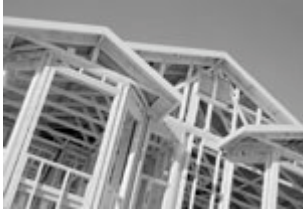


PortReal, LLC // serving institutional investors
Residential market update // 4th Quarter, 2008



www.portreal.com

Market recovery expected in late 2009

Nationally, residential housing prices are dropping with a persistent downward trend. Various fundamentals indicate the fall will continue for a few more quarters. We foresee the market bottoming out by 4th quarter of next year.

First, the bad news:

- Market prices in all sectors (investment grade, median, and luxury) are still trending down.
- No particular region or sector appears to be protected from the steady decline in pricing.
- Falling prices are spreading to more cities, after a slight rally earlier in the year
- Bankers report tightening credit across all types of property, lenders, and loan types, despite the recent Congressional effort(TARP) designed, in part, to help home-owners and buyers
- We estimate prices could fall by as much as another 8% before the market bottoms out.
- Ambiguity in tax policy under the new administration, the role of various bailout programs aimed at financial institutions and at borrowers, and the extent of a global recession will slow down investment until at least after inauguration
- Resort-based metropolitan areas (coastal, mountain, and other leisure destinations) have suffered significantly worse than more diversified markets.
- Key regional markets (much of Florida and California) are still dismal investment opportunities

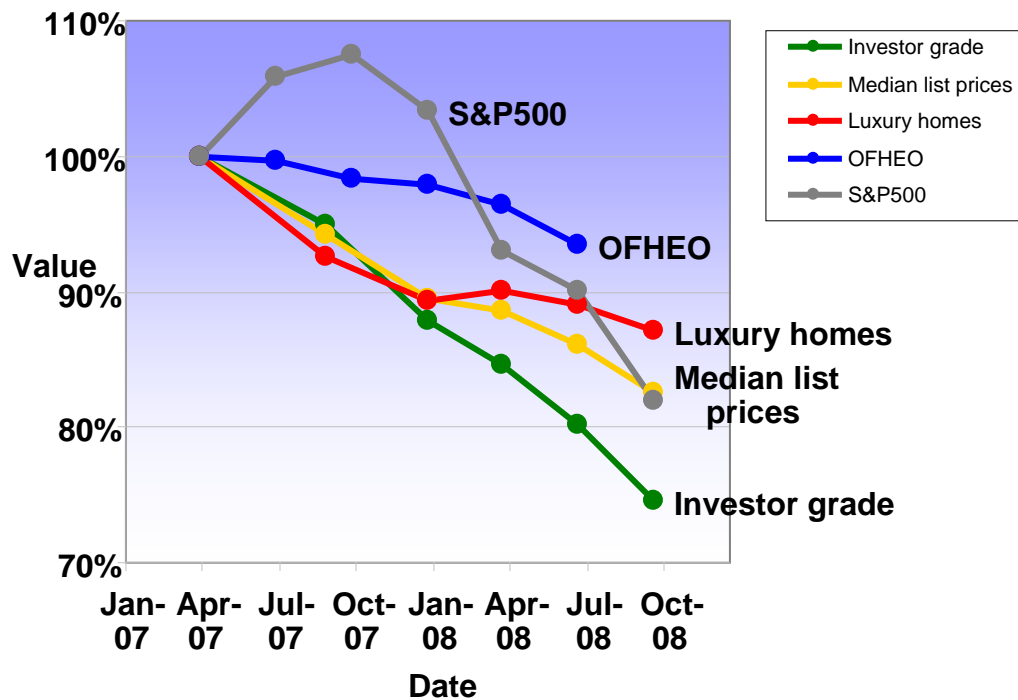
The good news:

- Inventories of both “for sale” and distressed inventories appear to be settling out. This means existing inventory is not being absorbed. But it also means no new inventory is flooding the markets.
- Net rental income matches or exceeds the costs of property ownership in 88% of US markets, making markets increasingly affordable for investors in terms of return on investment.
- There’s light at the end of the tunnel: we expect prices to hit bottom by middle or end of next year, by which time the incentives for investors to acquire properties should be very attractive
- If you owned real estate for the last 18 months, or even the last 10 years, you may have been better off than having invested in the stock market.
- Some of the best places to invest are a handful of major metropolitan areas, or a number of fairly small metropolitan areas.
- There are a number of markets for investors seeking opportunities in terms of direct investment in single family residential housing. The economic fundamentals of these markets would appear to support continued demand for housing, and their market is characterized by good rent-to-value, price trends, and inventory.
- The price free-fall is slowing down among median and especially luxury-priced segments of housing. Luxury properties have held their value better than lower-end properties.
- TARP and a change of administration in Washington may improve the psychology of both consumers and institutions. Government intervention may also provide direct support to housing markets and credit. We expect either case, hopefully both, to help housing markets in 2009.
- President Obama’s focus on Midwest labor markets, especially Detroit, should energize housing markets in those regions.

