

# CIRIOS TRENDS

IN SEARCH OF REAL ESTATE OPPORTUNITIES.



## The State of the Markets

It feels a bit like the world is starting to come apart at the seams. Again.

The EU finally “solved” the Greek problem, only to find out the solution just accelerated the day of reckoning for Europe’s other sick children, Portugal and Spain. Global markets should have breathed a sigh of relief this week, but instead they’re hacking up a lung.

The reality is that Greece is a symptom, not the disease. Look around this country at the ailing finances of our states, counties and cities and the story is essentially the same: Bloated budgets, shrinking income and debt burdens that are impossibly high.

Nevertheless, domestic economic data continues to point towards a recovery, however fledgling and government-supported it may be.

The housing market is just as muddled.

Foreclosures continue to hit record highs, as do defaults on commercial mortgages. But home price data show improvements and over 100 people recently showed up to an open house at a decrepit duplex in a hardly desirable part of Oakland. Foreign buyers armed with loads of cash are swooping into the market, begging the question of whether our markets are that far undervalued, or if markets across the pacific are that close to collapse.

Supply remains constrained in most markets, as bad areas recover before good ones. Buyers, flogged on by expiring tax credits and the promise that it’s a great time to buy, are scrambling to get in before the next boom. If there is one.

These are confusing times, to put it mildly. Well-educated people are quietly wishing they paid more attention in high school econ class so they knew how a plunging euro will effect corporate bond spreads and, ultimately, their jobs.

Yet, despite the imminence of a sovereign credit crisis that would make the mortgage mess look like a fender bender, there is an odd calm in housing, like things were so bad for so long the financial gods wouldn’t dare put us through all that, again.

The good news, however obscured by the deluge of smoking SUVs and leaky rigs, is that from the depths of chaos, opportunity is wrought. Last spring, when hope was all but lost, turned out to be the best short term buying opportunity for real estate in decades, if not more.

Warren Buffet, still a legendary investor despite his bewildering defense of credit rating firms, made his name buying when no one else dared.

So when you happen upon an open house and there’s a line to sign in, walk away. Look under a rock no one else is turning over, for there you’ll find the opportunities - especially when “everyone” else says you’re crazy to do it.

Chart of the Month:  
US Homeownership Rate



Source: CalculatedRiskBlog.com

“From the depths of chaos, opportunity is wrought.”

### Housing Data Feeds the Optimists Fire

- FEB. CASE-SHILLER HOME PRICE INDEX: +0.6% Y/Y | -0.9% M/M
- MARCH EXISTING HOME SALES: +16.1% Y/Y | +6.8% M/M
- MARCH NEW HOME SALES: +24.0% Y/Y | +27.0% M/M
- MARCH HOMEBUILDER SENTIMENT INDEX: 19 (UP FROM 15)

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“Opportunity is missed by most people because it is dressed in overalls and looks like work.” - Thomas Edison

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**“Gamblers made large sums of money at the expense of other gamblers.”**

## Feature: What’s in a CDO, anyway?

Over the past several weeks, the federal government’s increased scrutiny of Goldman Sachs has brought complex financial securities at the heart of the housing market collapse back into the government’s crosshairs. We thought an attempted explanation of not just the case against Goldman Sachs, but of how these instruments in question, CDOs, actually work would be valuable.

On April 16th, the Securities and Exchange Commission, or SEC, filed a civil suit against Goldman Sachs, and late last week it surfaced that the Justice Department was conducting a criminal investigation into the company’s trading practices.

Both departments are focusing on Goldman’s involvement in setting up collateralized debt obligations, or CDOs. The charge, and one that on the surface sounds like a slam dunk for the folks at the SEC, is that Goldman colluded with a hedge fund to create a security designed to fail, then peddled it to unsuspecting investors while the hedge fund placed huge bets the security would fall in value.

During the boom, investment banks like Goldman Sachs bought up thousands of individual mortgages and packaged them into mortgage back securities. These securities aggregated monthly cash flow payments from individual borrowers, then distributed them to investors based on their risk tolerances. Risk-averse investors (pension funds, big banks, insurance companies, etc) were paid first while more risk hungry investors like hedge funds, were paid second if there was enough money left after the first group was paid.

For taking on the risk of being paid second, investors were paid a higher rate of return.

CDOs function similarly, but rather than aggregating individual mortgages, they group together mortgage-backed securities (stay with us).

