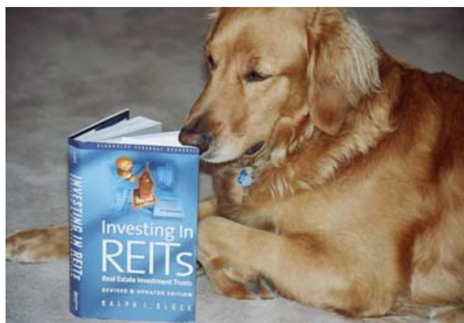
"The Essential REIT"

July 21, 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. "Is It Time to Sell Your REIT Stocks?"

That oft-repeated and inane phrase led off a recent article in Forbes.com (July 13, 2005), which does a lot of hand-wringing over a substantial amount of stock sales by REIT insiders in Q2 of this year. The writer asks, "Okay, so should you be thinking of taking profits on your REIT shares?" But she wisely never answers the question, suggesting "That depends on where you intend to reinvest the dough." But Ms. Fitch also seems to suggest, not so wisely, that investors are able to shift from one asset class to another, always, of course, at the right time, on their way to wealth beyond the dreams of avarice. Someone ought to give Forbes writers a lesson on asset allocation and the advisability of periodic rebalancing. That, or a good spanking.

But the article wasn't a complete waste of time; investors shouldn't ignore stock sales by insiders. It seems intuitive – like Sammy intuitively hanging around the patio table while others are there dining – that sales by insiders can portend dire events at the company, a deteriorating business or industry, or substantial stock overvaluation. After all, if they believe the stock is cheap, why are they selling? And selling they are. David Harris, the new head REIT guru at Lehman Brothers, was quoted in the Forbes article as saying that "total insider sales volume during the three months ended 6/30/05 was $296 million," and, even if we exclude sales due to option exercises, sales volume increased 35% over the first quarter and was the highest since Lehman Brothers began tracking this data in 2002.

But what shall we make of this insider selling? Although we know that "selling all your REIT stocks" is as smart as hiking Death Valley in July,[1] shouldn't we nevertheless be concerned? I believe that all investors

[1] The mercury there reached a mere 128 on Monday.

should track the trading activity of insiders in companies they own – but, people who have studied such things have concluded that insider sales data isn't terribly useful, or predictive of anything. Indeed, insider buys seem to be more meaningful. Here are some questions to ask when considering the importance we should attach to insider selling and its role in our decision-making process:

How much of an insider's stock is being sold in relationship to his/her total holdings, and how much stock is still retained after the sales? Most of these guys have the vast majority of their net worth invested in their company's common stock (or OP units). I'd be concerned if, say, David Simon sold 95% of his Simon shares – but not if he sold 20% of them. We investors believe in diversification; shouldn't we allow our REIT executives the same investment strategy? Dear reader, is 90% of your net worth represented by a single REIT stock investment? If so, only a curmudgeon would begrudge your lightening up a bit.

Furthermore, with the performance numbers that REITs have posted over the past 5 ½ years, I don't think I would want to own stock in too many REITs in which the insiders haven't been tapering back – such neglect might indicate a foolhardiness that's not becoming in a conservative REIT executive.[2]

Another question to ask is, "Is the sale taking place after a period of substantial outperformance, or underperformance?" I'd be more worried about an insider dumping stock following a period in which it hit 52-week lows than after making new highs. Another: Is the sale option-related? Corporate America has, for quite some time, been supplementing executive officers' and directors' salaries with stock options and/or restricted stock. These grants are often considered by the executive or director to be part of his or her regular compensation package, and are often relied upon to pay for large but oft-recurring expenses such as college expenses for the kids, or to fund charitable donations.

Insiders don't want to sell stock while in possession of materially adverse information – that would get them Martha Stewartized by the SEC or other Gestapo-type governmental agencies (you know to whom I'm referring). But they may believe they can sell stock safely despite knowledge of "soft" information, such as modest near-term declines in growth rates, increasing competition or product obsolescence.

Fortunately, selling by REIT insiders isn't likely to portend problems of that type; we REIT investors know quite well what market conditions and cap rates are like, and REIT cash flow streams are both predictable and slow to change, certainly to any material extent. Further, technological changes haven't played more than a bit role in REIT investing since a few ill-fated attempts by some REITs to become tech-heads in the late 1990s. But perhaps selling by REIT insiders reflect their secret knowledge of pending adverse changes in interest rates? Ha, ha, ha! So it's unlikely that insider REIT stock selling is predictive of impending negative developments known only to the insider doing the selling.

