LFM&P

LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

REGISTERED INVESTMENT ADVISOR

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Outlook & Trends

The reporting of financial events reminds us of the fireworks we see on July 4th. Conditions build almost unseen, explode in the media, and then vanish shortly afterwards. The ".com" craze came and then imploded 5 years ago. Predictions of Dow 5,000 arrived and disappeared two years ago. The jobless recovery was last year's worry. Today's obsession is real estate. The problem with getting excited about whatever hot story today might bring is that, by the time it explodes into everyone's awareness, it is usually well on the way toward changing, and it is often too late to profit. To stay on the course to your financial goals, it is helpful to maintain an accurate perspective of where we are in the continuous flow of economic events, as well as having a sound investment strategy and a financial plan as a guide. After a brief rundown of current conditions, the emphasis of this quarter's letter will be on real estate. Hopefully it will provide you with an alternative view and additional perspective.

Economy

Economic conditions remain strong, but some forward-looking indicators are softening. The economy grew at a 6.7% rate during the first quarter (3.8% excluding inflation). Consumer confidence is up. Retail sales are 6% higher than last year. Unemployment is down to 5.1% from 5.5% a year ago. Inflation is running at a reasonable rate of 2.8%. Corporate profit estimates are 15% higher than similar estimates last year at this time. On the down side, the leading indicators have dropped for 6 months, bond yields are lower, and manufacturing activity is barely growing, so there is no immediate danger of the economy overheating.

Financial Markets

Stocks, as represented by the S&P 500, rose last quarter, but are still down a bit from the beginning of the year. Since this time last year, stocks have returned about 6%, which is less than their normal pace. Ten-year treasury bonds on the other hand gained almost 5% during the quarter and 10% over the year. For the first quarter of this year (the most recent quarter available), existing house prices rose 2.2% nationally and were up 12.5% for the last twelve months.

Since stock prices are fundamentally based on company earnings and interest rates, it is valid to ask why have they gained only 6% while earnings are up 15% and bond yields are down. As we see it, the answer is because investors have not forgotten the recent bear market and continue to shy away. This has created a situation where stocks continue to become evermore undervalued in relation to bonds.

The reverse is true for real estate. Real estate values have increased due to low mortgage rates and greater mortgage availability. According to data provided by the Office of Federal Housing Enterprise Oversight, national home values have increased an average of 5.3% annually since 1980. The last time national home prices increased by more than 7% in a year was 1987. After that, price increases dropped off to 1% by 1990 and averaged just 3.4% for the decade of the 1990's. Just as in the stock market, periods of inordinately high appreciation will eventually be corrected. Value is found in areas where there is little buyer interest. High prices and excess are found in areas of high interest.

Real Estate and Financial Planning

Today, the media is prominently reporting about "hot" real estate markets and speculators are buying and selling properties on a short-term basis ("flipping"). In fact, a web site, "condoflip.com" promises to assist buying and selling condominiums before they have even been built. Should you jump on the real estate bandwagon? Please consider the following brief analysis.

All assets have unique characteristics. Real estate can have the important characteristic of being both a "use" asset and an investment asset simultaneously. A home can be lived in, or rented for others' use to provide income while its value grows. The economics of use and investment are different however. Owning your home is less expensive than renting from others. If your property value increases at the long-term average rate of 5.3%, this pays a lot of your 5.5% mortgage and taxes of 1.5%. Income tax incentives, providing tax-free capital gains and deductions for interest and property taxes can all work together to provide housing at almost no cost. "Almost no cost" is a strong incentive to own, rather than rent, a home.

From an investment perspective, however, a 5.3% return is not overly attractive when compared to other investment assets. After subtracting closing costs, commissions, mortgage costs, property taxes and capital gains taxes, a pure real estate "investment" may not keep pace with inflation, or even produce a positive return. In order to make a real estate investment worthwhile, you must 1) just enjoy the property, 2) derive additional income by renting the property to others, or 3) believe that your property will appreciate faster than the historical average. In the first instance, you are buying your enjoyment by accepting lower returns than are available from other investments. The second case requires some work as a landlord. The third approach is speculative and is often unrealistic, particularly if the property has already appreciated rapidly during conditions like those found today.

Acquiring different types of assets (stocks, bonds, real estate, collectibles, etc) is the essence of portfolio diversification. Performance variability and risk is reduced, because each asset responds differently to economic conditions. Losses in one asset are balanced by gains in another. If you own a home, chances are your real estate exposure is already relatively large. Adding additional real estate to your investment mix may provide a higher concentration than is appropriate for one type of asset.

Financial planning can help you see how to balance today's opportunities and requirements while building an effective approach to provide for your own future. Investment management can help you achieve securities market returns while managing risk. If you would like help planning to reach your financial goals or managing your investments, please give us a call or send an e-mail.

Dave

David C. Linnard
President

Barby

Barbara V. Linnard
Vice President

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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.
46 CHESTER ROAD
BOXBOROUGH, MA 01719

LFMP@LINNARDFINANCIAL.COM
978-263-0025

A Registered Investment Advisor