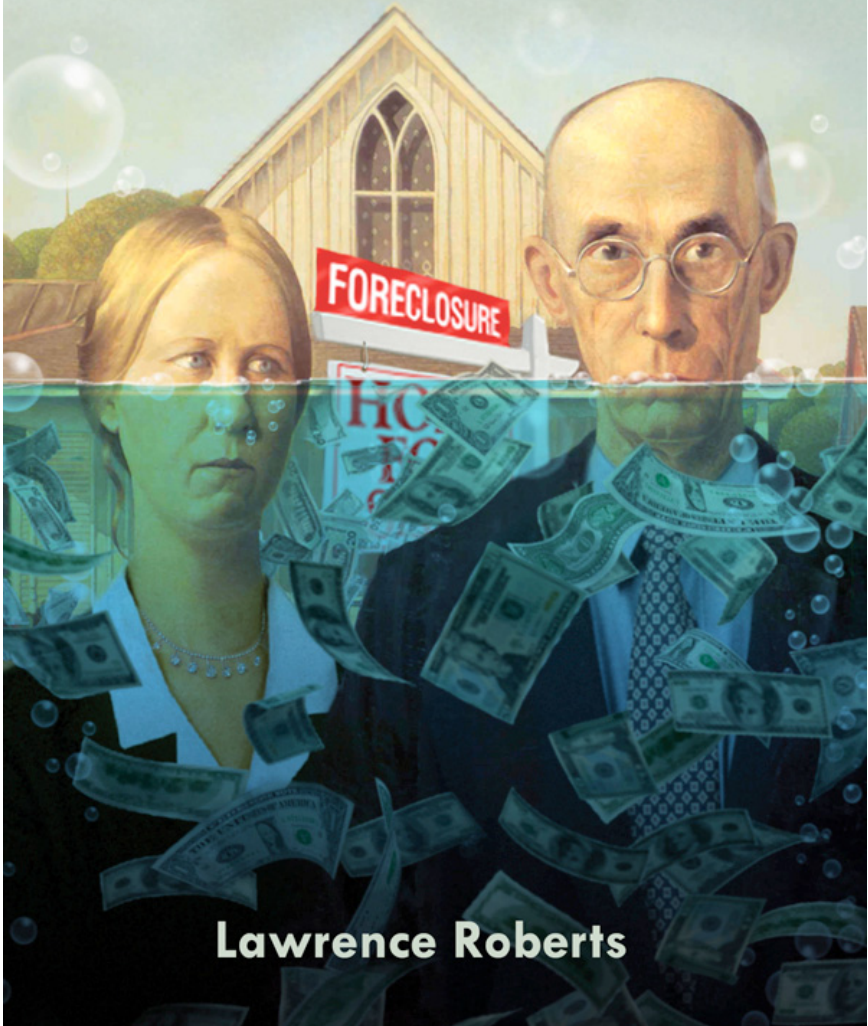


THE GREAT
HOUSING BUBBLE
Why Did House Prices Fall?



Lawrence Roberts

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The author's work can also be found at the Irvine Housing Blog where he has been the primary writer since February of 2007.

<http://www.irvinehousingblog.com/>

The Irvine Housing Blog has become noted for its unique delivery of real estate market analysis in Slate Magazine, the Washington Post, and Newsweek Magazine. The blog reaches an average of 3,500 unique visitors a day, and it received over 2,000,000 page views in its first year of operation.

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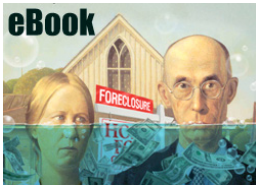
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Preface

I work as a development consultant in the real estate industry in Southern California. My education and experience has acquainted me with a variety of real estate markets, but residential real estate is the one with which I am most familiar. I am not a realtor or a mortgage broker, and my livelihood, though dependent upon the real estate industry, it is not dependent upon facilitating a home-sale transaction. What is presented here is both historical account and unbiased analysis. My observations of the residential real estate market are not tainted by any need or desire to convince anyone they should buy a house. In fact, one of my motivations for writing about the Great Housing Bubble is to convince people *not* to buy a house when prices are inflated and save them from financial ruin. It saddens me to watch homebuyers get caught up in the bubble mythology and enter into a financial transaction that will have a strongly negative impact on their financial lives. People who have already made that decision cannot be helped except at the expense of a naïve buyer. Sellers have the marketing machine of the National Association of Realtors to help them. Buyers have few sources of unbiased information to assist their decision. Part of the purpose of this writing is to educate both buyers and sellers on the realities of the residential real estate market.

One of the difficulties of writing a book on the Great Housing Bubble in 2008 is that the bubble has not played itself out yet. There is a necessary change in tense required when speaking of events prior to 2008 and those projected to occur during and after 2008. Someone reading this in 5 years may look back on it as history, but for those of us living it now, it is a history not yet lived. Much of what is presented here may not come to pass, or it may not happen in the way hypothesized in this book. History will judge whether this is prescient, or if it is “a tale told by an idiot, full of sound and fury, signifying nothing.”¹

Irvine Housing Blog

I discovered Real Estate Bubble Blogs in November of 2006.² Many were in existence much earlier, but I was not a big reader of blogs prior to this time. I

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first discovered the Irvine Housing Blog when my wife found a series of interesting posts on people who were attempting to sell properties for a quick profit (flipping,) and they were getting burned. I was quickly hooked. From the blogroll (links to other blogs) I was able to locate several other bubble blogs, and I quickly became a regular reader and commenter on several blogs in this community.

In February of 2007, I was asked to write for the Irvine Housing Blog. I had a great deal of pent-up energy for writing about the housing bubble. Over the months that followed I wrote a series of analysis posts which became the structure of this book. Daniel Gross, a freelance writer published in Slate Magazine, the Washington Post and Newsweek, characterized the writing as follows (Gross, *The Real Morons of Orange County*, 2007): "IrvineHousingblog, brilliantly drives home the same point with daily dispatches. The blog is a guide to the seventh circle of real estate hell – people who buy houses on spec with no money down. A typical entry chronicles the purchase price, tracks down the amount of debt on the property, and then calculates how much each party – the buyer, the first mortgage holder, the second mortgage holder – stands to lose assuming the seller receives the asking price."

The Reservoir of Schadenfreude

The readers of the Irvine Housing Blog have a voracious appetite for profiles of losing properties. They are not alone. Why do people get so much pleasure from seeing would-be real estate moguls lose a great deal of money? I can think of no other human endeavor that has engendered so much pleasure in the misfortune of others by otherwise caring, compassionate people. In my opinion, the outpouring of schadenfreude we are seeing as the housing bubble deflates is a mixture of Greek tragedy and bad karma. In short, bubble participants should have seen it coming, and they are getting what they deserve.

Schadenfreude is not a spiritually uplifting emotional response. Most religious traditions would counsel us against it. In Buddhist teaching, people are taught to cultivate feelings of compassion for the misfortune of others – feeling empathy and sadness for the slings and arrows of outrageous fortune when they impact another.³ The near enemy of compassion is pity: it masquerades as compassion, but it has an element of separateness which detracts from the sense of Oneness with all things. Joy is good: Sympathetic joy, the joy in the happiness of another, is another pillar of a spiritual existence; however, joy in the misfortune of another – schadenfreude – is not a skillful behavior leading to happiness. Even knowing that, many of us feel this joy anyway. Why is that?

I recognized financing terms were creating artificially high prices early on. By 2004, I was telling people I knew that this was a problem which would cause a market crash. Most people looked at me like I was crazy. "Real estate always goes up," I was told. "The government would never allow prices to crash," I was told. "If you do not buy now you will be priced out forever," I was told. This is the intoxicated language of real estate junkies who have overdosed on the real-estate-appreciation kool aid. If these statements had been offered in a defensive

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manner of someone who is being made to realize they made a serious mistake, I could have felt sympathy for them; I would have been able to disarm their defensiveness and helped them see the light. However, what I generally got was a smug assuredness of someone who truly believed he was right and I was wrong; not just that I was wrong; I was a stupid, cowardly fool who did not have the brains or the bravery to take the free money being given out. This was particularly surprising given my line of work. It was as if a patient after getting a diagnosis of cancer told the doctor that the physician did not understand the tissue growth was a natural, healthy process. The buyers caught up in the Great Housing Bubble did not recognize the financial cancer even when an expert in the field told them how dangerous it was.

During the bubble rally, those of us who chose not to participate were labeled as “bitter renters.” It was suggested we were envious of the good fortune of homeowners as their property values rose, as they took on insane amounts of debt, and as they blithely financed a lifestyle well beyond their means. This was undoubtedly true for some, but in my opinion, this is not the primary reason so many derive so much pleasure from the misfortune of those now suffering from declining property values. These same people who chided us for being envious actually wanted us to be envious: they wanted us to know they were the winners in our competitive society; they wanted us to view them as superior. This act of putting themselves above us created a separation which prevented us from feeling sympathetic joy for their good fortune, and it prevented us from feeling compassion for them when they fell.

In our collective unconscious which manifests in our dreams and our mythology, water is often symbolic of our emotions or our emotional state. Have you noticed people are often categorized as deep or shallow? If you are in debt you often feel “underwater.” Anger is much like water: if not given an outlet, it will fill a reservoir until it reaches a breaking point and is expressed in a flood of emotional rage. Each encounter with a pathologic, kool-aid-drinking housing bull during the bubble rally has added to this reservoir, and reveling in failed flips is an outlet for this pool of toxic emotional waste.

There is an element of tragedy in every disaster, but financial bubbles are some of the most interesting because they are completely man made. They are created by the accumulation of individual decisions of buyers who are motivated by greed, foolish pride, and a false sense of security. Each of these people should have known better. Many of them were warned of their impending doom by those who saw trouble brewing, and yet, many chose to go down the path to the Dark Side. Newton’s Third Law states, “For every action, there is an equal and opposite reaction.” The Law of Karma states, “For every event that occurs, there will follow another event whose existence was caused by the first, and this second event will be pleasant or unpleasant according as its cause was skillful or unskillful.” It became obvious as the crash began; the behavior of buyers during the bubble rally was not skillful. Whether it is Newton’s Third Law, Karma, or a Calvinist form of retributive justice, as this bubble deflates, many of the participants in this bubble are about to experience a great deal of hardship. Like many others, I will enjoy their suffering until my reservoir of schadenfreude is emp-

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tied. For the sake of my own personal spiritual well being, I hope this happens soon so I can regain my normal emotional balance and rekindle my feelings of compassion for my fellow human beings.

Introduction

Why did house prices fall? This is the fundamental question to most Americans, and to those who lent them money. Most homeowners did not care why residential real estate prices rose; they assumed prices always rose, and they should simply enjoy their good fortune. It was not until prices began to fall that people were left searching for answers. This book examines the causes of the breathtaking rise in prices and the catastrophic fall that ensued to answer the question on every homeowner's mind: "Why did house prices fall?"

Even though the decline is nowhere near over in 2008, already the Great Housing Bubble witnessed the largest decline in house prices since the Great Depression. The asset bubble for the Great Depression was the stock market while the asset bubble for the Great Housing Bubble was residential real estate. The title of the book, the Great Housing Bubble, is an allusion to the Great Depression of the 1930s. Both of these dramatic events were the result of a wild expansion of credit and a subsequent crash in asset prices that stressed the banking system and led to a dramatic economic slowdown.⁴

The book is arranged into 10 chapters. The first 4 chapters provide background information and are used to define terms and provide a broad conceptual understanding of residential real estate economics, chapters 5 through 8 discuss the structural and psychological factors that inflated and deflated the bubble, and the final two chapters describe methods of coping with the housing bubble. Chapter 1 is a general description of financial bubbles as a psychological phenomenon and the unique beliefs of residential real estate bubbles. Chapter 2 details the financing environment surrounding residential real estate. It defines and categorizes the types of borrowers and the types of loan programs available, and it illustrates how financing impacts the wealth of individual owners and the economy as a whole. Chapter 3 summarizes the mathematics determining the value of residential real estate and examines issues pertaining to the rent-versus-own decision, and chapter 4 delves into the fine points of determining the value of individual lots and raw land. Chapter 5 illuminates the credit bubble (which was largely responsible for the real estate bubble) with rigorous detail on the structure of the secondary mortgage market and how the expansion of credit

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through this market inflated the housing bubble. Chapter 6 looks at the housing bubble, its various measurements, and explains why the bubble burst. Chapter 7 is a review of the psychology of real estate bubbles. Financial bubbles are primarily psychological phenomenon, and the various aspects of investor psychology are explored to see how they shape the market. Chapter 8 is a projection of future house prices based on the data and conditions as they existed in early 2008. Chapter 9 contains advice for both sellers and buyers who plan to be active while prices are declining. Chapter 10 is a review of the causes of the bubble and proposals for reforms to prevent residential real estate bubbles from happening again.

The examples and data used in the analysis are national in scope, and they are also focused on the local residential real estate market in Irvine, California. The Great Housing Bubble is a national phenomenon; however, the national statistics soften the extremes and make the rise and fall look less remarkable. In some local markets, the prices changes are truly extraordinary, and it is through examining these markets that the story of the bubble is best told. A fine exemplar of the Great Housing Bubble is Irvine, California. Irvine is a large, master-planned community of over 200,000 residents. The high incomes of Irvine residents are reflected in the rental rates for properties which are consistently near the highest in the nation. High incomes and rents translate into high real estate prices, even at the bottom of down cycles. When reviewing the properties in Irvine and the price tags attached to them, it is not uncommon for outsiders to believe a decimal point has been misplaced. The lessons learned from the Irvine experience are universal. Though many the examples from this work focus on Irvine, this is a book about the Great Housing Bubble of which Irvine was both a catalyst and one of its biggest participants.

