IN THIS ISSUE

2  ANNOUNCING PATHFINDER’S NEWEST FUND!

2  CHARTING THE COURSE
   Into Thin Air

5  FINDING YOUR PATH
   The Seniors Are Coming! The Seniors Are Coming!

8  GUEST FEATURE
   Amenity Overload – What Apartment Renters Really Care About

11  ZEITGEIST: NEWS HIGHLIGHTS

13  TRAILBLAZING
   Talavera Condominiums, Tempe, AZ

15  NOTABLES AND QUOTABLES
   Optimism
CHARTING THE COURSE
Into Thin Air

By Mitch Siegler, Senior Managing Director

Dizzying heights. Intense peril. Practically no oxygen. An extreme need for caution: one false move and you could lose everything. We're not talking about the new film, EVEREST, the docudrama starring Jake Gyllenhaal and Josh Brolin about the simultaneous expeditions in 1996 resulting in the deaths of eight climbers.

We’re talking about the Thursday, September 17 meeting of the Federal Reserve’s Open Market Committee where, as we had predicted, the FOMC agreed to again leave the key Federal Funds rate unchanged at 0.0% to .25%. And, we’re talking about the more than $6 trillion in stimulus central bankers have injected into the economy these past several years that, by all accounts, hasn’t really turned the economy around (or, you might say, has vanished into thin air).

In one week in August, China’s woes manifested in a collapse of the Shanghai Stock Exchange, pushed down the S&P 500 by nearly 10% and increased the S&P’s Volatility Index to its highest level since 2011. Like climbers on Everest, the economy remains on thin ice and the Fed’s unwillingness (inability) to boost rates is just the latest glaring sign. The Fed’s key rate has been near-zero for 6½ years and the last time the Fed hiked rates was nearly nine years ago.

Investors and traders were not amused by the failure of rates to ascend once again following the Fed’s September meeting. Overseas markets immediately fell 2% to 3% and Wall Street followed suit the next day with major indices down 2% and oil tumbling nearly 5%. The Alice in Wonderland reaction – good news about interest rates staying low is bad news for the markets – may be explained by the fact that the Fed is essentially out of
bullets (climbing without an ice ax may be the more appropriate metaphor) and we’re starting to hear more cocktail party chatter about QE4 (yet another round of quantitative easing, Fed-speak for stimulative monetary policy).

The markets took notice of the Fed’s accompanying dreary statements about a weakening global economy, especially the references to the great China slowdown of 2015. China, heretofore, the global economic engine, is suffering from altitude sickness as its steady and stellar (or shaky and suspicious – depending on your point of view) economic growth rate of 7% has plummeted – with profound implications for employment and political stability. Commodity prices continue to free fall.

Fed Chairwoman Janet Yellen’s wait-and-see approach might be driven by the markets or by her desire not to repeat the mistakes of other central bankers, who tried raising rates after years of accommodative policy only to reverse course after acting too soon. The European Central Bank, which raised rates in 2011, turned a recession into something critics call a near-depression. U.S. Federal Reserve governors remain loathe to commit career suicide by raising rates too early and then having to reverse course.

So, is higher inflation just around the corner? Well, those who follow the Fed’s policy statements don’t think so; the Fed’s latest musings suggest we won’t see the 2% target rate of inflation again until 2018. And while a move up in rates at the Fed’s next meeting, in October, remains a possibility, it’s hard to call the first economic sedative in seven years this month (or even in December) a slam-dunk. The September tally showed ten Fed governors calling for a zero to 0.25% move up in 2015, six calling for .50%-.75% moves up before year-end and one super-dove calling for rates to be reduced.

A move up in rates is inevitable and odds are the Fed will act this year but global markets are a slippery slope. And the Fed’s decision not to act could pressure foreign central banks to raise their rates. “It puts pressure on the European Central Bank to act and pressure on the Bank of Japan to act” to stimulate growth says Andrew Balls, Chief Investment Officer for global fixed income at Pacific Investment Management Company (Pimco).

