

April 2010

Japan Real Estate First Quarter 2010

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Summary

The global economy handed Japan a shapely business cycle during the first quarter. National GDP fell 5.2% in 2009, but Deutsche Bank forecasts a front-loaded rebound this year of 2.8%. Mixed signals from other economic indicators point to a relatively slow, long-term recovery. A deflationary period could persist through the next year or two. Meanwhile, real estate capital markets have shown some signs of life again, with J-REITs recently stepping up their purchasing activities. The bulk of bank lending, however, continues to be snapped up by large developers, leaving some small and mid-sized players on the sidelines.

This quarterly review of Japan's property markets begins with the 'First Quarter Market Outlook 2010'. This section explains the latest fundamentals of each property sector and illustrates trends affecting the finance market, transaction volumes, cap rates, returns and leasing markets. It also provides a short-term outlook for each of the major property sectors. A high unemployment rate continues to weigh heavily on performance across Japan's property sectors in spring 2010, with office vacancies rising, retail sales still falling, and incentives for residential renters becoming more common.

The 'Research Topic' section provides a brief analysis each quarter of a topic that is timely and relevant to Japanese real estate markets. This quarter we ask the question, how much of the overall investment portfolio should be allocated to real estate? We work through this question incrementally, first reviewing the obstacles to such analysis (like limited liquidity, for example), then comparing risk/return profiles of asset classes in Japan, and finally applying these risk/return profiles and setting realistic parameters for a constrained optimal allocation. What we discover is that Japanese pension funds invest far less in real estate than optimal allocation suggests they should. The 'Research Topic' concludes by analysing why this misallocation occurs and then speculating as to how it could eventually change.

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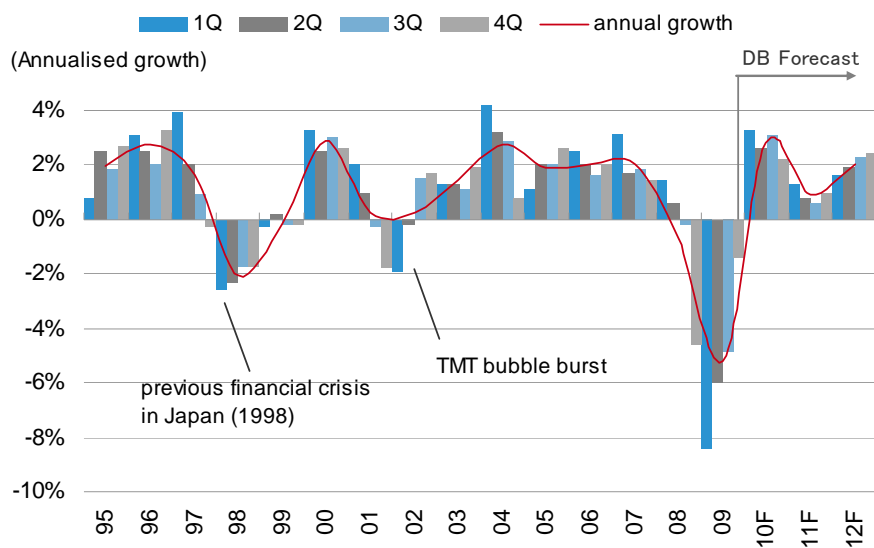
First Quarter 2010 Market Outlook

Macro Economy

After posting an unprecedented steep decline in economic activity in 2009 with a contraction of 5.2%, the growth rate in Japan is expected to turn positive in the first quarter of 2010 due to the contribution of public spending and the increase in external demand.

Deutsche Bank economists expect a rebound of the economy with a 2.8% growth rate in 2010, but followed by a plateau in economic activity in 2011 due to the expected end of the stimulus effect and further uncertainties for the economy given a still high level of unemployment.

Exhibit 1: GDP growth outlook for Japan

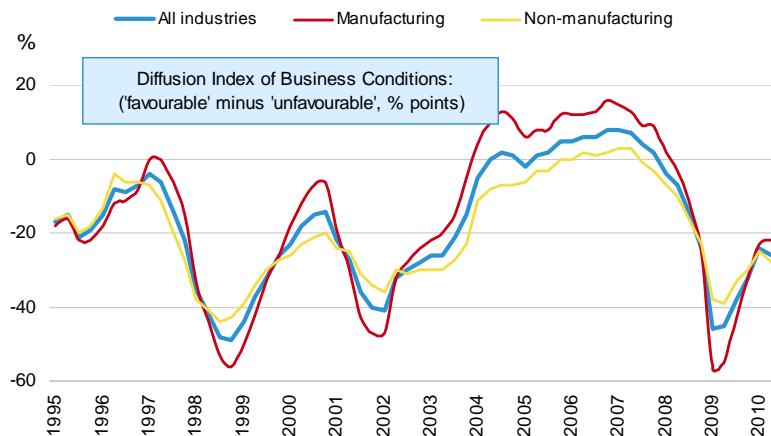


Source: Deutsche Bank, April 2010 (F= forecast by Deutsche Bank economists);

Note: TMT = technology, media, and telecommunications

The Tankan Survey conducted by the Bank of Japan confirmed the trend of gradual improvement in the economy. The diffusion index (DI) of business conditions for all industries made four consecutive quarterly improvements in March 2010, an 8-point gain from the previous quarter or 22-point improvement from a year ago. The outlook for the second quarter, however, is slightly below the current level due to ongoing stagnant demand. Small to mid-sized companies are being adversely affected while larger companies still retain the momentum of recovery because of healthy export demand.

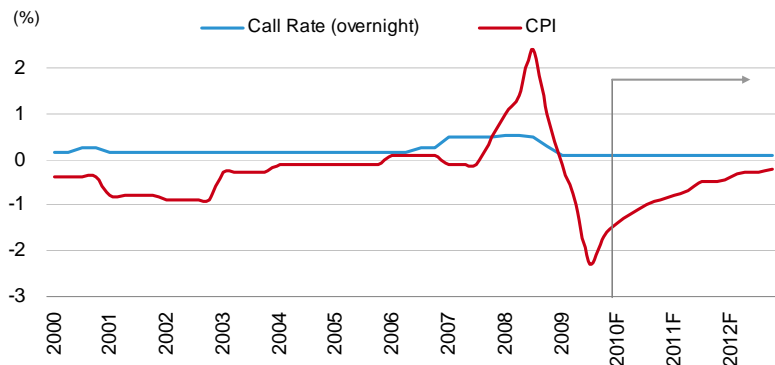
Exhibit 2: Tankan Survey: Diffusion index of business conditions



Source: The Bank of Japan, April 2010

Japan's Consumer Price Index ("CPI") fell rapidly on a year-on-year basis. Consumer prices fell by 2.3% during the third quarter of 2009. It was Japan's worst deflation rate on record and was followed by a negative 1.7% decline for the fourth quarter with a further 1.4% decline expected in the first quarter in 2010. While much of this deflationary trend in 2009 was a negative payback after an earlier surge in international commodity prices, stagnant domestic demand and declining household incomes are now playing key roles in pushing prices further down in 2010, and a mild deflationary period is expected to last into at least 2011. Deutsche Bank economists do not expect any further interest rate cuts in 2010 and onward.

