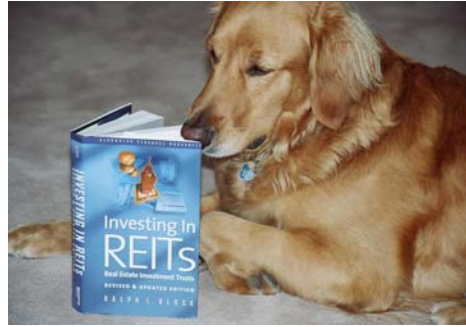


# "The Essential REIT"

August 11, 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. Mr. Bary Lays an Egg.

I have been reading Barron's ever since I graduated from U.C.L.A. Law School in 1967. I stupidly thought that a "hot-shot" lawyer like me should be able to kick some serious butt in the stock market. Well, I became a journeyman lawyer (not a hot-shot), and even Barron's couldn't help me make money in the market. Indeed, I never did very well in that department until I began to invest in REIT stocks in the early 1970s. Anyway, despite my singular lack of investment success in those early years, I took a liking to Barron's – and like it still, despite its occasional shortcomings. It can be helpful at times, if approached with sufficient skepticism. But Barron's has never cared much about commercial real estate, and its knowledge of that asset class – as well as REIT investing – may be only slightly better than Sammy's knowledge of quantum physics.

It was thus with substantial foreboding, as if my assignment was to patrol the mean streets of South Central Los Angeles, that I began, last Sunday, to read Barron's featured article, which addressed REIT stocks (issue of August 8, 2005). The headline foretold its dire conclusion ("**POP – the Other Real Estate Bubble**"), so I didn't need to read beyond the first six words to know that I was in hostile territory. But I plowed ahead gamely, choking on my waffle breakfast only a few times during the ordeal. When I had completed this undertaking (no pun intended), I was left with only two thoughts: (a) a number of newbie REIT investors would be frightened out of their stocks on Monday, and (b) Mr. Bary's knowledge of commercial real estate and REITs is superficial at best, and his understanding of what has driven their performance over the past five years is as deep as the Los Angeles River in mid-August.

But let's take a closer look at the article and see what we can (or should) make of it. After all, Barron's is very influential in the investment community and its journalists are quite capable. I have reproduced below

the most salient points in the article, most of which criticize REIT stocks, and have added (in *italicized blue*) my comments where I thought appropriate. Finally, some may sneer, and ask, "Block, what gives you the right to challenge Mr. Bary, one of the best financial writers out there in the world today?" While Mr. Bary is no doubt a very bright guy and has "earned his spurs" as a fine journalist writing for Barron's, I am presumptuous enough to claim that I have spent many more years studying REITs and investing in them than has Mr. Bary, and I justify my audacity on that basis.

**"Pop! – The Other Real Estate Bubble"** *(Nothing like an inflammatory headline, huh? Just what is a "bubble" in the investment world? Houghton Mifflin's dictionary defines it as "something insubstantial, groundless or ephemeral," or a "speculative scheme that comes to nothing." Tulip bulbs? Of course. The gold and silver markets in the 1970s? Perhaps. Dotcoms in the late '90s? Sure. But although we can debate until the cows come home whether commercial real estate, direct or securitized, is "overpriced" today, calling it a "bubble" is beyond the pale, as I will try to show below.)*

By ANDREW BARY

THE NATIONWIDE INFATUATION with property has spilled over into the stock market, where shares of real-estate investment trusts have soared, despite spotty operating results and higher interest rates. The run-up in REIT shares, which have doubled since early 2003, has raised concern on Wall Street that a bubble could be forming in the \$300 billion sector. *(The word "could" is clever, and may be compared to "some say..." Mr. Bary, let me know when I must accept a 4% cap rate on a strip center in an Atlanta suburb or whether REIT stocks begin to trade at 25-30% NAV premiums; I'll worry about bubbles then.)* "Our view is that valuations are in uncharted territory, and the group is very susceptible to a correction," says Jonathan Litt, the REIT analyst at Smith Barney. What's the downside? Litt says that shares of real-estate investment trusts could fall more than 10%. *("Susceptible to a correction?" Every stock (and group of stocks) is "susceptible to a correction." JP Morgan reminded us that "stock prices will fluctuate," and any investor who doesn't expect a 10% decline at any time shouldn't be in the market at all. Oooh...a 10% downside move! How frightening!)*

