

Is It Time For Pan-European, Open-End Real Estate Funds?

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Research

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US institutional investors have used open-end real estate funds as a staple investment vehicle for many years, whereas European institutional investors, being much less familiar with the structure, have preferred to acquire real estate directly or with closed-end funds. Thus, the acceptance of open-end funds for investment on a pan-European basis has been rather limited. In this report, we outline the current parameters of the European open-end fund landscape, compare them with closed-end funds and examine whether current conditions will encourage a broader acceptance of open-end funds by institutional investors who seek to gain exposure to European real estate.

The Current Landscape

Despite European institutional investors' limited acquaintance with open-end real estate funds, Europe has 150 such vehicles, about two-thirds of them in Germany and the UK (see **Exhibit 1**). In terms of gross asset value (GAV), German and UK vehicles form about half the European total, estimated to be about €65 billion, based on INREV data.

In Germany, the main open-end real estate structure for institutions is the *Spezialfond*. According to Bulwien, 72 such vehicles existed at the end of 2004, with a combined GAV of €14 billion. In the UK, the dominant open-end real estate structure for pension funds and charities is the unauthorized Property Unit Trust (PUT),¹ while insurance companies can access real estate indirectly through Managed Property Funds (MPFs). Based on IPD data, about 30 unauthorized PUTs and MPFs exist, with a combined GAV of more than £13 billion.²

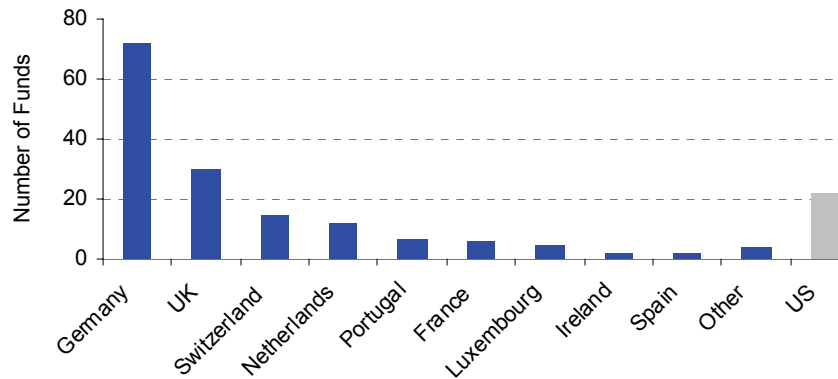
The US has 22 open-end funds, with a GAV of about \$70 billion, according to NCREIF. The small number of funds, operated by even fewer managers, and a much larger average fund size³ highlights the relative maturity of the US open-end fund industry.

¹ Unauthorized PUTs are less highly regulated than authorized vehicles and cannot be marketed to retail investors.

² Other open-end real estate structures exist in both countries (e.g., Authorized PUTs in the UK and *Publikumsfonds* in Germany), but retail investors dominate their investor bases. Institutions are either not allowed to invest in them, or choose not to because of a lack of tax transparency or because they are more regulated.

³ Eleven funds operated by eight managers form more than 70% of the total GAV of US open-end funds.

Exhibit 1: Open-End Real Estate Funds By Country



Sources: INREV; Prudential Real Estate Investors

In part, because European institutional investors are unfamiliar with open-end funds, they use them for only a relatively small share of their total real estate exposure. Direct real estate holdings and investment in closed-end funds form the vast majority of most portfolios. That said, the size of real estate exposure is highly polarized. Smaller pension and insurance funds, without the resources to manage a large, directly owned real estate portfolio, have found open-end vehicles to be a much more appealing way to diversify real estate exposure.