Table 1 - Top Subprime Lenders 2006

Rank	Lender	Market Share %
1	Wells Fargo	13.0%
2	HSBC Finance	8.3%
3	New Century	8.1%
4	Countrywide Financial	6.3%
5	CitiMortgage	5.9%
6	WMC Mortgage	5.2%
7	Fremont Investment	5.0%
8	Ameriquist	4.6%
9	Option One	4.5%
10	First Franklin	4.3%
11	Washington Mutual	4.2%
12	Residential Funding	3.4%
13	Aegis Mortgage	2.7%
14	American General	2.4%
15	Accredited Lenders	2.3%
Top 15 Lenders		80.2%

Source: Inside B&C Lending

INTRODUCTION

The epicenter of the Great Housing Bubble is located in Irvine, California. One of the primary causes of the bubble was the lowering of lending standards and the extension of credit to people who could not handle the responsibility: Subprime borrowers. The word “subprime” has become indelibly linked to the Great Housing Bubble. It is one of the causal factors that make the bubble unique, and the collapse of subprime is widely regarded as the pin-prick which began the bubble’s deflation. Irvine, California, is the center of the subprime universe. Three of the top ten subprime lenders, New Century, Ameriquest, and Option One, are (or were) headquartered in Irvine. Most subprime lenders have processing offices in Irvine due to the large number of trained personnel living in the area. Irvine’s New Century Financial, formerly the second largest subprime operator, is heralded as the poster child of the bubble. The company name “New Century” implies a new era and a new paradigm. It embodies the fallacious beliefs and ideas that inflated the Great Housing Bubble.

Volatility in real estate prices is not new to California. During the 1970’s, real estate prices detached from typical valuations of three-times yearly income seen in the rest of the country. Once residents realized they could push up prices in their real estate markets to dizzying heights, they have been doing it ever since. Greed springs eternal. The Great Housing Bubble is the third such bubble in the last 30 years, and it is the largest of all. The detachment from traditional measures of valuation was so extreme that it is difficult for many to comprehend. Each time the bubble bursts, the crash is incorrectly blamed on some outside force, and each time the rally is thought to be different than the rally in previous cycles. It never is.

Bubble Market Psychology

Financial markets are driven by fear and greed: two basic human emotions. Rationality and careful analysis are not responsible for, or predictive of, current or future price levels in markets exhibiting bubble pricing as the emotions of buyers and sellers takes over.⁵ The psychology of speculation drives bubble markets, and because of the nature of fear and greed, most speculators are doomed to lose their money. In contrast, true investors are not subject to the emotional cycles of the speculator, and they are more able to make rational decisions based on fundamental valuations. Of course, many investors also miss the excitement of a runaway price rally in a speculative bubble. The Great Housing Bubble was inflated by people trading houses. Residential real estate took on the character of a commodity, and it became subject to the same chaotic price gyrations as a speculative commodities market. This behavior was caused by lenders who provided the financing terms which enabled speculators to use mortgages as option contracts with the risk of loss being transferred to the lenders.

With any loss, an individual must go through a grieving process. Since markets are the collective actions of these individuals, markets experience the same psychological stages which are apparent in the price action. Efficient markets theory attempts to explain market price action through the collective action of rational market participants. This theory fails to explain the irrational behavior exhibited in bubble markets. Behavioral finance theory seeks to explain irrational exuberance. The price action in a bubble has other impacts on the beliefs and behaviors of individuals and society as a whole. These beliefs and behaviors may become pathological in nature leading to suffering and social problems. As with any form of mass hardship, there are calls for government action which lead to proposals for bailouts and false hopes among the populace.

Speculation or Investment?

Owner-occupied residential real estate is viewed by many people as a good investment.⁶ Realtors often use this idea as part of their sales pitch. As men-

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tioned previously, this view is fallacious and it is one of the beliefs responsible for creating an asset price bubble. To understand why houses are not a great investment in most circumstances, one needs to understand the difference between investment and speculation.

An investment is an asset purchased to obtain a predictable and consistent cashflow. This would include things such as bonds and rental properties or even cash in a savings account. The value of the asset is based on the cashflow, and this value can be determined in a number of ways. For a “point in time” analysis simple division will yield the rate of return (return = income / investment). Risk is evaluated by comparing the rate of return of the investment to the safe return one can obtain in a savings account or government bonds. For more complex financial structures the value can be determined by a process known as discounted cashflow analysis. The sales price at the time of disposition is often not a major factor in the investment decision, particularly if the eventual disposition is many years in the future. In fact, true investments need never be sold to be profitable. As Warren Buffet noted, “I buy on the assumption that they could close the market the next day and not reopen it for five years.”⁷ In contrast to investment, speculation is the purchase of an asset to sell at a later date at a higher price (Actually, you can also speculate by selling first and buying later in a process known as “selling short”). Speculative assets are not valued based on cashflow but instead are valued based on the perceived probability of selling later for a profit. Houses can be purchased as an investment at the right price, but most often when people purchase a property they are engaging in speculation based on the belief they will be able to sell the house for a profit at a later date.

Since 1890 houses have appreciated at 0.7% over the general rate of inflation. Over the long term house values are tied to incomes because most people buy houses with mortgages for which they must qualify based on their income. Inflation keeps pace with wage growth because people will bid up the prices of goods and services with their available income. Therefore, over the long term house prices, wages and inflation all move in concert. There are short-term fluctuations in this relationship due to variations in financing terms, migration patterns, employment, local limits on construction and irrational exuberance, but any such deviations from the mean will be corrected over time by market forces. As an investment, houses serve as a hedge against the corrosive effect of inflation, but over the long term appreciation much in excess of the general rate of inflation is not possible. In this regard, houses are little better than savings accounts as an asset class, and they are inferior to stocks or bonds in the long term.

Leverage and Debt

As a speculative investment, residential real estate has the potential to make or lose vast sums of money due to the impact of financial leverage (debt). Houses are typically leveraged at 80% of their value. During the Great Housing Bubble, this leverage was often provided at 100% by various lenders. Leverage is a powerful ally when prices increase, but leverage works just as strongly against

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the speculator when prices decrease. For example, if a house is leveraged 80% and it increases in value 5% in one year, the return to the investor is actually 25% due to the 5 times multiplier created by leverage. With the effect of leverage, speculation on housing can far exceed any competing investment strategy. However, the inverse is also true. If a house is leveraged 80% and it decreases in value 5% in one year, the loss to the investor is 25% of her downpayment, not just the 5% the house declined in value. Leverage magnifies both the return and the risk of any speculative venture.

One of the worst mistakes lenders made during the Great Housing Bubble was to allow 100% financing and negative amortization loans. This was a boon for speculators because it allowed them to participate in the market without any of their own capital and it allowed them to hold the speculative assets with a minimal debt service expense. Plus, there was the implicit idea that they would simply default if the deal did not go in their favor (which of course many did). Combine these facts with the near elimination of loan underwriting standards allowing anyone to participate, and the conditions were perfect for rampant speculation, a wild increase in prices and so much speculative demand that many new and existing home purchases would remain vacant.

Why Speculators Fail

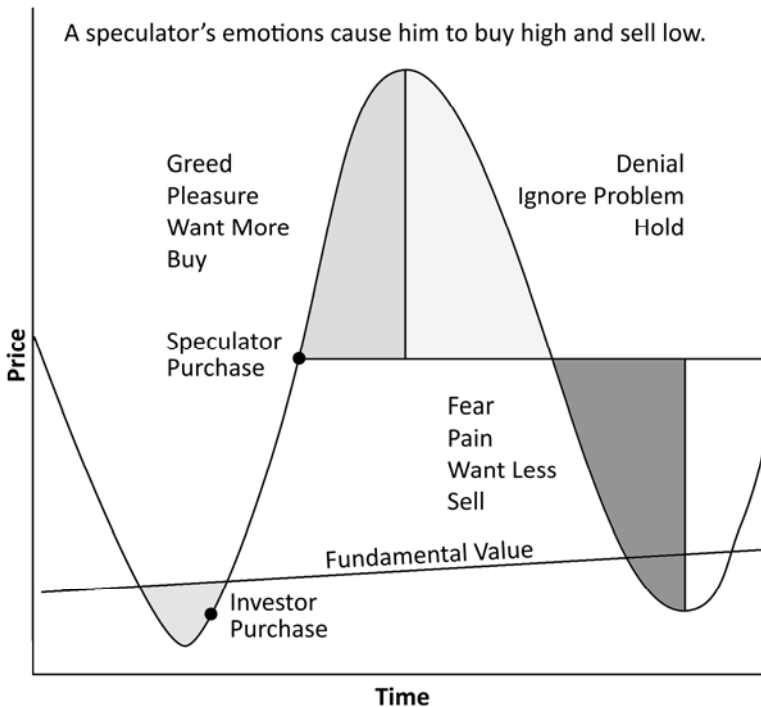
Despite the huge price spike in the final two years of the bubble caused by wild speculation, most speculators will lose a great deal of money. The causes are rooted in basic human emotions that work against making the proper decisions to profit in a speculative market. The moment a speculative asset is purchased and the speculator has taken a position in the market, emotions are immediately in play. If the potential resale price in the market is rising, the natural reaction is to want more. Greed takes over and the asset is strongly coveted by the speculator. If possible, the speculator will purchase more of the asset in question. This was common in the bubble when people would take the equity from one property and purchase even more residential real estate. The problem with this natural emotional reaction is that it prevents the speculator from selling the asset and taking profits when they are available. People who successfully make a living participating in speculative markets have learned to override this natural instinct and sell when their emotions are telling them to buy more. The average residential real estate speculator does not have this discipline or awareness. He will hold the asset through the good times.

When prices begin to fall in a speculative market, most speculators immediately lapse into denial. They were so emotionally rewarded by purchasing and holding the asset, they see no reason to believe the first signs of a declining market are anything other than a temporary aberration. As prices continue to fall, the emotions change: fear begins to creep in, and the battle between denial and fear goes on well past the breakeven point where the speculator could have closed the position without losing any money.⁸ As prices fall further, the fear begins to take an emotional toll and the speculator starts to feel pain. As prices drop further, more pain is inflicted on the speculator. What is the natural reac-

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tion to pain? Push it away. As a speculative investment becomes painful, the natural reaction is to want to get rid of it. This prompts the speculator to sell the asset – only after he has lost money. Speculator's emotions always work against them. When the asset is rising in price they want more of it, and when it is falling in price they want less. This is a natural reaction, and it is a primary cause of losses in speculative markets. This is why most speculators fail.

Figure 1 - Speculator Emotional Cycle



Two Kinds of Real Estate Investors

There are two types of true real estate investors: Rent Savers and Cashflow Investors. These two groups will enter a real estate market without regard to future appreciation because either the cash savings or the positive cashflow warrant the purchase price of the asset. These people are largely immune to the emotional pitfalls of speculators because the value of the investment to them is not dependent upon a profit to be garnered when the asset is sold. They will hold the asset through any price declines because they are not feeling any pain when prices drop. Since these investors will purchase houses even if prices are declining, they are the ones who move in to create a bottom and end the cycle of declining prices.

In a declining market, a market where by definition there is more must-sell inventory than there are buyers to absorb it, it takes an influx of new buyers to

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restore balance. Since it is foolish to buy with the expectation of appreciation in a declining market, the buyers who were frantically bidding up the values of properties in the rally are notably absent from the market. With the exception of the occasional knife-catcher, these potential buyers simply do not buy. This absence of buyers perpetuates the decline once it starts. Add to that the inevitable foreclosures in a price decline, and the result is an unending downward spiral. It takes Rent Savers and Cashflow Investors entering the market to provide support, break the cycle and create a bottom.

Rent Savers are buyers who enter the market when it is less expensive to own than to rent. It does not matter to these people what houses will trade for in the market in the future. They are not buying with fantasies of appreciation. They just know they are saving money over renting, and that is good enough for them. Cashflow Investors have a different agenda; they want to turn a monthly profit from ownership. For them, the cost of ownership must be less than prevailing rent for them to make a return on their equity investment. Cashflow Investors form a durable bottom. If prices drop low enough for this group to get into the market, the influx of investment capital can be extraordinary.

Buyer Support Levels

When do Rent Savers and Cashflow Investors move in to a market and create a bottom? When comparative rents come into alignment with the total cost of ownership, Rent Savers enter the market and begin purchasing real estate. It makes sense for them to do so because ownership becomes a savings over renting (hence the term Rent Saver). The "return" on the investment is the hedge against inflation the Rent Saver obtains by locking in the cost of housing with a 30-year, fixed-rate, fully-amortized mortgage. As rents in the area continue to increase, these costs are not borne by the Rent Saver. Utilizing the price-to-rent concept, the Rent Savers will enter the market when this ratio falls to 154 (based on financing terms available in 2007). There will be some buyers who enter at higher prices, but there will not be enough of them to stabilize the market. It takes a decline in prices to where it is less expensive to own than to rent before enough new buyers enter the market to create a bottom. However, there are some properties that Rent Savers will not purchase because they really do not want to live in them. This includes transitory housing like apartments or small apartment-like condominiums. Prices on these properties will generally drop below the 154 price-to-rent breakeven for owner occupants until they reach price levels where Cashflow Investors will purchase them as rental properties. Since these investors do not want to merely break even, the price must be low enough for the rental rate to exceed the cost of ownership by enough to provide a return on the investor's capital. Historically, price-to-rent ratios from 100-120 are required to create the conditions necessary to attract Cashflow Investors' capital.

When it comes time to consider purchasing a house, each person should evaluate if their motivation is one of an investor or one of a speculator. Investment in real estate requires an accurate assessment of the revenue (or savings)

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and the costs associated with the property. If the cashflow from the property warrants the purchase of the investment – without regard to future asset value – then it is a true investment, and the risks of ownership are much reduced. If the property’s asset resale value were to decline, the investment value would still be there, and the investor would feel no pain and no pressure to sell. In contrast, speculation is a loser’s game, and if the motivation is to capture a windfall from future appreciation, there is a good chance it may not work out as planned because the emotions of a speculator will cause a sale at the worst possible time. A few can put their emotions aside and properly evaluate the market and trade the asset, but most who profit from speculation simply sell at the right time due to life’s circumstances. In short, they get lucky. The people who bought late in the rally and are holding on to the asset while they drift further and further underwater – they are not so lucky.

