Make Room for Real Estate

October, 2005

Freeman & Co. LLC

An Asset Class Whose Time Has Come

Expanding upon our prior theme of asset convergence, asset management firms that seek to provide clients with a full array of investment options should consider adding real estate to their product platform. Though historically a highly cyclical and privately financed asset class, real estate has become global in nature and gained broad acceptance by the capital markets. Over the past 5 years, both REITs and private real estate investments have consistently outperformed equity, fixed income and hedge fund benchmarks

Index Returns as of June 30, 2005

Index	Total Return YTD	Total Return 1 Yr	Total Return Annualized 3 Yr	Total Return Annualized 5 Yr
NAREIT Index	8.2%	24.8%	19.5%	16.2%
NCREIF Property Index	9.0%	18.0%	12.1%	10.6%
S&P 500	(0.8)%	6.3%	8.3%	(2.4)%
NASDAQ	(5.4)%	0.4%	12.0%	(12.3)%
Lehman Brothers Aggregate Bond	2.5%	6.8%	5.8%	7.4%
HFRI Funds of Funds Composite	1.0%	1.5%	7.3%	6.6%
CSFB/Tremont Hedge Fund Index	1.3%	8.0%	9.3%	7.3%

Source: Morningstar; NAREIT; Bloomberg; NCREIF; HFR Inc.; CSFB/Tremont

Summary

- Real estate has moved from a highly cyclical asset class to a worldwide investment class
- We believe that on a global basis real estate will continue to attract capital inflows due to the growth of the worldwide economy, demographic trends (aging population) and increased acceptance on behalf of investors
- It is our view, in light of the foregoing, that real estate will play an ever increasing role in institutional and retail investment portfolios going forward

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Background

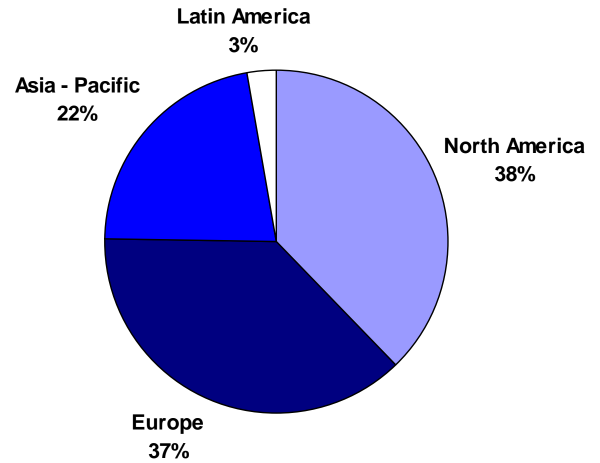
Size of the Real Estate Industry

Real estate is a large and important asset class. Total core[1] commercial real estate market worldwide is approximately $14 trillion, with the US representing approximately 38%, or $5.3 trillion.

Global annual investment in commercial real estate has been increasing. According to Jones Lang LaSalle, global investment in commercial real estate was $457 billion in 2004, an increase of approximately 12% from 2003. Cross-border investment in 2004 experienced a 21% increase with $99 billion of new money invested in real estate.

Institutional demand for real estate has been strong and growing. According to Pensions & Investments, annual U.S. institutional commitments to real estate have grown from $125 billion in 1994 to over $260 billion in 2003. Strong demand continued in 2004 – 2005. On average, U.S public pension funds allocate approximately 3% to 4% of their assets to real estate, while their European counterparts allocate 6% according to Investment & Pensions Europe.

