Investment Stewardship Guidance

InvestmentPerspectives

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The State of Real Estate: Location, Location, Location...Where Are We?

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Core real estate has been an attractive investment since the market's recovery began in the first quarter of 2010. In this three-and-a-half year period, the NCREIF Property Index ("NPI") has returned a stunning 50.7%. Given this 13.1% three-year annualized return and unrelenting appreciation gains reported quarter after quarter, investors may wonder if they are too late to enter into private real estate or if their current investments are poised for a downturn. This newsletter will address these very issues by examining the health of the real estate market as suggested by the key indicators of performance, fund leverage and cash balances, transaction volume, asset values, income environment, and investor appetite.

Performance

As mentioned above, core real estate has strongly rebounded since 2010, with double digit annualized returns over the last three years. In an effort to more accurately gauge returns over different time periods, the table below examines the realized performance of the NPI[1] and the NFI-ODCE.[2] Although slightly different in composition (the NPI explains the overall real estate market, while the NFI-ODCE reflects underlying managers' performance), both are valid benchmarks and illustrate the recovery of the real estate market.

Exhibit 1: Annualized Performance of the NPI and NFI-ODCE as of June 30, 2013

Index	2Q13	YTD	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr	30 Yr
NPI	**2.9%**	**5.5%**	**10.7%**	**13.1%**	**2.8%**	**8.6%**	**9.1%**	**8.0%**
Income	1.4%	2.8%	5.7%	5.9%	5.9%	6.2%	7.5%	7.4%
Appreciation	1.5%	2.7%	4.8%	7.0%	-3.0%	2.3%	1.6%	0.6%
NFI-ODCE	**3.9%**	**6.6%**	**12.2%**	**15.0%**	**-0.2%**	**6.9%**	**8.5%**	**7.1%**
Income	1.3%	2.6%	5.3%	5.6%	5.7%	5.9%	7.3%	7.3%
Appreciation	2.6%	4.0%	6.6%	9.0%	-5.6%	1.0%	1.1%	-0.1%

Source: NCREIF

[1] NPI: a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only. All properties in the NPI have been acquired, at least in part, on behalf of tax-exempt institutional investors – the great majority being pension funds. As such, all properties are held in a fiduciary environment.

[2] NFI-ODCE (NCREIF-Open End Diversified Core Equity Index): an index of investment returns reporting on both a historical and current basis the results of 31 open-end commingled funds pursuing a core investment strategy, some of which have performance histories dating back to the 1970s. The NFI-ODCE Index is capitalization-weighted and is reported gross of fees. Measurement is time-weighted. NCREIF calculates the overall aggregated Index return.

Exhibit 1 (previous page) shows how the real estate market has improved since first quarter 2010 as reflected in the quarterly, year-to-date, one-, and three-year annualized returns. The income levels of the two indices are very similar; the difference in performance is directly linked to the appreciation component of each index. The Global Financial Crisis ("GFC") impact is clearly illustrated in the five-year returns, but long-term performance is attractive as evidenced by the trailing 20- and 30-year annualized performance values.

