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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENTARY

TIME TO BUY REITS?

March 2008

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Time to Buy REITs?

Given the revival of inflationary fears in recent months, coupled with a savage sell-off in property shares worldwide, some investors have asked whether it makes sense to look at REITs as an inflation hedge and/or value play. Further, several factors, such as the significant liberalization of continental European property structures, the recent introduction of U.K. REITs, and the rapidly expanding REIT sector in Asia, raise the question of how REIT investments should be allocated on a geographic basis. Our conclusion is that while REITs are certainly much cheaper than they were a year—or even six months—ago, there is potentially more downside yet to come. Problems in the commercial mortgage-backed securities (CMBS) market, which have only begun to surface, threaten to constrain property funding for some time to come, while a protracted recession would likely drive vacancies higher and put downward pressure on rents. While the cash flow element of REITs is certainly an attractive feature, particularly in difficult economic times, yields are low (especially given rising inflationary pressures). Still, REIT valuations are undeniably better than in the recent past, and also do not look particularly high relative to those of broad equity markets. From a geographic standpoint, we are more favorably inclined toward European and Asian REITs than those in the United States and United Kingdom at the moment, partly due to the better economic prospects of these regions, but also because public property investment vehicles in these areas remain relatively new, raising the likelihood that skilled managers will be able to add alpha.[1]

A Word on Inflation

We are often asked our thoughts on REITs as an inflation hedge, as they have certain characteristics that make them seem appealing (e.g., they are a "hard asset," and rents generally tend to rise with inflation), but are also tied to the business cycle. Our opinion is that while REITs are far from an ideal inflation hedge, they do provide some benefits and should be expected to track inflation relatively well over the long term. However, short-term returns have historically been more correlated with broad equity markets than with inflation. We should note that historical data on REITs during high-inflation periods are next to nil. Indeed, the one period on which we have reliable data—1973–81 in the United States—featured a REIT market vastly different from the one that exists today. Still, it is at least worth mentioning that during this period, the NAREIT Index not only exhibited a negative correlation with inflation, but also posted inferior returns to other inflation-hedging asset classes.

Broadly speaking, REITs provide investors with predictable cash flows, abundant liquidity, and the ability to easily invest across borders, all of which could be quite valuable in a period of high inflation and declining equity markets, particularly if one's home currency were also depreciating against other currencies. Further, while REITs tend to track equity markets in the short term, they are in fact claims on real estate, and should therefore be expected to provide real estate–like returns over longer timeframes.

[1] For more details on the European market, please see our November 2006 Market Commentary *Bullish on European Property.*

United States

We have considered U.S. REITs overvalued since April 2006, and while valuations have certainly become more reasonable in recent months, they remain a bit expensive, particularly considering the uncertain economic environment. The price-to-trailing-12-month-funds-from-operations ratio, for example (basically analogous to the price-earnings [P/E] ratio for equities), is now 13.5, right in line with its historical average of 13.3 (Table A). However, in the event of a continued economic slowdown or recession, funds from operations would almost certainly come under pressure; thus, current multiples do not provide a particularly large margin of safety. Dividend yields (DYs), meanwhile, have risen sharply in recent months, to 5.2%, 170 basis points (bps) above those of ten-year Treasuries (Tables B and C). This certainly represents a dramatic improvement from January 2007's low of 143 bps *below* Treasury yields, and is well above the post-1986 average spread of 69 bps. However, we believe relative yield metrics of virtually *all* credit markets are currently skewed by the extraordinarily low levels of U.S. Treasury yields, which continue to be driven down by non-economic buyers such as Asian central banks. Thus, while REIT yields are certainly attractive relative to those of Treasuries, they remain low in absolute terms.

While some observers put great faith in REITs being undervalued due to their near 25% discount to net asset value (NAV), we are less sanguine. As seen in Table D, this series has fluctuated widely over the years, largely due to the fact that while REITs are "marked-to-market" daily, underlying property values tend to change at a much slower pace. The question, therefore, is whether the gap will be closed by a rally in REIT shares, a decline in NAV, or some combination of the two. Our expectation is that the brunt of the adjustment will be borne by declining property prices. It is also reasonable to expect cap rates, which have been absurdly low, to increase in coming months, which would make the sector appear more expensive on a NAV basis.

Finally, the ongoing turmoil in credit markets has increased the cost of debt for buyers of real estate (including REITs) and reduced merger and acquisition (M&A) activity, which has itself been a driver of REIT price appreciation in recent years. M&A activity slowed in 2007, with 13 announced transactions totaling $77.6 billion (including debt), compared to $83.1 billion in 18 transactions in 2006. Still, activity for both years was more than double the $33.7 billion total (11 transactions) for 2005. On balance, we continue to believe U.S. REITs are overvalued, but clearly some of the near-term price risk has been eliminated due to their -25.8% return over the past 13 months.

United Kingdom

Last October, we penned an analysis[2] that concluded it was "a particularly inopportune time to allocate funds to U.K. property." We were speaking of direct investment in property, of course, and indeed one of the data points we used as evidence for our conclusion was that REIT prices had fallen far further and faster than those of property prices. Since that time, while property prices have fallen, returning -10.9% for

[2] Please see our October 2007 Market Commentary *Has U.K. Property Finally Peaked?*

the five months ended in February, REITs have declined still more, returning -11.9%. In other words, while property prices have begun to follow REITs down, REITs have fallen *even faster*, suggesting either that property prices will plunge significantly from here, or that REITs have become more attractive, at least from a relative perspective.

The dramatic nature of the U.K. REIT sell-off (REITs have fallen by more than a third since the beginning of 2007), coupled with the U.K. market's deep discount to NAV, certainly argues for the latter. However, as in the United States, we believe U.K. REITs have it "right," and that the plunge in REIT prices simply means property prices have a long(er) way to fall.

Indeed, despite their precipitous drop, U.K. REITs are not particularly cheap on an absolute basis. DYs, for example, are 2.5%, far below the 5.2% available on U.S. REITs, and also below the 3.8% DY of U.K. equities. While P/E ratios have fallen sharply and are right in line with the broad equity market (Tables E and F), this gives us relatively little comfort considering the bleak macroeconomic environment. In short, if the U.K. economy continues to deteriorate, as seems likely, the "E" will almost certainly fall sharply. In fact, somewhat paradoxically, several strategists have actually argued that the weak economy will be *positive*, at least in the short term, for U.K. REITs. Morgan Stanley, for example, recently listed three "catalysts" for a rally in U.K. REITs:

1. Expected rate cuts from the Federal Reserve.
2. The April 3 publication of the Bank of England's (BOE) *Credit Conditions Survey*, which Morgan Stanley expect "will show just how rapidly the 'credit crunch' is spreading to the 'real economy' in the U.K."
3. Coming reductions in the BOE's policy rate, based largely on its belated acceptance of point number two.

