

Understanding Real Estate's Value Proposition

While investment returns from publicly traded real estate securities have been more volatile than expected in the last number of years, over the long term, real estate securities have typically delivered investors attractive risk-adjusted returns when compared to other asset classes. In addition, publicly traded real estate securities generally give investors income stability, diversification, inflation-protection potential, and liquidity. The past may be a prologue in many situations, but we believe the long-term performance and differentiated investment attributes of publicly traded real estate (especially in the context of lower return expectations and heightened global unpredictability) warrants consideration of an allocation to the asset class.

Comprising in value the equivalent to anywhere from 10–90% of a country's GDP, commercial real estate is a sufficiently large asset class both globally (\$26 trillion) and domestically (\$6.2 trillion) to warrant consideration within a diversified investment portfolio.¹ Even when considering the substantial price correction witnessed from the latter half of 2007 through the end of 2009, the long-term performance of commercial real estate has demonstrated strong total return performance, stability of income returns, and lower correlations to other investment alternatives.

Relative to other asset classes, however, the assessment of real estate performance has been more complicated in the past as the preponderance of commercial real estate has been held in various private ownership and investment structures thereby creating opacity around performance metrics. Thankfully, over the past 10 years in particular, some of that opacity has been removed due to the growth in the securitized real estate market (driven by the increasing adoption of the real estate investment trust, or REIT, model and the development of the commercial mortgage-backed securities [CMBS] market) and the resultant wealth of public information. In addition to helping prove commercial real estate's value proposition, the growth in listed real estate securities (namely REITs) has added additional dimensions to the real estate proposition—liquidity, transparency, and governance.

Currently, the global listed real estate market is comprised of over 700 companies with a total equity market capitalization of \$1.5 trillion and ownership of \$2.7 trillion in commercial real estate. (See Exhibit 1.)

While there is some difference across the three primary regions in terms of commercial real estate weightings, listed market exposure is more balanced across the regions, with each major region comprising approximately 1/3 of the total.

As one would expect given its economic size and listed market maturity, the United States has the largest and most liquid listed real estate market comprising approximately 30% of the total

Exhibit 1
Sizing up the Global Listed Real Estate Market

Region	Commercial Real Estate (\$ millions, estimated)	Total Listed (\$ millions)	% Listed
Asia-Pacific	6,774	872	12.9
Europe	9,318	938	10.1
Africa/Middle East	795	39	4.9
Latin America	1,703	38	2.3
North America	7,681	828	10.8
Global	26,271	2,716	10.3

As of July 31, 2011

Estimated data is not a promise or guarantee of actual results and is subject to change.

Source: EPRA, IMF, Lazard

global listed market. The United States also has one of the longest track records of listed real estate performance, having originated the REIT model in 1960.

We highlight what we believe to be the key attributes of consideration when investing in listed equity real estate:

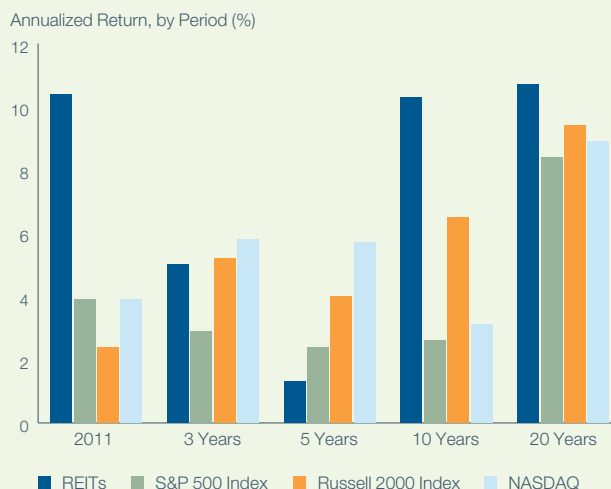
- Total return performance
- Diversification
- Income and Inflation protection
- Liquidity
- Transparency and governance
- Volatility

Total Return Performance

Within the United States, the commercial real estate asset class has generally provided competitive returns when compared to broad market indices. Through July 31, 2011, U.S. listed real estate, as measured by the FTSE NAREIT All Equity REITs TR Index, has delivered compounded annual returns that have outperformed stocks not only in 2011, but also for the last 10- and 20-year periods, as illustrated in Exhibit 2.

