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Pathfinder Investment Outlook

We are pleased to bring you our Investment Outlook for the week ending July 24, 2015

Pathfinder Macro Recap & Outlook

This week we address a topical domestic issue: Vancouver housing and whether it is a good investment.

As we stated in the Semi-Annual report for the Real Return Plus Fund, we are often asked our opinion on the direction of markets (including housing markets). Our answer is that we do not have specific insight into the short-term direction of markets. We believe time is better spent analyzing whether an asset or asset class is potentially expensive or undervalued. If our analysis is accurate, it may give us insight to the long-term direction of that asset's value:

- If undervalued, it may be reasonable to expect that asset to increase in value over the long-term
- If expensive, it may be reasonable to expect that asset to fall in value in the future

So to gain insight into the long-term direction of Vancouver housing we question,"is Vancouver housing expensive?"

According to an actual example, a $3.1 million Westside Vancouver home currently rents for $3,100/month or $37,200/year. The house has $10,000/year in annual maintenance and insurance costs, and $8,000/year in property tax. This means that the owner of the home will earn $19,200/year in income which represents 0.62% the current value of the home. Said differently, if we were to view the Vancouver home as a savings account, this would be equivalent to putting our money in a savings account that paid us a 0.62% interest rate in the next year. Below we look at how this compares to other investable assets today:

Investable Asset Comparison July 24, 2015

Asset Class	Annual Expected "Interest"
Savings Account	0.50%
Vancouver Home (flat LT net rent)	0.62%
30 Year Government Bond	3.20%
S&P 500 (ex-energy, flat LT earnings)	6.21%

Source: Bloomberg Markets LP, Pathfinder Asset Management

As seen above, Vancouver housing seems to offer an inferior "interest rate" versus other investable asset classes. The income from a Vancouver home actually has a higher risk profile then a government bond (what happens if an uninsured natural disaster destroys homes, like the recent floods in Calgary or if the rental tenant leaves and cannot be replaced) but offers only a fraction of the interest a government bond does. This seems unreasonable because investors are supposed to seek a higher expected return for taking on more risk. As a result, it may be reasonable to expect investors to sell their Vancouver home to earn the superior interest they could earn in a government bond, equity, or even a home elsewhere in the world. This could cause Vancouver housing to fall in the future.

The number one response I receive to the above analysis is, "but Christian you are ignoring how much the house will rise in value per year; the net rental income is actually irrelevant". In response, it is important to highlight what most of the world's best investor's note. "The true value of any asset is dependent on the long-term income that asset will generate". In other words, the price of any asset should be completely reliant on the income the asset generates. Assets don't magically go up in value, they increase because 1) the asset now generates more income than previously expected (ie: a house is able to increase its rent) or 2) investors are willing to accept a lower return from said asset (ie: if the Vancouver home were to increase in value without an increase in rent, it is because an investor is willing to accept a 0.5% annual return versus 0.6% previously).

It seems Vancouver real estate is mispriced versus other assets and undoubtedly expensive. It may be reasonable to expect prices to fall as a result. However, there are several realistic scenarios that could cause Vancouver real estate to keep rising despite being "expensive":

1) Vancouver continues as an "off-shore" store of "questionably earned" wealth. A realtor recently told me a story of a new Chinese immigrant who stated he didn't care if Vancouver real estate fell 50% because if it did he would still be up 50%. What he was referring to was losing 50% of his money in a Vancouver home was better than having 100% of it confiscated if he kept it in China. Worldwide, Vancouver continues to be one of the easiest places for global immigrants to access. Will this continue? An asset will keep going up if the buyers continue buying at any price.

2) The Bank of Canada adopts a "save Canadian housing at any cost" policy. It is possible that the Bank of Canada would prevent a housing correction at any cost by devaluing the Canadian dollar (lowering interest rates, QE) at a quicker pace than the fall of housing. This would create a perception that Canadian housing was actually stable, relative to Canadian dollars but one would notice that it would be falling relative to other things. In fact, this has already been occurring.

