Zeppelin's

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A Newsletter by Zeppelin Real Estate Analysis Limited of the Zeppelin Group
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Hong Kong real estate prices continue to go up: the Centaline's real estate index, which is a barometer for measuring residential real estate prices, continues to show improvements and now hovers around 45%, i.e. prices now are around 45% of what they had been during the last peak period in 1997. While this sounds scary still, prices were around 33% the same time last year, i.e. prices have increased by around 36% ((45-33) / 33) in less than a year, in some cases such as luxury residences even more. Improvements have also been observed in the office and retail sectors. Nonetheless, recent measures intended to cool the pace of economic growth and over-investment in Mainland China caused some concern, in addition to the prospect of interest rate rises in the USA in the perhaps not too distant future.

In this Issue:

We are very honored again to have Mr. Gary Carmell, CFA, President, CWS Partners LLC, to share with us his latest insight on the global economy, interest rate trends, China, and USA real estate investments. We would also like to hear from prospective readers / writers who wish to share their real estate knowledge and experience with us.

This quarterly (January, April, July and October) newsletter is circulated freely via email to over thousands of readers including real estate developers, investors, owners, users, financiers, top executives, senior managers, prominent academics and related professionals from Hong Kong and abroad. Our content is / has also been published in newspapers and web portals such as **China Daily**, **Hong Kong Economic Journal** (a Chinese daily), **21st Century Business Herald** (China), **MITCRE Alumni Newsletter**, the **Surveying Newsletter** of the Hong Kong Institute of Surveyors, **Centanet.com, Netvigator.com, Hongkong.com, E-finet.com, Red-dots.com, Realtradex.com, FrogPondGroup.com, Icfox.com**, **PacificProperties.net**, **Soufun.com** and **House18.com**. We had also been quoted in the **Asian Wall Street Journal** and interviewed by **Radio Hong Kong**. We also publish monthly articles and analyses in the months between. This newsletter is now into its **8th year** and **30th** issue.

We also operate a website **www.real-estate-tech.com** through which we intend to share some of our real estate knowledge and ideas with interested parties. We also make available charts, tables, spreadsheets, reports, and the like for reference, the majority of it being free with some requiring a token fee.

Zeppelin Real Estate Analysis Limited is involved in real estate development, investment, and asset management with a focus on **independent analysis**, investment strategy, and portfolio management. It can also assist in setting up real estate analytical computer systems, software applications and content development. It is part of the Zeppelin Group of Companies which collectively also offers project management, facility management, marketing management, architecture, and capital management services.

A Letter from the President

By Gary Carmell

Editor's Note = the following is an article that our invited guest writer wrote to his shareholders and investors after having made an earlier trip to Asia including China in late 2003. We thank Gary for permitting us to publish the article in our newsletter.

Let's Get Personal

Lost in Translation had a profound impact on me. It was a movie not only about alienation, but losing site of what's important because you have severed a connection with your core being. In a number of ways, the last three years has been a lot like *Lost in Translation* for me at CWS. We made a big bet on an industry that was decimated by policy measures taken by the Federal Reserve and the Bush administration. These measures were designed to keep the economy afloat by stimulating massive appreciation in housing values through a dramatic reduction in the cost and accessibility of mortgage capital. Our customers, high income, white-collar knowledge workers, were either laid off at a historically unprecedented rate or bought homes and our markets continued to experience new supply of apartments in the face of dwindling demand. Further, for a few of our properties we locked in long-term, fixed-rate debt at high interest rates with the result being that they could not be economically pre-paid as interest rates fell precipitously. These decisions have cost not only our investors and CWS dearly, but it has rocked me to my core and made me carry out a degree of soul-searching that I have never gone through in my life regarding what it takes to be successful in business. Although I profoundly believe in the immortal words of the Beatles, "I have to admit it's getting better," it doesn't lessen the pain of producing deeply disappointing results for those properties purchased prior to 2002.

"…CWS is an organization of extraordinary integrity, humanity, openness, skill, and a hunger to not only survive but also prosper over the long-term. We will not hide bad news from you and will make every effort to keep you fully informed as soon as possible. We are partners and honor this relationship…"

The one thing that motivates me more than anything in my job is to make a difference in the lives of our investors, employees, and residents. Few things are as fulfilling to me as hearing about how our investors could retire early, send their kids to a private college, purchase their dream home, take a never previously contemplated vacation, or fund a favorite charity, partially or entirely because of the success of their CWS investments. When I hear stories about this I say to myself all of the travel, family separation, hard work, and challenges are worth it. This is why I come to work every day.

Given this personal insight, one can then see that producing poor results is something I take very personally no matter how powerful some of the environmental forces were that we faced. This experience has reinforced in me George Soros' belief that no one has a monopoly on the truth and that human beings are fallible and should always be questioning their actions, motivations, and decision-making processes. After all, we can never divorce the observer from the observed because the mere act of observing something can change what is being observed.

