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The Truth About Real Estate Allocations

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As the commercial real estate sector in the U.S. transitions from collapse to recovery, we believe that institutional investors are re-evaluating the composition of their real estate allocations. In our view, the historical performance of private real estate funds does not justify the high allocations to direct property typically found in corporate and public pension plan portfolios. Notably, investors have not been compensated for the costs or risks of illiquidity. The recent real estate downturn has illuminated those costs, and has demonstrated why listed real estate, through REITs, provides a superior investment vehicle for core and value added real estate allocations.

We now have a sufficient time frame since the modern REIT era commenced in 1992—a time frame that encompasses the full real estate cycle—from which to evaluate listed versus private fund performance. This paper will make the case that:

- Listed REITs have outperformed core and value added real estate funds consistently over the long term, while providing the benefit of liquidity.
- Returns for the average opportunistic fund have been comparable to REIT returns over the long term; however, the return cycles for these two strategies have been out of phase, resulting in distinct periods of outperformance for each.
- Core and value added fund investors clearly have not been adequately compensated for the risks of illiquidity through higher returns.
- Core and value added funds do not generate enough alpha to justify their fee structures.
- The REIT business model explains most of REITs' performance advantage over private real estate funds. Opportunistic funds, if the vintage year is properly selected, can be an attractive vehicle for distressed, capital appreciation-oriented real estate strategies.
- A rational, merit-based reallocation would drive significant capital flows away from core and value added allocations and into REITs.

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Historical Performance of Listed vs. Direct Real Estate

Over the past 30 years, which encompass two commercial real estate crashes (1989-1992 and 2008-2010), REITs have outperformed diversified core funds by 470 basis points annually. Over the past 10 years, REITs have outperformed core funds by 560 basis points annually.

We measured listed REIT performance using the FTSE NAREIT Equity REIT Index (NAREIT Index)—a market-capitalization-weighted index of 106 U.S. REITs. We used the NCREIF Fund Index–Open-End Diversified Core Equity (NFI-ODCE) series, which is also capitalization-weighted, to chart the performance of its open-end commingled funds that pursue a diversified core investment strategy. At March 31, 2010, the REITs in the NAREIT Index had an aggregate market capitalization of $273 billion, and owned an estimated $515 billion of real estate. As of December 31, 2009, the last period for which data are available, the funds in the NFI-ODCE had appraised net equity of $48 billion and owned gross real estate assets of $71 billion.

Table 1 compares their performance. Both indexes show results on a leveraged basis, with NFI-ODCE funds operating with less leverage (33%) than the NAREIT Index companies (47%, per Cohen & Steers estimates). Leverage, which adds to the volatility of returns, is a drag on returns in real estate bear markets, but enhances returns in up markets. Greater leverage has benefited REIT performance versus core funds over the long term, but has detracted from performance since the peak in real estate values in 2007 through 2009.

TABLE 1: ANNUALIZED TOTAL RETURNS THROUGH 2009
Listed REITs vs. Diversified Core Equity Funds

	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years	30 Years
NAREIT Index	28.0%	–12.4%	0.4%	10.6%	9.8%	9.9%	11.8%
NFI-ODCE Core (gross)	–29.7%	–9.8%	0.7%	5.0%	7.5%	5.4%	7.1%
Listed vs. Direct Performance (basis points)	+5,770	–260	–30	+560	+230	+450	+470

Source: Cohen & Steers, NAREIT and NCREIF.
Past performance does not guarantee future results. Investors cannot invest directly in an index. Information presented is for illustrative purposes only and does not reflect information about any fund, product or account managed or serviced by Cohen & Steers.

Another measurement consideration is that listed returns lead appraisal-based private fund returns, historically by six to twelve months. In our view, looking at a 10-year or longer time series, these adjustments would not change our overall conclusions. Later in this paper we discuss a rolling return analysis we performed, which adjusts for appraisal-based performance measurement.

The comparison in Table 1 uses a broad market index approach to assess the strategies and management skills of the underlying REIT management teams and private fund advisors. It is relatively easy to index a REIT allocation, yet impractical to replicate the performance of the broad, private fund real estate universe.

