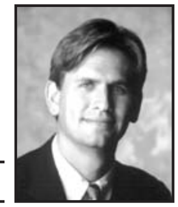
Steve Sjuggerud's **TRUE WEALTH**

November 2001

Don't Lose Money • Get in Early • Take the Government to the Cleaners • Landlords Don't Go Broke



MAKE SURE YOU GET PAID

Why REITs Are the Best U.S. Investment Today

An incredible 99% of U.S. equity funds ended the third quarter in the red.

—*Fortune* Magazine, October 29, 2001

If you haven't lost money this year, you are either a brilliant investor, or you've been extraordinarily lucky.

The stock market hasn't been clobbered like it's being clobbered right now since the early 1970s. The average stock fund lost 18% in the third quarter alone, bringing the year-to-date average to a loss of 22%.

Fortunately, I've been in the "lucky" camp this year. The **True Wealth 1-2-3 Stock Market Model** has never flinched — it's been in Strong Sell mode all year, which has kept my exposure to stocks at a minimum. And while this newsletter is relatively new, I had contributed a couple of articles for The Oxford Club earlier this year. One of them was a feature story on **Homestake Mining (HM)**, which has turned out to be the best performing stock in the S&P this year, up by triple digits. And another is Inflation Adjusted Treasuries. These "boring" Treasury bonds that have brought home double-digit returns this and outperformed every investable stock market in the world this year.

Of course I've had some losers too. But I've diligently stuck with one of the Four Laws of Lasting Wealth — "Don't Lose Money" and I've cut my losers with small losses before they could become big losses. And I've invested in MITTS, which have a built in loss-limiting feature. This has been my key to being a successful investor this year (and every year), I limit my losses, and I let my winners ride.

The point is, it ***is*** possible to make money out there right now. And you don't have to take crazy risks to do it.

But chances are, you're not going to make money by buying yesterday's winners. Who would have thought that Homestake Mining, a gold mining company of all things, would become the S&P's best performing stock this year? And who would have thought that a type of government Treasury bond could outperform every major stock market in the world — and by a wide margin?

Times are sure are different right now. We haven't seen a bear market in a generation. And we've never seen an attack on our homeland like we've just experienced. And these different times call for a rethink of how to create wealth.

In this issue, I'd like to share with you one of the most important strategies for wealth creation. It's worked for centuries — as long as people have been investing. And I would like to share with you the very best way to capitalize on this strategy. It's through an investment that you've probably never made before. But like a gold mining stock, or the inflation-adjusted bonds, don't let the fact that you've never considered it before deter you from making the right investment decision.

While I can't promise the moon (as many writers do), I do believe that this investment will bring home average annual double-digit returns and significantly outperform the stock market over the next few years.

Make Sure You Get Paid

When I grew up, we were always cash poor, but land rich — or at least that's what my parents always said. I remember my mom telling me stories of borrowing money to buy groceries. My father was in the military and my mom was a schoolteacher, and there wasn't any "family money" so there wasn't a ton of money floating around to invest.

But over time my parents were able to build a comfortable retirement by following one of the keys to creating wealth — <u>they made sure they were in investments that paid them regularly</u>. What's more, it seems that any time they veered from that simple philosophy, whether it was the stock market, or limited partnerships, or whatever, they ended up losing money.

What my parents did was slowly build up a portfolio of rental properties. Nothing fancy mind you — a townhouse here… a condo there… And they received significant income in the form of rent.

You see, if you own a rental property, you've got a (hopefully) stable source of monthly income in the form of rent. And likewise if you're in the stock market, you invest in stocks that pay you regular income in the form of dividends. This is making sure you get paid.

What these income payments do is to help smooth out the fluctuations in the value of investments over time. For example, if your rental property were to fall by 5% in value one year, that fall would have likely been more than offset by the rent you received, which may have totaled 8% of the value of the house.

Now most people don't know this, but <u>income has traditionally been a major part of investing in the stock market</u>. Over the 20th Century, dividends made up a whopping 40% of your total return on stocks. (Meaning if stocks returned 10% a year, 4% of it was from dividend payments and only 6% of it was from rising stock prices.)

But nowadays, getting paid is tough. The dividend yield on the average stock is much less than two percent. And the bank is now paying less than two percent on deposits. So far from offsetting any losses, the income you're getting paid isn't even keeping up with inflation. It's miserable out there.

