BUSINESS

Why Wall Street Loves Houses Again

The Blackstone Group and other members of the fast-money crowd have a risky new strategy for investing in real estate—this time as landlords.

BY WILLIAM D. COHAN

FOR MORE THAN a generation now, like it or not, Wall Street's financial engineering has helped determine whether the average American can buy a home. Once upon a time—before Wall Street stuck its nose under the mortgage tent—the formula for homeownership was pretty simple: if the neighborhood banker thought you would pay it back, you had a pretty good chance of getting a 30-year mortgage. The local touch gave both parties the incentive to do the right thing. Keep making mortgage payments, and you get to keep your house; the banker, meanwhile, has a valuable asset on the balance sheet. Everybody's happy.

This sensible dynamic between borrower and lender began to change in 1977. That's when the Brooklyn-born Lew Ranieri came up with the clever idea that everyone would be better off—the borrower, the banker, and of course Salomon Brothers, his Wall Street employer—if there were a way to buy up mortgages from local banks; package them together, thereby spreading the risk presented by any one borrower across a broad portfolio of borrowers; and sell slices of the resulting bundles to investors the world over, offering varying rates of interest depending on an investor's risk appetite. Ranieri, who started at Salomon in the mail room, assembled a team of Ph.D.s to package, slice, and sell mortgages after he realized "mortgages are math"—streams of cash flows that investors might want to buy. This powerful idea, dubbed "securitization," was one of those once-in-a-generation innovations that revolutionized finance.

Ranieri's idea caught on and, so the theory goes, helped reduce the cost of mortgages for borrowers all over the country, since the market for mortgages became far more liquid than when they had simply sat on a local bank's balance sheet tying up capital for years. Salomon Brothers—and Ranieri—made a fortune by implementing his insight. In 2004, *BusinessWeek* dubbed Ranieri one of "the greatest innovators of the past 75 years." But Ranieri's innovation also forever changed the *ethic* of banking, from one in which a buyer knew a seller and vice versa, to one in which the decision to buy something was separated from local market knowledge.

In 2007 and 2008, we learned how that turned out, after Wall Street's greed machine rewarded bankers and traders for manufacturing more and more of these mortgage-backed securities with lower and lower credit standards. In the ensuing crash, two of the nation's largest and most successful investment banks (Bear Stearns and Lehman Brothers) disappeared, and two others (Merrill Lynch and Morgan Stanley) would have too, but for last-minute rescues by large

ILLUSTRATION BY EMILIANO PONZI

commercial banks, with a timely assist from the Federal Reserve.

Now, five years later, the fast money has returned to the housing market, but in a more tangible way: big, institutional investors are buying up thousands of single-family houses out of foreclosure, renovating them if needed, and renting them out to people who can no longer afford to buy them. Leading the pack is one of the smartest guys in any room, Stephen Schwarzman, and his publicly traded private-equity behemoth, the Blackstone Group. Eighteen months ago, Blackstone created Invitation Homes to buy and then rent out single-family homes in 13 markets across the country, with a focus on places scarred heavily by the bust, such as Phoenix, Las Vegas, and Orlando. To date, Blackstone has purchased some 32,000 houses from banks, spending more than $5.5 billion in the process, plus another $500 million on renovations. Some 1,000 people work for Invitation Homes, and the venture, at the time of this writing, is continuing to invest at a clip of about $125 million a week. Blackstone's executives believe they have created a new engine of innovation, and that the struggling economy, and Blackstone, will benefit as home prices rise.

Nothing on the scale of Invitation Homes has ever been tried before, and a lot of people have been wondering what the venture might portend. Historically, when nonlocal investors have started speculating on houses, unfortunate consequences have tended to follow. In early June, the *New York Times* editorial board, noting a surge in home sales and prices, asked whether Blackstone and its ilk were inflating a new housing bubble. Just weeks later, new data showed that home prices in 20 large cities had risen 12 percent in the year ending April 2013—the largest increase in prices since 2006.

