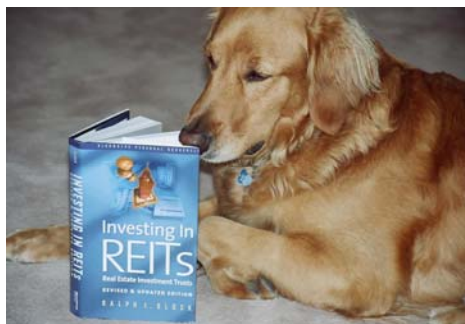


# "The Essential REIT"

May 10, 2006



*"The best way to become acquainted with a subject is to write a book about it." – Benjamin Disraeli*

*"An author is a fool who, not content with boring those he lives with, insists on boring future generations."  
– Charles de Montesquieu*

*"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. Of Bull Markets and Geniuses.

One of my favorite investment truisms is, "Don't confuse genius with a bull market." This pithy phrase reminds us that, even for relatively lengthy periods, making money on our investments owes more to market forces than to our brilliant investment acumen. A related lesson, of course, is that, when it comes to the whacky world of investing, we should always be as humble as economists should be when telling us where interest rates will be in six months. As W.E.B. has noted, while in the long run the market may resemble a weighing machine, in the short run it's a voting machine.

For the five years ending March 31, equity REITs provided us happy REIT investors with an average annual total return of 22.3% (per NAREIT indices), while private owners of commercial real estate probably did nearly as well; both sets of real estate investors benefited mightily by the increasing popularity of real estate as an asset class and the resultant inflows of capital into our favorite investments. Meanwhile, commercial real estate space markets haven't been nearly as fortunate (except in the retail sector), as same-store net operating income has turned positive only recently. So, although our ownership of commercial real estate has made us look even smarter than the guy who invented Post-It notes, we owe more to bull markets than to our stock- or property-picking skills. Thus rather than preening in front of the mirror like well-fed peacocks, we ought to be saying a few prayers to the Market Gods.

A key question for us real estate investors is whether these gods will continue to look upon real estate with a smiling and benign countenance. And the answer to this question depends, of course, upon a number of factors, one of which is now more significant than ever. I refer to commercial real estate's place in the pecking order of preferred investments.

During the past several years, due to greater liquidity, transparency and information availability, as well as a rediscovered interest in broader portfolio diversification, commercial real estate has taken its rightful

place as a valued asset class. Both individuals and institutions are now able to allocate investment assets to commercial real estate quickly and easily, and they will do so – or NOT – in large part on the basis of its relative attractiveness vs. other asset classes. And its value at any time will be much more dependent upon shifting capital flows than ever before. No longer will real estate cap rates always remain at 9%.

If I am right in this belief, real estate’s performance (including the performance of REIT shares) will be increasingly dependent upon the prospective returns, adjusted for risk, of every other asset class. But how can we determine this? Well, not easily. You can’t pick up your Wall Street Journal each day and find the following table:

DATE	Expected Returns on Stocks	Expected Returns on Bonds	Expected Returns on Real Estate	Expected Returns on Gold
Yesterday	8.2%	5.5%	7.5%	37.2%
Last Week	7.8%	5.1%	7.3%	31.9%

It would be easier to determine which of his Nylabones Sammy will chew on next. And yet, as this bizarro newsletter is devoted to provoking thought, rather than providing Answers, I will devote the balance of this issue to some thoughts on the subject – for what they may be worth. So, how *should* investors look at stocks, bonds and commercial real estate today, and what kinds of returns “should” we realistically expect?

To torture a phrase from Soren Kierkegaard, all investing is a Leap of Faith. As we cannot know, without looking at next year’s newspaper, what our return on any particular investment will amount to, we must have faith that our projections – for the economy, for interest rates, for profit margins, for market valuations, and for a whole host of unknowns – will be somewhat accurate. Regardless of the intricacies of net present value calculations and discounted cash flow growth models, the bottom line is that an investment’s return will be based upon a combination of the net cash income derived from it (and when), the differential between its cost and the proceeds derived from its sale, and the length of the holding period. If this is so, we must, of necessity, make projections not only of current income, but also the market value when we seek to sell, *e.g.*, those real estate owners boasting unlevered IRRs of 18% on their investments didn’t get there due to phenomenal increases in operating income – their exit cap rates were much lower than their entry caps.

