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Investors Ramp Up Allocations, Favor High-Yield Strategies

The Annual Plan Sponsor Survey

by Larry Gray

Real estate allocations are higher. Return expectations are lower. Capital flows will decline. Foreign investments will increase. Medical office and apartment properties are hot; retail is not. Those are just a few of the findings of Tax-Exempt Real Estate Investment 2008, the 12th annual plan sponsor survey conducted by Institutional Real Estate, Inc. (IREI) and San Francisco-based research and consulting firm Kingsley Associates.

Despite an air of uncertainty created by tightening credit markets and a slumping economy, real estate has maintained its high ranking among tax-exempt investors. In today's low-return investment environment, plan sponsors remain attracted to the asset class' competitive risk-adjusted returns and its current yield component, as well as real estate's proven role as a diversifier within a multi-asset portfolio. For these reasons, pension fund capital flows to the asset class are expected to remain strong in 2008.

"The debt markets are in turmoil, and it's unclear how long it will take for the market to reprice," states Geoffrey Dohrmann, president and CEO of IREI. "What is clear, however, is that with highly leveraged players forced to the

sidelines, pension funds — where equity reigns — will drive the market in the near future."

Real estate's high-flying returns of recent years and a sense of increasing transparency and opportunity in international markets have produced new investors — and an expanding menu of products and strategies. Tax-exempt investors' higher comfort level with real estate and overseas investing is reflected in the 2008 plan sponsor survey results. Investors' target allocations to real estate have reached historical highs, an indication of their willingness to invest in alternative investment classes to meet their funding obligations. In addition, the majority of new capital flowing to real estate in 2008 will be earmarked for higher-yielding opportunistic/value-added investments and nonsecuritized foreign real estate investments.

"Typically a defined benefit pension plan needs to hit an 8.5 percent return in order to meet its benefit obligations," notes Jim Woidat, a principal of Kingsley Associates and project manager for the survey. "Investors realize they will be challenged to achieve this type of return from a traditional stocks and bonds portfolio, so they are increasing their allocations to alternative investments, including real estate."

For example, late last year the \$245 billion California Public Employees' Retirement System (CalPERS) adopted a new investment asset allocation that boosted its real estate allocation from 8 percent to 10 percent, which represents a potential increase in capital flows of \$5 billion. According to Woidat, "Across our survey sample, on a same respondent basis, pension funds, foundations and endowments are raising their targets to real estate."

The survey found that tax-exempt investors have raised their target real estate allocation from an average of 8.7 percent in 2007

to 9.7 percent in 2008, the highest level reported in the survey's 12-year history (see "2008 Portfolio Weightings: Target vs. Actual Holdings," below). This increase has created a larger funding gap between target and actual real estate allocations of 115 basis points, up from 40 basis points last year. It is important to note, however, that having received survey responses between October 2007 and January 2008, the gap to target allocations for many investors likely has decreased due to the depletion of value within the U.S. equity markets. Assuming investors' U.S. equities portfolios declined in line

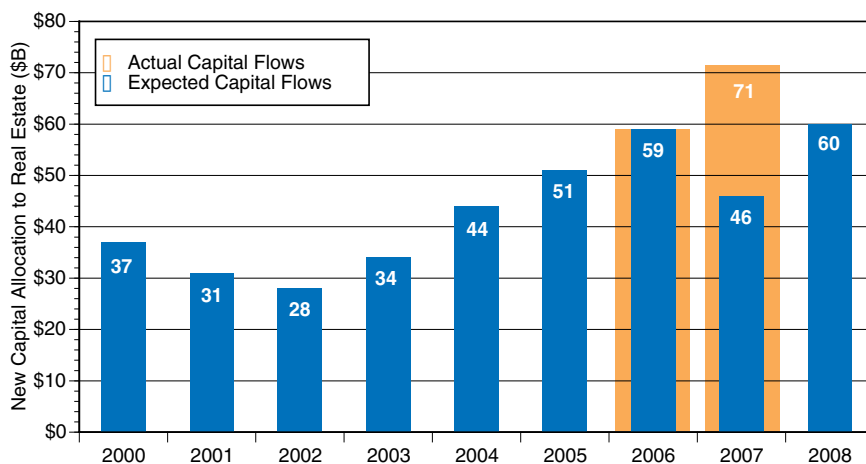
with the S&P 500 Index, this gap likely closed to under 90 basis points by Feb. 29, 2008, simply due to the shrinking asset base.

