

December 2005

The Tipping Point

“The Tipping Point is the biography of an idea”¹, the exploration of a thesis that expands the concept of a typical epidemic to the idea of a social epidemic or trend. It is built on a foundation of three characteristics – one, contagiousness; two, little causes have big effects; and three, change happens dramatically. These principles are extended into three rules that describe how a shock to the equilibrium is brought about by any or all of the three agents of change, namely: the Law of the Few, the Stickiness Factor, and the Power of Context, leading to the fabulously descriptive - Tipping Point.

It is with these principles and rules that we journey through the REIT Story since its inception in 1963, and prove that multiple Tipping Points have created a social epidemic in the last decade that has led to an investment trend in REITs way out of proportion to its growth over the previous three decades.

With this knowledge we hope to be able to identify future social epidemics or trends early enough to participate in their geometric growth, as well as to be forewarned with mature trends that an inevitable correction to equilibrium or beyond is around the corner.

REITS - Do We Have an Epidemic?

The answer to the above question I believe is a resounding yes. So if this is the case, is it a bad thing?

My view is that once a full blown epidemic is in place, the output that results from this dynamic energy, which we have learnt already bears no proportion to the input invested, will inevitably result in a distorted picture of reality, this distortion will need to be corrected to provide equilibrium to the status quo.

Sadly, what this means is a correction to the incredible REIT growth story of the last four decades. Assuming that our epidemic assumption is correct and that REIT growth has reached an epidemic stage, how to identify the impending end to this growth and time its climax is the subject of another paper and will be dealt with separately using the very new science of Socionomics. The purpose of this paper is twofold: Our first goal is to establish that there is in fact an epidemic, as this knowledge will allow us to prepare for the inevitable correction; the second purpose is to try to identify

¹ Gladwell, 2000, pg 7.



the 'Tipping Point' of the REIT epidemic so that we can be prepared in the future to identify other such investment epidemics prior to their outbreak.

REITs – THE TIPPING POINT

The REIT investment vehicle has enjoyed exponential growth in the last decade or so, even greater than the previous three decades combined. What was the Tipping Point and does the story fit within the principles and rules of change put forward in Malcolm Gladwell's book, *The Tipping Point*?

All three principles involved in an epidemic need to be present; however, when it comes to the agents of change it is only necessary for change to occur in one, or two, or three of the rules namely: the Law of the Few, the Stickiness Factor, and the Power of Context.

Contagiousness – Principle 1.

There is no doubt that REITs have become part of the lexicon of every diversified US money manager. The real estate securities investment world has also adopted the REIT structure as the default vehicle for real estate securities investing, with the largest remaining countries, the UK and Germany, about to embark on the REIT structure; in short everyone wants to become a REIT.

As the performance of REITs continue to outperform the other major indices they continue to draw large capital inflows, the positive energy directed towards REITs feeds on itself to create even better returns thereby creating a continuous loop. This creates contagious behaviour within the REIT world, just like a classic virus infects those that come into contact with it, who in turn infect others. Another infectious point is the increased desire from direct property owners who are seeing the benefits of a securitised investment and are either transforming their ownership vehicle into a REIT or are selling their properties to REITs that are able to acquire them at relatively attractive prices compared to their direct owner cousins.

The increased market capitalisation brought about by the increased values and larger asset pools as explained above; it is also leading to more investment capital flowing into the sector which in turn is leading to greater liquidity which makes REITs more attractive to larger fund managers and, with billions more dollars expected in market capitalisation, the need for more and more fund managers to pay attention to this asset class creates a self fulfilling interest, another feature common to an epidemic.



Pension funds, that for so long avoided REITs, are now major investors, with many 401(k) plans now offering a REIT option. This leads to more need for information, which in turn leads to more dissemination of information, which inevitably leads to information overload and before you know it, you have achieved contagion.

From residential property to commercial, everyone wants to buy property, and the easiest most astute way to get into the game quickly, without any infrastructure or expertise, is to buy a REIT, as this has become understood by the man in the street. That is why the number of people infected by this epidemic has grown.

I also believe that in many cases of an epidemic outbreak, there are multiple Tipping Points which I will describe more fully below, but the essence of this belief is that often one Tipping Point infects another to create a domino effect of Tipping Points.

Little Causes Can Have Big Effects – Principle 2.

As described above, I believe there are often multiple Tipping Points. I think the first Tipping Point for REITs came in the 1993 – 94 IPO BOOM. There were small subtle changes to the way REITs “looked”; their ownership profile, their management structure, conflicts of interests, management ability, etc. were all dealt with and improved, contributing greatly to the desire to be a part of the BOOM.

