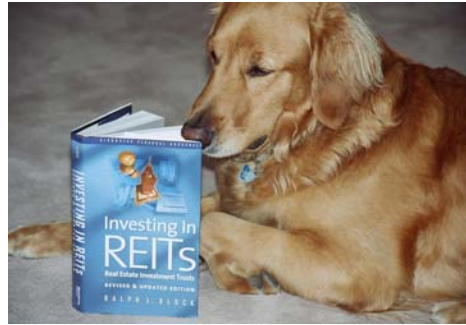


“REITWEEK”

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“Writing does for me what giving milk does for a cow.” -- H.L. Mencken

“Writing is not necessarily something to be ashamed of, but do it in private and wash your hands afterwards” -- Robert Heinlein

“Writing is like prostitution. First one writes for the love of doing it, then for a few friends, and, in the end, for the money.” – Moliere

1. Not Enough of a Good Thing?

Certainly, in degree of cosmic importance, it doesn't quite compare with questions such as, “Is there a God?” Or, “How can we most effectively root out terrorism while feeding the world's starving children?” But the question, “How much of my assets shall I put into commercial real estate?” is right up there. Indeed, research geeks armed with gee-whiz spreadsheets have proven that asset allocation is much more determinative of one's investment success (or lack thereof) than the specific stocks we own. Slow Joe, even if he owned only the dross of Reitland, would have done much better than his neighbor, Frantic Frank, if he had a 40% REIT allocation during the past five years while Frank had no REITs and pigged out on techs.

Of CAPM and Efficient Frontiers. Fine, so asset allocation is of supreme importance. But how do we decide how much of each asset class to own? MBA students and investment professionals have been manipulating such esoterica as “capital asset pricing models” and “efficient frontiers” ever since Messrs. Markowitz, Sharp, *et. al.* developed their theories of risk and reward in the mid-1960s (many of these guys won Nobel Prizes). Since then, some have worked hard to discredit their work, *e.g.*, “the death of beta” and all that jazz – none of which I understand. Furthermore, CAPM has often been abused by academic illiterates (example: “The goal of this article is to present the relationship between numerical optimization tools applied to investments and preference theory, using utility risk-aversion functions, in the determination of optimum portfolio for the upstream sector” (I did *not* make that up).

Despite its critics and abusers, CAPM and efficient frontiers still appear to be alive and well in most circles. Correlations, betas, standard deviations, Sharp ratios and such continue to be studied, not only in the halls of academia, but also in the offices of financial planners, pension consultants and others interested in maximizing the returns of their clients' investment portfolio at specified levels of risk.

So, a milestone was recorded in the history of the REIT industry when Ibbotson Associates issued a report, in May 2001¹, which measured the risks and returns of certain hypothetical portfolios, some of which included REIT stocks. The report concluded that an investment portfolio that included a 20% allocation to REITs during the measurement period would have boosted returns by 40 basis points (12.2% vs. 11.8%) over the REIT-less portfolio, and that “risk” declined in the 20% REIT portfolio by a similar 40 bps.² Keys to this, apparently, have been REITs’ solid investment performance and low correlations with other asset classes.

As noted by NAREIT’s Senior Vice President for Research and Investor Outreach, Michael Grupe, “There is a growing body of real estate research suggesting that direct real estate investments and publicly traded real estate securities perform well together as complementary investments. And there are compelling reasons for including both in an institutional portfolio.” Compelling indeed. 40+ bps of performance with less risk may not seem like much but, as Everett Dirksen might have suggested, 40 bps applied to trillions of investment dollars very quickly adds up to some real money. And, over many years, it can make a real difference even for one lonely mom ‘n’ pop investor looking for a few extra dollars to pay this month’s home heating bill.

Impressive. But then, why haven’t investors been stuffing their portfolios with large chunks of commercial real estate – directly or through REIT stocks? Even more important, just how much of it *should* they own? Now we’re in Holy Grail territory. Paraphrasing Archimedes,³ if you give me the “right” REIT (and real estate) allocation, and some basic Excel software, I can single-handedly deliver you the best risk-adjusted returns in the world.