We should note that Morgan Stanley expects the ensuing rally to be brief, and for values to subsequently halve over the following 18 months. Indeed, perhaps the best argument to be bullish on U.K. REITs is that sentiment has grown almost unremittingly bearish. For example, in a recent issue of *Property Week*, two of the main stories were titled "Ten Reasons Not to be Cheerful (Part II)" and "Dead Cat Bounce," while Neil Prime, head of Jones Lang LaSalle's City office, recently told the *Financial Times*: "The combination of impossible-to-get speculative funding, rising construction costs and uncertainty in the occupier market has meant that there are few willing to put a shovel in the ground right now."

Still, as noted in our October Market Commentary, such pessimism is well grounded given the weakening economic outlook and sudden paucity of buyers. The leveraged buyers who drove prices higher in recent years are increasingly constrained by the credit crunch, while cash buyers from the Middle East remain highly dependent on rising oil prices. Banks, meanwhile, are already stuffed to the gills with property loans. According to research firm Capital Economics, property loans as a percentage of overall bank loans hit a record 11.5% (£193 billion) at the end of 2007, well above the mid-1970s and late-1980s peaks of about 10% (both of which preceded sharp falls in property prices). Further, given that an additional £78 billion of commercial property debt is held in European CMBS structures, a total of £271 billion in loans is secured by

U.K. property. To put this in perspective, it is 55% of the size of the gilt market, and a third *larger* than the Tier 1 capital of the nine largest U.K. banks. Thus, lenders are far more likely to scale back property lending going forward than they are to expand it.

Continental Europe

As we noted in our recent report on European property companies,[3] "it is hard to make a compelling case today for European real estate as a whole, despite its clear long-term potential." Indeed, much as in the United Kingdom, continental property valuations remain high, with DYs of a mere 3.4% and a P/E ratio of 15. Also similar to the United Kingdom, the credit crunch has shrunk the pool of potential buyers, while economic growth has slowed.

As in the United States and United Kingdom, the best argument in favor of continental REITs is that shares trade at a substantial discount to NAV. However, we are particularly skeptical of this measure's value in Europe. To begin with, data on direct investment in European property are widely acknowledged to be of poor quality and questionable usefulness.[4] Further, the post-1989 average for this series is -16.1%, which either throws additional doubt on its validity, or suggests that a reading of -23.3% is actually not all that cheap.

Still, on balance we remain more bullish on continental property companies than their U.K. peers. Indeed, European property has yet to see anything close to the slowdown experienced across the Channel. In 2007, for example, U.K. investment activity slowed by 9%, while continental activity *rose* 15%, with 20 of 24 markets hitting record-high investment levels. CB Richard Ellis recently said they "do not see capital values on the Continent falling by anything like as much as they have done in the UK. The underlying economy will play the key role for real estate in the short term as investors are returning to fundamentals—rental growth and income return—to drive investment decisions." We would largely agree, and would add that as the continental market remains more fragmented and inefficient, talented managers should be able to add value.

Asia

The recent run-up and subsequent fall of Asian property companies was nothing short of spectacular (Table H). From April 2003 through October 2007, the FTSE EPRA/NAREIT Asia Index returned 237.6%, or 30.4% on an annual compounded basis. (Returns were even better for unhedged US$ investors—347.7% and 38.7%—due to the sliding greenback.) The index has since lost more than a quarter of its value, as the

[3] Please see our August 2007 Market Commentary *European Property: Is the Party Over?*

[4] As noted in our November 2006 Market Commentary *Bullish on European Property*, the publisher of the most widely cited data on European property, Investment Property Databank Ltd, says the current series are not "appropriate" for use as benchmarks due to their lack of inclusion of active management impact (e.g., trading, development, refurbishment) and the fact that historic series will change as more accurate data become available.

foreign banks that provided much of the deal financing in recent years have pulled back, while the Japanese securitized debt market has virtually ground to a halt.

However, unlike the United States and Europe, Asian REIT valuations look modestly attractive, with yields on Japanese REITs (J-REITs) a robust 4.7%, particularly attractive given the low levels of inflation and Japanese government bonds, most of which yield less than 2%. The ratio of J-REIT yields to equity market DYs, meanwhile (2.8), is the highest of any market (Table G). Hong Kong yields of 2% are less compelling, but overall Asian REITs appear to offer a bit more of a margin of safety than their U.S. and European counterparts.

We also continue to believe Singapore is poised to capture a growing share of the Asian REIT market, largely due to its ongoing efforts to make the country's REIT laws as shareholder-friendly as possible. As noted in a recent paper,[5] while Singapore's REIT (S-REIT) market is only five-and-a-half years old, it is far ahead of its Asian neighbors in progressive REIT legislation, such as (to pick just one example) exempting from tax S-REIT dividends to individual investors, regardless of the investor's nationality. CB Richard Ellis predicts that the total number of S-REITs—14 as of February 29, with a total market cap of US$15.3 billion (S$21.1 billion) according to Standard & Poor's—could reach 30 by the end of 2008.

Finally, as we have noted many times in recent years, we believe the world is currently undergoing a secular wealth shift from developed (mainly Western) economies to the emerging (primarily Asian) world. Thus, Asian REITs appear to have significantly more upside than do U.S. and European REITs, in large part because Asian markets remain in the formative stages, not just in terms of REIT structures but also with regard to economic growth prospects. For example, while many European countries have only introduced REITs in the past few years, the concept of investing in commercial property has been around for quite some time. While the same could be said of Japan and Hong Kong, this is less so in smaller Asian markets such as Thailand or Malaysia.

Conclusion

As noted at the outset, we do not view REITs as a particularly effective inflation hedge, although their predictable cash flows and good liquidity are likely to come in handy in a high-inflation environment. Those looking to REITs for this reason are likely to be better served by pursuing allocations (if accessible) to areas such as private real estate, oil and gas partnerships, and potentially commodities, although we would note that commodity prices are very extended at the moment, and better entry points will likely present themselves down the road.

For those without access to such vehicles, or who place a high value on the better liquidity offered by REITs, Asian and continental European REITs look to offer better opportunity at the moment than those in the United States and United Kingdom. While valuations are broadly similar across regions, the uncertain

[5] Please see our 2006 report *Asian REITs Investing.*

economic outlooks in the United States and United Kingdom suggest investors should require a greater margin of safety in these markets. Further, as continental and Asian markets remain in their formative stages, skilled managers should be able to add value in coming years as markets mature.

