

2010 U.S. Real Estate Investment Outlook and Market Perspective

March 2010

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Introduction

A new and more positive mood is developing in the first quarter of 2010, with early signs of a recovering economy providing new hope for the US commercial real estate markets. Transactions are becoming more frequent, especially in the apartment sector, as equity gathers and debt becomes more available. Property fundamentals plummeted through the downturn, but an improving economy is creating the foundations for better times ahead. However, optimism should be met with caution as economic growth, although positive, is forecast to remain sluggish for the next of couple years. Economic recovery always leads the rebound in commercial property, so growth of private equity real estate fundamentals is likely to be lethargic over the next couple of years as well.

After the free-fall of the economy in 2008 and 2009, the US real estate market followed the broader markets downward. Demand fundamentals deteriorated rapidly, which resulted in a decline in property incomes. The transaction market remained at a stand-still as buyers and sellers had difficulty agreeing to a price and debt became difficult to procure.

Fear became the theme of the overall financial market, but real estate was a special target. The asset bubble that formed in 2006 and 2007 was originally focused on residential pricing and debt, but then spread to commercial real estate, which turned out to be similarly over-priced and over-leveraged. This bubble reached a zenith in 2007 and subsequently popped resulting in plummeting values. Many commercial real estate loans that were underwritten using aggressive assumptions quickly submerged underwater, causing the Commercial Mortgage-Backed Securities (CMBS) market to freeze. Bank and insurance company construction lending became particularly problematic with a dormant leasing and sales market, and a dearth of capital available to retire construction debt. In summary, 2009 was a year in which most real estate lenders and investors were deer caught in the headlights of the oncoming credit crunch!

Nevertheless, positive macroeconomic trends are pulling some investors out of their gloom in anticipation of better times ahead. The broader US and global equity markets experienced a strong rally in 2009 and public real estate securities moved in step. Many real estate investors note that trends in the public real estate market provide a forecast for private market behavior, suggesting that a path toward stabilization should come to the direct side during 2010.

The year is getting off to a promising start for transaction activity in direct real estate. The fourth quarter of 2009 produced a transaction volume that was nearly double each of the first two quarters, albeit on a very low base. We should see similar or better results in first quarter 2010. A trickle of high quality core properties with strong near-term tenancies has come to market and been countered by a higher volume of investment dollars, thereby bidding pricing upward. This has been surprising given that the real estate market has yet to reach bottom in terms of fundamentals and values, but is a reflection of increasing optimism of buyers. It is likely that higher pricing will attract more properties to market later in 2010.

The debt markets should continue to improve in 2010 as the marketplace clears some toxic CRE loans. Portfolios of distressed debt are beginning to transact, providing transparency in the market and pushing interest rate spreads downward. Clarity will help the market assert value to the growing mountain of distressed debt in the coming year. The FDIC has been selling pools of commercial mortgages to opportunity funds, while retaining a participating

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position to prevent vultures from bidding the assets too far down. Special servicers of debt have also been selling portfolios of loans and foreclosed properties and the values to these assets are down substantially more than of those of non-distressed assets. Single asset sales of substantially vacant properties are also occur more often, selling to opportunistic investors, and senior tranches of CMBS debt are beginning to transact in greater volume and lower spreads. Overall, the real estate market on both the debt and equities sides is beginning to transact with higher frequency and as a result yields are being bid downward on the higher quality assets.

Caution Advised

RREEF Research views 2010 as a unique period of time for real estate investors, with the opportunity to buy into a recovering economy and improving real estate fundamentals. However, caution is imperative as the enthusiasm of investors may be getting ahead of the forecasted performance of the asset class.

The US economy is still in its early stages of a fragile recovery and the real estate markets, which need robust employment growth to recover, will likely lag. Most office markets and other property sectors in the particularly troubled metros will require additional time to recover. An unprecedented mountain of troubled real estate debt adds risk to the recovery by overwhelming the appetite of available investment capital. Higher yields would be required to attract additional capital and pushing values down further.

In addition, the steepness in the drop of both occupancy and rents, along with the forecast of only a moderate economic recovery, suggest that several years of growth will be required before previous healthy levels of occupancy and rents will be regained. Leases renewed or signed during the downturn will depress property income even further into the future, particularly for industrial, office and retail properties.

Opportunistic investments, particularly those with substantial vacancy or incomplete construction are particularly risky given the time required to generate meaningful leasing activity. Pricing for such deals needs to fall significantly before appropriate yields can be achieved.

Top Predictions for 2010

The following are our top predictions for 2010:

- **Capital Flows.** Following a year of minimal transactions, real estate will attract increasing amounts of capital during 2010. Investors will plunge in prior to or in the early stages of recovery. Appetite will be particularly strong for well leased core properties, but interest will accelerate for opportunistic distressed assets as the supply of core assets remains limited and downward pressure yields persists. Transaction volume should be at least twice that experienced in 2009, with even higher volumes likely.
- **Pricing.** Values are down over 40 percent according to Moody's/REAL Commercial Property Index (CPPI) and RREEF Research believes that this is near the bottom of the market. Pricing, which is still opaque, will become much clearer during 2010 as transactions become more frequent. Transparency will emerge as the transactions market accelerates, for both core and opportunistic properties.
- **Private Real Estate Equity Returns.** RREEF Research forecasts NPI total returns of between negative 4 and 0 percent for 2010, reflecting continued depreciation. For core investments acquired in the coming year, a total unleveraged return of between 8 and 10 percent will likely be required. Leverage will likely become more widely

available, but on a conservative basis and should be beneficial to returns. With 10-Year Treasuries forecast to average only 3.7 percent for the year, real estate should be a relatively attractive asset. Longer term inflation fears, along with real estate's traditional role as an inflation hedge, will provide an added advantage to the asset class. Agency debt continues to be available at very attractive returns, so apartments will transact at lower yields than will be required for other commercial real estate.

- **Publicly Traded REITs.** As is typical, the public market is ahead of the private market for real estate, having rebounded significantly in 2009 from severe losses experienced in 2007 and 2008. As a result, less of a rebound is likely in store for the public relative to the private market. Nevertheless, the outlook is excellent for most public companies, which have regained liquidity and can now acquire properties at attractive pricing. Returns averaging about 10 percent are forecast for 2010, with an average annual return of approximately 11 percent over the next five years.
- **The Economy.** Modest economic (GDP) growth of 2.5 percent to 3.0 percent is forecast for 2010, during this early stage of recovery. Job growth is forecast to turn positive in the first half of the year, but unemployment will likely remain elevated throughout 2010.
- **Apartment Markets.** Apartment markets are forecast to stabilize in 2010, with some supply constrained metros experiencing improving fundamentals. Overall, only modest rent loss is forecast for 2010, with a solid rebound expected in 2011. Due to (typically) short leases, this rebound should contribute to solid income growth beginning in 2012. Transaction activity is likely to be strongest for this sector, which is expected to be the first to recover and will have the most widely available debt.
- **Industrial Markets.** A further, albeit modest, deterioration in rents and occupancy are forecast for industrial markets in 2010, with stabilization and modest improvement forecast for 2011. Rents should hit bottom toward the end of the year and remain flat in 2011. Solid rent growth forecast for 2012 should begin to translate into income growth in 2014. Infill submarkets in major gateway metros will outperform in response to a business-led recovery. Retail and import-oriented distribution warehouses, especially those in peripheral locations, will likely underperform.
- **Office Markets.** Further deterioration in rents and occupancy are forecast for office markets in 2010. Rent loss will continue to be pronounced in 2010, but remain flat in 2011. Solid rent growth should begin in 2013, with recovery in income growth beginning in 2014 or 2015. A few markets with stronger fundamentals, like Washington DC, will see improvement in rents beginning in 2011. In general, central business district (CBD) office markets will outperform suburban. The possible excess of underutilized shadow space could impede the magnitude of absorption during the recovery, potentially stifling rent growth.
- **Retail Markets.** Heavily impacted in this recession, retail markets are forecast to experience the slowest recovery. While the market should stabilize in 2011, subsequent growth will be slow. However, generally long lease terms will help to smooth out this decline, as well as the ensuing recovery.

Capital Markets

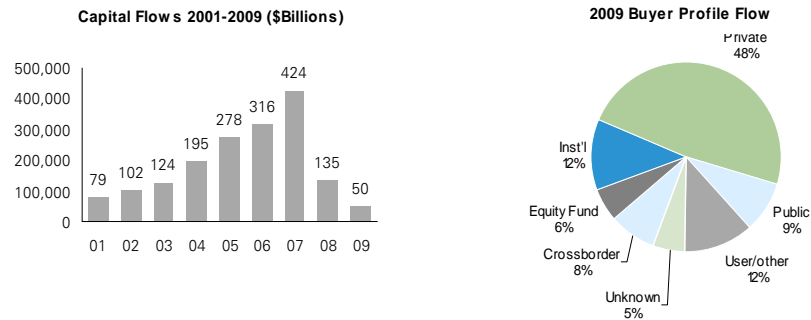
Significant uncertainties still overshadow the outlook for US commercial real estate, but signs indicate stabilization is taking hold in 2010. Transaction volume hit a low in 2009, with total volume reaching \$49 billion, 63 percent lower than the 2008 level. Transactions hit a nadir in the first and second quarters and grew significantly in the third and fourth quarters, albeit from

a historically low base. Volume should continue to expand in 2010, but will still be far below historic averages.