Performance against some of the equity benchmarks has been more moderate over the last few years as real estate has been impacted by the economic recession and financial crisis, but due to the good quality of the industry's underlying real estate assets and a recovery in the financing markets, in our view, many listed real estate companies have stable balance sheets (40% leverage, >2.0 fixed charge coverage) and we believe are well positioned to benefit from an economic recovery (even if tepid).

Exhibit 2
Performance Comparison for U.S. Listed Real Estate



As of July 31, 2011

Past performance is not a reliable indicator of future results.

Source: NAREIT

Of note, one of the benefits demonstrated by the public real estate market over the past three years is the flexibility in financing alternatives that are available to public companies as compared to private companies. While the “re-equitization” of public company balance sheets through stock issuance has taken a toll on short-term performance because of equity dilution, the benefit is that public real estate (both in the United States and internationally) currently has a much healthier balance sheet than that in the private markets. With continued leverage stress among banks and in the private market, we feel public real estate companies should be well positioned to accelerate earnings growth through strategic and accretive acquisitions in the coming years.

International real estate within developed countries also has demonstrated good returns as compared to international equities, but has performed slightly short of the United States over longer time periods (10 and 15 years), as illustrated in Exhibit 3.

While these data reflect only the developed country markets (given the short history and limited size of listed real estate within emerging market countries), we expect the combination of population growth, GDP-per-capita growth, and increasing growth in the REIT format to propel emerging markets real estate opportunities over the coming decade.

Exhibit 3 Performance Comparison for International Listed Real Estate

Annualized Return, by Period (%)



As of July 31, 2011

- 1 S&P Developed BMI Property ex-U.S. Index
- 2 MSCI EAFE Index
- 3 DJ U.S. Select Real Estate Securities Index
- 4 S&P 500 Index

Past performance is not a reliable indicator of future results.

Source: Bloomberg

Exhibit 4 The Sectors of the Real Estate Market

Real Estate Sector	Market Cap ¹ (\$ millions)	% of U.S. Listed Market	Economic Drivers	Key Tenants	Lease Duration
Office	67,044	13.9	Corporate profits, business segment growth, GDP	Corporations, professional service industries	5–10 years
Industrial	20,431	4.2	Consumer spending, retail sales	Logistics, manufacturing, retailers	3–5 years
Regional Malls	76,449	15.9	Disposable income, consumer sentiment	Soft goods retailers, jewelry, department stores	7–10 years (in-line)
Shopping Centers	36,171	7.5	Consumer spending, CPI, population	Grocery and drug, local necessity retail	3–5 years (in-line)
Single Tenant Retail	7,256	1.5	Consumer spending, CPI, population	Restaurants, banks, gas/convenience	10–15 years
Multifamily	68,047	14.1	Age cohort growth, interest rates	21–35 yr and 65+ age cohorts	9–12 months
Manufactured Housing	3,854	0.8	Interest rates, population, age cohort growth	55+ age cohort, lower-middle class families	
Diversified	36,488	7.6	Various	Various	Various
Lodging	24,672	5.1	Business spending, disposable income, consumer sentiment	Business and leisure travel	Daily (consumer); 10–15 years (management contract)
Health Care	50,097	10.4	Aging population, government	65+ age cohort	9–12 months (resident); 10–15 years (management contract)
Self Storage	24,689	5.1	Population	Adults	Monthly
Timber	23,461	4.9	Construction, new home sales	Construction industry	Various
Mortgage REITs	42,344	8.8	Interest rates, financial system health	Real estate owners	3–10 years ²

