Counselors of Real Estate
San Francisco, CA
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The Long Cycle: How Does Real Estate Measure Up to the Stock Market?

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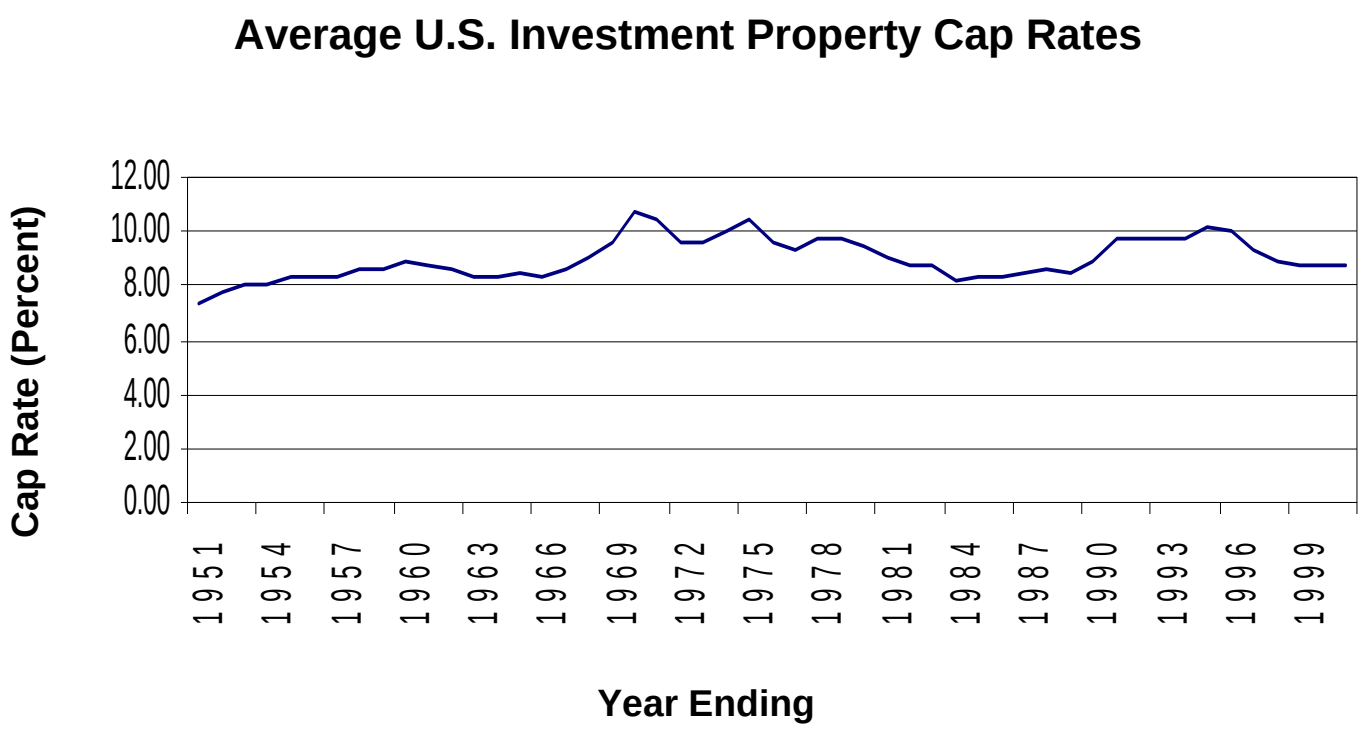
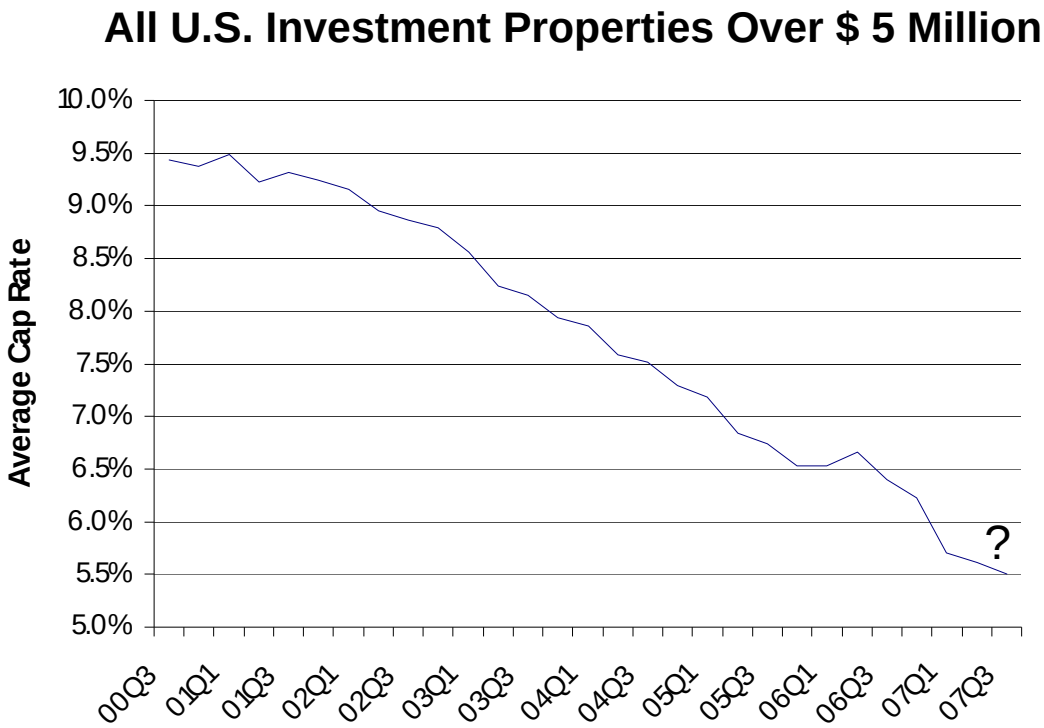
The Once Stable Historic Property Cap Rate…