Some cracks may be starting to form in the REIT sector. *(Hmmm...why, Mr. Bary, do you assume it is a "crack," and not a normal reaction to the 25% rally we enjoyed from late March through the middle of last week, when REIT stocks became a tad pricey? Perhaps because a "crack" sounds ominous, as though the entire structure is about to implode?)* The group declined 2% Thursday and was down about 3% Friday, hurt by a setback in the bond market that followed the release of stronger-than-expected July employment data Friday morning. *(And it fell another 3%+ on the day your article appeared; so what?)*

The two-day sell off illustrates the volatility in REIT stocks. Morgan Stanley's REIT index, for instance, dropped 10% in January and had rallied 25% from late March until the middle of last week. Still, REITs often appeal to risk-averse investors who don't recognize this. *(Yes, Virginia, REIT stocks have indeed become more volatile, due, in part to their wider acceptance and presence in many non-dedicated portfolios, and being used by some as trading vehicles. But today's REIT investor understands that this volatility is here to stay, and is the price of such wider acceptance and liquidity. And fund flows into the industry have been steady and positive despite the bouts of vertigo we encountered during a portion of last year and earlier this year. REIT investors seem to be taking the volatility in stride.)*

Litt acknowledges that a sustained REIT retreat might not come soon because "a wall of money" continues to chase the sector and the entire U.S. commercial property market in which the group invests. *(Is Mr. Litt suggesting that today's buyers of commercial real estate are dumb schmucks, "chasing" prices higher and higher with wild abandon? I don't think that this is what the gentleman is saying, but Mr. Bary appears to use Jon's words to support that thesis.)*

What could derail the REITs? Further interest-rate increases, a bursting of the property bubble, *(assumes facts not in evidence, and inflammatory to the jury)* a slowing economy *(Say what? Commercial real estate investors thrive on slow-growing economies)* or a shift in investor preference toward common stocks. *(Not bad; he got two of four right).*

Danger signs abound. The group, which offered dividend yields of 8.75% in late 1999 (*sure, pick the lowest point in the REIT cycle, when REIT stocks were being given away*), now has an average yield around 4.5%. (*An eminent logician such as Mr. Spock would have a field day with this one. Wiggling his pointy ears furiously, he might say, "A lower dividend yield suggests higher valuations; it does NOT necessarily mean "danger" or dangerously high valuations." Any student of the stock market knows that there are often good reasons for higher valuations vs. historical norms. Why sell a stock trading at a 20x P/E ratio (vs. 15x historical) if we can still snag our required return on it, even at those higher valuation levels, due to improved cash flow growth prospects.*)

The low REIT yields mean the sector is far less defensive than it used to be. (*Mr. Bary, that's a very debatable point. How does one define "defensive?" Are you assuming that a high dividend yield is sufficient to provide protection against a stock price decline? Did high REIT yields at the end of '98 prevent losses in '99? And, many REIT yield-hogs who bought Meditrust and its ilk will take issue with you. Furthermore, perhaps REIT stocks have become more defensive rather than less, i.e., there is greater liquidity in the shares today, the managements are better and the depth and quality of their portfolios is much improved.*)

REITs look pricey based on virtually every historical financial metric: dividends, dividend yields relative to Treasury rates, and various earnings measures, including funds from operations, or FFO, and adjusted funds from operations, or AFFO. (*You're forgetting the most important determinant of REIT stock valuation: the NAV premium or discount. The other measures you cite suggest that investors are willing to pay more today for a dollar of real estate cash flow than has been the case historically; shouldn't we debate the wisdom of that, rather than merely assuming that historical yardsticks must be right? And, on an NAV basis, REIT stocks don't look pricey at all, selling for a modest 5% premium (below the historical norm of 7%). In fact, REIT dividend yields are at a 30-year low. (Again, this is a caution light, suggesting that we ask whether these higher than historical valuations are logical or not – which Mr. Bary fails to do).*