Market overview

US real estate prices remain in a steady downward trend. However, as of January, 2008, we see trend differentiation among the three grades of pricing that we track (“investor grade”, median, and “luxury”). Luxury homes began to hold their own, while lower-priced properties (median and especially investor grade homes) continued their declines. We track for “For Sale”, or asking prices. The overall downward trend is corroborated by the OFHEO index of sold home prices, which has a one quarter lag. The good news, if it can be called that, is that real estate has performed no worse than the stock market over the last 18 months. The chart below shows pricing trends on a weighted-average basis across 379 US cities.

US real estate prices still in free-fall, but decelerating in higher price grades



The percentage of cities and listings nationwide that have experienced price declines over the last quarter is also increasing. In other words, more markets are again losing value rather than recovering value. The chart below shows how the decline is, for now, becoming more pervasive.

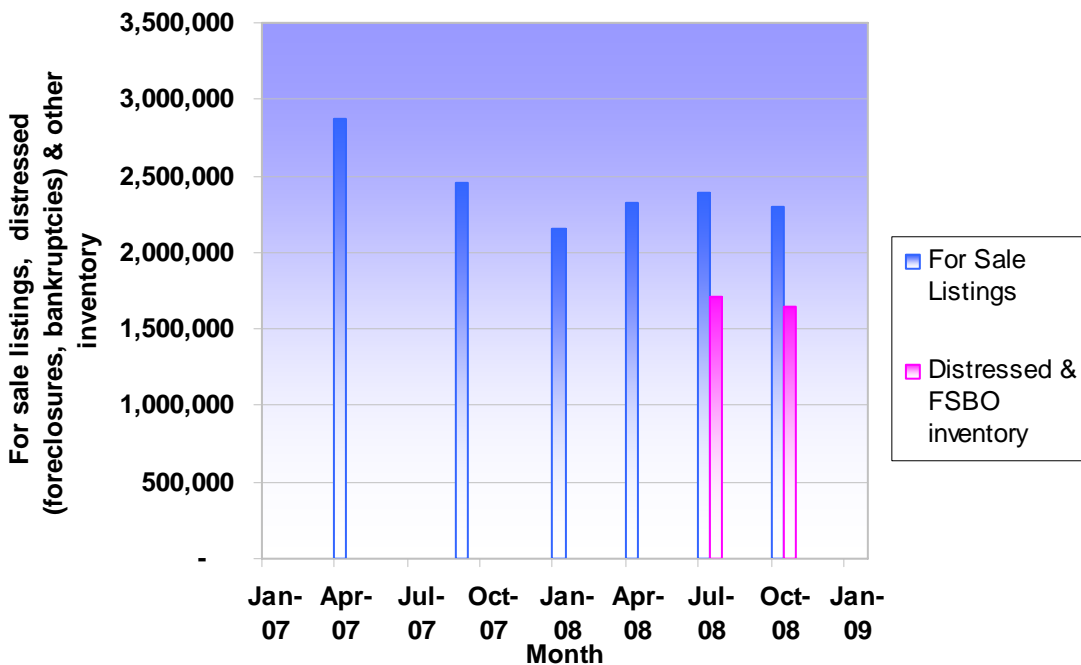
There are several reasons for the continued decline, and some of the most common reasons are low consumer confidence and tightened credit. The Federal Reserve Board’s most recent survey of bank loan officers (www.federalreserve.gov/boarddocs/SnLoanSurvey/) reports continued across-the-board tightening of credit. This applies to lending for prime, subprime, and alternative (e.g., alt-A) loans, and home equity lending. It also reflects trends across the board (commercial and industrial loans, commercial real estate, and consumer loans and credit cards). Tighter credit shows up as stringent terms (such as higher spreads) and higher credit standards. Until Congress’ TARP bill begins to ease credit and provide direct support to borrowers, housing demand will continue to be choked.