Exhibit 3: Forecast of short-term interest rate and CPI



Source: Deutsche Bank, April 2010 (F = forecast by Deutsche Bank economists)

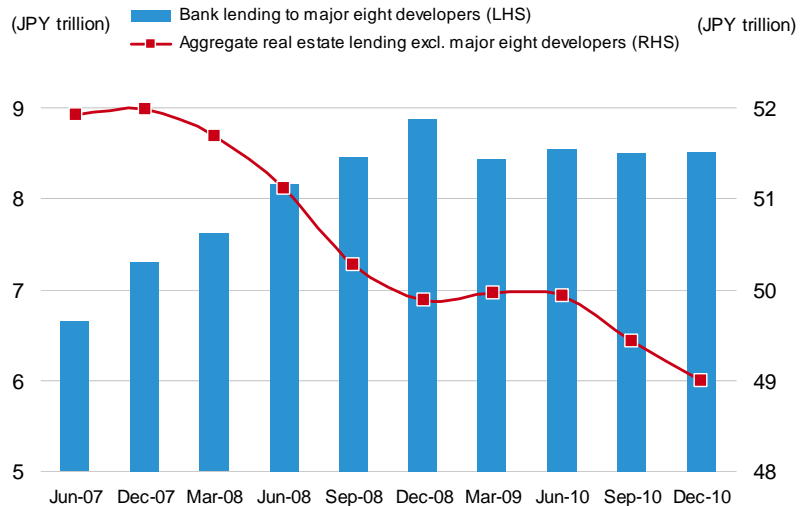
Capital Market and Pricing

The credit market remains relatively tight in Japan. The amount of bank borrowings at Japan's eight major developers¹ remained flat in the last two quarters of 2009, while aggregate bank borrowings among all other developers and managers declined by almost JPY1.0 trillion, or more than US\$10 billion in the same period according to RREEF Research estimates.

¹ The eight major developers in Japan include Mitsubishi Estate, Mitsui Fudosan, Sumitomo Realty & Development, Tokyu Land, Tokyo Tatemono, Nomura Real Estate Development, Mori Building, and Mori Trust.

The CMBS market remains inactive, with new money borrowings (non-recourse loans) still limited to selective transactions, predominantly in central Tokyo. The number of non-recourse loan defaults increased in 2009. Most banks still tend to extend the terms of existing loans rather than trigger defaults at maturity even if equity value is negative, thus limiting sales of distressed assets.

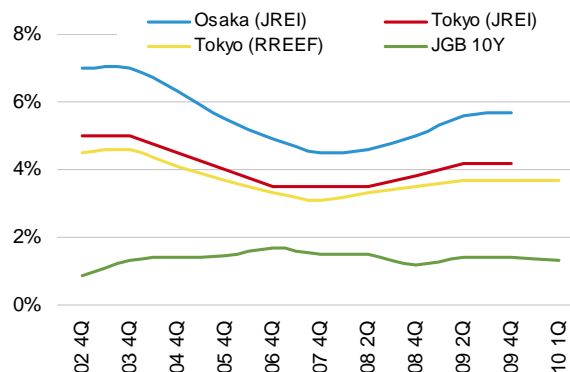
Exhibit 4: Real estate lending by Japanese banks



Source: RREEF Research, The Bank of Japan, Annual Reports, March 2010

According to RREEF Research, cap rates for prime offices in Tokyo's CBD² have stabilised since mid-2009 with corrections still ongoing in lower class assets because of lack of demand and tight credit conditions for these types of assets. This should eventually widen the yield spread between prime assets and lower grade assets.

Exhibit 5: Cap rates and government bond rate



Note: JREI's survey is conducted only semi-annually.

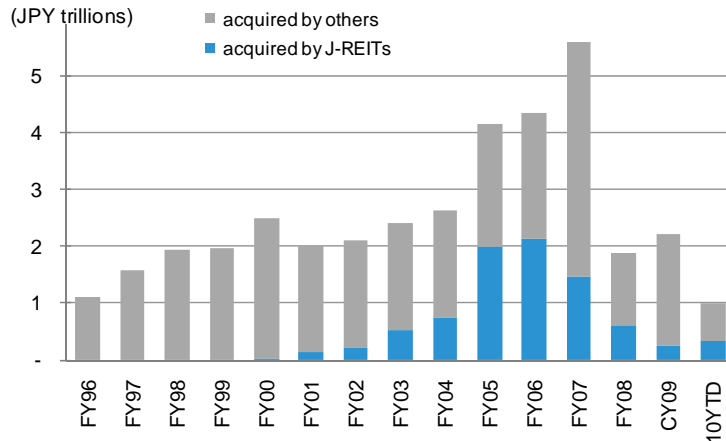
Source: RREEF Research, JREI, Deutsche Bank Global Markets, April 2009

With stagnant sentiment and tight credit conditions prevailing in global real estate investment, the Japanese market is hardly an exception. The volume of identified commercial real estate transactions in the country totalled approximately JPY2 trillion annually in 2008 and 2009, more than a 60% drop

² The CBD is defined as the Marunouchi and Otemachi areas near Tokyo Station in Chiyoda-ku.

from the overall volume reported in 2007. The number of transactions, however, started to increase gradually in the fourth quarter of 2009, fueled by a series of successful public offerings by J-REITs as they started to acquire real estate assets. The volume of assets purchased by J-REITs in 2010 YTD amounted to JPY340 billion by mid April 2010, already exceeding the total volume acquired in the whole year of 2009 (JPY247 billion).

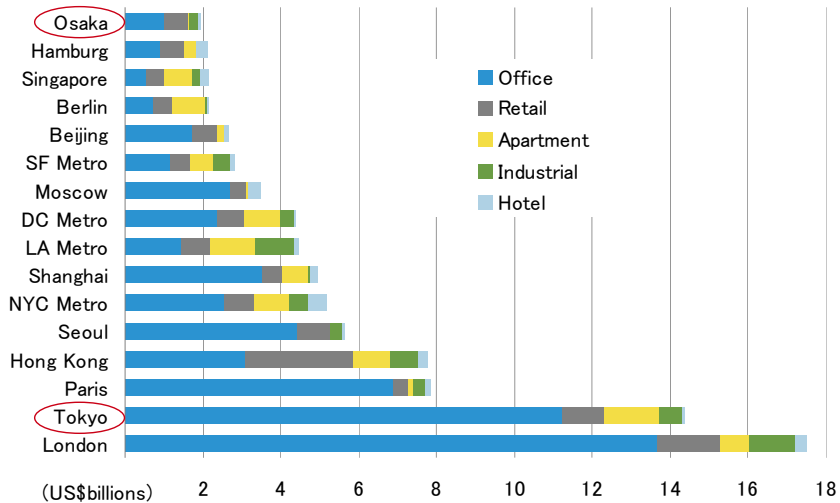
Exhibit 6: Real estate transaction volume in Japan



Note: 10YTD is the preliminary number from January till April 2010. Financial year starts in April and ends in March in Japan.
Source: Real Capital Analytics, Urban Research Institute, Deutsche Securities Inc, RREEF Research, April 2010

Within the global investment market, Tokyo maintained a leading position in terms of the volume of commercial real estate transactions³ closed in 2009. London and Tokyo led all cities worldwide—and by a wide margin—in overall commercial real estate transactions for all property types during the period. Osaka ranked 16th, slightly behind Beijing and Singapore.

