Hidden Opportunities In Housing

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Home sales in the US may be poised for a sustained, but jagged, multiyear recovery, supported by an array of demographic, cyclical and financial factors. With such a favorable backdrop, investors may be looking for ways to add exposure to housing, often starting with homebuilders. But, as Michael K. Arends and Celine E. Demonsang explain, there are compelling opportunities beyond the builders, hidden in the housing transition supply chain.

We believe both new- and existing-home sales appear positioned for a sustained, moderate, but jagged, multi-year recovery.

INTRODUCTION

For the past year, investing in the recovering US housing market has not exactly been a smooth ride. Buoyed by a backdrop of an improving economy and better employment data, many investors followed a traditional path, flocking to homebuilding stocks as a way to participate in the sales recovery.

But that strategy led to broad-based disappointment in 2014, as many housing-related names experienced a sharp selloff. After a modest initial bounce off multiyear lows, new- and existing-home sales reversed lower and remained soft through the rest of the year, as shown in Figure 1. Several factors contributed to this unexpected weakness, including an unusually harsh winter, shrinking inventory, still-tight lending standards and a sharp increase in 30-year fixed mortgage rates.

In recent months, however, the housing recovery resumed and has been steadily improving. At this point, we believe both new- and existing-home sales appear positioned for a sustained, moderate, but jagged, multiyear recovery that should persist for years, supported by a plethora of demographic, cyclical and financial factors. In this paper, we will explore some of those drivers, as well as outline the compelling investment opportunities that may result.

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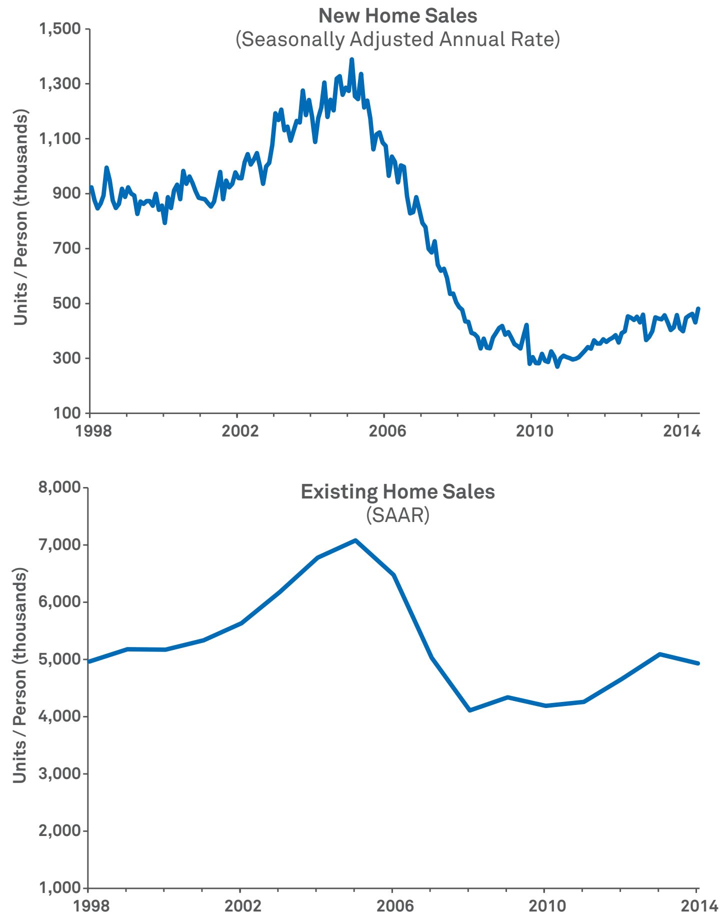
The percentage of young adults living at home has surged to a record high of 28%.

