Investing in

Real Estate

Investment Trusts

November 2000

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

Preserving and Perfecting the REIT for 40 Years: 1960-2000

Research Team

Michael R. Grupe
Vice President & Director of Research
mgrupe@nareit.com

Jack C. McAllister
Vice President of Institutional Investment Affairs
jmcallister@nareit.com

Charles J. DiRocco
Director of Industry Analysis
cdirocco@nareit.com

Soyong Cho
Senior Research Analyst
scho@nareit.com

Danielle E. Endreny
Research Analyst
dendreny@nareit.com

Abigail R. Fleming
Associate Research Analyst
afleming@nareit.com

National Association of Real Estate Investment Trusts®
Preserving and Perfecting the REIT for 40 Years: 1960-2000

1875 Eye Street, NW, Suite 600
Washington, DC 20006
www.nareit.com
202-739-9400 1-800-3-NAREIT

Following is an annotated version of an article printed in the November 2000 issue of the ***American Association of Individual Investors Journal****.*

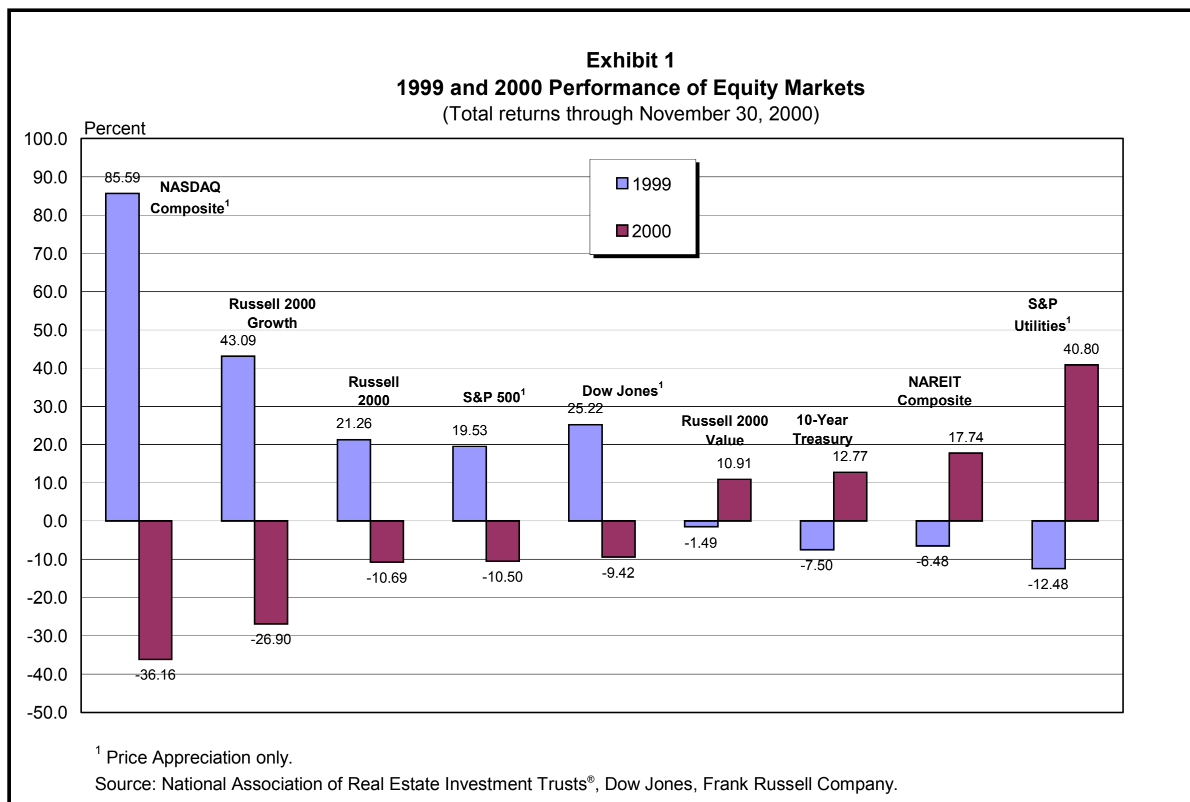
For monthly updates of the exhibits, please refer to the NAREIT web site at www.nareit.com, Research and Statistics>> Market Analysis>>Chart Book.

Investment Performance in a Turbulent Market

Following two years of negative returns, real estate investment trusts (REITs) are outperforming most other sectors of domestic equity markets so far this year. As calculated and published by the National Association of Real Estate Investment Trusts® (NAREIT), the NAREIT Composite index of total returns for all publicly traded equity, mortgage and hybrid REITs through the end of November was up 17.7 percent. What has changed? Why have the stocks of REITs and other publicly traded real estate companies performed so well? More important, how should investors view this development?

Short-run investment performance may be affected by many factors. However, long-run performance eventually must reflect the level and growth of corporate earnings and the discount rate applied to those earnings. Thus, investors this year are focused intently on corporate earnings reports, the tightening of Federal Reserve monetary policy, and the degree to which the Fed's policy goal of appreciably slowing domestic economic growth also slows corporate profits growth. Other factors in play include investor unease over

Exhibit 1
1999 and 2000 Performance of Equity Markets
(Total returns through November 30, 2000)



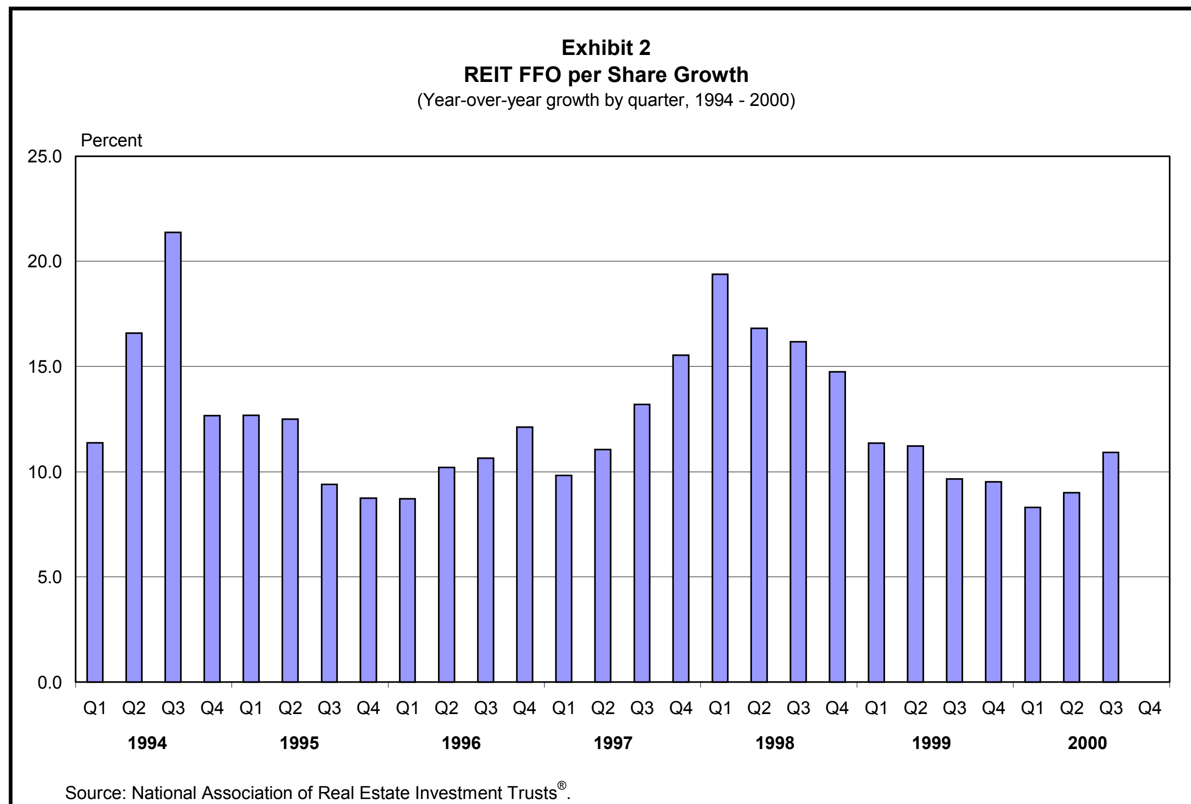
[1] Price Appreciation only.
Source: National Association of Real Estate Investment Trusts®, Dow Jones, Frank Russell Company.

technology stock valuations, which has weighed on the market for much of the year, and more recent concerns pertaining to higher oil prices and the relentless decline of Europe's unified currency, the euro.

Together, these factors have led to a significant increase in stock price volatility, particularly in those sectors that include large-capitalization and high growth stocks. As volatility increased, investor attention shifted to companies characterized by more predictable cash flows, higher dividends and lower multiples. Exhibit 1 illustrates the shift in investor sentiment. As measured by the Dow Jones Industrial, NASDAQ Composite, Russell 2000 Growth and S&P 500 indexes, the outsized returns of large capitalization, growth and technology stocks in 1999 have turned negative in 2000. At the same time, the shares of companies offering investors more value, income and predictable performance, as measured by the NAREIT Composite, Russell 2000 Value and S&P Utilities indexes, have turned negative returns into above average performance.

REIT Stocks in 2000

Four factors help to explain why the stocks of REITs and other publicly traded real estate companies are performing well in 2000. These factors include stabilized earnings growth, a well-balanced real estate economy, increased stock price volatility and good value. By the end of 1997, the commercial real estate economy had recovered from the collapse of real estate prices in the early 1990s and had entered a



period of relative equilibrium. Thus, REIT earnings growth slowed in 1998 and 1999, and price-earnings multiples contracted. Nevertheless, average earnings growth remained positive, and earnings reports in 2000 suggest that the slowdown of earnings growth has stabilized. In fact, year-over-year earnings growth – as measured by funds from operations (FFO) per share and illustrated in Exhibit 2 – picked up on average both in the second and third quarters of 2000. (See sidebar on FFO.) Therefore, assessments of future earnings prospects are more upbeat, and price-earnings multiples have firmed.

Investors also appear more convinced today than three years ago that the commercial real estate sector is less prone to episodes of speculative building. For years, commercial real estate was almost entirely owned by private investors, including partnerships, pension funds and wealthy individuals. In addition, most properties were financed primarily with debt, which traditionally came from pension funds, insurance companies, commercial banks and savings and loan institutions. In these private markets, proprietary information often held the key to economic success. Thus, information was seldom shared, and comprehensive data pertaining to supply, demand and new financing arrangements were slow to develop.

