

## Research

Kevin R. Smith  
Managing Director  
U.S. Office  
Tel 973.683.1730  
kevin.r.smith@prudential.com

Robert Hess, PhD, CFA  
Principal  
U.S. Office  
Tel 973.683.1689  
robert.hess@prudential.com

Prudential Real Estate Investors  
8 Campus Drive  
Parsippany, NJ 07054  
USA

Tel 973.683.1745  
Fax 973.734.1319  
Web [www.prudential.com/prei](http://www.prudential.com/prei)  
E-mail [prei.reports@prudential.com](mailto:prei.reports@prudential.com)

### Executive Summary

- Private real estate investors now have a choice of two indexes to use as benchmarks – the NCREIF Property Index (NPI) and, since mid-2005, the NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE).
- The indexes have quite different structures. The NFI-ODCE aggregates the performance of a group of open-end funds with core investment strategies. The NPI measures the performance of a collection of wholly owned, unleveraged properties held by a wide variety of funds and single-investor portfolios with many different investment strategies. Moreover, there are important differences in the investments that compose the indexes. Statistics now available from NCREIF provide new insights into the differences between the investment selection choices of the funds in the NFI-ODCE compared with those of other NPI investors.
- The NFI-ODCE fund investments differ distinctly from those of other NPI participants in two key ways. NFI-ODCE funds tend to invest in larger properties than do NPI investors. This feature applies to all property types and is pronounced for the apartment, industrial, non-mall retail and hotel categories. The NFI-ODCE funds also tend to retain properties longer than the average NPI investor.
- The composition of the NFI-ODCE funds by property type and region varies modestly from that of the NPI. They hold proportionally less equity in apartment, office and retail assets, and they invest more heavily in the largest metropolitan areas. Less than 2.5% of NFI-ODCE gross assets are held in investments not included in the five property types in the NPI.
- Historically, the two index's returns showed a high degree of similarity. This arose in part because of the offsetting effects of leverage and the cash balance drag. Recent performance suggests that the NFI-ODCE has begun to exhibit more volatility than the NPI over the business cycle.

## **New Perspective, New Distinctions**

In May 2005, the National Council of Real Estate Investment Fiduciaries (NCREIF) launched a new index, the NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE), the first in a new family of indexes measuring fund performance in the private real estate industry.<sup>1</sup> It augments the NCREIF Property Index (NPI) family of performance indicators and its predecessors, which have been available to investors for nearly 30 years.<sup>2</sup>

Many plan sponsors and advisers have come to use the NPI as a performance benchmark. Now they have a choice, which leads to questions, including: Should they adopt the NFI-ODCE? How different are the indexes and their performances? Which index is most appropriate for them?

Statistics now available from NCREIF clarify important differences in the investment allocation, property selection and disposition practices between the funds in the NFI-ODCE and the rest of the NCREIF universe – closed-end, value-added and opportunistic open-end funds, and single-investor portfolios. We now have some insight into the details of the different investment strategies executed by the participating property fund managers, made possible by linking funds in the NFI-ODCE to properties in the NPI. These observations support the view that the NFI-ODCE will serve as a better benchmark for open-end funds pursuing a core investment strategy than the NPI.

The two indexes differ strikingly in their structure (discussed below) but historically have had very similar index total returns. As performance benchmarks, both indexes could have served equally well in the past. The performance similarity appears to have reflected the combination of similar investment choices and the offsetting effects of structural differences. But recent statistics suggest that important differences have emerged in the investment choices that the NFI-ODCE member funds now make compared with those of other NPI data providers. Proper benchmark choice now requires a deeper understanding of the differences between the indexes.

## **Rising Share of Core Funds**

The composition of the NPI universe during this decade has shifted sharply toward open-end funds, especially core open-end funds. **Exhibit 1** compares the proportions of total NPI value by three major fund categories: closed-end/single investors; open-end diversified core; and open-end noncore. Open-end funds have grown from less than one-third of total NPI value to nearly one-half. Overall, the NPI has increasingly become a collection of properties representing these three large and distinct groups of investors and strategies.