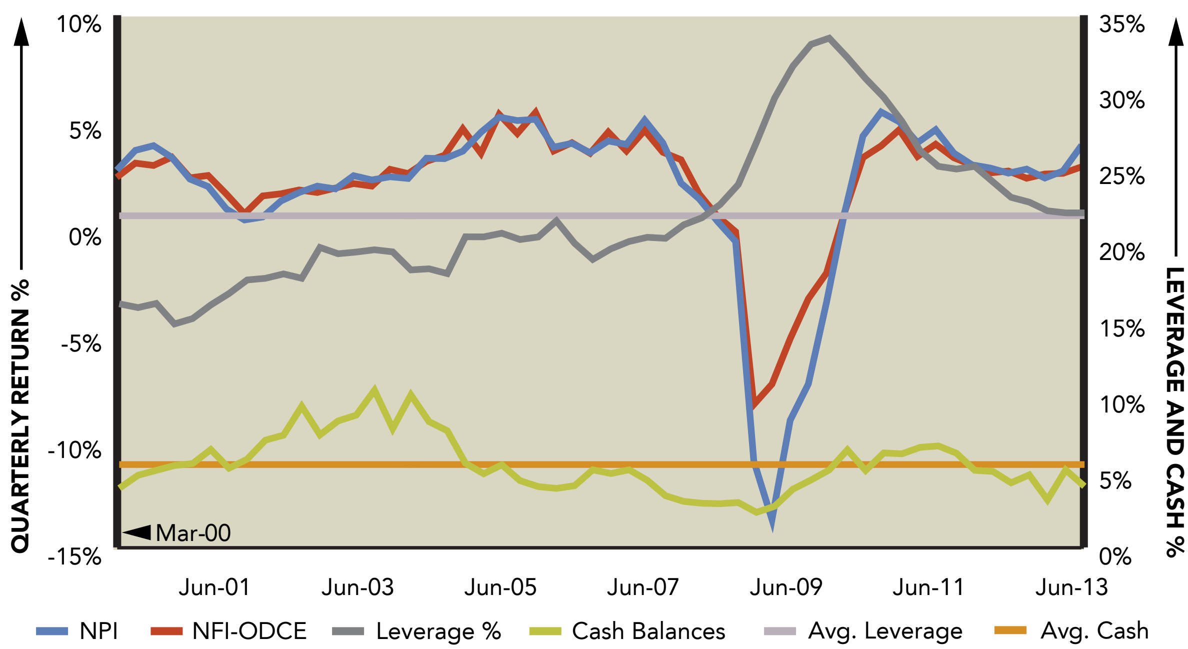
Thus from a return perspective it is evident that core real estate investments have benefitted investors, which naturally explains the renewed interest in the asset class. The important question going forward, though, is if such strong returns will continue.

Leverage Levels and Cash Balances

Leverage magnifies values in both up- and down-markets. Cash balances create a drag on overall fund returns in an up-market, and buoy returns in a down-market. Collectively, these two metrics provide some insight into future return expectations from managers.[4] Quite simply, a large deviation of either of these metrics from their long-term averages would be a cause for concern about the future of the real estate market. Remarkably high leverage levels are a risk in the event of a market slowdown or liquidity event, while excessive cash levels could indicate an overheated market that does not offer compelling value to investors.

From first quarter 2000 through second quarter 2008 (when returns turned negative), the NFI-ODCE managers held 19% leverage and 6% cash, on average. From third quarter 2008 through fourth quarter 2009, average leverage increased to 30% while cash decreased to 4%. Leverage increased for a simple reason: property values dropped while outstanding debt remained constant, therefore translating into higher leverage levels (this is also known as the "denominator effect").

Exhibit 2: Quarterly Returns of NPI & NFI-ODCE Overlaid with Historic and Average Leverage & Cash Balances



Source: NCREIF

As of second quarter 2013, cash balances are 4.1%, well below the long-term average of 5.5%. The overall leverage level of 22% is in-line with the long-term average of 21.8%. Therefore, cash and leverage positions are normal, and indicate a healthy yet not over-heated investment opportunity.

[4] Of the two indices referenced in this article, only the NFI-ODCE reflects leverage and cash.

