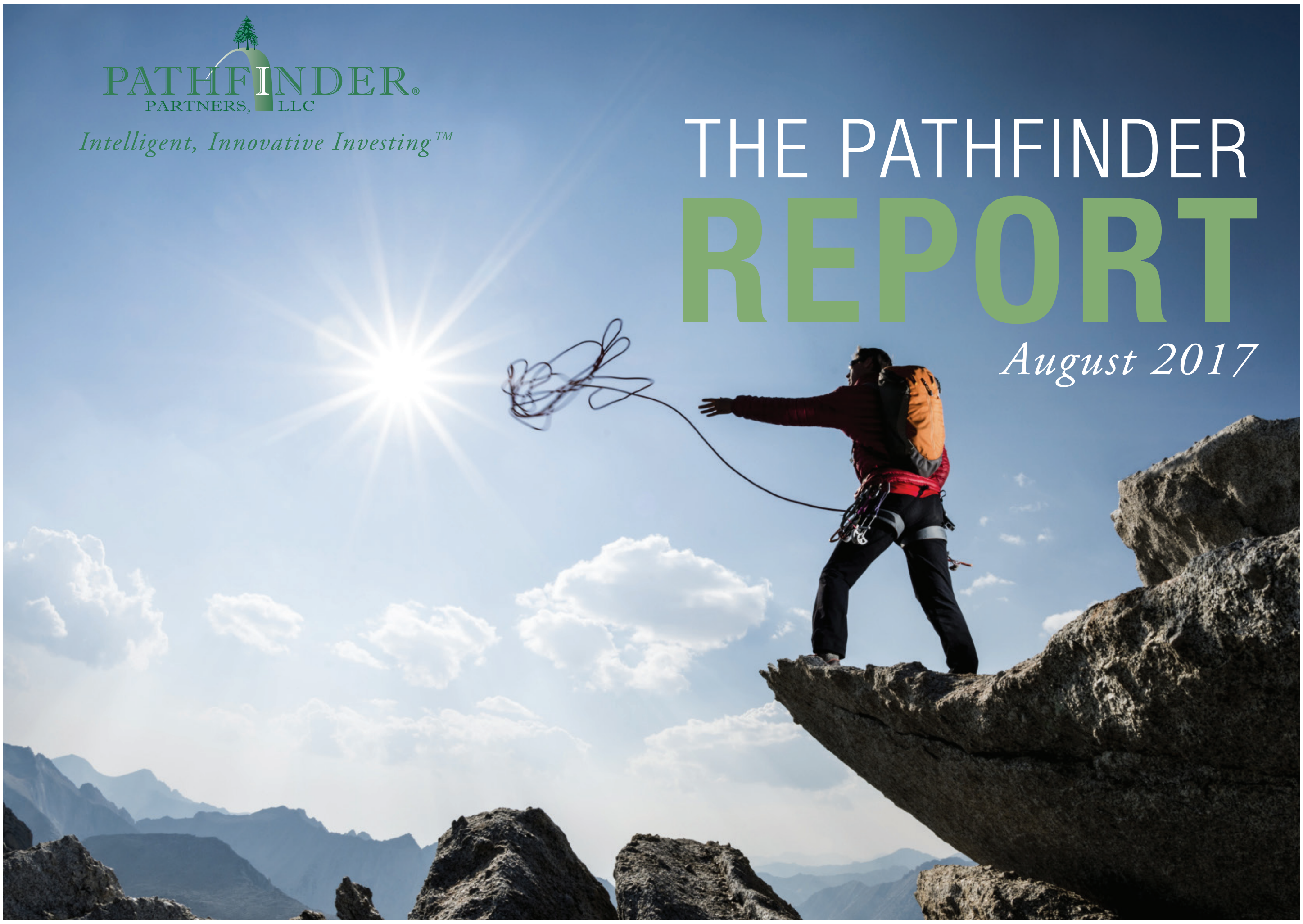

THE PATHFINDER REPORT

August 2017

IN THIS ISSUE

CHARTING THE COURSE

What – Me Worry?

By Mitch Siegler, Senior Managing Director

Risk is inversely related to price. Are investors paying excessive prices for the risks they're taking?

Legendary investor Bill Gross says U.S. markets are at their highest risk levels since before the 2008 Crisis. "Instead of buying low and selling high, you're buying high and crossing your fingers," Gross said in June to attendees at the Bloomberg Invest New York summit. The reason? Central bank policies of low- and negative-interest rates, which drive up asset prices while creating little real economic growth.

