GLOBAL REAL ESTATE INVESTING

THE ADVANTAGES OF GOING GLOBAL

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We believe that investors with a dedicated long-term strategic allocation to domestic real estate should strongly consider taking a global investment real estate approach due to attractive returns, unique diversification benefits and greater stability of income.

Despite recent market turmoil, real estate continues to play a key role in asset allocation strategies. However, it requires investors to rethink their approach in order to gain an edge in the current environment. A critical look at the typical U.S. investor reveals a consistent home-country bias among real estate investments. For example, an investor whose real estate exposure is limited to the United States has ignored roughly 60% of global-market capitalization measured by the FTSE EPRA/NAREIT Global Real Estate Index. As markets, companies and investors all continue to shift toward a global orientation, investors should consider rebalancing their domestic allocations to capture the benefits associated with a well-diversified global real estate portfolio.

While we are cognizant of the short-term challenges the ongoing credit crunch poses to real estate investors, adding an international component to a real estate portfolio could significantly lower risk while enhancing real returns net of inflation. In addition, a global indirect (securitized) strategy can provide enhanced liquidity, risk efficiency and transparency — all critical factors when expanding the investment universe to include international real estate markets.

THE GROWTH OF GLOBAL REAL ESTATE SECURITIES

Investing in real estate has become increasingly popular since the turn of this decade. The growth of global real estate has been facilitated by rapid expansion in real estate investment trust (REIT) legislation and IPOs for securitized real estate. A decade ago, REITs existed in only five countries. *Today, over 20 nations host a total of several hundred publicly traded REITs and real estate operating companies (REOCs).*

Currently, according to NAREIT, global real estate is estimated to comprise roughly 10% to 20% of developed countries' total capitalization across stocks, bonds and real estate. The ongoing integration of financial markets around the world, increased cross-border flow of capital and investor appetite for a global mixed-asset base has led the free-float market capitalization of the FTSE EPRA/NAREIT Global Real Estate Index to increase to $793 billion at the end of 2007. Investors have benefited to the tune of a 16% annualized return since the end of December 1999.

Several factors have contributed to the rapid growth in global real estate securities:

- **The global real estate market has offered investors strong double-digit performance and lower volatility** over the last several years relative to other asset classes such as equities.

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- **The significant growth in tax-efficient investment vehicles across Europe and Asia** has helped to attract international investments, resulting in increased liquidity and transparency in foreign REITS. While the United States offers the world's most established public REIT market, a number of countries in Europe and Asia have adopted legislation authorizing the creation of REIT structures.
- **Investors can cost-effectively globalize asset allocation mixes** with nominal capital investments. Competing direct real estate investment strategies do not accomplish this nearly as well.
- **Since 2001, REIT legislation has been adopted** by the United Kingdom, Germany, France, Japan, Singapore, South Korea and Hong Kong.

25 COUNTRIES WITH REIT-TYPE LEGISLATION, INCLUDING:

Country	Year	Country	Year
United States	1960	Japan	2000
Netherlands	1969	South Korea	2001
Australia	1971	France	2003
Malaysia	Late 1980s	Hong Kong	2003
Canada	1994	Taiwan	2003
Belgium	1995	Thailand	2003
Turkey	1998	United Kingdom	2007
Singapore	1999	Germany	2007

Source: FactSet, Northern Trust.

SIGNIFICANT RETURNS OVER THE PAST 15 YEARS

Global real estate as an asset class has provided investors with significant returns over the last 15 years both on real-return and risk-adjusted bases. Returns for the FTSE EPRA/NAREIT Global Real Estate Index since 1993 tell the story. Global real estate outperformed all major stock indexes — including two core domestic real estate indexes — while exhibiting lower volatility. For example, the FTSE EPRA/NAREIT Global Real Estate Index provided a 3.5% higher nominal return than the S&P 500 and a corresponding 3.5% higher inflation-adjusted return.

TABLE 1: **15-YEAR ANNUALIZED RETURN DATA AS OF 12-31-07**

Index	Nominal Return	Inflation Adjusted Return	Sharpe Ratio
FTSE EPRA/NAREIT GLOBAL REAL ESTATE	14.04%	11.19%	0.61
DJ WILSHIRE REIT — U.S.	12.94%	10.09%	0.58
FTSE NAREIT — U.S.	12.33%	9.48%	0.56
S&P 500	10.49%	7.64%	0.43
RUSSELL 2000	10.10%	7.25%	0.32
MSCI EAFE	9.56%	6.71%	0.34

CPI = 2.85% annualized since 1993, includes food and energy.

