

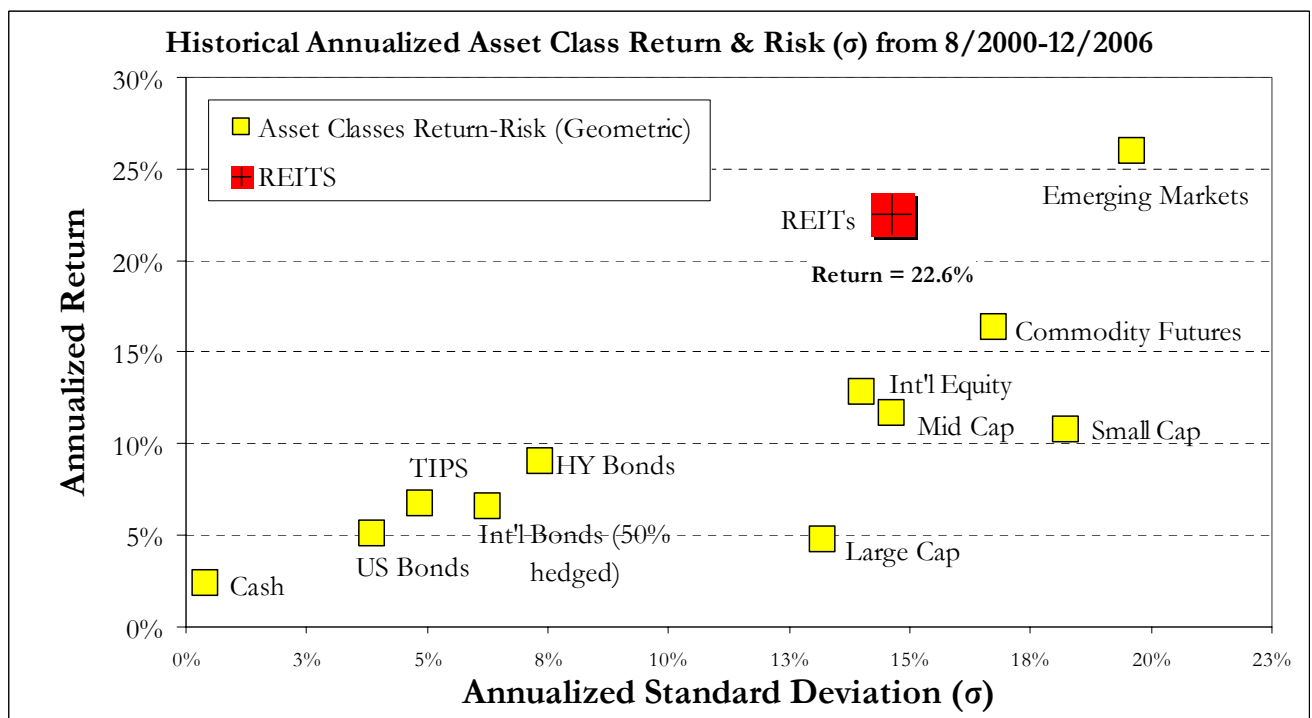
REIT Valuations Approaching the Stratosphere

By: Matthew Rice, CFA
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In December of 2005, we authored a paper titled, “REIT Valuations Relative to Other Asset Classes”. At that time, we concluded that REIT valuations were approaching the high side of normal, but advised our clients to stay the course and maintain their existing strategic allocations. However, since 2005, we believe the REIT market has skyrocketed to the stratosphere and are advising our clients to take heed.

Recent History:

Since the beginning of the last bear market, REITS have generated an impressive 22.6% annualized total return (from August 2000 – December 2006). With the exception of emerging markets, REITs have been the strongest performer, outperforming the next closest asset class by over 6% per year.