Sir Isaac Newton and Warren Buffett might concur, though each in his own way. Newton's Law of Gravity (What goes up must come down) is a physics axiom for investors who subscribe to 200-day moving averages and other principles of momentum investing. It likely applies to central bank Quantitative Easing (QE) which may be morphing into Quantitative Tightening. Buffett's colorful maxim, "Only when the tide goes out do you discover who's been swimming naked," sums up periods of excessive optimism. Bill Gross's warning can't be lost on the Oracle of Omaha.

Equity Valuations are in Nose-Bleed Territory

The S&P 500 is trading at 25 times trailing 12-month earnings compared to a long-term median of 15 times. The S&P 500 hasn't had a 5% pullback in more than a year, only the sixth time this has happened since 1950. U.S. equities have only been more expensive during the 1997-2000 dot-com bubble period. The S&P 500 cyclically adjusted price-earnings (CAPE) index stands at 30 versus an historic median of 16; the index has only been higher in 1929, just prior to the Great Depression and 2000, before the dot-com bubble burst.

Adding to the flock of canaries in the coal mine, U.S. corporate profit margins appear to have peaked several years back. Corporate profits have grown at an anemic annual rate of .097% over the last five years; from 2000-2012, five-year profit growth was 7.95%, says 720Global's Michael Lebowitz. And, corporate debt levels, at $8.6 trillion, are 30% above the prior peak in September 2008, per Lebowitz.

Other warning signs include rising credit-card charge-offs and used car loans with record long terms and loan amounts. The much-ballyhooed student loan crisis is also a concern; the average graduating college senior was saddled with $35,000 in debt in 2015, from less than $10,000 in 1993, according to CLSA strategist Matthew Sigel. Perhaps this explains why 32% of 18-to-34-year-olds still live with their parents, up from 27% in the past decade, per Sigel.

Meanwhile, in Silicon Valley, mega venture capital funds have been raising larger and larger funds, a sign that their investors – notably pension funds, university endowments and non-profit foundations – are backing up the truck to invest in startup and emerging growth companies. VC funds haven't raised this much capital since – drum roll, please – the dot-com era. And it's not like valuations are low. As of July, there were 100 American "unicorns" – startups valued at more than $1 billion. That's triple the level of 2014, says the *Wall Street Journal*.

With all these signs of irrational exuberance, one would think there would be a stampede for the exits. You know, not so much. There seems to be a bit of a fear of missing out (FOMO), a kind of complacency. Perhaps it's just the summer weather but maybe there's more to it. The VIX, a measure of volatility and a gauge of investor sentiment about future volatility, is near the lowest level of its 27-year history. Prices of hard assets like fine art, collectible firearms and fine wine are at or near record levels. Complacency abounds. LaTeDa, things just couldn't be better.

One more "trees don't grow to the sky" anecdote. In June, Argentina issued $2.75 billion of 100-year bonds at an interest rate of 8%. Sounds juicy until you consider that Argentina has defaulted on its debts eight times in its 200-year history and five times in the past 100 years. Didn't stop the buyers – there was nearly $10 billion in demand for this issue. Now, what are the odds that we 'Don't cry for me, Argentina' sometime in the next century?

Dammit, Janet.

The world's central bankers have pumped $1.6 trillion of newly-printed money into the financial system during the past year, says BMO Wealth Management. If you believe the Fed and other central bankers, the money supply is tapering as central banks sell bonds and boost interest rates. The Fed's announcement that it will gradually shrink its $4 trillion balance sheet, initially by $10 billion per month, fits right in. But, it's a marathon, not a sprint. Economists at the Lindsey Group estimate that the Fed will still be tapering in 2023, unless conditions change – which they could at the drop of a hat.

In normal times, the job of a central banker is daunting, what with the challenges of predicting the future and all. It's not made easier by sub-2% annual economic growth, basically the new normal the past few decades, notwithstanding a certain bombastic New Yorker's dreams of growth climbing shortly to 3%, even a beautiful 4%. Wage inflation should be imminent with unemployment in the 4.4% range (that was "full employment" back when we were studying Economics) – except it isn't. Wages for most folks seem stuck in neutral. No huge surprise, that, with 95 million Americans out of the labor force and robots being deployed in factories, warehouses and service industries as far as the eye can see.

