

**Stanley Iezman**  
Chairman & CEO

**Walter Page**  
Managing Director,  
Research & Strategy

## THE CASE FOR CORE REAL ESTATE TODAY

### FALL 2011

*Most institutional investors try to maximize returns while controlling risk through a diversified portfolio of low correlated assets. In this publication, we revisit the role of lower-risk high-quality core real estate in a multi-asset portfolio, and discuss why including commercial real estate makes sense today.*

### THE LONG-RUN ROLE OF CORE REAL ESTATE IN A DIVERSIFIED PORTFOLIO

Since real estate has a low correlation to other asset classes and has traditionally achieved competitive returns that are typically between stocks and bonds, investors can benefit from the inclusion of real estate in their

Total Returns By Asset Class (Annualized)				
	3-Year	5-Year	10-Year	30-Year
Cash	3.5%	2.1%	2.1%	5.2%
Bonds	9.9%	5.8%	5.5%	8.8%
<b>Private Real Estate</b>	<b>-3.6%</b>	<b>3.5%</b>	<b>7.5%</b>	<b>8.0%</b>
Stocks	4.4%	2.6%	3.3%	10.9%
International	7.7%	4.5%	8.5%	10.1%
Small Cap Stocks	9.3%	5.5%	10.0%	12.6%

Source: NCREIF, NAREIT, Dow Jones, Federal Reserve, ARA Research

portfolios to improve total risk-adjusted returns. In fact, based on the past 30 years of returns, American believes that investors would benefit from allocating 10% to 20% of their portfolio to real estate, especially with a targeted strategy of 60% to 100% of this allocation invested in core real estate

The features that make core real estate compelling in the current setting include:

- **Competitive returns** relative to equities and fixed income, both over the near-term as well as longer-term periods;
- **Predictable income** providing 70% of the total return to the asset class over time;
- **Low correlation to publicly traded assets** allowing the addition of real estate to increase return with limited increase in risk;
- **Attractive yields** currently higher than both the yield on the S&P 500 Index and the annual income returns of the Barclays Aggregate Bond Index; and
- **Hedge against inflation** since real estate values tend to rise as replacement costs rise.

We will look at each of these in the context of today's slow economic recovery and outline the advantages that can be gained through prudent diversification into core real estate.



**AMERICAN**  
REALTY ADVISORS.

**RETURNS**

For over 30 years, the National Council of Real Estate Investment Fiduciaries (NCREIF) has collected and tracked the performance of unleveraged private commercial real estate investments, providing an easily accessible benchmark for investors. According to the NCREIF Property Index (NPI), over the past 30 years, real estate has achieved an unleveraged 8.0% average annual total return, only slightly below that of fixed-income, and, if viewed for only the past 10 years, real estate returns have actually exceeded the returns of both stocks and bonds.

Investors have done well by including commercial real estate in portfolios and, while it is impossible to time the exact peaks and troughs of the capital market cycle, American believes that selecting points of positive relative value, like today, can enhance overall investment performance.

**INCOME**

Real estate is an attractive asset class primarily due to its stable and relatively high cash flows from lease income. Tenants are required to pay rents under their lease schedule and this results in lower volatility of income.

Correlations To Private Real Estate - Since 1980	
Cash	33%
Bonds	-9%
Stocks	11%
International	9%
Small Cap Stocks	5%

Source: NCREIF, Dow Jones, ARA Research

Since 1980, the income return from real estate has averaged 7.6% and has represented 91% of the total return to the asset class. The income return from real estate has been fairly stable, holding in the 6% to 8% range in both good and bad markets, with a 6.4% income (annualized) return as of 2Q11. Real estate’s strong income return includes a high cash yield paid out to investors (4.2% as of 2Q11), in addition to non-cash income that is typically retained to cover capital improvement costs.

**LOW CORRELATION TO PUBLIC SECURITIES**

Real estate has a low correlation with both equities and fixed income, thus making it an ideal asset to include in a multi-asset portfolio to reduce risk. The low correlation is largely due to the different way that the asset is valued.

