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Where is the Real Estate Market Headed?

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In a market in which both home values and commercial real estate values have fallen, and have an uncertain future, where do we see the market going near-term and what should an institutional real estate investor consider?

OUTLOOK

- **Job Market**—Job losses for 2008 should come in at a 0.7% decline, compared to 1.1% growth in 2007. Due to the recent financial market crisis and the negative feedback loop this is likely to have upon the economy, we are now forecasting employment in 2009 to range from 0.0% to -1.3%.
- **Real Estate Demand**—As we forecasted in 2007, net absorption of commercial real estate should be close to zero this year. However, with the diminished job outlook, real estate demand in 2009 should decline by the level of job loss. If the worst case outlook holds true, the loss of demand for office and industrial space is likely to be similar to what occurred during the 2001 recession, with significant declines for retail and multi-family, as these segments have never experienced negative net absorption. The net result of this could result in a vacancy increase of 3% to 4% over the two-year period from year-end 2007 to year-end 2009.

Vacancy Forecasts								
% Change in 2009 Jobs	Office		Industrial		Multi-family		Retail	
	Zero	-1.3%	Zero	-1.3%	Zero	-1.3%	Zero	-1.3%
2007 Actual	11.3%		9.9%		4.6%		10.8%	
2008	13.1%	13.3%	11.7%	11.9%	5.8%	6.0%	15.3%	15.5%
2009	14.2%	15.4%	12.0%	13.0%	6.0%	8.0%	17.7%	20.2%
2010	13.6%	14.6%	11.7%	12.6%	5.7%	7.9%	16.4%	19.8%

- **Commercial Real Estate Values**—Due to lagging appraisals, NCREIF property values could decline by an additional 10% to 20% from now, although some of this will be offset by the income return during this adjustment period. New investments will have less exposure to value declines, as cap rates on recently completed transactions are near long-term averages.

STRATEGIES

- **Include Debt Strategies**—Core and value-added debt strategies, with sufficient owner equity cushion providing downside protection, have current yields that are often higher than projected equity returns.
- **New Funds**—Now is the time to allocate to new funds, as this minimizes problems with lagging appraisals.
- **Dollar Cost Average**—Since predicting market bottoms is difficult, spread new investments out over 3 to 6 quarters.
- **Take a Long-Term Investment Perspective**—In the long-run, growth in property income returns will comprise the majority of the total return and current shifts in market pricing should have very little impact.



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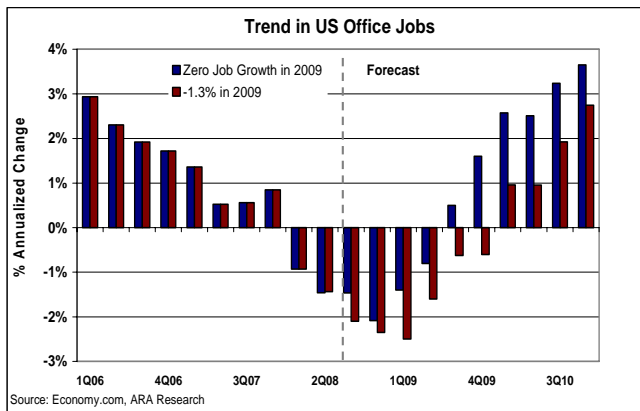
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STRATEGY

Job Market

Fueled by the weak housing sector, total US employment has now declined for each of the first nine months of 2008 and the economy is likely to continue losing jobs into 2009. Job losses have now spread to the broader economy and only markets dominated by energy and agricultural product demand are showing significant job growth. Housing-dominated markets such as South Florida, Phoenix, Las Vegas and Riverside, CA are experiencing a significant slowing in employment relative to 2005 and 2006.



So What Will Pull Us Out of This Slowdown?