Plenty of structural factors at work as well; notably, competition from workers in countries with daily wages below the average U.S. hourly wage. Labor force participation is lower today than at the end of the Great Depression, writes Nicholas Eberstadt, the American Enterprise Institute's ace demographer. Beyond run-of-the-mill economic modeling, Fed policymakers also must contend with assorted moving parts like a new Fed Chairman/woman, the Administration's ongoing battles with Congress and a special prosecutor, health care and tax policy, Brexit, China policy, Russia policy and nuclear cat-and-mouse with North Korea and Iran, to name just a few.

A Time for Caution?

At Pathfinder, we've been walking on eggshells for a while now. Our "belt and suspenders" approach has long informed our investment strategy and we turned more cautious last year. That drove us to raise less capital than in the recent past and we've been laser-focused this year on investing in a particular strategy that we think is about as bullet-proof as you can find: buying and improving older apartment properties in a handful of growing markets that we know well.

We have friends still making a killing repositioning retail centers, developing massive industrial buildings for e-commerce companies and entitling raw land in the path of growth. Smart guys, all, and they'll likely do well. By being a little gun-shy, we'll probably leave some chips on the table but it seems better to turn cautious a little too early than a bit too late.

As we close, a question: If folks are having more trouble paying their debts with unemployment hovering around 4% and interest rates near record lows, how might things look if rates move higher or – heaven forbid – the stock market declines?

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FINDING YOUR PATH

Welcome to the Beach. There's Plenty of Sand!

By Lorne Polger, Senior Managing Director

Summer vacation plans now in full swing? Bouncing around Bali? Dancing in the Dolomites? Of course, here in beautiful, California, the sun will be shining, the beaches will be brimming with swimmers and surfers and the warm sand will be curling your toes. Come see for yourself, or if you are already here, go out and enjoy it and appreciate how lucky we are to live here.

Speaking of sand, I have an increasing sense that we are burying our heads in it. Not literally of course, like my kids used to do on a sunny Saturday at La Jolla Shores. But figuratively across many beachheads. Here are some musings.

Student Debt. I've written before about this looming, enormous crisis. It's not going away. It's probably getting worse. While our public and private universities are hoarding cash in runaway proportions (the ten largest university endowments now exceed **$168 billion**; likely enough to put every kid through school for the next 30 years), tuition costs have risen to record levels. Why are we not talking about it? Does it really make sense that a four-year undergraduate degree is now approaching $300,000 (when you factor in housing, books, travel, etc.)?? That's about $500,000 in after-tax dollars. That's crazy!! Are we all sheep on this one? Is the sand that far over our heads? Not sure what to do here other than continue to write about it, talk about it and think about it. Think about it, folks, the ripple effects here will be a drag on for generations.

Talking Head Sound Bites. I truly wonder how many people are getting their "thoughtful" analysis from daily television sound bites? No matter whether you are watching CNN, FOX or any other channel, but should these be your sole sources for analysis of daily events? How many newspaper editorials are you reading these days? Academic journals? Have you noticed how grossly mundane "the news" has become (regardless of your party affiliation)? Do we really need 15 minutes on the color of the President's tie that day? Or 20 minutes to dissect Mike Pence's recent haircut? Half an hour to analyze SNL's weekly parody? Is that a productive use of our time? Couldn't the collective "we" be doing better things at this point? Like maybe, saving the earth? Having a glass of wine with a friend? Taking the dog for a walk? All seem like much better pursuits to me at this point. Unless you like the sand crawling up your neck…

Non-Reading. Was reflecting with my college roommate a few months ago about how much harder we studied back in college and grad school than kids seem to be doing today and how much more we read, both for pleasure and for academic pursuits. I'm fearful that reading for pleasure will become a lost art in our current "gotta have it now", easily distracted, must-be-entertained society.

News from Social Media. Heh, I'm not going to lie, I'm a pretty big Facebook poster. Not the crazy stuff, like the Osso Bucco from the restaurant two weeks ago, but more about people and memories, which are the things that are important to me. But I'm amazed at the number of people that have told me over the last few years that the majority of their news is coming from Facebook and Instagram. Because you can digest it in six seconds, does that make it either reliable or authentic?

Overly Exuberant Financial Markets. In 2016, Tesla lost $773 million on over $7 billion in revenue. The company has $3 billion in cash and will likely bleed billions more as it launches its Model 3 for the everyman.

In 2017, it is projected to lose several billion more on revenues of $12 billion based on sales of around 100,000 cars. Its current market valuation of over $57 billion makes it more valuable than both Ford and GM. Really? I think they are an incredibly innovative company, but at some point, profits do matter, don't they? Don't you need to make money (or have a clear path toward that goal) to increase your valuation? The Dow at 22,000 and the S&P around 2,500 feel pretty darn bubblicious. As they say on Shark Tank, "for that reason, I'm out."