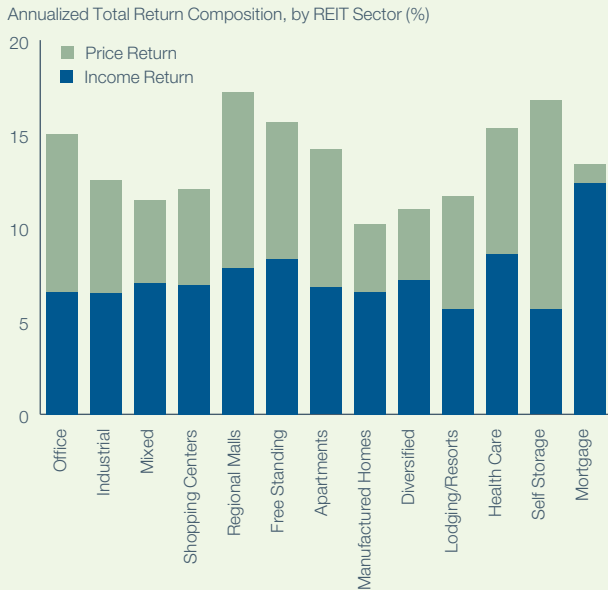
As of July 31, 2011

1 Implied

2 Maturity Duration

Source: NAREIT, Lazard

Exhibit 5
Composition of Real Estate Returns



For the period 1994–2010.
Past performance is not a reliable indicator of future results.
Source: NAREIT, Lazard

as 1) the underlying key economic or demographic drivers of a particular sector’s demand, 2) the primary tenant concentrations, and 3) lease structure both in terms of duration and rent exposure to consumer price inflation (CPI). While these elements help drive the ability for diversification within a real estate portfolio, they also are among the components that allow real estate to generally perform with lower correlations to other investment classes, and also provide low correlations across countries.

The diverse exposures across the various asset classes in the United States (see Exhibit 4) should help cause varied performance of each sector and provide the ability to drive lower correlations and risk through a diversified real estate portfolio.

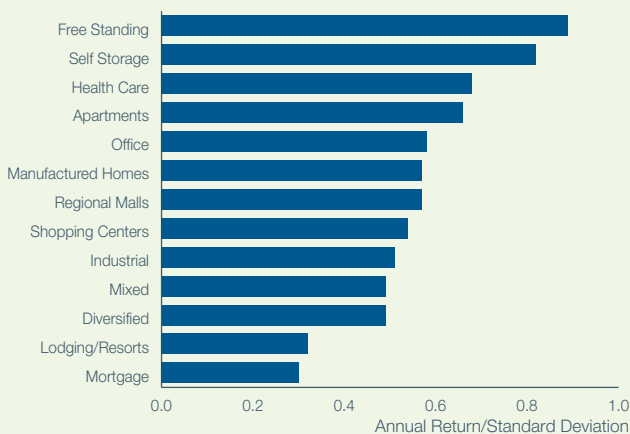
Understanding the true risk profile of each sector within real estate, and how the economic drivers, lease structures, and tenant credit health (among others) relate to value is critical to the assessment of real estate investments. For example, Exhibit 5 looks at the composition of each sector’s average returns from 1994 to 2010. Taking into consideration the income-orientation of the real estate asset class and the history of REITs paying out consistent dividends, one might assume Mortgage REITs (highest dividend to price return mix) to be a low-volatility pick while Self Storage REITs (lowest dividend to price return mix) would conceivably be of higher volatility.

Diversification – of Exposure, Cash Flows, and Geography

Creating an investment portfolio of assets that behave differently across market conditions has always been a key element to managing and reducing risk. Traditionally, direct real estate investors have looked to build portfolio diversification by property, tenant, business sector, asset sector, and geography. This cross-set of elements creates diversification due to differences across sectors such