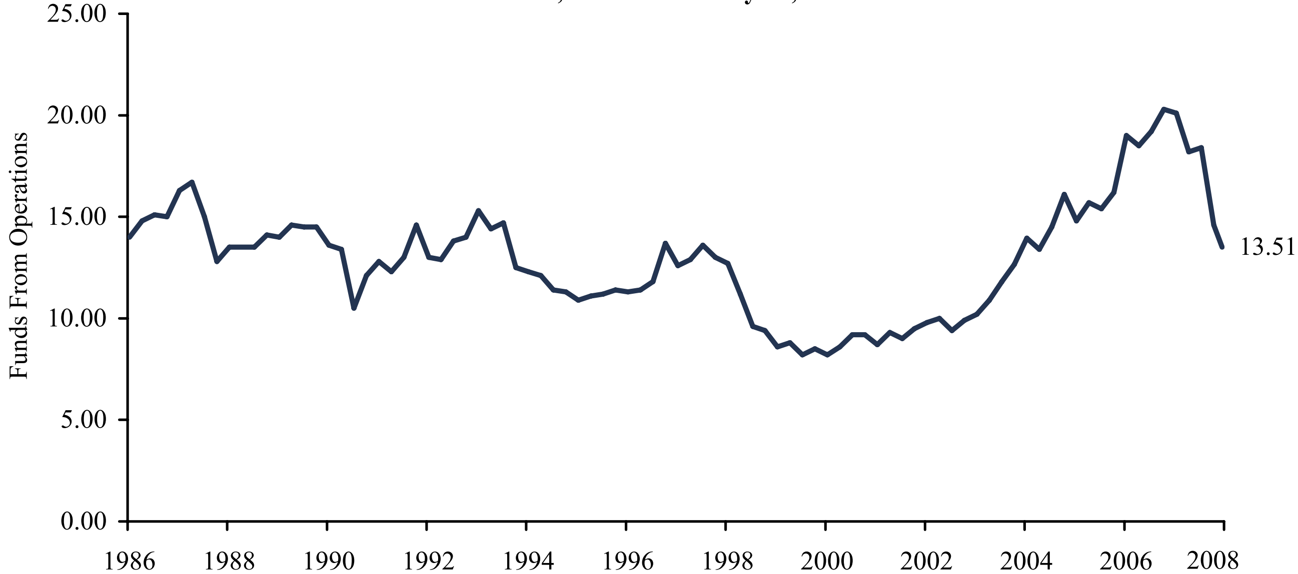
Finally, for U.S. investors worried about a continued fall in the US$, we would recommend buying Asian REITs, as not only are valuations reasonable, but Asian currencies appear likely to benefit more than the euro or pound if the greenback falls further.

