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THE CASE FOR REAL ESTATE TODAY

SUMMER 2010 NEWSLETTER

Commercial real estate has experienced one of the most severe declines in recent memory during the past 18 months. Values appear to be bottoming out and as such many have raised the question: “Does real estate make sense now?” In this newsletter, we will address this question in the context first of the role real estate traditionally plays in a multi-asset portfolio and how the asset class is likely to stack up against alternative investments over the market cycle, as well as what opportunities investors should consider now.

THE LONG RUN ROLE OF REAL ESTATE IN A DIVERSIFIED PORTFOLIO

Since real estate has a low correlation to other asset classes and has achieved competitive returns that are typically between stocks and bonds, investors can benefit from the inclusion of real estate in their portfolios. In fact, based on the past 30 years of returns, we found that investors would benefit from allocating as much as 15% of the portfolio to real estate, especially with a targeted strategy of 60% to 100% of this allocation invested in core real estate.

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), real estate over the past 30 years has

| Total Returns By Asset Class (Annualized) | | | | |
|---|---------------|--------------|-------------|-------------|
| As of 4Q09 | 1-Year | 5-Year | 10-Year | 30-Year |
| Cash | 0.2% | 2.2% | 2.8% | 5.7% |
| Bonds | 4.5% | 5.8% | 6.3% | 8.7% |
| Private Real Estate | -16.9% | -3.4% | 7.3% | 8.2% |
| Large Cap Equity | 26.5% | -5.6% | -1.0% | 11.2% |
| Small Cap Equity | 27.2% | -6.1% | 11.5% | 11.5% |
| International Equity | 24.0% | -9.0% | 5.2% | 9.6% |

Source: NCREIF, S&P, NAREIT, Dow Jones, Federal Reserve, ARA Research

achieved an unleveraged 8.2% average annual total return. While this 30-year return trails that of bonds at 8.7% and large cap equity stocks at 11.2%, it should be noted that unlike stocks and bonds, real estate has yet to stage a recovery in pricing from the recession, and if viewed for only the past 10 years, real estate returns have exceeded those of stocks and bonds. To investors this means that, while it is impossible to time the exact peaks and troughs of the capital market, picking attractive points of relative value like today can help improve long-term investment performance.

On a risk adjusted basis, due to the stability of cash flow from long-term leases, real estate shows a volatility that is between that of cash and bonds and is roughly one third of stocks. Over the past 30 years, real estate has proven to be a good portfolio shock absorber, as in most



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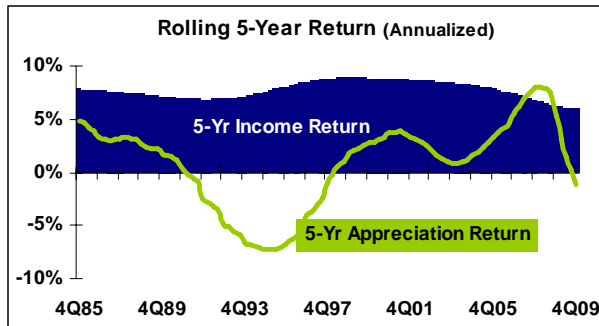
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quarters when other asset types are down, real estate is up by 2.5% to 2.9%. In fact, real estate has only had 15 down quarters in 30 years, which is nearly half that of bonds at 29 and less than large cap equity stocks at 35 negative quarters.

INCOME

Real estate is an attractive asset class due to its stable and relatively high cash flows from lease income. Over the past 30 years, the income return from core real estate has averaged 7.6% and over a normal market cycle represents over 65% to 75% of the long-term total return. The income return from core real estate is so stable that it has approximately one-ninth the volatility of the appreciation return and has averaged from 6% to 8% in both good and bad markets. Real estate’s strong income return includes a high cash yield that is paid out to investors (approximately 5.0% as of 4Q09), plus non-cash income that is typically retained to cover capital improvement costs.