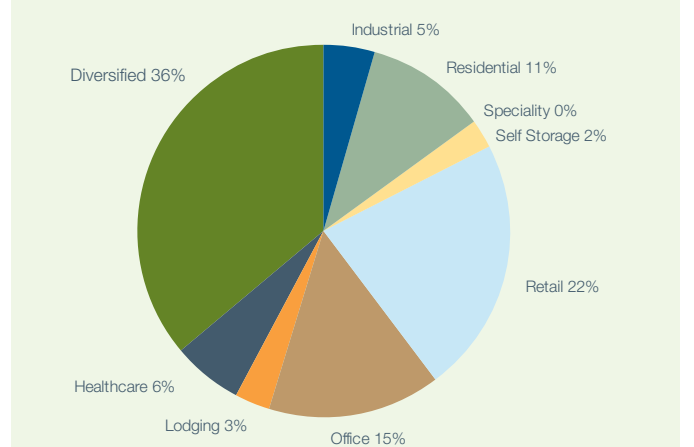
In fact, the opposite is the case. Mortgage REITs have the highest volatility of total returns and Self Storage REITs, while not the lowest in volatility, are behind only Free Standing Retail (the most investment credit orientated of any sector) and Manufactured Homes (lowest tenant turnover of any sector). (See Exhibit 6.) This apparent mis-match is due to the differing compositions in the underlying fundamentals and structure of each sector. For example, Self Storage REITs have been the beneficiaries of strong,

Exhibit 6
Volatility of Returns, by Sector



For the period 1994–2010.
Past performance is not a reliable indicator of future results.
Source: NAREIT, Lazard

Exhibit 7
Global Listed Real Estate, by Sector



As of June 30, 2011
Source: EPRA

multi-year increases in demand due to population growth and increasing consumer consumption. Meanwhile, due to the nature of a facility whereby a single location has hundreds of leases (comprised of both individuals and businesses), the cash flow is well diversified and ultimately secured by goods stored within a unit. As a result, the Self Storage REIT sector has exhibited both solid earnings growth and dividend income. These differences can be utilized to enhance portfolio diversification.

Moving globally, an investor can continue to build diversification. There is a healthy diversification by asset type and geography among global listed real estate securities, providing investors with

differing levels of exposure to various components of regional or country economies as illustrated in Exhibit 7.

Not only is the investment universe of listed commercial real estate large (\$1.5 trillion market capitalization), the investment opportunities are spread across 30+ countries and over 700 companies owning in excess of 68,000 distinct properties.² The last component then, is to link real estate's underlying diversification potential (again, by property, tenant, etc.) with 1) listed real estate's performance across countries and 2) listed real estate's performance as compared to other investment classes.

As expected, the differences in economic patterns, population growth, market maturity, and country stability do create the ability to gain meaningful diversification by expanding an investment set to the global markets. (See Exhibit 8.)

However, of note, the correlation against broad equity benchmarks, as illustrated in Exhibit 9, is not as low as it has been historically, due, in our view, to two primary reasons. The first is that over the last decade, led by the United States, an increasing number of listed real estate companies have been included in broad benchmark indices creating an index drafting effect. For example, in 1996 there were no U.S. REITs in the S&P 500 Index. Today, 15 REITs comprising 45% of REIT market capitalization are included in the S&P 500. In total, approximately 75% of the REIT market (by capitalization) is included in the S&P 500, S&P 400 Mid Cap, or S&P 600 Small Cap Indexes.

For an industry with long-term hold attributes and an income-orientation, we believe this index inclusion has cemented REITs' stronger short-term linkage with broader equities. The second factor is that listed real estate has not been immune to the enhanced correlation across all asset classes over the last 3-4 years. While

Exhibit 8
Country Correlation of Listed Real Estate Total Returns

	Asia-Pacific				Europe		
	Australia	Hong Kong	Japan	Singapore	France	Germany	UK
Australia							
Hong Kong	0.40						
Japan	0.40	0.52					
Singapore	0.53	0.70	0.56				
France	0.57	0.38	0.43	0.49			
Germany	0.53	0.42	0.41	0.53	0.70		
UK	0.52	0.40	0.45	0.52	0.69	0.61	
US	0.46	0.36	0.36	0.41	0.53	0.50	0.57

As of August 12, 2011

Note: Correlation coefficients for period January 2001–August 12, 2011 based on monthly returns, except for period ending August 12, 2011. Past performance is not a reliable indicator of future results.