REIT INVESTORS HAVE SEEMED unconcerned about rising yields on Treasury paper, including the move in the benchmark 10-year T-note to 4.4% from a June low of 3.9%. (*Unconcerned? Excuse me; I seem to recall REIT stocks taking big dumps as recently as early this year, when the yield on the 10-year spiked, and again beginning last Thursday when that yield approached 4.4%). As income vehicles (You're getting off on the wrong track again. REITs are not "income vehicles;" rather, they are total return investments, in which up to 50% of one's returns will come from capital appreciation, driven by higher profits and dividends. Thus a strong economy, which often comes with higher interest rates, helps long-term REIT stock performance. For pure income, buy bonds.), real-estate investment trusts become less attractive when yields on alternative investments move up. (No, not less attractive as investments, but rather the valuation metrics change and return expectations rise, thus impacting "fair values"). Short-term bond rates, now at 3.25%, probably are heading to 4%. That could hurt realty trusts that rely on floating-rate debt. (Yes, this is an issue for some REITs, but most have fixed the great majority of their debt – and increases in short-term borrowing costs are already baked into earnings estimates).*

"There has been an enormous demand for yield and enormous demand for real cash income," says Greg Whyte, a REIT analyst at Morgan Stanley. "A lot of people are surprised at the amount of money chasing (*there's that pejorative word again, implying empty-headed investors closing their eyes and buying indiscriminately, a fact not in evidence*) real-estate assets and REIT stocks." Where there once were three to five bidders for a \$1 billion "trophy" commercial property, now there could be 20 or more. (*But might we be seeing greater institutional interest in real estate for rational reasons, e.g., most investors have been substantially underweighted in real estate for many years, despite its outstanding risk-adjusted performance over many, many years?*)

Many Street analysts, including Litt and Whyte, have underestimated the power of the REIT rally. (*What are you suggesting, Mr. Bary? That those wise analysts who have been bearish – and wrong – on commercial real estate (and/or REIT stocks) must now become right? Those underestimating the power of the REIT bull failed to see the Big Picture. Has that Big Picture now changed? Is the desire for current income and predictable and stable cash flows about to end? Is the yield on the 10-year about to go into orbit? Will investors suddenly decide that they no longer want to increase their allocations to commercial*

*real estate, and believe they will score much better returns in tech stocks, or in the broad equities markets? Sure, this could happen at any time, but from my office here in Westlake Village I see no signs of it yet.)*

The upside potential in REITs may be limited, barring a drop in long-term rates. *(What a revelation! Look, we REIT investors expect no free lunches; we realize that buying at current prices moderates our expected returns. But that hardly equates to “bubble” pricing.)* REIT profits are rising, but outside the hot shopping-mall sector, the gains haven't been large. Profit growth could run at 6% to 7% annually in the coming years, barring an economic downturn. *(6-7% profit growth? Please, Mr. Bary, don't throw me into that briar patch!).*

OFFICE REITS CONTINUE to contend with the expiration of leases signed at high rents in 1999 and 2000. *(This is hardly an unknown fact. Besides, office rents are now beginning to increase in a few markets, and office owners are likely to enjoy more widespread increases beginning next year).* Another problem: continued corporate consolidation, which has hurt markets like Boston, where such big hometown employers as FleetBoston Financial, John Hancock and Gillette have been taken over. *(On a size-of-the-problem scale, this one ranks with Sammy having to temporarily snack on bologna rather than ham).* Apartment REITs are only starting to recover after a tough stretch in which occupancy and rents were pressured by the growing trend toward home ownership. *(This is a negative? I love investing at cyclical bottoms.)*

"REITs are being priced for perfection," says Peter Siris, who heads Guerrilla Capital, a New York investment firm. "REITs have benefited because the economy has stayed strong while rates haven't gone up. *(I am sure Peter is a very bright guy, but can he be suggesting this is the only reason REIT stocks have appreciated in value?)* But I don't think you're going to have a decent consumer economy and lower rates forever." *(This isn't the issue. The issue is whether interest rates rise so high as to kill off the resilient American consumer. Also, rising job growth and salaries will offset some of the effects of higher interest rates and gas prices. Finally, it's not as though the consumer will wake up one morning and say, "No more shopping for me." We are talking about incremental changes that won't much affect REIT cash flows.)* Siris points to steady insider selling by REIT executives as a sign of the sector's overvaluation. *(We've discussed REIT insider selling in a prior "Essential REIT." Suffice it to say that there has been no study concluding that insider selling in REIT world has been predictive of future REIT stock prices).*

Institutional investors are clamoring to buy virtually every kind of commercial real estate, not just in the U.S. but around the world. "There's a global rush to buy real estate," Litt says. "It's driven by a desire to own hard assets, diversify and buy into a group that has been working." *(Maybe some momentum investors have plowed into commercial real estate (or REIT stocks) because "they're working," but perhaps Mr. Litt underestimates the intelligence of institutional investors. Perhaps Mr. Bary should discuss the numerous valid reasons why investors are developing a greater appreciation for this asset class, their investment return expectations, and whether they're likely to achieve them. That's what it's really all about).*

