

GUGGENHEIM REAL ESTATE *PLUS*

SECOND QUARTER 2004 MARKET COMMENTARY

by Mike Miles, Portfolio Manager

“Did Multiples Peak in the Second Quarter?”

Observations: In real estate investing, the capitalization rate (or cap rate) can be thought of as the inverse of the price multiple, and in technical real estate speak, “cap rates got really, really low in the second quarter.” As indicated by the Equity Office/Teacher’s Insurance purchase of an office building in Santa Monica, California, the cap rate on the best office properties dropped below 6%. Even more startling was a continued decline in cap rates, now below 7%, for second-tier shopping centers and industrial portfolios. Apartment cap rates have been below 6% for some time, but the second quarter saw some second- and even third-tier apartments trade at that level. The trailing NCREIF Property Index income yield is now down to 7.7%, but remains above the yields at which properties are trading, implying future appreciation in the index.

The long downward spiral of capitalization rates has been driven by declining interest rates coupled with declining fundamentals (rents). These two trends now seem poised for a reversal. Long-term U.S. treasury yields started up early in the second quarter and the Federal Funds rate started what is expected to be a long climb at the end of the quarter. Also, rents are now forecasted by all three national forecasting services to rise in all four property types (the sole exception being a forecast decline in industrial rents by Torto Wheaton). Denominator down and numerator up suggest a rising capitalization rate.

We are seeing this play out in the markets in two very telling ways: First, the number of offerings seems to be approaching an all time high. Are people trying to get off the boat before multiples drop? At the same time, more “agreed to” transactions came back to market in the second quarter. For several quarters, it has been a seller’s market with buyers willing to suffer a bit in the closing negotiations to get the deal done. This seems to have ended with more transactions breaking up after signed agreements this past quarter. We recently agreed on terms to purchase a Florida shopping center after losing in the normal bidding process. Our final price is actually lower than our losing purchase offer in the original bidding.

All this is playing out against a very interesting economic backdrop. Globally, demand will be impacted by higher U.S. interest rates, the forced slowing of China’s economy and spread of turmoil in Iraq to other countries. In the U.S., we have come to the end of the Bush tax stimulus and the peak of Greenspan liquidity. Both of these direction changes will play out in a presidential election year. In the real estate sector, we see record industrial availability and only modest rent growth forecasts for the other property types. Adjusting investment strategy for these trends, one shouldn’t lose sight of the well known longer-term influences on both the domestic economy overall and the real estate sector specifically. These include 1) rising longevity, 2) escalating health care costs, 3) inadequate retirement saving, 4) the fiscal train wreck in physical infrastructure, 5) inadequate public education, and 6) an unsustainable energy infrastructure. The interactions of these long-term forces

create some very important trends, which will have a pronounced impact on the relative value of different real estate.

As we have said before, this is (in our opinion) a time to carefully avoid the marginal properties. By MSA, by submarket, as well as by individual property features functions and benefits, every property must meet a particular niche's needs or it runs the risk of becoming surplus. For the investor, surplus means lots of future capital expenditures to make the property more competitive and/or lower rents.

Performance over the last quarter: The benchmark return was 0.45% in the second quarter. The performance of our funds was helped by recapturing the valuation lost in the first quarter when a rapid drop in long-term interest rates resulted in a revaluation of the mortgage loans secured by our direct property investments. In addition, the funds' REIT managers performed well during the quarter on a relative basis, and our direct property portfolio had its best quarter since inception on an absolute basis. It is interesting to note that we have received a number of unsolicited offers to purchase properties owned by our funds. We are evaluating each offer and believe that these unsolicited offers are simply an expression of the fact that if one holds solid real estate, sometimes unique buyers find specific reasons to own particular properties for which some buyers are willing to pay a premium price.

During the quarter we closed on the first loans in our mezzanine loan program as well as on an office building in Southern California and an apartment complex in Chicago, Illinois. With these acquisitions, we are very close to our target allocations by property type and geography.

Looking to the future, real estate is not cheap in terms of the perspective real return embodied in today's multiples (cap rates). From an investment perspective, the same can easily be said for the stocks, and bonds don't look particularly attractive in a rising interest rate environment. That said, our goals remain to generate returns of 2-4%, before fees and expenses, above the benchmark, and to provide a net real return of close to 6%.

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