Price deterioration is again spreading among cities and listings



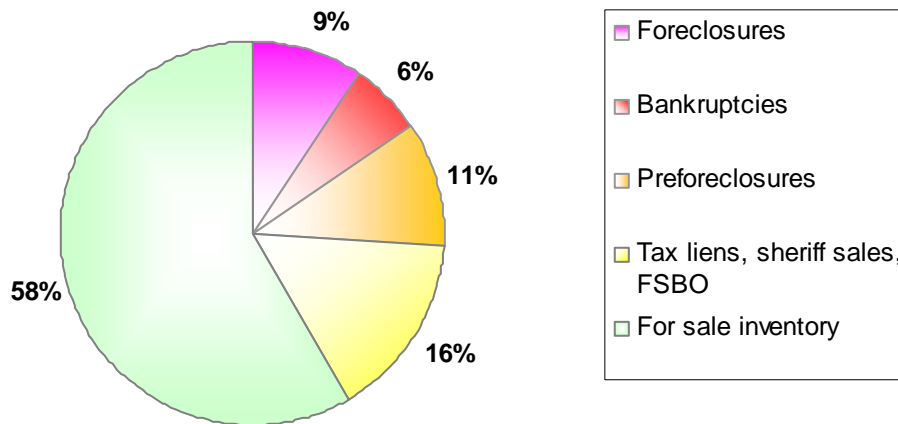
Notably, inventories appear to have stabilized nationally. Both the numbers of “for sale” listings and the inventory of distressed and FSBO properties appear to have settled out. The good news is that there is no new net inventory flooding the markets, but there is also no net absorption of the existing inventory.

Inventories--For sale, distressed, FSBO--are stabilizing



Distressed and FSBO inventory still comprise a whopping 42% of total inventory on the market. The Wall Street Journal has reported that there may be as many as 3 million mortgages at risk of default, which means that the 'distressed inventories' shown above may double unless Congress' TARP assistance catches them before they fall.

US foreclosures, bankruptcies, other distressed sales, & FSBO comprise 42% of inventory



Light at the end of the tunnel?

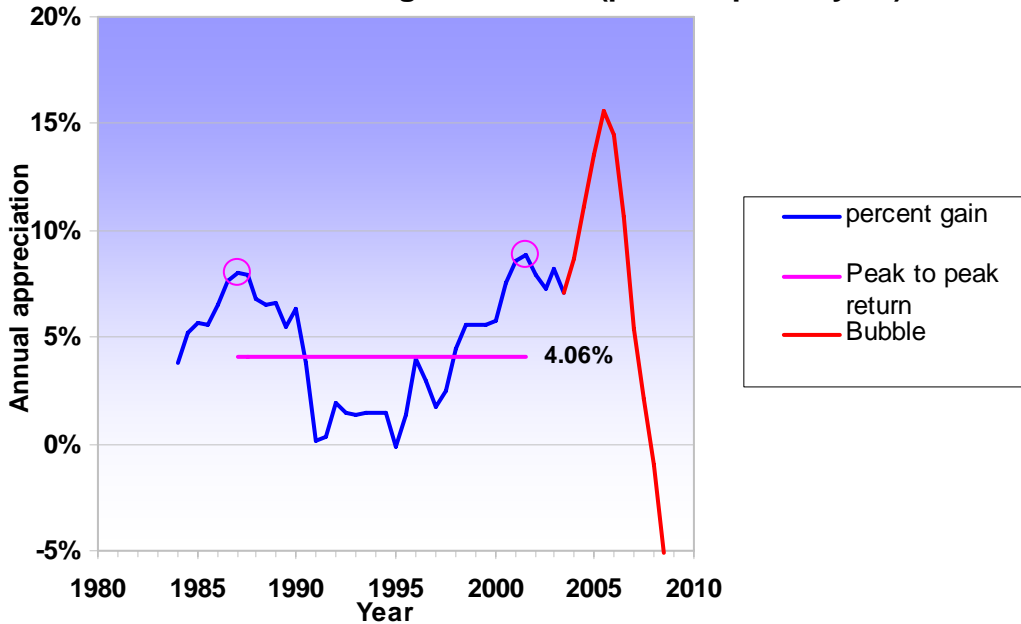
Forecasting the bottom of market is unrealistic. There are many factors which cannot be modeled reliably. Principal among these is consumer and institutional confidence. However, we will present a simple analysis to bracket a timeframe for recovery.

On the short end, we evaluate market prices vs. the economics of investing in properties. Our models show that 88% of US markets are nominally "affordable", meaning that an investor who can borrow at prevailing interest rates can potentially break even on an annual basis because local rents cover operating and financing costs. Under this analysis, pricing has dropped as far as it needs to attract investors back into the market and thus support pricing. Obviously this isn't happening, and there are several reasons for this: fear of further losses, ambiguity about the effectiveness of TARP in supporting home ownership, and tightening credit (both availability and real cost of borrowing).

Assuming these issues are ironed out in the coming year, housing may already be priced rationally. If it continues to fall, we need to ask: what is the next lower floor for price decline?

