

Viewpoint

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Private Open-End Core Real Estate Funds:

Ready for Recovery

Private open-end core real estate funds that target core investments are a significant and growing part of the global real estate investment universe. While not unscathed by the global financial crisis, institutionally managed U.S. and pan-European open-end funds appear to have weathered the worst of the storm, and are repositioning their balance sheets in an attempt to take advantage of opportunities in the trough and recovery periods of the cycle. The fundamental appeal of the strategy has not changed: institutional-quality, income-oriented portfolios — characterized by top-tier assets in major markets, with bond-like cash flows — may be positioned to benefit early in the market recovery and to offer an attractive risk-adjusted return.

The recent global financial crisis (“GFC”) deeply impacted virtually all asset classes, including commercial real estate. Real estate is a capital-intensive business, and the withdrawal of cheap and abundant access to commercial mortgage debt battered property prices. The economic slowdown following the GFC has curtailed business activity, occupier demand and retail sales. These factors have contributed to a recent peak-to-trough real estate pricing correction of 30% to 45% in the U.S. and Europe.

At the same time, the utility of real estate as a diversifier of risk within a multi-asset portfolio was questioned. During the GFC, with its extraordinarily high levels of investor risk aversion, most asset classes displayed a strong degree of correlation. Yet today, most institutional investors are demonstrating renewed interest in allocating capital to global core private real estate funds.

For these investors, what is the attraction of global core real estate funds, and what role do such funds play in a diversified portfolio? Might the current environment offer an appealing entry point for long-term investment? What lessons have we learned from the

recent crisis, and how can we attempt to achieve appropriate returns while minimizing risk? In this paper, we address these questions.

Emergence of institutionally managed real estate open-end funds

Open-end real estate funds in the U.S. date to 1970, and the universe of funds grew gradually through the 1970s and 1980s as institutional investors began to incorporate real estate as a permanent and accepted part of their asset allocation model. Most real estate investment vehicles, including open-end funds, experienced challenges during the global property downturn in the mid-1990s. However, those funds that successfully navigated the mid-1990s recession emerged stronger. Investors, recognizing the maturation of both the real estate market and the fund industry, began to invest in open-end funds again in 1997, and the universe experienced a net inflow of capital. This inflow gained momentum in ensuing years, and investment managers responded to the growing demand by offering new funds to the market. The 16 active funds included in the NCREIF Fund Index–Open-End Diversified Core Equity (or NFI-ODCE), an index of institutional U.S. core strategy open-end funds, currently total \$54.7 billion in net asset value (NAV) and range in size from \$0.4 billion to \$10 billion.¹

The success of U.S. open-end funds during the economic growth period, as well as European investor interest in vehicles that offered broader geographic diversification, contributed to demand for open-end funds targeting European markets. The advent of the euro enabled institutional fund managers to offer funds that had a pan-European (specifically, Organisation for Economic Co-operation and Development, or OECD) and Eurozone orientation. The universe of institutionally managed pan-European real estate funds grew significantly in the early 2000s. According to Investment Property Databank, there were 269 funds included in the unlisted European Pooled Property Fund Index, with a total NAV of €86.5 billion; pan-European open-end funds comprised a cohort of 17 active funds.²

Today the global universe of open-end funds continues to grow, and is dominated by funds operating in the United States and Europe. Asia-focused open-end core real estate funds are just beginning to organize and gain critical mass, but they could be a significant growth segment in the decade ahead. Australia has a robust core property fund industry, and German open-ended funds (primarily oriented for retail customers) also own large pools of core property assets; but because of the specialized focus or characteristics of these funds, non-domestic investors represent a small segment of the investor base.

This paper will focus primarily on the large and mature core property fund marketplace in the U.S. and Europe, referencing other regions and funds as appropriate.

WHY CORE REAL ESTATE FUNDS?

INCOME YIELD ORIENTED

Core real estate has historically offered a relatively robust current income yield, generally ranging between 5% and 9% per annum. Due to the operating nature of the underlying investments, a significant portion of an open-end fund's return (in the range of 65%–80%) is derived from income. In core real estate, income is generally underpinned by long-term leases, often 5 to 10 years in length, which provide a measure of stability to cash flows. In the U.S., income may also be derived from ownership of high-quality apartments. Income can grow over time as the result of contractual rent

¹ NFI-ODCE data as of September 30, 2010.

