PATHFINDER PARTNERS, LLC
Intelligent, Innovative Investing™

THE PATHFINDER REPORT

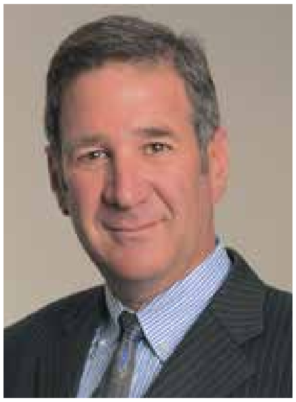
March 2016

IN THIS ISSUE

CHARTING THE COURSE

No March Rate Hike. (Surprise, Surprise, Surprise.)

By Mitch Siegler, Senior Managing Director



That was the signature line of Gomer Pyle (Jim Nabors), the good-natured, naïve fellow from Mayberry, North Carolina in the 1960s television program, *The Andy Griffith Show*.

Nothing really worked for Gomer the way he thought it would and nothing now is really working the way most of us thought it would. (And we're not just talking about the Bern, Trump and the rest of the merry band.)

We weren't surprised about the Fed's March 16 decision to stand pat on interest rates and the Fed's announcement that it now sees just two 2016 rate hikes, down from four in December. The conventional wisdom now is that June is the new March. Perhaps – but even Gomer might not leap to that conclusion based on the current fact set. The Fed desperately wants to raise rates so they'll have a few spare bullets to fight a future recession. The conundrum – raising rates in the absence of inflation may actually bring on that recession. The Fed's between a rock and a hard place.

Now, compared with their central banker pals in Europe and Asia, Fed governors have it good. Those other guys are *really* in a box having resorted to negative interest rates. Paraphrasing Henny Youngman, "take central bankers – please." They basically say "give me your money. I'll hold it for you and rake a little off the top. Then – and here's the kicker – I'll give you back less than you originally deposited with me." Now, who in his right mind would take that deal?

Well, that deal is the new normal in Europe. The European Central Bank (ECB) just lowered its key overnight deposit rate from -0.3% to -0.4%. Now, all European banks must pay the ECB 40 basis points (bps) for the privilege of depositing their money. Oh, joy! The ECB also expanded its quantitative-easing program with an additional €20 billion per month of bond purchases in a further attempt to stimulate a moribund economy. Meanwhile, ECB President Mario Draghi said interest rates would stay "very low" for at least another year. Super Mario thinks deflation is here to stay – the Eurozone would have faced "disastrous deflation," if the ECB hadn't gone even more negative, he said.

It's a similar story in Japan, where the government gets paid to loan money. For the first time ever, the Japanese government sold $19.4 billion of new 10-year bonds with an interest rate of 0.1% at an average price of ¥101.25 – do the math and the effective yield is -0.024%. The government also sold 30-year bonds at an all-time low yield of just 0.47%. Like us, Japan runs a large budget deficit and has huge debt (240% debt-to-GDP ratio); these negative-yield bonds will help Tokyo a skosh because more than two-thirds of Japan's government debt now carries a negative yield.

And it's not only governments. In March, a German mortgage bank was selling bonds with negative interest rates. Berlin Hyp AG was offering €500 million (US$550 million) in 3-year bonds at a yield of -0.162%. Virginia, it's a brave new world. When companies are able to jump on this crazy bandwagon, it's a safe bet that it won't be long before the miniscule interest rates you may be earning from your U.S. fixed income portfolio stand a good chance of turning negative as the rocket scientists at the Fed consider joining the other central banks at the NIRP (negative interest rate policy) party.

It's not easy to swim against the tide in a world that's awash in negative rate debt. There's already **$7 trillion** of negative-yielding debt swirling about, almost 30% of the Bloomberg Global Developed Sovereign Bond Index. And, it's an A-list of issuers, countries like Switzerland, Sweden, Denmark and Japan plus the European Central Bank. We've seen this movie before – for a brief period during the 2008 financial crisis, U.S. Treasury bill yields actually turned negative as investors, seeking a safe haven, poured into Treasuries sending prices skyrocketing and driving yields into the negative.

