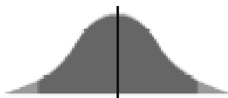

Park Piedmont Advisors LLC

Registered Investment Advisor

VICTOR LEVINSON **NICK LEVINSON**

MAY 2005 COMMENTS

IMPORTANT NOTICES:

MORTGAGE AFFILIATION:
To broaden the financial services we offer our clients, we have established an affiliation with Verticallend, headquartered in Melville, New York, so that we can directly assist our clients in obtaining home mortgages, whether as purchases, refinancings, or other mortgage-related transactions. In much the same way as we have offered advice and assistance in the purchase of a variety of insurance products over the years, we can now offer advice and assistance in obtaining mortgages through Verticallend. These services are in addition to our basic business of offering asset allocation and investment advice focusing on the stock and bond markets and indexed investments. Please feel free to contact us if you want to discuss these additional services further.

SEC DISCLOSURE DOCUMENTS: ADV PART II
As a Registered Investment Advisor with the SEC, Park Piedmont Advisors LLC (PPA) has provided each client with a copy of its required SEC Disclosure Document, ADV Part II. Among other matters, the ADV Part II describes PPA's advisory services, fees, and the business and educational backgrounds of its advisors. This is our continuing Notice, required by the SEC, that you can request a copy of PPA's ADV Part II, which we will send to you by return mail. To receive a copy, please contact Lynette Carmelli at 212-391-2323, or lynettec@parkpiedmont.com. You can also access our ADV at any time from our website, at www.parkpiedmont.com.

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Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.

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COMMENTS: INDEX RESULTS, period ending MAY 31, 2005

STOCKS	YEAR 1999	YEAR 2000	YEAR 2001	YEAR 2002	YEAR 2003	YEAR 2004	YTD 2005	CURR. MONTH
Vanguard Total Stock Market Index Fund (1)	23.8%	(10.6%)	(11.0%)	(21.0%)	28.4%	12.5%	(1.1%)	3.6%
Standard & Poors 500 Index (2)	19.6%	(10.1%)	(13.0%)	(23.4%)	26.4%	9.0%	(1.7%)	2.8%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(22.2%)	(13.0%)	(23.7%)	25.9%	7.2%	(1.3%)	4.6%
Vanguard S&P 500 Value Index Fund (1)	12.6%	6.1%	(12.0%)	(20.9%)	32.2%	15.3%	0.3%	2.1%
Dow Jones Industrial Average Index (2)	25.2%	(6.2%)	(7.1%)	(16.8%)	25.3%	3.2%	(2.9%)	2.6%
NASDAQ Composite Index (2)	85.6%	(39.3%)	(21.0%)	(31.5%)	50.0%	8.6%	(4.9%)	6.8%
Vanguard Midcap US Index Fund (1)	25.0%	2.6%	(4.8%)	(16.3%)	34.1%	20.4%	1.0%	5.0%
Vanguard Smallcap US Index Fund (1)	19.6%	(4.2%)	1.0%	(21.6%)	45.6%	19.9%	(2.6%)	5.6%
Vanguard International Index Fund (EAFE) (1)	25.3%	(15.2%)	(22.6%)	(17.5%)	40.3%	20.8%	(2.1%)	0.0%
Vanguard Real Estate Invest. Trust Fund (1)	(0.4%)	26.4%	12.4%	3.8%	35.7%	30.8%	1.2%	3.2%

BONDS								
Vanguard Total Bond Market Index (1)	(0.8%)	11.3%	8.3%	8.2%	4.0%	4.2%	1.9%	1.0%
Vanguard Interm. Tax-Exempt Index Fund (1)	(2.9%)	9.2%	5.0%	7.9%	4.4%	3.2%	1.4%	0.7%
Vanguard Short-term Bond Index (1)	2.1%	8.9%	8.9%	6.1%	3.4%	1.7%	0.7%	0.4%
Vanguard Short Tax-Exempt Index Fund (1)	2.6%	4.9%	4.8%	3.5%	1.6%	1.1%	0.4%	0.1%
Vanguard High-Yield	NA	NA	NA	1.7%	17.2%	8.5%	(0.4%)	1.8%

