

# Investment Perspectives

MARKET PREVIEW  
JANUARY 2012

## INTRODUCTION

GREGORY J. LEONBERGER, FSA, EA, MAAA, DIRECTOR OF RESEARCH

### Reflecting back on 2011 does not elicit a lot of warm and fuzzy feelings.

News highlights include a downgrade to the U.S. credit rating, political gridlock in Washington D.C., ongoing sovereign debt issues in Europe, and a stubborn lack of economic growth. Predictably, these major news items took a toll on the capital markets, with U.S. equities mostly down for the year, and non-U.S. equities considerably worse off than their U.S. counterparts. Not surprisingly, the ongoing frustration (and dispersion) of equity markets pushed investors to the bond market, as rates – contrary to popular sentiment one year ago – fell yet again, thus making the year a profitable one for fixed income investors. Moving outside of the traditional capital markets, alternative asset classes had more of a mixed 2011: hedge funds again disappointed, while real estate and private equity continued their recoveries from the abyss known as 2008 - 2009.

But enough about 2011 – it is 2012 and investors are less concerned about what happened, and more interested in what the coming year holds for their portfolios. In the following articles, we will take a closer look at critical issues for each asset class in 2012. Each article contains insightful analysis and key themes to monitor over the coming year, themes which will underlie the actual performance of the asset classes covered. Articles are offered for the following asset classes: fixed income, U.S. equities, non-U.S. equities, hedge funds, real estate, private equity, and infrastructure. As a backdrop to the capital markets, we examine some crucial macroeconomic topics as they pertain to the U.S. economy. ■

## U.S. ECONOMY: The Frustration Continues?

GREGORY J. LEONBERGER, FSA, EA, MAAA, DIRECTOR OF RESEARCH

Going into 2011, the general economic outlook was one of guarded optimism, with GDP slowly climbing, unemployment trending downward, and inflation under control. One year later, it's hard to find that same optimism, as 2011 turned out to be disappointing from a macroeconomic perspective. A cocktail of Eurozone sovereign debt issues, a downgrade of U.S. debt, persistent unemployment, and an overall loss of consumer confidence has left the overall economic outlook for 2012 more shaken than stirred. Adding to all of this uncertainty is the presidential **CONT...**

## INTRODUCTION

PAGE 1

## U.S. ECONOMY

PAGE 1

## FIXED INCOME

PAGE 3

## U.S. EQUITY

PAGE 5

## NON-U.S. EQUITY

PAGE 7

## HEDGE FUNDS

PAGE 9

## REAL ESTATE

PAGE 11

## PRIVATE EQUITY

PAGE 12

## INFRASTRUCTURE

PAGE 14

“As we turn our attention to 2012, several factors appear poised to dominate the economic headlines, perhaps none more than the ongoing Eurozone debt issue.”

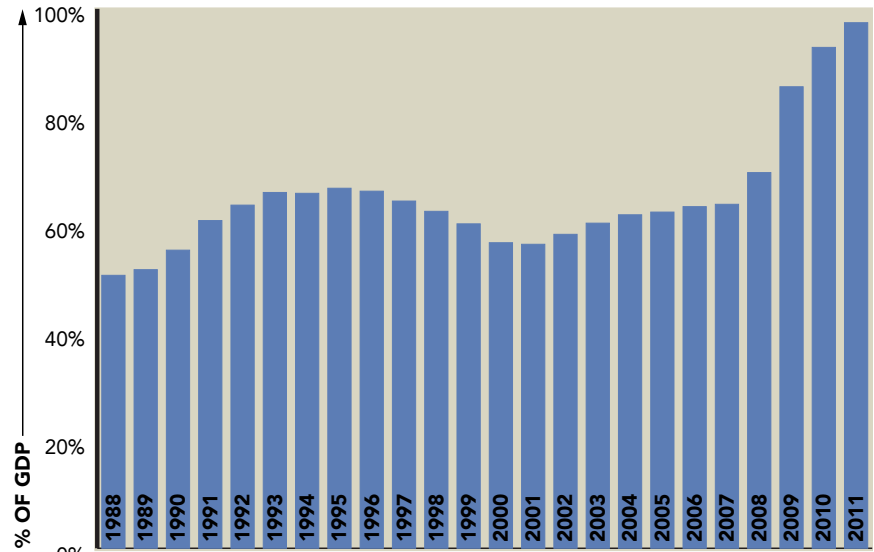
election in November.

As we turn our attention to 2012, several factors appear poised to dominate the economic headlines, perhaps none more than the ongoing Eurozone debt issue. More specifically, the ultimate solution to the sovereign debt challenges faced by Greece, Italy, and Spain will have material impacts on economies and financial markets worldwide. Among the available solutions, none are pain-free and will essentially boil down to either a structured default by the countries (less likely, although already priced into prices via yields), or the European Central Bank printing money to buy up the bonds of debt-challenged countries. Either solution contains risks that could have detrimental effects on both the European and U.S. economies:

- A structured default must be carried out with great care so as not to create another credit crisis a la Lehman in 2008. Any solution which creates a “run on the bank” will severely impair liquidity in the credit markets and potentially trigger a global economic slowdown.
- In the case of expanding its balance sheet to support sovereign bonds, a failure by the ECB to control for inflation could simply replace one problem with another, thus creating a new economic challenge for the global economy. The worry would no longer be about debt issues, but rather how escalating prices in the Eurozone could wreak havoc with the other economies in an increasingly integrated global economy.

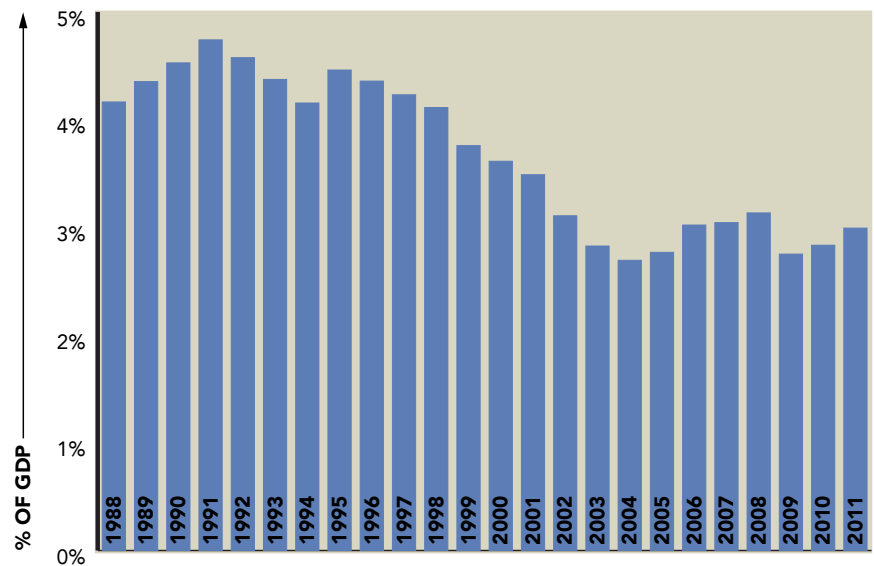
Closer to home, the large budget deficits and increasing government debt relative to GDP have sparked concerns

**Exhibit 1: Debt to GDP (%)**



Source: St. Louis Fed

**Exhibit 2: Interest Payments as % of GDP**



Source: St. Louis Fed

that the U.S. does not have a credible intermediate fiscal plan and could encounter similar problems to those currently facing Europe. These fears were crystallized for many investors in August when Democrats and Republicans squabbled until the eleventh hour before agreeing to raise the federal debt ceiling and avoid a technical default. The lack of political consensus on how to solve the country’s budget woes led Standard &

Poor’s to downgrade its rating of U.S. government debt from AAA to AA+.