The "New Normal" in Real Estate

These upside-down central bank policies combined with the comic book environment that is American politics, circa 2016 (yep, truth is stranger than fiction) will likely exacerbate the already heightened level of market volatility making for a challenging investment climate. Meanwhile, we've observed several interesting shifts in real estate that are worth pointing out.

• **Office space per worker has plummeted** – The real estate brain trust at Goldman Sachs Asset Management's Alternative Investments Group found that companies lease substantially less space per worker nowadays than they did in the 1970s – a decline from 600 feet/worker to just 176 feet/worker in 2012. Law firms, in particular, are leasing about one-third less space than a decade ago because cloud-based storage has replaced law libraries and file cabinets. Implications galore for investors, landlords and tenants.

• **Cloud computing is also lessening companies' office space requirements** – At the recent Amazon Web Services (AWS) *re:Invent 2015* conference, both General Electric and Capital One Financial Corp. mentioned that they were closing a significant number of their data centers and moving workloads to the AWS cloud. Moving to the cloud makes companies much more efficient since it frees them from building excess capacity for their peak usage requirements.

• **A housing bubble has given way to a housing shortage** – The bubble in homeownership that was the catalyst for the 2008 financial meltdown has now been completely eliminated, even reversed. Subprime, Alt-A and other forms of liar loans which led to millions of homes sold to people who weren't qualified to buy them or service the mortgages have given way to more stringent loan underwriting standards and demographic forces have brought about a dramatic decline in the homeownership rate (from 69.4% in 2005 to 63.7% in 2015). In many markets, there's an outright housing shortage, driven by strong household formation and solid demand for homes that is once again stimulating new construction.

• **The inevitable mortgage interest rate increase is nowhere in sight** – For the past couple of years, people raced to refinance in order to avoid the big rise in rates that everyone knew was just around the corner. It's a question of when, not if, folks said. As recently as December, pundits predicted four rate increases in 2016 – now it's looking like two, at most. Today, rates are incredibly depressed with 30-year mortgage rates having been lower just 5.9% of the time since 1976, according to Goldman Sachs. It would take a big increase in mortgage rates to put a big dent in today's high home affordability. In fact, mortgage rates would need to increase almost three full percentage points to return housing affordability back to its long-term average.

Turbulence brings volatility and volatility brings stress. But it also creates opportunity for those whose eyes are open. Surprise, surprise, surprise.

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 an investment banking and venture capital firm. Reach him at msiegler@pathfinderfunds.com.

FINDING YOUR PATH

Harrowing Tales of Business Travel and Observations of Life

By Lorne Polger, Senior Managing Director

Monday. Zero Dark Thirty. Leave the house exactly 58 minutes before scheduled departure. The traffic pattern of every cab and Uber driver on the freeway at 0620 is imbedded in my memory like the birth of my kids. I know that it takes a minimum of 17 minutes, 35 seconds and a maximum of 20 minutes, 14 seconds to get to my secret parking space. The TSA line snakes around the terminal like the endless line for a popular Disneyland ride on a summer day. There is no prize at the end of the TSA line.

No worries for me, Mr. Mileage Plus/Admiral A-Lister! I'm smarter than the average bear! Gosh darn it, I haven't spent 60-80 days a year on the road for the last decade without learning a trick or two. I know more than these rookies. Line, schmine. I'm TSA Pre-Check! I practically own the place! I got this one.

Wait. TSA Pre-Check not printed on the boarding pass?? Horrors!! You mean a Federal agency made a mistake? Couldn't be. I paid big money ($54, as I recall) to be on that list. Humph. Someone is going to get an earful.

No worries. I fly 85% of my flights on Southwest Airlines. They go everywhere we do. I can book a flight in about 96 seconds the day before online, the easiest site to use (by about a million miles) of any major carrier. I'm a proud A-Lister with free drink coupons spilling out of my briefcase! I even recognize some of the flight attendants! The A-list line isn't as short as TSA Pre, but it's not the cattle call line for the amateurs. Sure, I might have to take my shoes and belt off, but they don't really make you take the liquids out or your sweater off. I got this one.

