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The Road to Recovery - Paved with Opportunities: Why Industrial Real Estate Now?

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Introduction

Although the industrial property sector in the US has long been established as an institutional asset class by real estate investors, it ranks among the least researched property sectors. It has also been viewed as the least “glamorous” of the core property sectors, rarely winning design awards or featured on the covers of prominent architectural magazines.¹ The merits of industrial real estate as an investment have thus been largely underreported and appreciated despite the fact that it represents a sizeable share of both private and public real estate equity investments. The purpose of this report is to provide empirical support to the case for investing in industrial properties. The key findings below are followed by a discussion of what constitutes industrial real estate, including a list of long-term stylized facts that characterize the sector. This is followed by an analysis of the characteristics of industrial return performance with a comparison to alternative property sectors. The next section focuses on the difference in performance characteristics and trends of public and private industrial real estate. This is then followed by a review of industrial space demand drivers and the outlook for key macroeconomic variables that are correlated with industrial assets. This analysis is further disaggregated across the primary industrial sub-types and geographical regions. Implications for real estate investors and implications for an industrial strategy conclude the report.

Key Findings

Industrial real estate supports the broad array of necessary activities that we require to live our daily lives. This connection to everyday utility gives it long-term value and relative stability among investment types. Some industrial uses, however, are or will become obsolete, so choosing the right properties in the right places is imperative for success.

There is no simple methodology for developing industrial real estate investment strategy. However, real estate fundamentals data and investment returns data have improved during the past two decades and this allows for a more in-depth view into historical and expected performance compared to the past. The simple universal truths of real estate investing still apply – good functional assets in core locations with capable management tend to outperform – but now we can better support up that assertion. The purpose of this report is to provide empirical support to the case for investing in industrial properties today.

The NCREIF property index (NPI) historical data confirm that during the past 15 years the industrial sector total returns of 9.2 percent, were higher than the apartment, retail and office sectors in absolute terms and trailed only retail on a risk-adjusted basis. This time frame is a good historical indicator of relative long-term performance, as it contains an equal number of economic up-cycle and down-cycle periods, the collection and dissemination of real estate data was relatively unevolved prior to the mid-1990s, and relatively small property counts in NPI prior to the mid-1990's limit definitive conclusions on a metro basis in prior periods.

Investors can continue to achieve favorable returns by including industrial properties as a key component in their long-term investment strategies. While the most recent downcycle has

¹ Lendlease Real Estate Investments Commentary, No. 5, 2002

been devastating to real estate returns, the industrial sector included, recent pricing indices support the view that a market bottom has formed. Cyclical recovery and projected growth patterns still point to the wisdom of direct industrial property investment.

The outlook for US industrial real estate depends largely upon the well-being of the national and global economies. The property market convulsions caused by the extraordinarily distressed economic environment of the past few years have eased and market fundamentals are beginning to reflect this nascent recovery. We expect modest positive industrial space demand in the second half of 2010 and vacancy to ease slowly from its mid-year 2010 peak.

Global trade and changing US transportation infrastructure are arguably the most important drivers of national industrial space demand and are key economic pillars in many markets with large manufacturing components. The near- and long-term implications of trade growth and changing gateways directly impact our views about industrial property market selection. Favorable trends should further enhance the desirability of Global Gateway markets and potentially improve the prospects of markets that have traditionally been average performers.

Public and private real estate investments have a place as a prominent alternative to stocks and bonds. Varying performance characteristics between direct property investments and publicly traded Real Estate Investment Trust (REITs) reveal that the REITs exhibited greater volatility and lower risk-adjusted returns compared to the NPI, particularly in the industrial components of each. Leverage in NAREIT components and appraisal smoothing in the NPI play rolls in this and make for an imperfect comparison, but the results are compelling.

Market and asset selection strategies should reflect the realities of a slower-growth US economic environment in the next cycle. Beyond the growth component, supply constraint drives rent and return performance for core properties. High barrier markets, those where land supply constraints limit development, broadly outperform on a fundamentals and returns basis. Historical NPI returns indicate that high barrier markets consistently produce higher total returns than low barrier markets in all time periods measured.

What Constitutes Industrial Real Estate?

Institutional investors largely view the industrial sector as warehouse properties, but user profiles within the broader industrial sector are varied, perhaps more so than other types of real estate. Industrial real estate is anchored first in land and as a place with access to physical infrastructure and economic activity. Physical improvements added to the land complete the industrial property, but the ultimate value of those improvements lie in the ability of the site and building to meet the needs of potential users. Whether individual buildings located at the edge of small metropolitan areas or vast industrial parks in core locations of larger ones, they are designed to support the broad array of necessary activities that we now require to live our daily lives. This connection to everyday utility gives industrial real estate long-term value and in the past decades, relative stability among property types. The potential loss of this connection is an underlying risk.

NCREIF classifies industrial properties into six types – Warehouse (Whse), Flex, Manufacturing (Mfg), Research and Development (R&D), Office Showroom (OS), and Other/Special Purpose, several of which have smaller more specific segments. For the purposes of this report and to align more closely with a well accepted market data sources, we have consolidated industrial real estate into three general types, Warehouse/Distribution, R&D/Office-Service and Flex/Mfg/Light Industrial. These classifications are grouped primarily according to common use, physical design and improvement levels, which provide like-kind development costs, land requirements and demand drivers. Exhibit 1 on the following page outlines each type and its respective common characteristics.

**Exhibit 1
Characteristics of Industrial Properties**

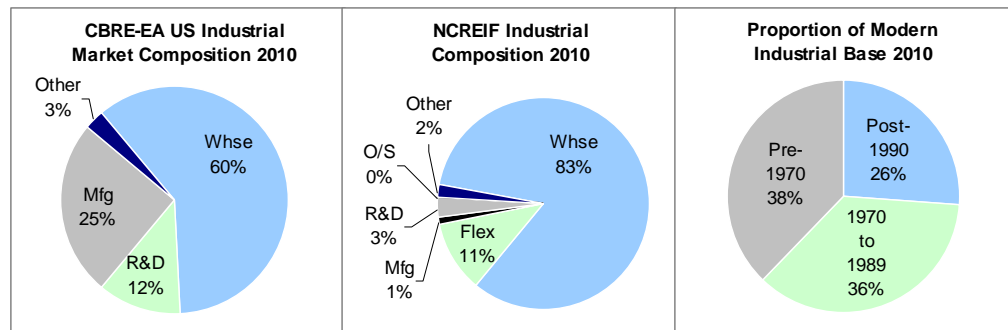
	Warehouse/Distribution	R&D/Office-Service	Flex/Mfg./Lt. Industrial
Uses	Storage, logistics services, sorting and packaging of finished goods. Some assembly, office and/or showroom components. Can be single or multi-tenant designed.	Higher improvement levels consisting of office, lab, assembly, server and/or other improvements that allow for value-add processes; some storage/shipping space.	Flexible buildouts that accommodate a mix of heavy and light manufacturing, assembly, storage, showroom and office; less labor intensive than R&D/Office-Service.
Key Types	Large-Bay Bulk Warehouse	R&D Mfg/Lab, Headquarters	Single Tenant Flex
	Mid-Bay Multi-Tenant	R&D Office Single & Multi-tenant	Multi-tenant Flex
	Shallow-Bay Multi-tenant	Incubator/Business Park (Office)	Manufacturing
	Air Freight/Truck Terminal		Incubator/Business Parks (Ind.)
Location Criteria	Efficient access to transportation infrastructure; highways, interstates, ports, airports, rail and intermodal hub facilities as well as large population and job centers.	Proximate to research universities, worker and executive housing and well-educated labor force. Markets containing multiple industry clusters and linkages to global markets a plus.	Highway and major roadway access, park location desirable. Proximate to worker housing and client industry clusters.
Parking/Site Requirements	Typical coverage 0.4 to 0.5, with parking of 1 - 2 spaces per 1,000 sq. ft., secure yard and/or secure ring road for large facilities. Trailer parking and rail spurs can be plus.	Parking ratio of 3.5 to 5 spaces per 1,000 sq. ft. Effective site coverage (FAR) of less than .35. More extensive landscaping and security potentially important	Can have site coverage between 0.3 and 0.4 FAR and parking ratios can range from 2.0 to 3.5 spaces per 1,000 sq. ft.
Building Height	One story with 22' to 32' clear height and some as high as 36'. Clear height standards lower for smaller shallow-bay buildings.	One and two story with 14' to 18' ceiling height, but higher in cases to accommodate specialized systems.	Mixed depending on type and processes - 12' with dropped ceilings in office up to 22' ceiling height in warehouse areas.
Building Design	Typically less than 15% office. Column Spacing of 48' - 52'. Flat 6" thick concrete floors, advanced lighting and fire sprinkler protection. Windowed ground and/or mezzanine office space	Higher image with project amenities and more window line (75% of perimeter). Potentially specialized rooms and building systems and security.	Typically 15% to 50% office finish, window line 35% to 50% of perimeter. Heavier power and floor load capacity. Security and sinage potential. Flexible for light assembly and heavy manufacturing.
Truck Loading	120 to 150 feet of space in front of docks and ramps with no more than 5% slope.	Less important than for warehouse and flex.	Separate truck and car parking.
Truck Docks/Bays	Dock-high doors 4' above ground measuring 10' high and 9' to 10' wide. Drive-in bays 10' wide and 12' to 14' high. Cross-dock desirable	Fewer doors than flex and warehouse but grade level doors common. Dock high loading generally not needed.	Mix of drive-in and grade level doors (8'x10' or 9'x10') and Dock doors

Source: NCREIF and RREEF Research

National Industrial Market Composition

We define the US industrial market as both leased and user-owned industrial property comprising more than 13.2 billion square feet in 52 metropolitan markets as tracked by CBRE-EA. Within this base approximately 60 percent is classified as warehouse/distribution, 25 percent as manufacturing and 15 percent as R&D and Other/Special Purpose. The industrial component of NCREIF, by comparison, is largely warehouse and flex. Between these two sources, space type definitions are not consistent, particularly as it pertains to the difference between Flex, Manufacturing and Warehouse. The exhibits below highlight the relative size of the primary space types, the composition of the industrial component of (NCREIF Property Index) NPI and the approximate age of stock in the national market. Of particular note is that only 26 percent of current industrial stock is modern, stock with class A functionality.

