INVESTING IN THE REIT MARKET: A SEARCH FOR LONG-TERM GROWTH

FUND FACTS

CGM REALTY—(CGMRX)

CATEGORY:
Growth & Income

PERFORMANCE: (thru 6/30/00)

Compound Annual Return (%)	Fund	Category
1 Year	6.0	2.7
3 Years	3.0	12.1
5 Years	14.2	16.6

RISK: (relative to category)
Average

TOTAL ASSETS: (as of 8/31/00)
$500 million

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With all eyes on technology stocks in particular and growth stocks in general, other sectors of the market have been ignored, at least until recently. Since the beginning of the year, however, one relatively undervalued market segment that has started to roar to life is the real estate investment trust (REIT) industry.

A number of low-load mutual funds focus on REITs. Of these funds, CGM Realty has one of the best long-term track records, with the highest performance over the last five years and second-highest over the last three years. The recent surge in REIT performance is reflected in the fund's strong performance for the first six months of 2000, in which it ranked among the top 20% of all growth and income funds. Currently, the fund has around $500 million in total assets.

In early September, portfolio manager Kenneth Heebner discussed his approach with Maria Crawford Scott.

What is the philosophy and objective of the fund?

The fund is a dedicated realty fund—65% of the investments will be in real estate or real estate-related investments. Practically speaking, with the exception of one stock that we held for a couple of months once, we have been 100% invested in real estate investment trusts since inception, and will continue to be unless something happens and I have to be particularly defensive for some reason, which I do not foresee.

In terms of the returns that you're trying to provide for investors, is it a combination of income and growth?

Yes. All of our REITs pay dividends, and in most cases it is a significant dividend. But in terms of the way I manage the fund, I look for the companies that will show the highest growth in revenues and cash flow per share.

What types of REITs does the fund invest in?

The fund invests in equity REITs—I have never owned anything else.

I think the highest growth potential is realized by investing in a REIT that owns properties which have rising net operating income. Rising same-property net operating income is a key growth driver, because although property acquisitions and reinvestment of retained cash flow can add to the REIT's value, the real change comes from what happens to the REIT's existing property portfolio.

When you talk about rising same-property net income, is that a REIT industry term?

Yes. To simplify it, you can simply say it is revenues from existing properties, and rising revenues come from increases in rent and occupancy.

How do you decide which REITs you're going to invest in?

I look for the ones that have had the greatest growth in FFO [funds from operations—net income plus depreciation and amortization charges, and excluding gains or losses from debt restructuring and the sale of property; FFO is the accepted measure for return in the REIT industry]. The biggest determinant of FFO growth is same-property revenue growth and I look for sustainability of that growth.

For instance, right now the greatest same-property revenue growth is in the big office buildings in the big cities of Boston, Manhattan, Washington, D.C., and San Francisco. There is also growth in suburban Washington and suburban Boston, as well as apartments in California.

What do you base your projections on?

It's based on the experience of the companies, and they all report their same-property growth revenue. It's also based on knowledge and the conditions of these markets. High growth in same-property revenues is created by strong demand and supply limitations, where developers can't build competitive properties. In all the big cities I mentioned, demand is strong, but the approval process for development is lengthy. Similarly, in the California apartment market there's land limitation in a very tough regulatory environment.

How much has your mix of REITs changed? In some years, you seem to have a relatively low portfolio turnover rate, while in other years it is quite a bit higher.

In some years, we changed our strategy. For instance, back in 1997 I was invested in hotel REITs and I had to get out because the environment was turning the wrong way. I don't know what it will be this year. This year, the strength in California became apparent to me, so I have been selling off some industrial REITs and buying apartment REITs, not because there was anything wrong with what I owned but because there was opportunity elsewhere. It's a function of changes in the environment and changes in how the companies are doing. I've been fortunate that most of these companies have performed as I expected.

What role does geographical location play in terms of REIT performance?

It's critical—there is tremendous variation by region. In the apartment business, for instance, in the southeast the developers are able to move along quite well, and the minute rents start to rise, there's a surge in construction, and then the rent growth recedes. So, in the environment we have today, I don't want to own apartments in Texas and the southeast. But California looks great, and the northeast is promising. In the northeast, it's generally tougher to build than in the wide open spaces in Texas and the southeast.

Are individual REITs very diversified in the properties they own?

