2nd Quarter Commentary

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The Shaky Foundations of Asset Allocation Practices, Continued

Our 1st Quarter letter addressed the question of whether some basic presumptions of asset allocation work in the real world the way every one presumes them to… such as whether emerging markets equities actually outperform developed markets, whether the historical rate of return from the stock market can be repeated or is, indeed, even valid, and so forth. Understanding these questions can hardly be more critical, since we all invest based on these foundational assumptions. One element such models share is that in the freedom of the marketplace, any rigid, definitional approach will come to be invalid, later if not sooner, since investors do react to new information and, thereby, alter supply and pricing. If a particular sector is discovered to be superior or to outperform, will not capital flow into it and inflate the price? And at what degree of price inflation does the sector become a source of average or negative, rather than superior, return?

Another shared element in the accepted wisdom of asset allocation practice is the selection of a factor that is merely semantically descriptive but not intrinsically predictive. An example would be to label an index comprised of companies domiciled or incorporated in a given emerging nation or set of nations as an emerging market index, even if it happens to be significantly constituted by multi-national businesses with stock market values every bit as large as the largest developed market companies. Or, there is the reliance upon the historical returns and behavior of an index without examining how it was created: what if the greatest and most influential returns from an index occurred during a period or with a set of securities that was unique to that period and circumstance, and is no longer repeatable? An example would be an index dominated in its early years by one or a handful of dramatically undervalued securities, yet which in the current era is relatively diverse and reasonably valued.

The 1st quarter commentary addressed the question, labelled Proposition 1a, of whether emerging markets stocks actually outperform domestic stocks. This commentary will address Proposition 2b*: I invest some of my portfolio in private equity for: a) return enhancement; b) lower volatility; and c) risk diversification. Do you really receive all of those presumed benefits?*

a) <u>Private Equity: The Official Record</u>

Big institutions plan to make yet more investments in private equity. We know that from a poll by Preqin[1], which is probably the leading compiler of data on private equity and other alternative asset classes. According to this poll of large institutions, 45% of 430 respondents—a quite large sample of institutions, lending it validity—stated that private equity is the best alternative investment opportunity. It is noteworthy that alternative assets under management now have reached the level of $6 trillion and, according to the poll, 68% of respondents stated that they will commit more money to private equity in 2014.

The following table, the Preqin Private Equity Committed Capital Index, is very interesting. It shows the unit values of all private equity funds in its universe on a committed capital basis—meaning the money that is actually invested, not uninvested cash subject to capital calls—therefore, this is an index that effectively measures what happens to fully-invested portfolios. As can be seen in the quarterly return

[1] Preqin Investor Outlook: Alternative Assets, H1 2014

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column, there is not one double-digit number—either positive or negative—during the 14-year period tracked, which begins in December 1999 and ends in June 2013.

The Preqin Private Equity Committed Capital Index

Quarter End	Quarterly Return	Quarter End	Quarterly Return
Mar-00	3.94%	Dec-06	6.35%
Jun-00	-0.78%	Mar-07	4.20%
Sep-00	-0.78%	Jun-07	6.58%
Dec-00	0.83%	Sep-07	4.59%
Mar-01	-2.17%	Dec-07	2.24%
Jun-01	0.44%	Mar-08	2.69%
Sep-01	-0.12%	Jun-08	-0.77%
Dec-01	-0.47%	Sep-08	-7.42%
Mar-02	-0.78%	Dec-08	-9.08%
Jun-02	2.33%	Mar-09	-3.54%
Sep-02	-1.16%	Jun-09	3.50%
Dec-02	1.76%	Sep-09	4.68%
Mar-03	1.58%	Dec-09	2.62%
Jun-03	4.12%	Mar-10	0.11%
Sep-03	1.38%	Jun-10	-1.42%
Dec-03	6.48%	Sep-10	5.91%
Mar-04	2.99%	Dec-10	3.93%
Jun-04	1.59%	Mar-11	4.94%
Sep-04	3.98%	Jun-11	4.10%
Dec-04	7.52%	Sep-11	-5.73%
Mar-05	1.13%	Dec-11	1.02%
Jun-05	1.51%	Mar-12	5.23%
Sep-05	4.42%	Jun-12	-1.97%
Dec-05	5.03%	Sep-12	3.70%
Mar-06	2.73%	Dec-12	3.05%
Jun-06	4.07%	Mar-13	2.28%
Sep-06	2.32%	Jun-13	1.78%