1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

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%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
		1999				**2000**				**2001**		
S&P 500	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1
NASDAQ	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3
BONDS Interm. Tax.	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0
		2002				**2003**				**2004**		
S&P 500	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8
NASDAQ	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9
BONDS Interm. Tax.	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0
		2005				**2006**				**2007**		
S&P 500	(2.6)											
NASDAQ	(8.1)											
BONDS Interm. Tax.	(0.5)											

MAY 2005 COMMENTS

STOCK index prices reversed course from the declines of the previous two months and posted significant gains for May, ranging from 2.8% for the S&P 500, to 2.6 % for the Dow, and 6.8 % for the NASDAQ, which had been down almost 12% through April 2005. The gains reduced YTD losses to much more modest levels of approximately -(2%) for the S&P 500, -(3%) the Dow, and -(5%) for the NASDAQ. See page 2 for the monthly and YTD figures, and see pages 5 and 6 for detail on the surprisingly favorable economic reports to which the media attributed the stock gains.

BOND returns (price change plus interest) posted their second consecutive month of significant gains. During April, the perception of an impending economic slowdown was used as an explanation for a decline in interest rates and corresponding rise in bond prices. But May's reports, covering data for April, showed "surprising" economic strength (see pages 5 and 6), so explanations were hard to come by. (A "conundrum," as Fed Chairman Alan Greenspan has called the low rates for intermediate and longer maturities, which are determined in the bond market, even as the Fed has raised the ultra-short term rates it controls directly eight times over the past year). The benchmark 10-year US Treasury yield closed the month at 4.00%, well below the April close of 4.20% and even further below March's 4.49%. The May yield is below the January close of 4.14%, even as the Fed's overnight rate has risen to 3% from 1% in June 2004. The highest 10-year Treasury yield for the past twelve months was reached in mid-May 2004, at 4.85%.

The narrowing to 1% of the spread between short term and longer term rates represents, at least based on historical data, a very narrow "yield curve" and correspondingly high longer-term bond prices. All the YTD figures for bonds are in positive territory with the exception of high yield bonds, which had a strong month but were still down fractionally for the full year. Bond result figures for the month and YTD are reported on page 2.

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The stock market rally that began decisively in March 2003 has raised the S&P 500 by 53% from the October 2002 low. While these gains have made investors believe again that stocks do not go down in perpetuity (a widely-held view during the depths of the 2000-02 bear market), the question of whether this recovery will continue is, as always, dependent on unknown future events. Indeed, stocks are still down for the year through May, even after the current month's gains. (Note also that after a 50% price decline, it takes a 100% gain to return to the previous level. Since the S&P 500 reached its high of 1,527 in Q1 2000, and then declined by almost half to 777 during Q4 2002, the current level of 1,192 is 53% higher than the low but still another 335 points, or 43%, from the prior high).

In order to keep the current recovery in perspective, we continue to show the chart below, which sets out the extent of the declines measured from the highs of Q1 2000. The chart also puts these declines in the context of results since the end of 1994 (also see the figures on page 12). Note that the three indexes have positive average annual returns ranging from 9.6% to 10.2% for the ten-year and five-month period from the end of 1994 through May 2005, very much in line with long-term stock returns going back to 1926. Further, as these returns converge more and more, the idea of "regression to the mean" seems quite applicable.

The long-term investor therefore has a very different view of the stock market's returns than those measuring returns from the highest levels.

	S&P 500 (1)		DOW (1)		NASDAQ (1)	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
April 10, 2001 Low	1,103	(28)%	9,390	(20)%	1,684	(67)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2003	1,112	(27)%	10,454	(11)%	2,003	(60)%
Year End 2004	1,212	(21)%	10,783	(8)%	2,175	(57)%
May 31, 2005	1,192	(22)%	10,467	(11)%	2,068	(59)%

Context: Prior Five-Year Gains in Bull Market of 1995 - 1999:

	S&P 500 (1)	DOW (1)	NASDAQ (1)
End 1994	459	3,834	752
End 1999	1,470	11,500	4,070
Gain	1,011	7,666	3,318
Avg.Ann.%Gain:'95-'99; 5 years	26.2%	24.6%	40.2%
May 2005	1,192	10,467	2,068
Gain	733	6,633	1,316
Avg.Ann.%Gain:'95-05/05; 10.42 yrs	9.6%	10.1%	10.2%

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

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I. UPDATE OF KEY ECONOMIC INDICATORS

The strength of the overall US and world economies is one of a number of factors likely to influence the future direction of both stock and bond prices. We, along with many market observers and academics who write about the markets, believe stock and bond prices already reflect consensus expectations of economic growth. Further, we believe that even if you could accurately predict any number of actual economic figures, the market's reaction to those figures is essentially unpredictable. In any event, an understanding of the direction of current economic trends may at times be useful as a context to help understand market conditions. This section of the Comments provides an update of key economic indicators.

