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Summary

This quarterly review of the UK's property market includes an economic outlook and an overview of the prospects for market fundamentals and the real estate capital markets. The theme running through this edition is uncertainty – not just political uncertainty associated with the new coalition government, but also uncertainty stemming from the fragility of the economic recovery. A lack of convergence among recent economic forecasts underscores this general ambivalence, and it remains too early to assess the effectiveness of the new government in tackling the UK's significant economic challenges. Despite this, it has become increasingly clear over the past few months that the UK economy has demonstrated some resilience even in the face of unusually inclement weather, a disruptive volcano, a VAT increase, and the protracted process for forming a new government. Property markets continue to recover, and while solid rental growth still remains elusive, enough occupiers and buyers have stepped into the market to create a stir of activity, even if it is not yet widespread.

This quarter's "Research Topic" revisits a subject covered by RREEF back in 2005¹, that of optimal real estate allocations in the UK market. The analysis covers two distinct dimensions. First, allocations to Direct Real Estate and REITs relative to other asset classes of Bonds, Equities and Cash. Second, allocations to the main UK real estate sectors, defined in terms of the classic IPD segments of Retail (retail warehouse, high street units and shopping centres), Industrial and Offices (City and West End, Rest of the South East and Rest of the Country). The analysis of appropriate allocations is timely given the recent (post 2006) relatively poor performance of real estate. Traditionally, optimisation analysis calls for high allocations to real estate due to its strong risk adjusted returns and low correlations with other asset classes. The analysis presented in this paper explores the impact of the recent period of performance and provides a series of important insights into real estate allocations.

In terms of multi-asset allocations the analysis demonstrates that, despite real estate experiencing its worst ever recorded performance, strong allocations are called for along the efficient frontier. In the past, real estate has tended to benefit multi asset portfolios through return enhancement and risk reduction. The inclusion of the recent period of poor performance means real estate plays more of a risk reduction role rather than one of return enhancement.

The analysis also provides important insights into allocations to different property sectors. In terms of risk adjusted returns, the best performing sector both pre (1988-2006) and post (1988-2009) crisis is Industrial. The performance of Retail has suffered over the past three years, but continues to generate stronger risk adjusted returns than Offices. Although Offices tend to generate weak long term returns, the volatility of the sector points to the case for high allocations at certain stages of the cycle, such as in 2010. The analysis demonstrates the need for a dynamic approach to allocations with relatively high allocations to Industrial and Offices during 2010-2012 likely to be followed by high allocations to Retail in the outer years of the forecast.

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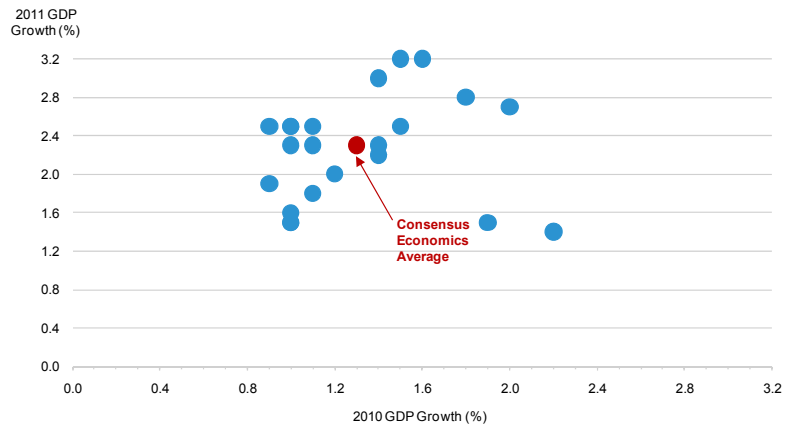
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¹ DB Real Estate, *Real estate portfolios for UK Investors*, January 2005

2. Economic Outlook

The relative strength of the UK's current economic recovery continues to provoke much debate amongst economists. Part of this stems from the political changes associated with the general election which has created additional uncertainty at a time when the nascent economic recovery remains fragile and prone to a series of shocks. The formation of a coalition government between the Conservatives and the Liberal Democrats reduces some of the short term political uncertainty. Despite this, there remain significant concerns over the ability of the government to establish fiscal discipline and reduce the huge fiscal deficit. The ability of the new government to achieve these goals will be an important influence on the health of the UK economy through 2010 and beyond. Beyond these UK-specific issues, there remain a range of more international factors, including the sovereign debt challenges across much of southern Europe, the weakness of European growth and ongoing global trade imbalances that overshadow economic prospects. Economic forecasts reflect these concerns as well as overall mixed confidence in the country's fragile economic recovery, as illustrated in Chart 1 that summarises the diversity of recent UK GDP forecasts for 2010 and 2011.

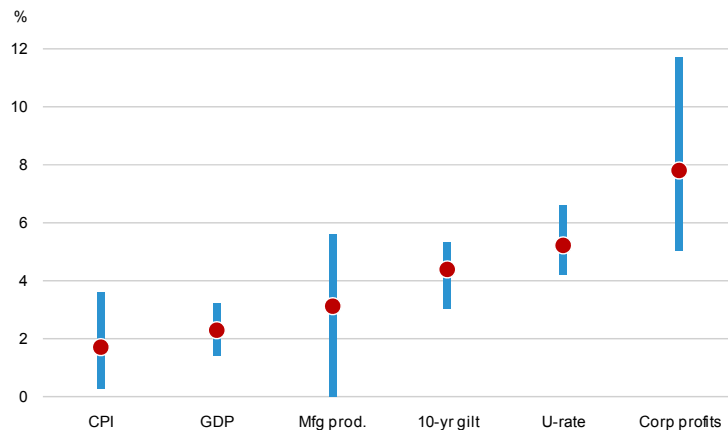
Chart 1: GDP Consensus Forecasts for 2010 and 2011



Source: Consensus Economics April 2010

The lack of agreement among economists extends to other indicators as well, some of which reflect an even greater range of expectations than GDP. The outlook for manufacturing production in 2011, for example, ranges from a bullish 5.6% to a much more pessimistic zero-growth scenario.