Exhibit 2
Industrial Market Composition



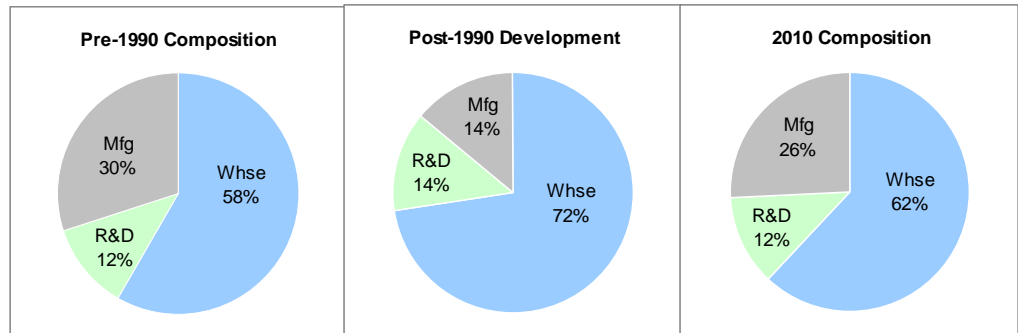
Source: CBRE-EA, NCREIF and RREEF Research

The universe of industrial property is large and diverse, but only a small portion is accessible to institutional investors as much of it lies in specialized corporate-owned facilities and older, functionally obsolete buildings that are more suitable for small operators or local investors. The broad market contains space ranging in size and quality from Boeing-owned, state-of-the-art multi-million square-foot aircraft manufacturing facilities in Seattle, to investor owned large- and small-bay warehouse facilities in Southern California, to 1970's vintage business parks that can accommodate sole-proprietor machine shops smaller than 1,000 square feet in Dallas, to even older brick or concrete block single-tenant light industrial buildings that pepper the inner-urban core of most metro areas. In some cases large, obsolete facilities are essentially land disguised as industrial vacancy waiting for demolition and re-use.

The definition of 'institutional quality' is perhaps the broadest for the industrial sector among the major property types. The sector tends to have the lowest improvement values so proportionally functionality does not erode as quickly as office. Compared to the national base it is still a rather confined universe. By square footage, NCREIF properties only amount to about 4% of the national industrial base. NCREIF properties would be only 9% of the base of properties built in 1980 or later.

Industrial real estate is becoming less specialized today compared to the past, as the rise of global business models and advancements in transportation and information technology enabled a shift away from domestically produced goods in favor of imported goods. Space requirements for goods movements (logistics) are different and somewhat more standardized than for the manufacture of goods. The result has, during the past two decades, changed the landscape of industrial real estate. Exhibit 3 shows the accelerated development of warehouse space, flat trends for R&D and the relative erosion of the manufacturing base. This may have downside volatility implications for the warehouse sector in the coming decade as the US economy shifts to a slower consumption growth trend.

Exhibit 3
Composition of the US Industrial Market



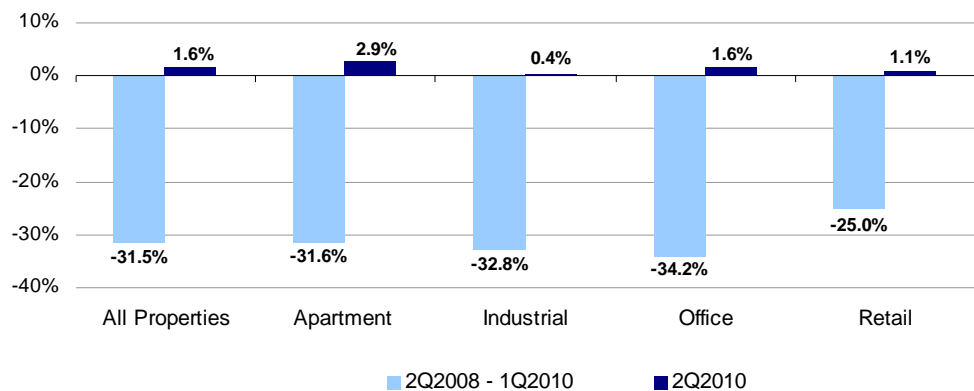
Source: CBRE-EA and RREEF Research

Performance Characteristics of Industrial Property Investments

Recent Evidence

Real estate markets are cyclical, but not necessarily correlated to stocks and bonds. The global macro events that have unfolded since the onset of the 2007 financial crisis have hurt US property sector returns, including industrial investments. Real estate values based on the NPI declined by an average 31.5 percent between the second quarter of 2008 through the first quarter of 2010 (Please refer to Exhibit 4). Industrial NPI values fell by a slightly higher 32.8 percent during the same period. By comparison, the office sector has been hit the hardest and retail has fared best on a relative basis.

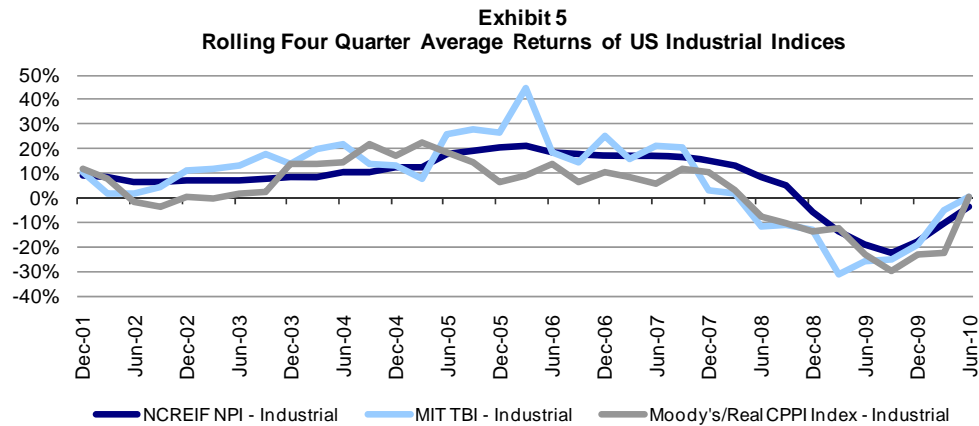
Exhibit 4
Dislocation of Property Values - Return on Capital



Source: NCREIF, as of June 30, 2010

After the steep erosion of values, the second quarter of 2010 saw a nascent recovery in NPI appreciation, boosted by renewed capital inflows to the real estate sector. The current low interest rate environment, mild economic recovery, and less-than-compelling returns on alternative investments are supporting property pricing in the US, but to varying degrees. Core office and apartment assets have seen the bulk of the increase in values during the second quarter, as cap rates have recompressed. Industrial capital values, however, have not yet benefited to the same extent as these two sectors from the recent inflow of capital. The recovery in industrial values should continue at a stronger pace, however, as the US and global economies gain further traction. Other leading price indicators continue to foreshadow

better pricing ahead for industrial investments. Exhibit 5 presents three different indices tracking the most recent industrial pricing performance. By all three measures, it is apparent that industrial market values have corrected significantly and we are at the cusp of a more sustainable pricing recovery.



Source: NCREIF and RREEF, as of June 30, 2010

Longer-term Evidence

Private equity real estate is an asset held longer term for the majority of investors. The relatively high transaction costs associated with acquiring and disposing of real properties on a direct basis renders them a less frequently traded asset class. Property investment characteristics and return performance, therefore, should be judged based on a longer term perspective as compared to the more frequently traded public and more liquid asset types. For comparative return analysis, Exhibit 6 presents return comparisons across the four core property sectors over a number of different time periods.

