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A Tale of Three Cities: Market and Property Type Selection are More Important Than Ever

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In today's difficult economy, geographic and property sector choices are critical to making successful decisions that drive investor performance. In this newsletter, we will discuss market fundamentals and capital market pricing for the four property types in three different metro areas — San Diego, Chicago and Boston. These three represent a broad picture of the nation's real estate markets; however, the performance differences of these markets clearly highlight that real estate is heavily influenced by local factors.

SAN DIEGO

Demand Trends

San Diego can be described as a market that entered the recession earlier than other metros, due in part to above-average housing value declines. Supporting this view, year-over-year employment trends are down 0.5% here vs. 0.4% nationally, and demand for office space is down an exceptionally large 2.8%, compared to a 0.7% increase nationally.

Demand Trends				
	3Q07 to 3Q08 % Change		2009 Forecast %	
	San Diego	National	San Diego	National
Total Jobs	-0.5%	-0.4%	0.0%	-0.2%
Office	-2.8%	0.7%	0.6%	-1.5%
Industrial	-0.9%	0.0%	0.0%	-0.2%
Multi-Family	-0.3%	-0.4%	0.0%	-0.4%
Retail	-1.7%	-1.0%	-1.0%	-1.1%

Source: Economy.com, TWR, PPR

Sales Trends

Median commercial property sales prices in San Diego are down for all property sectors, with the largest being a 10% decline in office pricing to \$281 price per square foot (PSF). While transaction cap rates in the market have generally increased to the 6% range, they are still well below the 7.5% long-term average and are likely to trend upward over the next year. Additionally, based on broker interviews, we are finding that the limited transaction activity is being skewed towards higher quality assets, which also suggests that further near-term value adjustments are likely.

Market Implications

- San Diego entered this recession earlier than most markets due to its ties to the housing industry. As a result, San Diego is expected to slightly lead the national recovery. In general,

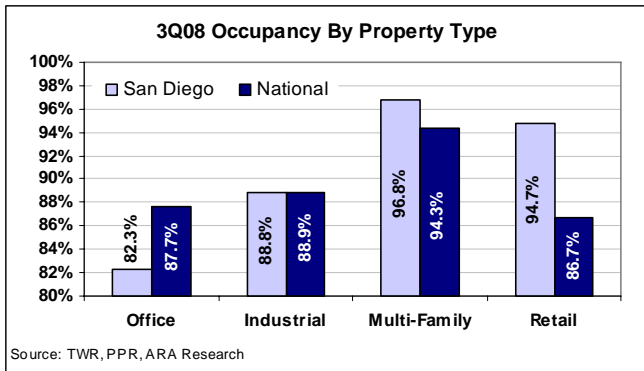


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market pricing for commercial real estate is still somewhat expensive relative to the long-term trend and U.S. valuations. This suggests that investors should wait on making new investments in San Diego until the pricing metrics adjust.



- Once the market stabilizes, the more supply-constrained locations within San Diego, such as the north coastal areas, are likely to outperform market averages due to a history of high occupancy, especially for office and retail properties.

has suffered a loss in demand of 0.4%. Going forward, we expect 2009 to be a difficult year for Chicago's economy and real estate markets, with demand losses of up to 1.5% in the office sector. However, the demand trends should be similar to national trends.

	3Q07 to 3Q08 % Change		2009 Forecast %	
	Chicago	National	Chicago	National
Total Jobs	-0.3%	-0.4%	-0.6%	-0.2%
Office	1.5%	0.7%	-1.5%	-1.5%
Industrial	0.2%	0.0%	-0.7%	-0.2%
Multi-Family	0.6%	-0.4%	0.0%	-0.4%
Retail	-0.4%	-1.0%	-1.2%	-1.1%

