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Home Builders Could Be a Risk Worth Taking

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To be a truly contrarian investor, you need the nerves of a cat burglar. How else can you buy stuff others are unloading in disgust? And few sectors are more loathed today than home builders.

Nobody expects the home-building business to pick up tomorrow. Analysts forecast that nearly every publicly traded builder will lose money in 2009.

But that's exactly why you might want to add some builders to your portfolio. Builders' profits are highly leveraged to the ups and downs of the economy, and their stocks usually start to recover vigorously well before a recession ends. And with the stocks down an average of 84 percent from their 2005 highs, there's no denying that they're cheap.

The most conservative builders are the best positioned to thrive once the economy rebounds. NVR (symbol NVR) and MDC Holdings (MDC) are unique for their small land inventories. At current building rates, MDC's inventory would last 1.4 years, compared with the industry average of 3.6 years. And NVR's inventories are nonexistent; it pays third-party owners for the option to buy lots within a certain period of time, but the company can always walk away from a deal and forfeit what it paid for the option. At last report, NVR's outstanding land options were worth just \$29 million. So the amount each company may have to write down in the future if land prices fall should be comparatively modest.

With more cash than debt, both can snatch up cheap land when demand turns around. "There's NVR, there's MDC, and then there's everybody else," says Morningstar analyst Eric Landry.

The stocks trade at a premium relative to the sector: NVR shares trade for 1.3 times book value (assets minus liabilities), and MDC trades for 1.1 times book value. NVR also happens to be the only large builder that is expected to turn a profit in 2009.

Although luxury is practically a dirty word in light of Americans' newfound penchant for thriftiness, luxury home builder Toll Brothers (TOL) is another potential winner. Toll is the only large builder to cater exclusively to the high-end market. Its expertise in that niche gives it extra clout among sellers of land, and the company is talented at choosing locations that appeal to its target audience.

Landry says the Horsham, Pa., company should come out of the recession with a larger share of the luxury market than it had going in.

If you find picking individual stocks too onerous or too risky, buy an exchange-traded fund that focuses on the building sector. A fine choice is SPDR S&P Homebuilders ETF (XHB), which charges just 0.35 percent in annual expenses.

But remember, nibble on these shares with caution.