

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Residential Real Estate as an Important Investment Concept



JOHN F. OSBON is the Founder and Chief Investment Officer of Osbon Capital Management. Previously, he was a Managing Director at Credit Suisse First Boston and Head of its private client office in Boston. Prior to that, Mr. Osbon was a Managing Director and Head of Atlantic Trust Pell Rudman in Boston. He began his private wealth career in 1982 at Morgan Stanley, where he held several positions, including Head of the New England region. He opened Morgan Stanley's private wealth office in Boston in 2000. Mr. Osbon earned a B.A. from the University of Chicago and an MBA in finance from the Columbia Graduate School of Business. He serves on the board of overseers for the Boston Ballet and the development board of the Park Street School, in Boston. He is also a member of the vestry of St. Paul's Church on Nantucket. Former associations include Adjunct Professor of

Finance at Babson College Graduate School of Business, Trustee of the Nantucket New School, board of the trustees of both the Boston Lyric Opera and the Boys and Girls Club of Nantucket and board of overseers of both the Boston Children's Museum and the Peabody Essex Museum.

SECTOR – GENERAL INVESTING

TWST: Please begin with an overview of your firm and your investment strategy or approach.

Mr. Osbon: Osbon Capital is a registered investment adviser. We call ourselves “the index boutique” because we deal with a small number of clients, all individuals by design, and we use only index-based investments for tax efficiency and cost control. Our specialty is what I would call “goal-oriented wealth management,” rather than beating markets and things like that. Our plan is to come up with the best possible route for you to reach your financial and investment goals.

TWST: Talk a bit more about the index strategy and why you follow it.

Mr. Osbon: The index — and we use ETFs, exchange-traded funds, to implement our investment strategies — allows us to invest anywhere in the world in any asset class. ETFs have come of age, and we can access any market we want, but we use them for three reasons. One is tax efficiency — it is very important for individuals to measure returns in after-tax components. And with ETFs, you own your own basis, so you control your tax destiny.

They're very tax efficient. Second is cost control. You can make money two ways, by increasing returns or by cutting costs. We do both. They're very cost-effective, and there are very incremental costs in using ETFs. And the third is the most interesting: It's been shown both in theory and fact that index funds will beat active managers 80% of the time, and the longer the time period, the more likely they are to beat them. And on an after-tax basis, it's not even close. So when you use index investment, automatically you're above average, and you are probably at about the top fifth of all money management performers.

TWST: Talking a little more specifically about the topic of residential real estate-related stocks, such as publicly traded homebuilders, what role should those investments have in terms of portfolio diversification today?

Mr. Osbon: Real estate performs a vital function, a very valuable function in diversification, and that's what individuals need when they work with any wealth manager. They need tax efficiency, they need to keep most of their money, they need diversification. In other words, they shouldn't make their money twice over. Diversification allows you to control risk, and then

they need access to superior products or services that they couldn't otherwise get themselves. In particular, real estate's valuable function is that it's a hybrid. It has both bond and equity characteristics, and does not move in tandem with other markets necessarily. Using exchange-traded funds, you can access real estate both domestically and internationally.

So you would want to be aware of that before you were going to enter it. It's come down quite a bit, and I think in many markets, you're probably looking at maybe only small premiums or even parity, which we haven't seen for a long time. So that's one thing that's very positive about residential real estate in general.

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TWST: Are there particular funds you would recommend right now, especially ones that would offer some exposure to the housing market?

Mr. Osbon: We look at real estate very, very broadly. I'll talk about housing more specifically. But when we look at real estate, we look at it as the backbone of an economy. For example, the REIT index we use, Vanguard (VNQ), is a composite of office buildings, apartment buildings, shopping centers — it's really the backbone of the United States. Every business and every person needs a place to be. So that is highly diversified, not only by type of real estate but all across the country. We specifically don't get into more specialized types of markets, which would be homebuilders, for example, or apartment owners, or shopping mall owners and things like that, even though you can access those in almost all occasions by ETFs. I'm happy to talk about residential real estate investing as a concept if you would like me to.