(1) Gross Domestic Product (GDP) is the broadest measure of goods and services produced in the US economy (GDP figures are inflation-adjusted, annualized growth rates). The initial estimate for Q1 2005 GDP was 3.1%, down from 3.8% in Q4 2004, which gave rise to a number of articles reporting an economic slowdown (see April 2005 Comments). But at the end of May, the quarterly growth rate was revised upward to 3.5%, and the reports of an impending economic slowdown came to an end (Vanguard Economic Week in Review, (VEWR), 5/23-27/05, and New York Times (NYT), 5/27/05, pg. C6). (For more on the media, see pages 7 and 8.)

(2) Employment for April grew by 274,000, "far surpassing analysts' expectations, and a significant gain over the upwardly revised March total of 146,000 jobs" (VEWR, 5/2-6/05). A front page NYT article (5/7/05) stated that "the unemployment report was the most positive news about the economy in weeks, and dented the gloom that had accumulated after a number of recent measures provided evidence that last year's robust growth rate might be fading." (Note the media's use of the word "gloom").

(3) Interest Rates declined substantially in May for the second consecutive month. The benchmark 10-year U.S. Treasury interest rate, which is set by buyers and sellers in the bond market, closed at 4.00%, below April's level of 4.20% and far below the March level of 4.49%. This decline occurred even as the Federal Reserve increased the short-term rate it controls by another _ point, the eighth such increase since June 2004, bringing that rate to 3%, up from 1% a year earlier. A major bond market puzzle continues to be why longer rates have stayed in a range between 4% and 4.5% in the same time frame when short rates have gone from 1% to 3%. According to a NYT article (5/19/05, pg. C3), on a day when the yield fell below 4.10%, "the last time the yield was this low, Fed Chairman Greenspan said the surprisingly low level was a conundrum, given how far the Fed had already pushed up short term rates."

(4) Inflation, as measured by the Consumer Price Index (CPI) "core" rate, which excludes the volatile food and energy sectors, was unchanged in April, and up 2.2% over the preceding twelve months. With food and energy included, the CPI was up 0.5% for the month, and 3.5% for the year. The Producer Price Index (PPI) core rate was up 0.3% in April, and a much higher 0.6% with food and energy included. The annual PPI rates are 2.6% for the core rate, and 4.8% overall. "These indexes reveal a fair amount of pricing pressure evident at the wholesale level that generally were not getting passed along to consumers as much as expected" (VEWR, 5/16-20/05). Also, the CPI measures prices of goods and services; the PPI, only goods.

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(5) Sector Economic Activity was mostly stronger in May

(a) Durable goods orders (industrial and consumer) increased 1.9% in April, "almost double the expected showing" (VEWR, 5/23-27/05). The previous month's decline was revised to be "much less severe than the initial report (NYT, 5/26/05, pg. C3).

(b) Industrial production fell 0.2% in April; while business equipment production rose, consumer goods production declined even more. Capacity utilization fell to 79.2%, compared to the historical average of 81.0% (VEWR, 5/16-20/05).

(c) Retail Sales "racked up hefty gains in April after lackluster results in March, up 1.4%" (WSJ, 5/13/05, pg. A2). (Retail sales are not adjusted for inflation, and include such disparate categories as gasoline sales, auto sales, and non-store retailers such as the Internet).

(d) Housing sales for existing homes and new homes gained 4.5% and 0.2%, respectively, in April, at the same time prices were rising rapidly (WSJ, 5/26/05, pg. A2, and NYT, 5/26/05, pg. C3). Additional articles and discussion of housing as an investment appear on pages 9-11.