The yield demanded by institutional buyers on U.S. commercial property has fallen to the 4%-6% range from 9% as recently as 2002. These yields, called capitalization rates, are based on the annual income generated by a property, divided by its purchase price. Litt points out that cap rates outside the U.S. now are comparable to those domestically, reflecting the growing efficiency of worldwide real-estate markets and the tens of billions of dollars looking for opportunities. *(4% cap rates? Where, other than sales to condo converters? The data I've seen suggests that the "yield demanded" by investors is closer to 6% than to 4%. Yes, these investors are indeed willing to accept lower initial yields than were available several years ago, and presumably lower IRRs, but there ARE reasons for this. These should be discussed and examined before suggesting "bubbles," asset chasing, and other forms of irrational exuberance.)*

ONE CAVEAT: REIT DIVIDENDS didn't benefit from the cut in the federal tax rate on dividends two years ago. Thus, they're disadvantaged relative to payouts on common stocks. The after-tax dividend yield on a REIT yielding 4.5% is around 3.2% for an investor in a high tax bracket. *(But this isn't an issue for IRAs and 401k plans.)* An investor could buy common shares of non-REITs yielding 4% and get an after-tax yield of 3.4% -- beating the after-tax REIT yield. *(All right, so the after-tax yields are comparable in taxable accounts with respect to some S&P stocks. But this means nothing without comparing the risk and*

*reward trade-offs between a REIT stock yielding 4.5% and a non-REIT stock yielding 4%. Personally, I would rather own Macerich, yielding 4.3% and trading at NAV, than the 4%-ers suggested in the article, i.e., Baby Bells, Merck, Altria, Citigroup, Bank of America and Sara Lee).*

What's the REIT bull case? Mike Kirby, the director of research at Green Street Advisors in Newport Beach, Calif., says that, if the U.S. is in a sustained period of low interest rates, REITs are apt to perform well. "The valuation question is tied up with the bigger-picture question of whether we're in a low-return environment for a long time. If that's the case, the 4.5% dividend yield on REITs doesn't strike me as too bad," given expectations that REITs' profits will rise 6% to 7% annually. *(Well said, Mike).*

But Kirby and others acknowledge that REITs are likely to perform badly if the 10-year Treasury is heading toward a 6% yield. *(Sure. But guess what? If the yield on the 10-year streaks even to 5%, which asset class isn't going to perform poorly? Besides, let he who is without error in the interest forecasting game cast the first stone, er...hazard the first guess. But let's be honest; we all know that a big jump in rates – should it happen – will negatively affect the prices for REIT shares. But that's a risk that we all know about, and doesn't affect the validity of REIT investing today or prove that commercial real estate is bubble-priced.)*

REIT executives dismiss the bubble talk, pointing to the increasing demand among institutional investors for "alternative assets," as well as the underinvestment in real estate by pension funds and endowments relative to their equity holdings. The U.S. commercial property sector is pegged at about \$5 trillion, about half the size of the S&P 500 index. *(Doesn't this suggest that, to be market weighted in commercial real estate, for every \$10MM invested in S&P stocks, another \$5MM should be invested in US commercial real estate? Right now, that figure is only about \$600K or 700K for the "average" institution. Mr. Bary might have pursued this point, but he leaves it hanging like a Florida chad.)*

REIT enthusiasts say that commercial real estate has undergone a revaluation that's unlikely to reverse, driven in part by the increased cost of new buildings. *(Huh? The value of a real estate asset may be driven, in part, by its replacement cost, but this has little to do with the revaluation of real estate as an asset class. The latter is being driven by larger "macro" issues, such as a greater preference for income, predictability and stability of cash flows, increasing diversification needs, underweighting in commercial real estate, and lack of exciting investment returns elsewhere.)*

The problem is that, based on FFO, REIT stocks are at record valuations. *(This is a "problem?" Record valuation, as such, is never a problem. What IS a problem is record valuation that's not substantiated by the likelihood of returns in line with expectations. Example: ElectroCeramics trades at 30x earnings, a "record valuation." This isn't a problem as long as ElectroCeramics' future cash flow growth is strong enough to support the higher return expectation inherent in the higher ("record") valuation.)*