Source: Preqin

Bearing in mind that these return figures are not based on public share prices, but on the estimates made by the private equity firms themselves of the values of their private equity investments, let's compare this with the actual, rather than theoretical, price behavior of two publicly-traded such companies, The Blackstone Group and Onex Corp., which are major participants in this field and probably two with the longest pedigree. Since they are publicly-traded, their shares represent two sources of return from investors' point of view: both invest their capital alongside private equity investors, and they also collect the fees for managing their clients' capital.

	Quarterly Return	
	Preqin Index	S&P 500 Index
Jun-08	-0.77%	-2.69%
Sep-08	-7.42%	-8.33%
Dec-08	-9.08%	-21.95%
Mar-09	-3.54%	-11.01%

Source: Preqin, Bloomberg

During 2008, the total return, inclusive of dividends, if any, was negative 67.4% for Blackstone and negative 48.9% for Onex. The S&P 500 Index ("S&P 500") return was negative 37% that year and the high-yield index, HYG, had a negative return of 23.9%. Interestingly, the high-yield index contained many of the bonds issued by many of the private equity deals—bonds, after all, that are ranked senior to equities.

With all that in mind, consider that the total return of the Private Equity Index of Committed Capital in 2008 was negative 14.2%. In other words, private equity, according to the record, outperformed not only the private equity firms that have the very significant benefit of collecting the fees generated from those deals and have their money invested in the exact same deals, but it also outperformed an index that included the bonds that finance the private equity deals themselves. Irrespective of how junior those bonds might have been, they still would be senior to equities. This outperformance is said to have occurred during the worst financial crisis in about a century, when the credit markets essentially froze. Is that not astonishing? How would one explain it? In this light, the Preqin index is an extraordinary document.

b) <u>Private Equity, in Asset Allocation Argot: Duration Risk and Diversification Risk</u>

Rarely does a day go by that the media does not focus upon possible—or coming, if one prefers—increases in interest rates, changes in the interest rate environment, and the damage that it can do to a bond portfolio. If one reviews some broadly representative bond indexes, like the iShares Core Total U.S.

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Bond Market ETF (AGG), which emulates all the investment grade bonds in the United States, one will find that the average maturity is not much longer than six years. Or, taking the iShares iBoxx $ High Yield Corporate Bond ETF, the average maturity is just over four years. In other words, even though there are buyers of 30-year bonds, looking at the bond market as a whole, it is clear that very few are interested in taking duration risk. Everyone is aware of the interest rate risk, and they are preparing for it. Bond buyers, especially those taking credit risk, certainly do not want to add duration risk.

However, there is one group taking the risk, but it just does not realize it. In that group are those institutions—and they are only institutions—that are placing large amounts of money in private equity. They think they are lowering risk. They are removing money from publicly traded equity, and even bonds in some cases, and placing it in private equity.

Of course, private equity is borrowing the money because it is only private equity in name. A more functionally accurate term would be leveraged equity. The idea behind buy-out private equity investing is to find a suitable public company, pay a control premium for it, and then bring it private with an extraordinary amount of debt. If the maturities on those borrowings are short (and, unlike the historical norm, there is much less availability of long-term high-yield lending to match the extended workout periods ordinarily required for private equity) and if interest rates rise, then the refinancing risk is entirely on the private equity investor. The bond buyer, assuming the company remains solvent, is going to get a higher coupon; the private equity investor is going to pay the higher coupon.