Stocks and bonds fluctuate in price daily due to market activity. Real estate, however, is valued through appraisals, usually quarterly, and, as such, private real estate values change more slowly over time. As a result, non-investment related shocks and short-term investor opinion usually have a minimal effect on the pricing of private real estate assets, making this asset class ideal for long-term investors seeking return stability.

Also, due to the predictability of cash flow from long-term leases, a broadly diversified core real estate portfolio has a low level of volatility that can act as a portfolio shock absorber. This means that real estate returns are often up when other investment returns are down. For example, since 1980, in 32 out of the 36 down quarters in the stock market, real estate has achieved positive returns averaging 2.5%.

Real Estate as a Portfolio Shock Absorber - Since 1980					
	Real Estate	Bond	Stocks	International	Small Cap Stocks
Quarters Negative	15	30	36	41	42
Average Loss	-2.6%	-1.7%	-6.9%	-6.7%	-7.0%
# Quarters Real Estate Up	25	32	35	35	38
Average Real Estate Gain	2.8%	2.5%	2.5%	2.6%	2.7%

Source: NCREIF, Dow Jones, ARA Research

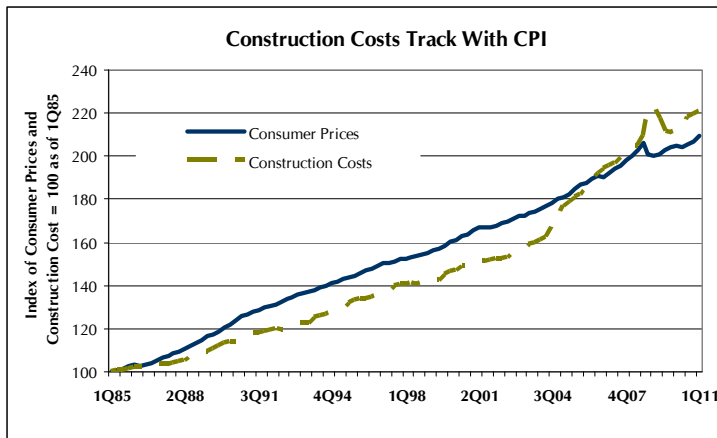
Since combining assets with low correlation can increase the returns of a portfolio at a given level of risk, real estate can be a significant contributor to portfolio stability.

**INFLATION HEDGE**

Real estate is a significant segment of the institutional investment base and appreciation returns participate in the growth of the overall economy.

In times of inflation, real estate assets have traditionally performed well. This is because real estate values are driven not only by tenant and investor demand, but also by building material prices for new construction and the replacement cost for existing assets which tends to move with inflation (see chart on the following page). As commodity prices increase, replacement costs for real estate assets also go up.

In addition, during times of inflation, owners often have more traction to increase rents as well as most leases being structured with regular increases, with the resulting increased income translating to higher asset values in the future.



Source: Moody's Analytics, Bureau of Reclamation, Bureau of Labor Statistics, ARA Research

## ATTRACTIVE RELATIVE RETURNS DURING INFLATION

With the economy experiencing historically low yields on fixed-income securities, real estate has presented investors with an attractive alternative. However, at the present time, interest rates are more likely to stay stable or rise, rather than decline further. Investors should ask, "How will various asset classes perform in an environment of rising interest rates and inflation?"

- Bonds clearly benefit from falling interest rates, having averaged an 8.8% total return over the last 30 years, a sustained period of falling interest rates. However, during the last period of rising interest rates (1940 to 1979), bond performance was poor at only a 2.5% average total annual return, as the fixed interest payments reduce bond returns during periods of rising rates.
- Stock performance was fairly steady across both periods of rising and falling interest rates, averaging 10.5% annual returns from 1940-1979 and 11.4% from 1980-2010. This is due largely to the fact that stocks, like real estate, can benefit from price increases due to inflation.
- Real estate performance during periods of falling interest rates similar to 1980-2010, had an average 8.3% total annual return. Given a real estate owner's ability to raise rents during periods of inflation, the performance of real estate in the face of rising interest rates is likely to be more like stocks than bonds, although the longer-term returns are still expected to fall between these two asset classes.