Smaller Real Estate Not Highly Correlated with Equity Markets

Meanwhile, commercial real estate continues to outperform, according to a recent Marcus & Millichap report, driven by increased investment, declining unemployment and generational trends. The shift in retail spending from brick and mortar stores to the Internet is driving demand for industrial space; industrial vacancy rates have fallen to 6.9%, per M&M. Increased hiring is driving down office vacancies, 15.3% in the second quarter; office space absorption should continue further given the dearth of new office construction. There’s similarly limited construction of retail real estate so any growth in demand swamps fixed supply. And, more than two-thirds of Millenials live in rental households, which explains the 97%+ occupancy rates Pathfinder is enjoying in many of our apartment properties.

So, if you expect the volatility and downdrafts in global equity markets to continue, one sector that has historically been loosely correlated, real estate, might be a good place to increase exposure. In 14 of 15 previous U.S. equity bear markets dating back to 1956, the home price index rose. During the Great Recession, of course, real estate markets collapsed together with stocks. But, that was an anomaly caused by subprime lending and
CMBS securitization according to Yale University’s Robert Shiller, co-creator of the Case-Shiller Home Price Index.

As we reflect on the downdraft and emotional angst facing traditional investors, we’re reminded of why we’re so keen on Pathfinder’s strategy of buying smaller properties – those below-the-radar of the larger institutions – where we can add value through renovations and upgrades and “manufacture income.” Another benefit of the asset class is that these types of investments are not highly correlated with broader equity markets, especially emerging markets – so they should provide a nice buffer (and cash flow) during periods of high volatility.

Markets ascend and descend – this is part of the natural order of things. As we look out over the next few months, higher volatility and more choppiness look like part of the landscape. And a Fed rate bump could be around the next bend in the trail. Whatever surprises global markets and central banks may throw at investors, we remain bullish about a real estate component – especially smaller, value-add properties – in an overall investment portfolio. Think of a real estate allocation as your support team on your next expedition – it’s easier to make the summit with their help.

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Well, we’re not getting any younger! We see it every day when we look in the mirror and conversations with friends increasingly turn to “what’s next for mom and dad?” I’ve reached the point where I’ve been discussing future housing options with my folks and we’re far from alone. That process has been really eye opening on a number of levels.

One of the most significant demographic trends is our aging Baby Boomers (increasingly seniors) and their housing transition. Boomers, those born between 1946 and 1964, number 76 million. By 2020, Boomers will be pre- and early-retirement ages (55 to 64 years) and the young old ages (65 to 74 years). The Social Security Administration estimates that 9,600 people a day are turning 65 in 2015, up from 7,800 a day in 2010. Today, 6.1% of the population is over 75, and by 2030, that’s expected to grow to 9.5%. In 1994, 3.5 million Americans were age 85 or older; that grew to 5.8 million in 2012 according to the U.S. Census Bureau and by 2040, it is expected to increase to a whopping 14.1 million.

According to the National Investment Center for Seniors Housing & Care, an Annapolis, Md., nonprofit organization that tracks the senior market, the senior housing segment fell off a cliff during the recession, along with the rest of the housing market. It has since bounced back, but since 80 is the new 65, it may take a few more years for demand to fully crank up, because the target population segment may choose to stay in their homes longer than previous generations did. The stigma often associated with traditional nursing homes (stark semi-private rooms, shared bathrooms, etc.) still looms over this sector, and while the majority of existing stock is obsolete, new options are becoming more readily available. With people living longer, there is a gray period that could last decades when seniors can live semi-independently. This factor has altered the makeup of 55+ developments in recent years.

Predicting what type of living arrangements seniors will seek out as they age, and when they may need senior housing, particularly given longer lifespans and changing attitudes about such types of housing, is a challenging task. The options are varied, both in terms of amenities and expense levels. Today, people may be able to continue to live independently, long past the time that we used to think was the “right time” to send sweet Aunt Edna off to the senior home. Perhaps they want to downsize, but can no longer easily accommodate multi-level housing due to health issues. They may be considering moving into communities that provide special services to seniors but are fearful of increased costs or potential loss of independence. These trends suggest a growing need for various types of transitional housing for our aging community. But we have plenty of affordable housing options for our senior community, right? Think again. Plenty of choices but they’re all rather expensive.

Available Options

Below are the most common senior housing options available. It may be helpful to think about each in terms of you or your parents’ situation.