Figure 1: A Lull in Home Sales

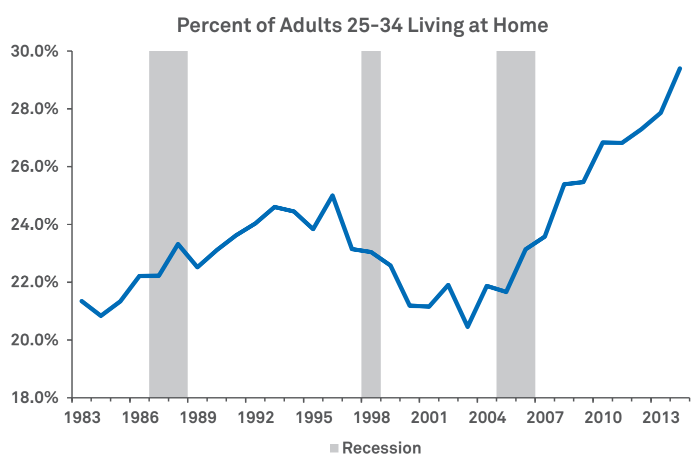


Source: Bloomberg, June 1998 – December 2014.

DEMOGRAPHICS: *HOME ALONE*, 2015

In the 1990 comedy film classic *Home Alone*, 8-year-old Kevin McCallister (played by actor Macaulay Culkin) is mistakenly left at home as his family leaves for Christmas vacation in Paris. If Kevin, now age 33, has followed the typical path of his generation, he has finished college and returned to live at home. For the past decade, the percentage of young adults living at home has surged to a record high of 28%, as shown in Figure 2.

Figure 2: We're Not Home Alone Anymore

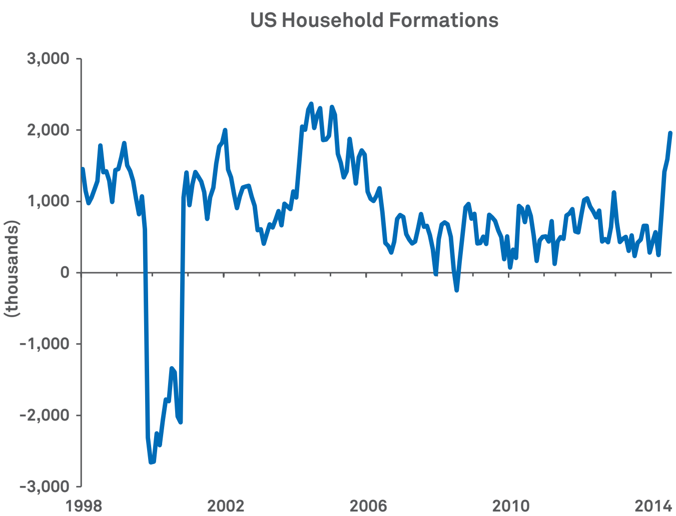


Source: US Census Bureau, January 1983 – January 2015

But this trend may be about to reverse course. As shown in Figure 3, US household formations may be at a significant inflection point. As the Millennials enter their prime household forming years, we could see the release of pent-up housing demand over the next three to five years. This could be spurred by improved job prospects, accumulated savings from living at home — and parents' growing desire to be home alone!

Right now, mortgage payments are about 60% of rental costs.

Figure 3: A Notable Pickup in New Households

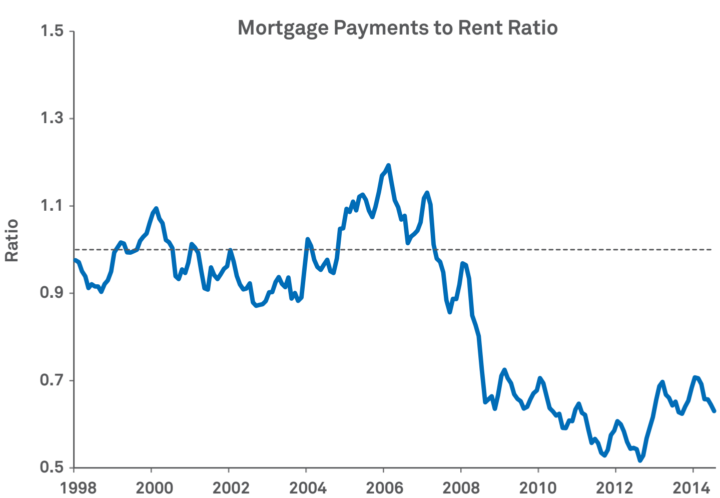


Source: Bloomberg, June 1998 – December 2014.