CDOs aggregate the payments of individual securities, whose cash flow is determined by the mortgages that make up each one. Investors in the CDO get in line for payments and are compensated based on their place in line for cash flows.

The Goldman security in question, called Abacus, takes this one step further. Abacus was hatched using a collection of what are known as credit default swaps, or CDS, and is thus known as a “Synthetic CDO.”

CDS, for all their complications, are nothing more



than insurance policies. Let’s say you own GE bonds, and even though GE is a solid company, you’re a little nervous GE may run into trouble and not be able to pay back its bondholders. To alleviate this concern, you could buy a CDS that guaranteed your investment in the event GE couldn’t make good on its bond payments. The seller of that CDS (think insurance company) only has to pay if GE stops making its payments. So, if news were to break that GE were running out of cash, the insurance would go up in cost (value) since bond holder protection would be in high demand.

An investor in a synthetic CDO is paid from premiums collected from CDS buyers who want to bet that the securities protected by the CDS default, thereby increasing the value of their investments in the CDS (get all that?).

So, here you have two sides of the trade. Synthetic CDO buyers hoping the underlying securities keep paying and that CDS buyers keep paying their premiums vs. CDS buyers who hope the underlying securities fail, thereby pushing up the value of their protection.

Since CDS contracts do not require that the insurance seller (or buyer) own any of the underlying securities, these devices were essentially high risk gambling devices, where many gamblers made large sums of money at the expense of other gamblers. Clear as mud, right? It’s easy to see how these often opaque securities got out of control.

At issue is if Goldman, as issuer of the security, made proper disclosures to buyers about the nature of the security and who designed it.

And while it’s easy to cast the case in the “Evil Wall Street Greed” category, investors too deserve their share of the blame for blindly buying what they were told was good quality.

What ever happened to Caveat Emptor?

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## Around the Bay: Local News Bites

### Silicon Valley Defies California Gloom (Silicon Valley Business Journal)

Even though consumer confidence in California has fallen to a historic low, Silicon Valley residents remain some of the country's more optimistic folks. California's Index of Consumer Sentiment registered an all-time low of 68.8, five points lower than last April's 73.8 tally. Silicon Valley, on the other hand, came in at 75.9. Just 14% of the state's residents believe they are better off now than they were a year ago. On the flip side, only 13% believe they'll be worse off next year at this time. So, even though Californians think the current situation generally stinks, by in large we don't think it can get much worse!

(Read more here: <http://tinyurl.com/cirios trends may1>)



### Calls for a Bottom in Commercial Real Estate Ring ... Softly (Cornish and Carey Commercial Real Estate)

A growing consensus is emerging that despite fears of a collapse in commercial real estate, the market may be quietly healing itself. In its latest quarterly survey of San Francisco commercial real estate activity, brokerage Cornish and Carey reported that Class A asking rents inched up by 0.4% from the previous quarter. A smidgen indeed, but this marks the first Q/Q increase since the market peaked in Q2 2008. Even though unleased inventory still appears massive when you look at the data, most of it is concentrated in vast, empty swaths of space. Smaller chunks and premium view space are in limited supply and deals are on occasion seeing multiple bidders. Recovery? Not yet, but investors are licking their chops.

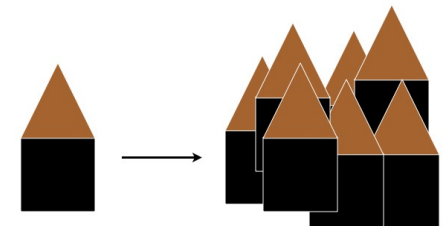
(Read more here: <http://tinyurl.com/cirios trends april2>)



### Are Mortgage Backed Securities Back? (San Francisco Business Times)

For the first time in almost two years, investors placed bets that mortgages not backed by the government were a good investment. Redwood Trust, a Mill-Valley based real estate investment firm, issued and sold the first private label jumbo mortgage backed security since 2008. The deal, small by bubble-craze standards, consisted of 255 mortgages issued by Citigroup for a total deal size of \$222.4 million. The secondary market for mortgage backed securities not insured by Fannie Mae or Freddie Mac has been literally non-existent, as investors have proven unwilling to buy debt without Uncle Sam's implicit (or explicit) stamp of approval. The deal, adding more fuel to optimists fire, was over-subscribed.