The maximum risk one can take in bonds is the risk of being the borrower (as opposed to a lender). The lender, such as a bond holder, can legally enforce payment by a troubled borrower, can force bankruptcy if necessary, and has dominating influence in bankruptcy proceedings, where the weakest interested party is typically the common equity owner. Paradoxically, private equity investors are making themselves, effectively, large-scale borrowers in that the institutions that place or pledge equity with the private equity firms as limited partners, by putting themselves in the position of providing a small amount of equity collateral to back the substantial borrowing of the deals, are essentially issuers of a) low-quality debt, or b) debt that can become low or lower-quality quite rapidly. In both cases, this debt is subject to refinancing risk during a period that is an historic bottom in interest rates. It is astonishing that institutions and asset allocators that are very mindful of duration risk are actually taking the greatest duration risk they have ever taken (although, to be precise, it is not duration risk in the conventional sense, so much as it is really refinancing risk). It is a different kind of risk than in bonds. There may be select institutions that understand the underlying refinancing risk; however, we surmise many are unaware.

Looking at the world of private equity statistically, one can see an alluring Sharpe ratio (which measures the amount of price volatility relative to the return experienced). Historically, there has not been a lot of volatility in private equity, and it has provided an acceptable rate of return for that limited volatility. Of course, during the entire time span of those historical rates of return, interest rates have been declining, not going up. There is no data on what happens when the maturities are short and the refinancing risk is high. That should prove a very interesting data point when it arrives.

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Questions of the Day

Our relationship managers are often polled before the quarterly conference calls as to any commonality of recent questions from our clients. The most recent, as communicated, were:

1) Concern about the general lack of revenue growth being reported by many (agent-managed) companies; therefore, it would be helpful to highlight companies with expanding revenues. A related question is whether valuations are too high (or fair).
2) There is interest in commentary on land-owning companies.

Both sets of questions, interestingly, share a narrative thread. As to revenue growth by those companies that are the almost sole subjects of public commentary, namely the large-capitalization index constituents, it was one year ago, in the 2nd Quarter commentary of 2013, that we observed what appeared to be an absence of revenue growth in the 20 largest non-financial corporations in the S&P 500. It is intrinsic to the nature of large-company investing that businesses that have achieved the greatest market expansion success in preceding decades are, inevitably, closer to market saturation and slower growth, or even a decline into cyclicality, than they once were. The accompanying schedule reprises the data from last year's commentary, along with updated figures for the most recently completed full year. There does seem to be an absence of robustness in these numbers. And valuations are higher.

Company	Revenue Growth	
	Q1 '13 vs. Q1 '12	Latest Fiscal Yr vs Prior Yr
Apple	11.2%	9.2%
Exxon	-10.1	-6.8
Microsoft	17.8	5.6
Chevron	-6.4	-4.5
Johnson & Johnson	8.7	6.1
General Electric[1]	-9.3	0.4
Google	31.1	19.2
Procter & Gamble	2.0	0.6
IBM	-5.3	-4.5
Pfizer	-9.4	-5.6
AT&T	-1.3	1.0
Coca Cola	-0.9	-2.4
Philip Morris Int'l	2.8	-0.5
Verizon	4.3	4.1
Merck	-8.6	-6.8
Wal-Mart	3.9	1.6
Pepsi	1.6	1.4
Oracle	-0.9	2.9
Intel	-2.3	-1.1
Disney	10.4	6.3

[1]Excludes GE Credit.
Source: Company reports

For most companies. Not for all. There are about 4,000 exchange-listed equity securities in the U.S. alone, and this excludes a much greater number of over-the-counter securities, some of which are actually quite large companies. If one considers for a moment, it is only a very narrow slice of this large universe of potential investments that are followed by the financial news media – those that comprise the most liquid or tradable upper echelons of the major indexes such as the S&P 500, the Russell 1000, or the Russell 2000, or the Nasdaq 100. As discussed in these pages over time, the requirement for high trading liquidity by indexes and index users has continuously directed asset flows toward the largest companies, which does have a differential impact upon their valuations.

The 1,000th largest security in the Vanguard Total Stock Market Index exchange-traded fund, or ETF (ticker VTI), which tracks those 4,000-odd securities and which contains shares of 3,671 companies, is Bank of Hawaii. Its ranking not quite places it among the top quarter, by size, of the largest exchange-listed companies in the U.S. It has a stock market capitalization of $2.6 billion and trades at 15x consensus estimated earnings for 2015, and at 2.6x book value. That hardly seems inexpensive. Whatever it's valuation and potential return, it amounts to a mere 9 basis-point position in this ETF, which is nine 100ths of 1%. By comparison, Apple is 2.6%; the largest 10 holdings together amount to 14%.