Trading Houses

During the Great Housing Bubble, many speculators tried to make money through trading houses. The vast majority of these traders were not professionals but amateurs who thought they could be professionals. Most amateurs ended up losing money because they did not understand what it takes to be successful in a speculative market.⁹ The first and most obvious difference in the investment strategy between professional traders and the amateurs in the general public is their holding time. Traders buy with the intent to sell for a profit at a later date. Traders know why they are entering a trade, and they have a well thought out exit strategy. The general public adopts a “buy and hold” mentality where assets are accumulated with a supposed eye to the long term. Everyone wants to be the next Warren Buffet. In reality this buy-and-hold strategy is often a “buy and hope” strategy – a greed-induced, emotional purchase without proper analysis or any exit plan. Since they have no exit strategy, and since they are ruled by their emotions, they will end up selling only when the pain of loss compels them to. In short, it is an investment method guaranteed to be a disaster.

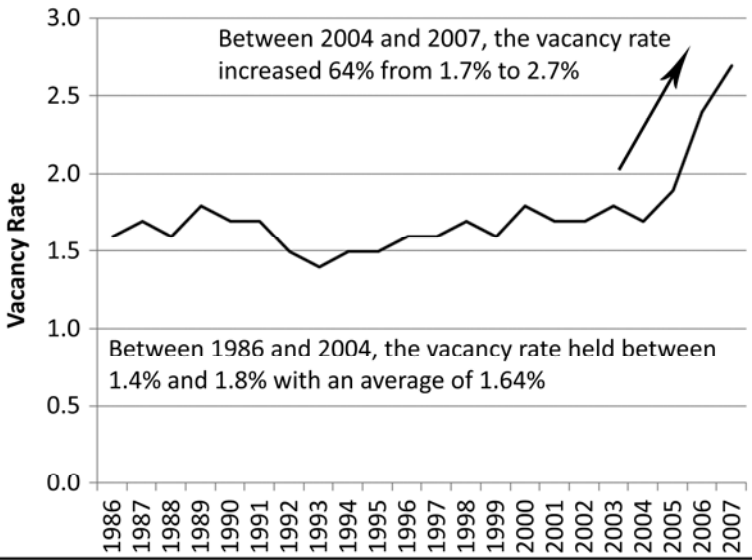
There is evidence that houses were used as a speculative commodity during the Great Housing Bubble. Since the cost of ownership greatly exceeded the cashflow from the property if used as a rental, the property was not purchased for positive cashflow, and by definition, it was a speculative purchase. Confirming evidence for speculative activity comes from the unusual and significant increase in vacant houses in the residential real estate market.

If markets had not been gripped by speculative fervor, vacancy rates would not have risen so far above historic norms. If houses had been purchased for investment purposes to make money from rental income, the houses would have been occupied after purchase and vacancy rates would not have gone up. A rise in vacancy rates would have resulted in downward pressure on rents, and the investment opportunity – if it had existed initially (which it did not) – would have disappeared with the declining rent. There is only one reasonable explanation for increasing house prices and increasing rents during a period when house

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vacancy rates increased 64%: people were purchasing houses for speculative gains and leaving them unoccupied while the owners waited for prices to rise.¹⁰

Figure 2 - National Homeowner Vacancy Rate, 1986-2007



Source: US Census Bureau

When house prices stopped their dizzying ascent, many speculators found themselves with large monthly debt service costs and no income to offset expenses. Many chose to quit paying their mortgage obligations and allowed the property to be auctioned at foreclosure. Many chose to rent the properties to reduce their monthly cashflow drain, and they became accidental landlords. In the vernacular of the time, they became floplords – flippers turned landlords.

Becoming a floplord was fraught with problems. First, they were not covering their monthly expenses, so the losses on the “investment” continued to mount. For houses purchased near the peak in 2006, rent only covered half the cost of ownership unless the speculator used an Option ARM with a very low teaser rate (which many did). Becoming a floplord was a convenient form of denial for losing speculators because they believed they were buying themselves time until prices rose again, allowing them to sell later either at breakeven or for a profit. Since they bought in a speculative mania, prices were not going to recover quickly and the denial soon evolved into fear, anger and finally acceptance of their fate. Another problem floplords faced was their own inexperience at managing rental properties. Most had never owned or managed a rental property, and none of them purchased the property with this contingency in mind. They often found poor tenants who did not reliably pay the rent or properly care for the property. This created even more financial distress and greater loss of property value as the property deteriorated through misuse.

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The problems of renting were not confined to the floplords. Sometimes innocent renters were the ones who suffered. Many floplords collected large security deposits and monthly rent checks from tenants and yet failed to pay their mortgage obligations. This situation is called “rent skimming,” and it is illegal in most jurisdictions, but this crime is seldom prosecuted. Most of the time, the first indication a renter had that their rent was being skimmed was finding a foreclosure notice on their front door. By the time of notification, several months of rental payments were gone and the renters were evicted soon after the foreclosure. Renters seldom recovered their security deposits.

Houses as Commodities

Commodities are items of value and uniform quality produced in large quantities and sold in an open market. Although every residential real estate property is unique, these properties became uniformly desired by investors because all real estate prices rose during the Great Housing Bubble. The commoditization of real estate and the active, open-market trading it inspires caused houses to lose their identity as places to live and call home. Houses became tradable stucco boxes similar to baseball playing cards where buying and selling had nothing to do with possession and use and everything to do with making money in the transaction.¹¹

In a commodities or securities market, rallies unsupported by valuation measures fall back to fundamental values. It is very clear the rally in house prices was not caused by a rally in the fundamental valuation measures of rent or income. Many people forgot the primary purpose of a house is to provide shelter – something which can be obtained without ownership by renting. Ownership ceased to be about providing shelter and instead became a way to access one of the world’s largest and most highly leveraged commodity markets: residential real estate.

Commodities markets are notoriously volatile. In fact, this volatility is the primary draw of commodities trading. If market prices did not move significantly, traders would not be interested in the market, and liquidity would not be present. Without this liquidity, hedgers could not sell futures contracts and transfer their risk to other parties, and the whole market would cease to function. Commodities markets exist to transfer risk from a party that does not want it to a party who is willing to assume this risk for the potential to profit from it. The commodities exchange controls the volatility of the market through the regulation of leverage. It is the exchange that sets the amount of a particular commodity that is controlled by a futures contract. They can raise or lower the amount of leverage to create a degree of volatility attractive to traders. If they create too much leverage, the accounts of traders can be wiped out by small market price movements. If they create too little leverage, traders lose interest.

The same principles of leverage that govern commodities markets also work to influence the behavior of speculators in residential real estate markets. If leverage is very low (large downpayments or low CLTV limits,) then speculators have to use large amounts of their own money to capture what become

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relatively small price movements. If leverage is very high (small downpayments or high CLTV limits,) then speculators do not have to put up much money to capture what become relatively large price movements. The more leverage (debt) that can be applied to residential real estate, the greater the degree of speculative activity that market will see. Also, the smaller the amount of money required to speculate in a given market, the more people will be able to do so because more people will have the funds necessary to participate. When lenders began to offer 100% financing, it was an open invitation to rampant speculation. This makes the return on investment infinite because no investment is required by the speculator, and it eliminates all barriers to entry to the speculative market. In a regulated commodities market, the trader is responsible for all losses in the account. In a mortgage market dominated by non-recourse purchase money mortgages, lenders end up assuming liability for losses in the speculative residential real estate market.

Mortgages as Options

An option contract provides the contract holder the option to force the contract writer to either buy or sell a particular asset at a given price. A typical option contract has an expiration date, and if the contract holder does not exercise his contract rights by a given date, he loses his contractual right to do so. An option giving the holder the right to buy is a “call” option, and the option giving the holder the right to sell is a “put” option. Writers of option contracts are typically obtain a price premium for taking on the risk that prices may move against their position and the contract holder may exercise his right. The holder of an options contract willingly pays this premium to limit his losses to the premium paid if the investment does not go as planned. Most options expire worthless.

Mortgages took on the characteristics of options contracts in the Great Housing Bubble. Speculators utilized 100% financing and Option ARMs with low teaser rates to minimize the acquisition and holding costs of a particular property. The small amount they were paying was the “call premium” they were providing the lender. If prices went up, the speculator got to keep all the gains from appreciation, and if prices went down, the speculator could simply walk away from the mortgage and only lose the cost of the payments made, particularly when this debt was a non-recourse, purchase-money mortgage. Another method speculators and homeowners alike used was the “put” option refinance.¹² Late in the bubble when prices were near their peak, many homeowners refinanced their properties and took out 100% of the equity in their homes. In the process, they were buying a “put” from the lender: if prices went down (which they did,) they already had the sales proceeds as if they had actually sold the property at the peak; if prices went up, they got to keep those profits as well. The only price for this “put” option was the small increase in monthly payments they had to make on the large sum they refinanced. In fact, on a relative cost basis, the premium charged to these speculators and homeowners was a small fraction of the premiums similar options cost on stocks. Of course, mortgages are not option contracts, and lenders did not view themselves as selling option

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premiums to profit from the premium payments; however, speculators certainly did view mortgages in this manner and treated them accordingly.

The "put" and "call" option features of mortgages during the bubble are the direct result of 100% financing. Speculators and homeowners have too little to lose to behave responsibly when 100% financing is available. Without increasing the cost to speculators through downpayments or a loan-to-value limit on refinances, speculators are going to utilize these mortgage products in ways they were not intended. There are many expensive lessons learned by lenders concerning 100% financing during the Great Housing Bubble.

The Stages of Grief

Markets are the collective actions of individuals, and the psychology of the markets can be broken down to the psychology of the individual participants who make it up. When price levels in a financial market collapse, most people lose money. Any loss has a psychological impact on the individual causing her to experience grief. The grieving process is generally divided into several overlapping stages: denial, anger, bargaining, and acceptance. These stages are also apparent in the mass psychology of the market.

When prices first drop, the individual market participants feel confusion and attempt to avoid the truth. They feel denial. This is motivated by fear (or truth) they may have been wrong to purchase when they did, and they might lose money. They seek ways to quell these fears. Rather than attempt to objectively review facts to ascertain whether or not the unexpected market behavior is the beginning of a new trend, most market participants will seek out data consistent with their original assessment. Denial is a natural reaction, but it is a very costly one when applied to a financial market.

When the initial price drops in the market begin to show the signs of a new trend, market participants become fearful. They work to maintain their denial, but there are moments when the awful truth cannot be contained. The little, fearful voice inside of each buyer gets louder and louder. This boils over into anger, frustration, and anxiety. The individual desperately is seeking ways to maintain denial, but reality becomes stronger than denial. She imagines the possibility that reality she is trying to deny is the truth. This leads to depression and detachment as reality is too painful to accept. The sadness of the imagined loss is often suppressed or glossed over with a veneer of anger.

Finally, "as the going gets tough, the tough get going," and the individual seeks ways to get out of the problem through emotional bargaining. This behavior is often takes the form of a negotiation with Fate or the market. One amusing example of this behavior is the purchase of a St. Joseph statue.¹³ Burying this statue in the yard is supposed to secure God's blessing and ensure a quick sale. Some will take more productive action. Perhaps it is lowering an asking price, or taking the property off the market and doing some renovations to "add value." Some will not take action, and they lapse back into denial because the market is "coming back soon." Those owners who chose to lower their price as part of their bargaining may get out with minimal losses (assuming they lower it

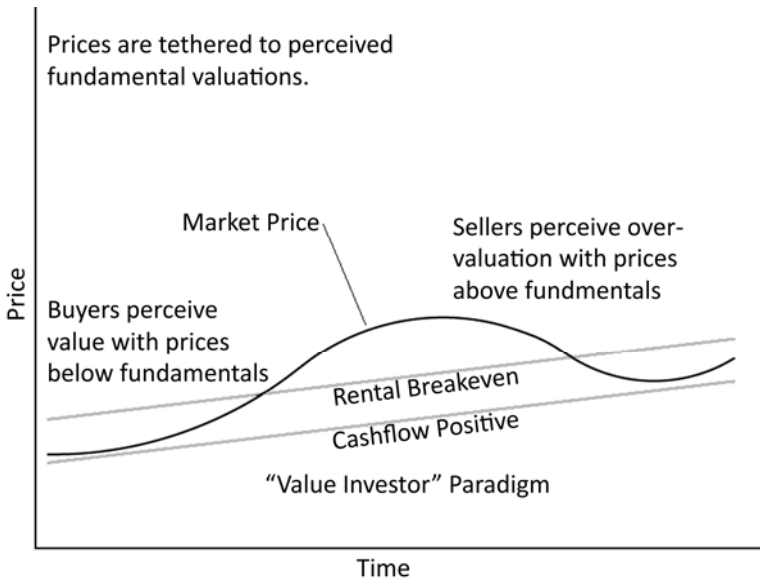
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enough to actually sell). Those that choose other courses of action, lose much more money.

In past market declines each individual reached acceptance of the market reality. Some chose to continue making payments on their “investment” and wait out the bear market. In the aftermath of the coastal bubble of the early 90s, many sellers accepted the market was a buyer’s market, and many sellers chose to keep making their payments and keep their properties. Those that chose to keep their property in the Great Housing Bubble did not have the ability to make these payments, and the property became a forced sale at a foreclosure auction. Some individuals reached acceptance and chose to sell their property on their own.

Efficient Markets Theory

Figure 3 - Efficient Markets Theory



The efficient markets theory is the idea that speculative asset prices always incorporate the best information about fundamental values and that prices change only because new information enters the market and investors act in an appropriate, rational manner with regards to this information.¹⁴ This idea dominated academic fields in the early 1970s. Efficient markets theory is an elegant attempt to tether asset prices to fundamentals through the common-sense notion that people would not behave in irrational ways with their money in financial markets. This theory is encapsulated by the “value investment” paradigm prevalent in much of the investment community.

