

on course

SUMMER 2005

SOARING HOME PRICES DAZZLE INVESTORS

Experts Warn Against Bubble Mentality

By Bill Montague | Consulting Group Senior Financial Writer

Many Americans appear to believe there's no place like home—no place better to invest their money, that is. Lured by low mortgage rates, easy terms and double-digit price gains in some U.S. cities, they're rushing to buy bigger homes, second homes and rental properties in hopes of cashing in on the boom.

More adventurous buyers are stretching—some might say overstretching—their finances in an effort to maximize their potential gains. No money down loans and interest-only mortgages (which allow borrowers to avoid repaying principal for the first few years of the loan) are becoming increasingly popular.

Some would-be tycoons are even borrowing from their 401(k) and IRA accounts to finance down payments on their real estate deals—on the assumption that their properties can be quickly sold, or “flipped,” for a profit which will more than pay back the loan.

Helping drive the boom: The relatively tepid performance of the U.S. stock market over the past few years. With long-term bond yields also still relatively low, many investors have been looking for higher returns outside the financial arena. As is often the case, increased demand has pushed home prices higher in many markets—attracting still more buyers.

There's no question a house or condo unit can be a smart investment, especially considering the tax breaks and other benefits associated with home ownership. But, like any other investment, residential real estate carries risks. Investors who ignore those risks could suffer the consequences.

The outsized gains of the past few years may have left many home buyers with unrealistic expectations. Indeed, some financial experts warn that overeager investors have fueled speculative bubbles in some markets—especially on the east and west coasts and in several fast-growing sunbelt regions.

When those bubbles burst, these experts warn, reckless investors could see dreams of wealth turned to ashes. Some may end up owning properties that are worth far less than the mortgages on them. Costs—such as taxes, insurance premiums and maintenance fees—that seemed trivial when prices were soaring could become a substantial burden.

continued on page 2

PAGE 4
Markets Overview

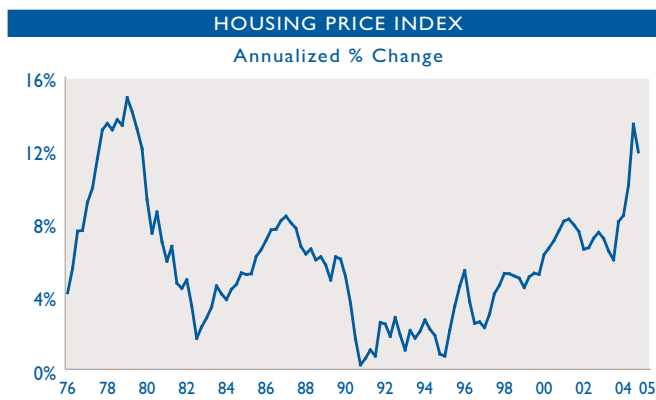
PAGE 6
Fear Strikes Out

Housing Heats Up

It's easy to see why many home buyers have thrown caution to the wind. As the chart at right shows, U.S. home prices have been rising at the fastest rate since the late 1970s. A national index of home prices maintained by the Office of Federal Housing Enterprise Oversight, a regulatory agency, jumped more than 12% in the year ending in March. Some metropolitan areas—such as Los Angeles, Washington D.C. and Phoenix—saw price gains of 20% or more.

The OFHEO's figures are adjusted for changes in the size and value of the homes people buy, meaning price gains were *not* artificially inflated by heavier demand for larger, more expensive houses. The National Association of Realtors (NAR), which collects its own price data, reports that a record 66 of 136 U.S. metropolitan areas saw double-digit increases in median home prices in the year ending in March. But the NAR's data is not adjusted for changes in the mix of homes purchased.

Such gains look even more remarkable when you consider that the last time housing prices rose so quickly, the Consumer Price Index was rising almost as fast, making home ownership an attractive hedge against inflation, which tends to erode the real value of outstanding mortgages.



Source: Office of Federal Housing Enterprise Oversight

After taking inflation into account, home prices nationally have been rising recently at the fastest pace in almost 30 years. Yet real fixed mortgage rates—that is, after adjusting for inflation—are *higher* than they were through most of the '70s. And the prospects for loan values to be eroded away by future inflation appear much lower than they did back then.

To some experts, this suggests home prices in some hot markets are now fundamentally out of kilter with economic fundamentals. Price increases have greatly outstripped income gains in many areas—pricing some potential buyers out of the market. Prices also have risen faster than rents, making renting an increasingly attractive alternative. Yet prices have continued to rise.

continued on page 3

The REIT Stuff

Investors looking to add real estate to their portfolios might want to consider the advantages of REITs—Real Estate Investment Trusts.

REITs allow investors to own an interest in a property—such as an apartment building, shopping center or office park—in paper form, by buying certificates in a trust, which in turn manages the property on behalf of the investors.

REITs have been around since the 1960s, but became more widely popular in the 1990s. One key advantage: REITs don't have to pay corporate income tax, as long as they pass the bulk of their earnings along to their participants.