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At least for now, these fears seem overheated. For all its scale, Invitation Homes is a flea in comparison with the U.S. housing market, representing three-hundredths of 1 percent of the nation's 115 million housing units. And house prices have been rising nationwide, not just where Blackstone has been buying. Jonathan Gray, the powerful head of Blackstone's real-estate group and the mastermind behind Invitation Homes, says the rise in house prices is a simple function of supply and demand, in which his firm is playing only a tiny role: the combination of a steadily increasing population and a dearth of home construction in recent years has led to the higher home prices. "Why are the home prices up 11 percent in Salt Lake City," where Blackstone has made no purchases, Gray asked me in his corner office, far above Park Avenue. "Is it the ghosts of us?"

Still, the question lingers: What, exactly, are Blackstone and its brethren up to? And what is that likely to mean for the economy?

HERE'S THE LOGIC Gray used to convince his partners to form Invitation Homes and to bet Blackstone's capital: To keep up with its rising population, the country needs to build about 1.5 million new houses each year, but in the past four years, the pace of building has been less than half that, even as several hundred thousand houses have been razed annually. At some point, with demand outstripping supply, prices simply have to rise. Invitation Homes was started, in part, to profit from this phenomenon. Gray predicts that the housing market won't move into balance until the value of existing homes rises sufficiently to approximate the cost of building a new home. "Then you'll get more construction, and you'll get back to equilibrium," he says. All the talk of a new "bubble" in the housing market is nonsense, he believes. Using data produced by housing experts, Blackstone's models show that housing prices are still 22 percent below the 48-year "trend line" between 1951 and 1999—it's as if the run-up in the 2000s never happened.

But according to Gray, Blackstone isn't planning to simply flip the houses it has been buying. Rather, the firm sees a new, untapped market that it believes it can serve—a growing group of renters who, thanks to tightening credit standards, can no longer afford the down payment to buy a home, or have been unable to convince a bank to give them a mortgage, or who have simply soured on the idea of homeownership. Since the crisis, Gray says, the number of single-family houses being rented has increased from 11 million to 14 million. Yet many people are renting from small, absentee landlords who have not always kept the houses in great condition, and who may not be responsive when something goes wrong. His idea is to "professionalize" the level of service offered to these renters by fixing up the homes and by fixing problems reliably, with on-call maintenance through a 24-hour hotline. "The downturn created an opportunity to create a business," Gray says, "and in doing so we actually could do something for tenants that never existed before ... Wouldn't somebody pay for that experience?" He says that 93 percent of Invitation's homes are rented out within 60 days of renovations' being completed.

BLACKSTONE'S STRATEGY IS both novel and risky. Sam Zell, the iconoclastic Chicago billionaire and real-estate investor, doesn't think the firm will pull off the logistical challenge of owning so many homes in so many different markets. He said as much at a recent investor conference in Las Vegas, and again in a recent interview with me. Zell is the founder of Equity Residential, one of the largest owners of apartment buildings in the country. "I think operating a pool of rental homes that are not next door to each other is a challenge that nobody has ever dealt with yet," he says, especially "on the scale that some of the private-equity firms are doing it ... It's gonna be a hell of an operation to run." Christopher Leinberger, a professor at the George Washington University School of Business and a nonresident senior fellow at the Brookings Institution, agrees. "You can cobble something together," he says, but a lot of the houses "are going to fall through the cracks as far as day-to-day management attention is concerned." Most houses are not built to withstand the heavier wear and tear of renters, and managing a sprawl of them is a lot harder

than managing an apartment building.

Both Zell and Leinberger also have their doubts about Gray's supply-and-demand equation. Invitation Homes isn't buying "housing supply" in the abstract—it's buying specific houses (suburban single-family) in specific places (regions and neighborhoods marked by heavy foreclosure). "We're in the middle of what I would call major cultural change," Zell says. People aren't marrying or having babies as early in life, and many seem disenchanted with traditional suburbs. "Motorola built a huge campus outside of Chicago 30 years ago, and now it's almost two-thirds empty and they're renting space downtown because they can't get people to come out there." Leinberger thinks that Blackstone has bought too many houses in the "structurally obsolete" parts of metro areas—suburban fringes, far from urban amenities, that are no longer desirable—and that it could end up with poorly managed houses in decaying neighborhoods as a result. "They bought low, and it's going to stay relatively low," he told me. Still, he says, the fact that Blackstone wants to invest its money in single-family houses when few others will is "what makes capitalism great." What also makes capitalism great is Blackstone's recently rumored plan to securitize the rent payments from about 1,500 of its recently purchased houses by selling to public investors a bond, underwritten by Deutsche Bank, for about $250 million—shifting the risk of nonpayment of rent onto the bondholders and, in a throwback to last decade, creating a new tangle of warring incentives among landlord, renter, and investor along the way.