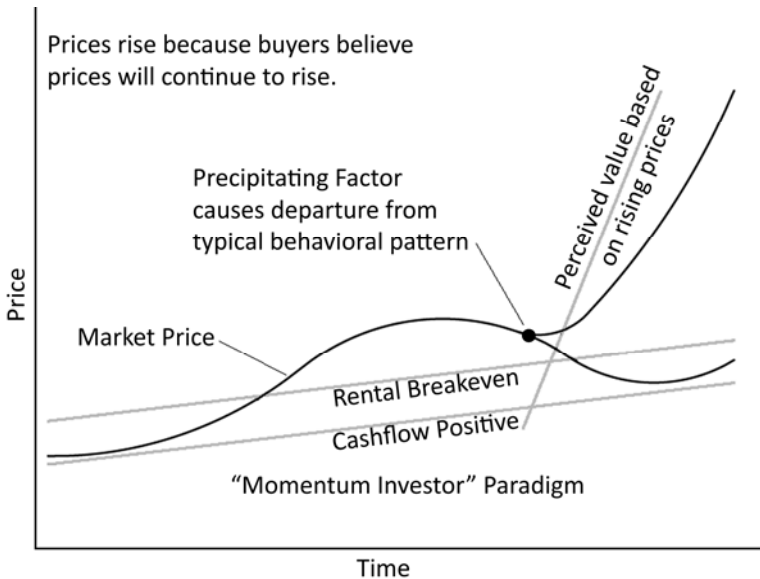
In an efficient market, prices are tethered to perceived fundamental valuations. If prices fall below the market’s perception of fundamental value, then

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buyers will enter the market and purchase the asset until prices reach their perceived value. If prices rise above the market's perception of fundamental value, then sellers will enter the market to sell the asset at inflated prices. Efficient markets theory explains the majority of market behavior, but it has one major flaw which renders it inoperable as a forecasting tool: it does not explain those instances when prices become very volatile and detach from their fundamental valuations. This becomes painfully obvious when adherents to the theory postulate new metrics to justify fundamental valuations that later prove to be completely erroneous.¹⁵ The failed attempts to explain anomalies with the efficient markets theory lead to a new paradigm: behavioral finance theory.

Behavioral Finance Theory

Figure 4 - Behavioral Finance Theory



Behavioral Finance abandoned the quest of the efficient markets theory to find a rational, mathematical model to explain fluctuations in asset prices. Instead, behavioral finance looked to psychology to explain asset valuation and why prices rise and fall. The primary representation of market behavior postulated by behavioral finance is the price-to-price feedback model: prices go up because prices have been going up, and prices go down because prices have been going down. If investors are making money because asset prices increase, other investors take note of the profits being made, and they want to capture those profits as well. They buy the asset, and prices continue to rise. The higher prices rise and the longer it goes on, the more attention is brought to the positive price changes and the more investors want to get involved. These investors are not buying because they think the asset is fairly valued, they are buying because

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the value is going up. They assume other rational investors must be bidding prices higher, and in their minds they “borrow” the collective expertise of the market.¹⁶ In reality, they are just following the herd. This herd-following has long been a valid investment technique employed by traders known as “momentum” investing.¹⁷ It is not investing by any conventional definition because it relies completely on capturing speculative price changes. Success or failure often hinges on knowing when to sell. It is not a “buy and hold” strategy.

The efficient markets theory does explain the behavior of asset prices in a typical market, but when price change begins to feedback on itself, behavioral finance is the only theory that explains this phenomenon. There is often a precipitating factor causing the break with the normal pattern and releasing the tether from fundamental valuations. During the Great Housing Bubble, the primary precipitating factor was the lowering of interest rates. The precipitating factor simply acts as a catalyst to get prices moving. Once a directional bias is in place, then price-to-price feedback can take over. The perception of fundamental valuation is based solely on the expectation of future price increases, and the asset is always perceived to be undervalued. There are often brave and foolhardy attempts to justify these valuations and provide a rationalization for irrational behavior. Many witnessing the event assume the “smart money” must know something, and there is a widespread belief prices could not rise so much without a good reason. Herd mentality takes over.

Psychological Stages of a Bubble

Once a bubble starts to form, it will go through several identifiable stages: enthusiasm, greed, denial, fear, capitulation, and despair. Each of these stages is characterized by different speculator emotional states and different resulting behaviors. There are outside forces that also act on the market in predictable ways in each one of these stages. Most often, these outside factors serve to reinforce the market’s herd behavior and exacerbate changes in price.

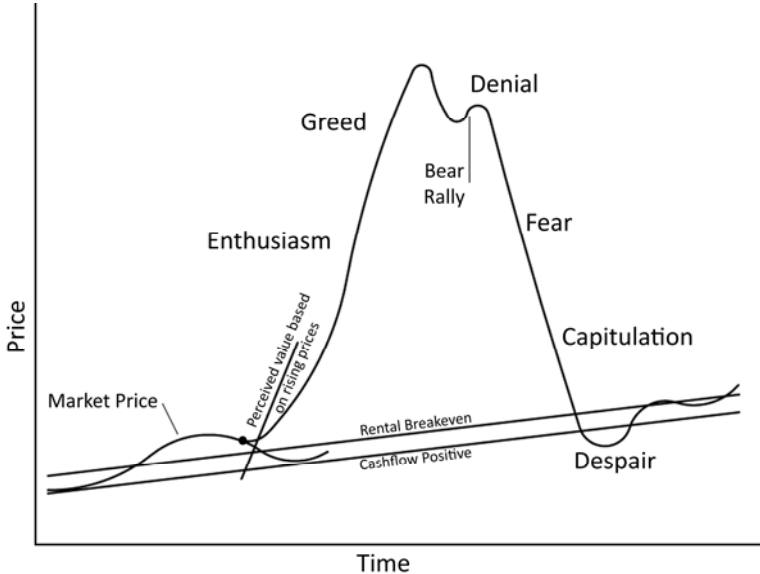
Precipitating Factor

There is often a precipitating factor causing the initial price rally that pushes prices above their supported fundamental values. A bubble rally is usually kicked off by some exogenous event, but it may occur simply because prices have been rising and investors take notice, or it can be merely the result of a lack of investor fear and the widespread belief prices cannot go down.¹⁸ In a typical market, there is a significant selloff when prices exceed fundamental valuations. This selloff is a natural reaction to inflated prices as a decline to fundamental valuations is normal and expected. Many seasoned market observers will “sell short” here to profit from the initially inflated values caused during the take-off stage. However, in a financial mania, this sell off is short-lived, and it traps many who are bearish on asset pricing on the wrong side of the trade. This “short squeeze” may prompt a feverish activity of buying as short sellers cover their positions before their losses get too great. A short squeeze may act as a precipitating factor. In a securities market, a precipitating factor may be a very

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large order hitting the trading floor, and in a real estate market it may be a dramatic lowering of interest rates as it was in the Great Housing Bubble. Regardless of its cause, the initial price rise has the potential to spark sufficient interest to prompt further buying and set a series of events in motion which repeat with a remarkable consistency. Market bubbles can be found in all financial markets and on multiple timeframes.

Figure 5 - Psychological Stages of a Bubble Market



Enthusiasm Stage

At the beginning of the enthusiasm stage, prices are already inflated, so there is cautious buying from traders looking for trends and momentum. If prices fail to drop to fundamental valuations and instead push higher, media attention is often drawn to the speculative market. The general public starts to take notice of the money being made by people who have bought the featured asset and they begin to participate in larger numbers. Of course, this stimulates more buying and prices continue to climb. The market sentiment turns very bullish. Buyers are everywhere and sellers are scarce. At this point, prices are completely detached from fundamental valuations, but people are not buying because of the underlying value, they are buying because prices are going up.

In residential real estate markets, the enthusiasm stage is often greeted by lenders with open arms. With prices rising, there is little risk of loss from default. If a borrower gets in trouble, they can simply sell into rising prices, and neither party takes a loss. With neither party fearing loss, and since lenders make most of their money on the transaction itself through origination fees, there is an inevitable lowering of standards to meet market demand. This in turn creates more market demand leading to further lowering of standards. The credit

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cycle reinforces the bullish psychology in the market and helps push prices even higher.

Greed Stage

In the greed stage, the bullish sentiment reaches a feverish pitch and prices rise very rapidly. Every owner in the market is making money and most believe it will go on forever. As prices continue to climb, buyers become very enthusiastic about owning the asset, and they tell all their friends about their great investment. The word-of-mouth awareness and increased media coverage bring even more buyers to the market. Egomania sets in as everyone thinks she is a financial genius. Any intellectual analysis at this stage is merely a cover for emotional buying and greed. During the Great Housing Bubble, there were many instances of properties receiving a dozen or more offers the day they were listed, with many in excess of the asking price. Encouraged by realtors, some buyers wrote emotional letters to sellers to convince them why they should be bestowed with the honor of home ownership.¹⁹

Most people who are bullish already own the asset, but for prices to continue to rise there must be more buying. For buying to occur, someone who was either bearish or ignorant of the rally must be convinced to buy. In other words, a greater fool must be found. Once everyone is made aware of the market rally and is convinced to buy, you simply run out of new buyers. Once there is a shortage of potential buyers, prices can only go down.

Denial Stage

When the limit of affordability is reached and the pool of available buyers is exhausted, prices start to decline. At first market participants are still overwhelmed by greed, and they choose to ignore the signs that the party might be over. In 2007 most real estate markets were in the denial stage as prices had not dropped enough to cause real fear. Denial is apparent in polls in mid-2007 where 85 percent believed their home would rise in value during the next five years, and 63 percent believe a house is a good investment. That is denial. It is also apparent in the number of homes purchased during the greed stage that are held for sale at breakeven prices – even if this is above market. When the inventory is large, and houses stay on the market for a long time, prices are too high. Sellers who refuse to lower their prices to take a small loss are in denial about the state of the market. They believe bids will increase and some buyer will come along and pay their price – after all, that is the way it was just a couple of years prior. Buyers who bought in the enthusiasm stage are still ahead, so they feel no urgency to sell. They have made good money already and they will hold on with hopes of making a little more. Since they believe the asset will appreciate again (and they have no exit strategy), this group of buyers does not sell.²⁰ In contrast, the few traders who still hold positions liquidate and go back into cash. Successful traders recognize the emotion of denial as a signal to exit their positions to lock in profits or prevent further damage.

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In the denial stage of a residential real estate market, many speculators are unable to obtain the sale price they desire.²¹ The accumulation of unrealistically priced houses starts to build a large inventory of homes “hanging” over the market. Overhead supply is a condition in a financial market when many units are held for sale at prices above current market prices. Generally there will be a minor rally after the first price decline as those who missed the big rally but still believe prices will only go up enter the market and cause a short-term increase in prices. This is a bear rally. It is aptly named as those bullish on the market buy right before the bear market reverses and quickly declines. For prices to resume a sustained rally, the overhead supply must be absorbed by the market. Once prices stopped going up and actually began to fall, demand is lessened by diminished buyer enthusiasm and the contraction of credit caused by mounting lender losses. With increasing supply and diminished demand prices cannot rally to absorb the overhead supply. The overall bullish bias to market psychology has not changed much at this point, because owners are in denial about the new reality of the bear market; however, the insufficient quantity of buyers and the beginnings of a credit crunch signal the rally is over and the bubble has popped.

Fear Stage

In the grieving process there is a shift from denial to fear when the reality being denied becomes too obvious to be ignored or pushed out of awareness. There is no acceptance of reality, just the idea that reality might be fact. The fact that an investment might turn out to be a very poor financial decision with long-term repercussions to the speculator’s financial life is generally very difficult to accept. The imaginings of a horrifying future creates fear, and this fear causes people to make decisions regarding their investments.

The most important change in the market in the fear stage is caused by the belief that the rally is over. Price rallies are a self-sustaining price-to-price feedback loop: prices go up because rising prices induces people to buy which in turn drives prices even higher. Once it is widely believed that the rally is over, it is over. Market participants who once only cared about rising prices suddenly become concerned about valuations. Since prices are far above fundamental values and prices are not rising, there is little incentive to buy. The rally is dead.

Another major psychological change occurs in this stage after people accept the rally is dead: people reassess and change their relationship to debt. During the rally, debt becomes a means to take a position in the housing commodity market. Nobody cares how much they are borrowing because they never intend to pay off the loan through payments from their wage income. Most believe they will pay off whatever they borrow in the future when they sell the house for more than they paid. Once prices stop going up, people realize they are simply renting from the bank, and the only way to get ahead and build equity is to pay off a mortgage. The desire to borrow 8 to 10 times income diminishes rapidly as people realize they could never pay off such a large sum. What started in the denial stage as an involuntary contraction of credit, in the fear stage becomes a

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voluntary contraction of credit as people simply do not want to borrow such large amounts of money.

In August of 2007, a more serious credit crunch gripped financial markets, and during the times that followed there was increased liquidation of bank held inventory. Banks tried to get their wishing prices through the prime selling season, but by the end of the year, there was pressure to get these non-performing assets off their books. The sales of bank foreclosures and the ongoing tightening of credit drove prices down an additional 5% to 10%. This caused some major problems for owners of residential real estate. Fear began to grip the market.

By the time a financial market enters the fear stage, greed stage buyers are seriously underwater. Comparable properties may be selling for 10% less than their breakeven price, and there is little hope that prices will rally. Some sell at this point and take a loss, but most do not. People who bought in the enthusiasm stage come up to their breakeven price and face the same decision the greed stage buyers faced earlier: sell now or hold out for a rally. Even though there is good reason to fear, most do not sell here. They regret it later, but they hold on. Speculators generally only sell an asset when the pain of loss becomes acute. The pain threshold is different for each individual, but there is no real pain until the investment is worth less than the purchase price, so few sell for a profit or at breakeven. Inventories grow in the fear stage because many would like to sell, but sales volumes are light because few are willing to sell at prices buyers are willing to pay.

Prices do not rally here because there are even fewer buyers in the market and a reduced appetite for debt due to the change in market psychology. There are more and more sellers either choosing to sell or being forced to sell, and since there are more sellers than buyers, prices continue to drop. During the fear stage, a majority of buyers during the rally go underwater on their mortgages and endure the associated pain and stress. In the past, since the bubbles of the 80s and 90s were largely built on conventional mortgages, people just held on. During the Great Housing Bubble, people used exotic loan financing terms, and they simply could not afford to make their payments. They borrowed from other sources until their credit lines were exhausted and they imploded in foreclosure and bankruptcy. During this stage many renters who would otherwise have purchased a home put off their purchase and save more money because they correctly see the decline in prices has momentum and prices should continue to drop further.