But nobody knows the “right” allocation, of course, and anyone suggesting a specific allocation to real estate invariably hedges his language as carefully as a Chinese Communist apparatchik. In the real world, allocations are “constrained” in recognition of investment practicalities, *e.g.*, even if 19th century whiskey shot glasses could be demonstrated to have delivered investment returns of 15% annually with no deviation (standard or otherwise), it isn’t likely that advisors would recommend a 40% allocation to them.

Musings on History. However, I have long mused about what appears to be allocations to real estate, on the part of both institutions and individuals, which are, in my opinion, below optimum levels. Indeed, guesstimates and surveys I have seen suggest that the “average” institutional investor has somewhere between just 5% and 10% of its assets in real estate (direct and securitized), and many own none at all.⁴ And individuals who’ve jammed more than 10% of their portfolio with REIT stocks are looked upon as though they are either dumber than stones or more reckless than Evel Knievel. Certainly few financial planners suggest 20% REIT allocations; more typical is 5-10%. And anything above 10% is generally viewed as wild and crazy. A number of years ago I mentioned to an investment banker that our firm’s clients had an average allocation to REITs of 20%; he looked at me as though I’d just escaped from the VA psychiatric ward.

But let’s start from the beginning. Why has commercial real estate garnered such small portions of investors’ portfolios in the past? For good investment reasons? Or just due to practicalities in effect at the time? Even if such reasons were logical historically, do they still apply today – or, perhaps like hoary dinosaurs, these mind-sets have failed to adapt to changing market conditions, and thus need to be reinvented.

¹ See <http://www.nareit.com/mediaresources/IbbotsonFinal.pdf>.

² The Ibbotson study was updated a year later, and it was concluded that portfolios that included a 20% REIT allocation would’ve beaten the non-REIT portfolio by 80 bps (1972-2001). For the “modern REIT era” (1992-2001), the outperformance would have been 130 bps. See <http://www.nareit.com/mediaresources/ibbotson2002.pdf>.

³ “Give me a lever long enough, and a prop strong enough, and I can single-handedly move the world.”

⁴ An extensive survey of tax-exempt institutions completed last year by Kingsley Associates for Institutional Real Estate, Inc. noted, “Not surprisingly, the 2003 study confirmed the trends seen in 2002, with pension fund real estate holdings growing from 7.81% of the average portfolio in 2002 to 8.32% in 2003.” The survey is very enlightening, and is well worth reading.

I cannot believe that pre-existing modest allocations have been based upon risk aversion. Real estate is not a particularly risky asset; it is lack of diversification and the high debt leverage that's often used to finance it that can make commercial real estate ownership risky. Investors – at least the institutional variety – have always been able to diversify risk by owning a substantial number of properties of many types in various locations. Furthermore, no law says that real estate must be bought with 80% leverage (the REIT industry's average leverage has rarely exceeded 50-55%). And property values (even REIT stocks) haven't been as volatile as equities.

I suspect that the low level of institutional ownership of commercial real estate (vs. other asset classes such as stocks and bonds) has had more to do with administration practicalities and liquidity issues than anything else. A large staff is needed to watch over the assets acquired and owned (and to monitor the outside advisors, leasing agents and property managers). This can be daunting (and very expensive) to all but the largest of institutional investors. And conflicts of interest between the investor and the outside advisor have been rife; the latter earned its bones by bringing deals to the table, and often never invested side-by-side with the client. Meanwhile, commingled funds – for good reason – have had their detractors.

And it has certainly been true that office buildings and shopping malls have not been particularly liquid. But if liquidity has been an issue, why haven't REITs been substituted? Fuggediboudit! Until fairly recently, institutions couldn't obtain liquidity via REIT investing for the simple reason that REITs weren't much more liquid than real estate. As recently as 1996, the aggregate average REIT stock trading volume never exceeded \$200 million per day. It might take months for a mega-billion dollar institution to accumulate even a 2% position in a modest-sized REIT, and that might give the buyer a 10% stake. Furthermore, institutions could legitimately claim that REITs had not proven themselves, *i.e.*, they were “not ready for Prime Time.” In truth, it has taken a while for some REIT management teams to learn to behave well as public companies.

