



Diversification through real estate investment

The recent global financial crisis and downturn in the real estate market has triggered widespread risk-aversion among investors. Once the worst of the crisis passed, investors and money managers were left with the task of carefully reappraising risk and revisiting performance expectations of every asset class in order to rebuild investment portfolios. This column reviews the diversification benefits of private real estate within investment portfolios.

Private real estate is defined as any private property ownership. Public real estate is defined as property owned in shares and is traded through public offerings.

Because private real estate has a low or negative correlation with stocks, bonds and public real estate investment trusts (REITs), it may help smooth out fluctuations in returns within a traditional portfolio of stocks and bonds. A low correlation with other asset classes suggests that private real estate returns generally do not move in tandem with the returns of bonds, equities or public REITs.

Private real estate's low correlation also stems from the valuation methods. Private real estate utilizes appraisal-based valuations, which are much less sensitive to short-term market volatility than daily stock market valuations of publicly traded REITs.

Publicly traded real estate such as REITs are subject to extreme market fluctuations and are highly correlated to stocks. Because private real estate is typically valued quarterly as opposed to daily, private real estate values react more slowly and less severely to shocks in the economy and the investment market than public real estate. Its volatility has historically been below that of the general market and real estate equities through previous investment cycles.

"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."

~ Warren Buffet

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In the past cycle, the total return index for public real estate reached its peak five quarters before private real estate returns. According to "The Case for Real Estate" by ING REIM Research & Investment Strategy, this past performance lends support to the idea of the public real estate markets leading the cycle relative to private real estate. Moreover, the strong recovery of REITs since 2009 (Total Return Index up 173% from February 2009 to May 2011 period) may be a harbinger of robust returns in private real estate over the next several quarters, if not years.

Since each investment in private real estate is unique in terms of location, size, characteristics, value and other factors, each real estate portfolio provides the potential to diversify geographically and strategically and to build an investor-tailored portfolio.

Over the past 10 and 15 years, private real estate returns have even outperformed the S&P 500, the Dow Jones Industrial Average, the Russell 2000, and the Barclays Capital Government Bond Indices.



Moreover, private real estate has historically delivered income returns for the period 2000-2010 and 7.7% for the period 1978-2010.

Private real estate has shown relatively low volatility, and has achieved among the highest risk-adjusted returns among the major asset classes over the past three decades (1978-2010). That means that for each unit of risk, it is estimated that private real estate has provided higher returns than stocks and public real estate, and has matched the bond index.

The low or negative correlations of private real estate returns with the returns of bonds, equities and public REITs suggest that it can be an effective diversifier, leading to lower volatility of portfolio returns and enhanced returns for a given level of risk.

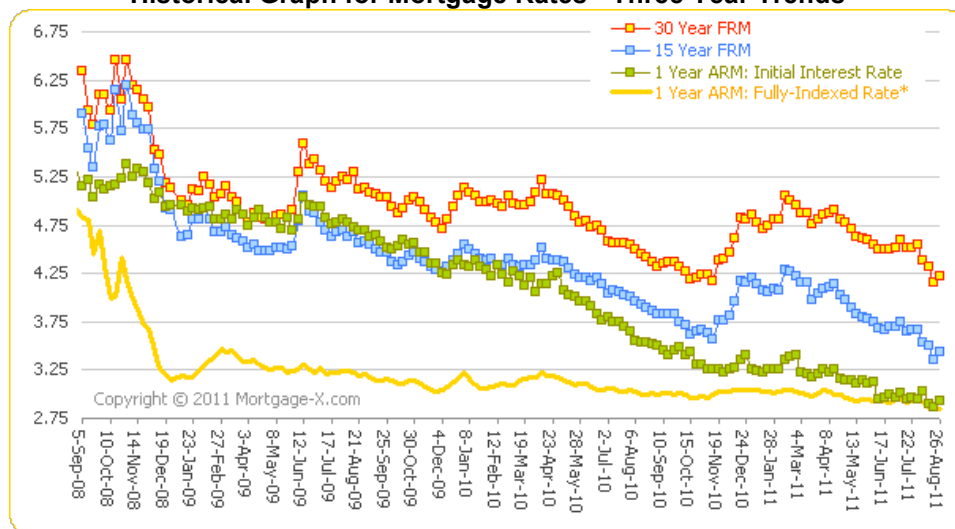
This is particularly important in an increasingly unpredictable global economy. As the country appears to be in the initial stages of a cyclical recovery, it is anticipated that the long-term benefits of private real estate will persist, much like in the past. Diversification of an investment portfolio through private real estate will benefit investors across the risk-return spectrum.

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"In the business world, the rear view mirror is always clearer than the windshield." ~ Warren Buffet

Interest Rate Trends

Historical Graph for Mortgage Rates - Three Year Trends



Three year trends of mortgage rates: 30-Year FRM, 15-Year FRM, 1-Year ARM

* Fully-Indexed Rate = index (1-year [CMT](#)) + margin (assuming a 2.75% margin)

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