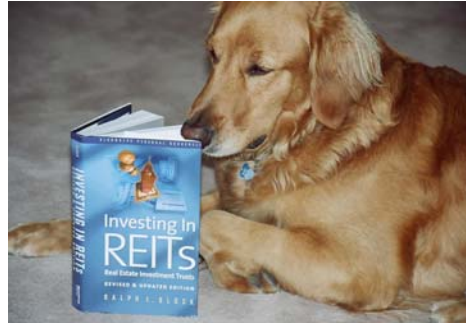


“The Essential REIT”

September 5, 2006



“Be who you are and say what you feel, because those who mind don't matter and those who matter don't mind.” – Dr. Seuss

“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. “Macro, Macro, On the Wall...”

Who's the fairest stock of all?” And which is the very best asset class? Silly question, of course. But let's not lose sight of the importance of assessing macroeconomic issues when positioning investment portfolios. First, take a step back in time. Until fairly recently, real estate cap rates never changed, and those who could get markets, occupancy rates, rent trends and NOI growth reasonably right were automatic winners. But today it's different (yes, it really is). Commercial real estate and REIT stocks are, more than ever, a significant part of the world's investment tapestry.

Due to the increasing velocity in the flow of global capital, cap rates (and REITs' inverse version, P/AFFO multiples) will change quickly in response to “big picture” changes in interest rates, economic and employment growth, inflation, perceived geopolitical and related risks, and other issues of interest to those allocating capital. Obtaining reasonably good investment results requires, at the least, wearing the right clothes to the party. Or, to put it another way, being out of touch with the forces that drive capital allocations towards the best risk-adjusted returns will result in worse than a poor night's sleep or a bad hair day.

“But, wait, Reitnut” you may say, “The Fed, until the most recent meeting, has goosed interest rates 17 straight times. Surely that should have kicked up cap rates if your claim is correct.” It is true that cap rates generally haven't changed in response to significantly higher short-term rates (although there has been modest fallout in some property types and locations). However, other assumptions determining the current value of commercial real estate really haven't changed much at all, *e.g.*, employment growth, new space supply, long-term interest rates, economic growth, and even inflation assumptions. When these assumptions do change, however, the prices of commercial real estate will be very much affected.

Thus getting the Big Picture right has enabled smart investment advisors to keep their clients in REIT stocks down through the present date despite all the braying and nay-saying from the reversion-to-the-meaners who have boldly proclaimed the “overvaluation” of REIT stocks. But, of course, clients want to know what we’ve done for them lately, and others merely want to catch the very top of every market. So where are we now? What’s the current macro picture, and how will it affect REIT stocks (and the pricing of commercial real estate)?

Well, since I am often justly accused of chasing unicorns, I will merely update my prior discussions on this topic with my current views (for the little they may be worth). Over the past few weeks we have seen signs of a pretty clear slowing of the U.S. economy. Inflationary pressures are abating, both here and overseas. Bond markets are stronger, while all-important retail sales growth is certainly moderating (the S&P Retail index – RLX – has underperformed the broader equities market for the past year).

We have seen the highs in short-term interest rates for the current cycle, and the Fed’s refusal to goose rates yet another time, at their last meeting, now looks ingenious – or lucky. But, of course, it’s better to be lucky than smart. The yield on the 10-year has declined 50 basis points, from 5 ¼% in early July to 4 ¾% at the end of August. That’s a big rate decline in a short time, and those who ignore it are several seeds short of a watermelon. Employment growth is moderating (albeit still at reasonably healthy levels¹), *real* chain-store retail sales are barely up year over year, commodity prices look toppy, and even capital expenditure numbers are coming in a tad light. Meanwhile, there are clear signs that foreign economies are slowing as well.

We are thus pretty clearly in what ISI Group refers to as a “mid-cycle slowdown,” a refreshing pause in any normal economic expansion. But might we slow so much that we fall backwards into recession? As noted in the last Essential REIT, probably not. However, the joker in the deck is the housing market. Homebuilders surveys and confidence levels are plunging to levels not experienced during the past decade, and the inventory of unsold homes is rising faster than the liberals’ ire over President Bush. So the key to bragging rights among economists lies in foretelling the extent of the home market decline, and what this will do to consumer spending in the months ahead. We certainly know that it’ll impact spending – *but by how much?*

Robert Shiller and Karl Case, pretty good economists in their own right, have noted in a recent Wall Street Journal article² that the S&P/Case-Shiller Home Price index (tracked on the Chicago Mercantile Exchange) suggests a 5% year over year decline in home prices by May of next year. They note that home buying has been stoked by a number of factors that have since weakened, and that the psychology of grandiose expectations for price appreciation has been dashed. Yet the economy remains healthy (at least for now), job growth remains respectable (if not robust), and interest rates (on the long end of the curve) haven’t changed a whole lot.

