

I'LL HUFF AND PUFF...

January 2008

STEPHEN K. SHUEH

INVESTMENT THESIS

Residential real estate prices in 2005-2006 marked a long-term peak. It is almost impossible for any investor to predict the depth, duration and all of the consequences of a decline from this high level. A contracting housing market has profound negative implications because:

1. Homes represent the largest single asset for most Americans. Net housing wealth as a share of GDP rose from 60% in 1997 to about 85% in 2006 according to the Federal Reserve Bank of St. Louis.
2. Most Americans now view their home as an investment asset. It wasn't long ago that a house was simply a place to live and raise a family.
3. America remains the locomotive of the global economy and is responsible for between 1/4 to 1/3 of the world's goods and services.

Contraction in U.S. residential real estate will lead to a contraction in worldwide demand for goods and services.

OVERVIEW

I. HOME IS WHERE THE HEART IS...

II. I'LL HUFF AND PUFF AND BLOW YOUR HOUSE DOWN

A. Demographics

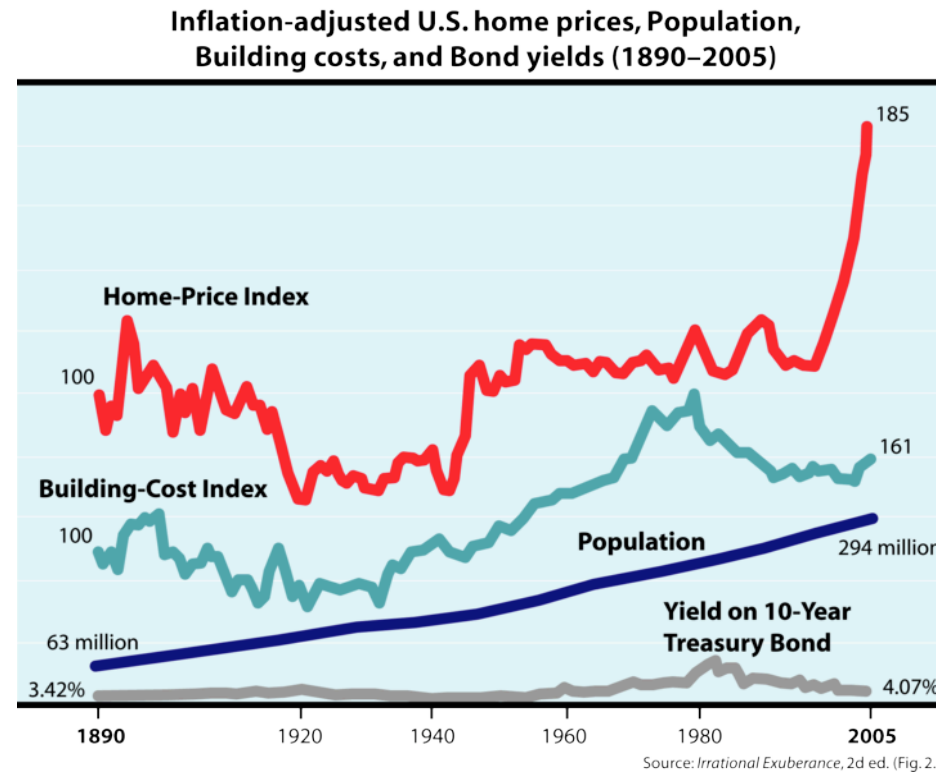
B. Valuations

C. Taxes

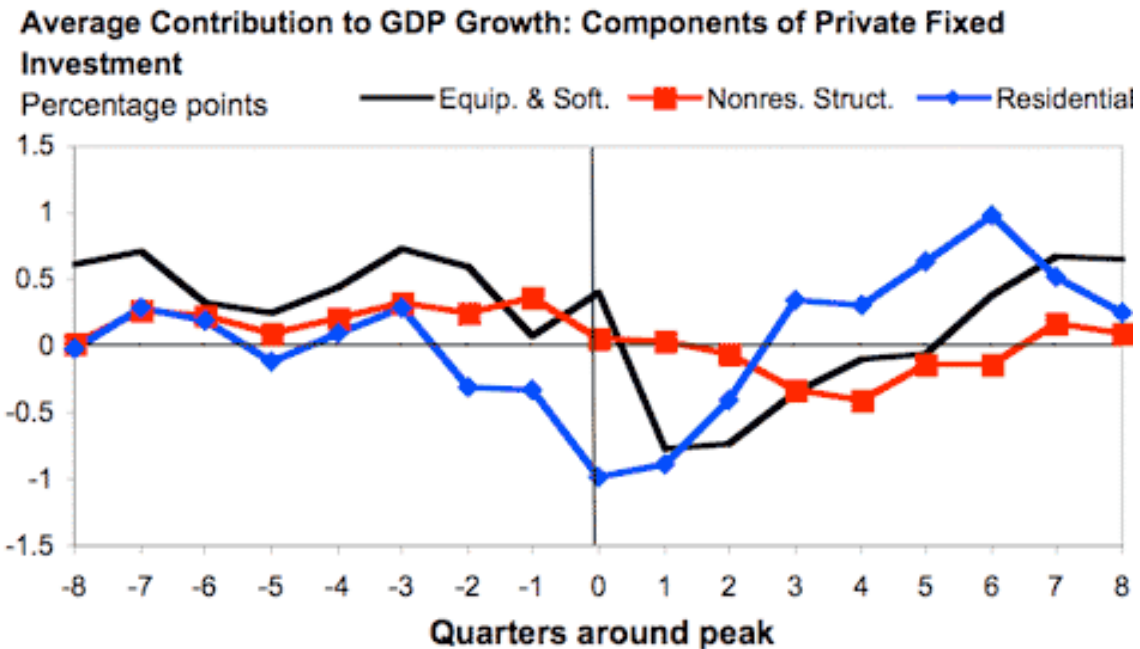
D. Credit

III. OPPORTUNITIES

I. HOME IS WHERE THE HEART IS



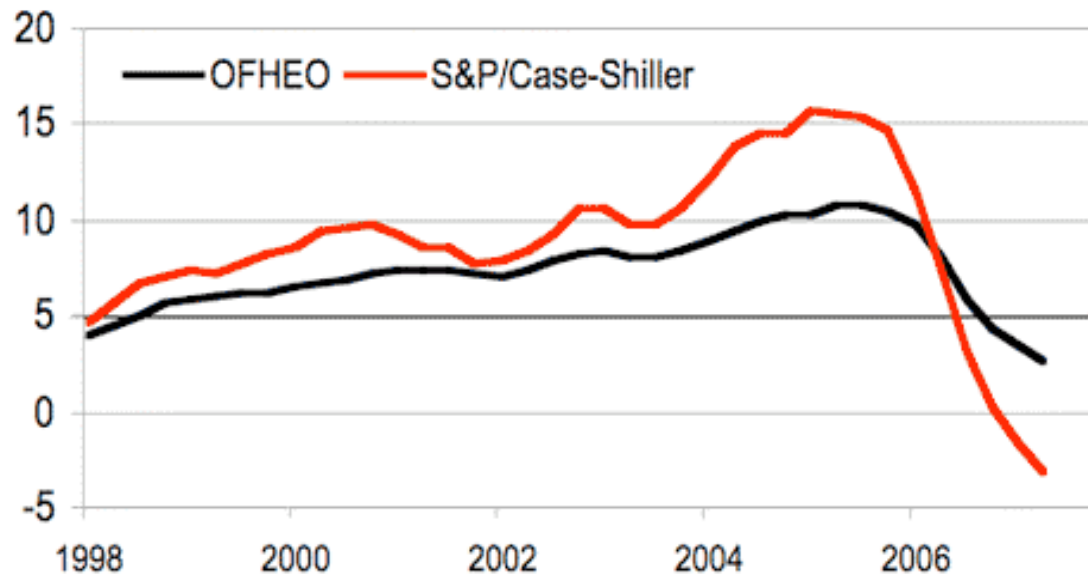
Inflation-adjusted house prices have always been relatively stable. The contrary impression is driven by inflation and changes in what was being measured.