I am humble, flawed, and constantly at risk of making serious errors influenced by optimism, pessimism, or whatever else is impacting how I/we see the world. You must know that anyone to whom you entrust your money is subjected to the same human shortcomings. But what I can say to you is that CWS is an organization of extraordinary integrity, humanity, openness, skill, and a hunger to not only survive but also prosper over the long-term. We will not hide bad news from you and will make every effort to keep you fully informed as soon as possible. We are partners and honor this relationship and would expect nothing less in return. For those of you disappointed, I am sorry. The world changed in ways we never anticipated, but maybe should have. Please know that with apartment values holding strong, interest rates remaining low, and over $150 million of high cost debt maturing in the next year, we are on the cusp of making a dramatic change in the economics of a number of our investments. Tomorrow really does look better than today. In addition, because we have such a good reputation in the apartment industry and a large portfolio, we have access to some of the lowest cost debt capital in the market.

For the increasing number of you who are enjoying a very positive experience (our post-2001 investments and refinances), we are proud to help make a difference in your lives but in no way will we rest on our laurels. We are extremely proud of the properties we purchased and believe they were bought at attractive prices and are in outstanding locations.

One of the key lessons I have learned over the last three years is that we are in the business of predicting interest rates and key economic trends. When we borrow 75%-80% of the value of a property with the potential to lock in loans that cannot be economically pre-paid if interest rates drop, then we are in the interest rate forecasting business whether we like or not. For this reason, I now spend an extraordinary amount of time contemplating the major economic forces that can influence interest rates and job growth so we can make better capital allocation decisions.

Enough Gestalt Therapy

Let's transition to something much more interesting than the demons I am trying to exorcise and move on to the apartment industry (another demonized entity). The year 2003 was schizophrenic for apartment owners. Virtually every publicly traded apartment real estate investment trust (REIT) had financial results that produced lower operating cash flow than in the previous year. An extreme example of this is Post Properties. Green Street Advisors, a highly regarded REIT research firm, estimates that Post will produce $2.09/share of funds from operations (FFO) in 2006 (this is the REIT-equivalent of earnings), just slightly ahead of the $2.03/share Post produced in 1993! Yet despite such poor results, values have increased significantly. Green Street estimates that the average value of apartment company net assets increased by 0.1% per year for the last three years, while share prices have increased 10.3% per year with one-year returns averaging 30.9%! This phenomenon has been wide spread throughout the apartment industry over the last couple of years and is entirely attributable to a dramatic reduction in interest rates and the wide availability of capital for private apartment investors.

The extraordinary presence of Fannie Mae and Freddie Mac (our largest lender) within the apartment industry has provided private apartment investors with incredible access to inexpensive capital with which to buy and refinance properties. As interest rates have dropped significantly and fierce competition has arisen among apartment lenders for market share, the cost of capital has never been lower for apartment owners. As such, prospective apartment owners evaluating new acquisitions now have the capability of paying higher prices relative to a dollar of earnings than in past years because the cost of money has dropped so significantly. This has pushed yield requirements down for apartment investors and lenders and has more than offset the drop in Net Operating Income most apartment owners have experienced in the last three years, with the end result being apartment values have not only been sustained but have probably gone up despite lower operating income.

"The year 2003 was schizophrenic for apartment owners. Virtually every publicly traded apartment real estate investment trust (REIT) had financial results that produced lower operating cash flow than in the previous year."

The key factor in this whole equation is the ability of an apartment owner to deliver to the market properties unencumbered by higher cost, fixed-rate debt that cannot be economically prepaid. This allows the new buyer to take advantage of current low interest rates and enables him to pay a higher price than if he were forced to take over the more costly debt that cannot be pre-paid.

As most readers of my articles know, I've written at length about the power of low cost, variable interest rate loans. Financing properties with this debt instrument has the ability to change the economics of an investment overnight. As mentioned previously, a number of our properties will have loans maturing in the next 12 to 36 months so that we should be able to take advantage of either lower interest rates to refinance or prevailing low capitalization rates with which to sell our properties into a very frothy marketplace. Loans maturing in 2004 and 2005 are The Marquis on McKinney, Montclair Parc, North Creek, Shoal Creek, Talavera, The Brooks on Preston, and The Marquis at Walker's Bluff. Properties already benefiting from variable rate financing are The Marquis at Deerfield, The Marquis at Ladera Vista, The Marquis at Stonegate, The Marquis at Willow Lake, The Marquis at Quarry, Huntington Cove, and The Marquis at Turtle Creek. The Marquis at Bellaire Ranch was purchased with a relatively high cost loan that had to be assumed, but the purchase price, in our opinion, more than compensated us for taking on this high cost debt.

Unfortunately, however, because of some past financing decisions, there are other properties encumbered by debt with interest rates significantly above market that don't mature for another 6 to 8 years. These cases are much more problematic as operating incomes have dropped significantly with the economic downturn without a commensurate reduction in debt service. Given the increasingly competitive environment, we made a concerted effort in 2003 to implement some very rigorous financial management and operating systems to benchmark all of our properties. We did this to maximize operational efficiency and to spot problems or opportunities as early as possible so that we can take the appropriate action in the event market conditions begin to turn more quickly than anticipated.

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Despite the implementation of these new systems, which have already borne fruit, the bottom line, however, is we need more revenue per occupied unit. There is only a certain amount of cost that one can cut out of the system, particularly in tough times when properties have to be aggressively marketed, kept in excellent condition, and customer service has to be even stronger because of fierce competition to attract and retain residents. It's absolutely critical that we begin to see rent improvement in the marketplace to give us more pricing power. And as many of our investors and readers know, this is inextricably linked to job growth and the economic performance of our local markets specifically and the United States economy more generally.

