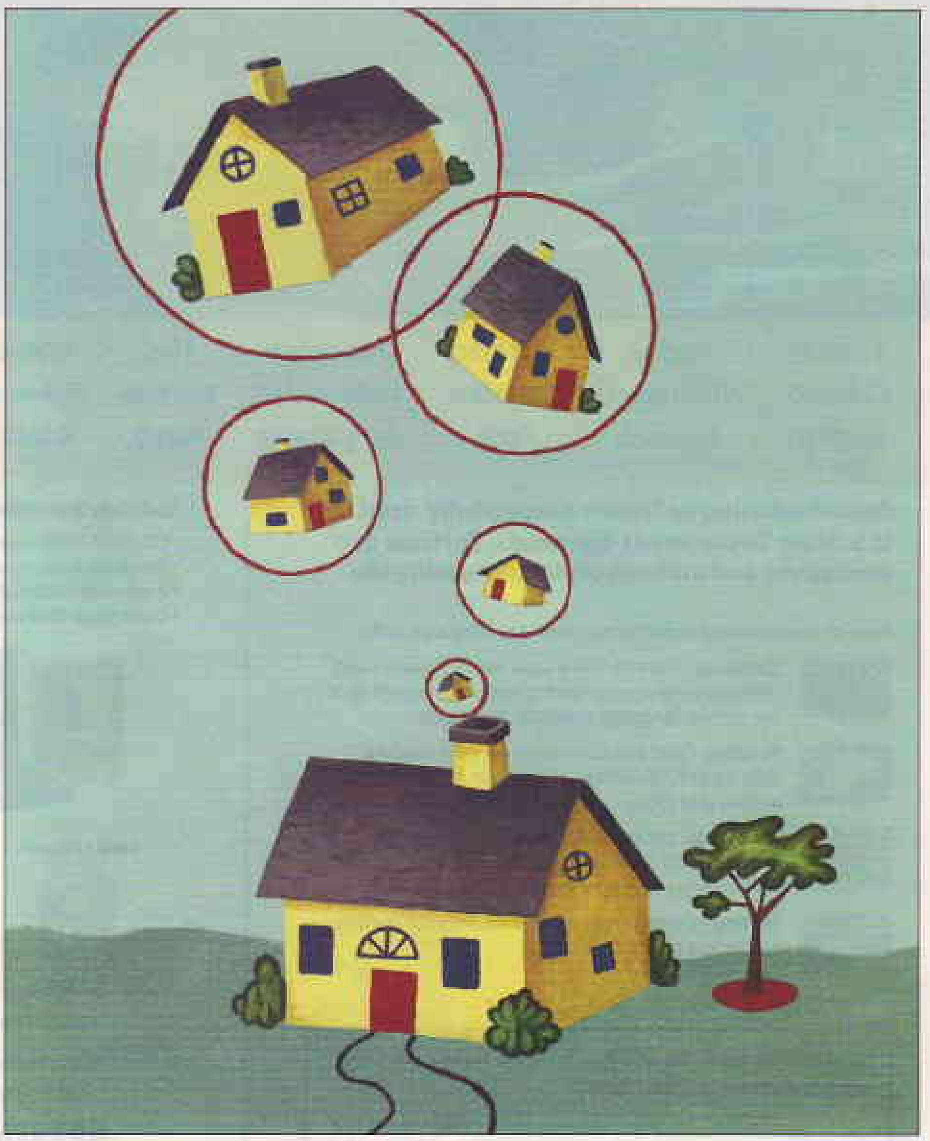
Real Estate Roulette

WITH TALK OF A REAL ESTATE "BUBBLE" AND AN INEVITABLE INTEREST RATE HIKE, INVESTING IN A SECOND HOME MAY BE A BIG GAMBLE. BY KRIS FRIESWICK

Author Janet Evanovich is the typical second-home buyer, in an atypical sort of way. At 62, she is a baby boomer just hitting her peak earning years as a wildly successful mystery and adventure writer. Last year she and her husband, Peter, who live amid the forests of Hanover, New Hampshire, bought a vacation home in Naples, Florida, one of the hottest second-home markets in the country.

"We thought the winters were hard here," says Evanovich from her Hanover home. "We wanted to be snowbirds." Another factor is that with her workload, Evanovich has no time for vacations, so she wanted a second home in an exotic location "where we could have fun, but where we could still work."

Evanovich and her fellow baby boomers, hitting their financial stride and putting their cash down on dream vacation homes, are fueling a dramatic increase in the percentage of second homes that make up total home sales, 36 percent in 2004. Vacation-home purchases alone were up 19.8 percent. In general terms, the second-home buyer is between 47 and 55 years old, makes between $71,000 and $85,000 annually and buys a second home for between $148,000 and $190,000. And while second-home sales volume is up markedly, the profile of the average second-home buyer hasn't changed that much over the years, says David Lereah, chief economist for the National Association of Realtors. "Everything inches up over time," says Lereah, "but if you're looking for big changes in the aggregate of who is buying, there aren't any."



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There is, however, a surge in a new type of second-home buyer that threatens to rewrite this same old demographic in the coming years. Fueled by the sharp rise in property values, many buyers are cashing out equity in their primary residence to invest in a second—a trend that is fueling what some believe are speculative bubbles in large real estate markets for second homes, like Las Vegas, West

Palm Beach and Orlando.