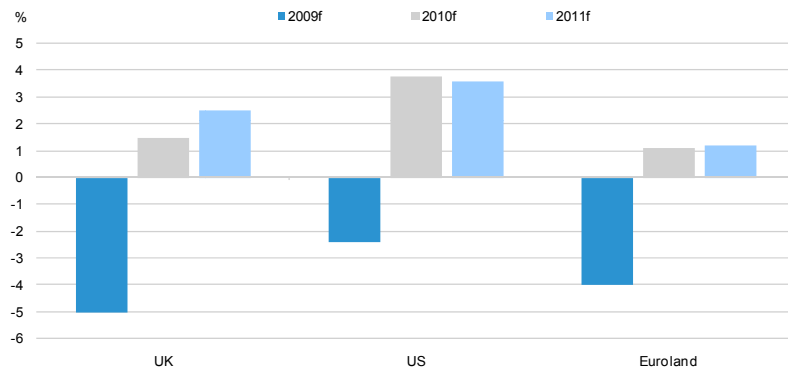
Chart 2: Consensus Forecasts for Key Indicators: Range and Average for 2011



Source: Consensus Economics, April 2010

Amid this seeming uncertainty, however, cautiously upbeat conclusions can be drawn. In fact, the fragile UK economy continues to show resilience despite a string of unfortunate obstacles that have fallen in its path. The first quarter included severe winter weather and a hike in the VAT tax while the second quarter kicked off with major disruptions to air traffic not to mention political uncertainty. Through all of this, Deutsche Bank's forecast for modest GDP growth of 1.5% in 2010 has budged little so far this year.² In its April report, the Bank of England continued to report modest signs of progress across a range of variables, including bank lending ("improved a touch"), exports and manufacturing ("gradual recovery"), employment and inflation ("stable"), and wage pressure ("muted").³

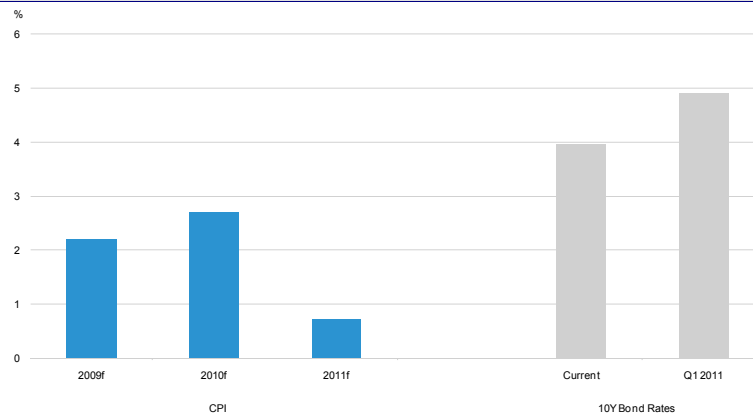
Chart 3: Comparative GDP across the UK, US, & Euroland: As of May 2010



Source: DB Global Markets, April 2010, f=forecast

The approach to fiscal policy in the UK will be closely watched especially with the additional uncertainty created by the formation of the coalition government. With fragile economic growth in the near term, the Bank of England will be under pressure to hold rates down through most of this year, with a modest rate hike coming perhaps by late 2010 or early 2011. A stronger-than-anticipated economic recovery — hardly the baseline scenario at this point — could put pressure on consumer prices, and thus lead to a more aggressive approach by the central bank.

Chart 4: Inflation and Bond Yields: As of March 2010



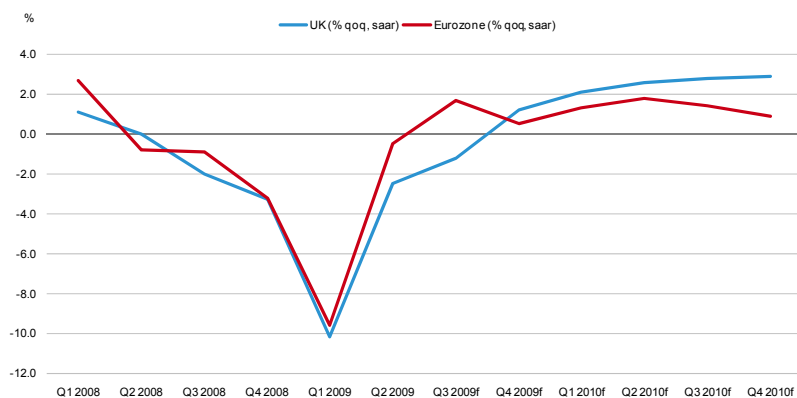
Source: DB Global Markets World Outlook, March 2010, f=forecast

² Deutsche Bank Global Markets Research, April 2010

³ Bank of England, *Agents' summary of business conditions*, April 2010

Through most of 2009, the UK recovery seemed to lag the Eurozone, but both the manufacturing and services sectors surprised on the upside in Q4 2009. This led to an upward revision of GDP growth which boosted the UK's pace of recovery ahead of the Eurozone going into 2010. Still, these gradual economic improvements are tempered by other factors which may weigh on the property markets in 2010. The Bank of England anticipates "subdued" business investment as firms wait to see how the country's political priorities will unfold this year. In the interim, this translates to relatively low occupier activity across most UK markets, with leasing characterised more by churn than by solid net absorption. Only in those markets with a unique supply/demand imbalance has take-up shown more resilience.

Chart 5: Quarterly GDP Growth 2008 - 2010

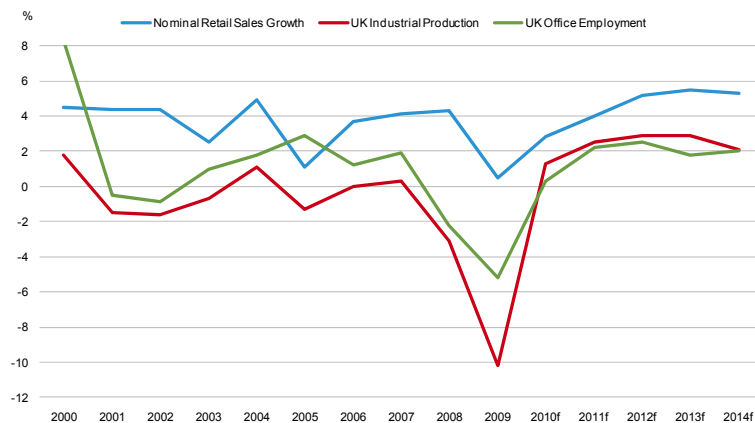


Source: DB Global Markets World Outlook, March 2010, f=forecast

3. Market Fundamentals

Key drivers of the property sectors such as office employment, retail sales, and industrial production, reflect the fragile state of occupier demand in early 2010. All of the drivers are poised for marginal recovery this year, but with most forecasts indicating that steady, widespread demand may still be a few quarters out. Across the property sectors in the UK, market fundamentals remain depressed, despite signs of rental growth in selected locations. As of March 2010, IPD's three-month rental growth index still registered negative for Retail and Industrial and flat for Office.⁴

Chart 6: Property sector drivers



Source: Global Insight, PMA, April 2010, f=forecast

UK Office markets generally saw an increased level of occupier activity in the second half of 2009 as compared to the first. The City and West End proved particularly buoyant and agents⁵ reported rents stabilising with improving levels of occupier activity in regional markets. RREEF Research forecasts are cautiously optimistic on the prospects for the City of London Office market in 2010, but less so for regional markets where the impact of public spending cuts and muted growth in the UK economy may be more profound.

