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PDV *OBSERVATIONS*

A personal note: As we conclude the second year of publishing ***Observations*** with this issue, we would like to extend our heart-felt thanks and appreciation to all our clients and friends for their trust and support in the past year. Thanks to you, PDV *Financial Management* continues to grow in a most gratifying way. As always, if you know someone who would like to receive complimentary copies of ***Observations*** or who might benefit from our services, please let us know. You can call us or e-mail us at ***pdvfinmgt@aol.com***. Happy New Year!

Real Estate Investment Trusts: How They Might Benefit You

Real estate investment trusts (a.k.a. "REITs") are publicly traded companies primarily engaged in the real estate business... At this point, you might be tempted to skip this article. Were you among those unfortunate souls who got burnt by a broker selling you one of those "can't-lose" real estate limited partnerships in the 1980's purportedly offering tax advantages that were going to make the heads of IRS agents spin? Or did you buy California real estate in the early 1990's, and are you still trying to figure out where the equity in your house went over that time span? If you are, you might indeed be overcome by an uncontrollable urge to rip up this issue of ***Observations***.

In fact, REITs are vastly superior to the real estate limited partnerships of yesteryear. There are three primary types of REITs. Some REITs own real estate, others own mortgages secured by real estate, while the third type owns real estate *and* mortgages. This article discusses the first type of REITs (a.k.a. "equity REITs").

As publicly traded companies, shares of REITs are traded on the stock exchanges, just like any other publicly traded company. REITs therefore are much more liquid investments than real estate limited partnerships. Just ask anyone who has ever tried to unload one of these partnerships how much fun it was.

Under current tax laws, REITs that pay out at least 95% of their income each year can avoid taxation at the corporate level. So unlike other publicly traded corporations, REITs have the ability to avoid double taxation. As a shareholder, you benefit because there's less given to Uncle Sam and more left over for you.

Because REITs are required to pay out at least 95% of their income to their shareholders to avoid double taxation, the average dividend yield of REITs tends to be much higher than the average dividend yield of other publicly traded companies that may

Inside This Issue:

- **A Personal Note p.1**
- **Real Estate Investment Trusts: How They Might Benefit You p.1**
- **Earnings versus *Normalized* Earnings: It's Important to Know the Difference p. 3**

retain more of their income for reinvestment in their businesses. REITs are therefore often perceived as a good substitute for bonds and an especially appropriate investment class for income-conscious investors.

However, it is too simplistic to view REITs as just bond substitutes. A typical bond pays a fixed income stream over time, repaying the principal at maturity. On the other hand, REITs have the potential to appreciate in value by improving operations and increase their income stream and dividend distributions to their shareholders over time. Moreover, typically a portion of a REIT's annual distribution to its shareholders would be a return of their capital, and therefore exempt from taxation.

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REITs can potentially increase their income to fund higher dividend payments over time in several ways. REITs generally earn a return based on the "spread" between their cost of capital and the return on their real estate investments. Any actions that tend to increase this spread or the size of the asset base on which the spread is based (assuming no overriding reduction in the spread) will tend to increase income generated by REITs. Therefore, actions like reducing the cost of capital, or ownership and operating costs associated with the underlying real estate or increasing rents and the size of the asset base through real estate acquisitions would all boost income for REITs.

The overall quality of REITs coming to market has steadily increased over the last few years. While some brokerage companies will continue to bring shoddy REITs to market, overall the situation has greatly improved. Also, currently there is consolidation among REITs, with the merged companies becoming much bigger entities that enjoy economies of scale. This trend has begun to attract institutional investors, who often are prohibited for a variety of reasons against owning companies that are too small. This should generate considerable future demand for REIT shares, giving them a nice boost.

Lastly, a REIT's performance is tied closely to the real estate and not the stock market cycle. Numerous research studies have shown that price movements of REITs have a low correlation to the stock market in general. In fact, there may be negative correlation, since investors often see REITs (with their high dividend yields) as safe havens when the stock market is on a roller-coaster ride. This "flight to safety" means REITs might outperform just when the stock market is going through tough times. *This was precisely what happened in July 1996, when some segments of the stock market corrected sharply.*

Before you rush out to buy as many REITs as you can put your hands on, you need to know their downside (*there's always a downside to any investment*). First, like any other investment class, you have to be extremely selective among REITs. Some REITs are outstanding investments under *some* circumstances, while others are terrible under *any* circumstance. Make sure the REITs you invest in have good management, clean balance sheets, substantial insider ownership, long and successful operating histories, access to low cost of capital, and reasonable valuations.