The second Tipping Point came about when the US equity markets tumbled on the back of a technology “bubble” bursting. A collapse in the general equity market and more specifically the technology sector, a sector built up to a large extent on nothing more than a dream and spectacular hope, had a profound effect on investors’ attitudes to bricks and mortar as a safer option for investment.

The third Tipping Point came in October 2001, when Standard and Poor’s admitted the largest REIT, Equity Office Properties, with an equity market cap of \$12 billion, into the S&P 500 Index. Equity Residential Properties Trust, the largest apartment REIT, was admitted soon thereafter. Once again a seemingly small incident thrust REITs into the forefront of the investment fraternity and gave it a stage to attract much larger interest in the asset class.



The fourth Tipping Point came in early 2002 with a NAREIT commissioned Ibbotson Associates report. Ibbotson, a leading authority on asset allocation, examined the historical investment performance of the publicly traded equities of REITs to determine whether REITs provide meaningful diversification benefits in diversified portfolios. Ibbotson found that, historically, REITs have earned competitive returns and exhibited lower volatility than other types of stocks. Ibbotson also found that REIT returns are relatively uncorrelated with those of other stocks and bonds. In fact, as the total equity market capitalization of REITs increased and the companies achieved wider analytical coverage from Wall Street analysts and a broader base of investors, the correlation of REIT returns with those of other investments declined appreciably. As a result of these investment characteristics, the Ibbotson analysis demonstrates that REITs are a strong source of portfolio diversification, raising returns and lowering risk in a wide range of diversified portfolios. This report, with its credibility, helped pave the way for the pension fund community to once again seriously consider real estate as an asset class and, more specifically, REITs.

Each of the above Tipping Points on its own and out of context does not have the energy to create the kind of epidemic that I propose is currently in effect. However, in context we can see how small and seemingly simple things can have a dramatic effect.

Change Happens Dramatically – Principle 3.

Chart 1.

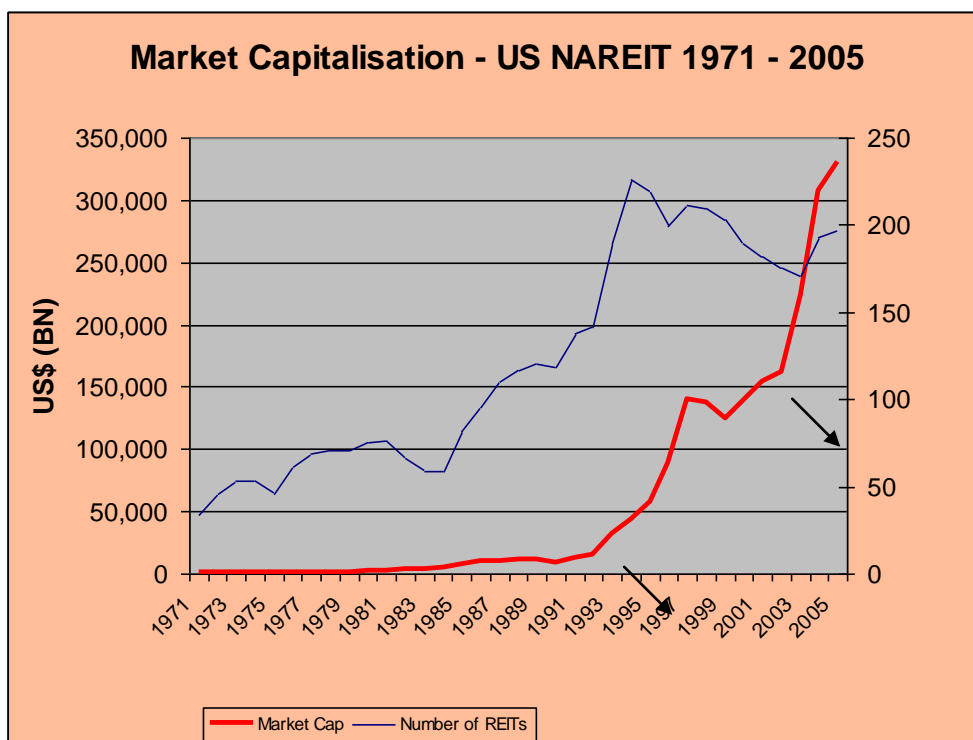


Chart 1, above, helps us visualise how dramatically change happens when an epidemic takes effect.