Table A

U.S. AND JAPANESE REITS PRICE-TO-FUNDS-FROM-OPERATIONS RATIO

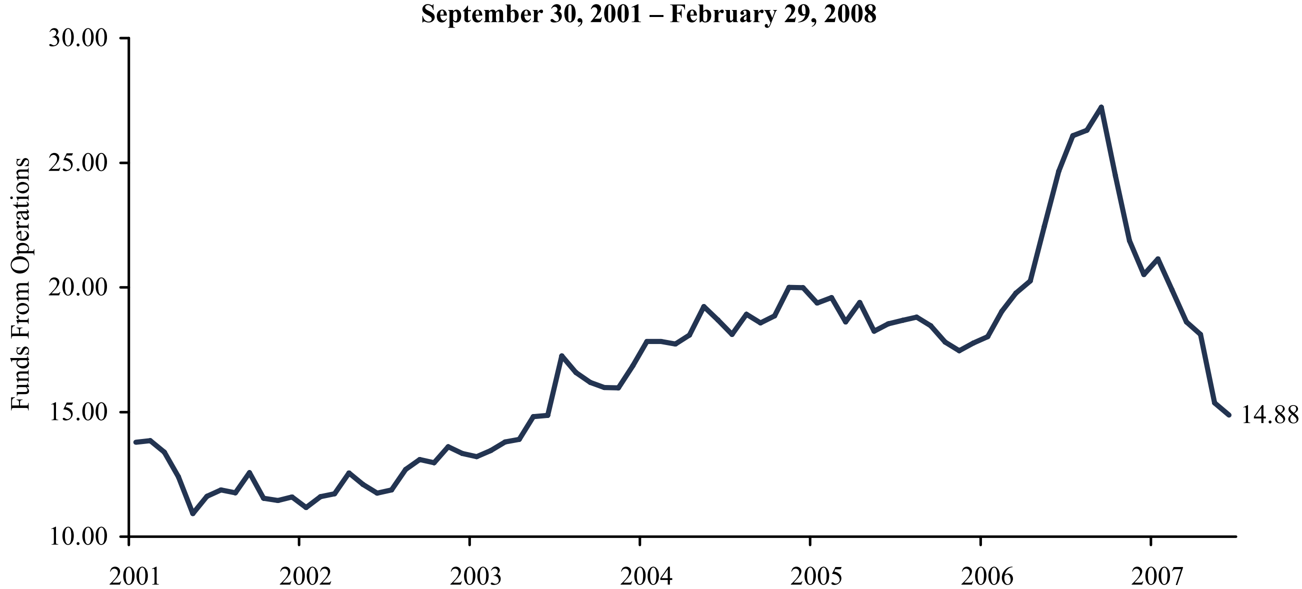
U.S. REITs

March 31, 1986 – February 29, 2008



Japanese REITs

September 30, 2001 – February 29, 2008



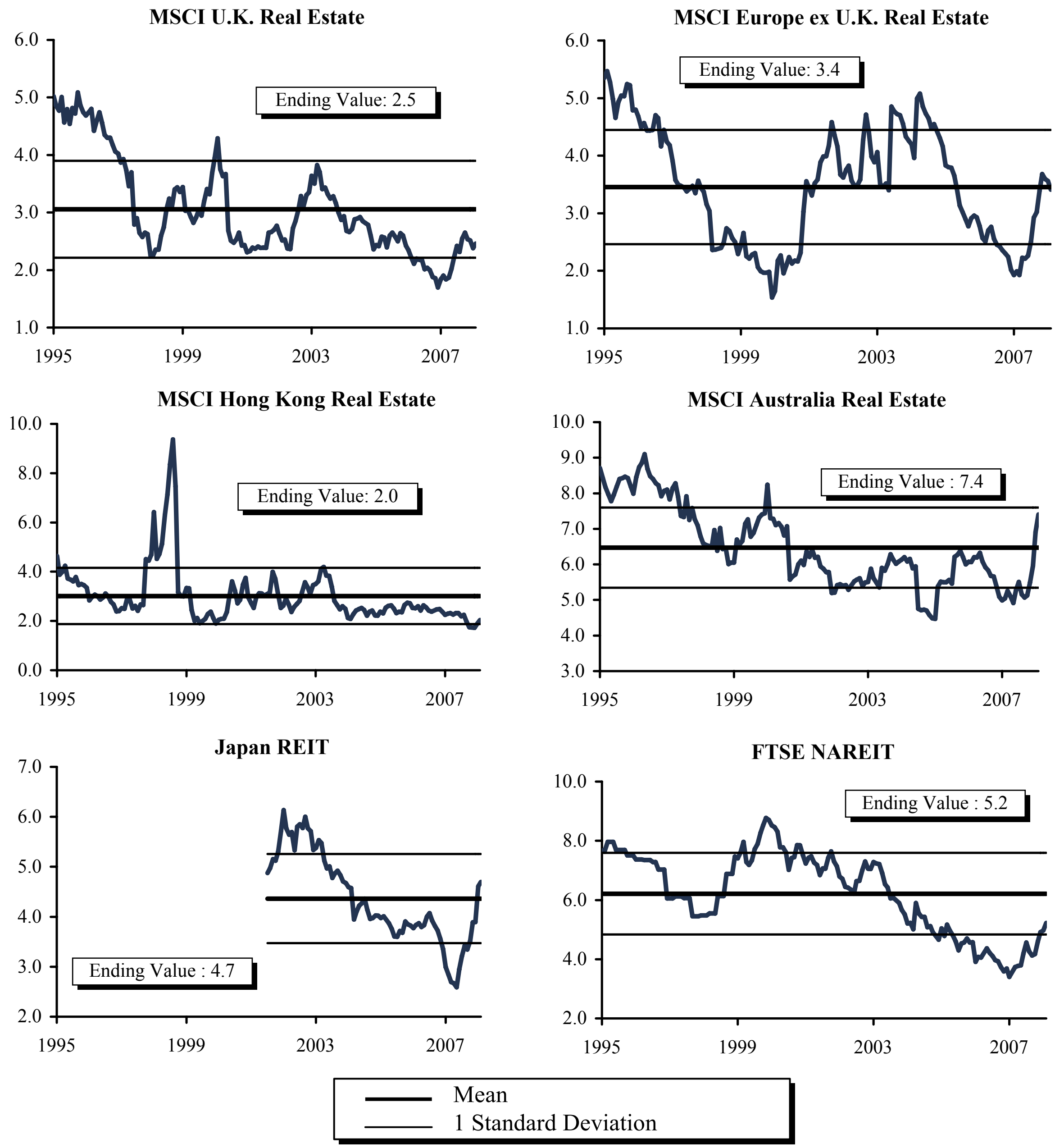
Sources: Goldman Sachs and UBS Asset Management.

Note: The funds from operations data for Japanese REITs begin on September 30, 2001.

Table B

GLOBAL PROPERTY INDICES DIVIDEND YIELD

January 31, 1995 – February 29, 2008



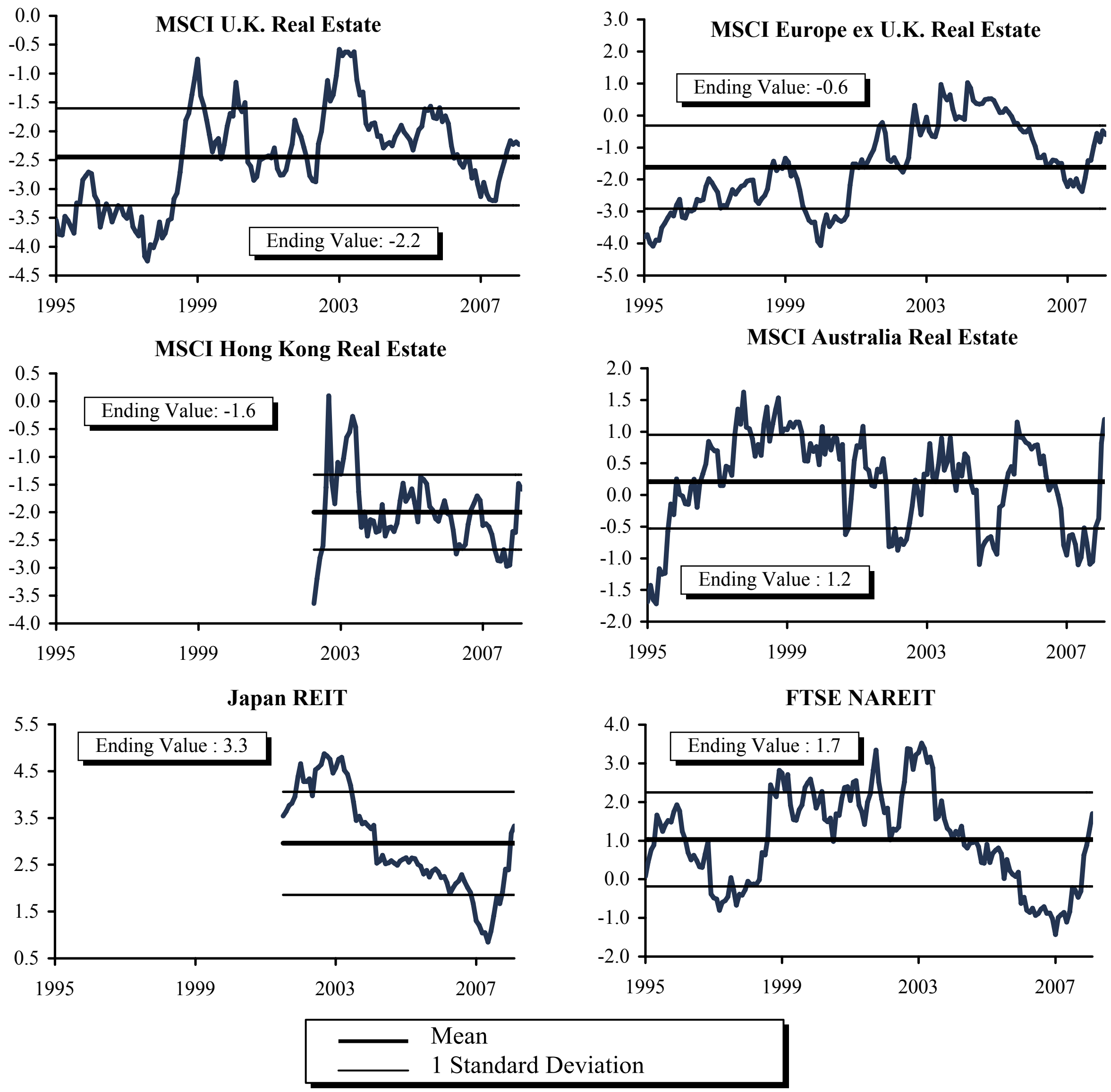
Sources: Thomson Datastream and UBS Asset Management.