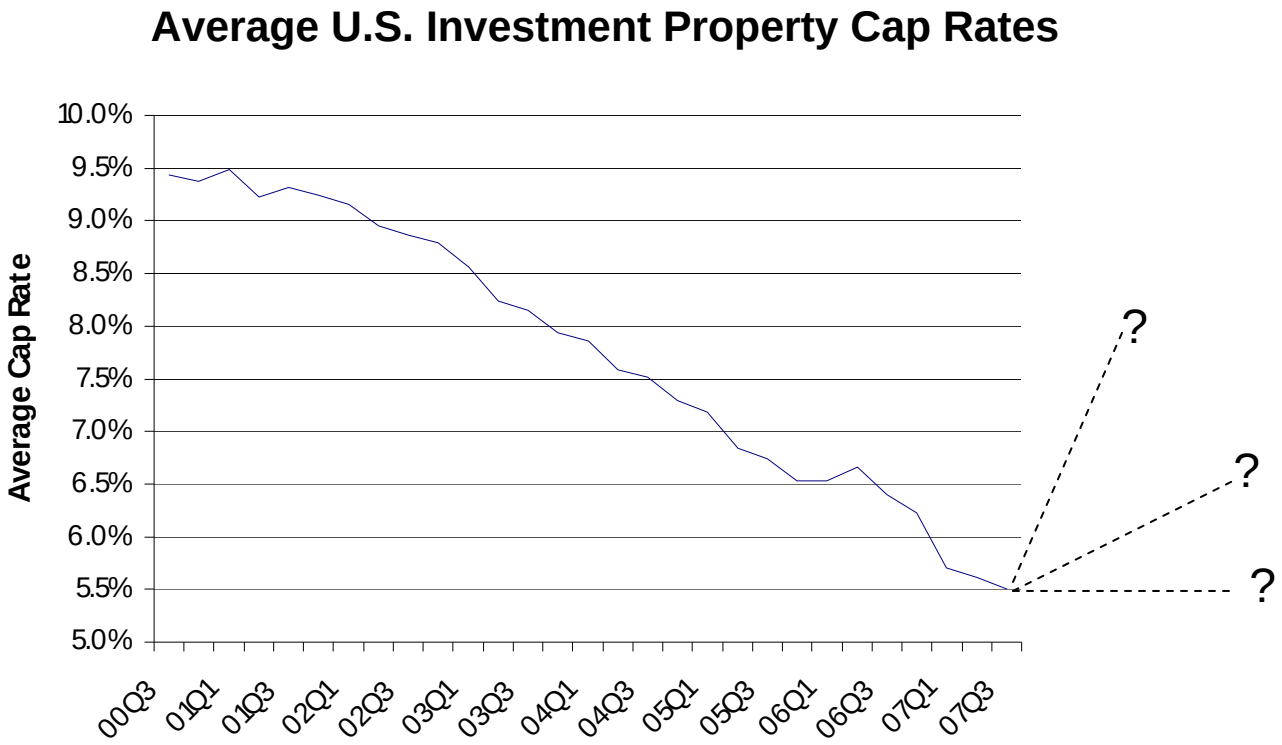
Source: American Council of Life Insurers; Bailard, Inc.; National Real Estate Index

…Had Become the Amazing Shrinking Cap Rate…



Source: Real Capital Analytics, New York

What is a Rational Cap Rate Once the Dust Settles?



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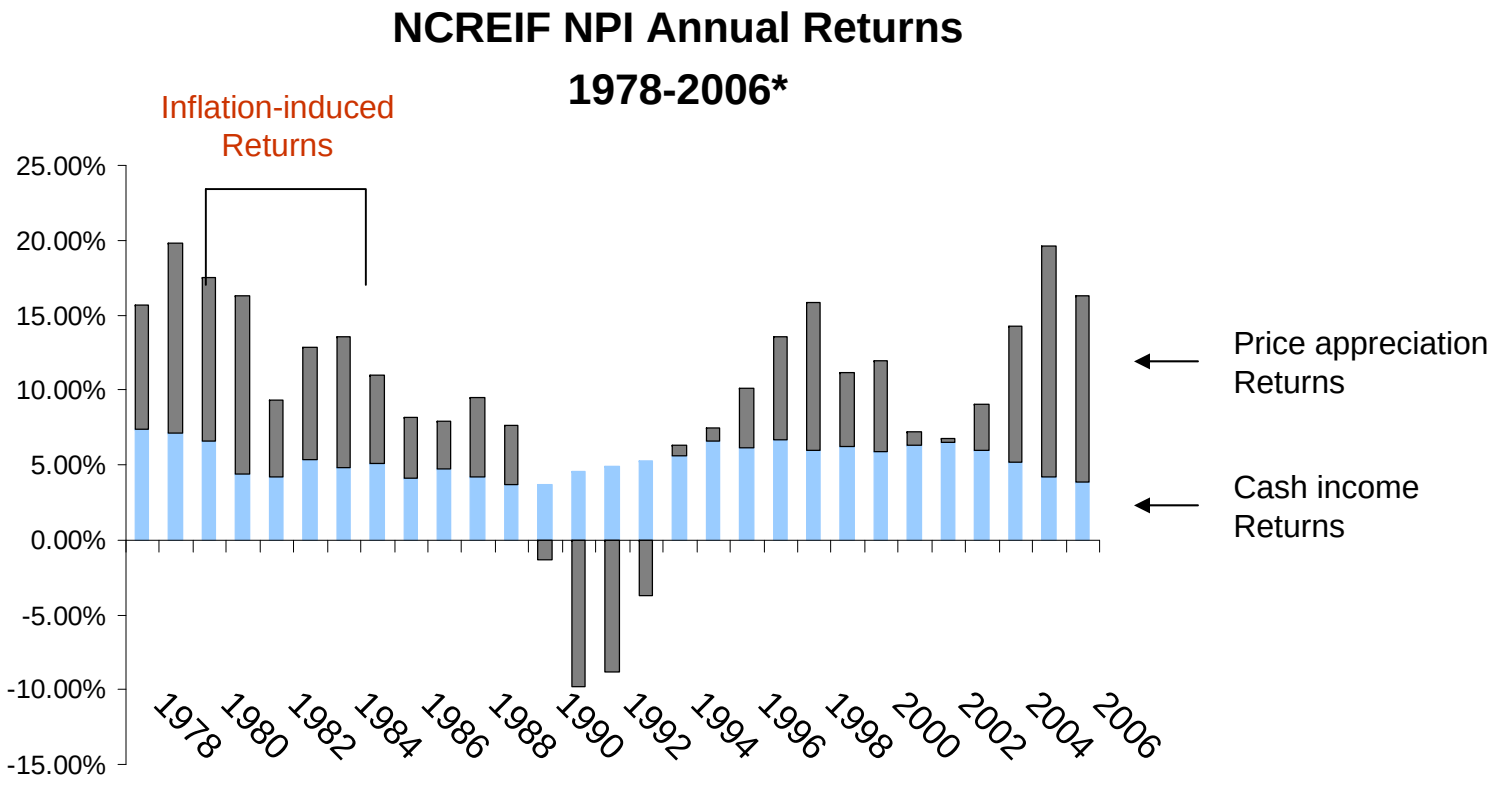
- That interest rates are really low?
- That stocks are cheap after the 2000 bubble burst?
- That real estate returns should normally lie somewhere between that of stocks and bonds?

Real Estate Returns: a Brief History



Source: NCREIF. *Past performance is no indication of future returns.