Going forward, it is important to track not only the debt as a percentage of GDP, but the interest payments as a percentage of GDP. While most are aware of the first metric, the overall interest expense as a percent of GDP is considerably lower than prior years.

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While the debt to GDP graph is a sobering picture, there is some comfort knowing that the interest expense on such a large debt burden is not yet crippling. However, a spike in interest rates could dramatically alter that graph and make the large debt obligation more of a barrier to healthy economic growth. Regardless, government spending is likely to dip as austerity measures take hold and political infighting prevents the extension of several entitlement programs. While beneficial for the long term economy and lessening the debt burden, this could translate into additional headwinds for an already fragile economy.

While not quite to the same degree of the two items above, business investment could also have a material impact on the 2012 U.S. economy. Corporate balance sheets currently reflect more than \$2 trillion of cash on hand, so companies have the means to invest in equipment and other capital. Of course, the overarching uncertainty is a general lack of confidence (on behalf of consumers and companies) of future economic growth; companies may still be hesitant to deploy this capital. However, if the record amounts of cash on hand combined with low borrowing costs do not spur further investment, it seems likely that economic expansion will be lukewarm at best.

While the above topics are likely to pack the biggest punch, other items to follow for 2012 include:

- The 2012 Presidential election - although the results are unlikely to have much of an impact on this year's economic growth, the November winners (President, Congress, and the Senate) should provide some insight into any changes for monetary and fiscal policy for the next two to four years.
- Ongoing deleveraging – high debt levels make it increasingly clear that a long period of (continued) deleveraging is needed throughout most of the developed world to address excessive consumer and government debt. While this should stabilize the financial system and global economy, the processes may lead to an extended period of below-trend growth as two typical sources of growth - government and consumer spending - are likely to be muted due to the need to pay down debt.
- Commodity prices – through the end of November, the food component of CPI-U increased 4.7% and the

energy component rose a whopping 14.2%. Such increases in essential item prices leaves less room in consumers' budgets for other expenditures, which can create another drag on GDP growth. Though energy prices have reversed course more recently, the volatility as well as magnitude of these prices could serve as a further impediment to economic progress.

Collectively, the factors discussed above will ultimately determine the overall economic health of the U.S. in 2012. Unfortunately, these factors do not offer much optimism for a year of robust economic growth with dramatically lower unemployment a year from now. Rather, economic growth is projected to be about 2%, well below what growth figures should be coming out of a recession. The unemployment rate will likely remain above 8.5%, as any increase in job creation will be offset by an increase in the number of people actively looking for work, therefore effectively leaving the unemployment rate mostly unchanged over the course of 2012. The one bright spot in these projections is that inflation is expected to remain under 2% as commodity prices continue to abate and consumers demand discounts before making large purchases. Overall, it will likely be another frustrating year for the economy, with low growth and high unemployment continuing to plague efforts to rejuvenate the overall economic condition of the country.

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## **FIXED INCOME: Macro Risks, Value Opportunities**

ERIC PRZYBYLINSKI, CAIA, SENIOR RESEARCH ANALYST

In a year where interest rates "had nowhere to go but up", the ten-year rate fell 130 bps, touching lows not reached in the past 50 years. After experiencing a 30-year bond bull market, the U.S. seemed poised for weak fixed income returns in the minds of many analysts. It is true that given a 2.4% yield on the BarCap Agg, long-term fixed income returns are likely to be low. However, forecasting low returns is not the same as forecasting higher interest rates. Since the collapse of Lehman brothers, two main drivers of rate movements have been expectations of economic growth (or lack thereof), and external shocks related to the Eurozone crisis.

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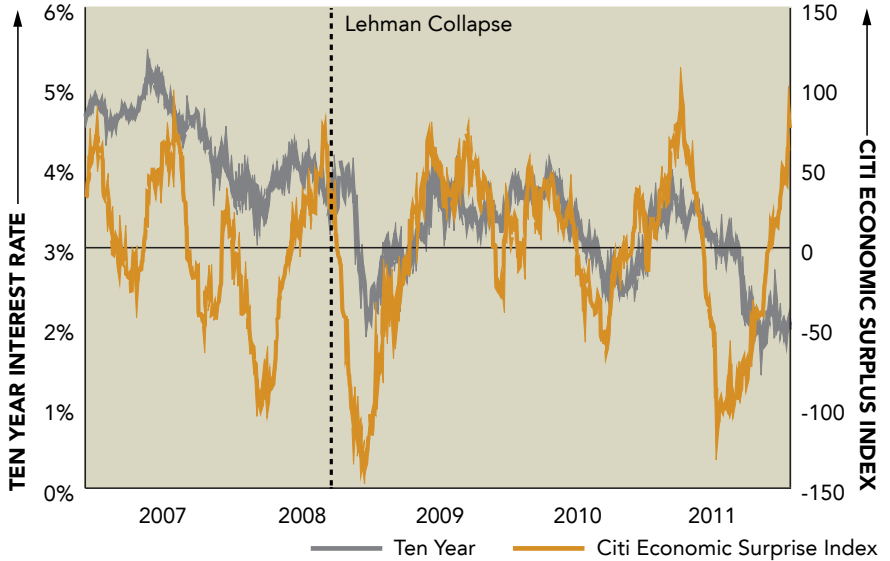
This relationship is highlighted in Exhibit 1, which plots the Citi Economic Surprise Index versus the ten-year interest rate. Over the past few years, interest rates have tended to increase when the economy surprises to the upside, and decrease when the economy surprises to the downside. Recently this relationship has diverged. After a spate of weak economic news, the ten-year dropped over 100 bps from July to August. On August 9th, the Fed explicitly pledged to keep the Fed funds rate near zero until 2013. From that point until the end of 2011, the U.S. economy has significantly outperformed expectations while the ten-year rate has hovered around 2%. Three plausible explanations exist:

1. Economic improvements are not yet priced in and rates are set to rise.
2. Economic surprises are not sustainable, as falling savings, not rising real incomes, have fueled increased spending.
3. Investors fear a financial crisis in Europe and are fleeing risk assets for the relative safety of Treasuries, pushing down U.S. interest rates.

Because credit spreads widened over 200 bps from August to September, explanations 3, and possibly 2, seem most plausible. If the U.S. economy operated in a vacuum, growth could likely continue to muddle along. This would be a weak environment for equities, but strong for credit and neutral for Treasuries. However, the risk of an exogenous shock emanating from the Eurozone is rising. Against this backdrop, spreads have widened and yields on Treasuries remain depressed. Even at these levels, if a

“After experiencing a 30-year bond bull market, the U.S. seemed poised for weak fixed income returns in the minds of many analysts.”

**Exhibit 1: Economic Surprises vs. Ten-Year Rates**



Source: Bloomberg, St. Louis Federal Reserve

true crisis were to materialize rates would likely drop further and spreads would surely widen.

Despite the negative macro outlook, there remain some potential value opportunities for long-term investors. Spreads on investment grade credit are now as wide as they were during the

2001 recession, though still significantly narrower than during the most recent credit crunch. Spreads on financials versus industrials are at levels not seen since the 2008 crisis, shown in Exhibit 2. U.S. banks are much better capitalized than 2008, but now as then, risks are elevated. Investors overweighting financials versus industrials would cont...