(Read more here: <http://tinyurl.com/cirios trends may3>)



### Foreclosures Continue Steady March Upwards (San Jose Mercury News)

For all the signals that the housing market may actually be improving, that nasty fly in the ointment, foreclosures, just won't go away. Despite hundreds of billions of dollars thrown at the problem, foreclosures in Santa Clara County rose 72% from a year ago. This trend is being echoed around California and indeed the country, where foreclosures, the market clearing mechanism everybody loves to hate, continue to plague local economies. One bright spot, however, is that investors are stepping into the market. 4,000 homes were sold directly to investors at auctions - up almost 4-fold from 2009.

(Read more here: <http://tinyurl.com/cirios trends may4>)



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## Zip Code Spotlight - Los Gatos - 95032

“Prices have essentially plateaued since the precipitous drop in 2008.”

This month's zip code spotlight falls on a decidedly high end area of the San Francisco Peninsula – Los Gatos. Los Gatos is a suburb to the southwest of San Jose, known for large, secluded lots at the very high end of the pricing scale.

Looking at the sales activity graph below, the first thing that jumps out is the high price: Running average prices peaked at over \$1.5 million in 2005. In fact, for clarity, this graph cuts off sales above the \$2 million level even though homes still regularly sell above this level.

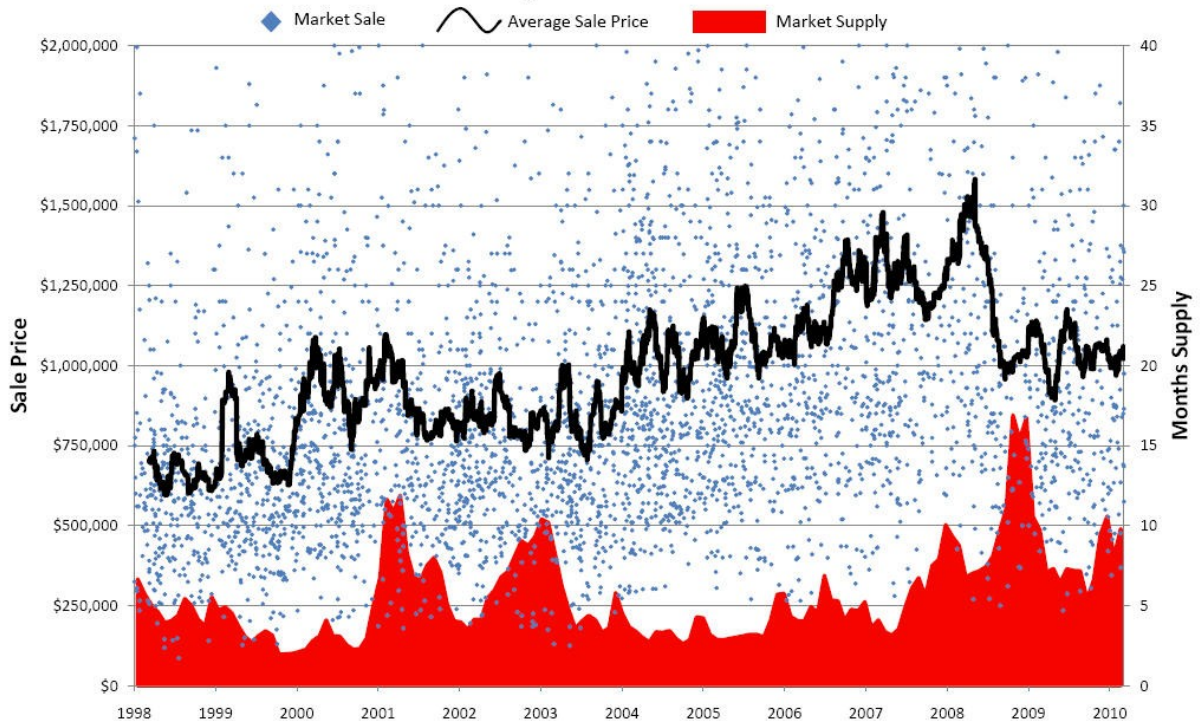
The next item worth mentioning is the 30% drop in prices this area experienced in the space of

only around six months. As we have so often seen, this cliff drive in prices corresponded with a spike in available supply. Interestingly, the price dive appears to have preceded the supply spike, as it usually happens the other way around. Also, a 30% drop in prices in this short of a time span is pretty unusual for this type of luxury market. This evidences, among other things, the extent to which aspirational buyers were reaching for a Los Gatos address, only to have reality quickly set in when the bubble burst.