Key Trends

Because real estate is a derivative industry and should not be the primary driving force of an economy, it is important to have an understanding of global and national economic trends and conditions because we are so heavily impacted by job growth and the cost of money.

Let me focus on jobs first. I think the stage has been set to see an improvement in job growth throughout the country. Corporations have lowered their break even points, meaning it takes a far lower dollar value of sales from which to generate profitability than it did just a couple of years ago. Or said differently, the next dollar of sales can flow more quickly to the bottom line. With corporate profits at record levels, this should give companies the financial strength with which to increase their expenditures on capital equipment and software as well as hire new people. Will it be robust growth? No. In fact at this point, Steven Roach of Morgan Stanley believes that if this cycle followed the trajectory of the average of all the post-World War II recoveries, we would have 8.2 million more jobs today than we do right now. So something clearly different is happening and I've written about this in an article titled "What's Going On?" which appeared in the July 25, 2003 CWS Quarterly Update.

"Because real estate is a derivative industry and should not be the primary driving force of an economy, it is important to have an understanding of global and national economic trends"

There are some very deep and powerful forces at work that are constraining domestic job growth and this is a very complex analysis that requires a way of thinking to connect dots that seemingly appear to have no connection whatsoever. To properly analyze this situation, it's important that we look not only domestically but also internationally for the reasons. We have to go back to two catalytic events that rocked the global financial markets to help us assess where we are today and where we may be headed in the future.

Blowing Bubbles

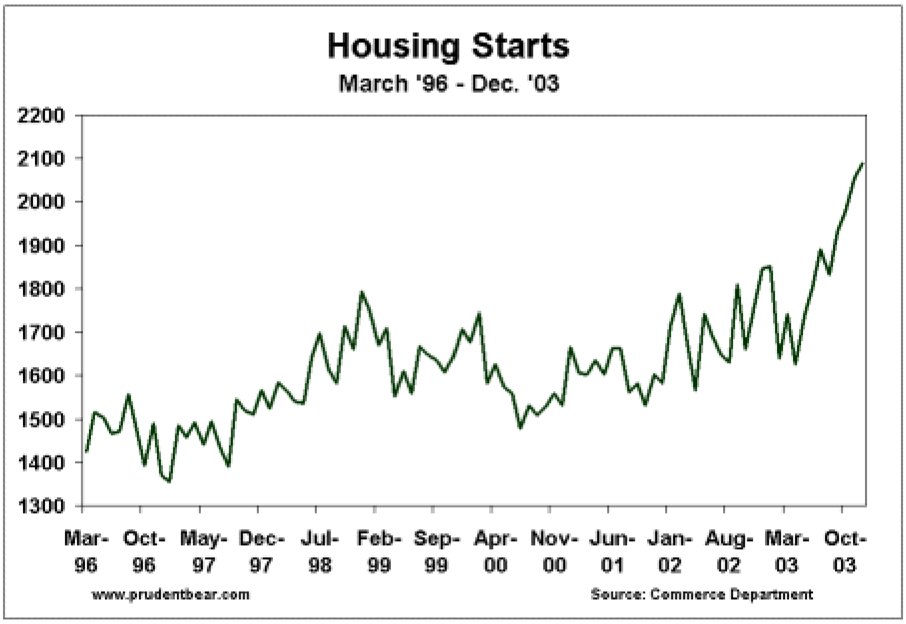
The first critical event was the 1997-98 Asian currency crisis. The second and equally important one was the bursting of the stock market bubble in 2000-2002. With the possible exception of 1990-1, this was the first post-war recession in which the policy response was far different than virtually all previous recessions. In the past, inflation was the biggest concern of the Federal Reserve as the economy grew relatively rapidly. The rapid growth put pressures on resources - labor, capital, and capacity utilization. This strain tended to result in an increase in inflation. In order to slow down inflationary pressures the Federal Reserve would tighten credit and increase interest rates with the result being a slow down in economic activity, particularly in interest rate sensitive industries like housing and automobiles. The country would go into recession, jobs would be lost, and then the Federal Reserve would begin loosening credit and the cycle would go in reverse.

"So what did Alan Greenspan and the Federal Reserve do?"

With the bursting of the stock market bubble, however, we had a very different phenomenon. We already had a relatively low inflation rate and with trillions of dollars lost as the NASDAQ melted down from 5,000 to below 1,200 the propensity for investors, corporations and stock market investors to spend was diminished because of the wealth effect working in the opposite direction. As immature businesses could no longer go public, venture capital funding dried up for high tech companies and profitability became the most important goal. This resulted in a tremendous curtailment of capital expenditures and layoffs that rippled through high tech industries and impacted the entire US economy because so much of the output, particularly at the margin, was high tech related. At the same time there was a fear that consumer spending would decrease because so much wealth had been lost in the stock market.