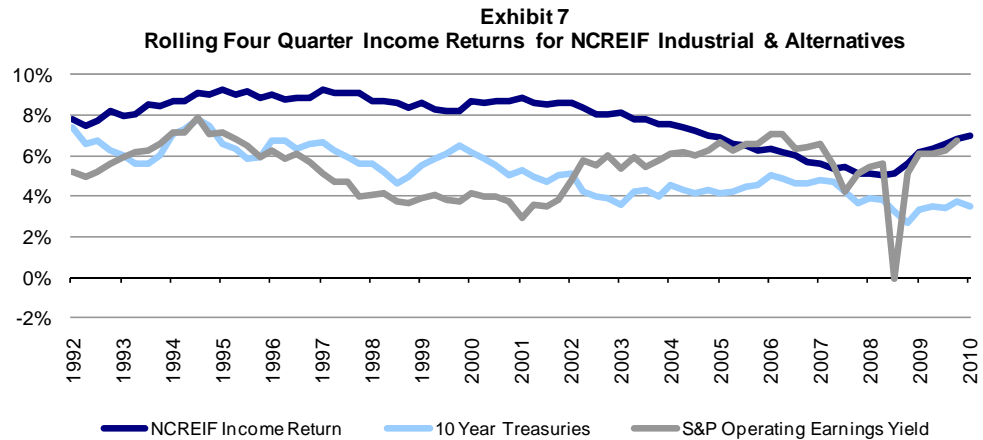
Exhibit 6
NCREIF Total Returns as of June 30, 2010

	<u>Total NPI</u>	<u>Apartment</u>	<u>Industrial</u>	<u>Office</u>	<u>Retail</u>
1 Year	-1.48%	-0.11%	-3.74%	-1.96%	-0.22%
3 Year	-4.70%	-5.62%	-5.52%	-5.26%	-1.88%
5 Year	3.79%	2.51%	3.16%	4.39%	4.69%
10 Year	7.16%	6.90%	6.94%	6.41%	9.51%
15 Year	8.78%	8.70%	9.20%	9.04%	9.04%
15 Year Standard Deviation	9.36%	9.28%	9.54%	10.87%	8.58%
15 Year Return per unit of Risk	0.938	0.938	0.964	0.832	1.054

Source: NCREIF and RREEF Research

Returns for the total NPI, apartments, industrial, office and retail property sectors are calculated on a 1, 3, 10, and 15 year basis. Volatility measures and sharpe ratios are also provided. The data confirms that industrial delivered the lowest return on a one-year basis. Office had been the laggard up until the second quarter, but the compression in core office cap rates has improved returns markedly. On a longer term basis, however, industrial assets have outperformed considerably. Over a fifteen-year period, industrial has delivered a 9.2% return, exceeding all other property sectors. At the same time, the volatility of industrial returns has been moderate, far below that witnessed by the office sector. Moreover, after retail, industrial sharpe ratios have been highest for industrial during this period, underscoring the sector's relatively higher risk-adjusted return potential over time.

A second important characteristic of industrial investments is their relatively high income and cash yields. For real estate investors that have a requirement for steady and high income yield, the industrial property sector is an outperformer. Exhibit 7 charts the NPI income for the industrial property sector versus 10-Year Treasury Notes and S&P Operating Earnings Yield. On a ten-year basis, the industrial sector provided the greatest income yields. For most income-oriented investors, the high income and cash returns of industrial holds great appeal.



Source: NCREIF, Federal Reserve, as of June 30, 2010

The industrial category, however, masks the varied behavior of its' sub-types. As discussed previously, the industrial sector can be divided into three categories including warehouse, R&D, and flex space. Warehouse is by far the largest component but the R&D and flex have also gained prominence in investor portfolios. The performance characteristics of each are further disaggregated in Exhibit 8.

Exhibit 8
NCREIF Industrial Returns by Sub Type

	<u>All Industrial</u>	<u>Warehouse</u>	<u>R&D</u>	<u>Flex Space</u>
1 Year	-3.74%	-4.09%	2.80%	-2.77%
3 Year	-5.52%	-5.55%	-5.17%	-5.91%
5 Year	3.16%	3.14%	3.50%	2.80%
10 Year	6.94%	6.99%	5.91%	7.21%
15 Year	9.20%	8.97%	9.71%	9.46%
15 Year Standard Deviation	9.54%	9.36%	11.87%	9.76%
15 Year Return per unit of Risk	0.964	0.958	0.818	0.969

Source: NCREIF and RREEF Research

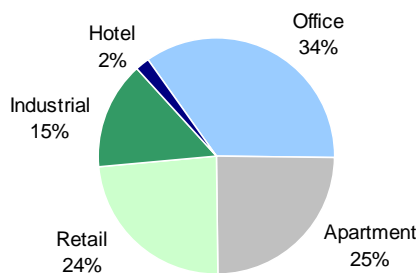
On a one-year basis, warehouse and flex have underperformed R&D. Indeed, on a one-year basis, the R&D sector reported positive results. This trend holds true on a fifteen-year basis as well as R&D outperformed both Warehouse and Flex Space. During that period, Warehouse was the laggard. Not surprisingly, the R&D sector had the highest volatility (as measured by the standard deviation) and warehouse was relatively less volatile. The nature of the leases and tenancy in the R&D space accounts for the higher degree of volatility over the long term.

Public vs. Private Industrial Real Estate

Purchasing shares in real estate investment trusts (REITs) is an alternative to direct property investment. REITs provide investors the ability to diversify with smaller amounts of capital and lower transaction costs, plus they provide greater liquidity. Investment performance, however, may not align with all investors needs. In this section, we will use the FTSE NAREIT Equity REIT Index (NAREIT index) to measure REIT performance and the NPI to measure private real estate performance in the US.

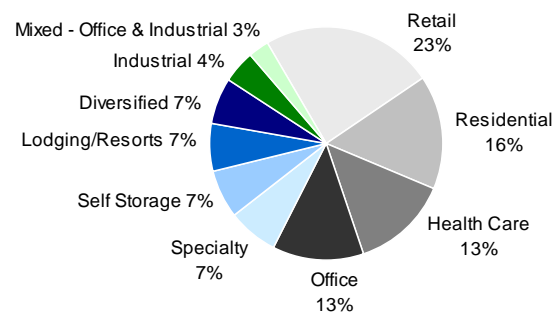
As of the second quarter of 2010, the equity NAREIT index contains 111 US REITs with an aggregate market value of \$268 billion. As shown in Exhibit 10, retail is the dominant property type within the NAREIT index at 23%, followed by Residential at 16%, and Healthcare and Office each at 13%. The industrial sector comprises only 4% of the NAREIT index, but this increased to 7% if Mixed-Office & Industrial is incorporated. As of the second quarter of 2010, the NPI index contains 6066 properties with an aggregate market value of \$234 billion. Exhibit 9 shows the breakdown of the NPI index by property type. Office is the dominant property type at 34% followed by Apartment and Retail sectors each at about a quarter of the index. The Industrial sector comprises 15% of the NPI index.

Exhibit 9
NCREIF NPI Property Index by Sector
(as of June 30, 2010)



Source: NCREIF

Exhibit 10
FTSE NAREIT Equity REIT Index by Sector
(as of June 30, 2010)



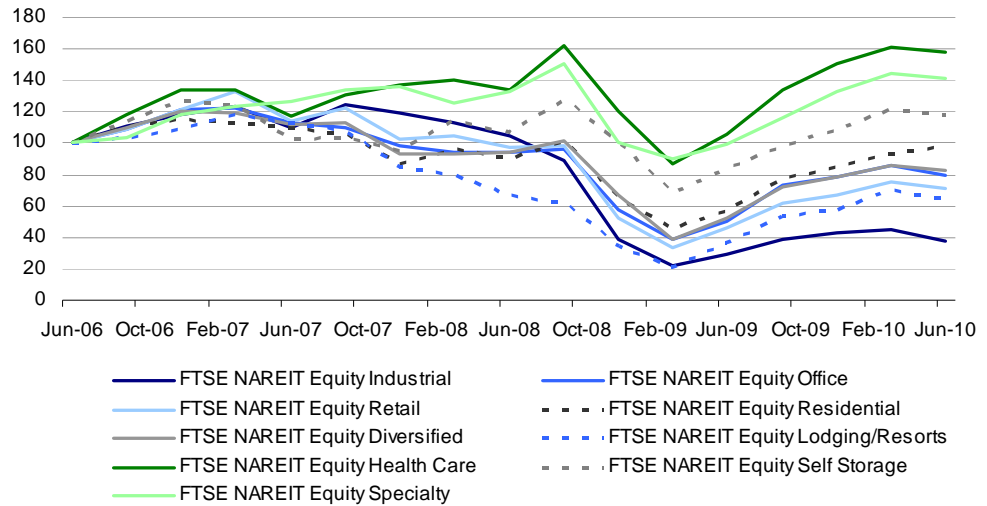
Source: NAREIT

The speed at which the REIT market has rebounded since early 2009 has been remarkable, but uneven across property type sectors. On a one year basis, the NAREIT index outperformed the broader stock market, returning 53.9 percent while the S&P 500 index returned 14.4 percent. Despite temporarily retreating in the second quarter of 2010, the NAREIT index recovered significantly from its low point last spring. The price indices for all major property types have more than doubled from last year with strong increases in the lodging and mall REIT indexes (see Exhibit 11).

Improved capital markets liquidity allowed REITs to lead a yearlong rally and Fitch Ratings to revise its Ratings Outlooks on the overall US equity REITs from negative to stable in its mid-year 2010 outlook report. Also driving the outlook revision has been modest delevering by REITs and the slowly strengthening US economy. Most US REITs are taking a “back to basics”² approach by focusing on liquidity, conservative capital structures and maintaining high-quality unencumbered portfolios. Moody’s Investors Service believes that REITs are starting to move into recovery with few ratings downgrades expected over the next 12 months.

² US REIT and REOC Review & Outlook, Moody’s, June 2010

Exhibit 11
FTSE NAREIT Equity Indices Performance



Source: Bloomberg, August 2010

Severe economic recession led to a sharp contraction in demand for industrial real estate space. Despite upward revisions for US equity REITs by Fitch Ratings, the outlook for industrial REITs remained negative due to high debt levels and sagging cash flow expectations (especially for warehouses), due to downward mark-to-market pricing on expiring leases. Industrial REITs are often more highly levered than other property types. A modest rebound in occupancy, however, is expected due to renewed space demand and limited new supply. The national vacancy rate for warehouses reached 14 percent in mid-2010, but rising demand for goods should spur space demand and stabilize vacancy by year-end. Nonetheless, growth in same-store NOI may not occur until after 2011 according to Fitch.