Capitulation Stage

The transition from the fear stage to the capitulation stage is caused by the infectious belief that the rally is over. There is a tipping point where a critical mass of market participants either decide to sell or are forced to sell. In residential real estate, people are compelled to sell by anxiety, and the mechanism for force is foreclosure. Once a critical mass of selling is reached, the selling causes prices to decline further which in turn causes more selling. This convinces even more people the rally is over yielding even more selling: a downward spiral. The

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same price-to-price feedback mechanism that served to drive prices up during the rally works to drive prices down during the crash. Collectively, everyone in the market accepts prices are going to drop further, and they need to get out: Now! Of course when everyone knows prices are going to drop, and everyone is trying to sell, there are very few buyers. Each market participant has a different threshold for pain. Some give up early; some give up later; some stubbornly try to hold on, but in the end, by choice or by force, everyone who cannot afford their home sells out and capitulates to the forces of the market. Each seller accepts the market rally was a bubble, and the frenzy of selling activity clears out the overhead supply. The capitulation stage is the counterpart of the greed stage. Sellers are everywhere and buyers are scarce. This puts prices into free-fall until a critical mass of buyers is ready to buy again.

Since buyers in the aftermath of a bubble tend to be the risk averse who did not participate in it, they will make cautiously low offers on properties. Buyer caution is reinforced by lender caution. In stark contrast to the days of bubble lending, large downpayments are suddenly required, appraisals are carefully reviewed, eligibility is tighter, and most exotic loan programs are gone. This cautious buying together with desperate sellers causes the market to drop below normal valuation standards. The market enters the despair stage. Here the market participants think nobody wants the asset, and nobody ever will again. Of course, nothing could be farther from the truth as those who recognize the fundamental value of the asset are buying it in preparation for the next cycle.

Despair Stage

From a perspective of market psychology, it is difficult to tell when the capitulation stage ends and the despair stage begins. Both stages have an extremely negative bearish sentiment. It is called the despair stage because most who own the asset are in despair and wish they did not own it, and the general public is still selling. Most who still own their homes are able to afford the monthly payments, but realize they will face a large loss if they sell their house anytime soon. They feel like prisoners in their own homes because they are unable to relocate for a better job or any other reason. One distinguishing feature of the despair stage is the increased buying activity of investors – true investors, not the speculators who were wiped out during the price decline. Investors are not in despair during this stage. This is the time they were anticipating to make their purchases.

There is an extreme emotional toll paid by those who participated in the mania. Losing a home to foreclosure is devastating. The emotional ties to a home go beyond seeing it as an investment. A home is supposed to be a safe haven where people raise a family. It is a unique reflection of the family, adorned with mementos and family photographs. Being forced to leave the family home is difficult for reasons that have nothing to do with money. Unfortunately, this is often followed by personal bankruptcy, and the difficulties in bankruptcy have everything to do with money.

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In some ways, those who endure foreclosure may be the lucky ones as they get to leave their debtor's prison and go find an affordable rental. The income that used to go toward housing is now freed up to go toward living a life. Those homeowners who hang on, who are desperately underwater, and who are putting 50% or more of their income toward a house worth less than they owe on it, their circumstances are arguably even more dire. There is no light at the end of their tunnel; they must live with their pain every day.

The despair stage is not desperate for everyone. What makes the despair stage different from the capitulation stage is that buyers who focus on fundamentals like rental savings or positive cashflow return to the market and begin buying. Affordability has returned to the housing market, and those who did not participate in the mania finally get their chance to become homeowners – at reasonable prices. These buyers are not concerned with appreciation; they simply want an asset which provides a savings or a cash return on their investment. They are not frightened by falling prices because their financial returns are independent of the asset's market valuation. It is the return of these people to the market that creates a bottom.

Bubbles as Cultural Pathology

What is a Cultural Pathology? There are certain beliefs if widely held and acted upon by a group of people leads inevitably to collective suffering and personal destruction. One example of a cultural pathology is demonstrated by the American auto industry. Before the age of imported cars, the American auto industry believed the quality of their product did not matter; people bought their product irrespective of quality. For many years, the industry was successful despite this pathology. This belief allowed offshore competitors to enter the market, build market share, and finally take over the industry. The American auto industry's belief system had had a pathologic effect on their business which caused much suffering in Detroit. This commitment to quality in the industry is still suspect, and it may lead to the bankruptcy and destruction of our major automakers.

The best treatise on the pathology of cultural beliefs was George Orwell's novel, 1984.²² In Orwell's vision, a totalitarian State had convinced the populace of the following:

- WAR IS PEACE
- FREEDOM IS SLAVERY
- IGNORANCE IS STRENGTH

Although these statements are clearly contradictory, in the story the slogans do make sense to the State. For example, through constant "war", the State can keep domestic peace; when the people obtain freedom, they become enslaved to it, and the ignorance of the populace is the strength of the State. Just as Orwell's Big Brother convinced the populace the above contradictions were true, Californians and other bubble participants have convinced themselves of the following:

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- APPRECIATION IS INCOME
- CREDIT IS SAVINGS
- DEBT IS WEALTH

Just as these statements are contradictory and ridiculous, the proof that these statements are believed is that they are reflected in the actions of many homeowners during the Great Housing Bubble. For example, through borrowing against increasing home values, appreciation is turned to income; when people obtain more credit, they spend it like available savings, and a large amount of debt used to finance a large, opulent home makes one wealthy. To many buyers and homeowners during the Great Housing Bubble this made perfect sense.

The problem is rooted in a basic misunderstanding of what separates the rich from the poor: the habit of saving. There is an old expression, “the rich get richer and the poor get poorer.” It is more accurate to say the rich save money and the poor spend it: in the end, the rich will have money, and the poor will have none.²³ This is not one of life’s inequities, but rather one of life’s simple truths. When the average Joe says he wants to be rich, what he is really saying is he wants unlimited spending power. He wants the ability to *spend* like the rich people he sees wearing Rolexes and driving BMWs to their mansions. This is why, when given the chance, poor people will emulate the rich by spending beyond their means in order to *be* rich. Of course, in the process, they spend themselves poor.

Appreciation is Income

There is a noticeable difference between the behavior of rich and poor when it comes to home price appreciation. The rich view home price appreciation as adding to their net worth. If lower interest rates allow them to refinance, they will restructure their debt to pay off the loan more quickly in order to increase their wealth. Poor people view home price appreciation as income; free money for them to spend. If lower interest rates allow them to refinance, they will restructure their loan to pull as much home equity as possible and reduce their payment as much as possible so they can spend more. If any net worth happens to accumulate, they obtain a home equity line of credit and spend the appreciation as quickly as possible – it makes them feel rich even though it really makes them poor.

Credit is Savings

So how do the rich and poor deal with credit? The rich do not carry consumer debt. Why would they pay interest on a credit balance when it almost always costs more than the income they earn on their savings? The rich will use credit sparingly and most often pay off any credit balances each month as the bill comes due. In contrast, the poor carry as much consumer debt as they can afford to service. Whenever they receive an increase in a credit line, they believe they have more money to spend, just like it was savings. In a strange way, a credit account is like a savings account, only it has a negative balance. In a sav-

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ings account, the saver earns money; in a credit account, the spender pays money. Again, the rich have savings, and the poor have credit.

Debt is Wealth

There are a great many homeowners who live in big houses, and they believe that makes them rich. To them, the possession and use of an expensive house makes them wealthy even if they have no equity in the property. The rich buy less home than they can afford and work to pay off the debt in order to maximize their net worth. The poor stretch their finances to possess more home than they can afford with loan terms which never retire the debt, or in the case of negative amortization loans, actually increases their debt held against the property. This ensures they never gain any equity or only gain it by appreciation, and as mentioned previously, if prices appreciate they quickly withdraw the gain to fuel more consumer spending.

It's a California Thing

So what happens when you give poor people money? They spend it. The stories of people who won the lottery and managed to spend themselves into bankruptcy a few years later are classic examples of the pathology of the beliefs of spenders.²⁴ A great many Californians are spenders. This is why California has a strong cultural pathology. The main psychological reason house prices in California were bid up to such dizzying heights during the Great Housing Bubble was because there was a high percentage of the population in California that subscribed to the spending habits just described. They went out and borrowed as much money as they could with exotic loans, bought up all the real estate they could get their hands on, and in the process drove real estate prices into the stratosphere. In other areas of the country, reckless spending was not so trendy, and home prices were not bid up so high.

Preentious displays of conspicuous consumption are less common in the Midwest, and consumerism is often viewed with contempt rather than envy. In short, there is a smaller percentage of the general population in the Midwest with the aforementioned pathologic beliefs.²⁵ To substantiate this claim, observe the profile Minnetonka, Minnesota, a suburb of Minneapolis with very similar income and demographics to Irvine, California. The median income in Minnetonka, Minnesota in 2006 was \$84,024, and the median income in Irvine, California in 2006 was \$84,253.²⁶ This is close enough to be a good comparison. The median home price in Minnetonka in 2006 was \$305,600, and the median home price in Irvine in 2006 was \$722,928.^{27,28} If the thesis is correct, one would expect to find a much higher percentage of home loans utilizing exotic loan terms in Irvine as compared to Minnetonka. In 2006 the Minneapolis area had 8.7% of its loan originations were negative amortization, while Orange County had 32%.²⁹ In all of California more than 80% of loan originations in 2006 were either Option ARM or interest-only. Here are two groups of people with the same median income, and with the same access to credit making very different choices. Potential homebuyers in Minnetonka and Irvine faced the

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same decision on taking out an exotic loan and buying more house than they can afford or choosing to live within their means. Very few in Minnetonka chose to overextend themselves, so they did not bid up the values of their houses. Residents of Irvine (and the rest of California) chose to utilize exotic financing and thereby real estate prices were bid much, much higher. The high utilization of exotic financing was the *cause* of the price increase, not the result of it. Nobody was forced to buy.

Perhaps Californians were just more financially sophisticated than the rubes back on the farm in the Midwest? If many in California were spending freely, feeling rich, and enjoying life, where is the pathology? The beliefs and resulting behavior is pathological because it is not sustainable. There is an inevitable Day of Reckoning when all debts must be paid. Charles Ponzi was the most excessive example of this pathology. So extreme was his activities, that the term Ponzi Scheme has become synonymous with the use of ever increasing amounts of investment or debt.³⁰ This scheme is also encapsulated in the expression “robbing Peter to pay Paul.” The twentieth century economist Hyman Minsky wrote about the “Minsky Moment” when borrowers must liquidate assets to pay off debts which in turn lowers asset prices and creates more margin calls and even more asset liquidation.³¹ At some point, the debt becomes so large that no lender is willing to loan more money, no greater fool can be found to bail them out, and the whole system comes crashing down. However, while the debt was building, the debtor becomes accustomed to a certain lifestyle and level of spending. When the credit is cut off, the debtor can no longer spend, and a great deal of suffering ensues. This is Armageddon for debtors: the spending stops, they lose their homes and with it their illusion of wealth, and they definitely are not enjoying life. The cause of all the weeping and gnashing of teeth is not an exogenous event, but rather a direct result of the circumstances they themselves created.

The California Social Contract

Satire is often more revealing than detailed explanations. The pathology of a collection of beliefs becomes apparent when natural the end result of a group of people acting on those beliefs is an absurd contradiction and an obviously unsustainable state. The following is a satirical essay written from the point of view of a desperate homeowner trying to sustain the Ponzi Scheme of the Great Housing Bubble:

You fence-sitters are failing to fulfill your part of the California Social Contract. Your failure to continue buying homes is disrupting the social order, and it is causing those of us who bought before you psychological, emotional and financial damage. It is time for you to get off the fence and buy – NOW!!!

In any social contract, you give up something personally for the greater good. When those of us who bought before you purchased our homes, we had to commit unrealistic percentages of our income to housing, lie on mortgage applications, and take out financing on unstable mortgage terms in order to do our part for the continuing social

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good. We made these sacrifices willingly because the benefits of maintaining the social contract are worth the price we paid. Look what those who bought before us received in return:

1. Dramatic increases in wealth through home equity. I think we can all agree this is desirable. You want to be rich, right?
2. The ability to spend more than what is earned through productive activities like work. Think of all the BMWs, Mercedes, vacations to Maui, Coach Bags, designer jeans, Rolex watches and other items purchased with home equity lines of credit. You want to double your spending power, right?
3. The ability to buy furniture and home improvements without saving or spending income. Your house should be a self-sustaining asset which provides the ability to maintain itself with perpetual appreciation. Who would not want that?

We provided all of this to the buyers who came before us, and all we ask is that you do the same for us. Is not this a fair bargain? You want the same for yourself, right? If you do this, the next generation of buyers will learn from your example, and they will be willing to do the same.

Some have argued it is our fault that the social contract is falling apart. If we recent homebuyers had simply made our payments, the contract would not have been broken. This is rubbish. The lenders failed us. They knew we could not make those payments when we took out the loans. They knew we were not truthful on our loan applications. They knew they were going to have to provide opportunities for serial refinancing of ever increasing amounts of debt. They failed us. They are the ones who broke the social contract, not us.

The tightening of credit just means you will have to make more significant sacrifices to keep the social contract. You may need to borrow money from family members or solicit larger gifts. You may need to become more creative in your attempts to inflate your income or assets. All we had to do was sign some fraudulent paperwork, but you may have to forge some documents or buy a seasoned credit line or find a hard-money lender who does not record the debt (loan sharks). It is going to be tough, but look at the benefits listed above. Is it not worth the sacrifice?

It is time for you to buy now. Trees really can grow to the sky; prices really can go up forever – if you hold up your end of the California Social Contract. To paraphrase Winston Churchill,

Let us therefore brace ourselves to our duties, and so bear ourselves that if the {California Social Contract} last for a thousand years, men will still say, 'This was their finest hour.'

This is your chance to stand up for what is right and perpetuate a system that is beneficial to our society. History will remember what you do. Will you be the generation that lived up to its duties, or will this be the end of the world as we know it? You decide.

