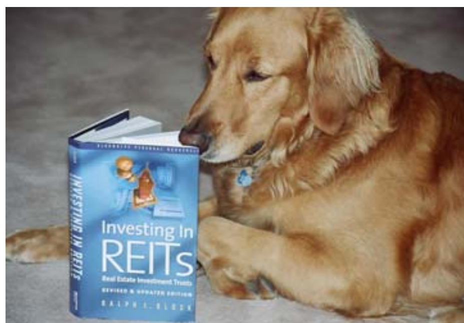
"The Essential REIT"

June 27, 2005



"If my doctor told me I only had six minutes to live, I wouldn't brood. I'd type a little faster." – Isaac Asimov

"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. Chasing the Grail (Continued from Last Time).

[Note: Let's again eavesdrop on a conversation between Carey Cautious, a financial advisor, and his client, Reid Luvver, in which they search for the Holy Grail: How much of one's assets "should" be invested in REITs and/or commercial real estate? To save you all time, we'll begin anew.]

Reid: Mr. Cautious, I just noticed that you added a 5% REIT allocation to my investment account. Why?

Carey: REITs are a very good alternative asset class and, according to the recent study by Mr. Pagliari and friends, a good proxy for commercial real estate. They have performed quite well over long time periods, *e.g.*, equity REITs have provided average annual total returns of 12.0%, 13.5% and 14.6% for the past 20, 15 and 10-year periods, respectively, have low correlations with other asset classes, provide stable and predictable cash flows, deliver much higher dividend yields than other common stocks, and are less subject to global economic upheavals or "diworsifications" by management teams. The well-known Professor of Finance, Jeremy J. Siegel, recently stated in his new book,[1] "I believe that REITs should be a part of a well-balanced equity portfolio, especially one with a bias towards high-dividend stocks."

Reid: But then why only 5%? Why not 25%? Or even 50%? I will be retiring next year, and will need a stable source of cash flows for traveling, golfing and sky-diving. Us baby-boomers aren't yet ready to go gently into that good night. I need income, my friend; let my kids worry about capital appreciation. Besides, in the past five years, equity REITs have cranked out average annual total returns of 19.3%, kicking sand in the faces of the Equity and Bond Bullies. They've got the Big Mo!

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[1] "The Future for Investors, Crown Business (2005).

Carey: Ah, but REIT performance will revert to the mean. Their returns won't be so spectacular over the next five years. That's why I am recommending only a 5% allocation. Even more important, due to their incredible recent performance, REIT stocks are overvalued at the present time.

Reid: Oh? According to a self-appointed REIT expert who calls himself by the strange name of Reitnut, the average REIT stock today trades at a premium to estimated net asset value (NAV) that's just a bit below its 12-year average of about 7%. Why do you claim that REITs are "overvalued?" They are *not* overvalued vs. commercial real estate.

Carey: Well, real estate itself is overpriced. Cap rates have come down at least two hundred basis points from two years ago, and there's a feeding frenzy among buyers. When commercial real estate prices fall, REITs' NAVs will decline even more – and so will their shares.

Reid: It's certainly debatable, my friend, whether commercial real estate today is "too expensive." It seems to me that the typical real estate asset of reasonable quality in most markets of the US today can be bought at an economic cap rate (after tenant improvements, other capital expenditures, leasing commissions, etc) of about 5.5% (office and industrial cap rates are a bit higher, apartments and retail slightly less), and can generate long-term growth in net operating income of perhaps 2% annually – let's assume flat exit cap rates and a 5-year unleveraged IRR of 7%. That doesn't seem so unreasonable as to require a near-term markdown in pricing – especially when the yield on the 10-year is struggling to even remain at 4%, the stock market ain't exactly cheap and real estate is coming off its cyclical bottom. And real estate is a low-risk asset.

Carey: But is it low-risk? Real estate owners were nearly wiped out in the early '90s, when their properties were foreclosed due to cash flows falling short of mortgage payment obligations.

Reid: Back then real estate owners were done in by excessive debt leverage and overbuilding. Today leverage is much more modest (the REIT industry is just slightly above 50%), property values are up, allowing for refinancing when necessary and, except for a few places, new developments aren't more than 2-3% of existing stock and can be readily absorbed. And unlevered real estate is even less risky, especially when considering the stable cash flows coming from long-term leases. Even if a tenant goes belly-up, space in a well-located building can be leased to another tenant at modest cost and down time.