Sources: FTSE EPRA/NAREIT, Dow Jones Wilshire, S&P, Russell, MSCI, Fact Set, U.S. Department of Labor – Bureau of Labor Statistics, Callan Pep Database.

The three major real estate indexes have provided substantially higher nominal and inflation-adjusted returns than three key stock indexes, including the S&P 500. Sharpe ratios, measuring how well an asset compensates investor risk, are comparably higher.

DIVERSIFICATION: LOW CORRELATIONS

Use of a global real estate strategy can provide major diversification benefits versus other traditional asset classes. The global approach offers a low correlation of roughly 0.5 to commonly used asset classes such as the S&P 500 Index. (See Table 2.) Since real estate is a hard asset driven by rental incomes and capital appreciation, adding global real estate to a mix of financial assets such as equities and fixed income can lower total portfolio risk.

TABLE 2: MONTHLY CORRELATION OVER A 15-YEAR PERIOD ENDING 12-31-07

	S&P 500	Russell 2000	MSCI EAFE	LB Aggregate	FTSE EPRA/ NAREIT
S&P 500	1.00	—	—	—	—
RUSSELL 2000	0.72	1.00	—	—	—
MSCI EAFE	0.72	0.65	1.00	—	—
LB AGGREGATE	0.03	–0.07	–0.06	1.00	—
FTSE EPRA/NAREIT GLOBAL REAL ESTATE	0.53	0.58	0.64	0.13	1.00

Source: FactSet, Northern Trust.

While most investors at the portfolio level recognize the low correlation component, incremental benefits compared to a stand-alone domestic strategy appear more obvious with the addition of new geographies. For example, North American property returns have correlations of less than 0.5 versus both the Asian and European regions, while many countries tend to price independently from each other. (See Table 3.) We believe this unique diversification benefit represents more than a function of expanded opportunities across multiple real estate markets; it reflects local economies positioned in different phases of the economic cycle.

TABLE 3: HISTORICAL REGIONAL CORRELATIONS FOR FTSE EPRA/NAREIT GLOBAL REAL ESTATE INDEX FOR TIME PERIOD 1990-2007

Correlations	Asia	Europe	North America
ASIA	1.00	—	—
EUROPE	0.63	1.00	—
NORTH AMERICA	0.43	0.44	1.00

Source: FactSet, Northern Trust.

Correlations among Asia, Europe and North America are significantly low.

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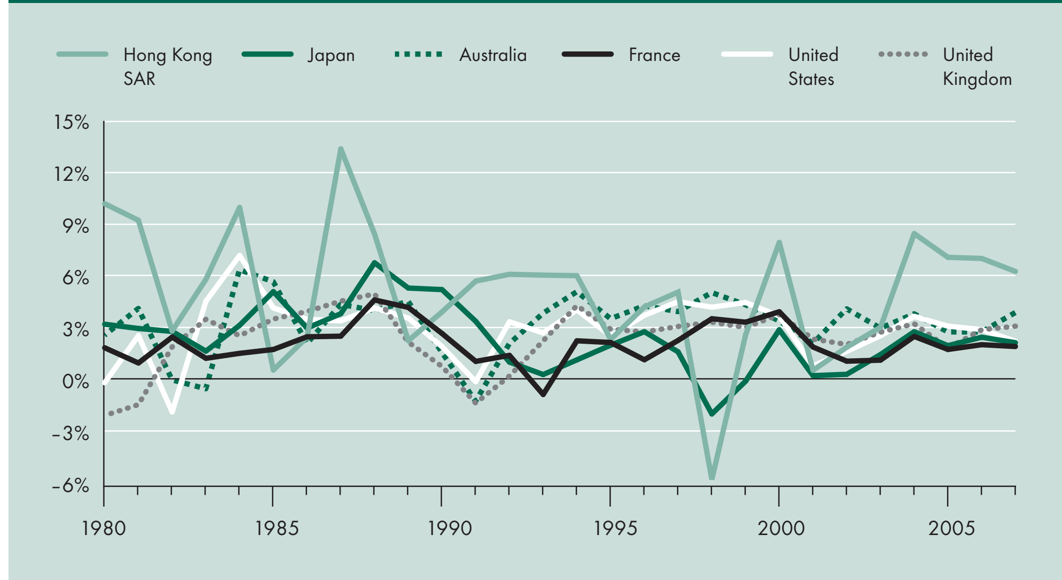
Investing indirectly in hard assets with exposure to multiple economic factors can be one of the primary drivers behind the diversification benefits versus a domestic allocation. Economic activity driven by GDP growth, interest rates and capital spending can vary significantly worldwide.