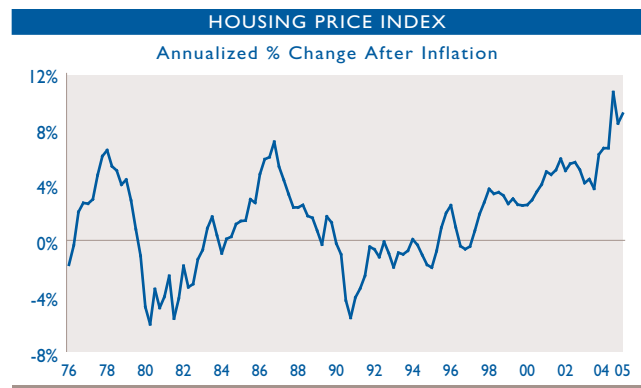
An even bigger advantage for individual investors is the fact that most REITs are publicly traded, either on the major stock exchanges or over the counter. This makes

them relatively easy to buy and sell, and keeps transaction costs down. As of the end of last year, over 150 REITs, with a total market value of \$275 billion, were publicly traded.

The large number of REITs makes it possible for investors to diversify their holdings across different properties, different regions and both the commercial and residential sectors. Past returns on REITs have shown relatively low correlation with stocks and bonds, increasing the diversification benefits.

While the NAREIT Index—a benchmark covering all publicly traded REITs—slightly outperformed the S&P 500 Index over the 22 years ending in 2004, investors may want to approach the sector with short-term caution. Returns have been exceptionally high in recent years, thanks in part to the real estate boom. This has left some valuation measures at the high end of their historic ranges. ■

continued from page 2



Source: Office of Federal Housing Enterprise Oversight, Consulting Group

Irrational Exuberance?

One driving factor is a widespread perception that some areas are so desirable, or so prosperous, that prices can only continue to rise, thanks to the limited supply of homes available. Or, as the old saying goes: Buy land; they've stopped making it.

However, as financial behaviorist Robert Shiller notes, such confidence can be misplaced. "It is easy for residents there to imagine that more and more people are thinking similarly, and that they will continue to bid up real estate prices in their city," he writes. "This is irrational exuberance in the context of real estate."

Shiller points out that many metropolitan areas still have plenty of raw land within easy commuting distance that can be developed, adding to the supply of houses. And as prices continue to rise in high-cost markets, companies and people may be inclined to move elsewhere. "Prices rise while people are optimistic, but forces are set in motion for them to crash when they get too high," Shiller warns.

More aggressive lending practices may also be part of the explanation for the boom. Many mortgage bankers have become less demanding about financial qualifications and down payments, and more willing to offer terms that allow borrowers to keep initial payments low—at the price of larger future payments. This helps buyers qualify for larger loans, but also pumps more money into the market, pushing prices higher.

According to the National Association of Realtors, 25% of homebuyers polled in a November 2004 survey reported that they were able to get a loan with no money down. And one in five new mortgages is now an interest-only loan, up from just 5% two years ago, according to *Business Week* magazine.

At the same time, more buyers are buying houses for investment purposes. The NAR reports that 36% of all

home sales in 2004 were second homes. Of those buyers, 64% viewed their purchase primarily as an investment. In some areas, this speculative tide may have created a classic "greater fool" market, in which buyers are bidding based upon what they think other investors will pay for a property, not its fundamental value.

When Bubbles Burst

When—and how—this cycle will end isn't clear. Federal Reserve officials, including Chairman Alan Greenspan, generally have taken a relaxed view of the housing boom. They argue that while certain markets may have turned bubbly, the risk of a sharp national downturn in home prices is fairly remote.

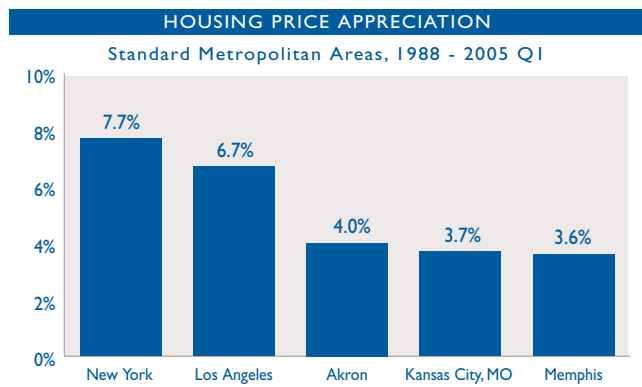
In a recent testimony before Congress, for example, Greenspan noted that "the U.S. economy has weathered such episodes before without experiencing significant declines in the national average level of home prices." Rising production costs for new homes, he explained, tend to support prices of existing homes.

On the other hand, there have been some extremely painful *regional* declines. From the third quarter of 1990 through the first quarter of 1995, for example, home prices in the Los Angeles metro area fell an average 21%, according to the OFHEO. Prices didn't regain their peak value until the second quarter of 2000, nearly ten years after the bubble burst.

However, even if housing prices in today's hot markets simply plateau instead of dropping sharply, long-run price trends may not provide the high returns that many property investors appear to expect.