TWST: Yes, please.

Mr. Osbon: As Alan Greenspan paraphrased Tip O'Neill, a local hero here, all real estate is local. That's what makes it so difficult to really make hard-and-fast rules about residential real estate because it's very much influenced by local factors. But there are a couple of key variables that you want to know any time you invest in residential real estate, either personally when you buy a home, or when you buy homebuilders or REITs that involve residential real estate. One is replacement cost, that's a key one. The second one is cost of capital, and the third one is rent-to-own ratio. Those might sound fairly obscure, but they're really not; they're pretty straightforward.

For a long time, starting in the late 1990s and certainly into the early 2000s, suddenly the price of residential real estate surged way, way above replacement cost. I think it peaked at about two and a quarter times — not a good sign.

The second thing is cost of capital for the homebuilders. Again, we don't pick individual stocks, or buy individual stocks or buy markets like that. But as a longtime investor, those markets are all priced on forward prices, so it's all about their cost of inventory right now versus what they can sell it for. History doesn't matter. It's kind of like Two-Buck Chuck. Remember the guy who sold wine for \$2 a bottle? How could he sell it for \$2 a bottle? Because he bought it for \$1 a bottle. And how could he buy it for \$1 a bottle? Forced liquidations. The wine manufacturers and distributors virtually paid him to take the inventory off their hands.

So I would use the Two-Buck-Chuck approach in buying any public securities related to real estate. Don't look at the price, look at the cost. And if you do your research, you can find out what the costs are in a lot of these homebuilders. And then you have to decide whether you think prices are going to be going up from there, and they can sell them above cost. So it's fairly straightforward.

And the third thing is the rent-to-own ratio, and the test on that is when you buy your house, for example, say you bought a house for a \$1 million, and let's say there is some sort of market rent out there, whatever it might be

— \$2,000 a month or \$5,000 a month, or whatever. Ask yourself, “Would you rent your own home at that price?” If the rental price is \$5,000, then that's \$60,000 a year. That's what would be called a p/e ratio of about 16 times; that's not bad. But if the rent is \$3,000, you probably overpaid because then you're talking 30, 35 times rent, and that's way, way up there. And you can perform that calculation on any property or any group that you're looking at.

TWST: All those factors can vary a great deal depending on the geographical markets you're looking to.

Mr. Osbon: Yes, it's huge. For people who are complaining about high real estate prices, who are not being able

Highlights

John F. Osbon discusses the benefits of using ETFs as an investment strategy, specifically mentioning the Vanguard REIT Index ETF his company uses to invest in a broad spectrum of real estate companies. Mr. Osbon offers an in-depth analysis of residential real estate investing, advising investors to pay close attention to three concepts when playing the real estate market — replacement cost, cost of capital and rent-to-own ratio. The investment manager also highlights homebuilders as the ultimate high-return potential investment, citing several demographic trends that make the homebuilding sector an attractive long-term buy.

to find the homes that they want at reasonable prices or own homes at reasonable prices, move to Florida or Michigan or Nevada — they would love to have you. You can get a \$250,000 brand-new home, 4,000 square feet. Move to Florida. So as you point out, on the other hand, in Greenwich, Conn., you're not going to find too many of those deals.

TWST: Outside of the stock market, do you find your clients typically have exposure to real estate through direct ownership or investment?

Mr. Osbon: Yes, but almost exclusively in terms of personal property. And that we segregate because there is a value that comes from personal property. In other words, you get to live in it. You get some value out of it. I discourage people from looking at their homes or their personal property as investments. That could be very misleading. Look at it as the value you get, whatever that is — it might be financial, might be emotional, might be psychic or whatever.

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TWST: Any thoughts on the trends we're currently seeing among the big mortgage lenders and the government in terms of trying to lessen the impact of foreclosures and short sales?