(e) Personal Income was up 0.7% in April, while Consumer Spending was up 0.6%. "Taken together, the trends in income and spending were seen by many economists as signals that the economic expansion remains firmly on track" (WSJ, 5/31/05, pg. A2). The rate of Personal Savings fell to 0.4%, "the second lowest rate on record" (VEWR 5/23-27/05). (Personal Savings figures exclude capital gains from stocks and homes, and, according to some analysts, have a number of other measurement flaws, greatly understating actual savings (David Malpass editorial, WSJ, 3/28/05, pg. A16). The last paragraph on page 8 of these Comments also discusses this issue.

(6) Consumer Confidence, as measured by the Conference Board's Index, "unexpectedly rebounded in May after declining in April, as worries eased about the economy and jobs" (NYT, 6/1/05, pg. C11).

(7) Corporate Profits for Q1 2005 were up 22% from a year earlier, based on 1,391 earnings reports. "While profit growth has slowed after soaring in 2002 and 2003, the slowdown hasn't been nearly as sharp as some expected" (WSJ, 5/27/05, pg. A2). Previous profit estimates for full year 2005 were in the 7-10% range.

Overall, the economic news reported in May for the month of April was quite favorable, and was contrary to the developing conventional wisdom that the economy had hit a "soft patch." This improved economic news coincided with higher stock and bond prices for May. While better than expected reports of economic growth and the perception that inflation is still under control provide plausible explanations for these market results, the surprisingly positive news ("surprising" when compared to the media reporting of the more negative consensus view amongst economists) highlights the fact that future market prices will, as always, be driven by unpredictable, unknowable future events.

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IIA. THE MEDIA'S IMPACT ON INVESTMENT DECISIONS

"Trouble is, there is usually nothing meaningful to say about a market's day-to-day moves. The news was becoming noise. The problem is, if you're a daily newspaper, you have to come up with something different to say every day" (from "Bull," by Maggie Mahar, pp. 165,170)

We consistently advise our clients to try and ignore the day-to-day fluctuations of market prices, as well as the media's ongoing efforts to explain those fluctuations. The financial media has a need to sell its product/service, and, in order to do so, must fill space and make the content of interest to its audience. "New news" sells, excitement sells, and change sells. Advice to establish an allocation that best meets long term financial goals, and then maintaining the corresponding investment portfolio over extended time periods, on the other hand, has virtually no immediate sales appeal.

An even more significant problem arises when thoughtful people are constantly presented with new information, since there is a tendency to believe that something should be done with that information. As you know, we believe the best investment advice, once an appropriate allocation is in place, is more than likely to make no changes. It should be clear, therefore, that the short term focus of the media on selling products, and our much longer term focus on our clients' needs and goals, often conflict.

In the May 2005 edition of *Investment Advisor* magazine (pp. 51-52), Dan Wheeler, who writes a regular column and is associated with a firm that emphasizes indexed investments, wrote an excellent article on the media's influence on investing. "It is almost impossible these days not to stumble across a newspaper column, magazine, television show, or even an entire TV network devoted to the topic of investing. Investment advice is literally everywhere. The question…is whether all that advice is any good… Much of the financial press also operates with incentives that may not be in the interest of investors….Like any business, their goal is to increase their revenue. They do so by running stories that will maximize their audience, and, accordingly, their advertising revenues….What type of stories do that? All too often they come with headlines that will motivate a reader to buy the publication in order to learn how to make a killing in the market."

The author continues that this type of advice "can be more dangerous than the stuff you get from a salesperson, since the SEC might come down hard on financial service firms that don't operate in their client's best interest…but there is no one around to hold the financial media accountable when it steers investors into making poor decisions with their money." He then describes the "conflicted arrangement" that exists between reporters and the sources they use to get the forecasts about the future that the media thinks investors want to read and hear about. The sources are Wall Street analysts and brokers, which leads the journalists to adopt the "source's agenda" in order to get the story. The author concludes that this arrangement makes "losers" out of the readers, "who desire the "fair and unbiased" reporting that many promise but few deliver."