Source: Economy.com, TWR, PPR

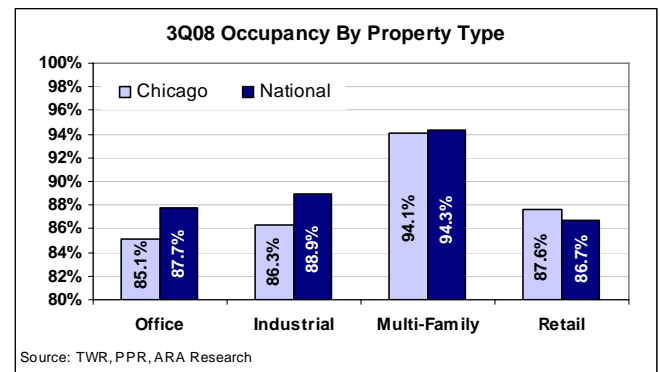
Sales Trends

Pricing per square foot in Chicago tends to be lower than the national average. For example, at \$157 PSF, office values trail those of the U.S. by 21%. Despite the changing capital markets, recent sales transactions are priced at cap rates that average about 0.2% above the national average. This is interesting given that historically Chicago's cap rates have averaged about 0.2% less than the national average, as the market offers significant depth and economic diversity. What this means for investors is that while we expect Chicago cap rates to rise by about 0.5% to return to long-term averages, the re-pricing of risk in Chicago is likely to be slightly less than the national average.

	Median PSF		% Change	
	San Diego	National	San Diego	National
Office	\$281	\$200	-10.0%	2.0%
Industrial	\$169	\$88	-1.0%	-2.0%
Multi-Family	\$132,400	\$97,400	-2.0%	3.0%
Retail	\$283	\$235	-4.0%	13.0%

	Median Cap Rate		% Change	
	San Diego	National	San Diego	National
Office	6.4%	7.0%	0.20%	0.04%
Industrial	6.5%	7.2%	0.04%	0.03%
Multi-Family	5.6%	6.2%	0.06%	0.00%
Retail	5.7%	6.2%	-0.03%	0.02%

Source: Real Capital Analytics



CHICAGO

Demand Trends

As one of the nation's most diverse economies, Chicago tends to follow national employment patterns. Corresponding to this trend, Chicago has experienced a 0.3% decline in jobs over the past year, which is slightly less negative than the -0.4% national average. Overall, real estate demand has also done slightly better than the national trend, with gains of 1.5% in office (+0.7% nationally), 0.6% in multi-family (-0.4% nationally) and 0.2% in industrial (no change nationally). The retail sector

Market Implications

- Chicago's diverse economy and real estate market is so far experiencing less "pain" than the nation in this recession, and is likely to weather the current downturn in better shape, as housing market declines have been less pronounced than in the coastal markets.

- The re-pricing of risk for commercial real estate in Chicago is less than average, as indicated by cap rates that are slightly above the national average, compared to a long-run history of slightly below average cap rates. Because of these pricing facts, combined with one of the nation’s most diverse economies, we are expecting that Chicago real estate should perform at or better than national trends during the next few years.

Demand Trends				
	3Q07 to 3Q08 % Change		2009 Forecast %	
	Boston	National	Boston	National
Total Jobs	0.8%	-0.4%	-0.8%	-0.2%
Office	1.9%	0.7%	-1.1%	-1.5%
Industrial	0.7%	0.0%	-1.2%	-0.2%
Multi-Family	1.2%	-0.4%	-0.2%	-0.4%
Retail	-1.1%	-1.0%	-1.7%	-1.1%

Source: Economy.com, TWR, PPR

Property Sales Trends (3Q08)				
	Median PSF		% Change	
	Chicago	National	Chicago	National
Office	\$157	\$200	2.0%	2.0%
Industrial	\$63	\$88	5.0%	-2.0%
Multi-Family	\$87,000	\$97,400	-6.0%	3.0%
Retail	\$258	\$235	14.0%	13.0%
	Median Cap Rate		% Change	
	Chicago	National	Chicago	National
Office	7.2%	7.0%	0.03%	0.04%
Industrial	7.1%	7.2%	0.02%	0.03%
Multi-Family	6.4%	6.2%	0.09%	0.00%
Retail	6.9%	6.2%	0.03%	0.02%