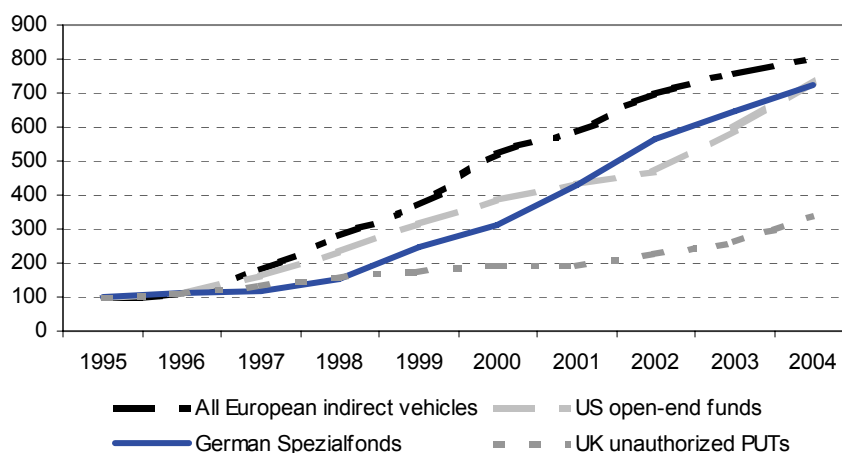
Also, while the European indirect real estate investment industry has grown very robustly since the mid-1990s (see **Exhibit 2**), closed-end funds have absorbed most of the capital seeking indirect exposure. Part of the reason for the modest growth in the number and value of open-end funds lies in the source of industry growth. The last decade has seen increased investor interest in cross-border investment and in non-standard property types, which require specialist management. Both have increased demand for third-party fund managers who are experts in specific markets or sectors. Closed-end funds have been more popular for cross-border and product-specific strategies. This is partly because few existing open-end funds, which could have facilitated a more strategic or permanent cross-border exposure, were structured to invest outside their home markets or to accept capital from non-domestic investors.⁴ More importantly, however, investment in non-standard or niche property types was often viewed as an opportunistic play, where the specific opportunity could be capitalized on during the typical life of a closed-end fund.

Characteristics of Open-End Funds

Open-end vehicles take various legal forms, but most have three primary characteristics in common. First, as the name implies, they have a perpetual or a long life, such as 75 years. Second, they must allow investors to invest at various times in the fund's life rather than only at formation and, conversely, must enable investors to redeem their investments periodically.

⁴ The main exception to both these points is the German *Spezialfond*, which has often been used for cross-border real estate investment (often in pursuit of closed-end strategies) and can accept non-German capital (but with difficulty due to complex German investment law). Also, several US open-end funds have recently been structured to accept non-US capital.

Exhibit 2: GAV Growth in Open-End Funds (1995 = 100)



Sources: INREV; Bulwein; IPD; NCREIF; Prudential Real Estate Investors

Finally, the fund manager must be able to modify the fund’s strategy to adapt to changing conditions, which is more easily accomplished when the manager has discretion. **Exhibit 3** outlines the basic differences between open- and closed-end funds. The following discussion examines the implications of these characteristics.

Exhibit 3: Fund Characteristics

	Open-End Funds	Closed-End Funds
Fund life	Perpetual life	Specific period
Strategy	Evolving	Usually specific theme or focus
Communication	Proactive	Regular and transparent
Liquidity	Regular	Generally none
Unit pricing	Bid-offer pricing	Negotiation between buyer and seller
Valuation	Critical to unit pricing	For performance and ongoing fees
Fees	Generally ongoing	Many types
Benchmarking	Index-based or regularly reviewed, more emphasis on cash flow	Fixed nominal target rate of return

Source: Prudential Real Estate Investors

Fund Life and Strategy

Closed-end funds often have static strategies that pursue a specific theme over the life of the fund, typically five to 10 years. Fund strategy (sector/regional focus, gearing, risk profile, target return, etc.) is chosen before raising capital and is then fixed for the life of the fund.⁵ Investors’ decisions to invest in funds will depend, among other things, on their confidence in a manager’s ability to execute the specific strategic opportunity.

⁵ This is not always the case. Unlisted closed-end funds with few investors may be able to influence a managers’ acquisition or disposal decisions or more general strategy (even a manager with a discretionary mandate).

The perpetual nature of open-end funds demands a different approach to strategy. Efficient market theory suggests that abnormally high risk-adjusted returns of a particular strategy should erode over time (unless significant and sustained barriers to entry exist). What might be a winning strategy for a five-year period may well be an underperforming strategy or a strategy that cannot be implemented during the next five years.

A perpetual fund, therefore, demands an evolving investment strategy – one that can capitalize not just on mispricing that persists over the short term but also on different investment opportunities in the future. Thus, open-end funds tend to work best when the fund manager has the ability to respond quickly to new opportunities and to changing market conditions. This is more easily achieved if the manager has full discretion (subject to some broad, predefined parameters and mechanisms to ensure that investors are fully apprised of strategy changes).⁶

Also, open-end funds usually have many investors, each with a relatively small share. The combination of many investors and manager discretion typically results in investors having less control over strategy than in a closed-end fund. This can be a source of concern for some investors and, therefore, demands a different kind of client communication.