What about individual investors? The REIT industry was largely unknown until the mid-1990s. Just when individual investors began to learn about the virtues of REIT investing – and what they could do for a diversified investment portfolio – two bad things happened: (a) the industry shot itself in the foot with excessive equity offerings, creating a supply/demand imbalance for REIT shares, and (b) investors shot themselves in the head by shifting money out of REITs and into La-La land, *i.e.*, into techs and Internets. It took a cathartic bear market in equities to cause investors to again look for yields, predictable cash flows and non-correlating assets.

A New Paradigm? But much has changed since the advent of the 21st century, and hordes of sadder but wiser investors are beginning to recognize a new set of realities. Today it is easier for institutions to invest in, and to monitor, commercial real estate holdings. We have such things as – are you ready for this? – computers! Spreadsheet analysis, cost controls, performance figures and the like are more easily implemented. Conflicts of interest with outside advisors have been reduced, and concepts such as “co-investment” rule the day. And, in case you hadn't noticed, there is more capital flowing into real estate today, creating a lot more liquidity whereby specific assets can readily be traded, at lower bid-ask spreads.

Perhaps even more important, REITs, finally, may be used as an alternative to direct real estate, even for substantial pension funds. Average trading volumes, under \$200 million per day in 1996, have spiked and remain much higher. Average trading volume was running at \$600-800 million from 2001 to 2003, and is now in the area of \$1-1.2 billion.⁵ Furthermore, REITs' market capitalization has exploded. At the end of 1991, equity REITs had an aggregate equity market cap of just \$8.8 billion. At the end of 2003, it was \$204.8 billion. The REIT industry has come of age, and it is now possible to invest in commercial real estate of all types and in nearly all locations – with a great deal of liquidity. Of course, an investment in a REIT stock is not precisely the same as investing in a piece of real estate. But these sister markets should

⁵ These are my estimates from eyeballing a NAREIT chart covering trading liquidity from March 1990 to August 2004; see <http://www.nareit.com/researchandstatistics/CB0409.pdf>, page 6.

track one another rather closely over time after adjusting for certain variables, as recent studies have suggested.⁶

Liquidity has rarely been an issue for individual investors, but other issues blinding them to the virtues of REITs have, *e.g.*, unfamiliar territory, strange terms like “FFO,” the lack of information, etc. Yet even these issues are dissipating. Investors are becoming much more knowledgeable about REITs and REIT investing, as evidenced by numerous articles about them in the popular press. Financial planners and advisors, perhaps goaded by traditionally low correlations between REIT stocks and other asset classes and by events such as the Ibbotson study and the inclusion of REITs in the S&P 500 index, are now regularly recommending them for diversified portfolios. They are being offered in 401k plans. Many investors, including ‘boomers, are becoming more risk-averse as they edge closer to retirement, and appreciate the stability of REITs’ income streams and, of course, their outsized dividend yields.

But it’s not just sentiment and increasing liquidity that argue for higher REIT allocations. Low correlations, as noted earlier, are huge. One need not be an Efficient Frontier guru to understand the benefits to a portfolio’s performance that are provided by low-correlating assets, coupled with strong investment returns. Since 1976, direct real estate, as measured by the NCREIF index, delivered a compounded annual return (though March 2004), of 9.4%,⁷ while REIT stocks’ total returns, aided by the REITs’ use of moderate debt leverage, have been in the low teens over many different time periods. When one can own an asset class with excellent total returns and moderate risk, along with low correlations and adequate liquidity, those arguing that such assets must be limited to a 10% portfolio allocation are suffering from a failure of imagination (or worse).

And then, of course, there’s the issue of *prospective* relative returns. While I cheerfully acknowledge the great difficulty of making “macro calls” on future performance of various asset classes, it is a fact that experienced investors and academics such as Warren Buffet and Rob Arnott have expressed the view that average annual returns on equities won’t exceed 7-8% over the next few years; indeed, as future corporate profit growth has been estimated at 6%, adding a dividend yield of 1.7% gets us to about 7.7%. Betting on multiple expansion from current valuation levels doesn’t seem like a good idea to me. Even at very low cap rates (vs. historical norms), real estate should at least equal that return, and will probably do better.

