THE PATHFINDER REPORT

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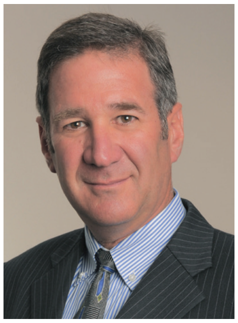
IN THIS ISSUE

CHARTING THE COURSE

The Secret to Success – Hard Work or Luck?

By Mitch Siegler, Senior Managing Director



Ask a self-made man or woman about the secret of success and you're likely to hear "hard work," "true grit" and the like. E.B. White said "Luck is not something you can mention in the presence of self-made men." Ask a *really* successful person in business, politics, art, athletics, medicine, science – whatever – and more often than not, you'll hear them attribute their success, at least in part, to luck.

Warren Buffet frequently attributes his good fortune to having lived in the U.S., during the 20th-21st centuries and having a particular knack for business and finance – capital allocation – a skill of dubious value in sub-Saharan Africa and which would likely have not made him über-wealthy had he lived in an earlier era. I've heard more stories than I can count about successful folks who walked away unscathed from a childhood accident, feel fortunate simply because they were raised by parents with a healthy marriage or had a teacher at a young age who took a particular interest and provided guidance or mentorship that is still recalled decades later.

The Latin expression "fortune favors the bold" rings true but so does "luck is blind". Of course, you have to buy a ticket if you want to win the lottery but there's also not much you can do about being in the wrong place at the wrong time – like those poor souls on the 9/11 airplanes.

Sometimes, the luck argument is used to support a political agenda, like equal opportunity. In 2012, President Obama famously stated that it's largely luck and those opportunities which come to those from higher socioeconomic status when he said "If you've got a business, you didn't build that – somebody else made that happen." While the President's word choice was clumsy at best, it's hard to argue that America's education system, scientific research and infrastructure contribute to the success of many American dreams. An outstanding teacher or mentor can also have an outsized impact.

Of course, hard work and luck can be interconnected, even synergistic in contributing to success. Thomas Jefferson nailed it when he said "The harder I work, the luckier I get." Hard work means different things to different people. It might mean "the "sweat of the brow" to a farmer or coal miner, "true grit" to a marathon runner, "shoe leather" to a commissioned salesperson, "thinking outside the box" to an investor, "knowing where to cut" to a surgeon, "creativity" to an actor or artist or "working smart" to a software engineer.

Impulse control – delaying gratification until later – can be a variant of work, also contributing to success. The medical technician who attends nursing school in the evenings to move up demonstrates this commitment clearly. So does the guy who moonlights with a second job or drives an old jalopy and eats peanut butter sandwiches to save for a down payment on a house or bankroll a business. These folks are making a sacrifice today for a better tomorrow.

In the '60s, Stanford professor Walter Mischel made a splash with his now-famous marshmallow experiments. Kids were offered a choice of one marshmallow now or the prospect of two marshmallows simply by waiting 15 minutes. Kids being kids, some just couldn't wait but many could – and follow-on studies demonstrated that those who waited had had better life outcomes, as measured by higher SAT scores, greater educational achievement, lower body mass index and other measures.

One especially crucial area of luck is a person's health, which insurance actuaries are wise to. This includes the power of genetics (pick your parents carefully), lifestyle (diet, exercise, stress) and avoiding accidents (birdwatchers have fewer accidents than skydivers). Certainly, many of these factors aren't controllable but combine a lousy diet with an aversion to exercise, add in a pack-a-day smoking habit and a penchant for fast cars and you can be unlucky in the health department pretty darn quick.

Now, back to work. In his best-selling book *"Outliers: The Story of Success"* Malcolm Gladwell talks repeatedly about the 10,000-Hour Rule, which posits that the key to achieving excellence in any endeavor or profession –

golf, tennis, music, software programming, litigation, whatever – is putting in the time, literally practicing the correct way for 10,000 hours. Gladwell says "the biggest misconception about success is that we do it solely on our smarts, ambition, hustle and hard work." His goal with *Outliers* was to show that there are lots of other variables involved in an individual's success [and that not] everything that happens to a person is up to that person."