In conclusion, Vancouver housing seems undoubtedly expensive. There are several scenarios (previously highlighted) which could continue to cause the price of a Vancouver home to rise, but we believe these scenarios are a poor investment thesis at best. We believe the most consistent investment results are driven by analyzing whether an asset or asset class is expensive or undervalued. If undervalued, it may be reasonable to expect that asset to increase in value and we may want to own that asset. If expensive, it may be reasonable to expect that asset to fall in value and perhaps we should avoid owning that asset. Such may be the case with Vancouver real estate.

Christian Anthony, CFA | Portfolio Manager

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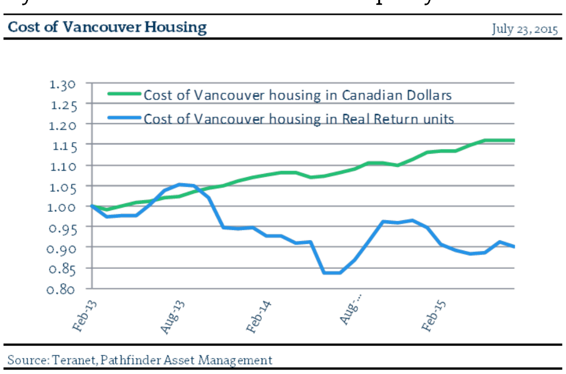
Real Return Plus Fund

Spotlight: Vancouver Housing

Continuing our Vancouver housing theme, we highlight that housing often represents one of our biggest living costs. The CPI highlights housing costs as the cost to rent, but for a family wanting to live without the stress of moving, housing costs may better be defined as the cost to purchase a home. For this reason our custom cost of living index uses the cost to purchase a home versus the cost of rent.

One of the main objectives of the Real Return Plus Fund is to preserve and grow our ability to afford a home. As a result, we spend a lot of time analyzing whether housing could be increasing or falling in the future. Our general thesis on housing is highlighted in our macro section this week, and since we view Vancouver and Canadian housing as expensive, the fund has refrained from making any investment in Canadian housing.

It is easy to dismiss our thesis as wrong, as according to Teranet, Canadian and Vancouver housing prices have increased 12.4% and 16.1% respectively since the start of our fund. However, that is if you measure the value of a home in Canadian dollars. Long-time readers of our commentary will note that we have been equally if not more bearish on the Canadian dollar. Just like Canadian housing the fund hasn't owned Canadian dollars, in fact, we have borrowed/shorted Canadian dollars at certain times. Instead, we have invested in other assets we believe offer a higher return than Canadian housing or dollars. To the right, we highlight the cost of Vancouver real estate versus the value of a Canadian dollar and versus the value of a Real Return Plus unit. As can be seen, the cost of a Vancouver home is higher in Canadian dollars but cheaper versus the value of our fund.



Often people don't practice what they preach; they say one thing but do the complete opposite. However, your fund manager practices what has been highlighted in this commentary. Instead of tying up my capital in Vancouver real estate, I very happily rent and invest my savings in Pathfinder investments (mostly this fund). To date, this has resulted in the ability to purchase more or higher quality Vancouver real estate and I work with the objective that this will continue.

Christian Anthony, CFA | Portfolio Manager

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Sources: Bloomberg, Pathfinder Asset Management Limited

Disclosure

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* All returns are time weighted and net of investment management fees. Performance returns from The Pathfinder Partners' Fund and Partners' Real Return Plus Fund (the 'funds') are presented based on the masters series of each fund. The Pathfinder Core: Equity Portfolio and The Pathfinder Core: High Income Portfolio are live accounts. They are segregated assets managed for Pathfinder senior management, which are then duplicated in the construction of all other client accounts. Monthly inception dates for each fund and portfolio are as follows: Pathfinder Core: Equity Portfolio (January 2011), Pathfinder Core: High Income Portfolio (October 2012) Pathfinder Partners' Fund (April 2011) and Pathfinder Partners' Real Return Plus Fund (April, 2013).

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