"Sir, you'll have to step over to secondary security screening (the dreaded "Triple-S") so we can look in your briefcase." Really? Stomach now grumbling, realizing that dreams of an Einstein Bros. toasted bagel with plain cream cheese, tomato slices and iced coffee may not be in the cards. Quick glance at the watch – now 0637. Departure in T minus 28 minutes. Couple of deep breaths. Don't let the 23 year-old TSA border guard see the beginnings of a soft sweat on the brow. "Sir, we just need to use this swab on your laptop and then put it into this other machine that looks like it came straight from Star Trek central casting that will tell us if you're carrying C4 explosives in your Lenovo. Is that okay?" "Uh, sure, that's okay, but could you hurry up so that I can get my coffee and bagel before my three-hour flight where they only serve stale peanuts and lukewarm water?"

Make it through Checkpoint Charlie. Pathfinder top secret info still safe in the special compartment of the briefcase. Wafting smells of shoe polish, grilled meat (still unclear who eats burgers before 0700; must be the East German tourists) and Folgers coffee hit like a bag of bricks. Glance down at the boarding card. A16. "Who da man? You da man!"

Use the patented left handed curve toss of the Wall Street Journal across the middle seat, row five, premium left side ocean/bay view on departure, and sufficient elbow room for the laptop keypad maneuver. Begin the "faux flu" ritual. Hacking cough, followed by the full arm-length nose wipe, at exactly sixteen second intervals, or as needed when the "is this seat taken?" query occurs. Avoiding all eye contact. Amateurs, can't believe they keep falling for it.

RED FLAG WARNING! RED FLAG WARNING! SCREAMING BABY ALERT! FULL SHIELDS UP!! INCREASE HACKING COUGH FREQUENCY TO EIGHT SECOND INTERVALS! INCREASE USED KLEENEX DEPLOYMENT!!

"Uhm, sir, this is my first flight with my baby and I wonder if you can help me?" Full scale global warming begins. "Of course, happy to help." Possible full L4/L5 disc herniation occurs lifting combo baby stroller/play pen/four wheel drive into overhead compartment. Note to self: Book the physical therapy appointment once the Wi-Fi is activated.

Hour two. Fascinated to learn that Toys R Us no longer sells diaper genies, but that Amazon Prime will deliver them via drone within seven minutes of the poop explosion. Surprised to hear that Raffi no longer plays "Baby Beluga" to sold out crowds everywhere. New mama not overly interested in the article I share from Section Three of the Journal on predictions for rising oil prices in Uzbekistan. Feeling every bit of my 53 years at this point.

Sailing through arrival terminal with my Tumi superlight bag in near O.J. sprint mode to the rental car shuttle. Chest puffed, headphones on, two conference calls in, I so have this. I'm National Executive Elite! You get that people? I just don't pick my car in the aisle, I can pick "that car." Because nothing says success like a shiny black Ford Mustang with crushed velour seats that looks exactly like all the other rental Mustangs that never seem to look like a real Mustang. En route to check in at the hotel

"Sir, I see that you are a platinum/titanium/super alloy member of the Starwood SPG family. Thank you so much for staying with us. You are entitled to an upgrade from the 15th floor to the 16th floor. Can we do that for you today?" "Uh, sure Tiffany, but is there anything we can do with that $56 overnight parking charge? And how about that $48 daily resort fee? Because there is nothing here that resembles a resort." "Sorry Mr. Polger, that's our corporate policy."

Tuesday. Zero dark thirty. Raining. May impact drive time back to the airport. No worries, I'm TSA Pre, I've got this. Always good knowing that I'm heading home to San Diego. Safe travels, everyone.

A personal note: I wanted to thank the many, many people who reached out to me with kind thoughts, prayers and condolences during my wife, Cindy's illness and passing. The journey was made easier by your actions and I will always be profoundly appreciative of the kindness shown by so many.

