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The Return to Core: Back to Basics

The credit turmoil that began in mid-2007 has pummeled commercial real estate, along with virtually every other risky asset class. The evaporation of credit has not been particularly easy for the capital-intensive real estate sector and the past couple of years will be marked among the worst on record for the industry as a whole. The global financial meltdown and ensuing recession has resulted in sharp valuation declines across the commercial real estate sector. On a NCREIF Property Index (NPI) basis, values for core real estate in the US have declined by over 30% as of year-end 2009 and we expect a further 5% to 10% downward adjustment in values. This sharp fall-off in real estate values has put the role of real estate in a multi-asset portfolio under scrutiny. In particular, the diversification benefits of real estate have come under question as correlations surged to one across all asset classes, whether traditional or alternative.

Real estate is a cyclical business and in this down-cycle, impaired capital market dynamics dominated underlying industry fundamentals. The heightened use of highly favorable leverage during the boom years of 2005 through the first part of 2007 rendered private equity real estate investments much more risky and this risk was not appreciated fully by the institutional investor community. Levered investments in properties performed much worse during the down-cycle than investments that did not use debt. What was forgotten is that altering the capital structure of the deal, i.e. by adding leverage, turned core assets into non-core through heightening the volatility of returns. The excess liquidity of the pre-crisis years also drove down cap rates to record lows and as investors searched for yield, led to investments in secondary assets and secondary markets. These riskier strategies effectively eliminated many of the positive attributes of real estate in a mixed-asset portfolio.

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We strongly believe that this past crisis was a period of aberration. Despite the damage to commercial real estate in this cycle and the temporary rise of correlations across all asset classes, we still believe in a strategic allocation to real estate. On a multi-asset portfolio level, the goal of diversification is to hedge against asset-class specific risk, but not “systemic” risks which may be common to all risky asset classes. In this downturn, the credit crisis led to a flight to risk-less assets, impacting all risky asset classes. The bottom line is that no asset was immune to the crisis, including private equity real estate.

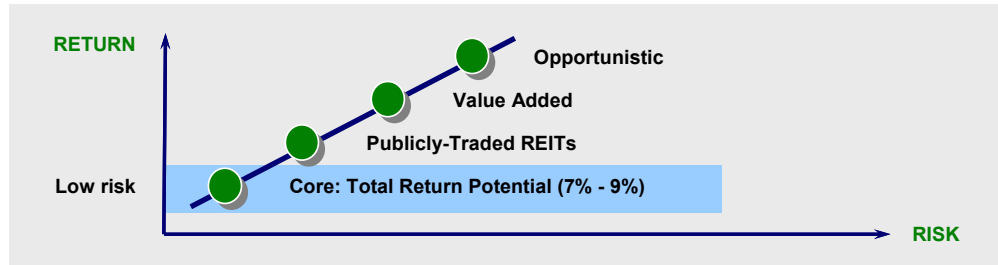
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The merits of real estate and its role in a multi-asset portfolio have been well-documented in the past. What has not been well-documented, however, is that those positive attributes refer to investments in “core” real-estate and not the highly-levered, riskier non-core strategies. Looking ahead to 2010 and beyond, it is worth reminding the investment community what constitutes core real estate and providing an update on the primary reasons for investing in such assets.

There are a number of definitions of core real estate and we provide the broadest definition to characterize the type of investments that would be considered core by a large number of institutional investors as summarized in Exhibit 1. Core real estate investments include high-quality, multi-tenant properties located in major metropolitan areas. The credit quality of such tenants is high and the lease expirations are staggered over the hold period. These are unleveraged or low leveraged investments in income-producing office, apartment, industrial or retail properties. Investments may be individual buildings in portfolios or portfolios of properties diversified by building type, investment size and geographic location. Finally, unlike non-core investments, private equity core real estate has a well-established benchmark, which in the US is the NCREIF Property Index (NPI).

**Exhibit 1
Core Property Investing**



Property Characteristics

- High quality, multi-tenant properties
- Located in major metropolitan areas
- High credit quality tenants
- Staggered lease expirations

Return Characteristics

- High income yield
- 70% - 80% of total return from income
- Low volatility
- Most bond-like due to its reliance on the income component
- Least correlated with other major assets
- Diversification and inflation hedging benefits
- High degree of liquidity
- NCREIF used as benchmark

Leverage 0 – 30%

Source: RREEF

There are several primary factors that have been cited for investing in commercial real estate and these empirically-documented factors refer to investing in low-risk, core properties. Most basic of the factors includes the attractive risk-adjusted returns of the asset class and the benefits of risk reduction from including real estate in a mixed-asset portfolio. We have highlighted these benefits below and updated the quantitative metrics.