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In just over 1,700th place in this ETF is Seaboard Corp., which is one of the largest hog growers and processors in the U.S. It is 76%-controlled by the Chairman/CEO, it is very conservatively capitalized (current assets exceed total liabilities by a factor of 2, so it is essentially debt free), and it has been extremely successful: in the 9 years ended 2013, its per-share book value has risen by 277%, or by 15.9% annually. Although it trades at 17x its 2013 earnings, it is a business that experiences volatile year-to-year operating margins, which lately have negatively affected earnings. Relative to earnings in 2012, though, its P/E is 12.7, and it is only 10.5x 2011 earnings. In the meantime, its revenues are 16% higher than in 2011, so it clearly has a great deal of positive earnings possibility. This might well be said to be an inexpensive stock. However, it represents all of three 100ths of 1% of VTI. Even if it were to appreciate by 30% annually for the next half-decade, it would a complete irrelevancy as to the impact upon returns for holders of this index. There are no Wall Street analyst estimates.

So, the questions about slower revenue growth and higher valuations are valid—with respect to those largest and most liquid companies that now suffer both from their historical success and their commoditization as equities in service of the needs of indexation. But, as we saw, there are other companies of high quality and lower visibility.

The nature of our portfolios is that companies are chosen for their various predictive attributes, not all of which conform to one or two common descriptive valuation measures such as P/E or price-to-book value ratios. One can't derive a single statistic or two from these portfolios that has any meaning, although some of the holdings are more or less amenable to this approach. Among the more conventional business profile holdings are, for instance, **AutoNation, Jarden Corp, Colfax Corp., Towngas China Company, Live Nation,** and **Platform Specialty Products**. They recorded revenue growth in 2013 (or fiscal 2014, as the case may be) of: 11.8%, 9.8%, 7.5%, 11.3%, 29.5%, and, for Platform, a non-meaningful number, since this company was only recently created in order to make a series of acquisitions in a particular segment of the specialty chemicals industry. It has made two acquisitions this year and will be a high revenue growth company. Each of these companies is controlled by or associated with an owner-operator, has a distinct expansion strategy for a specific market, and is far from the inevitable limitations of market saturation.

On the other hand, value and investment return need not depend upon an observably high rate of revenue or earnings growth. A significant holding, reviewed last quarter, is **Wendy's Company**, the fast food chain, which is being operationally recast by activist investors Nelson Peltz and Peter May. Revenues are unchanged from two years ago, and lower than three years ago. The shares trade at more than 20x the estimates for earnings next year. Superficially, a decidedly unappealing statistical profile. Yet, viewed over an arc of time that permits the company's operating margins to approach those of similar fast food chains, which implies a doubling of profitability, the company is undervalued. There is a very specific strategy in place to accomplish this goal and it appears, in its early stages, to have demonstrated proof of concept.

Wendy's is an example of the use of latent earnings—those not yet in evidence—to identify a good investment. Not yet being in evidence, such earnings can't be searched for by simply looking at a table of growth rates and P/E ratios. It requires knowledge of a change in circumstance that can be every bit as real as observable revenue or earnings growth; there has yet to be invented, though, a searchable database that can quantify changes of this sort,so such companies remain largely invisible.

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This leads us to a yet deeper version of latent earnings as an investment tool, as well as the second client question about land companies.

The Diversification and Inflation Hedge Benefits of Land

Like many pension funds, CalPERS, the investment arm for various classes of California public employees, and the 2nd largest pension fund in the U.S., invests in real estate. As of June 2013, its most recently reported fiscal year, CalPERS managed over $260 billion. To provide a different sense of its size, because size has very much to do with how CalPERS can or can't invest, it paid out $790 million just in base management fees, as well as $377 million in performance incentive fees, and another $220 million in professional fees to auditors, tax advisors, administrators, and the like: over $1.3 billion in aggregate. And CalPERS negotiates very low fees. As an aside, this discussion is not to be critical of CalPERS in any way, but it does publish a rather comprehensive and informative annual report that makes these figures available to the likes of us.

