Trader's Notes

RIVERFRONT INVESTMENT GROUP

May 8, 2008

REITs…..Rally should run out of gas

REITs have been rallying strongly relative to the S&P 500 since the beginning of the year and we have recommended investors stay on the sidelines. Our pessimism towards the group has caused us to leave roughly 10-14% points of relative performance on the table and for that we are sorry. However, we continue to believe the rally in REITs is only a bear market bounce from oversold levels and more weakness is ahead. From Chart 1 we make two observations.

1. From the top panel we can see that the relative bounce in the group from January 2008 to today has brought it right back into significant areas of resistance.

2. The bottom panel displays the dividend yield of REITs relative to the 10-yr Treasury. The 10-year relative average is 1.29x.... meaning that REITs have historically offered dividends 29% higher than treasuries. Early in 2008, that premium had grown to nearly 1.6x or a dividend yield 60% higher than treasuries. Since then REITs have rallied and Treasury yields have increased bringing the current dividend yield to just 1.18x 10-year treasury ratesí . A premium to their 10-year historical level.

Fundamentally, we remain bearish on the group for the following reasons:

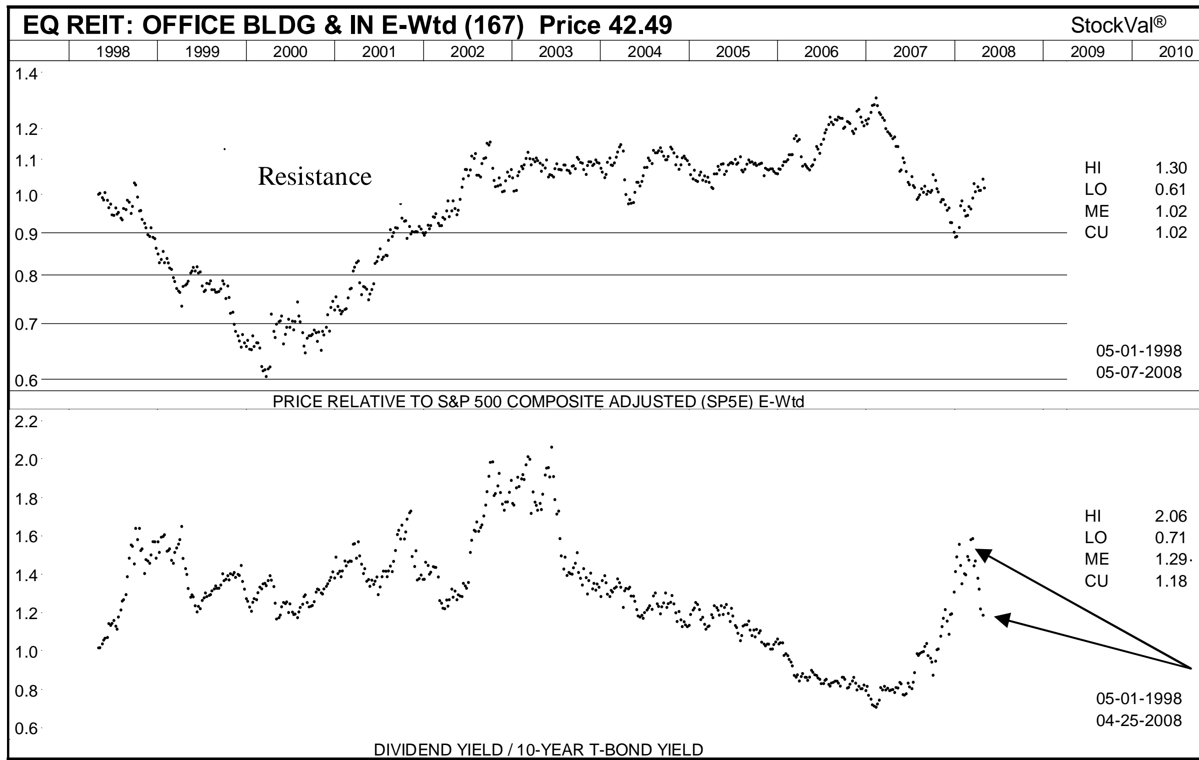
1. **Governor on Growth:** Since REITs by statute are required to pay out the majority of their earnings, they are dependent on the capital markets and lenders to grow. We believe that the credit crisis of ø07-08 will have long-term negative the granting of credit. Credit will be more difficult to get and more expensive for those who can attain it. We see this hampering the growth of companies dependent on external sources for funding.

2. **Real Estate:** Rarely does residential real estate decline significantly without some sort of ripple-effect being felt on the commercial side. Although REITs have suffered since early 2007, the degree of their pain has been in-line with the average financial company while we believe their exposure to the real estate market is greater. Furthermore, many real-estate developers have been taking their own equity capital out of development projects over the past few years, similar to the ÷cash-out refisø homeowners have embraced. Therefore, many developers are ÷playing with the houseøs moneyø and have a lower vested interest in a projectøs success and are more willing to walk away.

3. **Recession:** If we enter a recession that is more than just the ÷touch and goø scenario the bulls are forecasting, the impact on commercial real estate could be significant. REITs are dependent on the economy for two reasons. First, tenants could go out of business and the cost of finding a new tenant is time-consuming and costly. Second, **and more importantly,** REITs went on a buying binge in 2004-2007 causing cap rates (the rate of return implied by the purchase price) to decline to historically low levels. These low cap-rates were justified by management under the assumption that they could ÷jack-upø rates significantly in the future. You donøt have to be a real-estate expert to recognize that rents are much more difficult to raise when economic times are poor.

Bottom Line: We have kicked ourselves for being so bearish on the REIT industry in 2008 given its strong gains. However, we are no more inclined to chase the rally than we have been throughout the last few years. Furthermore, if we owned any REITs, which we donøt, we would be using this recent rally as an opportunity to cut positions even further.

Chart 1:



Relative yields rose to nearly 1.6x Treasuries. They now stand at 1.18x

Chart Courtesy StockVal

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