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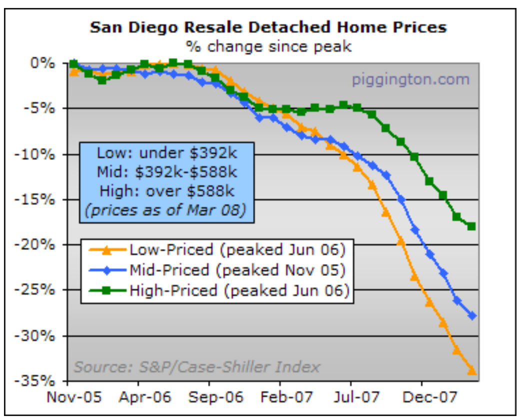
Section One: The Real Estate Market

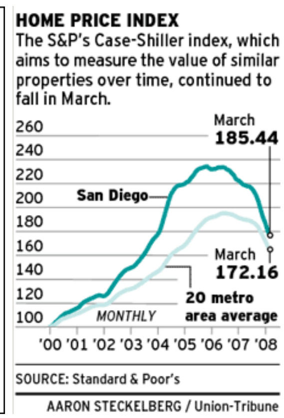
Economic and Investment Commentary for June 5, 2008

"The principal reason to heighten our cautiousness…is a once theoretical catalyst for accelerated real estate depreciation is closer to becoming reality: the implosion of the sub-prime mortgage market."

-Our Q1 2007 Newsletter (when reported data showed a 6%+/- decline)

The Most Recent S&P Cash-Shiller Home Price Index Numbers





The most recent S&P Case-Shiller Home Price Index show the average San Diego home price is down about 30% from its peak and the average urban US home price has declined by about 14%. Does this mean properties are good values? NO. (The graph on the left shows San Diego data broken down by market segment; the graph on the right shows both San Diego and national data together)

By now virtually everybody knows real estate prices throughout the country have recently been experiencing record declines. In fact it seems every month housing sales figures achieve new records for rate of depreciation. It is also now common knowledge why values are dropping: defaults on speculative sub-prime loans made for speculative purchases. We anticipated the potential severity of the problem and warned from 2004 onward to avoid real estate speculation – and issued a special report in Q1 2007 specifically warning of the possibility of a real estate valuation free-fall (the quote at the top of the page is from that report). Now that real estate is down by so much (over 40% in some areas) some of you are asking "is now the time to buy?"

My continued advice with single family real estate is generally to *stay away*. I believe most homes in most areas of the country *still* remain significantly overvalued. As illustrated by the graphs below, homes are still very expensive by historical standards.

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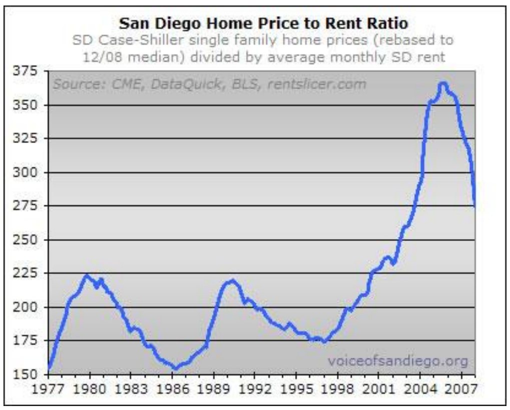
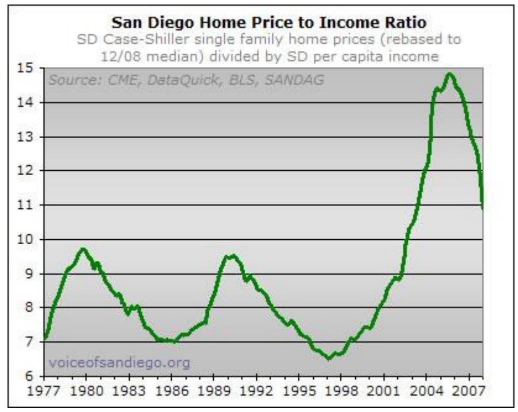
A Historical Perspective of Real Estate Values





AFFORDABILITY: In our 1st Quarter of 2007 newsletter I argued financially sound investment real estate appraisals and decisions should consider *price to rent ratios* (similar to a price to earnings ratio for stocks). The graph on the left shows price to rent ratios in San Diego over a 30 year period. As with the tech bubble of 1999 investors threw out the concept of earnings under the belief they were no longer important.