The NFI-ODCE universe consists of 14 open-end funds with diversified core investment portfolios. That is, the funds invest primarily in the major property types within the U.S., with modest leverage.<sup>3</sup> Over the past three years, NFI-ODCE member funds have increased in relative importance in the NCREIF universe. All the funds in the NFI-ODCE also report property

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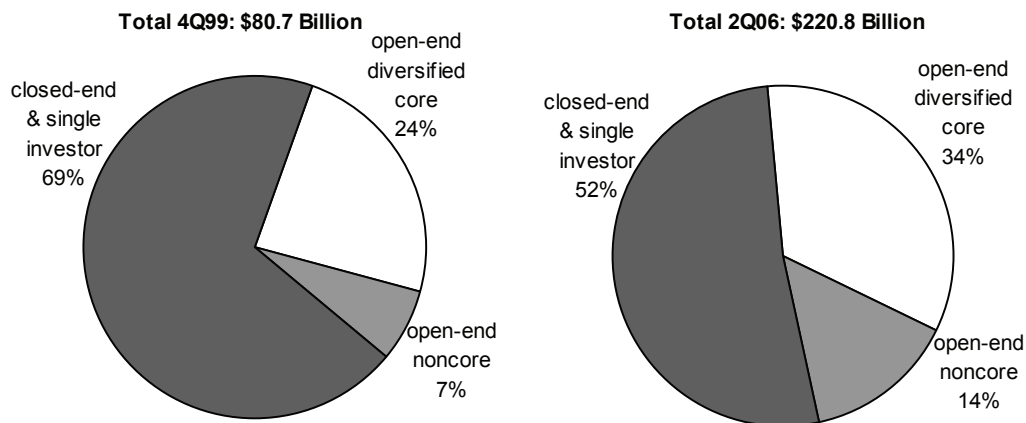
<sup>1</sup> For more information on NCREIF and its indexes, see [www.ncreif.org](http://www.ncreif.org).

<sup>2</sup> The Frank Russell Company launched the first private real estate performance index in 1977.

<sup>3</sup> **Exhibit 8** lists the criteria for membership in the NFI-ODCE index.

performances to the NPI. The rapid expansion of these funds over the past few years has outpaced the growth of other funds in the NPI universe.

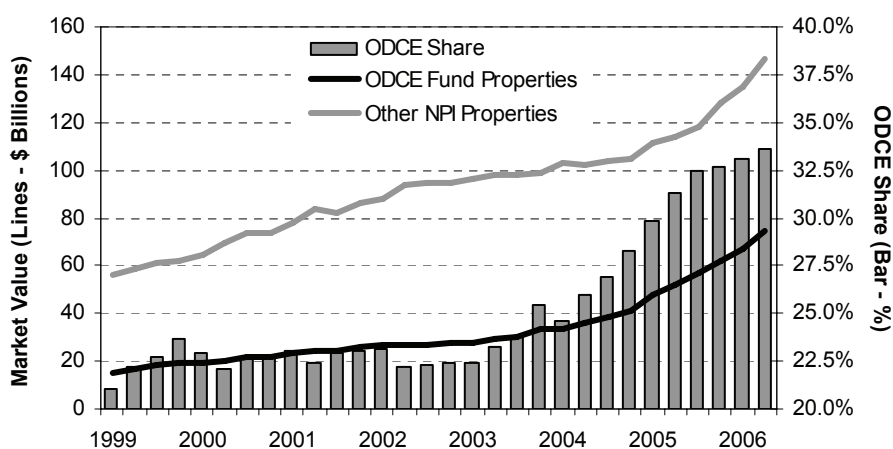
**Exhibit 1: Composition of NPI by Fund Type: 4Q99 and 2Q06**



Source: NCREIF

Exhibit 2 shows the growth of market value for properties in the NFI-ODCE funds and for all other properties in the NPI. In 1999, the ODCE fund share of the NPI stood at about 23%. During the early years of this decade, market value in both groups grew relatively slowly as the share held steady. In late 2003, ODCE fund growth accelerated. The share began to rise and continues to do so. By midyear 2006, the share passed 33% at \$74.4 billion. The combined market value of all properties in the NPI universe stood at \$220.8 billion at midyear 2006. On average, individual NFI-ODCE fund net assets have increased over the past five years from \$2.1 billion to \$5.2 billion. The average fund at mid-2006 had 107 properties, up by 50% from five years ago.