**Exhibit 2: Investment Grade Financials over Industrials**



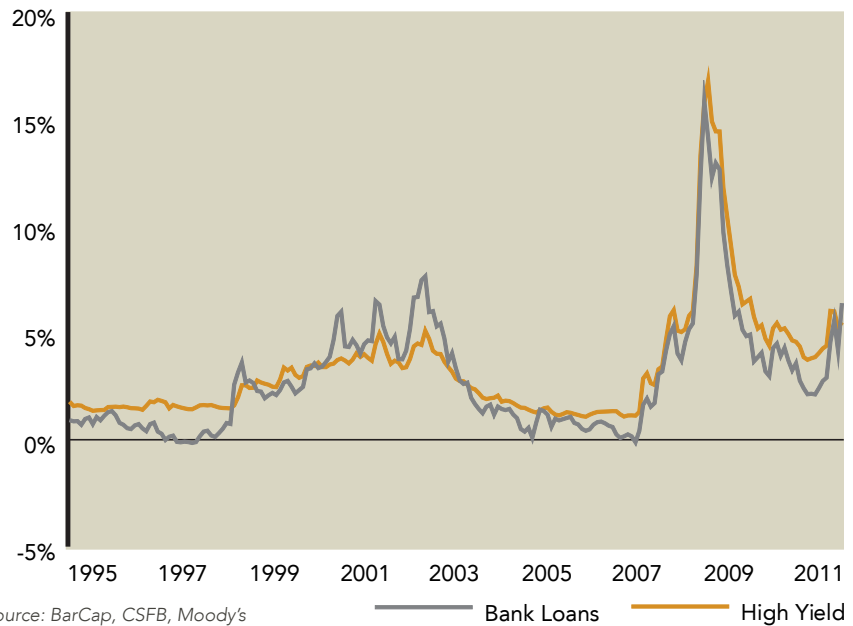
Source: BarCap

have outperformed by 241 bps through June of 2011 had they avoided event risk and bought financials in July of 2009. However, annualized gains would have been lower (82 bps) with significantly more volatility if the entry point was just six months earlier. Investors buying financials over industrials pre-Lehman would have lost 71 bps annualized through June 2011. Timing is important.

Further down the credit spectrum, high yield bonds and bank loans look cheap relative to historical averages. On a default loss adjusted basis, spreads are attractive relative to Treasuries. Compared to 2008, the last time spreads were this wide, companies are in better financial health. Additionally, refinancing pressures in 2012 are low, with only \$5B in loans and \$38B in high yield scheduled to reach maturity. Defaults are non-linear; they are much higher in times of crises than long-term averages. Still, investors are being paid a reasonable premium to take such risk in below investment grade credit.

Perhaps the best long-term opportunity in the fixed income markets in 2012 lies in non-agency residential mortgage backed securities ("RMBS"). Similar to high yield, non-agency RMBS have become cheaper toward the close of 2011. Whereas the investment case can be made for other credit sectors from a top down perspective, there is no index that tracks the non-agency market. Individual securities are analyzed based on mortgage prepayment and default assumptions. However, even based on pessimistic assumptions of foreclosure rates and declining home prices, prime and Alt-A non-agency RMBS can offer yields in the high single digits and low teens. With loss adjusted yields at about 6% for high yield assuming long-term average default

**Exhibit 3: Loss adjusted Spreads, High Yield and Bank Loans**



Source: BarCap, CSFB, Moody's

rates, non-agency RMBS offer the potential for higher returns in credit with a wider margin of safety. In sum, 2012 will likely be a difficult year for fixed income managers. While valuations in credit are relatively attractive, uncertainty is high. The ongoing crisis in the Eurozone is at the forefront of investors' minds. The spotlight may also turn to developments at home. The 2012 elections and changes to the FOMC

committee and communications policy could have unpredictable market effects in the coming year. Ultimately, even fixed income investors that experience strong long-term outperformance could be in for a bumpy ride. ■

**U.S. EQUITY:  
Uncertainty and Global Fears  
Dominate U.S. Markets**

KELLI SCHRADE, MANAGING PARTNER

**2011: Volatility and Disappointment**

After two consecutive years of double-digit gains, the U.S. equity market ended 2011 relatively flat. Mid- and small-cap equity indices were in the red, with small caps faring the worst. Large cap stocks provided some relative safety, as investors sought out larger, more established

companies during these uncertain times. The S&P 500 eked out a small gain of 2.1%, while the Russell 2000 lost more than 4%.

The flat market returns mask a year of unprecedented volatility, particularly during the third quarter. The next chart represents the performance of the Volatility Index ("VIX") vs. the S&P 500. There is an inverse relationship between the VIX and the S&P 500 index: fear increased and performance toppled as macroeconomic cont...

issues dominated the financial headlines.

Sentiment more than fundamentals drove the market in 2011. The S&P 500 companies had more than 15% earnings growth this year, yet the index was basically flat. Global macroeconomic concerns negatively affected the U.S. stock market throughout the year.

**Opportunities:  
Value Stocks Remain Cheap**

Using traditional quantitative measures, each broad area of the U.S. equity market appears undervalued compared to historical averages. The following chart depicts each broad asset classes' current price-to-earnings ratio compared to its 20-year average.

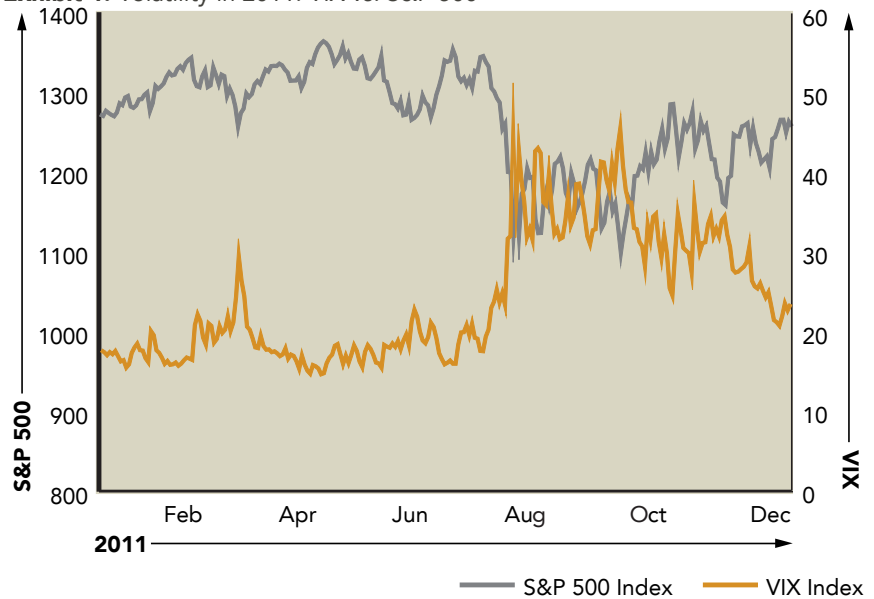
At first glance, large-cap growth stocks appear the cheapest, trading 35% cheaper than their historical average. However, it is worth noting that the growth segments' (large growth, mid-cap growth and small-cap growth) 20-year average P/E ratios are skewed upward by the late 1990's technology bubble. At the bubble's peak, the average large-cap growth product reflected a P/E of 43<sup>1</sup>, an all-time high. Because of the abnormal skew in the growth averages, the greatest opportunities lie in the value areas. Large-cap value, in particular, looks attractive, trading 21% below its 20-year average.

Large-cap stocks offer a yield advantage, as well. The S&P 500's dividend yield of 2.2% compares favorably to Treasury yields. The 10-year Treasury is currently yielding just 1.9%.

**2012:  
Potentially Darker Days Ahead**

Euro Crisis: Much of 2011's U.S. market volatility resulted from concern over

**Exhibit 1: Volatility in 2011: VIX vs. S&P 500**



Sources: Bloomberg and Yahoo, data through December 31, 2011

**Exhibit 2: Current P/E vs. 20-year avg. P/E**

	Value	Core	Growth
Large	11.0 / 14.0	12.3 / 16.8	13.8 / 21.1
Mid	12.3 / 14.0	13.9 / 16.3	15.7 / 21.9
Small	13.0 / 14.2	14.6 / 17.1	16.4 / 21.3

Source: JP Morgan, data through 12/31/2011

**"More likely, however, is that the U.S. stock market will continue to experience heightened volatility until the Euro situation is resolved..."**

the European sovereign debt and banking crisis. Going into 2012, a solution to the Euro problem will likely involve tighter integration of the seventeen EU countries, especially on budget matters. A dissolution of the Euro altogether cannot be ruled out in 2012. If the Euro were to collapse, we would expect a steep drop for the overall global stock market, including the U.S. More likely, however, is that the U.S. stock market will continue to experience heightened volatility until the Euro situation is resolved.