² IPD unlisted European Pooled Property Fund Index data as of June 30, 2010.

bumps during the lease term and as leases expire and roll to (sometimes) higher market rental rates.

Additionally, potential for capital appreciation may result from the application of a consistent capitalization rate (the conceptual inverse of the stock market's price-to-earnings ratio) to a higher future income stream. Of course, the possibility exists for further capital appreciation in instances when residual capitalization rates compress. Therefore, with a contractual, bond-like income stream and the potential for capital appreciation, core real estate should compare favorably to, and complement holdings of, equities and bonds on both a risk and a return basis, as suggested in the table below.

Compound Annual Total Returns: Q1 1979–Q3 2010			
Asset Class	Index	Return	Volatility
Real Estate	NCREIF Fund Index–Open-End Diversified Core Equity (NFI-ODCE)	7.8%	5.9%
U.S. Stocks	Russell 3000® Index	11.3%	17.1%
U.S. Bonds	Barclays Aggregate U.S. Bond Index (Barclays Aggregate)	8.6%	6.9%
U.S. Bonds	Barclays U.S. Government/Credit Index	8.6%	6.9%

Source: NCREIF, Barclays, Russell Investments; period ending September 30, 2010.

OPPORTUNITY FOR QUARTERLY LIQUIDITY

It is important for investors, particularly those accustomed to equities and bonds, to understand that open-end real estate funds offer limited liquidity. While quarterly liquidity may be available for many funds during normal times, the GFC demonstrated that, in times of market duress, funds may employ a variety of methods to conserve capital and delay the redemption process.³ In Australia, wholesale funds may declare themselves “not liquid” in severe market conditions and delay executing redemptions until after the fund manager deems that the market has stabilized. In the U.S., funds may balance the need to provide liquidity to redeeming investors against their fiduciary responsibilities to their other investors, and in practice this can result in redemption pools taking many quarters to clear.

Many U.S. and pan-European open-end funds instituted investor withdrawal queues by late 2008, and strategically managed their funds’ balance sheets in the wake of significant valuation declines associated with the risk repricing and lack of available credit. Fund managers focused on initiatives to shore up their funds’ liquidity positions as they sought to meet near-term capital obligations and address the elevated leverage positions that resulted from valuation declines. However, for many funds, income distribution provided an ongoing mechanism for providing partial liquidity to investors during the GFC.

The liquidity positioning of institutional U.S. and pan-European open-end funds has improved markedly in 2010, with funds generally experiencing significant reductions in the numbers of investors in withdrawal pools, and with certain funds clearing their withdrawal pools altogether. In recent months, generally, these funds have experienced positive traction to varying degrees in their capital-raise efforts. This apparent rebound in liquidity among institutional core fund managers reinforces investor confidence in the

While funds typically offer the opportunity for quarterly liquidity, fund managers seek to balance liquidity goals and fiduciary responsibility to all investors.

³ Real estate private equity open-end funds tend to offer the opportunity for quarterly liquidity, but do not guarantee ongoing liquidity. Fund managers seek to balance their fiduciary obligations to all investors with the need to protect the ongoing viability of the funds.

ability of these managers to navigate through economic shocks and to be responsive to investor liquidity needs over time.

COMPELLING DIVERSIFICATION BENEFIT

The historical diversification benefit of adding core real estate to multi-asset-class portfolios is well documented. Historically, from a U.S. perspective, private core real estate returns have been neutrally to slightly negatively correlated to government bond returns, and modestly positively correlated to equities. As demonstrated in the following table, from 1985 to the second quarter of 2010, the NFI-ODCE had only a 0.20 correlation with common stocks and a negative 0.16 correlation with fixed income. Therefore, core real estate has served to reduce overall portfolio volatility while simultaneously providing a relatively high level of concurrent returns.

Rolling 4Q Correlations: Q1 1986 – Q3 2010			
INDEX	NFI-ODCE	Russell 3000 Index	Barclays Aggregate
NFI-ODCE	1		
Russell 3000 Index	0.20	1	
Barclays Capital U.S. Aggregate Bond Index	-0.16	0.18	1

Source: NCREIF, Barclays, Russell Investments; period ending September 30, 2010.