Global Real Estate Market by Region



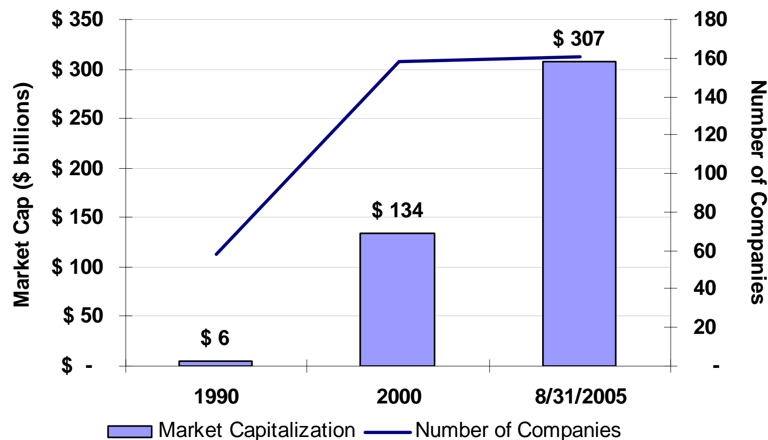
Source: Prudential Real Estate Investors, *"Global REITs: A New Platform of Ownership"*

History/Evolution

Real estate has historically been considered an alternative asset class to debt and equity. Perceived to be highly cyclical and subject to booms and busts, real estate had difficulty attracting cross-border investment. In fact, the global marketplace is just now beginning to realize the return potential and diversification benefits offered by real estate investments.

The way in which real estate was historically financed contributed to the lack of investor demand that plagued the asset class until the 1990's, when equity REITs began to gain traction. Commercial banks were the main providers of capital to mortgage REITS in the 1970's. By the 1980's savings banks and insurance companies had joined the real estate lending effort. These three sources became the main providers of capital to real estate investors and provided the bulk of construction loans to developers. Souring economic conditions ultimately lead to a credit crisis that threatened the solvency of the U.S. banking industry. Exacerbating the problem was a U.S. tax policy that permitted widespread syndication of real estate solely for tax benefits.

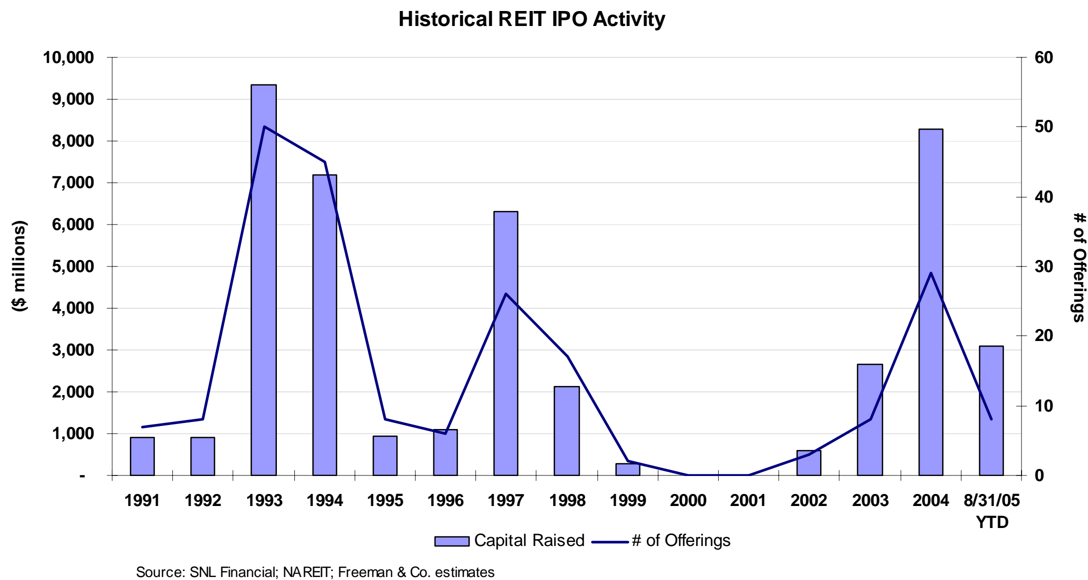
Growth of the US Equity REIT Market



Source: NAREIT

(1) Includes property types suitable for institutional ownership, excluding owner occupied buildings and small properties

