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THANKS FOR WRITING IN

Thanks for writing in. Please keep those cards and letters coming.

Several of you have asked about guest-writing features for upcoming newsletters. If you have expertise in an area that could be of interest to our readers, please email us at info@pathfinderfunds.com with information about your proposed subject matter – we will be happy to consider it for a future edition.

CHARTING THE COURSE

2012: The Great Transition

Ten Predictions for the Year Ahead (Including a Few Shockers)

By Mitch Siegler, Senior Managing Director



“A triumph of hope over experience.” That’s what 18th century English writer Samuel Johnson said about second marriages but that’s how we feel about the parade of fixes for Europe’s debt crisis, America’s deficit and banks’ troubled loans. Hope springs eternal, we reckon.

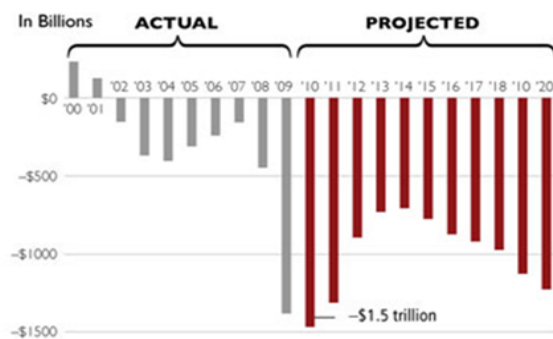
As we ring in the New Year, the Great Recession of 2009-2011 gives way to the Great Transition of 2012. The question is “Transition to what?” We recall that old Chinese adage “May you live in interesting times.” We’re sure 2012 will be interesting but our Mandarin is awfully rusty and we wonder if interesting translates to volatile and roller coaster-like.

In the U.S., pundits predict the 2012 presidential election could be the most important in our lifetimes. Across the pond, the potential collapse of the E.U. creates challenges that boggle the mind – and will likely send ripples across the pond that may end as a tsunami on our shores. Japan remains mired in a 20-year economic slump and China’s economy is slowing.

Investors remain shell-shocked after another uninspiring year for the stock market (the S&P 500 finished 2011 unchanged and equity investments have gone sideways for a decade). Tried-and-true strategies of yesteryear – buy and hold and 60/40 equity/fixed income mix (or 40/60, for the older set) are a sure-fire recipe for plenty of delicious Hormel® chili and Kraft® mac-n-cheese dinners during our golden years. Alternative investments – distressed real estate, managed futures or lending platforms – are popping up on investors’ radar screens.

When we last sang Auld Lang Syne, we offered up *“Ten Predictions for 2011.”* A year later, it’s apparent that the Fed’s stimulus-inducing strategies have not succeeded – unless your definition of success is swelling the U.S. budget deficit (\$1.65 trillion in 2011, projected to exceed \$1.0 trillion all the way out to 2020, per the Congressional Budget Office; before 2009, the deficit never topped \$1.0 trillion). And the Administration’s “tax the billionaires and millionaires” rhetoric is a sure-fire way to induce CEOs to forestall investment and small business owners to avoid risk-taking and hiring.

Obama Deficits will Exceed Previous Deficits



Source: Heritage.org, Congressional Budget Office and Office of Management and Budget

The trouble with the future, according to American humorist Arnold Glasgow, is that it

usually arrives before we're ready for it. Before we stick out our necks for 2012, let's see how we did with our 2011 predictions:

- 1. Unemployment rate will remain painfully high (A+)** – The good news is the official unemployment rate declined from 9.8% in January to 8.6% in December. The bad news is that it's still well above our very, very *best case* forecast of 8.5% made a year ago. And, the U-6 rate (which gives effect to the millions of discouraged folks who've stopped looking for work and those part-timers seeking full-time work) remained stuck at a painfully high 15.6% in November. We feel for them.
- 2. Inflation and interest rates will remain low (A+)** – We saw lots of slack in the economy a year ago and forecast rates would remain unchanged until Q4, 2011. At press time, the Federal Funds rate was 0.25%, 30-day LIBOR 0.27%, prime rate 3.25% and 30-year fixed mortgages under 4.0%. Well, we were spot on yet too optimistic once again (make that “unchanged until after the presidential elections,” please).
- 3. Consumer credit will continue to decline (B+)** – You wouldn't know it by looking at the crowds in the Apple® store, but we still think the Great Recession has brought a return to frugality for the masses. Sure, lower rates are a boon to homeowners, but if you've refinanced or know anyone who has, you'll know that, in the words of the David Bowie song, “It ain't easy.” Consumer credit shrank by \$60 billion in Q3 to \$11.66 trillion, according to the N.Y. Fed. This is 7% below the \$12.5 trillion peak in Q3, 2008. This level of decline is unprecedented. And, as anyone who's bought groceries in the past three years knows, prices aren't exactly declining – so the *real* decline in consumer spending is much greater.
- 4. Positive retail news won't last (B-*)** – Consumer spending has actually hung in there. Black Friday sales set records. Christmas was okay for many retailers. Storm clouds remain on the horizon. Adjusted for inflation, Americans' disposable income declined in 2011. The savings rate, which rose sharply during and after the '07-'09 recession, fell year-over-year from 5.3% to 3.5% through October, per the Commerce Department. Revolving credit is trending up – many households are financing grocery purchases on credit cards to make it to the end of the month. With high unemployment, declining house prices and stock portfolios flat for a decade, strong consumer spending doesn't compute. When the bills come due, consumer spending will pullback.
- 5. Housing will roll over again (A-)** – Last year, on the heels of the expiration of the first-time homebuyer's tax credit, which goosed housing sales in the first half of 2010, we said “another 5-10% decline in housing prices in 2011 seems baked in the cake.” Through Q3, the median U.S. housing price was down 3.9%, according to S&P/Case-Shiller – down to Q1, 2003 levels. Q4 will be tough – existing November home sales, announced at 4.42 million in late December, came in far below estimates of 5 million+. Our forecast for a 5% or greater decline for 2011 seems a pretty safe bet.
- 6. Mid to high-end housing prices will be hard hit (B)** – Last year, we were troubled by the difficulty buyers had obtaining jumbo (\$750,000+) loans and the implications for



pricier homes. It's been a mixed bag, depending on the area. In many high-end neighborhoods, sellers who've owned for years with imbedded home equity, haven't slashed prices so transaction volumes remain low, making it difficult to gauge the market. In second-home markets, sales volumes and prices continue to get pummeled. Our friend, mortgage and housing guru Mark Hanson calls Santa Clara County (Silicon Valley), CA "a perfect example of an overvalued market with clear signs of weak supply/demand fundamentals that will cause further house price depreciation in 2012."