When Kevin and his peers finally face the decision whether to rent or buy a home, they will most likely find homeownership the more attractive option. After many years of mortgage payments exceeding monthly rents, this ratio changed in 2007, as shown in Figure 4. This was largely because of declining mortgage rates and steadily rising rents.

Right now, mortgage payments are about 60% of rental costs. We believe that accelerating rent increases, the chance to lock in monthly mortgage payments near record-low levels, and growing confidence in building home equity over time will push more people toward homeownership.

Figure 4: Owning Becomes Cheaper Than Renting



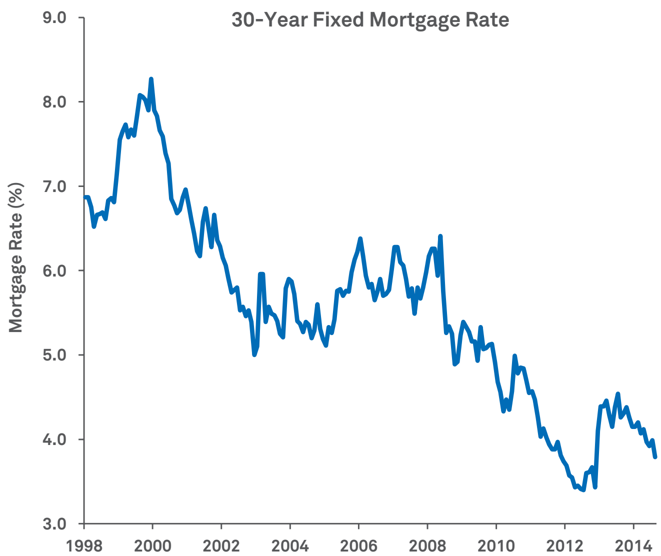
Source: Bank of America Merrill Lynch, June 1998 – December 2014.

Rates on 30-year fixed mortgages are near historic lows, which may rekindle demand for housing.

FAVORABLE FINANCING

As illustrated by Figure 5, rates on 30-year fixed mortgages are near historic lows, which may rekindle demand for housing. When combined with respectable new job creation and rising consumer confidence, prospects for a sustained recovery in new and existing homes sales appear bright.

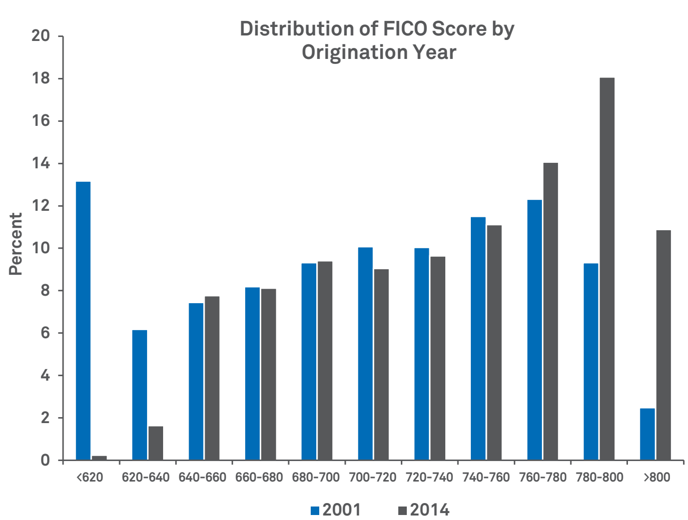
Figure 5: Rates Remain Low



Source: Bloomberg, June 1998 – January 2015.

However, since the financial crisis, mortgage lending standards have tightened substantially, which has posed a significant obstacle to the US housing recovery. Figure 6 contrasts the distribution of borrowers' FICO credit scores among loans originated in 2001 and 2014. In 2001, 13% of homebuyers who were granted loans had a FICO score below 620, but by 2014, this buyer pool was virtually eliminated. In 2014, about 45% of mortgages were awarded to homebuyers with credit scores above 760.