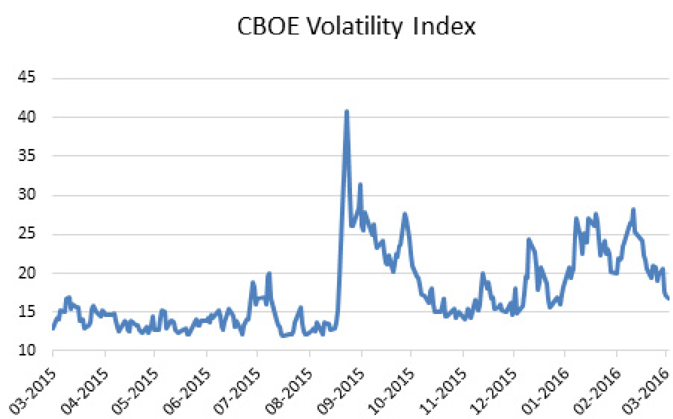
Lorne Polger is Senior Managing Director of Pathfinder Partners, LLC. Prior to co-founding Pathfinder in 2006, Lorne was a partner with a leading San Diego law firm, where he headed the Real Estate, Land Use and Environmental Law group. He can be reached at lpolger@pathfinderfunds.com.

GUEST FEATURE

Why Real Estate Can Be Attractive When the Stock Market is Volatile

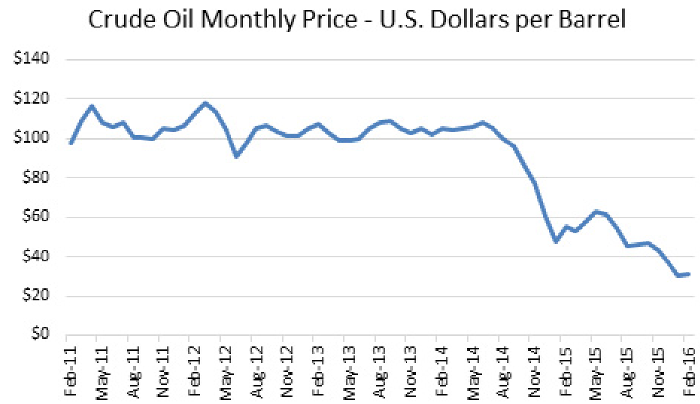
By Scot Eisendrath, Managing Director

The financial markets have been marked by volatility for the past six months – volatility to the downside at the end of 2015 and into the beginning of 2016, and volatility to the upside more recently. A common gauge of stock market volatility is the CBOE Volatility Index (the VIX). The VIX measures the market's expectation of near-term volatility, and is known to reflect investors' fears. As the graph below indicates, 12-month volatility and investors' fears peaked at above 40 in September 2015 and still remain at elevated levels. (The VIX reached 80 during the heart of the 2008 financial crisis.)



Source: Chicago Board Options Exchange

The primary factors that have led to this volatility include slower growth in China and a plummet in the price of oil. Apparently, investors have woken up and now understand that China will not have 10% annual economic (gross domestic product or GDP) growth for eternity. Last year, China grew at 6.9%, its slowest pace in 25 years, and the Chinese government is now projecting an average of 6.5% growth over the next five years. The price of oil has collapsed more than 70%, from over $100/barrel in June 2014, to $27 in February (at press time, it's back to about $41/barrel). One would have thought that cheaper gas would be a shot in the arm for the economy, but the markets may be thinking otherwise.