The NAREIT – All Property Index broadly outperformed the NPI during much of the past 15 years, but extreme downside volatility of NAREIT in 2008 and 2009 caused it to be an underperformer on a risk adjusted basis. To the contrary, when comparing just the industrial components of NAREIT and NPI, the NPI broadly outperforms on absolute and also a risk adjusted basis, due largely to the same recent downside volatility. Exhibit 12 shows that while the All Property NAREIT index tends to outperform the All Property NPI index, except during the three to five year period, the All Property NPI index yields a higher return per unit of risk. It is worth noting that the spread between the return per unit of risk for Industrial NPI and Industrial NAREIT indices is wider than the spread between the return per unit of risk for the All Property NPI and All Property NAREIT indices.

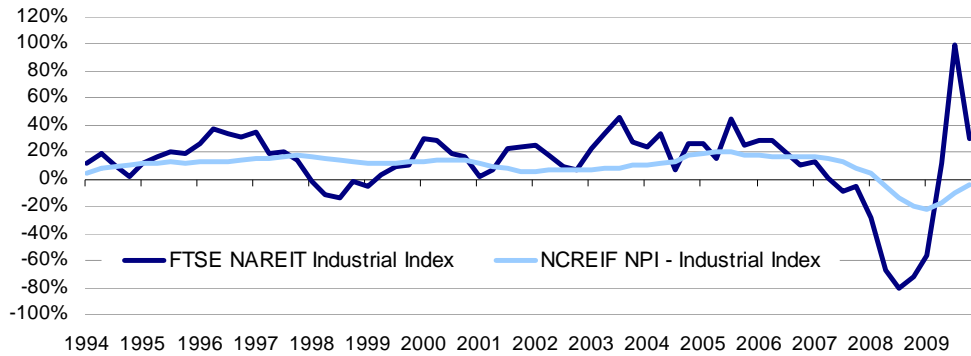
Exhibit 12
FTSE NAREIT Equity Index vs. NCREIF NPI Index Performance

	NCREIF NPI - All Property	NAREIT - All Property	NCREIF NPI - Industrial	NAREIT - Industrial
1 Year	-1.48%	53.90%	-3.74%	29.84%
3 Year	-4.70%	-9.00%	-5.52%	-30.20%
5 Year	3.79%	0.20%	3.16%	-14.09%
10 Year	7.16%	9.86%	6.94%	1.66%
15 Year	8.78%	9.76%	9.20%	5.64%
15 Year Standard Deviation	9.36%	25.64%	9.54%	28.46%
15 Year Return per unit of Risk	0.939	0.381	0.964	0.198

Source: NAREIT, NCREIF, RREEF Research

Trends seen in the listed property securities market can provide valuable information about the direct property market cycle. According to research conducted by the European Public Real Estate Association (EPRA), the listed market leads the direct market by about six months on average as REIT liquidity allows for greater pricing transparency and quicker information transfer than less-liquid direct markets. This lag, however, may have temporarily shortened as a result of unprecedented government intervention which resulted in the prevention of wide-scale direct real estate foreclosures.³ While listed property can act as an indicator on the directionality of direct property markets, it tends to overshoot the measured eventual direct market moves at market inflection points. The magnitude of the over/understatement of returns varies by market, and depends on the quality of the direct market valuations. Some of the overshooting can be attributed to the fact that listed property series incorporate leverage, while the direct property index (as represented by the NPI index) does not. Exhibit 13 shows the four quarter rolling returns of the Industrial NAREIT Index and the Industrial NPI index. The Industrial NAREIT index rose sharply in 2009, from a very deep trough, but it seems to currently be in the process of correcting that move. The severe fluctuation seen in the listed index may indicate a possible pricing risk for the direct real estate market. The correction may also be attributable to a 'market concern' about excess leverage and land holdings particular to industrial REITS this downcycle.

Exhibit 13
Rolling Four Quarter Returns:
FTSE NAREIT Equity Industrial Index vs. NCREIF NPI Industrial Index



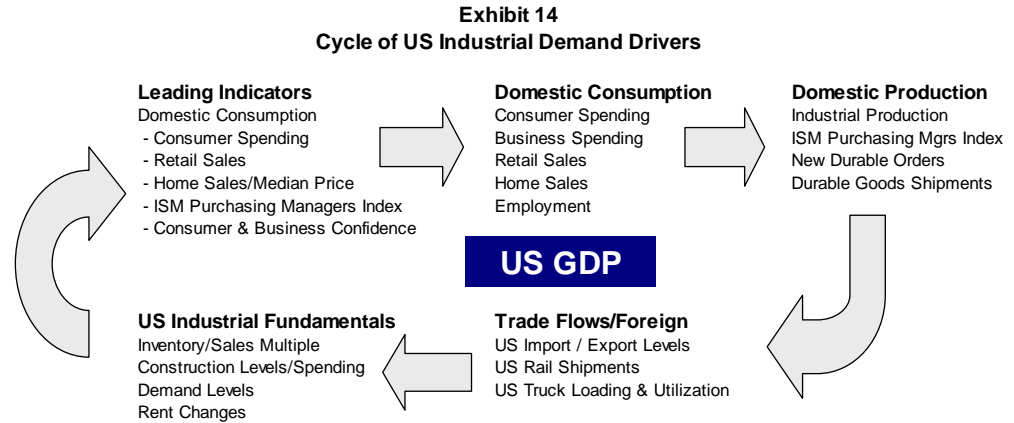
Source: NAREIT, NCREIF and RREEF Research

³ Listed Property Performance, EPRA Research, July 2010

Key Drivers of Industrial Markets

A Cyclical View of Economic Drivers

Growth of the US and global economies broadly fuel industrial space demand. The cyclical flow of domestic consumption and production supports manufacturing activity, housing production, incomes and international trade. Consumer and business confidence are also integral parts of the equation, as consumption and production activities reinforce each other. The following chart exhibits a snapshot of industrial space demand drivers and leading and coincident indicators for the US industrial market.



Source: Adapted from RBC Capital Markets Equity Research, June 2010. RREEF, BLS, US Census Bureau, Association of American Railroads, ISM

On a national basis one or two key economic variables can serve as reasonable barometers of expected space demand, but these relationships cannot necessarily be applied with precision to metro level activity, as markets tend to move based on a combination of local and broad national drivers. While local employment and population growth tends to correlate to industrial demand, other factors such as national housing or retail spending trends may supplement or detract from activity in a given metro. There are space-type implications linked to specific economic sector growth as well, so the mix of drivers that support demand for large bulk warehouse product can be different than those for smaller flex and R&D product. Local land constraints and changing transportation infrastructure also play a roll in how growth manifests into local industrial space demand. An industrial investment plan should take into account market and space type selection in order to optimize the benefits derived from future economic growth.

Economic Recovery will Support Industrial Real Estate Demand

The outlook for US industrial real estate depends largely upon the well-being of the national and global economies. The property market convulsions caused by the extraordinarily distressed economic environment of the past few years have eased and market fundamentals appear to have formed a bottom; recovery trends, however, remain tentative. Some of the key economic drivers influencing the industrial sector are displayed in Exhibit 15 and discussed in the paragraphs that follow.

The Recession ended in June 2009 but the US economy struggled to maintain positive momentum in the quarters that followed, posting weak GDP growth and only modest job creation. Most industrial demand indicators turned positive beginning in the third quarter of 2009, but a considerable gloom remains over near-term economic conditions due to weak employment and housing conditions.

Exhibit 15
Macro Drivers of Industrial Space Demand: 2008-2014
(annual percent change)

	History		Forecast				
	2008	2009	2010	2011	2012	2013	2014
Real GDP	0.0	(2.6)	2.6	2.2	3.1	2.9	3.2
Consumption	(0.3)	(1.2)	1.5	2.2	2.2	1.6	2.2
Durables Consumption	(5.2)	(3.7)	6.5	6.9	7.2	3.8	3.5
Nondurables Consumption	(1.1)	(1.2)	2.5	1.8	1.7	1.2	1.6
Business Spending	(2.4)	(15.3)	14.6	10.9	10.1	7.8	6.3
Exports	6.0	(9.5)	11.9	7.6	7.3	8.8	8.1
Imports	(2.6)	(13.8)	12.3	6.2	5.3	4.2	4.0
Industrial Production	(3.3)	(9.3)	5.3	2.8	3.3	3.8	3.9
Factory Operating Rate*	75.0	67.2	71.5	73.8	75.7	77.3	78.7
Non Farm Inventory Change**	(39.0)	(116.9)	53.1	38.3	52.9	52.1	53.3
Employment:							
Total	(0.6)	(4.3)	(0.5)	0.9	2.2	2.2	1.8
Trade, Transportation, Utility***	(1.3)	(5.1)	(0.8)	0.4	2.9	2.4	1.5
Information	(1.6)	(5.9)	(3.1)	1.7	3.8	2.1	0.3
Manufacturing	(3.4)	(11.3)	(1.9)	2.3	3.0	2.5	1.3

*Annual Average, ** in billions of 2005 dollars

*** Includes wholesale and retail trade, transportation and warehousing, and utilities

Source: RREEF Research and Global Insight

Inventory rebuilding and fiscal stimulus helped the US economy post GDP growth in the first quarter of 2010 of 3.7 percent, but second quarter growth decelerated markedly to just 1.6 percent. On the jobs front, encouraging gains in March and April, averaging 200,000 per month, were followed by weak summer months. June through August produced an average of only 78,000 new jobs per month. Businesses are reticent to hire and consumers are wary to spend; however, consumer goods imports surged in the first half of 2010 and renewed growth of US trading partners supported a strong rebound in export growth.

Manufacturing output showed signs of life as industrial production and the capacity utilization rate steadily climbed for the past 12 months ending July 2010. The pace of business equipment and software spending growth continues to be a bright spot, posting 20-plus percent growth in the first half of 2010.