In brief, privately-held, core real estate provides investors with the following:

- **Diversification.** Including asset classes that react differently to exogenous shocks lowers the volatility of returns. Core real estate has been shown to be a powerful diversifier for mixed asset portfolios. Returns from core real estate as measured by the NPI are largely uncorrelated with those from the stock and bond markets. Correlation measures for the period 1985 through 2009 are presented in Exhibit 2. The imperfect correlation of real estate to bonds and stocks over the past 25 years suggests that if core real estate is added to a mixed-asset portfolio, there is a potential for return enhancement given the level of risk. Over the broadest measurement period of 1985 to 2009, real estate has only a 0.27 correlation with common stocks and a negative 0.12 correlation with fixed income.

**Exhibit 2
Rolling 4Q Correlations: NPI, S&P 500, Barclays Capital Government Bond Index
December 31, 1985-December 31, 2009**

	NCREIF NPI	S&P 500	Barclays Capital Government Bond Index
NCREIF NPI	1		
S&P 500	0.27	1	
Barclays Capital Government Bond Index	(0.12)	0.07	1

Source: NCREIF, Bloomberg, RREEF Research

- **Strong, steady income returns.** Core property provides investors with strong income returns over time. The high income returns offered by commercial real estate investments (relative to other stocks and physical assets) are supported by the attractive operating margins of core real estate assets and the stability of lease obligations. The high income return component is depicted in Exhibit 3. The since inception returns for the NPI affirm that the majority of the return from private equity core real estate can be attributed to income and virtually none to appreciation. A significant benefit of core real estate for investors seeking dividend-producing investments is the high income component of this asset class.

Exhibit 3
Annualized Returns Over Three Decades

	Gross Income Return	Gross Appreciation Return	Gross Total Return*
1980 - 1989	7.8%	2.6%	10.5%
1990 - 1999	8.3%	(2.4%)	5.7%
2000 - 2009	6.8%	(1.7%)	5.0%
Since Inception Returns	7.8%	0.0%	7.8%

*Annualized Income and Capital Returns are Not Added

Source: NCREIF ODCE Index**

**NCREIF data based on the ODCE Index

- **Inflation hedge.** The structure of commercial leases, many of which include CPI adjustments, also provides investors with a long-term hedge against inflation. We believe as US economic growth gains traction, the expansionary monetary policy and increased levels of liquidity injected by the Federal Reserve, the higher federal debt burdens and the higher trajectory for fiscal deficits, have increased the likelihood of higher inflation in the medium term. Institutional investors that include assets with inflation-hedging characteristics in their portfolios should be well-rewarded. Until recently, the inflation-hedging characteristics of core real estate were widely ignored since we were living in a disinflationary environment. Going forward, core real estate should provide an inflation hedge as markets return to balance. Exhibit 4 shows correlations between the NPI and inflation during high inflation and low inflation periods. As illustrated in Exhibit 4, the value of real estate as an inflation hedge truly asserts itself during high inflationary periods. The correlation between the NPI and CPI, at 0.80, was highest during the high inflation episodes in US economic history.

Exhibit 4
NPI Correlation to Inflation

	Private Real Estate (NCREIF)
High Inflation Period (1978 - 1982)	0.80
Low Inflation Period (1983 - 2009)	0.16

Source: NCREIF, RREEF Research

- **High absolute returns:** Real estate has provided solid, low-volatility returns with respect to stocks and bonds over time. Exhibit 5 provides average returns and volatility (standard deviation) measures for private equity real estate, stocks and bonds for the period 1978 to 2009. Real estate has delivered an 8.8% annual return over this period with a volatility of over 8%. On a risk-adjusted basis, core US real estate has performed solidly during this period.

Exhibit 5
Compound Annual Total Returns
Time Period: 1978 – 2009

Asset Class	Index	Return	Volatility
Real Estate	NCREIF Property Index (NPI)	8.77%	8.11%
US Stocks	S&P 500 Index	11.31%	18.43%
US Bonds	Barclays Capital Government Bond Index*	7.77%	5.78%
	Barclays Capital US Government/Credit Index	8.27%	7.51%

