

# REIT returns baffle some advisers, please others

April 3, 2006

NEW YORK - The good returns that continue to be generated by real estate investments - particularly real estate investment trusts - puzzle Veena Kutler, a principal with financial advisory firm Mosaic Wealth Management.

With interest rates continuing to move up, she thought the market would have weakened, because the dividend yields from REITs looked less attractive relative to those from fixed-income investments.

For example, as of last Wednesday, the average yield generated by the NAREIT Composite REIT Index, which is published by the National Association of Real Estate Investment Trusts in Washington, was 4.45%, while the yield on the 10-year Treasury was 4.81%.

Such figures suggest that the justification for investing in REITs is disappearing and that investors should be moving their money out of real estate, Ms. Kutler said.

Indeed, that is what her Bethesda, Md.-based firm has done.

"With interest rates moving up and price appreciation making yields shrink, we just thought there wasn't much value in REITs," Ms. Kutler said.

It is an understandable reaction, said Steve Cowen, principal at Cowen & Associates, a financial advisory firm in La Jolla, Calif.

## Surprising resiliency

"I've been a little bit amazed by it myself," he said about the resiliency of real estate investments.

As a result, Mr. Cowen is reluctant to cut back on his real estate positions. The underlying fundamentals supporting the price appreciation of REITs look strong, making REITs a good investment for investors looking for total return, he said.

Industry experts agree, though at least one warned that price appreciation appears to be running ahead of market fundamentals.

Because the economy is improving, it is only natural that office and mall REITs would do well, said Arthur Oduma, senior REIT analyst with Morningstar Inc. in Chicago.

Office REITs in particular will benefit from an improving economy, because as companies grow, they need additional office space, he said.

Apartment REITs should also do well, thanks to the weakness in the residential-housing market, Mr. Oduma said. As interest rates rise, it moves the cost of owning a home out of the reach of many individuals, who will turn to apartments, he said.

As a result, landlords will be able to raise apartment rents because of the increased demand, Mr. Oduma said.

But though market fundamentals are improving, they haven't improved enough to justify how well real estate investments are performing, he added.

The NAREIT Composite REIT Index was up 15.30% year-to-date though last Wednesday, while the Standard & Poor's 500 stock index was up 4.85%, and the Nasdaq Composite Index was up 6.01%.

There are variables aside from market fundamentals, however, that are propelling real estate investment returns, said Jim Trowbridge, co-manager of both the \$1.5 billion AIM Real Estate Fund and the \$123 million AIM Global Real Estate Fund. Both are advised by AIM Advisors Inc., a unit of AIM Management Group Inc. in Houston.

One factor is that nine publicly traded REITs were taken private last year, Mr. Trowbridge said. That is important, because it means that the money invested in those REITs - about \$10 billion - was recycled back into the REIT market, he said.

It is anyone's guess as to whether that activity will continue, though Martin Luskin, a New York-based attorney who specializes in REITs with Blank Rome LLP of Philadelphia, said he thinks there will be more such deals this year.

Another indication that real estate will continue to be a good place to invest is that higher interest rates mean that the costs of construction will rise, said David Lee, manager of the \$1.2 billion T. Rowe Price Real Estate Fund. The fund is advised by T. Rowe Price Associates Inc. of Baltimore.

Less construction means that "supply-and-demand dynamics" favor REIT appreciation, Mr. Lee said.

But the strong fundamentals more than anything else are supporting REIT stocks, said Michael Winer, manager of the \$3 billion Third Avenue Real Estate Value Fund, which is advised by Third Avenue Management LLC in New York.

He said, however, that he is aware of the volatility that can occur in the REIT market when people start to worry about REIT yields.

That is one of the reasons why his fund invests in real estate operating companies, which aren't as susceptible to interest rate fluctuations, Mr. Winer said.

But though the fundamentals of the real estate market look good, that hasn't always

stopped investors from pulling money out of REITs when yields get low, he said.

Fortunately for the REIT market, that doesn't appear to be happening yet.

While some advisers, such as Ms. Kutler, are cutting back their exposure, others are standing firm.

REITs are an important diversification tool, said Jorie Johnson, president of Financial Futures LLC, a financial advisory firm in Manasquan, N.J. REITs would have to take a severe hit before she would think about cutting back her exposure to the asset class, she said.

Regardless, Ms. Johnson is concerned that the run-up in REITs is nearing its end.

"It's something I'm watching," she said.