

INVESTING IN UNCERTAIN TIMES

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In this month's newsletter, we will discuss investing in real estate during uncertain times, examining real estate's performance in past periods of uncertainty, as well as defensive strategies which tend to work in uncertain times. Our Focus section will compare price trends for the housing market vs. the commercial real estate market.

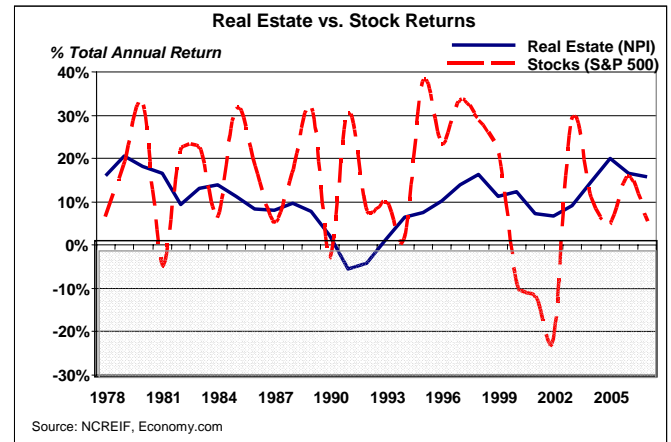
Since the summer of 2007, market uncertainty regarding the future direction of the economy has increased, as falling housing prices, tightening of the credit markets and a slowing economy have contributed to a rising level of uncertainty. Investments, including real estate, are now being scrutinized anew for any possible weakness. So what should a real estate investor do in this uncertain environment?

In responding to this question, we see that most real estate investors follow the principal of matching long-term assets with long-term liabilities. We also see that real estate investors tend to follow either a long-term hold strategy or follow a market mispricing strategy. But, before we examine these strategies, it is important to look at how real estate has typically performed in a soft economy and how the current market fundamentals compare to past slow downs.

Real Estate Performance in a Soft Economy

Over the past 30 years and four recessions, real estate has recorded only two years of total return losses, with a cumulative loss of 10%. In contrast, the stock market has recorded five years of losses during this same period, with a cumulative loss of 50%. Indicated by the limited number of down years, real estate has a lower level of return volatility relative to other asset classes, such as stocks.

Comparing market fundamentals of the last period of real estate losses (1990) to today (2007), it is apparent that the current period is significantly stronger with respect to job growth and building occupancy rates. For



example, the current job growth rate is nearly twice the 1990 rate, while office occupancy rates are currently 6.8% higher than in 1990. For investors, this means that even if real estate demand were to be cut due to an economic slowdown, occupancy and rents would most likely perform at a higher level today than in the previous period.

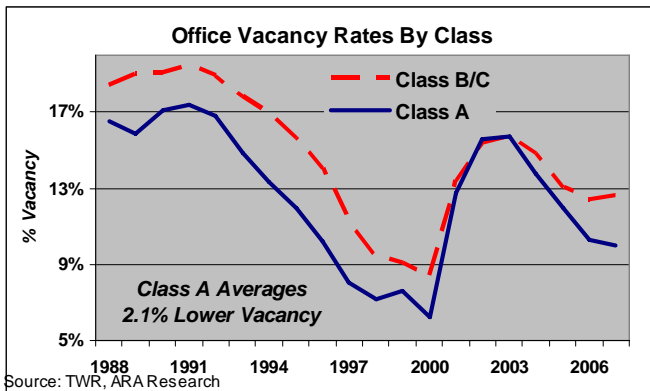
Market Fundamentals 1990 vs. 2007			
	1990	2007	Difference
Job Growth	0.5%	0.9%	0.4%
Office Occupancy	82.0%	88.8%	6.8%
Industrial Occupancy	89.5%	90.3%	0.8%
Retail Occupancy	83.5%	89.0%	5.5%
Multi-Family Occupancy	93.0%	94.1%	1.1%