U.S. Presidential election: The election season officially kicked off on January 3<sup>rd</sup> with the Iowa caucus. It is likely to be a bitter campaign season, with the two major parties divided on issues such as taxes and federal spending. The stock market historically performs well in an election year (up 8% on average since 1932). However, if the election outcome and subsequent policy agenda becomes decidedly "anti-business," the U.S. stock market would be negatively affected.

Apprehensive CEOs: Given the uncertain economic climate, CEOs in the U.S. have been hoarding cash. Non-financial CONT...

<sup>1</sup> Morningstar, Inc.

firms in the S&P 500, for example, have \$1.1 trillion in cash on their balance sheets. Going into 2012, it remains to be seen whether U.S. companies will start utilizing that cash. A clearer overall economic and fiscal policy picture would lead to more capital spending and potentially increased hiring in the U.S. That could put an end to the current disconnect between U.S. stock

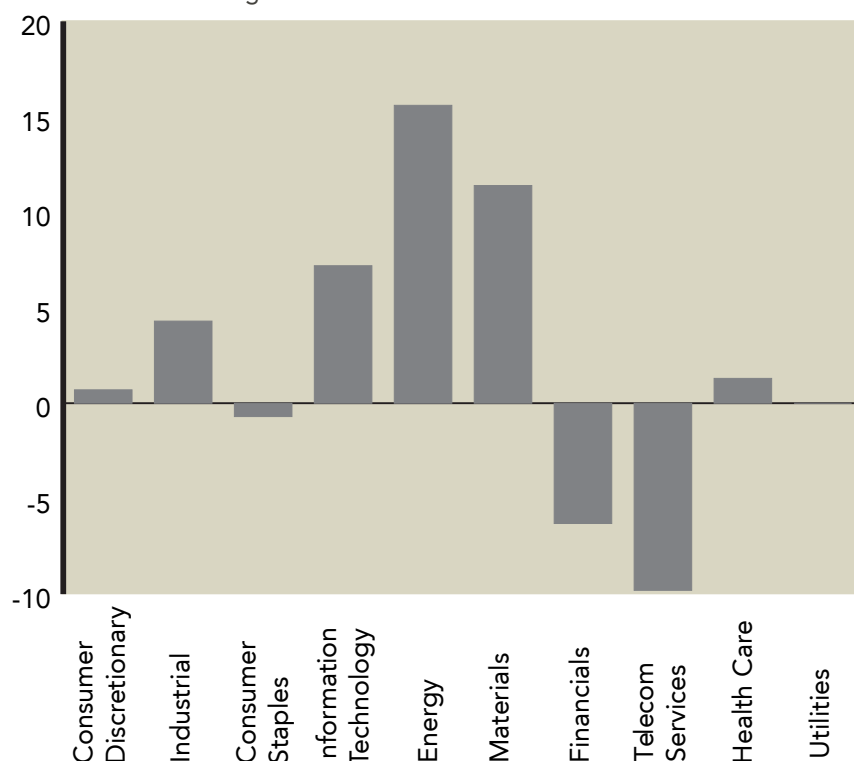
market performance (poor to flat) and earnings growth (strong) of companies.

That disconnect is further exasperated by the current consensus estimates for 2012. Despite the fact that company earnings are at an all-time high, consensus earnings estimates for 2012 have declined recently for

all sectors within the S&P 500, furthering the conclusion that macro "doom and gloom" scenarios and not actual company fundamentals are dominating analyst opinions.

Despite the downward earnings revisions, most analysts still anticipate strong absolute earnings growth from the energy and materials sectors, while financials and telecommunications are in negative territory. Exhibit 3 lists the current consensus expected earnings of the S&P 500 sectors for 2012.

**Exhibit 3: 2012 Earnings Estimates**



Source: Bloomberg

### **NON-U.S. EQUITY: Does Opportunity Outweigh the Questions?**

TOM SALEMY, CFA,  
SENIOR RESEARCH ANALYST

For non-U.S. equity investors, 2011 was a year filled with both uncertainty and volatility. Stock market fluctuations during the year were driven predominately by the European debt crisis, rather than fundamentals.

Ireland, Portugal, and Greece required bailouts to rescue their economies from crippling debt obligations, while Italy and Spain came dangerously close to needing similar rescues. In an effort to stabilize the European debt crisis, a host of new policies were introduced within the European Union ("EU") during 2011, but to this point no comprehensive solution has been established. Consequently, the year ended with ongoing questions

about fiscal stability in the EU, as well as potential ramifications for non-U.S. equity investors.

As a result of the ongoing debt concerns and lack of credible solutions, non-U.S. equity indices were all in negative, double-digit territory for the year with the MSCI ACWI ex-U.S. index, the EAFE index, and the emerging market ("EM") index returning -13.3%, -11.7%, and -18.2%, respectively.

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Although emerging markets are not directly involved in the debt crisis, their reliance on demand from developed countries has left them exposed to global economic slowdowns and volatility.

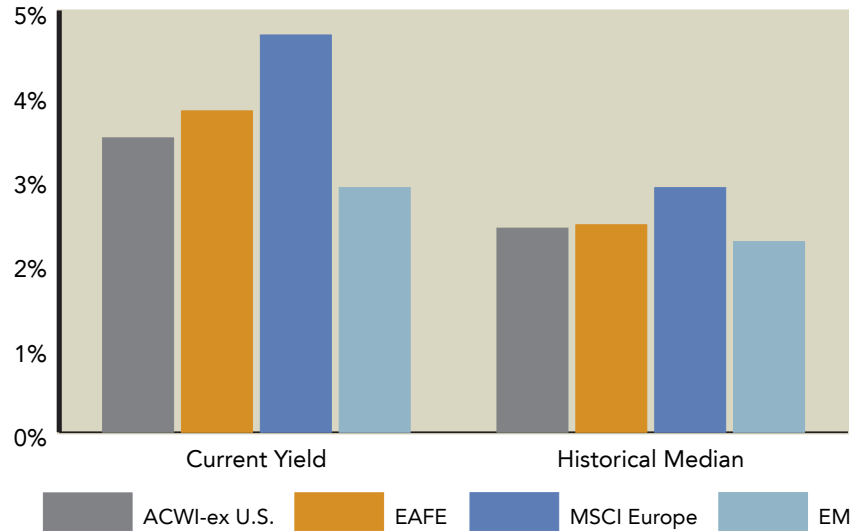
### Looking Forward to 2012

Similar to 2011, the European debt crisis is likely to be the biggest driver of non-U.S. equity returns for 2012. The vast amount of unresolved issues still present in the Eurozone - along with the lack of policies, confidence, and growth prospects needed to stabilize the future of the Euro - should lead investors to expect the market to trend based on two factors: policies and valuation levels. Policy decisions could play the largest role in market returns for 2012. If investors feel that the policies introduced and successfully implemented by the EU, European Central Bank, International Monetary Fund, and European leaders are credible and adequate enough to both stabilize the Eurozone and establish fiscal continuity (while maintaining some emphasis toward overall GDP growth), then markets should perform well. Ultimately, though, it is a game of confidence: market participants must be confident that the right policies have been put in place to instill fiscal responsibility while fostering economic growth.

From a valuation perspective, dividend yields across the international equity markets are a key metric to follow when investigating the relative attractiveness of investment options, as dividend yields act as somewhat of a floor to equity prices. Exhibit 1 shows that current yields are anywhere from 28% to 62% higher compared to their historical averages, suggesting that non-U.S. equities are an attractive opportunity, despite the ongoing Eurozone debt problems.

