September 23rd, 2009
Volume 8, Issue 4

Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

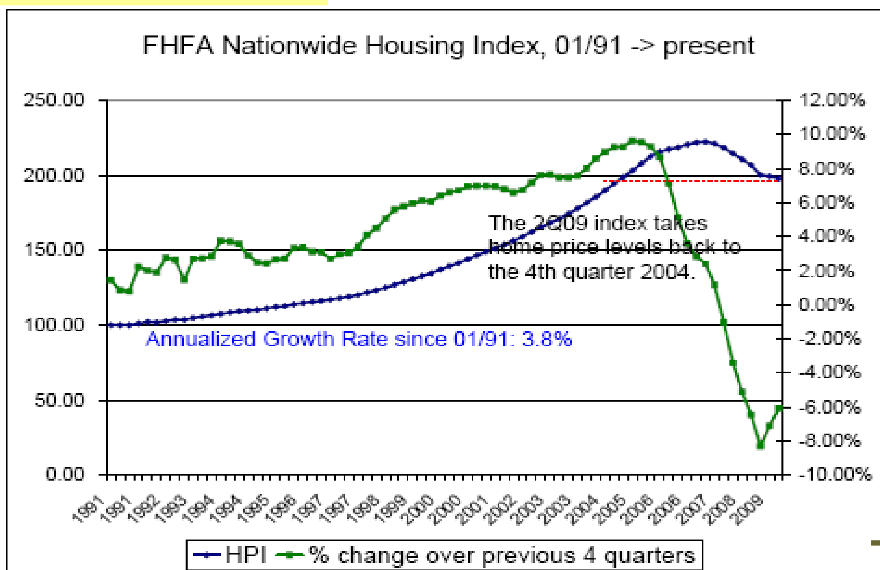
As of September 22, the aggregate estimate for the S&P 500 earnings is $60.84 – implying a price/earnings ratio of 17.6

Home Price Indices … and What They Tell Us

Most Americans have routine familiarity with common stock market indices such as the S&P 500 or the Dow Jones Industrial Average (DJIA). Indeed stock and bond prices are tracked continuously. At any time, investors can calculate the value of their investable assets to a high degree of certainty. Yet the value of a family's largest asset, the home, is often left to guesswork. The Federal Reserve estimates that 15% of household net worth is home equity. The value of residential real estate is estimated to be comparable to the value of publicly traded stocks in the US. The problem is that each house is unique and trades infrequently, rendering the valuation of an individual home an exercise in informed speculation.

Until about 20 years ago, the most widely used information on home prices were measures based on the change of an area's median home prices. Economists were frustrated with this approach. Indices based on median home prices in a geographic area can provide misleading indications of price changes as a result of shifts in the sampling of homes from one month to the next.

More sophisticated methods of measuring home price changes evolved in the 1980s. As national transaction databases became more sophisticated, statisticians began using repeat transactions of the ***same*** property to build price indices that were not affected by drift in size and type of homes sold in a given period.



Today, the Federal Housing Finance Agency (FHFA), publishes a national home price index known as the HPI. It is a weighted, repeat-sales index, meaning that it measures average price changes in repeat sales on the same properties in 363 cities. HPI only includes houses with mortgages within the conforming amount limits. It does not cover expensive homes with "jumbo" mortgages. Nevertheless, the geographical breadth of the FHFA data is extensive. The graph below illustrates the considerable decline in housing prices after an unprecedented run up.

Meanwhile The economists who contributed to the repeat sales technique in the 1980s were busy developing their own home price indices. Karl Case, Robert Shiller and Allan Weiss were directing research to areas that might more directly benefit traders. The suite of products they developed became generally known as the Case-Shiller Indices. Unlike the FHFA data, Case-Shiller transaction data included homes with non-conforming mortgages. In other words, there is no cap to the value of homes considered. That allowed the development of indices that covered historically expensive metropolitan areas.

The Case-Shiller product suite includes a national index and, perhaps more importantly, indices of 20 distinct metropolitan markets. The Case-Shiller group has licensed its indices to tradable products in an attempt to create tools for real estate speculators and hedgers. In 2002, the they partnered with Fiserv to gain the scale necessary to license their indices as tradable products.

On June 30, the first products that let investors bet on home prices were launched. Called MacroShares, they trade on the New York Stock Exchange; their value is derived from changes in the Case-Shiller 10-city home-price index. If you expect home prices to rise, you'd buy the Up Metro Market (UMM); bears can buy the Down Metro Market (DMM). It's too early to tell if there will be sufficient liquidity in these instruments to sustain them. Right now, the management fees of the products are high. At a strategic level, it's reasonable to see some practical value to these products for certain homeowners.