In practice, the advantage for REIT investors shown in Table 1 is understated, as most institutional investors hire active managers for their REIT allocation, many of whom outperform the NAREIT Index benchmark. In our view, active REIT management for a diversified strategy should add 200 basis points of alpha; REITs' stock-exchange liquidity enables portfolio managers to capitalize on valuation anomalies and performance variances across property types and markets as economic and real estate cycles change.

There are fund-of-funds managers who add value in private fund investment management, but the alpha is derived from strategy, property type and fund manager selection at a point in time, and from advisor oversight of strategy and governance—rather than from portfolio rebalancing throughout the cycle. Lack of liquidity for private funds precludes the same style of active portfolio management REIT investors enjoy.

REITs vs. Core, Value Added and Opportunistic Strategies

We expanded the study to evaluate the spectrum of actively managed real estate strategies. Table 2 summarizes the indexes used for the analysis. Data from eVestment Alliance have been used for active REIT manager returns. For private, the indexes cover approximately 270 funds, a subset of the 2,700 private-fund universe. According to NCREIF's definitions, core funds tend to have low leverage and concentrate their investments in stabilized assets within the United States. Opportunistic funds are typically highly leveraged. They are willing to assume more market risk—traditionally focusing on value creation and restructuring, rather than buying stabilized assets with steady cash flows—and some may invest globally. Value added strategies tend to fall between the other two. The results, which cover a property pool of $784 billion—65% owned by REITs and 35% by direct real estate funds—are revealing.

TABLE 2: INDEX OVERVIEW: LISTED REITs AND DIRECT REAL ESTATE FUNDS AS OF DECEMBER 31, 2009

	Assets (billions)	Equity (billions)	Leverage
NAREIT Index	$515	$273	47%
NFI-ODCE Core Funds	$71	$48	33%
NCREIF Townsend Value Added Funds	$53	$20	58%
NCREIF Townsend Opportunistic Funds	$145	$47	64%

Source: Cohen & Steers, eVestment Alliance, NCREIF and The Townsend Group.

Table 3 summarizes performance results for the 5-, 10- and 15-year periods ended December 31, 2009. Gross of expenses, opportunistic funds performed the best over 15 years, with a 12.6% annualized return, and actively managed REIT portfolios placed second, at 11.4%. For the past 10 years, actively managed REIT portfolios performed best, at 12.1%, while a passive REIT portfolio strategy based on the NAREIT Index was second, at 10.6%.

TABLE 3: ANNUALIZED TOTAL RETURNS THROUGH 2009
REITs vs. Core, Value Added and Opportunistic Strategies

	5 Years		10 Years		15 Years	
	Gross Return	Net Return	Gross Return	Net Return	Gross Return	Net Return
Listed REITs						
Active	1.9%	**1.2%**	**12.1%**	**11.3%**	11.4%	**10.6%**
Passive	0.4%	0.1%	10.6%	10.3%	9.8%	9.5%
Direct						
Core (NFI-ODCE)	0.7%	-0.2%	5.0%	4.0%	7.5%	6.5%
Value Added	-3.1%	-4.7%	3.9%	2.4%	7.1%	5.6%
Opportunistic	**3.1%**	0.2%	8.9%	6.1%	**12.6%**	9.8%

Source: Cohen & Steers, eVestment Alliance, NCREIF and The Townsend Group.
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However, looking at the more important net-of-expenses returns, actively managed REIT investors realized the highest returns for the 5-, 10- and 15-year periods. For the 15-year period, they earned an annualized 10.6%. Of the other active strategies, opportunistic funds placed second, at 9.8%. Core and value added funds lagged significantly, with annualized returns of 6.5% and 5.6%, respectively, over 15 years.

The results in Table 3 do not account for a private fund investor's ability to select an attractive vintage year, and assume that the investor has a systematic program of investing in all funds each year—again, not feasible for the private market, but easily executed in the listed market.