Exhibit 7: Commercial real estate transaction volumes by city in 2009*



Note: Commercial real estate transactions exclude non-income producing asset transactions, such as development site transactions
Source: Real Capital Analytics, RREEF Research, April 2010

³ Commercial real estate transactions exclude non-income producing asset deals like development site transactions.

The first four months in 2010 ushered in a number of sizable real estate transactions, most of them related-party transactions including J-REIT purchases from their sponsors. These were predominantly partial office sales in Tokyo which included partial sales of some high profile buildings such as Roppongi Hills and the Tokyo Shiodome Building. In other property sectors such as retail, industrial or hotel, the deals are still limited. Foreign managers and investors remain quiet, except for investments in multi-family residential assets by Chinese investors. The largest deal so far in 2010 YTD is a 50% sale of the Tokyo Shiodome Building acquired by Mori Trust REIT for JPY110 billion (US\$1.2 billion) in April. The highest unit price was a partial sale of Roppongi Hills purchased by Mori Hills REIT at JPY3.1 million per square meter.

Exhibit 8: Major real estate transactions in Japan in YTD 2010

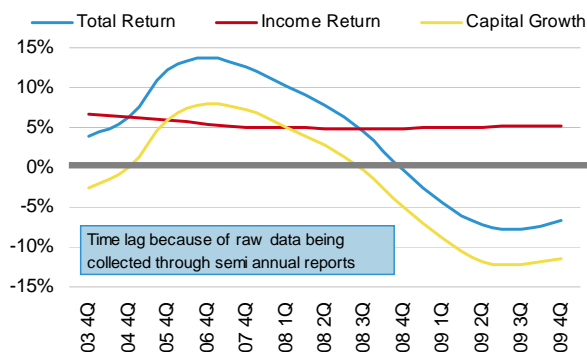
JPY1 billion = US\$11 million

Month	Type	Asset	Price (JPY billion)	Price (JPY m /sqm)	Cap rates	Pre-ecture	Acquired by
Jan-10	Retail	Labi Ikebukuro Main Store	75	3.0	-	Tokyo	Simplex
Jan-10	office	Shiodome Building (30%)	55	1.6	4.6%	Tokyo	Japan Real Estate (REIT)
Feb-10	office	Risona Maruha Building (27%)	42	2.1	-	Tokyo	Nippon Oil
Feb-10	office	GrandTokyo South Tower (12%)	40	2.5	-	Tokyo	Yaesu Investment
Feb-10	office	Tokyo Opera City Bldg (23%)	22	0.4	5.9%	Tokyo	Japan Real Estate (REIT)
Mar-10	Industrial	Sakai Logistics Center North	10	-	6.1%	Osaka	Orix REIT
Mar-10	office	Roppongi Hills (0.7%)	7	3.1	4.1%	Tokyo	Mori Hills REIT
Mar-10	office	Ark Mori Building (0.8%)	3	2.5	4.2%	Tokyo	Mori Hills REIT
Mar-10	office	Aoyama Building	44	1.3	-	Tokyo	Aoyama Property
Mar-10	Hotel	Hilton Niseko Village	6	-	-	Hokkaido	YTL (Malaysia)
Apr-10	office	Aoyama Rise Square	38	1.8	-	Tokyo	Daibiru
Apr-10	office	Tokyo Shiodome Bldg (50%)	110	1.2	4.5%	Tokyo	Mori Trust REIT

Note: This table is prepared solely for information purposes and not intended to recommend or endorse any specific company's shares or other products.
 Source: Real Capital Analytics, Nikkei Real Estate Market, RREEF Research, April 2010

Based on IPD Japan's monthly indicator, the average annual total return for direct real estate investment on an unlevered basis in Japan peaked at 13.8% in 2006 and has since been pulled downward in line with a steep decline in capital value. As 12-month rolling capital growth fell to negative 11.4% in December 2009, the preliminary total return became negative 6.7%, but this was a 1.0 point improvement from 7.7% recorded in September 2009 and it is the first improvement observed since mid-2006. Although capital values are still deteriorating, the speed of decline has slowed. Since the appraisal values of assets seem to have already incorporated the current market correction to a considerable degree, returns are likely to improve gradually in 2010.

Exhibit 9: Return of unlevered direct investment (all types of property)



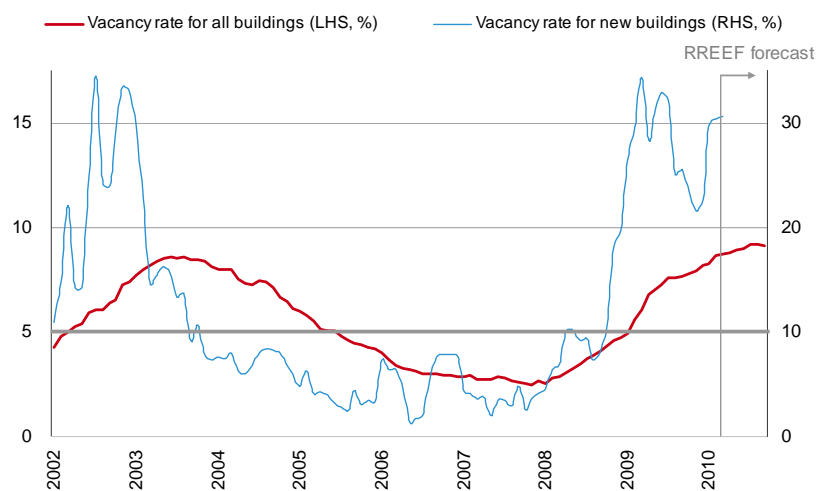
Source: RREEF Research based on IPD Japan Monthly Indicator, April 2010

Market Fundamentals: Office

Because of the sluggish economy, the office vacancy rate in Central Tokyo⁴ is still increasing. Office vacancy rates rose to 8.8% in March 2010 from 8.1% at the end of 2009, or from 2.7% at the end of 2007. It exceeded the previous peak recorded during “The Year 2003 Problem” when supply surged.

The vacancy rate for newly developed buildings (blue in Exhibit 10) reached 30% again in February and March 2010. Historically the vacancy rate for overall buildings has followed the trend of the newly developed building vacancy rate with a time lag. Therefore the overall office vacancy in Tokyo is expected to increase a little further, to be followed by a slow and gradual recovery starting in late 2010.

