RESEARCH

Public and Private Real Estate:
Room for Both in a Diversified Portfolio

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There has been much debate about the relative merits of public and private real estate in recent years. Proponents of public equity real estate investing cite its liquidity and transparency. They note that public real estate is easy to diversify and that its long-term performance is a bit higher than private real estate. Proponents of private equity real estate investing, on the other hand, tend to focus on its steady values and lower volatility vs. the stock market, as proof that it is the more favorable investment.

Until recently, there hasn't been adequate data to conduct a thorough evaluation of the relative merits of each. New research, however, is beginning to shed light on the issue. This whitepaper aims to summarize the key findings in some of those papers and will demonstrate why we believe that a well-balanced portfolio should include both public and private real estate investments.

THE CASE FOR REAL ESTATE

Before diving into the particulars of the various types of real estate investments, it is important to recognize that real estate, in any of its forms, is a valuable asset in an investor's portfolio. During the past two years, much investor attention has been focused on the fact that, in many cases, private equity real estate and public equity real estate was over levered. During the financial crisis, as a result of the decline in property values and the widespread use of high leverage, there were a significant number of bankruptcies, mortgage delinquencies and foreclosures, even on some high quality, relatively well-known assets.

The good news is that today, property fundamentals are improving worldwide. Whether in the United States, Europe, or Asia, we are seeing strong demand return for commercial real estate, relatively limited new supply (which helps improve rents as tenants begin to lease up the available vacancy), and a capital market that is once again ready and willing to provide both prudent debt and equity financing to the commercial real estate markets.

> We believe that each type of real estate investment has a key role to play, and that there is room for both in a well-balanced investment portfolio.

The recovery in values since March 2009 has been impressive. Real estate equity values in Asia have increased 140 percent from their low point in March through May 2011 (Source: FTSE E/N Asia Pacific Index). The U.S. real estate market has improved almost 220 percent over a similar time period (Source: FTSE NAREIT Equity Index).

With the asset class on the upswing again, we believe investors may want to consider real estate for the following reasons: First, real estate is an income generator. Historically, more than 50 percent of real estate returns were generated from income (source: FTSE E/N Developed Index). Second, real estate has a low correlation to other asset classes, and can act as counterbalance in the portfolio. Third, investors widely consider commercial real estate an asset class that can help offset the impact of inflation over the long-term. As owners of a hard asset, investors have the ability to adjust rents over time. Typically, robust economic growth results in higher inflation, but also stronger rent growth. Finally, real estate can provide investors with overall capital appreciation in markets where occupancy and rental rates improve and supplies are constrained.

A MYRIAD OF CHOICES

When considering an investment in real estate, an investor has many choices ranging from building size, location, number of properties and risk strategy, but ultimately all real estate investments are one of two types: public, or private.

Public real estate, namely REITs, are corporations or trusts that use the pooled capital of many investors to purchase, manage and develop income properties. Often called "listed" real estate, shares of these companies are traded on major stock exchanges. REITs derive their value from rental income, which

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they in turn pass on to the shareholders in the form of dividends. This form of investing is also called indirect investing, because the investor owns a share of a corporation or trust, rather than owning the properties directly.

When an investor purchases a property directly, it is called private real estate investing or investing in unlisted real estate. This is sometimes also known as a "bricks and mortar" investment, because the owner has invested in the physical space.

Investors may also access private real estate through collective investments, known as pooled funds. Pooled funds are operated by an investment company, which raises money from shareholders and invests in a group of assets, with a stated set of objectives. These funds can be open-ended, or closed ended. Open-ended funds own a group of properties perpetually and individual investors can buy or sell their share of the fund at designated points in time (usually weekly or monthly). Closed-ended funds, on the other hand, have a specified life span, typically 7 or 8 years, and investors are expected to remain in the fund for its duration.

WEIGHING THE PROS AND CONS

There are advantages and disadvantages to each type of real estate investment.

Directly owned private real estate, the most tangible investment choice, allows investors to target specific markets, property types, strategies and business plans by purchasing individual buildings on a case-by-case basis. This strategy, however, comes with high asset specific risk. If the building loses a tenant, or if there are fiscal problems with the asset, for example, it could have a significant impact on the investor's overall real estate portfolio. Additionally, these investments require a considerable amount of oversight and, many investors hire a property or asset manager to oversee the building and tenant needs. Finally, when it comes time to sell, investors sometimes find their investments are much more illiquid than other asset types.