Another item worth noting on this graph is that supply remains elevated above traditional levels for this area, and that prices have essentially held steady since the precipitous drop in 2008. Does this mean this high end market is consolidating for another leg down? Only time will tell, but the folks here at Cirios Real Estate are watching luxury markets like these with baited breath to see which way they go.



Sales Activity - 95032 - Los Gatos



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**“Where there are information gaps, opportunity abounds.”**

## Cirios Opportunities - Is it Time to Buy Commercial?

One of the most frequent questions we get here at Cirios is, “Is it time to buy commercial yet?”

Clearly, this is an immensely complex question, particularly because “Commercial Real Estate” means something different for each person you ask. It could be office buildings, hotel chains, apartment buildings, industrial centers or any other piece of real estate that isn’t a single family home or condo.

And while the answer to this question is one which cannot quickly or simply be answered, we believe the time is right to start examining opportunities in certain segments of the commercial market.

Let’s look specifically at small multi-family properties around the Bay Area.

We are defining “small” as anything below 50 units, which may or may not be small depending on who you talk with. We chose this segment because these deals fit nicely between two very crowded markets.

In the Bay Area, the distressed single family residence market is becoming increasingly crowded. As we see each time we list a property, the number of all-cash buyers in the market - in particular foreign nationals - is astounding. As optimism gains steam that the worst is behind us in the housing market, this market will only become more crowded. Investors are out there looking for opportunities, which squeezes profits and makes good deals tougher and tougher to find.

The perception is that buying a single family home and either rehabbing it or renting out is simple, straightforward and carries less risk than buying multi-family or commercial properties. As such, this segment attracts so-called “mom and pop” investors, who may lack the sophistication of larger, more experienced players.

These big players, while sophisticated and often armed with piles of cash and leverage, are forced to look at large deals in order to put the money they raised to work. This means bigger deals are often chased by many well-financed investor groups. And while each investor will have a different minimum investment size, operating in the space between mom and pop and these large institutions can be an attractive proposition.

The question then becomes, at what point should

investors steer away from the single family market and refocus on commercial? Again, defining commercial for this exercise as small multi-family properties, we believe the answer is: Sooner than you think.

In the Bay Area, rents have fallen considerably in the past three years, despite the widely held view during the early stages of the downturn that rents would be buoyed by former homeowners moving back into to the rental market. It turns out that rents were in a bubble of their own.

The value of apartment buildings is closely tied to rents, so property values have tumbled along with rents. However, the multi-family market is far less liquid than residential and price discovery has not yet fully gotten underway. In other words, sellers have been holding out for want of buyers, which have been few and far between. This means prices are yet to have fully corrected to reflect lower rents.

But as sellers become more desperate and buyers gain more confidence, the market will continue shaking out and prices will keep coming down to more sustainable levels.

This dynamic is beginning to play out in other segments of the commercial market as well. And while we do not profess to be experts in all aspects of commercial real estate, from talking to our contacts in the industry, opportunistic investors are looking much more seriously at deals than they were even a couple months ago.

One additional aspect of this opportunity which intrigues us is the widespread belief among old school landlords that operating costs are fixed, and cannot be lowered.

For all the hype surrounding solar panels on houses, tankless hot water heaters and environmentally friendly insulation, the real pop for energy efficient building upgrades is in the commercial space. You could drive a truck through the gap between the understanding of how efficiency upgrades add value to commercial real estate and the actual improvements being done.