Figure 6: Credit Standards Set to Relax

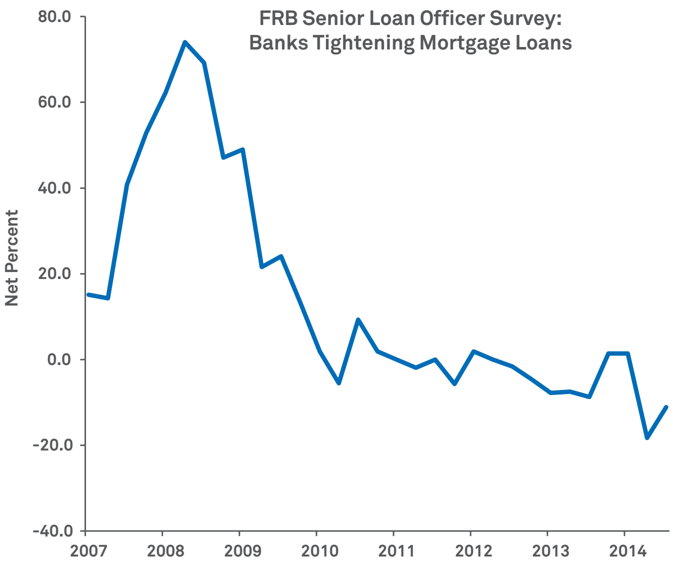


Source: LPS, Goldman Sachs Global Investment Research, 2001 vs. 2014.

These tight standards created challenges for first-time buyers and those with impaired credit histories. However, signs of easing credit standards are now emerging. One established gauge of this is the quarterly Federal Reserve Senior Loan Officer survey, which surveys roughly 80 domestic banks and 24 US branches and agencies of foreign banks about changes in the standards and terms of bank loans to businesses and households over the preceding three months.[1] As seen in Figure 7, survey respondents have reported two consecutive quarters of modest easing.

Several new initiatives aimed at easing mortgage credit availability have been introduced recently.

Figure 7: Mortgage Credit Is Easing



Source: FactSet, June 2007 – December 2014.

In addition, several new initiatives aimed at easing mortgage credit availability have been introduced recently. In late 2014, Fannie Mae and Freddie Mac announced a new option for qualified homebuyers to obtain a mortgage with only a 3% down payment.[2] In January, the Federal Housing Administration cut annual insurance premiums for new borrowers by half of a percent, a move expected to prompt a quarter of a million buyers to purchase their first home over the next three years.[3]

SO WHERE ARE THE OPPORTUNITIES?

With all of these factors creating a favorable backdrop for a recovery in home sales, investors may be looking more closely at opportunities for additional exposure, naturally beginning with the homebuilders segment. Historically, homebuilders have frequently been valued on a price-to-book basis, as investors are generally most concerned about whether the value of these companies' assets will grow over time.

Before the stocks of homebuilders plunged in 2007, they traded at lofty price-to-book ratios, as shown in Figure 8. However, throughout the course of 2014, homebuilders' shares became more reasonably valued, given price declines and growth in book value. Yet, to us, the stocks do not appear to reflect the potential for higher levels of building activity as well as the extended cyclical recovery in new-home sales.