Housing's role as a leading economic indicator has been demonstrated by research conducted by the Federal Reserve Bank of St. Louis and data from the U.S. Bureau of Economic Analysis. On average, housing peaks about three quarters before a recession starts. Housing also makes the largest negative contribution to growth during a recession.

U.S. House Price Indexes

Percent change from four-quarters earlier



Real estate has always been highly regional. That said, national price decreases since 2006 are just the tip of the iceberg.

II. I'LL HUFF AND PUFF AND BLOW YOUR HOUSE DOWN

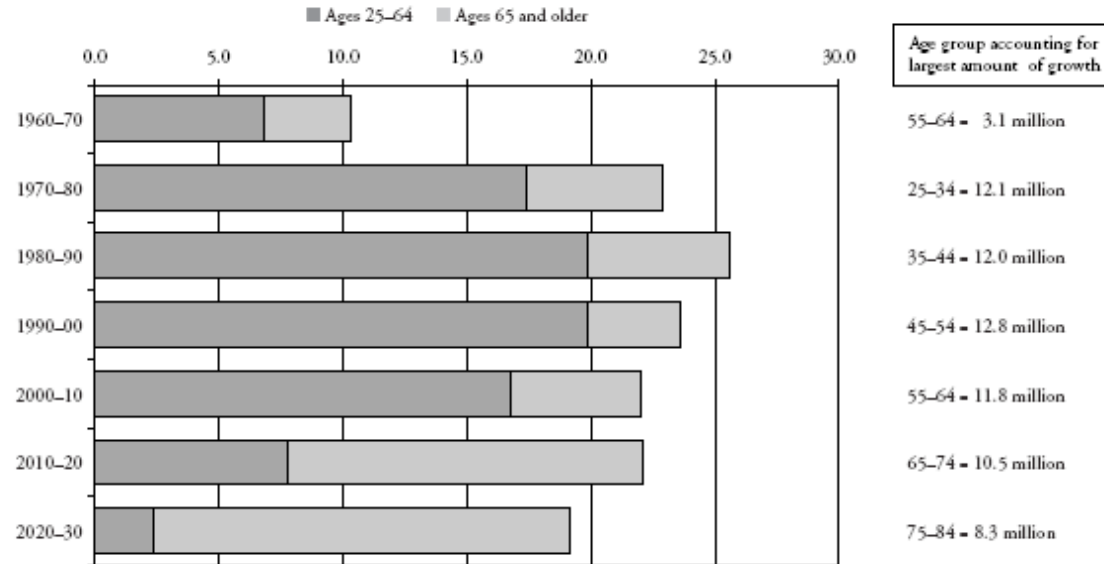
A. Demographics

B. Valuations

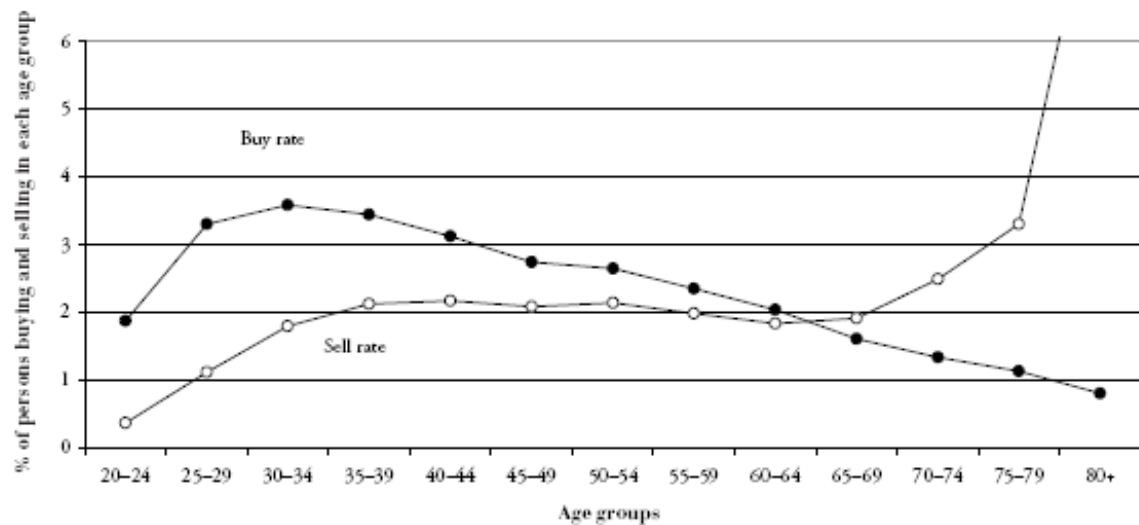
C. Taxes

D. Credit

A. DEMOGRAPHICS



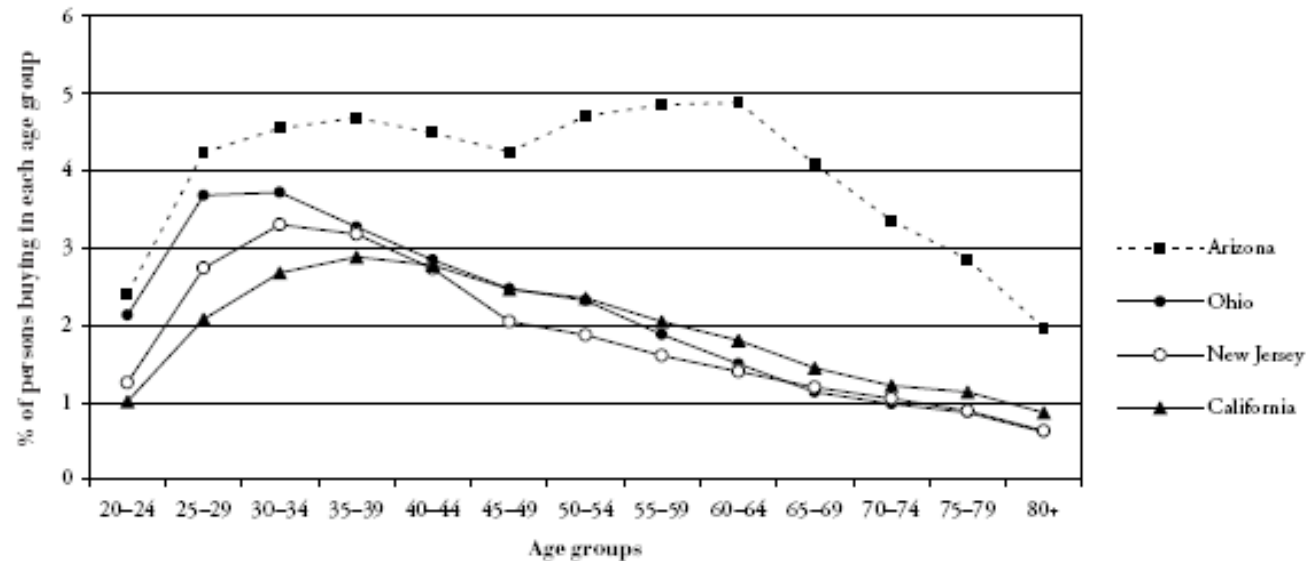
Sellers of existing homes provide 85% of the annual supply of homes. According to the U.S. Census, the first wave of baby boomers will reach age 65 in 2011 with the last of this generation scheduled to cross this threshold in 2029. Over the next two decades, the ratio of seniors to working adults will surge over 67% to unprecedented levels.