For example, in the opportunistic category, the long-term return over 15 years shows a 12.6% compounded annual return. However, if an investor had selected the well-timed vintage year 2000, the median return would have been 25.3% (20.0% net) through 2009, according to The Townsend Group. By contrast, vintage years 2006 or 2007 would show starkly poorer results—in some cases, a complete loss.

Looking at expenses over the 15-year holding period, REIT investors with actively managed portfolios saw the greatest efficiency, with just 7% slippage from gross to net returns (75 basis points in expenses). Active REIT portfolio managers outperformed the NAREIT Index by 160 basis points, gross of fees, for the 15 years. Core funds lost 13% of their gross returns to fees and expenses (100 basis points). Value added funds had 21% slippage from gross returns to net (150 basis points) and opportunistic funds lost 22% (280 basis points). While opportunistic fund expenses appear to be high, the index data include the promote fees that the successful opportunistic funds earned above their hurdle rates.

These results, to us, do not justify the fees paid for most private funds, nor do they justify the cost or risks of illiquidity that private investment vehicles require.

Rolling Return Analysis

Another method to evaluate performance, which addresses the issue that results may be influenced by the endpoints selected for measurement, is to look at rolling periods of returns. Table 4 tallies the results for the NAREIT Index and the three private fund strategies for rolling 3-, 5-, 10- and 15-year periods.

This study also creates a four-quarter time lag between the return series of listed REIT and private fund performance to account for the measurement differences of appraisal-based private fund performance. Note that all results are gross of expenses, which provides a performance advantage to private funds.

TABLE 4: ROLLING RETURN PERFORMANCE ANALYSIS OF REITs vs. CORE, VALUE ADDED AND OPPORTUNISTIC FUNDS THROUGH 2009

	Rolling 3 Years	Rolling 5 Years	Rolling 10 Years	Rolling 15 Years
Number of Periods Starting Q1 1978	113	105	85	65
NAREIT Index (1)	14.5%	14.2%	12.7%	12.8%
NFI-ODCE Core (gross)	8.7%	8.5%	7.8%	7.3%
% of periods listed REITs outperform	**79%**	**81%**	**96%**	**100%**
Number of Periods Starting Q1 1983	92	84	64	44
NAREIT Index (1)	12.9%	12.4%	11.9%	11.9%
NCREIF Townsend Value Added Funds (gross)	8.9%	8.5%	8.6%	8.7%
% of periods listed REITs outperform	**75%**	**73%**	**80%**	**100%**
Number of Periods Starting Q1 1988	70	62	42	22
NAREIT Index (1)	13.6%	13.4%	12.0%	13.2%
NCREIF Townsend Opportunistic Funds (gross)	13.9%	15.0%	15.2%	14.9%
% of periods listed REITs outperform	**43%**	**35%**	**26%**	**32%**

Returns are simple averages of compounded annual return snapshots.
Source: Cohen & Steers, NCREIF and The Townsend Group.
(1) The NAREIT performance is calculated using a four-quarter lag.
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Starting with a comparison of REITs with core funds, we analyzed 85 quarterly periods of 10-year returns. The simple average of compounded REIT returns over those 85 periods was 12.7%, compared with 7.8% for core funds. REITs had a batting average of outperformance of 96%. For 15-year periods, REITs outperformed core funds in each of the 65 periods. Over the 3- and 5-year rolling periods, REITs outperformed core funds 79% and 81% of the time, respectively.

REITs' record of outperformance tells the same story when compared with value added funds.

