



Don't swim upstream

Use caution when shorting real estate stocks in a bull market

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How Do Real Estate Stocks Trade?

More pronounced than other sectors of the stock market (as well as the market itself), real estate stocks trade in long cycles. These cycles extend for long periods of time without a change in basic direction. We have analyzed monthly data for real estate stocks (using the NAREIT index) back to 1971 and find very interesting, repetitive trends that we incorporate into our thinking in running the American Assets Real Estate Securities Fund.



The primary reason for these long cycles is that within real estate, most of the core drivers change slowly. These fundamental drivers include real estate leasing cycles, length of tenant's leases, construction cycle times, government approval times, and of course the overall economy. Real estate is less affected by labor issues, government regulation, product life cycles, fads, and innovations. Therefore, the business fundamentals of the companies participating in real estate usually ebb and flow together and slowly, especially relative to the wide dispersion of outcomes in other industries. For example, Apple can invent a product that instantaneously adds value to its company and detracts value from Research in Motion. The last major innovation in real estate was the elevator.

As the underlying business fundamentals gradually swing between bull and bear cycles, the stock prices of companies in the real estate sector follow suit, and tend to move in the same direction for long periods of time. Of course, there are differences in geography, property type, and the capital stack that will drive differences in company performance, and we pay a lot of attention to this to make our decisions regarding which securities to invest in. While some real estate securities may be overvalued, we think we're in about in the middle of a bull market in real estate, so we think it makes sense to be net long at this point in the cycle.

Defining Bull and Bear Markets

Bull and bear markets within real estate are clearly defined. Since 1970 when NAREIT started keeping records, there have been 11 cycles - 6 bull markets (including the one we are 2 years into now) and 5 bear



markets. Once a cycle starts, up or down, it continues for a while. Bull markets usually end with excess real estate development and bear markets usually end with assets selling at deep discounts to replacement cost and the associated failure of lenders to those assets. In only one case (1988) was there a break from this pattern, in which we had a rally year in a bear market.

Figure 1: All REITs - TOTAL Monthly Return (includes dividends)

Cycle	Market	+ months	% + months	- month	% - months	Years
Dec '71 - Jan '73	Bull	10	77%	3	23%	1.1
Feb '73 - Dec '74	Bear	9	39%	14	61%	1.9
Jan '75 - Mar '87	Bull	101	69%	46	31%	12.3
Apr '87 - Oct '87	Bear	2	29%	5	71%	0.6
Nov '87 - Aug '89	Bull	15	68%	7	32%	1.8
Sept '89 - Oct '90	Bear	2	14%	12	86%	1.2
Nov '90 - Dec '97	Bull	60	70%	26	30%	7.2
Jan '98 - Nov '99	Bear	5	22%	18	78%	1.9
Dec '99 - Jan '07	Bull	64	74%	22	26%	7.2
Feb '07 - Feb '09	Bear	11	44%	14	56%	2.1
Mar '09 - present	Bull	19	70%	8	30%	2.3
Total - Bull Markets		269	71%	112	29%	31.8
Total - Bear Markets		29	32%	63	68%	7.7

Source: NAREIT

The point is, once a bull market starts, if 41 years of history is a guide, the indexes will not have a negative total return year until the market simply rolls over – and this roll over is a ‘top of cycle’ event defined by construction and by assets selling for at least replacement cost (which is years away). On a monthly return basis, approximately 70% of the time returns are positive in a bull market and the reverse is true in a bear market – see Figure 1. In addition, all bull markets are basically the same, as the percentage of positive return months in a given bull market ranges between 68% and 74%, similar to the temperature range in San Diego.

After a negative return month within a bull market, the chances of the next month also having negative returns is 30%. So the chances of encountering two consecutive months of negative returns are less than 10%. In these long bull market cycles, there will be an occasional pullback of 10%. These pullbacks have never run more than three months, and three months later, the index usually sets new highs.

This is not simply manipulating statistics. The reasons for these long cycles are driven by the fundamentals discussed above, and they largely remain unchanged from cycle to cycle. We have worked



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through nine of the 11 cycles and while in each cycle people proclaim this cycle is different – they are not. It still takes three to four years to build an office building; a mall still uses 100 acres of land; steel is still steel; retail tenants still want to pay 11% of sales in rent; and industrial users still want to be near the freeway. At the margin, bank regulation and CMBS issuance and other financial factors affect liquidity which in turn affects values. But these factors don't alter the functionality to users of the assets or the physical nature of the assets.

In an environment defined by these parameters and given where the real estate cycle is today, we are long-biased. We will continue to search for overvalued securities and will take short positions when prudent, but we expect it to be the exception rather than the rule during this phase of the cycle, as we aim to avoid being a salmon swimming upstream. There will be a time to be net short as well, but we are likely years away.

Sincerely,

American Assets Investment Management, LLC, General Partner

Burland East, CFA
Chief Executive Officer

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