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**Great new ways to
invest overseas 34**

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► WATERFRONT LAND

It's going fast. How to find it,
buy it—and profit from it **88**

► A SECOND HOME

9 things you must know
before you buy **94**

**CHRISTIN and
JOHN SCHREI**
built their dream
vacation home
overlooking
Lake Michigan.

COVER | Where and how to buy a second home that will be a first-class investment.

By Jane Cameron

A

AFTER ALMOST two decades of ownership, the three-bedroom house in Federal Way, Wash., that Glenn and Carol Black bought early in their marriage has tripled in value, earning them \$149,000 in equity. But that's nothing compared with the one-bedroom vacation home they bought about 45 minutes away in Gig Harbor. With 50 feet of waterfront and views of the Olympic Mountains, that house has appreciated by \$211,000 in the two years they've owned it. "We are kicking ourselves that we didn't do this years ago," says Carol, 42, who works as director of finance for a Seattle investment bank.

A GETAWAY of your own

When people gather round the backyard grill this summer, chances are they won't be discussing their stock portfolios. Rather, they're likely to be chatting about their second homes—or maybe even their third or fourth. With the growing economy and interest rates still hovering around historic lows, people have been gobbling up vacation homes like potato chips before the dawn of the low-carb diet. Nationally, an estimated 445,000 vacation homes were bought in 2003, up 24% from 2001, according to the National Association of Realtors (NAR).

A 2003 survey showed that nine out of ten owners who bought in the previous year thought their decision was financially sound, and one-fourth planned to buy additional homes. "People are looking at real estate as the primary place to build wealth," says NAR's Walt Molony.

GETTING STARTED

THAT'S CERTAINLY what Roger and Michelle Rosenbaum have in mind. When the Saugerties, N.Y., couple came into an inheritance recently, they could have put the money into the reviving stock market. Instead, they used the \$34,000 as a down payment on a one-bedroom condo in Venice, Fla.,

with "peekaboo" views of the Gulf of Mexico. "The stock market scares me—it seems like educated gambling," says Roger, 39. "There's something to be said for having a key in your hand."

Owners of a Victorian-style house in Sauger-ties, the couple—he's a media-relations consultant, she's an academic adviser at a university—admit that the \$185,000 condo was something of a stretch. But they aren't planning to rent

the place to offset expenses. Rather, they're banking on the fact that it's in an area that appreciated 30% last year and is only one block from the beach. Over the next three years, the couple plan to invest between \$10,000 and \$15,000 to update the kitchen and bath and to replace furnishings in the 36-year-old condo. They'll stay there on weekends during the winter, then hope to flip it for a bigger unit. "This is our toehold place," says Roger.

An increasing number of buyers have been trying to get a toehold since 1997, when tax-law changes allowed most home sellers to exclude up to \$500,000 in capital gains from taxation. Before the change, sellers generally had to buy a more expensive house to prevent being taxed on profit from a sale. Now you can trade down to a less expensive house and use profit from the sale of the big place as a down payment on a second home. NAR doesn't track how many people are trading down, but its study did show that 21% of second-home buyers were using equity from the sale of a primary residence to finance their purchase.

Also increasing is the percentage of buyers who see a home-away-from-home primarily as an investment rather than a personal hideaway. Five years ago, about 20% of buyers said they

were more interested in profits than pleasure; now nearly four in ten say that money is their motivation. With vacation-home prices appreciating in the double-digits in most resort towns, it's easy to see the appeal.

But those high prices also mean it's more likely that today's buyers will need rental income to defray the costs of ownership. And as soon as they've built up equity in one vacation home, some people are using it to purchase more property.

That's the strategy of Brian Lucas-Smith and his wife, Carol, who live on a golf course in the resort community of Half Moon Bay, Cal. Both are real estate agents who have watched prices rise so quickly in their neighborhood, about 30 minutes south of San Francisco, that two years ago they decided to take some of the equity out of their \$900,000, three-bedroom home and invest it in vacation property in cheaper parts of the U.S.

They bought two homes in Las Vegas, for \$225,000 and \$230,000, which they rent for about \$1,800 a month each. They never visit except to do routine maintenance, and the homes' expenses run a bit higher than the income they generate. But the equity build-up on both houses is a combined \$100,000. The homes are now pledged as security for a bank line of credit that the couple is tapping to build the home of their dreams in St. Petersburg, Fla. With five bedrooms, four baths, a pool and 127 feet of waterfront, the place will cost \$1.4 million. Next March, Brian, 57, and his wife, six years younger, plan to sell their house in California and retire to Florida.

BLAME THE BOOMERS

THE TRICK TO buying a vacation home, Brian says, is to seek out a place with great potential—near a location known for its

natural beauty, entertainment or some other draw—that hasn't caught on with buyers yet. Waterfront anywhere is a good bet, he says, as baby-boomers start to look for places that can serve as a vacation home now and a retirement place later. "Boomers want to feel sand between their toes," says Brian.

Now in their peak earning years, the leading edge of the 76-million-strong baby-boom generation is spearheading the mania for beachfront bungalows, mountain chalers and high-desert hideaways. The median age for second-home buyers is 47, according to NAR's study, and the median household income is \$85,900. Demand is pushing up prices in resort areas—prices are up a whopping 51% over a year ago in tony places such as Palm Springs, Cal. Even in lesser-known Bodega Bay, Cal., a beachfront community about 65 miles north of San Francisco, a three-bedroom cedar-sided house that was built in 1973 on a postage-stamp 6,000-square-foot lot currently costs \$1.25 million. Buyers are snapping up everything they see, even at these heady prices. "In many cases, people are buying second homes that cost more than their primary ones," says real estate agent Thera Buttarro.