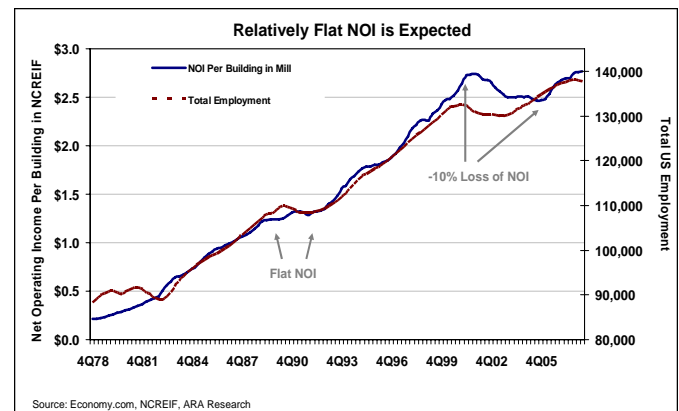
While housing is the key element of the economy that pushed the US into this slowdown, recoveries tend to be more broadly based with no one industry likely to lead the recovery. We believe that the drivers of the next recovery are likely to include:

- 1) Demographic needs of an aging population, driving the demand for health care, and support services such as medical offices.
- 2) Reduction in housing excesses, including price reductions in housing that increases affordability, and increased housing sales volumes which would help fuel the demand for consumer goods.
- 3) Continued growth in export demand to expanding global economies such as China, India, Russia and Brazil.

	2006	2007	2008	2009	
Job Growth Assumption	1.8%	1.1%	-0.7%	0.0% to -1.3%	
Year-Over-Year Change in Market Fundamentals (3Q Values)					
	Office	Industrial	Multi-Family	Retail	
Occupancy	2007	+0.7%	0.0%	-0.4%	-0.8%
	2008	-1.1%	-1.4%	-1.4%	-2.0%
Demand	2007	+2.1%	+1.9%	0.9%	+1.5%
	2008	+0.7%	+0.0%	-0.2%	0.0%
		(+0.2% 3Q08)	(0.0% 3Q08)	(+0.3% 2Q08)	(-0.1% 2Q08)
Supply	2007	+1.3%	+1.8%	+1.2%	+2.5%
	2008	+1.9%	+1.6%	+1.3%	+2.3%
Rent	2007	+13.3%	+4.5%	+3.5%	+2.9%
	2008	+2.3%	0.0%	+2.5%	-1.2%
		(0.0% 3Q08)	(0.0% 3Q08)	(-0.5 3Q08)	

Zero Demand May Still Mean Income Growth

We expect property revenue streams to follow a path similar to prior recessions, with flat to slightly rising net operating income (NOI) overall. In particular, NOI growth from many long-term leases that are up for renewal should offset the effect of forecasted decreases in occupancy, although the longer this slowdown lasts, the greater the risk of declining NOI. Contributing to our expectation of flat NOI, rent growth during this past recovery did not spike as it had in the tech boom, which should help reduce the downside risk for rents, as they were not above construction justification levels.

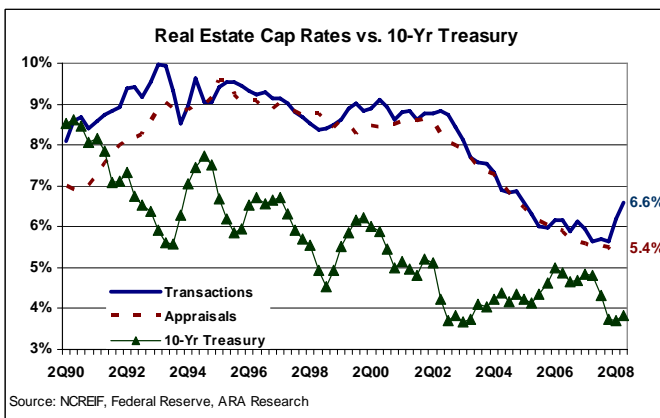


Commercial Real Estate Values

The global repricing of investment risk has caused commercial real estate values to decline. However, measuring the level of declines is somewhat difficult, as transaction volumes are down by 50% from the 2006 and early 2007 averages. Based on this limited data set, our research indicates that property prices for recent transactions are down by 10% to 20% from the peak. The good news is that real estate prices have now returned to levels near the long-term spread to the 10-year Treasury, suggesting that much of the pricing correction should be over.