Perhaps a more important issue, however, is whether insider selling indicates a belief by the seller that the REIT's stock is overvalued (or at least fully valued). This is a valid point; absent a compelling and immediate need for the money, insiders will be reluctant to sell if they believe their stock is significantly undervalued. So, normally, a sale suggests that these knowledgeable insiders believe their stock is at least fairly priced. OK, let's concede that point, even though many insider sales are done merely to fund required personal or family expenditures. But the key question we need to ask is, "Why should we assume that these fellows, as smart as they are about real estate and their company's business and its prospects, know the value of their own company's shares?"

While what I'm about to say may make it tougher for me to arrange one-on-one meetings with REIT management teams, it's my belief that very few REIT executives and directors have anything but a very rough guesstimate of the true value of their own company shares. How can I make this audacious claim? First, very few REIT executives were able to foresee the major decline in cap rates over the past few years, which has heavily influenced NAVs and REIT stock prices. Why should we assume that they will be well ahead of the next major curve in the highway? Strike one. Second, since interest rates substantially affect the value of all equities (and, to a large extent, real estate), and as nobody can effectively forecast interest

[2] Mr. Cooper, at Kimco is, of course, one noteworthy exception to the rule.

rates, opinions of value by insiders, perhaps as indicated by their stock sales, should be taken only a bit more seriously than the Kansas City Royals' chances of winning the World Series this year.[3] Strike two.

Third, accurate REIT stock valuation depends upon both objective data and subjective forecasts concerning future growth rates, cap rates, NOI, market conditions, and other sorts of stuff that is virtually unknowable. But the objective data is widely available to anyone, *e.g*., asset types, property locations and occupancy rates, balance sheet leverage, free cash flows and NOIs for recent quarters, etc., and the subjective forward-looking data is anyone's guess. Is Mr. David Simon, as smart as he is, in a lot better position to determine the value of a share of SPG than intelligent investors and analysts who have access to Simon's financial results and property information, and a realistic grasp on mall cap rates, prospective NOI growth for Simon and its likely operating results over the next year or two? Call me a heretic, but I doubt it. Strike three.

Discussions of insider selling by REIT executives are almost as prevalent as discussions of real estate "bubbles." One might even say that opinions on insider selling are like noses:[4] Everybody has one. I hope the foregoing discussion has helped to put the issue in context. Heavy selling by REIT insiders shouldn't be merely accepted with a "boys will be boys" dismissal. But neither should it necessarily cause us to lose sleep worrying about the prospects for our REITs or the valuations of their stocks. As so often is the case, the devil is truly in the details.

2. Summer Reading.

As an old fogy, I read a lot. Yes, I do get out nearly every day with Sammy for a 3-4 mile walk, I do my chores (most of the time) and lift weights two days a week, and goof around with photography – during the few hours per day when I'm not following the REIT industry. But I also read a lot, including murder mysteries, historical biographies, current affairs, adventure (lost at sea, Mt. Everest, etc). I even read REIT stuff. Today I'd like to share with you a small handful of articles I've read recently that perhaps should influence our thinking about the future direction of real estate and REIT prices.

a. "We Need More REITs." The first article was sent to me by a very bright guy at Solomon Smith Barney. It appeared in Fundfire.com, written by Jay Cooper (I cannot provide a link, as I am not a subscriber to that website). Cooper, citing a survey by Broadgate Consultants,[5] says that "64% of [the] institutional investors [surveyed] are likely to increase their investments in publicly traded REITs, while only 10% intend to decrease the allocation over the next 18 months." And this is despite the belief by these investors that REIT stocks are richly priced. Just 46% of the institutional investors surveyed, according to Cooper, believe REIT stocks are fairly valued, while 44% "found them overvalued." Only 10% were a lot more bullish on valuation issues. (I note in passing that another broad survey, entitled "Tax-Exempt Real Estate Investment 2005," is available from Institutional Real Estate. See http://www.irei.com/web/do/pub/bookstore/detail?productId=18&id=16).

The article's author cites a number of reasons for these increasing allocations, including REITs' transparency (though some survey respondents believe it can be further improved), enthusiasm of hedge funds and other private equity managers, and interest from large pension funds, *e.g.*, new REIT allocations from Texas Employees Retirement System, Arizona State Retirement Systems and Texas Teachers Retirement System, none of whom had ever invested in REITs previously.

