



Reconstructing Housing: Pent-Up Demand Could Power the Return of a Long Dormant Sector

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Executive Summary

New home construction has endured its four worst years on record; however the fundamental demand for living space has not changed, and could even accelerate as certain demographic and social factors normalize. With lending standards and inventories continuing to improve, an inflection point in housing may be at hand, which would have ripple effects across related industries as well as the economy at large. Notably, we are not calling for a reversion to the mean in activity levels; merely a return to the lows of prior cycles would drive significant growth across the value chain. From an investment perspective, we see opportunities in homebuilders, tools, building materials and home improvement retail.

The Opportunity

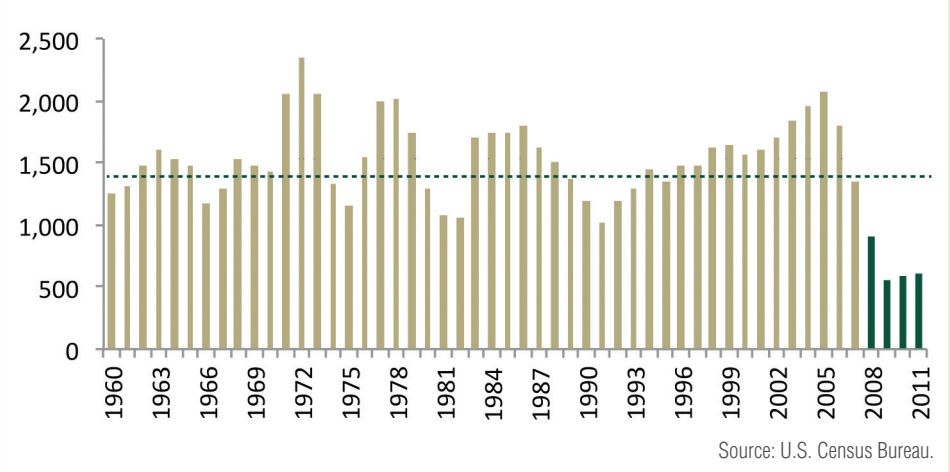
Various measures of U.S. economic health have steadily improved since their lows in late summer,¹ to the point where we believe the expansion is self-sustaining. While not reaching the heady levels seen in past cyclical rebounds, we believe that conditions are healthy enough for domestic growth to continue even as economies in the Eurozone and emerging markets potentially falter. Our ability to “decouple” from the global economy is supported by the critical role of consumer spending in our economy, with a correspondingly smaller role for exports.²

In this environment we are exploring ways to increase our exposure to the domestic economy. The most lucrative areas for investment are likely to be those where prior weakness in employment and confidence has spurred a deferral in spending that could now begin to revert to normalized levels, with potentially explosive consequences. One such area where we see the potential for material upside is the market for new home construction.

The deferral in home construction has certainly been extreme. *The years 2008 to 2011 were the four lowest for housing starts since 1960, and the 2011 housing starts figure was almost 60% below the annual average over this period.*³

In our view, this depressed level of starts is unsustainable in light of the structural demand for new U.S. housing which we conservatively estimate at 1.4 million

Figure 1: U.S. Housing Starts (in 000's), 1960-2011



¹The four week moving average of initial jobless claims improved from 422,300 in September to 379,000 in January. Source: Department of Labor. Consumer confidence improved from 55.7 in August to 74.0 in January. Source: Thomson Reuters/University of Michigan.

²In 2010, personal consumption expenditures comprised 70.5% of US gross domestic product, while exports comprised 12.7%. Source: Bureau of Economic Analysis.

³Average annual housing starts in 1960 to 2011 were 1,479,500 while 2011 housing starts were 606,900. Source: US Census Bureau.

