

White Paper January 2006

A REAL Real Estate Bubble

2006: Another bubble?

Is there a REAL, real estate bubble out there? Or is it merely a housing bubble? It's an important distinction because, while single-family homes are a big, boisterous factor in the public domain, investors in the *business* of real estate own properties that are very different from those of America's castle-barons.

Market valuation as a cycle

First, a simple statement of fact: *All capital asset classes....real estate, stocks, bonds, etc...should, and do deliver wealth-growth during periods of significantly falling interest rates.* The most serious mistake an investor can make during secular interest rate declines would be to hold capital on the sidelines. The high assurance of wealth-growth produced by falling interest rates is not very complex.

- Traders re-value the securities markets daily; one of their primary re-valuation tools is a change in the interest rate they use to arrive at the discounted value of the securities' forecasted income streams.
- The prospect of lower discount rates enhances the value of income-producing assets. Conversely, if rising rates are expected, the marketplace will whack away part of that value.
- When interest rates fall fairly steadily during a 20-year-long period (*a la* 1985 to 2005), the result is fairly predictable.* During that period, the S&P 500 Index had an annualized return of more than 13%, compared with its long-history compound return of about 10%. The variability (standard deviation) of those returns was also indicative of a 20-year bull market, compared to its more volatile history (15.5%, versus 18-20%).
- A sustained period of falling interest rates is almost certain to be a period of falling inflation rates, which further boosts the *real* return on invested assets.

Asset values as a metronome

We subscribe to a simple concept of natural asset pricing cycles which can be described as the Pendulum-Momentum Theory. In brief, visualize the market pricing of an asset class as the pendulum on a metronome, or a wind-up wall clock. All asset categories, like a moving pendulum, have a strong tendency to swing past their "fair value" point (the center)....often without regard to what is happening to the prices of other asset classes. Instead, an asset category will typically move through the center and into over- or under-valuation, until it reaches a reversing-point that is determined by how much momentum was in its swing. Most market cycle-swings do not have wide arcs; the peak-to-trough movements, and vice-versa are relatively mild. Occasionally however, driven by a significant *imbalance of supply and demand* that has wound its delicate spring too tightly, the pendulum keeps going in the same direction to an extreme turnaround point. When that happens, the next pendulum turnaround point is very likely to be a near mirror-image, as the supply and demand forces struggle to find equilibrium. Fortunately, there is a piece of metal at each edge of the arc...we'll call it the swing-stop...which prevents the pendulum from moving wildly out of control in either direction.

Real estate as a common stock

Equity real estate investment trusts (REITs) are the primary way for investors to own real estate that is both diversified and liquid...two important qualities that are nearly impossible to obtain from any other type of real property investment vehicle. In general, REITs do not speculate. Instead, they buy and hold developed,

*Even Rip van Winkle could have rested assured of very favorable results at the end of this particular 20-year sleep. And because Rip's money managers earn their living by calculating their fee based upon his portfolio's market value, they too have gotten rich, simply by keeping Rip invested in a diversified portfolio of stocks, bonds and real estate.

commercial rental properties, i.e., office buildings, hotels, warehouses and apartment complexes which produce steady net *cash* income. In some ways, REITs are like other small cap (under \$2 billion) stocks, but there are major differences: (1) REITs do not re-invest a significant portion of their earnings; in fact, to avoid paying corporate income taxes, they distribute at least 90 percent of their net income, in cash, to shareholders, (2) their dividend yield rate (ratio to their share price) is typically very high, compared to almost any other equity shares, (3) they pay no income taxes and (4) most of them are “open-end” funds, i.e., the number of shares is not constant. REITs have outperformed almost every other traditional asset class in recent years.

Year	10-yr US Treas	S&P 500	Russell 2000	REIT* Composite
2001	-0.09%	-11.9%	2.5%	15.5%
2002	-1.21	-22.1	-20.5	5.2
2003	0.44	28.7	47.3	38.5
2004	-0.04	10.9	18.3	30.4
2005 (11 mos)	0.25	4.9	4.3	8.5
Cumulative	-0.01%	2.8%	48.1%	138.1%

*Weighted composite includes equity REITs, mortgage REITs and hybrids.

