UNIVERSITY OF COLORADO AT BOULDER LEEDS SCHOOL OF BUSINESS

COLORADO BUSINESS REVIEW

A publication of the Business Research Division
Volume 71, Number 5, 2005

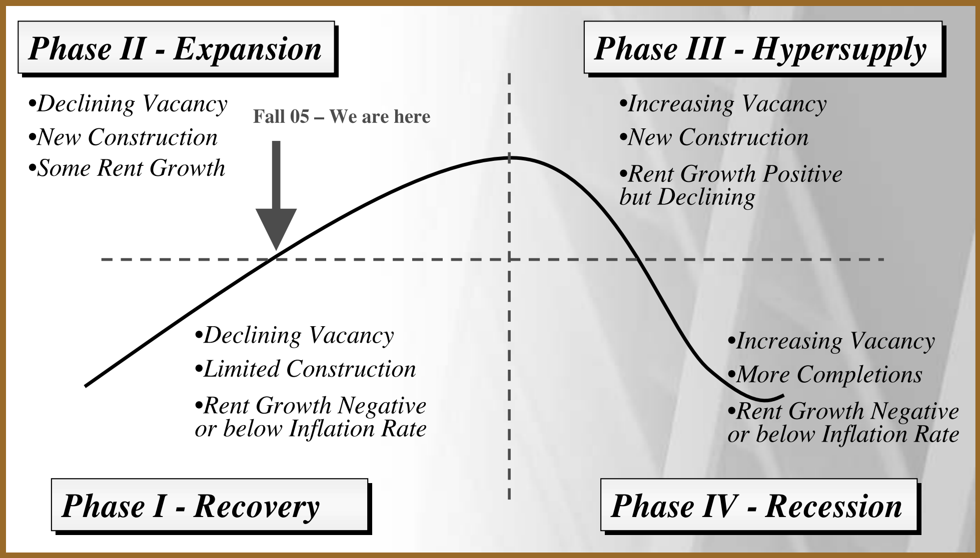
Inside: **Denver Office Market Update** begins on this page. **Financial Activities** overview on page 2. Page 3, **Mutual Fund Performance Ratings**.

Midyear 2005 Review

Metro Denver Office Market Coming Alive in '05!

Richard Damm and Mark A. Larocque

THE OFFICE REAL ESTATE MARKET CYCLE



After some starts and stops, metro Denver's office market recovery finally appears to be the real thing, with declining vacancies, positive absorption, and stabilizing rental rates. The market continues to favor tenants, but available inventory is shrinking and rates are rising somewhat in prime buildings in desirable areas such as the southeast/I-25 submarket. The local economy is finally emerging from its deep hole as average annual employment is up by about 28,000 through the first half of the year. Office employment has risen by about 5,200 positions. Employment growth in metro Denver of 2.1% through June outpaced the national rate of 1.7%.

Due to some fundamental changes in the way corporate America is doing business, the office sector's revival is likely to be more muted than in previous cycles. Although profits have been high, cost-cutting, rather than expansion and new initiatives, seems to be the dominant focus. Skyrocketing health-care expenses have been a major factor in the extended hiring slump as the annual cost now averages $6,700 per employee. Many firms continue to boost productivity by substituting technology (the Internet, computers, satellites, telecom applications) for labor. All of these factors, along with offshore outsourcing and telecommuting, will act to moderate long-term office space demand.

Construction Almost Nonexistent

Building activity continues to be extremely light, which has been a key factor in supporting the market's comeback. Approximately 626,000 square feet of office space was delivered last year, and speculative completions are forecast to decline sharply to just 112,000 square feet in 2005. Approximately 59,000 square feet in two projects was completed in the second quarter.

Demand on the Upswing

Net absorption of 296,777 square feet was recorded in the second quarter, bringing the total for the first half of 2005 to 713,320 square feet. In comparison, the figure for all of 2004 was a positive 362,555 square feet and a negative absorption of 137,319 square feet for 2003 and 2,730,000 square feet for 2002. The Midtown and Aurora submarkets led the way during the second quarter with 204,319 and 75,627 square feet of net absorption, respectively. Midtown benefited from Exempla's leasing of 72,051 square feet at the Diamond Hill Office Complex, while Verizon took 27,600 square feet at Cherry Creek Place 1 in the Aurora submarket. Boulder County and northwest Denver are also showing good positive absorption of 78,933 square feet total for the two submarkets.