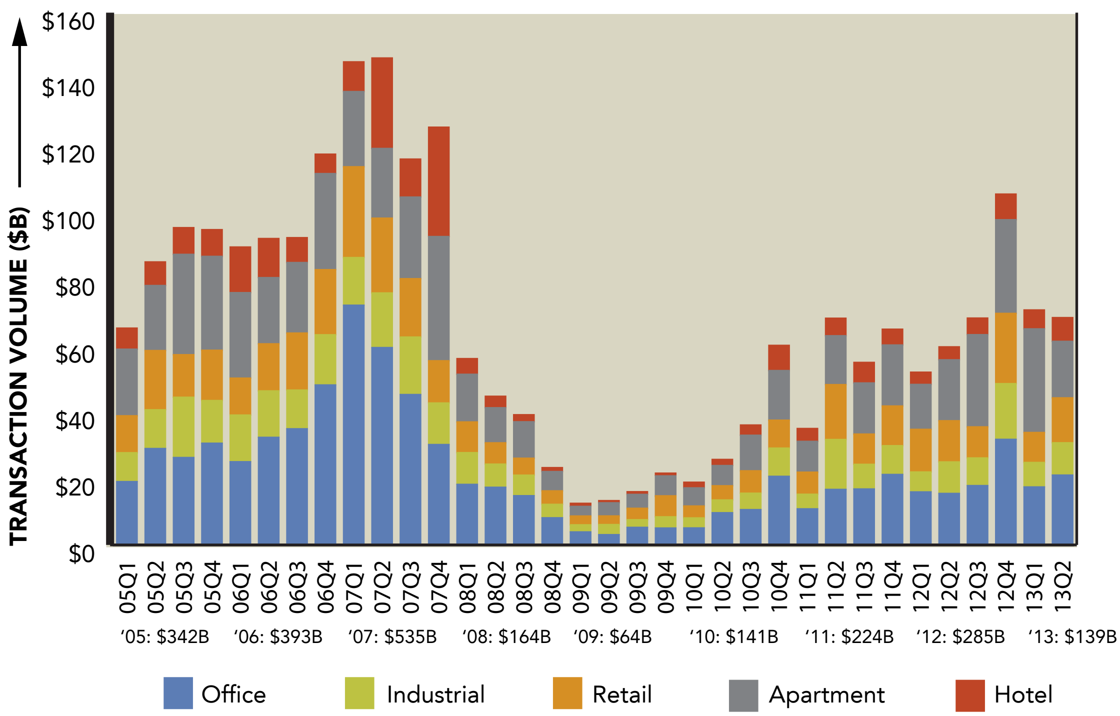
Transaction Volume

One of the most essential drivers in real estate pricing is transaction volume. Appraisers use comparable sales to calibrate their pricing models, so more frequent transactions should translate to more accurate pricing, whereas a lack of transaction data will lead to stale pricing. Simply put, more data points coincide with more accurate pricing, and vice versa. However, an overly active market as suggested by transaction volume can signal an overbought market and eventual correction which will be dilutive to investors.

Leading up to the peak real estate returns of 2007, the market experienced three straight years of record setting volume totaling $1.3T. Predictably, this volume coincided with remarkable property appreciation. Of course, this trend quickly reversed as property values tumbled and liquidity all but disappeared from the market, leading to a depressed real estate market and the onset of the Great Recession.

Exhibit 3 below displays historical transaction volume on a quarterly basis dating back to 2005. From the chart it is clear that activity has rebounded from the lows of late 2008/early 2009, but is nowhere near the historic levels of 2007. Since 2011, transaction activity has been fairly stable, and is expected to remain at these levels in the foreseeable future. At this point, transaction volume does not seem to indicate a misaligned market.

Exhibit 3: Historic Transaction Volume



Source: Real Capital Analytics via Clarion Partners, Q2 2013

Asset Values

The next relevant real estate metric to evaluate is property values. Similar to transaction data, property values can serve as a warning signal about the health of the market if they are above their previous highs. So are all asset values back to peak prices? The simple answer is no. By parsing real estate into various quality markets, one can see where the differences lie.

The major markets[5] (Boston, Chicago, Los Angeles, New York, San Francisco, and Washington, D.C.) have come back the most and are closest to pre-recession price levels, with current pricing approximately 9% below their prior peak values. This comes after a drop of 37.5% and subsequent rebound of 46%. These markets have recovered most rapidly due to property quality, market strength, and institutional acceptance. Core funds over-weighted to these major markets will have difficulty generating additional appreciation gains without significant improvements to net operating income.

Non-major markets such as Austin, Baltimore, Dallas, Denver, Portland, San Diego, Seattle, and South Florida fell 40% in value, rebounded 23%, and remain about 27% below peak levels. Therefore, exposure to properties in these markets may provide further appreciation gains.