Table 4 below outlines the percentage in real GDP changes from 1980 through 2006 in the United States, United Kingdom, Japan, Hong Kong and France — all held in the FTSE EPRA/NAREIT Global Real Estate Index. The historical differences in real GDP growth across countries and regions underscore why lower correlations to the United States prevail.

TABLE 4: **PERCENTAGE OF CHANGE IN REAL GDP FROM 1980 TO 2007**

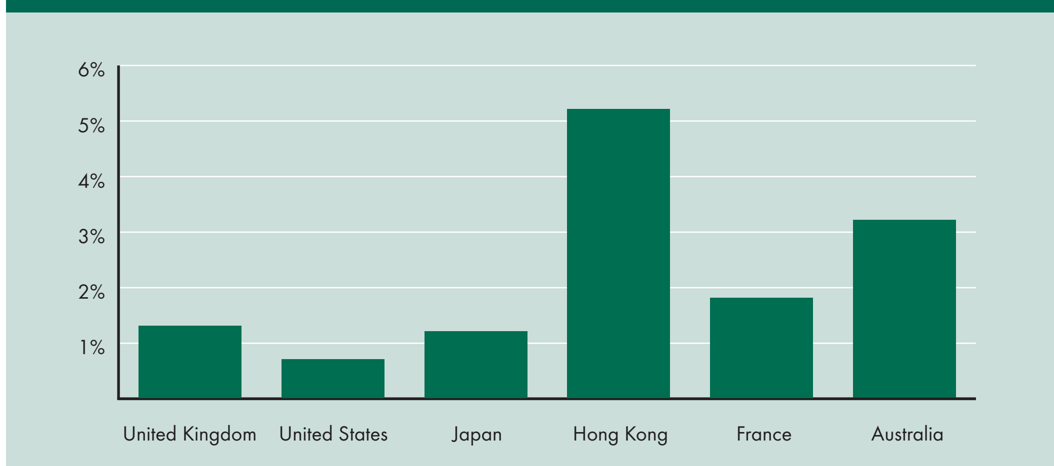


Source: International Monetary Fund, World Economic Outlook Database, October 2007.

Lower correlations in the United States prevail based on historical GDP differences in real growth across countries.

Further, diversifying across multiple economies may be even more important in the coming years. Projected GDP growth for the United States is expected to be lower than that of competing nations, especially in the Asian region where Hong Kong continues to demonstrate strong growth coming out of China. (See Table 5.) Assuming capital-market assumptions are the same for international and domestic real estate, diversification at both the portfolio and strategy level underscores the thesis for re-allocating to a global strategy.

TABLE 5: **2008 REAL GDP ECONOMIC FORECASTS**



Source: Northern Trust Economic Outlook Database, 2007–2008

At less than 1%, U.S. GDP growth for 2008 is predicted to lag significantly behind competitors. Hong Kong's GDP growth is expected to top 5%.

GREATER INCOME STABILITY

Over the long term, income can serve as the primary contributor to total returns in real estate. For individual investors and institutions with defined liabilities, income streams with greater certainty can carry a higher intrinsic value as market volatility rises and capital market expectations in the United States remain depressed. A diversified global real estate portfolio potentially provides a better hedge against inflation in an economic environment in which modest interest rates persist along with rising prices. This hedge results from diversified yields from rental and leasing incomes across the globe. The ability to invest in multiple local economies within a portfolio should provide a more stable stream of income over the long term.

KEY BENEFITS OF GLOBAL INDIRECT (SECURITIZED) VS. DIRECT INVESTING

Historically, many global investors were limited to real estate strategies via direct investing in individual properties or private equity structures. Direct allocations provided investors with more control over assets. However, global direct investments require significant capital to minimize property and geographic-specific risks. The requirement of capital as it relates to proper diversification across countries and property type creates a barrier to entry — one that is magnified exponentially when the investment scope broadens to include foreign countries.

