CASHING IN
On The
REAL ESTATE
BUBBLE

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Cashing in on Stock Declines

Using a "short" strategy, investors can profit when stock prices decline. But this is a very risky maneuver that should only be done by those with significant experience shorting stocks, or at the very least with the guidance of a full-service broker. Online brokers would have you think differently, as all it takes now to short a stock is a mere click of the mouse. But you should understand that *shorting stocks is one of the most risky types of investment strategies known.*

When one shorts a stock, they are borrowing it from an investor (through a broker) and selling it immediately at the market price hoping it will decline in the future. And since the investor who takes a short position is borrowing the stock in order to sell it, short positions are placed in a margin account.

Once a decline in price has occurred, the investor buys the stock back in the market (called covering the short). The shares are automatically returned to the original investor. He doesn't have any exchanges with the investor from which he borrowed the stock. Everything is transacted by the broker via back office operations.

Naked short positions (i.e. short positions where there is no hedging; a purely offensive strategy) have unlimited downside risk. In other words, theoretically, you could lose your

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entire investment. This is one reason shorting is considered very speculative. However, there are some ways to limit your potential loss (discussed later). Another thing you should consider is that while you have a short position, you must pay a small fee for borrowing the stock based upon the length of time you maintain the short position.

Finally, during the period that you have shorted the stock, you are responsible for paying any dividends that may have been awarded to the original owner. Previously, there was the up-tick rule, but it was removed recently so I won't bother discussing it.

Shorting Basics

It would be impossible for me to teach you how to become effective in shorting stocks in just one chapter (or in an entire book for that matter). But I will mention a few important things to keep in mind. Once again, unless you have significant experience shorting stocks, you should only do so with the assistance of a full-service broker who is experienced in shorting strategies.

High or Rising Short-interest Ratio

The short-interest ratio provides insight on the number of shares that are short relative to the average daily trading volume. These numbers can be obtained from many financial sites including Yahoo Finance (click the "key statistics" icon to the left then look down the lower right column).

Investors should also note the relative number of shares that are available for trading, known as the *float.* In contrast to the float, the *total number of shares outstanding* represents all shares issued but may not be available for trading on a daily

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basis (due to insider or treasury stock holdings). *When the float is significantly lower than the number of shares outstanding, investors should be very careful because in such cases, there is a greater tendency for stocks to move more rapidly when there is a large short position.* In other words, the number of shares in the float is what matters since these represent the number of shares that can be traded.

For example, let's say you want to see the possible effects of a large short position on two similar stocks, A and B. While both have the same number of shares outstanding at 20 million each, stock A has a float of 18 million while stock B has a float of 10 million. Let's assume you're a hedge fund manager and you decide to short 1 million shares of both stocks. Assuming all other factors are held constant (the reporting of new material events or anything else that might effect the stock prices), you will cause a larger decline (in terms of percentage, irrespective of the dollar price) after you short stock B. This will occur assuming the ratio of buyers and sellers of both stocks is about the same. The reason stock B will decline more upon shorting 1 million shares than for A is because a larger percentage of shares will be short ($1/18^{th}$ versus $1/10^{th}$). In other words, there is more selling pressure on stock B, so the price goes lower.

Be Careful of a Short Squeeze

A short squeeze typically occurs when the short-interest ratio is relatively large (say 25 percent or higher) and new short positions are not being taken. In other words, let's assume that over the past few months, the short interest ratio has been peaking out. Upon some key announcement, many investors may cover their short positions simultaneously (i.e. buy the stock), leading to a large rapid increase in the stock price. Alternatively, for whatever reason, if investors who are short see

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the price moving up, this could cause a chain reaction, known as a short squeeze, as they rush in to buy the stock (to cover their short to minimize loses) before it goes too high.

When looking for factors that indicate a declining stock price, a lower but rising short-interest ratio is generally more important than a high but steady short-interest ratio. This is because a high but steady ratio implies fewer new short positions are being taken. In contrast, a rising short-interest ratio indicates more new short positions, which will tend to lower the stock price due to more selling pressure.

However, in either case, a short squeeze can result anytime the short-interest ratio is above around 25 percent or higher, causing the stock price to move up rapidly. Note that short-interest data is delayed by 30 days.