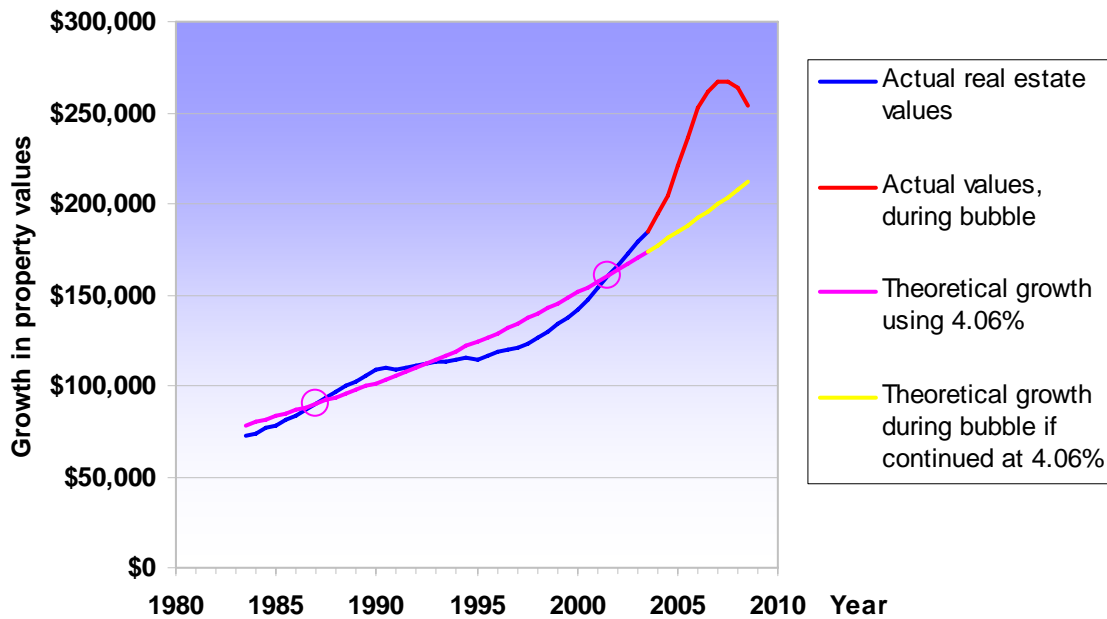
For this, we look at pricing trends. We assume that the bubble of the last 7 years inflated prices above historical norms, and that the air has yet to be let fully out of that bubble. First we try to determine an estimate of a "historically normal" rate of property value appreciation. In the following chart, we identify a real estate price cycle that occurs during the period of 1987 to 2001, based on peak-to-peak returns that appear to suggest a cycle that is repeating in 2001. The nominal rate of increase in national property prices during this cycle is 4.06% annually. For simplicity we are not accounting for inflation and other factors.

Prior to bubble, annual average appreciation of residential housing was 4.06% (peak-to-peak cycle)



When we extrapolate this rate of value growth (4.06%) into the period of the bubble (2003-2005) we find that the bubble over-inflated prices by an amount that exceeds the “normal” rate by 16% as of last quarter. Projecting the current rate of 8%/year in price collapse, combined with an anticipated normal growth of 4.06% suggests that this gap should close in November of 2009, or about a year from now. During this time, nominal prices will have fallen another 8% from today's prices.

Using 4.06% nominal growth of previous cycle, real estate prices have potential to fall further