During the GFC, the correlation among most asset classes approached a value of 1 – that is, virtually all asset classes were so closely correlated as to simultaneously experience steep declines. Does this disprove a key rationale for investing in real estate? The role of asset class diversification is to help mitigate asset class-specific risk; but “systematic risk,” during rare events when all asset classes are affected, is another matter. There is no mechanism for entirely avoiding systematic risk, apart from holding a portfolio of risk-free assets. Notwithstanding the impact to correlation during periods of economic shock, the diversification arguments for real estate within a multi-asset portfolio remain compelling.

RELATIVELY LOW LEVERAGE

Relative to non-core strategies, such as value-add and opportunistic, core real estate funds strategy tends to target a lower fund leverage position. For U.S. funds, the range is typically 20% to 40% of Fund Gross Asset Value (GAV). For pan-European funds, tax advantages (to the funds) associated with higher leverage positions push the range toward 60%. The lower leverage target should translate into reduced volatility relative to non-core strategies.

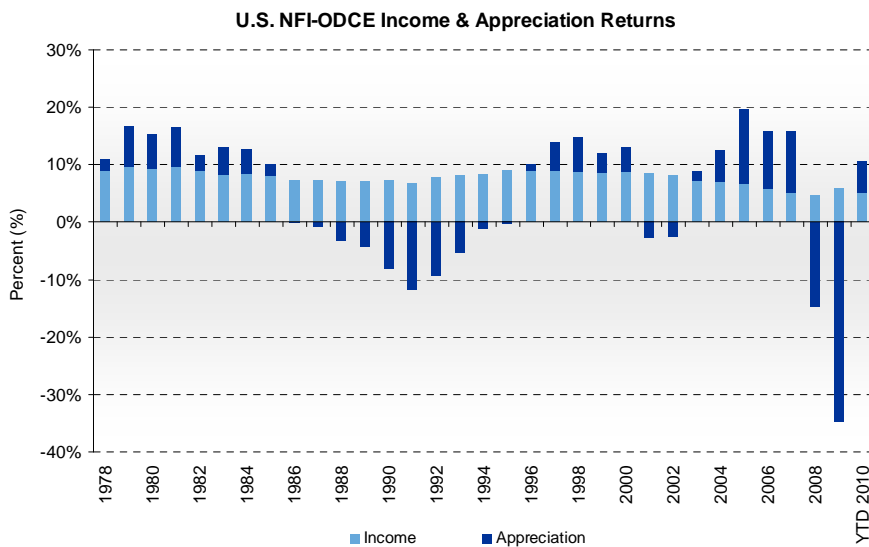
As discussed earlier, U.S. and pan-European core strategy funds were impacted by the value declines associated with the GFC. Those funds that were positioned toward the higher end of their leverage target range going into the downturn moved into elevated leverage positions, in certain cases beyond the policy limits set forth for the funds. Generally, the U.S. and pan-European fund managers sought to successfully navigate the liquidity challenges associated with the GFC, and to actively deleverage their portfolios to bring them back into balance with their policy targets. With the improvements in credit availability and “prime” property pricing in 2010, many of these funds have been able to bring their leverage positions back toward (or within) their target ranges.

The diversification benefit of a private real estate allocation for the multi-asset investor remains compelling.

WHY NOW?