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The article continues by citing some of the media articles that were most off base, including an August 1997 article in Money Magazine advising people to sell stocks in the middle of the bull market of 1995-2000, and then the May 1999 article in the same magazine entitled "Everyone's Getting Rich," a mere nine months before the start of the bear market of 2000-2002. He also cites Barton Biggs, one of the market "gurus" at Morgan Stanley, who was bearish on US stocks in 1993, as the market was preparing for the 1995-2000 bull market.

The author's messages are similar to those we present to our clients. He writes that "trying to predict the future is a loser's game. The screaming headlines prove that even the biggest names in the industry don't have an accurate crystal ball. But the magazines and TV networks will always keep putting their faces out there for one reason: forecasts and hype about the riches to be gained sell magazines…. It's pretty obvious that headlines like "Buy and Hold!" or "Best Bet: Do Nothing!" don't titillate." He cites a Fortune magazine reporter quoted as saying "by day we write "Six Funds to Buy NOW," and by night we invest in sensible index funds…unfortunately, pro-index-fund stories don't sell magazines."

The author makes another point that we emphasize: "Ignore the hype and invest using a firmly entrenched belief system." The article points out that retirees, "who have the most time to read lots of financial magazines, are often the most nervous about their future financial prospects. They need to be reined in against the natural desire to act on the recommendations of the magazines, newspapers, and talking heads on TV." And finally, the author writes that "when he was an advisor, he told his clients he had his own opinions about the future direction of market prices, but God forbid he would invest their capital based on those opinions." We agree wholeheartedly.

So how do we invest? By determining the appropriate asset allocation designed to meet each client's unique objectives, and using low-cost, tax-efficient indexed investments to implement that allocation. Once in place, changes are made only if the client's situation changes, or to rebalance back to the appropriate allocation, or to make room for new investments that add to a broadly diversified portfolio.

Before leaving the subject of the media's influence, we would like to reference two NY Times articles that raise interesting points. A May 19th article (pg. C2) discusses media bias. "Reporters who firmly believe themselves to be disinterested observers may further the strategy of using bias to increase consumer/reader loyalty if they share their audience's assumptions about how the world works and hence how to interpret particular facts." The example used is of two reports of the same basic fact, an announced increase in the unemployment rate from 6.1% to 6.3%. One presentation has the headline "Recession Fears Grow"; notes an increase in the number of people losing their jobs; and cites an economist comparing the current president to Herbert Hoover, with a photograph of people waiting to collect unemployment benefits. The alternative presentation, under the headline "Turnaround in Sight," emphasizes how small the percentage increase was, and quotes a market analyst on how "softness in the labor market bodes well for corporate profitability." The point is that even an objective presentation of fact can be made in such a way as to play on the fears and insecurities of the audience, potentially leading to a number of inappropriate decisions.

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The second article, which appeared in the Sunday May 22nd Financial section (pg. 6), discusses how the government's reporting of personal savings can create mistaken impressions, even as the reporting is perfectly accurate. The government reports a savings figure that is less than 1% of the country's gross domestic product, obviously a low number. But what is not reported is that the calculation of the savings rate excludes capital gains from the sale of stocks or a house. While economists debate the propriety of these exclusions, the fact of the exclusions is rarely made explicit, again leading to potentially inappropriate decisions being made based on the reported figures.

IIB. HOUSING AS AN INVESTMENT

The term "housing bubble" appeared recently in front page articles in both the NY Times (May 25th) and the Wall Street Journal (May 19th). The Times headline read "Steep Rise in Prices for Homes Adds to Worry About a Bubble," and the Journal headline read "The Fed Starts to Show Concern At Signs of Bubble in Housing." Accordingly, it seems appropriate that we consider this subject as well.

The Times article began: "Home prices rose more quickly over the last year than at any point since 1980…raising new questions about whether some local housing markets may be turning into bubbles destined to burst. With mortgage rates still low and job growth accelerating, the real estate market is defying yet another round of predictions that it was on the verge of cooling." The article goes on to state that based on April's figures, home prices nationwide had risen 15.1% from a year earlier, to a median price of $206,000. Housing markets are local in nature, with certain markets, including Florida, the Boston-Washington DC corridor, and the West Coast, recording some of the sharpest gains. The article uses as an example the fact that in the late 1980's, a typical house in San Diego cost about as much as two typical houses in Syracuse NY; today the ratio is six houses in Syracuse for one in San Diego. The article refers to Fed Chairman Greenspan's comments, delivered Friday May 20th, that although "home prices have never fallen by significant amounts, they have sometimes fallen sharply in certain locations, and that some metropolitan areas were clearly showing signs of "froth" (Greenspan's word).