Client Communication

Many real estate funds in Europe now provide good information to clients,⁷ but the greater manager discretion and the evolving investment strategy of open-end funds means that to maintain investor confidence, communication must be proactive, highly transparent and multifaceted.

One medium for client communication is fund reporting. Reporting should demonstrate a robust investment process that meets all valuation, regulatory, corporate governance, and other legal and statutory requirements. Managers usually report open-end fund performance and activity (acquisitions, sales, new commitments, withdrawals, unit pricing, gearing, etc.) to all investors quarterly and annually. In addition, fund accounts are usually prepared and distributed to all investors annually. In the interests of transparency, managers are increasingly preparing and auditing these accounts in line with international financial reporting standards.

Another important communication channel, the documentation of a fund's investment strategy, lays out broad parameters, which are sufficiently flexible to accommodate strategy for a perpetual fund. Typically, however, the fund's broad, perpetual strategy is divided into short periods, e.g., one or three years, in which strategy is more tightly defined. Managers can communicate these tighter parameters through annual or multi-year investment plans. In the latter, investors will receive regular assessments of progress against the plan. Further, many open-end funds have a board or investment advisory council, which has no decision-making authority but can comment on items such as the current investment strategy, progress toward meeting the objectives of the strategy and other relevant issues.

⁶ This is the model used in the US and for many offshore UK vehicles. In an alternative model (such as that generally used in onshore UK vehicles), a board is employed, which has the authority to amend strategy as appropriate and generally has the right to replace the manager.

⁷ Not least due to the work of INREV.

Client reporting standards in Europe have improved greatly over the last decade. In the US, the progress has been even more dramatic, driven partly by the rapid growth of REITs and CMBS. With Europe perhaps on the cusp of a similar REIT phenomenon and a growing CMBS market, further advances in transparency and investor reporting will likely occur over the coming decade.

Liquidity

Secondary markets for shares in closed-end funds are emerging, but significant impediments to trading remain. Investors in closed-end funds, therefore, typically enter the fund on establishment and exit on liquidation. In the meantime, investors' exposure during the life of the fund does not change. By contrast, open-end funds generally provide investors with the ability to enter and exit periodically (typically quarterly or annually and subject to the fund being open to new commitments and having sufficient liquidity to meet redemptions). Thus, investors can change their exposure relatively quickly in an open-end structure.

Four sources of liquidity exist for investors seeking to redeem interests in open-end funds. First, managers can meet redemptions by new commitments, either from incoming investors or from incumbents wishing to increase their investment. The second source is undistributed cash flow, i.e., the operating cash flow generated by the fund available for distribution, which investors choose to reinvest. Third, the manager may have the capacity to increase the fund-level gearing ratio to meet redemptions, if appropriate. Finally, asset sales can help meet redemptions. Analogously, liquidity serves four primary uses, namely redemptions, distributions to investors, debt repayments and new acquisitions of property.⁸

Although open-end funds offer investors the facility to enter and exit periodically, there could be periods when redemptions may not be met quickly.⁹ Redemptions are usually met on a best-efforts basis, but real estate is inherently less liquid than equities and bonds. When the underlying real estate market is less liquid (e.g., when capital is withdrawing from real estate due to weakening investor sentiment), investors may need to wait longer for their units to be redeemed, for three reasons. First, weaker investor sentiment is likely to lead to a lower volume of new commitments to a fund. Second, a fund's ability to increase gearing to meet redemptions may diminish because banks' appetite to commit capital to the real estate sector lessens when the underlying market is weak. Third, asset sales can be more difficult in a weaker investment market, when more redemptions must be met through asset sales.¹⁰ Moreover, funds typically have a fiduciary obligation to all investors, which prevents them from selling at distressed prices to meet redemptions at the expense of those that remain in the fund.

The open-end structure functions best when a fund holds highly liquid assets. Thus, a core-type strategy works better than an opportunistic one, and diversified strategies are better suited than sector or regionally focused ones. A niche or focused fund carries a higher liquidity risk than a

⁸ An additional use of funds is the payment of fees and expenses.