Lots to consider and this is pretty heady stuff. But maybe we should try to keep it simple. That's the leadership philosophy of former U.S. Navy SEALs Jocko Willink and Leif Babin who believe that leadership – at every level – is the most important thing on the battlefield. A team with effective leadership wins out over a bigger, better-equipped force and can overcome the harshest of conditions and circumstances. The same principles can be applied in business and life. In their own way, Willink and Babin took a page from Thomas Jefferson – the harder we work, the luckier we get. Here's to good luck.

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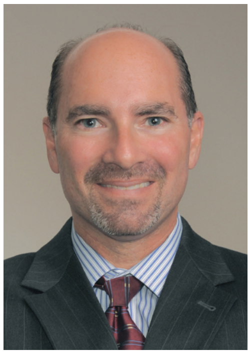
FINDING YOUR PATH

The Millennial Dilemma: "I Like the House, but I Don't Have the Dough." (Or "This is All I Can Get for $2,500 a Month?")

By Lorne Polger, Senior Managing Director



My oldest graduates from college this weekend. It is a very proud parent moment. She is a responsible, successful, hard-working, driven young woman. I know that success will her follow on her path, wherever that takes her. Can't ask for much more than that.

It has brought back memories from my college graduation, 32 years ago. I spent some time thinking this past week about some of the parallels and some of the distinctions between that time and now; how I felt about what lay ahead, and how she may be feeling about things. When I graduated in 1984, I had about $12,000 in student loans. My monthly bill from some arcane U.S. government agency was about $240/month. Seemed like a lot every time I had to write that check. I also remember being thankful for the additional loan deferment period when I started law school. I don't know if that amount was more or less than the average kid at the time, but it felt about typical. I was really bullish about the opportunities ahead, notwithstanding the uncertainties of what I was going to do or even where I was going to live. I had good friends and a supportive family, which helped to lay the foundation for that next chapter.

I worked a bunch of different jobs in Denver that first year after graduation. I remember renting a cute little house in a decent urban neighborhood….for $400/month (not including utilities!). I think my long showers may have boosted the monthly cost way up to $440/month. Had enough bucks left over to get some skiing in, grab an occasional meal and have some fun with friends. As I recall, $22 got you a day of skiing in Vail (not including beers). Even saved up for a nice trip to Australia and New Zealand and began to seriously think about what that first home might look like.

I finished law school in 1988 and moved down to San Diego. I will always remember having a conversation with one of the other associates that fall. He looked at me somewhat incredulously when I told him that my wife and I were renting a home. "Renting? Are you kidding? You're a lawyer now. Time to step up and buy! Why throw it down the drain?" In 1989, that first house cost us $189,000. The mortgage rate was at 10.8% and our payments were about $1,800/month. Big chunk of change at that time. But you know, it felt pretty darn good to own something (the fact that the value dropped like a rock from 1989 to the time we sold it in 1995 is a story for another article). My wife and I were building a life together and owning that house felt like a really big part of it. Most of our friends felt the same way. A house was the third leg of the financial stool, along with a good job and making some decent investments. It was a very prominent goal for us in our mid-20s.

Today, not so much. And there are many reasons why.

First and foremost is the ability of millennials today to save up sufficient money for a down payment on a home or condo. And they are getting hit on two fronts. Using my same Denver example, from 2009 to the first quarter of 2016, apartment rental rates in the Denver metro area rose by an **astonishing 51.9%**. From an average of $875/month to $1,315/month. And those are average rates. Great for an apartment owner, not as much for an apartment resident. But as they like to say on late night TV, that's not all. During that same time period, the average home price rose an **incredible 61.7%!** From $243,000 in 2009 to a whopping $393,000 this year. Now, that would work if wages rose correspondingly. But that's not the case – it's not even close. In 2009, the average annual income in metro Denver was $48,560. By 2015, it had risen to $54,435, a 12.1% increase. Of course, that increase doesn't account for the additional federal and state taxes on those higher wages. And by the way, Denver looks pretty damn inexpensive when compared to west coast cities like Seattle, Los Angeles, San Francisco and San Diego.

I've written about student debt before and most have seen the numbers, but they bear repeating. As of 2015, 43 million Americans have a combined $1.2 trillion in outstanding student debt. Trillion. Student loan debt in this country is completely out of control and it's a looming disaster of catastrophic proportions. If there was a way for me to short Sallie Mae, I would bet the farm (and I'm not a farm bettor). In 2015, the average undergrad walked away from school carrying a backpack filled with knowledge, enthusiasm, a Bernie Sanders decal, and a debt to Sallie Mae for $37,000. That represents a monthly payment of about $500 and interest costs of over $14,000 over the life of the loan. Ouch. And I've seen it first hand from my kids' friends and the children of my friends.

