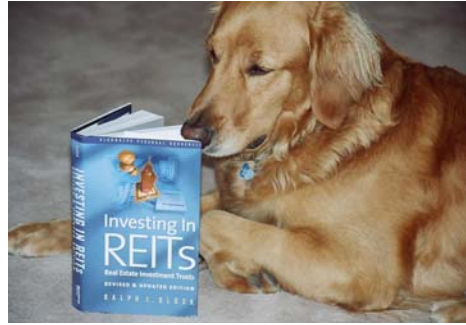


"The Essential REIT"

September 1, 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. Pass the Bubbly...(hic!).

I hate to do this to you, I really do. But I am going to ask you to delve into, yet again, the issue of whether real estate pricing deserves the epithet "Bubble." That term, of course, is as scary to investors as a growling pit bull might be to a gentle beagle – but, sadly, is often abused and misused by investors, financial writers and other assorted self-proclaimed pundits. "Bubble" discussions are wildly popular today, perhaps due to lingering memories of the Dotcom Madness of the late 1990s. Popular indeed; one wit has suggested that there may be a "bubble" in today's obsession with "bubbles."

"All right, Reitnut, but hasn't enough already been said about bubbles? Why do you insist upon yet another discussion that's full of sound and fury, signifying nothing? After all, The Chairman himself suggested that the existence of an investment bubble is known only with hindsight." There are two reasons:

(a) Financial writers such as Andrew Bary continue to shout "Bubble!" in crowded theaters (er, popular newspapers and magazines). Here's a headline from a story in yesterday's Wall Street Journal: "Commercial Real Estate Shows Bubble Signs, Too."¹ Even Mr. G is fretting about "real estate" – though he seems to be concerned only with the residential variety. Accordingly, I feel the need to add a bit of perspective to this discussion – if for no other reason than to encourage newbie REIT investors to hold onto their shares, which is in their own long-term best interests; and

¹ This article, consistent with the mindless fare on commercial real estate cranked out by most (but not all) WSJ - Barrons' reporters, was particularly weak and clueless.

(b) As I have just completed the manuscript for the next (3rd) edition of “Investing in REITs,” while feverishly working on Phocas matters and scrambling to prepare for a 3-week trip in Italy (I’m leaving on Saturday), I have had little time to draft a full and fresh issue of “The Essential REIT.”

I therefore decided to be perverse and to subject you to yet another discussion of “bubbles,” which I was able to quickly write and present in two parts: (a) a very short discussion, with related table, comparing the Dotcom Madness, the Condo Craze, and the current market for commercial real estate and REIT shares; and (b) a copy and paste from two old issues of “REITWEEK,” The Essential REIT’s predecessor, written in the era of the gunslingers, when the most reckless of investors were the most rewarded, and the Masters of the Universe were 22-year old college drop-outs with a Better Idea, but no coherent business plan and no clue – or care – as to when they’d actually book profits.

Investor psychology is a derivative of human nature. As long as both greed and fear are part of it, we will be subjected to waves of investor irrational exuberance from time to time, in which caution will sometimes be as much in vogue as Nehru Jackets. One of my favorite quotes is: “Avarice, or desire of gain, is a universal passion which operates at all times, in all places, and upon all persons.” – David Hume. But it does seem to wax and wane, particularly in the investment world. And here’s another: “There must certainly be a vast Fund of Stupidity in Human Nature, else Men would not be caught as they are, a thousand times over, by the same Snare; and while they yet remember their past Misfortunes, go on to court and encourage the Causes to which they were owing, and which will again produce them.” – Cato’s Letters, January 1721.

As greed is as prevalent as Sammy’s interest in food, we will encounter it from time to time on Wall Street, sometimes appearing in very frightening garb. When greed runs rampant across the investment community and overrides that part of our brain that is able to reason, weigh and assess, we will experience investment “bubbles.” Now, there are many different definitions of an investment “bubble;” one I particularly like, due to its simplicity, is “an explosive upward movement in financial security prices not based on fundamentally rational factors, followed by a crash.” This definition, however, is not terribly helpful when attempting to identify a bubble before it explodes. I will try to be more helpful, below.