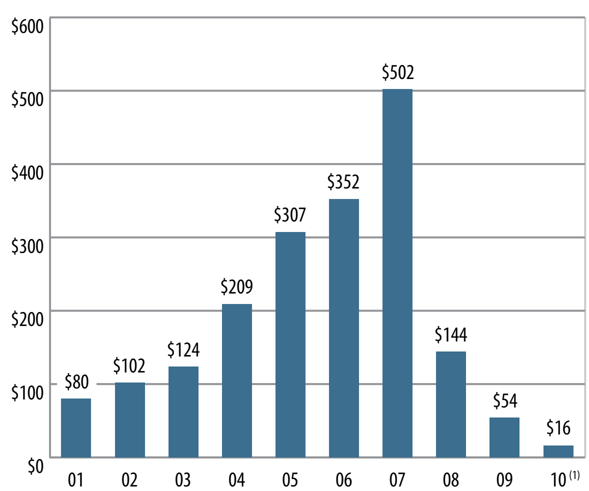
Compared with opportunistic funds, REITs underperformed 68% of the time for the rolling 15-year periods and 74% of the time for the rolling 10-year periods. Looking at net returns, however, passive REIT strategies and opportunistic funds performed about the same, using the rolling return analysis. Even though the net returns are similar, REITs still have the advantage over the opportunistic fund averages due to their lower-risk business models and liquidity.

Interestingly, while the returns for the averages are similar, the return cycles for REITs and opportunistic funds have been out of phase—meaning, there are distinct, sustained periods where one outperforms the other. This low correlation suggests meaningful diversification benefits between these two real estate strategies, especially if the vintage year for opportunistic is properly selected. Considering that opportunistic funds can be an attractive pure-play vehicle for distressed strategies, where capital appreciation or restructuring is the focus, they may further complement the cash flow-oriented strategy of a REIT allocation from a portfolio perspective.

Liquidity Comparison

Of the $270 billion in property held in all strategies of the private fund indexes, just 38% is controlled by open-end vehicles; the remaining 62% is controlled by closed-end vehicles that have no investor liquidity. The broader 2,700 private fund universe controls significantly more property than the funds in this study, and comprises predominantly closed-end vehicles. Open-end fund liquidity ranges from quarterly (in most cases) when times are good, to zero when private market transaction activity shuts down. At the end of the day, liquidity in private fund vehicles is a function of the liquidity in the underlying property markets, which evaporated from 2007 to 2009, as Figure 1 illustrates.

FIGURE 1: U.S. REAL ESTATE SALES 2001–2010 (billions)



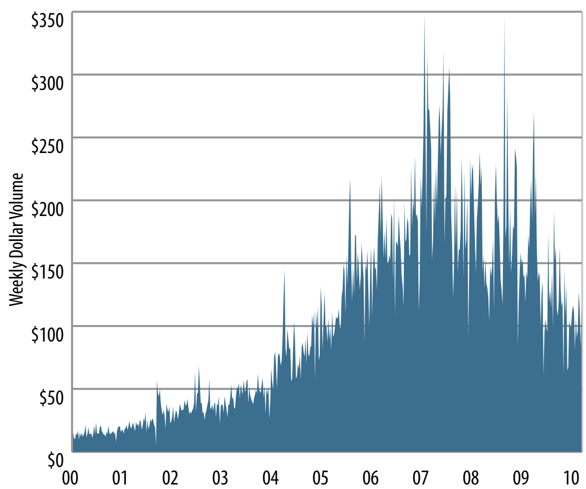
Source: Real Capital Analytics.
(1) 2010 data through March 2010.

Open-end private funds have far less liquidity than REITs, which have more than four times the equity base and are exchange-traded. Of the 14 NFI-ODCE funds that are active today, 12 have quarterly liquidity and two have daily liquidity. In some instances, once the property sales market shut down, this liquidity was created through borrowing—an inefficient liquidity mechanism that added risk when asset values were falling.

When investors' redemption requests spiked in early 2009, the majority of open-end private funds were forced to rescind liquidity and impose "gates"—that is, they halted redemptions. Today, most funds have either lowered their gates, or expect to soon. In fact, some funds are beginning to see investor queues form again to invest—which we find surprising, considering the findings in this study.