The group trades for 15 times projected 2005 funds from operations, versus an average multiple of 11 during the past dozen years, according to Morgan Stanley. The REIT FFO multiple is almost as high as the S&P 500's price-earnings multiple of 17, based on projected 2005 operating profits. That's a rarity; historically, the FFO multiple has been much lower than the S&P's P/E. The forward 12-month REIT FFO and S&P 500 P/E are about the same. *(Again, this isn't a problem if the risk/return parameters of REIT stocks are on a par with the S&P. If REITs' expected returns are better, and with less risk, they should trade at a higher multiple of earnings than the average S&P stock, and vice-versa. REIT stocks have generated total returns on a par with the S&P over long time periods, and with less risk; why should their P/FFO ratios have been lower than stocks? The market had things wrong for many years; who says that those historical valuations are the "right" ones? Furthermore, comparing REIT FFOs to non-REIT net income can be misleading.)*

Measured by AFFO, REIT valuations looks particularly stretched because the typical company trades at about 20 times estimated 2005 AFFO, considerably above the S&P 500's P/E ratio. *(“Considerably? The*

*gap between 20x and 16-19x<sup>1</sup> is hardly “considerable;” furthermore, if we exclude oil and gas stocks (with low multiples), the S&P’s forward multiple is about 20x. Also, Mr. Bary, you are again comparing apples with oranges; AFFO is very close to free cash flow, while GAAP earnings have only a tenuous relationship to non-REIT free cash flows). And REIT dividends average about 90% of AFFO, a high percentage. In contrast, the S&P 500’s payout ratio is around 30%. This means the average company in the S&P has far more room to raise dividends than the typical REIT. (Woulda, coulda, shoulda...so why aren’t the S&P companies raising their dividends more briskly if they have so much ability to do so? Perhaps these “earnings” are partially ethereal,<sup>2</sup> and their free cash flows are well below reported earnings? Or maybe their plate is full with new investments, which may – or may not – create value.)*

The cautious stance of REITs regarding acquisitions is another sign of a frothy market. (*“Frothy” means “playfully frivolous.” Although there is lots of demand for commercial real estate assets, the type of frivolity that we enjoyed in the action of the techs and dotcoms 5-6 years ago is conspicuous by its absence*). Boston Properties has been a net seller of office buildings, while Vornado has shifted gears and has sought real-estate plays in the stock market. (*Maybe a well-run REIT understands that its IRR requirements are higher than those of pension funds, and has the discipline to stay away when it cannot obtain outsized returns. If Boston were buying up loads of properties, perhaps Mr. Bary would have criticized BXP and the REIT industry for that, too – “REITs’ lack of discipline is another danger sign.”*)

"Given our underwriting standards and our return requirements, we are seeing a paucity of acquisition opportunities," said Ed Linde, the chief executive of Boston Properties, on the company's second-quarter earnings conference call in late July. Boston Properties recently announced a \$2.50-a-share special dividend, reflecting proceeds from property sales. (*The key words from Mr. Linde are “our return requirements.” I would also remind Mr. Bary that it’s a long stretch from a “paucity of acquisition opportunities” to bubble pricing in the real estate markets. Boston is looking only for great deals.*)

LINDE CITED ANOTHER SIGN of an overheated market. While buyers of office buildings historically have favored properties with high occupancy levels, many potential purchasers now prefer buildings with sizable vacancies because they assume they can push through big rent increases. (*Yes, we certainly recall Mr. Linde’s chilling remark. However, to my knowledge, this kind of fuzzy thinking is occurring only in a few markets such as San Francisco – perhaps buyers there have become addled by the salt air. One should be careful about making broad generalizations on the basis of the actions of the lunatic fringe.*) The reality is that while office rents in key markets have firmed, many office REITs still are getting lower rents on new leases than on expiring leases signed in the 1999-2001 period. (*True. But the spread is narrowing, as rents are beginning to rise. Concessions are topping out, and net effective rents will probably grow faster than quoted rents. Embedded rent reduction on office/industrial lease rollovers is waning. The worst is over; the only question is the speed and strength of the recovery.*)

APARTMENT REITS ARE BACK in favor, partly because investors are figuring that they may engage in wholesale condo conversions to capitalize on the roaring condo market. Watch out if the condo market cools. (*It is true that we are seeing some very low cap rates on apartment assets with condo conversion potential, but the apartment REIT stocks aren’t being priced on that basis. For example, Archstone-Smith trades at very close to net asset value, and the cap rate used for NAV calculation<sup>3</sup> is 5.5%, despite the fact that it has a horde of assets that it can sell to the converters at low cap rates. Thus current apartment REIT stock prices do not rely upon condo markets remaining hot.*)