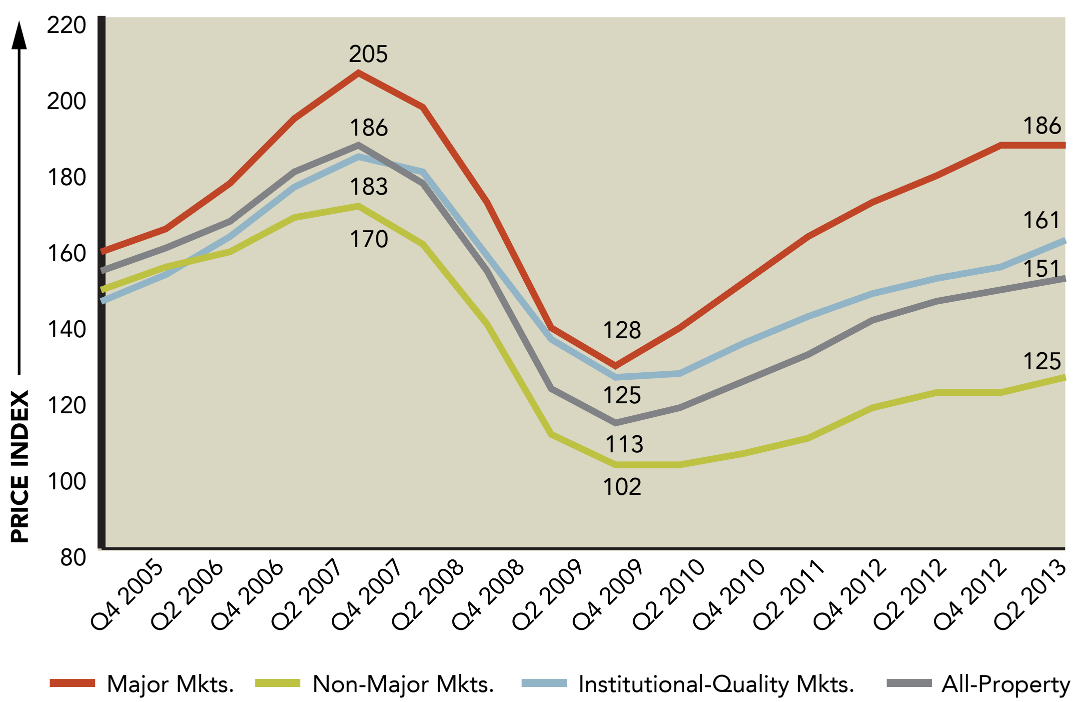
Exhibit 4: Property Markets Peak-to-Trough-to-Current Price Movements

Property Markets	Peak-to-Trough	Trough-to-Current	Peak-to-Current
Major	-37.5%	45.8%	-8.9%
Non-Major	-40.2%	22.8%	-26.6%
Institutional	-32.0%	29.4%	-12.0%
All	-31.1%	17.9%	-18.8%

Source: Moody's Analytics, Real Capital Analytics via Clarion Partners, Q2 2013

Exhibit 5 illustrates the price index of the different markets in graph form, and ties to the peak-to-trough, trough-to-current, and peak-to-current percentage movements (based on the index). Although the market fluctuations occur in harmony, the degree of the movements is dramatically different. While both the major and non-major markets have exhibited the same steep "V" decline, the recovery for the non-major markets has been much more gradual as compared to the rapid snap-back in the major markets.

Exhibit 5: Property Markets Peak-to-Trough-to-Current Price Movements



Source: Ibid

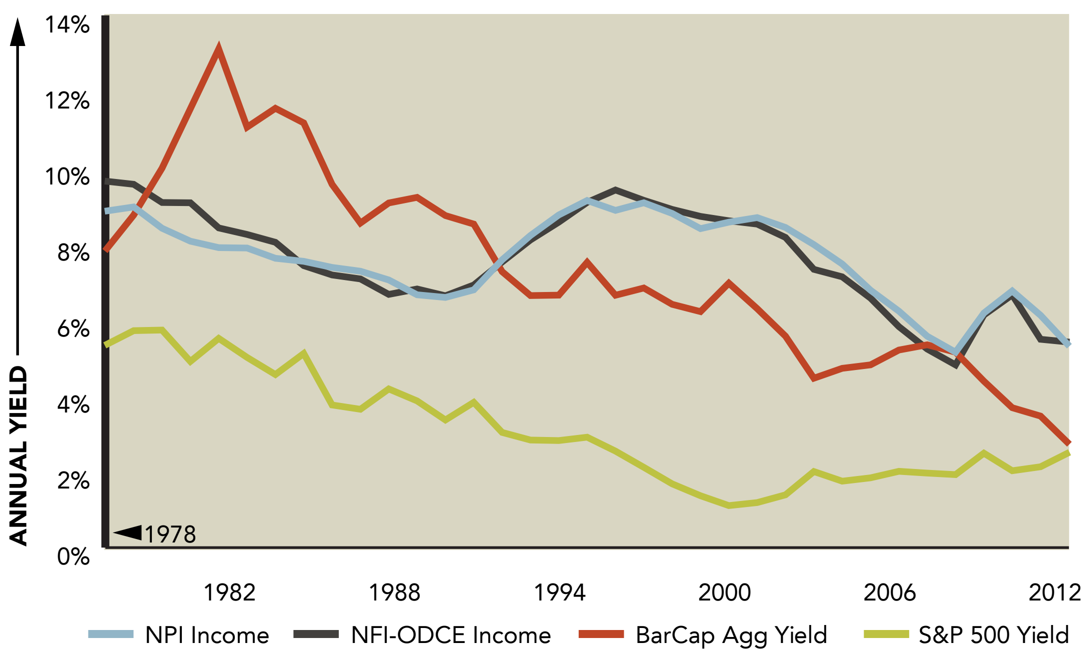
[5] Major Markets and non-major markets are defined by Moody's/Real Cap Analytics Institutional markets and based on the Altus Group's quarterly valuation of approximately 2,600 institutional grade assets in the NFI-ODCE Index.

