

SIX STRATEGIES TO SURVIVE THE REAL ESTATE BUST

Last year the question was whether the housing boom would slow down. Now it's how bad it will get.

By Ellen Florian Kratz, Fortune writer December 18 2006: 5:44 AM EST

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Bret and Tricia Baird are all too aware of what they're getting into.

Friends and family have admonished them to rent when they move this month to Mesa, a suburb of Phoenix, for Bret's new position as product manager with Bard Peripheral Vascular, a medical-device manufacturer. In the past few months the Bairds have been researching local real estate online and haven't liked what they've seen.

With an inventory of more than 38,000 homes for sale, up 94 percent from this time last year, Phoenix is one of the shakiest markets in the country. Nevertheless, Bret and Tricia, both 35, have decided to make a leap of faith. Mesa is Tricia's hometown, and the couple, who have four young children, are planning to live there for a while. So they just put in an offer of \$400,000 for a 2,700-square-foot, five-bedroom house right next door to her sister.

The place looks like a pretty good deal - 8 percent off the original asking price of \$434,000 and \$5,000 less than what the seller paid for it last year. But with the way things are looking in Phoenix, the Bairds realize they could be paying too much. Tricia's sister, for example, bought her house two years ago for \$225,000. "We're nervous," says Tricia. "If for some reason we have to sell a couple years from now, we're not confident that we could get what we paid for it."

This time last year the big question was whether the real estate market was going to slow down. Today it's "How bad will it get?"

The numbers tell a confusing story. For existing homes, buyers are trickling back into the market - sales inched upward in October even as the median home price fell by 3.5 percent, the largest year-over-year drop on record. And that comes after price declines in August and September.

'Dead-cat bounce'

On the new-home front, sales in October fell, but the median price crept upward. For homebuilders, cancellations are up and orders down. Last month, the White House revised its GDP forecast downward due to a housing decline that's unfolding faster than expected.

"It's possible that the broader housing market will firm in the next few months, that the worst is over," says Mark Zandi, chief economist at Moody's Economy.com. "But that to me is a dead-cat bounce." In a word, yikes.

So Fortune asked Zandi's group and real estate valuation company Fiserv Lending Solutions to give us their take on what lies ahead for housing in the country's 100 largest metropolitan areas. The picture, as you probably have guessed, isn't pretty. In 2007, 36 of the 100 biggest markets are expected to see price declines. For 2008 that number rises a notch to 37. The area poised for the biggest fall in 2007? Stockton, Calif., where prices are expected to drop by 7.1 percent and another 5.3 percent in 2008.

STRATEGY 1: LOWER YOUR EXPECTATIONS

If you were lucky enough to have bought a couple of years ago, the 23 percent price growth in 2004 and 30 percent in 2005 should cushion any blow. But buyer, beware. If the forecast holds true, a home purchased in Stockton today for \$350,000 will be worth a mere \$307,917 two years from now. And that doesn't account for the additional toll inflation can take on the true value of your asset. Next in line to take a turn for the worse: Las Vegas, where our forecasters think prices will sink 6.6 percent next year and another 8.1 percent in 2008.

But let's keep all this in perspective. If you're like so many other homeowners, the value of your abode has no doubt appreciated handsomely thanks to the great American real estate bonanza. Sure, you may not be able to cash out for as much as you could have gotten last year, but we're betting you can sell it for a lot more than you would have gotten five years ago.

And remember that your home is your castle, not your 401(k). It's a place to shelter your family and rest your head. So while it's wise to keep the near term in mind when making decisions, long-term perspective is what really counts in the real estate game.

What to do? Whether you're buying, selling, or staying put, we've put together some simple strategies that can make a big difference for you and your home. Sellers: Lower your expectations

As painful as it might be to realize that your house isn't worth what you thought, asking too much in a slow market is a mistake.

In order to seal the deal in Mesa, the Bairds need to sell their home in Plymouth, Minn. Initially their concession to the slowing market was to price their home at \$310,000, which

is less than the \$324,000 asking price for the most recent sale in the neighborhood, even though their house has a slightly better layout and nicer views.

But after noticing 'for sale' signs lingering too long in other people's front yards, they reconsidered. Last month they put their 2,200-square-foot home on the market for \$299,900.

"It's a little depressing," says Bret. "But that's what we think the market is willing to pay." Assuming they get full price, they'll be lucky to make a few bucks more than the \$279,900 they paid two years ago after commission and closing costs.

But they made the right call. As painful as it might be to realize that your house isn't worth what you thought, asking too much in a slow market is a mistake. "Trying to get last year's price is wishful thinking," says Hessam Nadji, managing director with real estate advisory firm Marcus & Millichap. "Often you're unable to sell your house, which compounds itself, and you keep chasing the market down."

Just ask Rob Sakey, 46, of Northampton, Mass. He and his siblings put their grandparents' Victorian in Cambridge, Mass., on the market for \$2.1 million last year, when real estate in the area was starting to slide. After four months they lowered the price to \$1.9 million. Then \$1.7 million. At \$1.5 million, they started getting bites. The house is now in escrow for \$1.2 million.