For his part, Zell is backing Hyperion Homes—a more modest venture created by none other than Ranieri, the godfather of mortgage-backed securities, and William Young, a former mortgage banker. Hyperion Homes accepts applications from credit-worthy people who would eventually like to own their home, and asks them to select a house that's for sale in a neighborhood they want to live in. Once a prospective tenant has passed stringent background and credit checks, Hyperion will negotiate to buy the house and then rent it out to him or her, giving the renter an option to buy the house from Hyperion, with an inducement to buy it sooner rather than later. Since November, Hyperion has bought and rented 200 houses in various Chicago neighborhoods and has begun to expand into Houston and Dallas. "Here, you're not buying the house until the client identifies it as the one he wants," Zell explains. "That's a whole different kettle of fish."

WHETHER OR NOT Blackstone, Hyperion, and other big investors succeed, what they are doing is in fact a classic example of the role that risk capital is supposed to play in broken markets: to make bets that others are fearful of making, and to profit from them if things work out. Invitation Homes is injecting money directly into troubled local economies, not only through its purchases but also through the $500 million the company has spent, at places such as Home Depot and Lowe's, to renovate the houses it's buying. And if it really does provide a growing rental population with better options and better service, that will also serve a nation still recovering from the excesses of the past decade. (Blackstone's thesis has yet to be proved, of course: already, a video has been posted on YouTube that mocks Invitation Homes' promotional claims, and showcases critical comments from a slew of unhappy renters.)

Robert Shiller, the Yale professor famous for tracking trends in the housing market, says that →

Very Short Book Excerpt

At a good teaching school, a professor is expected to run the class and, sometimes, have a small group of students over to his house for dinner. As the former function becomes less important, due to competition from online content, the latter function will predominate. The computer program cannot host a chatty, informal dinner in the same manner. We could think of the forthcoming educational model as *professor as impresario*. In some important ways, we would be returning to the original model of face-to-face education as practiced in ancient Greek symposia and meetings by the agora.

It will become increasingly apparent how much of current education is driven by human weakness, namely the inability of most students to simply sit down and try to learn something on their own. It's a common claim that you can't replace professors with Nobel-quality YouTube lectures, because the professor, and perhaps also the classroom setting, is required to motivate most of the students. Fair enough, but let's take this seriously. The professor is then a motivator first and foremost. Let's hire good motivators. Let's teach our professors how to motivate. Let's judge them on that basis. Let's treat professors more like athletics coaches, personal therapists, and preachers, because that is what they will evolve to be.

—From *Average Is Over: Powering America Beyond the Age of the Great Stagnation*, by Tyler Cowen (published in September by Dutton)

companies backed by the likes of Blackstone, Ranieri, and Zell might begin to rationalize a fragmented, disorganized industry, yielding quite a few upsides—and some not-inconsiderable drawbacks. "There are ambiguities in this," he says. On the one hand, demand for rental properties does seem to be increasing, and Invitation and Hyperion are meeting that demand. On the other hand, he notes, while raw land has often been the focus of speculators' interest over the years, speculating on home prices is relatively new (except in Manhattan).

Shiller understands why the fast-money crowd might be interested in pumping cash into the market. "Home prices are very directional. They go in the same direction; there's momentum," he explains. "For the guys interested in momentum, the natural thing now is to turn to housing, and I think they're right. Home prices are up now, and they'll probably keep going up for a while, a year or more." But he worries about what will happen when the private-equity crowd senses that home prices have peaked and decides to sell out. "That's why I'm not so optimistic about predicting home prices to go up for a long time," he says. "These guys will make the market more volatile."