So, the median home price in Denver today is $393,000 (let's call it $400,000). That requires a down payment of $80,000. That's after tax dollars of course, so really, it means that you are putting aside about $150,000 of income to meet that nut. Hmmm, let's do the math. Average Jane and Joe are making about $50,000, they're paying $16,000/year in housing costs, another $15,000 in taxes, $5,000 in student loan debt and the rest to live. Where is that down payment coming from? Frankly, I wonder where the beer and ski money is coming from? That's a pretty toxic mix: Higher costs, higher debt and higher prices.

For many of those reasons, the U.S. homeownership rate has plummeted to its lowest level since the mid-1990s. In 2005 (the peak), the rate was 69.1%. Today it sits at 63.5% and most pundits call for a continued, albeit slower, decline.

There are other reasons beyond math too. What is a home and what does it represent? A financial foundation, stability, a place to marry, raise a family. All of those decisions are being deferred. Millennials are more mobile. They are much less apt to stay at a job. They are much more likely to move. Generally, they have gone away to school. And they are getting married much, much later. In 1960, the average woman got married at 20, the average man at 22. In 1990, the numbers moved to 23 and 26. Today, they're 27 and 29. And then you overlay what they witnessed during the Great Recession.

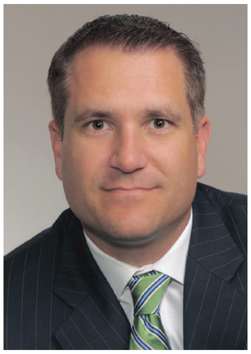
Takeaways? Based on the stats, you have to conclude that we will continue to transform from a society of owners to a society of renters. Bodes well for the apartment and rental housing businesses. But I don't think I would want to be a production home builder these days. The fortunate few millennials have a mom who says "Honey, do you need a little help from Dad with that down payment?" Good luck to the rest of them. Meanwhile, I'm meeting with my partner to discuss Pathfinder's acquisition strategy for the next few quarters. Think I'll lead with "Mitch, let's go buy more apartments!"

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. Reach him at lpolger@pathfinderfunds.com.

GUEST FEATURE

Best Practices at Work AND at Home

By Brent Rivard, Managing Director



Do you find that your business and personal lives sometimes blend and blur into one? I find myself discussing real estate with our investors one minute and negotiating the pickup of kids from school another. Although my wife and kids don't always like for me to apply business principles to our home life, there are great examples where best practices in business apply perfectly to best practices at home.

Best practices for building strong relationships can definitely apply both in business and family life. Great relationships are rooted in trust – which is built on clear communication and transparency. For our team at Pathfinder, we take the building and maintenance of the trust our investors place in us very seriously. Of course, trust is a key component of a good marriage and family life. So here are a few trust-building best practices for both personal and business:

• **Consistent Communication** – Trust is built by not leaving anything to the imagination. We are consistently communicating with our investors so they know the status of their investments. The timing of communication is also important. For our investors, quarterly reporting (and sometimes more frequent) has been the best cadence. In my personal life, daily communication is necessary to keep everybody on the same page. I believe a high level of responsiveness is also key to consistent communication and building strong relationships. When investors (or family members) reach out with questions or communication, responding as quickly as possible (within 24 hours at most) not only builds trust and confidence, but also shows others how much you value them.

• **Transparent communication** – There are many definitions for transparency, but the ones that fit best here are: "readily understood" and "honest and open: not secretive." At Pathfinder, we strive to provide our investors with both summary level updates on our fund and property performance, as well as detailed project narratives for those that want to dig in deeper. We believe in delivering good news regularly and, when there is bad news, delivering it right away along with our recommended resolutions to potential problems. Getting out in front of challenging situations builds investor confidence that we are actively, constructively and proactively dealing with issues. A key component to transparency, especially when dealing with complicated investments, is education. We strive to couple our detailed communication with education and details to help our investors understand how their money is working. At home, "honest and open" communication is a key component in building trusting relationships. Detailed communication of intentions and motives helps build trust and avoid the negative consequences of misunderstandings or miscommunication.