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Bailouts and False Hopes

One of the more interesting phenomena observed during the bubble was the perpetuation of denial with rumors of homeowner bailouts. Many homeowners held out hope that if they could just keep current on their mortgage long enough, the government would come to their rescue in the form of a mandated bailout program. Part of this fantasy was not just that people could keep their homes, but that they could keep living their lifestyle as they did during the bubble. What few seemed to realize was any government bailout program would be designed to benefit the lenders by keeping borrowers in a perpetual state of indentured servitude. With all their money going toward debt service payments, little was going to be left over for living a life.

All of these plans had benefits and drawbacks. One of the first problems was to clearly define who should be “bailed out.” The thought of bailing out speculators was not palatable to anyone except perhaps the speculators themselves, but with regular families behaving like speculators, separating the wheat from the chaff was not an easy task. If a family exaggerated their income to obtain more house than they could afford in hopes of capturing appreciation, did they deserve a bailout? The credit crisis that popped the Great Housing Bubble was one of solvency, and there was no way to effectively restructure payments when a borrower could not afford to pay the interest on the debt, and this was a very common circumstance. None of the bailout programs did much for those with stated-income (liar) loans, negative amortization loans, and others who are unable to make the payments, and since this was a significant portion of the housing inventory, none of these plans had any real hope of stopping the fall of prices in the housing market.

The main problem with all of the plans is the moral hazard they created because those who did not participate in the bubble and instead behaved in a prudent manner would be penalized at the expense of those who were cavalier about risk. In one form or another either through free market impacts or direct subsidies from the government paid by tax dollars, these bailout plans all asked the cautious to support the reckless.³²

Many of the early bailout plans called for changing the terms of the mortgage note. This might have been easy in the days when banks held mortgages in their own portfolios, but it was much more difficult once these mortgages were bundled together in collateralized debt obligations and sold to parties all over the world. Even if it would have been possible to easily change the terms, the resulting turmoil in the secondary mortgage market would have caused higher mortgage interest rates. When an investor faces the risk of the government changing the terms of their contract, and these changes would not be in their favor, the investor would demand higher returns. Higher investor returns means higher mortgage interest rates which would raise the cost of borrowing. This was the opposite of what the government bailout plans were trying to accomplish.

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Hope Now?

The first of the numerous bailout programs was “Hope Now” introduced in October of 2007. As the name suggests, Hope Now was sold to the general public as a reason for them to hang on and continue making crushing payments for as long as possible. It was a false hope, but even false hope gave homeowners a little emotional relief, and it provided a few more payments to the lenders. According to their website, “HOPE NOW is a cooperative effort between counselors, investors, and lenders to maximize outreach efforts to homeowners in distress.”³³ The plan was to streamline the process of negotiating workouts between lenders and borrowers to keep borrowers making payments and ostensibly to stop them from losing their homes. The emphasis was on making payments and maximizing investor value in collateralized debt obligations. Very few people benefited from the program, despite government claims to the contrary, and no rights or benefits were conferred to borrowers that they did not already contractually have. There was much fanfare when it was first announced, but the program did far too little to have any impact on the housing market.

The next bailout was aimed directly at the lenders with the Super SIV program introduced in October of 2007 (Paulson, 2007). An SIV is a special investment vehicle is an off-balance-sheet investment designed to hold investments a company (usually a lender) does not want to show on its own balance sheets. It is a smoke-and-mirrors device used primarily to get around regulations intended to stop lenders from taking excessive risk. The Super SIV program was intended to purchase assets from the troubled SIVs and provide liquidity for lenders who desperately needed it. The problem with the Super SIV was simple: nobody wanted these assets. Moving bad mortgage paper around was akin to rearranging the deck chairs on the Titanic. Few in the general public knew what this program was for, and even fewer cared. Most wanted to know their government was doing something to solve the problem, and the Super SIV announcement provided them with much wanted denial.

In December of 2007, the government offered a more direct homeowner bailout plan. The proposal was to freeze the interest rates on certain loans for certain borrowers for five years. This was greeted as a panacea by all parties, and the beast of homeowner denial was fed once again. As with the Hope Now program, few people qualified, and it did nothing to hold back the tide of increasing defaults and foreclosures. The denial was short lived, and this unnamed bailout plan quickly fell from the headlines.

In the Savings and Loan disaster of the late 1980s, the government was liable to investors for their losses through the Federal Savings and Loan Insurance Corporation (FSLIC). The government had no choice but to compel taxpayers to cover the costs of the industry bailout. The Great Housing Bubble had no such direct government liability. However, in February of 2008 Congress and the President signed the Economic Stimulus Act of 2008 temporarily increasing the conforming loan limit for Fannie Mae and Freddie Mac, the government sponsored entities (GSEs) that maintain the secondary mortgage market. The GSEs

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provide insurance to mortgage backed securities, and by raising the conforming limit, the GSEs were able to insure large, so called “jumbo” loans. This enabled the holders of jumbo loans who were unable to sell these mortgages access to capital in the secondary market. All of this was seen as another reason for homeowners in severely inflated bubble markets to hope the government was going to rescue the housing market.

Forgiveness of Debt

Perhaps the most outrageous suggestion put forth was the suggestion by the FED Chairman Ben Bernanke when he proposed lenders forgive mortgage debt in early 2008 (Bernanke B. S., Reducing Preventable Mortgage Foreclosures, 2008). The moral hazards were obvious. Would people stop making their payments to make sure they qualified? Would more people buy homes they could not afford then appeal for debt relief? Rational people became frightened when they heard the head banker in the United States propose massive debt forgiveness as they realized this meant the entire banking system was in peril. The implications of this proposal were lost on the typical homeowner who only saw how they might benefit from it. Debt forgiveness was the ultimate fantasy of every homeowner. They could be relieved of their financial burdens and get to keep their houses and their lifestyles. It did not matter to the financially troubled that the proposal made no sense and had no possibility of happening, the thought of it would motivate them to hang on a little longer to see if maybe they could hit the jackpot.

Housing and Economic Recovery Act of 2008

In late July 2008, Congress passed and the President signed the Housing and Economic Recovery Act of 2008 that included the following provisions: Federal Housing Finance Regulatory Reform Act of 2008, HOPE for Homeowners Act of 2008, and the Foreclosure Prevention Act of 2008. It will take time to implement these programs and determine if they are successful. Of course, success can mean different things to different parties. For homeowners, success means keeping their house, getting a lower payment, and profiting from its eventual sale. For lenders and holders of mortgages, success means keeping a steady flow of money coming in from previously insolvent debtors. For the government, success means doing something to make angry homeowners less likely to vote them out of office and keep our financial system from complete collapse. As with many pieces of legislation, it is an ugly series of compromises, and ultimately, none of the concerned parties may deem it successful.

The Federal Housing Finance Regulatory Reform Act of 2008 established a regulator to watch over the GSEs. This was too late to do anything about the serious problems facing the GSEs, and it acted as an interim step toward a direct GSE bailout of lenders and investors at the expense of the taxpayers. If one of the GSEs would have failed prior to this legislation, many in Congress would have resisted a taxpayer bailout because the activities of the GSEs were not

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strictly regulated. Once the regulatory framework was in place, Congress had greater political cover to justify a taxpayer bailout.

In early September 2008, not long after the legislation was passed, the Department of Treasury took over “conservatorship” of the GSEs. It is unclear what will happen once under government control. Ultimately, the government’s interests in the GSEs will likely be sold, and the GSEs will become private companies again, but this time with greater governmental oversight. With any regulatory framework, enforcement is pivotal to its success. If another bubble starts inflating, enforcement may not take priority over profits, particularly when the GSE lobbyists start donating heavily to key Congressional leaders.

The HOPE for Homeowners Act of 2008 and the Foreclosure Prevention Act of 2008 are of primary interest to homeowners.³⁴ It falls well short of what most homeowners wanted: direct debt relief from the government. However, it does provide incentives for lenders and investors to forgive the debts of homeowners, but it makes homeowners agree to take out an FHA loan with a higher interest rate and give half the profits on the eventual sale to the FHA. Neither of those provisions will be palatable to borrowers. Both the lender and the homeowner must voluntarily participate. If the lender is determined to foreclose or if the borrower is determined to give up paying back the loan, neither party is compelled to work with the other. For lenders facing taking a property back in foreclosure, writing off a significant portion of the original loan may be preferable to taking a larger loss in a foreclosure. Desperate owners facing foreclosure may like the idea of debt forgiveness, but their payments will not go down much, and giving up half their appreciation will not go over well when they go to sell the property.

Emergency Economic Stabilization Act of 2008

In early October 2008, the Congress passed and the President signed the Emergency Economic Stabilization Act of 2008. The purpose of the bill was “to restore liquidity and stability to the U.S. financial system and to ensure the economic well-being of Americans.” The law authorized the Secretary of the Treasury to establish a Troubled Asset Relief Program (TARP) to purchase the toxic waste poisoning the balance sheets of lenders and other financial institutions. This measure was passed in response to an unprecedented seizure of the short-term credit markets. Banks quit lending money to other banks once it became apparent that few of them were solvent. This fear spread to all short-term commercial paper and threatened to bring down the entire financial system. It is unclear whether or not this saves the institutions holding the toxic waste.

It is interesting that this legislation contained no mention of bailing out troubled homeowners who were the cause of all the financial distress in the lending industry. This may explain why there was widespread public disapproval of this legislation when it was first proposed. A series of dramatic drops in the equities markets while the legislation was being debated helped turn the tide of public opinion.

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Zero Coupon Notes

Of all the intervention programs put forward, only one had any chance of providing any real relief to homeowners if it had been implemented, but the terms would not have been to the liking of homeowners, and the long-term implications would not have been pleasant: convert part of the mortgage to a zero coupon bond. A zero coupon bond is a bond which does not make periodic interest payments. Think of it a zero amortization loan. The borrower pays neither the interest nor the principal, and both accumulate for the life of the loan. The loan would be due upon the sale of the house.

There were many borrowers who were capable of making the payments on a conventional 30-year mortgage when their loans reset, but they were unable to refinance because they owed more on their mortgage than was allowed to qualify for refinancing. For this group of borrowers, the government could have instituted a "loan guarantee" program similar to what they did for Chrysler in the 80s. It would have been in both the lender's interest and the borrower's interest to make the loan and have the borrower continue to make payments, and some banks would have done this on their own (or would have been forced to in a "cram down"); however, many other banks would not, so a government program would have been necessary to prevent further disruption in the market.

Here is how it would have worked for our typical homeowner: Assume a borrower utilized 100% financing and took out a \$500,000 interest-only mortgage with a 2% teaser rate that is due to adjust to 6%. Further assume the borrower's real income (not what was reported on the liar loan) could support a \$1,500 payment on a \$250,000 conventional 30-year mortgage at 6%. The bank could convert \$250,000 to a conventional mortgage, and convert the other \$250,000 to a zero coupon bond at 6% due on sale. The homeowner could have made their payment and kept their house; however, when they later sold their house, they would have owed the bank a great deal of money. If they sold the house in 20 years, they would owe \$800,000 on the zero coupon bond note. In other words, all the equity gain on the value of the home would have gone to the bank.

This would have solved a multitude of problems: First, it would have provided a mechanism whereby people who were victims of predatory lending could have kept their homes. This would have made the homeowner happy, and it would have kept government regulators out of the lender's business. Second, it would have made the lenders more money in the long run because they still would have been making their interest profit even if they did not see it until after the home was sold. (Many may not be aware of it, but lenders book income on the increase in principal on a negative amortization loan). Third, since foreclosures were the primary mechanism facilitating the crash, it would have kept home prices from crashing by reducing the number of foreclosures.

Sounds like a panacea, but there would have been some problems. The first problem would become apparent when people start selling their houses. People are greedy. They would not have wanted to give the bank all their equity when they sold. They would have conveniently forgotten the debt relief and avoiding

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foreclosure and all the problems they had earlier. All they would have seen is that they sold the house for much more than they paid for it, and they did not make any money. And what happens when the appreciation does not match the term of the note? Would they have completed a short-sale 20 years down the line? This would have caused a huge uproar and more calls for congressional intervention. In other words, for everyone involved the day of reckoning would be delayed, not avoided.

This solution would have done nothing for the affordability problem. If prices did not crash, a great many people really would have been priced out forever. To solve that problem, banks would have had to make zero coupon bonds available to everyone, and eventually everyone would have had them. Think about where we would have been then: we would have become a society of homeowners who had collectively agreed to give all our equity to the bank for the pride of ownership: starts to sound a bit like Pottersville from *It's a Wonderful Life*.³⁵ Is that the way we all would have wanted to live?

The zero coupon bond solution would have effectively eliminated the move-up market because people would not have had any equity to take with them from house to house. Unless a prospective move-up buyer has saved a substantial sum or obtained a large pay increase to afford a larger payment, they could not get a more expensive home. This would have resulted in a dramatic flattening of prices. In other words, the low end would have been supported at inflated levels while the high end would have stagnated or declined.

Also, based on the problems above, it would have been difficult to find a new equilibrium in prices. How would people have calculated how much anything was worth? How would all price ranges have been supported equally? Small changes in the interest rate on the zero coupon bond would have made the difference between hundreds of thousands of dollars at the time of sale, particularly on a long-term hold. Does anyone think this would have turned out in favor of the borrower? We would have undoubtedly seen many short-sales as the banks graciously agreed to take all the gains and forgive the rest of the debt. This would take us back to our first problem with angry, greedy sellers.

Finally, this would have been only a short to medium term solution to the foreclosure problem. For as much as we are addicted to credit in this country, there is a point where people would have said "enough is enough." When a house fails to have any investment value, people would not have been so excited about home ownership. People can blather on about pride of ownership all they want, but people want to make money when selling their houses. Inflated valuations are only supported by greed. If home ownership becomes less desirable, prices would have ended up falling back to their rental equivalent values because the demand would not have been there. In the long run, we would have ended up with prices where they should have been anyway, it would have been a much more prolonged and painful journey very similar to the Japanese experience of the 1990s.