Exhibit 10: Office vacancy rate in Central Tokyo (5 wards)



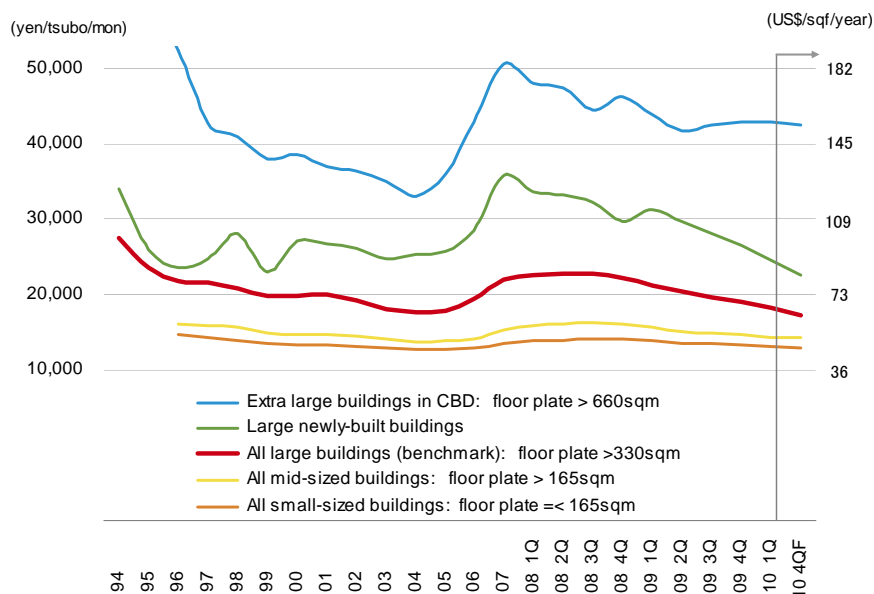
Source: RREEF Research, Miki Shoji, April 2010 (Forecast by RREEF Research)

Following a rapid increase in asking rents that peaked in 2007, office rents have been declining sharply (Exhibit 11). The average asking rents for large-scale newly built offices—the market niche most volatile and vulnerable to the recession—have dropped by as much as 31% to date since the peak in 2007. Average asking rents for all large buildings (i.e. the benchmark) in Central Tokyo have dropped 20% from peak as of the end of March 2010. On the other hand, average asking rents for extra large buildings in the CBD have leveled off since the third quarter of 2009.

While it is asking rents that are reported in statistics, it is important to differentiate asking and effective rental trends. Tenants tend to receive discounts and/or several months of free rent when signing new rental contracts, especially in newly developed buildings. These incentives are typically negotiated privately, and are therefore not reflected in the statistics. Given the high vacancy rate, we do not expect a rental recovery for benchmark buildings before 2011 although the speed of decline is expected to slow down in 2010. Rents for prime buildings could start to recover in 2010—earlier than the benchmark.

⁴ Central Tokyo is defined here as the central five wards (or “ku”) of Chiyoda, Chuo, Minato, Shinjuku, and Shibuya.

Exhibit 11: Office asking rents in Central Tokyo by building size

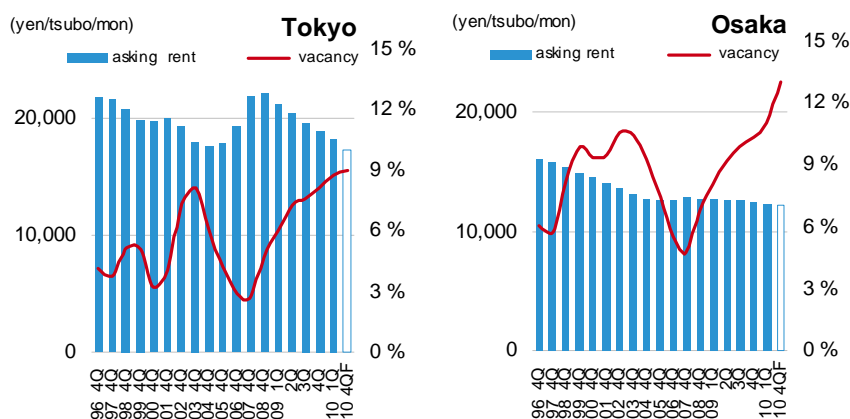


Note: 1 tsubo = 3.3 sqm or 35.6 sf

Source: RREEF Research, Miki Shoji, Sanko Estate, (F = forecast by RREEF Research), April 2010

Unlike the Tokyo market, office rents have been relatively stable in regional cities despite their higher vacancy rates. The office vacancy rate in Osaka rose to 11.0% in March 2010 from 10.3% in December 2009 while the average asking rent fell only 0.8% during the period compared to a 3.8% drop for benchmark office rents in Tokyo in the same period. Given the ongoing downward momentum in the regional economy and multiple large-scale redevelopment projects to be completed in 2011 and onward, the office leasing market in Osaka is expected to remain soft in the medium term.

Exhibit 12: Office rents and vacancies in Tokyo and Osaka

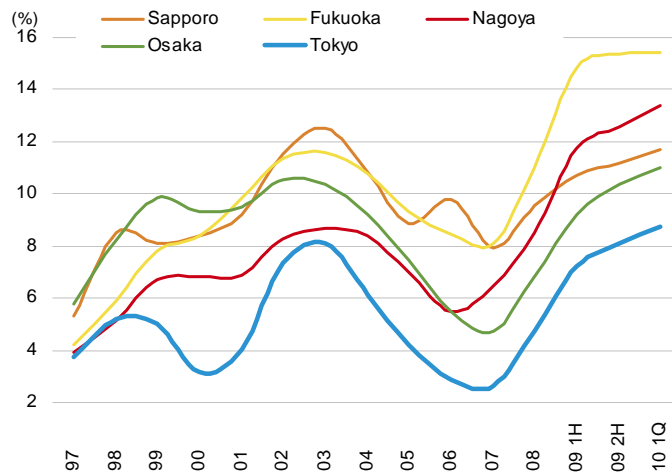


Note: 1 tsubo = 3.3 sqm or 35.6 sf

Source: RREEF Research, Miki Shoji (F = forecast by RREEF Research), April 2010

The vacancy rates in other second tier cities have risen past 10%. In March 2010 the office vacancy rate rose to 15.4% in Fukuoka, 11.7% in Sapporo, and 13.4% in Nagoya. Demand is still weakening in these regional markets, and the vacant space is not likely to be absorbed in the near future.