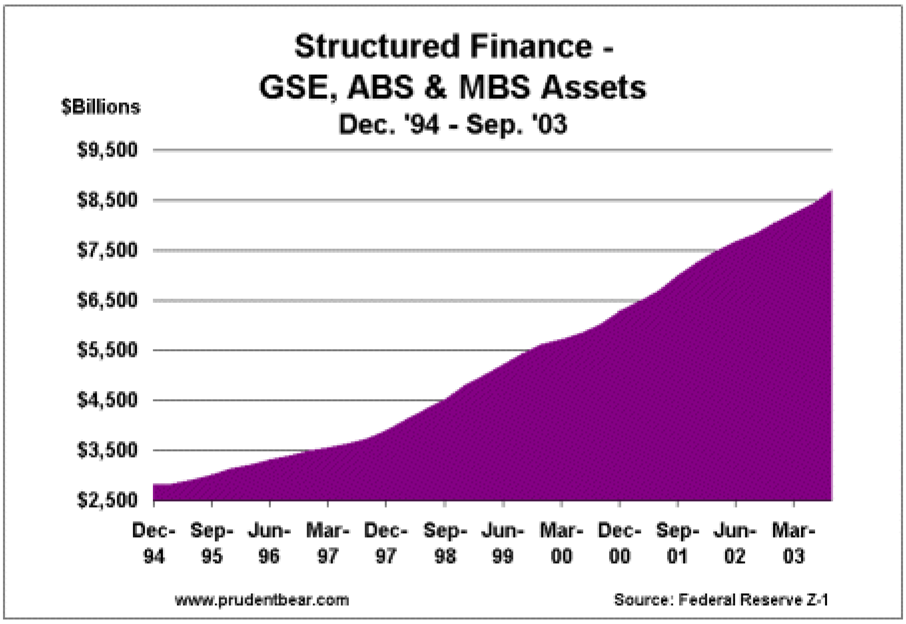
So what did Alan Greenspan and the Federal Reserve do? Critics of Greenspan call him a perpetual bubble blower and that the whole name of the game in 2000, 2001, 2002 was to buy enough time for corporate America to improve its balance sheets and earnings capability so that it could eventually spend money again on capital equipment and software and hire people once it became sufficiently profitable to do so. To do this however, the consumer sector (pretty much you and I and our friends and family), had to be propped up and the best way of doing this was through a dramatic reduction in interest rates. The Federal Reserve lowered its benchmark Federal Funds rate 13 times from 6% in 2000 to 1% currently, the lowest rate since 1958.

The most powerful impact of this policy was on the mortgage market as lower interest rates stimulated an extraordinary amount of housing activity. The graph below shows the trend in housing starts since early 1996 through October 2003.



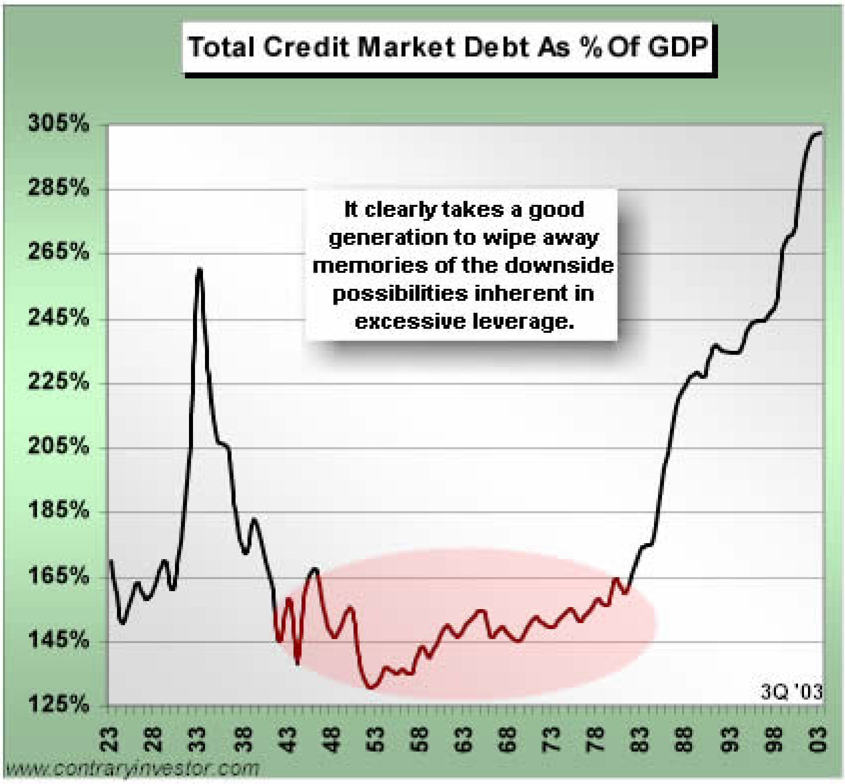
The dramatic reduction in mortgage costs had numerous positive economic effects. The first was to enable people to lower their monthly costs so that they could spend the savings on other areas of the economy while the second provided the opportunity to those so inclined to extract equity from their homes to pay down higher cost debt, improve their homes, save the money, or spend it. Obviously a combination of all of them could happen as well. Most importantly, lower cost, more accessible mortgage capital helped stimulate demand for housing which propelled housing values higher which made lenders even more interested in lending against the asset, stimulating further appreciation.