The expiration of the home buyer tax credit was a setback for the US housing market. Sales in July of existing homes posted a record low monthly figure and home buyers generally lacked conviction throughout the year. Housing and construction will be the last sectors to recover.

Economic recovery is forecast to be slow and weak by historical standards, but renewed growth will benefit the industrial sector in the near term, nonetheless. Real GDP growth is forecast to remain below 2.0 percent in the second half of 2010 then accelerate to 2.2 percent in 2011 and average 3.1 percent from 2012 through 2015. This is a similar pace to the 2003 through 2006 period. The unemployment rate is expected to remain elevated in 2011 at 9.6 percent but then decline steadily, reaching 7.0 percent 2015. Businesses are profitable and lean, so economic growth should lead to stronger hiring. Real estate market recovery will not be complete without healthy job gains, which are not forecast to begin until late 2011.

Consumers

Consumers pulled back spending hard in this recession, as reflected in goods consumption trends. Durable goods consumption contracted sharply in 2008 and 2009. Nondurable goods consumption was more stable, but also declined during the same period. Although durable

goods consumption is bouncing back strongly, non-durable goods consumption growth is still weak. Only modest employment and income gains, as well as high debt levels and tight consumer credit stand to constrain consumers in the near term. Consumers are expected to remain focused on saving and on paying down debt for the next few years. Generally the level of goods consumption is expected to re-attain prior peak spending levels in 2011, but on a per capita basis spending will be weaker than in the past cycle.

Businesses

Business spending contracted at a double-digit pace in 2009, but is set to rebound in 2010 at a 14.6 percent growth rate. Continued recovery should support robust spending growth in 2011 and 2012, averaging higher than 10 percent per year. This rate of growth would be made possible by strong profitability, solid balance sheets, high capacity utilization rates, and the continuation of a historically low cost of capital. Companies rebuilt inventories in late 2009 and early 2010 but the pace moderated with slowing final sales in the third quarter. Mounting concerns over slower than expected economic growth eroded business and consumer confidence and is expected to flatten inventory growth in 2011. Uncertainty about future tax changes may also impact business spending in the near term. As investment rises, inventories should expand over the forecast horizon. A pickup in industrial production growth to 5.3 percent this year should lead to steady hiring in goods-producing sectors and trade.

Jobs

Year-to-date through August, private employers expanded payrolls by about 683,000 positions, or an average of 85,000 per month. Government sector cuts amounted to 500,000 during the same period. Households and businesses remain cautious, however, which is reinforcing weak recovery trends. Consumers are not expected to lead the economy as strongly as in the past, but ultimately their renewed spending, paired with strong export and manufacturing trends, will fuel economic recovery and inspire businesses to hire again. There is great capacity for employment expansion, as more than eight million American jobs were lost in 2008 and 2009. US population trends are healthy and good linkages to emerging markets will benefit the economy. After a modest start in 2011, the pace of hiring is expected to accelerate translating into 2.9 million new jobs or 240,000 per month in 2012 and 2013. By 2014 the US is expected to return to 2007 peak employment levels.

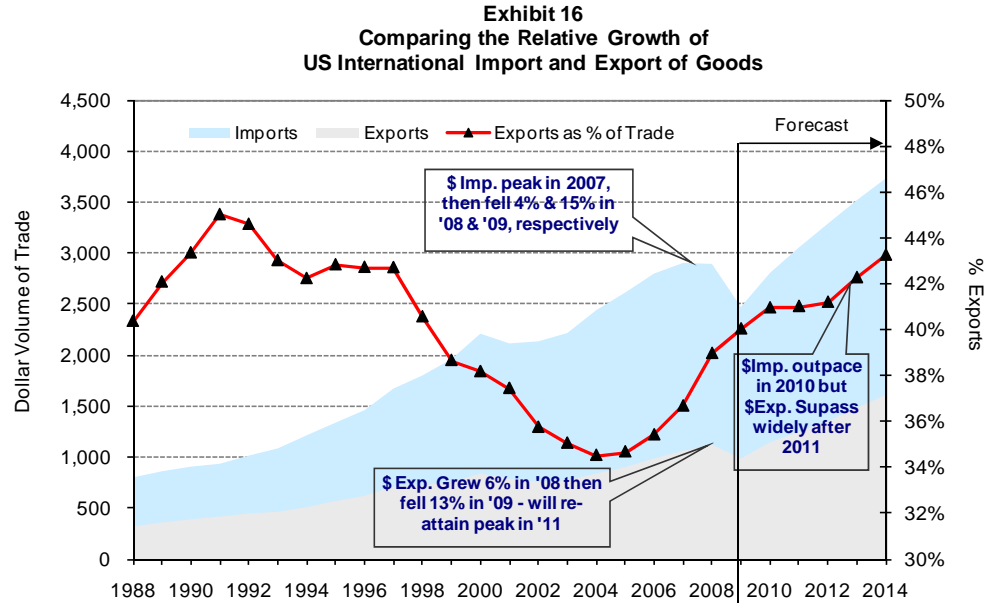
The pending recovery will be different in structure from the 2000s 'jobless recovery' and perhaps be more similar to the business and tech led recovery of the 1990s. Construction, financial activities and retail trade are forecasted to lag overall recovery, while transportation, manufacturing, information and professional and business services will lead. The manufacturing sector was hit disproportionately hard this past down-cycle, accounting for one in four jobs lost in 2008 and 2009. It is, however, expected to rebound at a pace not experienced since the late 1990s. Global growth and a weak dollar will help provide lift to US manufacturing, as will renewed domestic consumption. Computer and electronic products will continue to be a source of strength in the segment, but machinery and transportation equipment will also recoup many losses.

Trade Flows

The 'Great Recession' brought tremendous inventory cuts and a precipitous fall-off in trade. During the past decade international trade grew at a pace three times greater than GDP, but it plummeted by five times the rate of GDP decline during this recession. Trade is more volatile than the overall economy as it is composed largely of more volatile components of consumption, such as durable goods. Inventories are more nimble than in the past as well. It is quicker to cut imports than ramp down domestic production of goods. In this past cycle, the timing of economic slowdown in early 2007 allowed retailers to sense economic headwinds early enough to downshift imports for the 2007 holiday season. By the time Lehman Brothers collapsed in the third quarter of 2008, the nation's retailers had been suffering for a year. Distress among traditional industrial-related components of the economy preceded financial

shocks and job cuts. This translated into a 'first-in' dynamic for the industrial real estate sector. Industrial-related indicators have also been early to respond during recovery, well ahead of broad employment trends.

Trade is arguably the most important driver for national industrial space demand. It has absolute demand level and product type implications. Exhibit 16 presents historical and forecasted US international trade volumes from 1988 through 2014, as represented by the dollar volume of imports and exports. The chart highlights not only the dramatic long-term growth of trade, but two other important factors – the crash of trade in 2008/2009 and the changing composition of trade during the past 10 years.



Source: BEA and Global Insight, April 2010

Year-to-date figures indicate that both imports and exports rebounded strongly in the first half of 2010 and are on pace for double-digit growth for the year, driven in part by the replenishing of dwindled inventories. A weak US Dollar and trade with fast-growing emerging markets should continue to support demand for US exports, but import volumes, after an initial bounce in 2010, will face moderating headwinds until US employment trends improve. Nonetheless, both imports and exports are forecast to attain prior peak levels in 2011.

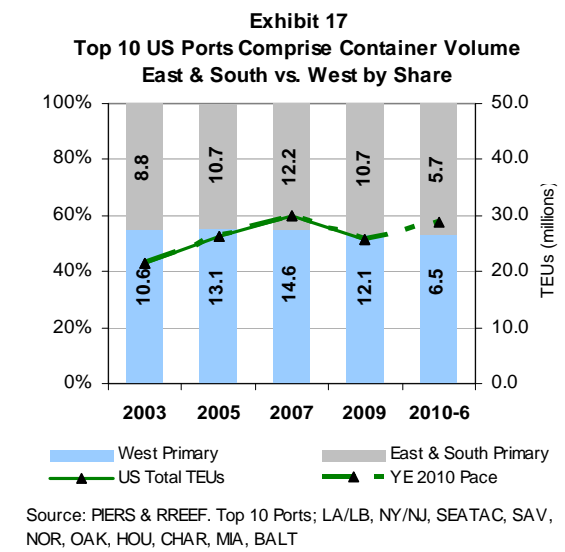
A return to growth and increase in trade volume will lead to a resurfacing of congestion concerns in seaports across the US. Long-term growth patterns indicate that US ports, roadways and rail infrastructure need to be upgraded in order to maintain or improve efficiency. Additionally, expected changes in global trade routes in the mid to long term will impact our outlook for the sector. The following section will discuss the impact of changing infrastructure over the next decade.