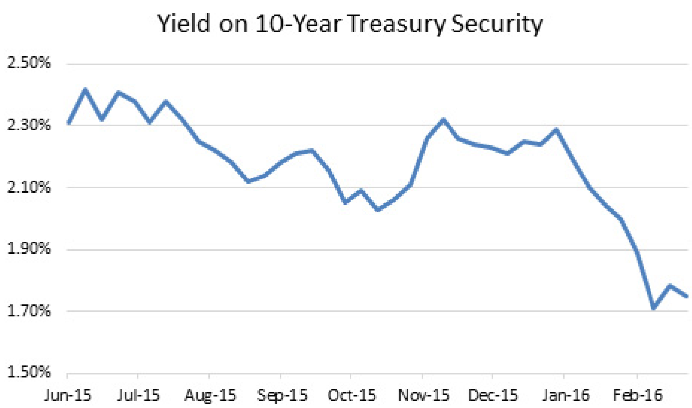
Source: World Bank

Overall though the U.S. economy appears to be doing reasonably well. The unemployment rate has fallen from nearly 10% at the height of the financial crisis in 2010 to below 5% in February 2016 (4.5%-5.0% is considered full employment and indicates a healthy economy; the post-war average is 5.8%). U.S. GDP grew at 2.4% in 2015, and is now at an all-time high of $53,042 per capita. Throw in the fact that interest rates remain at historical lows (and there seems little reason to believe they are going up significantly in the near-term), the economy seems to be in a decent spot. Putting aside the issues in China and the oil market, the fundamentals for a continued strong real estate market seem to be in place.

As during any period of volatility, there are implications and potential strategies to employ to benefit from the situation. Following are four observations on the current state of the real estate market and potential ways to play them:

1. Take Advantage of the Dip in Interest Rates

The yield on the 10-year treasury security has fallen from 2.4% in June of 2015 to about 1.9% at press time, a decline of more than 20%. That's a big move in a rather short time for longer-term bonds. Additionally, based on the Federal Reserve's mid-March meeting where they lowered their forecast for 2016 interest rate increases, it appears that short-term rates will not be rising as fast as was once predicted at the beginning of the year. Although lenders have increased spreads a bit, rates on commercial real estate loans have still fallen significantly, making it a great time to lock in long-term, fixed rate financing. That explains the 13% increase in mortgage re-financings from March 2015 to March 2016. Another strategy to take advantage of the dip in rates is to sell stabilized assets that qualify for long-term, fixed-rate financing. The buyers of these types of assets will typically pay a premium in the current market, since they are able to enhance their cash-on-cash returns with attractive financing.



Source: U.S. Federal Reserve

2. There's been a Flight to Quality, Including in Real Estate

As we've seen in the treasury market, during times of volatility there is a flight to quality, which drives down yields. The same happens in the real estate market – buyers push down capitalization rates for well-located, stabilized properties. Many buyers, especially private buyers, seem to get more aggressive on pricing for core assets during times of stock market volatility. Again, this makes it a great time to sell stabilized, core assets to yield-hungry buyers looking for a safe haven to store their cash.

3. Market Selection

Now, we sure wouldn't want to own an office building in Houston or apartments near the Bakken Shale – or other areas of the country that have been hard hit by the collapse of the oil prices. And we're not venturing to Flint, Michigan anytime soon – unless it's to invest in a bottled water plant. However, investing in areas with diversified economies, favorable economic and demographic trends, strong, local universities, supply constraints and high barriers to entry and proximity to transportation corridors, has never been more important.

4. An Opportune Time to Buy Value-Add Properties

During periods of volatility, it's always wise to follow the old adage to zig while others zag. That applies to real estate as well. In times of uncertainty, pricing may soften for some hairy, value-add assets with moving parts, such as high vacancy, operational issues, required capital investment and legal challenges. Those are the times to pounce. It's not a time to focus on the short-term blip in the market, but the long-term potential of the asset.

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ZEITGEIST – SIGN OF THE TIMES

California's Housing Crisis

A recent analyses by Los Angeles-based *Beacon Economics* makes the case that California's rapidly rising housing prices threaten to make much of the state unaffordable – think Malibu or Palo Alto – and is forcing working class folks to move east or out of state. Migration data from 2007-2014 suggests this trend is already occurring with 563,000 families making less than $50,000/year moving out of state and 80,000 families making greater than $150,000/year moving into the state. According to New Census Bureau, California is officially America's poverty capital with one in four residents barely able or unable to pay their bills.