⁹ Typically open-end funds maintain cash balances to meet redemptions (and in some cases are legally required to do so), but these may not always be sufficient to meet all redemptions.

¹⁰ This heightens the importance of the valuation process (see below).

diversified one since the risk that sentiment turns against the niche, sector or region is higher than that of sentiment turning against high-quality real estate in general.

Valuation and Unit Pricing

An investor's ability to enter and exit open-end funds from time to time, and to increase or decrease capital invested, requires fair and transparent unit pricing. This heightens the importance of a robust and consistently applied valuation process. Since unit prices are calculated with reference to valuations, valuations should accurately reflect fair market value.¹¹ If it does not, it can be more difficult and time-consuming to sell an asset, thus undermining the liquidity of units.¹² Clearly, investor confidence in the valuation process used in an open-end structure will be critical to a fund's success.

To invest in an open-end fund, an institution must buy the units that form the fund. When the number of units to be purchased exceeds the amount to be redeemed, new units are issued.¹³ However, buying into the fund at a price equal to NAV per share fails to account for transactions costs (transfer taxes, agents' and legal fees, etc.) incurred in acquiring the underlying real estate. Buying in at NAV per share means that new investors are paying too little, to the detriment of incumbent investors, because the latter bear a higher pro-rata share of the transactions costs. The appropriate price at which to buy into the fund is known as the offer price, which equals the NAV of each unit (on the date the units are purchased) plus a pro-rata share of the costs of acquiring the assets held by the fund, based on current values and estimates of current transactions costs.

A similar adjustment should be made on the disposal of units to reflect the costs of selling the underlying real estate. Failure to account for sales costs hurts the incumbent investors since they are left with a disproportionately high share of any taxes, legal fees, agents' fees, outstanding capital gains tax liabilities and the cost of premature termination of finance agreements. The appropriate price at which to sell out of a fund, the bid price, equals the NAV of each unit on the relevant valuation date, less a pro-rata share of any tax, sales expenses or other charges that would occur if the fund were to realize all of its investments on the relevant valuation date.

The difference between the bid and offer prices is known as the bid-offer spread, which is usually calculated as a share of the offer price. This spread represents the costs of transacting real estate and, importantly, is analogous and identical in magnitude to the costs of buying and selling real estate directly.¹⁴

A formal calculation of the unit price can be complex. The offer price can be calculated fairly straightforwardly since managers know the acquisition costs of the existing portfolio. Calculating

¹¹ Defined as the most probable price for which the appraised property will sell in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably and for self-interest, and assuming that neither is under undue duress.

¹² Valuation error can also lead to the mispricing of units, distort investors' performance experience and impact the timing of investors' entry and exit into and out of a fund.

¹³ Assuming the manager wishes to grow the fund and is confident of being able to invest the additional capital.

¹⁴ Assuming the investor and the fund incur the same transaction costs. In practice, a large fund may be able to negotiate lower legal and agents' fees than smaller investors due to economies of scale.

the bid price, however, is less easy since the disposal costs are not known at the time of the calculation. Therefore, the legal fees, agents' fees and other costs that would arise if the portfolio were to be liquidated on the valuation date must be estimated. Overestimating these costs penalizes the redeeming investors, whereas underestimating them penalizes the remaining investors.

In theory, this formal calculation is appropriate for all open-end funds, whether they comprise real estate or other assets. Market practice, however, varies considerably across different types of open-end structures, partly due to the fact that transaction friction (legal fees, agents' fees and transfer taxes) varies enormously across markets. For example, in the US, where transaction friction is low, open-end real estate funds, like mutual funds, tend to absorb acquisition and disposition costs. In other words, units are priced at NAV per share. Typically, buyers do not pay brokers' fees, transfer taxes are insignificant in most states (or paid by the seller), and legal fees are low.¹⁵ In Europe, and in other markets where transaction costs are significantly higher, the formal calculation is appropriate. The pricing of PUT units in the UK, for example, is usually done with the bid-offer calculation. Typically, the manager will assume the standard transaction costs (5.75% on acquisition and 1.75% on disposal), although some managers use lower rates on the grounds that they can negotiate lower agents' and legal fees.