ATTRACTIVE RECOVERY HORIZON AND TOTAL RETURN PROPOSITION

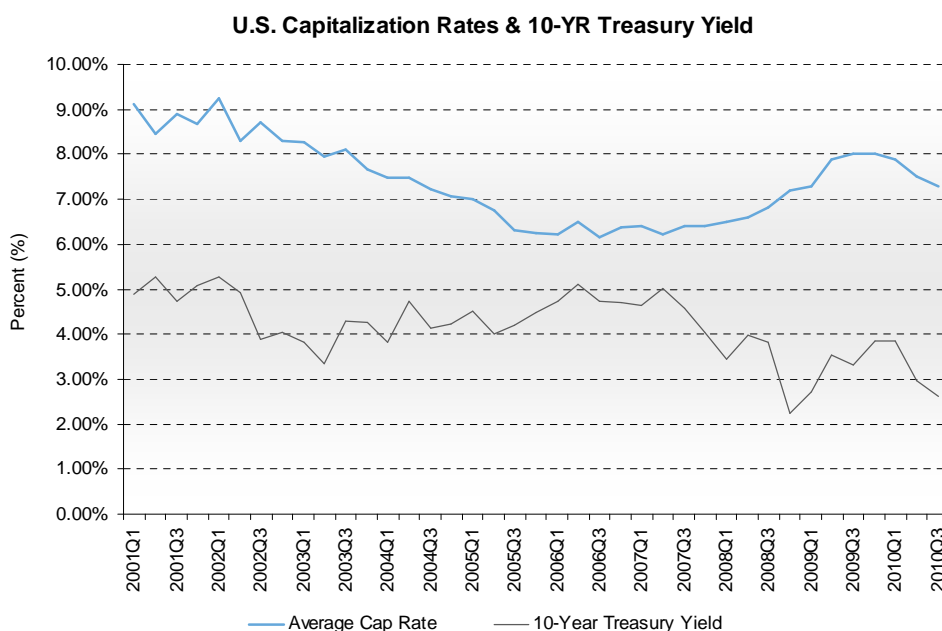
As noted previously, there has been a sharp correction in real estate values. Since mid-2009, improvements in credit availability and economic conditions, as well as the rally in the public markets, have contributed to significant buyer demand for “prime” core assets with bond-like cash flows. “Prime” core assets are usually well positioned within their submarkets, representing a “best assets in best markets” investment approach. These types of properties make up a substantial share of the holdings of U.S. and pan-European open-end core real estate funds.



“Prime” core assets are positioned to benefit early in the recovery stage of the cycle.

Source: NCREIF; period ending September 30, 2010.

In today’s low government bond yield environment, the spread between government bond and real estate yields in the U.S. appears particularly striking. The spread signals that real estate property may be attractively priced relative to the fixed income market.



Transparency and independence in the property valuation process supports investor confidence in the Fund NAV.

Source: Real Capital Analytics; period ending September 30, 2010.

It is worth noting that real estate fundamentals have been hit hard by the pronounced job losses during the GFC. While new construction across property types and major U.S. and pan-European markets has generally been modest, the falloff in space market demand due to weak labor market conditions signals that, from a fundamentals standpoint, we may not be “out of the woods” quite yet. However, current conditions may represent an attractive opportunity to be positioned for participation when the recovery does take hold.

ENHANCED TRANSPARENCY IN VALUATION

Open-end real estate funds are not priced on a daily basis, as are many equities and bonds, but rather use an appraisal-based valuation methodology. Shares of an open-end fund are typically priced quarterly to facilitate the ability to issue new units and redeem units. The price of a unit is based on the underlying value of the fund’s properties and cash at the end of the quarter. Trades between investors do take place, and funds are increasingly stepping up to provide matching services for potential buyers and sellers of their shares or units. However, no formal third-party secondary-market clearinghouse exists for the trading of units. Therefore, appraisals are the primary mechanism for determining value.

Twenty years ago, it was common for investment managers to control the valuation process; today, third-party independent experts are increasingly involved. General changes in the real estate industry (e.g., greater information flow and transactional volume, and the growth of the publicly traded sector) and investor focus on valuation practices have contributed to more transparent valuation processes that appear to be more responsive to changes in market conditions and investor sentiment. In the U.S., while it is standard practice to conduct annual independent property valuations (on a rolling basis, such that roughly 25% of the portfolio is appraised each calendar quarter), fund managers are increasingly transitioning to quarterly third-party appraisals. This

practice bolsters investor confidence in a portfolio's net asset value (NAV). For pan-European funds, independent property valuations are typically performed at least annually, and, similarly to their U.S. counterparts, managers have increasingly transitioned to a more frequent basis.

In the U.S. market, the adoption of FAS 157 ("fair value measurement standard") has had a significant impact. In 2008, certain U.S. open-end funds began the practice of recording their debt at fair value. Typically, the average of credit-spread quotes from knowledgeable parties for each secured and unsecured debt instrument is calculated for use as a discount factor in a present-value calculation. The difference between the calculated present value and the balance outstanding is the market valuation adjustment. During the GFC, credit spreads widened considerably, positioning certain funds to take a significant markup in the in-place debt value, which offset valuation declines at the property level. As credit conditions improved, the funds began to "give back" the debt markup, with certain funds settling back toward a neutral debt valuation position by third-quarter 2010. U.S. open-end funds increasingly report the debt mark-to-market impact in their standard quarterly reports, further supporting transparency with investors.