Following the severe capital loses of traditional lenders in the early 1990s, property owners turned to public markets for new sources of capital. In many cases, they re-capitalized their properties by transferring ownership to REITs or other publicly traded real estate companies and raising new equity in public markets to repay outstanding private market debt. With the transformation from private to public ownership, the decision-making

Funds from Operations

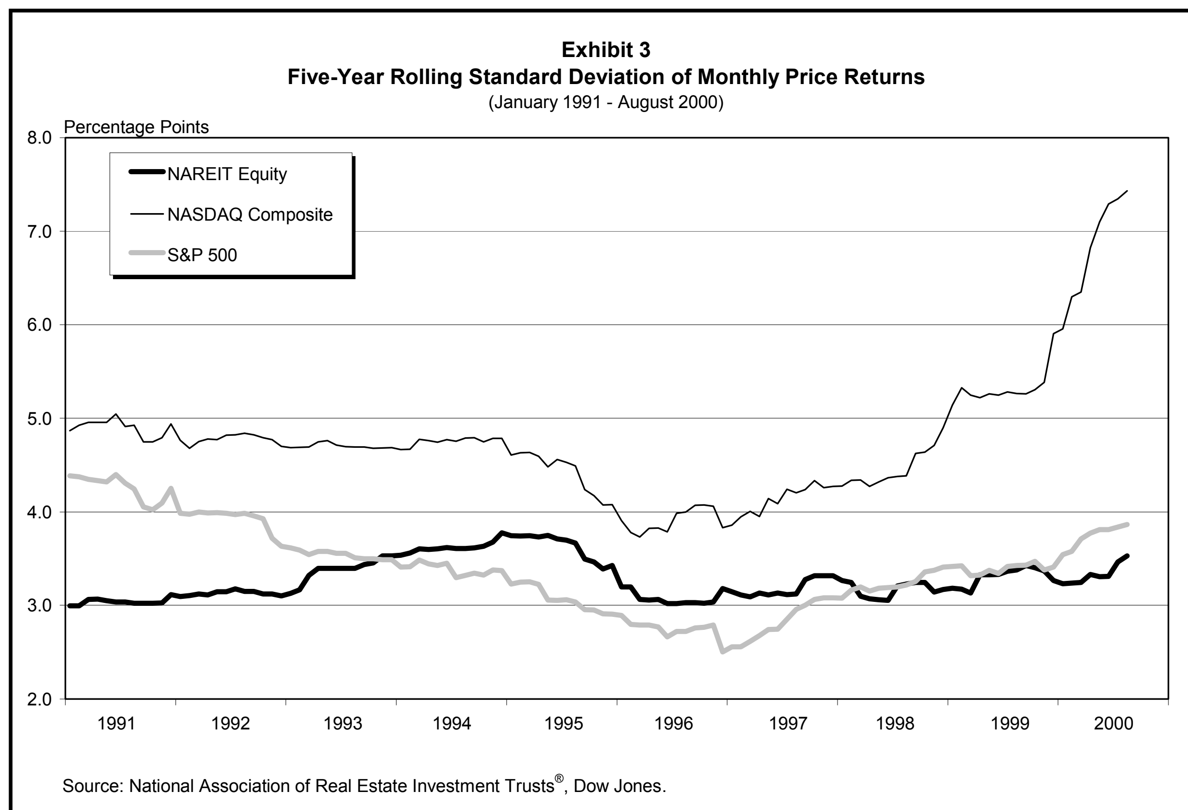
Like all other public companies, REITs report their net income and earnings per share (EPS) using generally accepted accounting principles (GAAP). However, GAAP requires that commercial property owners depreciate the cost of their properties to zero even though well-located and well-maintained properties continue to be highly valuable after 20, 30, or 40 years. Therefore, most REIT analysts and investors consider the traditional GAAP-based measure of net income to be inadequate for properly evaluating the operating performance of real estate companies because the large depreciation charges are widely believed to significantly overstate expenses and understate earnings.

To account for this shortcoming, NAREIT in 1991 adopted funds from operations or FFO to promote an industry-wide measure of REIT operating performance that would not have this drawback. FFO is intended to be a supplemental measure of earnings, and primarily adds back depreciation and real estate amortization charges to GAAP net income, while it excludes gains (or losses) from property sales. Individual investors need not be experts in computing FFO. Rather, they need only understand that it is a commonly accepted measure of operating performance in the REIT industry. Investors may obtain current and historical FFO information from company press releases and at company web sites. Further information pertaining to FFO, including links to individual company web sites, is available at www.nareit.com.

process of commercial property owners and developers became more transparent and subject to the scrutiny of analysts, the analysis of investors and the oversight of financial regulators. As the amount of public information increased, the likelihood of excessive speculative construction declined.

Investors this year also have sought shelter from rising price volatility. Exhibit 3 shows that stock price volatility, as measured by the standard deviation of monthly price returns, has been trending higher for the past four years. Since the end of 1996, price volatility of the S&P 500 has increased by 54 percent. Over the same period, volatility of the NASDAQ Composite has nearly doubled (up 94 percent), including a 26 percent increase in just the first eight months of 2000. Meanwhile, price volatility of the NAREIT Equity REIT index has increased just 11 percent since the end of 1996 and remains less than half as volatile as that of the NASDAQ. The turmoil in equity markets has reminded investors about the importance of including in their portfolios shares of companies with predictable cash flows, high dividends and lower multiples. These investment themes, while previously out of favor, are precisely what REITs and publicly traded real estate companies deliver to their shareholders.

Finally, investors clearly responded to the compelling values that shares of REITs and other publicly traded real estate companies offered in late 1999. Exhibit 4 shows that the average dividend yield of all



equity REITs reached 9.28 percent on December 16, 1999, its highest level since December 1990, and nearly 3 percentage points above the yield on 10-year Treasury securities. Since then, share prices of equity REITs on average have increased 18.7 percent through the end of November 2000.

The Long Term Performance of REITs

REITs and other publicly traded real estate companies are total return investments that provide high dividends plus the potential for moderate, long-term capital appreciation. Investors look to high dividend paying stocks both to provide income and to reduce the month-to-month changes in the value of their investment portfolios that come from more volatile stocks.

Because of their high dividends and moderate growth potential, the long term total returns of REIT stocks should be somewhat less than the returns of high growth stocks and somewhat more than the returns of bonds. Because most REITs also have a small-to-medium equity market capitalization, their returns also should be comparable to other small- to mid-sized companies. Exhibit 5 compares the average annual returns of different investment sectors over the period 1975-2000. The data show that stocks in the NASDAQ Composite index recorded the highest average annual returns over the entire period. The data also show that the average return of stocks in the NAREIT Equity REIT index fell between the returns of

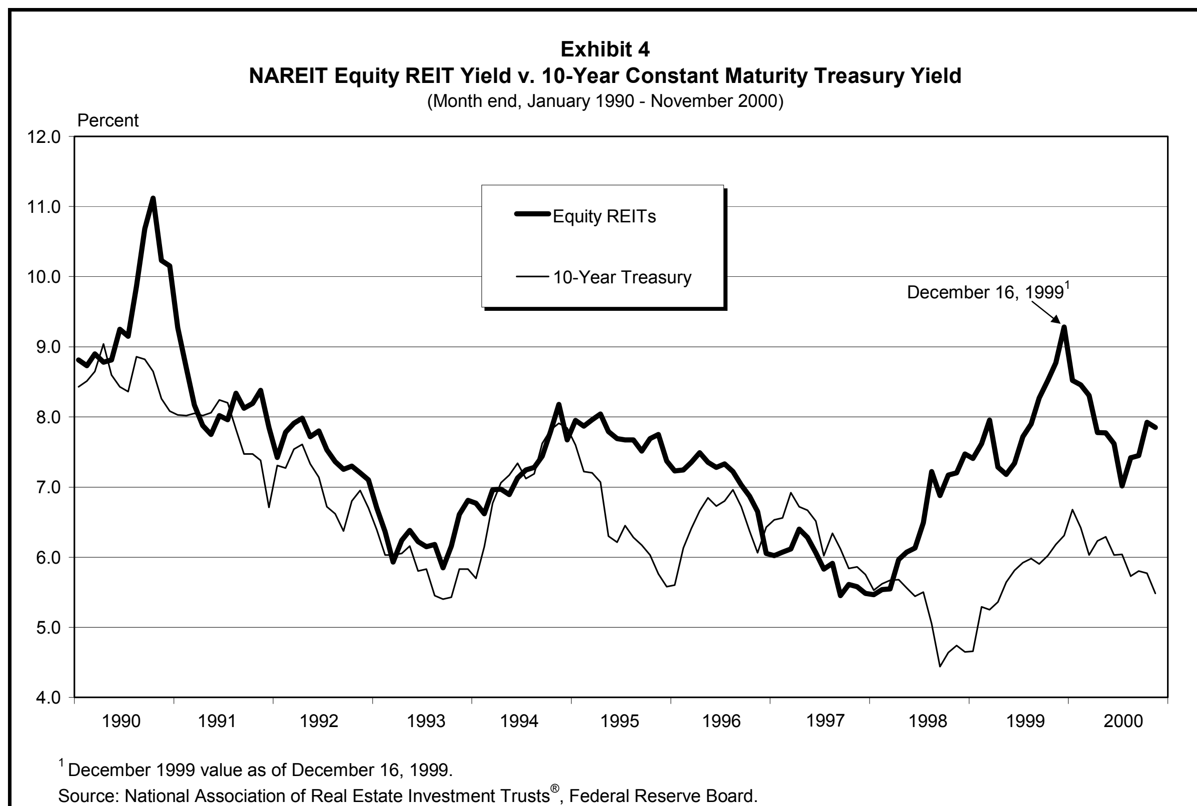


Exhibit 4
NAREIT Equity REIT Yield v. 10-Year Constant Maturity Treasury Yield
(Month end, January 1990 - November 2000)