7. **Mortgage interest tax deduction will be scaled back (C*)** – When we saw a survey in 2010 showing 60% of Americans favor a modification of the mortgage interest deduction and then saw this again on the Bowles-Simpson Commission's laundry list of budget-deficit reduction strategies, we made this call. Hasn't happened yet but the Occupy Wall Street crowd surely loves the concept and capping the deduction and eliminating it for second homes fits squarely in the current administration's agenda. So, give it time. [See excerpts from President Obama's December 6, 2011 "class warfare" speech in "Notables and Quotables," below.]
8. **Dozens of municipalities will default on their bonds (B-*)** – We thought governments' fiscal challenges would make headlines in 2011. For most of the year, nada. In October, Harrisburg, PA filed for bankruptcy. In November, Jefferson County (Birmingham), AL filed the biggest municipal bankruptcy in U.S. history, \$3.7 billion. Google "state municipal bankruptcy" and you'll get 22 million hits. Analysts are whispering about imminent fiscal challenges facing IL and CA with NY and NJ (all Democrat states, incidentally) close behind. A reading of the tea leaves suggests bailouts are coming.
9. **The Euro will fall (B+*)** – We've been saying so since early 2010 when the Euro was \$1.45. It started 2011 at \$1.32 and ended at \$1.29 and change. The shorts are pretty much out of the trade now so look for the Euro to continue trending south. We were early on this one but Greece, Portugal, Spain, Italy and others still threaten to unravel the E.U. Maybe 2012 is the year for that European vacation?
10. **The consensus may be wrong on the stock market (A+)** – Sentiment for stocks was wildly bullish this time last year (all ten strategists in December, 2010's *Barron's* "Outlook 2011" issue called for an up market in 2011, with the average forecast for a double-digit advance and a range for the S&P 500 of 1,250 to 1,450). We thought it was probably the egg-nog talking, which made the contrarian in us downright ebullient. Well, 2011 was sure a fine year to avoid stocks. A wild roller coaster ride that ended with the S&P 500 finishing the year unchanged.



The asterisks for #4, #7, #8 and #9 denote "incomplete" (we're early). Overall 2010 marks: B+.

Ten Predictions for 2012 (including a few shockers):

1. **The global economy will endure a significant deleveraging cycle** – Deflation, not inflation, remains the dominant theme – for proof, look at recent downward market action

for gold and the 10-year Treasury bond yield, which ended the year at 1.86%. Just as it was essential to understand that the peaking of the 50-year super-cycle led to the '07 financial crisis, today it's critical to see the linkage between the bursting of the credit bubble and decisions in millions of corporate boardrooms and household dinner tables. European sovereign debt defaults and write-offs, combined with debt repayments, bank consolidation, currency debasements and increased savings, will transform western economies. Notwithstanding record stimulus programs, the world needs to deleverage and the result will be deflationary. (Yes, Virginia, inflation lies ahead. To quote QB Asset Management, "There will be global hyperinflation that peels the skin off your face." But, we see deflation first; 2012 will be a harbinger of that trend.)

2. **Look out for QE3** – Most pundits think the Fed's gun, used to stimulate the economy, is out of bullets. We won't be surprised if the Fed finds one more and stops paying the banks interest on their reserves before 2012 is out. Today, banks don't have to make loans to make money – they can simply collect interest from the Fed on their currency reserves. If the Fed stops this gravy train, banks will make loans like there's no tomorrow and send the economy on another massive sugar high. In this case, don't expect high quality loan underwriting and look for the money supply to explode. This, of course, will sow the seeds for inflation a year or two later.
3. **Interest rates will remain low until at least the end of 2012** – We won't see interest rates creep up until late next year, at the earliest. The current über-low rates are the result of central bank manipulation. The yield on the two-year is an astonishingly low 0.25%. It ought to be north of 3%, in line with price inflation.
4. **The Fat Lady STILL hasn't sung on unemployment** – Sure, it's a time saver for a part-time newsletter prognosticator to dish up the same forecast three years in a row. Sadly, it's the data, not a desire to save a few minutes that drives this prediction. Blue Chip Economic Indicators compiled estimates from 50 forecasters in its December 10th report. The ten most pessimistic forecasters foresee a rise in the unemployment rate from November's 8.6% to 9.2% by Q4, 2012. The ten most optimistic see the rate falling to 8.1%. Our relatively downbeat call in an election year when the campaign promises will be thick and the cash from Washington flowing: the same or worse (8.6%+).
5. **Real estate will remain a "tale of two cities"** – We've been astounded at the dichotomy in commercial real estate. Prices for trophy properties declined 40% from the '07 peak to the '09 trough and have since recovered about half of that, for a net-net decline of 20%. Meanwhile, the value index for distressed real estate assets is down 58%, with virtually no recovery. We think capital allocations are out of whack, creating bubbles in certain sectors and markets and opportunities in others. This trend will continue in 2012.
6. **A bottom for housing prices is in sight** – More than five years since we founded Pathfinder to capitalize on the unwinding in real estate, we see (drum roll, please) a bottom in entry-level home prices. We'll defer to the analysts at Goldman Sachs (who have a larger research budget than us) for the data. Goldman thinks valuations have now



returned to “normal” levels, as demonstrated by the price/rent ratio (50% above its long-run value in early 2006, now slightly below its historical average). That translates to record affordability, for those who can obtain financing. Counterbalancing that are historic levels of housing supply and high mortgage delinquencies. Goldman sees a further 2.5% decline in the Case-Shiller index from mid-2011 to mid-2012 followed by stabilization the following year. Doesn’t mean all homes or all areas. Nor does it mean big appreciation in 2013. More of a bouncing along the bottom for a few years, we think.