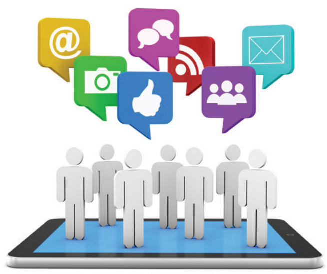
• **Communication Format** – In today's environment, there are an almost unlimited number of ways to communicate and you can't just focus on one format and expect to get optimal results. At home, knowing my audience and how they best communicate is key. Text and email seem to be the best way to communicate with my kids when not at home (or FaceTime with my daughter, who is obsessed with it!) and phone calls with my wife. At Pathfinder, we have a wide array of investors and find that providing a variety of communication formats and distribution platforms helps to build strong connections and relationships. Here are some examples of what we've found works best:

- <u>Email</u> – we use email as our primary mode of investor communication. Whether it is our quarterly fund updates, distribution notifications or this newsletter, email is a great way to deliver information to our investors.

- <u>Webinars and Conference Calls</u> – When the topic is more complicated and requires a venue for Q&A or additional education, webinars and investor conference calls are efficient and effective tools.

• Annual Meetings – We held our annual investor meetings a few weeks ago. Although these take considerable coordination and effort, nothing can replace an in-person meeting and the positive impact it can have on building trust and strengthening relationships.

• Social Media – Over the past few years, we've become more focused on social media. Many of our investors come from the business community and are active on platforms such as LinkedIn. We've made it a point to post press releases on property acquisitions, speaking engagements and company events. It serves as another touch point with our investors and business network.



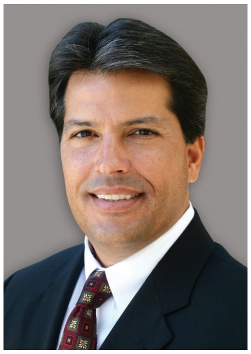
Although this focuses on investors and family, best practices can be applied to any situation where you want to build a trusting relationship. At Pathfinder, we apply these same principles to our relationships with real estate brokers, property managers, joint venture partners and, most importantly, residents in our properties. We believe that our success and reputation has been built on the strong relationships and trust we've built over the past ten years. Good luck and keep communicating!

Brent Rivard is Managing Director, CFO and COO of Pathfinder Partners, LLC. Prior to joining Pathfinder in 2008, Brent was the President of a national wealth management firm and CFO/COO of a one of southern California's leading privately-held commercial real estate brokerage firms. He can be reached at brivard@pathfinderfunds.com.

GUEST FEATURE

Inflation – Be Careful What You Wish For

By Damon Gascon, Vice President of Regional Planned Communities, Lewis Management Corp. and member of Pathfinder Partners Advisory Council



"In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."
- Rudiger Dornbusch

For the past seven years, central bankers have bombarded the world with unprecedented levels of acronyms – Quantitative Easing (QE), Zero Interest Rate Policy (ZIRP) and Negative Interest Rate Policy (NIRP), which has produced a significant amount of inflation in equities, real estate and bond prices, particularly in relation to income and GDP growth. Now, all that money printing has begun to spill over into core consumer prices.

In the U.S., the core Consumer Price Index (CPI), which excludes food and energy, has risen 2.3% year-over-year, which is the largest increase since May 2012, and well above the Fed's 2% inflation target. And if you dig deeper, you will find that prices of medical services, shelter cost, tuition, day care and general services have increased by 3.0% to 3.6% year-over-year. The inflation trend is clearly upward.

The primary drivers of the increase in the core CPI are rising wages and slowing productivity. Labor costs increased 2.3% over the past year. Further, minimum wages are on an upward trend in the country with Seattle, California and New York all having passed legislation to increase the minimum wage by 50% from 2016 to 2021. Unfortunately, legislation doesn't work for productivity. The latest quarterly Bureau of Labor Statistics (BLS) non-farm business sector productivity decreased 1% and has been on downward trajectory for more than a decade. With the possible exception of medical services, the U.S. is experiencing cost-push inflation.

If wages were increasing due to rising productivity and GDP, businesses and policymakers would receive a standing ovation. Real median incomes for the lower and middle-income segments of American workers have been hammered over the past two decades. However, wage increases are being driven more by populist political rhetoric rather than sound economic policies.