If mega-billion dollar institutions are willing to dip their toes into Reitland despite reservations about the stocks' valuations, what can this mean? This would obviously not be a trading move, based upon cheap valuations, but could signify long-term investment requirements, including the need for current yield to fund impending increases in outflows due to baby-boomer retirements. Another commonly discussed issue might be underfunding, perhaps caused by the S&P's inability to generate positive returns over the past five

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[3] As of July 18, they were 30 games out of first place.
[4] OK, I admit to taking liberty with the original phrase; after all, this is a G-rated newsletter.
[5] The survey, according to Cooper, was based upon 65 respondents, including large pension funds and mutual funds.

years. Yet another could be the puny returns offered by investment grade bonds – they sure as hell don't yield the 7% that so many pension funds have been counting on.

An alternative to REITs, of course, is buying commercial real estate directly, and pension funds are doing exactly that. But buyers are lined up six deep, and some real estate auctions are taking on the appearance of nosh pits (not that I've ever been to one). Thus it's increasingly difficult for these institutional investors to fill real estate allocations, particularly if one wants to do it this year – but REIT stocks are a great proxy for commercial real estate, and a lot more liquid. They also enable the use of debt leverage, which is often not permitted to pension funds. Toss in the underweighting in this asset class by institutional (as well as individual) investors, and who would be surprised by the increasing interest in REIT stocks by investors of all stripes and sizes? Can anyone attempt to argue today, without feeling as uncomfortable as an atheist at a Christian Coalition convention, that "a 5% allocation to real estate/REIT stocks is just about right?"

b. Gimme Yield. Another article, which I learned of from Barry Vinocur's REIT Wrap, is one soon to be published formally in the prestigious Journal of Portfolio Management. Authored by John R. Graham and Alok Kumar, at the Fuqua School of Business, Duke University, and at the Mendoza College of Business, University of Notre Dame, and entitled "Do Dividend Clienteles Exist?", the article concludes that certain types of investors do, indeed, gravitate to higher-yielding stocks. In plain English, and in confirmation of our intuition, Dividend Diehards do exist.[6] And there will be more of them.

The article is based upon an extensive survey of over 62,000 households that have traded stocks "at a major U.S. discount brokerage house for the period 1991 to 1996." The researchers sliced and diced the data lots of different ways, and isolated 31,260 households for which demographic data was available. The authors concluded, after 18 pages of explanation, that, with respect to holdings of dividend paying stocks, "among retail investors we identify a preference for dividend yield that increases with age…" (The study also concluded that the preference for income decreased with the investor's income; however, the study was for the period 1991-1996, a time when dividends were generally esteemed as highly as something the cat dragged in).

Messrs. Graham and Kumar speculate that the reasons for the increased appreciation of yield among older investors relate to life style considerations[7] or a "greater need for a greater income stream…to finance consumption." They also suggest that "previous studies … suggest that institutional dividend clienteles may [also] exist." Thus these academics have shown that, to put it simply, investors who are interested in yields (except for a few growthy types, that's most of us these days) are apt to have an even greater appreciation for higher yielding stocks as they get longer in the tooth. Expressing this as a formula that might appeal to academic types, a + b = c, where a = income needs, b = reduced confidence in S&P stock returns, and c = demand for REIT stocks.

The bottom line: Those baby-boomers ain't getting' any younger, and where they go, the entire economy (as well as the investment world) is sure to follow.

c. The Competition. I found the third article in Barron's, of July 11. Written by Adam Barth, of Barth Research, it contains some very interesting observations on the world of equities, and the kinds of equity returns that are forecasted by today's equity prices. Mr. Barth says that for 34 consecutive 20-year periods beginning in 1934 and ending in 1986, the return on equity of the Dow Jones stocks never strayed from a very tight band of between 10.5% and 11.6%; that book value growth, from 1920 to 2003, has been steady at 5% annually; and that earnings grow at "a little under 5% per year – the Dow's steady and predictable 20-year book-value expansion rate."