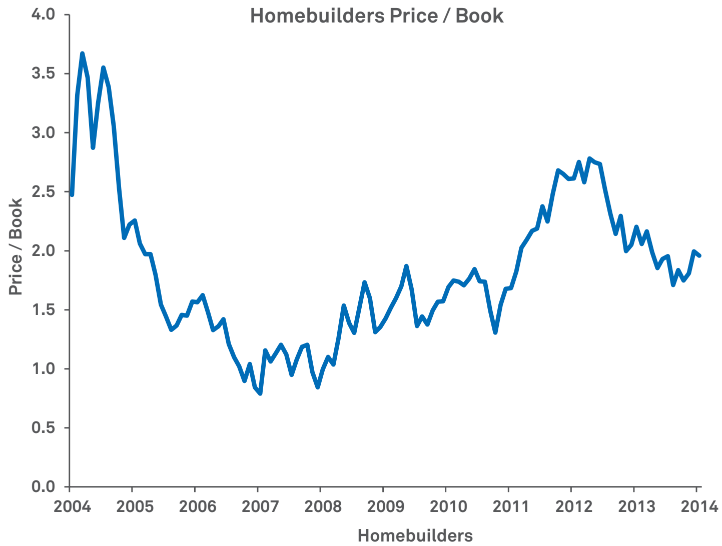
1 Senior Loan Officer Opinion Survey on Bank Lending Practices, The Federal Reserve Board. http://www.federalreserve.gov/BoardDocs/snloansurvey/

2 "Fannie Mae Announces 97 Percent LTV Option for First-Time Homebuyers," Fannie Mae press release, Dec. 8, 2014. "Freddie Mac Home Possible Advantage (SM) Mortgage Makes Home Financing With a 3 Percent Downpayment Possible," Freddie Mac press release, Dec. 8, 2014.

3 "FHA to reduce annual insurance premiums," US Department of Housing and Urban Development press release, Jan. 8, 2015.

We have found a broad array of less-familiar companies that we believe are well positioned for the US housing recovery.

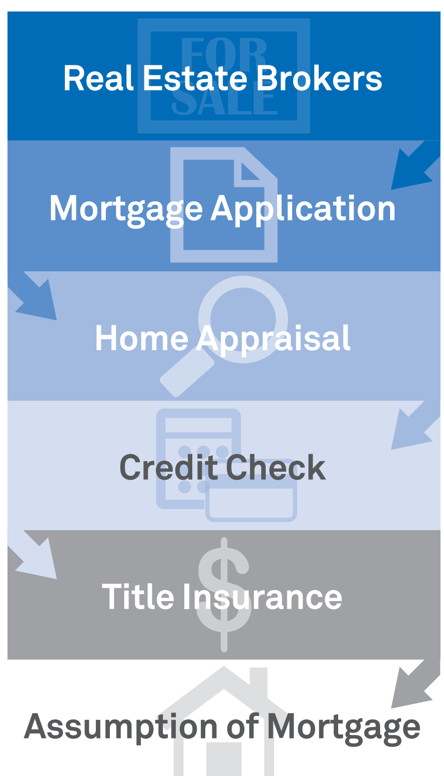
Figure 8: Valuing Homebuilders' Stocks



Source: Bloomberg, TBCAM. December 2004 – December 2014.

Beyond the builders, the housing transition supply chain, as shown in Figure 9, provides many compelling hidden opportunities. We have found a broad array of less-familiar companies that we believe are well positioned for the US housing recovery. The process of buying a home begins with a real estate broker, followed by a mortgage application, then an appraisal, a credit check, title insurance and, finally, the assumption of a mortgage.

Figure 9: The Housing Transaction Chain



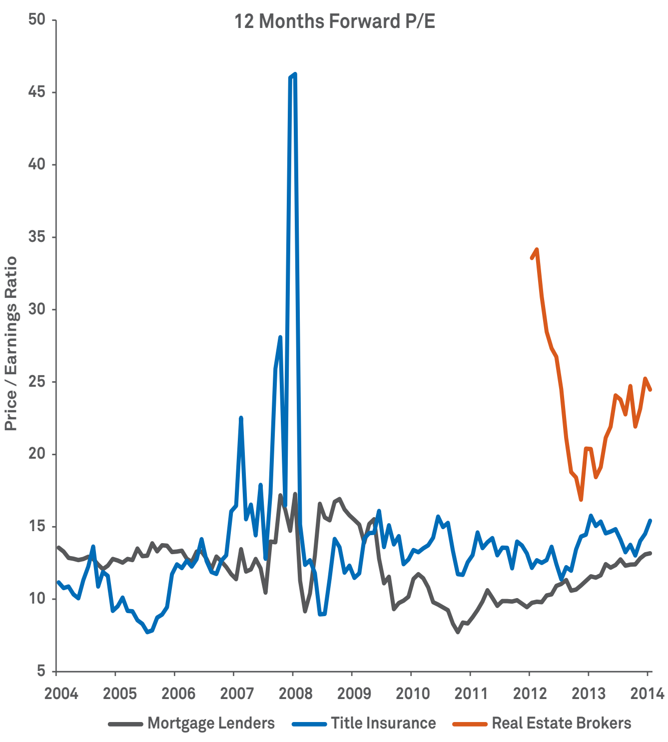
At this point, we believe leading companies involved in real estate brokerage, title insurance, appraisal, credit rating and mortgage lending are worthy of investors' attention, as we believe unrecognized strength in these industries' longer-term fundamental prospects will provide attractive investment options over the next three to five years.