Fewer transactions mean fewer data points on pricing, but the available data point to higher cap rates and lower values. Cap rates increased 200 to 250 basis points from the peak of the market in 2007 and this corresponds with property declines of more than 40 percent. Value declines are evident in Moody's/REAL CPPI, which is off 43 percent from its peak. The NCREIF National Property Index (NPI) is down slightly over 30 percent on capital return through fourth quarter 2009, and this appraisal-based index typically lags the transaction market so further decline is likely. RREEF Research expects this index to bottom at between 35 and 40 percent depreciation by the end of 2010.

In 2010, the transaction market will likely continue to improve with each quarter achieving higher volume than the previous. Apartment transactions are leading this activity as attractive financing from the Government-Sponsored Entities (GSEs) continues to support the market with substantially cheaper financing. Capital for other property types is becoming more widely available as time progresses but for the near-term, assumed debt and seller financing will continue to play an important roll in the transaction market.

Exhibit 1
Real Estate Transaction Volumes
as of January 2010



Source: Real Capital Analytics and RREEF Research

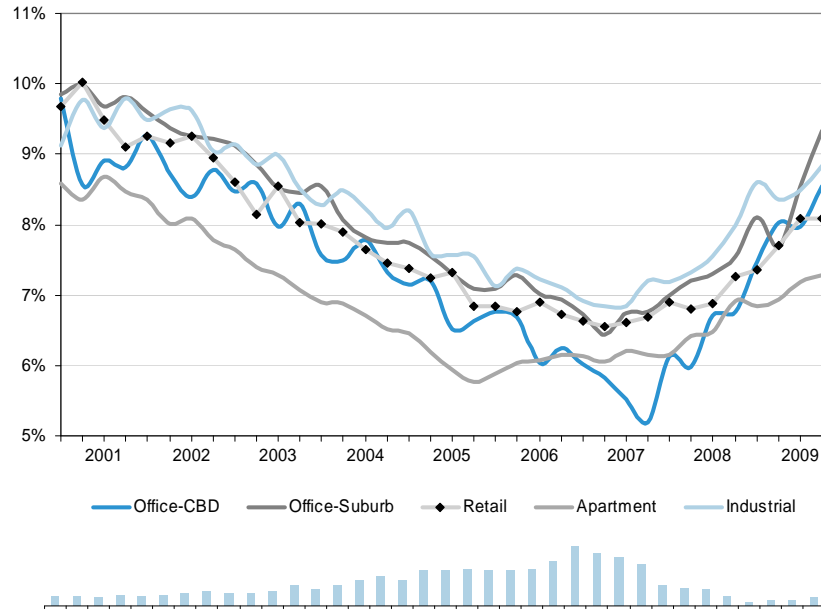
Capital currently targeting real estate is focusing on core properties with low near-term leasing risks in prime locations within gateway metros. Given that only a few properties with these characteristics have come to market thus far, yields are being bid downward for this segment while other properties, especially those with value-added risk profiles, still have trouble finding bidders. Apartments in core markets are particularly sought after given that the sector is expected to recover first and attractive financing from the GSEs is more widely available.

Recent capital flows to real estate are providing early signs of cap rate recompression for the most desirable assets, as investors become increasingly optimistic about the future. Unlike in 2009, when much of the equity came from private buyers, sources of capital will likely be dominated by foreign, institutional and REIT buyers. Cap rates for well-leased high quality properties are falling below eight percent for industrial, office and retail properties, and below seven percent (and below 6 percent in a few high profile cases) for apartments. Cap rates are also beginning to compress in second tier metros, but at significantly higher cap rates.

Higher risk properties, such as those with significant vacancy or tenant roll-over, are still not attracting abundant capital, with private buyers dominating. This is evident in the increased spread between the cap rates between value-added and core properties.

Even with capital returning to the market, RREEF Research continues to caution market participants to maintain strict underwriting standards. Over the next five years, we forecast a weak recovery in industrial, office and retail markets. During this forecast period through 2014, market rents are forecast to recover to only 90 percent of their prior peak period. New leases will likely be signed at lower rates and older leases will likely be blended with early renewals negotiated at lower rents. Thus, gains from increased occupancy during recovery will often be offset by lower rents, and investors should be cautious about expectations of income growth.

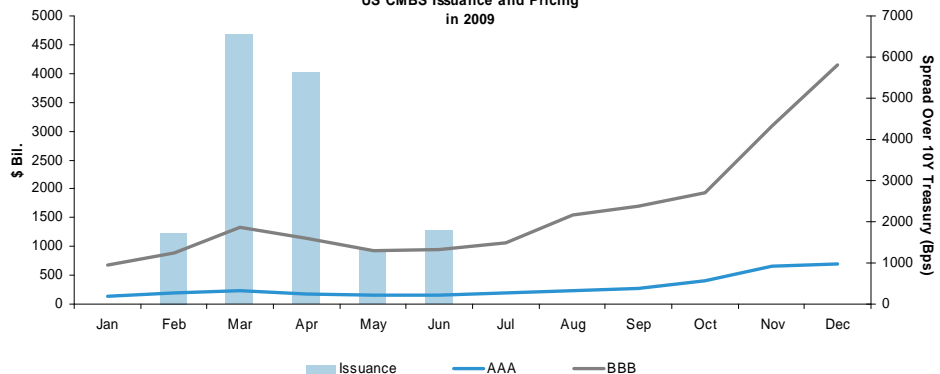
Exhibit 2
Capitalization Rate Trends
(Average Rates)



Source: Real Capital Analytics

Maturing and distressed debt, which could have an upward impact on cap rates, will continue to put strains on the market in 2010 and beyond. A significant volume of CMBS debt is maturing over the next several years and loans which were aggressively underwritten, most of which were originated in 2006 and 2007, will be of particular concern. A significant portion of these loans mature in 2011 and 2012, while the market is still in early stages of recovery. Although it is likely to be in the best interest of the lender to extend the terms of this debt on some mutually agreeable basis, it is also likely that some of these underlying properties will come on the market for sale. Adding to the volume of CMBS maturities is debt issued and held by insurance company and banks and many of these properties will also end up on the market.

Exhibit 3
US CMBS Issuance and Pricing
in 2009

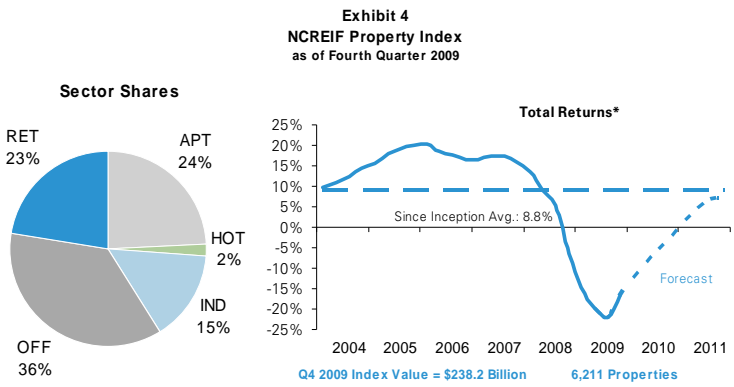


Source: Deutsche Bank and Commercial Mortgage Alert

Cap rates remain a concern for the longer term. While inflation is a distant issue at the moment, over the next five years it will become an increasing concern. As a result, the Federal Reserve is likely to move interest rates upward. By 2014, 10-Year Treasuries will likely reach 5.5 percent or higher. Baa corporate bonds, which are often considered comparable to real estate in their income returns, are forecast to reach 7.8 percent by 2014. Typically, real estate cap rates will need to maintain a spread from the risk-free rate Treasuries rate, and should approximate Baa bonds. As a result, cap rate expectations below 7.5 percent longer term would be unrealistic.

Cap rates for the apartment sector tend to follow a different track, given the advantages of GSE debt availability. Even assuming that GSE debt remains widely available, it would be unrealistic to expect that the current spread between commercial property loans and apartment loans will be maintained. RREEF Research believes that at the very least, this spread should narrow. With Treasuries at 5.5 percent or higher in 2014, apartment cap rate expectations below 6.5 percent would seem highly unrealistic.

While the transaction market has realized most of its downward value adjustment by the end of 2009, the NPI will continue to post negative depreciation through 2010. The NPI is based on appraised values of properties, and investors conduct appraisals on varied schedules. During times of market stress, property valuation inherently becomes more difficult, so the index will likely continue to lag the transaction market. We expect a further depreciation of 5 to 10 percent in 2010, as the index catches up to transaction values. Appreciation is forecast to be flat in 2011, with more normalized appreciation of 2 percent or more annually thereafter. For the total index, including both appreciation and income, RREEF Research forecasts an NPI of between negative 4 and 0 percent for 2010, followed by between 6 and 8 percent in 2011. Robust growth reflecting improving fundamentals are forecast to result in an NPI of between 9 and 11 percent in 2012.



