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CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT

REITS DECIMATED IN APRIL; TIME TO JUMP IN?

April 2004

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REITs Decimated in April; Time to Jump in?

The popularity of REITs has grown over the last several years, as investors have come to value their relatively high dividends and diversification benefits. Since the start of the bear market in equities in March 2000 REIT performance has been particularly strong, with the NAREIT Equity REIT Index generating a total return of 131.6%, or 22.8% annually, through the end of March 2004. Record capital inflows pushed up market values, despite deteriorating property-level fundamentals.[1] However, since the end of March, the REIT market has experienced a significant pullback. Precipitated by a report of very strong job growth in March, the REIT market returned -14.6% in April, erasing all the gains of the first quarter. While the addition of new jobs is actually a positive for real estate fundamentals, the strong jobs report sparked a sharp upward movement in interest rates that has proved unsettling for REIT investors. During this REIT correction, the retail and health care sectors have underperformed, while hotels and apartments have outperformed.

The extended rally pushed the REIT sector from undervalued to overvalued territory, with April's pullback improving valuations, bringing them to fair value based on most metrics. According to Green Street Advisors, the REIT sector traded at a 20.4% discount to its underlying net asset value (NAV) as of February 29, 2000, increasing to a 22.3% premium by March 31, 2004, compared to an average 5.5% premium over the past ten years. As of the end of April, REITs now trade at a more reasonable 4.8% premium to NAV. Other valuation measures indicate similar trends. The REIT price-to-funds from operations ratio, which is similar to a price-to-cash flow measure for other equities, achieved a new high of 14.0x in March 2004, before falling to 12.3% at the end of April, compared to an average of 10.8x over the past ten years. In addition, the REIT dividend yield increased from a new low of 5.0% at the end of the first quarter of 2004 to 5.9% at the end of April. Relative to bond yields, REIT dividends offered increasing value over the month, with yield spreads widening from 115 bps to 137 bps relative to the ten-year Treasury, compared to a ten-year average of 138 bps, and from 39 bps to 68 bps relative to BBB-rated corporate yields, compared to a ten-year average of -20 bps.

From a real estate fundamentals perspective, the recent economic news is strongly positive, as job growth is critical to increasing demand for all property types, particularly the office and apartment sectors. However, investors need to remember that real estate performance will lag that of the general economy, meaning that stronger economic trends will not likely be reflected in near-term REIT earnings. Continued weak profits could lead to dividend cuts, particularly in the office and apartment sectors, which would obviously have an adverse impact on performance going forward.

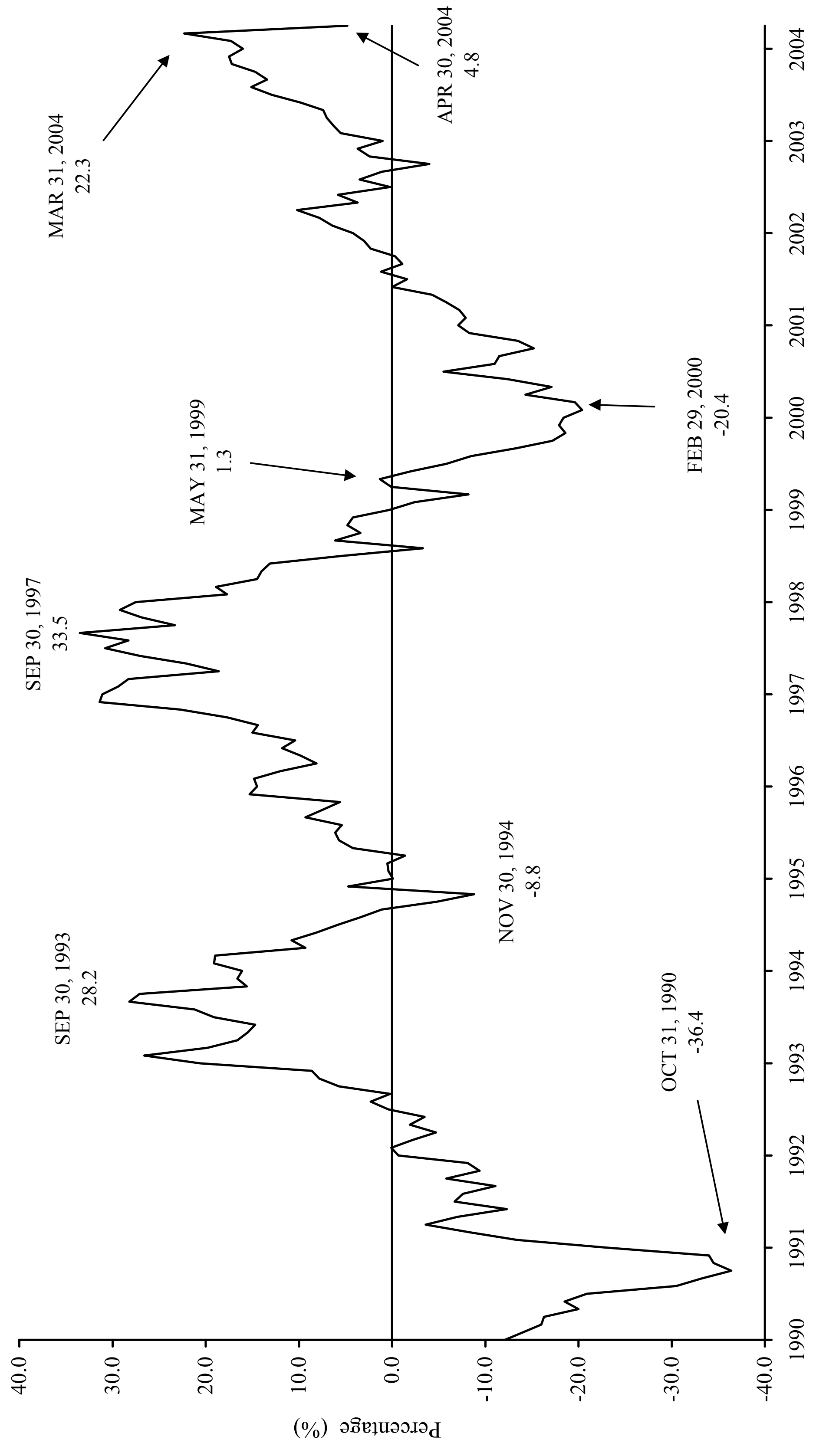
[1] According to Morgan Stanley, dedicated REIT mutual funds received a record-setting $4.5 billion in new money in 2003, followed by an additional $3.2 billion in the first quarter of 2004 alone. Similarly, closed-end funds that invest in common and preferred REIT shares raised $4 billion in 2003, followed by $2 billion in the first quarter of 2004.