Lincoln Institute of Land Policy Decennial Census of Land Prices

Year	Index Value	Change	Year	Index Value	Change
1930	17.39		1961	106.32	3.6%
1931	23.21	33.5%	1962	111.10	4.5%
1932	26.49	14.1%	1963	121.39	9.3%
1933	24.10	-9.0%	1964	125.30	3.2%
1934	24.40	1.2%	1965	118.61	-5.3%
1935	26.32	7.9%	1966	116.71	-1.6%
1936	25.43	-3.4%	1967	119.44	2.3%
1937	25.74	1.2%	1968	132.35	10.8%
1938	25.34	-1.6%	1969	158.61	19.8%
1939	25.84	2.0%	1970	210.88	33.0%
1940	24.89	-3.7%	1971	259.06	22.8%
1941	25.78	3.6%	1972	284.75	9.9%
1942	34.32	33.1%	1973	315.50	10.8%
1943	38.14	11.1%	1974	389.69	23.5%
1944	42.81	12.3%	1975	517.65	32.8%
1945	45.09	5.3%	1976	645.03	24.6%
1946	39.74	-11.9%	1977	741.46	14.9%
1947	31.61	-20.5%	1978	818.22	10.4%
1948	32.43	2.6%	1979	902.31	10.3%
1949	32.58	0.5%	1980	1051.52	16.5%
1950	31.16	-4.4%	1981	1285.52	22.3%
1951	38.02	22.0%	1982	1549.92	20.6%
1952	39.54	4.0%	1983	1834.04	18.3%
1953	49.72	25.8%	1984	2078.84	13.3%
1954	54.69	10.0%	1985	2293.90	10.3%
1955	54.37	-0.6%	1986	2473.50	7.8%
1956	59.52	9.5%	1987	2635.71	6.6%
1957	72.55	21.9%	1988	2870.64	8.9%
1958	83.94	15.7%	1989	3103.98	8.1%
1959	95.42	13.7%	1990	3393.05	9.3%
1960	102.58	7.5%			

Source: Lincoln Institute of Land Policy
http://www.lincolninst.edu/subcenters/land-values/price-and-quantity.asp

CalPERS has a major position in real estate: $39 billion, which would be 15% of its portfolio. Of this, only $700 million was in REITs (real estate investment trusts); the other $38.3 billion was actual, physical real estate. Real estate adds some very useful features to a portfolio. It turns out there are extensive data on land values. A policy and education organization, the Lincoln Institute of Land Policy, makes use of a Case Schiller White Land Price Survey; Case Schiller White produces the Case Schiller Home Price Index. This index records that in the 38 years from the first quarter of 1975 to the 3rd quarter of 2013, land prices appreciated by 6.3% per annum.

The Lincoln Institute of Land Policy conducted its own study, the Decennial Census of Land, detailed at left, and this study suggests that land prices appreciated at more than an 8.8% annual rate during the 60 years through 1990. An interesting feature of this study is that land held its value during the Great Depression. One would have thought land prices would have collapsed with the deflation, but they did not.

Another interesting observation is that there were very few periods in which land did not appreciate. Contrasting land with gold, it is clear that there were many periods when gold did not appreciate. From 1933, when the Roosevelt administration took the U.S. off the gold standard, until the

end of 1974, Americans were not allowed to own gold. Between 1974 and 1980, gold appreciated a lot, but between 1980 and 1999, gold declined a lot. Between 2000 and 2013, it again increased a lot, but between 2013 and 2014, gold declined a lot.

The price of gold can be very idiosyncratic. For someone desirous of an inflation hedge that is a much better mirror of inflation in any given year, land is a much superior index. Of course, land is not a hedge against political instability, which gold is because gold is mobile. Land is not mobile, so it is only a hedge against inflation, not against political instability. Gold got its reputation as a hedge because sometimes political instability and inflation arrive together.