7. The government will serve up a massive home mortgage refinancing plan – After TARP, HAMP, the first-time home-buyer tax credit, cash-for-clunkers, QE1, QE2 and a 0.25% federal funds rate, not many policy initiatives remain to generate economic growth. One ‘Hail Mary’ plan generating interest on both the right and left this election year would permit homeowners with good credit, including those underwater on their homes, to obtain super-low (4%) mortgage rates. The program would likely be targeted to the \$5 trillion of mortgages guaranteed by Fannie Mae and Freddie Mac, which comprise half of total mortgage debt and could goose consumer spending by \$50 to \$75 billion.

8. The E.U. will partially break apart – We’re likely early, so indulge us, please. The E.U. is already in recession with austerity measures barely initiated. Ratings agencies have downgraded Spain, Portugal and Italy; Hungarian and Greek debt is junk. France will lose its AAA rating. Only way out of Europe’s debt problems – growth. And, just three paths to take – austerity (spendthrifts in Greece, Spain and Italy won’t abide it), private sector-style debt restructuring (the correct approach but it would bankrupt the banks, wallowing in troubled sovereign debt) or bailout after bailout (won’t cure the underlying problem but an easy out for politicians – *et voila*). In December, the world’s largest central banks announced yet another coordinated monetary easing program. Each country prints more currency and lends it to other central banks, who, in turn, re-lend it to local banks, a scheme that would make Charles Ponzi proud. When all these countries (which lack unified banking systems and budget/tax policies) put a common currency ahead of their differences in language, history, social programs, work ethics and trade priorities, it can only end one way. (Mental image: Rearranging deck chairs on R.M.S. Titanic.)



9. U.S. state budget issues will displace Greece and Italy in headlines – While actual bankruptcy filings probably won’t occur until 2013, don’t be surprised if we hear rumblings about such filings late this year from IL with CA squawking in 2013 and NY and NJ not far behind.

10. U.S. economy will have another recession while stock market *could* hit a new high – No, they’re not mutually exclusive. We foresee gross domestic product declining by -1% to -2% in 2012. In response, the Fed may take aggressive stimulus action to keep the wheels from flying off the bus, which could propel the DJIA to 14,000. It doesn’t mean we’re pining to own stocks (giving effect to inflation, they’ve delivered zero real returns during the past ten years and we think Dow 10,000 makes more sense than Dow 14,000). We’re just tossing out the possibility that these two seemingly incongruous events could

occur simultaneously.

We wish you and yours a very healthy, happy and prosperous new year. We'll report back in 12 months to let you know how we did.

Mitch Siegler is Senior Managing Director of Pathfinder Partners, LLC. Prior to co-founding Pathfinder in 2006, Mitch founded and served as CEO of several companies and was a partner with a boutique investment banking and venture capital firm. He can be reached at msiegler@pathfinderfunds.com.



SELECTED PATHFINDER CLOSED TRANSACTIONS

Pathfinder Partners, LLC is the sponsor of the Pathfinder Opportunity funds, which acquire with institutional capital partners, distressed real estate properties and the underlying mortgages from financial institutions.

<p>GRANT STREET MANSION</p> <p><i>23,000 square foot historic office building in Denver, CO</i></p> <p>December, 2011</p>	<p>VISTA LAGO APARTMENTS</p> <p><i>\$3,200,000 defaulted senior mortgage on 102-unit apartment in Austin, TX</i></p> <p>September, 2011</p>	<p>BAROLO PLACE CONDOS</p> <p><i>16 residential condominiums in Scottsdale, AZ</i></p> <p>August, 2011</p>
<p>DORSEY PLACE CONDOS</p> <p><i>84 residential condominiums in Tempe, AZ</i></p> <p>July, 2011</p>	<p>DOBSON PLACE APARTMENTS</p> <p><i>120-unit apartment complex in Mesa, AZ</i></p> <p>July, 2011</p>	<p>THE SANCTUARY TOWNHOMES</p> <p><i>\$9,400,000 defaulted senior mortgage on 12 residential townhomes in Seattle, WA</i></p> <p>June, 2011</p>
<p>OTAY OFFICE CONDOS</p> <p><i>New, 68,000 square foot office condo project in Chula Vista, CA</i></p> <p>April, 2011</p>	<p>ORANGETHORPE OFFICE</p> <p><i>\$11,500,000 defaulted senior mortgage on 100,000 square foot office building in Anaheim, CA</i></p> <p>April, 2011</p>	<p>HUNTER'S CHASE CONDOS</p> <p><i>20 new residential condos in Denver, CO</i></p> <p>April, 2011</p>
<p>METRO LOFTS</p> <p><i>\$3,800,000 defaulted senior mortgage on a new, seven-unit mixed use project in Berkeley, CA</i></p> <p>December, 2010</p>	<p>LAS BRISAS CONDOMINIUMS</p> <p><i>18-unit condominium project in Long Beach, CA</i></p> <p>October, 2010</p>	<p>HAWTHORNE 44</p> <p><i>\$6,500,000 defaulted senior mortgage on new, 27-unit condo project in Portland, OR</i></p> <p>September, 2010</p>

FINDING YOUR PATH

2011 – A Year of Raves and Rants

By Lorne Polger, Senior Managing Director



2011 was an interesting year at Pathfinder. We closed our second investment fund and opened our third and fourth funds. We made ten commercial investments, a new record. We sold several portfolio investments and made nice profit distributions to our investors. We made new contacts and deepened our relationships with existing ones. We ran a few races, took a few trips, put on a few pounds, lost a few pounds and got a little greyer, older and wiser. After reflecting on the year, here are my raves and rants (I like to lead with the positive).

Rave. Friends, business associates, advisors and investors. Without you, we could not have gotten to where we are today, five-and-a-half years after starting our company. In 2011, we crossed over the \$400,000,000 mark in investments, the 2,000 mark in number of multifamily units and the 100 mark in number of lunches Mitch and I had at *Specialty's*, the great, new café next to our office. We especially appreciate those that have been with us from the start. We are forever grateful.