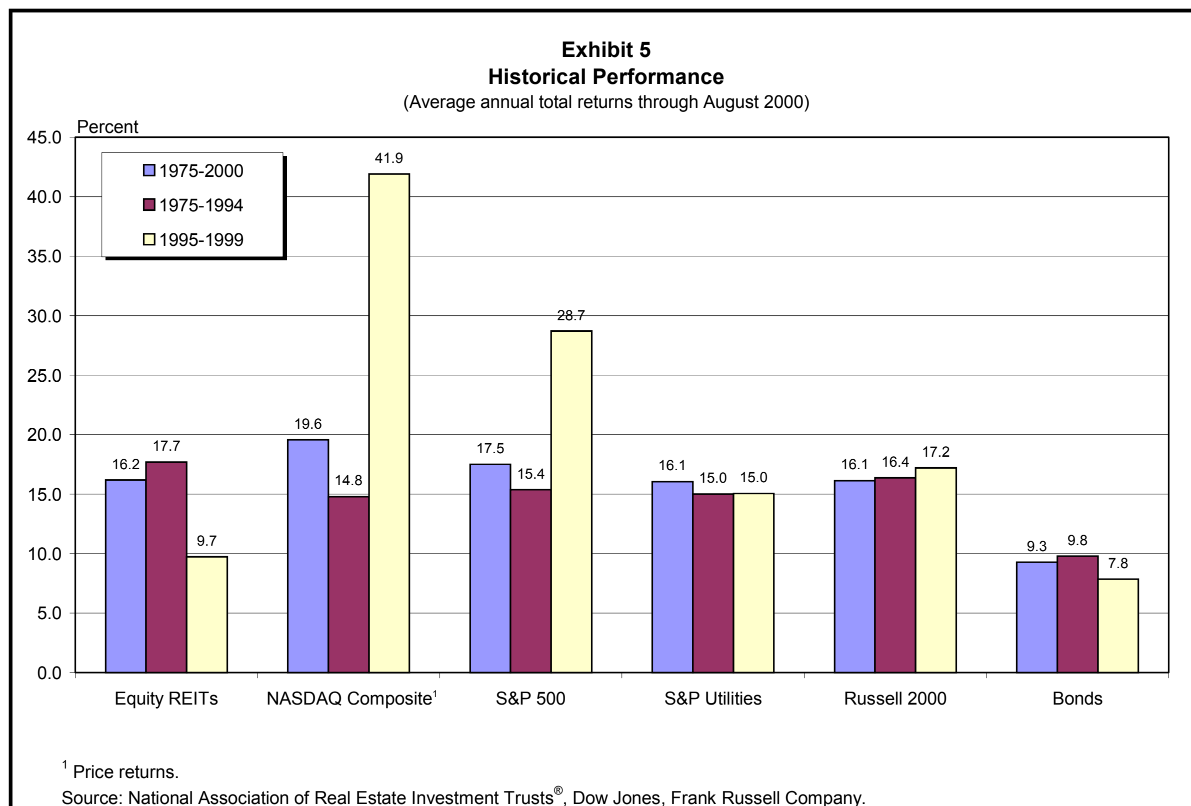
[1] December 1999 value as of December 16, 1999.
Source: National Association of Real Estate Investment Trusts®, Federal Reserve Board.

large-cap stocks and bonds and were about the same as the returns of small-cap stocks and utilities.

Investors should recognize that average returns over the 1975-2000 period have been significantly affected by the extraordinary and likely unsustainable returns of technology stocks and other large-cap stocks during the five years 1995-1999. When the performance over these five years is separated from that of the previous 20-year period 1975-1994, the data show that REIT returns on average exceeded the returns of other sectors, including small-cap stocks and utilities. The superior performance of large-cap and technology stocks in recent years is undeniable. However, as their returns have faltered in 2000, investors are reminded not to formulate their expectations of future investment returns too heavily on the recent past.

When compared with earlier market cycles, REIT returns over the past three years shed further light on the long-term performance of REIT stocks. Exhibit 6.a shows that the most recent cycle of returns is not much different from previous cycles. The NAREIT Equity REIT index of total returns fell 27.3 percent from the end of 1997 to December 16, 1999 (cycle 3), a little more than the decline recorded in 1989-1990 (cycle 2) but less severe than the decline posted in 1972-1974 (cycle 1). Moreover, since last December, the index has recovered at a pace that is somewhat more rapid than the pace of cycle 1, though not as rapid as the pace of cycle 2.

Exhibit 5
Historical Performance
(Average annual total returns through August 2000)



[1] Price returns.
Source: National Association of Real Estate Investment Trusts®, Dow Jones, Frank Russell Company.

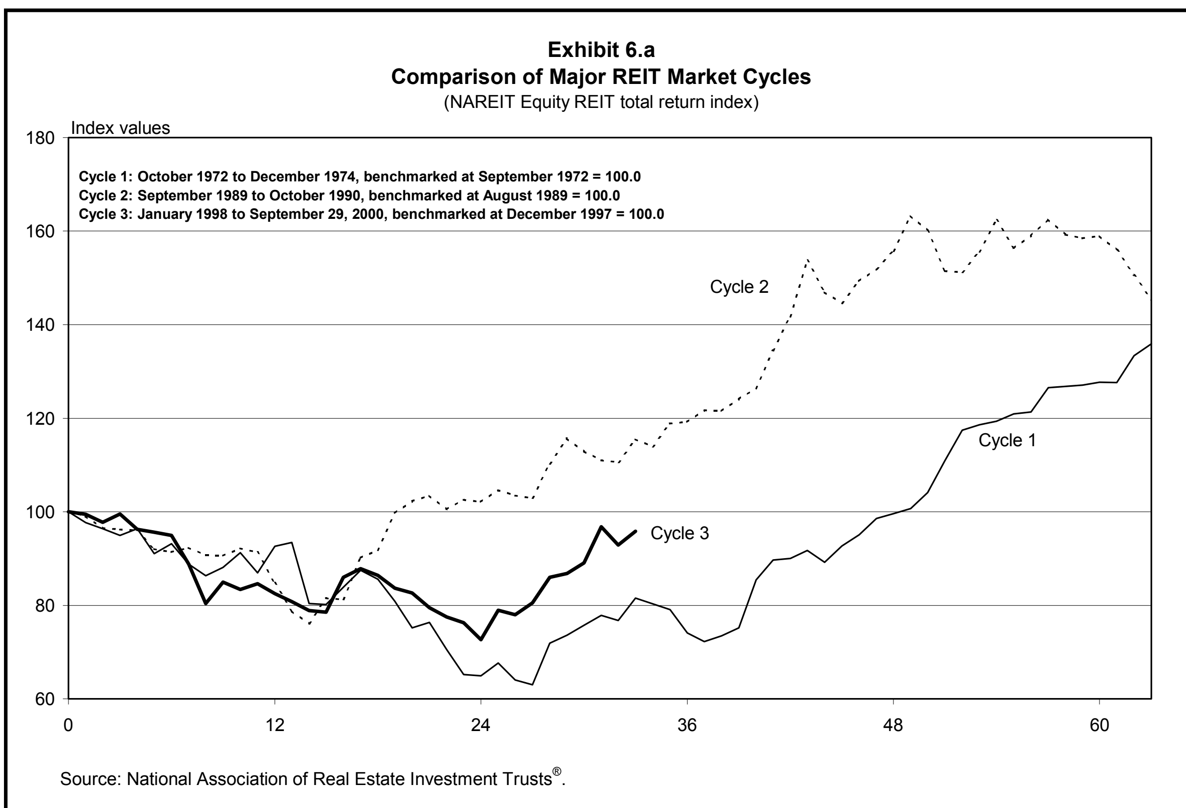


Exhibit 6.a
Comparison of Major REIT Market Cycles
(NAREIT Equity REIT total return index)
Index values
Cycle 1: October 1972 to December 1974, benchmarked at September 1972 = 100.0
Cycle 2: September 1989 to October 1990, benchmarked at August 1989 = 100.0
Cycle 3: January 1998 to September 29, 2000, benchmarked at December 1997 = 100.0
Cycle 2
Cycle 1
Cycle 3
180
160
140
120
100
80
60
0
12
24
36
48
60
Source: National Association of Real Estate Investment Trusts®.

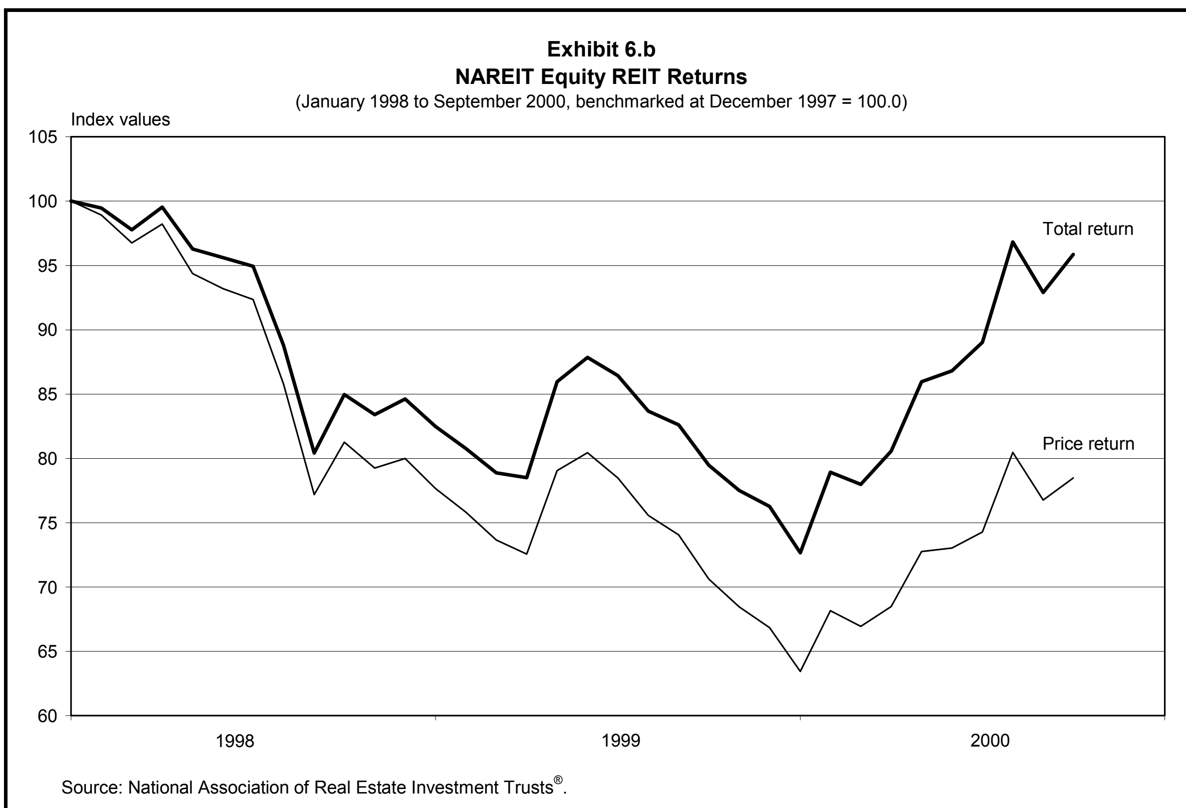


Exhibit 6.b
NAREIT Equity REIT Returns
(January 1998 to September 2000, benchmarked at December 1997 = 100.0)
Index values
Total return
Price return
105
100
95
90
85
80
75
70
65
60
1998
1999
2000
Source: National Association of Real Estate Investment Trusts®.