Protect Your Short Position

Investors wishing to short stocks should always enter *open buy orders* to safeguard against getting crushed during a short squeeze or due to a general price increase. Protecting your short position using an open buy order or buying call options is called *covering your short* and is highly recommended for even the most experienced investors. Providing such protection cannot be overstated when a stock has a high short-interest ratio.

The exact price of the protective buy order will depend on many factors but it shouldn't be too high above the price that stock was shorted. The higher the buy order is above the price of the short, the larger the potential loss. In contrast, if the buy order is placed too close to the short price, this could cause a buy to be triggered prematurely, just before the stock might tumble, erasing any gains that would have been made from the price collapse.

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Alternatively, another way to minimize losses in a short position is to buy call options on the stock. When an investor buys call options, he has paid for the right (but not obligation) to purchase the stock at a certain price (exercise price) by a certain time in the future (expiration date). Note that buying call options to hedge against potential losses due to a short position is not as effective as entering an open buy order since the options may not have a high enough trading volume to get an order execution. As well, stocks with small market caps (typically under $1 billion) tend not to have options.

When to Short

Consider shorting only after a breakdown of key technical indicators in the stock price chart. In general, you should look for a price breakdown below the appropriate relative strength and/or moving average indicators. This will depend upon the time horizon and investment objectives you have designated for the position. The more conservative approach would be to wait until the price has fallen below a 200-day moving average. Looking at moving averages of shorter duration would increase the uncertainty of a stock price trend reversal and therefore increase the risk of the short.

Select a Reasonable Expiration Period

In general, if you do buy calls, you should get expiration periods of at least three months, and preferably six months. Doing this will give you a better chance of getting a trade execution if you want to close your position early, since you will benefit from a greater chance of periods of higher volume due to stock price volatility.

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Shorting the Mortgage Stocks

There are a few mortgage-related companies that you should watch for a breakdown in price (which would be one indicator of a potential price collapse). First, the sub-prime lenders like Novastar Financial (NFI), Accredited Home Lenders (LEND), and Fremont General Corp. (FMT). As mentioned, those companies that do most of their business in the sub-prime markets should experience problems first. At a later time, and depending upon how these companies handle their exposure, Fannie Mae (FNM) and Freddie Mac (FRE) could get hit bad.

It's uncertain how much exposure to the sub-prime markets Countrywide Financial (CFC) has, but my guess is that it has a fairly large amount. The real question that's impossible to answer is how much and how well have these loans been protected through the use of other financial products.

Understand that as the riskiest loans default, credit risk will increase in the MBS market. This will not only cause a tightening of criteria for new loans, (and therefore hit the housing market), but it will also cause existing conventional mortgages to be seen as higher risk. This can be seen when the spreads between the MBS and U.S. government bonds increase, indicating elevated risk.

If in fact a severe collapse in the sub-prime market occurs, we will most likely see a huge MBS junk bond market over a period of time. And that would spell big trouble for the stock market. However, the Fed does have ability to lighten sudden blows by increasing the money supply (lowering interest rates). But this would most likely only provide a temporary "Band-Aid" remedy to the stock and bond markets.

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Some of the other finance companies that might have significant exposure such as Bank of America (BAC), Citigroup (C), JP Morgan Chase (JPM), Washington Mutual (WM), and Wells Fargo (WFC) are probably too diverse in their businesses to get crushed by the bubble collapse. However, large amounts of derivatives exposure could lead to huge losses. But rather than permanent or large declines, these companies might represent very short-term shorting opportunities or options trading for seasoned investors.

The key thing to keep in mind if you plan to short stocks is that you have to wait for critical technical signals, such as a breakdown through the long-term technical support trend line, as well as a growing short-interest ratio. *When gauging the short-interest ratio, you should look at both the course of increasing short positions as well as the total amount that has been shorted.*

Technical Analysis Basics

In the stock charts that follow, unless otherwise indicated, the best-fit line has been drawn through the price chart to illustrate the support level for the longer-term trend. You can also look at moving averages. In drawing these trend lines, the maximum number of price points have been intersected. *In order for a trend line to have any relevance, it must pass through at least three price points. In general, the more price points a trend line passes through, the stronger the trend.*

The reason why I have focused on the support (the lower stock price) trend line for these charts should be obvious; investors should be concerned with downside price movements. By following a stock price chart and continuously updating the support trend line, investors can be alerted when the price breaks below this trend.

