

GLOBAL

QUARTERLY



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A Blueprint for Global Real Estate

Building an Overseas Real Estate Program Takes Patience and Discipline

by Drew Campbell

Plan sponsors in the United States have grown more comfortable with the idea of investing outside of their domestic markets, and increasingly these plans target property in places such as London, Tokyo, China and India. The time and effort it takes to run a global real estate mandate is a challenge; however, the reality of global economic trends have changed the way institutional investors approach their real estate programs.

“Nearly 75 percent of the world economy resides outside the United States,” says Steve Marsh, managing director, real estate, with MIT Investment Management Co. “Many of these economies and their underlying demographics are expected to grow at rates in excess of those in the United States, while others have real estate markets that are undergoing favorable structural changes.”

The benefits of diversification and a wider set of opportunities have made overseas real estate markets attractive, but the process is complex. Differences in culture, language, business practices, legal frameworks, economics, tax and currency make international investing a challenge. “At the end of the day, you need to have an appreciation for the level of risk you are exposing your plan to in order to achieve your investment goals,” says Marsh.

Plan sponsors that do invest in global real estate will have to get comfortable with the new environment in which they will operate and understand the effects it can have on a program before committing large sums of capital. “Like any other investment program, you have to identify your goals and establish a business plan with sufficient resources in order to execute effectively,” adds Marsh.

GLOBAL REAL ESTATE INVESTING HITS CRITICAL MASS

During the past two decades the trend of economic globalization has changed how business gets done — Indian high-tech workers travel to Silicon Valley for good job opportunities, Coca-Cola and McDonald's export their products around the world, and the ease of investing in foreign stock markets drives cross-border investment. A globalized world is now a reality, but global property investing did not reach a critical mass until more recently.

“Four years ago, there were mandates that were global, but there was still a continuing strong flow of investors who were looking for regional mandates — U.S. investors looking for U.S. real estate securities and European plans looking for European securities,” says Ritson Ferguson, CIO with ING Clarion Real Estate Securities. “Today I would say that for every 10 searches for a real estate securities mandate, probably 80 percent to 90 percent are defining a global real estate securities mandate as opposed to a regional mandate.”

THE RIGHT VEHICLE

The process of moving from a domestic allocation where the rules of the game are well understood to a globally diversified portfolio can be daunting, especially for plan sponsors that often have only one or two people dedicated to the real estate program.

“For a plan starting an international allocation, a commingled fund is a good place to start,” says Henrik Jones, principal, and head of the real assets group at San Francisco-based Hall Capital Partners. “An experienced global manager can provide opportunistic investments, economies of scale, diversification, and alignment of interest with other investors.”

Jones explains that active strategies such as direct investments or separate accounts demand expertise to buy, manage and sell assets. Active strategies also require dedicated management and higher start-up costs. "Real estate securities funds are another avenue a first-time investor should consider," he says.

Each plan sponsor will decide the best strategy for overseas investment depending on the size of the plan, its staff and the resources it has, as well as its objectives.

"The advantage of securities is, if you are willing to consider a commingled vehicle, even a very modest investment — \$1 million — can be made into real estate securities; however, if you wanted to engage a manager like us for a separate account, typically that is at least \$10 million," says Ferguson. "For direct vehicles, that threshold gets much higher. Even if you are using funds or funds of funds, you have to commit a higher amount than would be needed for securities. And if you are going to go into a separate account, then you have to invest much more significant sums — \$50 million or \$100 million or more."

There is not a best way to invest in global markets, and an initial investment could take many forms; however, one bit of advice all plan sponsors may want to follow is to take an incremental approach and do not try to do too much all at once.

"At the highest level, I would advise executing at a pace that main-

tains prudent investment underwriting standards, even if it means slower progress in building the program," says Marsh. "It is simply not worth compromising due diligence standards just to put push-pins all over a map."

Another distinction investors should consider is whether they want to start with a global investment — U.S. and overseas markets — or with an international investment — 100 percent outside the United States.

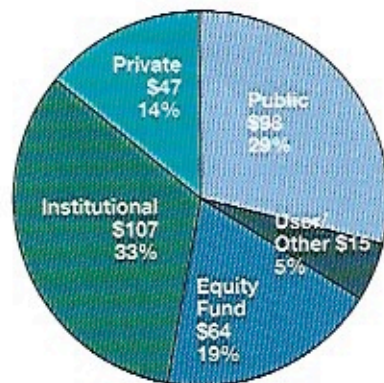
"A plan should consider a global fund that allocates where the opportunities are most compelling, including the United States," says Jones. "This strategy offers the plan an opportunity to put a toe in international waters while evaluating the performance of the global fund's U.S. portion based on the sponsor's knowledge of the domestic real estate market. A plan sponsor, for example, can set up a hub and spoke system, where the global fund is the hub. As the plan sponsor gains knowledge, experience, and conviction the sponsor can attach spokes to that hub in the form of niche funds," he says.