Although circumstances surrounding each cycle are different, previous cycles suggest that the opportunity for further positive returns in the current cycle remains considerable.

Exhibit 6.b compares price returns and total returns of the most recent cycle and illustrates the importance of dividends to the long-term performance of REIT stocks. While share prices from December 16, 1999 through September 29, 2000 recovered 41.2 percent of their losses over the prior two years, total returns since December 16, 1999 recovered 85.0 percent of their losses, nearly overcoming in nine months the losses of the previous two years.

(Individual investors can track the day-to-day, as well as long term, performance of REIT and publicly traded real estate stocks at the NAREIT web site, www.nareit.com.)

The Benefits of Investing in REITs

Investing in commercial properties requires financial resources that go beyond those of most individual investors. Thus, Congress created REITs in 1960 to provide small investors with opportunities to participate in the investment returns available from large-scale, income-producing real estate. Like other investments, REITs and other publicly traded real estate companies are properly evaluated by looking at both their benefits and their risks.

In this regard, the first thing investors should recognize is that REITs are public companies that, in most respects, operate like all other public companies. However, rather than manufacturing computer chips or light bulbs, or providing services like banking or insurance, REITs deliver real estate services to individuals and businesses. Thus, all of the skills that individual investors use to evaluate the stocks of public companies in general can easily be used to evaluate the stocks of REITs.

REITs are not limited partnerships, a popular form of real estate investing in the 1970s and 1980s. Because partnerships were permitted to pass losses, as well as gains, through to their investors, the losses could be used by investors to reduce their reported incomes and lower their personal taxes. Thus, partnership investors received economic benefits even if the partnership made uneconomic real estate investment decisions. The Tax Reform Act of 1986 put an end to this practice. Like other public corporations, REITs are prohibited from passing losses through to their shareholders, thereby eliminating the tax-motivated incentive to make real estate investment decisions for reasons other than sound economics and the creation of shareholder value. Moreover, REITs distribute no confusing Internal Revenue Service (IRS) Form K-1 to complicate the preparation of investors' federal tax returns and do not subject investors to state income taxes except those in their state of residence.

Most REITs also should not be viewed as closed-end funds, that is, passive vehicles for collecting rents on a portfolio of properties and passing those rents through to their shareholders. Although REITs, when first created, were prohibited from both owning and operating their properties, that restriction in most cases also was removed in 1986. Today, investors should evaluate REITs and other publicly traded real estate companies as genuine operating businesses. As such, equity REITs both own and operate their properties, actively manage their liabilities to reduce their costs of capital, exploit scale economies and other efficiencies in order to expand operating margins, and develop additional sources of

revenue by delivering new services to their tenants and others.

Liquid Markets

The benefits of investing in REITs begin with many of the same benefits of investing in other public companies. For example, shares of most REITs are easily bought and sold in the major, well-regulated markets in which the shares of all other U.S. companies are traded. As of December 1, 2000, there were 189 publicly traded REITs in the NAREIT Composite REIT index. Shares of most of these companies trade on the New York Stock Exchange®, with fewer companies listed on the American Stock Exchange® and the NASDAQ® National Market List.

Portfolio Diversification

Investing in REITs and other publicly traded real estate companies also provides diversification benefits because the correlation of REIT returns with the returns of other market sectors is relatively low. The correlation of returns in two different investment categories need not be negative to benefit from diversification. Even low to moderate positive correlation may help to increase long term risk-adjusted returns.

Exhibit 7 summarizes the correlation of monthly returns of Equity REITs with the returns of other broad market indexes. As shown in column 2, sectors are ranked from highest to lowest correlation over the period beginning January 1972 and ending August 2000. The data show that Equity REIT returns over this period were most correlated with the Russell 2000 index and least correlated with the NASDAQ 100. The data also show a trend of declining correlation between the returns of Equity REITs and those of nearly all other sectors. Columns 3-5 illustrate this trend across the three decades of the 1970s, 1980s and 1990s. As shown in columns 6 and 7, correlation in most cases declined even within the decade of the 1990s.

Individual investors also should recognize that homeownership is not necessarily a substitute for commercial real estate in a diversified portfolio. A house is an expenditure as much as an investment, particularly when financed with a sizable

Exhibit 7
Correlation of Equity REIT Returns with other Investment Sectors
(Correlation coefficients based on monthly total returns, except where noted)

	Time Periods[1]					
Market Sector Index	1972-2000	1972-1979	1980-1989	1990-2000	1990-1994	1995-2000
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Russell 2000	0.63	0.83	0.74	0.50	0.67	0.36
S&P 500	0.56	0.64	0.65	0.39	0.53	0.28
NASDAQ Composite[2]	0.54	0.73	0.71	0.29	0.64	0.09
S&P Utilities	0.38	0.65	0.38	0.33	0.29	0.37
NASDAQ 100[2]	0.34	NA	0.68	0.23	0.57	0.01
Merrill Lynch Govt/Corp	0.23	0.47	0.17	0.25	0.39	0.10

Notes:
[1] Data through August 2000.
[2] Price returns only.

Source: Ibbotson Associates, National Association of Real Estate Investment Trusts®.

mortgage. It does not produce income, but rather requires monthly mortgage interest payments and other occasional expenditures to be properly maintained. Some houses in some markets over certain periods have appreciated greatly in value. However, an index of house prices published by the Federal Home Loan Mortgage Corporation shows that house prices on average across the United States increased over the past 25 years by a compound annual rate of only 5.6 percent (ignoring both the benefits and costs of mortgage financing).

Management Experience and Ownership

Like other public companies, the corporate officers and professionals at most REITs have many years of experience in their profession. These officers and professionals are accountable both to their boards of directors as well as to their shareholders and creditors. Moreover, most REITs became public companies within the past 10 years, often transforming to public ownership what previously had been private enterprises. In many cases, the majority owners of these private enterprises became the senior officers of the REIT and rolled their ownership positions into shares of the new public companies. Thus, the senior management teams of many REITs today own a significant portion of the company's stock, thereby closely aligning the economic interests of management with the interests of public shareholders.

Public Market Oversight

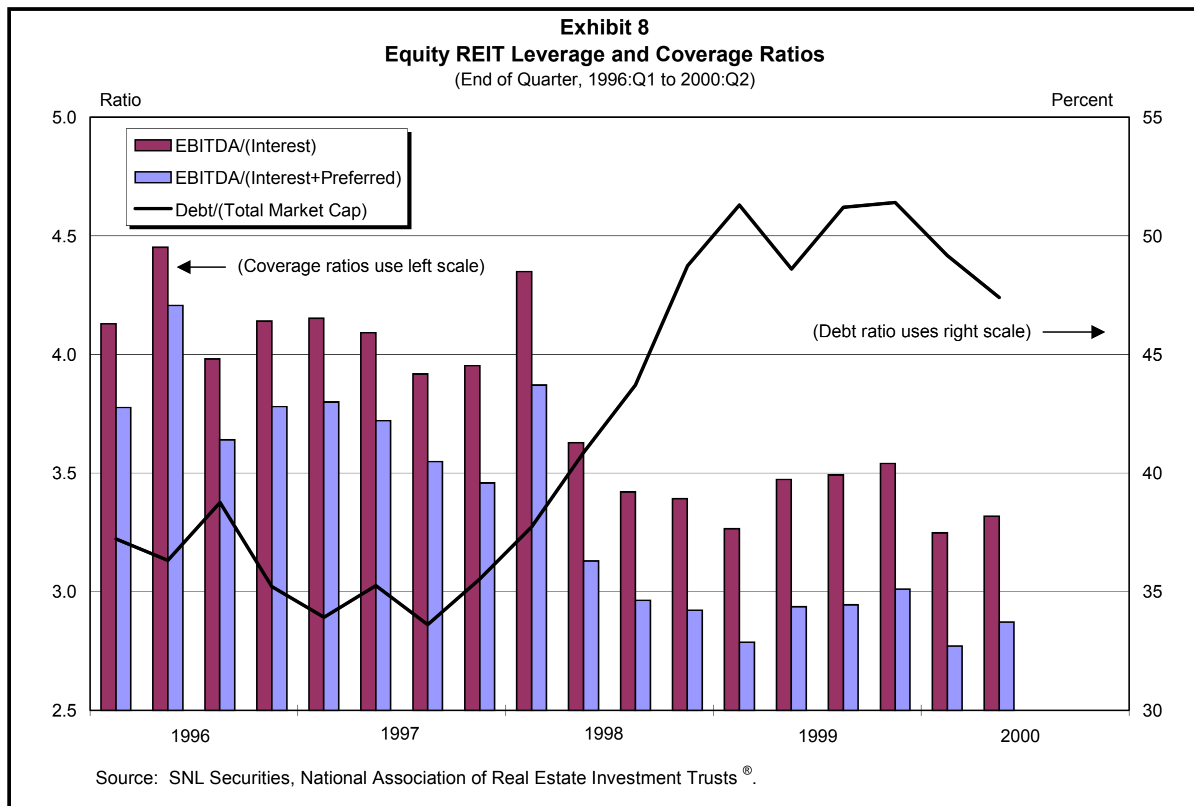
The management and operation of most REITs is characterized by a high degree of transparency and accountability. Like other public companies, REIT managers are accountable to equity analysts, credit analysts, financial market regulators, the financial media and public market investors.

High Dividends

As investments, REIT stocks pay among the highest dividends. These dividends come primarily from the relatively stable and predictable stream of contractual rents paid by the tenants that occupy the REIT's properties. Moreover, unlike interest payments on bonds, rental rates tend to rise during periods of inflation. Thus, the dividends from REIT stocks are protected to a degree from the long-term corrosive effect of rising prices. Many REITs also offer convenient dividend reinvestment plans that enable their shareholders to reinvest their dividends efficiently. (See www.nareit.com for a list of companies that offer dividend reinvestment programs.)

Strong Balance Sheets

Historically, income-producing commercial real estate often was financed with high levels of debt, both because the properties provided tangible security for mortgage financing and because the rental income from those properties was a clear source of revenue to pay the interest expense on the loan. Prior to the real estate recession of the early 1990s, it was not uncommon for individual properties to carry mortgages of over 80 percent to 90 percent of their estimated market value or cost of construction. Occasionally, loan-to-value ratios went even higher. At the time, lenders often recognized the sizable credit risk of such loans but assumed that inflation over a few years would significantly increase rents and thereby raise the value of the properties. Under this scenario, credit risk would be substantially reduced within a short period of time. However, the risk inherent in such underwriting practices became clear to many lenders in the early 1990s when the economy weakened,



inflation was effectively tamed and an excess supply of properties led to higher vacancies, lower rents and declining property values. In many cases, the lower rents no longer were sufficient to meet the interest payments on the loans. When borrowers defaulted, the values of the properties were less than the balance of the loans.