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Note however that several factors are critical in determining the probability of a price breakdown. In general, *the amount of price decline over a given time period, the duration by which the price remains below the trend line, and the trading volume that leads to these price declines are the most critical factors in determining the impact of the declines.*

When a stock sells off by a large amount over a short period, this is a strong indicator of negative short-term investor sentiment. And when the price has fallen through the support trend line and remains there for at least a few days, it further magnifies the impact of the move, and signals the future direction of price movements. *The longer the price stays below the support trend line, the more likely it will remain below it or even worse, continue to decline over time. Finally, the larger the volume during any price movement, the stronger the meaning of this movement.*

Note the very rapid price acceleration over a short period of time. In general, this can be argued as evidence of overvaluation. Therefore significant downside risk is possible.

In this chart, both the support and resistance lines have been drawn to illustrate the downward trend. Note that this is often thought of as a bullish sign. However, given the risk to the sub-primes, I would focus on the downward trend. Notice the symmetrical pattern of strong sell offs followed by gradual price rebounds or retracements. However, also note that these rebounds do not regain price levels prior to the previous sell offs, indicating a longer-term downward trend.

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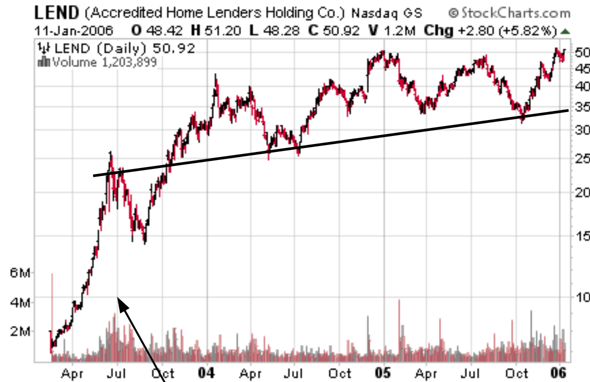

Note the very rapid price acceleration over a short period of time. In general, this can be argued as evidence of overvaluation. Therefore significant downside risk is possible.

This chart does not display a reliable support trend line pattern due to the lack of intersecting points through the resistance trend line. Therefore, what may seem to represent an upward long-term price trend has not been confirmed by the chart. Accordingly, it would be fairly easy for the stock to fall to low levels.

Note the very rapid price acceleration over a short period of time. In general, this can be argued as evidence of overvaluation. Therefore significant downside risk is possible.

While this price chart shows a more reliable support trend line, keep in mind that this stock surged from very low prices in 2003. This is the case with the other two sub-prime mortgage stocks, and therefore should be viewed as a very cautious sign given the risk in the economy and the vulnerability of these very risky mortgages.

I have drawn both the support and resistance trend lines for Fannie Mae. As you can see, it has a very strong downward trend with a cyclical pattern of large sell-offs followed by retracements that fail to regain price levels previous to the sell-offs. Note that when you have identified cyclical patterns such as what we see in this price chart, it can represent nice intermediate-term trading opportunities. A safe way to trade this would be to buy call options after a sell off.

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You should also be aware of *Fibonacci price retracements.* These are counter movements that typically occur after large rapid sell-offs, (almost always with large volume) and can cause confusion if you do not understand how they generally work. *Even when a stock moves up or down by a large amount, Fibonacci retracements will typically occur over a variable period in a direction opposite to the prior movement. While it is common for such retracements to occur over the next few days after a large movement has been made, sometimes the price stabilizes and results in a more gradual retracement (upwards), referred to as filling the gap.*

However, retracements don't necessarily indicate the reversal or cancellation of a trend. In fact, it's common for stocks that fall rapidly to encounter brief small retracements prior to further decent over the following days or weeks. It is critical to pay close attention to trading volumes after large price movements to help gauge the significance of any retracements. In general, the larger the trading volume, the more significant the price movement.