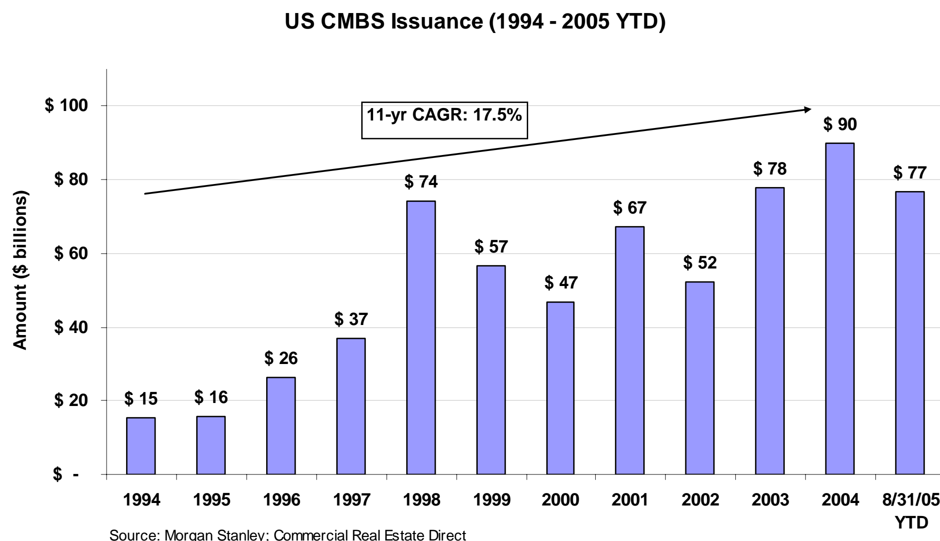
The 1980's left the U.S. banking industry with massive exposure and losses. It wasn't until 1991 when shopping center developer Kimco Realty Corp. defied market sentiment by raising approximately $170 million in a successful public offering that the real estate sector was able to recapitalize. Kimco's IPO was a watershed event that laid the groundwork for a rebound in the real estate market. REITs had gained the acceptance of the capital markets and private real estate companies could now repay significant portions of their bank debt through public offerings. The REIT market subsequently exploded, nearly doubling in size from 1992 – 1993. 50 IPOs were completed in 1993 alone, raising approximately $9.3 billion in capital. Another 104 IPOs were completed over the next six years raising an additional $17.9 billion. Activity slowed during 2000 and 2001, but demand rebounded quickly, and by 2002 REIT issuance was once again on an upward trend. From 2002-2004 approximately $11.5 billion was raised through REIT IPOs, with an additional $3 billion having been raised through August 31 of this year.



Public real estate debt has experienced a similar period of marked growth. Annual US CMBS issuance increased from $15 billion in 1994 to a record $90 billion in 2004, representing a compounded annual growth rate of 17.5%. Global CMBS issuance reached a record high of $129 billion in 2004 and it appears that amount will likely be exceeded in 2005 with approximately $115 billion having already been raised through August 31.

Private equity real estate firms have also started to develop en masse in recent years. We estimate there are over 100 independent private equity firms focusing on real estate with over $40 billion in real estate AUM.

Development of the REIT market, growth in CMBS, and an increase in the number of private equity real estate funds have helped transform real estate into an asset class with greater transparency, diversified risk and multiple sources of financing. As a result, real estate is attracting new capital at a rapid pace.



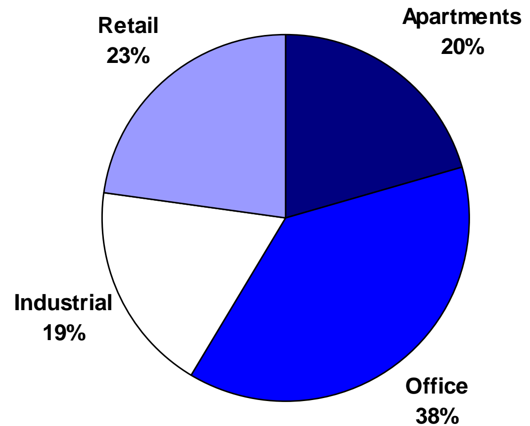
Methods of Real Estate Investing

Property Types

Returns for individual property types can vary and are largely uncorrelated. Investing in a mix of Core property types allows investors to gain real estate exposure while maintaining sufficient diversification in their portfolios. The Core real estate property types available to investors include:

- Apartments
- Office buildings
- Industrial space
- Retail space
- Other (lodging, healthcare, self-storage, specialty)

US Private Real Estate Market Value by Property Type*



Source: NCREIF
*As of 6/30/05

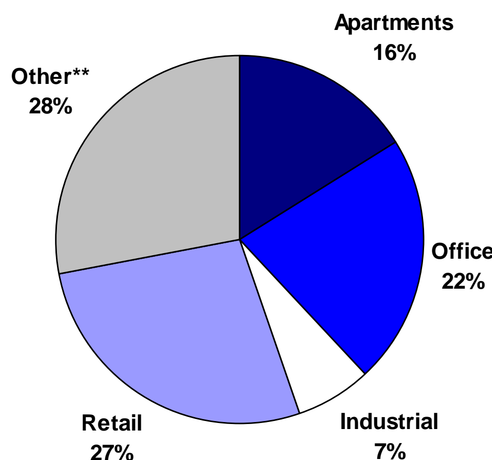
Different economic factors drive the fundamentals of each property type. For example:

- Mortgage rates have a significant effect on the demand for apartments, but not office space
- Office employment rates affect demand for office space, but have no impact on industrial space
- Availability of single family housing affects the apartments sector, but not the retail sector
- Economic growth drives demand for retail and office space, but has a minimal effect on apartments

Any disparity in returns between property types is likely due to a scenario similar to the ones outlined above; one in which an individual property type reveals particular sensitivity to a developing economic trend. At a given time, one property type might be struggling while another is experiencing a period of exceptional growth. Diversification by property type is therefore essential.

Currently, office buildings comprise the largest segment of the US private real estate market, representing 38% of the total. In contrast, retail properties make up the largest individual segment of the US REIT market, representing 27% of the total market capitalization

US REIT Breakdown by Market Capitalization*



Source: NAREIT
*As of 7/31/05
**Includes Diversified, Loging/Resorts, Healthcare, Self-storage and Specialty

Direct Investment Styles

Investors in real estate typically employ one or more of the following styles:

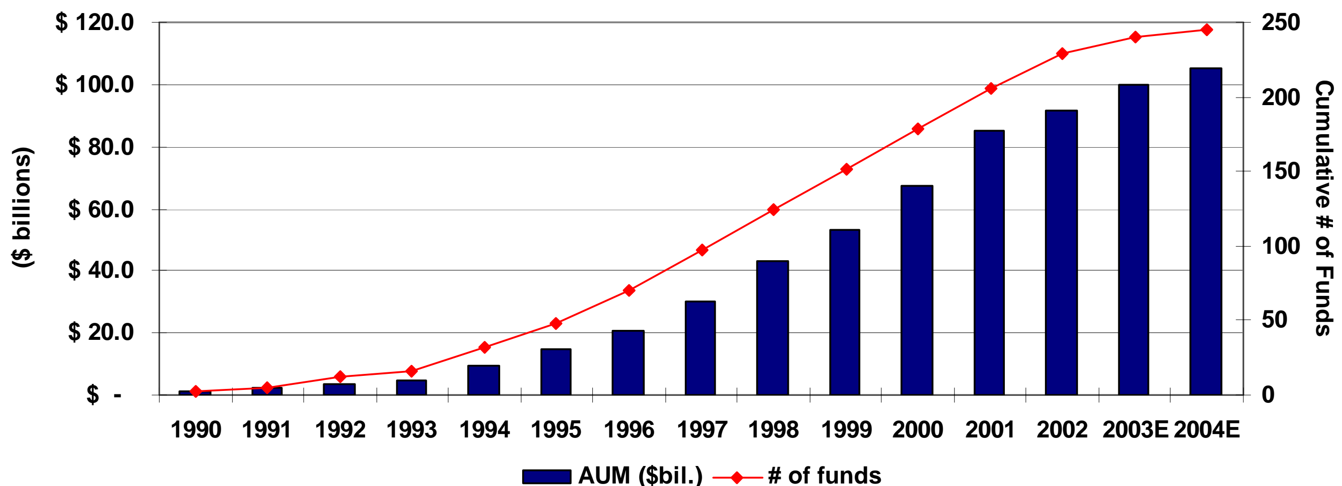
- Core
- Value-added
- Opportunity

Core investing is a low risk strategy of real estate investing. A core portfolio will include stabilized, institutional quality properties with high occupancy levels. Pension funds and others seeking a steady stream of cash flow are primary investors in core properties. Returns from this type of investment range from 3% to 7% annually depending upon the specific properties, market demand and capital markets conditions.

Value-added investing is more risky as it involves the purchase of properties with low levels of leasing and near term lease rollovers. Value-added portfolios often include redevelopment and rehabilitation projects. Cash returns are generated and annual overall returns can be in the low to mid teens, again depending upon demand and capital markets conditions.

Opportunistic investing involves new construction opportunities or properties that require significant redevelopment. Opportunistic investors may purchase empty buildings or properties with very high tenant turnover. It is a style that seeks to capitalize on opportunities arising from market distress. There is generally no immediate return on opportunistic investments and while this style carries with it a high degree of risk, returns can ultimately be significantly higher than those generated by core and value-added portfolios, often exceeding 20% per annum.

Value-added and opportunistic strategies have become major drivers of transaction activity over the last decade, raising more than $100 billion since 1991.



Source: Ernst & Young's 2003 Opportunistic Real Estate Equity Fund Survey; Freeman & Co. Estimates

Why Real Estate Makes Sense in an Investment Portfolio

Significant benefits can be realized by adding real estate to a traditional portfolio of stocks and bonds. This is due to the following characteristics of real estate as an asset class:

1. Attractive returns
2. Manageable risk
3. Low correlations with other asset classes

Returns

Both public (REITs) and private real estate have delivered attractive returns over the short, intermediate and long term. Recent performance of both real estate sectors also compares favorably with that of traditional asset classes:

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Index	Total Return YTD	Total Return 1 Yr	Total Return Annualized 3 Yr	Total Return Annualized 5 Yr	Total Return Annualized 10 Yr
NAREIT Index	8.2%	24.8%	19.5%	16.2%	10.4%
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S&P 500	(0.8)%	6.3%	8.3%	(2.4)%	9.9%
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Lehman Brothers Aggregate Bond	2.5%	6.8%	5.8%	7.4%	6.8%
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CSFB/Tremont Hedge Fund Index	1.3%	8.0%	9.3%	7.3%	12.3%

Source: Morningstar; NAREIT; Bloomberg; NCREIF; HFR Inc.; CSFB/Tremont
**Data as of June 30, 2004*

Through the first half of 2005, direct investment returns outpaced REITs. REITs, however, have performed better in the intermediate term. On the property level, retail has consistently been a top performing sub-sector of both REITs and private real estate, delivering returns in the top tier of both sectors over the short, intermediate and long term.