Retail fundamentals vary considerably by location as well as property format. Prime high street locations with large, modern floor plates continue to lead this sector, as tenants seek to lock in leases in anticipation of future supply shortages. Meanwhile, shopping centre vacancy rates have risen in almost all the major UK centres, forcing owners to show flexibility with rents and terms. While incentives may begin to wane in 2010, rental growth will likely remain elusive. Cushman & Wakefield report vacancy for out-of-town parks in the UK to be as high as 15% overall, with Open A1 parks maintaining much tighter occupancy levels.⁶ Colliers anticipates an uptick in occupier demand in 2010, with discounters actively looking for large floor plate expansion spaces in both prime and secondary locations.⁷

Following nearly five years of steady stock expansion, King Sturge counted 24 million square metres of un-let industrial floor space in the UK as of year end 2009.⁸ Despite the development pipeline effectively shutting down, an existing overhang of supply threatens to delay recovery in some markets until occupiers can generate enough demand to absorb it. Colliers⁹ reports limited leasing activity in early 2010 for both logistics and multi-tenant buildings, while occupier activity in 2009 was strongly influenced by space reductions in order to make cost savings. In such an environment where both supply and demand remain fragile, we continue to expect

⁴ IPD, *UK Monthly Index*, March 2010.

⁵ Colliers CRE, *Property Snapshot*, March 2010

⁶ Cushman & Wakefield, *Marketbeat: An Overview of the UK Property Market*, Q1 2010.

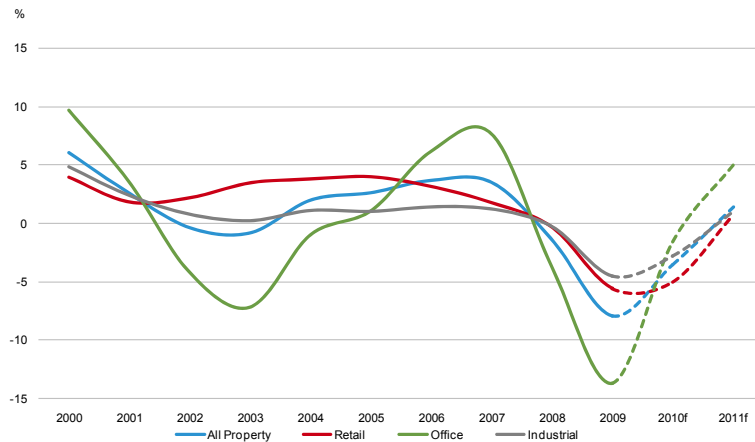
⁷ Colliers CRE, *Property Snapshot*, March 2010.

⁸ King Sturge, *Industrial & Distribution Floorspace Today*, March 2010.

⁹ Colliers CRE, *Property Snapshot*, March 2010.

relatively weak market fundamentals in this sector. The best prospects lie in those markets, such as the South East, where availability of modern units has declined.

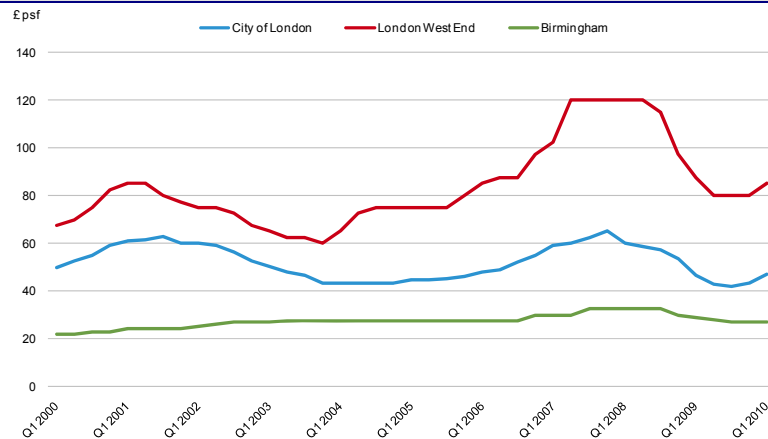
Chart 7: Timing of rental recovery to vary across sectors in 2010



Source: 12-month rental value growth is IPD, forecasts by RREEF Research as of January 2010, f=forecast

The City of London proved to be the UK's first office submarket to turn in this cycle. Pent up demand, favourable terms, and concerns over future shortages of modern properties with large floor plates led occupiers into a flurry of deals that began to push up headline rents for prime properties. JLL reported 2 million sq ft of leasing transactions in Q1 2010, an 18% spike over the previous quarter and the highest volume of first quarter leasing activity in the City in a decade.¹⁰ The sustainability of the recent improvements in demand in the City remains unlikely, at least in the near term. Supply has increased in most markets outside of London, putting their performance in 2010 at odds with more supply constrained locations.

Chart 8: Prime office rents



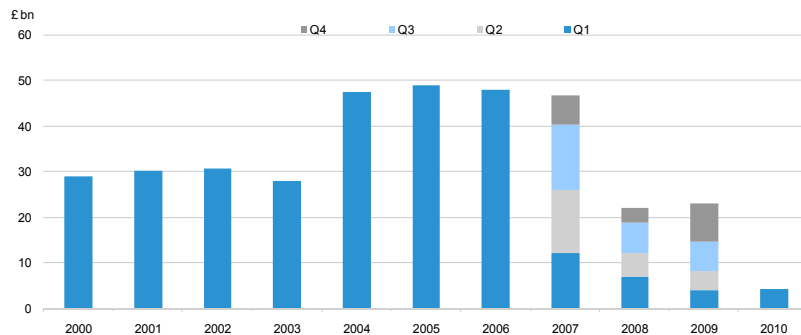
Source: CBRE, April 2010.

¹⁰ JLL, Q1 2010

4. Capital Markets and Performance

A spike in deal closings in the fourth quarter of 2009 pushed investment volume above £8 billion, or about the same amount as the first two quarters of 2009 combined.¹¹ Though strong investor interest carried into 2010, the deal volume in the first quarter fell by about half from Q4 2009. Anecdotal evidence suggests bidding for good quality assets remains competitive. Vendors do, however, appear more willing to take advantage of current pricing.

Chart 9: Investment volumes



Source: DTZ, April 2010

Greater London continues to attract widespread interest from both domestic and overseas buyers, but after pulling in more than 50% of the country's investment volume in Q2 2009, London's share of deal activity dropped back to 37% as of Q1 2010 (Chart 10). This shift can be attributed in part to a resurgence in interest from domestic investors who are typically more open to regional investments than are foreign buyers who tend to focus more exclusively on London. As London's share of deal volume has declined, so has the foreign proportion of total property investment; it fell from a peak above 40% in mid 2009 to 27% in Q1 2010¹².