**Exhibit 2: Market Value and NFI-ODCE Share of NPI Properties**



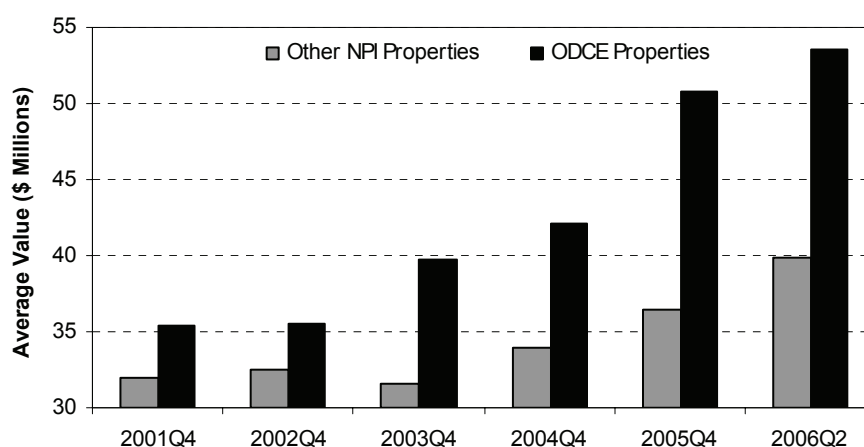
Sources: NCREIF; Prudential Real Estate Investors

Much of this increase arises from two distinct differences in the strategies that the NFI-ODCE funds have begun to follow compared with other funds and portfolios in the NPI: the large average value of properties they acquire and the slower pace of property sales.

### Average Property Value

Since 2003, the average value of properties in the NFI-ODCE funds has increased much more rapidly than other properties in the NPI. **Exhibit 3** highlights the rising spread between average property values. This has led to a striking difference between the average value for a property in the NFI-ODCE and that of other properties in the NPI.

**Exhibit 3: Average Property Value by Fund Category**



Sources: NCREIF; Prudential Real Estate Investors

As the exhibit shows, the average NPI property value in early 2001 stood at \$32 million. The average NFI-ODCE property value was essentially the same at about \$35 million. By midyear 2006, the average NFI-ODCE property value had reached \$53.5 million, far higher than the \$39.8 million value of other NPI properties. The average NFI-ODCE property now carries over 34% more value than an average property in other funds. During this period, NPI properties appreciated about 22%, explaining only part of the value increase and none of the growing gap between NFI-ODCE property values and those of other NPI properties. In fact, the appreciation of the NFI-ODCE properties over this period was slightly lower than the NPI average, totaling 19.7%. That is, property appreciation accounts for only about \$7 million of the average value increase of NFI-ODCE properties between 2001 and midyear 2006. Rotation of the portfolios to larger investments accounts for about \$11 million of the increase of average investment value.

For every property type, the average NFI-ODCE property value now exceeds that of other NPI properties. Allocation differences account for little of this excess: only about one-quarter of the variance of average investment value at midyear 2006 was explained by differences in property type allocations between the NFI-ODCE funds and other NPI properties.<sup>4</sup> At midyear 2006, the average NFI-ODCE value of industrial assets was 46% higher than the average value of other

<sup>4</sup> Metropolitan area allocation differences explain even less of the variance.

NPI properties. Non-mall retail was 36% higher, and hotels were 70% higher. The NFI-ODCE CBD office properties compose a somewhat smaller proportion of the total than they do of the other NPI properties, although their value was, on average, 22% higher. And, although malls formed a somewhat higher proportion, the average retail mall value in the NFI-ODCE is only 4% higher than the average of other NPI mall properties.

It is no coincidence that rapid growth of the NFI-ODCE funds and rising average values of fund investment have taken place simultaneously. As the funds grew, they acquired larger properties both because they could do so without straining diversification limitations and because pursuing larger investments offered advantages from the standpoint of buyer's market power.

Inefficiencies in the private marketplace rise with deal size and tend to benefit buyers more than sellers: the low volume and transparency of large transactions compared with smaller ones allow greater price negotiation; higher capital requirements limit access to fewer competitors; and the reduced liquidity of larger properties motivates sellers to cut deals with current prospective buyers.<sup>5</sup> The combination of these effects gives buyers in the market for larger properties a more attractive market environment than is the case for the more competitive market for smaller properties.

Also, higher valued individual assets allow NFI-ODCE funds to more efficiently deploy their asset and property management resources, keeping operating costs down. This scale economy translates to the ability to keep management fees low and to contain the costs of the asset management and portfolio management processes.

**Exhibit 3** overstates somewhat the average investment value for the NFI-ODCE funds because it displays property value expressed in 100% ownership terms, consistent with the NPI convention. In contrast, NFI-ODCE fund ownership is reported on a participating-interest basis. The NFI-ODCE funds hold, on average, about a 90% ownership share in the properties they report to NCREIF, a proportion that has remained relatively stable throughout the decade. Of course, the non-NFI-ODCE investors also hold many properties in joint ventures, although no figures for the average ownership share are available.