Rant. National politics. Regardless of party affiliation, no one can be proud of political gridlock on a national level, and the seeming inability of government (at virtually all levels) to be in touch with the needs and wants of its electorate. It's extraordinarily disappointing.

Rave. My family. The feeling of accomplishment and personal satisfaction in seeing your high school senior make it through the dreaded college application process in one piece, and look excitedly toward her college years (even if the "dream school" admission is still pending). The joy in seeing your son physically and emotionally rebound from a terrible accident, and knowing the satisfaction of marrying right many years ago – since the success of the kids was in large part due to my better half.



Rant. The cost of college education and the performance of 529 plans over the last ten years. Ugh. Somehow, I neglected to forecast losses combined with 150% tuition inflation when I planned for kids' college 15 years ago. Way behind on that one.

Rave. Southwest Airlines. I flew 70,000 miles in 2011, 90% on SWA. They get it. From an easy reservation and ticket change system, to the Fly By Lane (not an "A" list member yet? Better get on that), to flight attendants with a sense of humor. Smart company that allows its employees to take the initiative to make a difference. It shows.

Rant. The rest of the airline industry. They don't get it. Not even close. Pretty much hate flying with anyone else these days. And by the way, why can't anyone make a comfortable airplane seat? Is it that difficult? If Ford, GM and by gosh, even Chrysler figured out how to

make a better car, why can't someone figure out how to make an airplane seat that doesn't require six hours of yoga stretching after a three-hour flight?

Rave. Seattle, Portland, Denver and Phoenix – cities I spent a fair amount of time in during 2011. Despite challenges, all four appear to be heading in positive directions with proactive, get-it-done municipal governments, strong job growth, good infrastructure and public projects/initiatives.



Rant. Los Angeles, Las Vegas and Las Cruces. Still can't figure out why people live there. (Not so much Las Cruces, but it seemed like I needed a third "Las" and there weren't any others to pick on. Apologies to both of our loyal readers from Las Cruces.) L.A. is a tough place for business. Featuring a ridiculous level of bureaucracy, little long term planning, outrageous traffic and congestion, smog and did I mention traffic? On the other hand, after spending a day in L.A., I appreciate why I live in San Diego that much more. And Vegas – destined to remain a one-trick pony, tied to the gaming industry.

Rave. The entrepreneurial spirit still alive and well in the U.S. Given the roadblocks from a brutal economy and unnecessary governmental restrictions, now, more than ever, I truly appreciate and applaud those who have had the guts to strike out on their own. American initiative and entrepreneurship will be a key building block for a recovery.

Rant. Residential and Commercial Lenders. Really, should it take me 16 weeks to complete a refinance of my conforming first mortgage at 30% LTV? Really, should banks be pulling lines of credit from 20-year business relationships just because the bean counters don't like an industry type even if the borrower is profitable? I know banks are suffering from regulation overload. But take a small risk. Bet it won't hurt your bottom line.

Rave. Technology. I marvel at it, every day, even with a slight case of intimidation. I continue to be amazed at how it has changed our lives in such a short period of time. I'm fascinated by how both my kids' and parents' generation have adapted to and embraced it. My mother is friends with my kids on Facebook. I, on the other hand, have been blocked by my kids from seeing their pages. Perhaps some things never change. New Year's resolution: to switch from Blackberry to iPhone.

OK, I'm done raving and ranting now. Here's hoping that the year ahead is filled with health, happiness and prosperity for you and yours and wishing you more raves than rants.

Lorne Polger is Senior Managing Director of Pathfinder Partners, LLC. Prior to co-founding Pathfinder in 2006, Lorne was a partner with a leading San Diego law firm, where he headed the Real Estate, Land Use and Environmental Law group. He can be reached at lpolger@pathfinderfunds.com.

GUEST FEATURE

FDIC Insurance and CRE Volatility

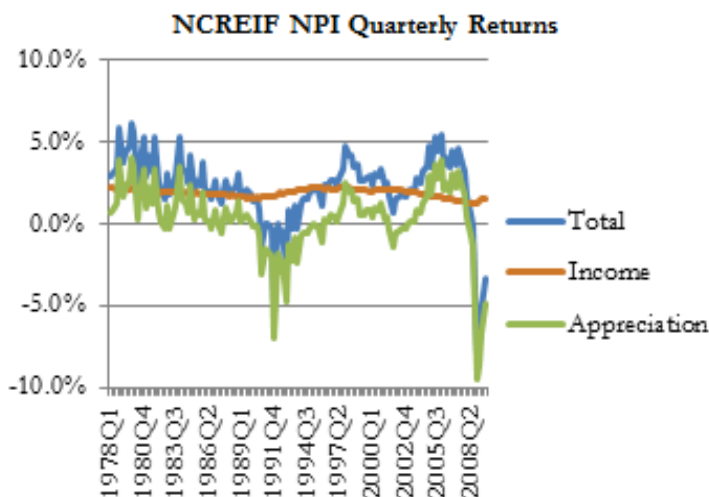
By: Timothy J. Ballard, Chief Investment Officer, Buchanan Street Partners



Regardless of all of the talk at the peak of the market in 2007 about a paradigm shift of value stability, real estate valuations continue to demonstrate high volatility. In contrast, historical property cash flows have proven to be very stable with little movement over the short to medium term. However, property values are often disconnected from their underlying cash flows.

This volatility has proven to be a major issue for commercial property owners and lenders with a significant contributor being the structure of our banking system. Many banks continue to fail (84 this year) due to their exposure to commercial real estate loans. Below are my thoughts on the drivers of this instability and how it could be remedied.

As measured by NCREIF NPI, commercial real estate has a long history of delivering very consistent cash flow return. Over the last 30 years, the cash flow return (red line) has averaged 7.3% on an annual basis with low volatility. Never has the cash flow return been negative. In contrast, the portion of return due to property appreciation has been far more volatile and a much more minor part of the overall return. Over the same time frame, appreciation (green line) has averaged 0.6% annually with significantly more volatility. Appreciation returns have ranged from -3.7% to 9.5% on a quarterly basis.