While performance characteristics between the two are similar over long term, the long-term benefits are magnified when making a global real estate allocation through indirect (securitized) investing.

INCREASED LIQUIDITY

Liquidity becomes the driving factor when we begin introducing the benefits of indirect global real estate investing. Owning an *indirect* investment valued daily enables investors to dynamically manage portfolio exposure without competing with tradeoffs, such as high transaction costs or lock-up periods. The flexibility to tactically raise cash or re-allocate across other asset classes can be very costly with global direct investments, especially during a political or financial crisis like the one we have experienced

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in 2008. In addition, a well-diversified portfolio across a global real estate asset base offers potential optimization of liquidity by reducing idiosyncratic risk at the country level.

IMPROVED RISK EFFICIENCY AT LOW COST

Perhaps the most attractive feature of *indirect* property investing is the efficiency gained from accessing local expertise across multiple countries and sectors at a *fraction of the cost* compared with direct property investing. Investing in properties across countries, regions and sectors demands large amounts of capital along with major risk management and property management capabilities.

Local market dynamics and investment properties are influenced by a number of factors that act as a barrier to entry for even the most sophisticated investors. Becoming a local expert is difficult for both practitioners and investors. Zoning, tax laws, data quality and cultural differences all can impede the ability to make informed investment decisions. As a result of these hurdles, management fees and transactions costs resulting from using direct intermediaries can be as high as 2% to 3% annually. This can significantly diminish returns over the long term. By comparison, a diversified global portfolio can overcome these hurdles at a fraction of the cost with increased risk efficiency.

GREATER TAX EFFICIENCY AND TRANSPARENCY

While investing in real estate can offer many advantages to a portfolio, it is important not to underestimate the risks specific to global investing, which an *indirect* approach can mitigate. A well-diversified portfolio of REITs or REOCs can minimize risks related to arcane tax structures, single-country currencies and lack of performance transparency. Consider that:

- **REITs provide tax efficiency at both the corporate and shareholder levels. At the corporate level,** REITs function as pass-through vehicles with no tax liability as long as 80% to 90% of income is distributed to shareholders. (Percentages vary by country.) Investors avoid taxation on income and gains, which can increase returns. For example, investors can achieve greater tax transparency in a commingled fund, since tax structures can vary depending on country or state when investing in direct partnership structures.
- **Investing in a global portfolio can significantly reduce currency risk and offset many currency effects on performance.** By comparison, direct investing globally can present unwanted currency risks resulting from the inability to diversify across multiple countries and economies.
- **Performance transparency is enhanced using a portfolio of indirect investments.** These are valued daily in "real time" by the marketplace and provide investors with greater insight into the value of their holdings as opposed to appraised values.

CONCLUSION*

The current market environment presents both challenges and opportunities for investors who are evaluating their long-term strategic asset allocations. Ongoing risk aversion in the equity markets has resulted in meaningful declines across many global indexes, including real estate. As of June 30, 2008, global real estate markets as measured by the FTSE EPRA/NAREIT Global Real Estate Index are down nearly 14% year-to-date on the heels of a 6.96% decline in 2007. The negative effect on performance in 2007 could have been more severe by a factor of 2.5x were it not for burgeoning markets such as Hong Kong, which bubbled up nearly 50%. This example should not be lost on investors and firmly supports our investment thesis and the benefits of global diversification.

The market deterioration that began in 2007 has continued to persist throughout the first half of 2008, with the FTSE EPRA/NAREIT Global Real Estate Index declining by nearly 20% over the last 18 months. The last real estate decline of this magnitude occurred in the U.S. market and had a duration of approximately 14 months — August 1989 through October 1990. The peak-to-trough return for that time period for U.S. REIT was –23.9%. In addition, REIT have been recently trading at nearly a 17% discount to NAV as of June 30, 2008. Historically, investors have benefited by increasing their REIT allocations at times when NAV discounts were the norm and have typically generated large positive returns over time. While visibility is still somewhat limited, we believe a great deal of risk has been discounted by the market and the risk-reward balance over the longer term — heading into 2009 — and in our opinion, may become more favorable. While research indicates that a sharp reversal is not expected in the near term, prudent long-term real estate investors will do well to consider moving to a global real estate strategy as outlined.

**Source for returns and historical data: National Association of Real Estate Investment Trusts.*

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FOR MORE INFORMATION

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