## WHAT IS THE CURRENT OUTLOOK FOR REAL ESTATE?

Despite what is expected to be a tumultuous and prolonged recovery, we believe that the fundamental drivers of the economy are likely to move back toward more normal levels over the next several years, with improvements in rents, occupancy and net operating income driving real estate gains. This is in contrast to 2010 and the first half of 2011, when returns were driven largely by capital market gains and cap rate compression. These improvements are likely to include:

- **Occupancy gains** — We are forecasting a gain in market occupancy rates of over 3% by 2014. Historically, real estate returns are approximately 3% higher in periods of rising occupancy than in periods of falling occupancy.
- **Rent gains** — As real estate rents remain depressed from the recession, market rents have the potential to increase by up to 20% before significant levels of new construction return to the market.
- **Net Operating Income (NOI) gains** — We are forecasting a 15% gain in real estate NOI by 2015. Since real estate is typically priced through the use of cap rates, a rise in NOI is likely to result in a corresponding increase in market value.

During the next few years, our outlook for core unleveraged investment returns is expected to range between 7% and 9% (8% to 10% leveraged), based on the assumption that most of the market cap rate compression has already occurred and with these rates remaining fairly stable over the next few years.

Core real estate prices are below long term trends by as much as 15%, with the gap narrowing, providing some downside protection and potential for significant upside going forward. In addition, the lack of new construction in most markets should help to protect occupancy.

Downward pricing adjustments for value-added investments have been even more significant, with distressed asset values down an average of 50% versus a 22% decline for core properties. We believe that value investors can now conservatively underwrite assets using realistic rent and occupancy estimates and that value-add investments may now provide a significant opportunity for those looking to expand their diversification plans, especially when these assets can subsequently be converted and redelivered as stabilized core assets.

## CURRENT STRATEGY

*As the economy and real estate markets move back toward normality after the “Great Recession,” we expect a bumpy recovery that is nevertheless likely to support several years of growth.*

*For core real estate investors, this has historically provided a period of above-average returns due to rising occupancy and rental rates. Since 1980, real estate has been proven to enhance an investor’s return/risk profile when combined with other assets, with optimal portfolio analysis showing a 10% to 20% allocation to real estate.*

*The key for investors is balancing expected return against potential risk. By including institutional quality core real estate assets in a carefully designed program undertaken with an experienced investment manager, investors can take a major step toward improving their portfolio in a way that can produce real benefits over time.*

For more information regarding  
**American Realty Advisors®**, please contact:

**Jay Butterfield, CFA**  
Managing Director,  
Fund/Separate Account Operations  
801 North Brand Boulevard, Suite 800  
Glendale, CA 91203  
Phone: (818) 545-1152 ▪ Fax: (818) 545-8460

[butterfield@americanreal.com](mailto:butterfield@americanreal.com)

*This newsletter is for your information only; is not intended to be relied on to make any investment decisions, and is neither an offer to sell nor a solicitation of an offer to buy any securities or financial instruments. The information in this newsletter has been obtained or derived from sources believed by American Realty Advisors to be reliable but American does not represent that this information is accurate or complete. Any opinions or estimates contained in this newsletter represent the judgment of American at the time this newsletter was prepared and are subject to change without notice. Models used in any analysis may be proprietary, making the results difficult for any third party to reproduce. Past performance of any kind referenced in this newsletter in connection with any particular strategy should not be taken as an indicator of future results of such strategies. It is important to understand that investments of the type referenced in this newsletter pose the potential for loss of capital over any time period.*

*This newsletter should be considered confidential and may not be reproduced in whole or in part, and may not be circulated or redelivered to any person without the prior written consent of American.*

*Forward-Looking Statements: This newsletter may contain forward-looking statements within the meaning of the federal securities laws. Forward-looking statements are statements that do not represent historical facts and are based on our beliefs, assumptions made by us, and information currently available to us. Forward-looking statements in this newsletter are based on our current expectations as of the date of this newsletter, which could change or not materialize as expected. Actual results may differ materially due to a variety of uncertainties and risk factors. Except as required by law, we assume no obligation to update any such forward-looking statements.*