Source: SNL, Lazard

Exhibit 9
Total Return Correlation, Real Estate to Broad Equity

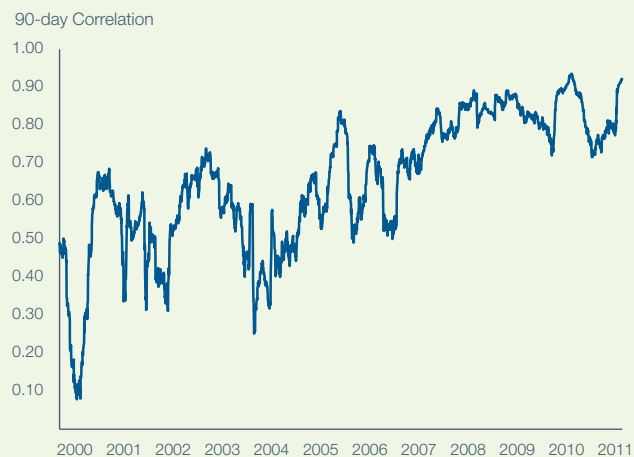
	Real Estate				Broad Equities			
	Asia-Pacific RE	Europe RE	North America RE	Global RE	MSCI World Index	Russell 2000 Index	S&P 500 Index	SNL All Financial Institutions
Asia-Pacific RE								
Europe RE	0.64							
North America RE	0.48	0.62						
Global RE	0.83	0.83	0.84					
MSCI World Index	0.72	0.80	0.72	0.88				
Russell 2000 Index	0.59	0.66	0.81	0.83	0.89			
S&P 500 Index	0.61	0.68	0.77	0.83	0.96	0.93		
SNL All Financial Institutions	0.56	0.65	0.77	0.79	0.84	0.84	0.89	

As of August 12, 2011

Note: Correlation coefficients for period January 2003–August 12, 2011, based on monthly returns except for period ending August 12, 2011. Past performance is not a reliable indicator of future results.

Source: SNL, Lazard

Exhibit 10
Correlation of U.S. Equity REITs and S&P 500 Index



As of September 12, 2011

Past performance is not a reliable indicator of future results.

Source: SNL

too early to draw substantive conclusions, real estate's correlations trend down during periods of seeming stabilization in the financial crisis and elements of a slow economic recovery, as illustrated in Exhibit 10. However, as soon as uncertainty increases, correlations pop back to very high levels.

Income and Inflation Protection

One of the primary investment characteristics of commercial real estate is that a property provides strong and stable income flows.

The stability of the income flow is derived from the multi-year term of most leases while the strength is generated from the contractual nature of the lease structure through which tenants gain access to the use of the property. The creation of the U.S. REIT structure in 1960 was an attempt (successful as it turns out) to create an income-orientated investment vehicle that would mimic the strong and stable income flows of direct real estate. Due to this structure, returns driven primarily by dividends have become one of the chief drivers in listed real estate performance, both historically, and prospectively, given current high dividend yields and expectation for future dividend increases. (See Exhibit 11.)

Average annual total returns illustrate the benefit of REITs' steady income returns. While REIT stocks have historically exhibited strong price appreciation, like equity stocks, the dispersion of returns can vary widely. In contrast, over the past 20 years REIT dividend returns have been more consistent and stable, averaging 7.76% over that period with a standard deviation of only 2.26. This represents approximately 60% of REITs average annual total return of 12.2%. The result of U.S. REIT returns in relation to dividends is also consistent with direct real estate (as measured by the NCREIF Property Index–NPI). For the NPI, 66% of total returns are attributed to dividend yields.³

The income return performance is certainly attractive, but the relation of income return and its growth relative to inflation helps substantiate real estate's role as an inflation hedge. Over the past 10 years, with the exception of 2008 and 2009 (i.e., during the impact of the financial crisis), the growth in U.S. REIT dividends has been in excess of inflation. (See Exhibit 12.)

Exhibit 11
Composition of U.S. REIT Returns

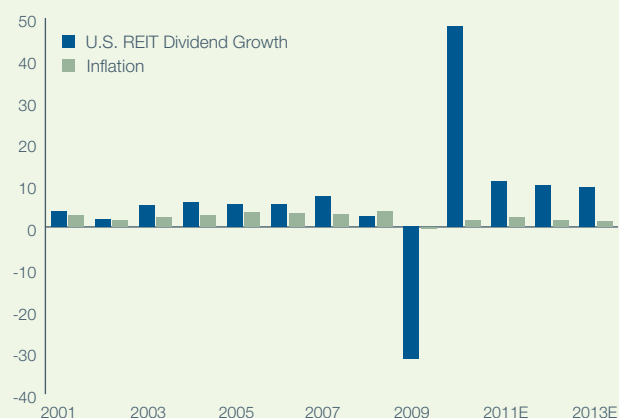


As of December 31, 2010

Past performance is not a reliable indicator of future results.