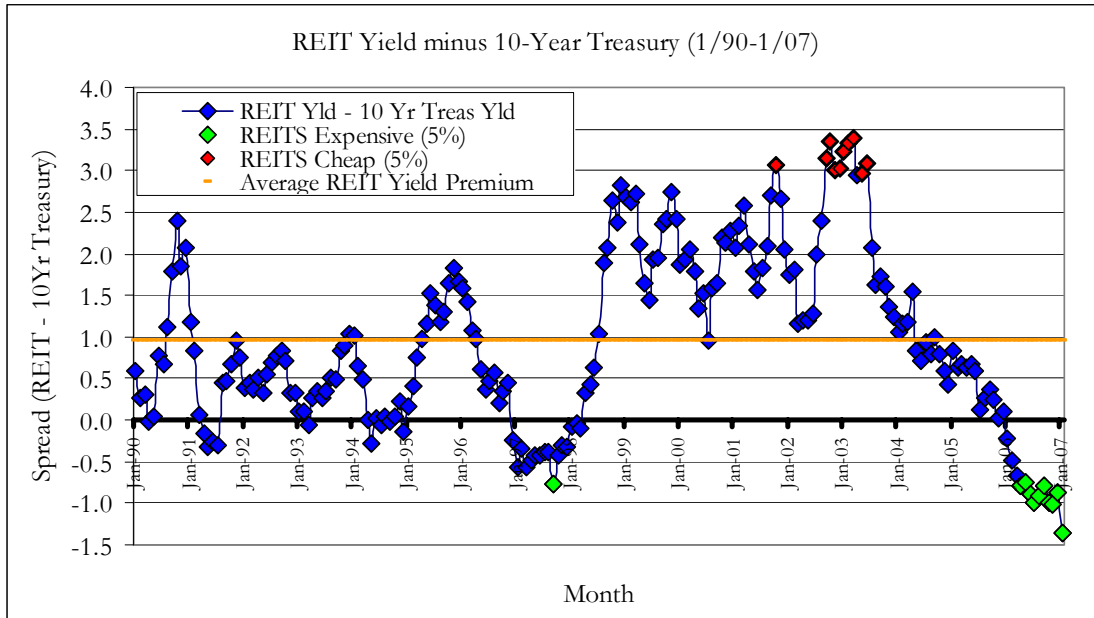
REIT Market Yield versus 10-Year Treasury Yield

By themselves, strong recent returns are not enough to cause us to predict doom for an asset class. Asset classes have frequently experienced prolonged periods of outperformance. However, some REIT valuation metrics have reached all time highs. The asset class could face significant future headwinds.

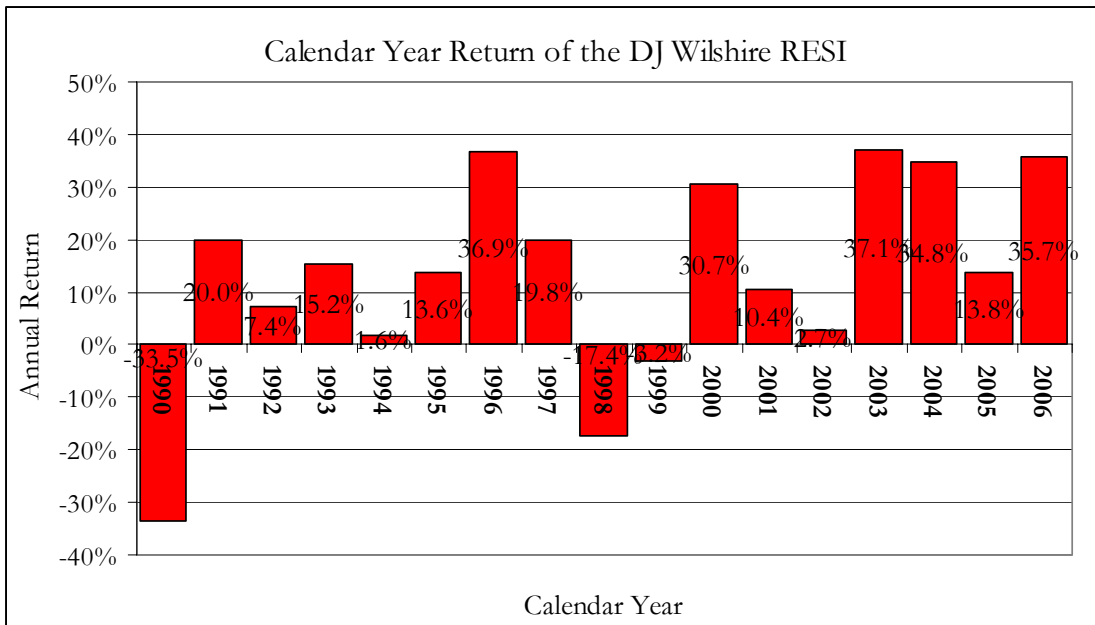
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The average REIT market (dividend) yield spread over the 10-year Treasury was +0.95% (from January 1990 – January 2007). In late 1997, the REIT yield spread over the 10-year US Treasury narrowed to -0.76%. History is not destiny, but REIT market returns during the two calendar years after 1997 were negative. As of 1/31/07, the REIT yield premium relative to the 10-year treasury was -1.36% (3.40% vs. 4.76%). This spread is an all-time low by a large margin.