**a. Bonds: What You See is What You Get (Almost).**

For bonds, the math isn’t terribly difficult. I’m no bond expert – bonds, for me, are as alluring as a traffic jam on the San Diego Freeway – but it seems to me that we can look primarily at the expected income during our holding period, the value at maturity date, default risk, and prospective market value should we desire to sell prior to maturity. As I write, the U.S. 10-year T-note, with near-zero risk of default, yields just over 5%, and so one’s nominal return, if held to maturity, will amount to 5%. (Obviously, if sold prior to maturity, the investment return will be somewhat higher or lower). Corporate bonds of the same maturity, as well as the myriad forms of credits available today through the machinations of derivative-crazed rocket scientists at the investment banks, will provide a somewhat higher return, allowing for default (and even early payment) risk. So, with bonds, what you see is pretty much what you get.

**b. Commercial Real Estate: The Residual Value Conundrum.**

What about real estate or, its securitized cousin, REIT stocks? Here, our task is significantly more difficult. Of course, we can project current cash flows, after required capital expenditures necessary to keep the property competitive, and REIT dividends (and/or REIT cash flows after making appropriate capital expenditures). But then we also must look not only at the anticipated increases (or even decreases) in current cash flows, from changes in rents, occupancy rates and other variables, but also at the expected value of the property (or the REIT stock) when we decide to sell. What will be our “exit cap rate?” At what multiple of free cash flow or what premium to NAV will a REIT stock trade when it’s time to sell and use the proceeds for some other design, intelligent or otherwise?

We do, of course, make these projections – with a judicious Leap of Faith – but we are still just guessing. And yet, we can use certain guidelines that, based upon years of history and current market data, may not be too wide of the mark. SL Green’s CEO, Marc Holliday, recently explained, in SLG’s Q1 conference call, that those who are today buying quality mid-town Manhattan office properties at 4.5% cap rates can garner unlevered investment yields of something like 7.5% if they are accurate in their “leaps of faith” that midtown Manhattan office rents will rise 25-30% over the next 3-4 years and can sell these properties at 5% exit cap rates. Of course, less stable and predictable commercial real estate assets, *e.g.*, hotels, are priced to provide somewhat higher investment returns.

Any smart quant jock, armed with weapons of mass destruction, *i.e.*, a spreadsheet and market surveys, can probably come somewhat close to determining an investment return from a stable commercial real estate asset, absent a major change in cap rates at the end of the holding period. While determining an exit cap rate may involve a fair amount of crystal ball gazing (and a leap of faith regarding interest rates and economic conditions), we should expect rent growth, over several years, to rise somewhat close to that of inflation, and that net operating income will perform in a similar manner. Thus the unlevered IRR on a quality real estate asset bought today will probably fall within a fairly narrow band of 6.5-8% (the average REIT may deliver slightly more, due principally to debt leverage).

Is this type of return sufficient to make “real estate” competitive with bonds, given today’s interest rates? Pretty much. A key element, of course, is one’s tolerance for risk, and what an “appropriate” risk premium ought to be. Based upon today’s US economy (and its prospects), and where we are in the real estate cycle for most property types, requiring an unlevered risk premium of 225 basis points over the 10-year, or 7.3% today, while low by historical standards, wouldn’t constitute irrational exuberance. This would make real estate and REIT stocks competitive with bonds, but not particularly cheap – or expensive – on a relative basis.

### **c. Stocks: The REAL Leap of Faith.**

But now it gets more interesting – much more interesting. How can we assess prospective investment returns in the wide and wild world of equities? Just what kinds of returns will equities deliver? And how competitive are these prospective returns with those of commercial real estate (direct or securitized)? Now we are truly in a thicket, perhaps almost as dangerous and confusing (albeit without the loss of life) as the battle of The Wilderness exactly 142 years ago.<sup>1</sup> I don’t pretend to have the answers to these questions, but perhaps some speculation might be worthwhile.