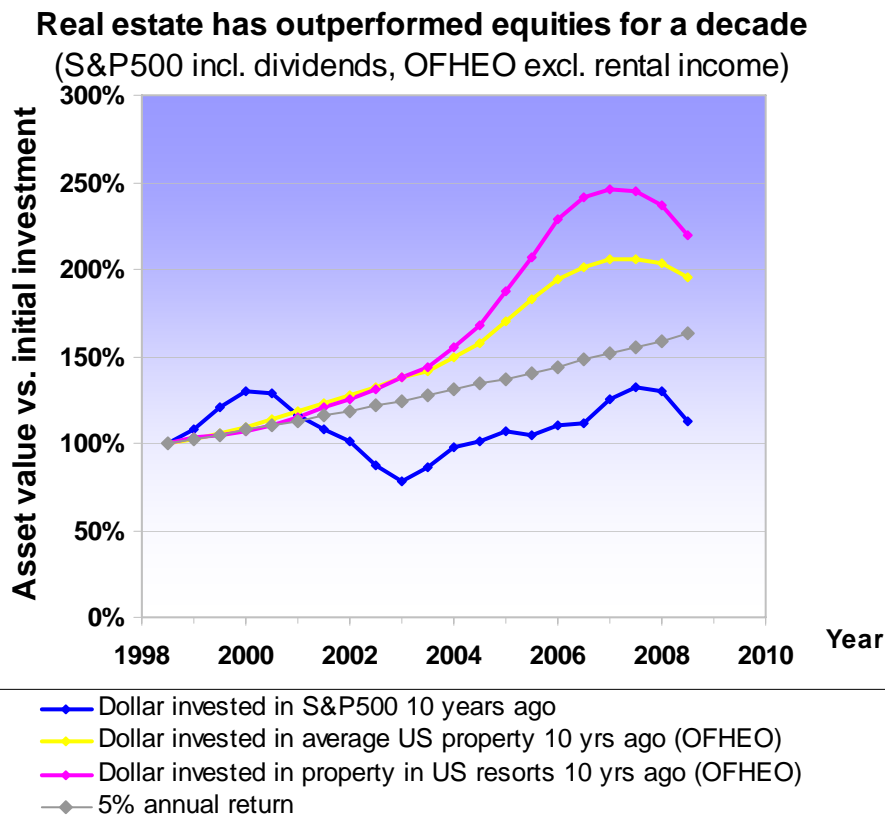


Do we really believe that the market is still significantly overpriced and that it will take another year to complete the correction? If the market was already poised for a cyclical downturn in 2003, then prices should have been significantly lower by now anyway. The bubble not only exceeded cyclical highs, but may have overshadowed a cyclical decline. In addition, pessimism and ambiguity in the market today will further suppress prices. So, yes, we believe that the market will continue to weaken well into 2009.

On the other hand, falling prices offer opportunities for investors, particularly those with cash or convertible assets who do not depend on institutional sources of credit.

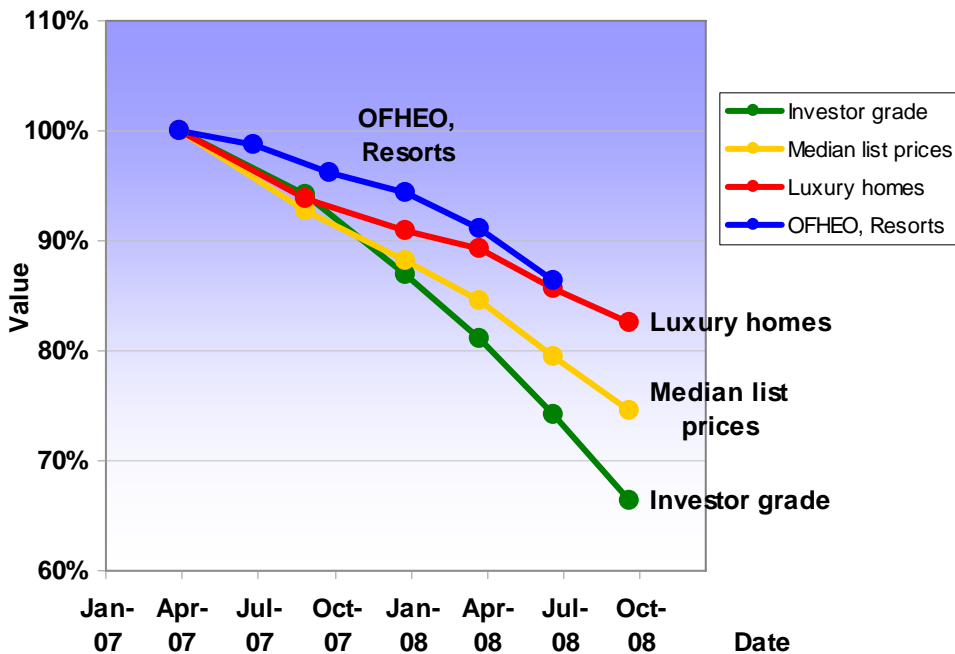
The good news—is there any?

As we mentioned before, real estate, on average, has out-performed the stock market in the last 18 months, and even over the last 10 years. This is particularly remarkable as the stock market data includes the benefit of reinvested dividends, while the real estate figures account only for market value and not rental income. Real estate is a protected investment in the US as government policy supports home-ownership. This protection shows up in tax benefits to homeowners and in monetary policy that reduces volatility in prices and financing costs. Real estate has a significant edge over equities from the standpoint of risk-adjusted returns (e.g., Sharpe Ratio).



Those investors who owned luxury properties should find consolation in the fact that these properties have held their value better than lower cost, entry-level properties. The chart below is typical of national trends whereby luxury grade properties have held their value better than lower cost segments.