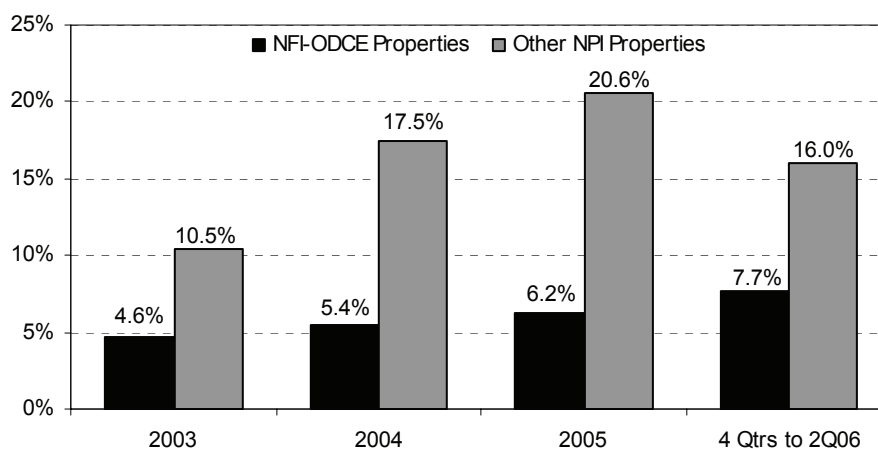
### **Pace of Property Sales**

The other striking strategy difference between the NFI-ODCE funds and funds holding other NPI properties is the much slower pace of property sales. **Exhibit 4** highlights this disparity. The difference seems to have widened during the recent episode of rapidly rising sales prices.

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<sup>5</sup> See Smith, Allen, "Open-End Real Estate Funds – How Big is Too Big?" IFE, March 2006.

**Exhibit 4: Sales as Proportion of Market Value by Fund Type**



Sources: NCREIF; Prudential Real Estate Investors Note: Sales figures before 2003 in the NPI database are not comparable.

Much of the difference in holding periods arises from closed-end fund dispositions in the NPI. By their nature, these limited-life funds hold properties for less time than open-end funds. Closed-end funds constituted about 75% of the property sales volume of non-NFI-ODCE properties over the past three years. During this time, their share of total property value in the NPI fell from 68% to 52%. However, during the same period, closed-end fund property value in the NPI rose by \$29 billion, an increase of 34%. Property appreciation and capital expenditures account for nearly all the increase. Closed-end fund sales and purchases were both intense, offsetting each other over this interval and totaling more than 60% of beginning value. Clearly, the transactions market has offered closed-end funds an unprecedented opportunity to recognize large value gains. But doing so came at the cost of portfolio growth in real terms.

#### **Minimal Asset Allocation Differences**

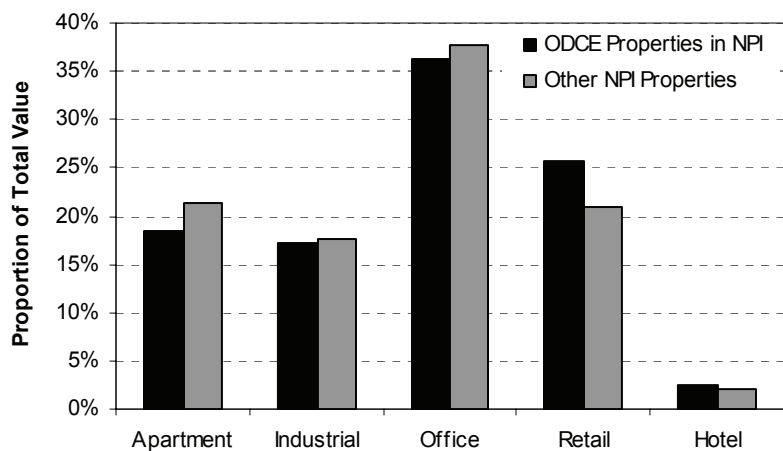
The composition of the ODCE fund properties in the NPI resembles that of the NPI as a whole, with a few important differences. Exhibit 5 shows the proportions of market value in each property type held by NFI-ODCE funds versus others contributing to the NPI. The NPI properties include only the five major property types, while some (2.4% at midyear 2006) real estate assets in the NFI-ODCE funds include other kinds of assets. Land holdings form the largest share of other assets, about 0.4% of total real estate value.