Today, properties owned by REITs are financed on average with far less debt. Exhibit 8 shows that the average REIT debt ratio (total debt divided by the sum of debt plus common equity market capitalization) never moved much above 50 percent even as stock prices declined in 1998 and 1999 and has moved lower this year as stock prices have risen. Investors also commonly evaluate a company’s ability to meet its debt obligations by dividing its cash flow – as measured by earnings before interest, taxes, depreciation and amortization expenses or EBITDA – by either its interest expense or interest expense plus other fixed charges such as dividends on preferred stock. For REITs, these coverage ratios on average currently exceed 3.0 and 2.5, respectively. Although no one ratio alone can fully describe the financial strength of a company, a recent report by Moody's Investors Service showed that companies with a median fixed charge coverage ratio of between 2.6 and 3.0 were rated A3 to Baa3, the company's highest four ratings.[1]

The Risks of Investing in REITs

REITs and other publicly traded real estate companies may be adversely affected from time to time by the same kinds of events that affect other public companies.

[1] See *Moody's Favorite Ratios for Evaluating REITs and REOCs*, September 2000.

Components of the Dividend

For REITs, dividend distributions for tax purposes are allocated to ordinary income, capital gains and return of capital. Because each of these components may be taxed at a different rate, all public companies, including REITs, are required to provide their shareholders early in the year with information clarifying how the prior year's dividends should be allocated among these components for tax filing purposes. This information is distributed by each company to its list of shareholders on IRS Form 1099-DIV. For investors whose shares are owned by their brokers (as nominees), or for those who invest in mutual funds, the brokers or investment companies, respectively, provide this information. Each year this information also is available to individual investors at www.nareit.com.

A return of capital distribution is defined as that part of the dividend that exceeds the REIT's earnings and profits. At first, some investors are puzzled that any company can pay out more than its income in the form of dividends. However, because real estate depreciation is such a large non-cash expense that likely overstates the decline in property values, the dividend rate divided by FFO per share (or similar measure) is used as a more appropriate measure of a REIT's dividend paying ability. Thus, a dividend rate that is 80 percent of FFO can easily exceed 100 percent of earnings and profits.

A return of capital distribution is not taxed as ordinary income. Rather, the investor's cost basis in the stock is

(cont'd.)

In some cases, these events may pose risks for all REITs. In other cases, the risks may affect only those companies that own certain types of properties or properties in specific geographic regions.

Market Risk

Market risk is the type of risk that cannot be eliminated by diversification. Market risk events include those that usually affect all companies or all markets and may be completely unrelated or only peripherally related to the economic fundamentals of specific companies or industries, including the commercial real estate business. These events may include changes in domestic economic growth, monetary policy, financial regulations, accounting guidelines and international markets. For example, turmoil in some Southeast Asian financial markets plus the unexpected default of Russian government bonds in the autumn of 1998 led to an international financial panic and a concomitant flight by investors from risk of almost any kind. Stock prices plunged in nearly all markets, and most public companies faced a sudden increase in the cost of both debt and equity capital, if they could obtain any capital at all.

Specific Risk

In addition to market risk, all companies face risks that are more specific to their own industries. For example, utility companies and automobile manufacturers may be more at risk than other companies to changes in federal and state environmental policies. REITs, on the other hand, operate according to certain provisions of the U.S. tax code. Therefore, changes to those provisions pose greater risks for REITs than they do for most other companies. In addition, state and municipal governments

***Components of the Dividend** (cont'd.)*

reduced by the amount of the distribution. When shares are sold the difference between the net sales price and the reduced tax basis is treated as a capital gain for tax purposes. Alternatively, if the distribution exceeds the shareholder's tax basis in the stock, the excess is treated as a capital gain. As long as the appropriate capital gains tax rate is less than the investor's marginal ordinary income tax rate, a high return of capital distribution may be especially attractive to investors in higher tax brackets.

may from time to time change property tax rates or land use policies that pertain to commercial real estate.

Specific risks also include changes in management or strategic direction, accounting irregularities, mergers and acquisitions and other economic events. For example, the recent hike in oil prices, while a negative for the economy as a whole, may not affect all companies equally. Moreover, not all such events have negative consequences for shareholders. Particularly attractive property acquisitions may significantly boost profitability or substantially increase market share.

The economics of owning and managing commercial properties also may be affected by developments in other industries. For example, the Internet is likely over the long run to affect how consumers shop for goods and services, thereby affecting how retailers conduct their businesses. New communications technologies, including broadband communications services, will change to some degree the nature of how office space is occupied and managed. However, such changes are common in our dynamic economy, and all companies must respond to them from time to time.

Economic Recession

A slowdown in the economy is likely to affect all public companies to some degree, including REITs and publicly traded real estate companies. When economic growth slows, the demand for space may decline or at least expand less rapidly, causing building occupancy rates to drop and market rents to weaken. However, such developments are unlikely to affect all REITs equally. Some geographic regions may experience greater economic weakness than others, and the businesses of some tenants may suffer more than others. Thus, certain REITs may withstand the effects of a temporary economic slowdown more effectively than other REITs.

For example, tenant leases for office and industrial properties usually are written for longer periods than for other types of properties, thereby providing some protection from a sudden and unexpected decline in market rents. Retail property REITs often structure their leases in a manner that enables the REIT to participate in store revenues if such revenues exceed certain preset levels. If an economic recession reduces these revenues, the REIT may be adversely affected.

Evaluating REIT Stocks

In most respects, investors evaluate the stocks of REITs and other publicly traded real estate companies using the same tools and techniques they use to assess the stocks of other public companies.

Commonly used indicators of performance and value include earnings

REIT Modernization Act

Like other major enterprises in the United States in recent years, the real estate industry has evolved into a customer-oriented service business. Building owners of all types, including REITs, increasingly are being called upon to provide new services or risk losing their competitive edge in attracting and retaining top-quality tenants. However, the laws under which REITs operate have limited them to providing only those services that were long accepted as being "usual and customary" landlord services. REITs have been prohibited from providing cutting-edge services to their tenants, thus placing them at a competitive disadvantage. The REIT Modernization Act, which goes into effect in 2001, removes this restriction and allows REITs to invest up to 20 percent of their assets in the stock of taxable subsidiaries that can provide the important, competitive services that tenants desire. For more information, see www.nareit.com.

growth rates, earnings multiples, dividend yields, and net asset values.

Corporate Earnings Growth

Corporate earnings measure how efficiently a company uses its resources to create economic value for its shareholders. Earnings also are important because they help to determine the market value of the firm and they provide the cash flow required for paying dividends. Therefore, investors often pay higher prices for the stocks of companies whose earnings are growing rapidly or are expected to grow rapidly.

Most REITs and publicly traded real estate companies report their earnings as net income, using generally accepted accounting principles (GAAP), as well as funds from operations or FFO. (See sidebar on FFO.) Most real estate analysts and investors look to FFO, or similar supplemental measure of earnings, as a more appropriate barometer of a REIT's performance. Boosted to some degree by the rapidly recovering commercial real estate sector in the second half of the 1990s, average year-over-year FFO per share growth peaked most recently in the first quarter of 1998 (Exhibit 2). With supply and demand forces now more balanced, earnings growth has settled back to a more sustainable pace.

Rapid earnings growth is an important attribute of successful companies. However, consistent earnings growth also is important and highly valued by investors. When buying common stocks, investors should focus on future earnings growth, as much as on past performance, and ask themselves where future earnings growth will come from.

Growth in funds from operations typically comes from several sources, including higher revenues, lower costs and new business opportunities. The most immediate sources of revenue growth are higher rates of building occupancy and increasing market rents. As long as the demand for new properties remains well balanced with the available supply, market rents tend to rise as the economy expands. Low occupancy rates in under-utilized buildings can also be increased when skilled owners upgrade facilities, enhance building services and more effectively market properties to new types of tenants.

Property acquisition and development programs also create growth opportunities, provided the economic returns from these investments exceed their cost of financing. Today, for example, many industrial REITs are developing specialized processing and distribution facilities that more effectively meet the business and location requirements of new internet-based companies.

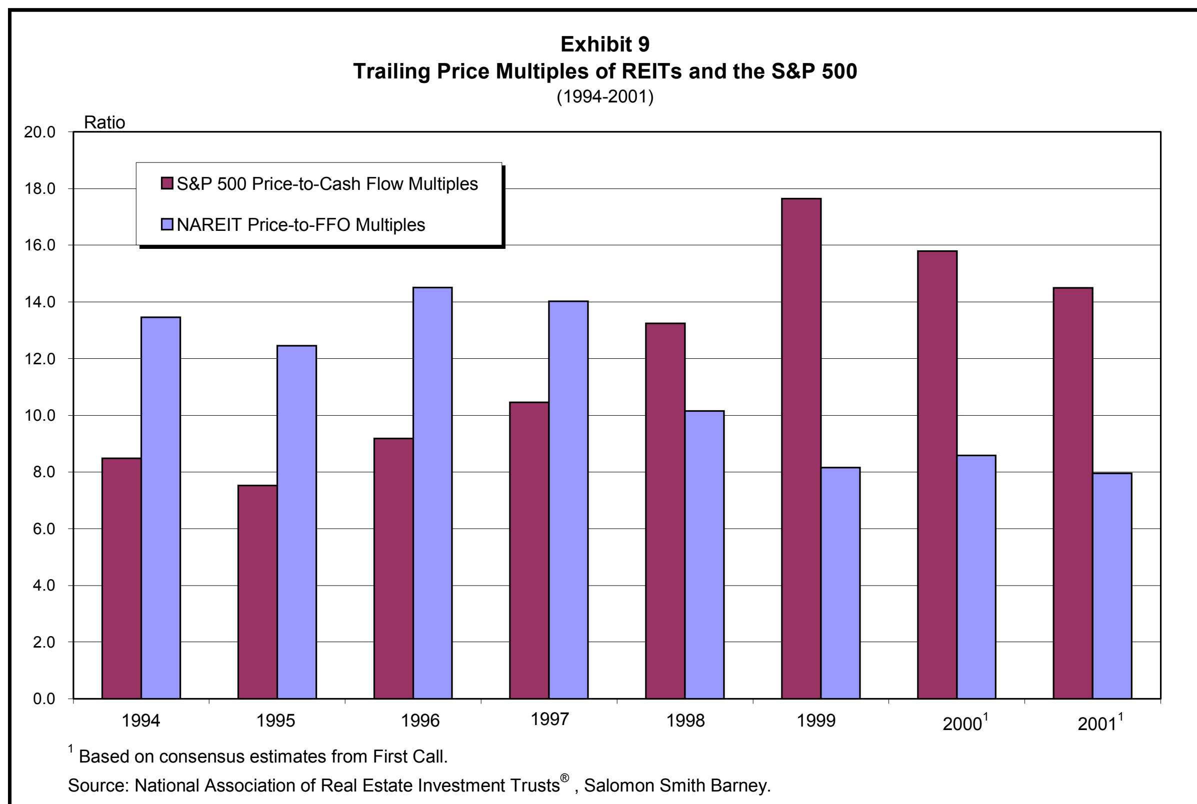
Like other public companies, REITs and publicly traded real estate companies also grow earnings by improving efficiency and taking advantage of new business opportunities. Investors should look for companies that increase their operating (profit) margins by running their businesses more efficiently and by taking advantage of economies of scale. Investors also should watch for companies that effectively develop new business activities in conformance with the recently enacted REIT Modernization Act. (See sidebar on REIT Modernization Act.)

