## HighBeam Research

**Title:** Hedging Home Equity: How advisers may soon be able to help their clients lock in their real-estate gains.

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By now talk of a housing bubble has become standard fodder for cocktail hour conversations, newspaper stories and political prognostications, with predictions running the gamut-from a quick leveling off of prices with no dramatic impact, to near catastrophe as all those adjustable-rate mortgages start ratcheting up just as home prices drop into the cellar.

No matter what one thinks about the future direction of the housing market, there can be no doubt that it has been quite a run for home prices. In the past five years, nationwide, prices have increased an average of 50%, boosting American's equity in their homes 68%, to $10 trillion. In total, according to Federal Reserve Flow of Funds data, U.S. residential real estate was valued at $18.6 trillion at the end of 2004, compared with $15 trillion in stock and $23.6 trillion in fixed income.

Given the uncertainty over the fate of all this appreciation, consumers, financial planners and Wall Street have been turning their attention to solutions. And one question that has begun to percolate is this: Can consumers who have benefited from the rise in value of their homes somehow preserve that value without selling? In other words, is there some way for homeowners to hedge against the risk that the value of their homes will decline?

"It's very interesting considering that many who own a home, especially on either coast, has substantial equity built up," says David Taube, president of Kalorama Wealth Strategies in Washington. "There's been considerable appreciation in people's homes that we haven't before experienced in such a short time."

The inception of the current residential real-estate cycle can be traced to the 1997 change in federal tax law, which effectively made the gain on the sale of most personal residences tax free, and eliminated the rules requiring sellers to buy more expensive homes to avoid taxes. The change in law allows single homeowners to exclude up to $250,000 ($500,000 if married) of gains when they sell homes they occupy. The essentially tax-free treatment of personal-residence sales has given residential real estate a relative advantage over other types of investments. Combined with two reductions in the long-term rate for capital gains taxes since 1997, the stage was set for renewed appeal of both owner-occupied and investment real estate. The question now, Taube says, "is whether there is some way to lock that [equity appreciation] in, or mitigate the downside?"

Never one to miss an opportunity for developing and marketing a new financial instrument, Wall Street is rolling out the first products that attempt to obviate housing risk. None of these products so far offers a perfect hedge for one's own home, but they do present some new and creative ways to bet on the direction of the housing market. Executives involved with this first generation of products say that more precise hedging products are just over the horizon after Wall Street learns how to construct the nascent instruments and liquidity builds.

Helping to build that liquidity, these executives predict, is pent up demand from big institutions such as insurance companies and pension funds that still do not have a good way to gain exposure to the residential real-estate market since, historically, the only way to gain such exposure is to buy a house. "Housing is a financial asset as much as a shelter asset," says Sam Masucci, president and CEO of Marco Securities Research, a research outfit based in Morristown, N.J., which is helping the Chicago Mercantile Exchange (CME) devise future contracts based on home prices in 10 U.S. cities. "There are not enough tools, and that's what we intend to change."

But for all the enthusiasm for the future of these hedging tools, there is also a healthy dose of skepticism. "I believe your home is something you consume, not equity," says Jeff Cribs, a financial planner at Chicago Wealth Management in Elmwood Park, Ill. "Besides, hedging has a cost, a carrying cost, even if a hedging strategy could be devised."

Echoing that sentiment is Bill Ramsey, a financial planner at Financial Symmetry in Raleigh, N.C., who says, "hedging is expensive and often doesn't work the way it's supposed to. I'm certainly skeptical about how [Wall Street] gets there."

So far, the first products out there intended to assuage some housing risk are tied to the stock of home builders. This year, several brokerages launched similar products. For instance, last spring, Merrill Lynch introduced its Protected Bear Notes, which offer a way to bet on a decline over the next eight years in the Philadelphia Stock Exchange's Housing Sector index, which is based on the stock prices of 21 companies involved in home building or closely related businesses. The notes gain in value if that index declines. Similar products are available through ABN Amro, Morgan Stanley and Royal Bank of Canada.