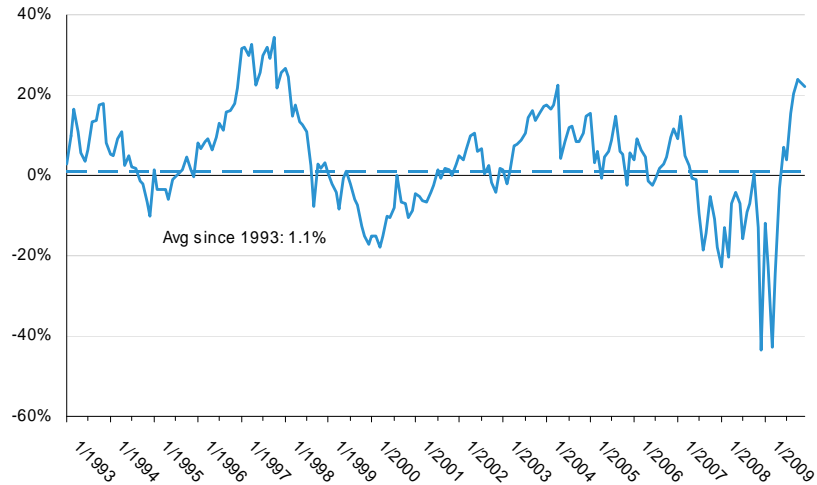
*Unleveraged Rolling Four Quarter Returns
Source: NCREIF & RREEF Research.

Publicly Traded REITs

Market conditions and sentiment for US REITs changed dramatically through the course of 2009. Hit by a sharp decline in credit availability, fears of refinancing risk, economic recession, and widening risk premiums, US REITs performed miserably during the early months of last year. By March of 2009, however, public companies' ability to raise capital and the normalization in broader financial conditions set the stage for a strong rebound in US REIT share prices. The recapitalization trend led to tightening of spreads as well. With the availability of multiple sources of debt, US REIT management moved from purely repairing balance sheets to acquisition mode. REITs produced an impressive total return of 28 percent in 2009.

Stronger balance sheets, a better acquisition track record, and a more sanguine outlook for economic growth have favored the REIT sector and REIT share prices. Not surprisingly, REITs are currently trading at a premium to underlying net asset value (NAV). For US REITs, we expect a 10 percent return for 2010 and 11 percent annual return for a five year time frame. From a 10 year long-term outlook, we expect to see a 9 percent return.¹

Exhibit 5
Share Price Premium to NAV



Source: Green Street Advisors

US Economic Outlook

The US economy remains on shaky ground, but economic growth is beginning to gain traction and will continue to do so during 2010. Government stimulus is bridging the economy from recession to recovery, while in the second half 2009, business investment and exports added to economic growth. Financial markets largely recovered in 2009 and although still tight, credit is slowly becoming more widely available. The Federal Reserve acknowledged the increasing stability in the financial market by raising the discount rate to 0.75 percent, encouraging banks to look to the market for funding. Housing markets are stabilizing nationwide. Home sales are positive on a year-over-year basis as homeowners take advantage of the federal tax credit and high home affordability. Increased sales are resulting in an uptick in home prices, which rose 7 percent over the past six months as reported by the Case-Shiller index. The market will continue to stabilize in 2010 as the labor market improves later in the year. Unemployment remains high and job growth as measured by the headline survey is still not positive, but the labor market is hitting a bottom and leading indicators are pointing to recovery beginning in the later part of 2010. Additional signs of improvement in both employment and the economy come from industrial production indicators which are up nearly 9 percent annualized over the past six months. Productivity growth exploded in 2009, reaching levels not experienced since 2002, and accordingly it is likely that job growth will follow as new demand outstrips production capacity in 2010.

¹ For more information about real estate securities for both the US and globally, see our *Global Securities 2010 Outlook* available on the RREEF website.

Exhibit 6
Forecast Highlights: U.S. Economy 2008-2011
(annual percent change, unless noted)

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>		<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Real GDP	0.4	-2.5	2.2	2.9	Consumer Price Inflation	3.8	-0.3	1.7	2.0
Consumption	-0.2	-0.6	1.8	2.4	Payroll Employment Growth	-0.4	-3.7	-0.9	1.8
Business Fixed Investment	1.6	-17.9	-1.4	10.3	Unemployment Rate (%)	5.8	9.3	10.2	9.6
Equipment & Software	-2.6	-17.1	7.2	14.0	Federal Funds (%)	1.93	0.16	0.24	1.70
Exports	5.4	-10.4	7.9	6.2	Ten-Year Treasury (%)	3.67	3.24	3.50	3.92
Imports	-3.2	-14.5	8.8	6.8	30-Year Fixed Mortgage (%)	6.04	5.03	5.11	5.54

Source: Global Insight and RREEF Research

Most indicators point to sustained improvement in the economy, but there are still substantial risks to the forecast that could prolong the current weakness. Pressure from depressed home prices is mounting on homeowners with near-zero or negative equity in their homes and a new wave of foreclosures could threaten recovery. The inventory of homes in danger of defaulting on the associated loans is potentially massive, but there are positive forces in the market that may mitigate the losses. Improvement in the job market and rising home prices will support homeowners in the near-term, aiding them through the recovery and into expansion. Government support through programs such as the Home Affordable Modification Program (HAMP), are just starting to take effect and should give additional help to at least a portion of the troubled loans. Another substantial risk to the economy stems from the wave of refinancing in commercial real estate debt. While this has little effect on the major banks, which have spent the past two years recapitalizing, smaller community and regional banks will continue to fail as loans signed at the peak of the market begin to default. Time is the best cure for this problem, and hopefully as the peak of the maturation wave hits, the economy will be strong enough to buffer against losses and have some available capital to refinance.

Inflation is unlikely to be an issue in the near-term given muted economic growth is projected leaving considerable excess capacity. However, exceedingly loose monetary policy and large infusions from government spending makes inflation a risk in the medium-term when stronger economic growth kicks in around 2013 and 2014. As the economy begins to ramp up, the Federal Reserve will have the delicate task of raising interest rates at the right time and in the right amount to maintain economic growth while limiting inflationary pressures. While there is considerable risk to the Fed getting this balance right, it is likely that both interest and inflation rates will be elevated beginning in 2013. As a result, we expect that 10-Year Treasuries will be at or above 5.5 percent, while inflation is likely to range between 3 and 4 percent by 2014. High interest rates could have a dampening effect on economic growth for several years as the Federal Reserve and the fiscal account rebalance. Higher taxation and reduced government spending will further dampen economic growth as the US economy rebalances.

Exhibit 7
Key Drivers of Regional Performance

Industrial Linkages

High-tech
Global Trade
Leisure & Hospitality
Health & Education

Structural Characteristics

Strong Demographic Flows
Low Business Costs
Availability of Skilled Labor
Warm Climate
Pro-business Regulatory Environment

Source: RREEF Research

Property Markets

Commercial real estate is still experiencing the effects of the economic downturn on multiple fronts. Construction halted in most metros as capital markets dried up in late 2007 and 2008. As a result, supply is not a near- to mid-term risk. Demand will continue to be the focus of concern over the next few years as recovery in fundamentals lags economic and employment growth. The decline in the labor market is further reducing demand in the apartment and office sectors. Consumer sentiment is negatively impacted by the jobs market, while lower household wealth and income is leading to softer retail spending accompanied by lower demand for retail space. Falling retail sales, reduced demand for manufactured goods and falling international trade has contributed to a downturn for the industrial property sector.

Rents are on the decline and not likely to stabilize until vacancy comes under control. Forecast peak-to-trough rent declines range from less than 10 percent for apartments to 25 percent or more for office and industrial. Since these declines are for core assets, weaker properties and properties in markets that achieved highly inflated pricing will experience more severe rent declines.

As the economy strengthens and the job market improves, the recovery will hit the real estate sector as well, with apartment properties improving first. As production and international trade recover the industrial sector should then benefit. As job growth becomes more consistent and broad based, vacancy in the office sector should then stabilize. The retail sector will likely lag the other sectors with vacancy improvements as consumer spending increases.

As indicated in Exhibit 8, vacancy rates for all four sectors are forecast to peak in 2010. However, the apartment sector is forecast to experience the strongest and earliest recovery and will nearly reach its previous low by 2012 while the other three sectors will recover much more slowly.

Exhibit 8
U.S. Vacancy Rate Trends

	Actual		Projected			
	2007	2008	2009	2010	2011	2012
Apartment	5.7%	6.8%	8.1%	8.4%	7.4%	6.1%
Industrial	9.4%	11.4%	13.9%	14.4%	13.3%	11.6%
Office	12.6%	13.9%	16.3%	18.5%	17.8%	16.5%
Retail	7.2%	8.9%	10.6%	10.9%	10.5%	8.0%

Source: REIS Reports, CBRE-EA, & RREEF Research

Apartment Properties – Recovery is on the Horizon

The Issues: The apartment sector moved to the head of class in early 2010 and recent surveys suggest that it is currently the preferred asset type for institutional investors. This optimism is supported by the widely held belief among investors that pricing in this sector is near or at a bottom and holds the best prospects for recovery. The combination of short-term leases, strong prospects for demand fundamentals, as job growth resumes, and the availability of attractive financing through the GSEs should enable the asset class to be the first sector to recover. Furthermore, there is significant upside for rent growth due to desirable demographic trends that will materialize over the next few years while only a few deliveries are forecast. Given this outlook for a relatively quick recovery, the apartment sector poses the fewest risks to investors at this time. However, caution should be exercised relative to market selection, as

some markets will require more time than others for recovery.