Source: Economy.com, TWR, PPR, ARA Research

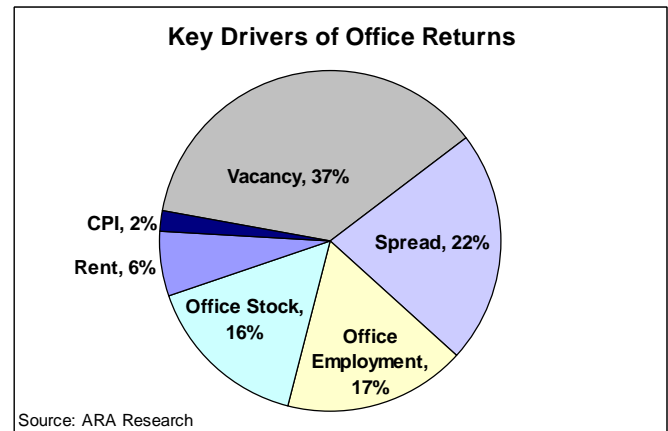
Low Risk, Long-Term Hold Strategies

There are several defensive strategies available to investors who wish to hold real estate investments during uncertain times. These strategies include a researched approach to selecting properties, markets and sectors, as well as emphasis on basic asset management.

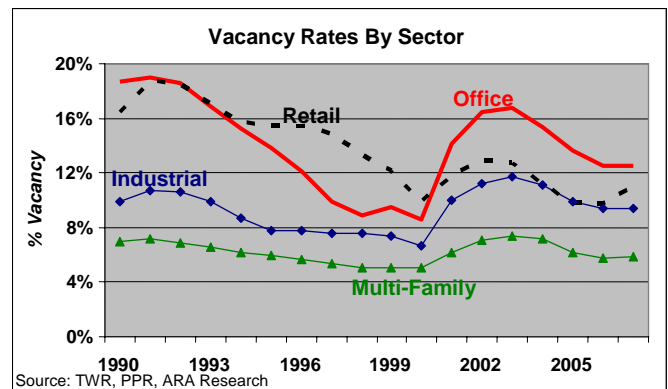
- Property Selection** – As a defensive strategy, an investor should choose Class A properties, in Class A locations. The rationale for Class A properties and locations is that they tend to have higher occupancy rates with less volatility. For example, in the office sector, vacancy for Class A properties tends to average 2.1% less than for Class B/C properties. Additionally, Class A properties tend to be the first to recover after any market softening.



- Market Selection** – As an additional defensive strategy, investors should choose larger metropolitan areas and submarkets that tend to have high occupancy levels. This is because larger submarkets tend to have more diverse tenant bases and are better able to sustain demand levels; thus these locations tend to have less volatile vacancy rates. In addition, because larger submarkets are better able to absorb additional supply, these locations normally achieve above-average rent and occupancy relative to metro and national levels. Supporting this view, we have found that roughly 37% of the long-term investment return is attributable to occupancy levels.



- Sector Selection** – As a further defensive strategy, investors should overweight investments in the industrial sector. On a long-term basis, the industrial sector has one of the lowest and least volatile vacancy rates of the property sectors. In fact, the vacancy volatility for the industrial sector is about half that of office or retail, as construction activity in this sector is very responsive to changes in demand. This responsiveness is due to the relatively short construction time needed to complete industrial buildings, thus reducing the level of boom and bust relative to other real estate sectors. While the multi-family sector typically has low vacancy rates and volatility, we feel that, because multi-family's performance is likely to be negatively impacted by weakness in the housing market, overweighting the industrial sector is a better option in the current market.



- **Asset Management** – As a final defensive strategy, investors should consider properties with long-term leases to credit tenants. In many respects, the returns from these properties are similar to that of a bond with inflation protection, since stable income is backed by an appreciating asset.

Market Mispricing Strategies

Another investment strategy real estate investors tend to follow in all market cycles is a market mispricing strategy. In any given market, not all investors will have the same opinion concerning market value or future market direction. It is this difference in viewpoints that creates pricing differentials – or mispricing – for investments from both a buyer's and seller's point of view.

There are several investment mispricing opportunities that exist in the current environment. In particular, we see mispricing occurring in high risk debt and to a lesser extent in locations which are currently out of favor.