While REIT valuations are more reasonable than they were at the end of the first quarter, the sector cannot be characterized as cheap. The April correction has brought REIT prices back only to December 2003 levels. We recommend that clients with existing allocations use any rebound in REIT prices as an opportunity to rebalance to target weights. For clients interested in initiating an allocation to the sector, we would advise them to proceed cautiously and perhaps wait for an additional 10% to 15% pullback before considering a full allocation.

Table A

REIT PRICE PREMIUMS TO NET ASSET VALUE RATIO

January 31, 1990 - April 30, 2004



Source: Green Street Advisors, Inc.
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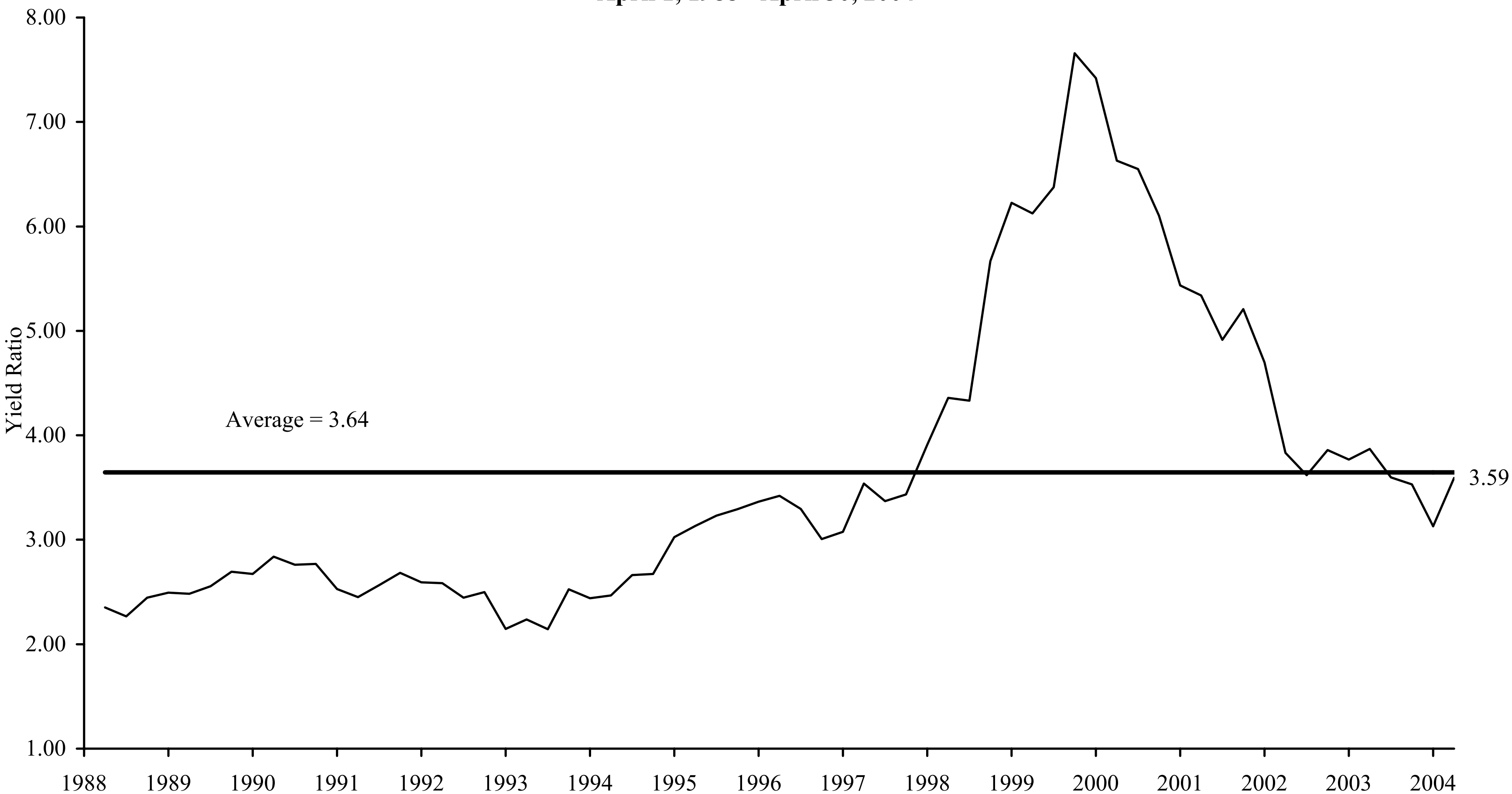
Table B

RATIO OF NAREIT EQUITY REIT DIVIDEND YIELDS TO S&P 500 DIVIDEND YIELDS

April 1, 1988 - April 30, 2004



Sources: Calculated from data provided by the National Association of Real Estate Investment Trusts, Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal.*
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