AMERICAN REALTY ADVISORS

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THE CASE FOR REAL ESTATE

OVERVIEW

The goal of most institutional investors is to achieve maximum returns while controlling risk. Over a long investment horizon, the most successful method of accomplishing this goal has been to diversify one's portfolio among asset classes that have a low correlation of returns and to hold these asset classes in proportion to their relative risk/return profiles. Since private real estate has a low correlation to other asset classes and has achieved competitive unleveraged returns that are typically between those of stocks and bonds, investors can benefit from the inclusion of real estate in their portfolios.

RETURNS

For just 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), real estate has achieved a 9.5% average annual total return over those 30 years. On a risk adjusted basis, this return is competitive with the 8.6% annual return for bonds and superior to the 9% to 11% annual return for stocks when the variability of return is considered. Real estate returns are built upon the value of long-term leases, so the volatility of the income stream, which accounts for 80% of the long-run return, is fairly low. The net result is that total return volatility for real estate tends to be low, with only three calendar years of losses in the past 30 years, all under -7% per year. This is in sharp contrast to the multiple years of double-digit loses seen over that period in the stock market.

Total Returns by Asset Class (Annualized)

As of 4Q08	1 Year	5 Years	10 Years	30 Years
Cash	1.8%	3.1%	3.3%	6.0%
Bonds	5.7%	4.6%	5.6%	8.6%
Private Real Estate	**-6.5%**	**11.7%**	**10.5%**	**9.5%**
Large Cap Equity	-37.0%	-2.2%	-1.4%	11.0%
Small Cap Equity	-33.8%	-0.9%	3.0%	11.2%
International Equity	-46.8%	4.2%	5.4%	9.4%

Source: Barclays Govt/Credit Bond, Dow Jones, NCREIF, S&P, Federal Reserve

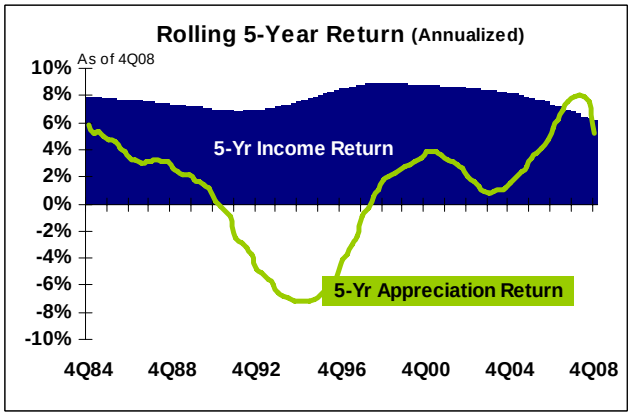
Sources of Real Estate Return
30 Years (Annualized)

As of 4Q08	Income	Appreciation	Total
Return	7.6%	1.9%	9.5%
% of Total Return	80%	20%	100%
Standard Deviation of Returns	**0.5%**	**3.8%**	**3.9%**

Source: NCREIF

INCOME

Real estate is an attractive asset class due to its stable and relatively high cash flows from lease income. Since its inception, the NPI income return has averaged 7.6%, compared to a 1.9% appreciation return. The income component of real estate has been stable with one-eighth the volatility of the appreciation return and has normally been in the 6% to 8% range in both up and down markets. Real estate's strong income return have included a high cash yield paid out to investors (3.2% as of 4Q08), plus non-cash income that is typically retained to cover capital improvement costs.



Source: NCREIF, ARA Research

LOSS MITIGATION

Real estate returns are not only competitive with other assets, but also help to offset losses from other areas of the typical investment portfolio. For example, over NCREIF's 30-year history, the stock market has incurred losses in 34 quarters, averaging -6.7% per quarter. In contrast, over the same 34 quarters, real estate generated positive returns in all but three quarters, averaging 2.5%. Real estate has achieved similar results versus bonds, international stocks and small cap stocks, providing stability to the overall portfolio, and when used at an optimal level, has more than cut in half typical portfolio risk levels.