But trolls still lurk under bridges. Loose lenders have been willing to shower mortgage money on anyone who is able to watch TV or drive a car, and have hatched a lot of weird-looking chickens, *e.g.*, option ARMs, “stated income” loans and such, which will come home to roost. When 3% teaser rates are repriced to market, the results will be uglier than a mutant naked mole rat.³ Meanwhile, many home speculators are now regretting their profligate ways. A 5% price decline, combined with a 5% selling commission, will vaporize a 10% down payment. Delinquency rates are likely to spike, while the keys to many recently-purchased homes will be mailed to lenders. Unfortunately, nobody is able to say with a good deal of confidence how this will affect the consumer-dependent US economy.

But, being the fool that I am, I will hazard a guess. GDP growth will slow, perhaps to as low as 2% or less, over the next 3-4 quarters, and interest rates will continue to moderate. The Fed will cut rates by early next year. The economy will become more fragile, and risk levels will increase for most investments. But, for the reasons noted in

¹ ISI Group notes that we have averaged a modest 117,000 new jobs over the past five months.

² Wall Street Journal, dated August 30, 2006, entitled “Full House.”

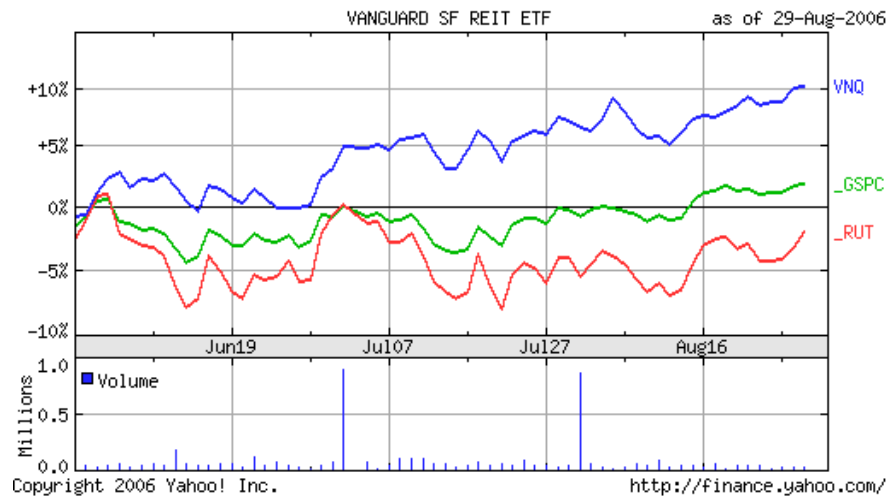
³ For those who care to see one, check out

<http://images.google.com/imgres?imgurl=http://www.bio.davidson.edu/people/vecase/Behavior/Spring2004/Iyons/Picture4.jpg&imgrefurl=http://www.bio.davidson.edu/people/vecase/Behavior/Spring2004/Iyons/Reproduction.html&h=398&w=288&sz=16&hl=en&start=5&tbnid=FZS0h2-WXQ6QiM:&tbnh=124&tbnw=90&prev=/images%3Fq%3Dnaked%2Bmole%2Bbrat%26svnum%3D10%26hl%3Den%26lr%3D>

the last issue of Essential REIT, owners of quality commercial real estate should fare pretty well in this environment. Let's quickly recap the virtues of a slow-growing economy for REIT investors:

- abatement of upward pressure on cap rates
- reductions in competing new developments, due to more difficulty pre-leasing new projects
- reduced costs of capital, due to lower interest rates and return expectations
- reduced competition from other asset classes, *e.g.*, bonds and even equities

The price action in REIT shares vs. the S&P500 and Russell 2000 indices over the past few months (see, for example, the chart below) and the NAREIT Equity and MSCI REIT indices hitting all-time highs last week would seem to confirm this assessment.