Based on pricing, major markets have almost fully rebounded, while non-major markets have further room to improve. At this point in the recovery cycle, meaningful gains in property values will be dependent on increasing net operating income. There are only three ways to do this: (1) increase rents, (2) increase occupancy, and (3) decrease property expenses/costs. Any one these three options will increase the net operating income thereby leading to higher prices as larger future cash flows are discounted. However, the majority of price rebound has already taken place, and appreciation gains are likely to be more modest going forward. With asset values approaching their prior highs, future real estate returns will be driven predominantly by income generation, which is consistent with a stable return environment for the asset class.

Income Environment

The next topic to evaluate is the income environment for real estate investments. Perhaps now more than ever (as a result of the low rate environment), institutional investors are searching for yield, and real estate is an established income provider. Though yields have decreased through time, the consistent dividend and 200-300 basis point premium over traditional asset classes remains.

Exhibit 6: Annual Yield of Real Estate, Fixed Income, and Equities



Source: Encorr and NCREIF

While the annual income levels of real estate have decreased over its 34-year history, yields remain well ahead of core fixed income and U.S. equities. This premium is expected to continue as bond and equity yields remain low while real estate maintains (or even increases) income through improvements to underlying rents, occupancy, and expenses.

Investor Appetite

The last element to evaluate is investor appetite. Real estate's recent performance along with its yield premium has led to increased investor interest, and consequently the formation of contribution queues.[6] Contribution queues are the value of the cumulative dry-powder to put to work, i.e. what could potentially get called by managers in a quarter.