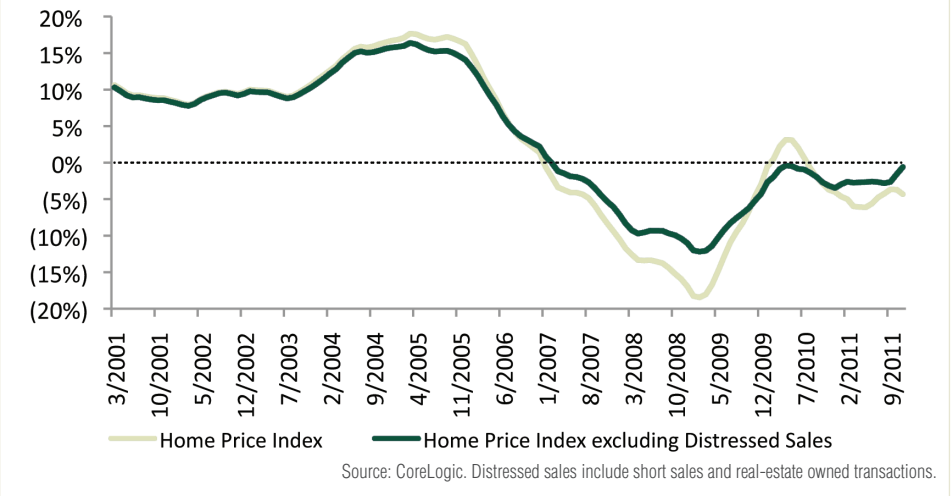


Figure 2

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| Household Formations | 1,100,000 |
| Replacement | 250,000 |
| Second Homes and Miscellaneous Factors | 50,000 |
| Annual Housing Demand | 1,400,000 |

Source: US Census Bureau and IHS Global Insight.

Figure 3: % Year/Year Change in Home Prices, 3/2001-11/2011



units annually. This estimate is derived from the annual average of 1.1 million household formations in the years 1980-2011 plus an additional 0.3 million homes required because of natural disasters, age, demand for second homes, changes in zoning and other factors.⁴

The major drivers of household formations are population growth and lifestyle changes. These factors restrained household formations in the aftermath of the Great Recession and could be a source of pent-up demand in a more normalized market. For example, consider the propensity for people ages 18 to 34 to live with their parents, which is at the highest level since the U.S. Census began tracking it in 1983. If this figure were to return to its historical average, it would create demand for 2.2 million additional living spaces.⁵ **As confidence continues its recovery, and the employment picture improves, some reversion to the mean in lifestyle choices could have outsized implications for housing-related markets.**

However, this favorable market backdrop has yet to be reflected in home prices, which have generally been in decline since 2007. While broad measures of home prices continue to drift lower, the picture is more promising when looking exclusively at non-distressed homes, which appear to be forming a bottom. The U.S. residential home market is bifurcated, with demand improving for homes in healthy neighborhoods while those in more distressed communities still must reduce prices to generate interest.

There are many reasons to expect the pricing environment to continue to improve in healthy neighborhoods where qualified households desire to live. **Affordability reached the highest level in 2011 since the National Association of Realtors began measuring it in 1997, and in many markets, purchasing a home actually costs less than renting.**⁶ In addition, mortgage lending standards began to loosen in 2011 after a period of consistent tightening in 2007-2010.⁷ Finally, the inventory of homes available for sale, after peaking in July 2010 at twelve months' supply, has declined by 40% to seven months, in line with the ten-year average.⁸ If we include shadow inventory, then the total has also declined by

⁴Average annual households formed in 1980-2011 were 1,131,000, excluding 2001 due to a change in survey methodology. Source: US Census Bureau and IHS Global Insight.

⁵In 2011, 31.0% of the 71.2 million US adults ages 18-34 were living at home, compared to the 1983-2011 period average of 27.9%. Source: US Census Bureau.

⁶The Housing Affordability Index reached a record level of 190 in 1Q 2011. Source: National Association of Realtors. The cost of buying was less than renting in 37 of the 50 largest US cities in 3Q 2011. Source: Trulia.