REITs as a diversifier

Longer term, equity REITs have demonstrated, not only strong cash dividend yields, but also very compelling total returns, Although most equity REITs do use limited amounts of mortgage debt in order to leverage returns, their net cash flows after debt service are typically quite strong. And while the table below shows (1998 and '99) that REITs certainly can and do experience market value declines, their low return-correlation with the small cap segment of the US stock market is rather apparent, without using a calculator. Compare the bolded pairs of figures which represent three of the past six calendar years' index returns for REITs and small cap stocks.

-----**Equity REIT Index**¹----- Compare:

Year	Dividend Yield	Net Income	Total Return	R2000 Index ³
2004	4.7%	7.2%	31.6%	18.3%
2003	5.5	8.7	37.1	47.3
2002	7.1	6.9	3.8	-20.5
2001	7.1	8.1	13.9	2.5
2000	7.5	9.9	26.4	-3.0
1999	8.7	7.6	-4.6	21.3
1998	7.5	4.8	-17.5	-2.5
3-year ²		7.6	23.2	11.5
5-year ²		8.2	22.0	6.6
10-year ²		7.7	14.8	11.5
15-year ²		8.1	13.3	11.1
20-year ²		8.2	12.7	11.5

¹Source: National Association of Real Estate Investment Trusts
²Returns for periods greater than one year are annualized
³Russell 2000 Index (small capitalization US stocks)

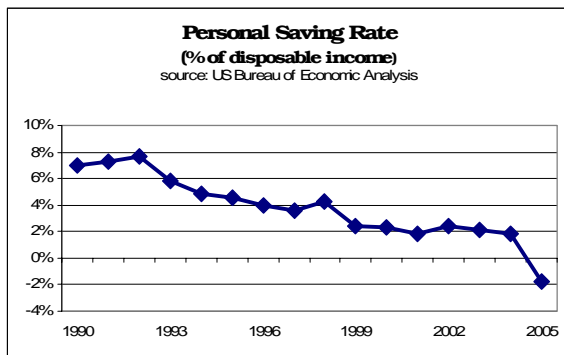
Home as an investment

One's privately owned homeplace has lately been a super-appreciating asset. Not only is the market price rising, but the *rate of growth*, after subtracting inflation has also shot up for the last 15 years....which is a very long period for any asset class to show such increasing strength. Moreover, although the pre-1990 period was weak for housing prices, it's not as though the sector was depressed, back then.

National Housing Prices



Now, compare the characteristics of a commercial income-producing property to the investment aspects of owning one's personal home: a home's cash flows are sharply negative, even after allowing for the income tax subsidy that, in effect, reduces homeowners' carrying costs (mortgage interest and property taxes). But from an investment point of view... the one shared by most homeowners... home is typically considered to be the Number One holding in personal portfolios, because, unlike stocks and bonds, *it ALWAYS grows in value*, right? So, why fool with old-fashioned savings accounts when you can get a much better return on a house.... And while you're at it, two houses are better than one.



With 40-year-low, 15- and 30-year fixed rate mortgages available, why would sensible people expose themselves to the raw-boned possibility that rising interest rates would quickly turn their variable rate mortgage into financial flood-waters that could lead to disaster? Apparently, the driving wheel is a cocktail of insatiable consumption and lack of sophistication: the *initial* monthly payments on this debt (in the first year of the loan) very simply produce more money to buy either a larger house, or more and bigger cars and boats. As a borrower-group, such families should be watched carefully, because there is strong indication that they will typically be the most susceptible to financial stress from a rising level of interest rates. And let's be reminded: the nation's high schools rarely offer courses in consumer debt-management; if they did, we would see a smaller population of multi credit card users paying monthly minimums and, in so doing, assuring their perpetual indentured status.

The Housing Pendulum is apparently very close to its upper-end swing-stop, for two reasons: (1) the supply of completed housing units is plentiful and (2) construction commodities are in shortage (thanks in large part to a trio of hurricanes with names that ended in 'a').

Home as a cash machine

Increasing family coziness with the notion of "home-as-investment," rather than the traditional home-as-castle viewpoint, has led millions to opt for the lowest monthly payment, via an adjustable rate mortgage loan. In fact, the chart below tracks an increasing tendency for consumers to treat the homestead's value growth as a source of spending cash. Mortgage Equity Withdrawals (MEWs) *compared to after-tax personal income* have more than quadrupled over the past six years.