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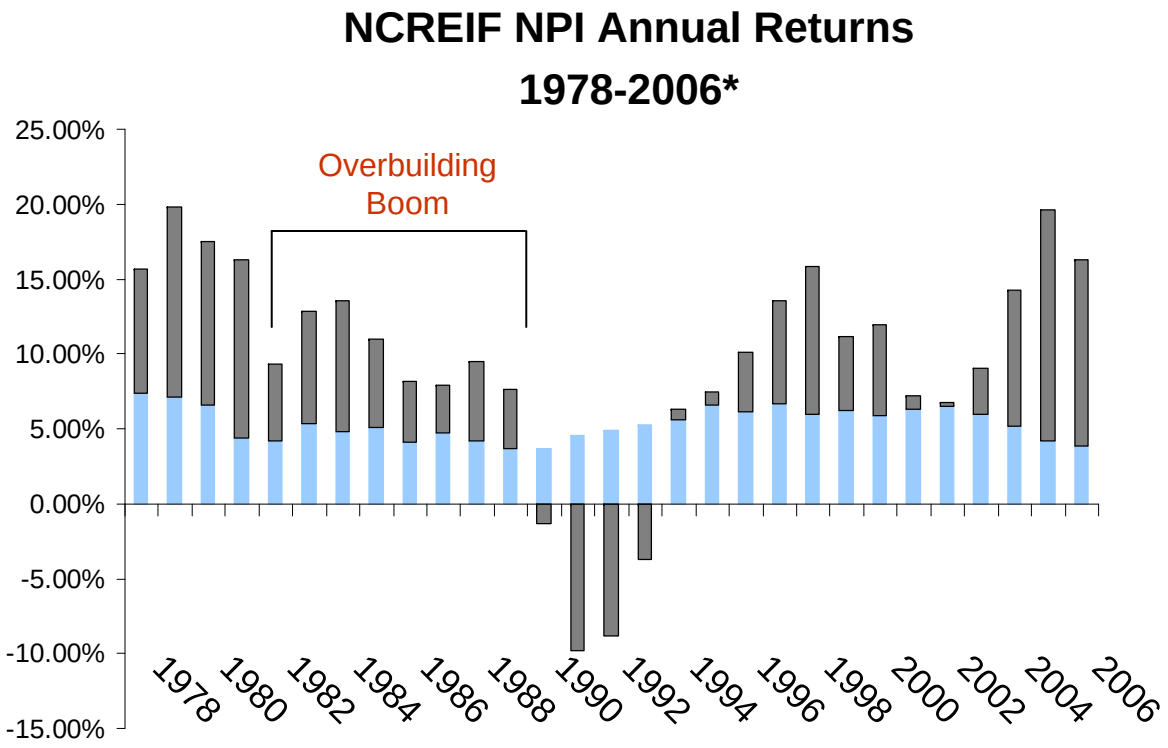

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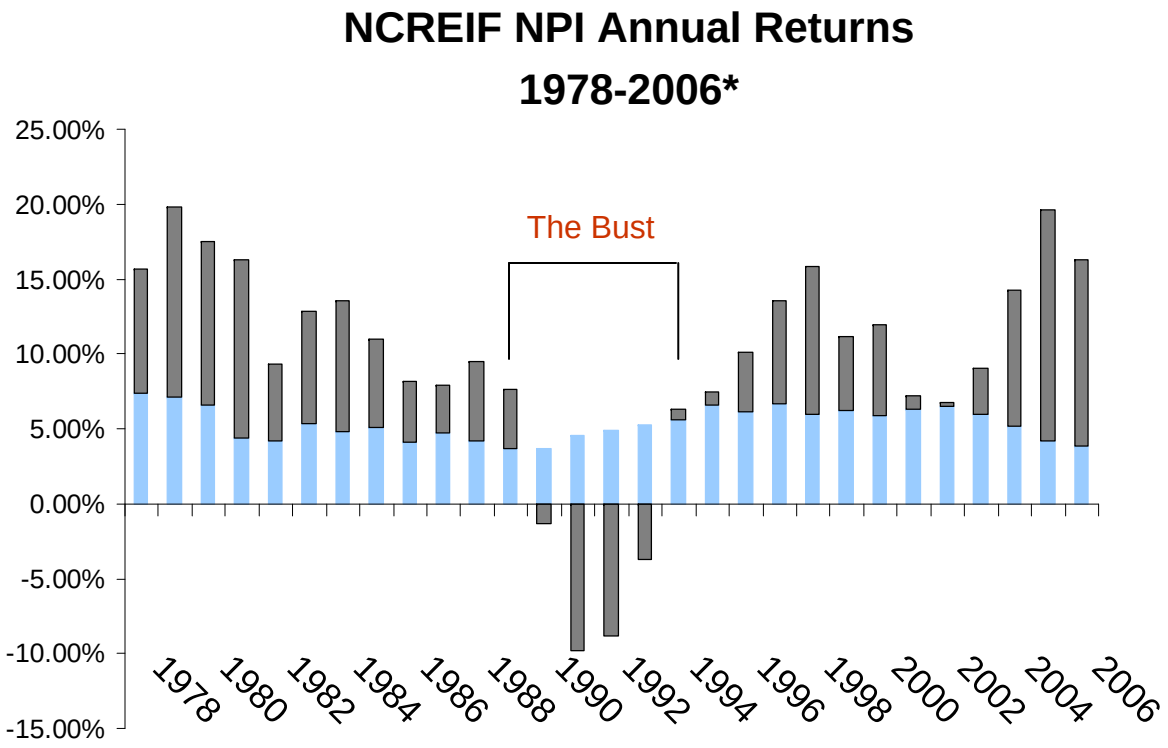

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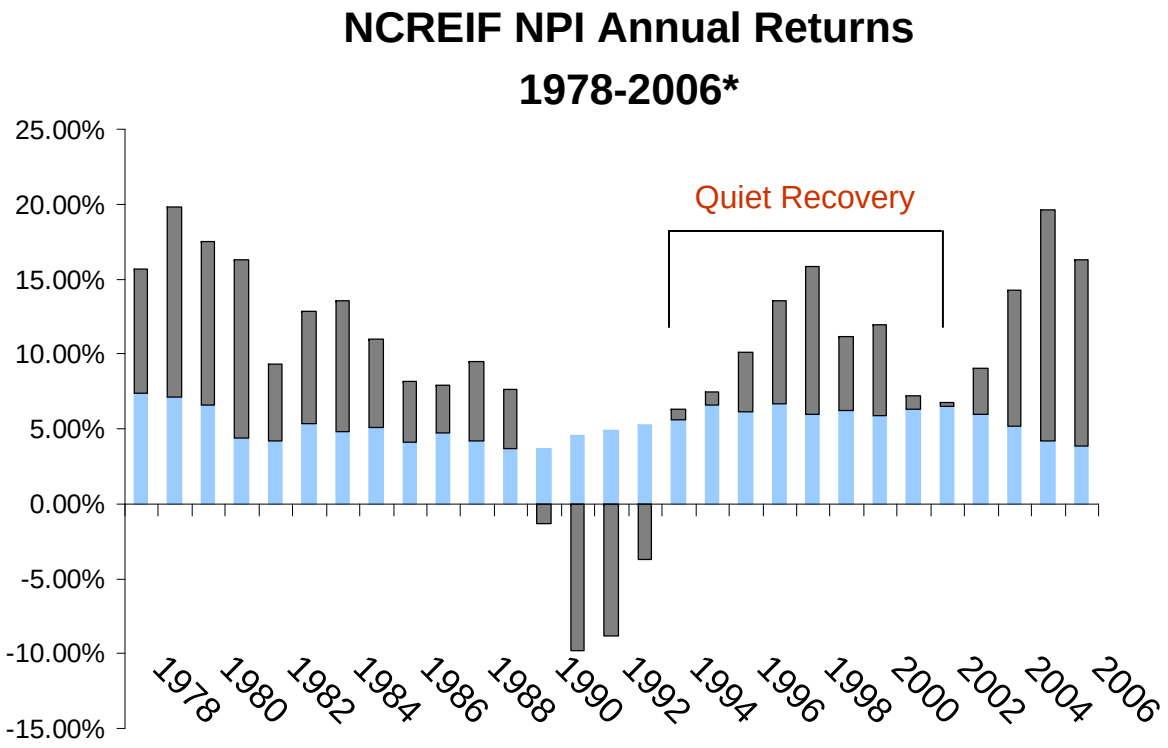