Notes: Dividend yields for the Japan REIT Index begin July 31, 2001. Quarterly data are used for the FTSE NAREIT Index until January 31, 1999, when consistent monthly data are available.

Table C

GLOBAL PROPERTY INDICES DIVIDEND YIELD SPREADS RELATIVE TO TEN-YEAR GOVERNMENT DEBT YIELDS

January 31, 1995 – February 29, 2008



Sources: Thomson Datastream and UBS Asset Management.

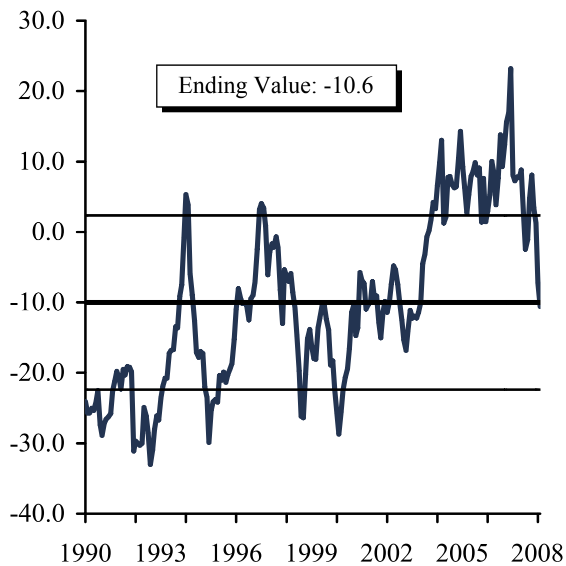
Notes: Each country's ten-year government interest rate was used to calculate the yield spread. Japan's ten-year government rate was used to calculate the spread for the Japan REIT Index. The U.S. ten-year Treasury rate was used to calculate the spread for the FTSE NAREIT Equity Index. A benchmark bond yield using the arithmetic weighted average of the ten-year benchmark yields for each of the European Monetary Union countries was used to calculate the spread for the MSCI Europe ex U.K. Index. Dividend yields for Japan REIT begin July 31, 2001. Quarterly data is used for the FTSE NAREIT Index until January 31, 1999, when consistent monthly data is available.

Table D

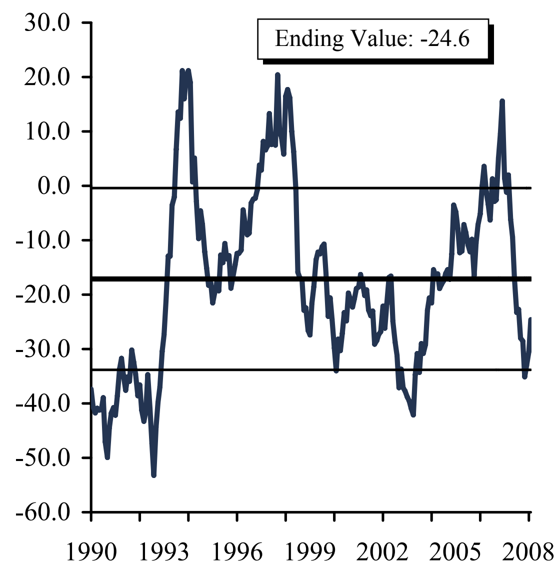
GLOBAL PROPERTY INDICES DISCOUNT/PREMIUM TO NAV

January 31, 1990 – February 29, 2008

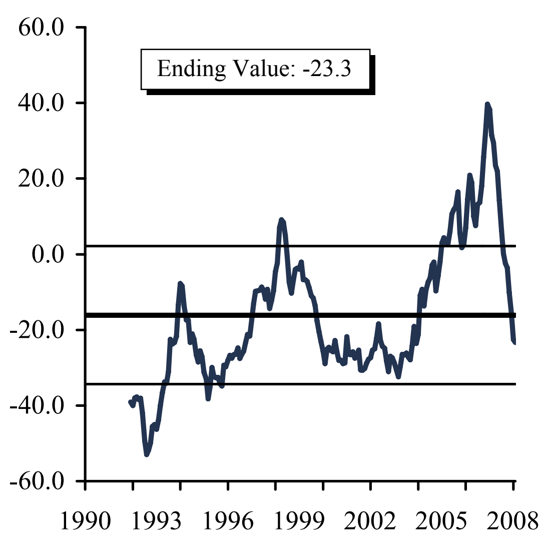
Global



U.K.



Europe ex U.K.



Hong Kong

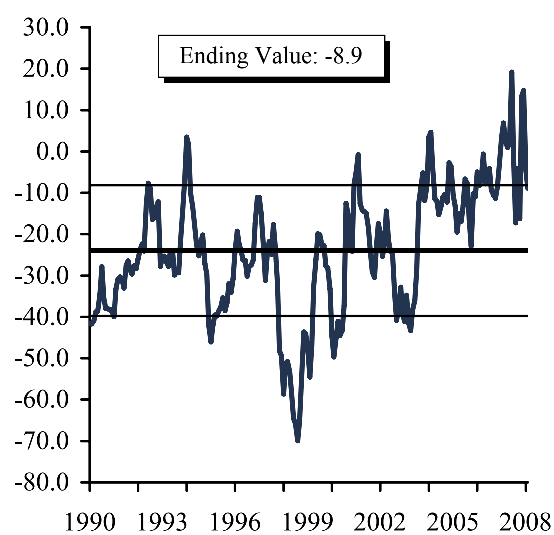
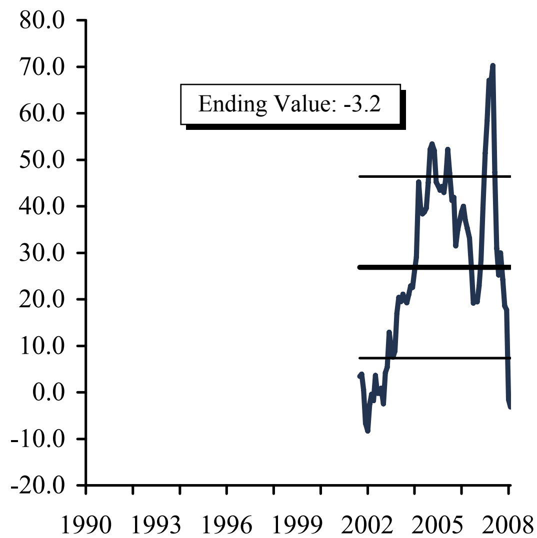


Table D (continued)