But there is a place where you're getting paid, and getting paid well. It's commercial real estate. I'm talking about owning apartments and office buildings. It's easy to do and it doesn't take a large investment — you can get in for $1,000 or less. You just buy a real estate company on the New York Stock Exchange — and the average dividend payment right now in these is income of 8.3% a year.

<u>I'd like to show you just how good an investment real estate stocks are</u>. <u>And why now is an excellent time to invest</u>. Before you make any judgments, please read everything I've got to say. I've done an incredible amount of research on real estate and real estate stocks, and I'm confident what I share with you is research you'll never see anywhere else.

Why Real Estate Stocks Are Great Investments

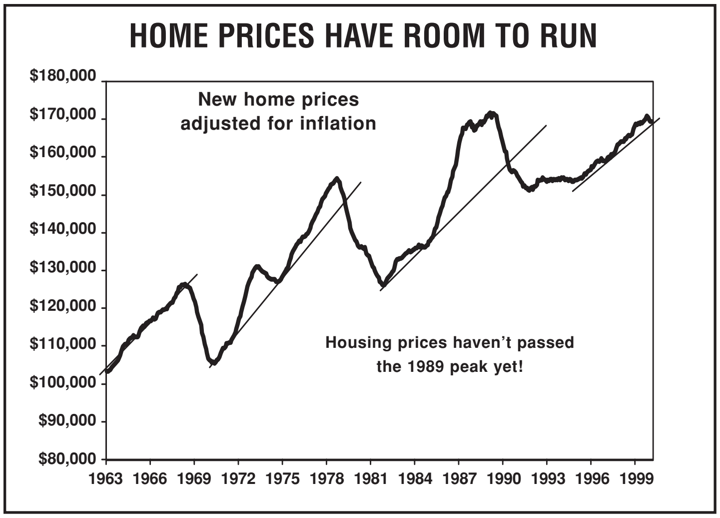
Let me start with your home, as it's a place that you understand the mechanics of. Then I'll move those principles to commercial properties and real estate stocks.

Let's assume we're interested in buying a rental property for income. We check out the market, and we say "boy, right now, a home costs a lot of money." And you're right, after all, new home in America costs on average about $170,000, and that is a lot of money.

But there is a huge difference between the phrases "a lot of money" and "expensive." And that's the key distinction. Let me explain. Let's say, for $100,000 dollars, I'd be willing to sell you 1,000 new computers. At first, you might say "$100,000, that's a lot of money." But then, you'd quickly realize "wait a minute, that's only $100 per computer — that's not expensive at all — that's a *great* deal." So you just need to figure out how to come up with the $100,000.

And that's the way I see real estate now. While real estate *costs a lot of money, it's not as expensive as you think right now*. And the main reason is interest rates. Let me show you a few charts so you'll see what I mean.

This first chart is the price of a new home in America adjusted for inflation, which you've probably never seen before. As you can see, even though the stock market went to the moon in the last dozen year, the housing market really didn't participate. Amazingly, the price of a new home is



still below its 1989 peak. For the last ten years, people have been investing in stocks and ignoring real estate.

The second chart is even more unique. But let me set it up first with a question…What's the first thing people consider before they go shopping for a house? It's *how much house they can afford*, right?

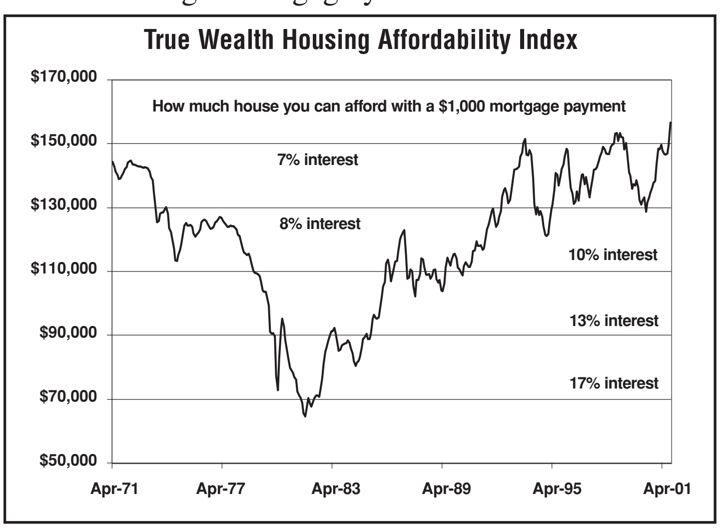
But how do people decide how much house they can afford? If you say they decide by *the price of the house*, I'd be willing to bet against you. Instead of shopping by price of house, I'd bet that people shop by *mortgage payment*.