Resorts & destinations: luxury housing has fared better than lower cost housing



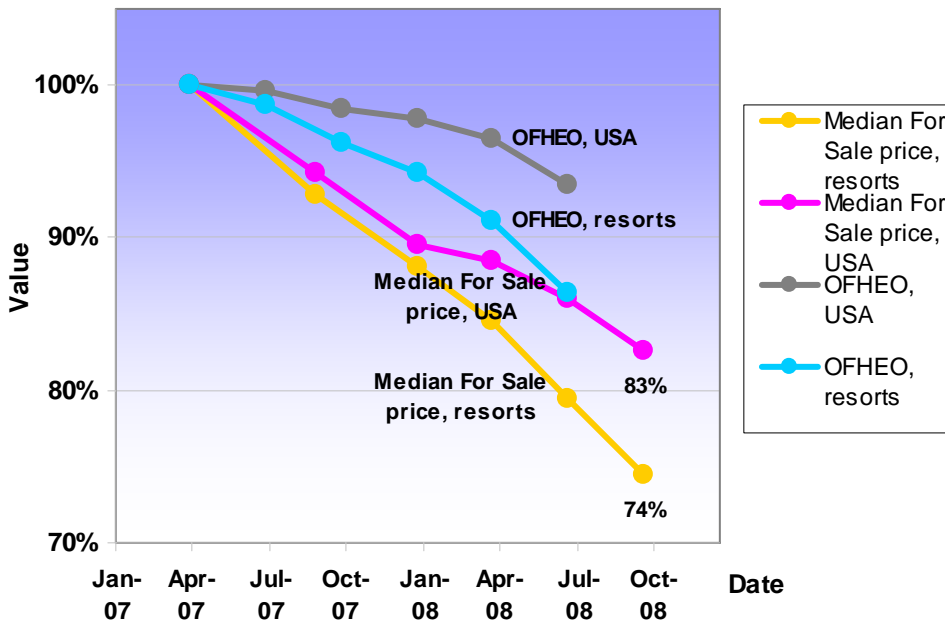
Washed up on the beach

A common investment strategy is to buy properties in resorts and travel destinations. After all, “they aren’t making any more of it.” Our Resorts and Destinations index includes 42 metropolitan areas centered on or near to such locations. These are mostly seaside or mountain destinations. Listing (for sale) prices in these markets have experienced even stronger declines than the national average in the last 18 months.

This finding will surely surprise many investors already sitting on properties in these areas. But there are many factors that have contributed to the decline in property values in leisure markets. These markets have a higher component of discretionary housing investments, so they easily turn into a first line of defense for liquidating assets in an economic downturn. An uncertain economy and higher fuel prices have cut vacation travel (i.e., demand for property) while higher energy and insurance costs have inflated the costs of ownership.

In the short term, leisure markets may hold their value better or grow faster. But over the long term, our index of 42 markets suggests that long-term appreciation is only slightly higher than more diversified markets (4.3% vs. 4.1%) at the expense of higher volatility, as we’re seeing now.

Resorts & destinations: Prices fell substantially vs. national markets



Regional markets

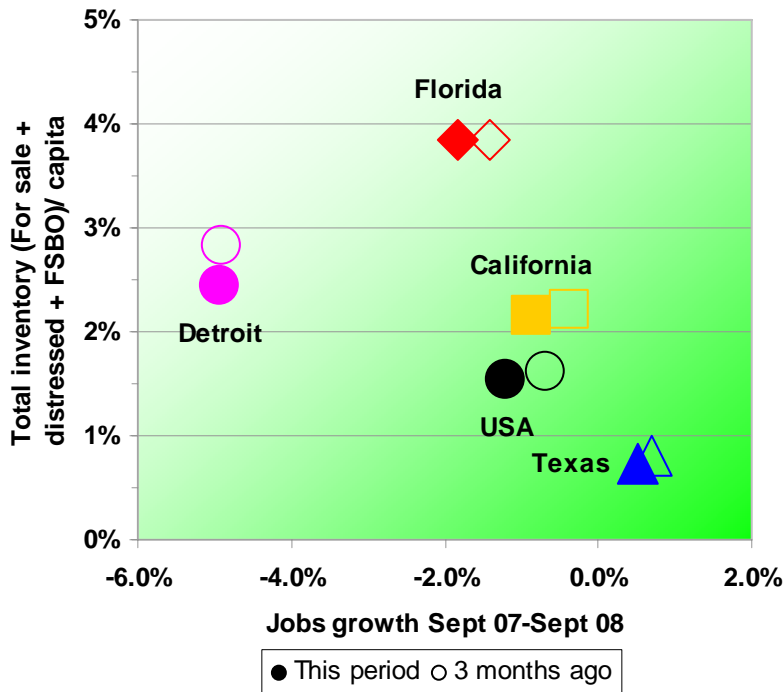
Florida continues to shoulder the burden of extremely high inventories. Until this inventory has been absorbed, we feel that investors must be extremely wary of investing in most markets in Florida.