The apartment sector is widely viewed as favorable by many investors and this is evident in the considerable amount of capital aggressively pursuing acquisitions in this sector, especially in the prime supply-constrained markets. There are already signs that pricing for core properties in favored markets is being bid up to surprisingly high levels, given that economic recovery has only recently begun. If this trend continues, acquisitions in this sector may be difficult to execute at returns that are acceptable to most institutional investors.

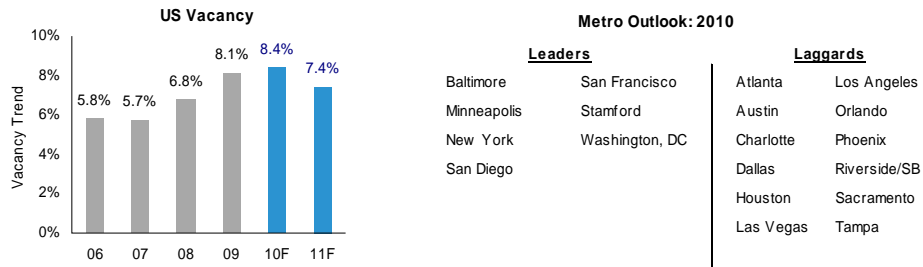
Market Highlights: Despite the growing optimism in investor sentiment, apartment market fundamentals remain challenged. The national vacancy rate reached a 30 year high at the close of 2009 in response to historically high job losses of 8.4 million over the last two years. The overall vacancy rate ended the year at 8.1 percent, a 240 basis point rise from two years ago. Effective rents for the US fell by an average of 6.6 percent, representing the most severe annual decline experienced in the last several decades. In the face of economic uncertainty, even tenants with jobs were more cost conscious as the importance of competitive rent outweighed amenities and convenience. Landlords offered aggressive concessions and perks in order to retain existing tenants and to attract new ones. Average effective rents are down 7.5 percent from their cyclical peak in the third quarter of 2008. Rents in the high priced coastal markets that had experienced significant gains during economic expansion fell sharply in 2009, bringing cumulative losses more inline with the Sunbelt markets, which experienced the majority of their declines during 2008. These latter markets had suffered from heavily over-built for-sale housing markets that impacted the rental market.

Despite substantial job losses during 2009, apartment demand turned positive during the second half of the year. The turnaround in demand is attributable to the increase in renter households tied to the fallout in the US housing market, where large numbers of homeowners defaulted on their mortgages and reentered the rental pool. As a result, the homeownership rate is down 200 bps from the peak and has returned to 2000 levels. Reinstitution of tighter credit standards from mortgage lenders is discouraging renters from buying despite reduced pricing. However, government sponsored homeownership incentives intended to stabilize the US housing market and the lingering competition from the shadow supply of single-family and condominium units continue to threaten recent gains in apartment demand.

Nationally, 122,000 apartment units were delivered in 2009, including a large number of condominium developments that were converted to rentals. The year-end figure represents the highest quantity of new rental units added since 2002 and as a result, vacancies rose substantially during the year.

The investment market deterioration mirrored the sharp correction on the fundamentals side in early 2009. Apartment values declined an average of 30 percent from the peaks set in 2008, and as 2010 begins, prospective investors are returning with expectations that pricing has bottomed and that rents should soon stabilize. In addition, attractive financing is available for this sector. With increased capital pursuing deals, pricing is beginning to increase and cap rates are declining for prime properties, ending 2009 at an average rate of 7.1 percent.

**Exhibit 9
Apartment Snapshot**



Source: REIS and RREEF Research

Outlook: The outlook for apartment investment is positive. The improvement in demand trends that emerged last summer indicate that the worst for the sector is likely over. Apartments are again positioned to be the first real estate sector to recover and it is expected that vacancy will stabilize in 2010, followed by rent growth in 2011. Due to their typical one-year lease structure, income growth is forecast to return in 2012, the earliest recovery of all property types, and this growth should be robust through 2014. There are excellent demographic trends now materializing that will counteract current weakness and enhance the recovery once sustained job growth finally reemerges. An upbeat outlook, access to attractive equity financing and indications that prices are bottoming places apartments to the top the list for investment in 2010.

Nonetheless, the recovery from the record high vacancy will take some time. Real estate demand generally lags economic growth, and so apartment vacancies will likely remain at elevated levels even as the economy recovers. The risk of additional competition from shadow supply will continue to be felt in 2010 as failed condo projects and foreclosed single-family homes become rentals. The supply of newly built apartments is winding down as the last projects funded before the credit crisis are delivered. Even though these new additions to supply are expected to total less than half of 2009 levels, weak new demand will leave the overall apartment vacancy rate modestly above 2009 levels in the low- to mid-8 percent range in 2010. Operationally, most of the year will remain challenging for apartment landlords as rents are expected to fall further, declining an average of 1 percent to 3 percent for the year.

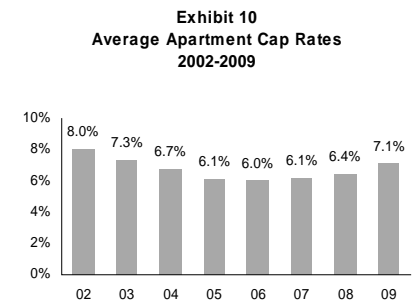
Near term economic risks notwithstanding, the mid- to long-term prospects for the apartment sector are promising. Rent growth is forecast to turn positive in 2011, growing an average of 2 to 5 percent for the year. Apartment starts set a post-World War II record low in 2009 and will likely set another record in 2010, which means new development will likely fall to unprecedented levels after 2010, aiding a recovery in vacancy. Demographic as well as behavior trends are emerging that will likely produce extraordinary apartment demand beginning in 2011. There are 75 million “echo boomers” entering the market over the next decade that will rapidly expand the prime renter age cohort (20 to 29 year-old households). Also, a fundamental shift away from the “American Dream” of homeownership is emerging as millions of failed homeowners reconsider the benefits of renting and also show a preference for infill urban locations over the suburbs. Tightened lending standards will also make it harder for would-be buyers to qualify over the next several years. Limited new supply and accelerating demand drivers should create strong performance for the sector long-term. Effective rents for apartments are expected to grow from 4 to 6 percent annually during the outer years of our forecast with some prime markets gaining upwards of 7 percent per year.

The widely held belief, which we share, is that Washington DC is expected to continue to be the best performing market over the near term. Due to investors’ focus on this market, recent buyer sentiment indicates that a pricing bubble may be forming. Capitalization rates are declining at an astounding rate and investors may need to consider other supply constrained,

coastal markets if they want to place core money in the apartment sector in 2010. Despite the recent sharp losses in rents, the high-priced infill markets of New York and San Francisco are forecast to rebound during the second half of 2010 with prospects of strong rent growth over the next several years.

We have identified specific markets that provide some of the same rent growth potential, albeit with a 12 to 18 month lag as the three aforementioned markets, but could offer a more opportune entry point in terms of yield. Located on the West Coast, these supply-constrained markets include: Seattle, San Jose, Oakland/East Bay, Los Angeles, Orange County, and San Diego. Additionally, South Florida, along with Austin and Denver are markets that we have identified, not only as strong recovery candidates in 2012, but also could provide the near term opportunity to acquire Class A properties below replacement cost. Selective nodes in the Boston, Baltimore, Northern New Jersey, and Chicago will also provide steady performance at a fairly good risk adjusted basis. Caution will need to be exercised in the cyclical markets of Atlanta, Dallas, Houston and Phoenix, which still have supply challenges to work through.

Transaction Market: A critically important component for apartment investment is the role the GSEs will play in supporting the sector. The GSE's currently dominate apartment lending, providing 84 percent of all financing in 2009, compared to between 40 and 60 percent historically. This debt is being provided at highly attractive terms and rates compared to private market debt offered to other commercial real estate. RREEF Research believes that the agencies are likely to continue their strong commitment to apartment financing. However, we also believe that as the economy recovers, the spread in interest rates between agency and private market debt will narrow.



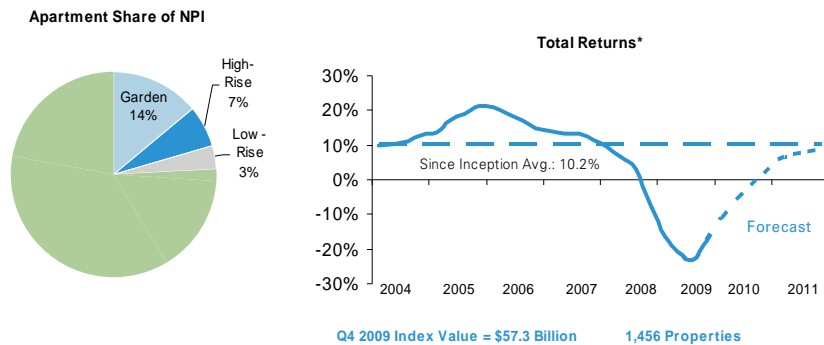
Source: Real Capital Analytics

Given our forecast for rising long-term interest rates during the next five years along with this narrowing of spreads will place upward pressure on yields and downward pressure on values.