It varies. For instance, I have two REITs that are completely California, and one that is only 50% California. I have one REIT, SL Green, that's pure Manhattan. But, Boston Properties is in San Francisco, Washington, D.C., Boston, and Manhattan—it hits all the good locations. I prefer the ones that are more concentrated geographically, but I have to compromise because there are not as many companies that are situated purely in the areas that I want. In terms of the types of properties they own, however, almost all of mine are concentrated in a particular sector.

How important is REIT management?

Very important. For instance, it is important for REIT management to be able to recognize changes in the environment and move into areas where there's more opportunity. For instance, Boston Properties made a lot of investments that anticipated the big increase in rent in the downtown areas of Boston and Manhattan.

Another example is Essex Property Trust, which is currently my favorite REIT. This company is 100% in California. They are in the best market in the state, the rent growth is extremely strong, their same-property net operating income growth was 10% in the June quarter, and FFO growth was 16%. And I think their top-line growth is going to accelerate. Additionally, this is a value-added company—they buy projects where there are opportunities to improve the facility with investment and raise rents. So you've got powerful markets, but you've also got the value-added investment process.

Good management is also important in terms of providing good service to their client, whether it be a business in an office building, or the individual tenant in an apartment complex.

How do you judge good management?

I'm heavily influenced by their track record. I also like to listen to their strategy in relation to what my own views are about where the rent growth opportunities are.

How do you value a REIT?

Interestingly enough, although there is variation, it's really not as great as it is in other parts of the stock market.

For the whole group, on a weighted average basis, REITs currently are valued at about 9 times next year's FFO. The ones I own are as high as 12 times next years' FFO, and as cheap as 6.5 or 7. Hotel REITs go all the way down to 5.

When I buy a REIT, I'm aware of the valuation, but I won't hesitate to buy a more expensive REIT if I'm going to get 15% to 20% FFO growth.

What would cause you to sell a REIT?

The most common reason is if I find something more attractive. Also, if I start to disagree with the strategy that the REIT management is pursuing, I will sell. When I had hotel REITs in 1998 and the management strategies in general weren't working, I sold them.

Do they ever become so overvalued that you would sell?

They could, but it has not happened during the time I have owned them.

Your fund tends to be extremely concentrated in a small number of REITs. For instance, you have several REITs that account for over 5% of the fund. Why do you prefer concentration?

There's tremendous variation in the group in terms of growth potential. For instance, in my own portfolio today, in most instances the growth is over 10%, and I like the ones with growth well into the teens. To get growth of 15% or more is unusual, and I want to make sure I make room in the portfolio for those. I think concentration helps you get that growth. If I really like a REIT, I may start out with roughly a 5% commitment. The reason some of our REITs account for more than 5% is because they have grown so much more relative to our other holdings.

REITs appear to be extremely volatile. Several years ago, returns were extraordinary, and then in 1998 the returns were dreadful. What causes the volatility?

In my judgment, the operating performance of these companies has actually been much more consistent than most other stocks. FFO growth in the REIT industry has been in the vicinity of 10% during the six years this fund has been operating, and I would say that there's been some acceleration this year as the strength of the economy and limited supply in certain markets have created an escalation in top-line same-property growth.

I think the big swings have really been related to alternative opportunities. In 1998 and 1999, the huge surge in technology stocks caused money to flow from every other part of the market. Value stocks were hurt as well, but I think it was more visible in the REITs because they're pure. When technology started to falter this spring, people noticed how cheap the REITs were and how reliable their growth had been over a period of years, and they started to buy them. So, I think it's really been the performance of other sectors that's created the variability in the returns of REITs, because the operating returns of the companies have been remarkably consistent.

How closely do REITs track the S&P 500?

They don't. When you look at it year by year, there is very little correlation. The S&P was up a lot in 1998, and the REIT index was down 18%. That doesn't mean they are lower risk than other stocks, but they are simply independent of the S&P.

The thing that would create a weakness in the operating performance of REITs would be a bad recession. I do think they would probably do better than the market as a whole because a number of sectors would not feel that much of an impact. The impact would be greatest among hotel and retail REITs, and it would be less in the office, industrial, and apartment REITS.

Why should individual investors put money into REITs?

The best argument right now is low valuation relative to the market. REITs are selling very cheaply compared to the overall market. The yield on the group is currently 7%, and I believe the dividend growth is going to increase with FFO growth. I think it's extraordinary to find an opportunity that gives you a current yield of 7% and growth of 5% to 10% in the dividend. And I think REITs may very well outperform the S&P 500. That combination makes a great investment opportunity. ❖