Source: NCREIF

The volatility of appreciation has proven to be very consequential to investors, especially those that utilized leverage. Many owners lost all equity invested in leveraged assets, especially in the early 1990's and during this last economic downturn. Much of this volatility however, is avoidable and is directly related to how commercial real estate is financed. Given the structure of real estate debt markets, the availability of debt over the long term has

been highly unpredictable. Leveraged investors must look at not only interest costs but the potential consequences of a loan coming due without a suitable replacement. When that

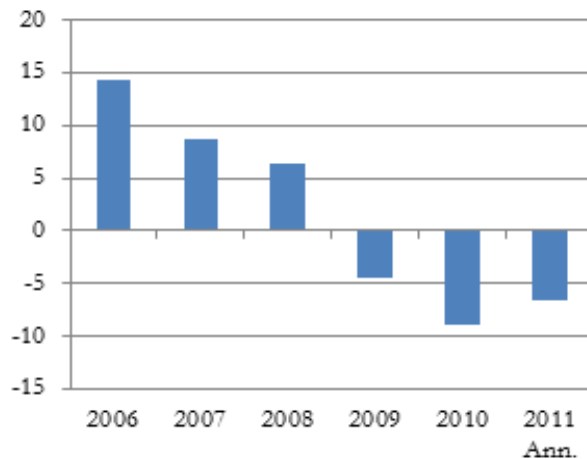
happens, the true cost of that loan is potentially the loss of all equity. In order to better understand the issue with real estate debt markets, let's look at one of the last banks to fail this year, Community Banks of Colorado with \$1.3 billion in deposits. The FDIC estimates that this failure will cost the FDIC approximately \$225 million. Half of the bank's loans were in commercial real estate, 30% of which were problem loans.

Throughout the financial crisis, this bank continued to attract deposits. Even after agreeing with the FDIC in March, 2009 to make wholesale changes in their operations, deposits continued to increase – apparently, depositors weren't paying attention. During the last nine months, the bank's Tier One capital fell by two-thirds and, in the second quarter, CRE loans represented 18 times Tier One capital. The reality is that this bank failed two years ago, but the regulators just got around to recognizing it.

Why is this important? More than three years into the banking crisis, the FDIC is still closing \$1 billion banks due to their commercial real estate issues. As these failures continue, regulators continue to clamp down on banks with questionable CRE portfolios. This will further restrict lending activity and potentially cost taxpayers and depositors billions due to imprudent lending practices. Oddly, these failures are occurring in an environment where real estate fundamentals and valuations are improving. Not only are bank failures expensive, they continue a vicious cycle where less available debt puts pressure on valuations, necessitating write-downs, causing additional bank failures.

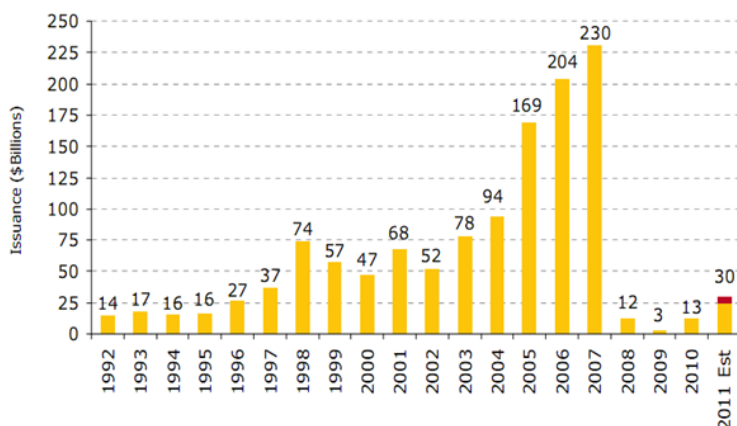
Most CRE loans have been issued by banks and securitized lenders. Banks aggressively lend when times are good as it's an easy way to grow assets in large chunks. This lending has a domino effect – pushing values up as properties are capitalized with more cheap debt capital. The opposite is true on the downside, as lenders retreat and borrowers replace debt with more expensive equity, eroding property values. The graph below shows that banks grew their real estate lending by 14% in 2006, helping to create the market peak in early 2007. As lenders aggressively cut lending beginning in 2008, CRE values collapsed.

Banks Continue To Cut Lending Volumes for CRE



Source: Federal Reserve

CMBS Securitization Remains Low



Note: Excludes agency deals and resecuritizations. 2011 is an estimate.
Source: Wells Fargo Securities, LLC and Intex Solutions, Inc.

The CMBS market is even more volatile as these lenders are trying to capitalize on the net present value of a 7-10 year loan hoping to make a 2-3% profit. This profit is meaningful to the originators because of the massive underlying leverage employed, providing a false sense of real returns. Any slight decline in the markets or ratings levels can cause profits to immediately vaporize. With this extreme leverage, profitability and volatility, we have seen the industry grow exponentially, completely shut down, restart and once again begin to struggle. At the beginning of 2011, firms committed \$1 billion to CMBS and hired large teams to execute loan originations to only close their shops nine months later. This, of course, does not provide for a reliable source of capital. Again, like the banks, this is a problem of too much leverage.

How can this be fixed? First, the government has created a monster by allowing thousands of banks to benefit from Federal government backing through FDIC insurance. Why do we need 7,000 banks in America? Can you imagine 7,000 airlines or car manufacturers to choose from? Throughout history, overpopulation turns out badly – think lemmings, locusts, mortgage brokers, etc. By comparison, Canada has 22 domestic banks and Japan has 40 domestic banks. Without FDIC insurance, banks would have to compete for capital and survive on their own merits. FDIC insurance has allowed depositors to ignore the safety of a bank and its management teams' ability to invest wisely. Every depositor knows that it doesn't really matter if the bank fails as they will get bailed out by the FDIC. This allows banks to leverage themselves at least ten times with a very low cost of capital and make risky loans. Further, banks routinely make long term loans that are mismatched with the short term nature of demand deposits. While a depositor can immediately withdraw cash from a bank, the bank cannot immediately call a construction loan.