Zero coupon bond structures and other exotic financing terms are quite common in complex real estate deals. Exotic loan terms are the exclusive purview of sophisticated investors who understand what they are doing. They are

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not intended for consumption by the general public. Given the profusion of interest-only, and negative amortization loans in the market, is not a surprise the financial innovations of the Great Housing Bubble turned out badly.

Let Markets Work

It is difficult not to become cynical about all the various bailout programs, and the proposals outlined were not the only ones discussed in the public forum. There was a steady drumbeat of public plans and announcements that were never substantial, and their only purpose seemed to be to foster denial among those who needed it.

There is no possible bailout program without the commensurate moral hazards and unfair benefits they would contain. The best course of action would be to ease the transition of people from overextended homeowner to renter and not to attempt to manipulate the financial markets for the benefit of a few. There is nothing that can be done to prevent of the collapse of financial bubbles. The solution lies in easing the pain of their deflation and in preventing them from inflating in the future.

Summary

The motivations for purchasing real estate or any asset differ considerably between investors and speculators. Since speculators rely on capturing the change in asset price, they are much more emotionally involved with the gyrations of market resale value, and since their emotions work against them, they most often sell at a loss. Trading houses became epidemic in the Great Housing Bubble. Houses became commodities to buy and sell and lost their intrinsic value as a shelter or a place to call “home.” People utilized 100% financing and treated mortgage obligations as little more than options contracts.

The emotional cycle of an asset price bubble emanates from the emotional cycle of individual speculators. Efficient markets theory would say these emotions are irrelevant as each investor acts rationally based on fundamental market data. Behavioral finance theory argues our herd instincts coupled with irrational beliefs and expectations are primary forces at work in financial markets. Efficient markets theory fails to explain asset price bubbles, whereas behavioral finance theory does. When the bubble bursts, each speculator must go through the stages of grief as she comes to accept her loss. These stages have analogous counterparts in the price cycle of an asset bubble, and it is through the actions of these grieving speculators that the timing of the cycle takes place.

Asset price bubbles can distort the values and behaviors of entire segments of society. Pathological beliefs can take root and grow into an unsustainable system doomed to crash down around all those who subscribe to the cultural pathology. The activity of governments can serve to reinforce pathological behaviors, and when called upon by a desperate public, the government can pander to the emotional needs of the citizenry through generating false hopes and supporting denial.

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Many people like it when houses go up in price. During a rally the bulls become intoxicated with greed and obsessed with owning real estate as an investment. However, once houses become an investment, the prices of houses begin to behave like an investment, and volatility is introduced into the system. When houses trade with the volatility of a commodities market, it causes more harm than good. Price volatility is a very disruptive feature in a housing market: the upswings are euphoric, and the downswings are devastating – and there are downswings. Declining house prices are emotionally and financially draining both to individuals and to the economy as a whole. The upswings create massive amounts of unsustainable borrowing and spending, and the downswings create economic contraction, foreclosures and personal bankruptcy. Is the ecstasy of a rally worth the despair of a crash?

Houses should not be viewed as a commodity to trade. Most people lack the financial sophistication to successfully trade in commodity markets. Buying and hoping prices go up is not a successful strategy. Volatility in housing prices is harmful to the community as the financial and emotional costs of the inevitable price crash are just too great. Everyone pays a price. Renters who chose not to participate are forced to wait to obtain the security of home ownership at an affordable price, and buyers who endure the crash... well, their pain is obvious.

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End Notes

¹ "Out, out, brief candle! Life's but a walking shadow, a poor player that struts and frets his hour upon the stage and then is heard no more: it is a tale told by an idiot, full of sound and fury, signifying nothing." Macbeth Quote (Act V, Scene V).(Shakespeare, 1603)

² Partial list of prominent real estate bubble and related blogs:

The Irvine Housing Blog – <http://www.irvinehousingblog.com/>

Patrick.net – <http://patrick.net/housing/crash.html>

The Real Estate Bubble Blog – <http://www.thehousingbubbleblog.com/index.html>

The House Bubble – <http://housebubble.com/>

Implode-o-meter – <http://ml-implode.com/>

Bubble Markets Inventory Tracking – <http://bubbletracking.blogspot.com/>

Housing Doom – <http://housingdoom.com/>

Southern California Real Estate Bubble Crash – <http://www.socalbubble.com/>

Calculated Risk – <http://calculatedrisk.blogspot.com/>

Housing Panic – <http://housingpanic.blogspot.com/>

Professor Piggington – <http://piggington.com/>

Dr. Housing Bubble – <http://drhousingbubble.blogspot.com/>

Bubble Meter – <http://bubblemeter.blogspot.com/>

Priced Out Forever – <http://pricedoutforever.com/>

The Bursting Bubble – <http://www.theburstingbubble.com/>

The Real Estate Bloggers – <http://www.therealestatebloggers.com/>

Housing Bubble Casualty – <http://www.housingbubblecasualty.com/>

Housing Bubble Bust – <http://www.housingbubblebust.com/>

Real Estate Realist – <http://www.realestaterealist.com/>

Housing Wire – <http://www.housingwire.com/>

Sacramento Area Flippers In Trouble – <http://flippersintrouble.blogspot.com/>

Seattle Bubble – <http://seattlebubble.com/blog/>

Westside Bubble Blog – <http://westside-bubble.blogspot.com/>

Marin Real Estate Bubble – <http://marinrealestatebubble.blogspot.com/>

Sonoma Housing Bubble – <http://sonomahousingbubble.blogspot.com/>

New Jersey Real Estate Report – <http://njrereport.com/>

New York City Housing Bubble – <http://nychousingbubble.blogspot.com/>

END NOTES

- ³ Much of the author's personal study of Buddhism comes from the writings and recordings of the author Jack Kornfield (Kornfield, *The Roots of Buddhist Psychology*, 1996), (Kornfield, *The Inner Art of Meditation*, 1993), (Kornfield, *A Path with Heart: A Guide Through the Perils and Promises of Spiritual Life*, 1993), (Kornfield, *After the Ecstasy, the Laundry: How the Heart Grows Wise on the Spiritual Path*, 2000). The audio recordings of the *Roots of Buddhist Psychology* have been particularly influential.
- ⁴ The stock market experienced a 500% gain in a five year period before its infamous crash. Much of the reason for the wild increase in pricing was very low margin requirements. People were allowed to buy 10 times as much stock as they had money due to 10:1 margin trading. This expansion of credit through the broker's margin is what drove prices up, and when prices started to fall, margin calls cascaded through the market and resulted in a crash.
- ⁵ Social psychology is an important factor in the transmission of booms and speculative mania; however, the perception of this fact by market participants is not common. Most individuals attribute price increases to some fundamental factor whereas the actual price movements are driven mostly by mass psychology. (Case & Shiller, *The Behavior of Home Buyers in Boom and Post-Boom Markets*, 1988)
- ⁶ Karl Case and Robert Shiller noted (Case & Shiller, *Is There a Bubble in the Housing Market*, 2004) 90% or more of households expected house prices to increase in the following year during price rallies. It is the expectation of 10-year appreciation that is most striking. Market participants in the coastal bubble markets expected a 10-year average annual increase of near 15%. This would mean a tripling of prices over a 10-year period.
- ⁷ (Miles, 2004)
- ⁸ In the paper *Investor Psychology and Security Market Under- and Overreactions* (Daniel, Hirshleifer, & Subrahmanyam, 1998), the authors document that investors have two biases which negatively impact their financial decisions: first, they have an overreliance on private information and analysis with regards to asset prices, and they have a biased self-attribution or belief in themselves that causes them to be overconfident in their investment outcomes. In short, people go into denial because they are overconfident about the direction of the trade.
- ⁹ The best books for understanding the mindset of a professional trader are the books by author Mark Douglas (Douglas, *The Disciplined Trader, Developing Winning Attitudes*, 1990) and (Douglas, *Trading in the Zone*, 2000). He lays out the emotional issues of trading in great detail.
- ¹⁰ (Mints, 2006) According to Victor Mints in his study of the Moscow housing market, the number of vacant houses held for sale by speculators showed the same pattern as the United States.

THE GREAT HOUSING BUBBLE

- ¹¹ In their paper *Prospect Theory: an Analysis of Decision under Risk* (Kahneman & Tversky, *Prospect Theory: An Analysis of Decision under Risk*, 1979), the authors note a tendency of people to overweight low probability events which contributes to the attractiveness of insurance and gambling. Toward the end of the rally of the Great Housing Bubble when prices stopped rising, it became apparent that a resurgent rally was not very likely; however, many still bought in anticipation of this rally because 100% financing was available and they tended to overweight the probability of a rally.
- ¹² In the paper *Moral Hazard in Home Equity Conversion* (Shiller & N.Weiss, *Moral Hazard in Home Equity Conversion*, 1998), Robert J. Shiller and Allan N.Weiss document the moral hazard issues in cash-out refinancing as follows “Home equity conversion as presently constituted or proposed usually does not deal well with the potential problem of moral hazard. Once homeowners know that the risk of poor market performance of their homes is borne by investors, they have an incentive to neglect to take steps to maintain the homes’ values. They may thus create serious future losses for the investors.” They miss the most serious problem resulting in lender losses, the predatory “put” exercised by borrowers. There are clearly moral hazards in cash-out refinancing; they are even more severe than the ones documented in this paper.
- ¹³ The author has a difficult time believing that a God would intervene in a financial market based on the purchase of an idol. It is not surprising a superstition like this one would spring up once houses started to be traded more frequently. There are myths about the practice going back hundreds of years, but references to the practice only go back to the early 1980s – a time corresponding to the slump after the first California real estate bubble.
<http://www.snopes.com/luck/stjoseph.asp>
- ¹⁴ Much of the history of the Efficient Markets theory is outlined in Robert Shiller’s paper (Shiller, *From Efficient Market Theory to Behavioral Finance*, 2002), “The efficient markets theory reached the height of its dominance in academic circles around the 1970s. Faith in this theory was eroded by a succession of discoveries of anomalies, many in the 1980s, and of evidence of excess volatility of returns. Finance literature in this decade and after suggests a more nuanced view of the value of the efficient markets theory, and, starting in the 1990s, a blossoming of research on behavioral finance. Some important developments in the 1990s and recently include feedback theories, models of the interaction of smart money with ordinary investors, and evidence on obstacles to smart money.” One of the groundbreaking papers of the early 1990s that influenced the change in economics thinking from efficient markets to behavioral finance was the work by David Porter and Vernon Smith (Porter & Smith, 1992) on *Price Expectations in Experimental Asset Markets with Futures Contracting*. In this paper, the authors demonstrated the volatility of returns was excessive as prices detached greatly from fundamental values and stayed detached for extended periods of time.

END NOTES

- ¹⁵ In the paper *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias* (Kahneman, Knetsch, & Thaler, *The Endowment Effect, Loss Aversion, and Status Quo Bias*, 1991), the authors, Daniel Kahneman, Jack L. Knetsch, and Richard H. Thaler, begin to lay the foundations for behavioral finance theory by documenting the many anomalies the efficient markets theory could not explain, "Economics can be distinguished from other social sciences by the belief that most (all?) behavior can be explained by assuming that agents have stable, well-defined preferences and make rational choices consistent with those preferences in markets that (eventually) clear. An empirical result qualifies as an anomaly if it is difficult to "rationalize," or if implausible assumptions are necessary to explain it within the paradigm."
- ¹⁶ In the paper *Learning from the Behavior of Others: Conformity, Fads, and Informational Cascades* (Bikhchandani, Hirshleifer, & Welch, 1998), the authors, Sushil Bikhchandani, David Hirshleifer and Ivo Welch, describe the phenomenon of herd behavior and observational learning. Much of human learning is accomplished through observation and imitation of others. This valuable survival skill results in the herd behavior observed in financial markets. It is the driving force behind the price-to-price feedback loop responsible for irrational exuberance.
- ¹⁷ In *House Prices, Fundamentals and Bubbles* (Black, Fraser, & Hoesli, 2006), the behavior of momentum investors is characterized as evidence against rationality in the marketplace. For the typical amateur speculator this is certainly true, but for momentum traders who have learned how to buy and sell to profit from the momentum, it is a rational and profitable method of speculation.
- ¹⁸ In *Risk and Return in the U.S. Housing Market: A Cross-Sectional Asset-Pricing Approach* (Cannon, Miller, & Pandher, 2006), the authors noted a 10% increase in volatility with each 2.48% increase in annual returns. This strongly suggests bubble volatility occurs just because prices are rising.
- ¹⁹ An article in *Real Estate Journal.com* (<http://www.realestatejournal.com/buysell/markettrends/20050106-capell.html>) from the Greed stage in the bubble anecdotally documents properties selling for over list and realtors telling clients to write emotional letters to sellers (Capell, 2004).
- ²⁰ Karl Case and Robert Shiller noted (Case & Shiller, *The Behavior of Home Buyers in Boom and Post-Boom Markets*, 1988) that prices in the early 80s leveled off, but they did not decline at the conclusion of the first California housing bubble of the late 1970s. This convinced people that prices could not decline and that if they just waited long enough prices would come back. This belief caused people to bid up prices even higher in the coastal bubble of the late 1980s. When the decline of that bubble (25%) was forgotten, market participants inflated the Great Housing Bubble.