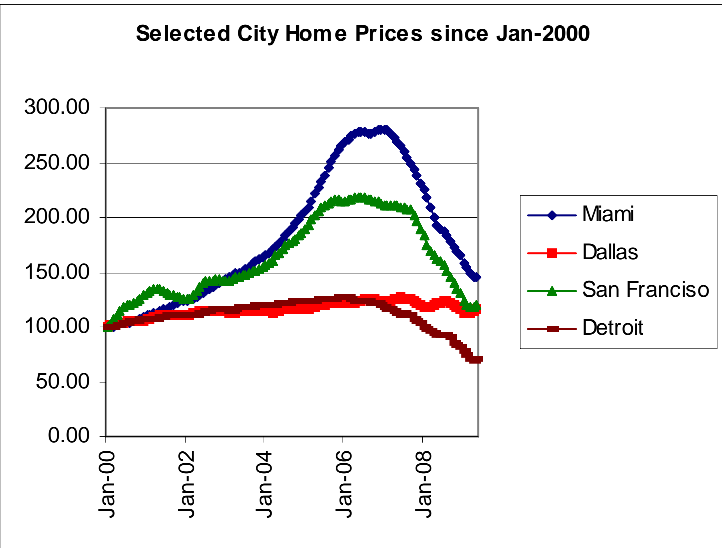
One could certainly make the case that many owners of quality homes in top metropolitan areas

have outsized investments in housing. They may want to hedge some of this value. While it is a bit early to recommend securities based on real estate indices, it is useful to monitor innovations in securities that are based on residential real estate indices. There should be considerable innovation in the near future.

Home prices in the US increased at their fastest rate in history from 1998 to 2007 – an annual increase of more than 9.3% with a volatility of less than 3%. That's an impressive record even with the problems in compiling a real estate index. Domestic bonds had higher volatility with only a fraction of the home price returns.

Of course, all real estate markets are local and most of the increase was concentrated in hip urban markets. The following graph illustrates how two hot coastal markets, SF and Miami took off in the new decade and came crashing back to earth. Meanwhile, Dallas, did not benefit from the bubble but has been largely spared from the subsequent correction.

Real estate markets tend to trend in part because of the higher leverage used to finance purchases. The values of Miami and San Francisco homes have been halved since they peaked. For those that purchased during the boom years, mortgage balances exceed the fair market value of the home. There is a strong incentive to default – further depressing prices. That's why the foreclosure problems are concentrated on the coasts.



Midwestern homeowners generally were not as levered. Unfortunately, cities like Detroit had other problems. Industrial decay has produced joblessness - creating a home price decline that was not preceded by a boom.

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Medicare Part B Premiums

The core benefits of today's Medicare program are Parts A and B. Medicare Part A pays for your inpatient hospital expenses and Medicare Part B covers your outpatient health care expenses including doctor fees. The former is free to retirees while the latter imposes variable monthly premiums. Since 2007, the level of premiums is tied to the participant's modified Adjusted Gross Income. The typical premium covers only 25% of the total costs of the program. However, the level of government subsidy declines as the retiree's income increases.

In 2009, the Part B premium for individuals making $85,000 or less is $96.40. Higher income individuals will pay more. Individuals making more than $213,000 will pay 308.30 per month – about 80% of the program's true cost. This raises a key question. What effect on part B premiums does a temporary income windfall have on a retired individual or couple? To determine part B premiums each year, the government uses the most recent tax return provided by the IRS. For 2009 premiums, Social Security generally used information from tax returns filed in 2008 (for tax year 2007). Thus, there is a two year lag on the results of the means test used to calculate one's Medicare Part B premiums. Social Security makes the calculation automatically so you will not be saddled with higher premiums indefinitely if you sell a large rental property after age 65.

There may be occasions where you will have to visit the Social Security (SSA) office to get your premiums adjusted. Sometimes, an annual tax return is not filed by the time the new premiums are set. If you notice that your higher premium is "sticky", visit the local office with an updated tax return.

Also, there are some life changing events that the SSA will review to determine if an immediate reduction in premium is warranted. These include marriage, divorce, and death of a spouse along with major changes in income such as a job loss or pension plan termination. In these circumstances, you may be able to obtain reductions in part B premiums without waiting to the results to filter through your tax returns.