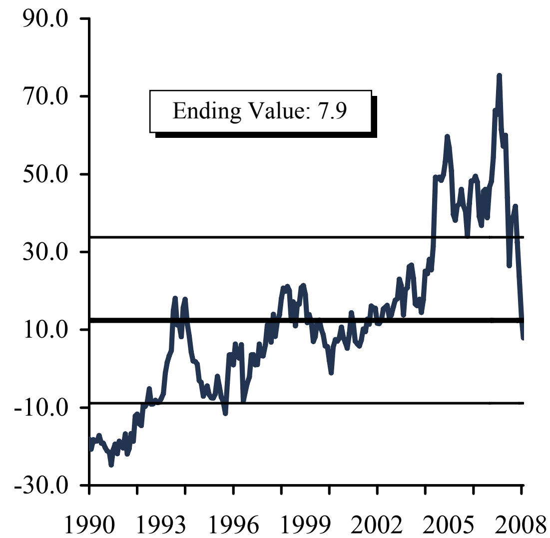
GLOBAL PROPERTY INDICES DISCOUNT/PREMIUM TO NAV

January 31, 1990 – February 29, 2008

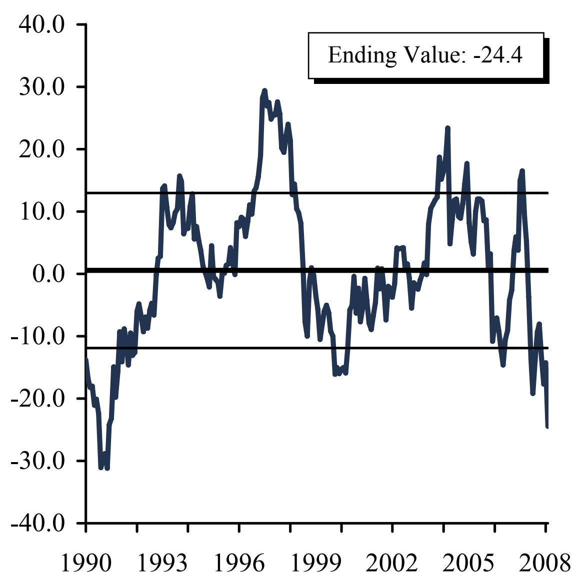
Japan REIT



Australia



U.S.



Source: UBS Asset Management.

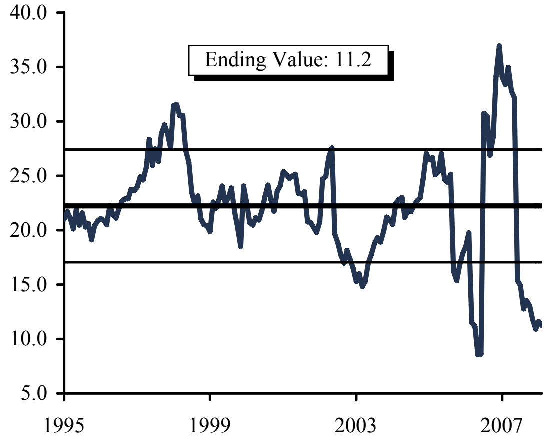
Note: The NAV data for Europe ex U.K. begin on December 31, 1991. The NAV data for the Japan REIT begin on September 30, 2001.

Table E

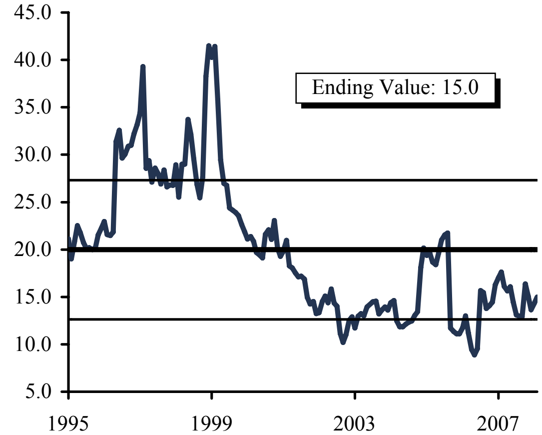
GLOBAL PROPERTY INDICES PRICE-EARNINGS RATIOS

January 31, 1995 – February 29, 2008

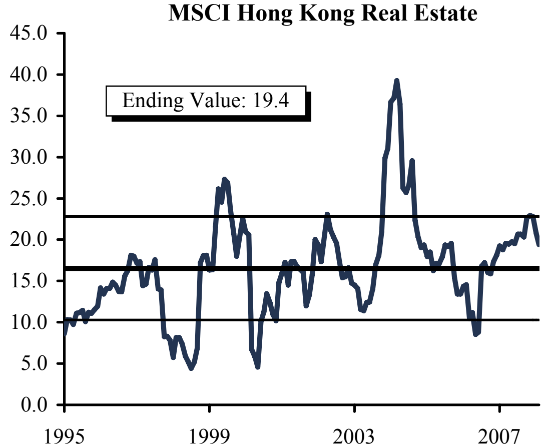
MSCI U.K. Real Estate



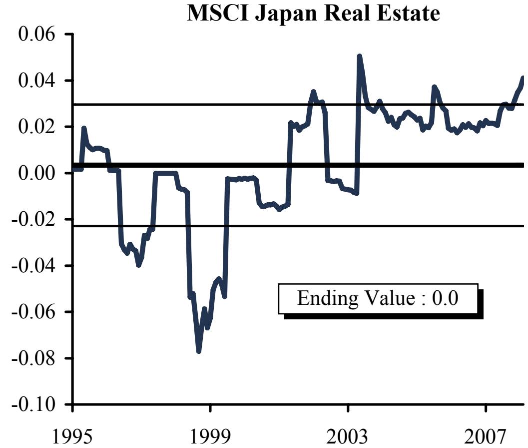
MSCI Europe ex U.K. Real Estate



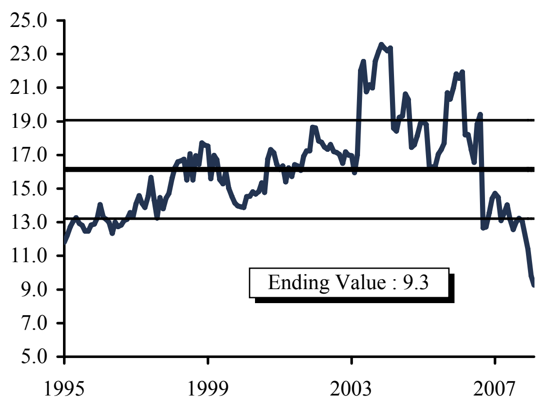
MSCI Hong Kong Real Estate



MSCI Japan Real Estate



MSCI Australia Real Estate



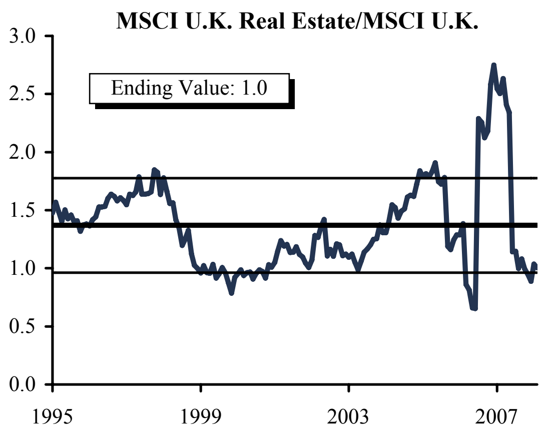
Sources: Thomson Datastream and UBS Asset Management.

