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Investment Newsletter – June 2006

Postponing Tax by Attempting an Exchange

In the current market environment it is a very good time to sell property but investors must figure out where to invest the money. If you can find investment real estate to replace the property within 45 days of closing, you can defer taxes on your gains under the exchange provisions of section 1031 of the Internal Revenue Code (IRC). If you do not set up a qualified exchange, you will pay taxes on your gains. These taxes may eat up a substantial amount of capital and should be deferred whenever they can be without sacrificing future returns on capital.

When evaluating what to do with sales proceeds you must balance the tax savings of deferring gains against the opportunity cost (loss of future return potential) of investing in overpriced real estate as compared to other opportunities. In some cases it will be optimal to pay the taxes and move the money into the stock market or an offshore real estate market. Or, just put the money in a low risk investment and wait for real estate prices to decline as interest rates rise and the Fed-engineered recession takes its toll.

Whatever you finally decide to do, it is worth it to at least attempt an exchange transaction. As I will explain, even a failed attempt in the second half of the year will likely produce tax deferral benefits. Once you have agreed to a sale transaction, you must hire a Qualified Intermediary (QI) to hold the sales proceeds while you try to find and close on a replacement property. This service can be had for as little as $400.

You should immediately start trying to get into contract on replacement property if one can be found where the expected returns going forward are acceptable. In my opinion, that means at least 6% after-tax over the next two years taking into consideration the likely effects of rising interest rates and a recession (but not sales commission). This will be difficult to achieve without finding a value-added opportunity (e.g. development using new cheaper building technology).

During the time up until the 45 day identification deadline you must make offers on potential replacement property. Your offers should be priced such that you would achieve your return goals - even if it means you lose the deal to a higher bidder. Optimally you will have three properties that you have some chance to close when you reach your 45 day identification deadline. Subsequently you have until 180 days after the sale closing to close your purchase of one (or more) of the three replacement properties identified. If all of the deals identified at the 45 day mark fall through (i.e. your offers were too low or you found a deal killing problem), you will be unable to complete the tax deferred exchange and you must pay the tax. The advantage of the attempted exchange in this case (if the 180 days takes you beyond the year end) is in the timing of this tax payment.

If the taxpayer has a "bona fide intent" to exchange at the beginning of the exchange period and the sales proceeds are not received until the following tax year, the sale should fall under the installment sales rules of the IRC. This means that tax is not payable until the cash is received by the taxpayer rather than the QI. The effect is that the tax liability is postponed by a year. The benefit to the investor is that they can earn returns on this money over that year of time. They will also have the opportunity to offset the tax liability by reducing taxable income in the year the gain is recognized.

The tax law is complex and determining the best reinvestment strategy is even more complicated. Investors should seek professional advice in this situation to ensure you meet the requirements of the IRC and choose the optimal reinvestment strategy. Call us before you sell!

A Way to Hedge House Price Risk: Housing Index Futures Explained

At the end of May the Chicago Mercantile Exchange (CME) introduced a series of new futures contracts whose settlement value is tied to the S&P/Case-Shiller housing price indices for ten U.S. cities and a U.S. composite housing index. The indices are constructed so that each city's index is 100 at January 2000. These indices are based on repeat sales rather than median prices and thus will not necessarily track prices reported by realtors associations and government statistical bureaus. These are useful contracts because they potentially allow us to make money when house prices decline and therefore hedge our personal housing investment. Alternatively, they also give us a way to speculate on rising or falling house prices without the huge transaction costs and lack of liquidity inherent in actually buying real estate.

A futures contract based on a housing index is an agreement between the buyer and seller that specifies a payment between the parties that depends on the value of the index at the settlement date of the contract. A "long" position in the contract means you make money when the housing price index goes up and lose money when it goes down. Conversely, a "short" position is a bet against housing prices: you make money when they go down. When opening a long position or closing a short position you are said to be "buying" the contract. You would "sell" the contract to open a short position or close a long position.

Your gain or loss on the contract depends upon the difference between the index values at which you bought and sold the contract. Specifically, every point in an index is worth $250 and you must put up collateral of about $2,500 per contract. Note that the index value at which you enter a contract is set by the bid and ask prices of other market participants and will likely diverge from the last observed price index value. For example the latest San Francisco index value (March 2006) is 216.03 while the (August) futures contract based on the June index (to be released in August) last traded at 215.4. The bid and ask prices for the August contract were 213.0 and 220.8 respectively as of June 27th.

The bid price tells you what price you can enter a short position and the ask price is the price at which you can go long. Thus you can only make money when the actual index rises or falls more than the market forecast reflected in the bid and ask prices. The implication is that you can not protect yourself against a price change that is already forecast in the futures market prices.

Another important point is that the CME deducts or adds money to your collateral account every day based on the lastest futures market transaction price and therefore trading volatility can cause real changes in your account balance before the actual index value comes out and the contract is finally settled. This means you could lose your collateral deposit and need to post more money even though you turn out to be right about the ultimate index value.

The table below shows bid and ask prices at June 27th for selected contracts.

	Latest	June06 Index		Sept.06 Index		Dec.06 Index		Mar.07 Index	
City	Index	bid	Ask	Bid	ask	bid	ask	Bid	Ask
San Francisco	216.0	213.0	220.8	206.2	224.2	196.2	215.0	193.0	220.0
Los Angeles	267.7	261.2	272.0	253.0	273.6	254.0	268.4	247.0	263.0
San Diego	248.1	244	248.0	239.2	252.0	231.0	244.8	223.0	239.8
Las Vegas	232.4	229.4	235.2	222.2	232.0	214.0	230.0	214.0	230.0

Note that index values and futures contract settlements occur with a two month lag. I.e the August futures contract is based on the June index value which is announced in August. The huge spreads between the bid and ask prices indicates that the market for these contracts is still rather illiquid and thus it may take some time before it will be practical to use them.

I expect these contracts to become a very useful addition to the financial marketplace once they become more popular. In the meantime they still have some limited usefulness for hedging and as market forecasts of residential housing prices.

Stock Market Notes

The large pullback in the market and related volatility seems to be driven by the market's belated realization that the Federal Reserve is likely to induce a recession to fight inflation. The mechanism for this is a contraction in demand caused by higher loan payments and dropping home equity lines in high-priced real estate markets. In markets where buyers have been speculating on real estate with floating-rate interest-only loans, there is a possibility of significant price declines that would reduce home equity and likely result in decreased consumer spending.

Our portfolios have fallen with the market, but my view is that most of our positions are in companies that will see little impact from housing related demand drop that I expect. This is especially true when looking at the long run value of these companies. Consequently, I see the pullback as an excellent time for new investors to put money to work with us.

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