So how can we solve the problem? *Beacon* believes that changes to California's housing policies are the key to incentivizing developers to build more affordable housing and keeping our teachers, policemen and nurses living in the communities they work in. At the heart of the problem is the California Environmental Quality Act – better known as "CEQA" – which makes it difficult and expensive to build new housing and easier for development opponents to bog down developers with lengthy court battles. If these policies do not change, the end result will be worker shortages and increased welfare costs – not to mention a lot of grumpy residents who are forced to commute further and further to work.

Millennials and the Great Migration Back to the City

With high income, even higher student debt and a burning desire to live the urban lifestyle, millennials have been gravitating toward new, downtown apartment communities. Renting allows them to overcome the burden of high student debt, while the location and amenities of their apartment communities provide the urban lifestyle they desire. In Alexander Snyder's recent report *"The Millennial Effect: Urban Demand Drives Multifamily Fundamentals"* the Center Square Senior Analyst evaluates the impact millennials have on urban demand and the multifamily housing market. His findings:

• **High Student Debt:** According to a recent *Fortune* article, nearly 70% of college students graduate with debt, an average of $28,950. This debt hampers the typical millennial's ability to cobble together a down payment or qualify for a home loan resulting in fewer home sales and increased rental demand.

• **Delayed Life Milestones:** Millennials are delaying marriage and, by extension, having kids and purchasing a home, which typically follows closely behind those life events. According to Snyder, in 1970 the estimated median age for a first marriage for men and women was 23 and 21, respectively. In 2015, the median ages were six years higher at 29 and 27, respectively.

• **Urban Drive:** The demand for city living is on the rise, particularly in coastal markets. For decades, Baby Boomers drove the explosive growth of the suburbs. For the first time in decades, millennials are reversing this trend and returning to urban areas.

• **Higher Income:** The most educated and skilled millennials are seeing a rise in income. The increase in disposable income, combined with a lower propensity towards saving, has led to a growing demand for upscale rental housing. Correspondingly, rents per square foot have been setting new records in urban areas throughout the U.S.

Because millennials comprise 24% of the U.S. population, these trends are contributing to the boom in new, high-end urban multifamily housing. Millennials can't be ignored and cities should expect to see more downtown cranes in the sky for the next few years.

Housing Experts: Prices to Continue to Grow in 2016

According to September 2015 data released by Clear Capital, a provider of real estate data and analysis, home values in 2015 increased in 236 of the 276 cities tracked. Despite strong growth in recent years, U.S. homes still remain approximately 19% below peak 2007 prices.

Interest rates remain at historic lows, employment metrics continue to improve, housing supply is limited and demand is on the rise. These leading indicators are pointing to another strong year for the housing sector in 2016. Here is what a few experts had to say in a recent *Barron's* survey:

"The continued rise in home prices will occur because we will again encounter housing shortages in many markets because of the cumulative effect of homebuilders under-producing for multiple years. Once the spring buying season begins, we'll begin to feel that again."

- Lawrence Yun, Chief Economist, National Association of Realtors

"If you're going to make a bet about home prices, the logical one is that they're going up. A variety of demographic factors are behind that, with a recovering economy."

- Jonathan Smoke, Chief Economist, Realtor.com

"Except for the energy patch, most housing markets are doing pretty well. It's reasonable to expect home prices to go up 3% to 5% this year. There's improved buyer demand for entry-level housing, and the financing market for purchasing a home is pretty healthy."

- Steven Brown, Portfolio Manager, American Century Global Real Estate Fund

TRAILBLAZING: SKY LAS VEGAS

Repositioning Luxury Condominiums in Las Vegas

In the past several years, the glittering lights of Las Vegas have brightened, as a resurgence in tourism has driven strong economic recovery. In 2015, the city welcomed a record-breaking 42 million visitors, an all-time high. With job and population growth outpacing national rates and driving housing demand, Las Vegas ranked fifth in the most recent Ten-X® (formerly Auction.com) Top Single-Family Housing Markets report, which ranks the nation's 50 largest housing markets. Of the top five markets, Las Vegas was unmatched in year-over-year home sales growth of 22.6%; its nearest competitor, Portland, saw an 11.2% increase. Home prices in Las Vegas also grew 8.3% over this same period. Pathfinder has been tracking various real estate opportunities in the city since 2009 and the recent economic improvement coupled with our discovery of Sky Condominiums created the perfect occasion to make our first investment (we have since acquired a second property in Sin City).