But, first, a quick history lesson. The term “bubble” isn’t new; indeed, many of us may recall discussions in history or economics classes of the “South Sea Bubble,” describing an early 18th century version of these irrationally exuberant phenomena. Before that, there were tulip bulbs. More recent versions of bubbles include U.K. and U.S. railroad bonds (19th century), auto and radio stocks (early 20th century), “nifty-fifty” stocks (late 1960s), Milken junk bonds and LBOs (1980s), Japanese country club memberships² (late 1980s) and, of course, our own “irresistible” tech and dotcom stocks (late 1990s). Bubbles may inflate to substantial size, and last for quite some time, before bursting.

In thinking about “bubbles,” I have identified several characteristics that most of them seem to share, including: Huge price spikes, crazy valuations (sometimes assets are priced on the basis of no intrinsic value at all), bizarre investment return expectations (“why shouldn’t everyone become rich by owning...[fill in the blank]?”), arrogance (and its cousin, hubris), irrationally exuberant behavior of the sell-siders (who become cheerleaders rather than analysts), “New Paradigms,” tremendous IPO activity as a way of assuaging the thirst of “investors,” and the ubiquity of heavy-breathing participants. Based upon these criteria, I have created a matrix (don’t you love that word?) to enable us to compare three asset classes, one whose bubble has previously popped (Tech and Dotcom stocks over five years ago), and two others that have been accused of rising to bubblehood: condos and commercial real estate/REITs. Included within the matrix is my assessment of the temperature level for each criteria of each of these asset classes.

Caveat: I believe there is no critical “bright line” which, when passed, converts a merely frothy investment trend into bubblehood. Furthermore, although the indicia of a true bubble are not hard to discern, the intensity of each component part may vary widely. Also, not all bubbles look alike, nor are all equally

² At the peak, the total market value of golf club memberships in Japan was about \$200 billion; see <http://www2.sjsu.edu/faculty/watkins/bubble.htm>.

dangerous to the participants (or to innocent bystanders). Some are no more evil than soap bubbles, while others are as ominous as aneurisms.

Bubble Characteristic	Techs and DotComs	Condos/Rental Housing	Comm'l RE and REITs
Price Spikes	From 12/96 to 3/00: NASDAQ soars 385%	40-50% price appreciation in each of the last several years in many markets	Cap rates fall from 9% to 6%; REITs up 37% and 32%, respectively, in '03 and '04
Crazy Valuations	50 largest S&P stocks traded at average P/E of 75x; dotcoms traded at 500x revenues	Owners lack positive cash flows; pricing at up to 150% of replacement cost	6% cap rates, 7-8% IRRs; REITs yield 4.5%, with 4-5% AFFO growth potential
Bizzaro Return Expectations	Frenzied; 20-30% return expectations; must own!	Levered returns up to 100% within 12 months	Expect 8-10% total returns; RE viewed as a sound long-term investment
Arrogance	Non-believers are old men who just don't get it; adulation for dotcom millionaires	Cocky and over-confident, lots of condo cocktail chatter	Low arrogance level; worry about valuation and things that may go wrong
Irrationally Exuberant Sell-siders	Wildly bullish and exuberant; cheerleaders for IPOs; "rock-star" status	Some real estate brokers stoke greed, encourage buying for investment	Mildly bearish to mildly bullish; most expected -5% to +5% for 2005
The "New Paradigm" Syndrome	"Net income? We don't need no stinkin' net income." Repeat after me: MindShare is key	Ride the New Wave of boomers' quest for urban "live, work, walk" lifestyles	"We'll never see 9% cap rates again" – but even bulls expect cap rates to rise with a spike in interest rates
IPO Activity	Inundated with new IPOs, most of them toxic waste	Developers and converters adding tons of new product	Nil; one recent deal was terminated due to – gasp! – valuation issues
Ubiquity (and Nature of the Heavy Breathers)	Across the US: from tack-room jockeys to doddering grannies	Speculators on both Coasts, but enthusiasm migrating to Middle America	Still primarily ageing boomers and pension funds; only 10% allocations to REITs and R.E.

What, if anything, can we conclude from the foregoing chart? We know that if the term “bubble” means anything, the techs and dotcoms of the late 1990s were in bubble mode, and investors were cut with shards when the inflated globe burst. As for the Condo Craze, I suspect that we are very close to, or perhaps within, a mini-bubble in certain markets. In these locations speculators and flippers hold forth, aggressively buying units with the certain knowledge that “real estate can only go up.” How about REITs and commercial real estate? Not even close.

Finally, to close out this issue of The Essential REIT, here are, for your amusement, two discussions from REITWEEKs past, written during an extraordinary period in US investment history. Remember the words of George Santayana: “Those who cannot remember the past are condemned to repeat it.”