In short, while real estate and REIT stocks may be somewhat riskier than bonds, they are certainly less risky and less volatile than the stock market (domestic or foreign). And, as many academics have shown over time, real estate is less exposed to inflation's deleterious effects than bonds. So why do you recommend 40% in bonds and 55% in equities, but only 5% in REITs? Is your head screwed on right?

Carey: Let's get back to overvaluation. REIT P/AFFO ratios are at all-time highs; furthermore, REITs are trading at even higher ratios, albeit only modestly higher, than those of other equities. This has never happened before. That's scary, Reid. So even though I continue to like REITs (and real estate) as an asset class, I don't believe your REIT allocation should exceed 5-10% of the total portfolio.

Reid: It is certainly true that, on a historical earnings multiples basis, REIT stocks look expensive vs. other equities. Green Street has lots of scary graphs on this issue. However, who's to say that the historical relationship, where REIT stocks' multiples were just 60-75% of the multiples of the S&P, was the correct one? Maybe REIT stocks have been too cheap in the past. Maybe that cheapness is what has propelled those enormous 10, 15 and 20-year total returns. Furthermore, we're talking about AFFO, or free cash flows, for REITs while, for the S&P companies, multiples are based on "earnings," not free cash flow – there's a big difference. I see no logical reason why REIT stocks shouldn't enjoy P/AFFO ratios that are at parity with the S&P's P/E ratios, or even a bit higher, especially when cash flow growth is ramping up for the former, and earnings growth is abating for the latter.

Carey: Well, look, even if REITs' relative valuations look OK vs. stocks and bonds, you still don't want to own REITs exceeding 10% of your portfolio. The reason for this is that REITs remain a very small asset class, and you don't want to have too much exposure to a very modest segment of the market.

Reid: When considering an "appropriate" weighting of REIT stocks, we oughtta look not just at REITs' place within the stock market, but also the role and importance of commercial real estate in the US economy. And, on this point, a good friend of Reitnut's, who's been following REITs for many years, has told him that a 15% allocation to real estate is "close to the total role real estate plays in the economy." Consider, too, that there is about $3-5 trillion in value of commercial real estate in the US, which is quite sizeable vs. the approximately $15 trillion in total market value of US stocks.

Carey: But REIT stocks are not real estate!

Reid: Aren't they? If REIT stocks had little or no correlation with commercial real estate's performance, then I would agree that REITs should be viewed as just a small part of the US stock market. However, I must remind you that Messrs. Pagliari, Scherer and Monopoli have written a very convincing research paper[2] showing that "public and private market vehicles ought to be viewed somewhat interchangeably" with respect to "return distributions." Thus a good case can be made that REIT stocks may be viewed as a reasonable proxy for the ownership of commercial real estate. Furthermore, Green Street has shown that changes in a REIT's NAV growth rate correlate well with changes in the REIT's stock price over time; that wouldn't happen if "REITs are not real estate." Some academics have shown this as well, but Reitnut (who's been whispering things in my ear) cannot find that paper at the moment (sloppy bastard that he is).

Carey: Well, I have another problem with REIT stocks. The industry is still small, and their stocks are not liquid. A modest amount of capital outflows will devastate REIT stocks, due to their lack of liquidity. Thus it makes no sense to put more than 10-15% of your assets into them.

Reid: This is a red herring, Carey, and you know it. Individual investors can buy, sell and generally trade their butts off without affecting REIT stock prices. Sure, the huge institutions may legitimately worry about liquidity; however, while the stocks may be somewhat more volatile than in prior years, REIT organizations' cash flows don't change much from year to year, and major "earnings surprises" are as prevalent as mean bones in Sammy's body.

So even if it takes a few weeks to exit a position, it's generally a no harm – no foul situation. Further, liquidity has improved immensely in recent years. Mark Howard-Johnson, senior portfolio manager for Goldman Sachs Real Estate Securities Strategy Group, has stated that the firm could invest $100 million in selected REIT stocks in 3-4 days without meaningfully moving the market.[3] The following chart, courtesy of NAREIT, measures the trend in average daily trading volumes:

[2] "Public vs. Private Real Estate Equities," The Journal of Portfolio Management, Special Issue 2003.
[3] See "REIT Liquidity – No Longer a Problem," Real Estate Portfolio, Nov-Dec 2004, at http://www.nareit.com/portfoliomag/04special/p26.shtml

Carey: Speaking of institutions, if these mega-investors, including pension funds, have placed only 5-8% of their assets in real estate, why should you put a lot more of your own assets into them? Surely that percentage reflects investment merit, balanced by risk, no?