“Ultimately, though, it is a game of confidence: market participants must be confident that the right policies have been put in place to instill fiscal responsibility while fostering economic growth.”

**Exhibit 1: International Dividend Yields**



Source: Bloomberg

This does not mean that non-U.S. markets can not drift any lower, however, dividends are tangible and at some level, dividend yields provide a compelling backdrop for equity investors.

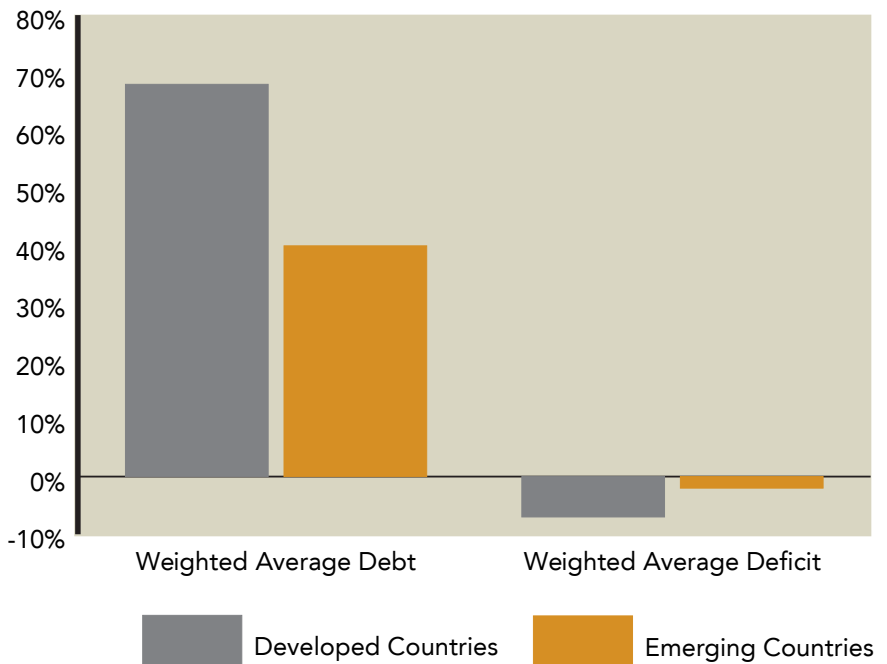
Other items to monitor for 2012 include the disparity of debt and deficit levels between developed and non-developed countries. This incongruity may lead to a notable divergence in returns across markets. More specifically, large debt and deficit levels along with slower growth prospects are likely to hinder developed nations relative to non-developed nations. Emerging markets exhibit superior growth prospects, stronger balance sheets, and are trading at similar valuations compared to their developed counterparts. Exhibit 2 shows that on average, developed

countries' public debt is roughly 68% of GDP, whereas emerging markets are at 40%. More importantly, on average, developed countries' deficits are 7.3% of GDP compared to just 1.5% for developing countries. However, one must not discount how demand from developed countries can impact the economies of emerging markets. While the economic data for substantial investment in emerging markets may be compelling, it must be balanced by the recognition that developing countries' economies are dependent on exports to their larger and more developed counterparts.

Overall, the current non-U.S. landscape is better than it was a month ago, though significant hurdles still exist before an investment in non-U.S. equities qualifies as a "no-brainer". Naturally, none of the European issues can be fixed overnight, and the journey to this point has been relatively painful for non-U.S. **CONT...**

markets. However, despite the continued concern resulting from the ongoing debt crisis, non-U.S. equities remain an attractive asset class heading into 2012. Most countries' economies are less concentrated to a specific part of the world (i.e. Europe) and more dependent on global demand. European equities are already priced for a recession, and many countries (both developed and emerging) outside of the Eurozone continue to show relatively optimistic macroeconomic indicators. P/E values of the indices are well below their historical averages, and the corresponding dividend yields are well above their considerable averages, thus creating the case for further allocations to the asset class. Once longer term EU policies / solutions are enacted for the marketplace to digest and risk appetite returns to equity markets, non-U.S. equities should experience the price appreciation needed to return valuation characteristics to more

**Exhibit 2: Debt & Deficit % of GDP**



Source: Bloomberg

"normal" levels. While it may take longer than one year and the ride is likely to be bumpy, the final destination may well be worth the trip. ■

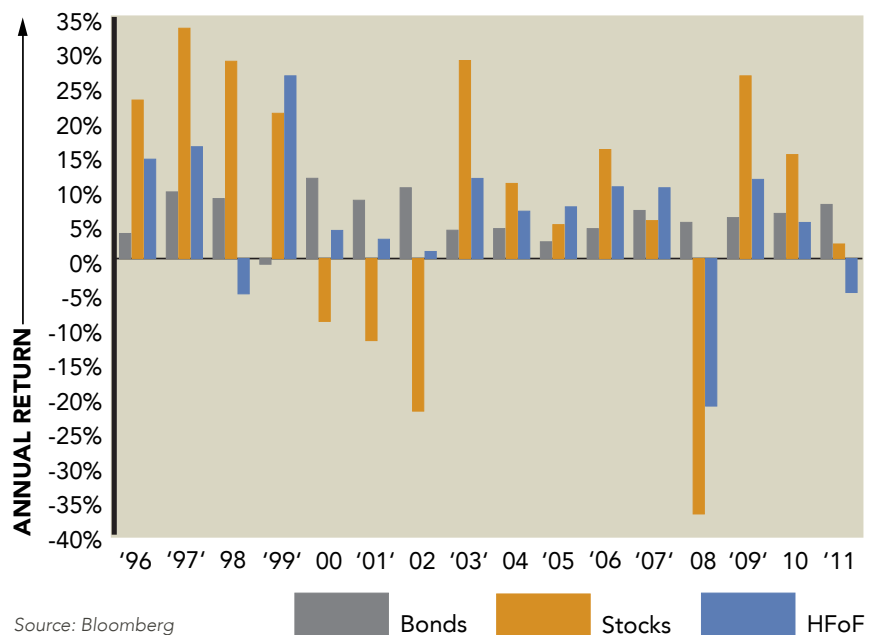
**HEDGE FUNDS:  
Tough 2011, Better 2012?**

NAT KELLOGG, CFA,  
ASSOCIATE DIRECTOR OF RESEARCH

Hedge funds struggled to generate attractive returns in 2011. For the second year in a row the HFRI Fund-of-Funds index underperformed both stocks (measured by the S&P 500) and bonds (measured by the BarCap Agg). Many of the same themes that plagued hedge fund managers in 2010 remained a problem in 2011, namely high correlations between stocks, high volatility, and low interest rates. Three of the four major hedge fund sub categories (hedged equity, event, and macro) experienced negative

"Many of the same themes that plagued hedge fund managers in 2010 remained a problem in 2011..."

