March 2011

The Case for Commercial Real Estate

An Important Part of a Long-Term, Well-Diversified Portfolio

Commercial real estate conjures images of malls and skyscrapers that have been accessible as investments only by large institutional investors. However, individuals not only can easily invest in commercial real estate through a variety of vehicles, but there are many sound financial reasons to include the asset class as part of a well-diversified investment portfolio. In fact, institutions that invest in commercial real estate target an average allocation of 10.3% of their portfolios to the sector, according to a January 2011 survey by Kingsley Associates and Institutional Real Estate, Inc. The benefits include:

- ***Superior Risk-Adjusted Performance:*** Over time, commercial real estate has produced compelling returns with lower volatility than other investment sectors.
- ***Healthy Current Income:*** Commercial real estate, including both privately held assets and publicly traded real estate investment trusts (REITs), historically has generated attractive current income in comparison to other asset classes.
- ***Large Investable Universe:*** Commercial real estate is the third-largest investment class, affording investors a wide range of strategies and opportunities.
- ***Diversification:*** Commercial real estate generally does not move in synch with other investments such as stocks and bonds.
- ***Inflation Hedge:*** Commercial real estate provides a natural hedge against inflation.

Opportunities in Commercial Real Estate

Superior Risk-Adjusted Performance: While some asset classes have historically generated higher returns than real estate, the incremental returns have generally come with exposure to higher risk. When one calculates returns in relation to risk over an extended period, measured in terms of volatility (or standard deviation), commercial real estate has produced competitive absolute returns to stocks and bonds and superior risk-adjusted returns to stocks. Publicly held real estate is typically more volatile, but over time it has produced a high absolute return with a risk-adjusted return comparable to the S&P 500. Private commercial real estate has exhibited significantly lower volatility and high absolute and risk-adjusted returns.

Commercial Real Estate Produces High Return Per Unit of Risk

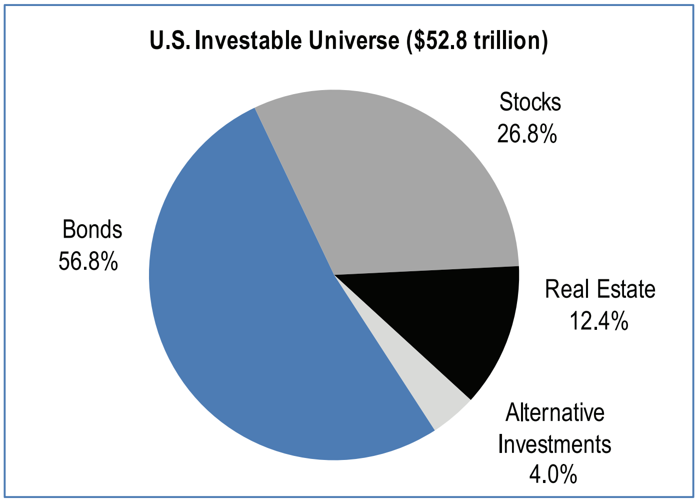
Historical Returns (1Q78 – 4Q10)

	Average Return (% year)	Standard Deviation (% year)	Return Per Unit of Risk
NCREIF Property Index	8.9	8.1	1.1
Barclays Agg. Bond Index	8.3	6.9	1.2
NAREIT Equity REIT Index	12.8	17.6	0.7
S&P 500	11.4	16.8	0.7
MSCI EAFE	10.7	22.5	0.5

Bloomberg, National Council of Real Estate Investment Fiduciaries (NCREIF)

Healthy Current Income: Most commercial real estate investments provide investors with stable, bond-like income from contractual leases. Typically, commercial properties are occupied by tenants that have long-term leases, making the cash flow fairly predictable, even during economic downturns. Unlike bonds, there is no prepayment risk, so income returns can flow as long as a property is operating. Income returns for the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index, which represent institutionally-owned private assets, have been stable over time. Dividends of property REITs are less stable since they change in relation to common equity prices, but they compare favorably to stock and bond yields over time.