Yet even that is not necessarily a bad thing. Historically, the market for housing has been highly inefficient: most people like to live in their houses and, unlike with financial assets, won't sell them merely because they think prices have been on a tear. That's precisely the sort of behavior that can lead to financial bubbles, as demand outpaces supply. Private-equity types, Shiller notes, behave entirely differently: they are highly motivated to sell when prices have risen enough to meet their investment criteria, flooding the market and dampening unwarranted enthusiasm before it takes a strong hold. That "might prevent a huge bubble from forming," Shiller says. "It could end quickly this time." A

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STUDY OF STUDIES

VIOLENCE IS CONTAGIOUS

What goes around really does come around.

BY REBECCA J. ROSEN

IN JUNE, a new study came out on how conflict has affected adolescents in southern Israel. As time went on, the researchers found, kids exposed to rocket attacks and terrorism weren't much more anxious or depressed than their peers. But they were more violent: for each point a teen scored on a scale measuring exposure to such attacks, he or she was about twice as likely to commit violence later on **[1].**

Social scientists have identified a host of traits and behaviors that seem to spread via social networks: obesity, voting, happiness. What about violence? Common sense tells us that some kinds of bloodshed (war, gang activity) spread geographically. But is violence itself contagious, or are other underlying conditions—say, poverty—at work?

A study of insurgent attacks in Russia's North Caucasus concluded that violence travels by the same routes as traffic and trade: it was transmitted more readily between villages that were connected by major roads than between those that weren't **[2].** And yet, other research suggests that factors beyond proximity determine where conflict crops up. A 2010 study on ethnic violence in Germany investigated whether neighboring areas are likely to "catch" such violence from one another. After controlling for demographic variables, researchers found that violence was not contagious per se; it just seemed that way because adjacent areas were socially similar **[3].**

When violence spreads, it can have a long incubation period. For years, researchers have recognized a "cycle of violence," in which victims eventually become perpetrators. A report by the National Institute of Justice shows that children who experience abuse or neglect are 30 percent more likely to be arrested for a violent crime by the time they reach their early 30s than peers who grow up in safer homes **[4].** (Sadly, victims aren't only more likely to become perpetrators; they're also at increased risk of being victimized multiple times: one recent study of African American teenage girls in Chicago found that those who had suffered sexual violence were more likely to report suffering other forms of violence **[5].**)

As for modes of transmission, violence seems to spread not just via human connections but also via media, even when the violence portrayed is fictional. One study found a correlation between a child's television-viewing habits and aggressive behavior 15 years later. "Men who were high TV-violence viewers in childhood," the authors wrote, "were convicted of crimes at over three times the rate of other men" **[6].** And in 2010, a major review of research involving more than 130,000 participants reported a causal relationship between exposure to violence in video games and aggressive behavior **[7].**

It's been said that violence is a disease. At the very least, it seems to spread like one. Could we one day develop an effective vaccine? A

THE STUDIES:

[1] Henrich and Shahar, "Effects of Exposure to Rocket Attacks on Adolescent Distress and Violence" (*Journal of the American Academy of Child and Adolescent Psychiatry*, 2013)

[2] Zhukov, "Roads and the Diffusion of Insurgent Violence" (*Political Geography*, 2012)

[3] Braun and Koopmans, "The Diffusion of Ethnic Violence in Germany" (*European Sociological Review*, 2010)

[4] Widom and Maxfield, "An Update on the 'Cycle of Violence'" (National Institute of Justice's *Research in Brief*, 2001)

[5] Kennedy et al., "Sexual Victimization and Family Violence Among Urban African American Adolescent Women" (*Violence Against Women*, 2012)

[6] Huesmann et al., "Longitudinal Relations Between Children's Exposure to TV Violence and Their Aggressive and Violent Behavior in Young Adulthood: 1977–1 (*Developmental Psychol* 2003)

[7] Anderson et al., "Viol Video Game Effects on Aggression, Empathy, a Prosocial Behavior in Ea and Western Countries" (*chological Bulletin*, 201

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