Detroit still has the lowest investor grade prices (\$20,000) in the nation. (We define “investor grade” as the 15th percentile price point in the For Sale listings market). Not coincidentally, it has one of the highest unemployment rates of any major metropolitan area in the U.S. Inventories are dropping, which may be due to absorption from investors and owners not putting homes on the market while they wait for the market to stabilize. The good news for Detroit and other Midwestern cities could be President Obama's focus on reenergizing industry and employment in those areas. At the low, low prices of housing in some of these markets, investors might consider taking positions to participate in a potential upswing.

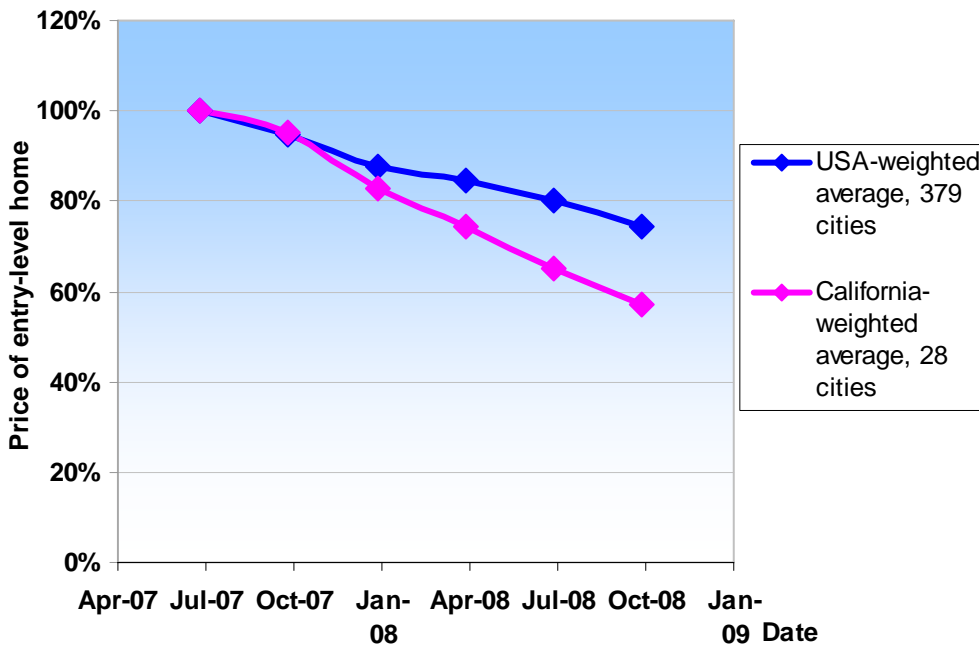
California markets continue their freefall with no end in sight. With few exceptions, we don't feel good about California for buy-and-hold investors, as we expect prices and demand to be uncertain for some time.

And, finally, California distressed property inventories (foreclosures, bankruptcies, FSBO, and other) are still at very high rates on a per-capita basis as well as a percentage of total inventories.

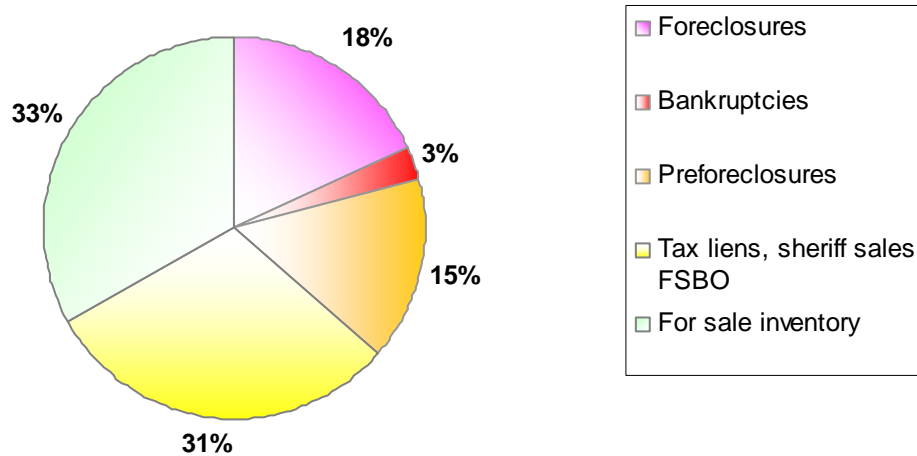
Florida with huge inventories, Detroit facing high unemployment as inventories decline



Entry-level housing dropped 43% in top 28 California cities vs. 25% nationwide, last 5 quarters



California foreclosures, bankruptcies, other distressed sales, & FSBO 67% of listings



Our investment picks

We use 4 criteria to assess markets for investors and home-buyers: (1) housing supply vs. demand (essentially absorption), (2) pricing trends, (3) rent-vs.-buy dynamics, and (4) fundamental economics of the region. We use four proxies for these criteria: housing inventory/capita, statistical evaluation of appreciation rates, affordability of buying vs. renting, and jobs growth in the area. We use these criteria to pick cities that appear to be poised for growth in demand and pricing.