Exhibit 13: Office vacancy rates in major cities in Japan (all grades)

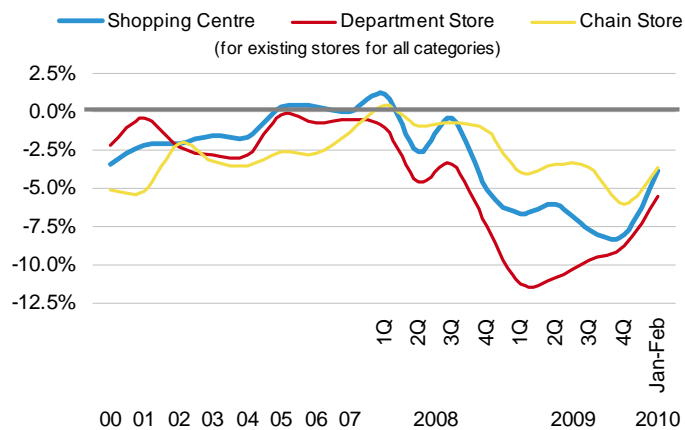


Source: RREEF Research, Miki Shoji, April 2010

Market Fundamentals: Retail

Economic turmoil and job cuts in the past several quarters have further eroded consumer demand in Japan. Sales at Japanese department stores in January and February 2010 (existing store basis) fell 5.6% from the same period last year, but the speed of deterioration has been slowing for almost four consecutive quarters. Sales at shopping centres (existing store basis) declined 3.9% while chain stores (existing store basis) declined 3.7% respectively in the same period.

Exhibit 14: Retail sales in Japan (year on year % growth)

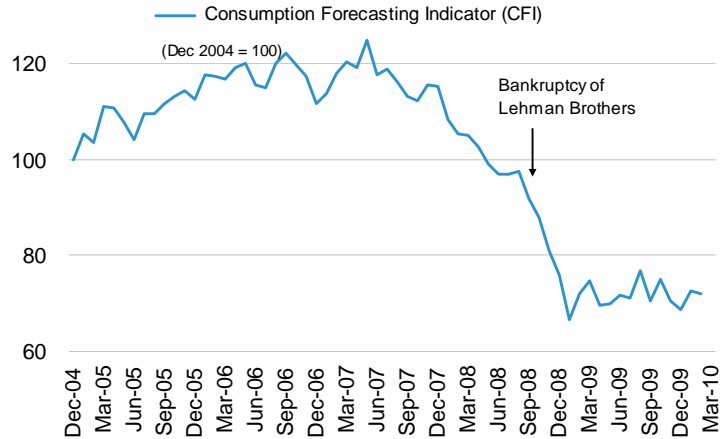


Source: RREEF Research, JCSC, JDSA, JCSA, April 2010

Nikkei RIM's consumption forecasting indicator (CFI)⁵, a survey that predicts future consumption trends six months in advance, also shows stagnant demand. In February 2010 CFI was 72, still significantly lower than the CFI of 92 which was recorded in September 2008 when Lehman Brothers went bankrupt. Given the ongoing harsh employment situation we expect it will take a while until consumer confidence recovers.

⁵ The CFI is based on a weighted monthly survey of up to 600 working-age adults (age 20 to 69) in the Tokyo metropolitan area.

Exhibit 15: Consumption forecasting indicator

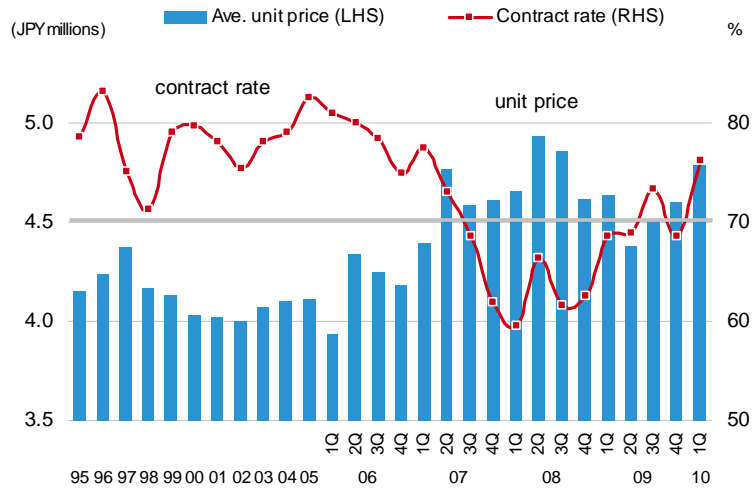


Source: Nikkei RIM, April 2010

Market Fundamentals: Residential

The Japanese built-for-sale condominium (condo) market hit the bottom in 2008 when the condo contract rate⁶ (red in Exhibit 16) was approximately 60%. The contract rate has been gradually improving since then for almost two years, and it reached 80% in March 2010 for the first time in 36 months. The average sales price has also increased in the last three quarters, due to small to mid-sized residential developers have difficulties in borrowing money to purchase new development lands, the overall supply pipeline is still limited and the sales market share of large developers is increasing.

Exhibit 16: Condominium unit price and contract rate in Greater Tokyo



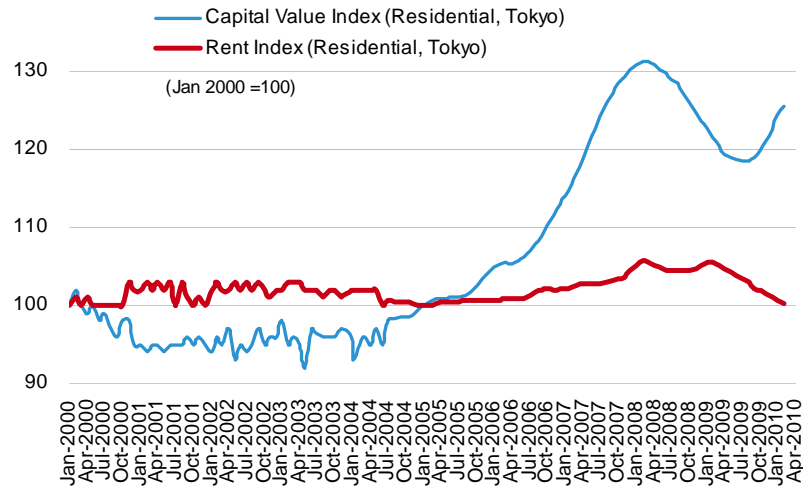
Source: RREEF Research based on REEI, April 2010

⁶ The contract rate is the ratio of units contracted to the inventory of units for sale.

The capital value index of existing condos (i.e., the re-sale price index) began to soften in April 2008 and it fell by 9.7% before hitting bottom in August 2009. Signs of recovery appeared in September 2009 with gradual price recoveries reported in the last six months.

Residential rents, which tend to remain relatively stable⁷, started to weaken in 2009 and have declined by 5.2% from the previous peak to date. Privately granting new tenants a free rent period for a month or two for new tenants is becoming a popular incentive, although it is not reflected in the statistics.

Exhibit 17: Residential capital value and rent index in Tokyo



Source: IPD RECRUIT Residential Index, RREEF Research, April 2010

An uptick in the amount of take-up in the residential leasing market in Greater Tokyo in the second quarter of 2009 initially raised hopes, but new demand proved fleeting. Take-up began declining again by summer 2009, with contractions of about 8% to 9% from levels a year ago. This reflects the ongoing slow recovery of the unemployment rate and indicates further gradual softening in the residential leasing market in 2010.