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2008 Portfolio Weightings: Target vs. Actual Holdings			
Sector	Target Mean (%)	Current Mean (%)	Difference
Real Estate	9.65	8.50	-1.15
U.S. Stocks	35.03	36.66	1.63
Foreign Equities	18.06	18.94	0.88
Fixed Income	22.70	21.92	-0.78
Venture Capital / Private Equity	6.17	4.97	-1.20
Money Market Funds / Cash Equivalents	0.47	1.28	0.81
Hedge Funds	5.48	5.76	0.28
Other	2.43	1.96	-0.47

Source: Tax-Exempt Real Estate Investment 2008

Projected Annual Capital Flows Based on Survey Results*



*Annual capital flow projections are based on respondent-provided new capital plans for each year, grossed up based on respondents' aggregate share of the entire tax-exempt real estate universe as defined by the annual Money Market Directory.

Source: Tax-Exempt Real Estate Investment 2008

At the time of the survey, investors reported plans to commit \$23.7 billion in new capital to real estate in 2008, compared to a total of nearly \$28.5 billion actually committed in 2007, which would represent a decline of 17 percent. Projecting the survey sample's plans to the rest of the domestic tax-exempt investment universe would yield approximately \$60.2 billion in new real estate commitments in 2008, down from the \$71.1 billion projected total for 2007 (see "Projected Annual Capital Flows Based on Survey Results," left).

And, as noted, investors will be going further out the risk curve in an attempt to goose returns.

"Investor holdings are currently overweighted to core real estate, so they plan to emphasize higher-yielding strategies with new capital commitments to balance allocations," says Woidat. "In 2007 about 25 percent of new investment capital was earmarked for core and core-plus strategies. This year that's down to 15 percent."

According to the survey, opportunistic strategies will capture the largest percentage of new capital (28 percent), with value-added receiving 23 percent and foreign real estate investments receiving 24 percent, up sharply from the 11 percent in planned foreign commitments last year. Investors' interest in Asian real estate has increased;

43 percent of new allocations to foreign real estate will target Asian markets, compared with 31 percent reported in 2007 (see “New Capital Allocations to Foreign Real Estate Markets,” below). European capital flows will decrease from last year, accounting for a projected 45 percent in 2008, down from approximately 56 percent last year.

Considering current economic and capital markets conditions, survey respondents indicated lower expectations for real estate returns, which likely reflects the sell-off in the REIT market and the anticipation of decreasing property values. Real estate is expected to return 8.7 percent in 2008, down from the 9.3 percent predicted for 2007

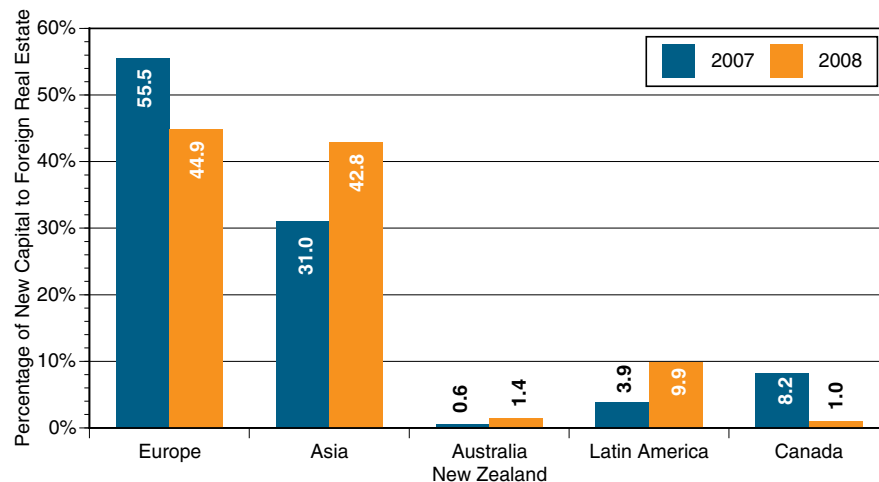
(see “Total Return Expectations,” below). However, the asset class still ranks high compared to other investments on a relative basis; the only asset class expected to provide a better risk-adjusted return in 2008 is hedge funds (based on Sharpe Ratios). Lower returns were also predicted for U.S. stocks, fixed income and cash assets. Total returns for foreign equities were pegged at 10.3 percent, up from last year’s forecast figure of 9.5 percent.

