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Investment and Planning Topics for WESCAP Clients and Other Interested Readers

REIT INVESTMENT DOUBLE PLAY

REITs as Investments An equity real estate investment trust (REIT) holds and manages real property. It passes through at least 95% of taxable income to investors. This income is not taxed at the trust level. REITs offer attractive investment diversification to traditional stock and bond portfolios. In addition, there are several trends within this industry which can increase the return on REIT investments.

The evolution that some REITs have gone through in the last decade is shown here:

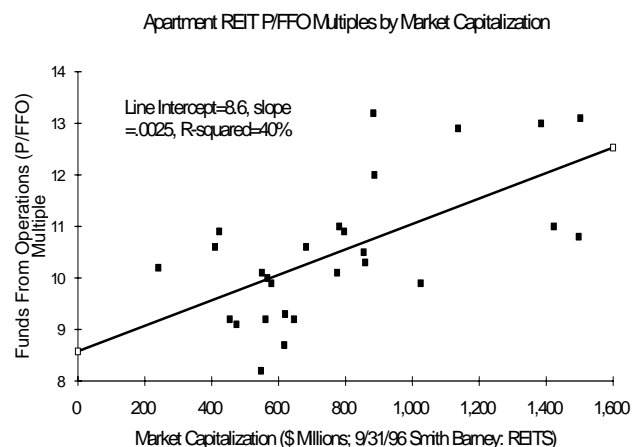
Formation A REIT is formed from a family-owned real estate business, a corporate spin-off or by the "roll-up" of tax-sheltered partnership properties. This REIT may have a dozen properties of different types in various locations. The trustees hire an outside property firm to oversee the management of those properties, usually through local property management. Mortgages on properties provide financial leverage.

Focus Then the REIT begins to focus on a specific property type (retail, apartment, office, or warehouse, etc.) and begins to sell off non-core properties to build the core portfolio. It also announces where (geographically) it will focus its efforts. It may raise additional equity capital.

Management and Economies of Scale As the REIT acquires additional properties (individually or in portfolios), strategic management is brought "in house". Eventually, on-site property management is also brought in house. These moves reduce costs and improve the return on properties through better property management.

Financing Costs Decline As the REIT gains stature and size, it begins borrowing directly from institutions or Wall Street with the REIT as borrower. Preferred stock can also be used. These changes significantly reduce the cost of debt as mortgages are retired.

Share Price to Cash Flow Cash flow (funds from operations or FFO) is a basic measure of REIT value. As REITs evolve, gaining the advantages outlined above, the stock price to per share FFO (P/FFO) can be expected to increase.



Thus, the potential investment return can consist of both growing cash flow plus the increased premium placed on the larger, more successful REITs (see graph). In percentages, the potential return for many REITs could include the annual dividend payout (six to eight percent) plus an expansion of the share multiple from about a 9 P/FFO multiple to perhaps a 13 multiple. Additionally, per share FFO is expected to grow, for a total potential annual rate of return in the high teens for several years.

Liquidity and Pension Demand for REITs Besides the obvious advantages outlined above, larger REITs are also more "liquid"

in the stock market (they are easier to buy and sell without affecting share price). While all investors value the liquidity REITs provide, pension funds are especially interested in owning REITs because they offer long-term inflation hedging characteristics critical to many pension plans. Since the changes in pension law which encourage portfolio diversification and the pension administrators' difficulties with commingled property pools of the

1980's, pension managers have sought liquid real property investments. The market of larger, liquid REITs is finally reaching a size where pension funds can make meaningful investments. We believe that this desire for liquidity by pension funds will continue to support high price premia for the best and largest REITs.

Investors can participate by selecting a number of individual REITs or by owning one of the existing REIT mutual funds.

If you have questions about the above, please contact Mark Gleason, Rick Weinlein or Joel Edstrom at (818) 552-2130 or fax to (818) 552-2133. WESCAP Management Group has obtained information from sources believed to be reliable, but no guarantee can be made as to its accuracy. WESCAP Management Group provides fee-only, personalized, objective financial and investment advice to individuals.

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