⁷ This relative stability for residential rents exists because without legitimate reasons, the landlord can neither reject the leasing contract renewal nor significantly increase existing in-place rents even when the market is tight

Research Topic: Portfolio Optimisation Analysis in Japan

Each edition of Japan Quarterly provides the latest overview of Japanese real estate markets across all the major property types, but one question often lingers un-resolved: How much of the overall investment portfolio should be allocated to real estate? This quarter's 'Research Topic' tackles the issue of optimal allocation in Japan by applying modern portfolio theory to real estate investment⁸.

No serious study of this topic can begin without first outlining the shortcomings of portfolio theory's practical application to real estate. We call these shortcomings the three Ls:

Liquidity. Direct real estate lacks the instant liquidity of equities and bonds, thus placing some practical limits on performance comparisons.

Leverage. Direct real estate indices are always collected and constructed on an unlevered basis even though most direct real estate investments are likely to carry some degree of debt financing.

Longevity. J-REITs were introduced into Japan only in 2001, and the data trail necessary to construct an adequate comparison of all relevant investment types extends back only to 2003. This leaves us with only seven years of data, less than we would prefer, but enough to provide a cursory attempt at portfolio analysis.

To simplify the analysis, we assume a portfolio focused solely on national asset classes, thereby minimising external exposure to global markets. As Exhibit 18 shows, correlations of total returns across asset classes in Japan show direct real estate's relatively low correlations with equities as well as with bonds. In contrast, listed real estate⁹ correlates strongly with equities. The same patterns appear in cross-correlations of US asset classes.

Exhibit 18: Return cross-correlations among asset classes in Japan and in the US

Japan					
	Listed RE	Direct RE	Govt Bonds	Equities	3m T bills
Listed RE	1.00				
Direct RE	0.27	1.00			
Govt Bonds	-0.22	-0.13	1.00		
Equities	0.68	0.23	-0.59	1.00	
3m T bills	-0.60	-0.29	0.35	-0.58	1.00

US					
	Listed RE	Direct RE	Govt Bonds	Equities	3m T bills
Listed RE	1.00				
Direct RE	0.29	1.00			
Govt Bonds	-0.23	-0.09	1.00		
Equities	0.81	0.30	-0.44	1.00	
3m T bills	-0.06	0.64	0.17	-0.04	1.00

Note: based on historical return data between 2Q 2003 and 4Q 2009.

Source: RREEF Research based on data from Datastream and IPD Japan, April 2010

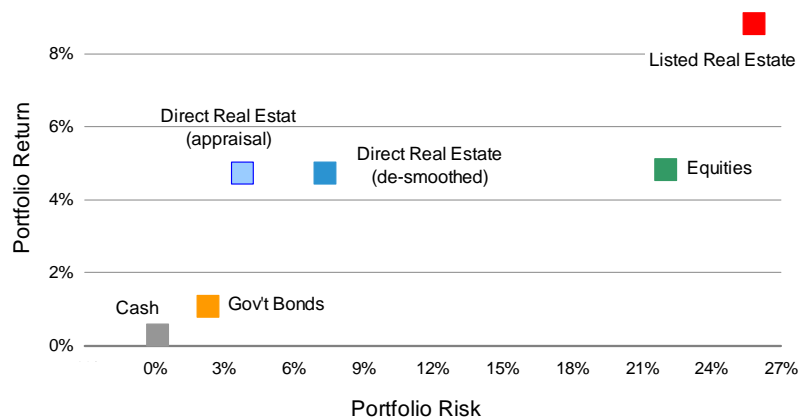
⁸ Applying the theory to real estate investment was done by J. Webb, R. Curcio and J. Rubens in "DIVERSIFICATION GAINS FROM INCLUDING REAL ESTATE IN MIXED-ASSET PORTFOLIOS" in 1988 and by others including Zebrowski (1999) and Sing & Ong (2000).

⁹ Listed real estate is defined as RREEF Research's original index for listed real estate in Japan, which includes listed J-REITs as well as selected listed developers.

Exhibit 19 shows annualised average total returns and risks for each asset class in Japan. Direct real estate has historically produced a high average annual return while the risk is relatively low for the time period analysed. For comparison purposes, direct real estate can be analysed in two ways: smoothed (based on appraisal values) and de-smoothed (based on transaction values).¹⁰ The total return for de-smoothed direct real estate investment averaged 4.7%¹¹ on an unlevered basis, while the portfolio risk was only 7.4%, compared to 22.1% for equities during the same period.

Exhibit 19 also shows high volatility for equities and listed real estate returns (the latter include both listed J-REITs and selected listed developers). Even though the J-REIT regime was originally designed and launched as a “middle-risk, middle-return” investment product, the risk still edged out equities in volatility over the measurement period. At least two factors contribute to this: First, the J-REIT market size remains relatively small, and second, the bankruptcy of New City Residence Investment Corporation (J-REIT) in October 2008 revealed underlying systemic risk. RREEF Research first addressed the need for J-REIT reform in 2008¹², and this was followed in 2009 with a slate of reforms, including consolidations among J-REITs and the launch of the Real Estate Market Stabilisation Fund designed to rescue REITs. With reforms and gradually restored financial stability, we expect past J-REIT volatility to moderate over time.

Exhibit 19: Annualised returns and risks for asset classes in Japan



Note: Risks and returns are both annualised average between 2Q 2003 and 4Q 2009.
Source: RREEF Research based on data from Datastream and IPD Japan, April 2010

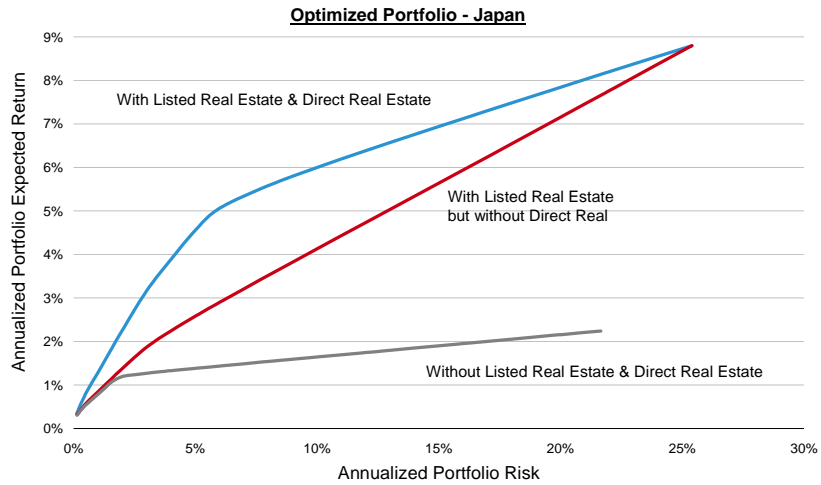
Exhibit 20 contrasts the efficient frontiers of three portfolios of Japanese investments, one that *includes* both listed and direct real estate (blue), another one that *includes* listed real estate but *excludes* direct real estate (red), and finally the one that *excludes* both direct and listed real estate (grey). A portfolio that includes direct real estate (blue) can enhance the performance significantly compared to the ones without it while a portfolio with listed real estate but without direct real estate (red) still performs better than the one without either asset class included (grey). Excess return of direct real estate is more significant when the portfolio risk is low, while excess return of listed real estate is more significant when the risk is high.