THE GREAT HOUSING BUBBLE

- ²¹ In Robert Shiller's studies, very few market participants said they would lower their prices until they found a buyer (Case & Shiller, *The Behavior of Home Buyers in Boom and Post-Boom Markets*, 1988).
- ²² (Orwell, 1950)
- ²³ Vernon L. Smith noted in *Human Nature: An Economic Perspective* that "We should all love rich people, because they consume such a small percentage of their accumulation, leaving almost all of it to work in the economy and make the rest of us better off." (Smith, *Human Nature: An Economic Perspective*, 2004)
- ²⁴ Newspapers frequently print stories of lottery winners who spent all their winnings or were unhappy after the windfall (Geary, 2002)(Sullivan, 2006).
- ²⁵ Karl Case and Robert Shiller noted (Case & Shiller, *Is There a Bubble in the Housing Market*, 2004) that Wisconsin had almost no volatility in the ratio of house price to income whereas the coastal bubble markets have price volatility where income only explains about half of the movement in price seen over longer terms.
- ²⁶ Median income information is available from the US Census Bureau <http://www.census.gov/hhes/www/income/income.html>
- ²⁷ Median home sales price from US Census Bureau.
- ²⁸ Data for the California market is from DataQuick Information Systems and the California Association of Realtors.
- ²⁹ BusinessWeek wrote one of the finest articles on the mortgage problem in 2006. In it they reference the now infamous Map of Misery showing the distribution of Option ARMs throughout the United States. The source of their data is not given. The data presented in this work on the loans in Minnetonka, MN and Orange County, California, come from this map. Two of the most moronic lender statements of the housing bubble are in the article's final paragraph, "Analyst Frederick Cannon of Keefe Bruyette & Woods says most banks don't apologize for their option ARM businesses. 'Almost without exception everyone says [the option ARM] is a great loan, it's plenty regulated, and don't bug us,' he says. In an April letter to regulators, Cindy Manzettie, chief credit officer for Fifth Third Bank in Cincinnati, said it's not the 'lender's responsibility to help the consumer determine the appropriate payment option each month.... Paternalistic regulations that underestimate the intelligence of the American public do not work.'" Those statements are wrong on every point, but they do serve to illustrate the mindset of lenders during the bubble.
- ³⁰ Charles Ponzi was an Italian immigrant who arrived in the United States in 1903. He was a consummate schemer and tried numerous get-rich-quick schemes. He hit the con-man's jackpot in 1920 with a scheme involving international postal reply coupons. When the structure collapsed, Ponzi paid out all his gains and ended up penniless. He was sentenced to prison in 1921 for mail fraud. (Zuckoff, 2005)

END NOTES

- ³¹ Hyman Minsky was a controversial economist of the late 20th century. He wrote extensively as a professor of economics at Washington University in St. Louis. (Minsky, Can "It" Happen Again? Essays on Instability and Finance, 1982)(Minsky, Stabilizing an Unstable Economy, 2008) As the Great Housing Bubble began to deflate, the causes were readily identified in Minsky's work from decades earlier. His writings rose from obscurity and attained a new prominence due to his prescience.
- ³² Todd Sinai in his paper, The Inequity of Subprime Mortgage Relief Programs (Sinai, 2008), documented the moral hazards involved with the various programs in the public forum of the time. He accurately characterized the problem as follows, "These programs may help some borrowers, but they do not bestow these benefits equitably. Some reward those who made riskier decisions over those who made prudent decisions, exclude those who live in states that experienced an early economic downturn, benefit those with high incomes at the expense of others, and spread the costs of the program among all taxpayers or future borrowers – regardless of whether they benefit from the proposals."
- ³³ The Hope Now Alliance website address is <http://www.hopenow.com/>.
- ³⁴ The Hope for Homeowners Act of 2008 was built on 5 principals: 1. Long-term affordability. The program is built on the idea, expressed by Federal Reserve Chairman Bernanke, that creating new equity for troubled homeowners is likely to be a more effective way to avoid foreclosures. New loans will be based on a family's ability to repay the loan, ensuring affordability and sustainable homeownership. 2. No investor or lender bailout. Investors and/or lenders will have to take significant losses in order to benefit from the proceeds of the loans refinanced with government insurance. However, these losses would be less than the losses associated with foreclosure. 3. No windfall for borrowers. Borrowers will share their new equity and future appreciation equally with FHA. Borrowers will pay for the FHA insurance. 4. Voluntary participation. This will be a voluntary program. No lenders, servicers, or investors will be compelled to participate. 5. Restore confidence, liquidity, and transparency. Credit markets are fearful and frozen in part because banks and other financial institutions do not know what their subprime mortgages and related securities are worth. The uncertainty is forcing lenders to hoard capital and stop the lending necessary for economic growth. This program will help restore confidence and get markets flowing again.
- ³⁵ (Capra, 1946)

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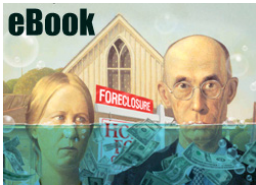
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THE GREAT HOUSING BUBBLE

Why Did House Prices Fall?

Are you thinking you might buy a house?

Are you trying to sell a house?

Are you a nervous homeowner worrying about declining home values?

Are you curious as to how and why real estate prices dropped?

The Great Housing Bubble has the answers!

What experts are saying:

“A very well-written and thoughtful analysis of what went wrong in the housing world and how we can avoid this problem in the future. Lawrence Roberts has a great understanding of the subject and does an excellent job communicating his ideas to the reader.”

James A. Randel, bestselling author of *Confessions of a Real Estate Entrepreneur*

Are you thinking about buying a house?

Many people will be active buyers despite the declining home prices. If you are considering buying during this time, there are many things you will need to know to make sure you do not become one of the casualties of the housing bubble.

How much are houses really worth?

Do you know how to evaluate the fundamental value of a piece of real estate? If you do not, you will probably over pay. Many people think comparative sales prices indicate value, but this incorrect. (The Fundamental Valuation of Houses, p. 29)

Do you understand complicated loan programs?

Many people think they have a grasp of how these exotic new loan programs work. Most people do not, and nobody should really be using them. (Conservative House Financing, p. 8)

How do you negotiate during a price decline?

Most buyers fail to take advantage of the powerful negotiating position they have during a price decline. There are specific techniques one can use to pay the lowest possible price. (Buying and Selling During a Decline, p. 163)

Buy this book now!

THE GREAT HOUSING BUBBLE

Are you buying a house as an investment?

Many people view residential real estate as a good investment, particularly during the real estate bubble. Historically, it has not been. The Great Housing Bubble tells the truth about residential real estate—the truth your realtor does not want you to know.

How do you make money in real estate?

Making money in real estate is about building equity. Most people believe you simply buy and equity appears by magic. It does not work that way. What exactly is equity? And how do you build it? (Equity Components, p. 19)

Why do most speculators lose money?

Most people who speculate in financial markets lose money. Why is that? (Speculation versus Investment, p. 99)

Are houses really a good investment?

Residential real estate has historically underperformed most other asset classes. The period of the Great Housing Bubble was a notable exception to the rule. (Renting versus Owning, p. 46)

What is the investment value of real estate?

There is an investment value to real estate. How is it calculated? What is it really worth? (Investment Value, p. 37)

What readers are saying:

“The detailed investigative work and deep market analysis is very insightful and thought provoking.”

Ben in Seattle

“I feel I have been given a first-rate education in real estate analysis and valuation from this book. I have continued to rent instead of purchase real estate in Irvine due, in large part, to data presented in this book.”

Jaysen in Irvine

What are you risking if you do not buy this book?

This book can save you from financial ruin and all the personal hardships that entails. **Many people lost their wealth, their homes, their credit and their good health during The Great Housing Bubble because they did not have the information presented in this book.** *You do not want to be one of them.* It is that important.

Extreme financial hardship

Residential real estate is generally an extremely leveraged financial asset. A 20% decline in house prices can completely wipe out your downpayment or any

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THE GREAT HOUSING BUBBLE

accumulated equity in a property. Buying at the wrong time and paying too much can have devastating financial consequences for you.

Foreclosure/ short sale

Many people who overborrow and overpay end up losing the property in a foreclosure or short-sale. Being forced to move out of your home is never a pleasant experience.

Bankruptcy / bad credit

With the foreclosure or short-sale often comes a personal bankruptcy. If you manage to avoid bankruptcy, your credit will still be damaged for years.

Stress and health problems

Seeing hundreds of thousands of dollars of your net worth evaporate, losing your home, and being forced into bankruptcy is a very stressful set of circumstances. Many people who go through this experience have major health problems.

Can you afford to risk this?

Do you want to risk these problems? Are you willing to face these dangers without knowing what you can do to protect yourself? Your hard earned money, your credit, and your health are far too valuable to put at risk.

You need to buy this book to prepare you for the dangers out there.

What readers are saying:

“I thought I knew real estate before I read this book. I was wrong. This book opened my eyes to the truth about the real estate cycle. I was thinking of buying and investment property because prices had dropped. It wasn't until I read this book that I realized I was speculating and not investing. I almost made a very big mistake.”

Janet in Irvine

“This helped me avoid buying at the peak and losing hundreds of thousands of dollars. It saved me a great deal of grief and money. Even now, with California housing prices down over 30%, declining prices could still quickly consume your downpayment and put you ‘under water’, unable to sell your house for more than the loan value.

An excellent read, and an important one.”

Brian in Malibu

Buy this book now!

THE GREAT HOUSING BUBBLE

Do you own your house? How did the housing bubble impact you?

Almost 70% of American households own their houses. Even those who do not plan to buy or sell are impacted by the housing bubble. Everyone who owns a house saw a dramatic change in their net worth as house prices rose then fell. Some people refinanced and increased their mortgage balances to obtain the “free money” accumulating in their homes. Some people stopped saving for retirement and other purposes and became completely dependent upon their houses for their financial future. Every owner of real estate was impacted by the bubble.

How much value is your house going to lose?

The most pressing concern of most homeowners is how much is the resale price of their property going to decline before prices stabilize. (Future House Prices, p. 130)

Why did your house lose value?

Many people are very interested in why house prices went down at all. (The Housing Bubble, p. 71)

What readers are saying:

“I loved reading this book and learning about the financial impact of this whole mess that we’re in right now.”

Joe in Austin

“I had no idea my neighbors and the lenders were so crazy. The bubble wasn’t too mad there, so I really didn’t understand what all the fuss was about until I read this book. Wow! I can’t believe what was going on.”

Gale in Nashville

Do you understand the terms of your mortgage?

Many people who took out mortgages during the bubble did not use conventional, 30-year fixed-rate financing. Many of these borrowers utilized new, innovative loan programs that very few understand. (Conservative House Financing, p. 8)

Why did the economy suffer so much?

The deflation of the housing bubble brought down the entire economy and nearly caused the collapse of our entire financial system. (Doomsday Scenario, p. 159; Lingering Problems, p. 161)

Buy this book now!

THE GREAT HOUSING BUBBLE

What every seller needs to know about the housing bubble?

The tactics sellers must use to sell a home have changed radically since the market topped and prices began to fall. Those nimble sellers who are able to make the proper adjustments will sell their houses. Those that do not adapt will fail to sell their homes and lose much more money.

What readers are saying:

“I was not able to sell my house, and I was getting very frustrated. When I read this book, I realized what I really needed to do. The truth helped me overcome my denial, and I sold my house in three weeks – once I did what was necessary.”

Kurt in San Clemente

“My house was on the market for months with no offers. I paid for professional staging, and I even bought one of those crazy St. Joseph statues and buried it in the yard. Nothing. Once I read this book, I realized why the house was not selling. I didn’t want to follow the author’s advice, but it was the only way to sell my home.”

Josue in Sacramento

What do you have to do to sell your house?

What is the number 1 thing a seller must do to sell their property in a declining market? (Buying and Selling During a Decline, p. 163)

What if you owe more than your house is worth?

Many people have loans balances greater than the resale value of their property. What are their options? (Selling for Less, p. 164)

Is the government really trying to save the housing market?

Government policy during the housing bubble was not intended to save the housing market; it was intended to save the banks. Home owners are kept in a state of denial and indentured servitude to their lending overlords. (Bailouts and False Hopes, p. 122)

What are some of the things will you learn in this book?

The Great Housing Bubble is an exhaustive analysis of the issues related to this dark chapter in American history. Even though the decline is nowhere near over in 2008, already the Great Housing Bubble witnessed the largest decline in house prices since the Great Depression. Below is a sample of the types of questions this book answers.

Buy this book now!

THE GREAT HOUSING BUBBLE

Why did house prices go up so much so fast?

With lenders quickly increasing the amounts they were willing to lend, borrowers were able to increase their bids and drive prices skyward. (The Credit Bubble, p. 54)

Why did people borrow so much money?

People borrowed so much because they could, and since prices were going up so fast, most wanted to. Lenders made huge sums available to almost anyone with a pulse on payment schedules they could afford—temporarily. (Negative Amortization Mortgages, p. 13; Stated Income Loans, p. 16)

How crazy were the lenders?

Everyone thought house prices would go up forever, so few thought there was any risk of loss. (What is a Bubble, p. 1; The Fallacy of Financial Innovation, p. 26)

Why did we have a credit crunch?

People stopped paying back their loans, so lenders stopped lending money. (The Credit Crunch, p. 93)

What readers are saying:

“Lawrence Roberts has his finger on the pulse of the housing bubble – the bursting forehead vein, I should say!”

LC in Irvine

“Lawrence Roberts is one of the best that I have seen at breaking down the complicated and confusing mortgage and real estate industry so that novices like me can understand.”

Alan in Toledo

Why did we have so many foreclosures?

People stopped making payments because they borrowed too much money and they could not afford to pay it back. (Types of Loans, p. 11; The Bubble Bursts, p. 87)

How does the secondary mortgage market work?

The activity in the secondary mortgage market provided the air that inflated the housing bubble. (Structured Finance, p. 57)

Why is real estate cyclical, and what are the stages of the cycle?

Real estate prices rise and fall due to market psychology and credit availability. (Visualizing the Bubble, p.67; Psychological Stages of a Bubble, p. 111)

Buy this book now!

THE GREAT HOUSING BUBBLE

Are most home buyers speculators?

Many homebuyers in volatile real estate markets are motivated by profit. This motivation causes a great deal of property speculation. (Trading Houses, p. 104)

How did the bubble change people's lives?

The housing bubble made and lost fortunes for its many participants. Those that lost faced both economic and personal problems. (Economic Problems, p. 173; Personal Problems, p. 175)

How do we stop future housing bubbles?

It is possible to prevent future housing bubbles. It requires a combination of market reform and government intervention. (Preventing the Next Housing Bubble, p. 173)

What experts are saying:

“Lawrence Roberts was completely right.”

“Lawrence Roberts is THE real estate guru... one of the few who knew it was coming.”

“He’s the guy that predicted the crash and year and a half before it happened.”

Johnny Wendell – KTLK 1150 AM

Buy this book now!