Source: NAREIT

Exhibit 12
Real Estate Dividends vs. Inflation: United States



For SNL and NAREIT data, as of December 31, 2010; Lazard estimates as of August 15, 2011.

Estimated data is not a promise or guarantee of actual results and is subject to change.

Source: SNL, NAREIT, IMF, Lazard

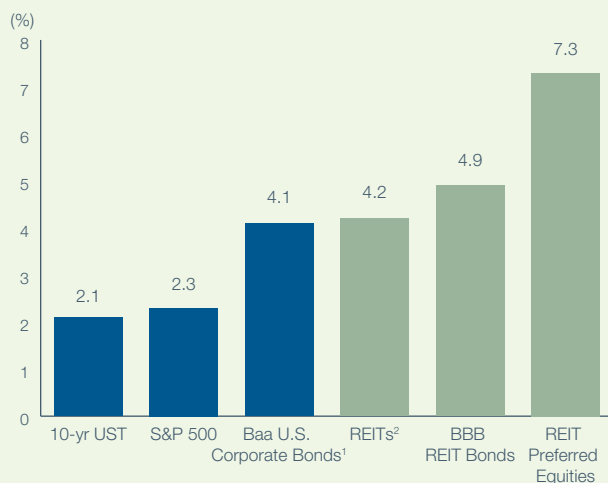
Due to the current recovery in the commercial real estate markets, both from a repair in the financing markets and an improvement in property fundamentals, U.S. public REIT balance sheets are currently solid. As a result, REITs are beginning to pass through cash flow growth to investors in the form of dividends. We currently expect that U.S. REITs will exhibit dividend growth well ahead of consensus estimates for U.S. inflation at 1.4–1.7%. With the current high yields, as illustrated in Exhibit 13, as compared to other alternatives, we feel REITs should continue to compare favorably against other income alternatives.

Moving outside the United States, the income performance of global listed real estate has kept ahead of inflation (see Exhibit 14), but our expectation for future performance relative to inflation is not as substantial as in the United States. The difference here is that the tax transparency/pass-through nature of the U.S. REIT model is not as prevalent in other countries, so from an overall listed perspective a smaller percentage of cash flow growth is distributed.

Liquidity

The U.S. listed real estate market controls approximately \$750 billion in commercial real estate, has an equity capitalization of approximately \$450 billion and trades between \$3.5–4 billion of equity daily. In comparison, the total U.S. commercial real estate market is approximately \$6.5 trillion, has between \$1.1–1.3 trillion of equity, and is on track to buy/sell a total of \$250 billion of assets for the entire 2011, or the equivalent of approximately \$200 million in equity value per trading day.⁵ To put it more succinctly, listed real estate securities are far more liquid than direct real estate. In addition to the raw trading liquidity, the nature of public securities

Exhibit 13
Current Yields



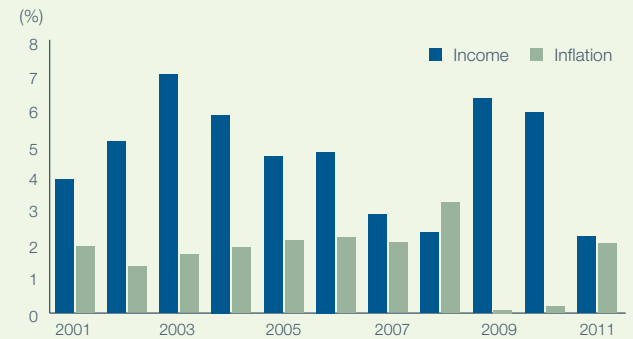
As of August 15, 2011

¹ As represented by the Barclays Corp Bond Index

² As represented by the FTSE NAREIT U.S. Real Estate Index

Source: Bloomberg, NAREIT, Lazard

Exhibit 14
Real Estate Dividends vs. Inflation: Global (Developed)



As of August 15, 2011

Source: NAREIT, EPRA, IMF, and Lazard⁴

provide a lower cost of trading, faster execution, and a more certain execution environment.