The chart below shows the annualized gains for home price indices in several major U.S. metro areas over the past 25 years. These have ranged from a high of 7.7% in NY to a low of 3.6% in Memphis, Tenn. The national index, meanwhile, has risen at a 5.1% annualized rate

continued on page 8



Source: Office of Federal Housing Enterprise Oversight

since 1980—less than 2 percentage points above the rate of inflation.

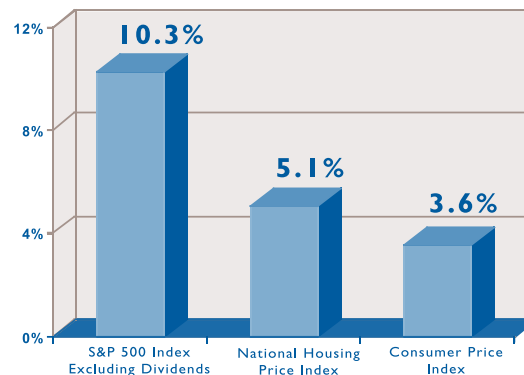
To be sure, these measurements leave out rental income or the equivalent benefit obtained by owner occupants. However, as the chart at right shows, a comparable stock market benchmark—the S&P 500 Index excluding dividends—has risen an annualized 10.3% since 1980, more than twice the growth of the national home price index and almost 7 percentage points above the rate of inflation.

When evaluating the potential benefits of investing in residential properties, investors also need to keep in mind the costs—such as brokerage commissions. These can range from 4% to 6% on the sale of a typical single-family home, depending on the market, far higher than the commissions or spreads paid on most stock and bond transactions. Property owners may also face a variety of fixed costs—such as property taxes, insurance premiums and water and sewer charges, etc.—not levied on financial assets. They also may need to arrange for collecting rents, making repairs and dealing with troublesome tenants.

It's also important to remember that housing markets tend to be less liquid than financial markets. Selling a home can take weeks or months—or even longer during a market downturn. The price received may be very different from the most recent comparable sale. Most publicly traded stocks and many listed bonds, on the other hand, can be sold in minutes or hours, typically for a price close to the last transaction.

Finally, it may be much more difficult for individual investors to diversify their property holdings adequately, given the capital required and the transactions costs. This could magnify the consequences

ANNUALIZED RETURNS 1980 - 2005 Q1



Source: Office of Federal Housing Enterprise Oversight, Smith Barney Consulting Group

of a single bad decision, and/or leave them heavily exposed to a slump in a particular regional market.

Conclusions

Owning a home has long been considered an important piece of the American dream. It also has been a financially rewarding experience for millions of Americans. But investing in residential properties carries many of the same risks as investing in financial assets—plus some additional ones.

The boom of the past few years apparently has convinced some homebuyers that prices can go only one way—up—and that fundamental values no longer matter. In the late 1990s, many investors felt the same way about Internet stocks, only to find out the hard way how wrong they were.

Real estate may have a place in your total wealth portfolio. But speculating on home prices is a poor substitute for having a diversified, long-term investment strategy, one that covers a broad range of asset classes. Your Smith Barney Financial Consultant would be happy to help you develop such a strategy, or fine tune an existing one. ■

Although the statements of fact and data in this report have been obtained from, and are based upon, sources that the Firm believes to be reliable, we do not guarantee their accuracy, and any such information may be incomplete or condensed. All opinions included in this report constitute the Firm's judgment as of the date of this report and are subject to change without notice. This report is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security. Past performance is not a guarantee of future results.

There may be additional risks associated with international investing involving foreign economic, political, monetary and/or legal factors. International investing may not be for everyone.

This material, or any portion thereof, may not be reproduced without prior written permission from Citigroup Global Markets Inc.

The securities of small-capitalization companies may be subject to higher volatility than larger, more established companies.

Citigroup, Inc., its affiliates, and its employees are not in the business of providing tax or legal advice. These materials and any tax-related statements are not intended or written to be used, and cannot be used or relied upon, by any such taxpayer for the purpose of avoiding tax penalties. Tax-related statements, if any, may have been written in connection with the "promotion or marketing" of the transaction(s) or matters(s) addressed by these materials, to the extent allowed by applicable law. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

The investment results depicted herein represent historical gross performance with no deduction for investment management fees or transaction costs. Actual returns will

be reduced by expenses that may include management fees and costs of transactions. The client is referred to the descriptive brochure (Schedule H of Form ADV) for a full disclosure of the fee schedule. As fees are deducted quarterly, the compounding effect will be to increase the impact of the fees by an amount directly related to the gross account performance. For example, on an account with a 2% annual fee, if the gross performance is 10%, the compounding effect of the fees will result in a net performance of approximately 7.81%.

Smith Barney and Consulting Group are divisions of Citigroup Global Markets Inc. Smith Barney is a service mark of Citigroup Global Markets Inc. and its affiliates and is used and registered throughout the world. CITIGROUP and the Umbrella Device are trademarks and service marks of Citicorp or its affiliates and are used and registered throughout the world. Citigroup Global Markets Inc is a member of the Securities Investor Protection Corporation (SIPC).

 Consulting Group

SMITH BARNEY
citigroup

© 2005 Citigroup Global Markets Inc

CS2141 • 8/05 • 176288

Additional information available upon request.