If we accept that land can be an attractive qualitative element in a portfolio, there is the question of the method or methods of owning it, as well as whether those instruments are priced attractively. The instruments of choice among most investors are the publicly traded REITs, which pay out virtually all of their income as dividends. Their income distributions have become so attractive that the share prices have been bid up to the degree that the largest REITs now yield only about 3.5%, which is roughly analogous to a pre-tax P/E ratio of 28x. They are now priced as bond substitutes, so their prices are likely to be very vulnerable to a rise in interest rates, among other risks.

Alternatively, one can invest in non-REIT real estate companies, particularly those that own land. There exist a number of publicly traded companies that own mostly or only undeveloped or partially developed land. For the following reasons, they can be a very interesting diversification element within a portfolio.

First, development activities are site-specific and occur on a reasonably unsystematic basis. There are zoning factors and engineering plans to consider, as well as the economy of the given neighborhood, changes in the demographic nature of the given city or neighborhood, and so on. Many of these circumstances are often unrelated to the overall economy.

Second, land's value is heavily dependent upon the type of development activity pursued. When a developer repurposes an existing building, more often than not that developer can create considerable value just by assigning a new use to the property.

The third point is that it is impossible to accurately value any of these situations, because one would need to know the specific development activity imagined by the developer; the developer could be considering many options and might not yet have even arrived at a conclusion. Much of what is going to happen in the future cannot be in the price of the shares.

Fourth, once there has been a development announcement, there is usually a very specific timetable, which removes considerable uncertainty. The return, such as it is, occurs in a very brief time period because, once the development is announced, the slope of the equity yield curve (which reflects the time and value-catalyst expectations of investors) changes completely. This behavior can be witnessed in our holding of **Howard Hughes Corp**., the price of which has varied closely with zoning and development announcements by the company.

Another way of describing the pricing paradox of land companies—which works to the advantage of the long-term holder—is to think about the presumed 5%+ expected appreciation of the property held by a land company. Let's agree that any given investor accepts that will be the case, except that if there is no

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present development, the property will be held on the balance sheet at cost (so no observable appreciation along the way), and no dividend paid. Not very interesting. Now what if that same company were to pay out a regular dividend equal to 5%+ of its share price? More interesting? Of course.

There is a further logic to the discount applied to land companies. Even if outside shareholders were to agitate for such a company to liquidate its holdings and pay out the proceeds, management could probably not get much for those properties, for the very reasons mentioned above. In truth, the shares are probably priced near enough to effective liquidation value. But that liquidation value embodies an enormous (equity yield curve-based) discount, because after a suitable period of time, once a strategic plan is put in place, followed by the appropriate legal and zoning allowances, followed by actual development, the value creation potential can be very large.

The net result of these factors is that undeveloped land is a genuine diversification tool. So why does CalPERS make direct, private investments in real estate, which is an expensive proposition? In fiscal 2013, CalPERS paid $201 million of management fees and $270 million in performance fees for the real estate segment of the portfolio for a total of $471 million on a net investment (minus debt) of $27.8 billion, or 1.69%. In addition to management fees, there are many other expenses, such as property maintenance, insurance, taxes, appraisal fees, legal fees, and possibly even litigation expenses.

A simpler alternative, in principle, would be to invest in undeveloped land through the public equity market. However, there are only about six firms with sufficient liquidity to entice an institution to even consider investment. Those six are: **Brookfield Residential, Dream Unlimited, TRI Pointe**, Pico Holdings, **Howard Hughes**, and St. Joe. Unfortunately, their aggregate stock market value is only about $13 billion, which is merely 33% of the CalPERS real estate portfolio alone, which itself is only 15% of its entire portfolio, and only three of those companies have market capitalizations meaningfully above $1 billion. Moreover, the aggregate float, or the value of the shares not held by insiders, of these firms is significantly less than $13 billion. Obviously, large pension funds, if they are to invest in real estate, must choose investments that offer the possibilities to deploy large amounts of funds.