Staying in the Home

Perhaps the most obvious choice for many seniors is to simply stay put. Certainly from an emotional standpoint, staying in your home may be the most comfortable alternative, as change is difficult, even more so as we age. And while on the surface this may make the most economic sense, there are physical, emotional and potential economic downsides, and various decision trees as a result. Do they have the ability and economic wherewithal to maintain and adapt their residence? Whereas a senior facility will generally have adaptive elements in parts of the home, that may not be the case...
in one’s existing residence. While certain things can be changed at minimal cost (tub access, grab handles, etc.), other elements (i.e., stairs) may be more difficult or costly to adapt. Do they have the ability or desire to continue to prepare their own meals? Do they need some assistance in the home? Although assistance in the home is readily available from various agencies, the costs of hiring home help can be significant (maybe more than the cost of a senior facility).

While not all seniors may need the full array of programming options typically offered in a senior community, there can be an increasing element of isolation for seniors living on their own, especially if they are no longer able or willing to drive or are far from various medical or social needs. So as with all of these options, there are both pros and cons depending on each individual situation.

**Independent Living Communities**

Senior independent living communities cater to those who are generally healthy and remain independent. Typically, residents live in fully equipped (i.e., full kitchen) private apartments or casitas. Dining services are generally offered and residents can typically choose to pay for a specified number of meals per day. Transportation and housekeeping services are available. Amenities usually include cultural, educational and entertainment programming.

Independent living communities are also known as retirement communities, congregate care, retirement villages, 55+ communities, senior apartments and continuing care retirement communities.

Financially, there are generally three types of programs available: Direct ownership of a residence, a buy-in program with a percentage rebate upon transfer or death and pure rental. In the first two cases, there are typically large homeowners association fees. In all three situations, housing costs are covered privately, and although there is some government funded programs, options are limited.

There is a very large price difference among independent living communities. In San Diego, for example, the median monthly rent in coastal areas for a couple range from $4,000-$10,000. Not an insignificant amount for those on a fixed income, especially since they have other monthly expenses that will need to be covered (medical, insurance, auto, entertainment, travel, etc.).

**Assisted Living Communities**

Assisted living communities are designed for those who are no longer able to live on their own, but do not require the high level of care provided in a nursing home. Assistance with medications, activities of daily living, meals and housekeeping are routinely provided. Residents live in private apartments which frequently have a limited kitchen area. Staff is available 24 hours per day for additional safety. Most assisted living communities provide licensed nursing services. Social activities and scheduled transportation are often available. A special memory care or Alzheimer’s unit is available in some, but not all communities.

Financially, this is mostly private pay, although some take Medicaid. Given the additional care, the cost of assisted living communities is generally greater than that of an independent living community.

**Nursing Homes**

Nursing homes (also known as convalescent care, nursing centers, skilled nursing and long-term care facilities) provide around-the-clock, skilled nursing care for frail patients who require a higher level of medical care and assistance. 24/7 skilled nursing services are provided by licensed nurses. Many nursing homes now provide short-term rehabilitative stays for those recovering from an injury, illness or surgery. Long-term care residents generally have high care needs and complex medical conditions that require skilled nursing services. Residents typically share a room and are served meals in a central dining area unless they are too ill to
participate. Activities are also available. Some facilities have a separate unit for memory care or Alzheimer’s residents.

Payment sources include private pay, private long term care insurance, Medicare and Medicaid. Not surprisingly, given the added care elements, the cost of nursing homes is generally greater than that of independent living and assisted living communities.

Trends

In addition to folks living longer and staying in their homes longer, another key trend is in this space is continuity of care. An increasing number of facilities now offer care throughout the spectrum, so that a resident can “age in place” (i.e., transition from independent living, to assisted living, to possibly nursing care or memory care, all within the same facility so that they have minimal disruptions both physically and socially during the transition periods).

Costs

As noted above, the costs of all of these housing options are high, and rising. Clearly, a significant portion of the aging population will not have the financial means to meet these costs. Is this a looming crisis? Possibly. Have we properly planned for it? Probably not. That will likely be more fodder for the elections of 2020 and beyond, but it’s certainly not too early to start talking about it with your parents and grandparents, and to begin planning for it.

Conclusion

We haven’t invested in senior housing yet here at Pathfinder, but many of our friends and associates are long-time players in the space. The trends and demographics suggest that this may be an attractive real estate sector. Well, it’s getting late (4:30 p.m.), so I’m heading out for the early bird dinner.