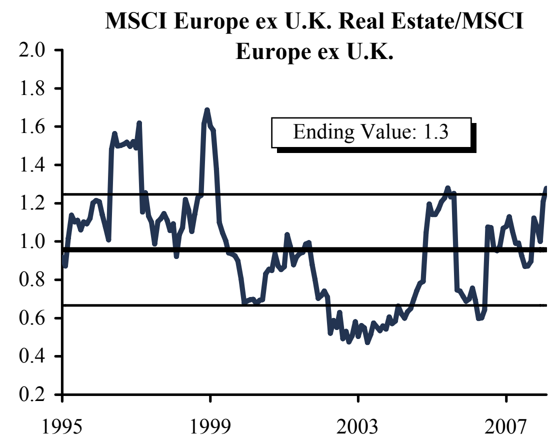
Note: Earnings yield is used for the MSCI Japan Real Estate Index due to periods with negative earnings in the dataset.

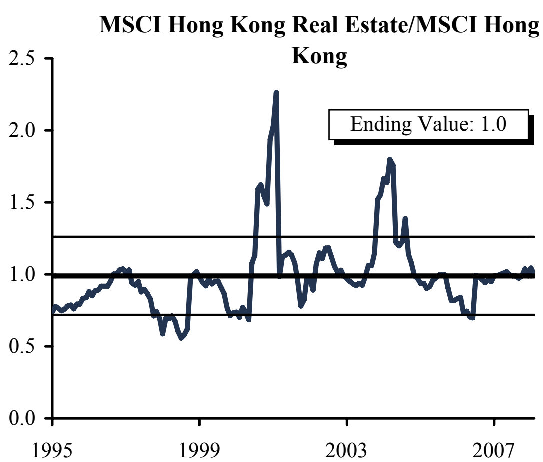
Table F

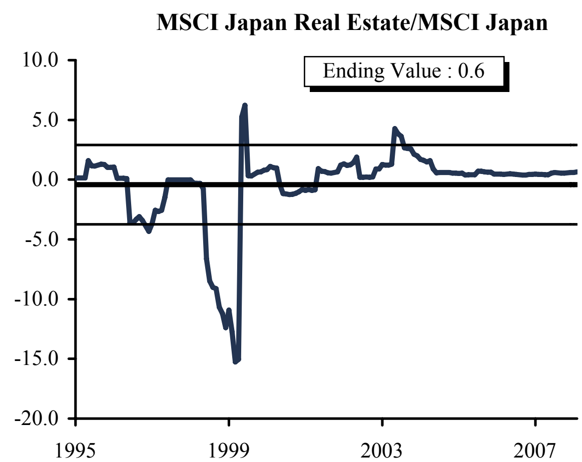
GLOBAL PROPERTY INDICES PRICE-EARNINGS RATIOS RELATIVE TO BROAD EQUITY MARKETS PRICE-EARNINGS RATIOS

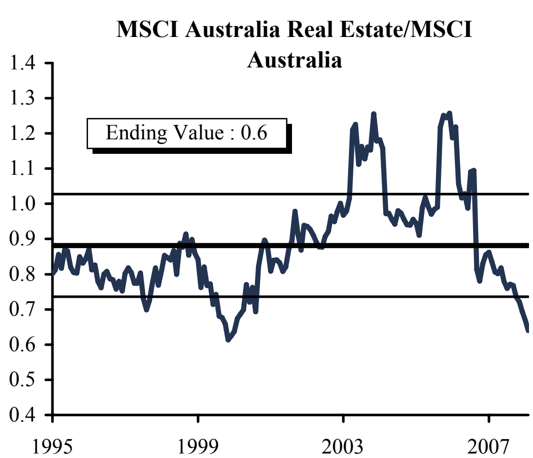
January 31, 1995 – February 29, 2008











Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

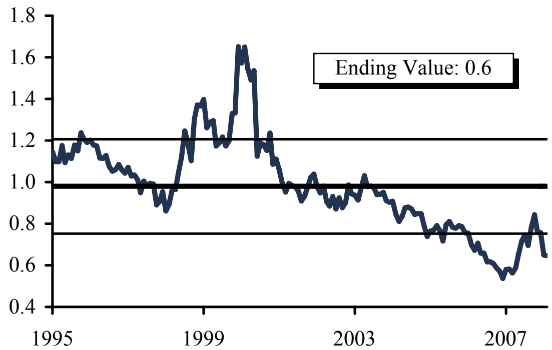
Note: The ratio for MSCI Japan Real Estate to MSCI Japan looks at the earnings yield for both indices.

Table G

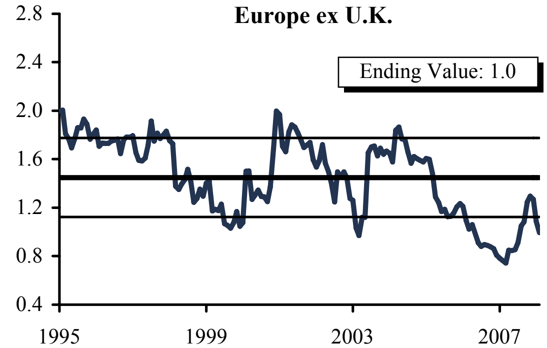
GLOBAL PROPERTY INDICES DIVIDEND YIELDS RELATIVE TO BROAD EQUITY MARKETS DIVIDEND YIELDS

January 31, 1995 – February 29, 2008

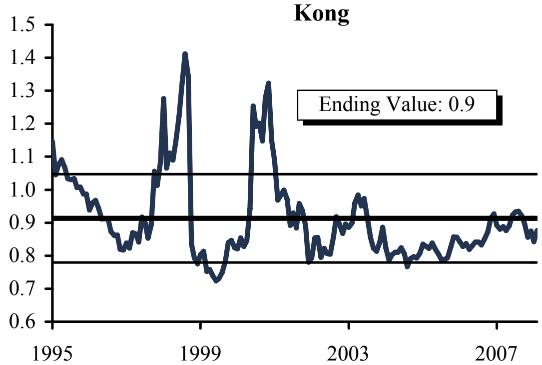
MSCI U.K. Real Estate/MSCI U.K.