**Exhibit 1: Annual Performance of the HFRI Fund of Funds index vs. Traditional Assets**



Source: Bloomberg

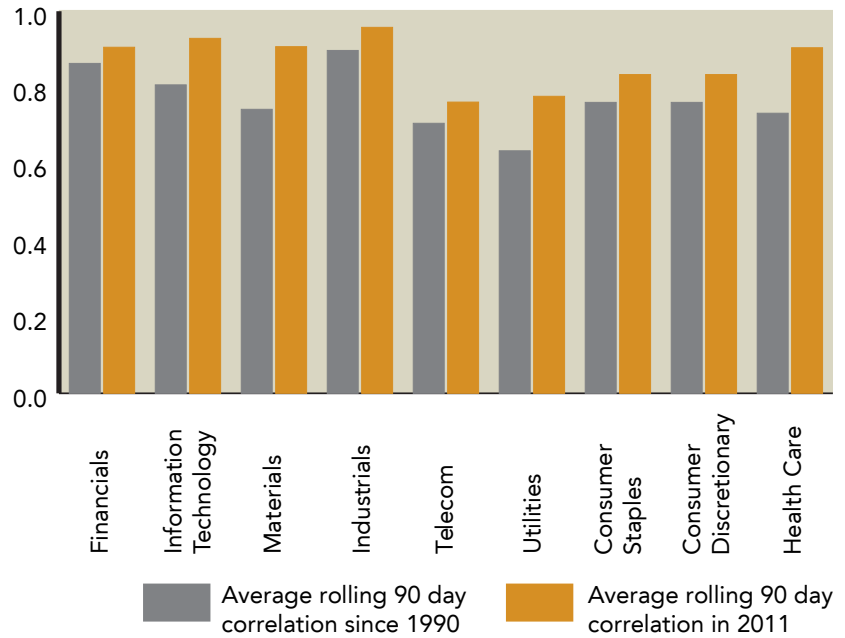
returns in 2011.

Turning to 2012, interest rates are expected to remain low and macroeconomic events are likely to dominate the headlines and drive investors' risk appetites. As a result, volatility and stock correlation are likely to remain high, making life difficult for hedged equity managers. As seen in Exhibit 2, large changes in volatility, both positive and negative, have a strong negative correlation to hedged equity returns.

European sovereign debt will remain the center of attention for hedge fund managers in 2012. One issue for hedge fund investors to watch is how a potential sovereign debt default, or restructuring, affects credit default swaps (CDS). Many hedge funds own CDS on European sovereign debt as a tail hedge to protect against a large market dislocation. However, EU policymakers have considered a number of restructuring options for Greece that would avoid a technical default specifically to avoid triggering CDS payment written on Greek debt. Investors should pay close attention to how any potential restructuring in Europe affects the CDS market, as some tail hedges may prove to be less valuable than expected.

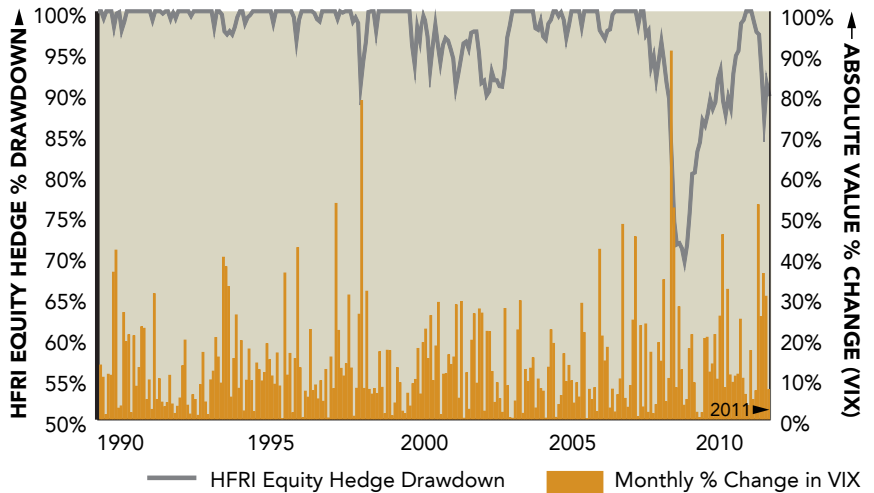
Despite these concerns, there are a number of opportunities that look attractive heading into the New Year. Due to a widening of credit spreads during the third quarter and continued weakness in housing prices, non-agency residential mortgage back securities have had lackluster returns in 2011, but now look attractive. The non-agency market (residential loans that do not conform to Fannie Mae or Freddie Mac standards, and thus are not backed by the government) is opaque, difficult to analyze,

**Exhibit 2: S&P Correlations with the Broad Index**



Source: Bloomberg

**Exhibit 3: HFR Equity Hedge Drawdown and Volatility changes**



Source: Bloomberg

and due to potential regulatory changes, there are a number of forced sellers in the market.

Current prices imply significant additional house price depreciation, economic stress, and offer attractive current yields. These characteristics make this market ideally suited for hedge funds with deep expertise in this market. A new distressed

cycle looks to be building in Europe as deleveraging by large European banks, and a slowing economy, are likely to combine to present hedge fund managers with very attractive buying opportunities at some point in 2012. Lastly, Global Macro managers appear to be ideally suited for the current environment, where investment returns appear to be largely driven by macroeconomic events, not company fundamentals.

## REAL ESTATE: The Recovery Continues

ELIZABETH FRANCIS, CIMA,  
SENIOR RESEARCH ANALYST

### Introduction

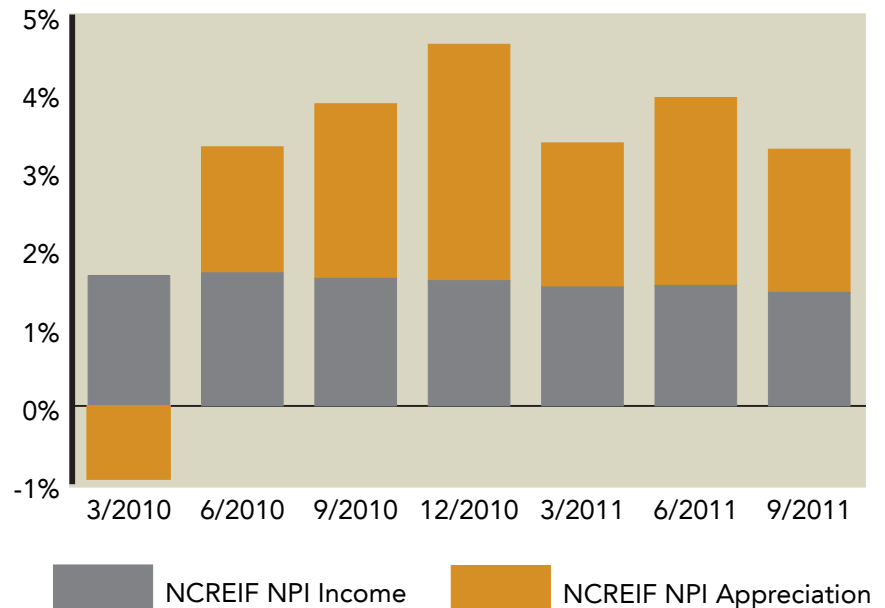
For 2011, core real estate was one of the only asset classes to provide a consistent, positive return each and every quarter. Two factors contributed to the positive returns: (1) the inherent stability in real assets and (2) the pricing rebound since the market trough. Appraisal values for properties have improved as more buildings have traded hands. The simple act of selling and buying a building adds a tremendous amount of stability to the market as this action creates comparables or “comps” for the appraisers. This stability promotes more sellers to bring assets to market and provides comfort of fair pricing for the buyer. Even with the stability we have witnessed in the real estate market, there are still some outstanding questions. Will the recovery continue? What will the returns be in the future? What property sectors will do well?

### Expectations

For the next three to five years, managers’ estimates of the real estate market in the United States remain positive. Estimates for the total real estate return range from 6.0% to 9.5%.<sup>1</sup> This is a rather large range, but the reason for the bulk of the difference is disagreement on what appraisals will look like in the next few years due to cap rate movements, available comparables, and income levels. Imbedded into these expectations of future performance, the income levels predicted are in

“Appraisal values for properties have improved as more buildings have traded hands. The simple act of selling and buying a building adds a tremendous amount of stability to the market as this action creates comparables or “comps” for the appraisers...”

**Exhibit 1: Real Estate Components of Return - Income and Appreciation**



Source: *Encorr*

a tighter range: 4.5% to 6.0%. One should remember that real estate has two primary components of returns: appreciation (or depreciation) of the property’s value and cash yield from the properties. Part of the income can be distributed to the investors of the fund, while the balance may get reinvested in the property to maintain or improve it.