Mr. Barth continues: Of the historical 11% return on equity, 6% has been distributed to shareholders in the form of dividends and stock buybacks; this allows 5% of the return to be retained for future growth, thus driving the Dow Jones' 5% earnings growth rate. He concludes: "The Dow is a perpetuity that can be easily valued by dividing (a) its current free cash flow (6% of current book value) by (b) its expected rate

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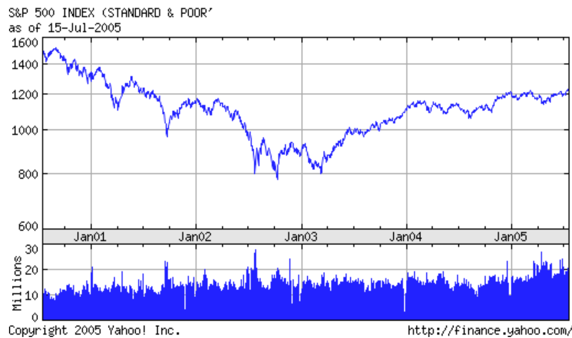
[6] I give credit to Barry Vinocur for coining this apt terminology.
[7] Citing a study by Messrs. Shefrin and Thaler (1988).

of return, *e.g.*, 9%, minus its long-term growth rate (5%). Barth says that the current book value of the Dow Jones is 3,000, and thus normalized free cash flow is 6% of that, or 180. Divide 180 by (9% - 5%), and you get a fair value for the Dow of 4,500 – which is less than half of where it sits today. Or, to justify the recent close of the Dow at about 10,500 as "fair value," investors must lower their average return expectations for Dow stocks to 6.7% annually, according to Barth.

OK, Mr. Barth is just one more guy who believes that current stock prices imply modest (or at least sub-par) equity returns going forward. We've heard similar arguments from stock bears, such as Rob Arnott, and from quasi-bulls, such as Jeremy Siegel, for quite some time. And yet, they seem to be right, don't they? The S&P hasn't exactly shot the lights out over the past five years. Check out this chart:



It takes time for investor perceptions to adjust to new realities, but adjust they will. Nevertheless, we would be remiss if we do not acknowledge that real estate must compete today for capital with perceived returns on other asset classes, and we need to thus keep a sharp eye on the wide world of equities. If they begin to deliver 9-11% returns on a sustained basis, the capital flowing into real estate will change course quicker than a politician who's way behind in the public opinion polls.

d. May The Force Be With You. I will always personally be heavily invested in REIT stocks; I like the safety, predictability and yield of this asset class. Others, of course, have their own agendas, which may not include REITs at all. However, I believe that a combination of forces have been at work to create a very hospitable climate for REIT and real estate investing, and these forces help to explain why cap rates have dropped further than anyone had dared to imagine and why REIT stocks have performed so well despite real estate markets that, up until recently, were uglier than mutant tarantulas.

And the above-noted articles reflect these forces, *e.g.*, increasing demand for commercial real estate and, by proxy, REIT stocks, from pension funds, a drive towards income investments by ageing Americans (particularly the leading edge of the boomers) and a scarcity of great investment returns in either bonds or the equities markets. Of course, every asset class – even every stock – must contend with short-term squiggles, including periods in which they fall out of favor with investors. And REIT stocks certainly will run into these head-winds from time to time, particularly if the shares reach such lofty levels that required returns cannot be achieved in view of realistic expectations for cash flow and NAV growth. Furthermore, the hobgoblins of rising interest rates have been known to derail even the sturdiest train.

So, although the short-term outlook is always unknowable, I believe we need to retain our long-term perspective. The winds are at our backs, and The Force is with us. As long as current trends and investor preferences remain in place, price dips are more likely to provide opportunities to buy in at better prices than to signal an end to this Great REIT Bull Market we've been enjoying since 2000. But keep tabs on interest rates and REIT stock valuations; misbehavior of the former will impact REIT and real estate values (perhaps violently), and irrational exuberance, reflected in out-of-control pricing, always causes bad hangovers for the late-comers to the party.

Finally, and off topic, I will leave you with a couple of quotes that I found amusing (and accurate). First, from Green Street Advisors' chief residential real estate analyst, Craig Leupold: "New accounting pronouncements, SEC interpretations and comments, non-recurring items, and inconsistent application by

companies have now rendered FFO virtually useless." And from Wharton Professor of Real Estate Peter Linneman: "If you do CAPM or other risk pricing models, you find that real estate remains 15 to 35% underpriced based on its cash streams and its risk profile relative to other alternatives." (Well, Peter, perhaps not 15-35%, but certainly real estate is still capable of holding its own in the Valuation Derby).

Your humble servant,
Ralph (Block)

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