CONTINUED ON BACK PAGE

Overview of Financial Activities in Colorado

Brendan Hickey

Industry Composition

The Financial Activities Supersector spans a diverse set of business activity, encompassing companies ranging from Wells Fargo to Janus and Blockbuster Video. According to the North American Industry Classification System (NAICS), the supersector is broken into two main sectors: Finance and Insurance, and Real Estate and Rental and Leasing. These two sectors can be further disaggregated. Some of the largest industry subsectors falling under the umbrella of Finance and Insurance include credit intermediation (commercial banks, S&Ls, and credit unions, and other lending institutions); securities, commodity contracts, and other financial investments (securities brokers, dealers, and exchanges, along with investment banks, advising, and portfolio management); insurance carriers (life, health, medical, property); and funds, trusts, and other financial vehicles (mutual funds, pension funds, real estate investment trusts). The Real Estate and Rental and Leasing Sector has two general subsectors: real estate (lessors, agents, brokers, property management, appraisers) and rental and leasing (rental and leasing of consumer goods, cars, equipment, clothing, videos, and nearly anything else that can be rented).

Analysis of the Supersector in Colorado

The sections that follow offer a snapshot of the Financial Activities Supersector in Colorado in 2004, based on employment and wage data from the Bureau of Labor Statistics.

Firms, Employment, and Wages

In Colorado, 19,793 firms are classified in the Financial Activities Supersector. These firms employ approximately 150,400 people, and pay wages of roughly $7.9 billion. The supersector has 12.2% of total state firms, 7.0% of employment, and 9.2% of wages. Of total supersector employment, about 104,000 are employed in the Finance and Insurance Sector; the remaining 46,000 work in the Real Estate and Rental and Leasing Sector. In Finance and Insurance, the largest subsector in terms of employment is credit intermediation (51,500 employees), followed by insurance carriers (36,500); and securities, commodity contracts, and other financial investments (13,500). The remaining supersector workers are in real estate (31,900), and rental and leasing services (13,100).

Average Wages

The general perception of this industry is that it is a high-paying one. Visions of Wall Street execs and power brokers in thousand-dollar suits and million-dollar penthouses often come to mind. The reality is that, for the most part, the supersector is much less glamorous, and a lot less well-paid than most people think. While it is true that the annual wage of $52,500 is significantly higher than the average state wage across all industries ($40,300), it must be noted that this is at the composite level. There is a great deal of disparity within the supersector. The average wage for the Finance and Insurance Sector is $59,300, while that of the Real Estate and Rental and Leasing Sector is $37,000. Further disaggregating the sectors shows average wages ranging from $105,100 (securities, commodity contracts, and other financial investments) to $30,400 (rental and leasing services).

Relative Concentration—Location Quotients

A useful tool in terms of measuring an industry's relative concentration in an economy is the location quotient (LQ). The LQ is a ratio comparing an industry's share of a total at a local level to that industry's share of a total at a national level. The Financial Activities Supersector makes up 7.0% of total Colorado employment, whereas nationally, the percentage is 6.1%. Thus, the LQ for Financial Activities in Colorado is 1.15 (7.0%/6.1%). That is, in terms of employment, Financial Activities is 1.15 times more heavily concentrated in Colorado than the country as a whole. The supersector's LQ is higher for the total number of firms (1.30), but lower for total wages (0.96), suggesting that Colorado's Financial Activities jobs pay less relative to the United States as a whole (the data confirms this as the national average wage for the supersector is $61,500). An examination of LQs across the subsectors reveal that they are much higher for the Real Estate and Rental and Leasing Sector than for the Finance and Insurance Sector (which serves as a plausible explanation for the wage difference between the United States and Colorado as the Real Estate and Rental and Leasing Sector has lower average wages than the Finance and Insurance Sector).

Geographic Distribution

Like health care and most other service sectors of the economy, financial services are largely population based. It should not be surprising, then, that the majority of business activity in the supersector can be found in Colorado's metropolitan areas. In fact, the state's 12 metro counties hold 83.0% of the supersector's firms, 89.0% of the jobs, and 92.0% of the wages. One out of every four finance jobs in the state is in Denver County, followed by Arapahoe County (23.0% of finance jobs), El Paso County (11.0%), and Jefferson County (9.0%). The disparity between average supersector wages across counties is also notable ($54,100 in metro counties, compared to $39,800 in rural counties). The highest-paying finance jobs are in Denver and Arapahoe counties, where the average wages are $68,900 and $60,600, respectively.

