At the recent Five Star Default Servicing Conference & Expo in Dallas, the halls were abuzz with the animated voices of enthusiastic experts and eager-to-learn listeners. And while there was variety in each discussion, one common sentiment seemed to emerge: “We see more REO every day, which is a tragedy. But I’ll tell you one group I don’t feel sorry for: the speculators.”

This comment, or something close thereto, was thrown out like chum in shark-infested waters time after time—in each instance, to knowing laughs and applause. Perhaps it is easier to criticize a shadowy group that seemingly had minimal presence at the conference when surrounded by so many others who are receiving negative attention in the midst of the subprime meltdown—appraisers, agents, and auctioneers, just to start with the A’s. You never know who is going to be sitting in the audience, and no one likes to be booted off a panel, so why not play the odds? But what if most of the people sitting in the audience—indeed, most of the people who were applauding—were the speculators?

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**Spotting the Speculators**

Who or what, exactly, is a speculator? During some of the Five Star sessions, the general operating definition seemed to be “someone who bought a home or homes with the thought of riding the wave to more money, and as a result aided in overvaluing the real estate market.” While speculation often refers to someone engaged in risky transactions to realize a quick profit—often making inferences and decisions before uncovering the cold, hard facts—the word “risky” itself is subjective and depends on a host of factors.

The fact is, when addressing the notion of speculation in real estate, a critical point arises: No one knows for a fact what the real estate market will do from one day to the next. No one is certain of the potential risk involved. There are conjectures aplenty, and those are often correct, but real estate prices are readily prone to change because they are based on so many variables—not the least of which is human nature. And because of this, anyone who puts a home on the market with a list price is speculating.

“Whoa! Now hold on a minute,” you might say. George Soros is a speculator, in your opinion, as are the people buying futures through the MacroMarkets Housing Futures and Options program. But you would never turn the finger on yourself. Yet, by slapping an asking price on a home, thousands of Americans become speculators every day. An asking price has been determined through the estimates of appraisers, agents and brokers, and the owner’s own wishful thinking. Regardless of their best intentions, none of these estimations represents fact. According to a 2007 October Research National Appraisal Survey, more than 90 percent of appraisers say they have been pressured to inflate home values. Agents and brokers do their best with comparisons of similar properties, though every house is unique and these become approximations at best. Sellers themselves have the greatest sway over the final list price, the most emotional commitment to the property, and usually the least expertise.

**CLOSER THAN YOU THINK**

So why do most Americans fall into the speculative process—usually not even realizing that they have become speculators? Because this is the way they’ve been told homes are sold. And that leads to the critical difference between stock speculation and real estate speculation: There is a viable, alternative way to sell stocks.
How many house-flipping speculators are there? Do they represent the majority of American real estate speculators? We have no way of knowing how many homes are on the market right now as the result of extreme speculation—ridiculously high list prices, testing the market, with no plans by the seller to lower the price to lure offers. Nor do we have any way of estimating the impact of this form of speculation on the housing market.

in this pricing troika—not exactly a winning combination. None of these parties—with a rare exception—is a potential buyer. The list price we end up with is a speculative number. Not knowing the facts—what the home is really worth—we put the home on the market to speculate, to see if the price we’ve determined leads to any offers. If it leads to quick offers, perhaps we speculated incorrectly—at too low an amount. If it doesn’t lead to any offers, a reasonable agent or broker will recommend lowering the speculative price in increments until the offers start to come in.

**Stock Around the Block**

This is no different than the way stocks are often sold. Stock brokers are regularly told to sell a stock once it reaches a certain market value. For example, let’s say you owned 10 shares of Acme Corp. stock, valued at $50. For whatever reason—you will make your desired profit when it reaches this amount, you think it will decline after reaching this price, etc.—you could call your broker and instruct them to sell it after it reaches 35 on the open market. John D. Rockefeller did this with his own stock portfolio, and—with more recent and notorious results—so did Martha Stewart. So do thousands of investors around the world every day. It is a normal business practice.