Let’s begin with a key assumption: One’s returns for any investment held over a reasonable time period will depend, in large part, upon its valuation at the time of purchase. Those who bought a quality REIT such as Weingarten at a 53% NAV premium at the end of 1997 didn’t do as well as those who bought the same stock at the end of 1999 at a 5% NAV premium. This is self-evident, but often ignored.

Accordingly, those who project stock returns on the basis of “historical returns” for stocks being 10%, or “7% real” (after inflation), are ignoring the fact that equities are now somewhat more richly priced than was the case at the starting points of these broad compilations.<sup>2</sup> According to an oft-cited study by Yale economist Robert Shiller, the average trailing 12-months PE ratio for stocks, going back 104 years, is 15.9x.<sup>3</sup> Today the trailing PE ratio on the S&P 500 index, based on reported earnings for the past four quarters, is 19x.

One interesting issue is whether that 19x PE is a bit misleading, as it is significantly influenced by unusually low PE ratios of oil and gas stocks, *e.g.*, Chevron’s trailing 12 months PE is 9.3x. Another is,

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<sup>1</sup> For those of you who are interested in this Civil War battle, see <http://www.civilwarhome.com/wilderness.htm>

<sup>2</sup> Like debating the number of angels that can dance on the heads of pins, we can argue forever whether investment conditions today merit higher, or lower, PE ratios than we’ve seen historically; yes, there is certainly greater liquidity in equities today, but competition among businesses is much more fierce.

<sup>3</sup> See, for example, [http://www.macrovostor.com/Stock\\_Market\\_PE](http://www.macrovostor.com/Stock_Market_PE).

what will be the “cap rate” on equities at the time we want to sell? PE ratios for stocks bounce around more than the backyard bunnies that Sammy likes to chase (but never catches), and can as easily sell at 12x earnings as 24x, as many hapless investors have learned over the years. Real estate cap rates may be a bit more uncertain today, but they can’t hold a candle to equities’ cap rates when it comes to volatility.

Yet another is whether reported earnings under GAAP are as meaningful for investors as free cash flow; what if 80% of a company’s GAAP “net income” must be reinvested in the business each year in order to merely remain competitive and generate the same net income in the following year? Microsoft recently announced that, in addition to doubling R&D spending on its MSN network, to \$1.1 billion, it would also goose capital spending to \$500 million in fiscal ’07, up 500% vs. fiscal ’05.<sup>4</sup> For some companies, there will always be jam tomorrow but never jam today. *Hint:* Mr. Buffett has been particularly focused on companies that generate substantial free cash flows.

A related problem is the “reality” of reported earnings. Sure, we Reitsters have our issues with GAAP, but so do other equities investors. Rob Arnott, the well-known Editor of the Financial Analysts Journal, claims that if pension obligations are accounted for properly and if management options were fully expensed, 25% of the S&P’s reported earnings would disappear. Another equally-respected market observer, Jeremy Siegel, thinks that Arnott is vastly overstating the point for most companies<sup>5</sup> but the issue isn’t insignificant in the context of stock valuations.

**Digression: Dividend Payout Rates.** Just why do companies pay such meager dividends? Nordstrom’s pays out just 19% of its expected 2007 earnings of \$2.25, while CVS, the large drug chain, is even more niggardly, paying out just 10%. Tech stocks? Fuggediboudit. Even a growth-challenged company such as Phelps Dodge pays out less than 10% of its earnings. The official reason, of course, is that it is inefficient to pay out dividends, as doing so taxes income twice; furthermore, wise management teams can reinvest retained earnings at a higher return than can the shareholder, particularly after the latter pay taxes on their dividends.

But, dividends are now taxed at just 15%, if they are taxed at all (pension funds and IRAs, of course, pay no taxes on received dividends). Also, it is certainly open to question whether companies can reinvest at better returns than their shareholders. Messrs. Siegel, Arnott and Lynch suggest that the track record of the corporate world leaves much to be desired in this regard. Perhaps the cynic might not be too far off the mark when suggesting that miserly payout ratios allow management teams to enlarge empires and their resulting compensation packages.

The bottom line, for me and others (perhaps including Professor Siegel<sup>6</sup>), is that today’s corporations ought to be paying out a much larger share of their net income to shareholders; doing so would likely generate better total returns over any reasonable period of time. REITs, of course, must pay out to shareholders at least 90% of their pre-tax net income, which is a little-discussed but important benefit of REIT investing.