⁷Source: Federal Reserve Senior Loan Officer Opinion Survey.

⁸Source: National Association of Realtors.



40% from 45 months' supply at the peak in July 2010 to 26 currently.⁹ Loosening mortgage standards and normalized inventory levels are significant milestones for this beleaguered market, since these issues have presented major obstacles to recovery thus far.

In distressed communities where foreclosures are more widespread, it is likely that pricing will not improve in the intermediate term without targeted stimulus measures. Although our investments are not predicated on such actions, there are several that would likely shorten the time horizon for a housing recovery and therefore contribute further upside:

- **Expansion of Existing Programs.** The Home Affordable Refinance Program and Home Affordable Modification Program offer assistance for refinancing and modifying distressed mortgages. These efforts could be expanded by relaxing qualifying criteria, reducing associated fees, waiving certain representation and warranty requirements, and broadening access beyond government-guaranteed loans.¹⁰
- **Mortgage Servicing Settlement.** The largest mortgage servicers are negotiating with the state attorneys general and the Office of the Comptroller of the Currency to settle claims of illegal servicing practices. A settlement could provide clarity around servicing rules, reducing the time to foreclosure, and could also require mortgage refinancing and principal reduction for underwater borrowers.¹¹
- **Foreclosure-To-Rental Program.** Government could facilitate bulk sales of foreclosed homes held by government-sponsored enterprises and banks to third-party investors for conversion to rental units, as outlined in a recent Federal Reserve whitepaper.¹⁰
- **Quantitative Easing.** A third round of quantitative easing ("QE3") by the Federal Reserve could target residential mortgage backed securities, as was the case in QE1.

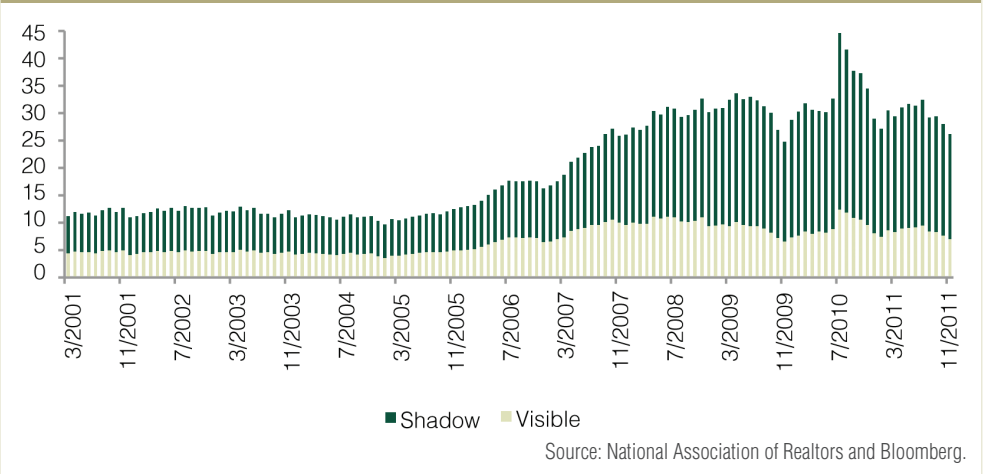
Our Approach **How does Roosevelt Investments' Domestic Equity Team seek to turn this opportunity into an investment strategy?** Generally speaking, we select our investments after identifying economic, political, social and demographic undercurrents that can be translated into long-term investment themes. 'Reconstructing Housing' is one such theme. Once we have identified a theme, we conduct research and apply fundamental analysis in order to identify companies that we believe are positioned to benefit from the shift. We also look for secondary and tertiary players that stand to benefit from the theme's ripple effects.