And yet, as Messrs. Shiller and Case note at the end of their recent article, “Listen hard and watch out.” So, while I remain cautiously optimistic for the balance of the year, in the housing markets, in particular, there be dragons that are capable of eating more than our lunches. Protective armor is useless in a bad recession.

2. “It’s a Small, Small (Yielding) World.”

It wouldn’t be fair to label me a Dividend Die-Hard; I do *not* choose the REITs in which I like to invest primarily on the basis of yield – indeed, some of my best REIT friends don’t yield much more than 2% these days. However, I admit to enjoy receiving significant current cash flows from my investments. Perhaps my interest in yield is due to my having been clawed badly in my formative investment years by the bear markets of 1968-1969 and 1973-1974, as well as a more skeptical view of the world as my hair continues to whiten.

According to the pundits of Academia, dividend yields are supposed to make no difference to rational investors, but to me they are important. Call me irrational. Today’s investment world, where time horizons are measured in nanoseconds and new and unexpected forms of competition lurk around every boardroom, has become as dangerous as a mistreated pit bull. It is tougher than ever to spot the long-term investment winners and to patiently hold onto them. Receiving a large portion of one’s expected annual total return in the form of current dividend payments, generated from persistent and predictable cash flows, would seem to remain a very desirable investment attribute – particularly these days.

The current yield on REIT stocks today is puny by past standards, and cap rates for commercial real estate are about as low as they’ve ever been. Nevertheless, even at today’s 4% average dividend yield, we can obtain half of our expected total returns by simply cashing our dividend checks (and a similar paradigm holds true with direct commercial real estate investment, if not more so). So it would be unseemly for us REIT investors to complain too

loudly. But investors don't live by real estate alone, and there is a much larger world of equities out there that beckons. The prudent man (or woman, or trustee) will own asset classes in addition to directly-owned or securitized real estate.

That being so, let's take a quick look at our non-REIT brethren in an effort to determine whether their dividend yields are reasonable in the context of today's world. Until the 1990s, S&P500 stocks yielded somewhere between 3% and 5%.⁴ Those yields, unfortunately, have gone the way of the Nehru jacket. The current yield on S&P500 stocks averages just 1.8%, and hasn't been above 2% since 1996. And the yields on smaller company stocks, such as those comprising the Russell 2000, are even skinnier. Accordingly, my first inclination, I will freely admit, was to launch a tirade upon the chieftains of Corporate America for adopting the practices of Scrooge McDuck, hoarding their cash in order to build empires and develop gee-whiz new products and services – but which, so often, amount to sound and fury, signifying nothing.

And, in fact, payout ratios have shrunk. From 1980 through 1994, S&P companies paid out approximately one-half of their income in dividends to shareholders, but the average payout ratio beginning in 2000 has ranged from 29% to 35%. And some companies are almost as stingy as Sammy when asked to share his Mother Hubbard biscuits with his boxer cousins. Are the opportunities for natural gas discovery so compelling that Anadarko and Apache can justify dividending out just 5 or 6% of their income? Valero Energy, a major refiner, will earn \$9 a share this year; why is its dividend just 32 cents? How does drugstore chain CVS look at itself in the mirror each morning while paying out only 10% of its annual net profits? (Most tech stocks, of course, can get away with paying nothing because their earnings have a bad habit of vaporizing).

I also thought that a primary culprit in the perpetuation of these miserly dividend yields was the current custom of stock buybacks, a practice in which a company uses retained earnings to purchase its outstanding (or not so outstanding) common stock, rather than boosting ol'-fashioned cash dividends. And there are significant issues that may be taken with buyback programs, including:

- The earnings per share increases generated by stock buybacks are often wiped out by lower trading multiples (and often doesn't happen anyway, as stock issued upon options exercises offsets the lower share count)
- Companies too often buy in their stock at absurdly high prices – a gambit that destroys shareholder value, *e.g.*, remember when Coca Cola was buying in their stock at 30x earnings?
- Shareholders cannot fulfill their income needs from uncertain stock buyback programs that are often never fully executed – sure, they can sell stock from time to time, but at what prices?
- Buybacks are rife with conflicts of interest, as stock option holders, *i.e.*, company management, normally receive no benefit from cash dividends
- The unpleasantness of cutting a dividend is apt to make management more focused and risk-averse with respect to company strategy and capital allocation; on the other hand, a buyback program can just be suspended when an aggressive strategy goes awry.

And yet, while walking Sammy on Saturday morning I began to realize that blaming short-sighted and empire-building executives and Board members for today's low yields is myopic.