This new group of buyers includes people like Robert Buck, a 38-year-old human resources director, and his partner Mike Whaley, 39, a college dean, who bought their first home in Provincetown, Massachusetts, in 1999. Eighteen months ago, after watching the value of the Provincetown house triple, they cashed out some of the equity to purchase and renovate their second home, a 1950s colonial in New Haven, Connecticut, which they now use as their primary residence. They bought the Connecticut house with an eye toward selling or swapping it once renovations are complete. Compared with many new second-home buyers, they played it safe: They have fixed-rate mortgages on both homes, and an adjustable-rate home equity line on the Provincetown house. "But we didn't leverage all the equity," says Buck, who plans to eventually retire to the Massachusetts house.

Investment second-home purchases, like Buck's, rose by 14.4 percent between 2003 and 2004. And while vacation-home buyers tend to pay cash for their homes, or take a second mortgage, investment buyers sometimes dance on the edge, financing their investment purchase with most of the equity from their first house, or taking out an interest-only or negative amortization loan under the assumption that property values will continue to rise in the coming years. (Interest-only loans allow buyers to pay back only interest for a fixed period of time, typically five years; negative amortization loans allow buyers to pay back even less than the interest owed for a specific period, but add any unpaid interest into the loan total, meaning buyers are paying interest on interest.)

Some pundits fear that these risky financing strategies, coupled with the staggering market appreciation of real estate (up 9 percent to 15 percent nationally last year alone), are two of the four horsemen of the housing bubble apocalypse that will spoil the market for everyone. Lereah says these doom-and-gloom scenarios are overblown.

But experts admit that if you're considering investing in the second-home market, the most important question you can ask yourself is what you hope to get out of it. The answer will help determine whether now is the right time to plunge into the overheated real estate pool.

If the growing equity in your primary residence is burning a big hole in your pocket, real estate is still a fine investment, crushing the stock market's year-over-year performance for the past several years, especially in metropolitan areas like New York, Boston and San Francisco. But if you're looking to cash out of a real estate deal quickly or generate cash flow from rentals, experts urge extreme caution, especially in hot markets like Miami and Las Vegas. "There's a lot of new supply coming on line soon [in those cities]," says David Hehman, CEO of EscapeHomes.com, which matches second-home buyers with real estate agents nationwide. Traditionally, investment buyers have purchased second homes anticipating paying the mortgage with the cash flow from rentals. Today, says Hehman, the buyers he sees are expecting to extract gains through pure value appreciation. "I've seen people buy properties pre-construction with plans to sell before or immediately after construction is completed," says Hehman. "That sort of thing is only for the astute investor."

Unfortunately, fewer astute investors are entering the speculation game as their primary residence value escalates. Many are young and have never experienced a dramatic interest rate rise, or home value crash, which could devastate the finances of anyone who can't afford to ride out a downturn. Borrowing all a home's equity is fine as long as values increase–if they decrease, you could end up owing more than your home is worth.

Even those planning to invest in a rental property may face tougher times. Many markets are becoming saturated with available rental properties. The Vacation Rental Managers Association reports that the inventory of vacation homes under management increased 7.45 percent in 2004, and expects it to jump another 8.77 percent in 2005.

But by far the biggest danger to these new speculators is interest rates. A jump would cool housing markets because financing would be tougher to get. This would inevitably lead to lower home prices, and slower turnaround times–a financial downfall for anyone banking on a quick-turn speculation play.

Mortgage companies are helping to inflate the potential bubble by making it very easy for people who can barely afford to be in the second-home market to get into it. In San Francisco, it is estimated that 70 percent of new home loans are interest-only (compared with an average 35 percent nationwide). Many of these people could

not have qualified for a traditional mortgage big enough for their home purchase, and interest-only was their sole option. These loans are heavily marketed by mortgage brokers and lenders, but Lereah calls them "renting from the bank" because there is no payment on the principal. The real danger to the second-home market, he adds, is not oversupply, but the dangers posed by these risky types of financing.

"I'm much more concerned about the lending side of the equation than the property side," says Lereah. "Supply is still very lean and demand is very strong because of the demographics, but the lending side is getting loose and very questionable. We're at a point where we need to tighten up on lending."

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There are signs that lenders are beginning to do just that. Some are clamping down on overly optimistic appraisals in several hot real estate markets, where comparable home appraisals are tough to find, given rapidly rising prices. Since lenders will usually loan only 80 percent of a home's appraised value, this forces sellers to lower their prices, or forces buyers to come up with more cash to close the deal.

But if you have the cash, investment deals can still be had, advises Hehman, but probably not in the country's hottest second-home markets, which include Myrtle Beach, South Carolina; Atlantic City, New Jersey; Naples, Florida; Barnstable, Massachusetts, and Panama City, Florida. Even those buying in less-heated markets must proceed more cautiously than they would have just a few years ago. "I would caution anyone from making aggressive financial assumptions to justify their investment," says Hehman. He advises that buyers take a cold, hard look at all anticipated costs and revenues—potentially lower rental rates, condo fees, management fees, routine maintenance—which many underestimate at their peril. "If you take out equity on your first home to buy your second home, and get in over your head, you might not be making payments on the first or second home," says Hehman.

KRIS FRIESWICK IS A BOSTON-BASED FREELANCE FINANCIAL WRITER.