

## Happy Holidays from Greenfield!

We hope all our friends, clients, and colleagues are having a great holiday season and looking forward to a safe and prosperous 2008. We're somewhat embarrassed that *The Greenfield Advisor* has been so irregular this year, but 2007 has been a pretty busy time for us. Among our many new years resolutions – more consistency in our communications!

## So how's the real estate market?

A year ago, I got asked this question about once a week. Earlier this year, with the sub-prime meltdown and the front-page headlines, the question started popping up every day. Now (December, 2007), it's the very first question people ask me when they see me.

I wish I had a nice, flippant answer. "The market's great!" would just ease everyone's pain and agony. However, and of course, its way more complicated than that. It's perhaps more complicated than I have room for here. Nonetheless, I'm going to try to provide an answer, which unfortunately won't be very succinct. I'll also go ahead and admit to the two big caveats. First, I'm absolutely positive there will be disagreement with this opinion. Indeed, I can already think of the leading candidates who will disagree with me! Second, of course, this can certainly not be construed as investment advice for anyone's specific situation, and anyone who needs such advice should seek appropriate counsel.

### ***Debt versus Equity***

It's important to understand that the current real estate "crisis" is a debt crisis, albeit one with equity roots. While there are cyclical downturns in the market (as there always are), at core of the current crisis is the problem of subprime lending. Note that subprime lending isn't in-and-of-itself a bad thing: lenders frequently take a risk on homebuyers with credit or income difficulties. The "starter home" market would cease to exist without the opportunity for first time buyers to get a foot into the home ownership door.

It's not even a problem that too many sub-prime loans were made. Current thinking is that about 25% of loans outstanding were to credit-challenged buyers, about 25% of those will fall into some struggle, and 25% of those will end up in default. When we do the math, we see that's not an extraordinarily high default rate, although admittedly this will vary from place to place. Some places, like Detroit, which have other cyclical economic issues, will have higher default rates. Suburban Seattle, where I live, will have nearly none at all. Indeed, this default rate is well-priced in the mortgages, and as such shouldn't be a reason for concern to investors. If you buy a pool of bonds with zero default risk, then the return should approximate the risk-free rate (plus a factor for expected inflation). If that pool has a 2% anticipated default rate, then you should earn a nominal return of the risk free rate plus the default rate. Generally, this algebra has served us well for quite a few decades, and the whole secondary mortgage market is built on it.

And before we get to the real problem, note that even those properties which go into default are not worthless collateral. Generally, foreclosed homes sell at auction for 60% to 80% of unencumbered market value, and most of that discount is due to fix-up problems and simple distress-sale discounts. (Notably, many investors earn an exceptional ROI buying selected repo's). In short, the problem really has very little to do with the riskiness (either ex-ante or ex-post) of the underlying collateral. Indeed, this is almost certainly not a real estate equity problem.

## ***If it's not an equity problem – what is it?***

To get to the answer, it's critical to understand how residential real estate is financed today. As I mentioned, for decades we've used securitized pools of mortgages to provide liquidity to the lending market. If you have a home mortgage loan, your promissory note, along with a hundred million dollars worth of your neighbors notes, are bundled together and sold to bond investors. As you pay off your loan, the investors receive back the principal. In a statistically large pool of loans, about half will be paid off in seven or so years, and nearly all of them will be paid off in twelve. Sounds simple, right? Perhaps a bit too simple. Somewhere along the line, someone realized that the safest loans to were the first ones that paid off, and the riskiest ones were the last ones to pay off (and which sometimes pay off not at all). Since there's no way to know which are which in the beginning, we create derivative interests in the mortgage pool, called *tranches*. The "A" tranche gets paid the first money out, and naturally gets a low rate of interest. The "B" tranche gets the next money, etc., etc. There's no real limit to how many tranches we create, or how big each one is, except that the "A" tranche needs to be sufficiently small and secure so that it can get a AAA rating, and it will receive an interest rate which is quite low. By convention, the last tranche to get paid is called the "Z" tranche. It gets all of the residual interest, which will be quite high.

For simplicity's sake, let's say we have a \$100 million pool divided into just two tranches – "A" and "Z", each of which has \$50 million in it. (It's never that simple, but this is a reasonable example.) The underlying mortgages pay 6%. Since AAA securities only pay about 4%, the "A" tranche gets about 4% interest, while the "Z" tranche, which bears all of the residual risk of default, gets something closer 8% (more or less).

Sounds pretty good, eh? You would think so. However, hedge funds and others who behave like hedge funds decided that wasn't enough. If we can borrow money at 6% and buy "Z" tranches at 8%, and leverage these things to the hilt, we can come out making significantly more than 8%, right? Well, of course, that works just fine as long as the default rate remains constant and predictable. What happened, though, is a very slight up-tick in the default rates stimulated a wholesale collapse in the hedge fund house of cards. Billions of dollars of over-leveraged derivatives saw their value disappear, even though the underlying mortgages were still in pretty good shape.

For the time being, it's the death of sub-prime lending, although I have every confidence that we'll find new instruments to satisfy that slice of the demand curve just as soon as the housing market starts cycling back up again – as it always does.

## ***But equity's OK, right?***

Sorry, but I didn't say that. Remember, we are in a period of cyclical change, which affects not only housing but also the commercial markets. Generally, cycles signal three issues for real estate investors: portfolio evaluation, disposing of up-cycle properties, and acquiring down-cycle opportunities. Even in those situations where no portfolio rebalancing is needed, the simple "frothing" of the market suggests the need for a portfolio review. Long-term investors usually use these cycles as opportunities to pick up distressed, turn-around, or out-of-favor properties. Institutions typically need some comfort during these market shifts, if for no other reason to provide fiduciary back-up.

Note that downturns in one market imply upturns in another. For example, a reduced demand for owner-occupied housing suggests an increased demand for apartments. Of course apartments have been selling at extraordinarily low cap rates for years, in anticipation of just such a generic shift in demand. Whether this plays out or not remains to be seen, but given recent pricing of apartments, a shift in demand doesn't necessarily play out to a shift in value. Of course, that's a truism for every facet of the real estate market.

Again, best wishes for the holiday season, and we promise to be more "regular" with the Greenfield Advisor in the coming year!

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