Changes in Infrastructure and Other Macro Themes

As discussed in the 2004 RREEF Report “The Impact of Shifting Container Cargo Flows on Regional Demand for US Warehouse Space”, freight movements are an important determinant of warehouse space demand. In this section, we will evaluate trade flows at the nation’s ports, the port’s capacity to meet expected growth in demand and expected changes in hinterland connections over the coming decade. In recent years, ports in the North America have been struggling to expand capacity to keep pace with increasing trade volume. At peak levels, ports are nearing the limits of capacity, with inefficiencies and congestion becoming critical issues. Despite the recent decline in container traffic, industry projections indicate strong growth on the transpacific routes and West Coast US container shipments are projected to triple over the next 20 years.⁴

Two main issues are driving a shift in trade flow at the nation’s ports. The first is the persistent bottleneck of transpacific trade at Southern California’s twin gateway ports, Los Angeles and Long Beach. Congestion, high costs and environmental externalities hamper the ports’ competitiveness, yet the retailers, wholesalers and logistics providers who move Asian imports into the rest of the continent are so invested in this location that it makes it difficult for other regions to gain a significant foothold. The second issue is the upgrading of the Panama Canal, now in process to accommodate today’s larger container ships. Where West Coast ports now form the field of competition with Los Angeles and Long Beach for the Trans-Pacific trade, the expansion of the Panama Canal will broaden this competitive circle to include East Coast and Gulf Coast ports as well.⁵

There are more than 300 ports in the US; however, approximately 40 percent of the US container cargo arrives at the Ports of Los Angeles and Long Beach alone.⁶ All of the Nation’s major seaports grew with surging imports and exports during the last cycle. Exhibit 17 shows the rise and fall of container volumes at the top 10 US ports during the last seven years, as well as an estimated year-end 2010 figure, based on ‘first half’ volumes. The chart also shows the share of trade volume between East and West Coast ports. At the height of West Coast capacity constraint in 2007, Eastern ports were able to capture more growth. Exhibit 18 shows the current main port-to-hub-to-market connections in the US. Traditionally, vessels arriving from Asia stop at the San Pedro Port Complex to transport cargo via rail to markets in the Midwest and East Coast. However, a number of shipping lines over the past few years have already chosen to bypass the congested West Coast for all-water services to the East Coast.⁷



The widening of the Panama Canal and the expected growth in trade has compelled seaports on both US coasts to expand and has encouraged industrial property investors to look for projects near these expanding ports. The

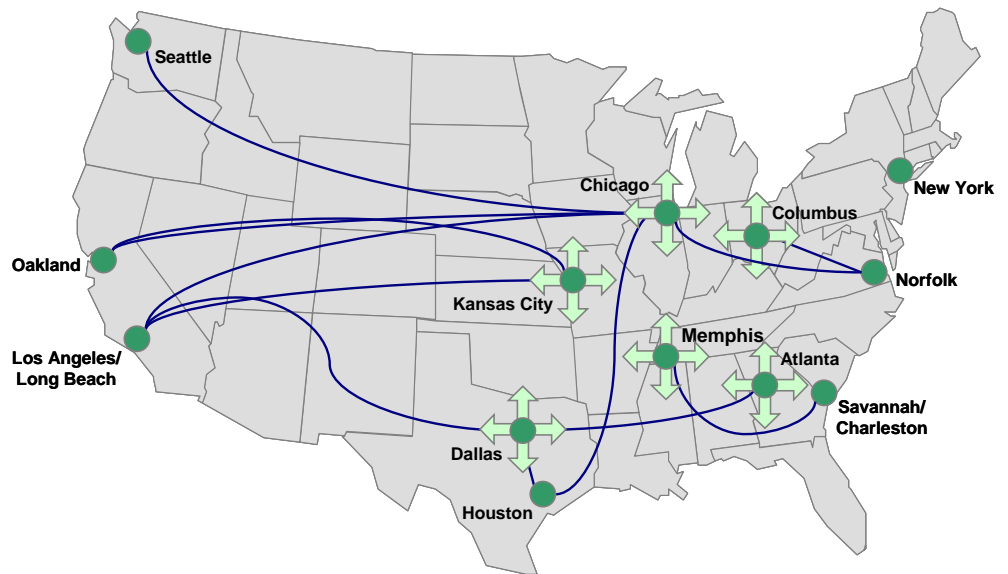
⁴ Port Metro Vancouver, <http://www.portmetrovancover.com/>, accessed 2 February 2009.

⁵ “Global Ports: Trends and Opportunities”, RREEF, April 2009.

⁶ “Studying Seaports: Industrial investment opportunities exist near ports”, Global Real Estate Monitor, December 2008.

⁷ “Global Ports: Trends and Opportunities”, RREEF, April 2009.

**Exhibit 18
Selected Port to Hub to Market Connections**



Source: NAIOP, Cushman & Wakefield

new canal will be able to accommodate container ships with load capacities of 12,500 TEUs, nearly three times their current load capacity under existing conditions.⁸ Ports along the East Coast in particular, are forging ahead with development plans to meet the completion of the Panama Canal expansion. Fortunately for port developers on the Southeast Coast, building permits are relatively easy to secure. With continued development, East Coast ports should be well positioned for increased activity when global trade recovers.

The need to accommodate Post-Panamax vessels (ships too large for Panama Canal today) with increasing volumes of trade is driving improvements in intermodal infrastructure near ports across the country. Ports along the West Coast of North America are preparing for the growth in manufacturing capacity from Asia by supporting rail network expansion, road construction and development of new information technologies to improve the management of traffic flow. While many ports in the West have improved their hinterland infrastructure, the pace of development has not matched the pace of growth in ship size. For many of these ports, urban development surrounding container terminals limit expansion and efficiency gains.⁹ Despite best efforts, intermodal congestion will remain a critical issue for Southern California ports.

Ports along the East Coast of North America have been strategically developing their hinterland transportation in anticipation of increasing trade volume. With the expansion of the ExpressRail system, the Port of New York and New Jersey hopes to continue to be the gateway choice for all-water services to the East Coast. At the Port of Virginia, Norfolk Southern has committed to a \$260 million Heartland Corridor project, which will speed up shipments of cargo containers from the port to the Midwest. When the project is completed this year, containerized freight moving in double-stack trains will be able to shave off about 200 miles and up to a day's transit time between the East Coast and the Midwest. We expect to see a healthy increase in demand for warehouse space from new businesses seeking access to ports in the industrial markets along this corridor. Additionally, the port has committed to a \$2 to \$3 billion I-81 Crescent Corridor project, which will ease the flow of cargo containers between the country's Southeastern and Northeastern reaches. The Port of Miami is pursuing a US\$1 billion underground Miami Tunnel Project, which will give truck drivers seamless

⁸ "Global Ports: Trends and Opportunities", RREEF, April 2009.

⁹ McCalla, Robert J., "Factors influencing the landward movement of containers: the cases of Halifax and Vancouver", Ports, Cities, and Global Supply Chains, 1 August 2007.

access to and from the interstate and reduce truck traffic congestion on surface streets.¹⁰ Construction is set to finish by 2014. According to the American Association of Port Authorities (AAPA), a “cascade” effect may take place after the completion of the Panama Canal, as the Panamax ships of today may become the feeder vessels for Post-Panamax ships of tomorrow.¹¹ We expect see an emergence of feeder services that will shuttle cargo from deep to shallower East Coast ports that have not developed in time.

Another inducement for shippers to expand to the East Coast is the goal of a balanced transportation network leading to greater reliability. A Supply Chain Consortium survey representing more than 200 leading companies, and more than \$1 trillion in total annual revenue, has indicated that corporate logistics professionals are looking to make changes in port routings from Southern California for this reason.¹²

Raising intermodal cost is yet another factor leading to the deployment of all-water service routes to the East Coast. In an analysis of the end-to-end transport costs of containers shipped to and from US interior points via the West and East or Gulf Coast, a 2008 Drewry report has found that for many destinations in the Eastern US, the route via the West Coast ports is now much more expensive than the route via East Coast and Gulf Coast ports.¹³ The cost of moving cargo through the San Pedro port complex has also risen over the years due to significant union and environmental issues. However, the toll structure at the Panama Canal, which has yet to be finalized, will also affect the end-to-end cost analysis going forward.¹⁴ Regardless, we believe that much of the new growth in port volume will be captured by the Eastern ports in the decade to come.

New trade patterns are set to emerge in the North America. Shipping experts believe that cargo originating in Northern China will have some incentive to move through the Panama Canal to the East Coast. Cargo from Southeast Asia, India and perhaps Southern China, however, will predominately move through the Suez Canal because the distance for cargo to ship from South and East of Vietnam is shorter.¹⁵ Secondly, when considering the trade-off between cost and time, high-value and time-sensitive goods will most likely continue to use West Coast ports.¹⁶ Navigating cargo through the Panama Canal and up the East Coast will take more time than transporting containers via rail from the San Pedro Port complex. Therefore, commodities and goods that are not time-sensitive will most likely choose the retrofitted Panama Canal route. Ultimately, changes in trade routes should lead to a more competitive balance among ports in the US.

¹⁰ “Global Ports: Trends and Opportunities”, RREEF, April 2009.

¹¹ The Changing Dynamics of Global Trade, AAPA Seaports Magazine, Summer 2008.

¹² The Changing Dynamics of Global Trade, AAPA Seaports Magazine, summer 2008.

¹³ Port Strategy, “No end in sight for US West Coast ports malaise”, 24 October 2008.

¹⁴ “Global Ports: Trends and Opportunities”, RREEF, April 2009.

¹⁵ Dutton, Gail, “Trade in the Americas: Expanding the Panama Canal for the 21st Century”, World Trade Magazine, 2 November 2007.

¹⁶ Dutton, Gail, “Trade in the Americas: Expanding the Panama Canal for the 21st Century”, World Trade Magazine, 2 November 2007.

