

ENVISION

MARKET REPORT

June, 2008

“Buy land, they're not making it anymore.” – Mark Twain.

Were you aware that nationally, home prices rose 0.8% in 2007? Yes, they rose. However, though we did see an increase in 2007 it was the slowest national growth since 1990. The national home price index fell 14.1 percent in the first quarter of 2008, the steepest decline in 20 years said Standard & Poor's/Case-Shiller. Home sales post unexpected increase in April for the first time in six months according to the Commerce Department. Decreases, increases, everything is unexpected by some and expected by others. What really happened to the housing market and is there currently a safe way to invest in real estate?

Starting in the early 1990s there was an oversupply of capital trying to buy “desirable” properties in the real estate market. The stock market crash of 2000 accelerated this glutton of capital when billions of dollars, euros, and yen fled from stocks and bonds and began pouring into real estate. The demand for quality properties exceeded the available supply, causing intense competition among capital holders to purchase the best properties and among lenders to make loans available so potential buyers could make such purchases.

Whenever there is more demand than supply for a product like real estate which cannot be produced quickly - meaning buildings cannot be built quickly, of course the supply of land itself is finite - competition drives prices up.

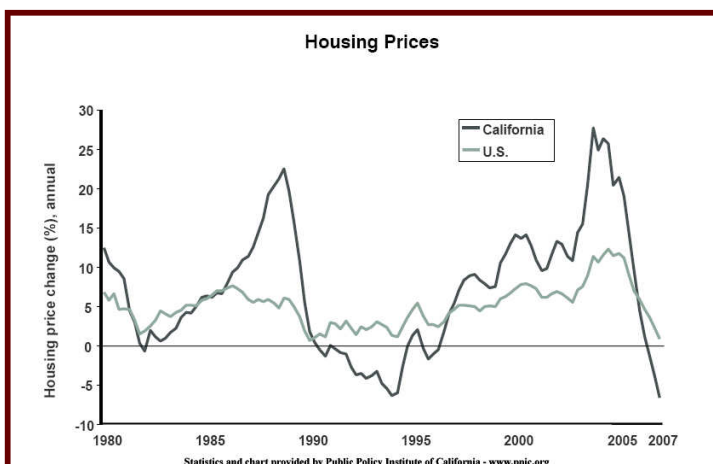
As property prices rose, the interest rate that lenders could collect fell. Lenders were forced to reduce rates in order to stay competitive in a world over-supplied with capital. By 2005 and 2006 lenders and buyers were not being compensated properly for the risks of their purchases. Lenders were handing out loans with historically low yields and buyers were purchasing houses with already historically high values.

Everyone wanted to buy real estate, even those who were unqualified to do so. Lenders were reducing not only their fees but their underwriting standards as well. Using “creative” ways to lend money became more typical; leading to the mass approval of precarious loans.

This risk-reward gap widened then was finally brought to light by the problems the subprime mortgage lenders ran into. As more borrowers began defaulting on their loans lenders realized they needed to increase the interest rates they were

charging in order to be sufficiently compensated for the risks they were taking.

Buyers were thus forced to pay higher interest rates and meet tougher loan terms - we use the term “tougher” quite loosely here as lenders went back to adhering to the standard underwriting guidelines. The amount buyers were able to get from the banks was not enough to pay the high prices that sellers were charging. Thereby, sellers were unable to get the high prices for their real estate like they had thought. What this led to, was finally a realization of the cost of the risks associated with these loans. This realization was that housing prices needed to fall, and they did in classic price correction fashion. Thus began the avalanche of foreclosures and defaults.



Over 1 million homes are in foreclosure, the highest rate ever recorded according to the Mortgage Bankers Association. This number seems a lot smaller as a percentage of the total loans out it equates to 2.5%. According to the S&P/Case-Shiller composite index of twenty metropolitan areas of the US, the values of single-family homes fell 7.7% in the

first quarter. The good news is - if we can call it good news - the rate of decline has not worsened. Prices are still falling, but the pace at which they are falling has - for the moment - leveled off.