I have focused on Southern California because it is a prominently affected location that is pertinent for a large number of my clients (and data is more readily available). Unfortunately the story is similar in most other areas of the country and, even though most areas are not as severely affected as Southern California, some areas are faring much worse (such as Sacramento/Modesto, CA; Las Vegas, NV; Phoenix, AZ; and Miami, FL).

"Is it time to buy foreclosed properties?"

My rationale continues to be that we are only on the leading edge of the foreclosure crisis and any "discount" can be quickly erased by rapid depreciation. The foreclosure wave is a vicious cycle where must-sell inventory further depresses home values which lead more homeowners to "walk away" from their properties, which creates even more must-sell foreclosure inventory. The supply of homes that must be liquidated does not appear to be abating anytime soon (see the map and figures below). We will consider buying when properties can foreseeably cover expenses through rental income. J*ust like any other investment purchase we consider (be them stocks, bonds, private companies, or real estate) we will make most decisions based on earnings*! In most areas of the country real estate is not a good value yet.

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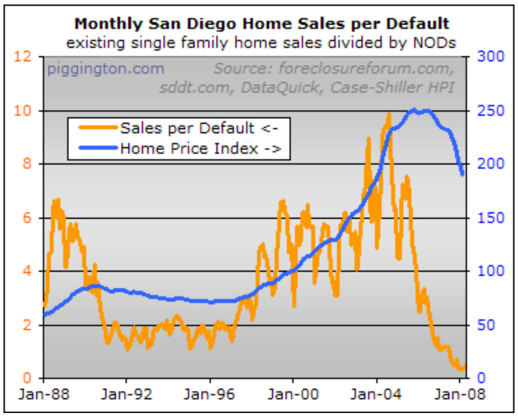
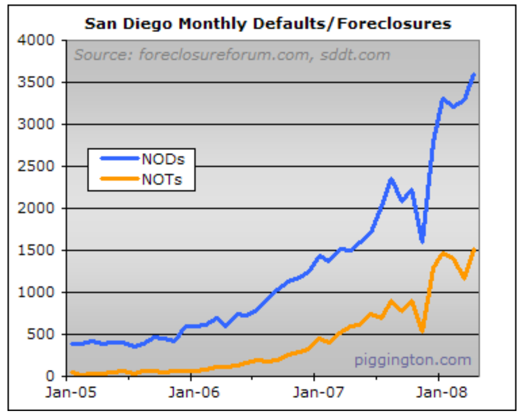
<u>San Diego Home Sales Compared with Mortgage Defaults and Foreclosures</u>





TWO MORTGAGE DEFAULTS PER HOUSE SALE! In San Diego the number of sales per default in April hit 0.47. Meanwhile the notices of delinquencies (NODs) and notices of trust sales (NOTs, similar to a foreclosure sale notice) continue to climb. It is probable a large percent of the NODs will become NOTs. This will bring additional must-sell inventory onto the market. This likely means continued price declines.

Off the cuff I have been stating that when the arenas used to sell foreclosed properties are mostly empty *then* we will be buying – and aggressively! Even though this seems extreme I believe that home prices are still inflated to such an extent that a much further decline could occur. And because markets have a tendency to overshoot on both the up and the downside the current rate of depreciation suggests we may be presented with a bargain opportunity in the future. For now most of us will keep accumulating a war chest of liquid stocks and bond.

I am also pleased and proud to report that *every person* with whom I spoke about foreclosure properties (and buying second deed of trust mortgages) over the last two years decided against making any purchases (unless they hid the purchases from me!). For many of these friends and clients the losses from these investments would have likely *already* exceeded the value of an initial cash investment and could have also surpassed the aggregate values of their entire stock portfolios (including retirement funds).

Real estate can be a spectacular investment when times are good because of the virtuous effect of leverage (borrowing a large percentage of the purchase price). However leverage also enables the loss of much more than an initial investment. A $100,000 down payment (initial equity) on a $1M Temecula, CA home a year ago could today be worth a *negative* $300,000 or more (not including losses from negative cash flow) *The carried losses could approach $500,000 after only one year on a $100,000 investment many investors considered "safe"!* As our stock portfolios lose value from time to time please keep everything in perspective!