People first decide how much they can afford per month to spend on a house payment. Then they find out just how much house they can buy.

Now I realize this is probably not new news to you. But this should be…

Right now, **people can afford more house than they could at any time in history**.

That's what I just discovered. You see, I wanted to see how big a mortgage you could afford with a



$1,000 mortgage payment. Right now, a $1,000 mortgage payment (just mortgage alone, not taxes, PMI, insurance, etc.) will get you a $156,000 house.

Compare that to 20 years ago, where a $1,000 mortgage payment would only get you a $65,000 house. You can afford over twice as much house today with the same amount of money!

The way I came up with this chart was simple. The only input is mortgage rates and $1,000 monthly payment. In fact if you charted mortgage rates over the last 30 years, the line would be the exact inverse of this chart.

What I'm saying is, when mortgage rates are high, people can only afford a low-priced home. But when mortgage rates are low, people can buy much more home for the same mortgage payment. That's what this chart illustrates. And right now, more people can buy a higher-priced home than ever!

The point is, your money goes a lot farther today than it ever has in real estate.

Getting back to our rental house, let's say that you could net 8.3% a year in income, after expenses. (I'm using 8.3% because that's what real estate stocks are paying in income right now.) Even if the house fell by 8% in value in one year, your income would offset that one bad year in the real estate market. And in a good year, let's say that the house appreciates by 5%, and you get your 8% income. That's a total return of 13% in a year. Of course, when you buy a house, you've got all kinds of "friction" costs which can eat into your returns. And it takes time and effort to get into and out of.

Well, with real estate stocks, you have all the benefits, and none of the pain. Real estate stocks currently yield 8.3%, and that yield comes from rent. That means that, after expenses, they're able to pay out a nice dividend. *You're getting paid*. And if you want to get out, you can sell your stock. You're out today — no finding a buyer for the house, no closing costs, etc.

Remember, these real estate stocks own commercial properties. When you start talking about office buildings, you've got to remember that many tenants have signed long-term leases. So that rental income is generally safe for at least another year, if not much longer in many cases.

Now eight percent may have not sounded that exciting a few months ago, but right now, with the dramatic fall in interest rates, *you can't get close to a guaranteed eight percent anywhere.*

Real estate stocks, or more specifically, real estate investment trusts (REITs) as they're called, are the way to go right now to get paid. It's a great way to own a group of professionally managed properties that pay you 8%. And you don't have to lift a finger.

When you stack up all of the investment alternatives out there right now, nothing compares. Consider these facts:

- Over the last 10 years, the total return on REITs has been 12.4% a year, with only one down period (1998-1999)
- While the returns have been comparable to the long-run return of stocks, over the last 10 years, the volatility of REITs has been half that of the NASDAQ.
- Over the last five years, REITs have shown no correlation to the stock market. Literally, REITs were falling during the stock market bubble, and they've been rising over the last two years, as the stock market bubble has burst.
- REITs have been generally out of favor for years. Stock investors think they're "boring" real estate, and real estate investors think they're "risky" stock plays. How funny. Nobody cared about value or stability in investing until the bubble burst.
- REITs offer stable dividend income, predictable cash flows, and low valuations (as I'll show in a minute)

I could go on. But what's important is that my 1-2-3 Model for REITs is in YELLOW LIGHT MODE. That makes REITs a better investment than stocks right now.

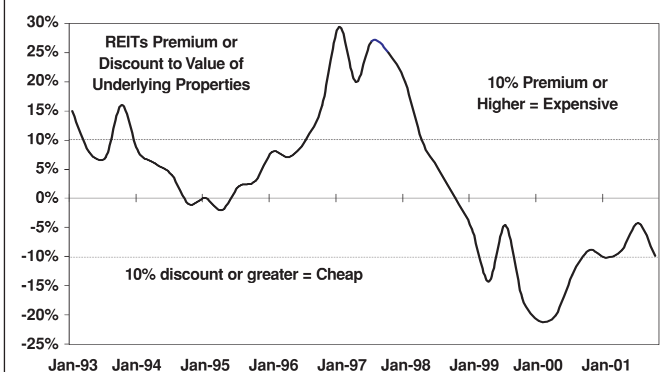
While this is not Strong Buy mode, it is Buy and Hold mode, and with nearly every investment class in free fall, that's about as good as we can get today.