Return expectations for various private equity real estate investment strategies were lower across the board (see “Equity Real Estate Return Expectations,” page 14). Comparing 2008 expectations to

investors’ estimated actual results for 2007, both core and value-added strategies are forecast to fall by roughly 300 basis points —

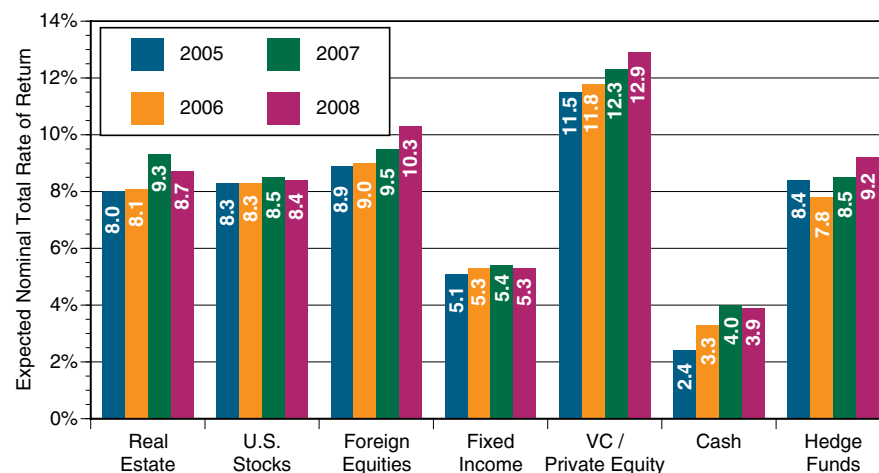
When asked to gauge the relative attractiveness of various property types ... investors gave high marks to medical office, multifamily and office properties.

New Capital Allocations to Foreign Real Estate Markets



Source: Tax-Exempt Real Estate Investment 2008

Total Return Expectations



Source: Tax-Exempt Real Estate Investment 2008

core/core-plus from 11.4 percent to 8.3 percent and value-added from 13.5 percent to 10.7 percent. Opportunistic-style investments are expected to drop a more modest 130 basis points from 15.6 percent to 14.3 percent. On the public side, investors expect a slight improvement from an estimated 2007 actual return of 5.9 percent to a projected 2008 return of 7.7 percent.

Investors expect foreign real estate investments to exceed last year’s performances; the projected 2008 return for nonsecuritized foreign investments was 13.4 percent, compared with last year’s estimated actual return of 11.8 percent, while securitized foreign investments are anticipated to return 13.6 percent, up from the 2007 estimated actual return of 12.8 percent.

“Clearly real estate has become a global asset class,” states Dohrmann. “Besides the diversification benefit, many investors are tapping international markets because they can get better returns than staying at home.”

“Two years ago in our survey, only 6 percent of respondents who were investing overseas had investments in India. That figure is up to 27 percent this year,” notes Woidat. “It’s the same with China. Going back two years, only 23 percent of investors were active in China. This year, about 37 percent of investors are in that market. So clearly we’ve had a lot of activity in some of these emerging markets.”

When asked to gauge the rela-

tive attractiveness of various property types — survey respondents were asked to rank property types on a one to five scale, with five being the most attractive and one the least attractive — investors gave high marks to medical office (3.71), multifamily (3.60) and office (3.49) properties. Retail was viewed as the least favored property type with a score of 2.51 (see “Attractiveness of Property Types for New Investments,” below).

When asked which real estate products currently offer the best investment opportunities, more than 61 percent of respondents indicated foreign real estate, while 19 percent listed structured debt.