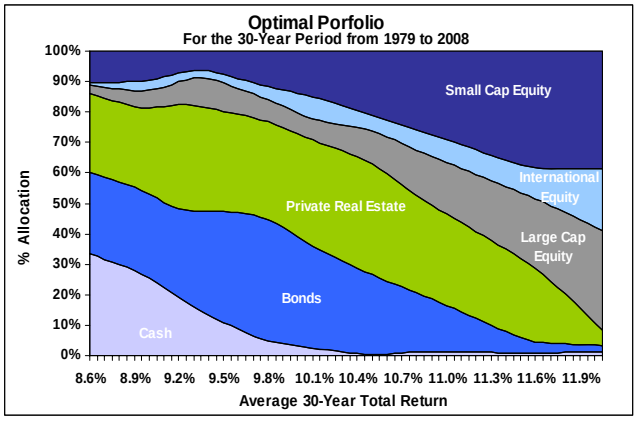
Real Estate Acts as a Portfolio Shock Absorber
30 Years (Annualized)

As of 4Q08	# Qrts Negative	Average Loss	# Qrts Offset by Real Estate	Average Real Estate Gain
Private Real Estate	**11**	**-1.9%**		
Bonds	29	-1.8%	26	3.0%
Large Cap Equity	34	-6.7%	31	2.5%
Small Cap Equity	39	-6.9%	36	2.7%
International Equity	44	-6.4%	38	2.7%

Source: Barclays Govt/Credit Bond, Dow Jones, NCREIF, S&P, Federal Reserve

OPTIMAL PORTFOLIO MIX

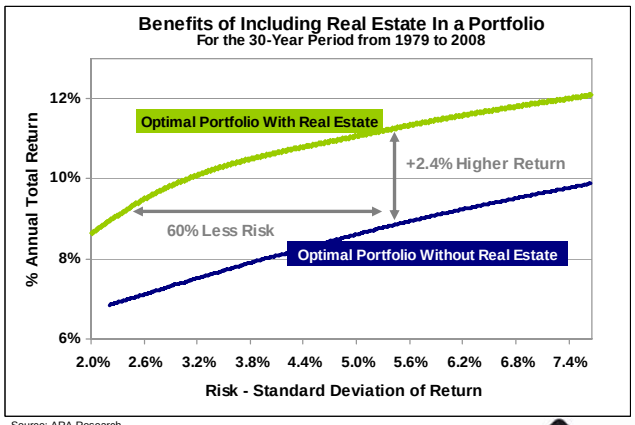
In a study of quarterly investment returns over the past 30 years for six asset classes, (including: cash, bonds, private real estate, large cap stocks, small cap stocks, and international stocks), it can be argued that real estate should represent between 10% and 25% of a portfolio.



Source: ARA Research

- Unlike stocks and bonds, the optimal allocation to real estate is relatively constant throughout the investment return spectrum, which suggests it is an important portfolio diversifier in all markets.

- Under normal market conditions (excluding 2008) the inclusion of real estate typically has added 50 basis points of return to the overall portfolio for any given level of risk. However, with the stock market collapse of 2008, the benefit from including real estate in a portfolio over the past three decades has increased to a 2.4% gain, as shown in the graph below. While this exceptional benefit from holding real estate could decline in future years, the recent trend suggests that the long-term benefits of including real estate in the portfolio are rising.



Source: ARA Research
Note: Real estate is represented by the NCREIF Property Index with 0% leverage and the standard deviation of return at 2x actual to reflect appraisal smoothing

- Suggesting that real estate can be a strong diversifier, the correlation of real estate to alternative investments is low and even negative to bonds (see table). This is mainly due to real estate's low volatility of returns and tendency to act as a portfolio shock absorber in bad times.

Correlations Between Asset Classes
30 Years (Annualized)

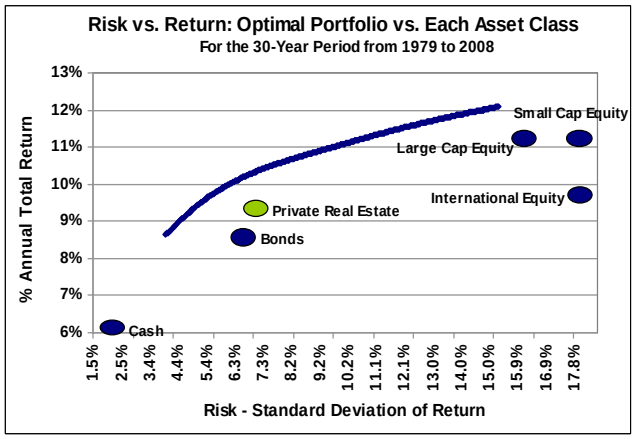
As of 4Q08	Cash	Bonds	Private Real Estate	Large Cap Equity	Small Cap Equity	International Equity
Cash	1.00	0.17	0.32	0.11	0.05	0.03
Bonds		1.00	-0.16	0.14	0.07	0.09
Private Real Estate			**1.00**	**0.16**	**0.11**	**0.16**
Large Cap Equity				1.00	0.92	0.80
Small Cap Equity					1.00	0.80
International Equity						1.00