The key actors in making this virtuous housing circle happen were the Government Sponsored Enterprises (GSE's), specifically Fannie Mae and Freddie Mac. They became the channel through which global capital entered the US mortgage market. The following chart shows how assets of not only the GSEs have grown since 1994, but the Asset-Backed Securities and Mortgage-Backed Securities markets as well. They have grown by over $6 trillion in slightly less than nine years with most of this money entering the mortgage market.



I often ask myself the question, how long can the American homeowner keep the weight of the world's economy upon its shoulders? And so far it's been able to do it remarkably well and for far longer than I would have thought. Ah, but there's no free lunch as the following graph shows.

" …how long can the American homeowner keep the weight of the world's economy upon its shoulders?"



(Editorial) We may have entered into a pact with the devil as we have borrowed massively from future growth into order to get through today by incurring Roaring '20s amounts of debt. There will be a day of reckoning. Unfortunately, many investors have lost a lot of money betting on a trend reversing far earlier than it actually happens. Debt growth will slow down, but you could have said that in 1982 and missed out on one of the greatest investment markets in history. At least learn this lesson, the boom of the '80s and '90s can be summed up as a massive leveraging of American businesses and households. If and when it unwinds, the opposite is virtually certain to take place. Debt reduction is bearish while leveraging up is enormously bullish. Shrewd investors have to have an Armageddon plan to account for a massive contraction in debt in our economy and how that will impact not only households and businesses but, most importantly, lending institutions. *(End of Editorial)*

"Why has job growth been virtually non-existent despite one of the greatest consumer booms in history…?"

Housing growth has been easily the most important catalyst for keeping the economy afloat despite the stock market bubble bursting and the September 11, 2001 terrorist attacks. So the question one must ask now is, why has job growth been virtually non-existent despite one of the greatest consumer booms in history and strong growth momentum in the economy as evidenced by the 8.2% GDP growth in the third quarter?

This is when we need to turn to Asia for some answers. Asia is also inextricably linked to the housing boom that's going on.

Go East Young Man

From 1995 to 2000 the US dollar appreciated dramatically in the global foreign exchange markets. Under the leadership of Treasury Secretaries Robert Rubin and Lawrence Summers, the mantra was, "A strong US dollar is in the best interest of the United States." At the same time, many Asian countries such as Thailand, South Korea, Taiwan, Hong Kong, China, and Malaysia had pegged their currencies to an ultimately overvalued US dollar. Without getting into too many details, these countries attracted a lot of speculative capital flows taking advantage of very good returns inside those economies.

The speculative capital flows led to booms inside these Asian economies as more money was created to accommodate them. Eventually the booms became unsustainable. The capital flowed outward and currency crises ensued as speculators sought to sell these currencies and repatriate their money. The International Monetary Fund was brought in to bail out South Korea and Indonesia. Hong Kong had to intervene dramatically in the stock market to help prevent a meltdown there. Malaysia put forth capital controls. Chaos ensued. Indonesia had an 85% reduction in the value of its currency and experienced civil strife and a de facto revolution. This was very nasty business and was not without harm or ramifications.

The point of that review of history is not to focus on the details but to set forth the fact that these countries were rocked to their core (I'm not alone). These were once in a lifetime experiences that helped shape leaders and generations for decades to come like the Great Depression did here. And so it became absolutely critical for these countries to build up very solid reserves of foreign currencies so they would never again be subjected to such a vicious speculative attack against their domestic currencies.

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So we now have a philosophical requirement among Taiwan, South Korea, Hong Kong, China and Japan, Malaysia and Singapore to build up a very strong reserve of foreign currencies. Now let's add another variable to the equation with the opening up of China as a global economic force, particularly with its admission into the World Trade Organization (WTO). This is a monumental event that will require very significant liberalization of its economy and certain key industries.

China, which I visited in December, is an unbelievably powerful force. There is no disputing this. It is on a growth trajectory for generations to come. That's not to say that it's not going to have financial problems, setbacks and reversals. It surely will, particularly with such a weak banking system and lending practices. But there is really no turning back the clock on this economic monster. At the same time, however, China also has an unbelievable challenge ahead as it goes through a massive restructuring of its state-owned enterprises to the tune of needing to lay off about three million people per year for at least the next three years. Combine this with approximately 750 million people living in the countryside that will ultimately have to migrate into the urban areas because virtually all industrialized societies have no more than 3-10% of their employment in farming, and you have the makings of a potentially explosive social situation if not handled properly and delicately.

When one takes this massive, potential social disruption into consideration and China's paramount need for social stability, we realize that it's going to be a huge actor on the world stage because it requires an incredible amount of private investment just to unemployment from growing. China's economic growth averages approximately 7% to 9% a year. With a labor force only growing about 1% annually, virtually all of that growth is coming from annual productivity gains of 6 to 7%. China is estimated to need 24 million new jobs a year just to keep its unemployment rate stable, a figure that is significantly understated because there are so many migrant workers and underutilized people who truly should be counted as unemployed (I saw many of them with my own eyes).