While the process of buying a home is well known, the names of major companies involved in the transaction supply chain are not. For example, the leading real estate brokerage firm is a holding company with a somewhat nondescript name. Data used in home appraisals and related statistics are created in the processing systems & products segment of the technology industry. The company with the largest exposure to the technology platform used in mortgage servicing is also one of the biggest title insurance providers for residential real estate.

Traditionally, homebuilders and real estate brokers have exhibited above-average volatility.

As shown in Figure 10, title insurance companies and banks with significant exposure to mortgage financing are trading in the middle of their historic 12-month forward price-to-earnings range. Real estate brokers have more limited history as public companies, but they are trading in the lower half of their abbreviated valuation range. These valuations have not discounted a multiyear recovery in new- and existing-home sales, its impact on earnings and cash, or higher levels of operating profitability as dominant franchises in their respective markets.

Figure 10: Supply-Chain Valuations



Source: Bloomberg, TBCAM, December 2004 – December 2014.

These types of investments are not without risk, of course. Traditionally, homebuilders and real estate brokers have exhibited above-average volatility. A sharp and sustained increase in mortgage rates could cause a drop in new- and existing-home sales; homebuilders and companies related to housing transactions would likely underperform in such an environment. Plus, the overhang of student-loan debt could delay the growth of first-time homebuyers.

Many of the most compelling investment possibilities fall into the small- and mid-cap asset classes and represent very small weights in major benchmarks.

CONCLUSION

Low mortgage rates, improving credit availability, demographic trends and healthy job creation are converging to strengthen the recovery in new- and existing-home sales, which could persist for longer than the consensus currently expects. Homebuilders will likely receive the most attention from investors, but other, less obvious peripheral areas also appear to offer appealing investment options.

Collectively, we believe the hidden opportunities in housing represent an area where active managers should significantly overweight using a three- to five-year time horizon. Many of the most compelling investment possibilities fall into the small- and mid-cap asset classes and represent very small weights in major benchmarks. We have found select leaders in each respective industry and view the sustainability of free-cash-flow generation, competitive positioning and visibility of fundamental prospects as more attractive than the consensus now does.

ABOUT THE AUTHORS

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Michael is a Portfolio Strategist on The Boston Company's Opportunistic Value investment team. He is responsible for communicating the team's strategies to clients, prospective clients and consultants.

Before joining the firm, Michael worked at Putnam Investments, where his duties included the role of Institutional Portfolio Manager for the small- and mid-cap asset-class portfolios. Additional investment experience was gained as a portfolio manager at Putnam Investments and Phoenix Investment Counsel. While at Kemper Financial Services, his responsibilities included research coverage of the media and entertainment industries, associate manager of the research department and co-management of six mutual funds.

Michael received an MBA from Indiana University and a BBA from Southern Methodist University.

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Celine is a Product Specialist at The Boston Company, where she provides market research, analysis and project support to enhance the development and promotion of the firm's products and services, including Opportunistic and Alternatives strategies.

Before joining the firm, she served as head of alternatives research and as an alternative investment research analyst at Brighton House Associates. She also completed internships at MFS Investments, Lincoln International and Deutsche Bank in Paris.

Celine graduated magna cum laude from Merrimack College with a BS in Business Administration.

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