Large Investable Universe: Commercial real estate is the third largest asset class in the U.S., representing some $6.5 trillion of market value, or roughly 12.4% of the $52.8 trillion investable universe in the U.S.[1] The size and scope of the market enables investors to participate in a wide range of strategies. The commercial real estate universe can be broken into components delineated by public and private vehicles that invest in equity and debt and various hybrid strategies.



Securities Industry and Financial Markets Association, Morningstar, Prudential Real Estate Investors; bond market excludes municipal and money market securities; data as of 12/31/2010.

Commercial real estate has pronounced supply/demand cycles, a product of the long construction lead times required to develop most properties. However, population growth and other demographic shifts ensure that demand for the product will grow over time. The Economist Intelligence Unit projects that the United States will grow by some 2.7 million people per year between 2010 and 2020, roughly the equivalent of adding a development the size of metropolitan Denver each year. That projection translates into continued demand for buildings in which people live, shop and work.

Diversification: The scale and characteristics of commercial real estate affords an investor several layers of diversification, and the income stream it produces is different than the income generated by other types of investment products. Within the context of a multi-asset portfolio (composed of stocks, bonds and other asset classes), private real estate can provide significant diversification benefits, as correlations with stocks and bonds over time has been low. In fact, a leading private property index calculated by NCREIF has performed well during many time periods in which the S&P 500 index fell. Expanding into investment classes other than stocks, bonds and cash "typically improves the risk-return characteristics of a strategic asset allocation," according to Ibbotson Associates.

A second layer of diversification comes from the real estate itself, as a result of the variety of property types and different geographic regions in the U.S. The major property types include office, retail, multi-

[1] Prudential Real Estate Investors, as of year-end 2010.

family, industrial and hotel, and there are others, such as self-storage, seniors housing and health care. Each property type has different fundamental drivers that provide some diversification for investors. Geography works in the same way. Markets in different cities or regions of the U.S. often do not perform in concert. Economic fundamentals operate under the same broad framework, but performance of commercial real estate across the country usually varies at any given time, for reasons that include local economic factors and supply dynamics.

A third layer of diversification comes from the multiplicity of investment types available within commercial real estate. Investments can be made in properties directly or in property companies. They can be made in private or public companies, through equity or debt. Equity carries with it the most risk but also the highest potential returns. Debt carries less risk but fixed returns without upside, even if the property performs above expectations. What's more, investors can choose vehicles that employ differing strategies, including mezzanine investments that capture higher fixed returns with an increased level of risk.

Size of the U.S. Real Estate Market, by Sector

Sector	Market Value (Tril)
Office	$2.1
Apartment	$1.6
Retail	$1.1
Industrial	$0.6
Hotel	$0.5
Self-Storage	$0.3
Seniors Housing	$0.3
Total	**$6.5**

Prudential Real Estate Investors

A fourth layer comes from the fact that commercial properties often are occupied by multiple tenants, providing diversification to the cash flow on the property level.

Inflation Hedge: Commercial real estate has the potential to provide a hedge against inflation, particularly when inflation rates are high. Property owners benefit from increasing rents and property values when inflation rises. Many long-term leases contain built-in rent increases over time, while shorter-term leases will roll over at the current market rate. With few exceptions, bonds provide no such opportunity to increase coupon payments or principal over the life of the investment, leaving investors exposed if inflation exceeds expectations.

Individual Investing in Commercial Real Estate

Because commercial properties typically require very large equity investments and must be operated by professional managers, investing in commercial real estate requires more capital and expertise than most individual investors possess. Moreover, building a diversified portfolio (by geography and/or product type) requires equity capital that limits commercial real estate investing to the largest of institutional investors.

As a result, in order to gain access to the asset class, individuals must pool resources in vehicles such as open-ended real estate funds or REIT mutual funds that invest in publicly and privately held real estate securities. Open-ended real estate funds invest directly in commercial real estate of various types and have a perpetual life. REIT mutual funds invest in the stocks of companies that own real estate. Within those broad investment types, there are many strategies. Some funds target stable properties with bond-like yields, while others purchase properties in need of rehabilitation that have a greater risk/return profile. In any event, the multitude of fund types available to individuals provides them with the means to invest in commercial real estate using a wide range of strategies.

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