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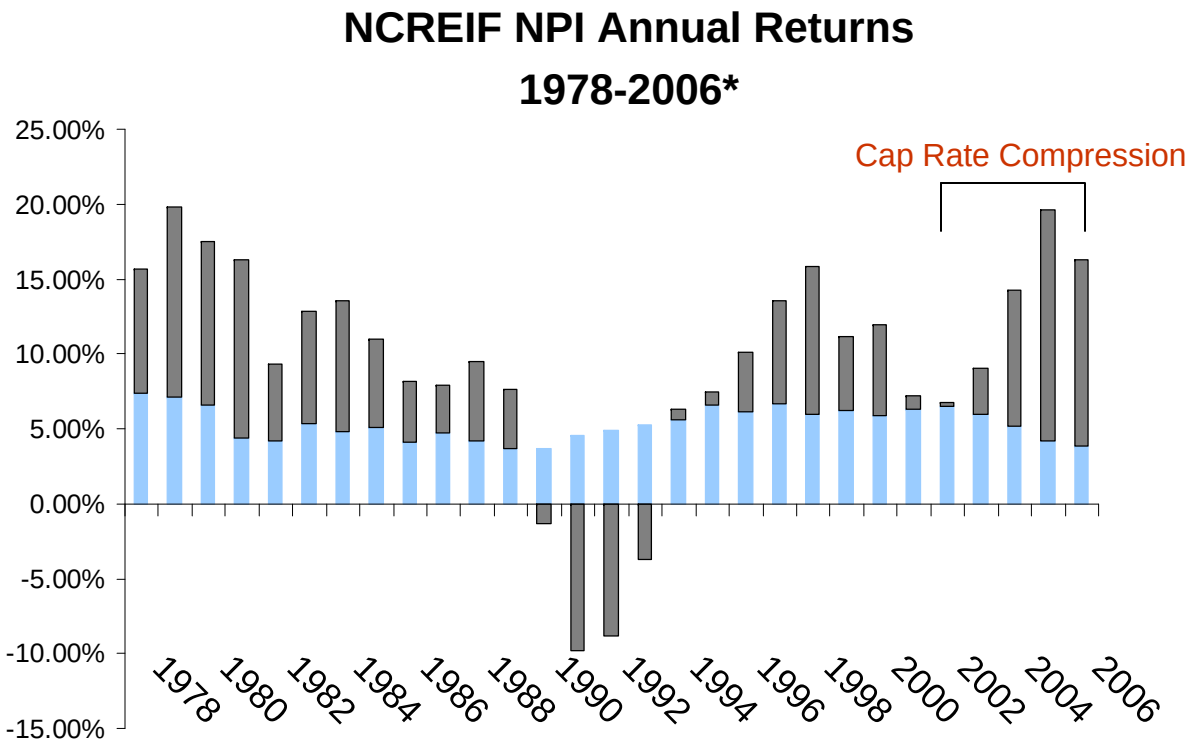

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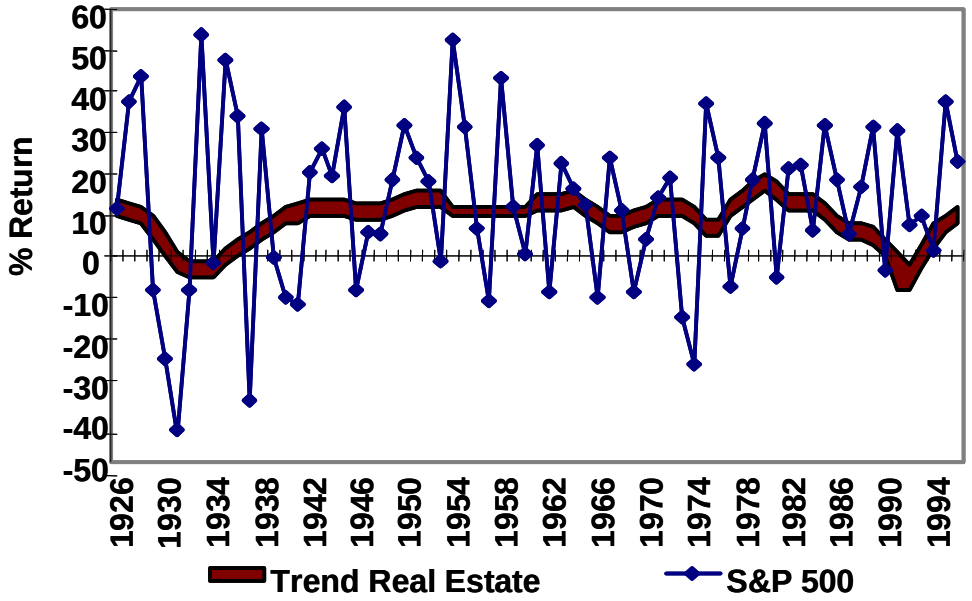
- The professional maturation of the real estate industry
  - Now an accepted institutional asset class
- The “Leverage Bubble:” Easy availability of mortgage and LBO debt; EOP buy-out

What's the Longer Picture for Real Estate?

Strong Competitive Returns: 10% Per Year Since 1926*

- Equivalent to Common Stocks, Lower Volatility but Less Liquidity

Trend Real Estate Return vs. S&P 500 Returns 1926-1996



*"Trend Returns" equals the author's estimated range of national real estate total annual returns based on a limited sample of metropolitan area studies prior to the 1978 inception of the NCREIF index and the NCREIF NPI from 1978-1996. Past performance is no indication of future results.

Source: "The Long Cycle in Real Estate," Ronald Kaiser, *Journal of Real Estate Research*, Vol. 14, No.3, 1997

What is the Long-Term Risk?

Attractive Downside Risk Experience

Up vs. Down Years for Real Estate, Stocks & Bonds

1934-2006

	Up Years	Down Years	Worst Year
Real Estate[1]	70	3	-6.1%
U.S. Stocks[2]	55	18	-35.0%
Long-Term Treasuries[3]	55	16	-7.7%

[1] Real estate: 1934-1977— Trend Returns (the author's estimated range of national real estate total annual returns based on a limited sample of metropolitan area studies prior to the 1978 inception of the NCREIF index);1978-2005 — NCREIF NPI [2] U.S. stocks: S&P 500 index. [3] Long-term Treasuries: Ibbotson long-term Treasury return series. Past performance is no indication of future results.