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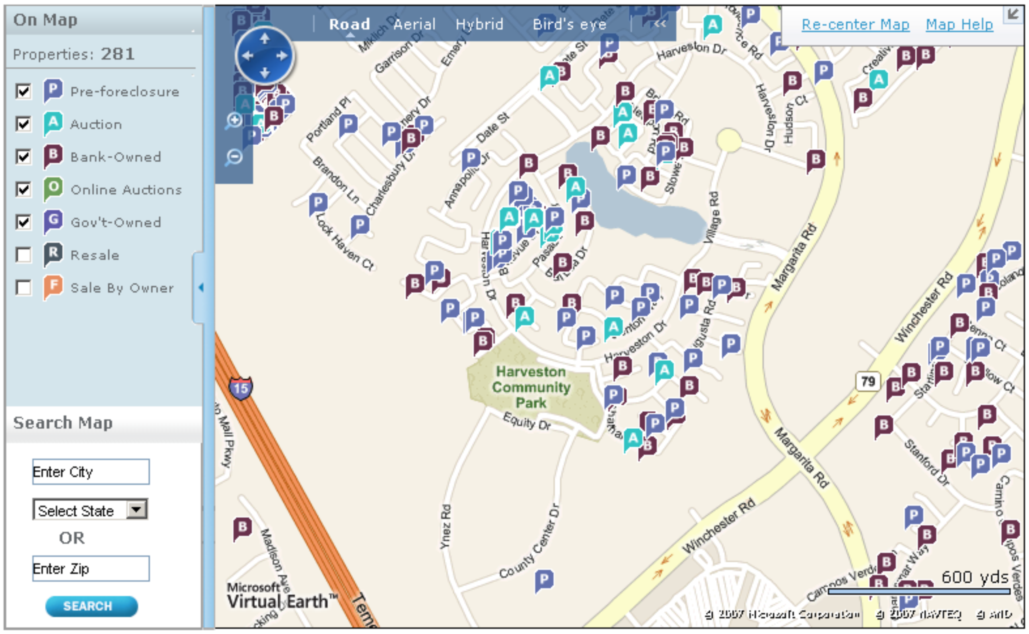
Current Foreclosure and Default Activity in One Temecula, CA Neighborhood



A snapshot of properties to be auctioned (A), owned by banks (B) and in pre-foreclosure (P) in a Temecula neighborhood (data from Realtytrac.com, June 1, 2008). Note that it is likely that many of the "P" pre-foreclosures will become foreclosures which will add to the inventory of "most sell" properties. Foreclosures show no signs of abating.

What Now?

I have always believed the real estate fallout would be worse and affect the economy more than the mainstream media ever suggested until recently. However, I do not think this shall be a terminal blow to the US economy. The economy will (eventually recover) and profits will be made by those who continue to invest in stocks. As is often the case, the sectors that are now the biggest losers may soon become those with the most spectacular gains – like the financial sector.

The financial sector has generally been the star of the US economy, now it is experiencing a hangover from a subprime lending debauchery. Most likely the majority of financial institutions shall emerge from the ruins and provide a very good long-term return on investment to patient investors. Therefore, despite continued losses in financial shares, we continue to invest in them for the *long term*.

One of the pinnacles of our investment plan it is to *never* just do what our gut or our neighbors tell us we should do. History has shown by resisting mainstream public opinion one is more likely to be a successful investor. We are doing just that by buying many stocks that have declined sharply in price (and, like any stock, they could decline further). For most of us our focus is not on next month or even the end of the year. I will review our plan, investment philosophy, and some of our recent investments in more detail the next installment. Expect it in about 3 weeks.