### Sectors

Within the real estate market, there are various property types into which one can invest. We are highlighting the established core sectors including apartment, hotel, industrial, office,

and retail. Not all sectors have rebounded with the same velocity, nor do the sectors perform in lockstep with one another. There is correlation, but it is not perfect correlation.

- **Apartment** – as an age group, Generation Y’ers (20-34 years old) are disinclined to purchase a home. This is occurring for a myriad of reasons: loans are hard to obtain, they may lose the home in the future to financial pressures if the value decreases, and owning a home is slowly falling out of the “American Dream” mantra. This has led to a boom for the owners of **CONT...**

<sup>1</sup> From conversations with BlackRock, Invesco, Prudential, Reef, and UBS

rental units. With the increased demand, units are renting for above market rates. Concessions to attract renters are no longer in place. Development for new buildings is beginning to occur (nationally, construction for multi-family is the prevailing property type to which banks are lending). All of these factors combined have made apartment buildings attractive holdings for real estate funds.

- **Hotel** – although the U.S. economic health is not on solid footing, there have been improvements in all three measures of hotel performance metrics – occupancy, average daily room rate, and revenue per available room. There is not much in the way of new hotel supply coming to market, so existing hotels will benefit as travel increases.
- **Industrial** – improving in terms of income generation and trading hands. Space is being absorbed and there is, again, limited development coming to market. Vacancy rates are diminishing, 9.4% through November 2011, as retail sales, manufacturing, and exports have increased.<sup>2</sup>
- **Office** – this segment of the market is very dependent on the state of the economy. If companies are not hiring, there is no need to fill space. That said, there are signs of stabilization starting to show. Occupancy rates have improved month over month and the top recent transactions of note have been in the office sector. In the last six months alone 1,318 offices have sold at an average price of \$32.1 million.<sup>3</sup>
- **Retail** – this has been the most stagnant sector of the market. Concessions are still in place. Although store closings have slowed, they are still occurring. The shuttered stores also cause an oversupply of space. With retailers' success contingent upon the U.S. consumer, we will not see this sector vastly improve until the U.S. consumer's position improves. There are contradictions to this, however: high-end retailers and specialty malls are doing well. These centers have fared well throughout the economic downturn due to the customer base.

## Conclusion

We expect real estate funds will continue to produce strong income returns for the next few years. Any outsized returns will be gained from how a manager invests the portfolio. Are there concentrations in any one strong sector or area of the market? Is there leverage on the properties or the fund that is accretive? Does the manager have cash on hand to buy a property at a fair price or sell a property in a bidding war? Strategy and execution will be of paramount importance.

Though our view on real estate is positive, we are mindful that debt in the real estate market is still a looming problem that will have to be addressed in the future. Over \$1.7 trillion dollars is coming due in the next five years with an estimated 61% or \$1.0 trillion of those properties currently positioned underwater, i.e. more is owed by the borrower than what the property is worth.<sup>4</sup> If these values do not come back to par or lenders/borrowers are not able to come to agreement, we may have another 2008 – 2009 real estate market. Therefore, proper due diligence of funds and underlying strategy is of paramount importance to ensure exposure and debt level of each fund is appropriate and in harmony with investor goals.

## PRIVATE EQUITY: Activity to Pick Up?

NAT KELLOGG, CFA,  
ASSOCIATE DIRECTOR OF RESEARCH

Despite a volatile year in the public equity markets, 2011 was a fairly normal year for private equity. U.S. buyout activity totaled \$74 billion through the first three quarters of the year, and is on pace to exceed the \$77 billion of transactions posted in 2010, marking a new, post-crisis high. Activity slowed noticeably in Europe during the second half of the year as the European debt crisis shifted into high gear, but from a global perspective overall activity was on par with last year.

Fundraising remains very challenging and the heady days of 2006-2008 are clearly a thing of the past. Fundraising in 2011 appears set to post another post-crisis low, as many large private equity investors have reevaluated the amount of capital they are willing to deploy into the asset class.

<sup>2</sup> "Real Assets Market Update Third Quarter 2011", Verdis Investment Management, 3Q 2011

<sup>3</sup> <http://www.rcanalytics.com>

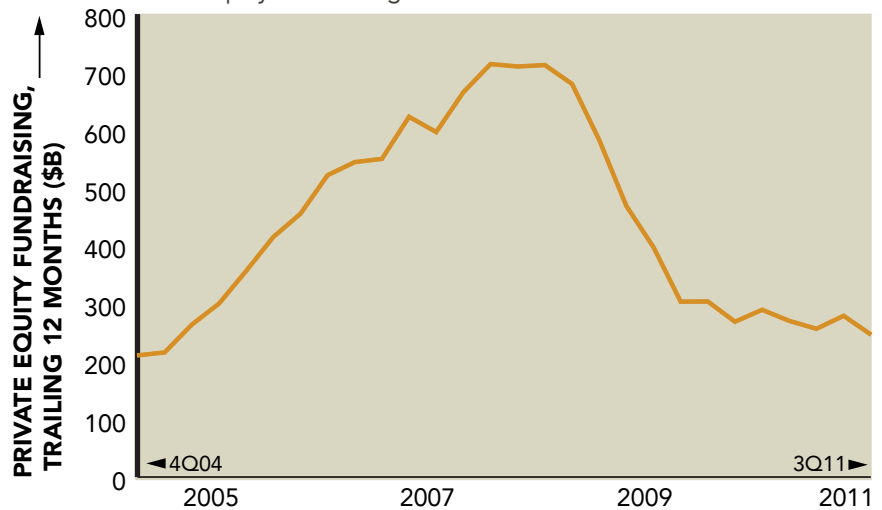
<sup>4</sup> Trepp LLC and BNY Mellon Asset Management

One of the main concerns for private equity investors is the significant amount of dry powder that remains outstanding from the fundraising boom of 2006, 2007, and 2008. While dry powder fell for the third straight year in 2011, there remains over \$350 billion of global buyout dry powder outstanding. This dry powder is an unfunded commitment for private equity investors and has served as a significant brake on the current fundraising environment.

The large amount of outstanding dry powder should lead to increased activity in 2012. The typical buyout fund has an investment period of five years, after which the general partner must release their limited partners from any unfunded commitments, or ask for an extension of the investment period. Investors can expect private equity firms to be aggressive about deploying capital in 2012 given the massive amount of capital that was raised in 2007, and the significant amount of dry powder from that vintage year that has not been called and invested. We also expect that general partners will be forced to ask for extensions and this will become a common theme in 2012 and 2013 as the industry continues to work through the huge amount of commitments made during 2007 and 2008.

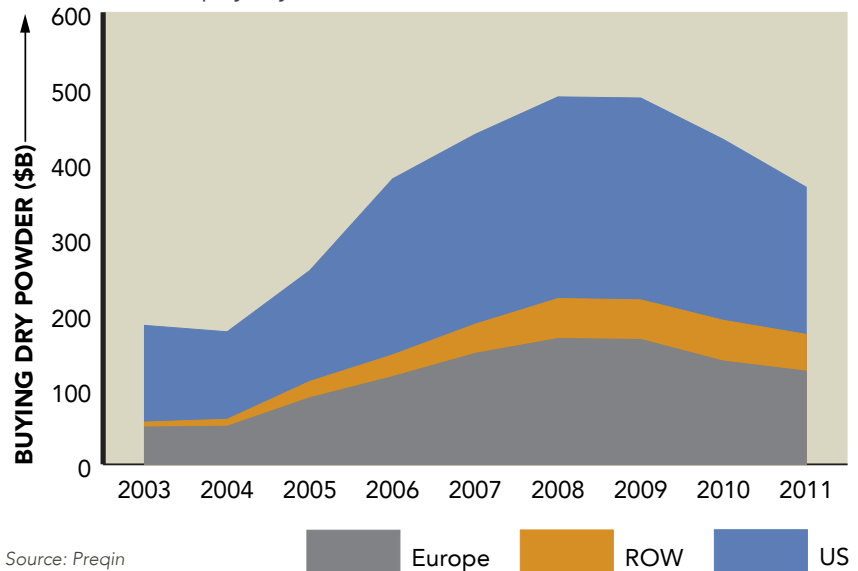
Facebook is set to IPO in 2012 and this will undoubtedly get investors talking about venture capital again. Valuation expectations remain robust with many investors expecting the firm will debut with a valuation above \$100 billion. The performance of Facebook will be a major driver of returns for the 2005 and 2006 venture vintage years. It may also help increase overall venture activity **CONT...**