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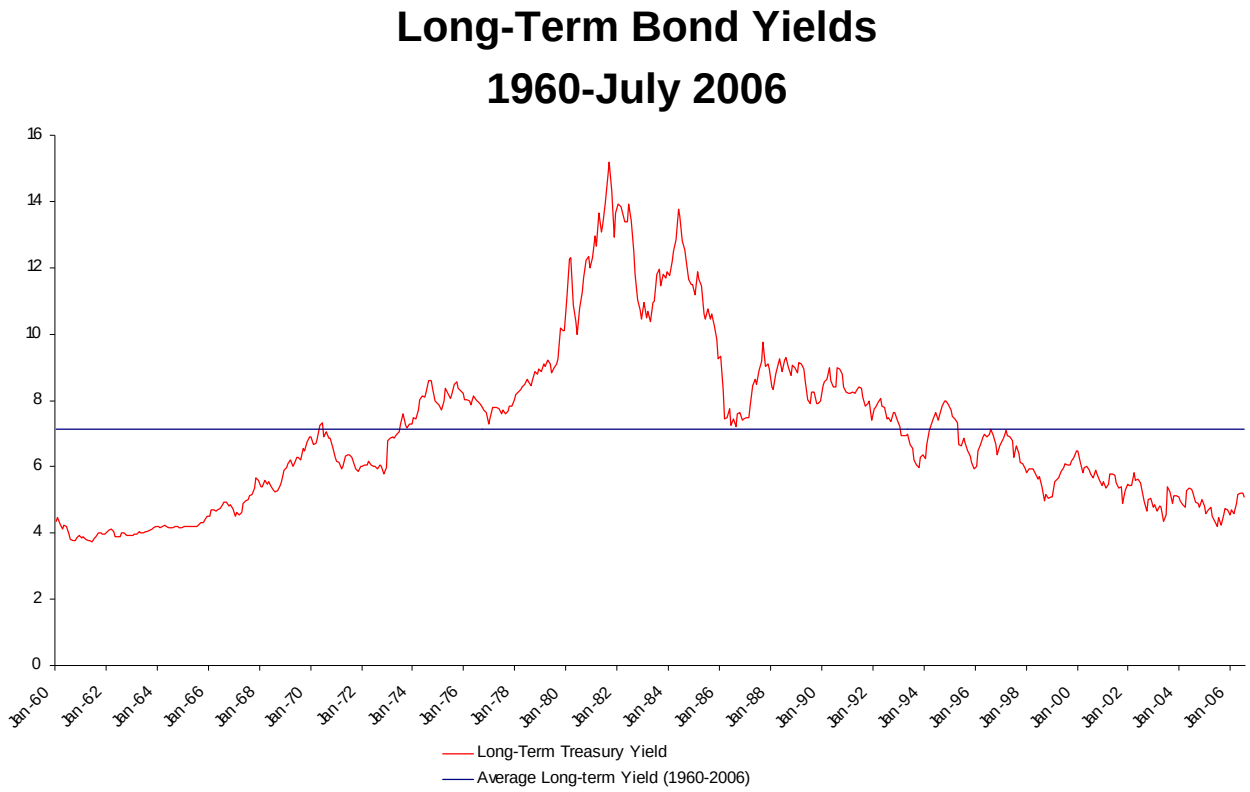
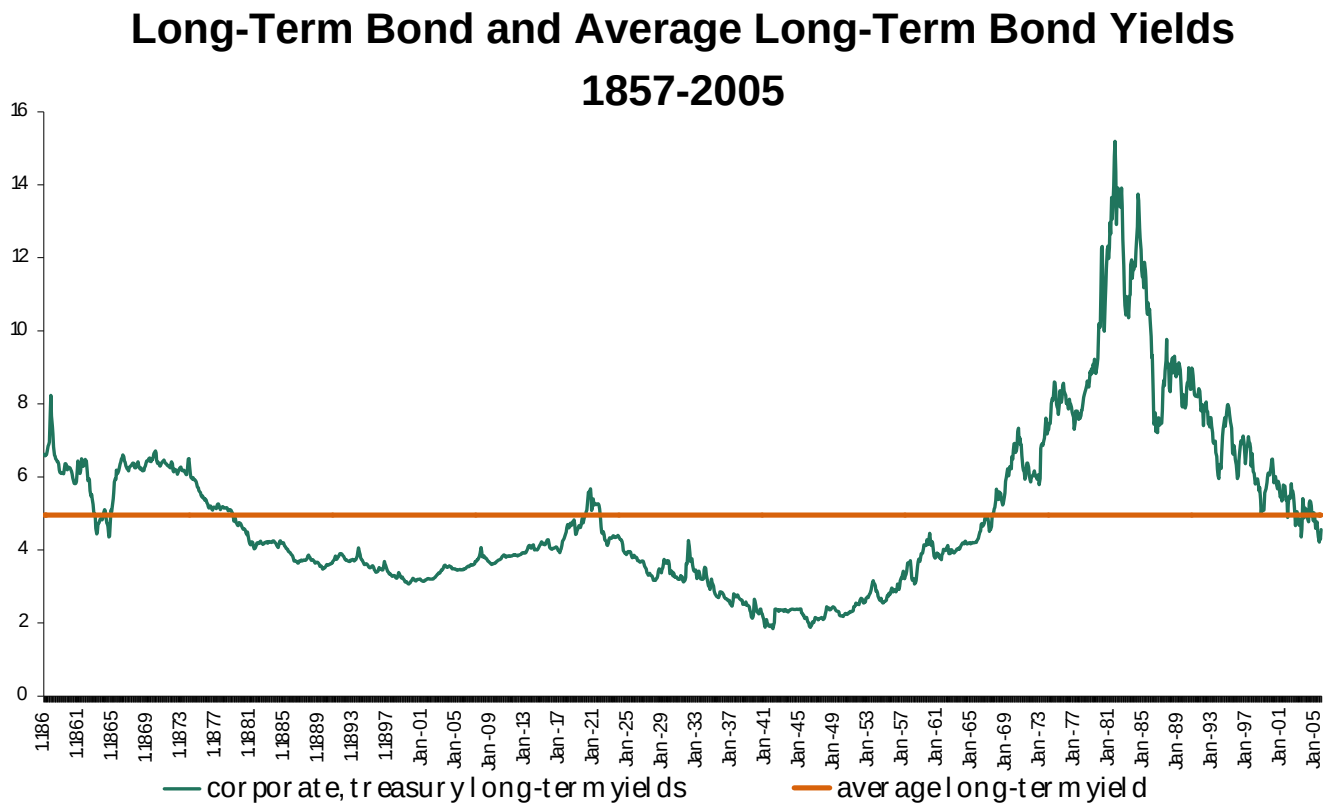
Interest Rates Are Really Low!



Source: National Bureau of Economic Research, Bloomberg. Past performance is no indication of future results.