CONTINUED ON PAGE 3

From the Editor

We examine financial topics of interest to our readers in this issue. The article on page 1 looks at the Denver office market, and the article that begins on this page presents a brief analysis of Colorado's financial industry. Michael Stutzer explores mutual fund performance ratings on page 3.

Thinking ahead, it's not too early to mark your calendars to attend the 41st annual Colorado Business Economic Outlook Forum. The half-day event will be held Monday, December 5, at the Marriott City Center Hotel, in downtown Denver.

As always, please contact me at 303-492-1147 with any questions or comments.

—Richard Wobbekind

Use and Misuse of Mutual Fund Performance Ratings

Michael Stutzer

Michael Stutzer is professor of finance and director of the Richard M. Burridge Center for Securities Analysis and Valuation in the Leeds School of Business at the University of Colorado at Boulder. He can be reached at Michael.Stutzer@Colorado.edu.

We have all seen references to Morningstar, Lipper, and other mutual fund tracking firms' ratings of fund performance, both in publications and press releases by the fund trackers and advertisements paid for by the funds they track. But many readers are left in the dark about how these ratings are produced, and how they might best make use of them. This is a highly technical research subject, so I can only try to help partially answer these questions here.

There are at least two reasons why fund trackers' respective ratings of a specific mutual fund may produce different results. One reason is due to their practice of placing mutual funds in style categories (e.g., large cap growth funds or mid-cap value funds). Over the years, each fund tracker has separately evolved a detailed classification system with many, many categories. Hence, it is not surprising to learn that the fund trackers may assign different funds to categories that may seem similar. Because each fund tracker rates the performance of any fund relative to others in its own category, each fund's ratings may differ across tracking firms. Second, even if two fund trackers agree about the funds to include in a specific category, they would not use the same numerical performance index to evaluate the relative performance of those funds. Their different performance indices might yield different relative ratings of those funds.

The easiest way to evaluate performance over the past, say, five years would be to compile each fund's cumulative return (i.e., how much a dollar invested in it five years ago grew—or shrunk!—to today). But professionals often frown on that performance index, because it does not adjust for the relative risk of the funds. Perhaps the fund with the highest cumulative return also had the highest risk of performing worse in the future. This justifies use of a more complex performance index that attempts to adjust for a fund's risk. But neither investors nor fund trackers agree about how to define the concept of "risk," nor how to incorporate a well-defined risk measure into a numerical performance index.

Fortunately, my research shows that the different performance indices adopted by the different fund trackers do not result in radically different fund ratings. Funds that are near the bottom of one tracker's ratings will not likely be judged stellar performers by another tracker. But this does imply that highly rated funds will continue to be good performers in the future. We now turn to that critical issue.

All fund trackers use a mutual fund's historical returns to produce their respective risk-adjusted performance rankings. Even under ideal statistical assumptions, one needs a lot more than 10 years of historical data to get reliable performance measurement. But relatively few funds have been around more than 10 years, and as all professionals know, ideal statistical assumptions probably aren't valid in financial markets. Even if they were valid, there is still the problem of comparing older funds with long track records over both bull and bear markets with much newer funds. So it isn't surprising that many funds rated highly in the past cannot sustain such ratings for an extended period, suggesting that currently highly rated funds may not continue to be so. Caveat Emptor!

So how should information from fund trackers be used? Here are two suggestions. Fund trackers compile and compare the annual return-reducing fees charged against by each fund against its return. There is growing evidence that after subtracting those costs from returns, funds with the highest expense ratios tend not to be great performers. So investors should be wary of those funds with the relatively highest expense ratios in their respective categories. Second, do not simply pick what you think is the best fund in each of, say, 15 categories. By doing so, you might just be producing a statistical replica of a broad-based stock index, which can be mimicked at much lower cost by an index or exchange-traded fund (ETF). Such products are part of many huge institutional investors' holdings (e.g., public pensions), and should be part of yours, too. What is important is the totality of your holdings.