¹⁰ Direct real estate indices use appraisal-based capital values which tend to smooth risk effects. De-smoothed indices, which reflect actual market transactions, avoid these smoothing effects.

¹¹ Direct real estate returns are calculated after cost deductions such as depreciation and management fees from the gross returns.

¹² RREEF Research, “Research Topic: Revitalisation of Ailing J-REITs,” *Japan Quarterly* 4Q 2008, December 2008.

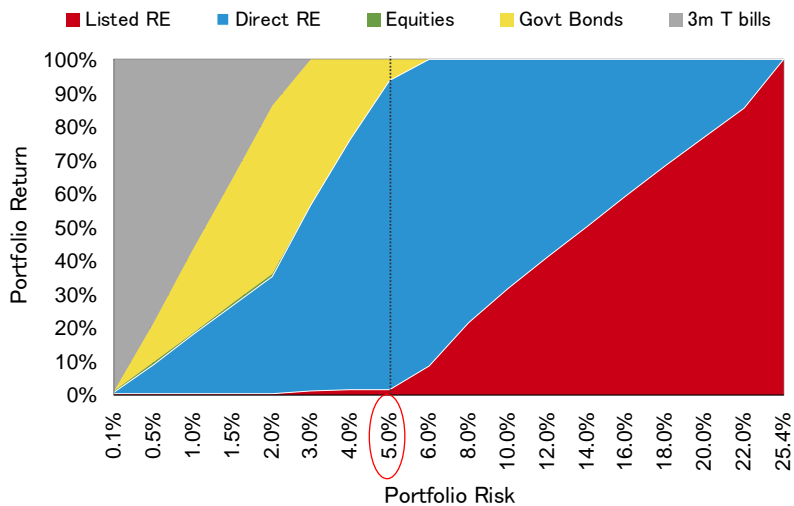
Exhibit 20: Efficient frontiers for assets in Japan



Note: Risks and returns are both annualised average between 2Q 2003 and 4Q 2009.
Source: RREEF Research, April 2010

Building on the correlations, risk-return curves, and efficient frontiers introduced in Exhibits 18, 19, and 20, it is possible to construct a theoretical optimal asset allocation for illustrative purposes. Exhibit 21 shows how such an unconstrained allocation model would look at incremental levels of risk tolerance. As risk approaches 5.0% under an unconstrained allocation, 92% of portfolio assets would shift to *direct* real estate (blue), reflecting relatively high returns and low volatility of direct real estate performance. As the risk increases beyond 5.0%, the allocation to *listed* real estate (red) increases until the allocation reaches 100%, reflecting the combination of high returns and high volatility of the asset class.

Exhibit 21: Optimised unconstrained asset allocation in Japan



Note: based on historical return data between 2Q 2003 and 4Q 2009.
Source: RREEF Research, April 2010

The unconstrained portfolio analysis of Exhibit 21, however, ignores the underlying weaknesses of both direct and listed real estate investments, primarily low liquidity for the former and the limited sizes of the transacted market for both.

Exhibit 22 attempts to rectify these issues with an optimal constrained

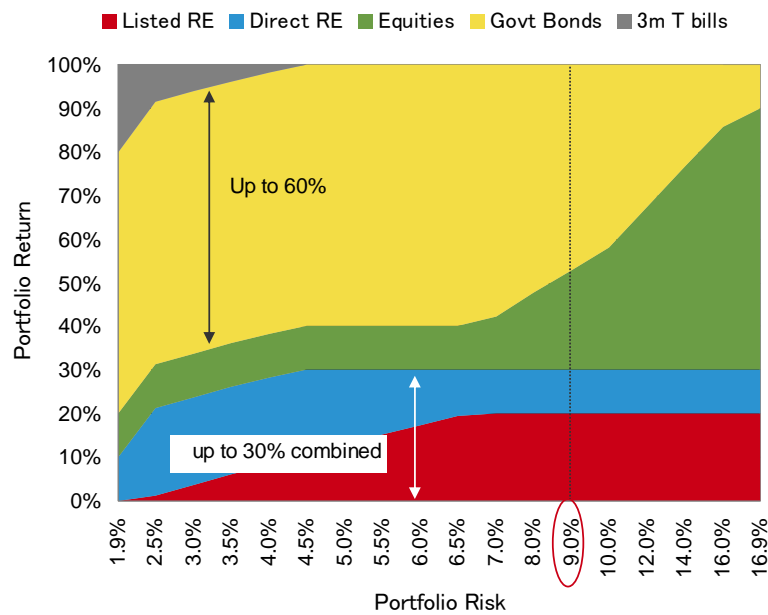
allocation by capping real estate allocation (both direct and listed combined) at a maximum of 30% of the portfolio in order to account for the relatively small market sizes¹³. For the most risk averse end of the spectrum, it imposes maximum allocations to cash (20%) and bonds (60%) if risk tolerance falls below 1.9%. These allocations would be lowered gradually as risk tolerance increases. For the most risk tolerant investors, a maximum allocation would be applied to equities (60%) if the portfolio risk rises beyond a risk level of 16.9%. Again, the allocation should be lowered gradually as portfolio risk decreases. A maximum allocation for real estate (direct and listed combined, 30%) would be applied along the risk spectrum at 4.5% or higher because of favourable risk/return profiles of these asset classes.

Exhibit 22: Optimised constrained asset allocation in Japan

Constraints (see foot note 11)

	Listed RE	Direct RE	Govt Bonds	Equities	3m T bills
Min Allocation	0%	0%	10%	10%	0%
Max Allocation	20%	20%	60%	60%	20%
	30% combined*				

*Maximum allocation to Listed RE and Direct RE combined is 30%



Note: based on historical return data between 2Q 2003 and 4Q 2009.
Source: RREEF Research, April 2010

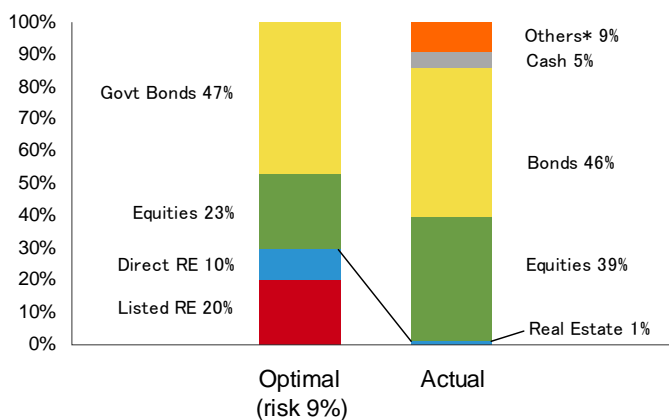
Exhibit 23 shows the difference between constrained optimal allocation (when the portfolio risk is 9%¹⁴) and the average actual asset allocations taken by private pension funds in Japan in FY2008¹⁵.