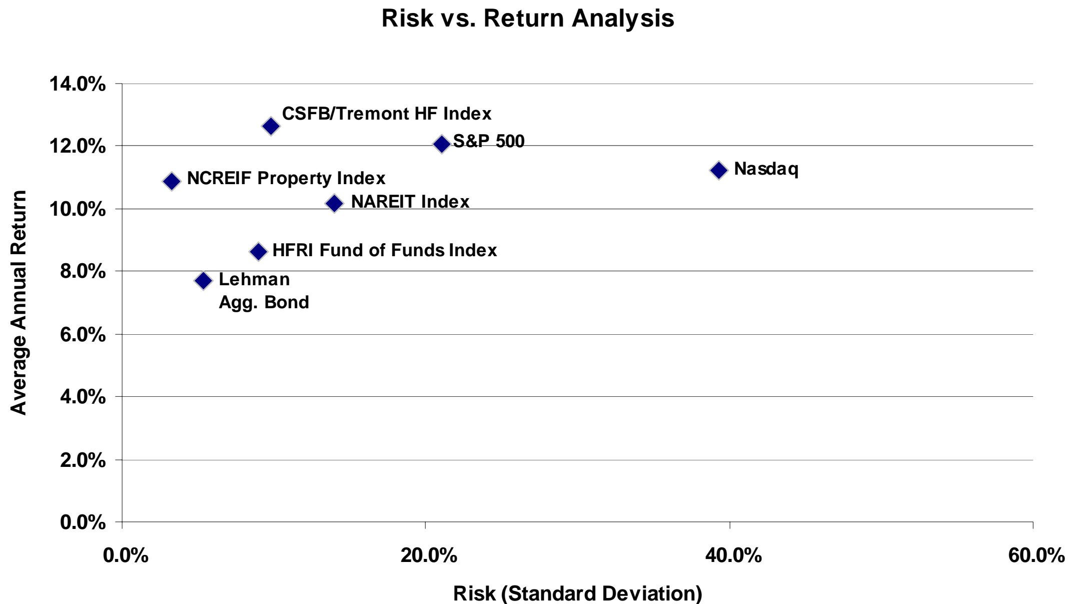
Real Estate Returns by Property Type*

	Segment	Total Return YTD	Total Return 1 Yr	Total Return Annualized 3 Yr	Total Return Annualized 5 Yr	Total Return Annualized 10 Yr
REITs	Apartments	5.9%	33.8%	17.2%	17.0%	15.8%
REITs	Office	9.1%	31.6%	17.0%	15.8%	17.4%
REITs	Industrial	4.8%	30.2%	20.2%	21.9%	n/a
REITs	Retail	7.6%	39.7%	30.4%	28.9%	n/a
	Total REITs	**8.2%**	**24.8%**	**19.5%**	**16.2%**	**10.4%**
Private	Apartments	9.6%	17.1%	12.2%	11.4%	11.9%
Private	Office	8.2%	15.8%	9.0%	8.5%	11.5%
Private	Industrial	10.3%	17.5%	11.4%	10.9%	12.3%
Private	Retail	8.2%	22.6%	18.9%	14.4%	11.2%
	Total Private Real Estate	**9.0%**	**18.0%**	**12.1%**	**10.6%**	**11.4%**

Source: Bloomberg; NAREIT, NCREIF
**Data as of June 30, 2005*

Risk

On the risk/return spectrum, real estate compares favorably with traditional asset classes. For instance, from 1995 to 2004 investments in private real estate had average annual returns of 10.9% with a standard deviation of 3.3% while REITS returned 10.2% with a standard deviation of 14.0%. Comparatively, the S&P 500 had an average annual return of 12.0% and a standard deviation of 21.0% and the Lehman Aggregate Bond Index returned 7.7% with a standard deviation of 5.3% over the same period.



Note: Calculations are based on 10-year annual data from 1995 - 2004

Source: Morningstar; Bloomberg; HFR; NCREIF; CSFB/Tremont

Correlations

In addition to having meaningful return potential and an attractive risk profile, real estate maintains low and often negative correlation with traditional asset classes. Adding real estate to an investment portfolio can potentially enhance returns while reducing overall volatility.

Correlation of Returns - Real Estate vs. Traditional Asset Classes

	NAREIT Index	NCREIF Property Index	S&P 500	NASDAQ	Lehman Aggr. Bond	HFRI Fund of Funds	CSFB/ Tremont Hedge Fund
NAREIT Index	1.00						
NCREIF Property Index	(0.08)	1.00					
S&P 500	0.07	0.39	1.00				
NASDAQ	(0.24)	0.24	0.82	1.00			
Lehman Aggr. Bond	0.06	(0.18)	0.03	(0.34)	1.00		
HFRI Fund of Funds	0.06	(0.02)	0.48	0.64	(0.33)	1.00	
CSFB/Tremont Hedge Fund	0.24	0.01	0.68	0.62	(0.05)	0.91	1.00

Note: Data is based on annual returns calculated between 1995 - 2004

Source: Morningstar; Bloomberg; NAREIT; HFR; NCREIF; CSFB/Tremont

Significant diversification can also be achieved within a real estate portfolio as individual property types exhibit low or negative correlation to each other.