The Aston [6<sup>th</sup> Avenue between 27<sup>th</sup> and 28<sup>th</sup> in Manhattan] sale could be the richest ever for an apartment building on a per-unit basis. The Aston and Trump purchases reflect an effort by apartment REITs to upgrade their portfolios by buying properties in hot markets and selling them in weaker markets in the

---

<sup>1</sup> Per the Wall Street Journal on August 10, 2005, the P/E ratio for the S&P 500 index was either 19x or 16x, depending upon whether one looks back or looks forward. The yield is 2.0%.

<sup>2</sup> For example, Wednesday’s WSJ contains a story about how Downey Savings records as income the amount of interest that borrowers are *required* to pay on their “option” loans, even though they are paying somewhat less than that and deferring the balance until later. This is not dividendable income.

<sup>3</sup> Per Green Street Advisors.

South and West, where rents are soft and barriers to new construction are low. The benefits to investors from this strategy are unclear because REITs are accepting earnings dilution by buying high and selling low. *(Mr. Bary. You are not alone in your belief, but short-term FFO dilution in a REIT is not a crime; indeed, it isn't even terribly relevant. Rather, look at the IRRs that a REIT is likely to earn when it acquires, swaps, sells or develops a property. I'd rather my REIT bought at a 5% cap with a reasonable expectation of a 10% IRR than a 7% cap with a probable 8% IRR. Also, the cap rate spread between assets in high barrier and mediocre markets is unusually small today; I am happy when any REIT I own sells Houston at 6% and buys 5% in Westlake Village. Dilution, pollution...red herring, Mr. B.)*

Mall REITs have enjoyed some of the strongest profit gains because of a robust consumer economy. Simon Property, the leading mall REIT, recently reported a 16% gain in second-quarter FFO. Its FFO is expected to rise 11% this year and 6% in 2006. Simon, however, isn't cheap at 80, trading for 16 times projected 2005 FFO and 22 times AFFO. *(But at only a 6% NAV premium. If I buy SPG stock today, at \$75, I think I can snag an average annual total return of at least 10% over the next few years.)*

The mall REITs face a challenge because of growth in off-mall retailers like Target and Wal-Mart Stores and the consolidation among department stores, highlighted by the coming merger of Federated Department Stores and May Department Stores, which will result in the closing of anchor stores in many malls. *(It would be a good idea here to look at the history of what happened when space occupied by an underperforming anchor in a quality mall was closed, e.g., Monkey Ward. Do I worry about a May store closing in a B+ or A- mall? Bring it on! History is on my side.)* Guerrilla Capital's Siris notes that America "remains overstored," *(how many times have I heard that? Besides, just who is Mr. Sirious? Is he a REIT expert? Is he long or short the REIT industry?)* yet investors are more bullish than ever about mall and strip-center REITs. *(Mr. Siris, have you listened in on any of the retail REIT conference calls? I wouldn't say that finding tenants is a particular problem these days, nor is raising rents. These strong markets may moderate, but, again, much depends on the magnitude of interest rate hikes and the price of gasoline.)* Siris fears that with anchor stores closing, "a lot of the second-class malls will get hurt badly." *(Perhaps, but the likes of General Growth, Macerich, Simon and Taubman don't own second-class malls.)*

The formerly dowdy storage REITs, led by Public Storage, have capitalized on Americans' penchant for accumulating more than they can fit into their homes. The storage industry has done particularly well in the South and West, where many homes lack basements. *(So?)* Public Storage last week offered to acquire a smaller storage REIT, Shurgard Storage (SHU), for \$2.5 billion, or about \$53 a share -- 14% above Shurgard's share price prior to the offer. Shurgard dismissed the offer as inadequate, even though it amounted to 26 times that company's projected 2005 FFO of \$2.05 a share. Shurgard was trading late last week at 52. *(Mr. Bary, what's your point? That Shurgard is stupid to reject PSA's offer? If so, I would certainly agree -- but does this say anything about the REIT industry in general, or the storage sector in particular? Are you saying that PSA is stupid? We won't know PSA's return on this investment (if it happens) for some time, but these guys aren't dumb. PSA will operate SHU's assets a lot more efficiently. By the way, why didn't you mention the storage REITs' substantial NOI growth?)*