The FDIC's current plan is to charge banks more for insurance. This is like giving a patient with a broken leg an aspirin. The FDIC needs to increase banks' required capital to qualify for the insurance (i.e., 25% required capital – investors bear the risk of bad behavior) or drop their insurance program altogether (depositors and investors bear the risk). If depositors did not solely rely on government guarantees, risky banks would need to pay more for deposits, depositors would be more careful about whom they did business with and bad banks would go out of business if they managed their affairs imprudently.

To net this out, the FDIC has become obsolete. It was created in a time where there were very few choices for safely keeping your savings after the Great Depression. With the advent of the modern financial system, investors have more than enough choices up and down the risk spectrum to invest their capital. Choices like buying a government bond mutual fund, which come with a better guaranty and without the risk to our economy of over-leverage and poor decision making by poorly run banks.

Obviously, this solution could not be employed immediately but if done prudently, could reduce the volatility of real estate investments. Consumers don't need 7,000 banking choices. For the banks, the current system ensures that everyone is miserable. This much competition incents the imprudent to behave very aggressively, until they go out of business or get bailed out by the government. Without this perverse incentive, the banking system would have fewer but healthier banks, creating more predictable investment outcomes.

Timothy Ballard is the Co-Founder, President and Chief Investment Officer of Buchanan Street Partners, a multi-billion dollar real estate investment management firm. Visit www.buchananstreet.com

ZEITGEIST - SIGN OF THE TIMES

A compendium of notable news articles relating to the economy, commercial lending and real estate which we've edited and commented upon.

Struggling Euro Banks Snap Up \$639 billion in Cheap ECB Loans

In late December, 523 European banks borrowed €489 (\$639 billion) in cheap, three-year loans from the European Central Bank. The unexpectedly high and broad-based demand highlights the depth of Europe's financial crisis.

The ECB wants the banks to use the funds to repay a portion of the \$700 billion in earlier loans maturing in 2012, including \$200 billion in the first quarter. Without the new loans, such repayments would be impossible and the banks would have had to further curtail business lending, adding to the slowdown in the European economy.



While the loans are a Band-Aid®, they don't address the root cause of Europe's financial crisis – heavily indebted governments with excessive spending and unsustainable borrowing costs.

[Editor's note: Of course, this is all somewhat meaningless as the debt is simply being moved from the left to the right pocket. A strategy of piling debt on top of more debt can only end badly, especially in a weakening economy.]

U.S. GDP Expanded at 1.25% for First Nine Months of 2011

The Commerce Department reported in December that the U.S.' third quarter growth rate was 2% and pundits are forecasting accelerating growth – perhaps 3% – for the fourth quarter. Relative to Europe and many other parts of the world, the U.S. appears to be one of the better investment climates.

[Editor's note: Since 3% was the rate of growth forecasted for all of 2011, don't pass out the champagne just yet. The Euro debt crisis, slowing growth in China and other emerging markets and fiscal tightening in the U.S. will be governors on growth in 2012. The U.S. is the tallest midget in the circus.]

NAR Revises Home Sales Data Back to 2007

The National Association of Realtors announced in late December that the number of existing homes sold was actually 14% below the level previously reported during the 2007 to 2010 period. Specifically, 2.9 million fewer homes were sold during those years than previously thought.

On the good news front, November's housing inventory was down 18% from year ago levels to 2.58 million units. However, realtors report that sellers are refusing to reduce prices further and buyers are frustrated because of limited selection and high prices.

Federal Housing Administration – Trouble Ahead?

The collapse in the housing market dealt a blow to Fannie Mae and the Federal Housing Administration. While the media has focused its attention on the woes of Fannie and Freddie, all is not well with the FHA. Nor has the National Association of Realtors, the housing industry's primary lobbying arm, lost its muscle.



During budget battles, the NAR wrangled agreement from a key Congressional budget committee to lift the maximum mortgage limit from \$625,500 to \$729,750 through December 31, 2013. The NAR says the deal is great for housing market “stability”. (Translation: government subsidies will keep flowing, even for pricey homes). The median nationwide home price was \$169,500 in Q3, per NAR data. Even in upscale markets, like L.A., median home prices continue to fall (L.A.'s is down from \$402,100 in 2008 to \$324,800 in 2011, less than half of the NAR's proposed new threshold.)

What's the big deal? The FHA's capital reserves are a shockingly low 0.24%, well below the 2.0% statutory minimum – for the third year in a row. According to a November *Wall Street Journal* article, the FHA's outstanding loan guarantees of \$1.1 trillion are 422 times its \$2.6 billion in capital reserves – that's a ratio that would make former Bear Stearns and Lehman Brothers executives blush.

In September, the FHA said it had more than 635,000 delinquent loans (8.7% of its portfolio). That's up from 8.4% in the prior year. Analysts estimate the FHA, which now accounts for about one-quarter of all home mortgages, is under-reserved by \$50 billion.

Banks, Brokerage Firms Cutting Jobs

On December 16th, Morgan Stanley joined the burgeoning list of financial firms by slashing 1,600 jobs in response to swooning markets. This year, 24 financial firms worldwide have cut or announced plans to cut 103,000 jobs, according to an analysis by *The Wall Street Journal*. Bank of America and HSBC have announced layoffs of 30,000 jobs each during the past several months. Citicorp and Credit Agricole also announced layoffs recently.

Analysts have cut earnings estimates for Morgan, Goldman Sachs and Bank of America citing “increased challenges financial markets face.” S&P said “the U.S. economy is undergoing its most radical structural change since the Great Depression.”

New York Real Estate Bubble?

So, if all of these financial services firms are cutting jobs, what are the implications for financial centers and for those real estate markets?

We enjoyed a recent *Barron's* article in which an analyst profiled SL Green (NYSE: SLG), a NYC office real estate investment trust with 62 properties, including 31 in Manhattan and the balance in the suburbs. SLG is trading at a sky-high valuation of 32 times “adjusted funds from operations” compared with an average of 23 times for office REITs. Teeny-tiny dividend, so really no yield.