**Exhibit 1: Private Equity Fundraising**



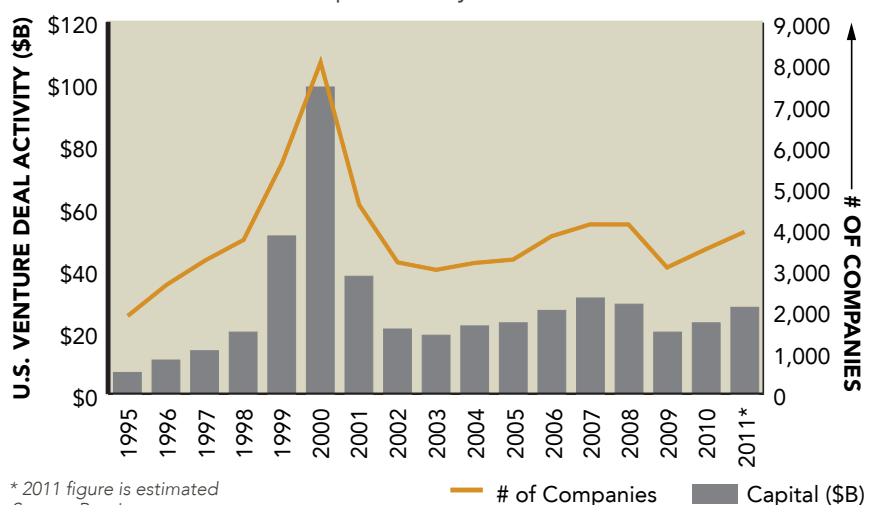
Source: Preqin

**Exhibit 2: Private Equity Dry Powder**



Source: Preqin

**Exhibit 3: Venture Deal and Capital Activity**



\* 2011 figure is estimated  
Source: Preqin

which had another solid increase in 2011 as companies focused on social media and the mobile web continue to attract investment dollars.

Another area to monitor in 2012 is U.S. tax policy. The “Bush tax cuts” are schedule to expire at the end of 2012 if Congress and the White House take no action. This is a replay of 2010, the first time the Bush tax cuts were set to expire. The looming potential tax increase led to the most active deal making quarter in the fourth quarter of 2010 since the credit crisis. We expect a similar level of activity toward the end of 2012 given the uncertainty surrounding tax policy and the large amount of capital private equity firms need to deploy in 2012. ■

“The “Bush tax cuts” are schedule to expire at the end of 2012 if Congress and the White House take no action. This is a replay of 2010, the first time the Bush tax cuts were sent to expire. The looming potential tax increase led to the most active deal making quarter in the fourth quarter of 2010 since the credit crisis...”

## INFRASTRUCTURE: Opportunities on the Rise

ELIZABETH FRANCIS, CIMA,  
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### 2011: What Has Been Trading?

In spite of market volatility and the Eurozone debt crisis, deals continued to be executed in the infrastructure market. The examples below highlight some of the more notable transactions closed in 2011<sup>1</sup>:

- **InterPark** – an owner/operator of parking facilities in central business districts throughout the United States, InterPark was sold by GE Capital to a private fund. InterPark manages 37,000 parking spaces in thirteen states.
- **El Paso/Kinder Morgan** - Kinder Morgan purchased El Paso Corporation for \$38.0 billion, thus creating the largest midstream and fourth largest energy company in North America.
- **Brussels Airport** – a 39% stake in the principal airport of Belgium serving 17.9 million passengers per year was sold to the Ontario Teachers’ Pension Plan.

### 2012: What to Watch

With the debt crisis affecting both public and private entities

throughout all of Europe, it is expected that more assets will be coming to market for sale. Private owners will need to raise cash to secure their balance sheets and divest of non-core competency businesses, while public entities (various governments) will use the sales proceeds to trim costs, reduce debt, or outsource the servicing needs of appropriate infrastructure assets.

It has been rumored that there are over €50 billion worth of utility divestitures expected to take place over the next eighteen to twenty-four months in Europe alone. These include assets in the PIIGS countries (Portugal, Ireland, Italy, Greece, and Spain) as well as the Czech Republic, Finland, France, Germany, the Netherlands, Turkey, and the United Kingdom. In the United States, utility companies have also seen more M&A possibilities versus other sectors of the infrastructure market, with over \$80 billion of public to private targets in the utility space.<sup>2</sup> With the top twenty utilities in the United States aggregating to an equity value of \$297 billion, it is possible that approximately 27% of the top two deciles of the market may go private.

Purchasers of infrastructure assets will need to have cash readily at their disposal as debt financing may be difficult to obtain. Fund managers who have ample cash on hand will be able to obtain assets more easily than those managers that are cash strapped or in fundraising mode. Well-positioned purchasers may be able to negotiate better terms or prices for the assets as it is a buyer’s market, not a seller’s market. According to data from Preqin, infrastructure funds have approximately \$68.5 billion of cash to put to work.<sup>3</sup>

CONT...

<sup>1</sup> Data from Preqin

<sup>2</sup> Alinda’s Fifth Annual Meeting, Greenwich, CT, October 26, 2011.

<sup>3</sup> As of December 2011

### New Investment Opportunity?

Managers (i.e. general partners) are starting to introduce debt funds. In lieu of banks issuing debt on an infrastructure asset for its purchase (by an infrastructure manager) or improvement, managers are raising capital from investors (i.e. limited partners) to provide the debt funding for the assets. Because banks throughout Europe and the United States are still in the midst of clearing out their balance sheets, they no longer have the capacity to be the sole provider of financing for infrastructure transactions. As a result, this is an opportunity for a captive pool of investors to provide funding for the purchase and/or improvement of infrastructure assets, while also creating a new investment opportunity. Though infrastructure assets are by definition long-term in nature, the debt on them is not necessarily so, therefore the liability/asset matching is not perfectly aligned. However, the attraction for the debt issuing manager is the steady interest and principal payments it will receive from the cash flow that an operational asset generates.

### Conclusion

2012 and beyond should continue to create numerous opportunities for infrastructure investors. New products and assets will be coming to market, and we may see more asset divestments from funds coming to the end of their investment lives. Regardless, investors are turning to infrastructure for income and steady values quarter to quarter; therefore, a focus on Brownfield assets with regulated pricing mechanisms and steady cash flows will be the “buying” targets. The upheaval in Europe, though painful for the equity markets and debt holders, should prove to be a veritable

“Well-positioned purchasers may be able to negotiate better terms or prices for the assets as it is a buyer’s market, not a seller’s market...”

**Exhibit 1: Investment Structures for Funds in Fundraising Mode**

Type	# of Funds	Aggregate Target Size (\$B)	Avg. Size (\$M)
Debt/Mezzanine	12	\$10.4	\$866.6
Fund of Funds	9	\$2.3	\$255.6
Multiple	7	\$2.9	\$414.3
Primary	127	\$85.7	\$674.8
<b>Total</b>	<b>155</b>	<b>\$101.3</b>	<b>\$653.5</b>

Source: Preqin, December 2011

breeding ground for infrastructure asset purchases.

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