A few new questions were added to the survey to determine

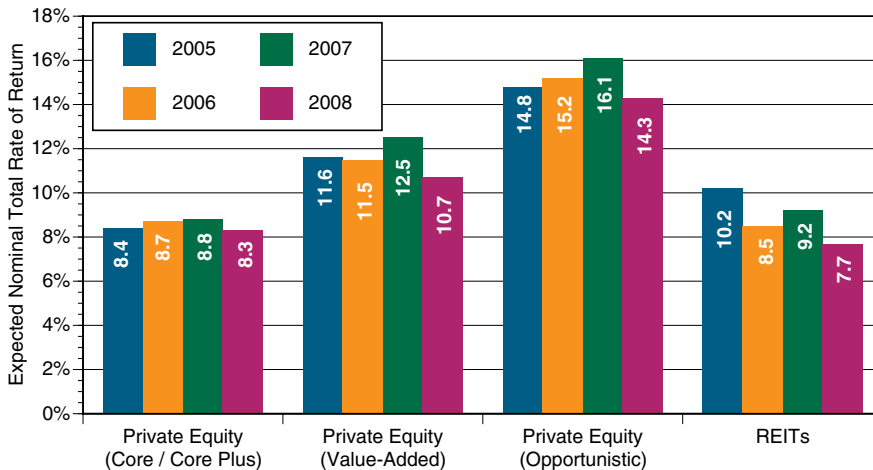
the appetite of tax-exempt real estate investors for real estate derivatives and “green” products. Some 94 percent of respondents indicated they are not currently invested and do not plan to invest in real estate derivatives in 2008. This lack of interest is driven by two key factors: 1) the perceived absence of liquidity within the derivatives market and 2) a general paucity of information on the products in the marketplace. More than 94 percent of respondents indicated they do not currently have a “green” investing policy, and few of these investors indicate they plan to implement a “green” investing policy in 2008.

“As we’ve seen with the acceptance of foreign investments, it

takes time for new ideas or concepts to gain favor in the pension fund marketplace,” says Dohrmann. “There’s an educational process and a fiduciary process that these investors must go through before adoption. We’ll continue to follow derivatives and green investing in our future surveys. And that’s the great thing about this survey: It serves to identify and assess the trends that will shape the real estate market in the coming year and the years ahead.” ♦

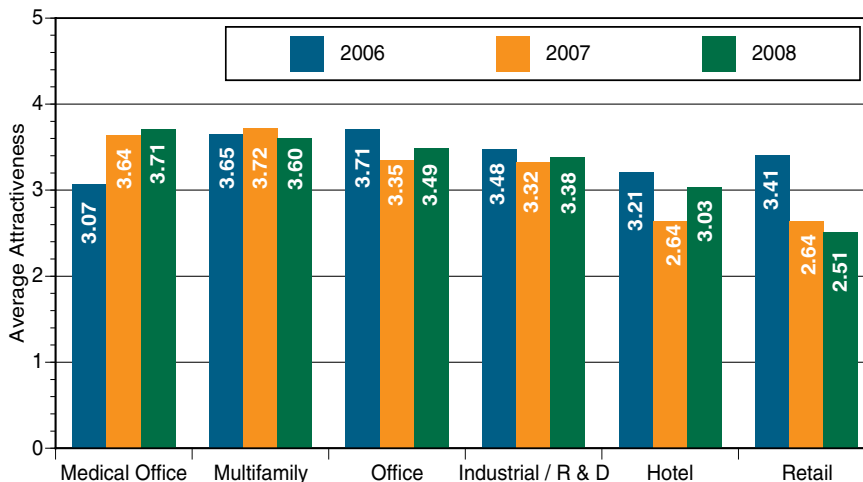
Larry Gray is editor of *The Institutional Real Estate Letter*.

Equity Real Estate Return Expectations



Source: *Tax-Exempt Real Estate Investment 2008*

Attractiveness of Property Types for New Investments



Source: *Tax-Exempt Real Estate Investment 2008*

About the Survey

The 2008 survey, conducted during the fourth quarter of 2007, captured responses from 106 domestic tax-exempt investors managing an aggregate \$140 billion in real estate holdings, representing 45 percent of all U.S. tax-exempt real estate assets as reported in Standard & Poor’s *2008 Money Market Directory*. (The survey is targeted toward large tax-exempt investors who are active real estate investors and control a sizable portfolio of real estate assets and thus drive investment trends in the marketplace.) The survey assessed investors’ fund allocations, risk and return assumptions, expected capital flows, and real estate investment strategies for the coming year. To purchase a complete copy of the *Tax-Exempt Real Estate Investment 2008* survey results and summary report, visit the IREI bookstore at www.irei.com, or call (925) 244-0500 and ask for an IREI sales associate.

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