STRATEGY 2: BUYERS: DRIVE A HARD BARGAIN

If you're purchasing from a developer, push especially hard. They can't afford to wait.

Shim and Neesa Patel were ready to pounce on a brand-new home in San Diego early this year. It was a 4,300-square-foot Spanish colonial coming on the market for \$1.2 million. But two months before the house became available, Shim, a 35-year-old engineer for Qualcomm (Neesa is 30), noticed that local home sales had more or less ground to a halt.

"It made me very uneasy," he says. The couple stood pat for nine months - and for about the same price, they're getting a place that's 1,000 square feet bigger.

If you're purchasing from a developer, push especially hard. Unlike individual sellers, who are prone to get emotional and dig in their heels, developers cannot afford to wait. "Builders are doing anything to move their inventory, because it costs money to carry it," says Ivy Zelman, a housing analyst with Credit Suisse. "Free cars. Vacations. No closing costs. You name it. [They're discounting] anywhere from 6 percent to a third off the base price."

Take, for example, Larry and Wanda Grover, 66 and 60, respectively, who bought a 1,700-square-foot house last August in Culpeper, Va. Ryan Homes, the developer, knocked \$10,000 off the \$319,000 starting price, kicked in \$9,000 for closing costs, and agreed to an

upgrade of the master bathroom. "Maybe if I'd held out, I could have gotten more," says Wanda.

North of Sacramento, Pulte Homes recently agreed to part with a 2,700-square-foot four-bedroom home for almost 18 percent off the \$497,000 list price, plus an additional \$8,500 in credits. "I've never seen anything like it," says Lance Pagel, the realtor on the deal. "I recently point-blank asked one developer's agent what incentives she was offering, and she point-blank answered \$80,000."

To compete with the big boys, sellers of existing homes are also sweetening the pot. Feel free to ask sellers to cover closing costs or several months of mortgage payments. In order for David Reznikow, 34, to get a buyer to sign on the dotted line for his one-bedroom Boston condo, he agreed to incur moving costs that the buyer would have to pay to get the current tenant out

You'll also need a reality check when it comes to the physical appeal of your home. In the days of bidding wars and waiting lists, buyers were so happy to land a house that they scarcely noticed carpet stains and chipped paint. Today they are picky about the cosmetic stuff. Already Bret and Tricia have laid new carpet, repainted, and replaced the kitchen sink. "We're making lots of trips to Home Depot," says Bret.

That's the spirit all sellers should adopt. "If it takes repaving the driveway or retiling the bathroom to get the house sold, do it," says Zandi. "Don't play a game of hoping the right buyer will come along just in time."

STRATEGY 3: CONSIDER RENTING

If you got out of the market when prices were high, bank those proceeds.

Stephen Levy knows how lucky he was to sell when he did. He put his San Diego penthouse on the market in August 2005 for \$2.65 million, more than double what he had paid for it in 1998. That October he got an offer for \$2.25 million but turned it down. It would be months before he got his next offer. Luckily for him, he was finally able to sell, closing for \$2.1 million.

"It was a gift," he says. "Is the property still worth \$2.1 million? I'm not so sure about that." Like any precious gift, Levy, who is 58, is holding it dear. So dear that he decided not to roll it into another house right now. He deposited the proceeds into accounts that earn about 4 percent after taxes. The interest just about covers the \$3,700-a-month ocean view home he is currently inhabiting. "I've never been a renter in my life," he says. "It's not bad."

Economist John Talbott, author of *Sell Now!*, applauds the notion of renting in a market like this - even if it isn't part of the classic American dream of owning your own home. "Maybe you don't live to the same standards, but don't worry about it," he says. "If we're talking about the chance to bank \$1 million, that's real money."

The economics of renting make sense to Spencer and Jacey Davis, 31 and 29, who are moving to the Boston area - probably for no longer than 18 months - with their three

children for Spencer's next assignment with medical technology company Medtronic. They took their sweet time weighing one rental in Concord that they'd been able to talk down to \$1,800 a month against another in Andover that was asking \$2,000.

Why no rush? "There is no competition," says Jacey. "We were hoping to get a bigger bargain." They did. The Davises are moving to the Andover rental. Monthly payment: \$1,850. Shop for a rate drop

With loan volume dropping, banks are willing to negotiate to get your business.

NEW YORK (Fortune) -- When Tom Downie and Rebecca Romajas first laid eyes on their 18th-century Connecticut colonial, they knew they had to have this historical gem. It had rough edges, so soon after purchasing it in 1999, they got to work. Tom, 35, a public relations manager, laid a stone patio. Rebecca, 33, a senior technical director for AT&T, framed the unfinished windows in the sunroom.