Historically, this liquidity advantage was not as stark because of the listed market's small size, but the growth in listed company market capitalizations has built up the liquidity to a point where investors can enter or exit most investment positions with relative ease and with less concern of moving the market. (See Exhibit 15.)

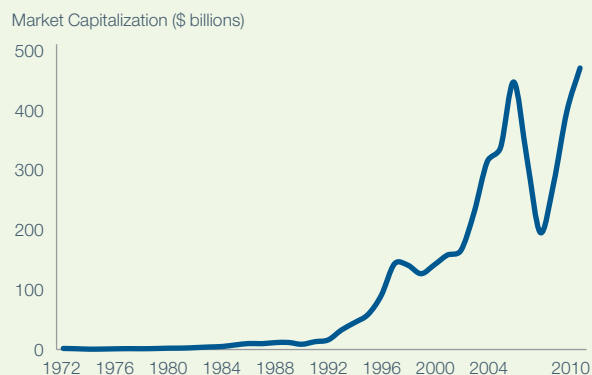
The global listed real estate markets are following the same development arc as the United States, and are witnessing increasing overall market capitalizations and trading volumes. For other countries (both developed and emerging), the difference in cost and efficiency of acquiring real estate exposure through listed securities versus going direct is even more pronounced. In our view, the result of this large cost and efficiency advantage of listed over direct should put the growth of listed real estate internationally on a faster track than the United States.

Transparency and Governance

While the benefits of transparency and governance extend to most public companies, and therefore is not in and of itself a large comparative benefit for listed real estate relative to other equities, transparency and governance is a substantial differentiator between public and private real estate investment alternatives. Compared to private real estate investments, listed real estate generally provides operating and portfolio-level transparency as well as strong corporate governance.

The one area in which the REIT format does provide an advantage over other capital intensive sectors is in tax transparency due to the pass through nature of a REIT's taxable income to shareholders in the form of dividends. Therefore, because the REIT is required to distribute at least 90% of taxable income to maintain a tax-free corporate status (U.S. REIT format), shareholders

Exhibit 15
U.S. REIT Equity Market Capitalization Growth



As of August 31, 2011
Source: NAREIT

typically receive stable, consistent dividends while the company does not have to give as much consideration to the tax impact of corporate finance or investment decisions. Especially important to tax sensitive investors, on average 68% of REIT annual dividends qualify as ordinary taxable income, 12% as return of capital, and 20% as long-term capital gains.

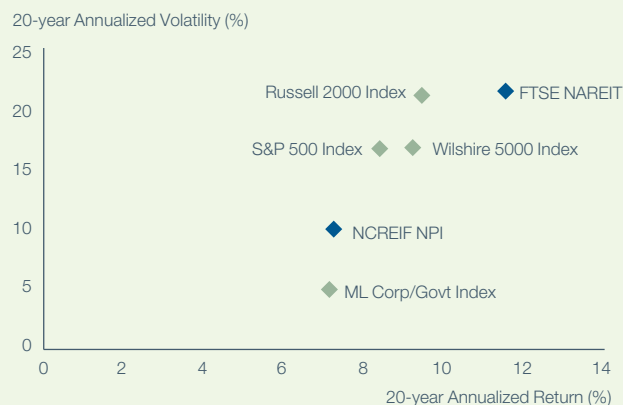
Volatility: The Cost of Performance

As mentioned, the income and credit orientation of real estate has helped smooth out annual returns, but even with that smoothing effect, the increasing volatility (as well as higher market correlations) of listed real estate securities over the last decade has been unexpected. We attribute this volatility increase to both a number of broader market factors such as electronic trading (that has heightened overall market volatility), and to real estate-specific factors such as average lower float volumes for listed real estate companies, a high percentage of the listed market's inclusion in broader market indices, and increased speed of real estate data dissemination.