UK institutions and to a lesser extent UK REITs have returned to the deal table in recent quarters. Institutional investors acquired 20% of all deals in Q4 2009, with domestic UK institutions accounting for three-quarters of that share.

Chart 10: Composition of recent UK property investment volumes

	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1
Volume (£ billions)	4.02	4.20	6.42	8.26	4.25
Offices (%)	25.1%	51.7%	47.8%	46.0%	43.7%
Greater London (%)	22.2%	50.3%	45.1%	42.7%	36.8%
Foreign buyers (%)	41.7%	44.0%	46.3%	35.9%	26.5%
↳ primary country	United States	Oman	Germany	South Korea	Germany
Lot size > £100m (%)	30.8%	23.1%	40.4%	36.5%	16.8%
Institutional buyers (%)	9.4%	4.3%	15.7%	20.1%	12.7%

Source: DTZ, April 2010

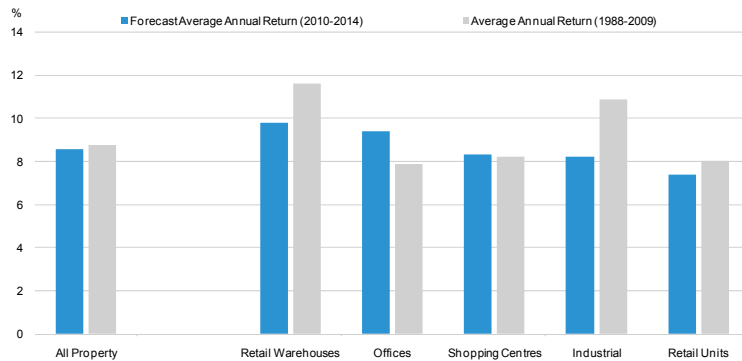
Following the exceptional 9.4% fourth quarter 2009 IPD all property total return, the first quarter of 2010 saw a further 5.7% return. Once again, this performance was driven largely by capital growth, which totalled 3.9% in Q1 2010. This overall pattern of returns has held across all three property sectors, although it is most pronounced in

¹¹ DTZ, *Investments Transaction Database*, April 2010

¹² DTZ, *Investments Transaction Database*, April 2010

IPD's retail index. Chart 11 shows RREEF Research's current expectations for 5 year average annualised returns across the major real estate sectors.

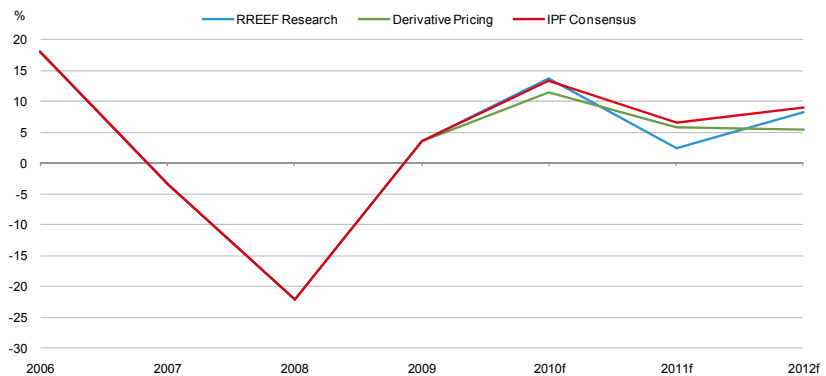
Chart 11: Average annual returns, 1988-2009 and forecasts for 2010-2014



Source: RREEF Research, Note: RREEF Research forecasts as at January 2010, f=forecast

The results suggest returns are likely to differ significantly between both sectors and across the forecast period. The near term return profile is largely driven by capital growth, with a correction forecast in late 2010/2011 resulting from excessive yield compression in the early period of 2010. The outlook assumes the unique combination of factors (limited availability of stock, weight of capital, attractive pricing) currently being seen in the UK market will give way to a more rational environment where pricing reflects the inherent risks in the UK market.

Chart 12: UK All Property Total Return, 2006-12f



Source: IPD; Cushman & Wakefield; IPF Consensus; RREEF Research, RREEF Research and IPF forecasts as at February 2010, Derivatives as at April 2010

With the first quarter of 2010 seeing further strong performance from UK real estate, we continue to believe that property performance in 2010 will be front loaded in the first half of the year, with returns slipping in the second half. While we do not expect a repeat of the 2007-2008 levels of capital decline, the current atmosphere of uncertainty surrounding the economic recovery, as well as the overhanging risks emanating from the severity of the recent downturn, increases downside risks to RREEF's baseline forecast and the prospect of the recent recovery faltering. We remain concerned about the possibility of a second period of outward yield movement. Such a scenario becomes increasingly likely should the economic recovery disappoint but could also be impacted by factors such as bank's attitudes to their loan book changing, new lending contracting further, overseas markets become increasingly attractive or the availability of investment stock increasing.

5. UK Real Estate Portfolio Analysis

Introduction

In this quarter's topic we revisit a subject covered by RREEF back in 2005¹³, that of optimal real estate allocations in the UK market. While in 2005 the strong performance of real estate was leading to growing interest in the asset class, the subsequent years have raised questions about the role of real estate in a multi asset portfolio. In the first part of this topic we consider the composition of the UK asset base, its performance characteristics to end 2009 and ultimately the role of real estate in a multi asset portfolio. Building on from this, the second section examines the composition of a direct real estate portfolio in relation to the IPD sub sectors. The analysis considers how the optimal allocations have changed over time and, using RREEF Research forecasts, how the structure of the portfolio may adjust over the period 2010-2014.

Real estate in the multi asset portfolio

The primary focus of the first part of this analysis relates to the impact of performance post 2006 on real estate's role in the multi asset portfolio. Over the past three years, real estate has suffered its worst ever performance so the analysis explores the ways in which this recent performance impacts the multi-asset allocation.

Limitations of portfolio analysis and data adjustments

Prior to explaining the steps of the analysis, it is important to recognise some of the key shortcomings of applying portfolio theory to real estate¹⁴, and to take steps to reduce these shortcomings where possible. Liquidity and transparency remain two crucial limitations and while data availability, comparability and consistency continue to improve, it remains a restriction in the real estate sector¹⁵. Furthermore, the behaviour of the asset class, with large lot sizes and heterogeneous performance make it critically important for investors to focus on property specific risks and opportunities. Despite these limitations, portfolio theory can be of use in offering insights into portfolio composition and diversification, especially when combined with a practical grasp of 'real world' considerations.