It's tough to say when real-estate investment trusts -- or any overheated *(again, assumes facts not in evidence, and inflames investors' passions)* industry group -- may cool down. Yet the feeding frenzy *(“feeding frenzy?” Mr. Bary, you are apparently suggesting that buyers are stupid, mindless sharks, with long sharp teeth and little gray matter, but you don't provide supporting documentation in the form of investors' expectations of unreasonable investment returns)* surrounding the group, along with the low yields and high valuations *(yes, yields are lower, reflecting lower acceptable total returns -- but does an 8-9% IRR on a REIT stock (vs. 11-12% historically) mean “overheated?”)*, has left many disciplined buyers on the sidelines. *(But other disciplined investors continue to buy, particularly on dips -- perhaps you should mention that.)* And it's turned some big institutions into sellers. *(What? Some institutions are sellers? How bizarre! There would also appear to be some institutional buyers as well.)*

The California Public Employees Retirement System, which has one of the largest real-estate portfolios among public pension funds, has sold \$7 billion of its \$21 billion core portfolio since December. Calpers sold most of its office properties. "The prices that people were willing to pay were higher than what we felt the properties were worth," observes Michael McCook, Calpers' senior investment officer for real estate.

He says the fund had bought the properties at cap rates, or yields, in the 7% to 9% range and sold them in the 4% to 6% area. *(Mr. Bary is presumably intending here to suggest that Calpers is really smart, and the pension funds buying from it are dumb. Insufficient facts on which to base such a conclusion. Let's return in three years and check the buyers' IRRs. And what kind of return will Calpers have generated on its new investments from the proceeds of the asset sales during that time? Sometimes investors are simply looking to get the best risk-adjusted returns available, and don't want to sit in cash.)*

Bulls talk of a new era of permanently elevated property prices. Tech-stock boosters said much the same in 1999 and 2000, before that group collapsed. *(With all due respect, Mr. Bary, to compare today's commercial real estate and REIT markets with the tech and dotcom markets of '99-'00 is ludicrous.)* Given their huge run-up, REIT shares could be at least 10% lower within 12 months. *(Oh, I am so frightened! And even if we DO get a 10% downward move, so what? Aren't REIT stocks entitled to a 10% retrenchment after 37.1% and 31.6% total returns in 2003 and 2004, respectively?<sup>4</sup>)*

So now might be a good time for investors to move away from them. *(Oh, it might be a good time, huh? Or it might NOT be a good time. Mr. Bary, I respectfully suggest that you are doing your readers a disservice to imply that entries into and exits out of asset classes can be successfully timed. The streets of the investment world are littered with the bodies of people who have attempted this impossible feat.)* In real-estate investing, location, location, location isn't always the most important thing. Often, timing is. *(Sure, it's easy: Just buy low and sell high.)*

**Summary.** I bear no ill will towards Mr. Bary; he was, presumably, only “doing his job.” However, I don't think he's done it particularly well. He focused on REIT stock valuations vs. historical “norms,” and failed to adequately delve into the reasons for today's substantial interest in commercial real estate, assuming it is mere irrational exuberance. Suggesting that this renewed interest has carried us into “bubble” territory is just plain wrong, particularly as he has failed to explore the reduced expectations of today's investors and to ask whether those expectations are likely to be realized. Did he begin the article with a particular (negative) mind-set? I do not know.

So, is Mr. Bary right or wrong? Neither commercial real estate nor REIT stocks is cheap today; however, those with modest and reasonable return expectations should be able to have these expectations met over the next 3-5 years, and longer. Mr. Bary should be talking about this, as well as the “right” real estate - REIT allocation, rather than prattling about bubbles. You have my opinion, but he will have the last laugh if we get that “10% correction.” And yet I will also laugh, as I will then be buying REITs at outrageously cheap prices.

Your humble servant,  
Ralph (Block)

***Disclosure: I and/or the firm(s) to which I provide services may from time to time have long or short positions in some or all of the stocks (if any) mentioned above. Further, this “newsletter” is not intended as a recommendation for the purchase or sale of any particular security and is not intended to be investment advice – or any other advice for that matter. The statements made in this newsletter are my own personal opinions, and do not represent the views of Phocas Financial any other person, real or fictitious, or even the views of Sammy, my Golden Retriever. © 2005 Ralph L. Block***

---

<sup>4</sup> NAREIT Equity index returns for these years.