This chart is scary because it does not show any reliable long-term support trend lines. Thus, the downside is very uncertain. Similar to Fannie Mae, one might chose to take advantage of the enormous price volatility for short-term trades.

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Buying Put Options

A put is an option contract purchased (or sold/written) on the Chicago Board of Options Exchange (CBOE). Depending on whether you buy (or sell/write) a put option, it allows you to sell (or commits you to buy) the analogous stock at a set price anytime from the point at which you buy (or sell) these put contracts up until their expiration date.

Specifically, if you buy a put option, you are paying for the right (not obligation) to sell the analogous stock at a certain price (called the strike price) once the option contract expires. In contrast, if you sell (also referred to as "writing") the put, you receive funds in exchange for obligating yourself to buy the stock if it reaches a certain price on expiration day.

Therefore, *you can take advantage of an anticipated stock price decline by purchasing put options on the stock in advance of a price decline.* Accordingly, buying covered put options is considered a bearish strategy to protect against declines in stock prices.

Benefits

One of the advantages of buying naked puts is that it allows investors to know their maximum potential losses ahead of time, unlike the case of naked shorting (shorting without having the stock or covering it with call options). *Thus, compared to shorting, buying puts allows investors a more conservative method to take advantage of a falling stock price.* However, it is still considered risky and should only be performed by those who have significant experience in options, or under the guidance of a stock broker.

Another benefit of buying puts over shorting stocks is that this strategy allows you to use a larger amount of leverage. In other words, you can risk less investment capital for larger gains

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(on a percentage basis). Therefore, you can invest less money and get a higher percentage gain versus one who shorts the stock. However, leverage can also work in the opposite direction if one is not careful.

Risks

Anytime you buy options (calls or puts) it's considered relatively speculative since you can lose your entire investment amount. However, at least you know ahead of time what your maximum potential losses could be. And when used as a protective measure (i.e. as a part of a covered strategy), it's considered less speculative. In contrast, selling naked options (i.e. you don't own the underlying stock) is considered more speculative since the potential losses are close to unlimited.

Although shorting is theoretically considered a leveraging strategy, the leverage is not multiplied as in the case of options. But once again, the potential losses are theoretically unlimited for naked short positions. In summary, the risks of buying puts are that you could lose the entire amount you paid for these contracts if:

(1) You do not sell them prior to expiration (i.e. closing your position),

OR

(1) The price of the stock does not fall below your set selling price (i.e. the strike price) on expiration day.

Irrational investors sometimes use too much leverage by taking excessive put positions. Therefore, you should only purchase an amount that you can afford to lose. If you in fact decide to invest with options, you should wait for definitive signs of the fallout in the real estate bubble prior to purchasing

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put contracts because the longer you want these options, (the longer the expiration period) the more you'll pay for them. And in order to make a profit, the stock prices will have to go down lower to account for your cost basis in the puts.

Options Pricing

It's important to understand the main factors that determine options pricing so you can maximize your options investment. Basically, *option prices are influenced by the strike price, the expiration (the time until expiration), and the relative volatility of the stock* (the magnitude and direction of stock price movements over time relative to that of the S&P 500 Index, or the beta). *For instance, buying options on a stock with a high volatility will be more expensive than one with a low volatility. In contrast, selling options on a stock with a high volatility will provide you with more money for accepting the obligation you have entered into.*

Options Execution

Even if you enter a protective open buy order to cover your short position (called a *protective short position*), you may not get that order filled until the price is higher than your order. This is often the result during a short squeeze due to the overwhelming buying volumes that occur.

Keep in mind that if a sudden large material event occurs that exchange officials expect will lead to large price movements, they will halt the stock (and the options) from trading so the market makers can prepare for the problem. As well, if the stock has moved by a certain amount over a certain time period, the stock can also be halted. The problem with this is that, when the stock reopens for trading, the price could be much lower or higher and orders will be triggered rapidly,

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causing one to potentially face significant losses. Obviously, the situation will be even worse for options since they have larger spreads and lower volumes then the analogous stocks.

If you do not have significant experience investing in options, I advise you to go through a full service broker who can help you decide which ones to buy, how much, when, and even if you should buy them at all. If you are looking to go the discount broker route, I advise you against this because in my opinion, the individuals employed there are not that knowledgeable about options (or the stock market for that matter). And there really isn't much of a commission difference when using a full-service versus discount broker for options contracts.