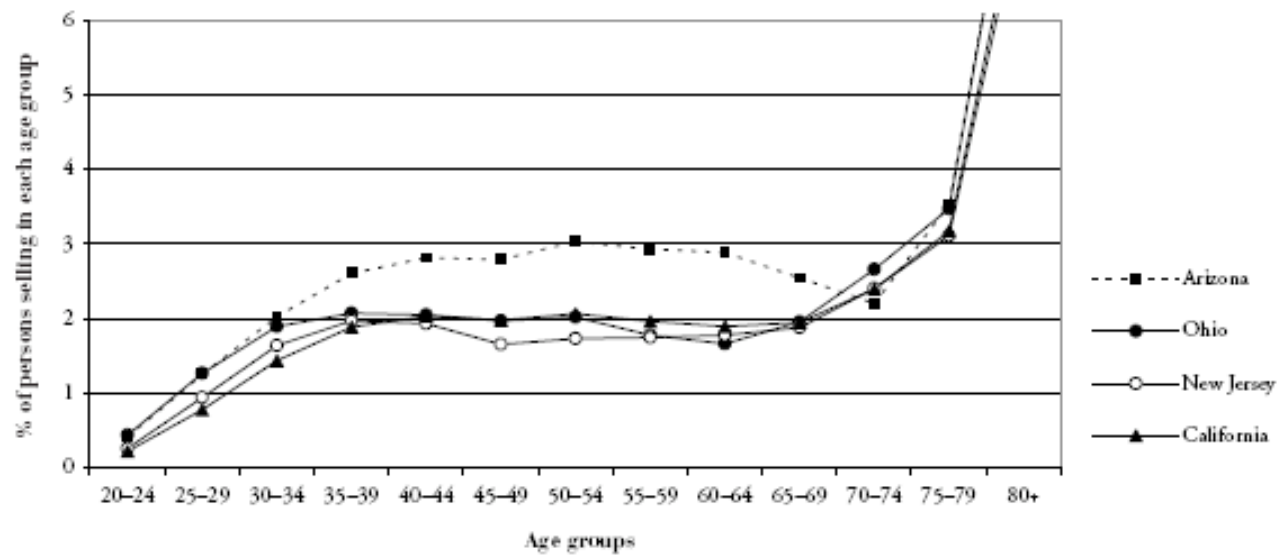


Increased age is highly correlated with the increased selling of homes. For most of the American lifespan, the rates of buying and selling are closely related because most of those who sell a home must buy a new one. Among individuals in their mid-60s, sellers begin to outnumber buyers before selling dominates among those who are in their 70s and beyond.