Outlook for Industrial

National Supply, Demand and Rent Fundamentals

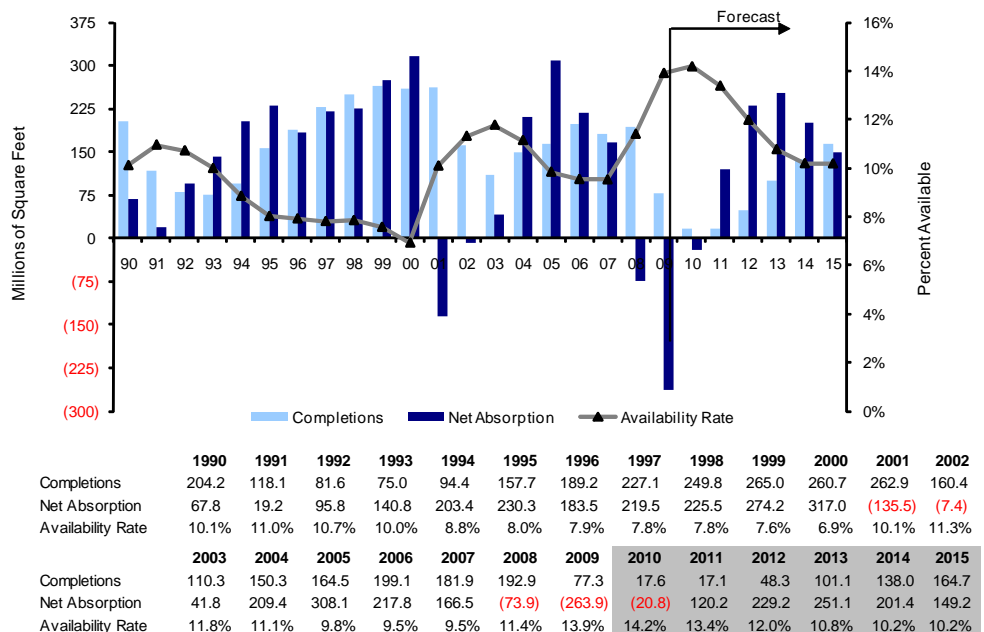
The US industrial market is forming a bottom in 2010 and is expected to begin recovery in 2011. Negative trends through mid-year 2010 should be followed by a return of positive demand in the second half. On balance, however, net new demand for the year will be slightly negative for 2010. Real estate fundamentals tend to lag economic growth by several quarters, so growth of the past year (albeit modest) should translate into better leasing momentum and positive net absorption in 2011. Tepid retail sales growth and only modest improvements in the US housing market will temper the pace of recovery over the near-term. It will take until 2012 before industrial demand trends revert back to historical norms and total occupied stock reaches prior peak levels.

The national industrial vacancy rate is forecast to peak at 14.2 percent in 2010 and recover steadily over the next few years. Sub-par economic growth in 2011 will result in below-average levels of new demand. Strong demand-side gains beginning in 2012 paired with a prolonged supply-side gap, will enable sharp increases in occupancy between 2012 and 2014.

Supply-side threats are not a concern in the foreseeable future. New development is forecast sink to an all-time low level for the next three years as weak rent fundamentals and limited development debt capital will temper speculative construction.

Market rent growth prospects in 2010 are 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, especially in leading coastal markets. By 2014 many of the leading metro markets will be close to attaining prior peak rent levels.

Exhibit 19
History and Forecast
Construction, Net Absorption & Availability
US National Industrial Market 1990-2014

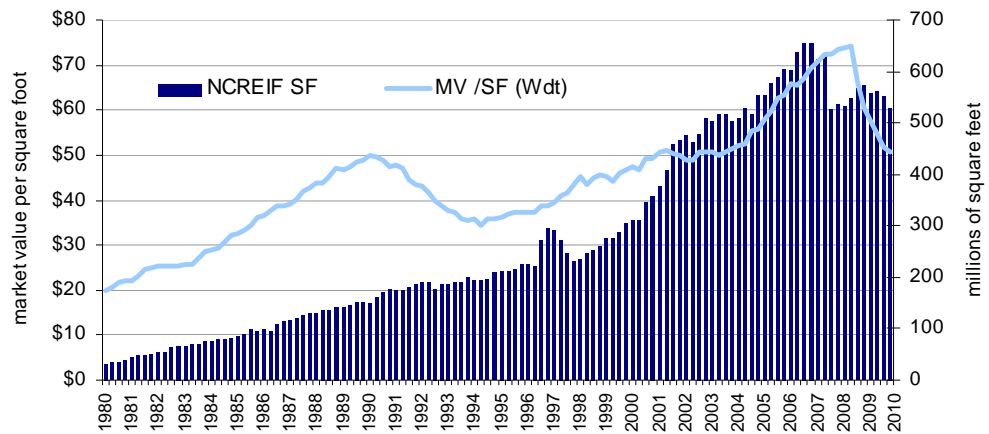


Source: CBRE-EA, RREEF Research

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 will be problematic in high vacancy, low cost environments. A flight to quality during recovery, while rents are low, will benefit Class A buildings and locations ahead of average ones.

The next two years should prove to be an excellent vintage period for investors of core industrial real estate. Current pricing for core industrial real estate, measured as a spread over 10-year T-Bills (proxied by Exhibit 7 in a prior section) or on a price per square foot basis (see Exhibit 20 below), is a relative bargain compared historical industrial values, current replacement values or to other sectors today.

Exhibit 20
NCREIF Size and Market Value 1980Q3 - 2010Q2

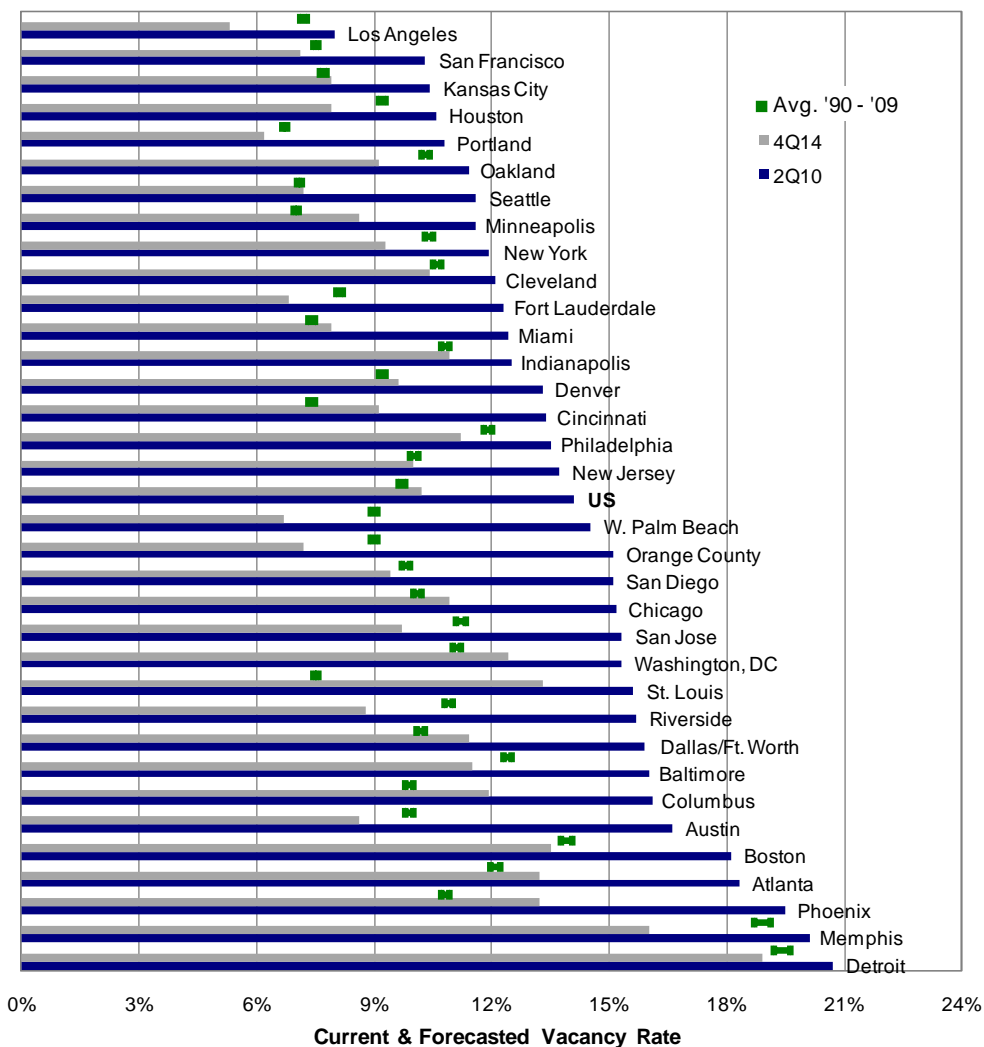


Source: NCREIF and RREEF

Review and Outlook for Regional Markets and Property Types

Industrial market fundamentals are uniformly weak across all markets. None escaped the negative impacts of recession, but there were variations in severity between markets. Exhibit 21 below highlights the current and projected for vacancy in 34 primary industrial markets, as well as each market's long-term average vacancy rate. All markets have vacancy rates well above their long term average, but many are forecast to recover strongly in coming years. Inland hub and housing-boom markets have been the hardest hit, as they saw the greatest amount of development and depend on national retail spending and housing production. This chart also reveals that there are wide vacancy rate variations between markets in the same region. East and West Coast markets have both leaders and laggards. This implies that specific metro performance is linked closely to local supply and demand factors.

Exhibit 21
Current & Forecasted Vacancy Rates
Stronger Recovery for High Barrier Markets



Source: CBRE-EA and RREEF Research

A tenet of real estate investment is 'location, location, location,' and industrial metro market performance over the past few cycles still adds credence to that staid phrase. Generally, investment analyses highlight the desirability of a location through demand drivers, as they are easy to quantify, compare and summarize. Perceived supply-side characteristics and barriers tend to be more subjective and difficult to quantify, but they are equally, if not more, important.