In order to overcome some of these limitations, a number of steps need to be taken including de-smoothing the direct real estate time series, adjusting the time series for the costs associated with investing and constraining the allocations according to the size of the markets. The direct real estate data is de-smoothed in order to attempt to better reflect the true volatility of the direct real estate market. As performance of the direct real estate index is based on valuations rather than market transactions, there is a concern that the resulting estimates of real estate risk do not fully capture the volatility of the market. The de-smoothed approach therefore attempts to provide a proxy of the mark-to-market view of real estate returns.

The costs associated with investing in different asset classes have also been factored into the analysis. This is particularly relevant for direct real estate where its 'round trip' cost is estimated to be in the region of 7%¹⁶. For this analysis, a deduction of 210bps from the IPD returns is included; this recognises the impact of transaction and management costs and equally importantly the impact of depreciation, assumed to be 110bps for the purpose of this analysis. Costs for the other asset classes are also included and are in line with other recent analysis¹⁷.

A final step in the analysis involves the application of constraints based on the scale and liquidity of the different asset classes. The neutral multi-asset portfolio for the overall £5.4 trillion UK market is heavily dominated by Bonds (52%) and Equities (32%), with a relatively small (10%) Direct Real Estate Market and even smaller

¹³ DB Real Estate, *Real estate portfolios for UK Investors*, January 2005

¹⁴ DB Real Estate, *Real estate portfolios for UK Investors*, January 2005; Lee S, Stevenson, S. (2005), *Real Estate Portfolio Construction and Estimation Risk*, Journal of Property Investment and Finance, 23(3), p.234-253; Hudson-Wilson, S (2000) *Modern Real Estate Portfolio Management*.

¹⁵ Blundell, *Property as Equity?*, IPE March 2010

¹⁶ DB Real Estate, *Real estate portfolios for UK Investors*, January 2005

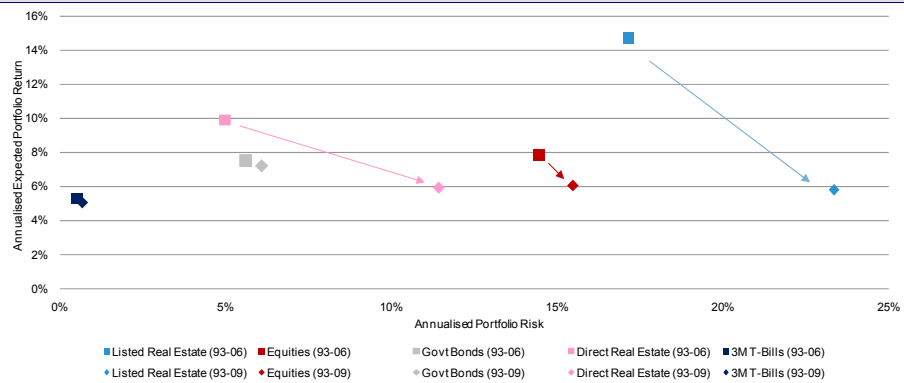
¹⁷ Blundell, *Property as Equity?*, IPE March 2010

(0.7%) REIT market¹⁸. Given these variations in size, it is important to constrain the upper and lower allocations to each asset class. This should help prevent excessive positions being taken in a relatively small and comparatively illiquid asset class. As often used in this analysis, allocations are constrained to being no less than half and no more than twice each asset class. This is the case for all allocations with two exceptions. First, for Bonds that already represent 50% of the neutral portfolio, upper allocations are constrained to 60% and for REITs, representing less than 1% of the neutral portfolio, the upper allocations are restricted to 5%.

UK Asset Class Performance and Portfolio Optimisation

Prior to the crisis, real estate produced relatively high average annual returns relative to the volatility of its performance, as shown on Chart 13 for the period 1993-2006¹⁹. Over this period, direct real estate had a higher performance than gilts for a lower volatility, and listed real estate had a far stronger performance than equities, albeit for slightly higher levels of risk. The severity of the recent downturn has, however, had a significant impact on the risk-adjusted returns of the asset classes. The impact is most significant for listed real estate, with a sharp reduction in performance and a far higher level of volatility. Direct real estate has also experienced a deterioration in performance but despite this falls somewhere between equities and bonds in terms of risk adjusted returns.

Chart 13: Annualised return and annualised risk of asset classes in the UK



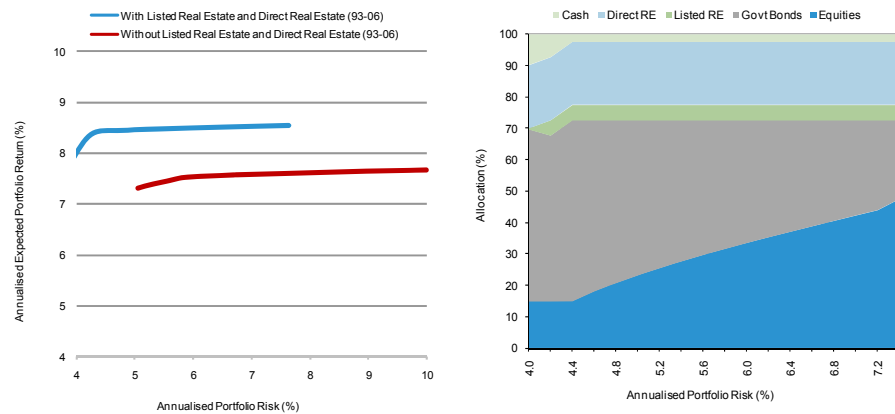
Source: Datastream; IPD; RREEF Research, April 2010

In order to assess the impact of the recent period of relatively poor real estate performance, Charts 14 and 15 show the efficient frontiers and asset allocations for two separate periods, 1993-2006 and 1993-2009. The first of these charts, covering the 1993-2006 period, provides a compelling case for including real estate as it enhances the portfolio return by around 100bps for all levels of risk. The allocations demonstrate that maximum allocations are called for by both direct and listed real estate along the efficient frontier. The major variations in the allocations is for the other asset classes, with equities having a relatively high allocation at higher levels of risk, and bonds anchoring the frontier at lower levels of risk.