As the exhibit shows, the pace of NFI-ODCE dispositions is far slower than the corresponding pace of other funds contributing to the NPI. Moreover, while both groups increased the pace of sales as property values soared, the NFI-ODCE funds' pace rose much more gradually. For the four quarters ending midyear 2006, the NFI-ODCE's average holding period was about 13 years, while the average holding period for other NPI properties stood at a little over six years.

Exhibit 5 indicates an unusually high proportion of retail investment in the NFI-ODCE funds. This arises largely because all NPI properties appear in the index in 100% ownership terms. Because of this, the NPI values can exceed fund investment values. Comparisons between the NFI-ODCE

investment values by property type and their corresponding values in the NPI database suggest that this effect is pronounced with the retail property type. About half of NFI-ODCE retail properties are regional malls, assets that lend themselves to joint venture ownership due to their very large investment size.

**Exhibit 5: Property Type Allocations by Fund, as of 2Q06**



Sources: NCREIF; Prudential Real Estate Investors

**Exhibit 6** compares the values at midyear 2006 by property type of the ODCE investments as tabulated separately in the NPI database and in the ODCE fund database. For most property types, the differences are small. For the apartment and industrial property types, the portfolio values in the ODCE fund exceed by a small amount the property values in the NPI. Although we cannot explore the detailed reasons for the variance, this can happen because properties in the ODCE funds may not qualify for inclusion in the NPI for several reasons. Properties purchased during the most recent quarter (2Q06) do not yet appear in the NPI. Properties under development are excluded from the NPI. Other standards may also cause properties to be excluded from the NPI. None of these criteria result in exclusion from the ODCE value. In the case of the retail sector, though, the gross portfolio value falls considerably below the value of the properties. In this case, joint ventures have materially affected the value of the ODCE fund retail portfolio.

**Exhibit 6: ODCE Investment Values by Property Type, as of 2Q06**

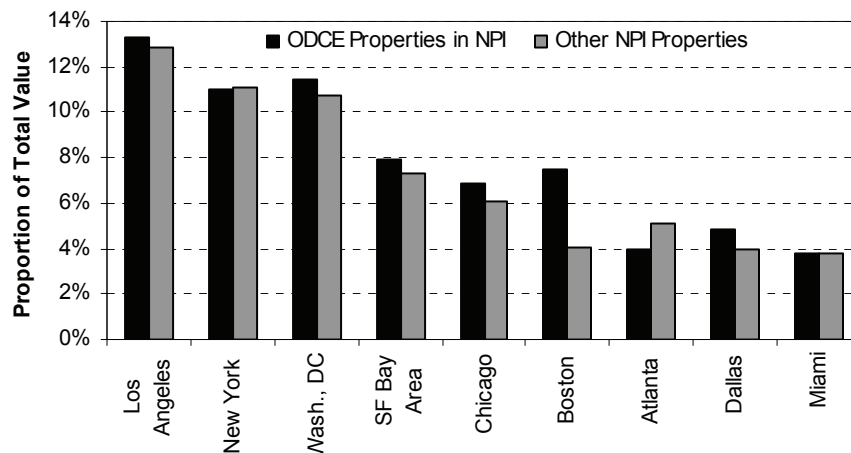
(\$ Billions)	Apartment	Industrial	Office	Retail	Hotel	Other	Total
<b>Portfolio Value - ODCE</b>	14.83	13.43	26.69	14.34	2.13	1.75	73.18
<b>Property Value - NPI</b>	13.70	12.73	26.91	19.05	1.89	--	74.27

Source: NCREIF

NFI-ODCE funds also focus their investments more heavily in the largest investment markets than other NCREIF investors. **Exhibit 7** shows the distribution of property investments in the seven major metropolitan markets with the greatest total NCREIF market values. At midyear 2006, these markets held about 71% of NFI-ODCE funds' property value; about 65% of the value of NPI properties held by other funds were in these same markets. However, NFI-ODCE

funds allocate a much higher portion of their properties to the Boston and Dallas metropolitan areas, while other NPI investments are weighted a little more heavily in Atlanta.<sup>6</sup>

**Exhibit 7: Major Market Allocations in NPI by Fund Type, as of 2006**



Sources: NCREIF; Prudential Real Estate Investors

### Index Structure Differences

The indexes have quite different structures, reflecting different compositions. First, the NFI-ODCE measures the performance of funds with core investment strategies, while the NPI measures the performance of properties held by funds and single-investor portfolios with varying investment strategies. **Exhibit 8** summarizes the key differences.