Price-Earnings Multiple

Another measure commonly used by investors to compare individual stocks is the ratio of the stock price to the company's most recent or projected annual earnings per share. When evaluating REIT stocks, the appropriate ratio is the stock price divided by FFO per share. The price-earnings ratio (or price multiple) measures how much current buyers of the stock are willing to pay for each dollar of expected earnings. In general, companies with more rapid or consistent earnings growth tend to be rewarded with higher stock price multiples. Stocks trading at lower multiples often are viewed as providing investors with better value because each dollar of earnings can be purchased for a lower price.

Exhibit 9 shows the average price-to-FFO per share multiple for REIT stocks

Exhibit 9
Trailing Price Multiples of REITs and the S&P 500
(1994-2001)



[1] Based on consensus estimates from First Call.

Source: National Association of Real Estate Investment Trusts®, Salomon Smith Barney.

using end of year stock prices and annual FFO per share for the previous four quarters. The data show that REIT stock-price multiples contracted in 1998 and 1999 as the pace of REIT earnings growth slowed. The data also compare REIT stock price multiples with those of companies in the S&P 500, with S&P multiples calculated as the ratio of stock price divided by four-quarter trailing cash flow per share, a more appropriate proxy than EPS for FFO. Today, REIT stocks trade at a significant price-earnings discount to stocks in the S&P 500, indicating that each dollar of REIT earnings can be purchased at much lower prices than each dollar of cash flow earnings in the S&P 500.

Dividend Yield

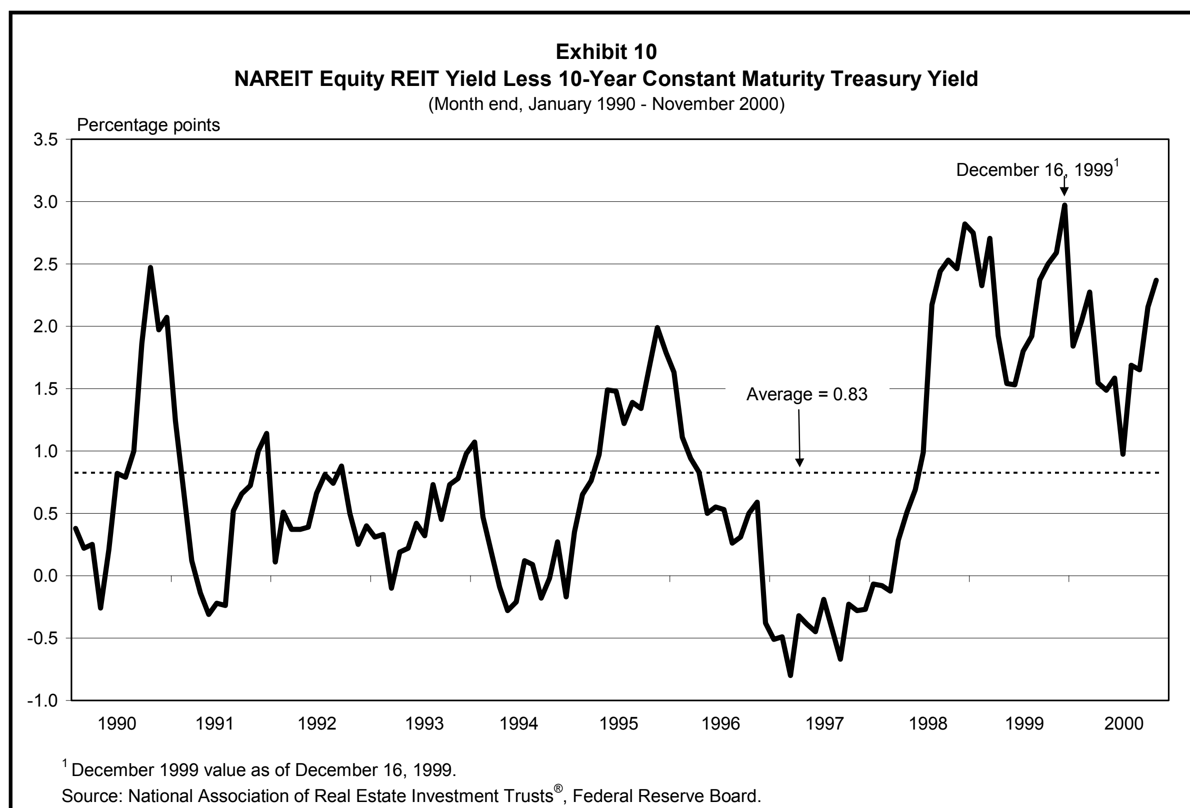
REITs are required by law to distribute each year to their shareholders at least 95 percent (90 percent beginning in 2001) of their taxable income, putting REITs among those companies paying the highest dividends. Individual investors that are retired or approaching retirement often seek investments that provide appreciable and dependable sources of income. Younger investors also may seek income-producing investments as part of their strategy for reducing the volatility and protecting the value of their portfolios. REIT dividends help to stabilize the value of individual stock portfolios because the contractual rental income from their properties is similar to the interest payments on bonds.

Many of these investors regularly turn to Treasury securities, corporate and municipal bonds and utility stocks to satisfy their income-producing investment

Exhibit 10

NAREIT Equity REIT Yield Less 10-Year Constant Maturity Treasury Yield

(Month end, January 1990 - November 2000)



[1] December 1999 value as of December 16, 1999.

Source: National Association of Real Estate Investment Trusts®, Federal Reserve Board.

objectives. However, two notable shortcomings of these investments are that they provide little protection against inflation and few, if any, opportunities for growth. REIT stocks on the other hand, provide substantial and dependable dividends that also provide a measure of protection against the corrosive effect of inflation because of the tendency for rents to rise during periods of rising prices. Moreover, REIT earnings are likely to grow over time as rents rise, economies of scale are realized, and operating margins expand.

Investors often look at the dividend yield – the dividend rate divided by the share price – to compare the income-producing ability of alternative investments or to determine which sectors or individual stocks are relatively over- or under-valued. At the end of November 2000, the average dividend yield for all equity REITs was 7.85 percent (Exhibit 4). Exhibit 10 shows that the average dividend yield was 2.37 percentage points above the yield on 10-year Treasury securities. As share prices this year have increased, the yield spread has narrowed but remains much above its 0.83 percentage point average since the beginning of 1990.

Exhibits 11 and 12 compare the average equity REIT dividend yield with those of the S&P 500 index and the S&P Utilities index, respectively. In both cases, the average equity REIT dividend yield spread remains appreciably above its long-run average.

An extraordinarily high dividend yield may be a sign that, owing to certain problems facing a particular company, investors demand an additional risk premium in their required return. Thus, when evaluating the dividend yield, investors should inquire about a company's long-term capacity to generate sufficient revenue both to meet and consistently grow its current dividend rate. Exhibit 13 shows that REIT dividends have grown at an average annual rate of 6.6 percent since 1992, a rate that has exceeded the rate of consumer price inflation each year.

REIT analysts and investors also look at the payout ratio – or the ratio of the dividend rate divided by FFO per share – to determine how much of a company's available cash flow is being used to pay the dividend. Exhibit 14 summarizes quarterly payout ratios and shows that payout ratios on average have declined from more than 85 percent in 1994 and 1995 to 65 percent in the second quarter of 2000. While maintaining a dividend rate of at least 95 percent of taxable income, REITs have been reducing the proportion of total available cash flow they use to pay their dividend, thereby increasing the cushion available to meet current dividend rates.

Net Asset Values

Investors often judge the relative value of a stock by dividing the market price of the stock by the book value per share of the company. A company's book value is based on GAAP and is the difference between the company's assets and liabilities or the sum of retained earnings plus other items under stockholders' equity. In its simplest terms, this yardstick is used to determine how much more or less investors are willing to pay for the book net worth of the company and the earnings capacity that the net worth represents. When the price-to-book ratio exceeds 1.0, the stock is said to trade at a premium to book value. When the ratio is below 1.0, the stock trades at a discount. Stocks that trade at a discount often are viewed as offering investors more value than stocks priced at a premium, although investors are well-advised to be