Cost of Housing. Can't quite call it a looming crisis yet, but I wonder how GEN X, Y and Z afford to live these days. Housing prices have risen dramatically over the last five years. Rents have skyrocketed. Young adults are paying staggeringly disproportionate percentages of their net incomes for housing costs. Are trees going to keep growing to the sky? I don't think so.

Global Warming/Climate Change. You can have a decent debate about whether it made sense to pull out of the Paris accord. I've actually heard decent arguments on both sides. But denying that climate change exists and will have a profound effect on our world for future generations? Seriously? Didn't realize there was that much sand…

Lack of Appreciation for Nature/Disconnecting. When is the last time you went to a national park? Last year? Within the last five? Ten? Really, it's been that long? Do you know these are national treasures? When is the last time you disconnected from your phone, tablet and/or laptop for more than a few hours or even one day? Really, that long? Do you think life will manage to go on without your connection?? Don't you think the world would be a better, happier place if we all disconnected for a while and had meaningful, soulful conversations with people who aren't staring into their phones? I do. And in fact, I've done some of that this summer. Hard to look at your phone when you're having great conversations with friends and family hiking up mountains. Has felt great to shovel some sand away from my body this summer. Give it a shot. About a month left to do it.

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

Delivering an Experience – What Renters Really Want

By Aaron Flores, Senior Associate

According to Steve Forbes of Forbes magazine, "Your brand is the single most important investment you can make in your business." At Pathfinder, we put great thought into the brand development of our communities. A well thought-out branding strategy can successfully differentiate an apartment community and provide a competitive advantage. It can help attract and retain tenants, drive referrals and ultimately boost rents and income. If you are an apartment owner lacking a strong brand for your community, you are simply not maximizing the value of your investment.

Today's renters are more sophisticated and seek much more than just a roof over their heads. They desire an experience, a lifestyle that is a reflection of them. Since apartment architecture doesn't vary greatly, one of the best approaches to position an apartment is to convey a unique living experience – this is the brand. Outstanding companies understand this. Apple doesn't just sell computers or phones – they sell a lifestyle, an experience. At Pathfinder, we want to go beyond renting a generic, two-bedroom, one-bath apartment – we seek to differentiate our properties and sell a better living experience.

So how do we create that experience? We start with a deep understanding of our target market and position a property to reflect the lifestyle those residents will appreciate. We endeavor to provide residents with well thought-out amenities they will use and value, regularly scheduled resident events they care about and social media engagement that matters to them.

Tailored Amenities that Enhance Living

One of the best ways to deliver an experience to renters is through lifestyle amenities. Some amenities, like a well-furnished clubhouse or a state-of-the-art fitness room are becoming standard these days. That's not to say you shouldn't have them, but they won't make you stand out or elicit as much excitement from prospective residents.

As noted above, we take a strategic approach to amenities based not only on what our residents want, but more importantly, what they will actually use. For example, at Driftwood, a San Diego apartment community near the beach, we are incorporating outdoor resident and pet showers and a car vacuum station. In Boulder, Colorado we are providing a bike repair station and a yoga room – seven out of 10 Boulderites own bicycles and Boulder was listed the third most Yoga-Friendly town in the U.S.

Amenities can also promote greater social interaction within the community. Dog parks, community gardens and bocce ball courts provide a great venue for residents to spend time together. Whether it is a rock climbing wall or pool cabana, the right tailored amenities can enhance a property and a renter's perceived value.

Resident Events that Promote Community

We live in an age where people increasingly value experiences over material goods. It's no wonder that the social aspects that come along with renting an apartment are becoming more important to today's renters. Everybody loves a good party and what better way to bring neighbors together than with a social gathering? Events like pool parties, watching the big game in the lounge area or an outdoor movie night with drinks and popcorn are guaranteed crowd-pleasers. Also, partnering up with local food trucks or restaurants is another creative way to create a sense of community at the property and tie in to the broader community.

Successful resident events require knowing your community and understanding what social event will attract residents. For example, if a majority of residents are athletic then a free CrossFit class at the fitness center will be of great interest or if it is a pet-friendly community a pet costume contest at Halloween will be a hit. Providing meaningful theme-related freebies or raffle prizes help to further drive attendance. Again, it's about connecting to residents through a custom tailored experience that they can appreciate.