To mitigate some of the asset specific risk and to add a measure of liquidity, some investors choose to invest into collective or pooled funds. Each fund typically owns a number of properties diversified by type and location. Investors share in the risk and reward of owning private real estate investments. An added benefit is that these funds can potentially offer more liquidity than would otherwise be possible when owning direct real estate individually, as an investor may be able to sell his share of the fund to another interested investor. However, as many investors experienced during the liquidity crisis, the demand for shares may dry up, and the investor may find himself stuck in exit queues, should the market suddenly sour. The value of shares of pooled funds is determined not by the total value of the assets held, but by investor demand for the fund.

The third option, public real estate, offers an indirect way to access the real estate market. Because REITs are traded

The Advantages and Disadvantages of Various Investment Types

Investment Form	Advantages	Disadvantages
Direct Real Estate	• Can target specific markets/property types • "Hard asset" investment • Specific cash flow from rental income • Can manage specific risk profile through leverage	• More asset specific risk • Requires a property/asset manager • Illiquid – physical assets take time to buy and sell • High transaction costs
Collective or Pooled Investments in Direct Real Estate	• More diversified portfolio of underlying properties • Potential for increased liquidity (open-end)	• Illiquidity (closed-end) • Open-end funds claim to offer liquidity, but underlying assets are illiquid • High transaction costs
Listed Real Estate Securities (REITs)	• Daily liquidity and pricing • Transparency of reporting • Easier to diversify portfolio and deploy capital rapidly • Low correlation to bonds • Attractive potential dividend income • Long-term returns similar (and in some cases superior) to direct real estate investing	• Moves more in line with short term movements in broad equities markets

Source: Urdang

on a public exchange, their share prices are listed daily and their values are highly transparent. Additionally, investors have instant liquidity and the ability to deploy capital rapidly should they want adjust their weighting to a particular region or strategy. REITs also show a low correlation to bonds, and offer attractive dividend income.

So which form of real estate investment is preferable, public real estate or private real estate? We believe that each type of real estate investment has a key role to play, and that there is room for both in a well-balanced investment portfolio.

RELATIVE PERFORMANCE AND RISK

For all their differences, recent research has proved that public real estate and private real estate perform quite similarly over time. In fact, one study suggests that the performance of public real estate will ultimately match the performance of direct real estate ownership over a very long investment horizon and therefore could act as a proxy for private real estate[1]. The reason an investor might want to add both public and private real estate is that each investment type offers a different short-term benefit or strategic strength depending on the market cycle.

A study by the National Association of Real Estate Investment Trusts highlights these advantages. By examining 20 years of data on the U.S. REIT market, along with private equity real estate fund data compiled by the National Council of Real Estate Investment Fiduciaries (NCREIF) and Townsend Associates, the researchers found that listed REITs outperformed core, value-added and opportunistic funds during the last full market cycle, while providing the benefit of liquidity. However, during the bull market phase, opportunistic funds outperformed REITs on an annualized basis due to a shorter trough-to-peak period. They found that if the vintage year is property selected, these private funds can be attractive vehicles for distressed, capital appreciation-oriented real estate strategies. Core and value added funds, on the other hand, did not perform as well as REITs during the same time period[2].

Risk is another area in which public and private investments differ. The Pension Real Estate Association compared private real estate core returns to the U.S. listed real estate market, making adjustments for property type concentrations, and found that though listed REITS have outperformed private real estate since 1994, it did so with much more short-term volatility. Adjusting for risk, they found that private real estate provided higher returns per unit of risk. They concluded that adding REITs to a portfolio constructed of equities, corporate bonds, treasuries, and hedge funds, was only more advantageous for investors with a higher risk tolerance. Adding both REITs and private real estate, however, created a better efficient frontier along all points of risk-return spectrum[3].

In fact, it turns out that the low volatility of private real estate is just an illusion. Because the values of private real estate are appraised periodically, rather than daily, like stocks, their values appear more stable. Stephen Lee, from the Cass Business School, City of London University, points out in his research for IPE Real Estate Magazine that once the private real estate data is "de-smoothed" the correla-