Interest Rates Are Right at the 150-Year Average



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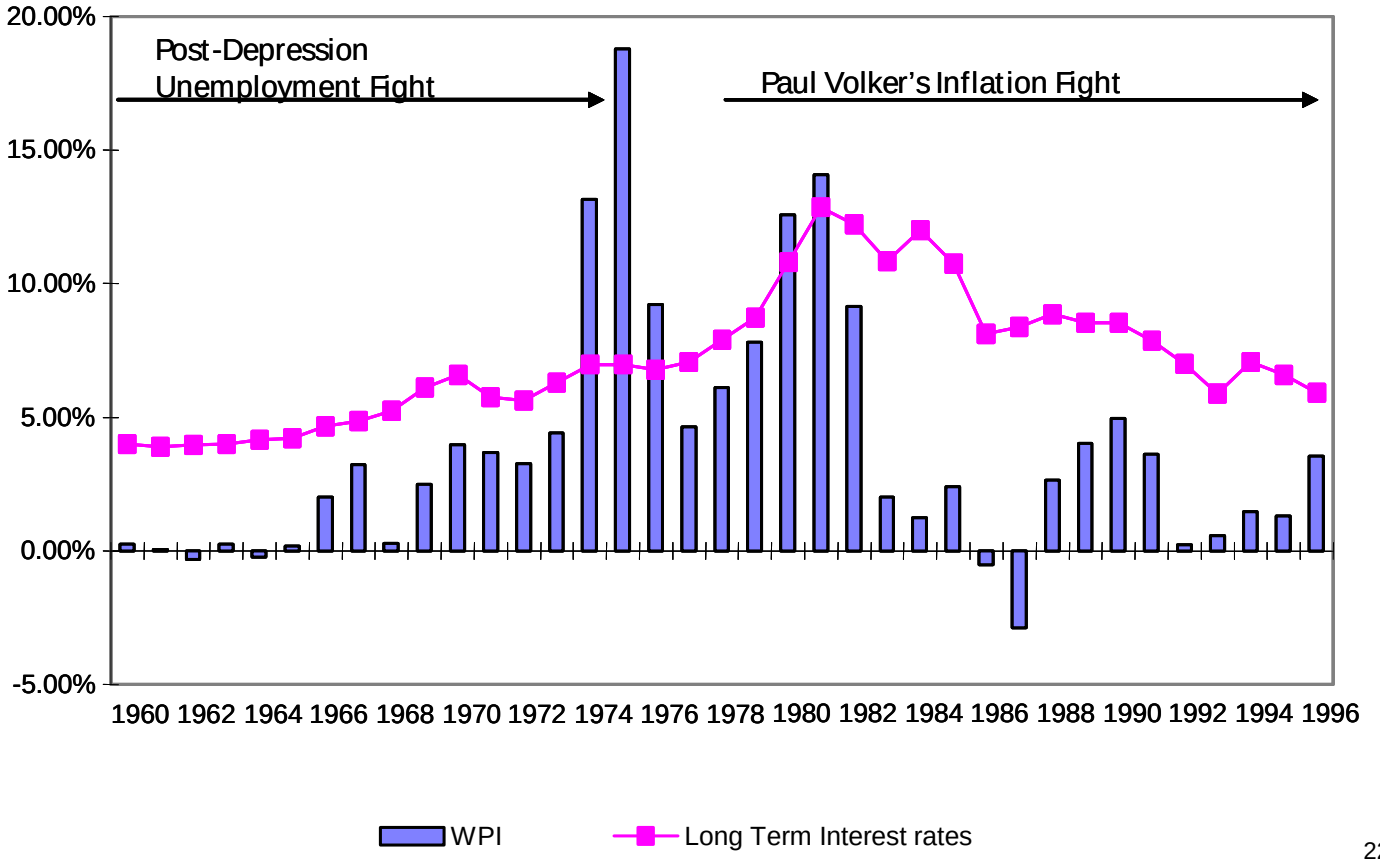
The Recent Inflation Spike in Detail

The Recent Experience of Long-Term Rates and Wholesale-Level Inflation



Components of Historic Returns: Bonds

U.S. Treasury 10-year Yields	1971-1981	1981-1991
Beginning Yield	6.5%	13.5%
Ending Yield	13.5%	6.9%
Total Annual Return	**3.2%**	**15.8%**

Conclusion: "The Starting Point Matters!"

Source: DataStream, Thomson One Analytics. Past performance is no indication of future results.

From Today's Starting Point: Bond Return Forecast

- Current 10-year yield at 4.6%

	Ending Yield in 10 Years		
	3.5%	4.6%	6%
Total Return	5.4%	4.6%	4.3%

Source: Bailard Research

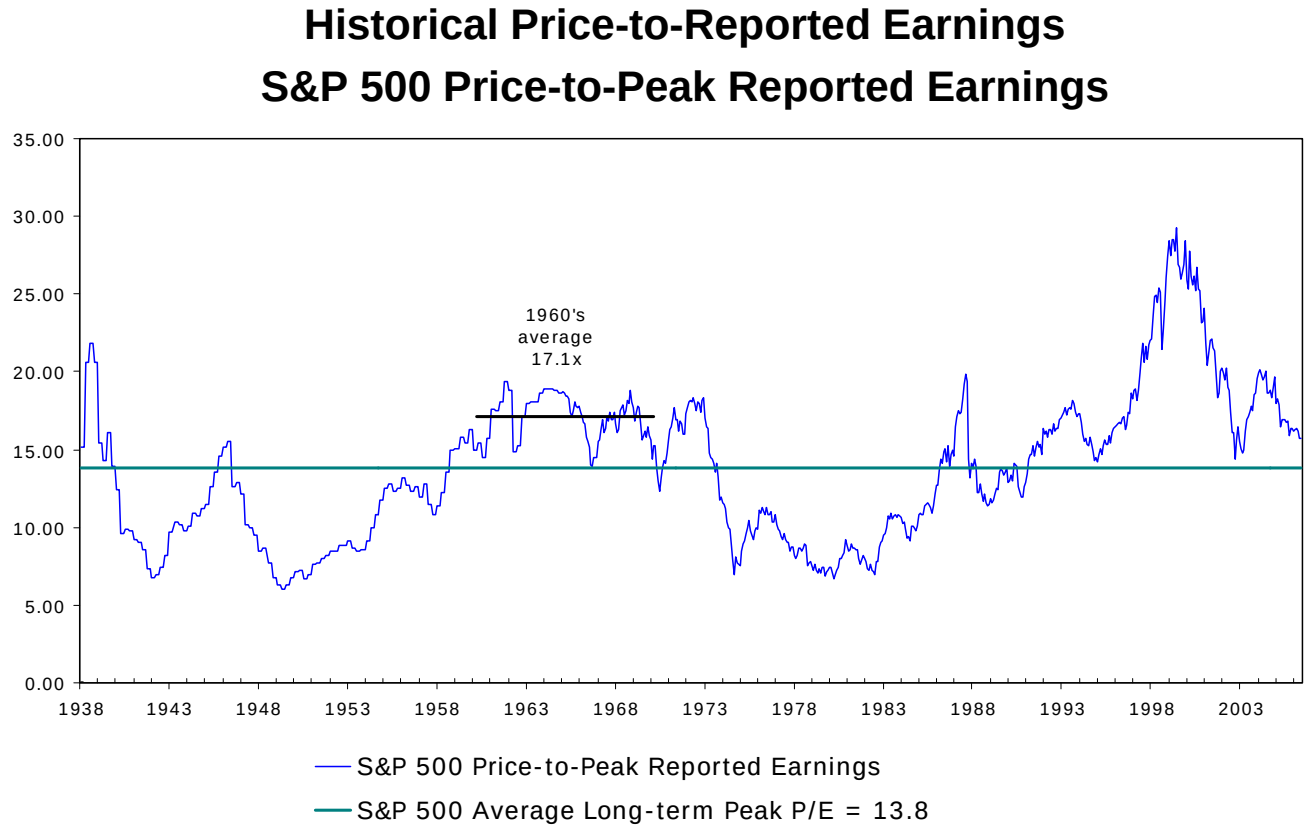
A Look at Stocks – the Competing Asset Class
Definition of Terms

Real Estate	Example	Common Stocks	Example
Capitalization Rate "Cap Rate"	8%	Earnings Yield	6%
Capital Expense "Cap Ex"	-2.5%	Retained Earnings	-4%
Cash Distribution Yield	5.5%	Dividend Yield	2%