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Resort-style pools, virtual group fitness, rock walls, bowling alleys, entertainment kitchens, fully equipped business centers and pet washing stations – these days, the sky is quite literally the limit for apartment amenities. Once off-limits to tenants, rooftops are now lavish gathering areas replete with grills, gardens, pools and outdoor movie theaters, and have become a near standard amenity in many cities. And the ubiquitous doggie park has also been a hit in the U.S., where people are spending more money on their pets than ever, collectively laying out in excess of $58 billion on Fido's food and frills in 2014 (American Pet Products Association).

As the housing market continues to improve and the “lifestyle apartment” gains popularity, developers are piling on the amenities to entice renters and gain an edge in an increasingly competitive market. Being multifamily rehabbers and developers ourselves, extravagant (and, in our opinion, borderline outrageous) amenities like rooftop bocce ball and golf simulators beg the questions: which amenities do renters really care about, which are they willing to pay more for and which have staying power? For insight, we looked to renters themselves to understand their behaviors and attitudes toward atmosphere, health, eco-consciousness and social life. After visiting several of the new lifestyle apartment communities right here in sunny San Diego and referencing some recent surveys from Apartments.com, Multifamily Executive and others, we have uncovered a few truths about what today’s renters are looking for, and, ultimately, which amenities we believe are most worthy of investment. Following Yoda's admonition to “always pass on what you have learned,” we wanted to share our findings:

Everyone wants to “fit” in.

The amenity that has arguably undergone the most significant transformation in recent years, the fitness center is no longer just a place to exercise, but also is a gathering space where tenants can socialize and take classes together. Interactive virtual group fitness is available at the touch of a fingertip and residents enjoy open, thoughtful spaces. Our friends at Alliance Residential’s newest lifestyle community Broadstone Corsair in San Diego told us, “The very first thing people do when they sign a lease here is cancel their gym membership”. And after taking a peek ourselves at the sunlit, two-story fitness club with state-of-the-art cardio and weight training equipment and a private yoga/dance studio with virtual group fitness...well, we weren’t surprised. But this trend isn’t limited to San Diego. A recent survey conducted by the National Multi Housing Council (NMHC) revealed that 84% of renters place great importance on their apartment building having a fitness center. The aforementioned Multifamily Executive (MFE) survey also showed that residents unanimously expressed the need for a large gym open 24 hours with a variety of modern fitness equipment and fitness classes.

Residents like “green” upgrades, but aren’t willing to spend the green stuff for them.

More and more people are embracing eco-consciousness as a lifestyle. In the MFE survey, when residents were asked about their preference for green features, “energy efficient appliances” was the top choice, with “walkability” and “recycling” following as second and third choices. Additionally, a survey conducted by Strata Research this year showed that 77% of renters felt “green” apartments were important. However, eco-friendly homes come with a price; are residents willing to part with the green stuff to be “green” and make costly upgrades a worthwhile investment for apartment owners?
like us? Well, historically, that answer has been “no”, and Strata and MFE’s recent findings show that things haven’t changed much. Strata found that only 60% of respondents said they would maybe pay more for green features; MFE’s findings also revealed that the majority of renters are not keen to pay more for an eco-friendly apartment.

**Pet-friendly apartments will fetch tenants.**

An August 2014 Apartments.com survey revealed that pet ownership among apartment renters has jumped from just 43% in 2012 to 72% in 2014. However, despite this upward trend, nearly two-thirds of pet owners in 2014 reported having difficulty finding an apartment that allows pets, and 70% of owners said their choice of where to rent was influenced by nearby pet amenities such as parks, veterinary facilities and pet stores. Dog parks have been a hit in the last few years, although, this shouldn’t surprise us considering “Doga” (yep – doggie yoga) is an actual thing as are iPhone apps that enable users to locate the nearest dog parks and set up play dates for Fido and Bella to bark and bond! All jokes aside, pet-friendly amenities are springing up across the nation, and research has shown that pet owners are willing to pay a premium to have furry friends, especially if there is a dog washing station and dog park downstairs.