Major centers of creativity, financial and political power are well-positioned: San Francisco, Boston, and New York City. We also continue to like the mid-Atlantic: selected cities in Virginia, West Virginia, Pennsylvania, Ohio and New York. We like Texas in general and have liked McAllen for many years. There are a number of cities in the Plains (North Dakota and Nebraska) and the three I's (Indiana, Illinois, and Iowa) that appear to be stable candidates for investment. Finally, we like Alaska due to jobs growth and low inventories.

Below is our pick of cities for this quarter, in alphabetical order by state. This list is only a starting point based on high level factors. Investors must perform their own due diligence regarding local market conditions and the viability of any specific investment:

AK: Anchorage, AK: Fairbanks, CA: San Francisco-San Mateo-Redwood City, FL: Gainesville, IA: Ames, IA: Cedar Rapids, IA: Des Moines-West Des Moines, IA: Waterloo-Cedar Falls, IL: Bloomington-Normal, IL: Champaign-Urbana, IN: Lafayette, MA: Boston-Quincy, MA: Cambridge-Newton-Framingham, ND: Fargo, ND: Grand Forks, NE: Lincoln, NH: Manchester-Nashua, NY: Elmira, NY: Ithaca, NY: New York-White Plains-Wayne, OH: Columbus, OK: Lawton, PA: Lancaster, PA: State College, PA: Williamsport, SD: Sioux Falls, TX: Killeen-Temple-Fort Hood, TX: Laredo, TX: McAllen-Edinburg-Mission, TX: Texarkana, TX: Waco, UT: Logan, VA: Blacksburg-Christiansburg-Radford, VA: Virginia Beach-Norfolk-Newport News, WA: Kennewick-Richland-Pasco, WV: Morgantown.

Getting out of the jungle

As noted earlier, we believe the free-fall may continue all the way through 2009, even assuming that consumer and institutional confidence is restored and that credit is eased during that period. In some

markets, it may last much longer due to heavy inventory overhang. Luxury housing is falling more slowly, but resort and destination markets are falling faster than more diversified markets.

A good strategy for investing in residential real estate is to maximize the ratio of net rental income relative to asset values, as long as net cash flows are positive. This generates earnings while property appreciates and equity grows (if there's financing). One must buy move-in quality properties at the lowest possible cost in markets that have underlying fundamental economics that support both continued occupancy and property value growth.

The coming year will offer opportunities to acquire investor grade properties at low prices in markets that will sustain housing demand as the economy recovers. It may also offer the opportunity to convert assets between markets or grades in anticipation of higher demand for entry-level housing once credit eases.

TARP, inauguration of a new President, and developments in the world economy will have a situational impact on investment opportunities. For example, President Obama's focus on reviving rustbelt industries and employment may revitalize and fund demand for housing. It's too early to tell what will happen, so from now until early 2009 may be a good time to take a wait-and-see approach in the market.

Definitions

Investor Grade is a starter-home property ready and suitable for renting or resale. We benchmark **Investor Grade** pricing using the 15th percentile price point in the market. **Investor Grade** housing shapes supply/demand for the overall housing market by defining a clearing price for investors. PortReal's **Affordability** benchmark is the ratio of the **Investor Grade** price to a "most you can afford" price based on rental income. If rent cover ownership costs, then the market is affordable. Our measure of **Affordability** can be a weathervane for imminent price trends. **Distressed properties** are those in foreclosure, pre-foreclosure, bankruptcy, and sheriff's sales. We associate **FSBO** (For Sale By Owner) with this category to distinguish from retail "**For Sale**" home prices.

PortReal news

Our fourth quarter Market Report has just been released, and is available from our website, or through EBSCO, Research and Markets, and Alacra.

Disclaimer: Investors should not rely on our data to make specific investment decisions. Economic and market conditions differ greatly by location and property. Our analysis ranks metro areas using standardized assumptions across geographies. Investors must perform their own analysis of vacancy, rents, operating costs, and other factors before making investments.

Sources: Census, OFHEO, Bureau of Labor Statistics, and online listings and foreclosure data (including Realtor.com and Foreclosure.com).

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