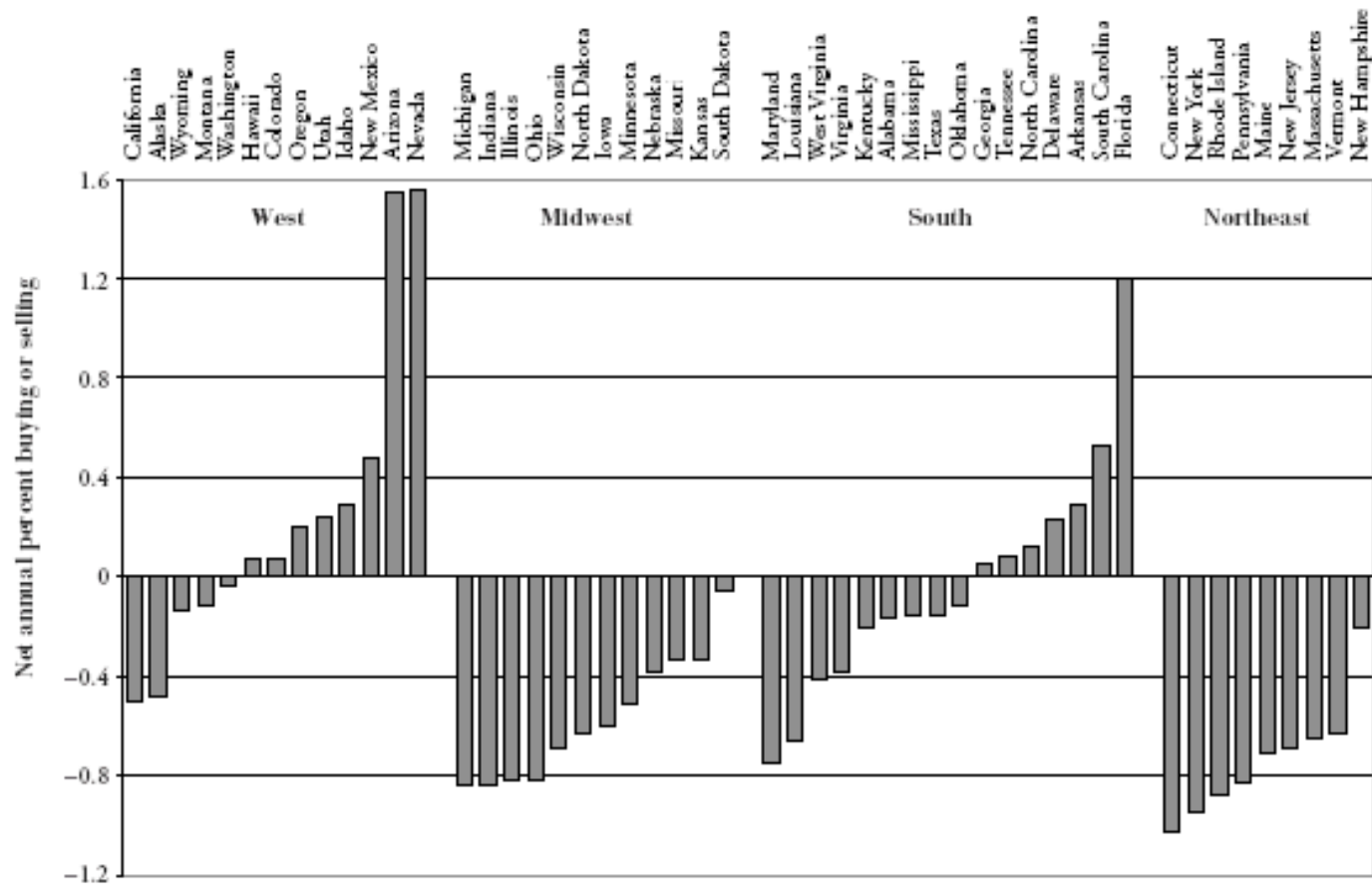
There are variations among states. Accordingly, buying and selling data in various states is provided to demonstrate that these trends exist across the board. We examine purchase and selling activities in:

- i. Arizona – A retirement state.
- ii. Ohio – A low-cost midwestern state.
- iii. California – A very-high-cost western state.
- iv. New Jersey – A high-cost eastern state and the state with the highest personal and median per capita income as of 2005.