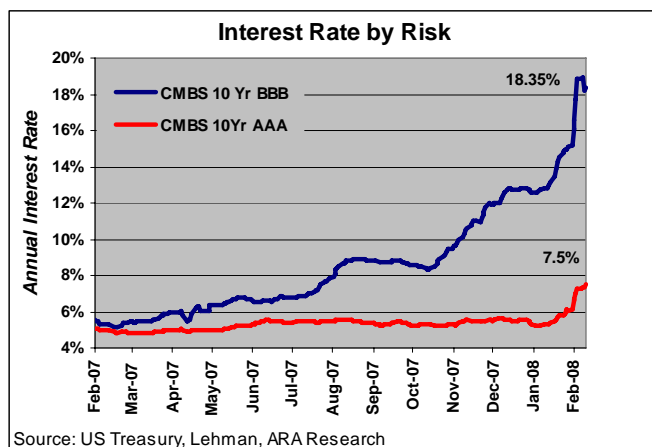
- **Mispricing of High Risk Debt** – Since the credit crisis, the interest rate on high-risk real estate debt has tripled to over 18%, while low-risk debt has only recently crept up past 7%. While investing in high risk debt is a high risk strategy, the return on investment could include the potential for increased debt value should the market interest rate reset to a lower level. However for this strategy to work, a high level of underwriting review is recommended, as many of the recent credit defaults are in-part due to deficient market review.

- **Buy Out-of-Favor Assets or Locations** – Similar in scale to the repricing of high-risk debt, the slowing economy has impacted pricing for high-risk real estate investments as well. For example, many value-added investments have experienced value declines, while top-tier, core real estate, due to its relatively low risk, has typically experienced only a 5 to 10% pricing correction. Currently, the most out of favor assets are in markets with exposure to the declining housing markets. While picking the recovery points for these assets is likely to be difficult and should most likely vary by location, the uncertainty in today's market is most assuredly creating future investment opportunities.

Conclusion

The real estate asset class offers one of the highest risk adjusted returns in the capital markets, with less return volatility than other investment vehicles, such as stocks. Nevertheless, in an uncertain market, it is important to remain cautious. Several defensive investment strategies are available to real estate investors. While some strategies have more risk than others, each represents a valid approach to investing in uncertain times.

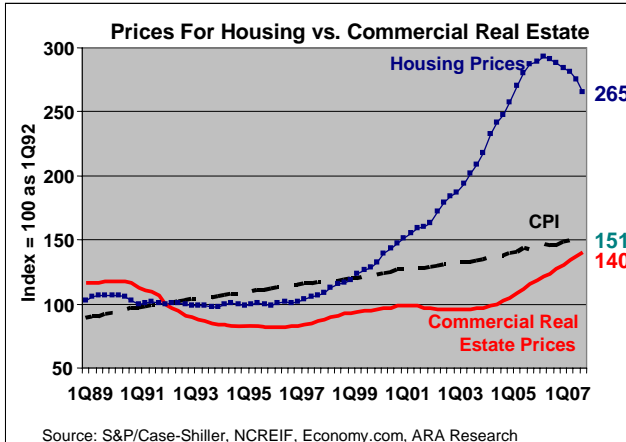
With this perspective, we are, however, mindful of the fact that no amount of optimism can counter the impact of a declining market in the shorter-term. Valuations of real estate assets will be affected. American will continue to adjust leasing and acquisition strategies as the ultimate direction of capital markets comes into focus. We will evaluate risk carefully, especially in a world where little clarity exists. The next six to twelve months, however, should reveal a more defined picture and we are confident that it will confirm that the firm's position of caution over the past year and going forward is to be rewarded.



Focus Topic – The Housing Market vs. the Commercial Real Estate Market

Question:

The housing market is currently facing its worst slump in at least 30 years or more. The question is, as housing prices decline, will this impact commercial real estate pricing as well?

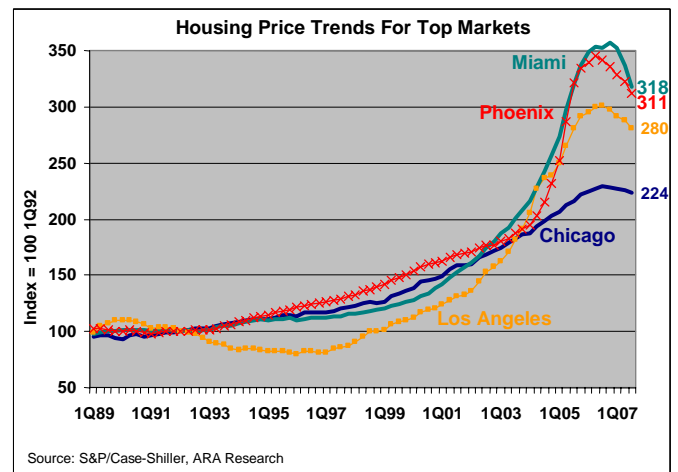


Answer:

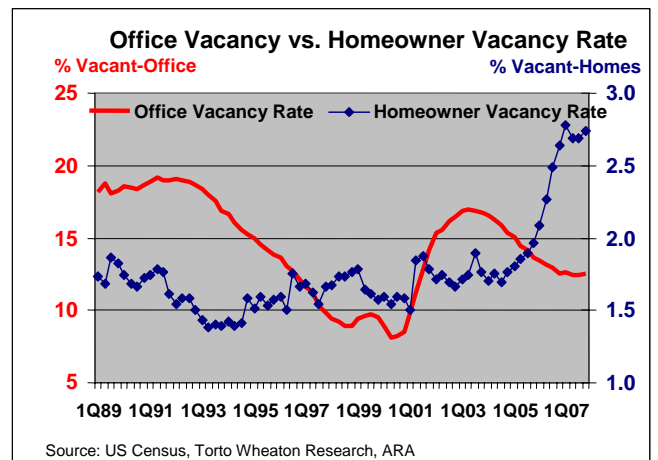
An analysis of housing prices and commercial real estate prices versus the consumer price index shows that since 1992, US housing prices have risen 6% annually, or more than double the average annual inflation rate of 2.5%, while commercial real estate prices have only risen 2.0% annually over the same time period. This would suggest that, on the surface, commercial real estate values appear “fairly” valued relative to inflation, while housing prices appear to be overvalued.

Of note, over the last ten years (from 4Q1997 to 4Q2007), US housing prices averaged a remarkable 9.6% increase per year, nearly double the 4.9% average annual increase achieved in commercial real estate and more than triple that of the consumer price index. As this sharp rise in housing prices was driven by liberal lending policies and to some extent speculation, it is likely that going forward, home prices should continue to decline. In fact, Economy.com is forecasting a 10% to 15% decline, while others are forecasting up to a 25% decline.

On a metro basis, Miami, Las Vegas and Phoenix are most at risk, while markets like Chicago are least at risk, as these areas have not yet experienced the extremes in pricing. Since a slowing housing market is likely to have an impact upon all forms of real estate, those markets with the least housing market downside are likely to have less “drag” from the housing sector.



Finally, while liberal lending policies allowing the use of high leverage also occurred in the commercial real estate market, speculation – while it occurred – was not nearly as evident as it was in the residential market.



Key Indicators			
Interest Rates	2/14/2007	1/14/2008	2/14/2008
10-Year Treasury Yield	4.78%	3.84%	3.85%
CMBS AAA Yield	4.99%	5.27%	7.50%
CMBS BBB Yield	5.34%	12.79%	18.35%
Cap Rates	4Q2006	3Q2007	4Q2007
CBD Office	6.2%	5.5%	5.9%
Suburban Office	7.1%	7.1%	6.9%
Industrial	7.2%	7.6%	7.3%
Multi-Family	6.2%	6.2%	6.3%
Strip Center Retail	6.9%	6.8%	7.1%
12 Mo Private Real Estate Returns	4Q2006	3Q2007	4Q2007
NCREIF-All Properties	16.6%	17.3%	15.9%
Office	19.2%	22.8%	20.5%
Industrial	17.0%	16.6%	15.0%
Multi-Family	14.6%	13.3%	11.4%
Retail	13.4%	13.0%	13.5%
Vacancy	4Q2006	3Q2007	4Q2007
Office	11.2%	11.0%	11.2%
Warehouse	9.7%	9.6%	9.7%
Apartment	4.8%	4.2%	4.7%
Retail	9.8%	10.4%	10.8%
Employment	Jan. 2007	Dec. 2007	Jan. 2008
Unemployment	4.6%	5.0%	4.9%
Total Employment Monthly %	0.09%	0.06%	-0.01%
Total Employment Yr/Yr	1.48%	0.83%	0.72%

Source: Lehman, NCREIF, Torto Wheaton Research, PPR, Real Capital Analytics, Economy.com, US Treasury



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