Exhibit 22 below classifies 34 important metro industrial markets into five types based on their economic structures (industry drivers and infrastructure), as well as composition of stock. It also highlights their respective development barriers (High or Low). National industrial market trends are heavily weighted towards the largest 15 markets but those are not necessarily the ones that have provided the highest returns to investors. Most markets are in fact oriented to regional and local economic activity. Markets with solid local drivers provide for excellent investment opportunities. The five market types, Gateway, Inland Hub, Manufacturing, Tech and Local/Regional, indicate key linkages to demand and imply potential upside recovery or downside risk given current economic conditions.

Exhibit 22
Primary US Market Types

High Barrier to Entry						Low Barrier to Entry					
Market	Size	Pct. Vacant	Pct. Whse	Driver Type	2nd Driver	Market	Size	Pct. Vacant	Pct. Whse	Driver Type	2nd Driver
Los Angeles	957.1	8.0%	52%	Gate	Mfg.	Houston	486.1	10.6%	75%	Gate	Energy
New Jersey	480.5	13.7%	67%	Gate	Mfg.	Chicago *	1,090.2	15.2%	52%	Hub	Mfg.
New York	309.2	11.9%	65%	Gate	Mfg.	Dallas/Ft. Worth	748.9	15.9%	70%	Hub	Mfg./Tech
Seattle	281.9	11.6%	61%	Gate	Tech	Atlanta	601.6	18.3%	76%	Hub	Diverse
Oakland	277.9	11.4%	54%	Gate	Tech	Riverside	439.8	15.7%	80%	Hub	Gateway
Miami	234.8	12.4%	76%	Gate	Local	Columbus	249.6	16.1%	76%	Hub	Diverse
Minneapolis *	325.8	11.6%	69%	Local	Mfg.	Memphis	185.4	20.1%	86%	Hub	Local
Orange County	292.1	15.1%	54%	Local	Mfg./Tech	Phoenix	287.9	19.5%	60%	Local	Tech
Baltimore	221.7	16.0%	64%	Local	Port	Indianapolis	280.4	12.5%	58%	Local	Hub
Portland	195.2	10.8%	70%	Local	Tech/Port	St. Louis	276.4	15.6%	68%	Local	Mfg.
Fort Lauderdale	131.5	12.3%	70%	Local	Gateway	Kansas City	243.8	10.4%	60%	Local	Hub
W. Palm Beach	57.2	14.5%	58%	Local		Denver	236.6	13.3%	55%	Local	Tech
Boston	432.5	18.1%	38%	Tech	Mfg.	Detroit	512.9	20.7%	39%	Mfg.	Auto
San Jose	223.5	15.3%	20%	Tech	Mfg.	Philadelphia	445.1	13.5%	58%	Mfg.	
Washington, DC	205.3	15.3%	51%	Tech	Defense	Cleveland	318.8	12.1%	39%	Mfg.	Local
San Diego	196.1	15.1%	35%	Tech	Mfg.	Cincinnati	293.1	13.4%	67%	Mfg.	Hub
San Francisco	96.6	10.3%	47%	Tech	Gateway	Austin	79.5	16.6%	51%	Tech	Mfg.
Totals & Averages	4,919.0	12.6%	56%	<i>Lacks Hubs & Mfg.</i>		Totals & Averages	6,776.2	15.4%	63%	<i>Lacks Gateway</i>	
US	13,714.5	14.2%	59%	All	All						

*Mixed land barriers, with some submarkets highly constrained, but others not.
Source: CBRE-EA and RREEF

The high barrier markets highlighted above also have more favorable economic structures and contain many of the nations' gateway and tech related markets. Additionally, several high barrier, local/regional markets also have linkages to trade and technology. On average, metros in the high barrier group of markets have below average vacancy rates, but also tend to have lower than average concentrations of warehouse space and older stock. The low barrier market group contains many of the nations' inland hub markets and old-line manufacturing centers. Average vacancy for this group is 340 basis points higher than the low barrier market average and there is a greater proportion of warehouse space. This group has newer stock and experienced more development during the past decade.

Further investigation reveals that markets with higher development barriers outperform on a total return basis. Exhibit 23 presents NCREIF total returns over various time periods during the past 15 years. In most periods, the high barrier market groups (all property and industrial) outperformed by a healthy margin. Most significantly, during the past 15 years the high barrier industrial component outperformed low barrier industrial group by 246 basis points, and the total NPI by 46 basis points. The 15-year period is a good measure for several reasons, it contains an equal number of economic up-cycle and downcycle periods, the collection and dissemination of real estate data was relatively unevolved prior to the mid-1990s, and metro property counts in NCREIF in the early 1990's and before were limited.

High barrier markets can be more volatile, but returns indicate that they reliably bounce back faster from recession and over the long term investors are rewarded for the additional volatility risk. Low barrier markets, even ones with superior economic growth, tend to have weaker occupancy fundamentals and consistently produce lower returns. However, some low barrier markets contain large, high barrier submarkets and those submarkets could outperform metro averages. Data is not available at the submarket level due to small sample sizes, but it is a logical extension in core metro markets.

Exhibit 23
High Barrier Markets Outperform in NCREIF Total Returns

	Low Barrier NPI	High Barrier NPI	Low Barrier Industrial Only	High Barrier Industrial Only
1 Year	-2.04%	-0.93%	-5.17%	-2.52%
3 Year	-4.03%	-5.21%	-5.93%	-5.51%
5 Year	3.52%	4.15%	2.32%	3.73%
10 Year	6.29%	8.01%	5.97%	7.86%
15 Year	7.87%	9.93%	7.93%	10.39%
15 Year Standard Deviation	8.31%	10.46%	9.11%	10.30%
15 Year Return per unit of Risk	0.95	0.95	0.87	1.01

Source: NCREIF & RREEF Research, through Second Quarter 2010

Market Selection Implications:

Choosing high barrier markets for investment, because of long-term land constraints, slants asset selection in two primary ways – assets will tend to be smaller and multi-tenant in nature and they will likely be older. Even though a flight to quality on the leasing front puts older assets at risk, for high barrier markets often second generation space is the only choice, so relative functionality is the key. On a relative basis, new Class A bulk warehouse space in a low barrier location could be more competitive than older but functional space in a high barrier location. We continue to prefer warehouse, multi-tenant flex and business park space in core high barrier locations over big-box warehouse or even newer vintage smaller-bay product in low barrier markets and submarkets. Large-bay warehouse product can perform well, but specific asset performance will depend not only on depth of demand, but some element of constraint. Locations and assets that have a low degree of substitutability should outperform.

Core business hub and technology markets face near-term challenges, as exhibited by high vacancy rates those markets today, but well located modern vintage product should offer out-performance opportunities during recovery. 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 high incomes tend to support land values, industrial development barriers and above-average rent growth.

US trading partners are experiencing relatively strong growth, which should aid economic recovery in globally-linked regions. Expanding US international trade benefits markets linked to major US ports. Both inland hub and gateway markets benefit from trade, but gateways tend to have greater supply-side constraints as they are proximate to large and affluent populations. Houston is an outlier in this group, as supply constraints are very low.

Port markets in the West and Northeast will provide favorable upside based on trade growth patterns and constraints near the ports. Industrial markets proximate to other East and Gulf Coast ports where land constraints are lower, are not expected to perform as well. Low barrier but high growth inland hub markets like Atlanta, Chicago, Dallas and Riverside, will offer rebound opportunities, but they may lag in timing this cycle and have greater supply-side risks over the long term. Some low barrier markets have high barrier components that could

outperform metro averages. Asset and submarket selectivity and timing of entry and exit should anticipate these supply risks.

Increased spending on equipment and software will support technology-linked metro economies. Demand from retailers is expected to lag in the near term and paired with severe oversupply at primary US inland hub markets, this will make for challenging conditions in the large-bay warehouse sector well into the recovery cycle.

Implications for Investors

The industrial real estate sector was walloped in the aftermath of the recent global financial crisis, as were all sectors. Global trade, a primary driver of demand for industrial space, contracted for the first time in post-war history. Until the onset of the crisis, global trade had growth more than three times the pace of global GDP, supporting the solid performance of the majoring of industrial assets.

As the global economy mends and trade activity rebounds, the outlook for the industrial markets has improved considerably. With a rebound in the drivers of demand and restrained supply, industrial market conditions have turned positive, suggesting that this is the time to gain exposure to the property sector. The industrial sector benefits from a high beta to the general economy and hence does better earlier on as economic conditions improve. The correlation between industrial demand and employment is 0.86, among the highest of the four core property sectors.

With income-oriented capital flows returning to real estate, the higher-yielding and lower volatility industrial sector should hold considerable appeal to institutional investors as well. Exhibit 24 summarizes the rationale for including industrial assets in a multi-property portfolio.

Exhibit 24 The Rationale For Including Industrial Assets in a Property Portfolio

- The performance of industrial tracks general economic conditions closer than other assets and we are in the early stages of recovery.
- The economic recovery should rejuvenate leasing activity: macroeconomic drivers of industrial demand are rebounding, including:
 - Global trade
 - Inventories
 - Manufacturing/production
 - High-tech employment
- Supply pipeline has shut down completely; shorter construction cycle as industrial supply responds much quicker to changes in demand as compared to the office sector.
- Industrial offers attractive, high risk-adjusted returns...less volatile than other sectors.
- The sector benefits from higher cash yields: capex spending generally lower for industrial properties.
- Lower volatility in industrial vacancy rates
- Greater potential for diversification: an industrial property is considerably smaller than an average office investment.
- Diversity of sub-property types, including warehouse, R&D, flex and manufacturing
- Flex space appeals to small business, a sector at the cusp of recovery.

Source: RREEF Research, as of August 2010

Important disclosure

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