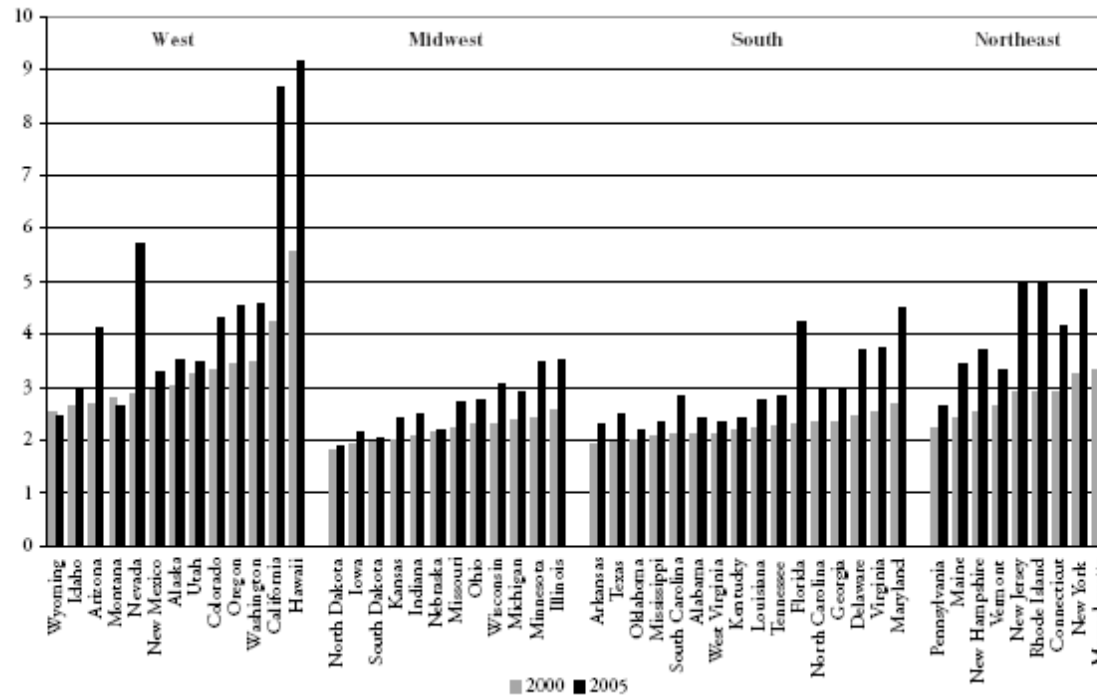


All four states experience greater selling as residents age.

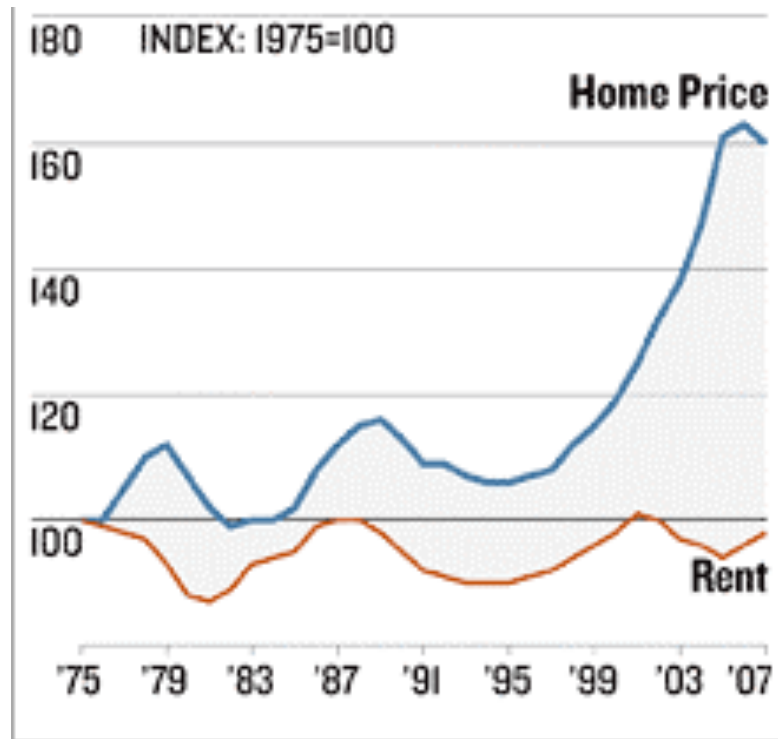


Net purchases by state.