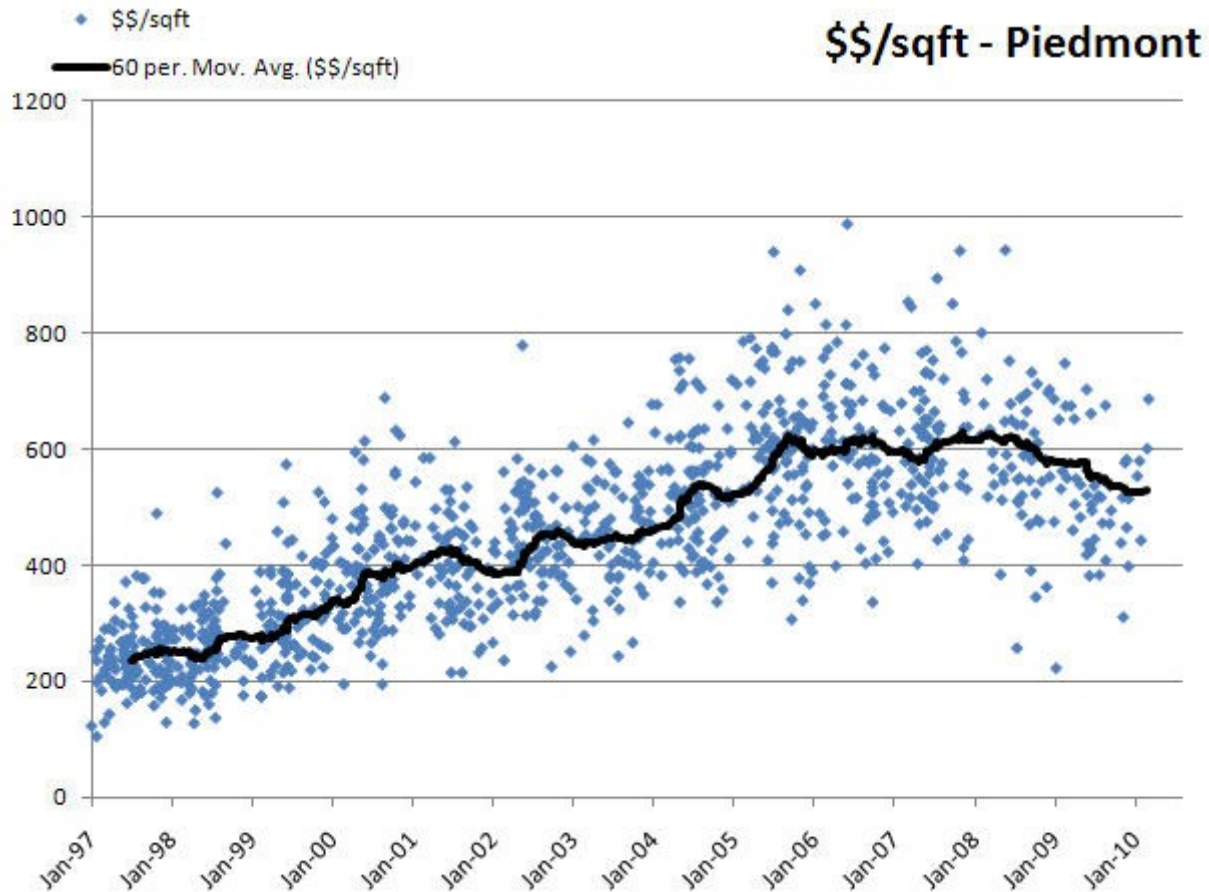
And where there are information gaps, opportunity abounds.

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## Talking Charts - Where Would you Buy? Piedmont

As the consensus builds that the worst is over for the housing market, it's a natural extension that proclamations such as, "it's a great time to buy" will continue to grow louder. As readers of this newsletter know, we at Cirios rail against this notion, believing firmly that such a statement is a misnomer. Without knowing each buyer's particular situation it's impossible to make such a catchall generalization. In the following slides, we look at seemingly unrelated markets, connected only loosely by geographic proximity. In each pair, we look at a market that is "desirable" and one that is "not so desirable." Clearly there is more to the home buying decision than dollars and cents, but from a pure investment standpoint, where would you buy? Or would you at all?