So here we are with two parts of the world going through incredible transitions. The US is trying to pass the baton from corporate America to the consumer for a long enough period of time to allow corporate America to get healthy again. China is trying to transition hundreds of millions of people into free market businesses while restructuring its state-owned enterprises that represent such a large percentage of its economy but a black hole for bad loans. Add to the mix the philosophical requirement of Asian countries to build a huge war chest of foreign currency reserves with, until recently, the U.S.' strong dollar policy. This has resulted in Asia building up vast foreign currency reserves by running massive trade surpluses with the U.S. because it has been able to export to a very consumption-oriented US economy blessed with a strong currency to buy global goods and services relatively cheaply.

We have the making of a mercantilist situation in Asia in which countries believe they must export their way to prosperity. This has lead to severe global imbalances and distortions as ultimately the currency intervention required by the Asian countries to keep their domestic currencies weaker relative to the US dollar has necessitated a significant amount of resources. This has had a profound impact on our housing and mortgage markets and is where one has to be willing to think creatively to connect the dots.

"Foreign custody holdings of the Federal Reserve, the Treasury and agency securities held on behalf of foreign central banks, have exploded to over $1.1 trillion dollars over the last few years."

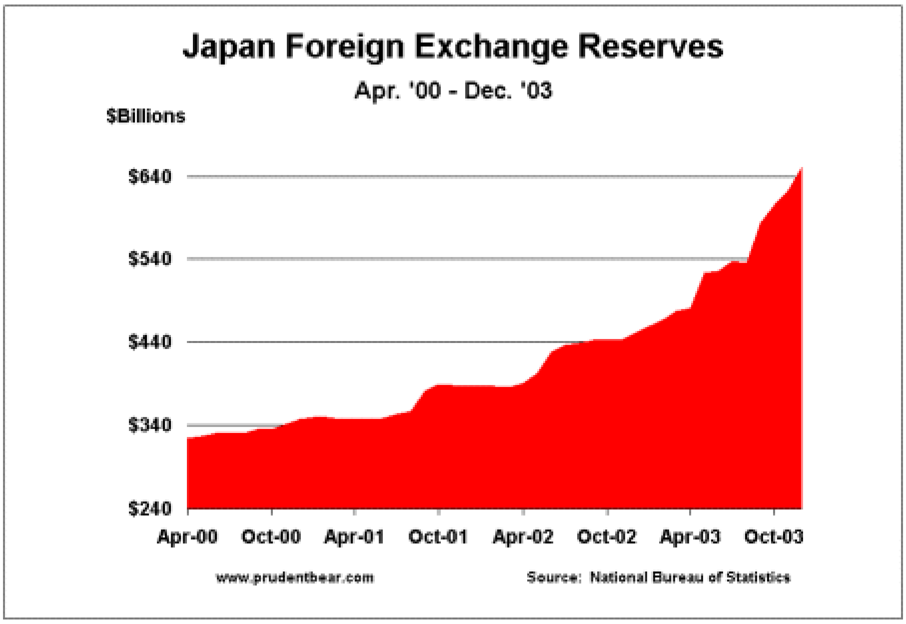
In order to stimulate the US economy, consumption has clearly been emphasized much more than savings. In fact, our savings rate as a country has hit close to a post World-War II low level. The excess consumption over savings results in a very large current account deficit - meaning we're importing more goods and services than we're exporting. Without sufficient savings in our economy, this has put tremendous pressure on the United States to import large amounts of capital from foreign investors.

This may sound alarming on the surface, but in the short run it is what the global economy has needed because if we return back to Asia with its desire to build up foreign currency reserves, this has created the necessity to focus on export-oriented industries at the expense of import, consumption-oriented businesses. This has resulted in Asia being more than willing to encourage, entice and create incentives for the United States to consume more than it saves or produces. And to do this, it has competed on price, quality, and at the same time, has been willing to recycle virtually all of the dollars that it accumulates in the foreign exchange market from its export surplus back into the United States. The Asian countries have taken those dollars and invested them in U.S. Treasuries and Fannie Mae and Freddie Mac securities, providing us with lower interest rates than they otherwise would be.

Foreign custody holdings of the Federal Reserve, the Treasury and agency securities held on behalf of foreign central banks, have exploded to over $1.1 trillion dollars over the last few years. In my opinion, this is the most important economic trend occurring in the world and it has had a profound impact on our US economy in general and our mortgage and housing markets in particular.

These excess dollars on the global stage have created pressure on the value of the US currency. There is more supply of dollars than there is demand. If the free market were left to its own devices and not disrupted by central bank intervention, then the US dollar would have dropped rather precipitously. However, if the dollar were to float completely freely against the Japanese yen and the Chinese remnibi and other Asian currencies, the countervailing force would have been for these currencies to appreciate rapidly. And when a currency appreciates it puts a lot of pressure on export industries because it makes their products more expensive to buy for weak currency countries.

With this mercantilist philosophy so prevalent in Asia and particularly in Japan, there has been tremendous pressure on the financial authorities to reign in the depreciation of the dollar. This intervention in the markets has taken unprecedented forms. Japan in 2003 spent over $200 billion dollars to intervene in the foreign currency markets to buy dollars ($100 billion in January and February 2004 alone) and it recently announced while I was in Asia that it was allocating another $500 billion dollars to support the dollar in the event foreign currency markets become too volatile.