¹⁸ Market size estimates based on data from EPRA; World Federation of Exchanges and IPD, April 2010

¹⁹ IPD, UK Annual Index, April 2010

Charts 14: Efficient frontier and asset allocations, 1993-2006

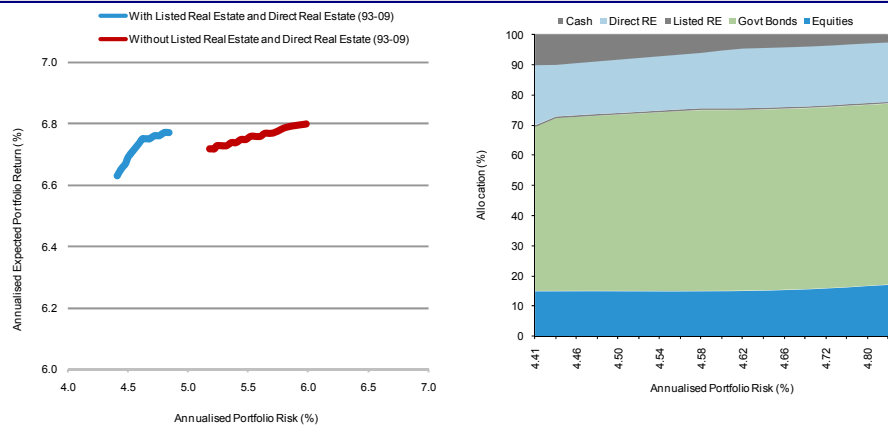


Source: IPD, RREEF Research, April 2010

The severity of the downturn over recent years has a significant impact on optimal allocations, as shown in Chart 15. The efficient frontiers are significantly lower and shorter than the earlier 1993-2006 period. This is particularly the case for the overall portfolio that includes real estate where the efficient frontier is close to 200bps lower than for the earlier period. Despite the lowering of the frontier, the analysis reveals two important results for allocations across the asset classes. First, the lower allocations to the more volatile equity-based asset classes of pure equities and of listed real estate. These asset classes suffered most significantly during the crisis and their long term behaviour has become less attractive than the more stable Bonds that receive maximum allocations along the frontier. Second, although the inclusion of real estate does not boost returns (as it did in the period to 2006), it does have a beneficial impact on risk reduction. The overall allocation with real estate has a risk of 50-75 bp lower than the allocation without real estate. The beneficial impact of real estate is demonstrated in the sectoral allocations with a 20% allocation to real estate (its constrained maximum) along the efficient frontier.

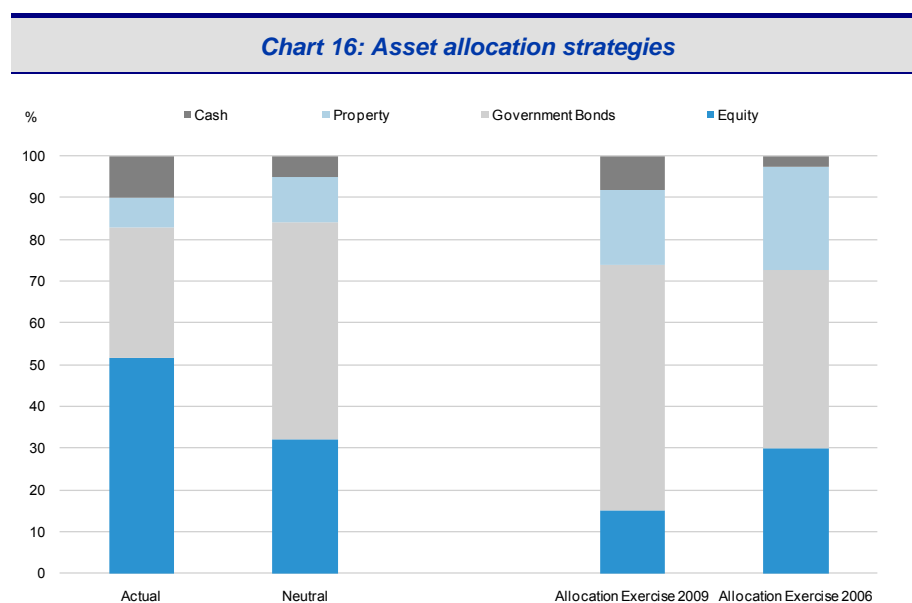
These conclusions have profound implications for real estate as they confirm the different roles of real estate in the multi-asset portfolio. On the one hand, as during the period to 2006, real estate can help to boost overall returns in the multi asset portfolio. On the other, in a period of relatively poor performance, optimal allocations call for high allocations to real estate as a way of reducing risk rather than boosting returns.

Charts 15: Efficient frontier and asset allocations, based on 1993-2009



Source: IPD, RREEF Research, April 2010

These important conclusions can be compared with recent studies²⁰ of pension fund allocations to real estate in the UK. These studies demonstrate that UK pension funds, on average, hold an allocation of around 7% in real estate. A comparison of the typical pension fund holding with a neutral portfolio and both our asset allocation results from 2006 and 2009 is shown in Chart 16. The analysis suggests that pension funds remain under allocated to real estate. This is further confirmed by the results of a recent INREV report²¹ which suggested the institutional real estate universe is expected to grow by around 20% in the next three years.



Source: Mercer; RREEF Research, April 2010

The analysis suggests that while the case for real estate remains, the reasoning has shifted over the last three years. In 2006 the results suggest real estate was a medium through which the return of the efficient frontier could be enhanced. At end 2009, the historic analysis suggests the growth story is less compelling. Average annualised returns over the longer period have fallen to levels similar to the equity markets. The addition of real estate does however continue to reduce portfolio risk by lowering volatility for a given return. This attribute is particularly welcome in the 2009 portfolio which has a far more risk averse composition with high weightings towards bonds and cash.

The case for real estate and the attraction of the asset class to institutional investors appears compelling. While the asset class has historically benefited the return of multi asset portfolios, even after the severity of the recent downturn, it continues to provide portfolio benefits through risk reduction. With this in mind, the current underweight position of many institutional investors is a trend that could result in increased allocations to real estate in the coming years. In this context, the next section considers the composition of a UK direct real estate portfolio.

UK Real Estate Allocations

Although the UK real estate market operates in one macroeconomic and capital market context there are, at times, significant variations in the behaviour of the different property types. The unique demand and supply drivers across segments of the market have historically driven very different cycles in both fundamentals and capital markets. These differences create the opportunity to improve performance by varying strategic allocations to the sectors over time. Although, as explained earlier, there are significant limitations in applying portfolio analysis to real estate, the techniques can provide important insights into the trade-offs from allocating across different property sectors.