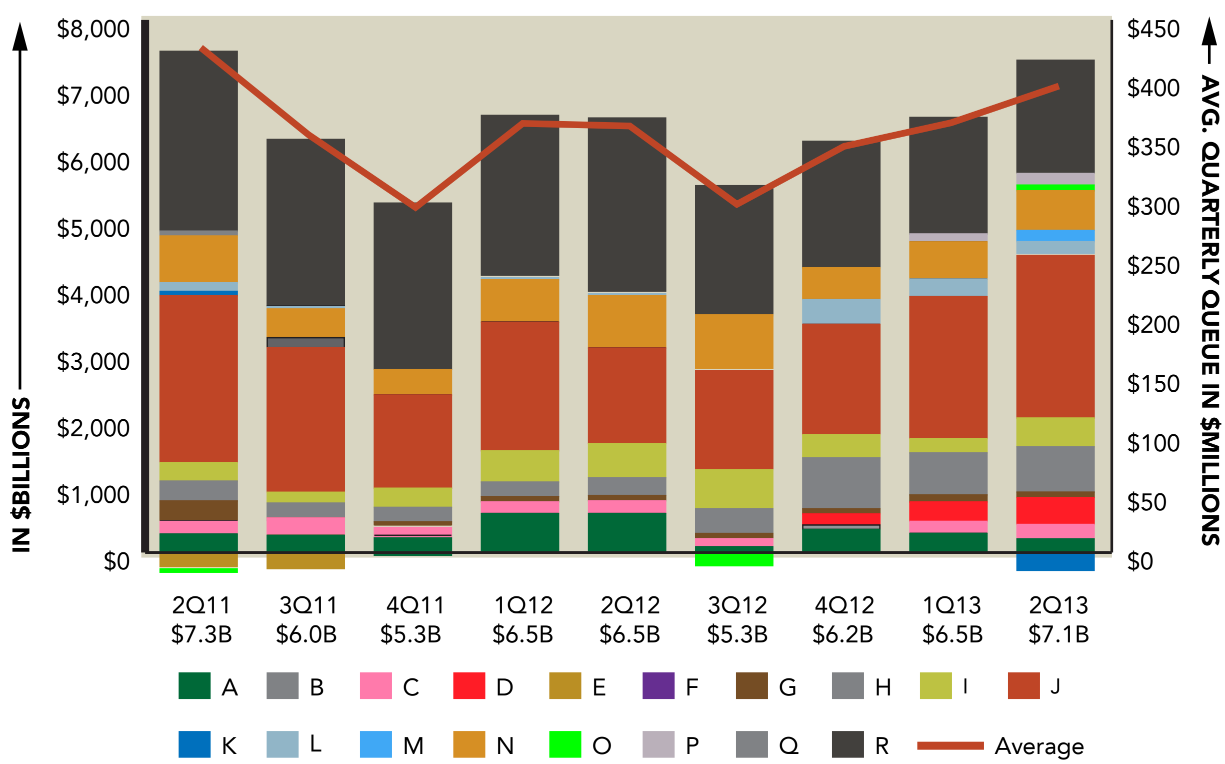
[6] When investors want to invest in an open-end real estate fund, the manager will call the cash when needed to avoid an unnecessary cash drag on the portfolio. When the contributions entering the fund outweigh the amount a manager is calling in any given quarter, a contribution queue forms.

If 100% of capital is called, the contribution queue is eliminated: prior quarter queue - capital called + new investor commitments = current quarter contribution queue.

Queue levels have to be monitored carefully because they could potentially dilute investment returns. The pressure to call capital and earn management fees might outweigh adhering to investment discipline or paying fair value for an asset. Additionally, the pressure to put money to work could lead to style drift by going outside of appropriate geographies or property types in order to increase fund size. If a significant queue exists for a particular manager, he/she may feel the pressure to put this money to work and overpay for an asset, as opposed to adhering to a more disciplined investment process. Such a practice is critical in today's market: if one overpays in the beginning, an asset's return potential is decreased.

Evaluating the last two years of data, the industry's quarterly contribution queue has averaged $6.3B. For the last two years, the average queue into a fund has ranged from $292M to $426M, but two funds are driving an upward bias with these values. Excluding these two managers, the quarterly average queue into a fund has ranged from $84M to $184M. Looking at exhibit 7 below, these values are shown graphically. Most important to note is that queue levels have remained relatively stable as prices have rebounded. Overall, the steady level suggests that managers are remaining disciplined when completing transactions and not rushing to put money to work.

Exhibit 7: Quarterly Reported Contribution Queues by NFI-ODCE Managers



Source: NFI-ODCE manager submissions to Marquette Associates, Inc.

Conclusion

The core open end real estate market has experienced tremendous positive performance over the last three-and-one-half years. There are not any glaring signals that intermediate-term annualized performance of 7 - 9% will not continue:

- Leverage and cash balances are normal.
- Transaction volumes have rebounded but are well below the levels preceding the Great Recession.
- Prices in major markets have rebounded while non-major markets and overall institutional quality assets have room to improve.
- Yields will continue to offer a 200-300 basis point premium over stocks and bonds.
- Contribution queues signal an influx of capital, but called capital amounts show manager discipline.

For investors contemplating an additional (or first) investment in real estate, a core fund focused on trophy assets in the six major markets should not provide outsized appreciation gains. With prices substantially rebounded in major gateway markets, investment managers with exposure outside of these six markets should be well positioned for yet-to-be-realized appreciation gains. One potential drawback in the current market is that access to the asset class may be delayed due to the influx of institutional capital. However, real estate's long-term benefits of portfolio diversification, income, and potential inflation hedging all remain.

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