There are still deals to be had, however, if you're willing to adjust your expectations and shop around. The beachfront homes in Gig Harbor, where the Blacks bought, are relatively affordable for waterfront property because you have to drive over a congested bridge to get to them (a second bridge won't be built for another five years). For example, a two-bedroom, custom-built house on two acres, constructed in 1984, with a view of Puget Sound and Mount Rainier, recently listed for \$519,000. "Real people can still afford us," says Victoria Burgess, a Gig Harbor real estate agent.

Those whose tastes run to mountains instead of beaches can find even better buys. Mountain homes aren't nearly as pricey as those on even the humblest pond. At the Cliffs at Glassy Mountain,

High prices mean it's more likely that today's buyers will need rental income to defray ownership costs.

in Landrum, S.C., a gated community with a swim club and fitness center, you can get a detached house with a stone fireplace, a master suite and two screened porches with a view of the Blue Ridge Mountains for \$425,000.

Even in Lake Tahoe, Cal., where waterfront homes cost as much as \$24 million, a three-bedroom inland home with "mountain charm" and "woody interior" was recently put on the market for \$469,000. But such houses don't last long these days because almost anything with a view is in demand, according to Trudi Lee, a Lake Tahoe real estate broker. "You list anything under \$600,000," says Lee, "and it's gone."

Have prices run up so fast and so high that this summer's vacation-home buyers are walking into a bubble? David Stiff, an economist at Fiserv CSW, a Cambridge, Mass., research firm, is "reluctant to use the word *bubble* because that implies prices will fall, when they will probably just slow." Stiff warns against buying a property in hopes of making a quick killing, particularly in what he calls "overheated markets," such as Southern California and parts of the Florida coast. "But if your goal is to hold the property for seven or more years, you'll be able to ride anything out," he says.

THE REAL COST

IN THE superheated competition for houses, it's easy to overlook details that can cost you later. In the rush to secure his place in the Florida sun, Roger Rosenbaum forgot to ask about taxes (because they're pegged to the purchase price, they turned out to be about \$1,600 more than the number he saw on the listing sheet, which was what the previous owner paid) or insurance (because his unit is in an area vulnerable to hurricanes, it cost him \$100 more a year than the estimate his real estate agent quoted). He also forgot to ask if there were restrictions on renting his unit out—there are—which could affect its resale value. Although he doesn't

HOTTEST PROPERTIES

The search for affordable vacation homes has sent prices surging in resort areas across the U.S. Below are top-performing cities in eight states where comprehensive data are available. The survey was conducted by Fiserv CSW, a research firm in Cambridge, Mass.

CITY*	PRICE APPRECIATION	
	2000-2003	1997-2000
Beach Haven, N.J.	74.9%	43.3%
Villas, N.J.	72.8	39.7
Brielle, N.J.	72.3	39.3
Miami, Fla.	70.8	26.7
West Yarmouth, Mass.	67.7	54.9
Mastic Beach, N.Y.	67.7	42.1
Morro Bay, Cal.	66.7	60.1
Pollock Pines, Cal.	66.6	27.1
Mystic, Conn.	44.2	22.2
Portsmouth, N.H.	40.4	44.0
Phoenix, Ariz.	33.4	47.8

*Cities are located in counties where more than 5% of homes are seasonal units and where the number of seasonal homes exceeds 5,000. Source: Fiserv CSW Inc.

regret his purchase, in retrospect Rosenbaum admits he "was caught up in the fantasy of owning a beach place."

No matter how much of a bargain you get on the purchase price, your vacation home will inevitably cost you more than you anticipate, whether you rent it or not. The median price of a vacation house is around \$200,000. If you put \$40,000 down and finance the rest with a 6%, 30-year loan, you'll spend about \$13,500 a year, assuming annual taxes of \$1,500 and \$500 in insurance costs, with no extra fees for a homeowners association or country-club membership. You should anticipate unexpected maintenance expenses, such as fixing a leaky roof or broken air-conditioner. And if you rent out your house, property managers will insist on an updated kitchen and new furniture every few years. "You have to think like a hotel would, because that's your competition," Buttaro says.

Unless you live within an hour of your vacation home, you'll also probably have to pony up management fees. Although local real estate agents and property managers generally charge around 10% of gross revenues, the big operators charge much more—though that may include such services as housekeeping, snow removal, firewood delivery and advertising in magazines or by direct mail. For example, ResortQuest International, a Nashville-based firm that manages vacation properties from Delaware to Hawaii, charges as much as 45% for services that include paying utilities and association fees. You'll also have to replace items that renters break or walk off with, such as glassware and towels. "Don't expect positive cash flow from renting," says Sarah Thompson, a real estate agent in Bonita Springs, Fla.

But positive cash flow is possible, if you're patient. Having invested in vacation properties for a dozen years, Buttaro, 54, and her husband, Don, were recently able to sell one and trade up for a brand-new, \$600,000 three-bedroom townhouse in Hawaii, less than a mile from the ocean. Thanks to the profits from the house they sold, the couple was able to put 60% down on their new townhouse, giving them carrying costs of less than \$2,000 a month. They plan to rent out the townhouse most of the year, and it should pull down \$2,500 a week—so even if they use it two weeks out of the year, it could net a little over \$100,000 annually. "The reality is, owning real estate is a money-making investment only over the long term," says Buttaro. "But it can give you a lot of stability and pleasure." **K** —Reporter: JOAN GOLDWASSER

WHEN UNCLE SAM CALLS

Many of the tax rules for your first home apply to your second, unless you decide to rent it out. Learn the drill at kiplinger.com/directory.