Near term, however, strong demand for the sector is placing downward pressure on cap rates, which we expect to decline an average of 25 basis points in 2010 and possibly more in high demand markets. A near term imbalance of too much capital chasing too little product, especially for stabilized class A properties, could create a mini-bubble in pricing, particularly in prime markets. Investment capital should be cautious in underwriting aggressive pricing given our longer term outlook for cap rates. If more product becomes available as the year progresses pricing should become more realistic relative to long term trends.

Performance: The apartment sector lagged the NPI composite return in 2009 mainly due to the quick correction caused by the sharp decline in NOI. The index posted a total return during the year of negative 17.5 percent. The income return posted only 5.3 percent, the lowest of the four main property types but still higher than the hotel sector, while the appreciation return, which posted negative 21.9 percent, was on par with the headline index. Garden apartments marginally led low-rise apartments, posting negative 15.8 percent and negative 16.8 percent, respectively. High-rise apartments trailed both other sub-sectors posting negative 20.5 percent. Positive trends in the capital markets and a strong correlation between NOI and rent growth will enable the apartment sector to recover the quickest in terms of total return, and the index will likely return 0 to 4 percent in 2010.

Exhibit 11
NCREIF Apartment Index
 as of Fourth Quarter 2009



*Unleveraged Rolling Four Quarter Returns
 Source: NCREIF & RREEF Research.

Industrial Properties - Forming a Bottom in 2010

The Issues: Although the economy is now in recovery, the fallout from the deep recession of the past two years continues to impair the US industrial market. Broad economic and financial market distress hurt multi-tenant space demand, while the protracted weak retail and trade environment hit big-box warehouse/distribution space demand hard. Landlords nationally are faced with persistent negative demand, rising vacancy and falling market rents.

The primary economic drivers of industrial space demand bottomed around mid-2009, but continue to remain weak through early 2010. Industrial demand will likely stabilize more quickly than office demand. The greatest beneficiaries will be space oriented to small and medium sized businesses in manufacturing, exports and business supplies and equipment. Lagging US construction and housing industries continue to depress economic conditions in traditional 'fast-growth' regions. The inventory of unsold homes has been on a downtrend, but new residential construction is still not supportable and industrial market recovery will likely be delayed in these high-growth regions.

US international trade collapsed in 2008 and remained subdued through mid-2009. Import and export volumes resumed healthy growth in the second half of 2009 as US businesses started to rebuild inventory and emerging markets began to grow. Both imports and exports are forecast to grow by approximately 10 percent in 2010 and robust growth is expected to continue for the next several years. Economic growth is forecast to resume in 2010 and strengthen in 2011 but industrial market conditions will remain challenging during the next two years.

Market Highlights: In 2009, the US industrial market logged its worst single-year performance of the past two decades. Highly negative industrial space demand pushed the national vacancy rate to a record 13.9 percent and fueled sharp rent declines across all markets. Our estimates for peak-to-trough rent declines range from negative 15 to negative 30 percent, excluding Phoenix and Riverside/Inland Empire, where rents fell about 40 percent.

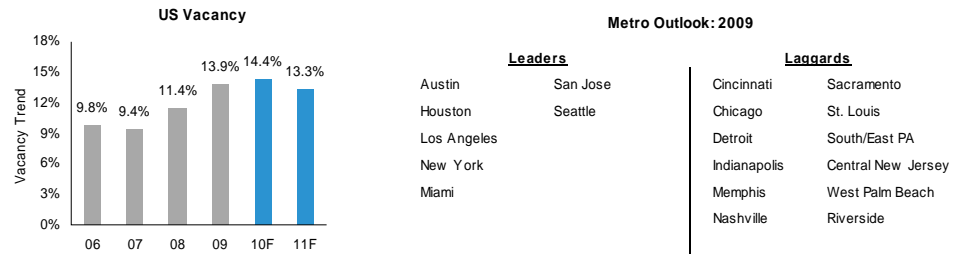
Shocked investors retreated from the market for most of the year, stifling transaction volume. Generally, investors remained highly risk averse as of early 2010, providing core pricing support only for well leased, high quality assets in primary markets. In the wake of property and financial market distress, cap rates for stabilized industrial properties jumped about 200 basis points during 2009. There are low-watermark deals that exhibit lower returns in the making, but generally transactions with normal rent rollover characteristics have not met seller

price expectations. In some secondary and tertiary markets there is simply no liquidity available at core-type returns.

Industrial property market fundamentals weakened on all fronts in 2009. The national vacancy rate, which increased 190 basis points in 2008, surged another 250 basis points in 2009 and ended the year at 13.9 percent. A mature development pipeline and tentative leasing momentum drove 2008 vacancy trends upward while in 2009, 267 million square feet of negative net absorption was the dominant driver of increased vacancy.

The development pipeline subsided in 2009, as market rents did not support speculative development and user demand was scarce. Additionally, the recent development cycle was short, spanning only five years and totaling 800 million square feet, half the amount built during the previous two cycles. Development during the past cycle was dominated by big-box warehouses in larger port or inland hub markets. These markets tended to carry the highest vacancy rates in 2009.

**Exhibit 12
Industrial Snapshot**



Source: CBRE-EA and RREEF Research

Outlook: The US industrial market is facing a long recovery, but demand fundamentals should begin to stabilize by mid-2010. On balance, however, we expect total new demand for the year will be slightly negative. Renewed GDP growth should fuel increased trade and inventory rebuilding and thus encourage better leasing momentum this year. Tepid retail sales growth and only modest improvements in the US housing market will temper the pace of recovery over the near-term, however.

Most if not all traditional demand-side drivers should lift off bottom in 2010. US trading partners should experience growth, aiding recovery in globally-linked regions. Expanding US international trade should also help markets linked to major US ports and increased spending on equipment and software should support technology-linked metro economies.

The national industrial vacancy rate is forecast to peak at 14.4 percent in 2010. Recovery should take hold nationally in 2011, resulting in average levels of demand for that year. A prolonged supply-side gap and stronger demand-side gains in 2012 should enable sharp increases occupancy.

New development will sink to an all-time low level for the next three years as weak demand and rent fundamentals and tight credit markets limit the viability of speculative development. Market rent growth prospects in 2010 are expected to be broadly negative, but modestly so in comparison to the dramatic losses in 2009. Market rents should reach bottom by early 2011. On average, market rents will fall about 4 percent in 2010 and remain essentially flat in 2011. Strong rent growth is forecast thereafter.

The next two years should prove to be an excellent vintage period for investors of core industrial real estate. Longer-term recovery prospects of core land-constrained markets outweigh near-term volatility coming out of recession. Picking quality assets in core locations is paramount as back-filling below-average space is problematic in a high vacancy, low cost environment. A flight to quality during recovery, while rents are low, will benefit Class A buildings and locations first. We continue to prefer warehouse, multi-tenant flex and business

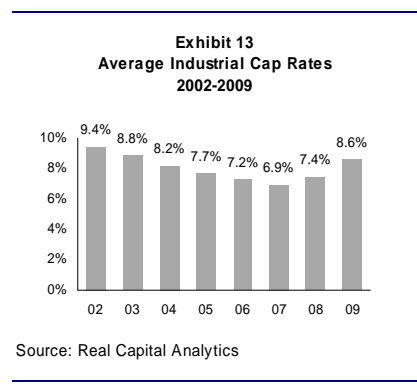
park space in core locations over big-box warehouse in less constrained markets and submarkets.

Core business hub and technology markets face near-term challenges, but well located modern vintage product should offer outperformance opportunities. High quality of life areas with favorable industries or global linkages – San Jose, Austin, South Florida, Seattle and Southern California – should also perform well over the longer term. Areas with high margin industries and good incomes tend to support land values, industrial development barriers and above-average rent growth.

Port markets in the West and Northeast will provide favorable upside on rent, occupancy and future liquidity over the long term. Low barrier but high growth markets like Dallas, Atlanta, Phoenix and Riverside will offer rebound opportunities too, but they have greater supply-side risks over the long term. In these markets, an exit strategy should anticipate these supply risks.

Surging US export growth should produce economic benefits in core manufacturing markets in California, Chicago and parts of the Midwest and Northeast regions. The last cycle did not favor this segment but in the 1990's, when US exports comprised a higher proportion of total US trade, demand fundamentals were broadly stronger for multi-tenant flex and warehouse space.

Transaction Market: Industrial investment transaction volume plummeted from \$22.0 billion in 2008 to just \$8.2 billion in 2009. Only Los Angeles, Chicago and Riverside/Inland Empire surpassed the \$500 million mark for the year. Buyers and sellers found little success at price agreement, closing an estimated 37 percent of properties offered during the year. The dearth of sales was notable by any measure. The number of transactions was so low that underlying pricing metrics were not available in many instances; 32 of 54 major metros had fewer than 10 completed transactions during 2009.