THE RIGHT MANAGER

Once a plan has made the decision to invest in global real estate markets, another hurdle they will face is access. Compared with U.S. markets, securing a global real estate allocation can be more difficult because there are simply fewer global and international real estate vehicles available.

"Start by identifying your return goals and your risk appetite, and with that you have criteria to think about

Cross-Border Buyers by Capital Sector



2007 Acquisitions (in billions)

Source: Real Capital Analytics

Global Trade Routes

	Source	Target	\$ Millions
1	U.S.	U.K.	14,777
2	Australia	U.S.	14,369
3	U.S.	Germany	13,996
4	U.S.	Australia	7,814
5	U.S.	France	7,657
6	Canada	Australia	6,057
7	U.S.	Japan	5,615
8	Germany	U.S.	5,209
9	Israel	U.S.	3,801
10	U.K.	U.S.	3,765

Source: Real Capital Analytics

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the vehicles you want," says Ferguson. "Only the largest plan sponsors can realistically address international opportunities through a segregated account or a true direct program. For plans other than that, and even some very large plans, the preference is to use funds or commingled vehicles to address the international opportunities. Then it becomes trying to identify the universe of managers who are offering access to vehicles to get the international opportunity," he says.

Traditionally, international real estate markets represented opportunistic investments for many plan sponsors. As institutional capital flows increase in global markets and these markets and economies mature, property assets and vehicles are developing a wider range of return opportunities, including core and value-added.

"All plan sponsors have different criteria, so some plans may want the opportunistic returns," says Ferguson, "but some investors coming to it naively may just grab the offer off the shelf and think, 'this is my opportunity to invest in international' — not recognizing that what they are really doing is making a decision not only to diversify their geography but to get into the higher-return and the higher-risk spectrum of real estate investing."

The universe of global and international real estate managers is large. Once a plan sponsor has decided on a vehicle for its global allocation, the next step is to find the right manager. The process is similar to how a domestic manager is selected —

meetings, presentations, finalists and then a winner. A global investment can take more time because of the complexity involved as well as the distance between the investor and the managers that are based overseas. Plan sponsors should resist the urge to quickly decide on a manager.

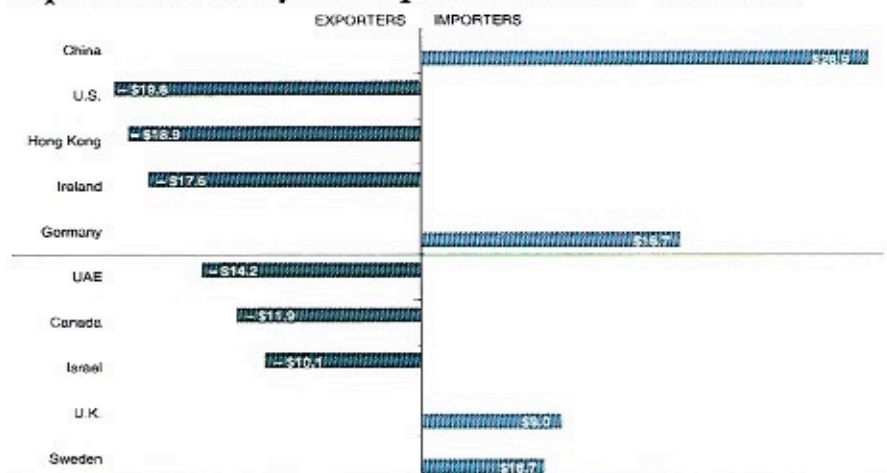
"Maintain patience while developing competency and take the time to understand the investment and macro dynamics," says Jones. "Some international markets are growing more quickly than the United States. International strategies are often dependent on successful growth and development. To optimize the plan sponsor's risk-adjusted returns, an international investment should have the same level of standards and return expectations as a U.S. investment. We have spent considerable time in different markets and sometimes we have invested and sometimes we haven't," he says.

