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MARKET MOVERS

Booming Sector Starts To Show Stress Cracks

Real-Estate Investments Soared, Before the Jump in Interest Rates; Fans of REITs Aren't Giving Up

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The sugar coating may be coming off of one of the sweetest parts of the stock market.

One of the few consistently lucrative parts of the stock market over the past four years has been an oft-overlooked investment called a REIT.

Real-estate investment trusts -- companies that own things like apartments, offices and shopping centers, and distribute almost all their income to investors in the form of dividends -- have jumped 63% overall since the end of 1999. During that same period, the Dow Jones Industrial Average has fallen 9%.

There's not much mystery to it. As most stocks sagged during the bear market, real estate surged. And as market interest rates -- bond yields, money-market rates -- fell to their lowest levels in 45 years, investors looked for other ways to generate steady dividend income. REITs on average have yielded about 7% historically. With real estate booming, they were the place to be.

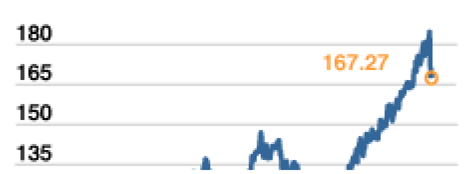
Now, some investors fear those glory years have just ended.

On Monday of last week, the Dow Jones REIT index fell 4.1%. On Tuesday, it fell another 3.8%, marking the two sharpest daily declines since the index was created 12 years ago. Overall last week, the REIT index fell 8%, while the Dow industrials were almost flat on the four-day week, declining 28.56 points, or 0.3%, to 10442.03. Markets were closed for Good Friday.

Why the sudden REIT problem? The declines follow news early this month of surprisingly strong March job gains. That stoked concerns that a surging economy could spark inflationary pressures. Such an environment usually leads to higher interest rates. If rates rise, many investors believe dividend plays such as REITs will become yesterday's hot item.

STORM CLOUDS OVER REITS

Real-estate investment trusts own residential and commercial property, allowing investors to have an indirect stake in this market. Below, the Dow Jones Composite REIT Index.



"If you look at the chart on this thing, it is pretty dramatic," says Jack Ablin, chief investment officer at Chicago money-management firm Harris Trust, who has been warning that REITs have taken on some characteristics of an investing bubble.

Some investors worry about trouble at other investments that also have benefited from low interest rates -- utility companies, brokerage firms, banks, home builders and concerns such as **General Electric**, **Ford Motor** and **General Motors** that have big financing arms.

Many on Wall Street shrug off those worries. They believe REITs and other rate-sensitive investments already have over-reacted.

Merrill Lynch, for example, published a report last week urging investors to use sharp declines as an opportunity to buy REITs that specialize in health-care properties such as nursing homes.

REIT fans point out that the Federal Reserve isn't likely to raise interest rates all that rapidly, meaning that REIT dividends could remain much higher than market yields for some time.

But there is a second problem, and it has to do with the size of the overall REIT market. In a U.S. stock market whose current value is more than $13 trillion, REITs taken together have a market value of around $210 billion, says David Shulman, senior REIT analyst at New York brokerage firm Lehman Brothers. That is less than 2% of the stock market. It is less than the market value of General Electric alone -- or **Microsoft** or **Exxon Mobil**.

So when investors began chasing REITs a few years ago, there were a limited number of REITs to chase. As investors' dollars poured in, REIT values soared to records, leading people like Mr. Ablin and Mr. Shulman to begin warning of a bubble.

"REITs peaked on April Fools' Day, which is a little joke we have around here," Mr. Shulman says. "These stocks were trading at all-time highs. They were up for 14 straight months without a correction. They were trading at 135% of net asset value," based on the overall appraised value of the assets that they own.

Their prices were 13 times their income from operations, also a record, he says. Prices got so high that their average yield -- their dividend divided by their price -- fell below 6%.

When an asset is that stretched, it takes only a small blemish to cause a problem for marginal investors. That is why REITs fell so sharply at the start of last week, on the fear that market yields are due to rise now.

Similar worries last week hit other sectors. Investors have begun wringing their hands about what they call the "carry trade," or the strategy of borrowing money at low short-term rates and investing it at higher long-term rates. That works fine until short-term rates rise, when it can turn into a vise.

Many financial companies have used that strategy. An investment institution can borrow short-term for 3% or less and get a yield from a REIT of 6% or more. A bank can borrow for as little as 1% overnight and then lend at 5% or more longer-term.

It sounds like a no-brainer. But when short-term rates go up, the cost of funding a longer-term investment rises, and the income from the longer-term investment stays the same -- or even falls, if the value of the longer-term asset declines. A brokerage firm or money manager investing in long-term mortgages, a bank that has issued long-term loans, or an individual who owns REITs finds his or her profit margin shrinking.

Investors generally don't wait and react after a problem blossoms; they react as soon as they get a whiff. That helps explain not only why people have begun moving out of REITs, but also why there has been erosion in junk bonds and in the stocks of companies such as banks, brokerage firms and money-management firms that have used the carry trade.

For REITs and similar investments, the question now is how badly overvalued they became during the period of extremely low rates, and whether last week's pullback was enough of a decline to correct the problem. Many investors think that some REITs, at least, are due to rebound.

"I think REITs have a lot of room to go up, especially if the economy improves," says Michael Cuggino, president of Permanent Portfolio Funds, which manages $250 million in San Francisco and invests in a number of REITs.

Higher rates could push individuals to rent apartments rather than buy homes, he says, meaning "apartment REITs are an area that could do well." That is especially true if employment continues to pick up. Office REITs also could benefit from a strengthening economy, as demand for office space improves, he says.

"If the long [30-year Treasury] bond is yielding about 5%, you have to go up another point or point and a half before you start to challenge REITs on a yield-only basis. And I think the outlook for REITs will improve as the economy improves," he says.

A gradual upward trend in bond yields "isn't enough to hurt the stock market big or the REIT market," says John Waterman, chief investment officer at Rittenhouse Asset Management in Radnor, Pa., an arm of financial-services group Nuveen Investments.

He worries more about banks that have been issuing cheap long-term loans and funding them with short-term borrowing, and, to a lesser degree, about home builders losing business due to higher rates, he says.

What worries other people is investment companies and brokerage firms that have borrowed short-term to invest in longer-term bonds and mortgage securities, which may be hard to sell at a profit now. But as long as any rise in market rates is gradual, Mr. Waterman says, "I don't think anyone is going to be caught by surprise."

Others point to 1994, when the Fed caught many investors by surprise with sharp interest-rate increases and the bond market fell hard, causing widespread pain for investors.

Mr. Shulman says he isn't so sure that the market is prepared for rising rates.

"Anybody involved in the carry trade is at risk," he warns. "I think there are a lot of inconsistencies in the market based on people profiting from low short-term interest rates."

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