Source: Real Capital Analytics

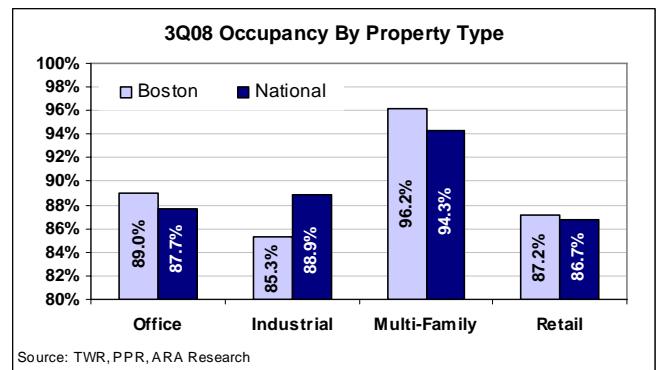
Sales Trends

Because of the stronger demand fundamentals, investors continue to have a very favorable view of Boston. The net result is that sales prices for all property types are up on a PSF basis. Given a typical 70% reduction in sales, some skewing to higher quality properties is evident. Indicating this preference, Boston cap rates for office (6.6%) and multi-family (5.0%) are significantly below national averages, with the valuation cap rate in the NCREIF Property Index at an exceptionally low 3% less than the long-term average. Given this aggressive pricing, the investment pricing risk from Boston is one of the highest in the country currently.

BOSTON

Demand Trends

Boston’s economy typically lags national trends by six months to one year. As such, the economy has yet to feel a significant impact from the slowing job market, with positive year-over-year job growth of 0.8% vs. a 0.4% national decline. Likewise, real estate demand for the major property sectors has been strong at 1.9% for office (+0.7% nationally), 0.7% for industrial (0.0% nationally) and 0.5% for multi-family (-0.4% nationally). Because of the trailing economic effect, we are expecting Boston’s economy to worsen significantly in 2009, with a 0.8% decrease in total employment and a greater than 1% decrease in the demand for office, industrial and retail space. Part of this decline is likely to be from the financial services sector, as the recent drop in stock market values will hurt mutual fund companies like Fidelity Investments, which is laying off 1,400 employees nationwide. The good news for Boston is that the other drivers of the economy, such as health care, education and technology, are doing reasonably well.



Source: TWR, PPR, ARA Research

Market Implications

- Boston’s economy has performed better than national averages until now, but it is likely to enter a recessionary stage in 2009, with slowing real estate fundamentals.
- The biggest investment concern about Boston is that real estate pricing is rich, with a 1% to 2% increase in cap rates very likely over the next year. In particular, we are concerned about pricing of multi-family, as this appears to be one of the most overpriced segments relative to long-term averages and the U.S.

Property Sales Trends (3Q08)				
	Median PSF		% Change	
	Boston	National	Boston	National
Office	\$214	\$200	7.0%	2.0%
Industrial	\$82	\$88	18.0%	-2.0%
Multi-Family	\$180,800	\$97,400	3.0%	3.0%
Retail	\$330	\$235	25.0%	13.0%
	Median Cap Rate		% Change	
	Boston	National	Boston	National
Office	6.6%	7.0%	0.07%	0.04%
Industrial	8.0%	7.2%	0.12%	0.03%
Multi-Family	5.0%	6.2%	-0.22%	0.00%
Retail	6.4%	6.2%	0.02%	0.02%

Source: Real Capital Analytics

Conclusion

When it comes to investing in real estate, the large differences in occupancy and rent trends by market support our view that real estate is a local business. As demonstrated by the trends shown in these three metros, it is important for investors to understand both local and national trends in the economy, real estate markets and capital markets before making an investment decision. Additionally, it is very important to understand local submarket level competitive factors, as differences in investment performance within a metro and between metros can be quite large.

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