Beware especially of REITs that are nothing more than pyramid schemes. Such REITs usually have misleadingly high dividend yields (that are not supported by their cash flow.) These REITs hype their prospects to raise capital from new investors and use this new capital to sustain the high dividends paid to the existing shareholders. *This game usually continues until the latest round of potential new investors wise up and the access to new capital*

dries up. These REITs then have to slash or eliminate their dividends.

Second, because REITs must pay out at least 95% of their income to avoid double taxation, they can retain only a small portion of their earnings for reinvestment in their businesses. To finance the growth of their asset base, REITs must continually return to the capital markets to raise money. If REITs use debt to finance their expansion, high interest rates can hurt their "spread". On the other hand, REITs that issue more stock/equity to raise capital increase the number of shares outstanding, diluting the existing shareholders' interest in such REITs.

Third, the performance of REITs is primarily affected by the performance of the underlying asset class (ie. real estate). Since the real estate business is cyclical, there are good and bad times to buy REITs. *Even good REITs may not be good investments at the wrong part of the cycle*. As with any cyclical company, the best time to buy is *not* when everything is going well, but a little time before the bottom of the cycle. Getting this timing right is very difficult, but you don't have to get it *precisely* right to benefit.

Please call us if you are interested in learning more about REITs. We would be happy to show you how investing a portion of your portfolio in REITs can benefit you.

Earnings versus *Normalized* Earnings: It's Important to Know the Difference

As most of you already know, PDV uses a value-oriented approach to analyze and identify undervalued stocks that are likely to be good long-term investments for our clients. We use a variety of valuation tools, one of which is the price-to-earnings ratio ("p/e ratio").

The p/e ratio is simply the current market price of a stock divided by its actual (or estimated) earnings per share over a certain period. Investors choose different time periods for calculation, with the more common ones being the previous fiscal year, the immediately preceding four quarters or the upcoming fiscal year. Please see the Spring 1995 issue of ***Observations*** for a more detailed discussion of the strengths and limitations of the p/e ratio as a valuation tool.

As a very gross generalization, it is usually easier to find undervalued companies among stocks with low p/e ratios. Of course, this is just a generalization, because many stocks with low p/e ratios have unattractive long-term fundamental prospects that account for their low p/e ratios. This type of stocks is not undervalued. The key to finding undervalued stocks is to seek out low p/e stocks that don't deserve their low p/e ratios.

While the concept of using the p/e ratio to find undervalued stocks sounds relatively simple, its implementation is anything but. There are many factors that could interfere with the successful implementation of this value-oriented approach. The critical distinction between earnings and *normalized* earnings is one such factor.

Normalized earnings are earnings that are ***adjusted*** for the impact of events properly considered transitory in nature. Long-term investors should focus on normalized earnings rather than accept earnings that companies report on their face without any such adjustments. Failure to focus on normalized earnings could distort the "e" part of the p/e ratio, leading to misleading conclusions about whether a stock is undervalued.

An example will help illustrate this point. Suppose you are interested in buying the stock of a manufacturing company whose long-term operating record has been stellar. This company relies heavily on a commodity like resin to manufacture its products. The pricing of resin, like pricing for other commodities, is simply a function of supply and demand. When demand grows, the price increases until supply grows to meet that elevated demand. Usually, supply overshoots demand at some point and pricing comes back down. This type of commodity pricing cycle usually takes awhile to play out.

In conclusion, making any necessary adjustments to reported earnings to arrive at normalized earnings is critical in properly applying the p/e ratio as a valuation tool. Knowing how to make these adjustments requires a good understanding of the company's business and the industry in which it operates. Most of our clients do not have the time or interest to do this. Here at PDV, researching potential investments to the thorough extent necessary for properly selecting undervalued securities is just one of many things we do to add value for our clients and serve their interests.

Back to our example. If resin prices go up alot for this manufacturing company during any one year, the company's earnings are likely to be adversely impacted. The extent of the impact depends on, among other things, the amount of sales growth and the company's ability to pass along its increased costs to its customers. If these factors do not adequately counteract the resin price increase, the company is likely to report a fall-off in earnings and its stock will be correspondingly punished in the market.

If you do not focus on normalized earnings, you might decide that this stock is overvalued even after the stock price has dropped substantially (and maybe excessively). This is because current earnings on their face have dropped off even more than the stock price, thereby expanding the p/e ratio. However, if you correctly conclude that earnings are only *temporarily* depressed and that they'll rebound once additional resin supply comes on line pushing prices down, then a ***price-to-normalized earnings ratio*** would give you a much better gauge as to whether the stock might be undervalued.

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