

IMPACT OF INTEREST RATES ON REAL ESTATE SECURITIES

INTRODUCTION This paper addresses the question of how increasing interest rates could impact real estate securities. This is a complex topic. *Numerous factors beyond interest rates contribute to investment returns.* For example, in the third quarter of 2005, ten-year government bonds fell 1.8%¹, yet preferred stocks rose 1.7%². Clearly, more factors were at work than simply interest rates. In an attempt to shed some light on the potential performance of real estate securities, we have focused on two questions:

- How have various securities historically behaved relative to interest rates?
- What will drive future returns in the real estate securities sector?

KEY Some interesting observations were noted, for example:

OBSERVATIONS

- REITs and stocks both have historically low correlations to interest rates.
- Preferred stocks have roughly two-thirds the correlation to interest rates as corporate bonds.
- Credit quality and yield spreads play an important role in driving investment returns.

Finally, when discussing the impact of interest rates on real estate securities, one must consider which interest rates are rising, why rates are rising and which real estate securities are being discussed.

“...not all interest rates move together.”

Which interest rates are rising and why? When one speaks of “rising rates,” are they describing ...

- Climbing corporate bond yields reflecting investor concerns about business credit?
- A spike in long-term bond rates due to inflationary pressures?
- An increase in short rates causing an inverted yield curve?
- An upward move along the entire yield curve?

The point is, not all interest rates move together. For example, every Federal Open Market Committee meeting in 2005 resulted in a 25 basis point increase in the Fed Funds rate, during which time the yield on 10-year treasury bonds did not increase at nearly the same rate.

“Each security type will react differently...”

Which real estate securities are being considered? Real estate companies, such as REITs, issue common shares, preferred shares, corporate bonds and secured mortgages. Each has different claims on the company’s cash flow and assets. Some have fixed payment streams while others participate in the earnings growth of the company. Each security type will react differently to changing conditions.

¹ Source: Lehman U.S. Treasury Long Bond Index (6/30/05-9/30/05)

² Source: Merrill Lynch Preferred Index (6/30/05– 9/30/05)

HISTORICAL CORRELATION, VOLATILITY AND TOTAL RETURNS

The statistics below are derived from analysis of the monthly total returns of government bonds, preferred stocks, corporate bonds, REITs and the broader equities market during the period September 1995–September 2005.¹

CORRELATION	Correlation between Government Bonds and:								
	<table border="0"> <tr> <td>Preferred Stocks</td> <td style="text-align: right;">0.58</td> </tr> <tr> <td>Corporate Bonds</td> <td style="text-align: right;">0.95</td> </tr> <tr> <td>NAREIT Composite</td> <td style="text-align: right;">0.02</td> </tr> <tr> <td>S&P 500</td> <td style="text-align: right;">-0.14</td> </tr> </table>	Preferred Stocks	0.58	Corporate Bonds	0.95	NAREIT Composite	0.02	S&P 500	-0.14
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VOLATILITY	Standard Deviation of Returns:										
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TOTAL RETURN	Annualized Total Returns:										
	<table border="0"> <tr> <td>Government Bonds</td> <td style="text-align: right;">8.09%</td> </tr> <tr> <td>Preferred Stocks</td> <td style="text-align: right;">6.99%</td> </tr> <tr> <td>Corporate Bonds</td> <td style="text-align: right;">6.57%</td> </tr> <tr> <td>NAREIT Composite</td> <td style="text-align: right;">14.23%</td> </tr> <tr> <td>S&P 500</td> <td style="text-align: right;">9.49%</td> </tr> </table>	Government Bonds	8.09%	Preferred Stocks	6.99%	Corporate Bonds	6.57%	NAREIT Composite	14.23%	S&P 500	9.49%
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¹ Performance of preferred stocks measured by the Merrill Lynch Preferred Index, corporate bonds by the Citigroup Broad Investment Grade Bond Index, and government bonds by the Lehman U.S. Treasury Long Bond Index. Monthly returns for the period September 30, 1995 – September 30, 2005.

OUTLOOK

Longer term, we believe two factors should mitigate the impact on real estate securities of rising interest rates.

“This provides a cushion for REIT preferred stocks should interest rates rise.”

Yield to call governs the price movements of preferred stocks. Preferred stocks are typically callable at par. This “callability” serves to dampen preferred stock price movements relative to the price movements seen in bonds. This has been the case over the last few years. Government securities have traded to low yield levels (relative to recent history), yet preferred securities have not traded to such relatively low yields. We believe this is caused by the fact that as callable preferred stocks begin to trade above par, their yield to call begins to decline. This slows price movements above par due to the potential that the stocks will be called back at par. As interest rates rise, the fact that preferred stocks did not fully participate in the prior move (falling rates, rising prices) should dampen their participation in the subsequent move (rising rates, falling prices). This provides a cushion for REIT preferred stocks should interest rates continue to rise.

“The dynamics that are driving up interest rates ...should also cause real estate fundamentals to improve.”

A linkage exists between inflation, interest rates, and real estate fundamentals. The Federal Reserve has pursued a tightening policy as a result of seeing confirmed signs of a business recovery that is putting inflationary pressures on the economy. Such a recovery is increasing demand for space and enhancing the financial health of tenants and their ability to pay rent. Thus, the dynamics that are driving up interest rates – inflationary pressures from economic growth – should also cause real estate fundamentals to continue to improve. Improving fundamentals are a positive for all real estate securities and can offset some of the impact of rising rates. Notably, REITs have grown dividends every year since 1987 at an average rate of 5.6%.¹

INVESTMENT STRATEGY

Investors have a wide range of real estate securities from which to choose. Each REIT has a distinct property type, geographic focus and business strategy. REITs also issue common stock, preferred stock and debt securities. Investors need to be skilled in identifying the best risk adjusted returns among the available options at any point in the business cycle or changing interest rate environments. We believe the historical performance of these securities, plus the two factors discussed above, provides some comfort that real estate securities warrant a position in investor portfolios. The key for investors is to own these securities for the right reasons, as a long term investment designed to provide a combination of current yield and growth potential through changing business environments.