The liquidity in the REIT market has grown significantly (as shown in Figure 2), as more investors have embraced the investment case for REITs and as the market has developed. The growth has been driven by new strategies, such as global or income-oriented portfolio strategies; new vehicles, such as closed-end funds; the development of indexing and ETFs; the addition of REITs to the S&P 500; and the entrance of more participants, including hedge funds. Over the past year, REIT volume averaged $129 billion weekly, as measured by the MSCI U.S. REIT Index (RMZ). While liquidity in the private market shut down during the global financial crisis, significant liquidity for REITs was sustained, enabling REIT portfolio managers and asset allocators to rebalance.

FIGURE 2: RMZ INDEX LIQUIDITY (billions)



Source: Cohen & Steers, Bloomberg as of April 2010.

Business Models Favor REITs

We believe structural factors explain the majority of REITs' outperformance. First is the agency issue: investment decision makers for most core and some value added private funds are paid fees based on assets under management, and are therefore motivated to invest regardless of the returns available. Once private fund capital is raised, there are strong motivations to put the money to work.

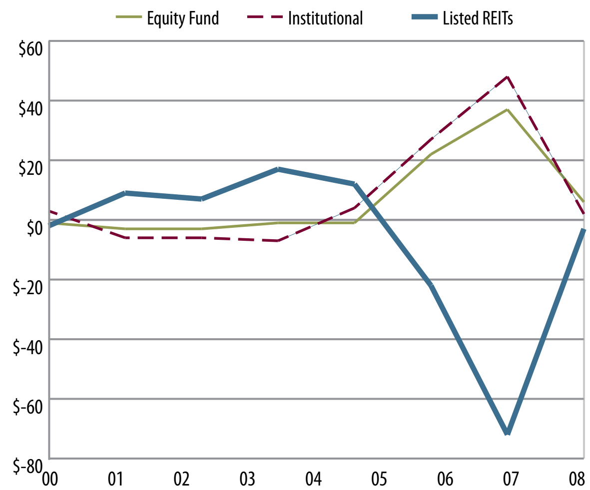
By contrast, REIT managements have significant "skin in the game" through share ownership, which acts as a governor on capital allocation decisions. In addition, they are subject to performance-based incentive compensation tied to a variety of fundamental objectives. Further, REIT managements are governed by boards of directors, SEC and NYSE regulations and, perhaps most importantly, by the invisible, efficient hand of the public market.

It is true that value added and opportunistic fund advisors also have skin in the game with co-investment, and incentive compensation through promoted fee structures tied to hurdle rates. Several factors, we believe, make these structural features less effective in the private fund world over the cycle, compared with the perpetual-life listed REIT model. First, there has been an asymmetrical payoff opportunity between co-investment amounts compared with the reward of management fees plus a 20% promote. Second, many sponsors have been accustomed to moving on to the next fund in the series, where a poor vintage fund might be followed by a strong vintage fund.

These structural dynamics are illustrated by the capital allocation decisions made through the peak of the last real estate cycle. Figure 3 shows that REITs sold $130 billion in assets from 2005-2008, while private real estate investors were net buyers.

Another major structural advantage for REITs is their access to public market capital. In the depths of the credit crisis, REITs were able to raise significant common equity to strengthen their balance sheets, address debt maturities and deleverage. Since March 2009, U.S. REITs have raised more than $45 billion through common stock, corporate debt and convertible offerings. By contrast, many private real estate owners have been unable to recapitalize. Without equity injections, they will be hard pressed to refinance loans that exceed lenders' current underwriting criteria. These overleveraged owners may default, may need to bring in high-cost equity partners in order to refinance, or may sell outright. Bottom line: REITs have a significant advantage today through their access to capital, at a superior cost, in the public market.

FIGURE 3: NET ACQUISITIONS LESS DISPOSITIONS OF COMMERCIAL REAL ESTATE (billions)



Source: Real Capital Analytics and Green Street Advisors.