Social Media that Engages Residents

At the 2017 Multifamily Social Media Summit, "Community Social Media" was listed as the second most important value driver by prospective renters – right after "Sense of Community". Social media is quickly becoming one of the most powerful tools for our property managers to connect with residents. A few interesting tidbits about the growth of social media from Brandwatch Analytics:

- There are 2.3 billion social media users.
- There are 1 million new active mobile social users added every day. That's 12 each second.
- Internet users have an average of 5.5 social media accounts.
- There are over 1.15 billion mobile daily active Facebook users, an increase of 23% year-over-year.

By engaging residents via social media, a property manager has the opportunity to interact with them frequently. Content that is authentic, relevant and timely with imagery that is evocative, differentiates and excites will make an impact. Some of the benefits of social media include building brand awareness, enhancing promotions, improving loyalty, gaining insight and providing a richer resident experience and a greater sense of community.

A Meaningful Experience

A one-size-fits-all approach to branding apartments is no longer enough to meet the expectations of today's renters. The majority of apartment communities don't exactly prioritize branding which provides plenty of opportunities to stand out. By making use of the branding techniques above and delivering an experience greater than the status quo we can provide an elevated living environment for our residents – one that is memorable, emotionally engaging, and purposeful.

Aaron Flores is a Senior Associate at Pathfinder Partners, LLC. Prior to joining Pathfinder in 2016, Aaron held senior management positions in two San Diego-based real estate investment firms. He can be reached at aflores@pathfinderfunds.com.

ZEITGEIST – SIGN OF THE TIMES

Doctor, More Apartments, Stat!

Based on recent research by Hoyt Advisory Services, a Florida real estate consultant, the U.S. will need 4.6 million additional apartment units by 2030 to quench the insatiable demand created by delayed homeownership, an aging population and continuing international immigration. With nearly 39 million U.S. residents living in apartments and a need for 325,000 more units per year just to meet the current demand, the apartment industry is struggling to provide sufficient supply with only 244,000 new units per year built between 2012 to 2016.

According to Norm Miller, Professor of Real Estate at the University of San Diego (and member of Pathfinder's Advisory Council), the largest driver is a shift in the country's demographics. "We're experiencing fundamental shifts in our housing dynamics, as more people are moving away from buying houses and choosing apartments instead. More than 75 million people between 18 and 34 years old are entering the housing market, primarily as renters. But renting is not just for the young anymore. Increasingly, Baby Boomers and other empty-nesters are trading single-family homes for the convenience of rental apartments. In fact, more than half of the net increase in renter households over the past decade came from the 45-plus demographic."

In conjunction with the demand for new units, there is also a growing demand for renovations to existing apartment communities. According to Hoyt's research, over 50% of existing apartments are more than 35 years old and will need to be renovated in the next 10-15 years. This is expected to provide a boost to the construction industry and to the overall economy.

U.S. Foreign Home Sales Breaks All-Time Record

According to a recent survey by the National Association of Realtors for the 12 months ending March 31, 2017, foreigners purchased over 284,000 U.S. homes for a total of $153 billion in gross sales, a 33% increase in transactions over the same period last year. The Chinese represented the largest cohort of foreign buyers at $31.7 billion (21%) followed by Canadian buyers at $19 billion (12%) although the Canadians represented the largest increase in total sales ($10.1 billion) when compared with their $8.9 billion in home purchases last year.

Among the states, Florida led the way with 22% of foreign-purchased homes followed by California and Texas at 12% each. The median price of homes purchased was $302,000, approximately $66,000 higher than the median home price for all U.S. home sales of $236,000. 64% of the transactions were detached, single family homes. The records came as a surprise to many realtors surveyed as 2016 saw a Chinese government crackdown on the outflow of capital, a rising U.S. dollar and increasing U.S. political uncertainty.

Sweet Home, Sacramento

The San Francisco Bay Area's ongoing tech industry boom has caused home prices and rental rates to skyrocket and has left many residents searching elsewhere for housing. As a result, the City of Sacramento – less than 90 miles northeast of the Bay Area – is experiencing an increase in net migration due to its relative affordability compared with San Francisco.

