2004 INVESTMENT OUTLOOK -- WIDER HORIZONS

Real Estate Is Finally Getting A Reality Check

Housing has been a great investment for several years -- especially compared with stocks. According to Federal Reserve data, in 1999 the value of residential real estate owned by American households and nonprofits was 33% less than the stocks and mutual funds that they owned. Then home prices jumped, and stocks crashed. By the end of 2002, their real estate was worth 50% more than their stocks and funds.

But plunging into a bigger house with a bigger mortgage will be a trickier move in 2004. Home prices are already high in many parts of the country and interest rates are rising, so price increases will likely be more modest. "Houses won't sell the first day they're listed," says Mike Sklarz, chief valuation officer for Fidelity National Financial (FNF) Inc., a real estate services company in Jacksonville, Fla. "The hysteria isn't going to be as prevalent."

In particular, price hikes at the high end seem to be cooling off. According to Sklarz's data, prices of homes with 4,000 to 10,000 square feet of floor space -- all but the very biggest houses -- rose only 4% in 2003 in 52 counties nationwide after a 15% gain in 2002. "The bloom is off the real estate rose," argues John Rutledge, chairman of Rutledge Capital LLC, a private equity investor in Greenwich, Conn.

However, it's still possible to invest in high-end real estate by paying close attention to local conditions. Home prices have run ahead of incomes in some metro areas, reducing the possible upside from residential investment. In other areas, though, prices have lagged, making homes still relatively cheap.

To identify areas where high-end housing might be a good investment, *BusinessWeek*, in cooperation with Fidelity National Financial, has created a city-by-city Luxury Housing Affordability Index. It compares the prices of high-end homes with the incomes of the top 10% of households in the local markets, taking into account current mortgage rates. A lower index means that housing prices are high relative to incomes, while a higher index means that high-end homes are more affordable for likely buyers.

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The new *BusinessWeek* index shows that luxury homes in Boston and Los Angeles may not have much room for appreciation because they stretch potential buyers' pocketbooks to the limit. By comparison, high-end homes in Atlanta, Phoenix, and Philadelphia are still highly affordable. New York, which appears expensive when considered in terms of median prices and incomes, is more reasonably priced for well-to-do buyers shopping for luxury homes.

Of course, local high-end markets are also affected by national trends. On the minus side, interest rates are up from their low, and are almost certainly going to go higher. The National Association of Realtors is predicting that 30-year fixed mortgage rates will rise to an average 6.4% in 2004, from 5.8% in 2003. If nothing else changed, that would slice nearly 5% off how much someone can afford to pay for a house.

On the plus side, prices in most markets will be supported by a rebound in the national economy and continued tightness in the supply of new homes, even with a recent surge in housing starts. David A. Lereah, chief economist of the National Association of Realtors, predicts that despite the rise in rates, the median existing-home price will rise 4.7% -- nearly half the 9.1% gain of 2003 -- while the median new-home price will rise 5.1%, up from 3.6%.

The days when your house was a growth stock with a roof are over, especially for the priciest homes. But there are still opportunities, if you know where to look for them.

By Peter Coy

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