Source: NCREIF, Dow Jones, S&P, ARA Research

OTHER BENEFITS OF INVESTING IN PRIVATE REAL ESTATE

In addition to strong total returns (over a full market cycle) and the potential to reduce portfolio risk, real estate provides stable income, low return volatility, and a potential hedge against inflation.

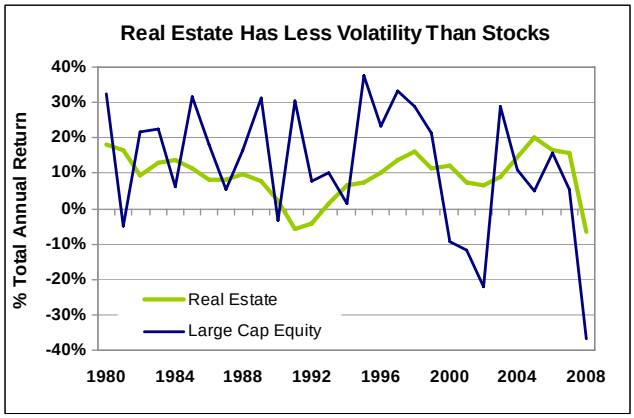
Stable Income: Since approximately 80% of real estate income is generated from rents paid by tenants through primarily long-term leases, the net operating income growth for real estate can be projected with some accuracy over a series of years. Additionally, real estate net operating income has rarely moved up or down by more than 7% in a single year and the worst ever business cycle decline in net operating income has been limited to 11%.



Source: NCREIF, Economy.com, Dow Jones, ARA Research
Note: Real estate is represented by the NCREIF Property Index with 0% leverage and the standard deviation of return at 2x actual to reflect appraisal smoothing

Low Volatility: Unlike stocks and bonds, which are subject to daily price volatility, private real estate is priced through valuations or appraisals that typically occur on a quarterly basis. As such, non-investment related shocks and short-term investor opinions 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.

Significant Portion of Wealth: Real estate represents 18% of U.S. institutional assets. In comparison, the average pension plan's real estate allocation is 9.6%, while an optimal portfolio allocation could be as much as 10% to 25%.



Source: S&P, NCREIF, ARA Research

Inflation Hedge: Real estate assets traditionally have performed well during times of higher inflation. 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, both of which tend to move with inflation.

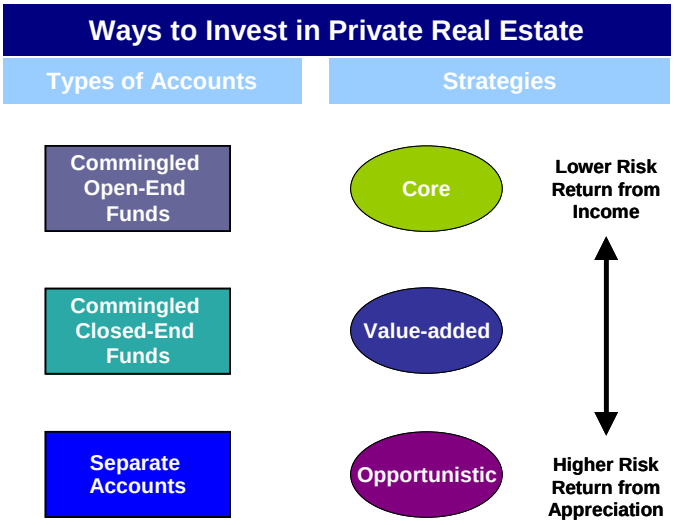
PUBLIC VS. PRIVATE REAL ESTATE

Investors should be careful to make a distinction between private versus public real estate investments (REITs). Although all real estate investments eventually generate returns based on their underlying assets, REIT pricing has suffered in the short-term as a result of higher volatility, as well as non-real estate related stock market risk. Consequently, short-term REIT returns can be substantially different from the longer-term returns expected from private real estate.