In spite of the optimal constrained portfolio indicating the maximum amount to be allocated to real estate (listed and direct combined, 30%), the actual average real estate allocation by Japanese private pension funds is only

¹³ Compared to the market capitalisation of JPY 330 trillion for the listed equity market in Tokyo and the government bond market of JPY 694 trillion at the end of March 2010, the market caps of J-REIT and listed developers were only JPY 2.9 trillion and JPY 4.4 trillion respectively. The AuM size of private real estate funds was JPY 14 trillion in the second half of 2009,
¹⁴ 9% is the average risk guideline for balanced asset management of pensions proposed by five trust banks in Japan in 2010.
¹⁵ Based on a questionnaire survey conducted by the Pension Fund Association in FY2008.

1%¹⁶, reflecting strong aversion to real estate by pension funds.

Exhibit 23: Comparison of optimal and actual pension's allocation in Japan



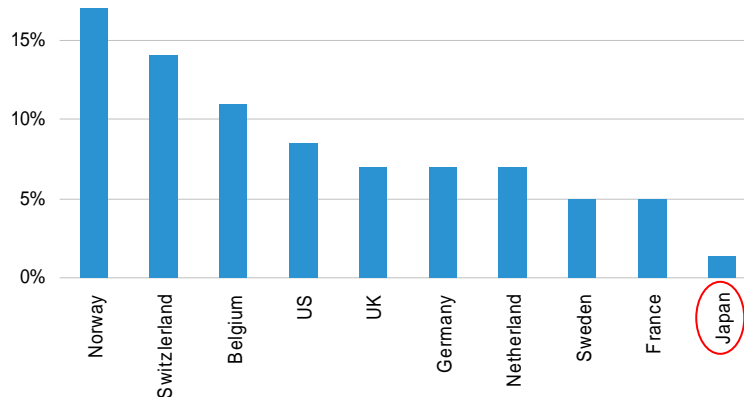
Note: Others* include hedge funds, private equities and commodities.

Source: Newsletter on Pensions & Investment, Pension Fund Association, RREEF Research, April 2010

In comparison with peer countries Japanese pension funds demonstrate less enthusiasm for real estate than their Western counterparts. In many Western countries, pension funds allocate around 7% of portfolios to real estate (direct and listed) compared to just 1.3% in Japan in 2009, according to a survey conducted by the Association for Real Estate Securitization (ARES). (See Exhibit 24.)

The demise of Japan's bubble economy in the early 90s may explain part of the aversion to real estate, since it has led indirectly to a lack of in-house resources. After two decades of withdrawal from real estate investment, the majority of pension funds now lack the experienced personnel internally to manage investments in this asset class. Furthermore, the construction of direct real estate indices for the Japanese market is relatively new. Without reliable datasets across multiple business cycles, Japanese investors are less likely to be enticed by the merits of direct real estate allocation, regardless of how appealing optimal portfolio allocation analysis may sound.

Exhibit 24: Actual allocations to real estate by pensions in selected countries

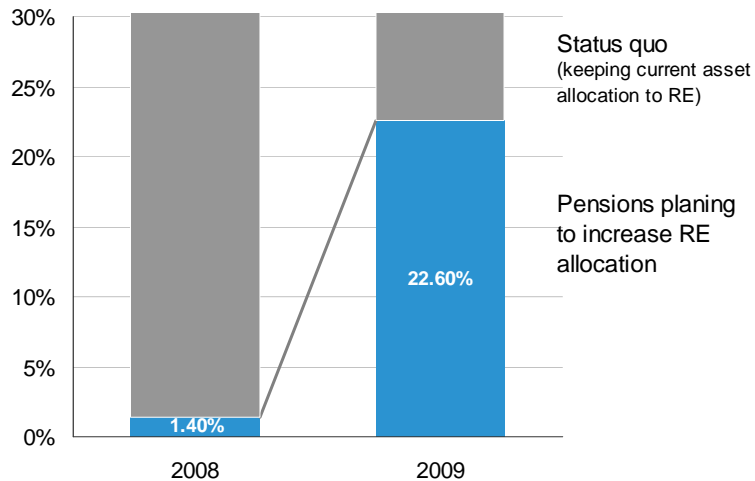


Source: RREEF Research based on Mercer; ARES; IREI/Kinglsey Associates; 2009

¹⁶ This includes both direct and listed real estate.

A survey conducted by STB Research Institute in 2009, however, indicates a growing appetite in real estate investment among pensions (see Exhibit 25). Besides having a historically favourable risk/return profile, real estate has gathered momentum among an increasing number of the pension funds that believe the price of real estate has become more attractive after the current price correction.

Exhibit 25: Changes in real estate investment appetite among pension funds



Source: RREEF Research based on STB Research Institute, 2009

Portfolio allocation theory is, as its name implies, merely theory. Theoretical allocation models cannot be applied to real estate investments without addressing practical implications such as liquidity, leverage, the existence of reliable multi-cycle indices, and the possibility of external exposure to global markets. This is why our initial unconstrained analysis showed heavy allocations to direct real estate at a relatively low risk level. By adding practical parameters, a more constrained analysis still suggested significant real estate allocations across the risk spectrum. The constrained portfolio analysis suggests that one might expect Japanese allocations to be similar to those of Western countries. Cross-correlations of returns also suggest comparable return patterns with U.S. investments.

The reality, however, is that Japanese pension allocations fall well below their Western peers. As noted, we attribute this in part to a lack of in-house real estate expertise in the post-bubble environment of the past two decades. Relatively short real estate indices in Japan contribute to this trend as well. Despite all this evidence, however, much of the underlying reason may well be psychological. Many of today's investors came of age before or during the collapse of the Japanese economic bubble in the early 1990s, and the trauma of that experience still lingers, no matter how convincing the risk/return data may appear. On the other hand, these memories at some point will begin to fade. For now, it is becoming evident that an increasing number of pension funds are more interested in real estate than they were before the market correction, and the tide is expected to change gradually in 2010 and 2011.

Appendix: Previous Research Topics Covered in This Publication

Vol	Year	Publication		Research Topic
1	2008	Second Quarter	Jun-08	Making sense of the rental market in Japan
2		Third Quarter	Sep-09	Impact of the credit crunch
3		Fourth Quarter	Dec-08	Revitalisation of ailing J-REITs
4	2009	First Quarter	Mar-09	Tokyo office market in its global context
5		Second Quarter	Jul-09	Japan residential market
6		Third Quarter	Oct-09	History repeats itself? A comparison of the 'year 2003 problem' with 2009
7		Fourth Quarter	Jan-10	Introducing unit pricing analysis in Japan
8	2010	First Quarter	Apr-10	Portfolio optimisation analysis in Japan

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