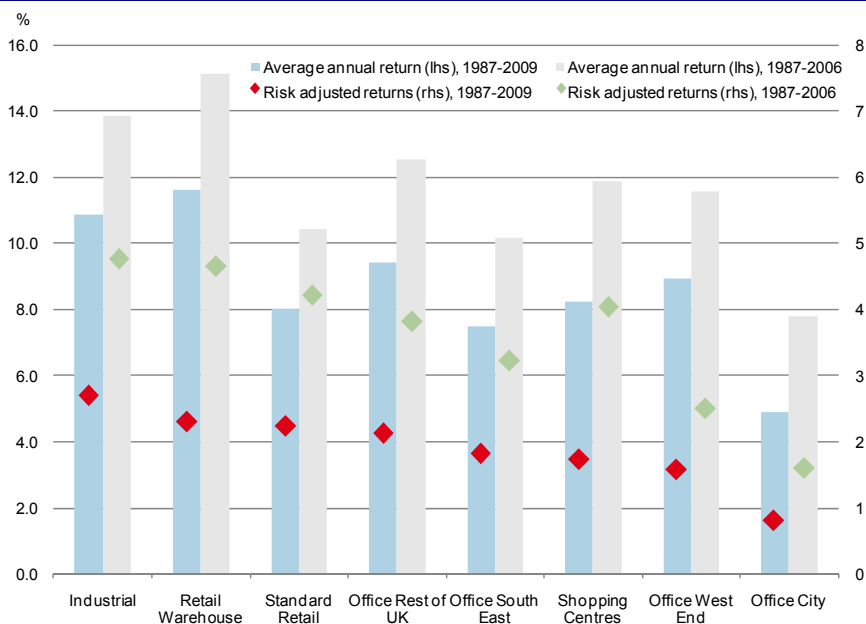
²⁰ Mercer, *Asset Allocation Survey and Market Profiles*, April 2010 and INREV, *Investor Universe UK Survey 2010*, March 2010

²¹ INREV, *Investor Universe UK Survey 2010*, March 2010

In a similar way as Chart 13 did for the major asset classes, Chart 17 plots the performance of the major IPD sectors between 1988 and both 2006 and 2009. The results provide a series of important insights into the behaviour of the different sectors, with the most relevant relating to the best and worst sectors, and the performance of the retail sector. First, the best and worst performing sectors remain the same through both periods. On a risk adjusted basis, Industrial is the best performing sector given its relatively high income yield, shorter supply cycle and more muted investment market. Over recent years, Industrial returns have reduced and volatility has increased, but the sector has improved its position relative to Retail, the second strongest sector. The worst performing sectors were, through both periods, the Office markets and, in particular, London Offices. These markets suffer from waves of over and under-supply, volatile demand, and a very liquid investment markets. The combination of these factors mean that the office markets tend to be the most volatile and deliver the weakest risk adjusted returns. These behaviour characteristics do not undermine the case for investing in office markets, but they confirm the view that it is a highly volatile market with a need for careful consideration of market cycles when investing in the sector.

The second important insight relates to the weakness of retail between 2007-2009 compared with its long term performance. The weak performance was a consequence of the over leveraged consumer culture prevalent in the UK in the run up to 2007, combined with high levels of supply and the severity of the financial and economic recession. The result is a dramatic shift in the risk / return performance of the retail sectors. Although it is too early to argue that retail has become inherently more risky, the prospect of further weakness in 2010/2011 raises important questions as to the long term behaviour characteristics of this conventionally “low risk / high return” sector of the UK property market.

Charts 17: Historic returns, 1987-2006 and 1987-2009



Source: IPD; RREEF Research, April 2010

Given the changes in market behaviour, optimisation analysis has been carried out to explore appropriate allocations to different sectors of the UK market. This analysis follows a similar approach to the multi asset analysis explained earlier, but with a number of important differences. Firstly, it is performed gross of costs and net of gearing. As a pure real estate portfolio, transaction and depreciation costs, as well as gearing levels, are assumed to be relatively uniform between the sectors. Second, the neutral portfolio is developed around the weightings of the IPD monthly index. While

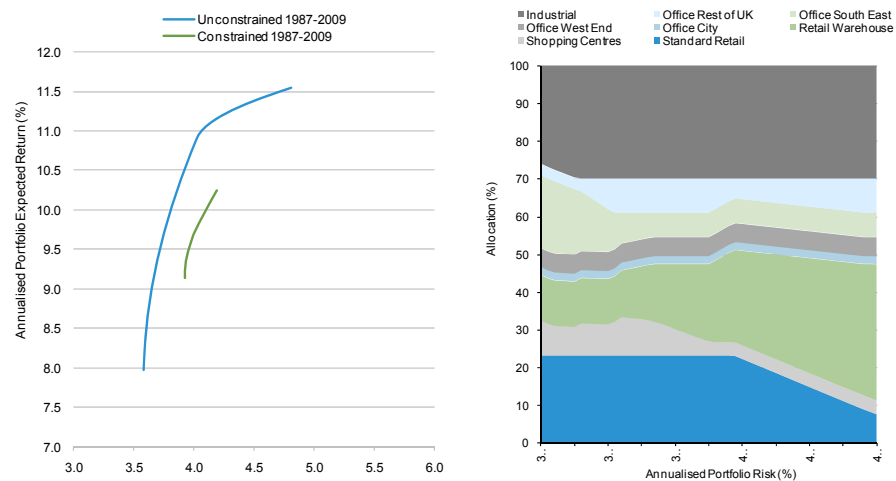
INREV²² highlight how investors are utilising an increasing variety of real estate benchmarks, the same report notes that the direct real estate based 'benchmark plus' approach remains the predominant method. As a consequence, the analysis has been constrained by utilising a neutral portfolio based on the IPD monthly sector weights, with a constraint range of no less than half and no more than twice the neutral allocation. The neutral portfolio is made up of 47% retail, 33% office and 20% industrial.

The third important difference involves comparing the historic (1988-2009) optimal portfolio with the expectations for future returns. For the purpose of this analysis, the expected returns are based on RREEF Research return forecasts presented in the capital markets section of this report.

The historic efficient frontiers, based on 1988-2009, are shown in Chart 18. The long and relatively steep shape of the unconstrained frontier implies significant scope to obtain different risk/return profiles for varying sectoral combinations. In the unconstrained frontier, the greatest allocations are taken by Retail Warehouse at the lower risk end and Industrial higher up the frontier. As explained in the earlier section, there is a need to impose constraints to prevent concentration risks, and the constrained frontier is shown in green on the chart. The constrained frontier is shorter, but comes at a relatively low cost of only 50-100bps lower returns along the frontier.

The asset allocation along the constrained frontier is shown on the right hand exhibit on Chart 18 and this demonstrates the strong allocations to Retail amounting to 40-50% for most of the frontier, despite the recent poor performance of these sectors. The composition of the Retail allocation does however shift markedly; Retail Warehouses become more prominent at the expense of the historically less volatile and slightly lower returns of both Standard Retail and Shopping Centres. Industrial remains a favoured allocation across the risk spectrum given its attractive risk adjusted return. The Office sector receives a below neutral allocation along the frontier, except at lower levels of volatility where South East Offices are favoured.