The REIT market's 5% highest and lowest yield spreads vs. the 10-year Treasury

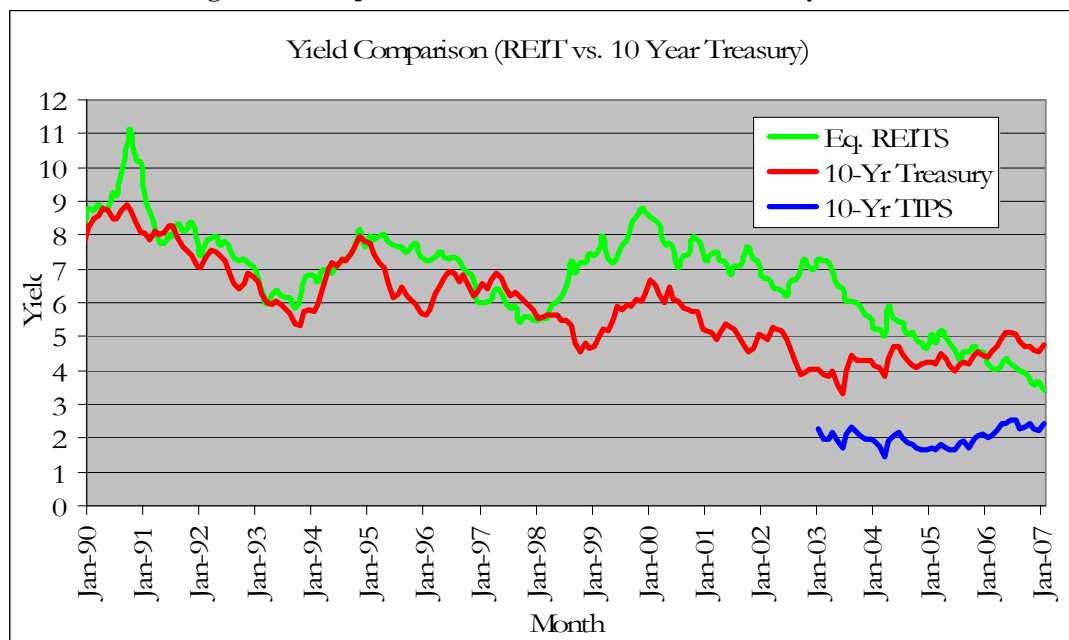


REIT Market Returns (1990 - 2006)



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Long-Term Comparison of REIT Yields to 10-Yr Treasury and TIPS



REIT Market P/FFO vs. S&P 500 P/E

In December of 2001, the REIT P/FFO (*funds from operations*) multiple was 12.7 lower than that of the S&P 500 Index. As of December of 2006, the REIT Multiple is 2.6 above that of the S&P 500. Quite a turnaround! Currently, stocks in the S&P 500 Index retain about 70% of their earnings and pay out about 30% as dividends. The retained 70% is reinvested back into the businesses to grow future earnings. For REITs, over 90% of earnings are paid out as dividends and less than 10% are retained to reinvest in future growth. Therefore, it is difficult to make an argument for why the S&P 500 growth rate (and P/E ratio) should be lower than the REIT market's expected growth rate (and P/FFO ratio).

Year Ending:	REIT FFO Multiple*	S&P 500 EPS Multiple**	Spread
December-01	9.3x	22.0x	-12.7
December-02	9.5x	16.0x	-6.5
December-03	12.3x	17.8x	-5.5
December-04	14.7x	16.3x	-1.6
December-05	15.2x	14.6x	0.6
December-06	18.5x	15.9x	2.6
10 Year Average	11.5x	18.7x	-7.1

Source: Morgan Stanley, Merrill Lynch, FactSet, Reuters

* FFO multiple based on consensus 12-month forward FFO estimates

** S&P 500 EPS Multiple based on 12-month forward bottom-up EPS estimates

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Price to NAV Estimates

According to Green Street Advisors Inc, REITs currently trade at about a 7% premium to their underlying property values, or net asset values (NAVs). While not extraordinarily high by historical standards, the Price-to-NAV metric is a relative value measure between the value of public and private real estate. However, it is quite possible for both public and private real estate to be overvalued at the same time.

**REIT Share Price Premiums to
Green Street NAV Estimates**
January 1990 – January 2007



Historical REIT Return Decomposition:

From 1971-2006, The NAREIT Equity REIT Index had a total annualized return of 13.9%. The price component of return was 5.24%. Figuring that 1.51% of this price return came from yield compression (*as the dividend yield declined from 6.13% in 1972 to 3.69% in 2006*), and that CPI averaged 4.7% annually, the real price return (excluding yield compression) was actually -0.97% annually. At 8.7% annually, the dividend was by far the largest component of return.