Remember, each option contract represents 100 shares of the analogous stock. So buying 10 put contracts will allow you to sell 1000 shares of the stock at a predetermined (strike) price. Likewise, selling 10 put contracts will obligate you to buy 1000 shares of the stock at the strike price (unless you close your position via buying 10 puts at the same strike price and expiration).

In order to calculate the amount it will cost you for puts, check an online quotation service and type the ticker symbol of the stock you want to buy puts on. This will give you a list of different options covering different strike prices and expiration months. Note however that some of these sites have quotes delayed by 20 minutes. For options, it is critical to receive real time quotes so you can squeak out the best price since the spreads are larger than for stocks.

For each option (and stock) you will see a bid and ask price. If you are buying the option (or stock) you pay the ask price (the higher price). If you are selling the option (or shorting the stock) you'll receive the bid price (the lower price). The price

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difference between the bid and ask is called the spread, which as mentioned, is typically higher for options.

If the volume is high relative to other option contracts of the same stock, you can probably place an open buy order closer to the bid and get it executed. In general, the lower the trading volume, the closer to the ask price you will have to buy the option.

Often, price execution can be the difference between a good or bad options trade. But when using call options to protect long positions (via selling covered calls) or to protect short positions (buying calls), you should not be concerned about getting the best execution price since your primary use for the options in these instances are defensive. You just want to make sure you're able to get the order filled. When trading naked options, getting the best execution and price is much more important.

Closing Your Position

Another great thing about options is that one does not have to wait until expiration (which is always the third Friday of the expiration month) in order to profit. At any time prior to expiration, you can usually sell the calls or puts you bought (and vice-versa). This is called *closing your position* since you no longer have options exposure (the two options contracts cancel each other out).

For long puts (i.e. owning put options) if the stock price has declined below the strike price by an amount greater than the cost of the put contract, you will make a profit either by selling the puts or by waiting for them to expire. *Closing your position prior to expiration will help you avoid sweating bullets while waiting to see what happens on expiration day*. As well, you can sell your puts to limit losses if things aren't going well.

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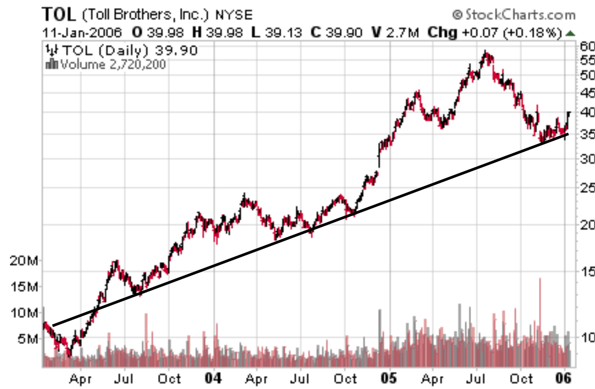
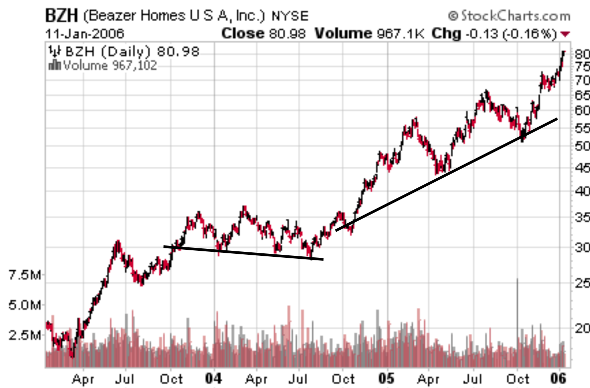
Shorting the Homebuilders

Ever since the Internet bubble deflation began, the homebuilder stocks have enjoyed an amazing run-up in price due to record low interest rates combined with low standards for obtaining mortgages. As the housing bubble deflates, you should expect the homebuilder stocks to get crushed. You should follow the price charts and update the support trend lines as needed, waiting for a breakdown in prices.