Earnings yield = $\frac{\$6}{\$100 \text{ price}}$ = **6%**

P/E ratio (price to earnings) = $\frac{\$100 \text{ price}}{\$6}$ = **16.7x**

Components of Historic Returns: Stocks



Source: Datastream, Thomson One Analytics

Components of Historic Returns: Stocks

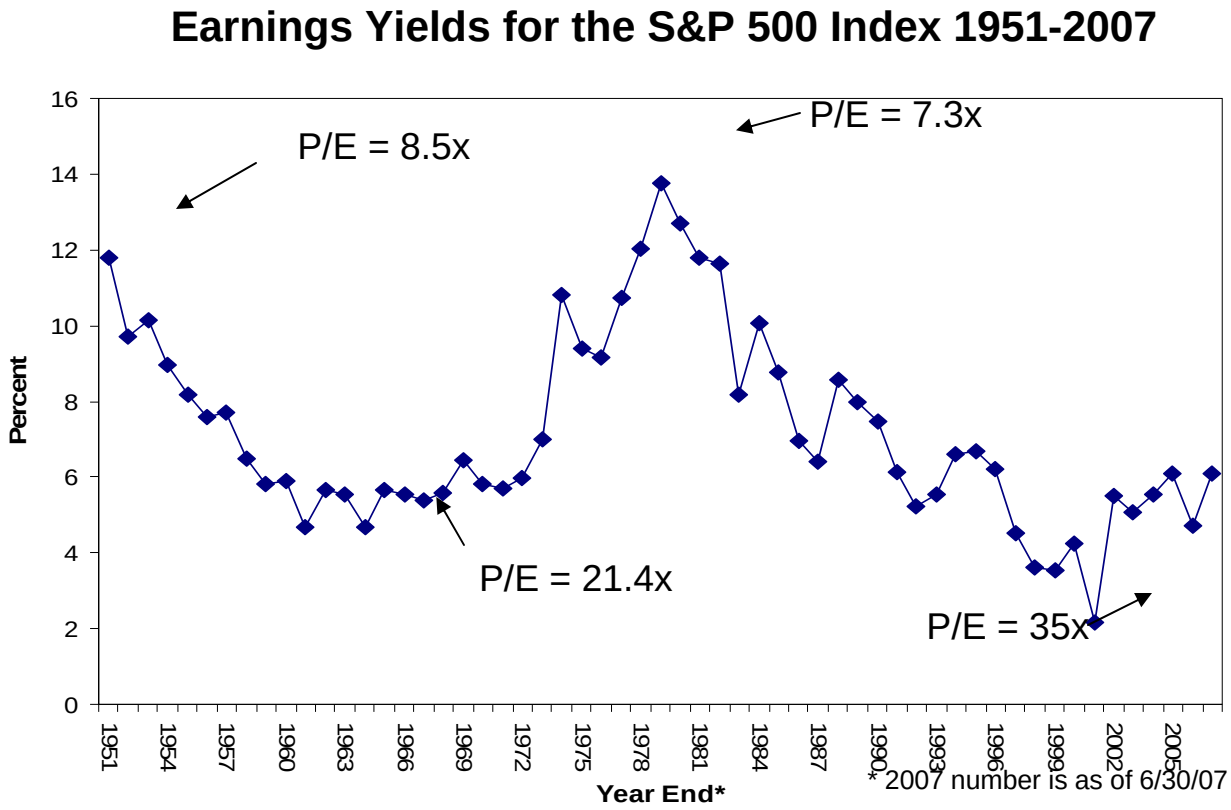
	1926-2001	1961-1979	1974-2002
Ave. Dividend Yield	5.1%	3.8%	3.7%
Dividend Growth	3.8%	8.2%	5.5%
Fundamental Return	8.9%	12.0%	9.2%
P/E Expansion	1.8%	-5.8%	2.7%
Total Return	**10.7%**	**6.2%**	**11.9%**

Current Dividend Yield = 1.8%

- **Conclusion: "The Starting Point Matters!"**

Source: S&P Index, Datastream, Thomson One Analytics. Past performance is no indication of future results.

Components of Historic Returns: Stocks



Source: Baseline, First Call estimates

From Today's Starting Point: S&P Return Forecast

Assumptions:

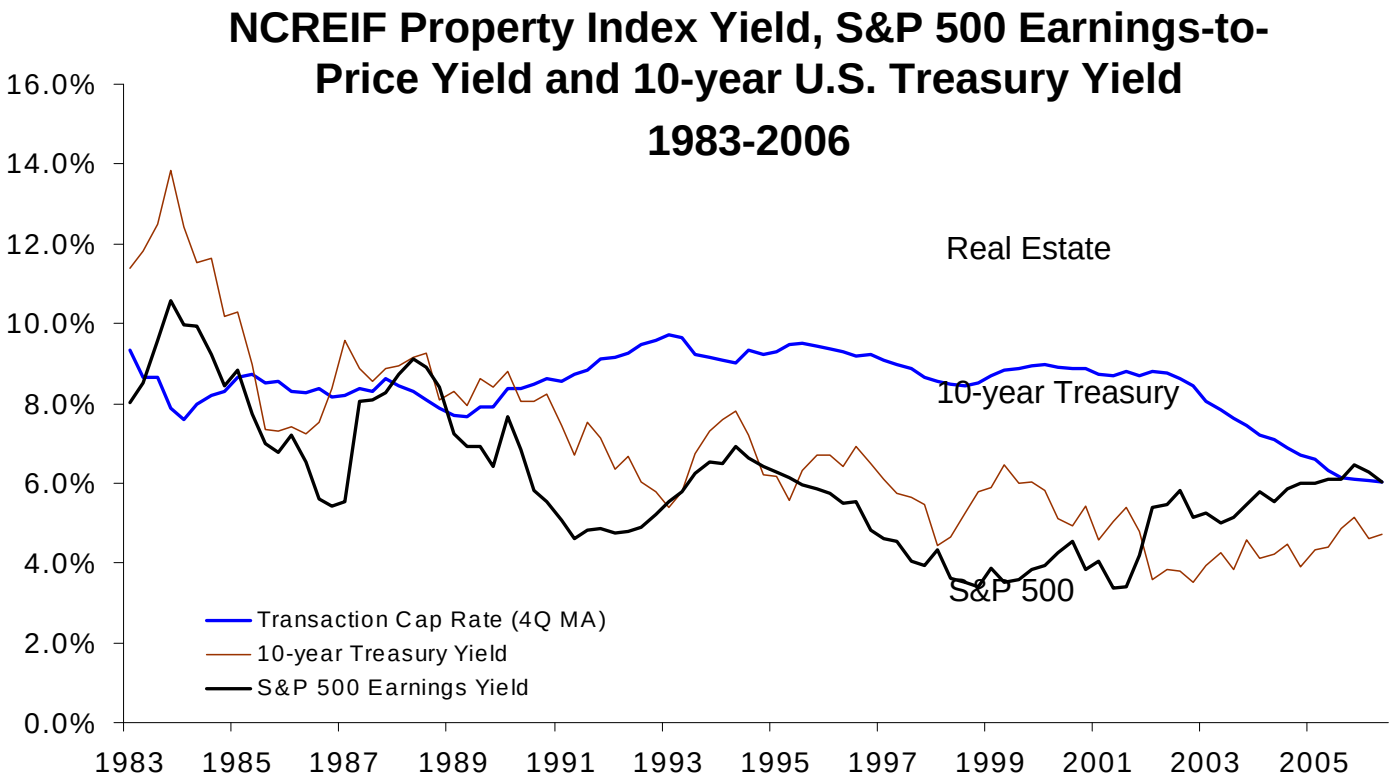
- Current P/E = 15x consensus '08 forecast of $103
- Current dividend = 1.8%; 5.5% annual dividend growth

	Ending P/E in 10 years			
	8x	**13.8x***	**15.0x**	**22x**
Valuation effect	-6.1%	-0.8%	0%	3.9%
Plus: dividend effect	7.3%	7.3%	7.3%	7.3%
Total Return (10-year Annualized)	1.2%	6.5%	7.3%	11.2%

*78-year median.