Of course there is as much debate about the “reasonableness” of current PE ratios as there is about what course to take in Iraq, how to handle illegal immigration or what to do with Tom Cruise. Perhaps one interesting data point on this topic is what I will refer to as the “Lynch Premise;” legendary investor Peter Lynch has long advocated buying stocks with growth rates at 2x the current PE ratio. But as the average stock today trades at 19x earnings, how many can we find that can grow earnings at 38% annually? The basic point, however, is that one’s prospective equity returns will depend in very large part upon the reasonableness of the price paid (for any stock or index fund). And, given the average stingy dividend

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<sup>4</sup> See “Heard on the Street,” WSJ, May 10, 2006, p. C-1, in which the reporter questions whether tech firms are spending too much just to stay ahead of the competition.

[http://online.wsj.com/article/SB114722545130148499.html?mod=todays\\_us\\_money\\_and\\_investing](http://online.wsj.com/article/SB114722545130148499.html?mod=todays_us_money_and_investing)

<sup>5</sup> See “The Future for Investors,” Crown Business (2005), pp. 156-157.

<sup>6</sup> Professor Siegel is a big fan of dividends. And he notes that, “From 1871 through 1980, the average dividend yield was 5%, or 76% of the annual real return on stocks over that period.” Economist Shiller’s data, from 1874 to 2004, shows an average dividend yield of 4.7%, or nearly half of nominal total returns.

yield today of just 1.8% (based on the S&P 500), there better be a pretty good rate of earnings growth if we are to generate acceptable investment returns.

OK, so how rapidly *do* earnings grow? Apparently, not very. Mark Hulbert's recent article, written for MarketWatch, dated April 11, 2006, is very interesting – and perhaps would be disturbing to equity investors.<sup>7</sup> It refers to Professor Shiller's data showing that “earnings per share on the S&P 500 grew at a rate of 3.8% annualized between 1874 and 2004; in inflation-adjusted terms, the growth rate was 1.7% annualized.” For a visual picture, see the following chart:

[http://aida.econ.yale.edu/%7Eshiller/data/ie\\_data.xls](http://aida.econ.yale.edu/%7Eshiller/data/ie_data.xls) Of course, many will object, claiming that as companies today are retaining a higher percentage of their earnings and reinvesting them, long-term growth rates will be higher than they've been historically. Whether they are right – or whether a large portion of retained earnings are simply invested in projects that “seemed like a good idea at the time” – is an open question.

Let's put aside earnings growth for the moment, and look simply at historical returns on stocks. Professor Siegel says that for the 122 years “from 1871 to 2003, 97% of the total after-inflation accumulation from stocks comes from reinvesting dividends. Only 3 % comes from capital gains.” So dividends have been extremely important. He also says that the average annual after-inflation return on stocks has been 4.5%, without the reinvestment of dividends.<sup>8</sup> If we use a 2.5% rate of inflation, that might produce a 7% nominal return on stocks over the next several years, assuming future returns are in line with those of the past. This view is echoed, incidentally, by John P. Hussman, PhD, who I would guess is the founder of the Hussman Funds. In a thoughtful May 2005 article,<sup>9</sup> he claims that, “... *provided* the S&P 500 P/E stays at an elevated multiple of about 20x into the *indefinite* future, stocks might reasonably produce annual total returns somewhere between 7-8% from here” (italics his, not mine).

But even that modest return may not be a reasonable expectation. The estimable Mr. Hussman also goes on to note: “More likely, assume that S&P 500 earnings continue to grow at the long-term 6% peak-to-peak rate that has contained earnings for the past century, and that the price/peak earnings ratio reverts to a still above-average level of 16 about 5 years from today (the typical bear market low has historically taken the multiple closer to 11, while durable troughs such as 1974 and 1982 reached as low as 7). In that event, given a current 1.8% dividend yield, we can estimate that the average annual return on the S&P 500 over the coming 5 years will be  $[(1.06)(16/20)^{1/5} + .018(20/16+1)/2 - 1] = 3.4\%$ .”