The US average cap rate increased in 2009 to 8.6 percent for the year and 9.0 percent in the fourth quarter, the annual figure representing a 490 basis point spread over 10-Year Treasuries. A few recent sales indicate there is a potential for cap rate compression in a few top markets, but generally low going-in return metrics are associated with abnormally low near-term lease roll exposure. We expect cap rates will generally remain flat in 2010, but a few prime coastal markets, notably Los Angeles, Seattle and New York/New Jersey Port Area markets will exhibit tighter spreads than average. Over the longer term as industrial market fundamentals improve, cap rates will likely compress to reflect below market in-place rents and the potential for above average future income gains.

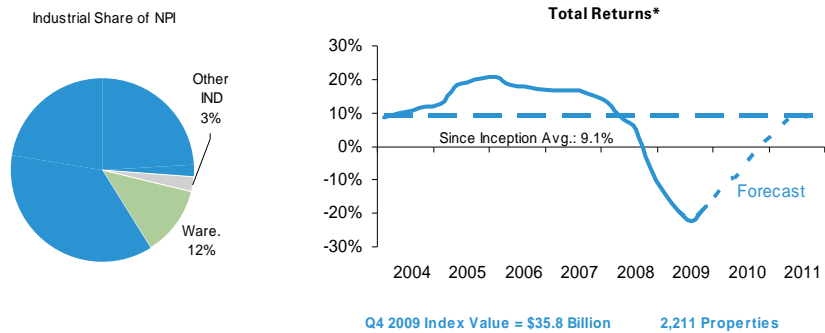
Our expectations for the transaction market in 2010:

- Increasing investor demand, stabilizing occupancy and decelerating rent losses will lead to a greater sales volume in 2010. Investors will gravitate to stabilized assets in core markets.
- Return premiums will be more firmly established for core assets in secondary markets and investors will still assign opportunistic price premiums for value-add type assets.
- Quality assets in good core markets will be readily available for the first time in about a decade, but total volume will remain below long term averages.

- The flow of capital into speculative new development will remain negligible. Markets with the greatest development pipelines in the past cycle will achieve opportunistic pricing metrics for land and vacant assets.

Performance: The industrial sector performed worse than the overall NCREIF Property Index returning negative 17.9 percent for the year-ending fourth quarter 2009, compared to negative 16.8 percent for the total index. Manufacturing space, which is a small portion of the industrial index, performed the best compared to other sub-types, returning negative 14.1 percent. R&D properties and flex space all returned similarly for the year, posting negative 16.9 and negative 16.4 percent, respectively. Warehouse space, which comprises most of the industrial portion of the NPI, fared the worst of the sub-sectors, posting negative 18.1 percent. The industrial sector is expected to outperform office in 2010, as was the case in 2009, and is also forecast to outperform the total NPI. The index will likely return between negative and positive 2 percent during the coming year.

Exhibit 14
NCREIF Industrial Index
 as of Fourth Quarter 2009



*Unleveraged Rolling Four Quarter Returns
 Source: NCREIF & RREEF Research.

Office Properties – In a Skid

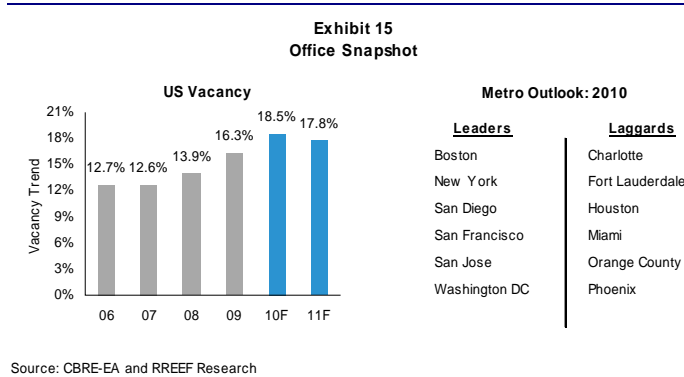
The Issues: Office employment typically falls faster than overall employment in downturns, contributing to the greater volatility of the sector, and this has been the case during the recent recession. Office employment comprises 20 percent of current jobs in the economy, but the sector accounted for 28 percent of all job losses, falling 7 percent from the peak to the end of 2009.

With such stark losses in office employment, the office market has been severely impacted. Arguably, this sector has been impacted the most of the four property sectors. Although new supply was introduced at relatively tame levels during this cycle, collapsing demand over the past two years led to profound rent deterioration. While rents should bottom out this year, there remains a risk of large pools of underutilized space that could dampen the magnitude of absorption during recovery once rehiring of office workers begins.

Market Highlights: As office employment retracted, the loss in demand pushed 2009 availability upward by 230 basis points to 16.3 percent. Although deliveries during 2009 were well below the level faced during the previous downturn, the magnitude and swiftness of job losses made demand the decisively weak point in the sector's performance. Market fundamentals crumpled, and rents plummeted rapidly during the year, bringing effective rents down about 19 percent since peaking in mid-2008.

Properties located in CBDs, which account for 35 percent of the US office stock by square footage, contributed a disproportionately low share of new construction, but suffered a disproportionately high share of demand outflow. As a result, vacancies rose equally in the urban and suburban sectors. Nonetheless, the US downtown vacancy of 12.5 percent remains well below the suburban level of 18.4 percent.

Metros most vulnerable to the deteriorating market conditions were those with economies more reliant on one or more of the interrelated housing, finance, real estate and constructions sectors, although some metros, such as San Francisco and New York, saw large erosions in rents simply because they experienced large gains made during the last recovery cycle. A similar pattern held in downtown submarkets, where rents slid more than suburban areas, largely due to having increased so much more during the up-cycle.



Outlook: The office market should reach bottom by year-end. The major risk facing the sector during the ensuing recovery period remains on the demand side. The immediate outlook for office job growth is weak, with significant recovery momentum not expected until 2012. In addition, underutilized shadow space left over from job losses to date could inhibit the magnitude of absorption generated during recovery.

New deliveries in 2010 will fall to their lowest level in 14 years and construction activity is expected to recede even further in 2011 to record low deliveries as building comes to a near halt. While the slowdown in new construction this year is welcome news to landlords, more than half is concentrated in a half-dozen metros – Atlanta, Chicago, Miami, New York, Seattle, and Washington DC – each of which are adding a million square feet or more, contributing to near-term further downward pressure to some of these markets. However, the magnitudes of additions in New York and Washington DC are relatively benign given the size of their inventories. Significant spikes in vacancy rates are forecast for the remaining four metros, however.

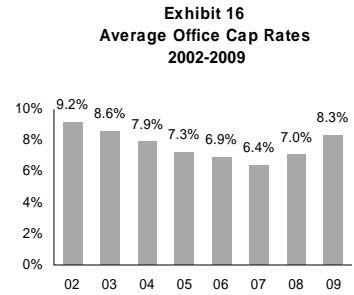
As the office sector finishes its shakeout in 2010, negative net absorption of 50 million square feet is expected during the year, although a handful of metros – Austin, Dallas, San Diego, San Francisco, San Jose, and Washington DC – already reached bottom in 2009. Overall, availabilities will peak at 18.5 percent in 2010, nearly 600 basis points above the last low point in 2007. Metros taking the greatest hits – Atlanta, Chicago, Miami and Seattle – will generally be those with high deliveries relative to stock. In addition, large pools of underutilized space remain, but are not showing up as availabilities, which could interfere with absorption traction as rehiring of office workers occurs.

With double-digit rent declines now in the past, effective rents will likely subside about 4 percent in 2010 before reaching bottom, bringing the total peak-to-trough decline to around 25 percent. Free rent remains a given, while tenant improvement concessions have eased as costs have come down and inflated packages make little economic sense at today's rent levels. Blend-and-extend will continue to be a common renewal tactic as tenants with near-term expirations seek to lock in today's low rates and landlords struggle to maintain occupancy in a thin market.

The bottom of the cycle is expected to be reached in late 2010, followed by a leveling of rents the following year. The national office vacancy is expected to require until 2013 to recede to 14 percent, by which time the sector should start experiencing a significant rent recovery pattern.