Since public and private real estate exhibit different risk profiles with similar long-term returns, American believes both public and private real estate can play a role in a mixed asset portfolio. In particular, we recommend investment in private real estate for the stable long-term portion of a portfolio's real estate allocation, with investment in public real estate for any tactical sector allocation strategies needed to balance the portfolio.

IMPLEMENTING THE REAL ESTATE PROGRAM

Investment in private real estate is typically accessed via the help of an investment advisor that conducts asset selection as well as active oversight of leasing and management. Real estate advisors generally offer three types of account structures including: commingled open-end funds, commingled closed-end funds and separate accounts.



Open-End Commingled Fund: The most common way to access real estate is via an open-end commingled fund. The advantage of an open-end fund is that it is designed to allow investors to increase or decrease their allocation to real estate, with entry and exit prices set each quarter based on updated valuations or appraisals of the assets. This fund structure allows for an infinite fund life and a high level of investment diversity and stability. Additionally, fees paid to the investment advisor tends to be lower than with other structures.

Closed-End Commingled Fund: A closed-end fund structure only allows investors to enter and exit the fund at established points, such as when a property is being acquired or sold. Under this fund structure, investors have little control, but are generally assured that entry and exit prices are based on transaction values and not on appraised values. Generally, the closed-end structure is used for real estate investments with little cash flow that generate most of their return from appreciation.

Separate Accounts: Larger investors who want a greater level of investment control can choose to invest in real estate through a separate account vehicle. Since separate accounts typically require a higher minimum investment, real estate asset values are relatively large in separate accounts and as such, portfolios tend to have less investment diversification than in a commingled fund. Additionally, the cost of a separate account is often higher than for a fund investment, although when the account size exceeds $500 million, the cost differences start to favor separate accounts.

STRATEGIES

Investment strategies for real estate range from low risk equity and debt strategies in which most if not all of the return is generated by current income, to high risk strategies that depend primarily on appreciation.

- Typically, an investor will have 60% to 100% of their real estate allocation invested in **core real estate**, which consists of a portfolio of well-positioned high-quality income-producing real estate assets in the primary property sectors – office, industrial, retail and multi-family – diversified across a wide variety of growing and/or supply-constrained markets nationwide. These assets are usually well-leased to credit tenants, produce steady income and have little or no deferred maintenance or other physical issues. In a core strategy, the majority of the total real estate return (80% over the past 30 years) is driven by the income return, with only a small portion attributed to appreciation. In the history of NCREIF, core real estate total returns have averaged 9.5%.

- **Value-added** strategies can include both real estate equity and debt investments in real estate, and typically include some type of action to enhance the value of the property. This can include re-positioning, re-tenanting, higher risk construction, or re-development strategies. While more aggressive use of leverage and complex financial arrangements is used in these strategies to enhance returns, these investments involve significantly higher risk and hopefully higher returns relative to a core real estate investment strategy.

- **Opportunistic** strategies are similar to value-added strategies, but typically exhibit a higher level of risk. Examples of opportunistic strategies generally encompass complex financial structures, investments in unentitled land, single or non-standard property types or real estate with environmental or other difficult to correct issues. These investments often have risks that are not easily quantifiable and should be approached with caution.

LEVERAGE

While as an asset class private real estate has generally low volatility, in today's market, some funds are escalating their exposure by increasing their use of leverage on investments in an attempt to enhance potential returns, such as with opportunistic strategies. In doing this, they are substantially increasing their risk of loss, especially over a longer-term horizon.

The use of leverage amplifies volatility, which erodes compounded returns and in effect, wealth accumulation over time. Leveraged fund performance over the long-term is not predictable as the impact of volatility accrues and lags relative returns, even though short-term gains may be reported or underperformance may seem minimal. Investors seeking stable long-term returns with low risk should consider funds employing minimal leverage in their portfolios.

CONCLUSION

Real estate has been proven to improve an investor's return/risk profile when combined with other assets. The key for investors is, as always, balancing expected return against potential risk. By including institutional quality real estate assets in a carefully designed program undertaken with an experienced investment manager, investors are making a major step toward improving their portfolio in a way that can produce real benefits over time.

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