

SARA-BAY FINANCIAL CORP.

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Extraordinary Popular Delusions and the Madness of Crowds

Over twenty years ago, I was talking with a young securities attorney in Key Biscayne with the objective of having him open an account with me. During the course of our conversations, he asked if I knew a good book would help him understand the stock market. I suggested one for him to purchase and read. He did buy it, subsequently became my client, and ultimately a good friend for many years. The book was Extraordinary Popular Delusions and the Madness of Crowds, written by Charles MacKay in the mid-1800's. While this work is wordy, it is enjoyable and decidedly worthwhile. It recounts the various and inane manias which have infected mankind throughout the ages: John Law's schemes, which almost bankrupt France, the idiotic prices paid for tulip bulbs in Holland, the Crusades to free the Holy Land, the popularity of witch hunts that killed thousands of people throughout Europe, as well as several other crazed passions. These were all causes, which garnered widespread acceptance among the masses and were temporarily deemed to be respectable.

We have all seen individual stocks make dynamic upside moves, driven by nothing more than expectations and vivid imaginations. This type of action has occurred so many times that they are too numerous to count. Infrequently, however, the entire stock market gets caught up in rampant upside speculation (some might call it irrational exuberance). This was clearly the case in the late 1990's and early 2000. Most people did not seem to be aware of it at the time, but the excessive valuations became crystal clear after the fact. During the three years of market decline, our managed accounts suffered, but nowhere near the drop in the S&P Index or even remotely close to the devastating drop in the NASDAQ. We had raised some cash, and I attribute it to the influence of books like the one above. In truth, I became concerned in 1997 and 1998, two to three years before the top, so our timing was less than perfect.

So, with regard to Charles MacKay's book, what brings it to mind? It is simply my observance (as a true non-professional) of the real estate market. The front page of last Friday's Sarasota Herald Tribune declared that real estate prices in Sarasota rose 36%, on an annual basis, during the first quarter. The median price of a home in this town is \$326,300. Prices in nearby Bradenton rose 45.6% during the same period.

If real estate continues to advance at thirty-six percent a year, today's median priced home of \$326,000 would be worth \$1,115,253 in only five years. Assuming one makes a down payment and borrows a million dollars on a thirty-year mortgage at 6%, the payment would be about six thousand dollars a month. This does not count taxes or other ancillary expenses the happy homeowner must pay. Remember, this is the median, and barring massive inflation, most people simply will not be earning that kind of money in five years.

"This time it's different," is a statement we are beginning to hear. It is the same proclamation that has heralded the culmination of almost every bubble in history. In the stock market excitement of early 2000 and the Florida land boom of the mid-1920's, there were "experts" who could give seemingly logical explanations as to the reasons for the advance. Today the excuses are: the demographics of baby-boomers, Florida waterfront

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communities are catching up with other markets, a growing population needs housing, etc. The fact is, that even with the wonders of creative financing, two plus two cannot be made to equal five.

In the same newspaper article referenced above, there is a quote: “Realtors dismiss the talk of a bubble . . .” Even as an avowed non-expert in real estate, I would beg to disagree. The speed of the advance, the topic of conversation in almost any group, and the stories of money to be made in months or weeks all serve to point toward a speculative bubble. Some bubbles are larger than others, and when the big ones burst, they do much greater damage to many more people, especially those who have borrowed the bulk of their purchase price.

Promises of large gains are so enticing as to be almost irresistible, while risks are downplayed, indeed if discussed at all. In my opinion, now is not the time for a novice investor to transfer money from savings or other investments to real estate speculation. The most profitable investments are made quietly when they are rarely of interest to most people.

Once again, thank you for the trust you continue to display by being our customer. Barbara, Esther, and I will do our utmost to give you our best service and advice.

Sincerely,



J. Michael Hard

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