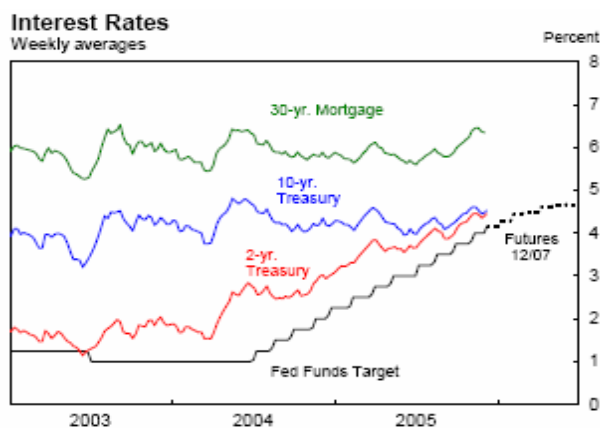
A bubble? You betcha...especially if long-term mortgage interest rates rise to a level that would restore their historical spread-relationship to money market rates. But, even if that doesn't happen, the quadrupling of short term rates over the past two years has already (or will soon) cause home equity lines and other adjustable-rate mortgage payments to soar.

2006: All eyes (should be) on US bonds

As 2005 came to a close, the bond-trading world was scratching its collective head about the current interest rate relationship-anomaly between long- and short-maturity investment paper. Where's this bus going in 2006? As shown in the chart below, it is clear that: (a) the 10-year Treasury rate has been on a collision course with money market rates and (b) 30-year mortgage rates have (as usual) moved in lock-step with 10-year Treasuries.

An upside-down interest market?

This scenario is very unlikely to persist, because, if bondholders are not compensated for the very real risk of long-term lending, they will logically opt for the safety and liquidity of the money market, until the bond market corrects the situation. Conventional wisdom has it that long rates will surely rise to cure this type of occasion. But, let's remember who literally dictates the rates for the short term market: The US Federal Reserve. The Fed has a nearly single-minded agenda... anticipatory inflation-fighting. If the bond market believes that economic expansion and accelerating inflation are not in the cards, then either: (a) the Fed has to back down (lower short rates), or else (b) one of two scenarios will exist: (1) a continuation of the current (one-rate-fits-all) stalemate, which is unstable and therefore not likely, or (2) an *inversion* in the yield curve (money market interest rates higher than long term bonds).



For a variety of reasons, an interest rate inversion, though relatively unusual, often portends bad things for the economy. In general, high short rates act as a growth-chiller and lower long rates represent the market-makers' forecast for a softening economy. How can that (simultaneously) be? Here's how: It is quite possible for both the Fed and the bond market to be right. If they are, when the results play out, we should see something resembling the "stagflation" days of the 1970s, or at least a general sluggishness, i.e., a set of economic conditions that is good for nothing and bad for almost everything, except perhaps a falling US Dollar which would help out with the US trade deficit.

The fat, sweaty kid

Just who, you might ask, is "the bond market" and why do they act the way they do? Answer (over the past 25 years or so): It's mostly non-US investors who wind up with wagon-loads of surplus US Dollars, as a result of selling us more goods than we can manage to sell to them. China is the prime current example. Sure, China buys a few Boeing jets and some Microsoft-ware, but most of the stuff on US retail shelves is now made in China. So, when all the transactions clear, that Asian giant winds up with a net fist-fulla dollars on deposit that need to be invested. And because investments of this sort are not going into high risk deployment, such as common stocks, they wind up in US bonds. Why US bonds instead of others? A bit mystical, but it's because the US Dollar is still the world's "reserve currency."

Thus, as long as the dollar maintains that reserve status (investors wanting dollars more than any other non-local currencies), the US can keep the dollar re-cycling game going. In fact, the US can continue to run vast (\$700 billion or so for 2005) foreign trade imbalances and get away with it...just as it has for most of the past 25 years. Sounds like the ageless children's game of musical chairs, right? Yep. And the US has always found a chair, because he's the sweaty, obese kid who the others fear might sit on them (and also, incidentally, because the fat kid's father owns the chair factory).