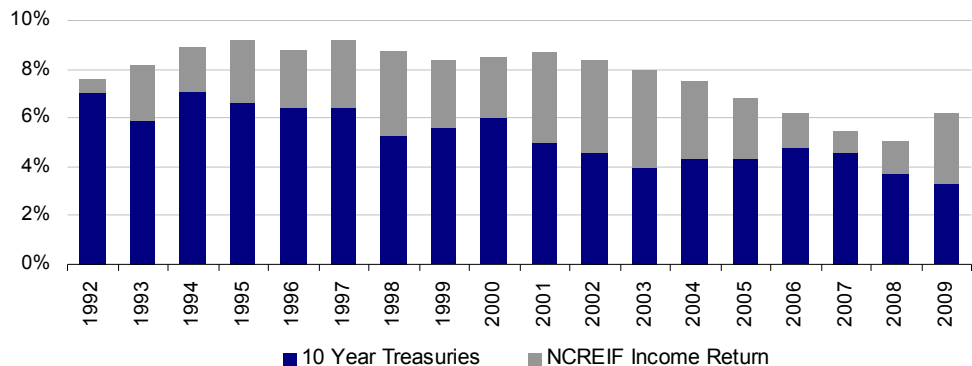
*Return starting 1985

Source: NCREIF, Bloomberg, RREEF Research

- A mixture of stocks and bonds:** Over the long term, core real estate should perform somewhere between bonds and stocks, both in terms of returns and volatility of returns. The dependence of property level cash flows on contractual payments from leases suggests that commercial properties can be regarded as a mix of bond-like and stock-like ownership rights. As leases mature, and property level rents are reset to prevailing market rates, investors are also able to participate in local market productivity and profitability trends. Exhibit 5 also reaffirms that the return characteristics of core private equity real estate falls between those of stocks and bonds.

After reeling from the credit turmoil and witnessing the sharp value adjustments across seemingly well-diversified portfolios, are there real estate solutions for institutional investors? The recent stock market volatility and low bond yields have renewed interest in income-producing investments. Investors have also become much more conservative in how they underwrite asset class risk. Real estate, specifically core real estate, should constitute the bedrock of an income-generating, low-risk private equity real estate portfolio. With the aging of the baby boomers and the transition to their retirement years, the increased need for current income should render core real estate's steady income-generating capabilities very appealing to most plan sponsors. The retirement of the baby boomers should further drive a shift towards less risky investments, which suggests a migration away from stocks to less risky assets such as fixed income and core real estate. Fixed income yields are at an all-time low and do not provide the necessary inflation-hedge going forward. As of April 1, 2010, the yield on the ten-year Treasury bond was 3.9%. Core real estate income yields are fairly stable at over 6%. (Please refer to Exhibit 6, NPI income return.)

Exhibit 6
NCREIF Income Return Spread Over Treasuries
1992 – 2009 Average: 250bps



Source: NCREIF, Federal Reserve, RREEF Research

But is it an opportune time to be investing in core real estate in 2010? The risks now to core investing are that the few quality assets on the market are commanding very low cap rates and are pricey. Transaction volumes were still low during the first three months of 2010 and there is now a wall of equity capital waiting to invest in core real estate. The three sources of equity capital for real estate in the US include foreign investors, public REITs and pension funds. Core deals that have come to the market recently are attracting numerous bids. We do expect that transaction volumes will increase in 2010 from their lows in 2009. The better-than-anticipated pricing that core assets are garnering should encourage more owners to bring assets to the market.

The legacy commercial mortgage debt overhang should also increase transaction volume over time. There exists an estimated \$1.3 trillion of commercial mortgage debt that will need to be refinanced over the next five years. This will surely provide opportunities for equity investors to acquire quality assets at better pricing. Much of the mortgage debt is sitting on the balance sheets of regional banks with that segment constituting mostly construction loans. Over time, both the regional banks and CMBS issuers will need to recognize the commercial real estate value losses on their balance sheets. This should unleash more assets on the transactions market.

Not only do we expect a greater volume of transaction activity, we are also at a trough of an economic and real estate fundamentals cycle. Past evidence has shown that the best vintage years for investing in commercial real estate are at the bottom of the real estate cycle when occupancies are at their lowest. We still expect a challenging year for real estate in 2010. Operating fundamentals will remain under pressure in 2010 despite the recovery in the broader economy. Real estate lags in and out of the business cycle and is more dependent on job than output growth. We do expect the US labor market to improve this year, however, setting the stage for an improvement in overall property market fundamentals. The timing of recovery will vary by sector and geography, however. The apartment and industrial fundamentals should improve first and the office and retail sectors should lag. A positive factor for the real estate sector in this recovery is that a supply overhang has not been the dominant issue. If we get some traction in demand side fundamentals, operating margins should perform better and at a quicker pace since there is not as much excess supply to be absorbed. If history is any guide, the years 2010 to 2012 should provide optimal vintage years for acquiring US real estate assets.

In conclusion, we believe a majority of institutional investors will not rotate away completely from private equity real estate but will now reassess the rationale for investing in the asset class and try to understand the risks within their real estate portfolios. The strategic role of low-risk, core real estate in mixed asset portfolios has not changed. The correction in the broader real estate markets globally should provide opportunities for tactical acquisitions over the next few years, especially for all-equity or low-leverage buyers. Private equity real estate is a long-term investment and it is difficult to time market tops and bottoms. With core assets, however, investors will be better protected on the downside with lower leverage exposure and income stability over cycles through leases to credit tenants.

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