Let me share my 1-2-3 REIT Model with you. It's based on the same three questions as the 1-2-3 Stock Market Model, so it should make sense. Remember, for it to be GREEN LIGHT mode, the answer to all three questions must be no. Here are the questions…

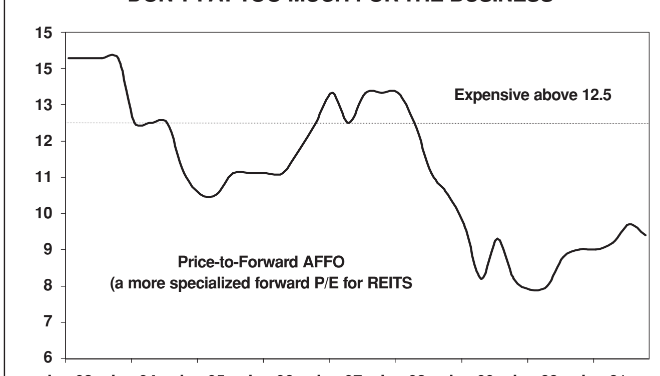
First, is the market expensive?

NO. I break this question down into two rules for REIT investing: 1) don't pay too much for the earth, and 2) don't pay too much for the business. At a 12% discount to net asset value, you're not paying too much for the earth. I prefer to buy at any discount to net asset value, and a double-digit discount, like we have right now, is really nice. And we're not paying too much for the business either. While price-to-earnings ratios on stocks are outrageous, the similar measure for REITs, price-to-AFFO (adjusted funds from operations — basically adding depreciation back to earnings), REITs are trading at a forward price-to-AFFO of 9, a huge bargain by real estate standards, as anything over 12.5 would be considered expensive.

DON'T PAY TOO MUCH FOR THE EARTH



DON'T PAY TOO MUCH FOR THE BUSINESS

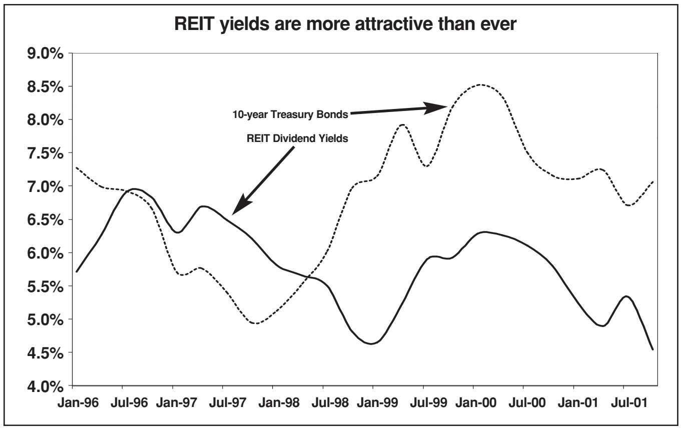


IN THE KNOW — REIT LINGO

Net Asset Value (NAV) - The liquidation value of a REIT's portfolio. When people evaluate stocks, they often look at the price-to-book value to gauge this. But book value is based on HISTORIC costs of assets, while Net Asset Value in real estate is the cumulative "best guess" of the CURRENT market value of the real estate portfolio.

Funds from Operations (FFO) - The most accurate number for a real estate company's earnings. It's basically net income with real estate depreciation added back in, to better represent the true earnings picture.

Second, are the Feds in the way?