So if speculation has been perfectly acceptable in the stock market for decades, why the ready finger of blame when it comes to real estate? Let’s return to the audience at the Five Star: The “professional” flippers, who ridiculed panalysts, should have known the risk they were taking when they got into the game. It is presumed these individuals made the foolhardy and greedy bet that real estate prices would always go up—that all they had to do was buy a house, possibly fix it up, and resell for a profit. And by doing this, they falsely raised the market value of real estate across the country. Yet, how many house-flipping speculators are there? Do they represent the majority of American real estate speculators? We have no way of knowing how many homes are on the market right now as the result of extreme speculation—ridiculously high list prices, testing the market with no plans by the seller to lower the price to lure offers. Nor do we have any way of estimating the impact of this form of speculation on the housing market. There is a viable, alternative way to sell stocks. House-flipping speculators are no different from everyday speculators when it comes to their main flawed assumption: Real estate values will always go up—sometimes at a greater rate than others, but they will always see increases. But what if they start to decline? Up to this point, real estate speculation has been perfectly reasonable and functional—almost everyone who has bought or sold a home in the last 50 years has engaged in this process without harm. But what if time matters more than market testing? With stocks, if you decide not to wait for a desired outcome, you can just call your broker and obtain whatever the market is currently delivering. If you lose your job, if you are afflicted with a severe injury or illness, if the family breadwinner dies, you are still fed into the same speculative mechanism as those who have the luxury of testing the market. In America, the most advanced capitalist economy in the history of mankind, the single greatest asset class—real estate—is still sold solely though an opaque, drawn-out, speculative process. Buyers and sellers are not given a range of options to choose from—the system we currently employ is the only show in town. To be sure, short sales have been utilized within this system, but only by speculating in the opposite direction—throwing out a list price that is so low the offers are guaranteed to come in quickly. It is accepted that this is a win-lose transaction benefiting the buyer. Yes, the lender and seller avoid the foreclosure process—but at the expense of any equity the seller might have in the home. This is the best we can do?

**Home Buyers Also on the Hook**

And what about the “suckers” who paid the inflated prices for these homes—don’t they deserve some of the blame too? It is important to remember the mind-set present at the time, one of irrational exuberance. As a 2004 report by the Homeownership Alliance, titled “America’s Home Forecast: The Next Decade for Housing and Mortgage Finance” pointed out: “As homeownership rose and house prices advanced, the market value of homes climbed to a record $15.2 trillion by the end of 2003—one-third higher than three years earlier, and homeownership equity stood at a record $8.4 trillion. Indeed, the overall housing debt-to-value ratio was only 45 percent at the end of 2003. America’s homeowners are not overleveraged, and measures of financial obligations remain within historical ranges.” The same report went on to predict that “home price appreciation should average around 5 percent per year from 2004-2013 but could be above 6 percent if supply constraints continue to tighten.” These are the consensus analyses and predictions of chief economists from Fannie Mae, Freddie Mac, the National Association of Realtors,
the Independent Community Bankers Association, and the National Association of Home Builders. For Joe Homebuyer on the street who doesn't have the time, expertise, or resources to conduct his own economic analysis, these conclusions would have sounded pretty similar to what most people were saying in 2004. And operating with that (as it turns out flawed) knowledge, he amiably went about engaging in the speculation game that is the U.S. real estate market. His pricing was based on conjectures that turned out to be wrong (or at least appear to be here in 2007) and not on what the real value of the home he was buying might be.

Risk Sans Rewards

We should feel sorry for the speculators. Given no readily acceptable alternative, most of them are fed into a process that doesn't necessarily address their needs and contains great risk—neither speed nor pricing accuracy being put at a premium as prices decline in a glutted market. At the recent annual Mortgage Bankers Association's national conference, Sir Richard Branson, founder of the Virgin consortium of companies and a success in a broad range of businesses, spoke during the opening session and was asked by an audience member for the best piece of business advice he had received. His response: Always protect your downside. When faced with an appealing opportunity, one should act boldly while also protecting possible losses. This speaks to a basic tenet of finance: With greater risk comes greater potential for reward. Conversely, if you don't care about making that huge windfall, your risk need not be so great. Yet American real estate consumers are not given a way to protect their downside. Indeed, they face a bizarre paradox, where greater risk is inherent in the system even when substantial rewards are not desired. Until a viable alternative is in place, American home sellers will be forced to speculate—whether they'd like to or not.