Metros positioned to benefit soonest from recovery include Boston, San Francisco, San Jose and Washington, DC, while other strong candidates include San Diego and New York., the later of which has been hit less hard than expected

Transaction Market: The transactions market remained frozen until late 2009, when bid-ask spreads narrowed, the bottom of the market came into sight, and most importantly, financing became more available. Cap rates ended 2009 about 130 basis points above 2008, but limited activity makes it difficult to peg current rates. With fundamentals continuing on the downside during 2010, a further uptick in cap rates would normally be a logical expectation. However, in the coming year, capital market demand is likely to have more influence on cap rate pricing than real estate market fundamentals, particularly for stabilized properties in the strongest markets



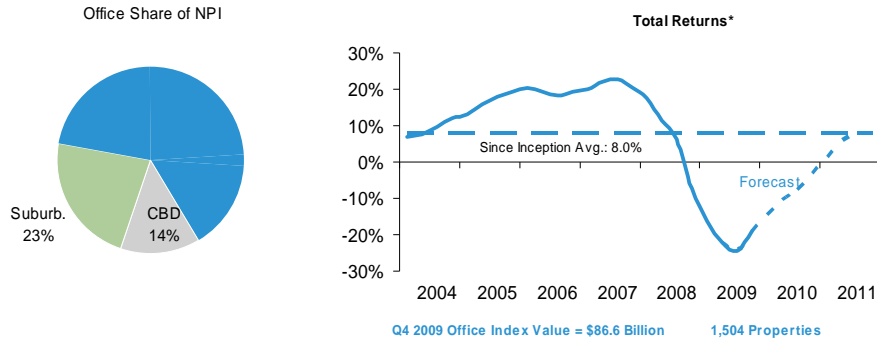
Source: Real Capital Analytics

The following themes are expected in the transaction market in 2010:

- Private and foreign buyers, which were among the most active players last year, will expand within the buyer pool, while US institutional players and REITs increase their presence, pushing overall demand upward in capital markets.
- Downward rental growth will put upward pressure on office cap rates, but increased investor demand will trump this effect and push rates downward.
- Core assets in top tier metros will remain highly favored, particularly by institutional buyers, while value-added acquisitions will require significant risk premiums that will make transactions challenging to find price agreement
- Despite declining overall market fundamentals during 2010, as investor appetite grows, and financing remains favorable, cap rates will decrease by 25 points during the year.

Performance: The NCREIF Office Index returned negative 19.1 percent in 2009, lagging the overall NCREIF Property Index by 225 basis points. Properties based in CBDs underperformed suburban properties, posting negative 19.5 and negative 18.9 percent, respectively. Office properties are forecast to lag apartment and industrial properties, returning between negative 5 and negative 1 percent in 2010. RREEF Research forecasts that office will continue to lag all sectors except retail in 2011, producing returns of between 7 and 9 percent.

Exhibit 17
NCREIF Office Index
as of Fourth Quarter 2009



*Unleveraged Rolling Four Quarter Returns
Source: NCREIF & RREEF Research.

Retail Properties – A Long Road to Recovery

The Issues: The nation’s retail property markets are being rocked by two distinct but related forces: reduced retail spending by consumers and reduced store demand by retailers. Job losses, reductions in income and wealth, and a generally sour mood have created some of the worst retailing fundamentals of the last 60 years.

Following the dot-com bust, retail sales entered an unsustainable trajectory, growing at rates far over what income growth, job growth and population growth dictate, between 5 and 8 percent annually excluding automobiles. Consumers curtailed spending as the housing market began to deflate, credit markets closed down and joblessness swelled. Consumers became significantly more frugal and retail sales fell for the first time since mid-60’s when the census first collected spending data.

The good news is that the retail industry appears to have hit bottom and is beginning to recover, and this was evident with the 2009 holiday season, which was a distinct improvement over the prior year.

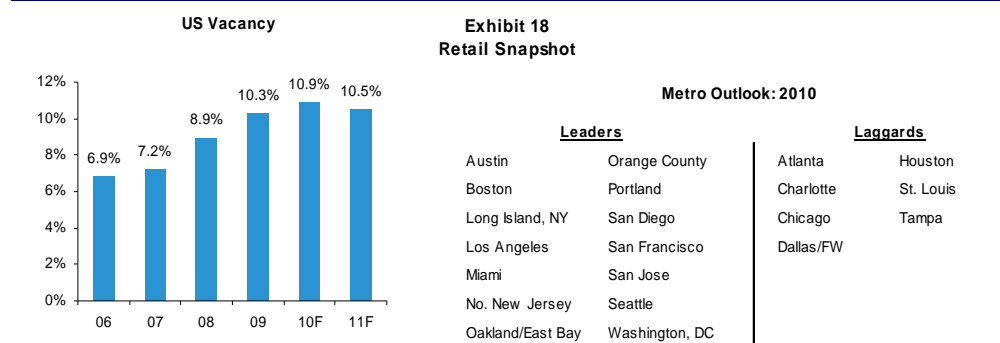
Unfortunately, this nascent revival of the retail industry has yet to translate into any benefits for the retail property sector. Vacancy rates increased over the past year and rents fell dramatically. Further pain is forecast for 2010 but, along with stronger consumer balance sheets, there are positives for retail properties. Supply additions during the peak years were relatively restrained in most metros limiting the vacancy spikes relative to other property sectors. Going forward, an even more dramatic cutoff of new construction should support the eventual, though slow, recovery in this sector.

Market Highlights: Retail markets by now are several years beyond their peak, which occurred when vacancy rates dipped to a cyclical low of 6.5 percent of space in 2005². Vacancy gradually increased over the following two years until jumping in 2008. The sector ended the year with a vacancy rate of 10.6 percent, a jump of almost 50 percent and the highest vacancy rate since the early 1990s, the end of the last retail building boom when vacancies peaked at just over 11 percent. Vacancy rates are forecast to peak in 2010 at nearly 11 percent. Fortunately, supply growth remained tame during the past cycle, so that most of the increase in vacancy can be attributed to a drop in demand – unprecedented in the extent and speed of the correction. Exceptional to the current downturn has been the near ubiquity of the market deterioration, with all metros and nearly all submarkets experiencing vacancy increases and rent declines.

² This vacancy rate is for neighborhood and community centers only.

As usual for the retail sector, the best performing geographic markets have been the relatively affluent, prosperous metros with the greatest constraints to supply; most of these metros are situated on the two coasts. Conversely, many of the metros with the highest initial vacancy rates and lowest rents at the peak of the cycle – typically located in the nation’s faster growing regions in the South and Southwest – have gone on to experience the greatest vacancy spikes and rent declines. Still, no market has been immune to declining rents, and few have escaped significant occupancy declines.

Drilling down to the various retail product segments, freestanding retail boxes have fared the best during the downturn, reflecting the high proportion of owner-occupied stores. Within shopping centers, grocery-anchored neighborhood and community centers have generally performed well, as have regionally-dominant enclosed malls. Faring less well have been unanchored centers and poorly-located lifestyle centers, as well as secondary malls. Worst of all has been the performance of the once-mighty power centers that house many of the nation’s big-box retailers. This turn of fortune is ironic in that power centers were invented specifically to leverage the perceived credit strength of these once-dominant retailers, many of whom have faltered or even disappeared during this recession.



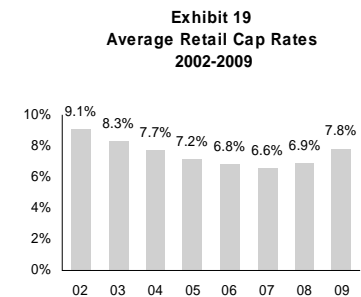
Source: REIS and RREEF Research

Outlook. The recovery seems likely to be postponed for another year and only modest improvement is forecast for this year. Retail sales seem to be hitting bottom, but appear unlikely to start recovering until the economy starts adding jobs and housing markets stabilize more broadly, neither of which are likely to occur before mid 2010. Solid gains will not likely be felt until 2011 and a vigorous rebound not likely to occur until 2012.

Though construction will likely decline more in the near term, retail conditions will continue weaken in most markets. Still, the rate and extent of decline should moderate considerably in 2010, and we expect the national vacancy rate at the end of the year to be only 30 basis points above the current rate of 10.6 percent. This compares to the 170 basis-point spike during 2008 and 2009, which was on top of a 170 basis-point increase during 2008.

Additional, albeit more modest, rent losses are forecast for 2010 in most markets and most product types, though power centers will likely continue to lag. While current rent levels are difficult to determine in a market where few retailers are signing new leases, rent declines could exceed 20 percent from peak to trough in some markets, though the drop should be more in the range of 10 percent to 15 percent in most markets.

Transaction Market: Retail properties continued to appreciate in 2006 and into 2007, as cap rates continued to decline. Although the retail sector had experienced healthy income growth over the past five years, most price appreciation has come



Source: Real Capital Analytics

from a decline in cap rates from 9.1 percent in 2001 to 6.6 percent in 2007. Cap rates reversed in 2008, and even while faced with falling NOI, have still managed to increase 120 basis points on average, reaching 7.8 percent in 2009.

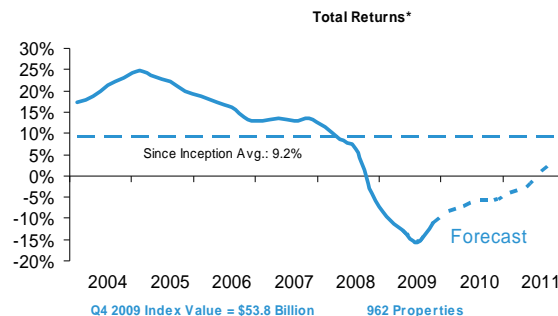
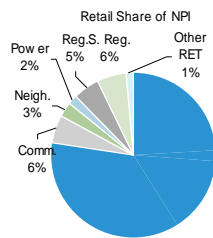
Retail property sales volumes fell abruptly in 2008 and continued to decline last year. Volume declined from approximately \$62 billion in 2007 to only \$20 billion in 2008, and then to less than \$12 billion for all of 2009. Modest signs of improvement began to appear in late 2009 and early 2010, largely driven by public REIT acquisitions given their new found capital availability. Grocery anchored retail centers have particularly benefited.