B. VALUATIONS



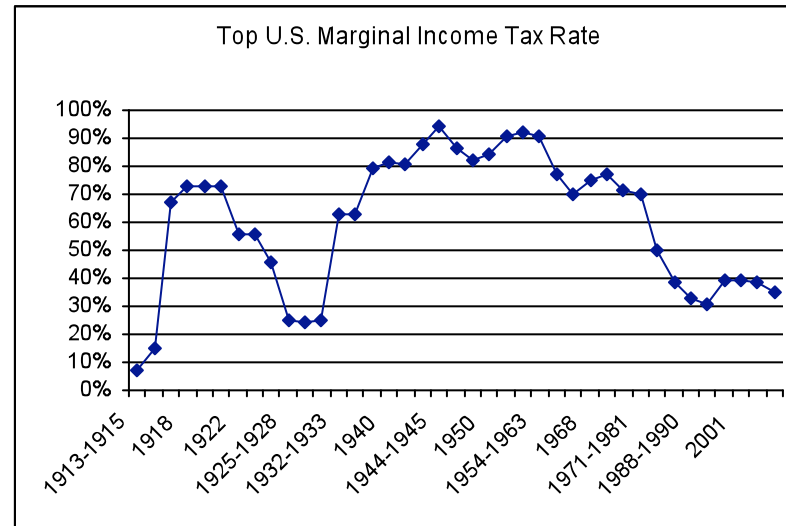
Median home price to median household income by state from 2000 to 2005.



SOURCE: CBRE TORTO WHEATON RESEARCH
FORTUNE GRAPHIC

Median home price to rents from 1975 to 2007.

C. TAXES

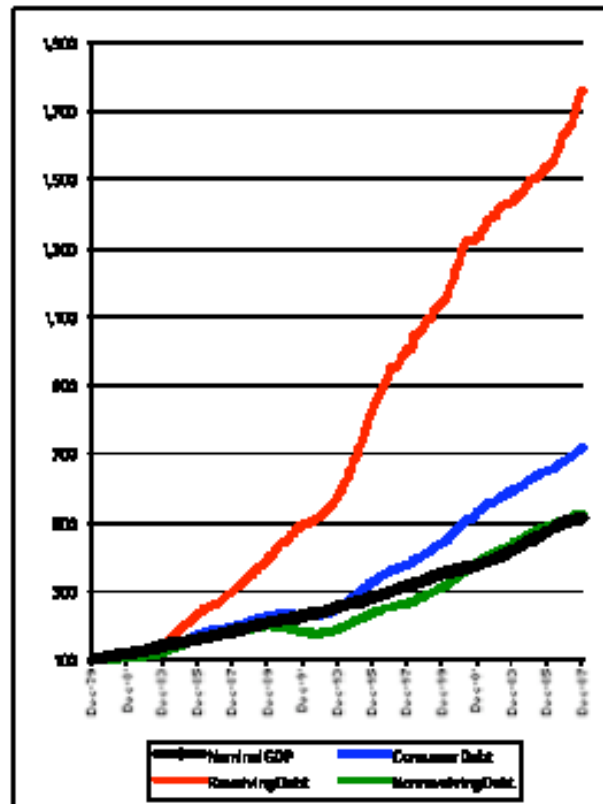


Taxes are going up. Tax cuts under President Reagan successfully lifted the economy in the early 1980s, but tax receipts did not offset the enormous growth in federal spending and entitlements. According to the National Center for Policy Analysis, if today's tax rates remain in place, 76% of all federal tax revenue in 2050 will be soaked up by Social Security and Medicare programs alone. State and local pensions face similar issues.

Income taxes, for example, are at historic lows and will rise over time.

When's the last time your property taxes went down?

D. CREDIT



Growth in consumer revolving credit has been exponential.
When will the U.S. consumer be tapped out?

IV. OPPORTUNITIES

危機

Sources

Barrons

Federal Reserve

Federal Reserve Bank of St. Louis

Federal Reserve Bank of Boston

Fortune

Internal Revenue System

Money

The New York Times

The Wall Street Journal

U.S. Bureau of Economic Analysis

U.S. Census Bureau

The Wharton School of the University of
Pennsylvania, Professor Jeremy Siegel

University of Southern California, Professor
Dowell Myers and SungHo Ryu

Yale University, Professor Robert Shiller