**Integration of digital and physical space is key.**

Millennials make up the majority of U.S. renters and thus remain the most influential demographic on apartment trends. In an attempt to allure this generation of Internet-age renters, big developers like Alliance Residential and Avalon Bay are constructing high-tech buildings with digitally-integrated common areas. Millennials – who spend much of their day within the digital realm (translation: they are constantly on their iPhones) – have the same expectations for physical spaces as they do digital spaces. The ability to connect and socialize in areas where they can personalize their experiences is highly attractive to this app-addicted generation. At Alliance’s Broadstone Little Italy, the “resident clubhouse” includes three flat-screen TVs, Wi-Fi, MP3 docking stations, USB electrical outlets and fully-integrated business centers with Windows® and Apple® connections. Convenience is everything, and while smart-home technologies like smart thermostats and lightbulbs are attractive to tech-savvy renters, most of those options are cost-prohibitive. Affordable upgrades like outlet covers with USB ports can definitely tip the scales in an apartment owner’s favor as renters assess similar properties (Multifamily Executive).

**The basics are still the basics.**

While preferences of amenities vary across U.S. cities, most renters are still keen on basic comforts in their homes. The surveys we analyzed indicate that even in a market bursting at the seams with amenities, the majority of apartment renters place the greatest importance on the essentials: high-speed Internet, a washer and dryer and a functional, spacious floorplan. The Apartments.com survey plainly states, “Primarily, renters seek properties that offer everyday interior comforts like air conditioning, Internet access and laundry.”

**Our Conclusions:**

1. Health and fitness are of great concern to today’s renters and fitness center upgrades are a worthwhile investment.
2. While today’s renter pool appreciates “green features”, they aren’t willing to pay a premium for them; for now, eco-friendly and smart-home options will typically be cost-prohibitive.
3. Pet ownership is growing and renters are willing to pay pet fees. The doggie bark park is here to stay and is a worthwhile investment in many markets.
4. High-tech is high-priority. USB outlets, Wi-Fi and digitally-integrated spaces are highly desirable.
5. Focus on the basics. The majority of renters today still care greatly about overall square footage, Internet access, functionality of floorplans and the convenience of doing their laundry in their unit or on site.

While flashy, resort-inspired common area amenities like life-sized chess and pool cabanas are gaining popularity in many markets, the majority of renters’ primary concerns are the basic comforts and conveniences within their private spaces. We believe that functional floorplans, upgraded appliances and polished interior finishes will continue to attract a steady stream of eager tenants in most markets. However, as apartment demand grows and floorplans shrink, creating attractive community spaces will become increasingly important. The “lifestyle apartment” is here to stay, yet understanding the behaviors, attitudes and social patterns of each city’s renter demographic is key to knowing the right amenities to invest in.

Last year, we tested the “doggie bark park” with great success at Talavera, our 144-unit condominium project in Tempe and are now convinced of the staying power of pet-friendly amenities. The jury’s still out on the longevity of “Doga”.

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Record-Low Homeownership Rate May Be Here to Stay

The country’s homeownership rate is the lowest in nearly half a century. A decade ago, 69.1% of Americans owned a home; today, the rate is just 63.4% – the lowest rate since 1967.

During the past year, total households have grown by two million (from 115 million to 117 million from the second quarter of 2014 to the second quarter 2015) and an estimated 22 million new U.S. households will be formed by 2030. Meanwhile, the homeownership rate continues to fall (declining from 64.7% to 63.4% in the aforementioned 12 month period). Notwithstanding the anticipated increase in new household formation over the next 15 years, a study released by the Urban Institute projects homeownership rates will fall further, to 61.3% by 2030.

While the decrease in homeownership rate is generally not the best news for the economy, owners of apartments and single-family rental homes are benefiting. This trend will have major implications for housing and developers are breaking ground on new apartment projects to keep up with the demand. With household formation rising and homeownership rates declining, many experts foresee accelerated demand for rental housing and continued rent growth for the apartment sector. Axiometrics reported apartment occupancy above 95%, near a record high, and annual rent growth hit 5% in the second quarter of 2015.

The Stock Market – Volatile and Unpredictable

The recent stock market volatility – driven by Chinese economic concerns and a cautious statement by the Federal Reserve following their “steady as she goes” September meeting on interest rates – does not necessarily reflect the reality of U.S. economic health. After all, the unemployment rate has fallen to 5.1% and inflation is well below the Fed’s 2% target. So why is the stock market increasingly volatile if the U.S. economy’s fundamentals are still strong? There is no really good answer – the stock market fluctuates like your teenage daughter’s attitude – unpredictably and often without basis in reality.