This brings us to the Fed. The fundamentals of the U.S. economy indicate a clear case for further rate hikes. Unemployment is down to 5%, job growth is strong and consistent. The trend in core inflation suggests that the Fed is falling behind the curve with core CPI at a post-crisis high. Yet the Fed's recent rhetoric remains dovish.

Recent remarks from Fed Chair Janet Yellen, indicate that she believes that there is still considerable slack in the labor market and the economy has greater capacity for above trend expansion without generating much inflation. An interesting theory but the inflation data does not support Yellen's logic. The fact is that the domestic economy is no longer the Fed's sole consideration in policymaking. In an environment where central bankers around the globe seem unable to raise interest rates (and many have lowered rates – some below zero), the Fed has all but explicitly recognized a new mandate: promoting global financial stability.

Messaging from financial markets increasingly influences the Fed's decision-making. Any suggestion that the Fed will hike faster or earlier than anticipated leads to violent risk-off moves in financial markets. It is clear that the Fed could not stomach the sell-off in global financial markets in January and February, which was largely driven by concerns about further tightening. The implications are worrying. A Fed beholden to financial markets risks sharper rate hikes down the road as the Fed falls further behind the inflation curve. As Oscar Wilde wrote, "In this world, there are two tragedies. One is not getting what one wants, and the other is getting it".

Damon Gascon, a member of Pathfinder Partners' Advisory Council, is a 20-year veteran of the homebuilding industry with substantial experience in strategic planning, land development and development of master planned communities. He can be reached at Damon.Gascon@lewismc.com.

ZEITGEIST – SIGN OF THE TIMES

Commercial Real Estate Acquisitions Poised to Rise in 2016

Several pension funds and other large institutions have recently increased their portfolios' real estate allocation creating more sources of capital for commercial real estate in the U.S. Many public pension funds have increased their real estate targets from 5% in 2011 to approximately 10% today. Additionally, foreign investors continue to look to U.S. real estate as a safe haven – in 2015, foreign investment in U.S. commercial real estate totaled $93 billion, almost double the 2007 level of $48 billion.

According to CBRE Capital Markets, U.S. real estate investors are bullish about increasing their acquisitions in 2016. CBRE's *Americas Investor Intentions Survey 2016* revealed that 81% of investors surveyed intend to maintain or increase their purchases in 2016. Playing to Pathfinder's strategy, major western markets L.A., Seattle and Denver are among the ten most attractive markets and multifamily continues to be the preferred product type for investors.

The Millennial Hamlet: "To Rent or to Buy – that is the Question"

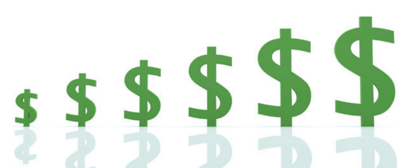
The Census Bureau just released its 2015 household data and the results speak to a continuation of the urbanization trend. As millennials take jobs and seek lifestyles in urban centers while grappling with student debt, the percentage of renters continues to grow. Many single-family housing developers are wondering when millennials will stop renting urban apartments and buy a home in the suburbs. While the overall homeownership rate remained steady at 63.6%, the millennial homeownership rate was only 34.7% – well below the pre-recession high of 43.6% in 2004. The Census data also suggests that this trend is not limited to millennials – individuals in their mid-30's and 40's are more likely to be renting than they were ten years ago with homeownership declining within this demographic from 67% in 2007 to 58% in 2015. While traditional homebuilders are lamenting the lackluster homeownership data, apartment developers are embracing the good news and there are cranes in the sky for the many new multifamily projects in major cities throughout the U.S.

China's Down Payment Lending Rings a Bell

It's been nearly a decade since the U.S.'s subprime bubble burst sending shock waves throughout the global economy. Memories can be short and it's not a huge shock that we're starting to see similar risky lending practices already. This time, however, it's in China.