This is another illustration of the reason that trading liquidity can play such a critical role in the modern era in share valuation. A fund like CalPERS might be quite aware of the theoretical attractiveness of a Dream Unlimited or Brookfield Residential, but they are of no practical use. As well, there is little research coverage of these companies, also partly related to liquidity—if there are few shares to trade, there are few commissions to be made. A second reason is that in most instances these land companies are not interested in speaking to Wall Street analysts. Probably more important, their financing is usually in place; they do not require much, if anything, of Wall Street.

A Portfolio Example

TRI Pointe Homes is a recent addition to some of our portfolios. It was founded in the depths of the Credit Crisis in 2009 by former homebuilding industry executives. Their objective was to acquire land lots in distressed regions, particularly in California and Colorado, which could be utilized for future home construction. TRI Pointe was certainly not alone. A number of companies led by astute investors acquired enormous amounts of land in heavily distressed areas such as California, Arizona, and Nevada.

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In 2010, real estate investor Barry Sternlicht capitalized TRI Pointe with $150 million of equity through his Starwood Capital private equity fund. Mr. Sternlicht became Chairman of TRI Pointe and received roughly 39% equity ownership of the company. Given his real estate experience, it is not surprising that he chose a vehicle that will ultimately benefit from a sustained recovery in the residential housing market.

TRI Pointe drew upon the entire $150 million infusion, using the proceeds to acquire lots in California and Colorado. As a result, it expanded rapidly, increasing its revenues from $14 million in 2011 to $247 million in 2013.

While seemingly on a rapid growth trajectory, Mr. Sternlicht chose to accelerate the company's expansion through the just-completed merger with the homebuilding operations of Weyerhaeuser (Weyerhaeuser Real Estate Company, or WRECO), which closed July 8th. WRECO's homebuilding operations were considerably larger than those of TRI Pointe, such that in terms of revenues and market capitalization, TRI Pointe has become one of the ten largest homebuilders in the U.S.

The transaction was structured as an equity offering by TRI Pointe for the assets of WRECO, increasing the company's shares outstanding from 31.6 million to 162.9 million; thus, the market capitalization has just expanded from less than $500 million to $2.5 billion. This could be an important catalyst for the shares, although not fundamental in nature whatsoever. TRI Pointe was rather illiquid, as Starwood owned nearly 40% of the shares outstanding, leaving a float-adjusted market capitalization of under $300 million. The enhanced trading liquidity could eventually attract the interest of the ETF index engineers.

Nevertheless, TRI Pointe is currently priced in a manner reflective only of present earnings power, not of its substantial land bank. That is, investors are unwilling to pay a premium for the vast optionality that exists in the company's largest market, California. To illustrate, the consensus revenue estimate in 2015, which incorporates the contribution of WRECO, is $2.77 billion. Based on an historical average for the industry, TRI Pointe should manage to earn a profit margin of perhaps 7.9% in a reasonably robust housing market. This would create $219 million of net income, and a $2.6 billion market capitalization using a 12x p/e multiple. This is only slightly higher than the current pro forma market capitalization of $2.5 billion.

However, homebuilding activity in California is still 74% below the normal average in that state. A return to a normal level would entail construction activity more than three times the current rate. As over half of TRI Pointe's land lots are in California, an eventual recovery in this market would have a great impact on its earnings. Moreover, broad construction levels in the U.S. are still well below normal levels. The addition of WRECO exposes TRI Pointe to other markets as well, such as Washington D.C. and Texas. The company therefore is positioned to participate in a much broader recovery.

Yet, given the fact that this presumed expansion in the company's earnings cannot be precisely estimated, this optionality is being discounted by investors at a very high rate. To evidence this, based on the company's own projections, WRECO as a standalone entity could produce over $200 million of net income by 2016. If investors were willing to pay a multiple of 12x this estimate, the resulting market capitalization of over $2.4 billion would about equal the current implied market capitalization of TRI

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Pointe. In other words, at this price one is not paying for the entire TRI Pointe stub business, which should report nearly $500 million of revenues this year.

Importantly, TRI Pointe has the benefit of a key intangible asset that does not appear on its financial statements and thus cannot be traditionally valued. Mr. Sternlicht is an experienced, well known, and serially successful real estate investor. He therefore has access to strategic information within the industry that the average executive does not. It appears that he is using TRI Pointe as a new investment vehicle.

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