Reid: Carey, look, get Ralph Block's book and read it, particularly that part of Chapter 5 that discusses "The Bias of Traditional Real Estate Investors." There have been many reasons why large institutional investors have put only a modest portion of their assets into commercial real estate, but these have to do with asset management turf wars, real estate's limited liquidity, the costs of maintaining and monitoring an extensive real estate portfolio, geographical diversification requirements, the lure of equities, the illiquidity and immaturity of the REIT industry in years past and other reasons. These reasons are less and less valid today and, indeed, pension funds are not only increasing their allocations to commercial real estate, but they are often using the REIT vehicle to accomplish this. It seems that every week some institution announces a new search for a REIT equities manager. Cohen & Steers and their cohorts are livin' large.

Carey: But non-REIT equities have tax advantages over REIT stocks. The vast majority of your return from Intel and General Electric will come from capital gains, for which you will be taxed at 15% upon sale. With REITs, however, at least 50% of your total return will come from dividends, most of which are taxed at ordinary income tax rates.

Reid: I will concede you this point, my friend. However, there are some other key points to remember as well. First, in 2004, it has been estimated that almost 40% of REITs' dividends are taxable at less than the maximum 35% tax rate; some of these dividends represented capital gains, others a return of capital and the remainder "qualified" dividends taxable at the 15% maximum tax rate. NAREIT has a great chart on this. Go to http://www.nareit.com/library/industry/1099info.cfm and then click on "Chart."

There are also some other things to think about with respect to the higher tax rates on REIT dividends. First, with REIT stocks the majority of your expected returns (dividends) are by and large ***certain***, as dividend cuts have been little more than noise for the past 12 years. And there is less variability in returns with REIT stocks. Is it an outrage to pay a somewhat higher tax rate for this greater certainty and lesser risk? Sure, your Intel dividends will be taxed at a lower rate than REIT dividends, but does that really matter much when considering asset allocation decisions?

Also, keep in mind that income available to shareholders (for non-REITs) is determined *after* corporate taxes; so, as an investor, you don't get to keep "your" share of your company's pre-tax income. With REITs, you do. There's another way of looking at this. If a non-REIT organization earns 10% on a new investment, its after-tax return (assuming corporate taxes at 35%) is 6.5%; if that 6.5% return is dividended out to shareholders, they get to keep 85% of it, or 5.3%. REITs, on the other hand, generally pay no corporate taxes. So a similar 10% return, when dividended to shareholders, results in a return of 6.5% after taxes at 35%. So REIT shareholders keep a higher portion of pre-tax returns on invested capital than do shareholders in non-REIT organizations (and although the taxation to shareholders of most of that non-REIT after-tax income will be deferred, it's a stretch to assume that it will always be reinvested wisely).

Carey: Look, Reid, you make some good points. However, REITs are still not widely accepted by the investment community. A case in point is a recent article in the WS Journal, written by James Stewart, editor at SmartMoney magazine. Extolling the virtues of stocks paying sizeable dividends, he says this: "I recently looked at a list of all stocks" with a current yield of 3% or more. "There were hundreds. I eliminated all limited partnerships, *REITs* and utilities, *which are primarily dividend-oriented and trade more like bonds*."[4]

Reid: Oh, uh-huh… The guy really likes stocks that pay substantial dividends but "eliminates all REITs." Because they "trade like bonds?" What the hell does that mean? That they offer only bond-like returns? With all due respect to Mr. Stewart, he needs a frontal lobotomy.

[4] WSJ, June 22, 2005, p. D2.

Carey: Perhaps. But, due to this still-prevailing lack of understanding of the REIT animal, we don't know how the stocks will perform when fickle investors decide that they've found greener pastures elsewhere, nor do we know how the REIT management teams will deal with this eventual unpopularity. It's not wise to put more than 15-20% of your assets into them.

Reid: Carey, please. With all due respect, you're full o' bull. Something like 13 years have elapsed since the beginning of the Modern REIT Era (depending upon where you mark its beginning), and REIT organizations have now been through several cycles – in real estate capital and space markets, and in equities markets. They've withstood the real estate recession of the early '90s and the post dot-com crash in the space markets; their stocks have been as *un*popular as airline "food" (in 1998-2000) and, later, have been as popular as vacation condos (both in the mid-1990s and over the past 4-5 years). And, through it all, the management teams have performed quite well in most respects.