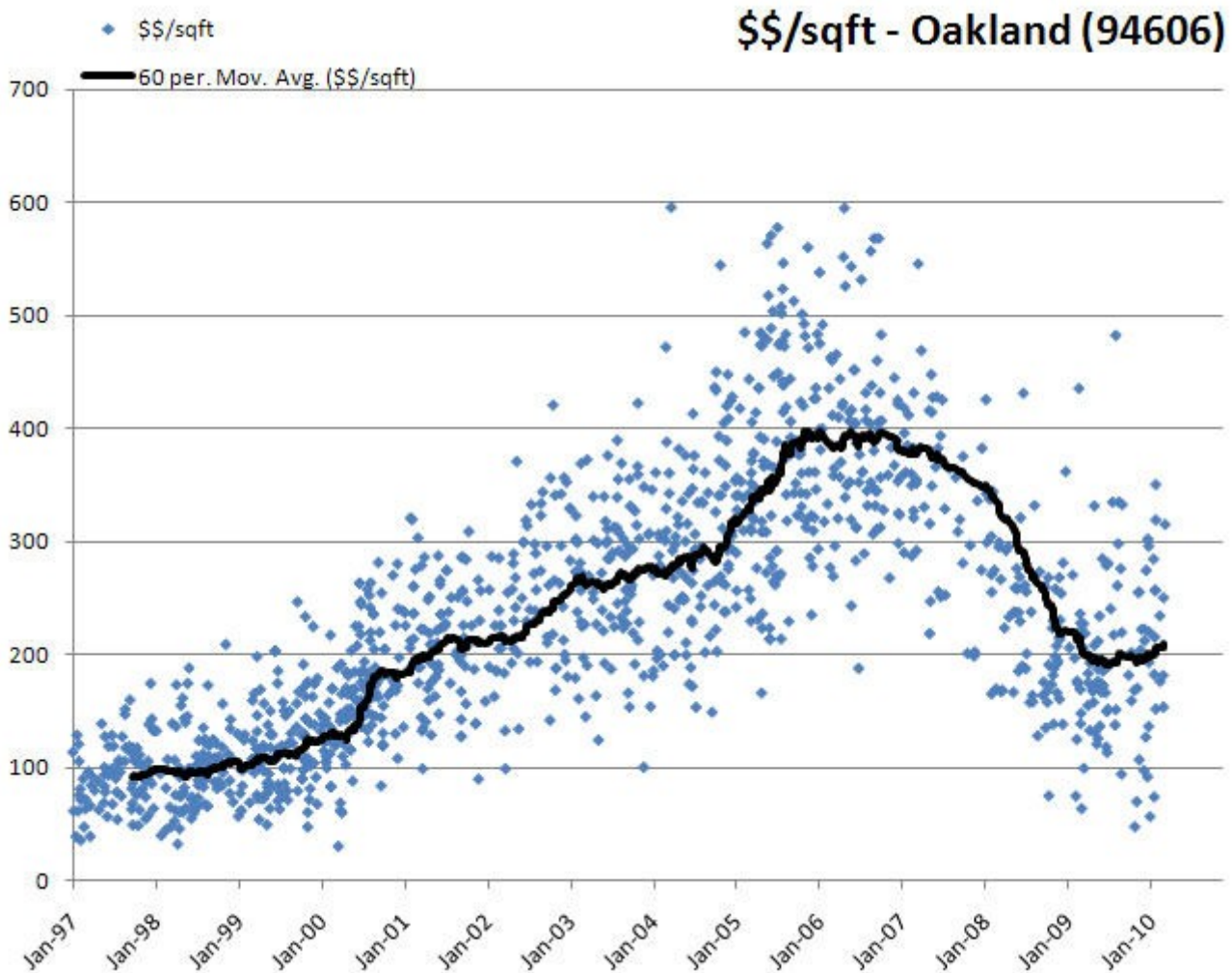


Piedmont is arguably the most desirable city in the East Bay. Minutes from San Francisco with large, secluded homes nestled in hillside communities, Piedmont is the dream locale for many families. As with most high end markets, Piedmont held up longer and has fallen slower than distressed areas like Oakland and Hayward. However, even as these distressed markets are picking back up, high end markets like Piedmont continue to languish. Prices are all the way back to ... 2005 levels? Recall that the broader housing market was peaking in 2005, as 2006 was the year when cracks in subprime began to emerge. We would argue that Piedmont, despite all the fundamental factors driving demand, is an area where buyers should tread lightly.

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## Talking Charts - Where Would You Buy? Oakland