Toll Bros. has a nice support line showing a rather strong upward trend. But often, stocks that are the strongest provide the best returns for short strategies once the risk has been exposed. After all, there is more downside potential in a rising stock. It is critical to wait for a very clear indicator of a trend reversal here.



I actually had to draw 2 support lines for BZH, due to the enormous runup this stock has had over the past 14 months. Once again, note the cyclical patterns of sell-offs and rebounds. In this case, the rebounds are stronger, accounting for the strong upward trend.

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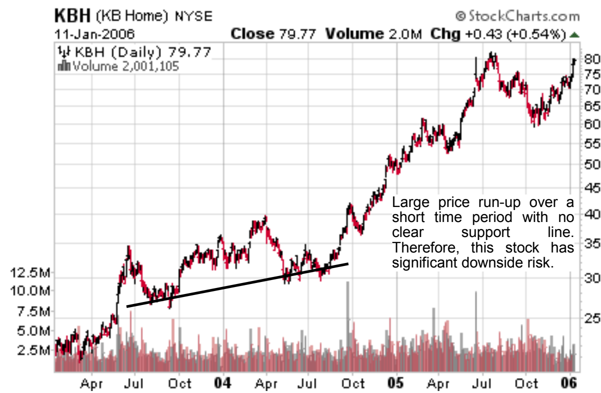
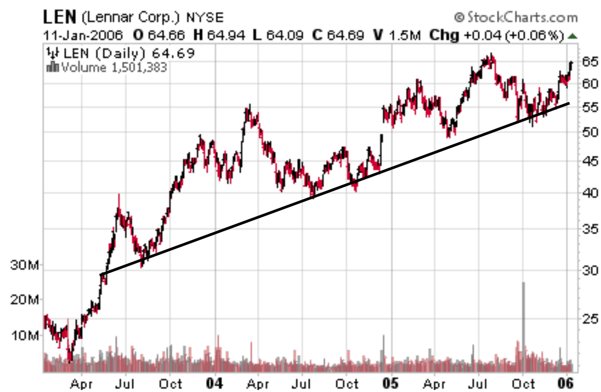


For KBH, I was not even able to draw a reasonable second support line. As such, the downside here is much more fragile.

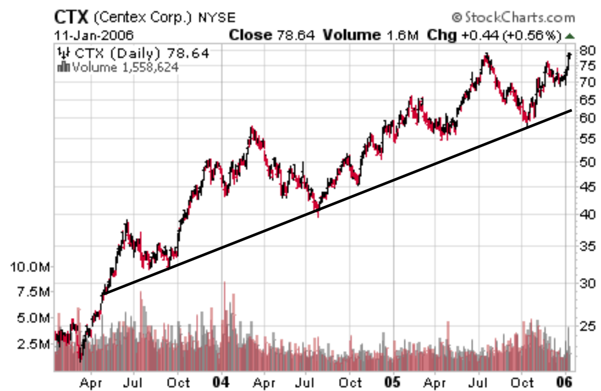
Once again, I would not go long in this stock or any of the others. The time to go long for the homebuilders was in the 2001-2004 period. There is simply way too much risk now.

When the real estate market corrects, you do not want to be holding these stocks because you might be waiting a few decades before you break even.



While the support line appears to look quite strong for both LEN and CTX, I simply do not like it. The lack of cyclical price patterns is troubling in my opinion. However, the fact is that the stock is experiencing a strong upward trend, similar to all of the homebuilder stocks.

Therefore, you should wait for triggering events such as some adverse data that might lead to a breakdown in the price.



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If you plan to short these stocks, you might need to maintain considerable patience. No doubt, they will decline, perhaps hard, but until you see sufficient evidence of a breakdown in price, you should be very careful.

Profiting from Inflation

Real Estate is a good investment during inflationary conditions, but if you buy when prices are too high it's going to hurt bad. Therefore, real estate investors must become value shoppers during this treacherous period. If you are able to do this effectively, you'll be positioned to profit from what I expect to be double-digit inflation over the next two decades.