The following returns decomposition model is used to forecast returns where total return is a function of dividend yields, real price return (excluding yield compression), yield compression and CPI (inflation).

Returns Decomposition Method: [(DIV) + (RPR¹) + (YLD C²) + (CPI²)]

(1972-2006): [(8.7%) + (-0.97%) + (1.51%) + (4.7%)] = 13.9%

10-Year Forecast: [(3.6%) + (0.0 %¹) + (0.0%²) + (2.3%³)] = 5.9%

10-Year Forecast Assuming Yield Expansion: [(3.6% + (0.0 %¹) + (-3.0%) + (2.3%³)] = 2.9%

If we assume the REIT market dividend yield gradually converges back to its long-term average spread (+0.95%) over the 10-year Treasury during the next decade, we would need to trim another 3% off the annual return, bringing the expected annual return down to 2.9%.

DIV = Dividend yield (8.7% from 1972-2006)

RPR = Real price return excluding yield compression (-1.22% from 1972-2006)

YLD C = Price return resulting from yield compression (1.75% from 1972-2006). Dividend yield fell from 6.13% in January of 1972 to 3.69% in December of 2006.

CPI = Inflation (4.7% from 1972 - 2006).

¹Unlike traditional stocks, REITs pay out virtually all their earnings (or FFO) in dividends and rely on the issuance of new equity to grow earnings (or FFO). Therefore, the expected long-term real price return is assumed zero.

²The forecasted return component that results from yield compression is zero.

³Forecast CPI is calculated by subtracting the 10-Year TIPS yield from the 10-Year Treasury yield (a.k.a. break-even inflation).

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Conclusion

What is the REIT market telling us? Some possible explanations for current valuation levels include:

- 1) For whatever reason, risk for the REIT market has fallen dramatically, justifying a greatly reduced expected return going forward.
- 2) Unlike the past 35 years, and despite the fact that REITs distribute 90 plus percent of earnings as dividends, REITs are now capable of generating substantially positive real earnings growth. *(In other words, it is different this time.)*
- 3) REITs are overvalued.

Any of the above explanations are possible. However, we think the third explanation is most likely correct. With a 5.9% forecasted 10-year return, assuming no yield expansion, the REIT market currently does not offer an overly attractive reward to risk ratio. By comparison, the 10-year Treasury Inflation Protected Security, backed by the full faith and credit of the US government, offers a 4.6% expected return (*2.3% expected inflation rate plus a 2.3% real yield*). In our opinion, a 1.3% expected premium (over TIPS) for taking REIT market risk is not a good use of a typical investor's risk budget.

We believe the capital markets are usually efficient and market participants adjust the valuation of asset classes based on their expected risk-adjusted returns. However, even the most creative have a hard time justifying current REIT valuations. As a note of caution, we fully understand that REITs could continue to post strong returns for several more quarters, if not longer. We also recognize that the fundamentals for the REIT market are currently quite strong, and have little reason to believe any erosion is imminent. However, regardless of the fundamental strengths, we still believe REITs do not offer an attractive long-term risk-reward profile at current valuation levels.

We advise that our clients immediately cap their REIT exposure to the allocation suggested by the Frontier Engineer™ asset allocation model using a 4.4% annualized 10-year return assumption. The 4.4% return forecast is an average of the 2.9% return scenario assuming yield convergence, and the 5.9% return from the equilibrium assumption. For clients currently above the Frontier Engineer™ suggested allocation, we recommend reducing the REIT allocation and spreading the proceeds to the remaining asset classes. We will provide a specific reallocation suggestion based on your unique portfolio mix. At some time in the future, REIT valuations will likely return to more reasonable levels. At that time, we will adjust our input assumptions and advise our clients accordingly.

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The views and opinions in the preceding commentary are as of the date of publication and are subject to change. This material represents our assessment of the market environment at a specific point in time. It is not intended to predict performance of any investment.

About the Author:

*Matthew Rice, CFA, CIMA: Matt is a firm Principal and its Chief Research Officer. As Chief Research Officer, Matt spearheads the firm's research efforts in the areas of capital market analysis, investment strategy, asset allocation modeling, portfolio rebalancing modeling and investment manager research. He is also a member of the DiMeo Schneider & Associates, L.L.C.'s investment committee that sets investment policy, establishes the framework for asset allocation and approves investment managers. In 2004, he co-authored *The Practical Guide to Managing Nonprofit Assets* (John Wiley & Sons). Matt received a BA in Economics from Northwestern University, is CFA Charter holder (Chartered Financial Analyst), a CIMA (Certified Investment Management Analyst), a CIMC (Certified Investment Management Consultant), and earned an Alternative Investment Certificate from the Wharton School of Business & IMCA.*