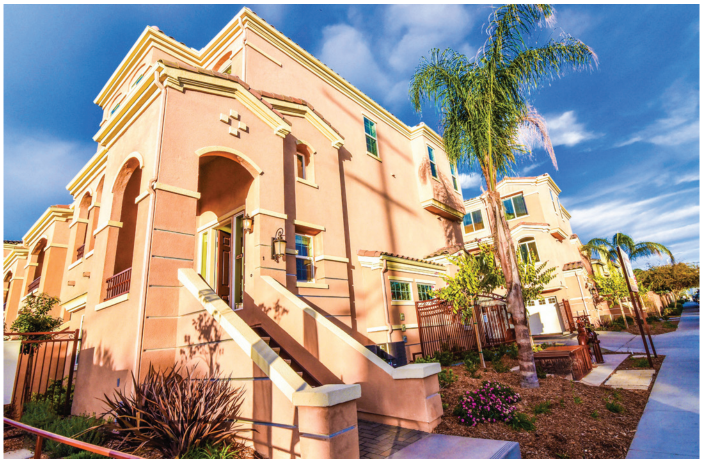
Recently, the Chinese government has started to crack down on the Middle Kingdom's version of sub-prime lending, dubbed "down payment lending". Typical home mortgages in China require a 30% down payment – compared with just 10%-20% in the U.S. A growing number of Chinese specialty lenders are now willing to finance the down-payment, allowing potential buyers to borrow up to 100% of a home's purchase price. In January 2016, these lenders made $143 million ($1.7 billion on an annual basis) in down payment loans – more than three times the amount made in July 2015.

This conundrum presents a vicious cycle: with down payment financing easily available, demand for homes has jumped which drives up home prices which exacerbates the need for down payment financing. Because of this, home prices are on the rise in some of China's hottest markets including a staggering 57% year-over-year home price increase in 2015 in Shenzhen.



TRAILBLAZING: BAHIA VISTA TOWNHOMES

New, Affordably Priced San Diego Townhomes



Jonathan Swift, the 18th-century writer of *Gulliver's Travels* said, "Vision is the art of seeing what is invisible to others."

Today, when we stand on Ada Street in Chula Vista, south of downtown San Diego and gaze up at our newly built, Mediterranean-style townhomes just a mile from the coastline, we scarcely recall the formerly empty one-acre lot. When we acquired the parcel in May 2013, we saw beyond an empty space and envisioned new, well-constructed townhomes with quality finishes and thoughtful floorplans located in an area undergoing significant revitalization.

Now complete and branded as *Bahia Vista Townhomes*, the project contains 21 three and four-bedroom townhomes ranging from 1,600 to 1,800 square feet featuring private balconies and front entryways, direct access two-car garages, stainless steel appliances, quartz countertops, custom cabinetry and, from many units, ocean, bay and mountain views. The community features a private drive with a secure, gated entrance, a "tot lot" and a barbecue and picnic area. Since closing escrow on our first unit in late January, we have sold out the project and raised prices several times.

Bahia Vista is located in Chula Vista's marina district, a focal point for several economic development and revitalization initiatives, which have fueled the area's rapid growth. In recent years, Chula Vista has experienced an increase in residential development, significant improvements in commercial and retail corridors and improved infrastructure along the streets and trolley lines. The area is also poised for a major revitalization of the coastline and marina district through the $1 billion Chula Vista Bayfront Master Plan. The 535-acre plan is intended to transform the Chula Vista waterfront into a world-class destination by means of a convention center, park, open space and recreation and cultural areas. The project is expected to create more than 2,200 permanent jobs and nearly 7,000 construction jobs. *Bahia Vista* is located just three miles from the pending Bayfront redevelopment.

In light of such exciting growth in the community and the success of *Bahia Vista*, we recently purchased the parcel two lots to the west for the development of 16 additional townhomes. We have received our grading and improvement permits from the City and commenced grading work this spring. We expect to receive a building permit and to commence construction this summer with completion anticipated next spring.

A vision now realized, *Bahia Vista Townhomes* foreshadows the future success of its sister project and reminds us of the importance of seeing opportunities that may not always be plainly visible.

NOTABLES AND QUOTABLES

What Lies Ahead

"What's behind you doesn't matter."

- Enzo Ferrari, Italian engineer and entrepreneur

"The fundamental nature of exploration is that we don't know what's there. We can guess and hope and aim to find out certain things, but we have to expect surprises."

- Charles H. Townes, *American physicist*

"The most reliable way to forecast the future is to try to understand the present."

- John Naisbitt, *American author*

"The expected rarely occurs and never in the expected manner."

- Vernon A. Walters, *U.S. diplomat*

"In a crowded room, you only have to see one inch above everyone else to notice things that others will miss."

- Jim Slater, *British business executive and author*

"Don't look back. You're not going that way."

- Mary Engelbreit, *American author*

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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.

Please add msiegler@pathfinderfunds.com to your address book to ensure you keep receiving our notifications.