Underlying the valuation is the belief that the NYC office rents will move upward, like trees growing to the sky. Unfortunately, SLG realizes 36% of its rental income from the financial services industry where, as noted above, layoffs are mounting. Downtown vacancy rates are 12% with rates in midtown hovering at 9%. It's a tenant's market with free rent, other concessions and generous tenant improvement allowances rampant.

[Editor's Note: SLG was trading at \$67.06 at year-end. The Barron's analyst pegs fair

value at \$40.00 with downside risk to \$20.00 in the event of a double-dip recession.]

U.S. Homeownership Rate Plummeting

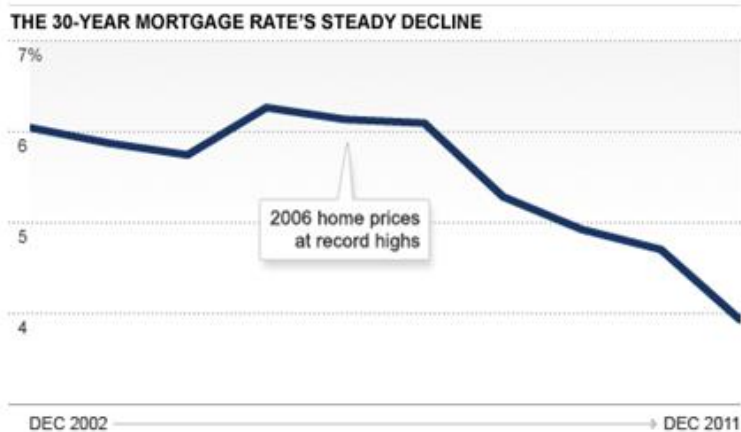
According to a November report from John Burns Real Estate Consulting, the U.S. homeownership rate is expected to decline eight percentage points from the 2005 peak of 70% to 62% in 2015.

The three main drivers are foreclosures (-5.6%), which have displaced millions of former homeowners; cyclical trends (-3.0%), including a weak economy, poor consumer confidence and tightening credit markets; and an aging population (+0.7%) a positive counterbalance to these two factors, increasing homeownership for those in their 60's and 70's. The homeownership rate is expected to increase after 2015, reaching 67% by 2025.

[Editor's Note: The American dream isn't dead but it does have a bad flu.]

Mortgage Rates Fall to Record Lows

Mortgage rates sunk to record lows again in the week before Christmas. The average rate on 30-year fixed mortgages dipped to 3.94%, matching the all-time low hit in early October, according to the weekly mortgage rate survey published by Freddie Mac. Meanwhile, 15-year fixed-rate loans hit a new record low of 3.21%, surpassing the record low set in October.



Source: Freddie Mac

Trouble Ahead for Commercial Mortgage Refinancing on 2007 Deals, Per S&P

More than half of commercial mortgages securitized as bonds in 2007 and maturing in 2012 may fail to refinance as maturing loans peak and skittish lenders refuse to refinance them, according to a December S&P report.

Nearly \$55 billion of securitized property loans come due in 2012, including \$19 billion which were originated in 2007, according to S&P analyst Larry Kay. The five-year mortgages have less than 50% odds of successfully refinancing, Kay said.

The year ahead will “usher in the first major wave of maturities from the 2007 vintage, which were issued during a frothy period at the peak of the market,” Kay said. “Retrenchment in the capital markets and among other lenders in the third quarter of 2011, which has continued into the current quarter, dims the refinancing prospects.”



Late payments on loans packaged into bonds are at 9.13%, up from 8.89% in January, according to the report. S&P forecasts delinquencies will rise to 9.5% to 10% in 2012.

Loans underwritten in 2007 will be challenged by tighter lending conditions, diminished borrower equity in the properties and the large loan amounts relative to current property values, S&P said. Property values have tumbled about 47% since the 2007 peak.

Today, lenders are generally willing to issue mortgages for no more than 70% of a property’s value, meaning nearly two-thirds of loans issued at the height of the real estate bubble will be difficult to refinance unless the borrower injects additional cash, S&P said.

Retail properties will have the most difficulty securing financing because of historically high vacancies and declining rents, according to S&P.

[Editor’s note: Pathfinder has been talking for several years about this upcoming “equity gap” – caused by declining property values, lower loan advance rates and tighter loan underwriting standards. It’s finally the stuff of front page articles in mainstream media.]

Typical American Household’s 2011 Gasoline Bill – \$4,155

For all the chatter about Washington shaving two percentage points off of the payroll tax for 2011 to stimulate the economy and boost jobs and economic growth, what’s not making the front pages is that most or all of the savings went up in smoke – literally.

According to the Oil Price Information Service, the typical U.S. household spent \$4,155 on gasoline in 2011, about 8.4% of the \$49,500 in median family income. That’s offset by a \$990 payroll tax cut for the same family. Walking and bike-riding are good for us!

TRAILBLAZING: SANCTUARY TOWNHOMES (SEATTLE, WA)

Completing the stalled conversion of a historic church into 12 luxury townhomes



Project Exterior



Unit Interior



Unit Interior



Unit Interior

The First Church of Christ Scientist, in Seattle's Capitol Hill neighborhood, was constructed from 1906-1909 and designated as an historic landmark in 1977. The building features neoclassical, European architecture and was constructed with Concord granite, quarter-sawn oak and Bedford limestone (used in many famous buildings of the era, including the Empire State Building, Pentagon and Washington National Cathedral).

In 2006, a Seattle developer acquired the property and began to convert the building into 12 luxury townhomes while preserving the architectural integrity of the original structure. As the project neared completion, the real estate market was unraveling. The borrower defaulted on the loan and the lender moved for the appointment of a court-appointed receiver. In June, 2011, Pathfinder and a partner acquired the senior mortgage and have been advancing the funds to complete construction.

The result is the Sanctuary, one of Seattle's most imaginative townhome developments – a state-of-the-art, earthquake and fire resistant building with modern conveniences in a turn of the century setting.