In a low transaction environment, cap market movements are even more difficult to predict than normal. Nonetheless, we believe retail cap rates will be stable for the near term, with further increases likely after two to three years to compensate for the threat of higher inflation and interest rates. Sales will evidence an increasing divergence between commodity or second-tier shopping centers and those that are market dominant. Class A malls, centers anchored by dominant grocers in affluent markets, power centers in strategic locations with strong anchors and well-conceived lifestyle centers should continue to perform best, but most centers will experience some value loss. Lesser quality assets could experience greater cap rate increases.

Performance: The NCREIF Retail Index produced a total return of negative 10.9 percent in 2009 (see Exhibit 20), leading the composite for the first time since 2004. Between 2002 and 2004, the retail index beat the composite by a substantial margin and matched the index in 2005. The other sectors recovered and began to expand rapidly in 2006 and 2007 and the retail sector lagged. The longer leases of the retail sector, which are partially at fault for slower growth in the recent boom years, have also enabled it to maintain relatively stable income and outperform during the recession.

Although the retail sector has outperformed to date, valuations will catch up in 2010 as it underperforms the NPI. A fall in income along with cap rates continuing to rise on a appraisal basis, have us believing that NPI returns for the sector will range between negative 7 and negative 5 percent for 2010. Retail returns are generally less volatile than other property types, so it is likely the sector will lag the NPI for the next several years.

Exhibit 20
NCREIF Retail Index
as of Fourth Quarter 2009



*Unleveraged Rolling Four Quarter Returns
Source: NCREIF & RREEF Research.

Implications for Investors

Commercial real estate transitioned from its role as a high return but liquid and appreciating asset class during the real estate growth period, between 2005 and 2007, back to its traditional role as an income producing investment. Equity buyers using leverage reflecting historical norms of 30 to 60 percent will provide the majority of the capital over the next few years. Transactions will begin to occur more frequently as the market becomes less opaque and more properties are brought to market. Investors with available capital are in the marketplace bidding on core properties and prices are being bid up as investor demand outstrips available assets. Pricing is attractive relative to that seen in recent years, although it is moving upwards, particularly in the best submarkets in major metro markets. Apartments, which are expected to rebound soon than the other property types and have more widely available debt, have received extraordinary investor demand over the past few months. However, pricing for non-core properties with substantial vacancy or near-term lease roll is still unclear. Thus far, most trades have either been to private buyers, or have involved lender or government agency participation to limit downside risk. Still, it is clear that capital that was previously on the sidelines is now ready to invest.

Acquisitions in 2010 and 2011 will place investments in the early phase of an economic recovery, prior to real estate market recovery. Experience has shown that investments made into a recovery produce superior long term returns, as they benefit from strong income and capital market growth. Hence, we believe that these will be exceptional vintage years for acquisitions. However caution needs to be exercised, given that capital appears to be entering the market earlier in the cycle than in previous recoveries. The next two years will offer weak real estate market fundamentals. Properties acquired should either have a lease profile that “bridges” these next two or more years, or pricing should recognize the likelihood of near-term income deterioration. Nevertheless, pricing that reflects a significant discount to replacement cost should provide opportunities for significant appreciation over a long term hold, although this discount will be more limited in the strongest submarkets.

Investors are currently defining ‘core assets’ more narrowly, focusing on a small handful of metros that tend to outperform over time, and on the best submarkets within those metros. In addition, investors are looking to fully leased properties, with minimal near-term leasing risk. Apartments are receiving the most attention, while retail demand appears to be limited to grocery-anchored centers and fortress malls. Offices with long-term leases are also receiving considerable interest. As the year progresses, core assets are likely to become more broadly defined, with capital flowing to a broader range of metros and types of assets.

Investment horizon should vary across risk-type. Core investments are the only type that will provide near-term returns with an attractive IRR. Longer-term investors may choose to take larger risk on leasing exposure in the near-term to gain higher longer-term IRRs. Traditional value-add and opportunistic investments seem overly risky at this point of the cycle. A hold period would need to bridge an extended period of weak demand. Debt strategies are the most widely discussed as a means to gain access to higher return strategies. Taking positions in the junior tranches of debt on troubled properties is a strategy that is being actively pursued by investors. As these properties default, the investor in the junior piece may attempt to acquire the senior note and therefore the property. Another strategy being attempted is the acquisition of whole loans from special servicers of debt with the negotiated acquisition presumably less than the face value of the debt. Other creative debt strategies are also being pursued by investors.

Strategies to consider across property types:

- **Apartments:** Core multifamily investors should stick to supply-constrained markets. Infill locations, including CBDs and higher income inner suburbs, should be the focus; apartments in mixed-use or multi-use employment centers are preferred. High barrier-to-entry markets with expensive housing costs and the least near-term downside risk include

New York, Washington DC, Baltimore, Boston, Seattle and coastal California. Acquisition of unsuccessful condominium projects to lease as apartments is also an emerging opportunity in some markets.

- **Industrial:** The best opportunities are within infill locations in metros with a track record in small to mid-sized firm manufacturing, exports, business service and equipment and local distribution. Such markets as **New York, Baltimore, Washington DC, South Florida, Chicago, Seattle, San Jose, Oakland, Los Angeles, Orange County and San Diego** offer especially strong prospects. Big-box distribution centers in peripheral suburban or rural locations should generally be avoided at this time.
- **Office:** Given its heavy losses, the office sector faces some of the greatest challenges in regaining traction in absorption and NOI growth, making it less favored than other sectors in the short-term. However, some attractive opportunities will emerge for the best fully leased properties in the prime submarkets. Focus should be on product in the nation's strongest CBD and inner suburban employment centers to take advantage of the long-term expanding business and professional services industry in the US. In many markets, "green" product will fare the best. Buy the best office product in recovering tech markets to take advantage of strong business spending, both domestically and globally. Metros positioned to benefit soonest from recovery include **Boston, San Francisco, San Jose and Washington, DC**, while other strong candidates include **San Diego and New York**. However, within these metros, only a few submarkets should be considered investable in the near-term.
- **Retail:** As the retail sector is forecast to require the most extended period for full recovery, this may be the most difficult property type for investment. Nevertheless, it could also offer some attractive opportunities, given that it is decidedly an out-of-favor sector. Centers anchored by dominant grocers in affluent infill markets are particularly appealing, given the highly effective consolidation that has occurred in the industry. The better located centers should be able to maintain occupancy in a challenged market at other centers' expense. Fortress malls will also continue to perform well, but at distinctly lower rents than were achievable in past years. Nevertheless, the desirability of such centers will help maintain occupancy. Power centers will provide the most challenging opportunities. However, those well located centers anchored primarily by the strong retailer "survivors" with a lease structure that locks them in for the next several years could be excellent acquisition opportunities.

Core strategies that we recommend include the following:

- **Core Strategy, Longer Term Hold** – Invest in top assets in the best long term performance markets. For such properties, investors will need to "pay up" in the near term for longer term above-average returns, but short term returns will likely be weak for the duration of the downturn. Favored markets include the best submarkets in **New York, Washington DC, San Francisco, and Los Angeles**. Investors should expect to hold through the entirety of the real estate cycle for long term outperformance.
- **Traditional Core Investment Strategy** – The dominant strategy for core investors will be to invest in fully leased infill assets in the top 15 metros. These should be medium- to long-term holds, recognizing that supply issues could arise in the medium-term in some of these metros. The initial price will need to allow for acceptable yields in this time frame.
- **Higher Return Core Investment Strategy** – This strategy could include fully leased assets within the top 15 to 30 metros. Given a propensity for supply risk in some of these markets, investors will need to be prepared to sell in advance of the next market peak. Investors will need to closely monitor supply pipelines and sell as soon

as supply ramping up becomes evident. These metros should generally perform well during the early stages of recovery, offering a high initial yield that will allow for superior returns over a short- to mid-term hold. This should be considered a core-plus strategy, solely based upon market selection.

The following **value-add strategies** could offer attractive opportunities:

- A significant quantity of assets is likely to come to market that are partially leased or have significant near term roll-over risk. To limit this risk, strong near term recovery markets should be targeted. However, some metros that are currently weak but have long-term strengths may also be targeted. At this early stage of recovery, pricing needs to fall further to reward for the risk and time that will be required to lease up the property at healthy income returns. Apartments, an early recovery sector, could perform well, and could include vacant condo projects. Risks might also be mitigated by targeting multi-tenant office/industrial and medical office properties.
- Many of the properties likely to be pushed to market by banks or due to loan maturities are likely to have value-add risk characteristics; a high volume of such assets should hopefully push prices downward, giving them attractive yields.

The following **opportunistic** strategies might be attractive to pursue:

- It is too early in the recovery cycle for traditional opportunistic strategies such as new development, empty properties or partially completed projects.
- Debt strategies provide better near-term opportunistic prospects, such as “loan to own”, high-yield bridge financing. Junior debt on high quality assets could be acquired at steep discounts with the intent to negotiate ownership or foreclose on senior position debt, thus affectively purchasing the property.

Special servicers need to dispose of a growing number of quality assets, but are looking for core pricing. Negotiations with such parties for purchase at a moderate discount to the loan value could produce superior results to acquisitions in the fully competitive bidding market.

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