The Times article made some other interesting points. "Even as the Fed has steadily lifted its benchmark short-term interest rate, mortgage rates have remained low….Mortgage rates are closely tied to the market for long-term government bonds, which are benefiting from purchases by foreign governments, particularly in Asia, that continue to buy Treasury bonds, as well as from investors looking for a haven from risky corporate securities." It should be noted (apropos of the prior section discussing the media), that the portion of the quoted section purporting to provide the reasons why mortgage rates and interest on long term government bonds have remained low even in the face of the Fed's lifting of the short term rates it controls, is, we believe, a matter of opinion, even though it is reported as fact.

Furthermore, economists worried about a bubble point to the "growing gap between house prices and almost everything else – rents, incomes, population growth – as the surest sign of trouble." The article cites other economists who "predict that powerful demographic forces, including baby boomers buying second homes, and their children buying their first, will keep prices increasing in most of the country." Our view: As with all market price movements, the future remains unknown, but the housing bulls are clearly in command at this time.

Turning to the WSJ article, written on the eve of Greenspan's May 20th remarks, there is a quote from his testimony to Congress back in February that "we do have characteristics of bubbles in certain areas, but not, as best I can judge, nationwide." And that remark was made three months ago! But let's remember that this is the same Alan Greenspan who called the stock market "irrationally exuberant" in December 1996, when the Dow Jones Industrial Average was in the 6000s, only to see the Dow top out over 11,000 more than three years later and remain at 10,500 today. So market timing of prices may not be Greenspan's strongpoint. (The Journal article goes on to refer to his stock market warning in 1996.)

The article begins: "In the debate over whether the housing market is a bubble about to burst, the crowd that argues it isn't has been able to cite reassuring utterances by Federal Reserve officials. But there are proliferating signs that the housing market is looking a bit frothy. And now the US central bank is beginning to worry about it. It isn't only that housing prices keep rising faster than almost anything else, up 10% on average nationally in 2004…and up 25% or more in the hottest markets in California, Florida and Nevada….It isn't only that the clever mortgage industry keeps coming up with new ways to lend people money to buy houses that involve ever-more leverage and little – or sometimes no – down payment. It's that more people are buying second and even third homes, expecting that prices will continue to rise so they can sell the houses quickly at a profit – and that is drawing the Fed's attention." The writer observes that "it's as if Americans got tired of the stock market, and decided to look elsewhere to try to lose money."

Other recent articles have focused on certain behavior related to the strong gains in housing prices. Another front page WSJ article (May 23rd) discussed how homeowners are going deep into debt to buy additional housing for investment. "Five years into a housing boom that has boosted U.S. home values an average of 50%, many Americans no longer think of their home as just a place to live. Instead it's a cash machine that can be used to rapidly build wealth. To that end, a growing number of people are tapping into their home equity to invest in more real estate. That's a lot like using a margin account – a line of credit backed by securities in an investor's portfolio – to buy stocks. When…shares bought on credit decline…borrowing worsens their losses. Economists say today's debt-fueled investment binge in real estate is fanning the flames of an already overheated housing market."

Another WSJ article (May 27th, pg. W12) discussed the idea that some homeowners are trying to time the real estate market, selling currently when prices are high and hoping to buy back later after prices fall. In the interim, these people rent homes. This behavior is triggered by the fact that they have "unexpectedly seen their primary asset rise so fast in value that they're tempted to sell, reap a huge profit – and rent for a while to wait until prices possibly come down, allowing them to trade up to a larger property, or pocket the difference when they purchase something comparable to what they owned." The article points out that for those who attempt such market timing, there is always the risk that prices continue moving higher, so that they are priced out of their local markets.