Housing is an area that touches broad swaths of the economy; thus, many industries would derive some benefit from a turnaround. New home construction is interesting because of pent-up demand following the four lowest years of housing starts on record and because activity going forward will be concentrated in the healthiest communities. This market is principally supplied by homebuilders that hold inventories of raw land and manage the construction of new homes. Several of the largest homebuilders reduced their fixed costs during the downturn to achieve profitability at the current depressed level of sales, so any acceleration in volumes should drive significant operating leverage. These companies also trade at an attractive level relative to book value, providing some measure of

⁹Source: Bloomberg. Shadow inventory is homes in foreclosure or 90 days delinquent, calculated by Bloomberg using delinquencies from the Mortgage Bankers Association and foreclosures from RealtyTrac.

¹⁰The US Housing Market: Current Conditions and Policy Considerations." The Federal Reserve. January 4, 2012.

¹¹"Mortgage Settlement Deal Very Close." USA Today. January 19, 2012.

Figure 4: Existing Home inventory (months of supply), 3/2001-11/2011

downside protection if the turn does not materialize.

Certain building materials markets are highly correlated to new home construction, including lumber, roofing and insulation. While lumber volumes have suffered along with the housing markets, timberland owners have compensated by selling more wood into pulp and paper markets, which are currently battling both cyclical and secular headwinds, making this industry a less attractive way to participate in housing. In contrast, roofing and insulation manufacturers have stuck to their core businesses, reducing costs to achieve breakeven despite low operating rates, and maintaining pricing discipline. Roofing and insulation also benefit from oligopolistic industry structures, while lumber production is much more fragmented. Finally, roofing had the added boost of numerous natural disasters in 2011 which created a backlog through the traditionally quiet winter season.

Beyond new construction, improvement in housing will also drive remodeling activity and related markets, which we examine in turn. The cabinetry market remains fragmented and beholden to the big box retailers such that, six years into the housing downturn, the path to profitability is still not clear. Paint enjoys better end market dynamics, acting as a profit center for large home retailers while also reaching the lucrative contractor market via smaller footprint stores. However, these companies must offset the escalating price of titanium dioxide, a key input cost, and their shares may have already priced in some improvement in demand. In our view, hand tool and power tool providers offer the most upside among manufacturers tied to remodeling activity. Strong brands and broad distribution give tool companies influence with retailers, while their shares are pricing in a slow pace of growth in coming years.

Outside of manufacturing, some service industries would benefit from a turn in housing. At the forefront are big box retailers that specialize in home-related offerings. In this group, where most participants trade in a narrow valuation range, we expect those companies with a store base located in desirable communities, carrying the right inventory and marketed with the correct value messaging, to gain market share. Financial service providers tied to mortgage markets would also see business activity increase in a rebound scenario, but continued uncertainty in the regulatory environment keeps us on the sidelines in this area for the time being.

Putting It into Practice

At Roosevelt, we have structured our domestic equity portfolios to take advantage of the Reconstructing Housing theme by investing in those companies we believe are positioned to benefit from the various market dynamics detailed above. Our holdings include:

- Several leading national homebuilders
- A major manufacturer of roofing and insulation
- The top global manufacturer of hand tools and power tools
- The largest home improvement retailer

In summary, the market for new home construction may be approaching an inflection point, with the potential to unleash significant pent-up demand across a variety of industries. **Through our emphasis on thematic investing, we are focused on identifying undervalued securities that we believe stand to benefit as companies capitalize on the Reconstructing Housing opportunity. ■**

About the Author

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Jason Benowitz, CFA, joined Roosevelt Investments in 2009 as a Securities Analyst and in 2011 was promoted to Portfolio Manager. Prior to Roosevelt, Mr. Benowitz was a principal at Druker Capital, a long/short hedge fund manager, and a Vice President in the U.S. Equity Research Group at Morgan Stanley Investment Management. He was also an investment banking analyst at Merrill Lynch. Mr. Benowitz earned a BA in Computer Science from Harvard College and an MBA in Finance and Accounting from The Wharton School at the University of Pennsylvania, where he was a Palmer Scholar. Mr. Benowitz received his CFA charter in 2010.

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