In cross-border vehicles, the calculation becomes marginally more complex due to differences in acquisition and sales costs. The market has tended to deal with this in one of two ways. The first approach, typically used by German *Spezialfonds*, is to incorporate the transaction costs into the valuation. Another approach imposes an exit charge equal to a fixed percentage of capital to be withdrawn. Clearly, this reduces the cost of entering the fund but increases the cost of exiting it and, thus, distorts investors' decisions on whether to quit a fund or to reduce their exposure.

These issues do not usually arise in closed-end funds, since typically no mechanism exists for investors to enter, exit or vary their exposure once the fund has raised its target equity. A secondary market for units in closed-end funds is emerging, but the terms of trade are usually determined by negotiation between the buyer and seller of the units.

Fees

The perpetual nature of open-end funds demands a different fee structure from those of closed-end funds. Fee structures for open-end vehicles should exhibit four main characteristics.

- Fees should be divorced from valuation. Not least due to the need for independent, third-party valuers, determining the value of real estate portfolios is less straightforward than for portfolios of listed securities. If fees for open-end real estate funds are not based on valuation, managers do not have a vested interest in a particular valuation outcome. Investors, therefore, are likely to have more confidence in the valuation of the fund and, therefore, in unit pricing.

¹⁵ Also, to the extent that these funds generally only accept capital from domestic, tax-exempt investors, funds tend not to pay capital gains tax on the sale of assets.

- The interests of managers and investors should be aligned. This characteristic can be difficult to achieve, particularly with performance and transaction fees. In both cases, they have the potential to distort the managers' decision-making. Transaction fees can be particularly difficult in actively managed open-end funds since they could create concern on the part of investors about the motivations for portfolio repositioning.
- Fee structures should treat all investors equally. Again, this can be difficult to achieve with performance fees. A fee based on the historic performance of the fund, for example, can impact the timing of investors' entry and exit into and out of a fund and can create discord when different investors experience different effects from the same event.
- Fee structures should be transparent. This can be difficult to achieve, particularly if the alignment-of-interest criteria is met. Numerous fee structures are currently used in European real estate investment vehicles.¹⁶ Typically, they represent some combination of the following: management fees (which can be charged, among other things, on costs, commitments, drawn commitments, GAV or NAV); performance fees (which can be index-based, hurdle-based, one-off or periodic); and transaction fees (at acquisition, disposition or both). Add to this list, administration, property management, asset management, development and accounting fees, all of which have been used in real estate investment vehicles, and it is easy to see how fee structures can be complex and opaque. However, investors should not have to pore over footnotes and small print to determine how much and in what ways managers are remunerated.

Benchmarking

Performance fees raise the issue of benchmarking. The evolving investment strategy and perpetual life of an open-end fund also implies a different approach to benchmarking than that used in closed-end funds. With a fixed (and often niche) strategy and finite life, most closed-end funds have appropriately opted for a fixed, nominal, absolute, target rate of return benchmark. This contrasts with the index-based approach typically used in open-end funds in the US and the UK.¹⁷ In the US, open-end funds are typically benchmarked against the NCREIF Property (or more recently Fund) Index or the index plus some spread. In the UK, balanced PUTs tend to be benchmarked against an IPD index.¹⁸

The absence of a deep and reliable index of pan-European real estate performance has necessitated that pan-European open-end funds take a different approach to benchmarking. A fixed hurdle rate is not suitable for a perpetual fund with an evolving strategy – a structural change in market conditions (such as the move to a low-inflation environment over the last

¹⁶ See “Fee Structures in Pan-European Real Estate Investment Vehicles,” by Anders Astrom and Antonio Alvarez, for a full analysis.

¹⁷ Although not in Germany, for two reasons. First, German institutional investors tend to focus more on cash flow and running yield rather than IRRs and total returns. Second, many *Spezialfonds* are either cross-border investment vehicles for which performance indexes are not readily available or are used in the pursuit of closed-end strategies.