The NPI contains properties whose type and location are specified, reported as stabilized properties on a 100% ownership basis, with no leverage. The NFI-ODCE has different investment restrictions and includes all investments regardless of property type or location. It incorporates the effects of leverage, joint ventures, cash held at the fund level and other assets. Also, NCREIF releases the NFI-ODCE in both a gross- and net-of-investment-management-fees basis.

The strong correlation between the returns of the two indexes stems both from similarities in the asset bases and from the fact that the effects of two key differences – debt and cash balances in the NFI-ODCE portfolio – largely offset each other most of the time.

### Leverage and Cash

The greatest structural difference between the two indexes is that the NFI-ODCE represents an aggregate of actual investment portfolios, while the NPI contains properties with the abstract portfolio characteristics of no cash balance and no leverage.

<sup>6</sup> Interestingly, we have argued that investors should consider investments in Dallas and Atlanta as a single group due to the strong correlation of returns and economic trends between them. See Smith, Allen, Robert Hess and Youguo Liang, “Size-Tiered Economic Geography: A New View of the US Real Estate Markets,” October 2004, and Hess, Robert and Youguo Liang, “Size-Tiered Economic Geography: An Update,” December 2005.

**Exhibit 8: NPI and NFI-ODCE Compared, as of 6/30/06**

	<b><u>NCREIF Property Index</u></b>	<b><u>NCREIF Fund Index - ODCE</u></b>
Composition	Properties	Private open-end funds
Leverage	Reported with no leverage	Not more than 40% (6/30/06 avg., 20%)
Joint Ventures	Reported on 100% ownership basis	Reported in net terms consistent with accounting treatment
Cash Balance	No cash	Includes cash balances
Size at 6/30/06	\$220.8 billion assets	\$73.2 billion gross RE assets
	5,055 properties	\$58.7 billion net RE assets 1,497 properties
Property Types	Apartment, Industrial, Office, Retail, Hotel	At least 80% of RE assets in these types
Geography	U.S.	At least 95% in U.S. (6/30/06: no non-U.S. properties)
Diversification	Not specified	Not more than 70% in one property type or one region
Management Fees	Not meaningful	Indexes for gross of fees and net of fees performance
Strategy	Various. Excludes properties in initial lease-up.	Diversified core equity

Sources: NCREIF; Invesco Real Estate; Prudential Real Estate Investors

Ironically, the effects on performance of cash and leverage usually offset each other in the NFI-ODCE. Cash balances should, in theory, lower the performance of the funds relative to a portfolio with no cash balance, due to the low expected return from cash. However, leverage raises the fund return when asset returns exceed debt costs.

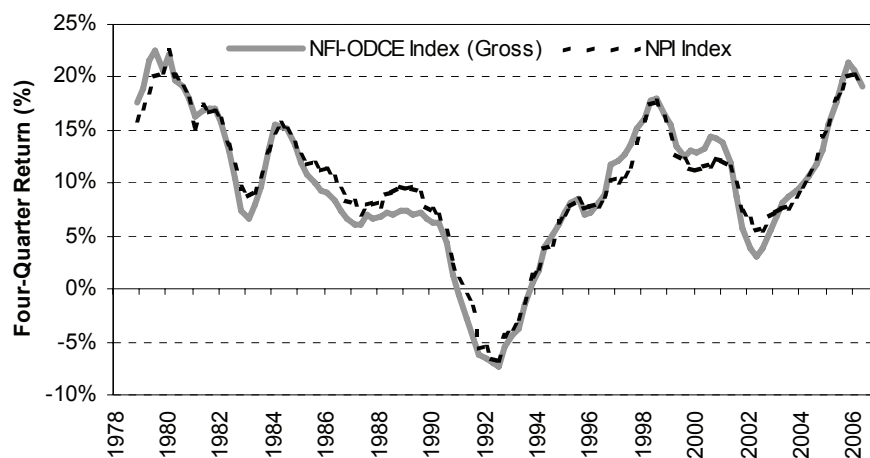
Over the past five years, the NFI-ODCE funds have in aggregate maintained a 19% leverage ratio and have held a 6.75% cash balance. We do not have information about the average cost of debt for these funds or about the yield on cash balances. Their effects, though, often largely offset each other under common interest-rate conditions. At these proportions, if the spread between debt costs and cash returns were about two-thirds of the spread between property returns and cash returns, the impact on the total return of these two segments of the portfolios would exactly offset each other. For example, suppose property returns are 8%, debt costs are 7% and cash returns are 5%. In this simple case, the property return spread over cash is 300 bps, and the debt-cash spread is 200 bps, exactly a two-thirds ratio. In this case, a 6.75% cash position would lower asset returns by about 20 bps. At the same time, 19% leverage with debt costs 100 bps below property returns (100 bps positive leverage) would raise the total equity return by about 23 bps. A portfolio with both a cash balance and leverage in the above proportions would register a total return near 8%, the same as the return on its property portfolio alone.