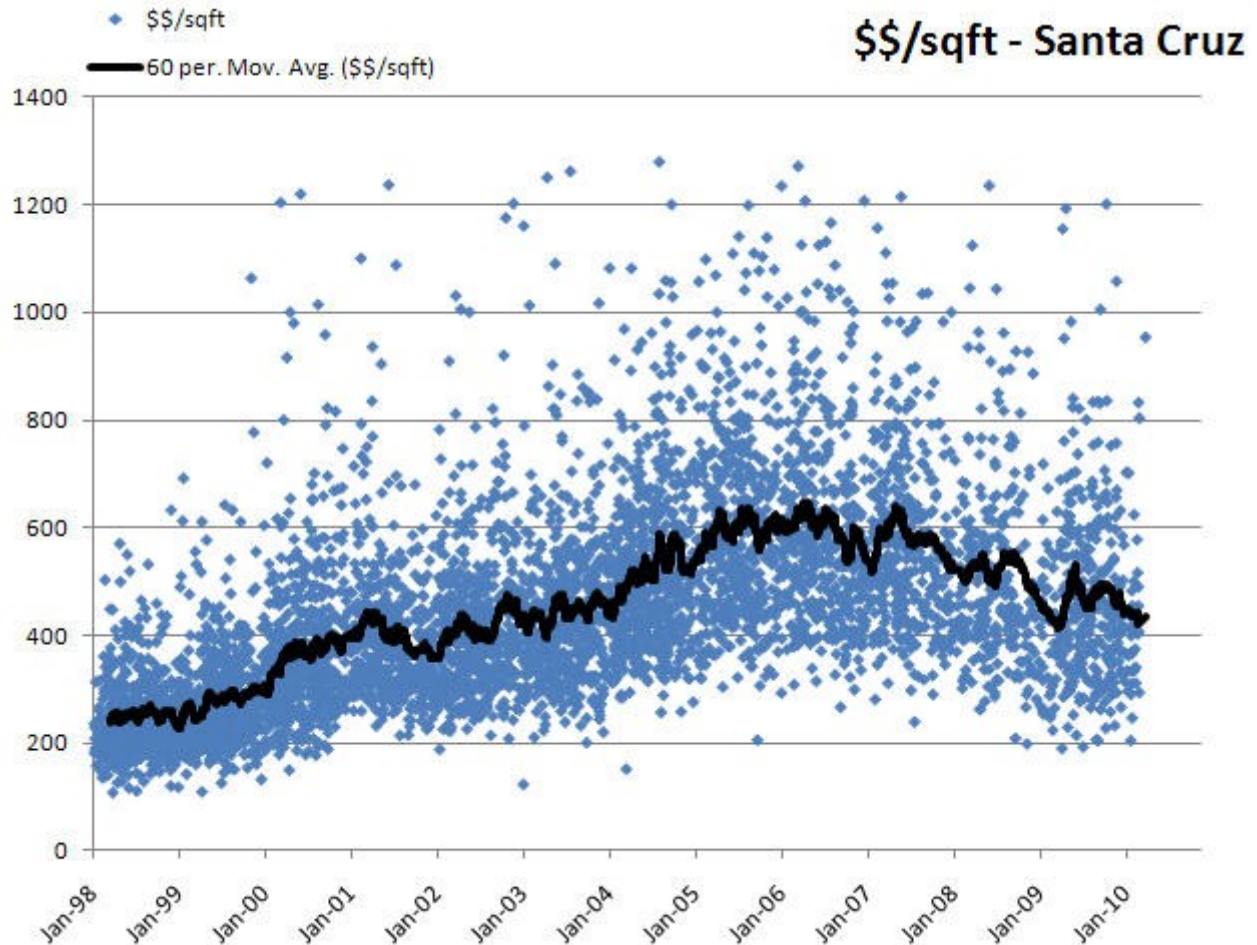


Roll down the hill into Oakland, south of Lake Merritt and through Chinatown and you run into the urban delight that is the 94606 zip code. The chart above shows prices for single family homes, which have tumbled more than 50% from their 2005-6 peak. Stabilization was found early last year as prices dropped back to levels not seen since 2001. And while 2001 represented the back end of the dot com bubble (witness the spike in prices during 2000), eyeballing a straight line from the trends of 1997-1999, prices almost seem back to where they should be. True, examining these two neighborhoods is the definition of comparing apples to oranges, but we're not arguing you should raise your kids in south Oakland. Cash flush investors are extremely active in this part of Oakland, as the city slowly, begrudgingly tries to clean itself up. But change is afoot, and change breeds demographic shifts, which move housing prices over the long run.