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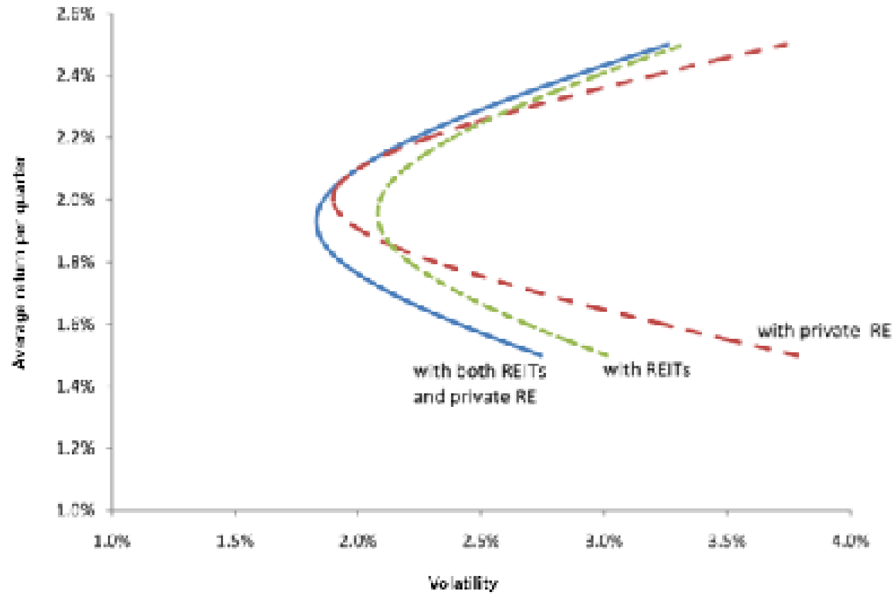
Efficient Sets with REITs and Private Real Estate
— Both are Better Than One



Portfolio theory provides a mechanism to examine the role of asset classes, e.g. private real estate and REITs, within a portfolio. An efficient set shows the best risk/return combinations available from a set of asset classes (i.e. the portfolios with lowest risk for a given target return, or alternatively the highest average return for a given risk budget). Given the limitations of portfolio theory as applied here, the specific results should taken with a grain of salt; the discussion is meant to illustrate general issues concerning REITs and private real estate within a mixed-asset portfolio rather than prescribe specific strategic asset allocations. The graph above shows three efficient sets, representing the best possible portfolios in terms of the return/volatility trade-off under three different scenarios. In all three scenarios, investors can allocate to equities, Treasuries, corporate bonds, and hedge funds. Two of the efficient set curves (the dashed lines in the exhibit) correspond to the cases where either REITs or private real estate are added to the basic asset classes. The third curve corresponds to the case where investment in both REITs and private real estate is allowed. (Source: PREA)

Source: PREA: NAREIT, MIT Center for Real Estate, Thomson Reuters Datastream. Based on portfolios including equities, BBB corporate bonds, Treasuries, hedge funds, along with REITs and/or private real estate. Data from Q2 1994 to Q2 2010. Private real estate and REITs measured with same property type weighting; REITs and private real estate are net of fees. Other asset classes represented by the Russell 3000, B of A Merrill Lynch BBB Corp. Index, B of A Merrill Lynch 7-10 year Treasury Index, and the Dow Jones Credit Suisse Hedge Fund Index.

tion between private real estate and REITs is significantly higher and increases steadily over time, reflecting the fact that REITs may behave like equities in the short run, however, over time the corelation between REITs and private real estate increases. Optimally, he believes, investors would include a 26 percent allocation to private real estate, but actual allocations are much lower, due to perceived risks and illiquidity[4].

BETTER OFF WITH BOTH

So, what does all this mean for the average investor's portfolio? We believe that the key take-away from this research is that better returns are available through strategic allocations to public real estate securities and private direct real estate vehicles. Investors, we believe, are best off with both: REITs' strong income profile, relatively low transaction costs and liquidity make them a valuable complement to a private real estate allocation focused on more opportunistic exposure to specific markets.

> Better returns are available through strategic allocations to public real estate securities and private direct real estate vehicles.

References:

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Disclosures

FTSE NAREIT Equity Index

The FTSE NAREIT U.S. Real Estate Index Series is designed to provide the most comprehensive assessment of overall industry performance, and includes all tax-qualified real estate investment trusts (REITs) that are listed on the New York Stock Exchange, the American Stock Exchange and the NASDAQ National Market List. The index constituents span the commercial real estate space across the U.S. economy and provides investors with exposure to all investment and property sectors.

FTSE EPRA/NAREIT Developed Index

The FTSE EPRA/NAREIT Developed Real Estate Index Series covers both the FTSE EPRA/NAREIT Equity REITs Index and the FTSE EPRA/NAREIT Developed ex-U.S. Index. Designed to track the performance of listed real estate companies and REITs worldwide, the series acts as a performance measure of the overall market. The index changed names on March 23, 2009, and was formerly known as the FTSE EPRA/NAREIT Global Real Estate Index.

FTSE EPRA/NAREIT Asia Pacific Index

The FTSE EPRA/NAREIT Asia Pacific Index provides investors with diverse representation of publicly traded equity REITs and listed property companies in Asia. Designed to track the performance of listed real estate companies and REITs in the Asia Pacific region, the series acts as a performance measure of the overall market. Stocks are free-float weighted to ensure that only the investable opportunity set is included within the index.