Of course, lower debt costs or high returns on cash produce higher NFI-ODCE returns than NPI returns when property returns are the same. Similarly, higher debt costs and lower returns on cash produce lower returns. In 2005, the spread between property returns and debt costs soared to levels not seen in many years. However, the spread has narrowed sharply in 2006 as property returns cooled, which is likely to affect the NFI-ODCE index more than the NPI.

## Index Performance Differences – Modest but Growing

Despite all their differences, the historical movements of the two indexes are very similar but not identical. Plus, the two indexes may not correlate in the future nearly as well as they have so far. **Exhibit 9** shows the similarity of the two indexes over the entire historical record. **Exhibit 10** provides numerical performance comparisons of the two indexes for specific periods.

**Exhibit 9: NFI-ODCE versus NPI Four-Quarter Trailing Returns**



Source: NCREIF

Clearly, the two series track each other closely. Return peaks and troughs occur within one quarter of each other in most cases. One recent exception took place in late 1999, when the NFI-ODCE led the NPI by two quarters in reaching an intermediate trough. (The NPI fell to the 3% quarterly return range for over a year, while the NFI-ODCE gross return rose to 3.8% in mid-2000. Quarterly returns for both indexes began to decline again in 2001.) And in this particular case, the index low points were more spread out than in other recent highs and lows. Over the past three years, the two indexes registered virtually identical total returns. The NFI-ODCE index posted a very slightly higher total return over the past 10 years, cumulatively totaling about 12.7% over the 40-quarter span.

Quarter-by-quarter comparisons summarized in **Exhibit 9** reveal a few relatively long-lived divergences. Two of the largest have occurred recently, coinciding with a minor peak in 2000 and a major trough in 2002.

The NFI-ODCE clearly outpaced the NPI in the past year, consistent with its tendency to reach higher peaks. However, the NFI-ODCE return does not consistently exceed the NPI return, as the comparisons for longer time intervals show. Moreover, the long-term standard deviation of quarterly returns for the NFI-ODCE appears higher than the NPI volatility, despite a somewhat lower figure for the most recent four quarters.

**Exhibit 10: Quarterly Returns and Return Volatility at Mid-2006**

	1 Year			3 Years			5 Years			10 Years		
	Annual Ret.	Mean Ret.	St. Dev.	Annual Ret.	Mean Ret.	St. Dev.	Annual Ret.	Mean Ret.	St. Dev.	Annual Ret.	Mean Ret.	St. Dev.
<b>NFI-ODCE Index</b>												
Total Return	19.2	4.5	0.7	15.8	3.7	1.1	11.6	2.8	1.5	12.7	3.0	1.2
Apprec. Return	12.4	3.0	0.6	8.6	2.1	1.1	4.1	1.0	1.7	4.3	1.1	1.2
Income Return	6.2	1.5	0.1	6.7	1.6	0.1	7.3	1.8	0.2	8.1	2.0	0.2
<b>NCREIF Property Index</b>												
Total Return	18.7	4.4	0.8	15.8	3.7	1.1	12.0	2.9	1.4	12.4	3.0	1.1
Apprec. Return	11.7	2.8	0.8	8.3	2.0	1.2	4.2	1.0	1.5	4.0	1.0	1.2
Income Return	6.4	1.6	0.0	7.1	1.7	0.1	7.6	1.8	0.2	8.2	2.0	0.2

Sources: NCREIF; Prudential Real Estate Investors

NFI-ODCE income returns tend to fall below those of the NPI. The volatility of NFI-ODCE income returns is slightly higher than the NPI's, which may simply reflect the smaller size of the aggregate NFI-ODCE portfolio rather than any underlying volatility differences.

