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The Real Estate Bubble: Dot-com Revisited

As a financial advisor, it can be awfully tough getting physician-investors to heed the lessons of history, especially when it involves shedding portfolio winners before they become losers.

A few years back, I advised my clients in dot-com businesses to move some of their 401(k) assets out of company stock. The idea was to offset the inherent risk of having their money tied up in a single asset, much less a single asset class. But when I suggested they replace some of their high-flying equity with more conservative investments, the typical response was, "I'm making 250% a year on my stock options. Three or 4 more years like this and I can retire. Why should I pull money out of that for the sake of balance?"

Happily, I was able to convince some of them to reinvest 20% to 25% into a defensive strategy. Many lost everything on the 75% they retained in dot-com stock.

I can't help but be reminded of that insanity when I see what is happening today with real estate. I wonder if investors really learned anything from the dot-com madness. While we have not yet experienced the same meltdown in real estate, the undeniable omens have surfaced. Many investors refuse to acknowledge them. Realtors will tell you the signs are evident: more properties on the market, unsold longer, with few overbid prices.

Perhaps that informaton has not filtered down to individual investors or doctors who are busy with their practices. A doctor friend of mine recently bought a property in Lake Tahoe, planning to generate cash flow with seasonal rentals. I advised against the purchase, citing the short 3-month rental season and that he was likely buying at the peak of the market, but he was undaunted. Mind you, this fellow is no neophyte, but a seasoned real estate investor. His thinking is, "Sure the market has slowed down, but real estate is always a good investment." The bigger problem here is that he is approaching retirement and plans to sell the property in a few years to help fund his golden years lifestyle. Buying at the top of the market and relying on appreciation is a seriously flawed strategy. He simply doesn't have enough time before retirement to recover from the impending selloff.

As with every other asset class that overheats and attracts a flood of investor money, the herd's love affair with real estate continues, virtually unabated. No one wants to get off the ride if there's a chance it will make another loop. Meanwhile, long-term rates are inevitably headed upward, triggering spiraling payments for all the wacky mortgages created during the boom -- negative amortization, interest-only loans, and such. Stretched homebuyers quickly run out of options when increasing supply overruns decreasing demand. Refinancing is no longer feasible once prices flatten, bringing equity gains to a halt. All of this translates into lower prices. Those least able to afford it will be the first to lose their homes.

I believe the real estate snowball peaked sometime last autumn and is now slowly but surely gathering downward momentum, threatening to engulf anyone who fails to get off the mountain in time. Just as with the dot-com craze, the real estate landslide is coming, and I think it will get ugly.

The point is, we all know the markets, if anything, are cyclical. Retirement portfolios require asset class balance, which calls for tempering enthusiasm for any single asset class, real estate included. But industry salespeople and the media fuel excitement for the cur-

rent hot asset class. Money pours in from all over, diluting value and investment returns. Savvy investors get out ahead of the stampede with some profits. Those who delay, risk losing what they have gained. The rest, stubbornly hanging on, may see their core principal decimated, and lacking sufficient time to recover before retirement, suffer a needless disaster.

Real estate is just another example of a single asset class euphoria overwhelming common sense. The heavy inflow of money currently into emerging markets is another example. Do you remember the late-night TV ads about how to trade stocks and options? A few years ago, stay-at-home moms were becoming day traders; now those same moms are real estate agents. It's a mirror of 1999 and 2000. Today, TV shows tout how to make big money flipping real estate. It's a repetition of the same conversations, just a different investment vehicle.

I don't mean to sound like the prophet of doom. Despite the weakened market, there is still time to pull money off the table that could otherwise suffer greater damage. The time for hesitation is over, however, particularly for physicians near retirement with real estate assets in their retirement portfolios. Real estate can be a useful diversifier in a long-term retirement portfolio, sometimes as an alternative to bonds. But when interest rates are rising, you must be especially cautious about your weighting. A physician at age 35 or 40 has time to ride out market cycles. A physician at age 50 or 55 does not.

My suggestion is to balance -- and periodically rebalance -- your retirement portfolio by diversifying your asset class mix and adopt an investment strategy designed to avoid sustained losses.

Balance and Rebalance

It's hard to balance your portfolio by moving out of an asset class you perceive as still being a winner. You can't help thinking you may be missing out on some meat still left on the bone. What you should be thinking, however, is how to protect your retirement portfolio against a downturn, the historically inevitable return to the norm experienced by every asset class: real estate, emerging markets, high tech -- all of them.

By rebalancing your portfolio, I mean sell your winners and buy your losers. I know the idea of selling what's making you money and buying what's losing you money is a difficult concept to embrace, but it's how many of the world's smartest -- and most successful -- investors have consistently made more money. It's the time-tested adage to "buy low and sell high." Everyone agrees with the concept; few people have the discipline to convert it into action.

Avoid Sustained Losses

If I was limited to offering a single piece of investment guidance, I would counsel you to avoid sustained losses. It takes much, much longer to recover from even modest losses than most investors imagine. Investors chase returns and ignore the risks associated with an aggressive portfolio strategy. When they sustain losses, they risk losing the capital they need to take part in market recoveries. Worse, they risk losing the principal they rely on for their retirement plans. Dedicated financial advisors never want to see that happen to any of their clients.

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