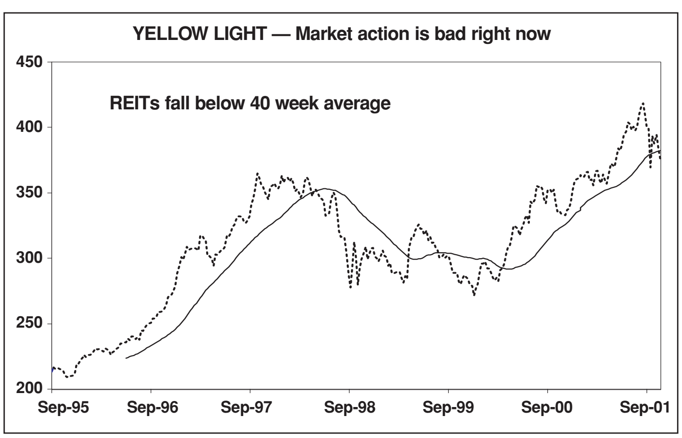


NO. The interest rate environment couldn't be more favorable for making money in real estate. And since interest rates are low, but real estate yields are high, we should see even more money flow into real estate stocks.

Third, is the market acting badly?

YES. There's no denying that September 11 has affected the market for commercial real estate. Share prices have fallen. And yes, they've dipped below the 40-week average. This, of course, is a dangerous sign. Market action is incredibly important to me, as the market is a leading indicator of the economy. And this is the reason we are in YELLOW LIGHT mode.

Since the answer to one of the three questions above was "yes" we are in YELLOW LIGHT mode — buy and hold. However, with the dirt-cheap prices and the positive interest rate environment, if the market action improves, we'll be thrust into GREEN LIGHT mode, which is Strong Buy mode. Now is the time to start building your positions.



The four real estate stocks on our list are incredibly attractive right now. With long-term tenants in place in many cases, and due to significantly lower interest rates, it's really a statement of fact that they will make money next year, in fact earnings at all companies will actually increase. ***How many NASDAQ companies can you guarantee will both make money and grow their earnings next year?*** Looking at them one by one:

Equity Residential (EQR) specializes in middle-market apartments. Business prospects are quite fine, at EQR actually. The dividend yield is 6.2%, and conservatively, earnings should grow by 5% or more, which conservatively gives us the potential for a total return of 11%+ over the next 12 months. While I'm not promising 100%+ returns, 11%+ returns are about what the stock market has done over the long run, and yet you're not taking stock market risk. You're just a well-financed landlord. And of course, landlords don't go broke.

Boston Properties (BXP) is a real bargain right now. Conservatively, earnings should grow in excess of 10%, and BXP is paying a 6.2% dividend yield. That brings our guesstimated total return over the next 12 months to 16%+ — and remember that's a conservative guess. The stock has struggled this year, and September 11th didn't help, as BXP owns many "trophy" properties, including San Francisco's Embarcadero Center, Boston's Pru Center, and New York's Citicorp. But now the stock is trading over a 15% discount to its net asset value. This is important because REITs have historically trended toward their net asset values over the long run. So we can buy in here extremely cheap. And how often can you buy professionally managed commercial properties at a double-digit discount? You haven't been able to do that any time in the last ten years.

Simon Property Group (SPG) is also cheap — it's the "value play" in the bunch. Specializing in regional malls, the stock has obviously weakened over the last month. But this puts it at a 15%

REITS Aren't Limited Partnerships!

"I got burned in real estate limited partnerships 20 years ago, and I'm not about to go through that again."

I hear that all the time, but you've got to understand, these are entirely different animals. Limited partnerships were <u>allowed to pass their losses</u> on to investors. So investors benefited economically from uneconomic real estate investment decisions by the partnership. Ultimately, those partnerships just threw money at anything.

REITs are <u>prohibited from passing losses</u> through to their shareholders. So their investment decisions have to make economic sense. A big difference.

discount to net asset value like BXP. Additionally, the fall in price means that the dividend yield is now 8.0% — extremely attractive. And the stock is only priced at a Price-to-AFFO ratio of about 8 — that's supercheap! Being conservative, Simon should still be able to post positive earnings growth in 2002, meaning that, with the dividend yield and the earnings growth, we should earn double-digit returns here over the next 12 months.

Lastly, **Equity Office Properties (EOP)** should be in your portfolio. As I predicted in my special report on real estate, last month EOP just became the first REIT to be listed in the S&P 500. It's about time, as it's one of America's largest companies. Like the rest in our recommended list, with a 6.5% dividend and earnings growth conservatively expected in the 5% range, we're looking at double-digit returns over the next 12 months.

Earnings just came out for the third quarter, and they exceeded expectations and grew at greater than 5%. This is a quality company, a real core holding. Buy it!

