Irvine Valley College at www.ivccommunityed.com or call Trusted Financial Advisors at 949-249-2057.

How to Find High Income in a Low Interest Rate World

Gary will be teaching this workshop at Saddleback College, Mission Viejo, CA Saturday October 2 from 9:00 AM until Noon. To register, visit www.saddleback-ce.com or call Trusted Financial Advisors at 949-249-2057.

For additional information see our web site www.trustedfinancial.com

(Footnotes)

1 Interest paid on borrowed capital would reduce the actual annual return from it's gross rate of 25%.

2 Preferred stock ranks above common stock in the hierarchy of equity financing for a corporation. After debt servicing, dividends must first be paid to preferred shareholders, and only after this obligation is satisfied can dividends be paid to holders of commons stock.

Trusted Financial Advisors bases it's articles on information from sources believed reliable. Accuracy cannot be guaranteed, however. Nothing in our articles or newsletter is to be construed as investment advice. Investment advice is rendered under written agreement only. ***You are cautioned not to act or invest on the basis of opinions rendered in our newsletter or at our web site. Trusted Financial Advisors will not be held responsible or liable for any actions taken by those who are not currently clients of the firm.***