¹⁸ It is also worth noting that in general more emphasis is placed on the cash flow element of performance in diversified, core, open-end funds.

decade) can render such a hurdle obsolete. It makes more sense to adopt a benchmark or performance range that is reviewed when strategy is reexamined.¹⁹

Benefits of an Open-End Approach

The benefits of the open-ended structure can be summarized as follows:

- Diversified perpetual funds can be very effective in providing investors with broad exposure to property and core-type returns. Since index funds do not exist for private asset classes, large, core, diversified open-end funds can often be a good proxy for “beta” exposure to real estate (as measured against an index), despite the fact that they are typically actively managed.
- Investors can control the timing of their entry into and exit from an open-end fund, as well as raise or lower the amount of their exposure to real estate.
- As open-end funds grow in size and number, they provide a way to invest a large part of a real estate allocation, allowing investors to focus on the more tactical or opportunistic parts of the portfolio, which may be better tackled using the closed-end structure.
- Investors entering a mature open-end fund can benefit from gaining access quickly to the performance of real estate, assuming the fund is open for new investment. It may take time for new commitments to be invested, but new entrants benefit from a pro-rata share of performance from day one. This contrasts with direct property investment and closed-end funds, where committed capital takes some time to be fully invested.²⁰
- The perpetual nature of these vehicles allows managers to form long-term, mutually beneficial relationships with developers and owner-occupiers looking to reduce their real estate holdings. Such relationships can be structured in several ways but, in short, the fund can benefit from enhanced deal flow, while developers and owner-occupiers benefit from the fund providing a credible exit strategy or source of equity.

Given these benefits and the fact that the technology has been around for many years (at least for domestic investment), why do so few vehicles allow investors in a global marketplace access to pan-European real estate?

Toward a Pan-European Structure

Germany, the UK and several other countries offer institutional investors an open-end real estate structure for domestic investment, and some provide exposure to non-domestic markets (e.g., the German *Spezialfonds*). However, few funds exist that provide institutional investors in a global

¹⁹ A target rate of return expressed in real terms can also help mitigate the problem of structural change in some circumstances.

²⁰ That said, open-end fund managers must manage the entry of new capital into their funds to minimize the negative effects of holding too much cash.

marketplace with tax-efficient, permanent and strategic exposure to pan-European real estate. Three factors have hindered the spread of such pan-European, open-end real estate vehicles.

First, until recently, institutional appetite for a pan-European vehicle has not been sufficient and widespread. Most European institutional investors allocated most of their real estate portfolios to direct or indirect home-country investing. A decade ago, cross-border investing was thought more risky than domestic investment, due mainly to a lack of transparency and market familiarity.²¹ A few of those seeking cross-border investment acquired real estate directly, but most have chosen to manage risks using closed-end funds, with specialist management pursuing a well-defined, themed or sector-focused strategy. These vehicles have often involved some investor discretion. Demand for diversified pan-European real estate exposure has been more limited.

Second, the costs of implementing a pan-European strategy were prohibitive for most European institutions, not least due to currency risk. Before the euro, cross-border activity was not genuinely pan-European but involved only a few countries. Lack of investor (and manager) familiarity with non-domestic markets also brought significant information costs, which could be a barrier to entry.

Third, five years ago few managers could execute a pan-European strategy. More than the other main asset classes, real estate demands a local presence. Compared with the US, the European real estate market is highly fragmented (mainly due to the number of countries), with many different languages, legal frameworks, fiscal regimes and valuation procedures, as well as capital and real estate market conditions. Local presence allows investors/managers to exploit the lack of transparency and other market inefficiencies to derive persistent outperformance. Local expertise not only provides a significant advantage when accessing stock in competitive conditions but also forms a key determinant of an investment manager's alpha over the long term.

In the last five years, barriers have greatly eroded. According to DTZ Research, cross-border acquisitions have grown four fold since 1997 due, in part, to greater investor awareness of the benefits of real estate, and the specific and well-known benefits of global real estate.²² Intense competition for stock in domestic markets has also increased cross-border activity. These factors have contributed to a general rise in demand for non-domestic real estate (see **Exhibit 4**).