So where does this money go? The Asian central banks typically print more of their domestic currency to purchase these dollars and then recycle them back into US credit markets. This puts downward pressure on US interest rates and strengthens our housing market, which in turn, stimulates more consumption and imports of consumer goods that helps the export industries and job growth of the Asian countries. This continues to put downward pressure on the US dollar and requires further intervention by the Asian authorities to help slow the dollar appreciation by recycling newly purchased dollars back into the US mortgage and Treasury markets. And the cycle goes on and on… meanwhile the imbalances continue to grow.

Our claims to foreign creditors continue to increase at a very rapid rate and we are exporting manufacturing jobs overseas. The logical, absurd extreme of this whole game is as follows. The United States becomes the least wealthy nation with the highest standard of living in which everyone lives in very large homes, has access to tremendous consumer goods and services while Japan becomes the largest global creditor and wealthiest nation in the world and has the lowest standard of living as all of its citizens survive on rice and live in very small houses. Obviously that's absurd but ultimately an extreme example of how this could end.

There has been no effort at rebalancing by either global monetary authorities (with the possible exception of the European Central Bank) or Bush administration. I have a very hard time seeing how we rebalance without a lot of pain because no major country seems to want to have a strong currency and so we run the risk of beggar-thy-neighbor policies developing whereby countries embark upon competitive currency devaluations in order to keep their export markets alive. The goal is the debasement of currencies by central bankers around the world. Anyway you look at it, virtually all major central banks are in a reflation mode.

"So the $64,000 dollar question is why do we keep choosing variable rate loans if most indicators point to higher interest rates in the future?"

The US has unbelievable fiscal and monetary stimulus taking place. The Federal Reserve is keeping short-tem interest rates below the rate of inflation, which is inherently inflationary. The Asian countries that are trying to weaken their currencies find themselves printing more local currency to buy dollars and that local currency goes into those economies and stimulates consumer and business activity. So the $64,000 dollar question is why do we keep choosing variable rate loans if most indicators point to higher interest rates in the future?

I won't go into too much detail here but suffice to say I've written a lot about this. The key factor is that the starting interest rate advantage is so strong as compared to fixed rate financing (approximately 2%) combined with the ability to buy very low, long-term interest rate caps (below 7%) and prepayment flexibility, that I believe fixed rate financing represents too much of an insurance policy. Our financial structure offers a low enough cost of capital such that it represents a very good risk-reward trade off. With that being said I do believe that the financial markets at some point, probably in the next five to seven years, are at risk of a major financial accident for lack of a better term, that could have an impact on interest rates, but that is where our interest rate caps will come into play.

The Year Ahead

So what does this mean for our strategy looking ahead in 2004? Obviously, financing is an important component of our strategy. We're going to continue to look for properties that are well located and have attractive going-in yields that can be financed with variable rate loans with interest rate caps. At the same time, we will continue to consider selling every property that has a loan maturing. We will always ask the question whether this is a good time to sell because, as mentioned previously, delivering an unencumbered property to the marketplace has potentially tremendous value for investors that can access the same low cost capital that we can.

We will always be faced with a sale or refinance decision and it will be one that will be thoughtfully made. We have usually been very good sellers if The Marquis, Edge Creek, Argonne Forest, O'Connor Ridge, and Laguna Terrace are any indication. They have all experienced a meaningful drop in Net Operating Income since we sold them. Even if we decide to refinance this does not mean we have no intention to sell within the next few years, as it may be that prevailing market conditions make it a less than optimal time to sell despite the low cost of money.

It is important that we have investment themes guiding our strategy from a macro-economic perspective. I will review those quickly as they have not changed over the last few years. Defense spending is not only here to stay but should continue to grow so we will focus on locations that have exposure to defense businesses such as Fort Worth, Texas. The weak dollar is part of the economic policy of the Bush administration. This should stimulate older economy, manufacturing export-oriented businesses despite long-term trends going against them. It should also encourage foreign manufacturers to open up facilities in the United States, with the most prominent being Toyota's enormous investment in San Antonio at over $800 million dollars.

"We will always be faced with a sale or refinance decision and it will be one that will be thoughtfully made."

Another key theme is the recovery of capital spending. I talked about this in last year's Annual Report in which I graphically presented that we were approaching a 45-year bottom in the ratio of capital expenditures to depreciation for corporate America. That insight seems to have proven correct. Companies were letting their capital equipment depreciate at a much more rapid rate than it was being replaced. This can only go on for so long until productive capacity is diminished. We should see a growing expenditure by corporate America for technology equipment and software, so that it will no longer be a drag on the economy and should be a source of economic growth. This should help Dallas, Austin, Raleigh, and Denver and assist in positioning our markets for relatively stronger economic growth than other areas of the country. We will selectively look at acquisitions in these markets.

As always, we find ourselves left with more questions than answers. Can corporate America provide enough growth in the event the American consumer has to de-leverage and spending slows accordingly? Can the U.S. avoid a significant economic contraction if and when debt growth slows down or is reduced? Can China, Japan, and the United States all create sustainable economic growth despite the enormous imbalances their policies are creating? Can China maintain social stability by restructuring its state-owned enterprises and continue to attract enough capital to produce large numbers of new jobs? When will Asian central banks begin to realize that currency intervention is ultimately futile? What will this do to the global economy? Will I be able to get over the pain of the last few years? I guess only God, therapists, and brilliant, independent-minded thinkers can see how all of the pieces will fit together. We look forward to 2004 being far more prosperous than 2003. Thank you Alan Greenspan.