As well, those concerned about inflation can purchase Treasury Inflation-Protected Securities (TIPS). These securities are indexed to the inflation rate, so their value increases along with inflation. Investors need to begin positioning themselves with cash now, while waiting for long-term interest rates to go up. That will be the time to buy the 30-Year Treasuries (TIPS). Based upon my current forecasts, I would begin buying 30-year Treasuries and related TIPS when long-term rates reach 8.0 percent.

Over the next few years, it is highly likely that mortgage rates will have reached the 8.0 percent range and could go higher from there over the ensuing decade. If you position yourself now with cash you will be ready to buy bonds when they are providing excellent rates of return.

Finally, gold and silver usually do well during strong inflationary periods. I anticipate gold will reach the $1200 mark within the next several years and could double from there within the next 15 years if the economy spirals downward due to other longer-

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term risks faced by America. Silver most likely has even more upside. And if you are experienced in commodities, you might want to take advantage of the weakness of the dollar. With little doubt the dollar will remain weak for several more years.

Profit During Deflation

If deflation becomes a problem, the last thing you will want to own is real estate. Cash, CDs, and T-bills are key vehicles of asset protection during periods of significant deflation. Remember, banks insure your account by the FDIC up to $100,000, so you can feel pretty safe there. And if you want a guarantee on another $100,000 at the same bank, you can open up a joint account with your spouse.

Precious metals should also perform well during a deflationary environment as people rush to buy gold for security. Fortunately for real estate investors, I do not expect any significant periods of deflation over the next several years, but I could be wrong.

Whether we witness an inflationary or deflationary environment during America's inevitable economic correction, I expect gold and silver to continue their bull run for at least the next six years, and most likely much longer. I do not feel that deflation will be a problem for at least several years, and might only surface as an aftermath of a very dark period in America.

Most likely, inflation will represent America's main problem over the next several years. And as the foreclosure market continues to heat up, Americans will be looking for rental units. Accordingly, I expect the rental unit market to do very well for many years.

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Conclusions

There is indisputable evidence that most Americans have been buying homes as an investment for more than a decade. This behavior is the primary indicator of a real estate bubble. Specifically, this evidence arises from the disparity in home prices versus rental costs, despite the lack of real wage growth and massive expansion of credit provided by Greenspan's reckless monetary policies. As we have seen, the GSEs have added to the real estate boom by providing endless liquidity, thereby encouraging the growth of the sub-prime market, which is poised to collapse.

Since 1997, the U.S. total home mortgage debt outstanding has risen by over 160 percent to about $11 trillion. With an estimated *75 million home owners* and over $4 trillion of increased residential real estate value in the past few years, there should be no doubt that the real estate bubble is peaking.

Under normal conditions, anywhere from *25 to 30 percent of the U.S. economy is directly affected by the housing sector*. However, due to exaggerated asset prices from the housing bubble, this share is significantly higher. I have shown the magnified effects of a loss of housing value on home equity, but this also has a magnified affect on the stock market because the wealth effect is reversed, resulting in dampened consumer spending.

Accordingly, numerous studies have shown that *housing prices have up to two times the effect on consumer spending as they do on declines in stock prices.* Consequently, if housing prices decline by 25 percent, the economic impact will be as if the stock market declined by 50 percent. Over the next few years, at least 30 percent of the $11 trillion residential mortgage debt market will correct downward leading to record foreclosures, which will

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affect the MBS and ABS markets. If this correction has not ended by 2011, the housing share of consumer expenditures will decline gradually as the boomers reach retirement.

Just as Greenspan denied any existence of an Internet bubble a few years back, he has also denied any trace of a real estate or credit bubble. He even recommended that Americans consider financing their homes with ARMs in January 2004, just a few months before he began raising rates by nearly 400 basis points over the next two years. Even his predecessor, Bernanke continues to deny the effects of inflation or the fact that America is at the end stage of the largest real estate bubble in history.

Americans have seen what happens when they listen to government pawns who are dubbed by the media as economic experts. And as we know, Wall Street has an even more toxic effect on investment portfolios.

If you're going to make it through this difficult period, you need to question what the "experts" say and learn to think for yourself because everyone has their own agendas, which are most likely much different than yours. Having cash on the sidelines will represent your best strategy to take advantage of the opportunities that lie ahead. And if you keep abreast of changes in the economy, you will be positioned to profit while others remain in the dark.

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