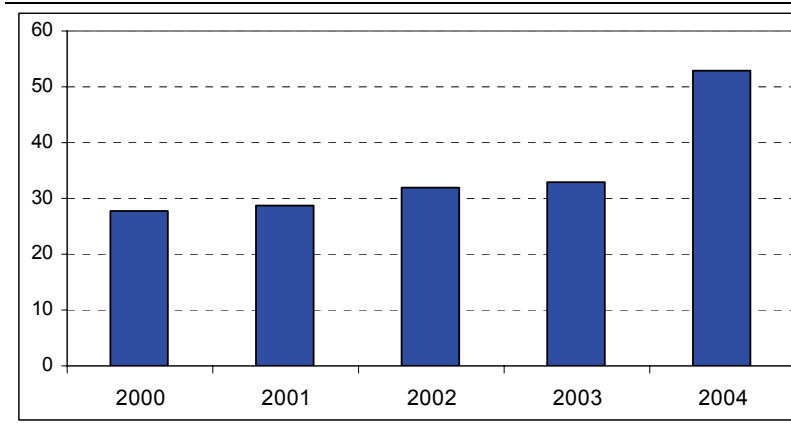
Importantly, however, a wider range of real estate investors is now seeking non-domestic exposure. The risk premium on cross-border investment has fallen as market transparency has increased, currency risk has decreased (with the euro's introduction),²³ and the set of experienced managers capable of executing a non-domestic strategy has widened. As a result, cross-border investment is no longer principally the domain of opportunistic investors seeking enhanced absolute returns. A lower risk premium has resulted in increased demand for non-domestic real

²¹ The absence until recently of a pan-European performance benchmark has also contributed to investors' apprehensiveness. IPD's recent progress toward a pan-European performance index is likely to raise the transparency of cross-border investment and thereby reduce investors' required risk premium.

²² The expansion of the investment universe by size and sectors, the ability to match international liability exposure, the opportunity for higher risk-adjusted returns and the ability to reduce portfolio risk through diversification.

²³ Internal analysis suggests that the spread of risk premium across the EU15 countries, excluding Greece, Portugal, Italy and Spain, is about 60 bps.

Exhibit 4: Cross-Border Acquisitions in Europe (€ billions)



Sources: DTZ Research; Prudential Real Estate Investors

estate from investors seeking core returns. For these investors, the motivation of going cross-border is to diversify portfolio risk and to widen the investment universe, rather than to enhance absolute returns.

At the same time, the costs of implementing a cross-border strategy have fallen significantly. The euro has eliminated much of the currency risk and therefore the hedging costs associated with pan-European investment. Investors no longer must hedge currency movements in each of the non-domestic markets where they are active. Increasing acquisition activity and greater availability of market research, together with a widening of the agency community, have also eroded the information barriers that investors once confronted.

Finally, the organic growth of the European real estate fund management industry over the last few years, together with the globalization of investment management, has increased the number of managers capable of executing pan-European strategies. A wide network of local offices means European managers can compete with domestic buyers to acquire real estate and to secure more competitive terms through principal-to-principal transactions.

In short, demand for cross-border investment is growing, investors are increasingly looking for a permanent strategic exposure to non-domestic markets, the costs of implementing a pan-European strategy are decreasing, and the number of managers capable of executing such a strategy is rising. As a result, growth in the number of pan-European, open-end real estate funds can occur.

Summary

The third-party investment management industry in Europe has grown very rapidly since the mid-1990s, but closed-end funds have absorbed most of the new capital. Part of the lack of interest in open-end funds comes from the fact that few funds are structured to admit non-domestic capital or to invest in non-domestic real estate. Also, European institutional investors are often much less familiar with open-end funds than are their US counterparts, for whom these vehicles have long been one of the main routes to real estate exposure.

Open-end funds are fundamentally different from closed-end funds, and the differences have significant implications for investors. The perpetual nature of open-end funds and investors' ability to enter and exit demand an evolving investment strategy, which is better gained with manager discretion. This demands a certain type of client communication and a greater sensitivity to valuation and fee structures. If any of these are compromised, investor confidence in the manager deteriorates. That said, the relative ease with which dissatisfied investors can exit an open-end fund ought to provide self-regulation.

Recent developments in the European real estate market will likely help open-end funds become more broadly accepted for pan-European investment. These include greater awareness of the benefits of such structures, the growing appetite of institutional investors for a strategic exposure to non-domestic real estate and the globalization of the investment management industry, which has raised the number of managers capable of executing pan-European strategies. Whether Europe is moving to a more US-style market structure, where open-end funds form the core or strategic component of institutions' indirect real estate exposure and closed-end funds form the satellites or tactical components, remains to be seen.

The 35-year history of US open-end funds suggests they work better with many investors in a large fund. The greater the number of investors and the larger the size of the fund, the more comfortable they feel with the liquidity aspects of the fund. A large, core, diversified fund provides investors with a proxy for the market, with strategy often linked to outperforming a market benchmark. With IPD having made significant progress toward a pan-European performance index, the successful pan-European, open-end funds are likely to be those that can achieve critical mass.

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