According to *Zillow*, the Sacramento median home price in July was $302,700 compared to $1,204,700 in San Francisco. In addition to being able to own a home for nearly a quarter of the cost, Sacramento residents benefit from the downtown area's recent urban renewal and easy access to a wealth of outdoor recreational opportunities not available in the Bay Area. On the flipside, the influx of residents has propelled apartment rent rental growth in Sacramento, although rates are still significantly lower than the Bay Area. According to the *Colliers International 2017 Sacramento Multifamily Forecast*, "Sacramento apartment rent growth in 2016 (10.7%) topped all major U.S. markets. We will continue to see positive rent growth in the 6%-7% range through 2017." Despite the increase in apartment rates, Sacramento was the fastest growing city in California in 2016 (1.4%) and this trend is expected to continue in 2017.

TRAILBLAZING: HARLOW, LAS VEGAS, NV

Some Solace Away from the Action

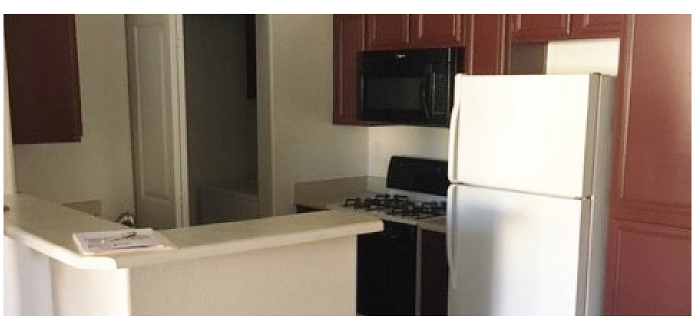
Newly Repainted Exterior at Harlow

When thinking of Las Vegas, many of us have images of the glitz and glamour of the "Strip", a pool party at the Bellagio, or bottle service and a high-priced DJ at a glitzy nightclub. The reality for most of the City's residents is a much more tempered lifestyle – they may work on the Strip at night but they stay far away on their days off.

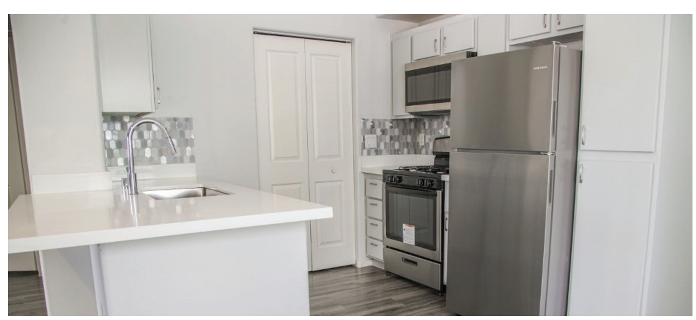
As the economy rebounds from the Great Recession and tourism continues to grow, the Vegas suburbs – where many locals reside – have also rebounded strongly.

Harlow (formerly Tierra Bella), built in 2003, is a 98-unit apartment community located in northwest Las Vegas within the Lone Mountain residential area – a quiet and quasi-rural suburban area adjacent to the award-winning Summerlin master planned community. The property is situated on 5.6 acres and includes 13 buildings consisting of 16 one-bedroom/one-bathroom units, 50 two-bedroom/two-bathroom units and 32 three-bedroom/two-bathroom units averaging 1,061 square feet. Many residents work in or around the Strip and enjoy the tranquil location and nearby amenities (there is a horse-trail and walking path in front of the property that winds through the nearby Lone Mountain hiking area).

Our business plan is to implement hands-on, professional management, renovate and modernize the unit interiors and common areas, rebrand and refresh the marketing and add several amenities. To date, we have completed a new exterior paint scheme on all buildings and are renovating the leasing office, clubhouse, fitness room and pool area, all scheduled for completion this month. We have rebranded the community and updated or replaced the property's signage and marketing materials. In addition, we have renovated four unit interiors and have three additional units in process. We believe there is a shortage of modern, renovated apartments in this submarket and our renovated units and exterior enhancements have been well received by our tenants.



Kitchen Before



Kitchen Renovated

NOTABLES AND QUOTABLES

Value

"Price is what you pay, value is what you get."

- Warren Buffet

"Try not to become a man of success, but rather try to become a man of value."

- Albert Einstein

"All intelligent investing is value investing – acquiring more that you are paying for."

- Charles Munger,
American investor

"Knowledge is of no value unless you put it into practice."

- Anton Chekhov,
Russian Author

"When the well's dry, we know the worth of water."

- Benjamin Franklin

"If you want to know the value of money, go and try to borrow some."

- Benjamin Franklin

"The major value in life is not what you get. The major value in life is what you become."

- Jim Rohn,
American entrepreneur

"A nickel ain't worth a dime anymore."

- Yogi Berra

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