In September, we acquired the remaining 64 unsold condominiums within Sky Las Vegas Condominiums, a 2007-vintage, 42-story, 409-unit luxury high-rise on Las Vegas Boulevard (the "Strip"). The majority of our units are ideally located above the 20th floor including 38 premier corner units featuring large wraparound private balconies with exceptional views of the Strip and surrounding mountains. The units feature high-quality finishes including granite countertops in the kitchen and bathrooms, custom cabinetry, high-end stainless steel appliances and wood flooring. The project boasts a concierge service, valet parking, a spa and fitness facility, billiards room, dog run, putting green, theatre, business center and a pool/lounge area complete with cabanas, a hot tub and fireplace. Sky is located just south of the intersection of Las Vegas Boulevard and West Sahara Avenue in a section of the strip that is undergoing significant transformation. Across the street, the Las Vegas Convention Center is planning an expansion and to the south, Resorts World Las Vegas has broken ground on the city's biggest investment in a decade, a $4 billion, 3,200-room resort development opening in 2018. Also across the street is the partially constructed Fontainebleau Hotel and Casino, which Carl Icahn acquired through bankruptcy in 2010. The project has been stalled for nearly a decade and in November, Icahn announced that he would be marketing the property for sale – a positive for the project and the neighborhood.

We plan to initially rent the condos at market rates and then implement a retail sales program following the completion of significant interior renovations – aimed at modernizing our units and differentiating them from the previously sold inventory – in the next 60 days. We have engaged local, best-in-class property management and residential brokerage teams.

Bulk condo purchases in high-rises on the Las Vegas Strip don't come around every day, and with no new condo towers being built in the area, we believe we'll reach new heights with our Sky investment.

NOTABLES AND QUOTABLES

Possibilities

"When you have exhausted all possibilities, remember this: you haven't."

- Thomas Edison

"To dare is to lose one's footing momentarily. To not dare is to lose oneself."

- Soren Kierkegaard,
Danish philosopher

"In the beginner's mind there are many possibilities, but in the expert's mind there are few."

- Shunryu Suzuki,
Zen monk

"There exist limitless opportunities in every industry. Where there is an open mind, there will always be a frontier."

- Charles Kettering,
American inventor

"Creative risk-taking is essential to success in any goal where the stakes are high. Thoughtless risks are destructive, of course, but perhaps even more wasteful is thoughtless caution which prompts inaction and promotes failure to seize opportunity."

- Gary Ryan Blair,
American conceptualist thinker

"A ship in harbor is safe, but that is not what ships are built for."

- William G.T. Shedd,
American theologian

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Investing involves risk of loss and you should be prepared to bear investment loss, including loss of original investment. Real estate investments are subject to the risks generally inherent to the ownership of real property and loans, including: uncertainty of cash flow to meet fixed and other obligations; uncertainty in capital markets as it relates to both procurements of equity and debt; adverse changes in local market conditions, population trends, neighborhood values, community conditions, general economic conditions, local employment conditions, interest rates, and real estate tax rates; changes in fiscal policies; changes in applicable laws and regulations (including tax laws); uninsured losses; delays in foreclosure; borrower bankruptcy and related legal expenses; and other risks that are beyond the control of the General Partner. There can be no assurance of profitable operations because the cost of owning the properties may exceed the income produced, particularly since certain expenses related to real estate and its ownership, such as property taxes, utility costs, maintenance costs and insurance, tend to increase over time and are largely beyond the control of the owner. Moreover, although insurance is expected to be obtained to cover most casualty losses and general liability arising from the properties, no insurance will be available to cover cash deficits from ongoing operations.

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