Times sure are different now. But different times call for a different approach to building wealth. Companies like Equity Office are proving that "landlords don't go broke."

Now is a time to make sure we get paid in our investments.

And the best place we can get paid handsomely and still have some potential for an increase in value is in real estate investment trusts.

Buy each of these four recommended real estate investment trusts today, with up to four percent of your portfolio in each position.

A DANGEROUS MISTAKE ON YOUR PART —
DON'T MAKE IT!

How much you invest is the most important decision you make

In last month's *True Wealth*, I wrote about my recommended asset allocation. Judging by some responses from readers, I must not have been very clear. So grab a pen, and please follow these instructions closely… and I'll try to be very clear.

1. write the number "100" somewhere on this page
2. now write your age ("55" for example) just below it
3. now subtract your age from 100 (so in this example, 100 minus 55)

Presto! That's how much you should ***normally*** have in stocks. (So if you're 55 years old, you'd have 45% of your portfolio in stocks.) If all else fails as you read along, refer back to those three steps.

Now *here's the wrinkle.* Now is not a *"normal"* time. A "normal" time for the stock market is when the market is in YELLOW LIGHT mode under the 1-2-3 Stock Market Model. During YELLOW LIGHT conditions, which we've been under about 50% of the time since 1927, stocks have returned about 12% a year, a pretty healthy return.

However, right now, we're still firmly under RED LIGHT conditions with the 1-2-3 Stock Market Model. That means conditions are bad. Under RED LIGHT conditions, which we've historically been under about a quarter of the time, stocks lose money. And sure enough, we've been under RED LIGHT conditions since late 1999. And the stock market has fallen 19.2% in that time.

Under RED LIGHT conditions, we've got to play it conservatively. In fact, under RED LIGHT conditions, I recommend that you reduce the amount of money that you have invested in stocks by half. So, going back to our earlier example, if you're 55, you'd normally have 45% invested in stocks. But in RED LIGHT conditions, you'll only have 22.5% (half of 45%) in stocks. And that's where you should be now.

Remember, the 1-2-3 Stock Market Model is made up of three questions **— Is the market expensive? Is the Fed in the way? And is the market acting badly?** If the answers to all three questions are "no", then you buy with near reckless abandon. If the answer to one question is "yes", then we're under YELLOW LIGHT conditions, and you buy and hold. And if the answers to two or more questions are "yes", then we're in RED LIGHT mode.

Right now, the stock market is very expensive, and the market is acting very badly, as the charts show. The only saving grace is the Fed is not in our way — Greenspan has been cutting rates like a wildman, and the effects should show soon — as soon as one of the other questions in the 1-2-3 Model cooperates.

Incidentally, paid up subscriber Dan Lamb asked what market index I used for the 40-week moving average and where he can follow it. I use the S&P 500 for the 1-2-3 Model, and the easiest place to follow the 40-week moving average will be right here every month, as I've decided to print the 1-2-3 charts every month.

But if you'd like to follow it more frequently than once a month, you can use Yahoo. Go to www.yahoo.com and click on "Finance". Then click on "S&P 500" on the right. Once that comes up, click anywhere on the chart to bring up a big chart of it. Above that, it will say "Moving Average"; click there. It will automatically bring up a 40 week moving average. (Actually, it will bring up a 200-day moving average — but since there are 5 trading days in a month, it's about the same).

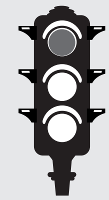
Paid up subscriber Alan Jones recently asked me questions about position sizing recently. Let me reiterate position-sizing rule number 1: **Do not have more than 4% of your portfolio in any one stock**.

And paid-up subscriber Shane Hess asked me what to do with cash. With interest rates dipping down to just above 2%, isn't that the $64,000 question? It's seems that just keeping up with inflation is hard to do with cash these days.

