Alternative Investment Update

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Real Estate Market Update:
Cheap by Some Measures, But Still Too Volatile

The pull-back in real estate stocks that has occurred in the last 12 months now ranks as the worst bear market ever seen in the sector, by far. Both U.S. and global REITs are down 55% for the year and over 70% from their highs, with the majority of these losses posted in the last two months. The stocks are trading at valuations and yields not seen since ten years ago, and by many accounts they can be considered cheap. However, everything else has been beaten up as well, so they are less valuable relative to other equities. Also, credit market concerns and skepticism remain a huge source of volatility, and we expect this to continue for some time. LPL Financial Research recently eliminated REIT exposure due to this continued volatility. For clients who wish to keep an allocation to REITs, we suggest a U.S. allocation, as we believe that the U.S. represents the best value at this point and we expect the U.S. markets to recover first.

WORST REIT BEAR MARKET IN OVER 20 YEARS

Period	Months	Decline
08/89 - 10/90	14	-31.20%
10/97 - 12/99	26	-28.10%
02/07 - 11/08	22	-73.50%

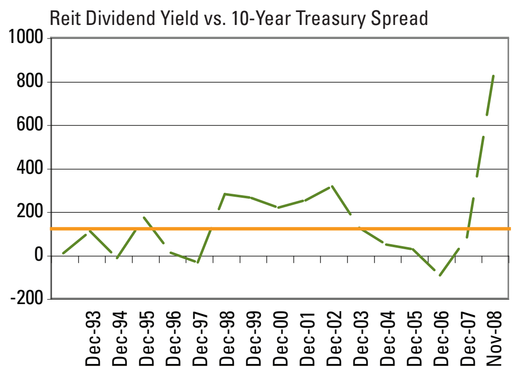
Source: FactSet

The good news is: REITs are on sale....

REIT stocks both in the US and abroad have been beaten down so much that they trade at yields, valuations, and discounts to NAVs last seen almost 10 years ago.

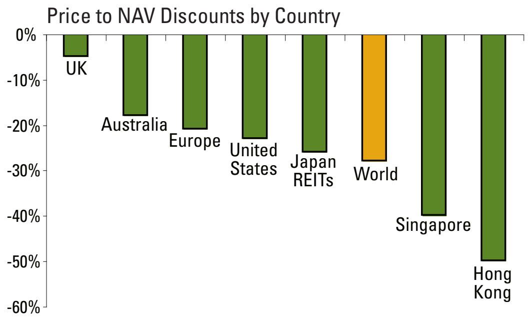
- **Dividends** The dividend yield for U.S. REITs is 11.35%, which represents an 821 bps spread over U.S. treasuries. This is the largest yield spread ever seen in the U.S., and many of the global markets trade at similarly high spreads. We do expect to see some dividend cuts as REIT companies look to strengthen the balance sheet, cover debt, or keep cash on books during tight liquidity environment. About 1 in 4 REITs are expected to cut dividends, which could result in a 50-100 bps drop in yield. Even with these cuts, dividend yield spreads are still above historical highs. [chart 1]
- **Discounts to NAVs** Global REITs trade at an average 28% discount to net asset values (NAVs), with Hong Kong trading at 50% discounts and the U.S trading at 23% discounts versus an average of a 3% premium. [chart 2]
- **Earnings Multiples** REITs trade at an average price/Funds From Operations (FFO) earnings multiple of 8.78x, versus a high of almost 25x at the end of 2006 and a low of 8.25x at the end of 1999. The stocks trade near the low end of the range, and the last time they traded at these levels preceded a run of 139% and seven years of REIT out-

1 REITS TRADE AT HISTORICALLY HIGH SPREADS VS. 10-YEAR TREASURY



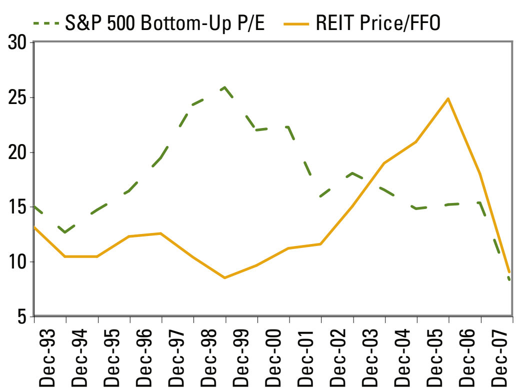
Source: Merrill Lynch Valuation Handbook

2 REITS TRADE AT SIGNIFICANT DISCOUNTS TO NAVS



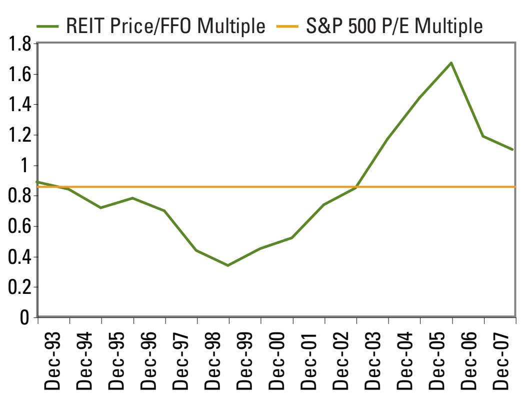
Source: ING Clarion Global Real Estate Outlook

3 REITS TRADE AT THE LOW END OF THEIR MULTIPLE RANGE



Source: Merrill Lynch Valuation Handbook

4 BUT THEY ARE STILL MORE EXPENSIVE THAN S&P 500 MULTIPLES



Source: Merrill Lynch Valuation Handbook

performance. The main difference this time is that REITs now trade at higher multiples than other equities, versus a much lower relative multiple in 1999. [chart 3]

.....But so is everything else!

REITs do look cheap based on their price/FFO ratios, yields, and price-NAV discounts. They are trading at levels not seen since 1999, which preceded a period of strong relative and absolute performance. However, there is a big difference this time, and that is that even after the worst bear market decline ever seen in the industry, REITs are still more expensive than other equities. On a relative basis, the sector's multiple is 1.08x the S&P 500 estimate, which compares to the long-term average of .85x and a trough of .32x reached during early 2000.

Debt Market Issues Will Likely Cause Continued Volatility

REITs are being whipsawed due to the issues in the debt markets, even though the issue has more of an impact on highly leveraged private real estate players than it does on most traded REIT companies. Traded property companies carry an average debt-to-market cap of 46%. This is a manageable level for most companies, and it is an acceptable debt level for refinancing even in this environment. Companies that are running into trouble are those with leverage ratios above 70%. Also, only 5% of all real estate debt owed by traded REITs rolls over in 2009, and only 13% rolls in 2010. However, there are a few high profile REITs making headlines this year that have been caught with high debt-to-capital ratios and significant debt up for refinancing within the next 12 months. These companies could face bankruptcy if the lending markets remain stuck. Because the index is so small and concentrated, any negative news on the highly leveraged companies causes a big move in the index. Volatility is at an all-time high in the index, and we expect it to remain elevated until there is more certainty in the credit markets.

What to do now

Traded REIT stocks represent a good buying opportunity based on current yields, multiples, and discounts to NAVs. However, they are still somewhat expensive relative to other equity asset classes, and we expect that credit market concerns will continue to pose challenges and cause significant volatility for some time now. We have eliminated our exposure to REITs in our model portfolios, and suggest a U.S. allocation for clients who wish to keep a REIT allocation.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Investing in alternative investment may not be suitable for all investors and involve special risks such as risks associated with leveraging the investment, potential adverse market forces, regulatory changes, potential illiquidity. There is no assurance that the investment objective will be attained.

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