From the February 11, 2000 issue of “REITWEEK:”

<<This is the looniest market I've seen since I first began my journey into the wilds of stock market investing back in 1967. We saw the glimmerings of true craziness last year, when the typical stock was just marking time while the techs and the Internets were delivering incredible returns; the NASDAQ finished last year up 86%, while the typical public company failed to deliver anything but yawns. And the Qualcomms and other assorted rocket ships zoomed to heights that can be justified only on the basis of the Greater Fool Theory.

But, as they used to say in show business, "you ain't seen nuthin' yet." From the beginning of the year through yesterday, the NASDAQ was up another 10.2% (before falling back 2% today), while everything else was sinking into the mud. How long can this Unreal Market persist? No one, of course, can say; maybe it'll persist for as long as Republicans continue to shoot themselves in the foot. [*Editor's note: It didn't – and they didn't.*] Can a market simply fall of its own weight? Here are the things that cause me to lose sleep at night:

a. Trading Volume. Nine of the 10 largest trading days in the history of NASDAQ have occurred this year, while the average order size has fallen from 909 shares a year ago to 697 shares today. This is a sign of a frenzied increase in small orders.

b. Narrowness. The rich are getting richer beyond the dreams of avarice, while everyone else is hemorrhaging. The 50 largest stocks in the S&P500 are trading at an average p/e ratio of 75x, while the average p/e ratio for the 1,800 stocks tracked by Value Line is just 14.5x. Yes, the perceived growth rates for the darlings are much higher, but can they continue to rise when selling at multiples that are 3x and 4x their growth rates? And when they no longer go up, will the Momentum Boys (which today is just about everyone) begin to dump them en masse?

c. Margin Buying. Back in August of 1999, an Associate Press article noted that <<As a percentage of Gross Domestic Product, margin debt has reached its highest level in 63 years. While the percentage, 1.8% in March (of '99) might seem small, a normal rate would be nearer 0.4 percent.>> And, of course, the amount of margin debt has risen dramatically since then, enough to worry our pal Alan Greenspan. It is reaching the levels which prevailed just prior to the 1997 market crash.

d. Arrogance. Garage mechanics and horse groomers are day-trading stocks on the 'Net. Grandmothers shun REITs and other conservative investments and are loading up on Qualcomm and Cisco. The most speculative stocks are being bought without regard to valuations, and investors of all stripes are heedless of risk. The cardinal sin is to be without tech and 'Net stocks, while our neighbors are chortling and quite proud of themselves for having the foresight to own 'em. The arrogance of investors is near peak levels.

e. "Whisper Numbers." This phenomenon is merely a symptom of the lofty expectations to which shareholders have become hostage. Not only are companies "supposed" to make their numbers, but they must do better; otherwise, "investors" merely move on to those companies which have exceeded them. They routinely expect to generate 20% returns in the marketplace, and woe to the fund manager who cannot deliver such "normal" returns.

f. Ute Stocks. Many electric utility stocks have skyrocketed on the basis of their getting into such gee-whiz businesses as fuel cells and Internet-based services. From a low of \$14.62 on April 1999, Avista (formerly Washington Water & Power) rose to \$68 by January 24 on news that Bill Gates took a 5% stake in the company (and was up 44% in just one day, January 21).

g. Biotech Frenzy. Check out the price action of many biotech stocks, most of which have no earnings. I've not the space to detail them all, but Fidelity's Biotech mutual fund was up 33.7%, year to date through yesterday, only a month and a week into the new year.

h. Price Targets. Do analysts change their recommendations from "buy" to "hold" when their favorite tech or 'Net stock reaches its price target? Not a chance. They just double the price target. Is this the sign of a healthy market?

i. IPOs. This is a point that needs no explanation. Stocks double and triple from their IPO price on the very first trading day, while "investors" place market orders for shares they cannot get at the IPO price. And some of 'em still make money.

j. Data from AMG shows that technology mutual funds issued \$5.575 billion of new shares during the past two weeks alone; according to DLJ Research, "this momentum is about the strongest it has ever been." Meanwhile, mutual fund investors continue to shun all other sectors, and funds continue to flow out of all Equity Income funds, including REIT funds.

k. Clients are leaving asset management firms who have the audacity to suggest that the client diversify his/her investments. They only have eyes for tech, and are outraged if total returns from all investments average "only" 10-11%. These clients feel they can do much better on their own, "having studied the stock markets for the past four months."