**Exhibit 11** compares the peaks and troughs of the two indexes since 1978. In recent years, the NFI-ODCE peaks often were somewhat higher than the NPI peaks and the troughs somewhat deeper. In the most recent peak, the NFI-ODCE return peak exceeded the NPI peak by 122 bps. At the same time, the NFI-ODCE 2002 trough dropped below the NPI low point by 240 bps. This can be understood in the context of appraisal frequency. The funds that contribute to the NFI-ODCE revalue their entire portfolios each quarter, while the NPI properties must be revalued at least once a year. This causes the NPI appreciation returns to spread out more broadly than the appreciation returns for the NFI-ODCE funds, blunting the highs and lows.

**Exhibit 11: Peak and Trough Comparison, NFI-ODCE versus NPI**

NFI-ODCE Peaks	4-Qtr Return	Nearest NPI		NFI-ODCE		Spread
		Peak	Qtr Lead/Lag	4-Qtr Return	Spread	
<b>Major</b>	<b>1979Q3</b>	<b>22.5%</b>	<b>1980Q1</b>	<b>Lead 2</b>	<b>22.5%</b>	<b>0.0%</b>
	1984Q1	15.5%	1984Q2	Lead 1	15.6%	-0.1%
	1989Q1	7.4%	1988Q4	Lag 1	9.6%	-2.2%
<b>Major</b>	<b>1998Q3</b>	<b>18.0%</b>	<b>1998Q3</b>	--	<b>17.5%</b>	<b>0.5%</b>
	2000Q3	14.4%	2000Q4	Lead 1	12.3%	2.1%
<b>Major</b>	<b>2005Q4</b>	<b>21.4%</b>	<b>2006Q1</b>	Lead 1	<b>20.2%</b>	<b>1.2%</b>
NFI-ODCE Troughs	4-Qtr Return	Nearest NPI		NFI-ODCE		Spread
		Trough	Qtr Lead/Lag	4-Qtr Return	Spread	
<b>Major</b>	<b>1983Q1</b>	<b>6.6%</b>	<b>1983Q1</b>	--	<b>8.6%</b>	<b>-2.0%</b>
	1987Q1	6.1%	1987Q2	Lead 1	7.3%	-1.2%
<b>Major</b>	<b>1992Q3</b>	<b>-7.4%</b>	<b>1992Q3</b>	--	<b>-6.8%</b>	<b>-0.7%</b>
	1995Q4	7.1%	1995Q4	--	6.4%	0.7%
	1999Q3	12.5%	2000Q1	Lead 2	11.2%	1.4%
<b>Major</b>	<b>2002Q2</b>	<b>3.1%</b>	<b>2002Q2</b>	--	<b>5.5%</b>	<b>-2.4%</b>

Sources: NCREIF; Prudential Real Estate Investors

Overall, the relative performances of total return for the NFI-ODCE and the NPI show that appraisal smoothing affects the NPI, although the impact is modest. The statistics refute arguments

that appraisal-generated performance lags exist in the NPI. More importantly, however, is the fact that the spreads between the NFI-ODCE returns and the NPI returns during these extreme episodes appear to be larger recently than they typically were in the more distant past.

### **Closing Thoughts**

Benchmarks work best when they gauge the performance of portfolios that resemble them. Private real estate investors now have a choice of two indexes to use as their benchmarks – the NPI and, since mid-2005, the NFI-ODCE.

From the standpoint of historical performance, the two indexes are very similar. Neither one offers an unambiguously higher standard for return performance based on historical movements. The NFI-ODCE has exhibited slightly greater volatility than the NPI. Based on their structure and performance histories, both indexes could have served as benchmarks for portfolios with diversified core strategies.

Nevertheless, the NFI-ODCE is better suited as a benchmark for core funds with modest leverage and small cash balances, as is the case with many open-end funds. It will more accurately reflect the impact of future changes in the relative cost of debt, the types and sizes of properties the NFI-ODCE funds hold, and changes in the pace of property acquisitions and sales on fund performance than the NPI will. The NPI is more appropriate as a benchmark, adjusted for the impact of leverage, for assets in equity portfolios using many different investment structures and strategies.

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Prudential Real Estate Investors  
8 Campus Drive  
Parsippany, NJ 07054  
USA

Tel 973.683.1745  
Fax 973.734.1319  
Web [www.prudential.com/prei](http://www.prudential.com/prei)  
E-mail [prei.reports@prudential.com](mailto:prei.reports@prudential.com)

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