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A final article discusses housing/real estate more generally in the context of a broadly diversified investment portfolio. Written by WSJ columnist Jonathan Clements, who we cite frequently for his advocacy of low cost indexed investments, the column begins with the provocative statement: "If you want to crank up your investment returns, take out a larger mortgage" (May 13th, pg. D1). Clemens continues by citing the work of three Nobel prize-winning economists who take the position that to get "the highest possible return for a given level of risk, you should buy the most broadly diversified portfolio possible and then either add conservative investments to reduce volatility or borrow money to goose performance." Clemens finds this "intriguing," but points out three key problems:

1) What is a broadly diversified portfolio? He says the portfolio would consist of a value-weighted mix of stocks, bonds, real estate, commodities, venture capital and "goodness knows what else." He quotes a Harvard Business School professor: "If you don't own the entire market, you're betting against the guys who own the stuff that you don't. What makes you so sure the other guys are stupid?" We heartily concur with this viewpoint;

2) Use of borrowed money to make the investments. While this may "conjure up images of gun-slinging hedge fund managers and dice-rolling margin account investors, in all likelihood you have done something awfully similar yourself." This similar behavior involves borrowing money, in the form of a mortgage, to buy a house with a far greater value than the amount of cash used to make the purchase. The difference, and it is a significant one, is that owning stocks on margin subjects the borrower to margin calls if the stock prices decline far enough, whereas a mortgage requires only continued payment of the agreed-upon amount, without regard to the changing value of the home; and

3) The after-tax cost of the borrowed money must end up less than the investment return for the strategy to work out favorably. Even aggressive investors may not have the stomach for a 100% stock portfolio, but…. investing in bonds would crimp returns. Still, if the bonds are owned in a tax deductible retirement account, the after-tax return should beat your mortgage's after tax cost."

Our brief view of these subjects:

(1) We are, as always, wary of adding to any high priced asset class, but we also respect markets as efficient pricing mechanisms most of the time. Housing involves the added feature that many people own houses for the traditional reason of living their lives, which does make it more than just another investment asset class; and

(2) We agree with much of the Clemens article, particularly with regard to establishing broadly diversified, comprehensible portfolios, and of measuring after-tax borrowing costs against investment returns. However, we are reluctant to advise clients to use debt in an effort to enhance investment returns, since we have found most individual investors to be risk averse, viewing losses as much more undesirable than the prospect of any gains they may earn.

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	S&P 500 (1)		DOW JONES (1)		NASDAQ (1)	

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

I. Figures From Period Starting 2000 (% Figures Are Cumulative Declines From 1/01/00)

	S&P 500		DOW JONES		NASDAQ	
Start of 2000	1,470		11,500		4,070	
End of 2000	1,320	(10.1)%	10,785	(6.2)%	2,470	(39.3)%
Sept. 21, 2001 Low	965	(34.3)%	8,235	(28.4)%	1,425	(65.0)%
End of 2001	1,148	(21.9)%	10,020	(12.9)%	1,950	(52.0)%
Oct. 9, 2002 Low	777	(47.1)%	7,286	(36.6)%	1,114	(72.6)%
End of 2002	880	(40.1)%	8,342	(27.5)%	1,336	(67.2)%
End of 2003	1,112	(24.3)%	10,454	(9.1)%	2,003	(50.8)%
End of 2004	1,212	(17.5)%	10,783	(6.2)%	2,175	(46.5)%
May 31, 2005	1,192	(18.9)%	10,467	(9.0)%	2,068	(49.2)%

II. Figures From Period Starting 1995 (% Figures Are Gains From 1/01/95)

	S&P 500		DOW JONES		NASDAQ	
Start of 1995	459		3,834		752	
End of 1999	1,470		11,500		4,070	
5 Year Gain; Annualized %	1,011	26.1%	7,666	24.6%	3,318	40.2%
End of 2001	1,148		10,020		1,950	
7 Year Gain; Annualized %	689	14.0%	6,186	14.7%	1,198	14.6%
End of 2002	880		8,342		1,336	
8 Year Gain; Annualized %	421	8.5%	4,508	10.2%	584	7.5%
End of 2003	1,112		10,454		2,003	
9 Year Gain; Annualized %	653	10.3%	6,620	11.8%	1,251	11.5.%
End of 2004	1,212		10,783		2,175	
10 Year Gain; Annualized %	753	10.2%	6,949	10.9%	1,423	11.2%
May 31, 2005	1,192		10,467		2,068	
10.42 Yr Gain; Annualized %	733	9.6%	6,633	10.1%	1,316	10.2%

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