Correlation of Returns - Real Estate Property Types

	REITs Apts.	REITs Office	REITs Indstrl.	REITs Retail	Private - Apts.	Private - Office	Private - Indstrl.	Private - Retail
REITs Apts.	1.00							
REITs Office	0.84	1.00						
REITs Indstrl.	0.81	0.81	1.00					
REITs Retail	0.59	0.61	0.93	1.00				
Private - Apts.	0.24	0.05	(0.19)	(0.35)	1.00			
Private - Office	0.10	0.04	(0.31)	(0.47)	0.94	1.00		
Private - Indstrl.	0.16	0.12	(0.24)	(0.43)	0.93	0.99	1.00	
Private - Retail	0.31	0.12	0.43	0.57	0.09	(0.11)	(0.18)	1.00

Note: Data is based on annual returns calculated between 1997 and 2004

Source: Bloomberg; NCREIF

Model Portfolio

To illustrate the potential benefits of adding real estate investments to a portfolio of traditional assets, we looked at a hypothetical investment portfolio as defined by the following asset allocation:

- 35% in equities, represented by the S&P 500
- 35% in bonds, represented by the Lehman Aggregate Bond Index
- 30% in hedge funds, represented by the HFRI Funds of Funds Composite

We varied the asset allocation by adding investments in private or public real estate (REITs). As summarized in the table below, adding real estate to the portfolio reduced risk (as measured by standard deviation) and in some cases increased returns.

Hypothetical Portfolio Asset Allocations

		Possible Asset Allocations			
		Portfolio A	Portfolio B	Portfolio C	Portfolio D
Asset Classes	Equities	35.0%	31.5%	31.5%	28.0%
	Fixed Income	35.0%	31.5%	31.5%	28.0%
	Hedge Funds	30.0%	27.0%	27.0%	24.0%
	Private RE	0.0%	10.0%	0.0%	10.0%
	REITs	0.0%	0.0%	10.0%	10.0%
		100.0%	100.0%	100.0%	100.0%
10-yr. Time Period	Avg. Annual Return	9.7%	9.7%	9.8%	9.8%
	Standard Deviation	10.5%	9.8%	9.6%	8.9%
	Largest Annual Loss	-6.8%	-5.8%	-5.5%	-4.4%
	% of Periods with Negative Returns	30.0%	30.0%	30.0%	20.0%

Note: Data is based on annual returns calculated between 1995 - 2004

Source: Morningstar; NAREIT; HFR; NCREIF; CSFB/Tremont

Current State of the Real Estate Markets

On a global basis the real estate markets continue to evolve. Governments worldwide have stepped up efforts to improve real estate investment opportunities. REIT legislation is being passed by countries throughout Europe and Asia giving further substantiation to the view that real estate is a global investment class.