Each home has a private street entry but may also be accessed from an extraordinary central atrium. The eye is immediately drawn to the art glass oculus 40' above where sunlight pours through the colors to splash about the huge interior commons. Individual units vary – no two are exactly alike. However, each has a balcony overlooking the interior atrium and oculus. All have original, stained glass windows, seven have decks with amazing views, two have an entire wall of art glass and one has south facing art glass that streams color into the dining/kitchen area.

These homes are super warm and super cool. In most places, the walls are more than two feet thick, efficiently insulating from weather and noise. All of the electrical systems are completely new and contained in each home. Most units have maple cabinets, stainless steel counter tops and sinks. Steel and glass counterpoints original, massive plaster details that are simply breathtaking.

The Sanctuary's grand opening is in January, 2012. Units will be marketed for sale at a nearly 50% discount to original prices. For more information, visit www.liveatsanctuary.com.

NOTABLES AND QUOTABLES

“No matter how insignificant the thing you have to do, do it as well as you can, as much of your care and attention as you would give to the thing you regard as most important. For it will be by those small things that you will be judged.”

- Mohandas Gandhi (1869-1948)

“Statistics are like bikinis – what they reveal is seductive but what they conceal is essential.”

- Unknown

“Investment performance is what happens when events collide with your portfolio.”

- Howard Marks, Chairman, Oaktree Capital Management

“...What if the gains in spending, like the gains in the stock market, have also been a paper illusion – a function of higher prices, not rising unit demand?...In nominal terms, growth is up \$783 billion from its pre-crisis levels. But, in real terms, we're up an imperceptible \$27 billion. And that's relying on the government's accounting of inflation...It is truly stunning to think that, after 14 quarters, \$787 billion in stimulus, TARP and repeated extensions of

unemployment benefits, an unquantifiable number of housing rescue attempts and a tripling of the Federal Reserve's balance sheet, we got a \$27 billion (0.2%) increase in real growth, and a \$90 billion (or 0.96%) increase in real consumer spending...To describe this as a spectacular failure would be to flatter it obsequiously. Rather than celebrating the 'strength' of the economy, we ought to be panic-stricken that it took so much to produce so little...The degree to which the 'recovery' has simply been an inflation mirage is even more evident when you narrow the lens from the broadest measures of spending to the most discretionary, a la retail sales...The \$111 billion increase in nominal retail sales from its pre-crisis peak morphs into a \$113 billion decline in real terms. The ineluctable conclusion...consumers aren't spending because they want to; they're spending because they have to...sales at grocery stores have risen at an accelerated pace off the crisis lows while department-store sales have collapsed."

- Stephanie Pomboy, MacroMavens

"It is far better to grasp the universe as it really is than to persist in delusion, however satisfying and reassuring."

- Dr. Carl Sagan, astrophysicist and award-winning author (1934-1996)

"For many years, credit cards and home equity loans papered over the harsh realities of this new economy. But in 2008, the house of cards collapsed. We all know the story by now: Mortgages **sold to** people who couldn't afford them, or sometimes even understand them. Banks and investors **allowed to keep packaging the risk and selling it off**. Huge bets – and huge bonuses – made with other people's money on the line. Regulators who were supposed to warn us about the dangers of all this, but looked the other way **or didn't have the authority to look at all**.

It was wrong. It combined the breathtaking greed of a few with irresponsibility across the system. And it plunged our economy and the world into a crisis from which we are still fighting to recover. **It claimed the jobs, homes, and the basic security of millions – innocent**, hard-working Americans who had met their responsibilities, but were still left holding the bag.

Ever since, there has been a raging debate over the best way to restore growth and prosperity; balance and fairness. Throughout the country, it has sparked protests and political movements – from the Tea Party to the people who have been occupying the streets of New York and other cities. **It's left Washington** in a near-constant state of gridlock. And it's been the topic of heated and sometimes colorful discussion among the men and women...running for president.

But this isn't just another political debate. This is the defining issue of our time. This is a **make or break moment for the middle class, and all those who are fighting to get into the middle class**. At stake is whether this will be a country where working people can earn enough to raise a family, build a modest savings, own a home, and secure their retirement."

- Excerpt from President Barack Obama's December 6, 2011 speech, dubbed his "class warfare" speech by many pundits [**emphasis ours**]

[Editor's Note: During the past several years, we've seen dizzying amounts of government interference in the private sector. Bailouts of the banking system, Fannie Mae, Freddie Mac, AIG and the auto industry. Obamacare. First-time home buyer's tax credit. Cash for clunkers. That's just for starters. Our New Year's wish is that the economy be allowed to work – let it be. Below, a few pearls of wisdom on the subject:]

“The more artificial taboos and restrictions there are in the world, the more the people are impoverished...The more that laws and regulations are given prominence, the more thieves and robbers there will be...”

- Lao Tzu, Chinese philosopher in 6th century, B.C.

“The Sage says: ‘I take no action, yet the people transform themselves, I favor quiescence and the people right themselves, I take no action and the people enrich themselves...’”

“I would rather roam and idle about in a muddy ditch, at my own amusement, than to be put under the restraints that the ruler would impose. I would never take any official service, and thereby I will [be free] to satisfy my own purposes.”

- Chuang Tzu, Chinese philosopher, 4th century B.C.

“There has been such thing as letting mankind alone; there has never been such a thing as governing mankind [with success].” The world “does simply not need governing; in fact, it should not be governed.”

- Unknown

“Where knights and hosts could not be assembled, there was no warfare afield...Ideas of using power for advantage had not yet burgeoned. Disaster and disorder did not occur...People munched their food and disported themselves; they were carefree and contented.”

- Pao Ching-yen, Chinese philosopher, 4th century

“Each man has only to be left to utilize his own abilities and exert his strength to obtain what he wishes...when each person works away at his own occupation and delights in his own business, then like water flowing downward, goods will naturally flow ceaseless day and night without being summoned, and people will produce commodities without being asked.”

- Ssu-ma Ch'ien, Chinese philosopher, 2nd century, B.C.

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