Source: NCREIF, ARA Research

OTHER BENEFITS OF INVESTING IN PRIVATE REAL ESTATE

Diversification: Real estate has a low correlation of less than 20% with other asset types. For investors, this means that the inclusion of real estate in a portfolio has typically helped reduce risk by 50 basis points or increased the annual return by 30 basis points, according to our historical analysis.

Low Volatility: Unlike stocks and bonds, which are subject to daily price volatility, private real estate funds are generally priced through appraisals that typically occur on a quarterly basis. As such, 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.

Inflation Hedge: Real estate assets traditionally have performed on pace with 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 which tends to move with inflation.

WHAT IS THE CURRENT OUTLOOK FOR REAL ESTATE?

While the near-term economic outlook is one of a bumpy recovery, we believe that as the fundamental drivers of the economy move back toward normal levels, by 2014, the market will be pricing in a stronger real estate market than it is currently. Although some areas of the country are expected to recover faster than others, we are currently estimating that it is likely to take three to five years before U.S. employment reaches some level of equilibrium similar to other stable periods in our economy, and commercial real estate is likely to follow a similar timeline for a recovery in demand. This implies that over the next five years, real estate occupancy rates are likely to trend upward, as a diminished level of recent construction means that most of the gains in demand will be used to support gains in occupancy and ultimately rent levels.

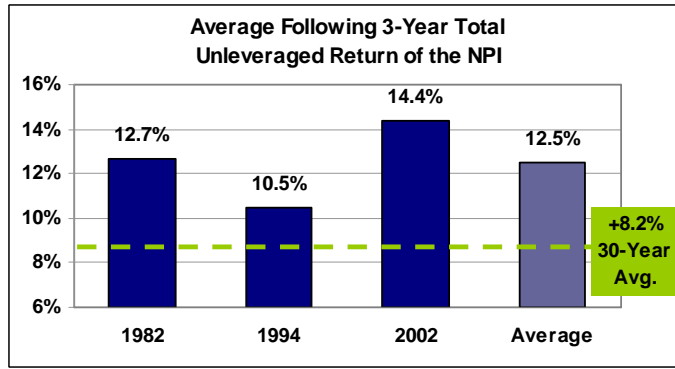
| Correlations Between Asset Classes | | | | | | |
|------------------------------------|------|-------|---------------------|------------------|------------------|----------------------|
| 30 Years (Annualized) | | | | | | |
| As of 4Q09 | Cash | Bonds | Private Real Estate | Large Cap Equity | Small Cap Equity | International Equity |
| Cash | 100% | 38% | 42% | 18% | 10% | 3% |
| Bonds | | 100% | -6% | 23% | 21% | 3% |
| Private Real Estate | | | 100% | 14% | 3% | 20% |
| Large Cap Equity | | | | 100% | 89% | 67% |
| Small Cap Equity | | | | | 100% | 76% |
| International Equity | | | | | | 100% |

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

Corresponding to this trend, we have found that one of the best times to be invested in real estate is following a spike in vacancy rates, as there is a 70% correlation between rising occupancy and rising net operating income (NOI) after factoring in a two-year lag in NOI trends relative to occupancy trends. In short, this means rising occupancy is beneficial for investment returns.

Specifically, in looking back at past periods of market stress including 1982, 1994 and 2002, the forward three-year return has averaged 4.3% higher than the long-term

real estate trend, at an average of 12.5%. 2010 is currently showing similar trends to those past periods of above average returns. On a longer term basis of a full real estate cycle of six to 11 years, we expect core real estate investment returns to average 5% or more over the inflation rate and to offer returns that are between those of stocks and bonds.



Source: NCREIF, ARA Research

In addition to total returns, one of the primary reasons to invest in real estate is due to the high level of income return, with private real estate currently achieving a 6.8% income return, including a 5.0% cash return after capital improvement costs are accounted for. As a means of comparison, this cash income exceeds the 3.9% yield on 10-year treasury bills and the 1.9% dividend yield from large cap equity stocks. So for investors needing significant cash flow, real estate can provide some of the needed income.