Charts 18: Efficient frontier and asset allocation, based on 1987-2009



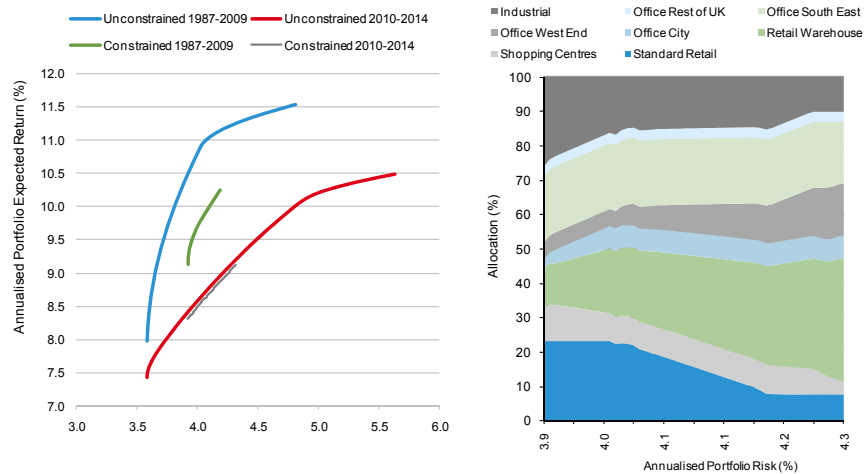
Source: IPD; RREEF Research, April 2010

The analysis shown in Chart 18 relates to historic performance and this can be useful in guiding overall and long term allocations across the property types. But real estate is inherently cyclical and there is a strong case for making shorter term and more tactical allocations based on the outlook for performance. For this reason, and based on the forecasts shown in Chart 11 earlier in the paper, the efficient frontiers for expected returns for 2010-14 are shown in Chart 19.

²² INREV, *Investor Universe UK Survey 2010*, March 2010

The frontier resulting from RREEF's forecasts suggest returns are likely to be 50-150bps lower than achieved over the long term historic average. Although 2010 is set to be a strong year, this is likely to be followed by weaker performance in 2011, reducing average returns over the five year period. Of greater significance than the height and shape of the frontier, is its composition, also shown on Chart 19. The major change relates to the increased allocation to Offices relative to Retail and Industrial, particularly at the higher end of the frontier. This increased allocation to Offices is based on their expected strong short term performance, with London Offices expected to generate a very strong 20%+ return in 2010.

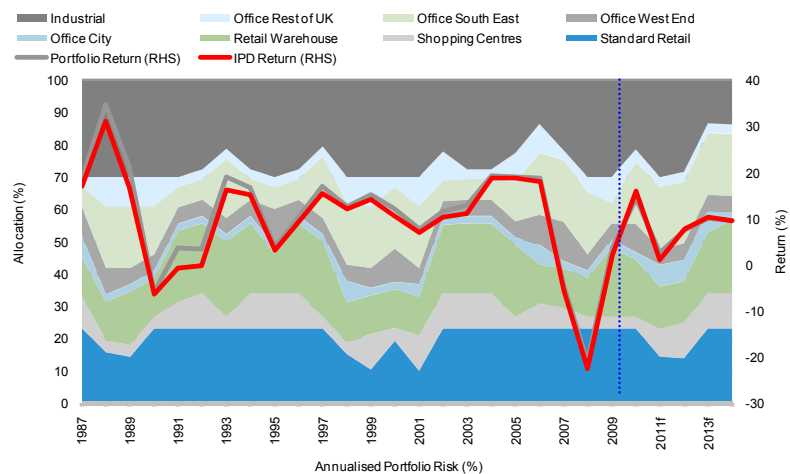
Charts 19: Efficient frontier and asset allocation based on forecast returns



Source: RREEF Research, April 2010, Note: RREEF Research forecasts as at January 2010, f=forecast

Although the optimisation based on forecast returns calls for higher allocations to Offices, it is important to recognise the dynamic nature of these allocations. As explained earlier, the cyclicity of Offices calls for periods of over and under allocation to the sector. The high allocation implied in Chart 19 is based on the returns generated over the entire period 2010-2014 and, as these are heavily influenced by the strong short term returns for Offices, these allocations will likely change during the course of 2010. The impact of this cyclicity is shown in Chart 20 that shows the results for the constrained portfolio re-weighted on an annual basis.

Charts 20: Constrained rolling efficient allocations



Source: IPD, RREEF Research, April 2010, Note: RREEF Research forecasts as at January 2010, f=forecast

The rolling allocations shown in Chart 20 demonstrates the importance of Standard Retail and Industrial over most years, driven by their strong and relatively stable performance. The principle portfolio adjustments are made around the Retail Warehouse and Office sectors which, given their volatility, is to be expected. The chart provides some important insights into portfolio adjustments which would have helped improve performance. For instance, a move towards Retail Warehouses ahead of 2002 would have allowed the portfolio to capture the 19% average annual returns from this sector over the next three years. Subsequent to this, while Retail Warehouse returns remained strong through 2006, the portfolio as a whole would have benefited from a shift towards Offices, and in particular Central London and South East Offices, in order to capture the outstanding returns of 2005-2006.

The Industrial allocation has generally been at its constrained maximum throughout the period 1987-2009. The only significant exception was the period 2005-2007 when the strong returns on offer from other sectors encourages the model to reduce the allocation towards the neutral position. Crucially however, the model called for increased Industrial holdings ahead of the downturn. During this period the more defensive characteristics of Industrial would, as so often in downturns, have been beneficial to portfolio performance.

Within the forward looking optimisation, Chart 20 points to a number of allocation shifts that should be made over the coming years. In the near term, the analysis suggests Retail allocations should be reduced and generally only up weighted from 2012. At this point the forecasts assume the economic recovery will be gaining traction, leading to stronger retailer performance which will ultimately benefit the real estate markets. The Shopping Centre allocation increases ahead of other retail segments, with strong centres expected to benefit from an improving consumer environment.

The short term underweight to Retail is made in favour of stronger allocations to Office and Industrial sectors. Within Offices, there are significant variations from market to market with the "South East Offices" benefiting most strongly in 2010-2011, and the Rest of the UK generally being out of favour. There is also a call for high Industrial allocations, particularly in 2011-2012. Given the risks facing the UK markets and the prospect of an overall downturn in 2011, there is a compelling case for retaining a high allocation to industrial. The model does, however, call for the Industrial holding to be down weighted in the later stage of the period. This is largely a result of the relative underperformance of the sector later in the cycle, when stronger rent growth in the office and retail sector may lead to better returns.

Conclusion

The case for real estate and the attraction of the asset class to institutional investors appears compelling. While the asset class has historically benefited the return of multi asset portfolios, even after the severity of the recent downturn, it continues to provide portfolio benefits through risk reduction. Within the real estate component of the portfolio, the analysis has highlighted the need for the strategy to remain dynamic and responsive to shifts in outlook. While the homogenous nature of real estate assets will always provide scope for out performance, the analysis illustrates the importance of adjusting portfolio weightings in order to minimise return volatility and to be well placed to capture sector performance.

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