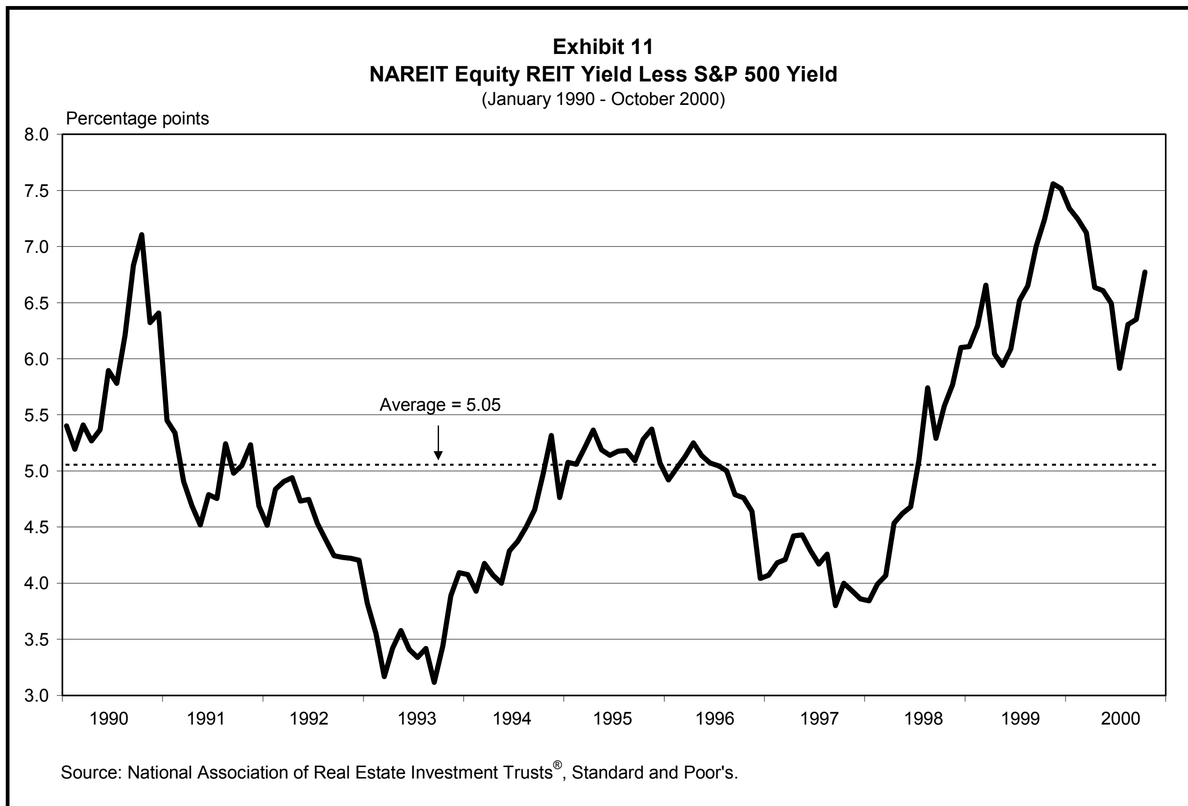


Exhibit 11
NAREIT Equity REIT Yield Less S&P 500 Yield
(January 1990 - October 2000)
Percentage points
8.0
7.5
7.0
6.5
6.0
5.5
5.0
4.5
4.0
3.5
3.0
Average = 5.05
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
Source: National Association of Real Estate Investment Trusts®, Standard and Poor's.

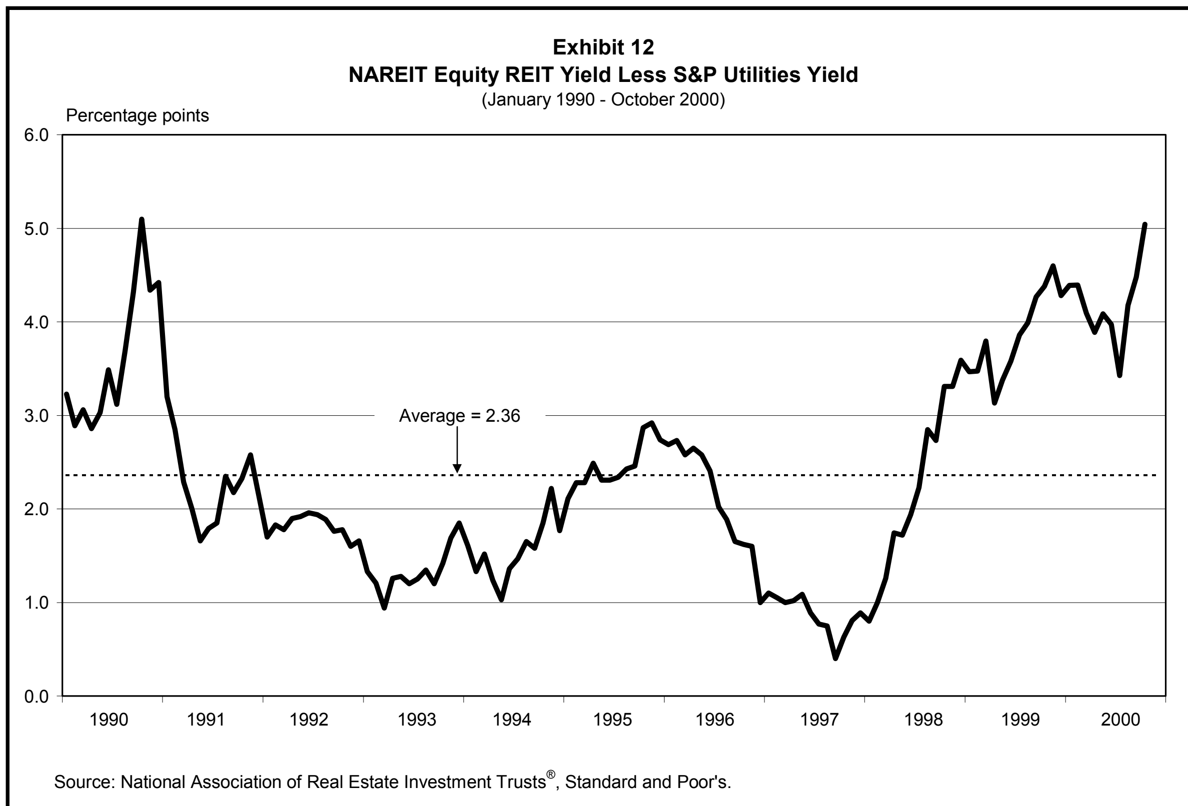


Exhibit 12
NAREIT Equity REIT Yield Less S&P Utilities Yield
(January 1990 - October 2000)
Percentage points
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Average = 2.36
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
Source: National Association of Real Estate Investment Trusts®, Standard and Poor's.

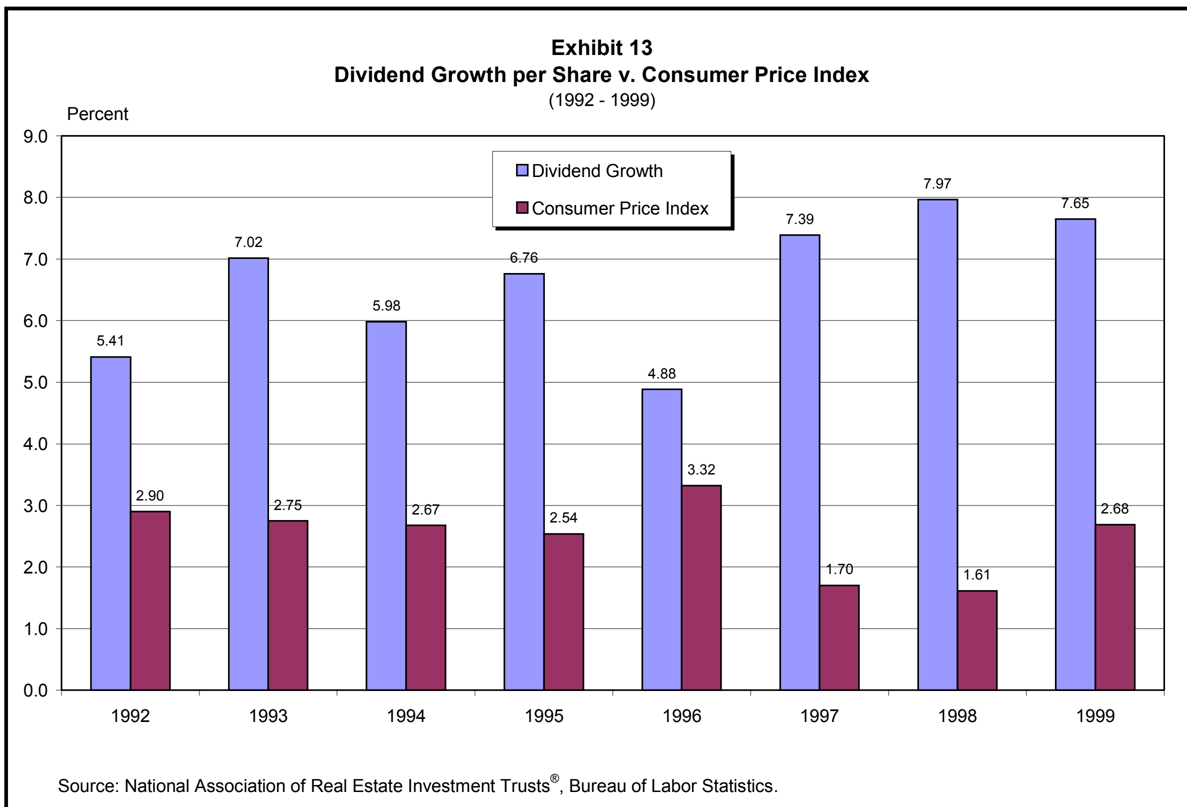


Exhibit 13
Dividend Growth per Share v. Consumer Price Index
(1992 - 1999)
Percent
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Dividend Growth
Consumer Price Index
5.41
2.90
7.02
2.75
5.98
2.67
6.76
2.54
4.88
3.32
7.39
1.70
7.97
1.61
7.65
2.68
1992
1993
1994
1995
1996
1997
1998
1999
Source: National Association of Real Estate Investment Trusts®, Bureau of Labor Statistics.