Source: Bailard Research

Real Estate: Relative Rates Are Narrowing



Source: NCREIF (Transaction Cap Rates), DataStream, Bloomberg and Bailard Research

From Today's Starting Point: NCREIF Return Forecast

Early 2007		Two Scenarios	
5.5%	Going-in cap rate	6.5%	7.5%
-2.5%	Capital expenditures	-2.5%	-2.5%
3.0%	Current cash yield	4.0%	5.0%
+1.0%	Real rental rate recovery	+1.0%	0%
+2.5%	Annual inflation	+2.5%	+2.5%
6.5%	Fundamental return	7.5%	7.5%

	Ending Cap Rate in 10 Years		
	5.5%	7.0%	8.5%
Valuation Effect	+2.4%	0%	-1.9%
Total Return	9.9%	7.5%	5.6%

Source: NCREIF, Bailard Research

Where Will Capital Flow?

Forecast Total Returns

(10-year annualized)

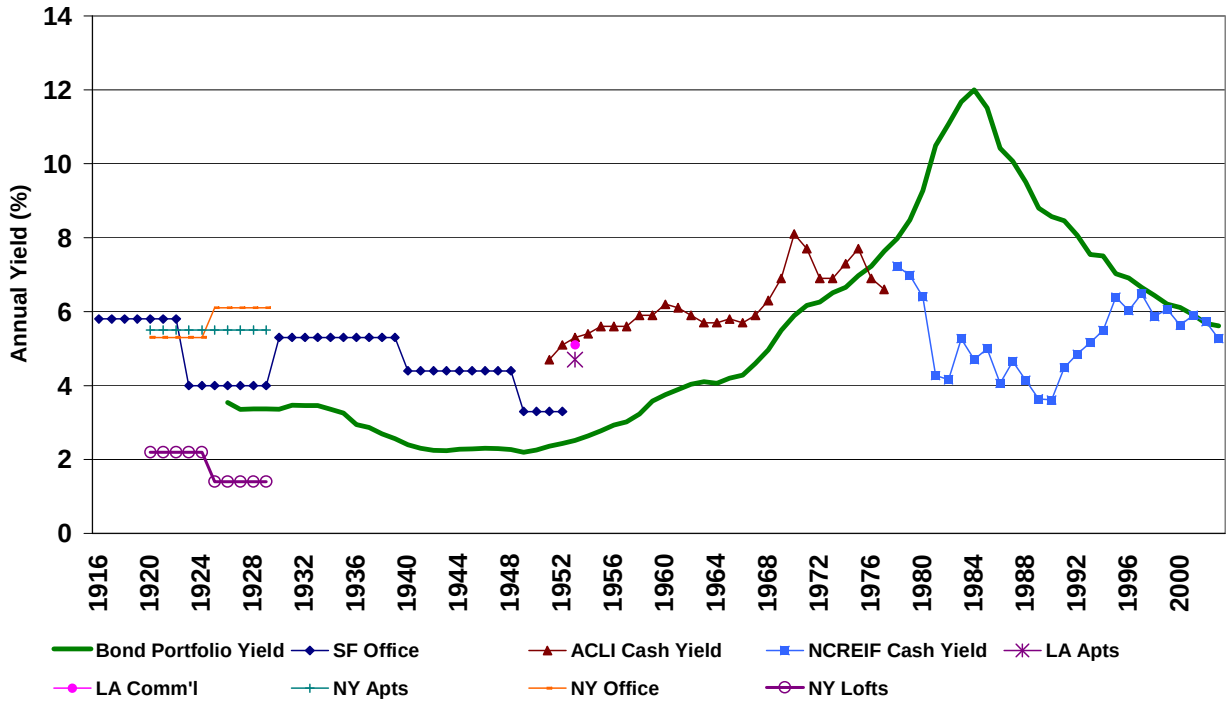
	Low	Expected	High
Bonds	4.3%	4.6%	5.4%
Stocks	1.2%	6.5%	11.2%
Real Estate*	5.6%	7.5%	9.9%

*Not including 100-200 b.p. for leverage and/or value-add.

Source: Bailard Research

Property Yields at 4-5% Are Not Unusual

Rolling 5-Year Bond Yields vs. Real Estate Cash Distribution Yields



Source: 10-year U.S. Treasury Bond portfolio yield: Ibbotson. Los Angeles commercial: Case (1960). San Francisco office: Wendt (1953). New York apartments: Grebler (1955). ACLI cash yield: American Council of Life Insurers. New York office: Grebler (1955). NCREIF cash yield: NCREIF. New York lofts: Grebler (1955). Los Angeles apartments: Case (1960).
Source: "Real Estate as a Surrogate for Bonds, Ronald Kaiser, Journal of Real Estate Portfolio Management, Vol. 10, No. 1, 2004.

What Might Start Cap Rates on a Renewed Rise?

- NOI trends turn negative
  - Overbuilding problems
  - Serious recession
- Major rise in interest rates, not driven by inflation
- A return to a long-term bull market in equities
- Continued tightening of credit markets

Coping with Low Cap Rates

Private Real Estate's Secret Weapon: Gamma

Total Return = Beta + Alpha + Gamma

Higher “Beta” Real Estate

- Use leverage to boost potential total return

Higher “Alpha” Real Estate

Total Return = Beta + Alpha

Managers create Alpha from:

- **Sector allocation**
  - Property type selection
  - Metro area selection
- **Asset allocation**
  - Best performing properties
- **Trading skill**
  - Best negotiated price/terms
  - Superior private information/access
- **Market timing**
  - Cash timing
  - Allocation timing

Alpha Requires Superior and Consistent Insight

- **Reality:** Superiority rarely exceeds 200 bps (2.0%) per year
- **Reality:** Alpha rarely works year after year

Private Real Estate's Secret Weapon: Gamma

Total Return = Beta + Alpha + Gamma

"Gamma" activities result from controlling the asset:

- Change management
- Invest additional capital
  - Refurbish
  - Redevelop
  - Retenant
- Refinance
- Partial sales

Source: "Analyzing Real Estate Portfolio Returns: More than Alpha and Beta…There's Gamma," Ronald W. Kaiser, *Journal of Portfolio Management*, Special Real Estate Issue, September, 2005.

Master Themes to Ponder

- 5% interest rates are normal by historic standards
- Historically, real estate returns = stock returns = 2x bond returns
- Moderately low cap rates should remain with us for years, absent some major shock
- Your real estate business should be good, just maybe not great
- Don’t forget the “gamma” in your tool box