Certainly, payout ratios are lower than they've been historically and lots of companies should be boosting their dividends significantly. And, stock buybacks are too frequently used (abused?) as a poor replacement for greater dividend payments. However, even if that guy with the magic lamp would grant my wishes for more liberal dividend policies, such happy event wouldn't make much of a difference. Look, for example, at Beckton Dickenson. BDX is a decent company, neither great nor lousy. It makes and sells a wide range of medical supplies and devices, laboratory equipment, and diagnostic products throughout the world. The stock sells at around \$70, and it's going to earn \$3.26 in its current fiscal year. Let's assume that its Board undergoes a religious catharsis and decides to significantly boost its current dividend, from \$.86 to \$1.63, or 50% of current income. At that dividend rate, however, the stock would still yield only 2.3%.

⁴ For a dividend yield history of the S&P500 index from 1960 through 2005, see http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/spearn.htm

It's important to note that Becton Dickenson's stock isn't trading at an outrageous PE multiple. At the current price, it trades at 21.5x earnings, pretty much in line with the broader market. Let's look at one more company, Intel. Intel has had its problems recently, but remains a very large and powerful company with lots of market clout. It's expected to earn \$.80 a share this year, and pays out a dividend of \$.40, or fully half of its earnings. So Intel is one of the Good Guys. Yet the stock, trading at 25x earnings (not an unusually large multiple for a tech company), yields just 2.0%.

The problem, it would seem, is the multiple at which stocks currently trade. The S&P500's average *earnings yield* (the inverse of the PE multiple) hasn't been above 6% (using end-of-year calculations) since 1990; it's pretty hard to reach a 3% dividend yield even with a 50% payout ratio under those conditions. Even if companies boost their dividends significantly, finding a quality stock yielding 4% and with reasonable capital appreciation prospects will be as difficult as teaching an alligator to play the fiddle. Sure, today we can find a few yielding 3%, but even the Dow Jones *Utility* index, for Chrissakes, yielded just 3.2% at the end of last month.

Here are a few other figures to ponder: At August 31, the PEs of the Dow Jones Industrials and the S&P500 were 22x and 17x, respectively (using trailing 12 months of earnings), and, significantly, the latter is heavily impacted by very low PE ratios for oil and gas companies. Utility stocks (per the DJ *Utility* index) are going for 19x, and the Russell 2000 is at 32x (as is the NASDAQ Composite). We cannot expect to extract large eggs from skinny chickens.

The bottom line is that today's equity valuations dictate that the average dividend yield is going to remain puny for some time to come. Investors who seek income beyond bonds, preferreds, REITs, royalty trusts, MLPs and other exotica are just going to have to live with yields beginning with a "1" or a "2" and must count on substantial price appreciation to arrive at their desired returns.

None of this, of course, is surprising to observers of today's investment scene. We live in a low-yielding world, and even those 5% yields on 2-year T-notes are evanescent. Wars and terrorism notwithstanding, our 21st century world is awash with capital, all of which is competing for good parking places. Foreign and domestic stock markets, commercial real estate worldwide, intermediate-grade corporate bonds, and even commodities are being priced at high levels by historical standards. And even government bond markets are offering unappealing fare. If you don't get excited about 4.75% on 10-year T-notes, you sure aren't going to like government bonds in Italy, France, Spain or Japan, where the yields are 4.1%, 3.8%, 3.9% and 1.5%, respectively, the dollar notwithstanding.

Those who scoff at today's low yields remind me of Sammy's habit of barking at the wind. My guess is that the modest uptick in inflation we've seen over the past few months will subside, and that global capitalism will continue to act as a deflationary force. Nevertheless, returns on our investments, whether real estate or equities, will continue to be respectable and in line with historical yardsticks,⁵ albeit, for REIT and commercial real estate owners, nothing like the serendipitous returns of the past six years. So we must accept current yields of 4% on our REITs and 2% on our conservative growth stocks, and stop whining. Unless and until we suffer a massive shutdown in the supply of global capital, that's the way it is.

Best regards,
Ralph (Block)

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⁵ In "The Trader" section of this week's Barron's, Michael Santoli notes that the total return on the S&P500 index for the past 10 years averaged 8.67% per year, pretty much in line with expectations. Returns from the Dow Jones and the Russell 3000 averaged 9.44% and 9.04%, respectively.