Due to this volatility increase, it is necessary to risk-adjust the total return performance of real estate. In the context of risk-adjusted returns, the performance of U.S. commercial real estate falls more in line with other equity classes, but still above the risk-adjusted performance of both large and small cap equities, as illustrated in Exhibit 16.

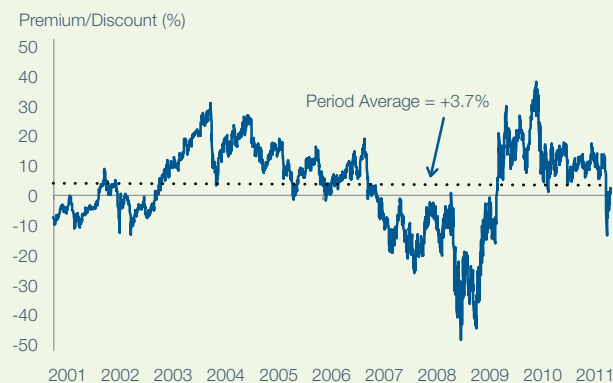
For the real estate asset class, volatility should also be measured against real estate values, as defined by net asset value (NAV). Exhibit 17 shows data from Greenstreet Advisors, a leading research group on REIT securities, who found that U.S. REITs traded at an average 3.7% premium to NAV over the last 10 years, although they exhibited significant volatility around this average.

Exhibit 16
Risk/Reward Profile of Real Estate



As of August 15, 2011
Source: Bloomberg, NAREIT, Lazard
Past performance is not a reliable indicator of future results.

Exhibit 17
U.S. REITs: Price vs. Underlying NAV



As of August 31, 2011
Source: Greenstreet Advisors

This matches data from other research groups that found REITs to trade close to underlying asset values over even longer time frames.

This suggests that there is a long-term, durable relationship between public and private real estate. On a short-to-medium-term basis though, there can exist a sizable disconnect between the two valuations. We believe that the short-term price based volatility should be viewed as the “cost” for access to the other attributes of listed real estate. But in addition, for the knowledgeable real estate investor this short-term volatility, especially relative to private real estate values, creates trading opportunities for alpha creation. This is possible due to the fact that listed real estate values migrate to net asset value over time, and therefore over a long hold period (for a similar portfolio and capital structure) returns should be consistent between a public or private real estate investment.⁶

Conclusion

Investing in listed real estate securities, especially within the United States, has proven to provide sustainable and durable returns to investors that enhances an overall investment portfolio through income stability, diversification, and above inflation income growth. Due to significant structural enhancements over direct real estate, listed real estate also provides enhanced liquidity and governance as compared to private real estate albeit with greater short and mid-term volatility as the “cost” for the structural enhancements. Looking out over the next decade, in our view real estate’s strong income characteristics and differentiated attributes should provide a good foundation for listed real estate investments. Meanwhile, growth in global listed real estate opportunities should accelerate as emerging markets move closer toward developed country status. We believe investors would do well to consider the role exposure to listed real estate can provide to a portfolio.

About the Authors

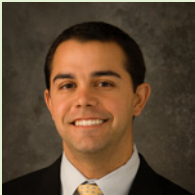


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Christopher Hartung is a Client Portfolio Manager on Lazard's Global Real Estate Securities team, focusing on investment strategy and research. He began working in the

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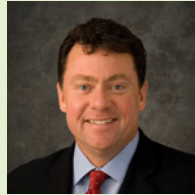


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Notes

- 1 Source: European Public Real Estate Association (EPRA), EPRA News Issue 39, July/August 2011.
- 2 Source: SNL Financial, August 1, 2011.
- 3 Tse, Palumbo, Ziering, Cornell Real Estate Review, July 2011.
- 4 Aggregate inflation data is a GDP-weighted calculation adjusted for the underlying country exposure of the FTSE EPRA/NAREIT Global Real Estate Index, Developed Markets Series.
- 5 Sources: Lazard, NAREIT, EPRA, and Real Capital Analytics.
- 6 Yuuns Hansz Kennedy, Greenstreet Advisors, December 2010.

Important Information

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