

INVESTMENT LETTER

A PUBLICATION OF CALDWELL TRUST COMPANY

MARKET SNAPSHOT: 06/29/06

DJIA: 11190.80

NASDAQ: 2174.38

S&P 500: 1272.87

10 YEAR TREASURY NOTE: 5.20%

A YEAR'S PERSPECTIVE

Almost daily headlines in our local newspaper trumpet what's going on in the real estate market, both here in Florida and nationwide. So, we thought it would be interesting to look back at an issue of this Letter published one year ago that dealt with the "Real Estate Bubble" in light of what we see happening today.

Southwest Florida, it appears, is experiencing its first decline in the real estate market since the incredible growth began a few years ago. So far, though, real estate professionals say the "bubble" has a slow leak, not a major rupture, and they are hoping it stays that way. Some say they feel the market is simply returning to a degree of normalcy after unbridled expansion and don't foresee anything constituting a collapse going forward. In fact, the Commerce Department recently reported that single-family home sales actually increased by 4.6 percent last month, albeit with industry analysts giving credit for the rise to unusually good weather during the past few months. The market—as usual—remains jittery about what the Fed will do with interest rates, and stock prices—as usual—have reflected those jitters no matter the underlying financial fundamentals of the companies they represent.

CONCLUSION: We stated a year ago we felt that both stocks and real estate are "appreciating" assets, and we haven't changed our minds. Read on to review our June 2005 assessment.

Re-Print of the June 2005 Caldwell Trust Company Investment Letter

REAL ESTATE BUBBLE

It is hard to pick up a paper or turn on TV today without some reference to the spike in real estate prices and the growing fears of some as to where this is going. Perhaps it would be useful to our friends, clients, and others to discuss in this month's Letter what we think is going on and to try to put to rest some of the blather that always comes along with such things when the media has so much time and space to fill and so little of importance to fill it with.

First of all, in the investment world, when something occurs that gives constant reminder to a problem, always remember that the worst is already built into the price of stocks. It is only new news that shakes markets, not old.

Secondly, it should be made clear that the biggest increases in real estate prices are highly localized, mainly in Florida, California, and other "desirable" locations around the country. It is not nationwide. In fact, my own personal travels around our beautiful country suggest the opposite. Maine, Tennessee, and other states, for example, still offer prices so low as to be almost unbelievable in the modern world. Would you believe that you can still buy the whole top of a mountain—118 wooded acres ten miles away from the state's leading ski area—for \$79,000 in Maine?! So much for the bubble up there. There are many more such examples I could cite, but readers get the picture.

This is not to make light of the fact that, yes, there are a number of places

in the country, especially in our own state of Florida, where prices have skyrocketed in the past several years. And, it does give one pause as to how this can be sustained without causing problems when things unwind down the road, which they usually do after such dramatic increases.

To give a little more perspective, however, some background is in order. First of all, everyone remembers the spike in share prices during the high-tech boom five years ago, which was followed by a nosedive in stock

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THIS ISSUE:

Volume XXXII, Issue 6

June, 2006



Caldwell Trust Company

prices. The automatic assumption of far too many who should know better is that investors got killed and lost a lot of money. The reality is that many large investors were simply taking money out of stocks on the way down in order to reallocate risk exposure into other investment areas. Those who were speculating on doubling their money every week surely lost a lot of money, much of which they never really earned in the first place. But large, honest to goodness investors are another matter altogether.

In our own case with our flagship total return public fund, in 2001 we moved to less than 25% invested in stocks. Approximately 18 months later, with the Dow Jones Industrial Average about 2000 points lower, we were aggressive buyers of stocks in the fund, moving up to 75%+. Today we're closer to the 90%+ level. I suspect that though we may have been more nimble than some, there are quite a few active traders who did something similar.

What this means is that once share prices peaked and there was solid evidence that the years ahead would produce much slower annual average returns in a slower-growing economy, a lot of reallocation had to take place with all those billions of dollars that were taken out of stocks.

At that time, real estate had been in the doldrums for a number of years, with one major residential real estate index that we follow showing average total returns for quite a while in the 6% range compared with the 15-30% returns that had been earned on stocks during the late 90's. With

these kinds of puny returns, money went elsewhere for the right reasons.

Also remember that during this period, many investors still kept a pretty wary eye on our ability to control inflation ahead, especially after the disastrous period of the late 70's when uncontrolled inflation caused us to have to pay double digit interest rates. Investors, twice burned in bonds, demanded shorter term investments plus other protections against another inflation rise. Banks and lenders did the same, which culminated in the mortgage lending market of today, wherein lenders now take very little interest rate risk via many different lending packages.

To the extent that our banking institutions are heavily into mortgage lending, here too there is less to worry about than might seem obvious. Comparisons with past disastrous lending problems and bank failures are incorrect.

A basic rule of risk taking is that one should never loan money at a rate that ignores the underlying collateral. In the case of real estate, as an "appreciating" asset, it is very unlike auto loans which are made on a "depreciating" asset. The former bails out lenders over time, the latter does not and thus requires a definite payoff before the collateral becomes worthless.

Accordingly, the fears today regarding rising real estate prices are pretty much unfounded—assuming two things. One is that today's bankers are not stupid. They are very sophisticated in matching liabilities against assets and constantly monitoring loan loss ratios by computer,

giving themselves the ability to respond quickly to specific areas of trouble.

The other assumption necessary to allay fears is that, other than for ever-present speculators, supply and demand for residential real estate is as always a self-correcting matter, one house at a time. Buyers scout various areas in their desired locations and pick a home they want and, mostly, can afford. Lenders, while eager, remain careful on the whole to make certain borrowers are capable and prices are competitive.

CONCLUSION: The real estate industry in the US is perhaps the single largest and most important investment sector affecting nearly every American. Almost all political and social policies are directed toward the encouragement of home ownership as a bedrock for a free democratic society. As such, excesses have, are, and will occur from time to time. Our sense at the moment is that this is not one of those times when investors need to wring their hands, fearing something that could cause harm to other areas of investment. If anything the opposite may be true in that, when stocks finally move to the higher levels where they belong, money will almost surely flee real estate speculating just as it fled stocks for real estate after the tech "bubble" collapse. Don't forget that unlike any other major investment types, both real estate and stocks for good and valid reasons have been "appreciating" assets and likely always will be.

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