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## Talking Charts - Where Would You Buy? Santa Cruz

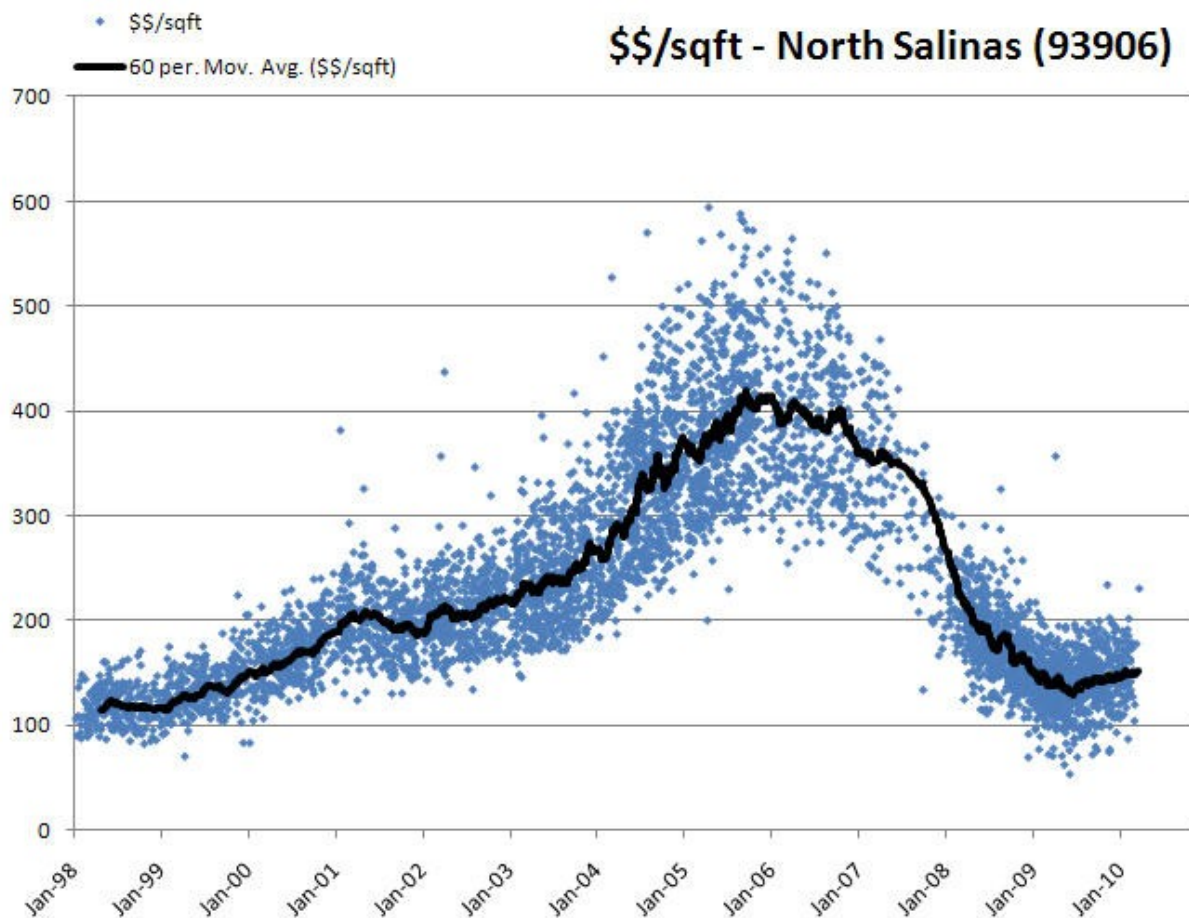


A couple hours south of Piedmont and Oakland lies Santa Cruz, part surf haven, part, well, all surf haven. On occasion the fog rolls in and temperatures drop, but as anyone who has spent time in Santa Cruz will tell you (or won't tell you, to keep the hoards away), the weather is actually quite good. Removed from the Bay Area by the treacherous Highway 17 and thus less appealing to Silicon Valley weekend warriors, Santa Cruz saw prices rise during the boom, but the trend was less than spectacular and driven more by buyers looking for remaining pockets of affordability than by aspirational social climbers trying to get into the next, biggest McMansion. On the way down, Santa Cruz has seen a smooth slide in prices, but one which is yet to display much in the way of stabilization. The waves are still there, as are the quiet cliffs, but we remain cautious, albeit envious of the locale.

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## Talking Charts - Where Would You Buy? North Salinas



Salinas, formerly known for lettuce, became one of the poster children for the housing market's boom and bust. The chart above tells the story. But, like Oakland in a previous slide, prices have retreated all the way back to levels not seen for 10 years. The ramp up during the height of the boom was only outdone in severity by the collapse when the bubble burst. But here in North Salinas, perfectly nice and relatively new homes can be had for at or below the cost of renting. This just makes economic sense, despite the fact that there isn't a point break in sight.



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