Eventually, the downtrend of housing prices will reach a bottom, then move sideways for a while, and then turn higher; real estate is cyclical like this. We may see somewhat better economic conditions during the second half of 2008, coupled with reduced drag from residential construction followed by growth picking up further in 2009. However, until the housing market, and particularly house prices, shows clearer signs of stabilization, we will see more downside in the short term.

With housing prices continually falling there is a lot of buzz about investing in foreclosed houses. We must note however, that the mechanics of foreclosure investing are the same as they ever were. There are professionals who have been doing this for years; you will be in direct competition with them for properties. Investors have a shot at high returns only because they undertake a difficult, time-consuming and risky process.

A process much more difficult than one might think. This is a risky investment that would need a lot of time, expertise, and money to nurture a decent return from.

The subprime meltdown and the credit crunch are having an effect in the commercial real estate sector as well. The general lack of capital is causing cap rates to rise and real estate values to drop off. JP Morgan Securities has projected a 20% drop in commercial real estate values from their recent peak. Meanwhile, appraisal firm Integra Realty Resources projects a 5% to 10% decline in property values this year.

Commercial real estate will remain strong compared to the housing market. In the last ten years commercial developers have been conservative in their growth strategies, generally showing restraint in order to preserve property values. Essentially, commercial real estate is keeping its head above water because the rents and leases of commercial buildings produce a steady stream of revenue for their owners, enough to pay off the loans. This allows the owner to hold and wait for the property value to rebound.

"While the majority of nationwide markets are mired in an economic slowdown, investors realize that the commercial real estate fundamentals are healthier than they were during the last downturn in the mid-1990s," said Susan Smith, author of the Korpacz Report.

This all sounds good, but we know commercial real estate is not entirely avoiding the subprime fallout. We have already seen commercial real estate developers cut projects in response to depressed economic conditions. Deal movement for commercial real estate has slowed as much as 80% in some areas. This conservative approach means that investors should expect steady rather than explosive growth once the market rebounds from its expected short-term contraction.

J.P. Morgan projects losses in the commercial property industry will hit \$120 billion in the next five to eight years - this is about 4% of the sector's \$3.2 trillion in debt outstanding. This is a major loss, but well short of the \$200 billion in losses that J.P. Morgan projects in residential real estate, 15% of outstanding debt. So while residential real estate will suffer more, the commercial sector will not be immune as property values fall, buyers remain scarce, and supply out-paces demand.

Why does all of this matter as it pertains to investing? This year investors have witnessed a string of Federal Reserve interest rate cuts that hopefully will help the subprime loan crisis and boost the U.S. economy. But there is a disadvantage of these cuts for investors: a sizeable decrease in yields on all domestic financial instruments, including bank certificates of deposit (CDs) and virtually all money market and short-term bond funds. Add to this a struggling stock market that is down over 12% year-to-date as well as lower rents or empty homes owned as investments. Many individuals are not getting the monthly income stream they

used to receive. However, there is an alternative that can offer relatively high yields: closed-end Real Estate Investment Trusts (REITs).

A REIT is a company that owns and/or develops large portfolios of income-producing real estate property. Average REIT yields now significantly exceed average yields for bank CDs and U.S. Treasuries. Whether investors are in or nearing retirement or looking for income, closed-end REITs can be a valuable component of a diversified portfolio. These commercial property funds are uncorrelated to the stock market, and previously had such high minimum investments that only institutions could participate in them. Now, most investors with a small amount saved up are able to participate just like large institutions.

Now that we know what happened to the housing market it is obvious the government and banks alike still have a lot of cleaning up to do in regards to the subprime mess. We will see more downside in the housing market but look for it to at least flatten out by the end of 2008 or early next year. If you were thinking of bottom picking and investing in a foreclosed home; remember that foreclosure investing is a very tough, risky, and time consuming way to try and make a return on an investment.

Commercial real estate will also face some downside but overall it will hold values much better than the residential sector. If you are looking to increase the yield you receive on investments then a closed- end REIT remains a safe way to invest in commercial, grade-A real estate, and get monthly income.

The bottom line is real estate remains a solid investment vehicle if you know how and what parts to invest in. With a little strategy and planning real estate is a lucrative investment.

Thank you for your business and support,

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