To winnow the field, plan sponsors will meet with managers to get a sense of their capabilities. These managers travel to U.S. investors on road shows and conferences, and this is an opportunity for plan sponsors to meet them and get to know their offerings. Through this process, a short list can be developed, and the next step often is to visit the manager's offices and its people in their home country before a commitment is made.

MANAGING THE PROGRAM

Once a plan sponsor has made an allocation to a vehicle one of the next steps is to monitor the

Top 10 Countries by Net Acquisitions in 2007 (\$ billions)



Source: Real Capital Analytics

investment and build knowledge in the markets in which they are invested. This is accomplished several ways, including periodic reports supplied by the manager.

"The reporting is largely akin to U.S. reports, but there is more information to examine," says Jones. "An investor needs to take into consideration the roll-up of all the currencies, different tax practices, accounting and unique characteristics of certain markets."

Beyond the reporting, plan sponsors also will discuss the investment with their manager and learn the subtleties of these markets. "German apartment cash flows are more stable because people don't move as often — they move

investment could target a geographic area, for example, a pan-European vehicle or a pan-Asian vehicle, and finally, depending on the goals and objectives of a plan sponsor, a program can be fine tuned with investments in country-specific funds or property-specific funds, such as Asian industrial markets or European office markets. Not all plans will decide to build out a large overseas real estate program.

"A smaller plan with more limited resources will likely have to choose where it wants to focus its energy in international real estate investing," says Marsh. "Several options may be available depending upon their goals and philosophy, including a targeted geographic pri-

in the listed pricing is creating an attractive entry point — certainly, on a price to value ratio, real estate stocks are much cheaper now than they were 12 months ago."

Valuations in the direct markets are down, too. According to the IPD U.K. All Property Index (a measure of unleveraged direct real estate investments) returns were -1.1 percent in August 2008. For the 12 months ending in August, values are down 17.1 percent. A plan sponsor that has not invested in global markets may not have the confidence to invest in the United Kingdom or continental Europe, but now could be a good time to put capital in those markets.

"U.K. managers report that City of London real estate has recently declined to a level at which one can achieve opportunity target returns," says Jones. "Financing, however, is currently scarce. Investors may not understand the rapid change in valuation or have as high a degree of conviction until they have invested globally and are able to compare one market to another with a degree of confidence based on their knowledge of global markets."

Allocating capital across multiple global markets can help even out the ups and downs in a portfolio. For example, while the United Kingdom has declined significantly during the past 12 months, Japan's property markets have performed well. According to the IPD Japan Monthly Indicator (the index reports direct unleveraged investments), Japanese property returned 9.1 percent in 2008 through May.

Real estate market performance in the United Kingdom and Japan during the past 12 months are good examples of the benefits plan sponsors can gain by expanding a portfolio beyond domestic markets. Because commercial real estate values are tightly tied to the local economic cycle, investors that open their portfolios to a global playing field and build a program based on the economic prospects of regions, countries or cities, thus protecting a portfolio from poor performance in any one market and also exposing capital to opportunities across the world. ♦

Drew Campbell is a senior editor with **Institutional Real Estate, Inc.**

"The fundamentals at the real estate level have continued to be relatively sound, and many institutional investors correctly perceive that this markdown in the listed pricing is creating an attractive entry point."

— *Ritson Ferguson, CIO, ING Clarion Real Estate Securities*

every 14 years, whereas in the United States, people move every three years or so," says Jones. "The reporting does not always give that information. Common U.S. metrics are often not transferable to international real estate. It's easy to make assumptions and be wrong."

Through regular reports and conversations with managers, a plan sponsor can begin to learn and understand the issues associated with global investing — currency fluctuation, tax treatment, contract enforcement, etc. — as well as gauge the resources needed to manage global property investments — the time and staff resources needed to manage the investment. Plans also can measure the effect a global investment has on the overall portfolio and decide whether to move forward or not.

When a plan sponsor becomes comfortable with an initial global investment, it could begin to build a more robust program. A second

vate equity program, use of asset allocator funds, or even a global real estate securities program. My only recommendation for smaller plans with limited resources would be to avoid trying to be all things in all places at one time."

IS NOW THE TIME TO GO GLOBAL?

In the midst of a global financial crisis, it might seem like an inopportune time to invest in global real estate; however, for plan sponsors with a long-term horizon, values in many markets have declined and could be attractive.

"Interestingly, we have seen a marked pick-up in institutional investors' interest in global real estate investing because of the declining prices," says Ferguson. "The fundamentals at the real estate level have continued to be relatively sound, and many institutional investors correctly perceive that this markdown