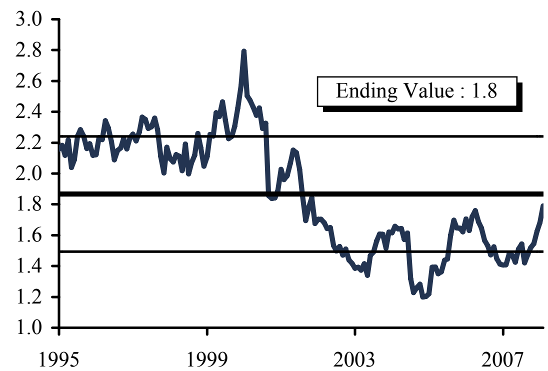
MSCI Europe ex U.K. Real Estate/MSCI Europe ex U.K.



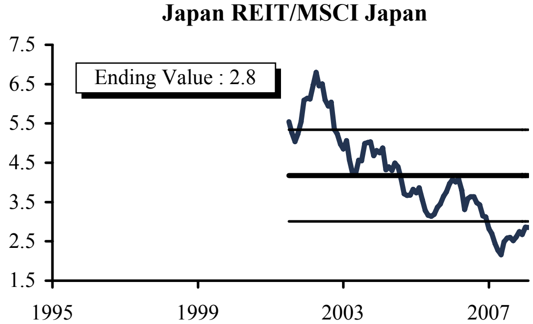
MSCI Hong Kong Real Estate/MSCI Hong Kong



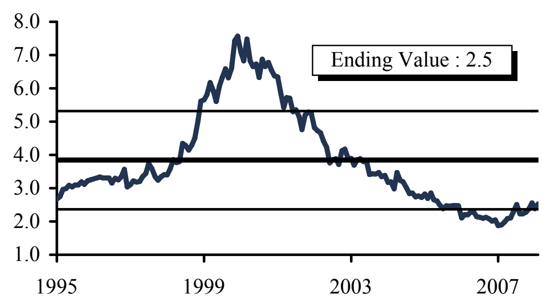
MSCI Australia Real Estate/MSCI Australia



Japan REIT/MSCI Japan



FTSE NAREIT/S&P 500



Mean
1 Standard Deviation

Sources: Thomson Datastream and UBS Asset Management.

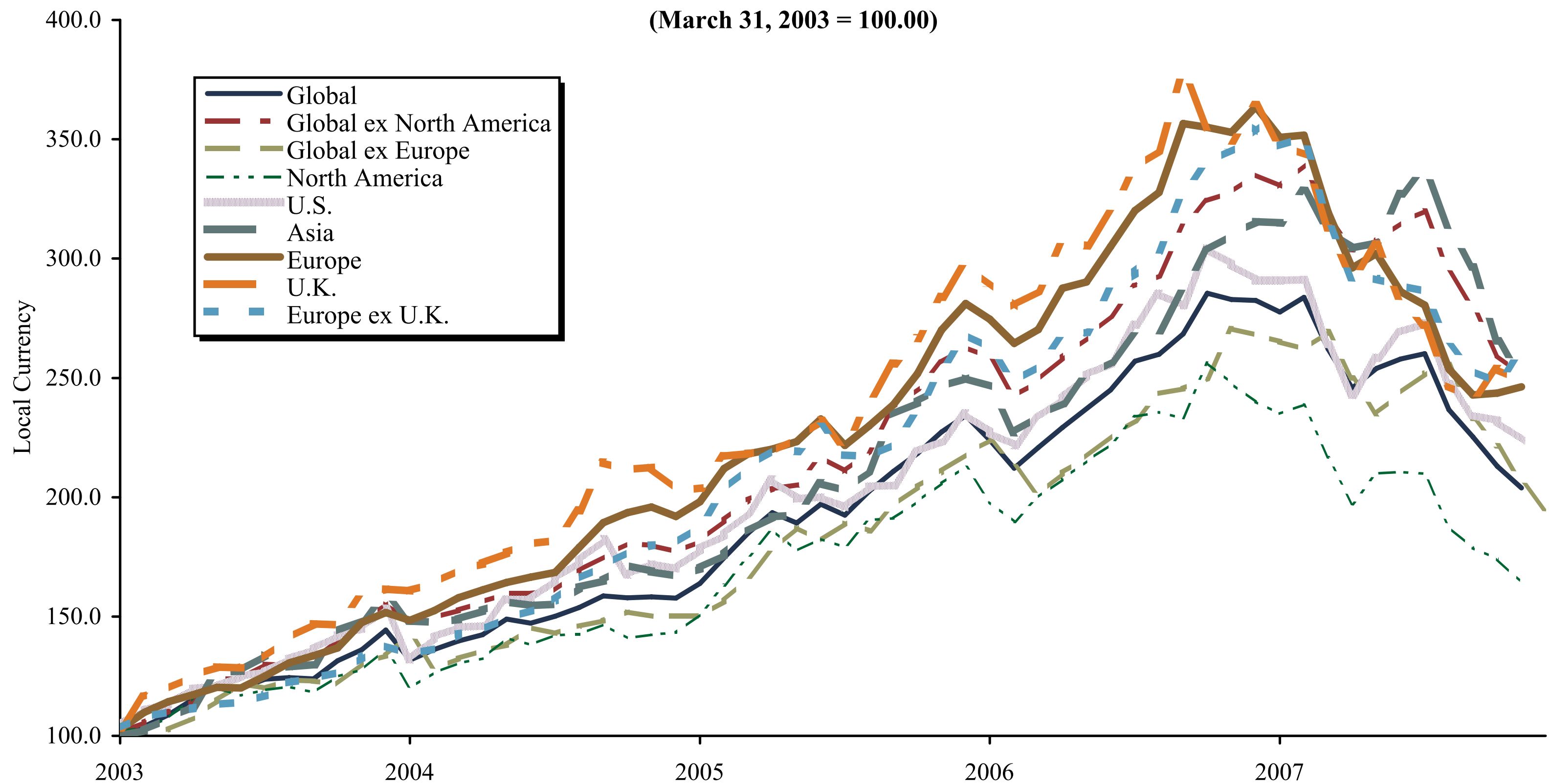
Notes: Dividend yields for the Japan REIT begin July 31, 2001. Quarterly data are used for the FTSE NAREIT Index until January 31, 1999, when consistent monthly data are available.

Table H

CUMULATIVE WEALTH OF FTSE EPRA/NAREIT REGIONS

March 31, 2003 – February 29, 2008

(March 31, 2003 = 100.00)



Sources: FTSE International Limited and Thomson Datastream.

Note: Performance figures are based on global and regional performance of FTSE EPRA/NAREIT Global Index in US$.