Global REIT Legislation Timeline

Region	Nation	Initial Legislation	Comments
North America	**USA**	1960	U.S. REIT market is the oldest and most developed in the world
North America	**Canada**	1994	Legislation creating "Mutual Fund Trusts" with similar tax treatment to U.S. REITs passed in 1994
Europe	**Netherlands**	1969	Dutch-listed real estate investment pools are among the largest real estate investors in Europe
Europe	**Belgium**	1990	Listed property funds established in Belgium
Europe	**Italy**	1994	Tax exempt semi-closed and closed end funds established in 1994; latest amendments passed in 2003
Europe	**France**	2003	Tax exemption granted to domestic real estate funds as part of 2003 legislation
Europe	**Luxembourg**	2005	New Luxembourg Law on Risk Capital Investments passed in June 2005
Europe	**UK**	Estimated 2006	Debate over requirements for listing, taxation and location restrictions continues. Final legislation unlikely before 2006
Europe	**Finland**	Estimated 2006	Once the issue of taxation has been resolved, legislation should come quickly
Europe	**Germany**	Estimated 2007	Proposed G-REIT legislation delayed due to unexpected German general elections. Completion likely by 2007
Europe	**Spain**	Pending	
Europe	**Sweden**	Pending	
Asia - Pacific	**Australia**	1972	Limited Property Trusts created in 1972; Australian REIT market is arguably the most developed outside of the U.S.
Asia - Pacific	**Singapore**	1999	5 REITs currently listed in Singapore. 2005 legislation eases tax burden on foreign investors
Asia - Pacific	**Japan**	2000	JREIT established to provide liquidity to investors during Asian financial crisis; 12 JREITs currently listed in Tokyo
Asia - Pacific	**South Korea**	2001	2001 legislation revised in 2004 to reduce red-tape. Currently 2 Real Estate Trust Funds (RETFs) trade in Seoul
Asia - Pacific	**Hong Kong**	2003	Securities and Futures Commission established legal framework for REITs in July 2003; REIT has yet to be listed
Asia - Pacific	**Malaysia**	2005	4 property trust funds have already been established; 3 listed and 1 unlisted

Source: Freeman & Co.

Most of what has been written with respect to the current state of the real estate markets and the outlook for the asset class centers around housing, in particular single family homes and for-sale apartments (condominiums/cooperatives). While it is difficult to overlook the significant risk inherent in this segment of the market, it is only one part of a sub-sector that also includes high rise, mid rise and garden style residential apartment buildings. Though these properties have generated less buzz as of late, in an increasing interest rate environment they will gain in occupancy levels and value.

One key distinction between the current real estate environment and that of the 1980's and early 1990's is that underlying fundamentals are significantly better today. Supply is in better balance due to the discipline provided by the capital markets. This is not to say that the current investor-driven market will not experience a downturn; ultimately it is inevitable. Given the development over the last decade of real estate as an investment class why should this be any different in terms of investment opportunity than high levels of default in the high yield bond market? When high yield bonds experience significant defaults, distressed and turnaround investors see an opportunity; real estate will be no different. Those employing opportunistic investing styles will see distress as opportunity and capital will be deployed accordingly.

Where are the Markets Headed

We believe there should be continued demand for real estate investments due to the following factors:

- Demographics (Pension fund demand for cash generating assets such as real estate will remain high to account for aging populations)
- Real estate remains an under-invested asset class
- Real estate is a good inflation hedge

Issues of Concern

The following issues might raise some concerns:

- Values are high and financing is both cheap and readily available
- Uncertain economic and interest rate outlook
- Levels of subordination in CMBS have decreased and there has been a proliferation of "B" note buyers resulting in a potential erosion of marketplace discipline
- Froth in the for sale housing market

Nevertheless, there remain many counters to the foregoing:

- Supply of real estate is under control in most markets (not addressing single family homes)
- Capital markets still exert a level of discipline that was historically absent, which should mean decreased (but not eliminated) cyclicality
- Rising interest rates will cause values to come down, but should signify a growing economy with better real estate fundamentals and increased cash flows (prolonged stagflation is the only real risk)
- Money keeps coming in to the sector

Conclusion

We believe there should be continued demand for real estate investments and that real estate should be included along with equities and bonds as part of a diverse investment portfolio. Though historically a privately financed asset class, over the past two decades real estate has gained the acceptance of the capital markets and has become an integrated worldwide asset class boasting a level of discipline and transparency it previously lacked. As with any asset class, potential pitfalls do exist. The risks associated with real estate investing are generally no different than those posed by equities or bonds. By comparison, real estate is relatively insensitive to key economic factors such as GDP growth and the fluctuation of interest rates, which are more likely to have an impact on equities or bonds. A real estate portfolio can thrive in an otherwise precarious economic environment depending upon the investment style and underlying property types included. Value-added and opportunistic properties in particular tend to have minimal correlation to the broader economy. Thus we believe asset managers that wish to provide their investors with a full array of product offerings should consider adding real estate to their investment platforms.

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