Finally, here are two suggestions for fund trackers. Adopt performance indices that ordinary investors can understand. For example, because many investors turn to fund ratings in an attempt to beat a category-specific benchmark (e.g., many large cap growth investors want to beat the S&P 500 Index), why not rank funds by their respective probabilities of beating a category-specific benchmark over a long horizon? And instead of solely using a fund's historical return series to compute that probability index or alternative performance indices, fund trackers should use modern statistical filtering techniques to (de facto) lengthen the return series, thereby facilitating more precise performance index measurement.

OVERVIEW OF FINANCIAL ACTIVITIES CONTINUED FROM PAGE 2

Growth—1994-2004

Since 1994, Financial Activities employment in Colorado has grown at a compound annual rate of 2.5%, which compares to 2.3% for the state as a whole. Within the supersector, the fastest-growing subsectors have been credit intermediation, and securities, commodity contracts, and other financial investments. Growth in the state has outpaced growth nationally, not only in terms of the supersector in aggregate, but also at each individual subsector level.

Other Benefits of Financial Institutions

Obviously, the Financial Activities Supersector plays a vital role in any well-functioning economy. Not only do financial institutions (FIs) provide significant employment opportunities, but they also serve the financial needs of consumers and business owners. In essence, FIs facilitate the transfer of capital from those who have it to those who need it—generally businesses. Thus, a well-developed financial sector is a critical component of business growth, expansion, and innovation. Today, the financial sector is global in nature, and large businesses can access capital from a vast number of international sources. Nonetheless, smaller local institutions continue to play an important role in economic development in that it is often these institutions that lend to small businesses.

Brendan Hickey is a student research assistant with the Business Research Division in the Leeds School of Business at CU-Boulder. He can be reached at Brendan.Hickey@Colorado.edu

COLORADO BUSINESS REVIEW

The *CBR* is a bimonthly publication of the Business Research Division at CU–Boulder. Opinions and conclusions expressed in the *CBR* are those of the authors and are not endorsed by the BRD, the Leeds School of Business faculty, or the officials of CU.

View our Web site: http://leeds.colorado.edu/brd/

Richard L. Wobbekind, editor; Cindy DiPersio, assistant editor; Gary Horvath, technical advisor; Lynn Reed, design.

This report is not produced at taxpayer expense. The University of Colorado at Boulder is an equal opportunity/affirmative action institution.

For information/address change:
Business Research Division
420 UCB, University of Colorado at Boulder
Boulder, CO 80309-0420 • 303-492-8227

METRO DENVER OFFICE MARKET CONTINUED FROM PAGE 1

Vacancy Declining

Direct vacancy fell 30 basis points, to 17.3%, during the quarter, and overall vacancy (including sublease availabilities) dropped 50 basis points, to 19.8%. The central business district's vacancy was unchanged at 12.8% during the second quarter, but is down 90 basis points over the last 12 months. Poor performance among Class B properties offset Class A buildings' performance downtown. Class A vacancy dropped a full percentage point, to 12.1%, driven by deals such as RTD's lease of 41,800 square feet at 1560 Broadway. The largest rise in vacancy, 170 basis points, occurred in the northeast submarket. With the region's economic recovery taking hold, we expect vacancy to continue on its slow but steady path downward for the foreseeable future. Our forecast is for direct vacancy to be in the 16.5-16.75% range by the end of 2005 and near 15% by year-end 2006. However, this is a tale of two markets, and Class A properties will lead the way. Functionally obsolete, poorly located Class B and C buildings will have to be repositioned or face skyrocketing vacancy.

Rents Up Slightly

The second quarter's weighted average rental rate increased marginally, to $17.84 per square foot. Rates continue to climb in prime space in the most desirable submarkets, but in general, tenants are still in control. While still relatively generous, tenant concessions are declining in magnitude as the office recovery finally gains traction. Look for average rates to be more than $18 per square foot by year-end and to continue this improving trend into 2006.

While the office market still has significant vacancy to absorb, the quality buildings are leasing, overall vacancy continues to decline, and lease rates are increasing.

Richard Damm is senior vice president and Mark A. Larocque is research director, both with the Trammell Crow Company. They can be reached at 303-220-0900.

ERRATA

In the last issue of the *CBR*, the value of mineral and mineral fuel production was incorrectly reported. The correct value follows: "The value of mineral and mineral fuel production in the state totaled $8.5 billion at the end of 2004. . . . This number is projected to rise another 14.0% by the end of 2005 for a total of $9.7 billion." We sincerely apologize for the error.