FAVORABLE CAPITAL MARKET PRICING FOR NEW INVESTMENTS

Core Investments: Real estate prices, as measured by the NPI, are estimated to be priced at a 22% discount, relative to long-term trends. For investors, this price basis could offer significant downside protection and potential for value growth.

With the trenches of this recession over for real estate pricing, real estate transaction data shows that, while the sales volumes remain at low levels, the market is picking up. Since reaching a bottom near \$10 billion sales per quarter in the first half of 2009, transaction volumes have increased to the \$15 billion range as of April 2010, and price per square foot is on the rise. The NCREIF database shows the trailing cap rate has on average declined by 0.6%

from a peak of 8.1% to 7.5% currently, implying an 8% rise in property values, all else being equal. So while fundamentals are likely to be anemic in the first half of 2010, the improvement in transaction pricing should translate into rising fund valuations.

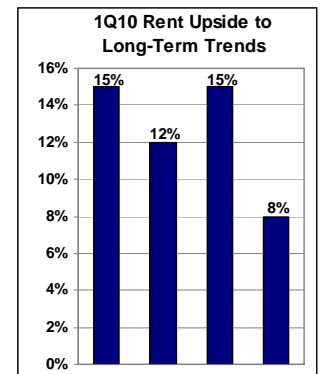
Value Investments: The pricing adjustments for value-added investments in this market downturn have been even more significant than for core investments. Distressed asset values are down an average of 56% vs. 33% for non-distressed properties. Investors have been cool to value-added investments recently and as such the lack of capital to this segment actually represents its greatest opportunity, as buyers who pursue investments can dictate more favorable terms. The net result is that forward-looking value-added returns are expected to provide a premium over core returns, especially when an investor can effectively purchase value-added assets and eventually convert the asset to a stabilized core property.

SUPPLY

Construction is down by 65% to 85% from peak levels due to constrained debt markets and rents that are below construction justification levels. This decline implies that, as the recovery starts and demand for space increases, most of the absorption will go directly to reducing existing vacancies. Additionally, given the low level of construction starts, the recovery could extend for several years once the trend of improving occupancy commences, as it will take time for rents and occupancy levels to recover to levels needed to support the investment risk associated with new development. Because current pricing is the most aggressive in the multi-family sector, most likely this will be the first property type to experience significant new construction in the next business cycle.

RENTS

The decline in rents experienced in most metros means that rent levels do not currently support the return needed to justify new construction. Given the prospect for rising demand and little new construction, the



Source: NCREIF, ARA Research

likely rise in market occupancy rates should eventually force rents upward. Suggesting rental increases of 8% to 15% before returning to long-term trends. This would have a significant positive impact on property values.

DISTRESSED PROPERTIES OR DISTRESSED OWNERS?

As capital markets remain constrained, undercapitalized properties that have loan balances that exceed property values may be a key opportunity. In some cases, undercapitalized properties may be core in quality but available at value pricing, as owners, with no economic interest remaining, have little incentive to put additional capital into leasing and/or improvement. Investors who can carefully underwrite the value potential and provide needed capital should be rewarded as the market recovers.

Downside Risks: Our analysis is based on the assumption that policy makers are likely to balance correctly the need to stabilize the economy and fiscal system as well as deal with the significant capital market constraints that remain. Additionally, since the U.S. is part of the global economy, the value of the U.S. dollar, balance of trade and global flow of capital are some of the factors that could derail the economic recovery, or at a minimum, result in slower than expected job growth. Real estate investors may face an increase in the sale of properties from foreclosures and underwater loan maturities, which could result in continued weakness in the capital markets. Alternatively, these distressed property sales may jump start the construction cycle due to the low cost of land, which would not allow a full recovery in occupancy rates, rents and values to the long-term trend line, translating into less than expected value growth and the risk of lower than expected returns.

Conclusion

As the economy and real estate markets settle down from the “Great Recession,” we are seeing a bumpy recovery in 2010 that is likely to support several years of growth. In addition, those investors willing to commit capital in today’s environment have significant opportunity for above normal returns as that recovery develops.

Real estate has been shown to improve the return/risk profile of a multi-asset class portfolio over the long term. 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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