However, cap rates (defined as the first-year NOI divided by the value of the property) for the overall NCREIF Property Index (NPI) property values have not been subject to this change and are at risk. Supporting this view on property value changes are the following observations:

- 1) Transaction cap rates on NCREIF properties have increased by about 1% to 6.6% (see graph). This change in cap rates equates to about a 10% decline in pricing, assuming a 4% increase in NOI over the past year. Confirming this general trend, other sources that track cap rates are reporting a 0.5% to 1.0% increase.
- 2) Appraisal cap rates on NCREIF properties are most likely at a business cycle low of 5.4% (see graph), and are now 1% lower than transaction cap rates for the first time since the early 1990s. This huge gap in pricing between transactions and appraisals cannot be maintained, as historically these metrics have been very similar. The net result is that appraisal values in the NPI are likely to decline by an additional 5% to 15% over the next 18 months, with the typical 6% income return expected to offset much of the value decline.

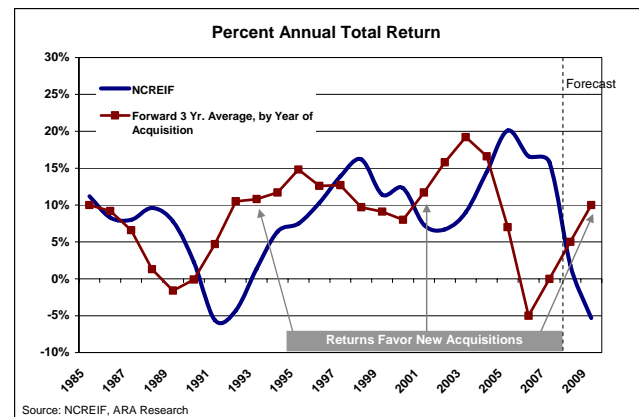


also expanding our investments in debt on properties that we would otherwise consider for acquisition. While this is likely to be a temporary strategy that depends on capital market pricing, current opportunities are compelling as:

- 1) Returns on many mezzanine deals are now higher than on corresponding equity investments.
- 2) Downside risk is protected by requiring a meaningful equity cushion, based on our conservative underwriting standards.

New Funds

In looking at performance of new acquisitions and the overall NPI, the performance of new acquisitions exceeds that of existing assets about half the time. This is mainly due to the lagging adjustments to value caused by the appraisal-based index. We expect that 2009 is likely to be one of those periods when the returns on newly created funds exceed the broader market averages.



STRATEGIES

Include Debt Strategies

Given the potential for value declines and a pool of money to invest, what should an institutional investor do? At American, we believe that protecting investment downside and maintaining investment returns are key goals particularly in today’s capital constrained market. While we continue to look for great equity investments, we are

Dollar Cost Average into Real Estate

Because timing both good and bad markets is difficult, we recommend dollar cost averaging investments regardless of the market environment. This strategy involves buying a fixed dollar amount of a particular investment on a regular schedule, regardless of the share price, thereby averaging out the price over time.



Take a Long-Term Investment Perspective

Investors should use a long-term horizon when investing in real estate, as transaction costs are high and assets are not as liquid as stocks or bonds. Under this view, institutional real estate investors should look at the quality of long-term income streams to identify segments and markets likely to outperform. In particular, we have found that high occupancy rates tend to be a key indicator of above average long-run returns, as this allows investors to achieve higher long-term rent growth and to minimize revenue losses associated with lease downtime.

Conclusion

Although financial markets are currently in uncharted waters, we believe that regularity will return in the coming years as markets deal with the liquidity crises and real estate fundamentals reassert themselves. Buyers and sellers will again seek markets in which they can transact effectively. Long-term investors should always have a commitment to real estate in a diversified portfolio.

We would counsel institutional investors to establish those allocations based on long-term horizons as noted above, in line with a carefully-defined strategy that more closely matches the liability horizon of their plans. Having the allocation to the real estate asset class, and capital ready to deploy as markets recover will be the key to securing buying opportunities that can provide superior returns coming out of the downturn. This has happened before in previous periods of market stress and we believe that 2009-2010 will present excellent opportunities for the alert investor.

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