Mr. Osbon: I have a great deal of sympathy for the problems that people are going through and the tremendous dislocation and damage that losing your home does and has, through whatever reason. Losing one's home is just about the worst thing that can happen, and it doesn't just affect the individual, it affects the family. So there is a huge multiplier effect, and it's just devastating. I can't overemphasize how bad it really is. Solutions, I think, that have been taken are probably as good as we can get them. The Fed buying a trillion and a quarter of mortgages to keep

TWST: Going back to homebuilder stocks, even though you don't pick them individually, would you say as a general rule those stocks pose great value right now? They were really hammered, to say the least, these past few years.

Mr. Osbon: Yes, they have huge potential because they're so incredibly volatile. They can go up five or 10 times, and they can also plunge to zero. So if you are looking for a high-return potential investment, I would have to say homebuilders are right near the top. Who needs venture capital when you have the homebuilders? You want to do 10 times, get the homebuilders, you will do great. Also keep in perspective that as much as homeownership is important to the U.S. economy, homebuilding, as big as it is, is a fairly small part of the U.S. economy, about 2% of GDP. And it's not a business that is required to be a certain size. In other words, it expands and contracts due to the total supply-demand situation. There is no rule that says it has to be 2% or 5% or 1%. And as we've seen, it took an outsized proportion of our economy, and now it's probably taking a smaller

portion of our economy. But there are a couple of demographic factors that are favoring the homebuilders, in my opinion, so heavily. Again, I don't recommend stocks or manage money this way, but if I were a speculator, I would say they are a great buy right now for a couple of very strong demographic reasons.

TWST: So is it a case of “no where to go but up?”

Mr. Osbon: I would buy them as a bet on immigration. The demand for houses is still outstripping the supply, it's just that the local markets are very dislocated. So there is too much supply in Michigan, Nevada and Florida, and there is not enough in other places. But if you just look at the population projections for this country and where they're going, we're going to need a lot more houses.

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rates low, I thought, was a good idea and so far has proven to be successful. As far as mortgage relief, I am in the camp that says, “Drunks can't drink their way out of a problem.” Unfortunately, there is going to be a price to pay, and a lot of that debt is just going to have to be defaulted on, regrettably. I don't see a way out. I'm not pessimistic, I just don't have any solution.

TWST: So perhaps it requires a longer-term view rather than a focus on short-term profits?

Mr. Osbon: Yes, exactly, definitely a long-term view. Markets have shown that it's generally a good time to buy when something just looks absolutely awful, and I would have to say that the homebuilders look like that right now.

TWST: Besides the homebuilders, are there other attractive ways to gain exposure to the housing market today? What about construction equipment or the big mortgage lenders?

Mr. Osbon: I think that would be a tough one. Because there is so much consolidation that is going on,

TWST: Is there anything we haven't discussed yet that you would like to add?

Mr. Osbon: I would encourage investors, whatever they are investing in, to make sure that whatever they are investing in fits part of their long-term plan, and they understand what role it plays. In other words, is it for speculation? Is it for

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it would be hard to get a purer play than the homebuilders themselves. Lumber companies or plumbing companies or construction equipment companies generally are very diversified, well beyond the housing market. So I would really be hard-pressed to come up with anything that's a play on housing or residential real estate other than the homebuilders themselves. And I wouldn't want to access it through the debt market because the debt market is fixed right now by the Federal Reserve. We have a nonmarket player in there. The Fed has said that they will exit at some point, but we don't know when and we don't know how. They are still in the game, so it's a bit of an artificial market right now.

TWST: That's a pretty big unknown.

Mr. Osbon: A very big unknown. I think if you're accessing anything debt right now, you're basically speculating for or against that, which is a pretty tough call.

conservation of capital? And to make sure they understand the exit point as well as they understand the entry point — not all things are meant to be held forever.

TWST: Thank you. (MN)

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