Not a pretty picture. But what do I know? I'm just a dumb Reitster.>>

And from the December 10, 1999 issue of "REITWEEK:"

<<You remember that song made famous by the movie "Butch Cassidy and the Sundance Kid," with Paul Newman and Robert Redford? It was called "Raindrops Keep Fallin' on My Head," and it sure sums up our world these days. We broke to new 1999 lows this week, and Barry Vinocur reminds us that we've also fallen below the prior bear market low seen in October of 1998 (273.03 on the RMS). We got our butts kicked again this week, as the RMS fell 2.6% and managed to score nary a gain during any trading session. Our negative total return for '99 is now 10.2%; the lethal combination of tax loss selling, UIT liquidation and growth investing is killing us. We've now seen red ink in 20 of the last 26 trading days, during which the RMS has shed 6.1%. As of yesterday's close, the dividend yield for the average equity REIT (per NAREIT) is now 9.0%.

This is one of those rare (but recurring) investment climates in which no one wants to own anything but the rocket ships. Did you check out VA Linux System's IPO yesterday? They brought it at \$30, and the first trade was at \$299, closing at \$239, a record one-day gain of just shy of 700%, amidst an orgiastic feeding frenzy for Linux-based software companies. Observes Dan Kusnetzky, program director at International Data Corp., "This is buying into a dream, and when people wake up, the dream might not be there." Then there's Akami, which reported revenues of \$1.3M for the nine months ending September and has a market cap of around \$20 billion. That's, well, only 15,000 times sales. Profits? Are you kidding?

REIT stocks aren't the only victims of the "what's working" crowd. We can start, of course, with the electric utes. Income investors are getting some nasty shocks this year; the Dow and S&P Utility indices were down 12.1% and 15.2%, respectively, from January 1 through yesterday. Value stocks continue to be wallflowers at the party. Heck, even Intel is being trashed as a has-been; the stock lost 8.2% this week despite investors' torrid love affair with Techs and Internets. I guess INTC's relationship with the 'Net is just too tangential for the go-go boys.

All this can be illustrated nicely by the saga of Reckson and its little child, Reckson Services (RSI). As you may recall, RA spun off this little guy in early 1998, to engage in various "real estate-related" services, and the stock traded sporadically in the pink sheets for a while at \$3-4. A number of months later, RSI decided it wanted to be an Internet company and went out and made some deals and hired some people. Now, almost two years later, RSI has \$136M in assets and a loss of \$1.18M. Ah, but it has a great Internet story! It's equity market cap? \$1.42 billion. And it's parent, Reckson, which owns almost \$3 billion of quality real estate, has an equity market cap of just \$1.2 billion. The son has become bigger than the father, but still hasn't yet even learned to walk.

But perhaps our problems are highlighted even more trenchantly by the plight of Kimco Realty. KIM, as you all know, is one of the most widely respected REITs in our universe, led by "Uncle Milt" Cooper, who has consistently underpromised and over-performed. On Tuesday, KIM announced a 10% increase in the cash dividend, followed two days later by its announcement that it had successfully won the bidding to assign certain leases held by Hechinger's, a bankrupt retailer, to other retailers who could benefit from Hechinger's locations. This was a deal that Mr. C had been working on for some time, and is characteristic of his company's ability to add value via the quirky (and highly profitable) transaction. The deal could add somewhere between \$.05 and \$.10 to FFO in 2000.

So what was the effect of these announcements? KIM stock fell 1/2 on the day of the dividend increase, another 5/8 one day later and, though rising a bit on Thursday, was nailed for another 7/16 loss on Friday. For the week, the stock was off 15/16. On a similar note, Kilroy finally announced its long-awaited stock buyback program, in which will buy up to 11% of its outstanding shares. The market was so impressed that it pushed the stock up a whopping 1/8 on the day of the announcement. What the hell does a REIT have to do to get anyone interested in buying its shares?>>

Return to September 2005...there is nothing like the passage of time to provide perspective. Unfortunately, investing is a forward-looking endeavor, and lessons learned with hindsight can be expensive lessons indeed. The trick, of course, is to distinguish between (a) a secular (and rational) revision in relative asset valuations that draws new adherents for all the right reasons, from (b) a massive wave of investor enthusiasm, based more on emotion than fact, and which drives prices to unsustainable levels. The tools we must use for this difficult task consist primarily of experience and judgment. If it were otherwise, our M.I.T. graduates would soon collectively own all of the world's assets.

Your humble servant,
Ralph (Block)

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