Soon they decided to tackle projects that went beyond the do-it-yourself level, so they borrowed \$32,000 from a \$60,000 line of credit and called in the pros to do something about their Brady Bunch-era kitchen. The terms of the deal: They were required to pay the interest only on a variable monthly rate of prime plus 0.99 percent. Rates were low at the time, but to be safe, they chipped away at the principal. (Tom and Rebecca have always been cautious when it comes to debt. As exotic mortgages were proliferating, they stuck with a 30-year fixed loan, which they refinanced in 2003 to a 15-year fixed.) Four years later the loan amount is down to \$23,000.

During that time the Fed raised short-term rates 17 times, and the Downies' monthly interest payments have risen along with those hikes (last month their rate was 9.24 percent). To get the most for their money they've decided to roll their line of credit into a fixed-rate loan. But before accepting their bank's kind offer of 8.5 percent on a five-year fixed, they're shopping around.

STRATEGY 4: STEP AWAY FROM THE EXOTIC MORTGAGE

A lot of homeowners out there are living under a roof they soon won't be able to afford.

Of all the nonsense that the boom has wrought, little has been crazier than the proliferation of adjustable-rate mortgages, or ARMs, often called exotic mortgages because so few people understand them.

A refresher: ARMs offer a low interest rate - a.k.a. teaser - for a certain period of time, after which it varies according to prevailing rates. To complicate matters further, banks also offer interest-only ARMs that allow borrowers to pay just the interest in the beginning and save the principal for later.

The most dangerous type is the "option ARM," which causes a home to amortize negatively. That means the borrower pays just a portion of the interest due; the rest is added to the

principal. As long as the home keeps appreciating, the borrower keeps his head above water. If the market stalls, an unprepared homeowner can drown.

ARMs have traditionally been the province of wealthy and sophisticated homebuyers. During the boom, however, banks went after anyone with a wallet. As a result, a lot of homeowners out there are living under a roof they soon won't be able to afford.

Worse than that, these poor saps may have no idea what they're in for: According to a study earlier this year by Fed economists, 41 percent of ARM holders do not know the maximum interest rate they might have to pay. They'll find out soon enough, though, because next year an estimated \$1.5 trillion worth of these mortgages are scheduled to reset. (By the way, ARMs make even less sense right now given that introductory rates aren't much lower than fixed rates.)

"There's all kinds of language in these ARMs that allow the rate to rise much faster than interest rates are rising," says financial guru and actor Ben Stein. "They can be treacherous. I had one, and it screwed me over."

Here's an example. Suppose a homebuyer obtains a \$350,000 mortgage today using a 5/1 interest-only ARM at 6.25 percent. That means the borrower pays just interest for the first five years at the guaranteed 6.25 percent, after which the principal kicks in and the interest rate becomes adjustable. The beginning payment is \$1,822.91 per month.

STRATEGY 5: SHOP FOR A RATE DROP

So what happens five years from now when the loan converts from interest only to interest and principal, and the rate faces its first adjustment? Fortune asked Greg McBride of Bankrate.com to calculate various scenarios. Best case: If the rate falls to 4.25 percent, the payment would still rise to \$1,896.08 as the principal starts to amortize. If the rate stays at 6.25 percent, the payment rises to \$2,308.84. If the rate were to jump to 8.25 percent - which is entirely plausible - the payment would hit \$2,759.58.

That's not necessarily the end of it: The borrower could still face further rate increases in subsequent years. "Make sure you can afford the fully amortized payment," says Zelman.

Pat Davis-Lemessy, 44, of Miami Lakes, Fla., knows firsthand how painful these sorts of home loans can be. In 2003, when she purchased her 1,700-square-foot home just minutes away from where she works as a medical plastics engineer for a subsidiary of Johnson & Johnson, she signed up for an interest-only loan with a 3.4 percent teaser for the first four months. At \$850 a month, the teaser was easily affordable.

But then her payments started creeping up by almost \$200 each month until she found herself paying \$1,770 - in interest only! Last year she did the smart thing and refinanced into a 30-year fixed at 5.25 percent. Doing so cost her \$5,000 in fees, but she considers that well worth the peace of mind of knowing exactly what she's going to owe each month. "If I'd done a fixed rate when I bought, it would have been 4.65 percent," she says. "The adjustable rate was a mistake. I lost thousands in equity on my home."

STRATEGY 6: KEEP AN EYE ON YOUR EQUITY

"I'll get four or five offers," says Rebecca. "I'll write them all out in a notebook and compare each one."

The Downies couldn't have chosen a better time to look for money. In 2003 the mortgage industry originated \$3.8 trillion worth of loans, according to the Mortgage Bankers Association. Next year it will hand out an estimated \$2.1 trillion. "That's nearly a 50 percent drop in volume, which means there's tremendous pressure on company earnings," says Doug Duncan, chief economist with the MBA. "They're going to negotiate to get your business."

Bank of America offered the Downies the same loan for 8 percent with no fees. Webster offered 7.74 percent. Wachovia came down to 7.44 percent with \$230 in fees. And TD Banknorth's rate is 6.49 percent, as long as the payments are deducted automatically from their checking account