REAL ASSETS' RELATIONSHIP WITH INFLATION

Looking forward, certain investors have expressed concerns about inflation, particularly regarding the possibility that revenue-strapped governments will "print their way" out of fiscal deficits by increasing their money supplies. However, Russell does not expect to see a material change in inflation any time soon. Yet there is the recognition that inflation is a particular worry for investors in or approaching retirement (and those who manage investments on their behalf), who are wary of a scenario in which they are dependent on fixed pension payments in an increasingly costly world.

Real estate has a relationship with inflation that differs from those of other financial assets. With the addition of real estate, the entire portfolio is expected to be more robust against inflationary pressures, due to the diversification benefit associated with a multi-asset portfolio. Second, should the real estate sector experience material inflation, the portfolio will be positioned to benefit from that exposure. It is worth noting that many core property leases include periodic Consumer Price Index (CPI) or fixed upward adjustments. Retail rents in particular may be tied to sales performance in nominal dollars. Though the relationship between core real estate and inflation should not be a driving factor for investment in private real estate, it is a component worth noting within the context of the broader diversification benefit to a multi-asset investment portfolio.

NOT ALL CORE FUNDS ARE CREATED EQUAL

There is significant diversity within the fund universe, given that each fund has distinct characteristics and a track record that reflects the investment philosophy and expertise of the sponsoring organization. Differences are manifested in property-type mix, competitive positioning of underlying investments, major market and asset exposures, and leverage employed. Additionally, active management, which contributes significantly to fund positioning and performance, varies from manager to manager. Alignment of interests is also a critical element of the manager selection process. Certain funds may allocate profits in ways that put pressure on the balancing of investors' interests with the fund manager's interests during different stages of the real estate cycle. Additionally, certain investment frameworks may be conducive to "style drift."

The legal structures of U.S. and pan-European core real estate funds have also evolved over time, allowing for broader, more globally oriented investor bases. It is typical for

U.S. funds to be structured as private REITs, and for pan-European funds to be structured as Luxembourg SICAVs (“open-ended collective investment schemes”) or FCPs (“fonds commun de placement”). There are tax implications associated with these structures that should be carefully considered. Additionally, the Foreign Investment in Real Property Tax Act of 1980, in the U.S., represents a challenge to foreign investors, but options exist for structuring investments to minimize tax leakage.

As in other asset classes, the investment acumen and the philosophy of the fund manager are reflected in each fund’s returns and structure and contribute to distinct performance differences across funds. There is potential for astute investors to exploit these differences and improve returns through careful fund manager selection.

CONCLUSION

Core open-end real estate funds have evolved over the course of 30 years to respond to changing investor needs and market demands, and have proven their durability in both up and down cycles. Institutional core open-end funds tend to offer high-quality property portfolios with bond-like current cash flows supported by leases to tenants with high credit ratings. Additionally, allocations to these types of funds can play a valuable role in diversifying risk within a multi-asset portfolio. Finally, core real estate funds may be positioned to benefit early in the current market recovery environment and to offer an attractive risk-adjusted return proposition to investors.

The global open-end funds market is expanding rapidly. For institutional investors willing to devote resources to understanding the complexities of open-end core real estate funds and the individual characteristics of their underlying funds, a growing array of choices offers the potential to simultaneously pursue income and alpha.

This paper is based in part on a previous Russell Investments monograph: *Open-Ended Funds, a Universe Overview*, by Sally Haskins and Adam Babson, October, 2006.

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The NCREIF Fund Index-Open End Diversified Core Equity-Equal Weight (NFI-ODCE-EQ) is a gross of fee, time weighted return index with an inception date of December 31, 1977. Gross of fee return is based upon reported net asset value, which takes into consideration the total leverage and cash holdings at the fund level and any ownership share of joint ventures. The index consists of 16 open-end funds meeting certain criteria. Open-end funds are generally defined as infinite-life vehicles consisting of multiple investors who have the ability to enter or exit the fund on a periodic basis, subject to contribution and/or redemption requests, thereby providing a degree of potential investment liquidity. The term Diversified Core Equity style typically reflects lower risk investment strategies utilizing low leverage and generally represented by equity ownership positions in stable U.S. operating properties. The NFI-ODCE-EQ is a quasi-managed index based on the periodic review by the Index Policy Committee of NCREIF.

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