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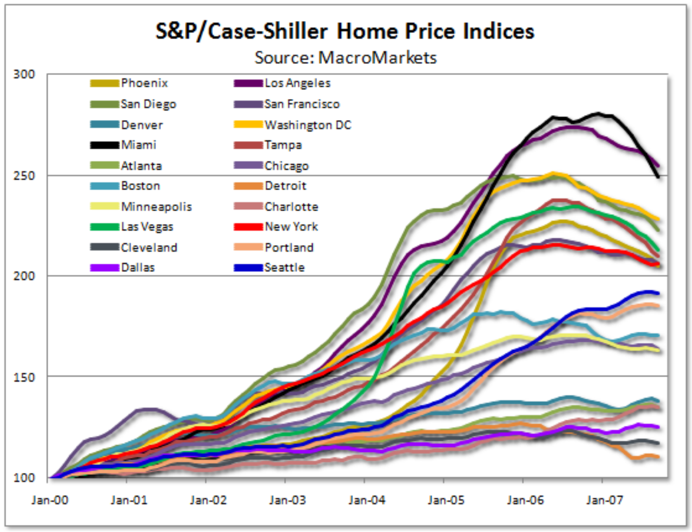
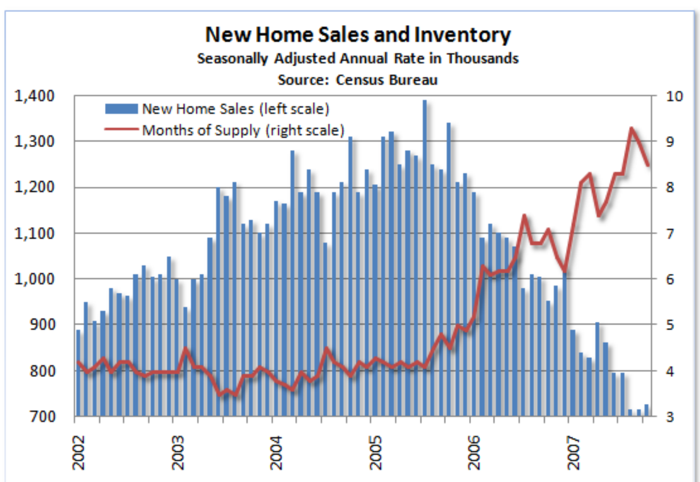
<u>Some Parting Data:</u>



Here are the home price data for all areas covered by the S&P Case-Shiller Index through March 2008 (March data was released near the end of May)



National home sales and inventory data: generally copious supply foretells price declines.

Warm Regards,

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And now, for fun, education, and to prompt discussion: our new Investment Hype Commentator!

Remember the Pets.com sock puppet? It has come to symbolize the excesses of the dot-com bubble so I thought, "why not use his image as a fun way to portray my impression of current investment market hype?"

To add a little fun and to quantify my perceptions on investment hype I have developed a new "Dot-com Dog" ranking system (it is completely subjective)! The more hyped an investment appears, the more sock puppet dogs it shall be awarded (on a 1 to 5 scale)! I hope you enjoy it.

<u>June, 2008 Dot-com Dog Hype-o-Meter:[1]</u>

 **4 out of 5 Dot-Com Dogs**

<u>Oil</u>: Oil has been the focus of almost every mainstream media outlet. But despite all of the chatter there has not been wholesale stockpiling of oil products and panicked selling of SUVs (to my chagrin). We issued a report when oil was reaching $135 per barrel last week. Was it coincidence that my phone was ringing as the oil market hit (at least a near-term) peak?
<u>Commodities</u>: Similar hype as oil but more speculative over the long-term, in my opinion.

 **3 out of 5 Dot-Com Dogs**

<u>Gold</u>: As gold hit a "4" back in January as it crested $1000 per ounce I received two calls asking "what are we investing in, gold or platinum?" I issued a report outlining why we were not buying either (and probably never will). Since then interest (and the price) has waned.
<u>Foreign Currency, Real Estate, Emerging Markets</u> are also "3"s

 **2 out of 5 Dot-Com Dogs**

<u>Stocks:</u> Stock sentiment changes quickly. Currently people are somewhat pessimistic, but Jim Cramer is still a popular show and I have not been fired by any clients. Stocks are out of favor, but pessimism is barely enough to merit less than a "3."

<u>Our Holdings</u> *Your account may or may not have similar weightings*
Oil: We still own substantial positions in deep water oil exploration companies
Commodities, Gold, Real Estate: We have minimal exposure to these industries. Emerging Markets and **Foreign:** We have substantial exposure to Brasil, Mexico, South Korea, Europe, and foreign bonds

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[1] Because a sector appears hyped or out of favor does not necessarily mean it is a good or bad investment, but *extreme* confidence *often* foretells a market top and extreme pessimism a market bottom. Consider "1" not hyped, "2" average to somewhat not-hyped, "3" somewhat hyped, "4" very hyped, "5" hype appears without logic and seems to be approaching mania.

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