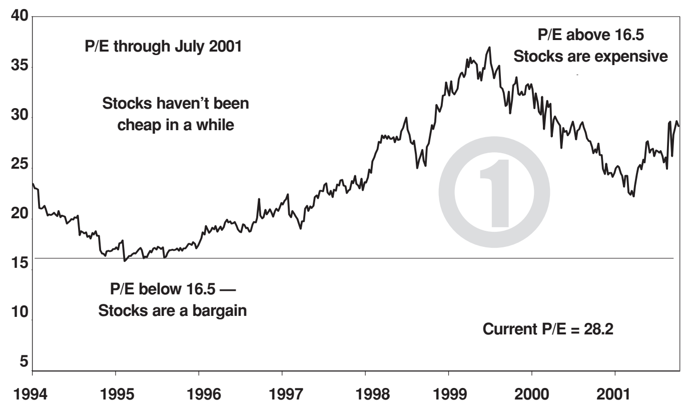
My recommendations are, of course, VIPSX, the Vanguard Inflation-Protected Securities Fund (www.vanguard.com) which has actually rewarded investors with double-digit returns over the last 12 months in boring government Treasury bonds. But it is not "SuperSafe" it can fluctuate.

I also received a question about MITTS, my favorite "limited-downside, unlimited-upside" investments. In last month's issue, I'd said "the Russell 2000 and the Japan Nikkei Index MITTS are nice, but right now they're trading at premiums to their underlying value, so I would be stingy buying these." Some subscribers said to me "Steve, these are

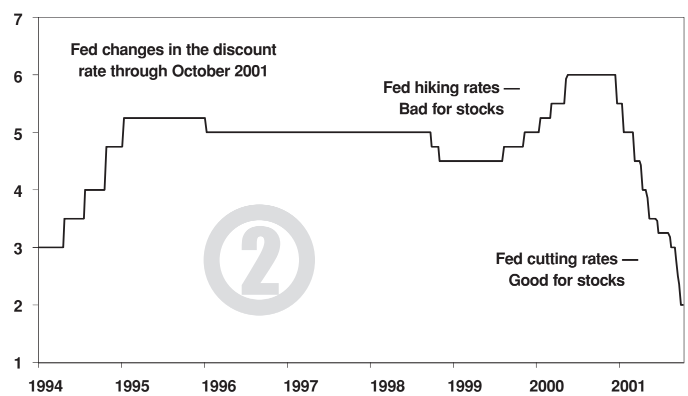
The 1-2-3 Stock Market Model
Current U.S. Stock Market Conditions:
RED LIGHT — STAY ON THE SIDELINES
Last change: YELLOW TO RED, 8/99
Market return since last signal: -16.9%



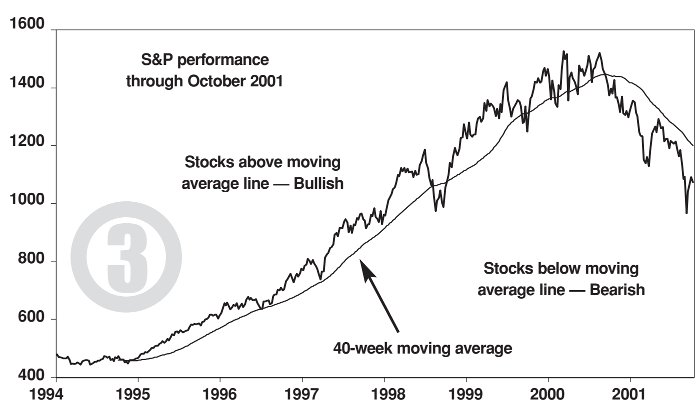
ARE STOCKS EXPENSIVE?



ARE THE FEDS IN THE WAY?



IS THE MARKET ACTING BADLY?



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under $10 — how can they be at a premium?”

Well, let’s take the Russell 2000 MITTS for example, which are selling for around ten bucks today. Here’s the deal: You’re guaranteed all the upside above 490 on the index. But the index is around 430 today.

That’s 12% below your guarantee. I don’t want to pay ten bucks today, when it has to climb so much before I start making a profit. I’d be comfortable paying nine bucks, or maybe even $9.50. But ten bucks seems a little rich, especially when you can buy the other MITTS closer to their underlying value.

I probably just confused things rather than made them easier. If I did, or if you have other questions about these great investments, please send me an email at steve@pirateinvestor.com and I’ll address it next month, I promise.

Good investing,

Steve Sjuggerud

*Investment Result: *True Wealth* nailed it back in 2001. Real estate entered one of the greatest booms in history, and folks who loaded up on REIT stocks made a fortune. Simon Property Group rose over 100% for *True Wealth* readers, and Boston Property climbed 45% before being sold.