While structural factors explain the majority of REITs' outperformance, we believe there are several additional factors to consider:

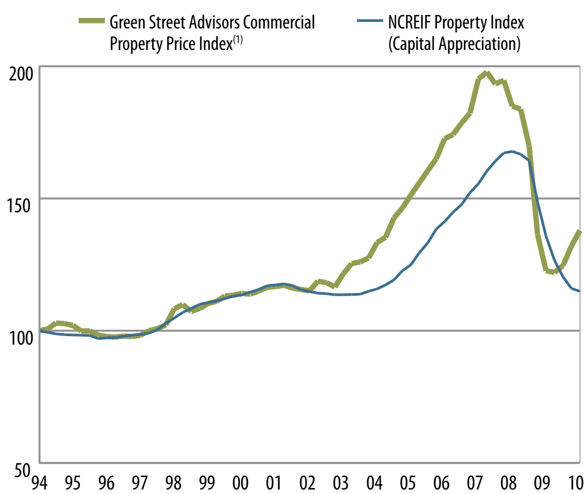
- REITs predominantly focus on one property type. As specialists, they have better market positions and are better managers in those specialties. These factors have led to superior revenue realization and cost efficiencies.
- Some REITs own niche property types that have not been considered institutional quality historically, but have performed well, such as self storage, student housing, data centers and laboratory/biomedical facilities. These property types have experienced strong relative cash flow performance and have enjoyed cap rate compression as they gained institutional acceptance.

Volatility

Historically, the case for direct real estate investment has been bolstered by the argument that real estate is less volatile than other asset classes. This is a misguided argument, in our view, because real estate cannot be measured in a real-time transactional framework, as stocks and bonds are measured in the capital markets. Furthermore, the appraisal-based valuations for the NCREIF Index or the private fund indexes smooth returns so that volatility is understated. Green Street Advisors has developed an index for its valuation of REIT portfolios that we believe gets closer to the truth on commercial real estate volatility.

Figure 4 compares the history of capital values for REIT properties (not the REITs themselves), as measured by Green Street Advisors Commercial Property Price Index (Green Street CPPI), with properties in the NCREIF universe, which are associated with the core property segment. Both of these data series are unleveraged, and simply measure commercial property values.

FIGURE 4: COMMERCIAL REAL ESTATE VALUES
3/31/94–3/31/10



Source: Green Street Advisors as of March 31, 2010.
(1) Adjusted to subtract capital expenditures for comparability to NCREIF.

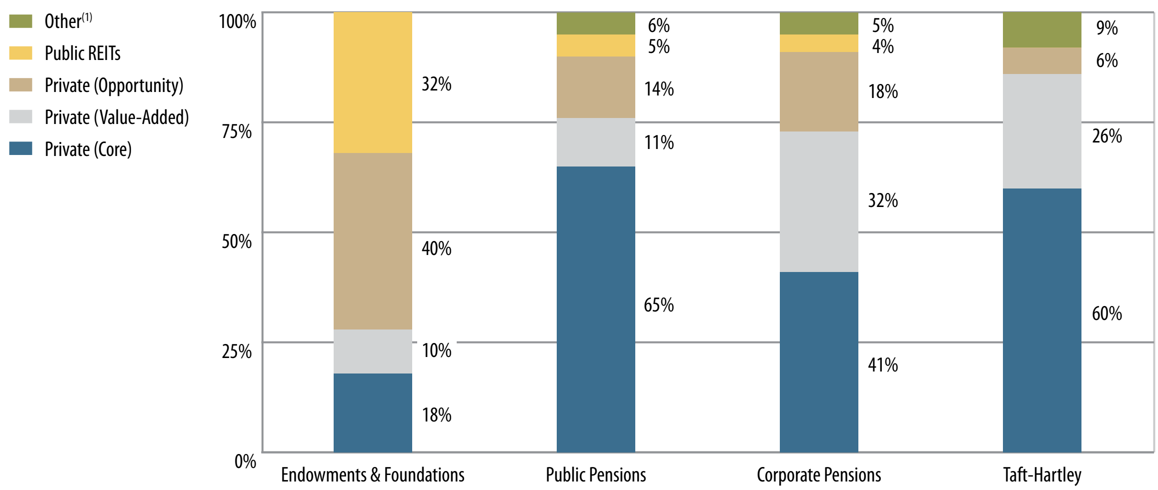
We believe Green Street CPPI is the index to watch, as we have found it to be the superior real-time indicator of commercial real estate prices. It is an equal-weighted index of real estate values calculated by Green Street's team of analysts for the key property sectors: office, industrial, regional mall, community shopping centers and apartments. Of note, it clearly indicates that commercial real estate prices are recovering: they are up 13% since the lows reached in May 2009.