**Home Alone**

While Merrill's Protected Bear Notes are certainly a way to play the housing market, they are far from an ideal hedge for the equity in an individual home. After all, the performance of any one local real-estate market is not a good proxy for a national homebuilder's financial performance. Indeed, Taube describes such notes as "completely inappropriate to hedge your home equity since your home equity is not necessarily correlated to housing company prices."

Meanwhile, the CME announced in September that it is working with Macro Securities to launch derivatives based on 10 of the Case-Shiller Indexes (CSIs), representing movements in housing price values. These futures contracts are scheduled to launch in the second quarter of 2006. The 10 cities include Boston, Chicago, Denver, Las Vegas, Los Angeles, Miami, New York, San Diego, San Francisco and Washington. The CME will also list a composite index of the 10 cities for trading. The contracts will be settled in cash based on the value of the CSIs for housing.

But the rub with the CME indices is that they will only be traded by institutions, keeping the opportunity to hedge home prices out of the reach of the typical retail homeowner and investor.

Masucci of Macro Securities acknowledges that the CME product he's designing is for institutional investors only. But this corner of the financial universe is in its infancy and institutional products are a necessary step before rolling out a retail product. "Once we develop liquid investments it will lead to retail products. Ultimately, I believe that you can hedge and gain exposure to home prices. Real estate is a great investment."

Part of Masucci's confidence is due to the fact that data on single family homes is decades old, providing good historical parameters and trends for any financial product. "We have very well developed indexes," he says. "There's been a lot of theoretical work done. Now it's time to develop and launch products to fit the need."

For instance, Masucci says, he could see the eventual development of first-time-homeowner mutual funds. Such funds could be focused on particular cities, such as Boston. The value of the funds would move in lockstep with the price of homes. In this way, a couple who wanted to move to Boston or who lived there and were saving to buy a house, could be sure that the money they saved would keep up with local prices.

Still another entrant into the home equity hedging game is Hedgestreet, which allows investors to bet on the direction of price trends in six different metropolitan markets: Chicago, Los Angeles, Miami, New York, San Diego and San Francisco.

Russell Andersson, vice president and co-founder of Hedgestreet, says that "We're trying to do for derivatives what E*Trade did for equities-extending derivatives to the mass market." The instruments are still thinly traded (although the company says there was a 155% increase in all contracts traded from the second and third quarters, home price contracts being a component of that), and so Andersson says it's still not possible to meaningfully hedge a home equity position. But like Masucci he thinks that day will come as liquidity builds. "It's an evolutionary process," he says. Eventually, "you'll be able to structure a hedge that can control some risk."

Nevertheless, financial planners and wealth managers cite problems with the future products. There's the carrying costs of home equity hedges for starters; since home prices tend to move slowly, any hedged position would need to be in place for years, much longer than the six-month contracts now offered by Hedgestreet. (Though Andersson says that longer contracts in more cities are on the drawing board.) "What I like about Merrill's product is that it [covers] several years, but the reason I'm not crazy about it is that national homebuilders' stock prices don't represent people's home equity," says Janice Hobbes, a financial planner in Orange, Calif. And what I don't like about [Hedgestreet] is there's not that much price change quarter to quarter."

**Who's Buying?**

Another serious challenge to creating an effective home-equity hedge product, wealth managers say, is that if homeowners across the country have benefited enormously from the runup in home prices and want to hedge their gains, what investors are going to take the other side of that trade? "How are they going to make that bet?" asks Ramsey. "When prices are out of line, you can't have mass hedging for the same reason not everyone can sell at the top-because there's nobody to buy."

The wizards of Wall Street say simply that there's always a difference of opinion when it comes to pricing anything and a willingness to take a position at the right price. Why would the direction of home prices be any different? "I really believe that there is a deep, two-sided market here," says Masucci.

Despite his reservations, Ramsey says that Masucci and the others may well be right. "They're all not quite there yet, but they will be at some time." In the meantime, he and other financial planners advise those who have a lot of equity in a house, which they may not be able to continue to afford, or who believe their retirement now depends on the equity, the most prudent thing to do is sell the house and downsize. "If they take on less house, they can build up more net worth outside that house," Ramsey says.