From 1963 to the beginning of 1993, REIT market capitalisation reached around \$16 billion. The offerings in 1993 alone surpassed the total amount of equity that REITs had raised during the previous 13 years. By the end of 2005 the market capitalisation had reached \$330 billion.

As you can see, once you reach a Tipping Point the change happens very quickly and takes on a geometric progression way above the normal arithmetic projections we are accustomed to in everyday life.

The Power of Context

It is my belief that although there are definitely connectors, Mavens and salesman and a strong element of stickiness in the REIT story, the Tipping Point has evolved essentially from the Power of Context.

“Epidemics are sensitive to the conditions and circumstances of the times and places in which they occur.”¹³ As I have already discussed, I believe there were a number of Tipping Points that created the REIT epidemic, but I believe there are two main Tipping Points that fit perfectly in context.

¹³ Gladwell, 2000, pg 139.



The kinds of contextual changes that are capable of tipping an epidemic are very different than we might ordinarily expect. From 1991 – 93 a major bull market developed in the REIT market, interest rates were coming down, property was being bought at bargain prices in 1991 on the back of a major correction, and REITs had finally got their house in order. The REIT vehicle was now an inviting investment vehicle for the real estate community (it is important to note that at this stage the bull was still confined to the real estate community). It was within this investment environment that a contagious IPO BOOM (93 – 94) led to the first stage of the REIT Tipping Point.

Understanding The Power of Context provides the insight that tinkering with the smallest details of the immediate environment can create an epidemic of extreme proportions. I believe the tinkering with the finer details of the REIT vehicle was what the industry needed to create the initial Tipping Point within the real estate industry.

The Tipping Point that followed in 2000 was, I believe, the catalyst in “mainstreaming” the REIT and ultimately creating it as its own asset class independent of real estate, equities or bonds. How did REITs do it? Simply by being in the right place at the right time; yes, that simple. It was no coincident that after the greatest equity sell-off since the 1929 Crash, investors would be desperate to find an investment that provided them with yield and stability. After investing in stocks with no earnings, or earnings that would take 100 years to recoup for the investor to recoup his investment, and now having to deal with the fact that these investments were quickly on their way to halving in value or, in some cases, falling all the way to zero, investors were frantic to bring a halt to the loss of trillions of dollars of value, and provide an underpin for their retirement. To compound matters further, the Fed was about to embark on a monetary easing policy of epic proportion, that would spawn a liquidity epidemic far greater than many REIT stories. The race was on to find yield in the fast declining money and capital markets. As the market was now scared of conventional equities, the REIT was the perfect solution to this problem. Through no fault of their own, REITs were now enjoying unparalleled interest and growth as an asset class.

It would be nice to say that it was all because of the REIT industry stakeholders, management, etc. That however would be fantasy; yes they played a major role in creating the environment for the first Tipping Point, which was localised within the real estate industry. It is far more plausible that the Tipping Point was caused by the environment of the day which had created an investment climate that required something to fill a void. REITs were the filling.



There is one further aspect within The Power of Context, and that is the critical role that groups play in social epidemics. The Rule of 150 implies that groups are most effective when they are small and close-knit, as this somehow creates the power to magnify the epidemic potential of an idea. Once we are part of a group, we are all susceptible to peer-pressure.

This is exactly how the REIT story spread. It was first started by a small close-knit group of real estate investors, then came another group that has been described as REIT Dividend Diehards, who simply bought REITs for their yield characteristics, no matter what growth story was being peddled at the time. Then more recently came the “Hot” money led by the momentum investors who have been quick to jump on the bandwagon, lured by the excellent investment returns produced by the REIT asset class.

Until recently many old time REIT investors referred to the asset class as REITville and/or REITdom. I no longer hear these affectionate terms as REITs are now serious business! Terms of endearment are reserved for the more sidelined type investments and no longer have a place in mainstream investment circles.

These small parochial groups helped create the context which inevitably led to the investment epidemic pervading the REIT universe today.

In Conclusion

I believe *The Tipping Point* is a very powerful book built on the foundation of very strong principles. I have proposed that REITs have taken on characteristics of a social epidemic, I have demonstrated how The REIT Story fits in very nicely with the Principles and Rules Gladwell proposes.

With the understanding of the power a social epidemic can unleash on the investment world, it is my hope that this paper will provide its students with the ability to identify an investment epidemic when one occurs and thereby avoid being swept up by the euphoria often associated with such infection.

Ultimately, the purpose of this paper is to create the groundwork to try to explore the possibility of identifying or modelling the timing of an impending Tipping Point.

REIT investors BEWARE!!!!

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