Now we are really confused (and not only by Dr. Hussman's arcane algebraic formula). Will we get returns on stocks at the historical rate of 10%, or the 7-8% which Dr. Hussman thinks is doable if the current PE ratio holds? Or will we get returns of only 3.4%, if the PE ratio reverts to the long-term mean of 16x? Do today's PE ratios assume that current peak profit margins will continue forever?

Yet another commentator, Steven Johnson, of SimCivic.org, acknowledges that stocks have delivered an average annual return of 7%, after inflation, from 1925 to 1995. However, he then pulls an Arnott-Siegel, noting that capital appreciation has accounted for only one-third of that long-term 7% real average annual return (with the balance coming from reinvested dividends).<sup>10</sup> Mr. Johnson concludes, after a lengthy discussion about productivity gains, GDP growth and such, that, in the future, returns on stocks are likely to be a combination of 2.5% dividend yield and only 1.6% capital appreciation. This fellow, like Rob Arnott, is probably too pessimistic, but his article is an interesting read.

So perhaps the crucial questions for us investors are: (a) will historical long-term earnings growth rates be goosed by a higher level of retained earnings, thus bringing earnings growth rates above the traditional 3.8% level and, if so, to where? 4.5%? 6%?; and (b) where will PE ratios (stocks' version of cap rates) sit

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<http://www.marketwatch.com/News/Story/8kcdFFrMdjF2qXDNJf15SQf?siteid=mktw&dist=TNMostMail>  
[ed](#)

<sup>8</sup> “The Future for Investors,” pp. 126-127.

<sup>9</sup> <http://www.hussmanfunds.com/wmc/wmc050516.htm>

<sup>10</sup> See <http://www.sscommonsense.org/page04.html>

at the end of, say, five years? As you can see, dear reader, I have spent more hours on these questions than I care to think about, and I am still very much baffled. Some of my conclusions to follow are intuitive (perhaps a bad word in today's spreadsheet-crazed environment), but I believe the following:

Not *all* retained earnings are p\*\*\*ed away, and some will enhance long-term growth rates in Corporate America. But, it would be inappropriately aggressive (not to say irrationally exuberant) to assume that average annual earnings growth will exceed 6% throughout an entire economic cycle (vs. 3.8% historical and approximately 5% since 1980). Adding another 1.8% in dividend yield brings us to 7.8% nominal returns, *i.e.*, before giving effect to inflation. PE ratios today aren't so far out of whack vs. the long-term averages so as to require that we build in shrinkage (or an "exit cap rate" increase). So, 7.5% sounds about right for stocks as an average total return over the next five years, give or take 3% on each side.

**Conclusions.** All right, I bet you forgot what this issue of The Essential REIT was all about (I nearly did). We have prospective returns on cash of 4%, and on bonds of 5-7% (depending upon quality and maturity). We have prospective returns on equities of somewhere around 7.5%. And we have returns on quality commercial real estate at about 7-8%, with REIT returns likely to be a tad higher through their use of debt leverage and what I like to think of as high-quality management. Risks? My assessment is low for bonds, modest for real estate, and moderate to high for stocks.

If these musings are accurate, or even partially so, then no single asset class is wildly overpriced or underpriced; the "efficient market" advocates should feel pretty good right now. We aren't apt to hear any giant sucking sound of the type that H. Ross Perot made famous some years ago, signifying a massive shift out of commercial real estate and into stocks (or, for that matter, bonds). I do feel, however, that bonds, given today's higher interest rates, are providing a bit more competition for commercial real estate, and this may be reflected at the present time by REIT stocks' valuations at somewhat below their historical average NAV premiums (Green Street has recently calculated that the average REIT in their universe trades at parity with its estimated NAV, as compared with a 6.8% average NAV *premium* going back to 1993).

So there are no free lunches available today, and – except for the hedgies and traders whose long-term time horizons encompass no more than 30 minutes – not much reason for capital to flow rapidly from one asset class to another. Commercial real estate is unlikely to continue to kick butt and take names relative to stocks and bonds like it has for the past five years, but isn't apt to embarrass us either. There will be less excitement in Reitland – but excitement, at least in the investment world, has always been over-rated.

Your humble servant,  
Ralph (Block)

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