So why do allocations to equities still substantially exceed allocations to real estate (and REITs), often by a factor of as much as 5x? If real estate will perform in line with (or better than) equities, and has a low correlation with them, why not boost allocations to real estate substantially? Wouldn’t a 20% allocation, or even 25%, be more reasonable and advantageous? What am I missing here, folks?

A last point. Some investors like to be market cap neutral in their investment allocations. So what is the value of all commercial real estate in the US, and what is the value of all U.S. equities? Both measurements are, of course, just guesses. However, consider this: According to a Paine Webber study in 1999,⁸ the total market value of all US commercial real estate at the end of 1998 was \$3.7 trillion.⁹ At that time, the value of all publicly-traded corporate equities was estimated at \$14.6 trillion. Thus real estate amounted to 20.2% of the combined values of equities and real estate, and 25% of the value of all equities. So, for those of us who like to be market cap neutral, shouldn’t a portfolio with a 60% allocation to equities also include a 15% allocation to real estate (or REITs)? One might also question whether, due to the shift in relative valuations between equities and real estate over the years since the Paine Webber study was concluded, today’s ratios would be more weighted in favor of real estate, *i.e.*, closer to 20% of total equity value.

⁶ See, for example, “Public vs. Private Real Estate Equities: A More Refined Comparison,” by Messrs. Pagliari, Scherer and Monopoli, presented to NAREIT in June 2003.

⁷ See, for example, http://www.dbrealestate.com/australia/proposal/files/RREEF_Approach_A4.pdf, pages 3-4.

⁸ If any of my readers has a more current estimate, I’d love to hear about it.

⁹ See the excellent article by Anthony Downs on the relative values of real estate and equities, <http://www.anthonydowns.com/WHTNREIT.PDF>, which references this estimate.

In closing, I don't know how many of you support my suggestion that the "typical" investor ought to have a 20% allocation to REITs/real estate. As you have been reading "The Essential REIT," perhaps many of you don't question my sanity (at least on this issue). However, we constitute well under 0.1% of all investment decision-makers and investors. Those who don't truly understand REITs or real estate will continue to be uncomfortable allocating more to this asset class than they have in the past. And even some that *do* understand it won't agree with me. So be it.

But, as Dylan would put it, "The times they are a-changin'." The change will be slow – slower than Sammy when I wake him up at 5 am. But change there will be. If I were to do a Rip Van Winkle, drifting off today and waking up in 2015, I would likely see a typical REIT and real estate allocation of something close to 20%, even among the largest and most tradition-bound institutions. I truly believe that. So, please don't snicker or throw rotten equities...er, tomatoes...at my forecast until then.

Off Topic: A final – and brief – observation. Whatever the correlation has been in the past between REIT stock prices and interest rates, anyone who doubts that REIT stocks will take a pounding – at least temporarily – upon a rebound in long-term interest rates is two leaves short of a 4-leaf clover. On Thursday, unemployment insurance claims declined, and yields on the 10-year US Treasury note spiked. REIT stocks fell by 1.4% that day. On Friday, however, the government issued a disappointing report on job growth (just 90,000 jobs were created), and the yield on the 10-year tumbled from 4.24% to 4.13%. REIT stocks? Up 0.8% (vs. a decline of 0.8% in the S&P 500). And as I put the finishing touches on this issue this morning, the 10-year's yield is down another 5 bps, to 4.09%, and REITs are up a tad in a down market. Those traders who care about the near-term direction of REIT stock prices (and who are long REIT stocks) had better pray for continued sluggish economic growth.

Although I am not predicting anything other than the normal backing and filling of REIT stock prices, I would personally welcome any sell-off that would enable me to increase REIT positions at more favorable prices – and, a better pace of growth would be good news for all Americans.

Best regards,
Ralph (Block)

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