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IF People Live To 800 Years Old

Real Estate Tech, April 2004

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From to time there have been news of someone or a scientist having found the secrets to longevity via making new bio-chemo-genetic discoveries, and that people can soon expect to live up to 800 years old. To most if not all this does sound like good news, and your humble author certainly wishes that such new discoveries could be made available to many and not just a wealthy few (that would mean a wealthy bunch who live much longer yet have to make friends over and over again century after century), yet being an analyst as it is, he is trained to be skeptical, not of the discoveries themselves as he harbors no such bio-chemo-genetic know-how, but whether such discoveries are (only) beneficial given certain assumptions.

For starters, there are <u>various combinations of how these 800 years are 'structured'</u>, and the following contains 3 of these:

A) **Assuming the current average years being 80, people will physiologically continue to grow old beyond 80** = i.e. an 800 year old will look / feel / act / be 10 times older than the 80 year old, the only difference now is that the 800 year old does not die but lives on. Imagine a very wrinkled person.

B) **People stay more or less in the same physical shape after 80** = i.e. they look practically the same from 80 to 800. And 80 year olds these days can be quite healthy and active.

C) **The aging or growing process is proportionately lengthened** = i.e. a current 10 year old will be 100 year old, or looking from another angle, the future 100 year old will look exactly like the current 10 year old.

Based on the above, we can do a bit of <u>wild guesses</u>:

1) **More goods and services will be required** = in scenario A and B, perhaps disproportionately more elderly, medical, and social services. Suicide rates may also tend to increase especially in scenario A. For scenario C, the 10-fold increase in demand for goods and services are more evenly distributed. Population explosion?! There is no need to even mention it.

2) **People may tend to be more careful in things they do / eat / live in etc** = as now the loss is several hundred years of life rather than just decades. The upside is that people may now lead healthier lifestyles, yet the downside is that people tend to be more 'chicken'.

3) **People may tend to try out different professions, lifestyles, locations, and the like at different stages of their lifetime** = with 80 years one can only focus on doing 1 or no more than 2 things in life (and doing it well). With 800 years, that is a different story, and a person can become a doctor for 50 years, an architect for another 50 years, a real estate analyst for another 50 years (are you sure?), a fireman in another 50 years, an entrepreneur in another 50 etc. The same applies to lifestyles and places of residence.

4) **Marital life and marriages will be affected** = depending on scenarios, people may tend to marry late, or not at all, and while some couples may stay together for hundreds of years, others may not out of boredom etc. This may have some implications for real estate as marriages decrease the number of residential units needed, while divorces (or remaining single) increase the number of residences required.

By no means are the above complete, it does serve to stimulate deeper thinking on the issue. Perhaps simply having much longer longevity without complimentary improvements in the many other aspects, economic, social, technical, scientific, political, or what else, may bring both pros and cons. Many challenges lie ahead.

Hong Kong Real Estate Market: No Bubble Yet

Real Estate Tech, April 2004

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Recently there had been some debates among industry players on whether there is a real estate bubble or not in the Hong Kong market. Those who say there is one are usually analysts or banking researchers, while those who opt for none would include generally real estate agents and developers. Your humble author thinks there is none yet and the reasons are as follows:

A) **From a GDP / Capita viewpoint** = we have written an article titled "GDP Per Capita 500 Real Estate Prices 300" a while ago (the article can be viewed at http://www.real-estate-tech.com/articles/SRS110302.htm) and interested readers can refer to it for details. Roughly speaking, say if we treat the GDP / Capita index being at 500, the home price index for the most part now (March 2004) as this article is written stands at around 360-390 having risen from 300 (20 to 30% increases) some 9 months ago. Not a bad rate of increase and technically there is still some room to grow, though whether this implies investment opportunity or certainty of growth is another matter. In any event, no bubble viewing from this aspect.

B) **No frantic buying from the user pool yet** = according to reported news and information, there have been some speculation activities and indeed many end-users who had been sitting on the sideline before have entered the market, especially with savings interest rates being so puny. Nonetheless, transaction levels have yet to match the peak in 1996-1997. No bubble yet from this angle.

C) **Support for bubble and no-bubble rather balanced** = generally this does not indicate the need to activate the bubble flashing light yet. Only when bubble commentators start to change or doubt their own views, or are simply "silenced", do people need to worry about a bubble. No bubble yet from this angle.

D) **Affordability ratio still reasonable** = based on reported figures, this stood at some 80% in the 1997 peak period yet hovers around 25% now. Naturally this has something to do with the (artificially) low mortgage rate environment and the market may lapse into coma should rates rise again. Nonetheless, no bubble viewing from this aspect.

E) **Bubble may exist in the other asset classes** = including certain stocks and equities, in particular those that have seen hefty gains with unexplainably high P/E ratios.

All considered, while there is no immediate bubble yet in the real estate market, this alone does not imply a "must invest" attitude. Furthermore, investors should pay some attention to risks, especially in a market that is 'easily persuaded' as such a market tends to be 'forgetful'.