The Green Street CPPI is not burdened by the price- and volatility-smoothing appraisal methodology of the NCREIF indexes. Over time, Green Street's index should prove to be a more accurate measurement of commercial real estate price volatility. Since its inception in March 1994, the Green Street CPPI shows that the volatility of commercial property values (rather than total returns that include income) is 55% greater than volatility measured by NCREIF. Volatility for REIT share prices—due to leverage, real-time discounting and the transaction-based framework of the public market—is still higher than volatility for direct property (44% greater than price volatility implied in the Green Street CPPI); but we believe proper measurement would close the perceived volatility gap meaningfully between listed and direct.

Institutional Real Estate Allocations Will Be Changing

Despite this evidence, U.S. corporate and public pension plans have allocated three-quarters of their real estate portfolios to core and value added private investments, according to research by Casey Quirk. And despite the evidence, listed REITs have garnered just 5% of their real estate allocation, as shown in Figure 5. But this appears to be changing. REITs' superior performance, liquidity, access to capital and transparency are attracting a growing number of institutional investors.

FIGURE 5: U.S. INSTITUTIONS' REAL ESTATE ALLOCATIONS



Allocation to All Real Estate	**14.3%**	**9.3%**	**7.5%**	**11.4%**

Source: IREI Tax-Exempt Real Estate 2009 Survey, Casey Quirk Analysis.
(1) "Other" includes private mortgages, Commercial Mortgage Backed Securities, securitized foreign investments and non-securitized foreign investments.
Asset classes not represented equal a 0% allocation. Allocations may not add to 100% due to rounding.

Corporate and public pension plans are estimated to have $252 billion of the $325 billion of institutional capital that is invested in real estate. Currently, about $12 billion of that is allocated to REITs. If these plans increased their REIT investments to the 32% allocation that endowments and foundations have—which is easily justified by the performance results, in our view—another $68 billion would shift into REITs.

Considering the new equity that we expect to be issued in the public market—by existing REITs that have begun to acquire properties and by initial public offerings of private companies—we believe the public market could easily accommodate those flows over the next several years.

Conclusion

The global financial crisis illuminated the benefits and shortcomings of a number of investments. For many institutions the costs of illiquidity were devastating. Some had to sell what they could—public securities. And as it turned out, regretfully for the sellers, public securities recovered first. Today, we believe that investors are more sensitized to the costs and risks of illiquidity, and will be more disciplined in demanding the return premium they deserve for locking up their capital. We are seeing some institutions asking to "start with a blank piece of paper" in order to create a portfolio with the proper beta and alpha components.

We also believe that institutional real estate investors are mobilizing to make better decisions, knowing that with private real estate, picking the right vintage year is critical. That is, performance in direct real estate investing is more a function of timing the cycle than picking the right property sector, strategy or manager. Accordingly, we expect to see institutions and their consultants commit more resources to designing frameworks that allocate effectively along the cycle and opportunity set, and between private and listed real estate.

With respect to private investing, we believe that we are at the beginning of a major upturn in the commercial real estate cycle; therefore, select private funds should do well because the vintage should be good. Furthermore, certain distressed investment strategies can be better executed in a targeted manner through direct rather than listed. For attractive vintage years, the opportunistic fund business model has worked well for higher-risk capital-appreciation strategies, versus income-oriented real estate strategies. But as the performance results in this study suggest, manager selection is critical.

Crisis is often the catalyst for change. We believe the global recession and financial crisis we are just now leaving will be the catalyst for institutional investors to re-evaluate their real estate investment decisions. Considering the case put forth in this paper, we believe that many institutional investors will seek to increase their investments in listed real estate over time; the data simply do not support the old way of making real estate allocations.

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