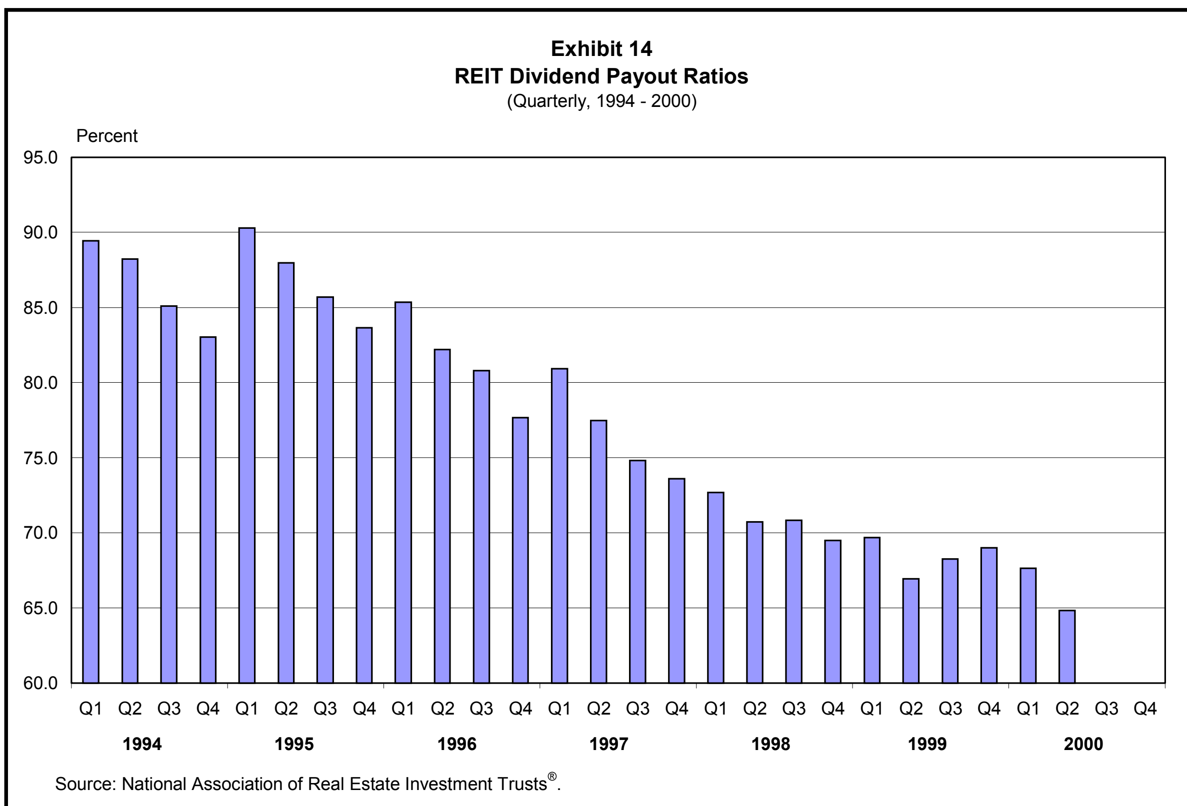


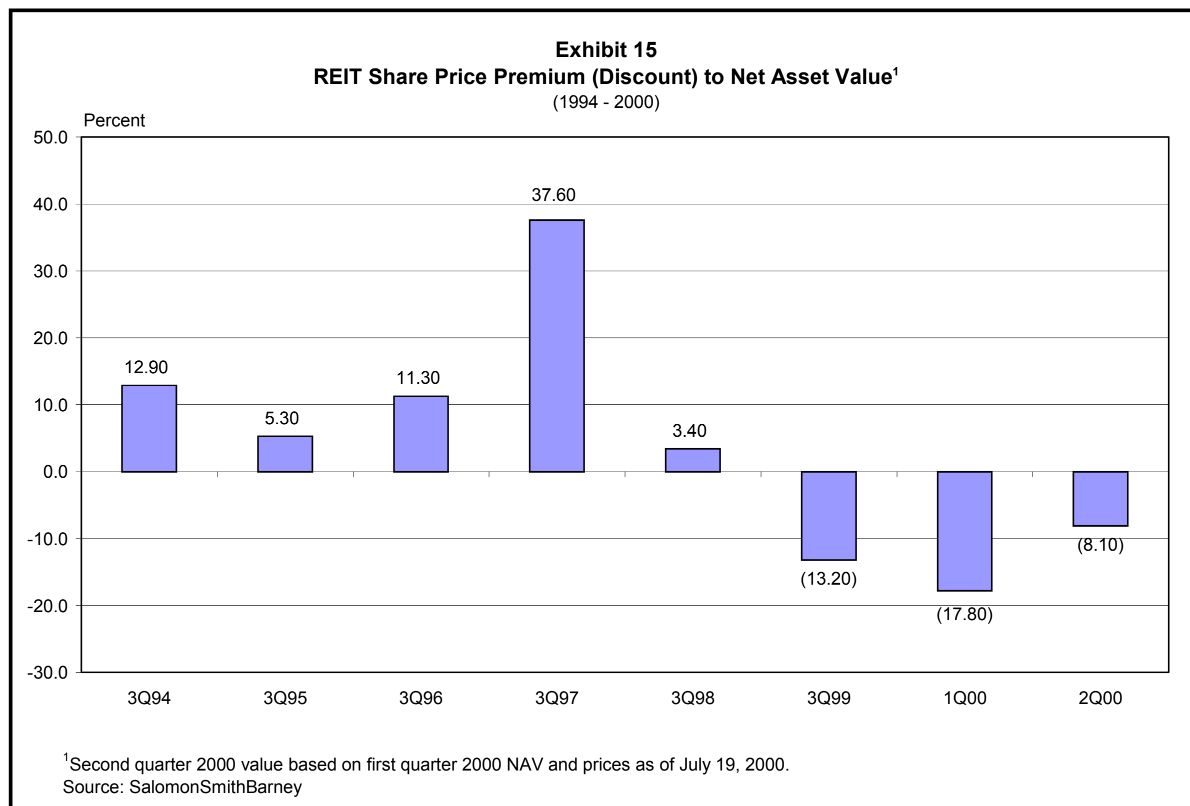
Exhibit 14
REIT Dividend Payout Ratios
(Quarterly, 1994 - 2000)
Percent
95.0
90.0
85.0
80.0
75.0
70.0
65.0
60.0
Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4
1994
1995
1996
1997
1998
1999
2000
Source: National Association of Real Estate Investment Trusts®.

especially cautious of stocks trading at unusually large premiums or discounts.

Most REIT analysts and investors consider price-to-book value ratios based on GAAP as inappropriate when evaluating REITs. Because a REIT's real estate assets are valued at their original purchase price less accumulated depreciation, book value accounting may significantly understate the current market value of the REIT's properties and the genuine earnings capacity of the company. Thus, most REIT analysts and investors use current real estate prices to estimate a REIT's net asset value (NAV) as a surrogate for book value.

Because NAV incorporates an estimate of the market value of a REIT's assets, most REIT analysts consider NAV rather than book value as a more appropriate measure of a REIT's net worth and calculate the ratio of price divided by NAV to determine share price premiums and discounts. Many of these analysts also argue that a REIT's stock ordinarily should be priced above its NAV to reflect the franchise value created by management. Exhibit 15 shows that, according to this view, REIT stocks on average remain undervalued because they continue to trade at discounts to NAV. On balance, when using price-to-NAV ratios, it is important for investors to view such ratios as only one of many tools available for judging whether the share prices of individual companies are relatively high or relatively low.

Exhibit 15
REIT Share Price Premium (Discount) to Net Asset Value[1]
(1994 - 2000)



[1]Second quarter 2000 value based on first quarter 2000 NAV and prices as of July 19, 2000.
Source: SalomonSmithBarney

Exhibit 16
Property Sector Comparison
(Data through second quarter 2000 in percent, except where noted)

Property Sector	2000 Year-to-Date[1]	FFO Growth	Debt Ratio	NAV Premium[2]	FFO Multiple[3]	Dividend Yield[1]	Payout Ratio	Dividend Growth
Industrial/Office	30.1	11.7	45.4	NA	9.3	6.5	62.6	8.8
Office	32.2	10.9	46.7	-25.0	9.0	6.4	62.9	9.8
Industrial	26.2	12.9	43.3	-5.9	9.9	6.2	62.9	3.6
Mixed	27.2	13.0	42.9	-19.7	9.1	7.0	61.1	11.4
Retail	13.4	7.5	54.0	NA	7.7	8.5	68.9	3.8
Shopping Centers	9.9	4.0	47.7	NA	8.1	8.9	72.4	4.3
Regional Malls	19.0	11.7	61.4	-17.2	7.3	8.1	64.9	3.1
Free Standing	5.9	5.0	42.7	NA	7.9	8.8	81.4	NA
Residential	24.9	12.4	45.2	NA	9.9	6.6	66.9	7.1
Apartments	26.5	12.9	45.5	-16.0	9.9	6.5	66.3	7.1
Manufactured Homes	7.7	6.9	41.2	-17.0	9.8	7.2	73.2	NA
Diversified	20.4	0.1	45.4	-16.4	8.9	9.5	69.5	5.3
Lodging/Resorts	35.9	9.2	55.0	-31.1	5.6	10.1	48.3	0.0
Health Care	25.4	-3.7	50.3	NA	6.7	9.9	84.3	5.4
Self Storage	10.0	0.2	45.6	-26.5	8.8	5.8	50.1	0.9
Specialty	-18.7	-1.8	31.1	NA	NA	7.0	NA	9.6

Notes:
[1] As of September 29, 2000.
[2] As of first quarter 2000.
[3] Based on annual 2000 FFO analyst estimates and prices as of August 31, 2000.
Source: National Association of Real Estate Investment Trusts®, SalomonSmithBarney, First Call.

Factors Affecting REIT Returns

Exhibit 16 summarizes for each major property sector of the REIT industry the various quantitative measures commonly used by analysts and investors to evaluate REIT stocks. Sector comparisons provide investors with a starting point when screening for individual stock selections. Individual investors can find current information on investment performance and operating fundamentals, at both the sector and company level, in NAREIT's monthly publication, REIT Watch®, AAII's Stock Investor Pro, the REIT research reports available from their brokers and the financial press.

When selecting shares of individual companies in which to invest, it is important for individual investors to recognize the many factors that affect the stock prices and valuations of REITs and publicly traded real estate companies. Some of these factors affect the prices of all stocks, whereas others primarily are related to the commercial real estate business.

Real Estate Fundamentals

Because investors often compare current stock prices to net asset values, investors should be aware of how well balanced the supply of new buildings is with the demand for new space. When new construction adds space more rapidly than it can be absorbed, building vacancy rates increase and rents and property values decline, thereby depressing NAVs.

In a strong economy, growth in employment, capital investment and household spending increases the demand for new office buildings, apartments, industrial facilities and retail stores. Population growth also boosts the demand

for apartments. However, the economy is not always equally strong in all geographic regions, and economic growth may not increase the demand for all property types at the same time. Thus, investors should compare the locations of properties owned by different companies with the relative strength or weakness of real estate markets in those locations. Information on company properties is available at their web sites, while information on local and regional real estate markets is available in the financial press.

Earnings and Dividends

The market usually rewards companies that demonstrate consistent earnings and dividend growth with higher price-earnings multiples. Thus, investors should look for REITs and publicly traded real estate companies with a demonstrated ability to grow their earnings in a reliable manner. For example, look for companies with properties in which rents are below current market rents. Such properties provide up side potential in equilibrium markets and down side protection when economic growth slows. Seek companies with management teams that are able to quickly and effectively reinvest available cash flow. For firms with the ability to develop new properties, look for companies that are able to consistently complete new projects on time and within budget. Finally, be alert for creative management teams with sound strategies for developing new revenue opportunities under the REIT Modernization Act.

Company Fundamentals

Finally, investors should look for companies with strong management and operating characteristics. Such characteristics include effective corporate governance procedures, conservative leverage, widely accepted accounting practices, strong tenant relationships, and a clearly defined operating strategy for succeeding in competitive markets. These characteristics inspire confidence in the marketplace and are the same characteristics that individual investors should use when evaluating all companies.