Yes, some will argue that they expanded too rapidly from 1996 to 1998, but with hindsight those acquisitions weren't all that bad. Since the bear market of '98-'99, they have been recycling assets, avoiding dilutive secondaries, and improving corporate governance. Some have been leveraging their expertise to boost fee income via JV strategies. They have managed their balance sheets well, and kept occupancy rates up. They understand their cost of capital. The Credibility Game is over; REITs not only are ready for Prime Time, they are living it. And, following Sam Zell's admonition, we have NOT blown it this time.

Carey: But I have another gripe about REITs. They cannot retain capital with which to grow their business. It is for this reason that the very wise Marty Whitman has expressed a preference for REOCs over REIT stocks. In his Third Avenue Real Estate Fund, only two of the top five holdings are REITs.

Reid: We all know what Rob Arnott says about the virtues of retaining earnings and keeping dividend pay-outs low. And, even if he's wrong, so what if REITs cannot retain much in the way of earnings? This lack of ability to deploy hoarded cash is offset by the benefits of greater management discipline (REIT managements face a form of investment triage, whereby they must pick and choose carefully among their limited opportunities). Keeping the external growth avenues available to most REIT management teams down to a dull roar isn't a bad thing; after all, there is plenty of competition out there, and great deals aren't exactly falling off trees. And, there is less worry about Peter Lynch's notorious "diworsifications."

Furthermore, and equally as important, we don't need much growth from the deployment of retained earnings to get us to our desired total return goals on equity investments. I don't know how greedy you are, Carey, or your clients, but I'll be very happy with 9% returns. So, with a REIT dividend yield of 4 ½ to 5%, all we need is enough growth to generate 4 to 4 ½% capital appreciation, on average. And that growth can come from 2% NOI growth, leveraged with debt to 4%, plus another 1% from investments made from retained earnings. Or, 2.5% average annual growth in gross asset values, leveraged to 5% with fixed-rate debt and a 50% leverage ratio, can get us there. So REITs' lack of retained earnings is as harmful to us REIT investors as a pack of angry butterflies.

Carey: You are, indeed, a smart-ass, Reid. But I have a practical issue with your pigging out on REIT stocks. They tend to go their own way, reflecting low correlations with other stocks and even bonds. If I put a big REIT component in your investment portfolio, and if they migrate south with the birds as they did in 1998-1999, your portfolio will underperform and you will be very unhappy. There is nothing that the American male hates more than seeing his neighbor or brother-in-law do better in the market than he does.

Reid: OK, now we're getting personal. Am I emotionally equipped to handle a bear market in REIT stocks, and the portfolio underperformance which that implies (assuming a very substantial weighting in REITs)? Yeah, I believe so. But, you can send me a CYA letter[5] if you wish. Besides, the only down years for equity REITs, on a total return basis, since 1972 were 1973-1974, 1987 (down just 3.6%), 1990, and 1998-1999. That's just 6 down years in the past 33 (and, despite a rocky start, it looks like 2005 will be up as well). So, yeah, I think I can handle the risk of underperformance once in a while. And don't

[5] For the uninitiated, "CYA" stands for Cover Your Ass.

ignore the long-term performance benefits which, according to the famous Ibbotson study, can be obtained with a 20% REIT allocation. How soon we forget!

Carey: Reid, my friend, I need to think about all this. None of my pals at NAPFA[6] have ever suggested that it might be prudent, or even reasonable, to put 20% of a client's assets into REIT stocks. Only that weirdo, Reitnut, has suggested that – and now you. Furthermore, I don't want my friends to think I'm a cowboy with my clients' assets. But, well, hmmm…I need to think about this some more. You haven't shown me the Holy Grail, but I think I'm somewhat closer to it than I was yesterday.

Reid: Glad to hear it, Pal…Get me more AMB, Alexandria, Avalon Bay, Boston…hey, I got a whole list here…Later, dude…I got a sky-diving lesson in a half-hour..

Personal Note: I am pleased to announce that our new firm, **Phocas Financial Corporation**, is now in business, and will be managing segregated all-REIT accounts for our new clients. Although the firm is new, our investment professionals (including yours truly) have successfully managed REIT accounts (including a 5-star, from Morningstar, rated REIT mutual fund) for many years, and collectively have 55 years of combined REIT investment experience. If you would like to learn more, please send me an e-mail. And if you don't, it's all the same to me…but Sammy will be disappointed.

Your humble servant,
Ralph (Block)

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[6] National Association of Personal Financial Planners.