Thankfully, today’s real estate market operates largely independently from the day-to-day drama of the stock market. Real estate owners’ balance sheets are no longer as highly leveraged and values are based on the reality of rental revenues and property incomes. Those of us who rent apartments or office suites in popular neighborhoods are painfully familiar with the high
rents associated with desirable, well-located properties. Demand for apartments is red-hot and although supplies in many U.S. cities are increasing, rental rates continue to rise with strong job growth and supplies have been slow to catch up. At the end of the day, the economic woes of China and Europe may have an effect on your retirement accounts but don’t expect the rent to decline in your downtown high-rise.

**Price Still Right (For Housing in 86 of 100 Cities)**

As U.S. real estate values continue to grow, concerns about overvaluation in many markets have also increased. CoreLogic, a real estate analytics provider, recently evaluated the top 100 U.S. metropolitan markets by comparing home price appreciation against the long-term sustainable levels that can be supported by income growth (i.e. if home price growth cannot be supported by income growth a market is deemed to be overvalued). The results indicate that the pricing concerns are unfounded in most markets as housing prices in 86 of the top 100 metro areas are at sustainable or undervalued levels. (Among those in the overvalued category are Nashville, Washington D.C., Austin and Houston). Notwithstanding the 14% of major metros flagged by Corelogic, the vast majority of U.S. markets are still recovering from the 2007-2008 economic decline and Corelogic believes there is plenty of runway for future growth in real estate values.
H.G. Wells, who wrote the famed sci-fi novella *The Time Machine*, is credited with popularizing the concept of time travel by using a vehicle to navigate through time selectively and purposefully. Today, we’ll go for a ride on the Pathfinder Time Machine to revisit *Talavera* – our 1980s-vintage, 144-unit condominium project in Tempe, Arizona.

Let’s set our dials to May 2013, when we purchased what was then called *Copper Creek* and prior to our comprehensive renovation program. Memories of the overwhelming sea of beige and brown stucco and a dark, drab leasing office come flooding back. Even then, we could see the community’s potential for greatness by virtue of private garages, large unit interiors, balanced unit-mix and functional property layout. In order to modernize the community, our renovation strategy would focus on enhancing the project’s exterior by adding a bold and complementary paint scheme, updating the landscaping and pool areas to provide for a more resort-style feel and adding common area amenities including a dog park and new leasing office and fitness center. Within the unit interiors, our plan would be to upgrade the kitchens (modern appliances, cabinets, countertops/backsplashes, lighting fixtures and flooring) and bathrooms (sinks, faucets, light fixtures and mirrors) and install new flooring, with the goal of adding stylistic elements suited to a younger and more design-conscious renter.

Hopping back into our time machine, let’s return to the present day. Exterior renovations are now complete and we have remodeled 40 of the unit interiors. Tenants are spending quality time bonding with their furry companions at the new “Bark Park” and prospective renters can relax in a welcoming and polished leasing office. Since we completed the exterior improvements in January 2015, we have maintained an average occupancy
of 95% and have focused our efforts on tenant retention through increased community events and greater use of the improved gathering spaces. Our vision of transforming Talavera into a relevant, modern apartment community has been realized and, in the words of H.G. Wells, we will continue to “strive to welcome change and challenges, because they are what help us grow.”
“An optimist is someone who goes after Moby Dick in a rowboat and takes the tartar sauce with him.”
- Zig Zaglar, American Author

“Optimism is that faith that leads to achievement. Nothing can be done without hope and confidence.”
- Helen Keller

“One pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty.”
- Winston Churchill

“Optimism is a good thing. It makes people go out and start businesses and spend and do whatever is necessary to get the economy going.”
- Ben Bernanke, Former Chairman of the U.S. Federal Reserve

“You’ll never find a rainbow if you’re looking down.”
- Charlie Chaplin

“Only those who attempt the absurd can achieve the impossible.”
- Albert Einstein

“Being challenged in life is inevitable, being defeated is optional.”
- Roger Crawford, American Motivational Speaker

“Those who wish to sing always find a song.”
- Plato
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