Revisiting The Truth About Real Estate Allocations

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Each year since 2010, Cohen & Steers has published *The Truth About Real Estate Allocations*. This series has provided an annual performance comparison of public and private real estate markets over various time frames, both short and long term.

While markets have changed significantly since we began the series, our findings have been consistent, year after year: listed real estate continues to outperform nearly all forms of institutional private real estate funds, regardless of the time periods in the study.

Executive Summary

Each year at this time, Cohen & Steers' *Truth Series* assesses the performance of public and private real estate markets. Once again, based on 2012 results, our analysis of short- and long-term trends pointed to the outperformance of listed real estate, compared with nearly all categories of private real estate funds.

- Listed REITs consistently outperformed core and value-added real estate funds, while providing the ongoing benefit of liquidity.[(1)]
- Returns for opportunistic funds were comparable to listed REIT returns over the long term; however, the return cycles for these two strategies have been out of phase, resulting in distinct periods for each and creating opportunities for complementary diversification benefits between the two strategies.[(1)]
- Core and value-added fund investors have not experienced any return premium in exchange for illiquidity.[(1)]
- Assuming the vintage year is selected properly, opportunistic funds have been attractive for distressed, capital-appreciation-oriented real estate strategies.[(1)]

With these findings, *The Truth About Real Estate Allocations*, first published in 2010, still holds true. The following performance summary provides a more comprehensive update based on the 2012 results of our study.

(1) Listed REITs are represented by the FTSE NAREIT Equity REIT Index (NAREIT). Core, Private Real Estate is represented by the NCREIF Fund Index—Open-End Diversified Core Equity Index (NFI-ODCE). Core value-added and opportunistic private real estate funds are represented by the respective NCREIF Townsend Indexes for these categories. See page 13 for index definitions.

2012 Performance in Review

Listed REITs vs. Core Private Real Estate Funds

Again in 2012, listed REITs significantly outperformed core private real estate funds on the basis of one-year total returns. But far more significant, in our view, was the consistent outperformance of REITs over longer time frames, ranging from three to 30 years.

The greater relevance we attach to longer-term comparisons reflects the measurement shortcomings we find in private real estate funds. To put this into perspective, listed REITs reflect transaction prices in a liquid market, while private real estate returns are based on smoothed appraisal-based methodologies. This creates a lead/lag relationship in how the data are reported, which can skew the comparison of returns, particularly over shorter time frames with less extensive data. However, the lead/lag tends to diminish with longer-return series, making these comparisons more relevant.

Exhibit 1 compares the performance of listed REITs with those of core private real estate funds. Listed REIT returns exceeded those of private real estate funds in all periods. Both categories show results on a leveraged basis, which magnifies the volatility of returns—generally exacerbating negative returns in real estate downturns and enhancing returns in up markets. Core private real estate funds typically operate with less leverage than listed REITs.

Over the long term, higher leverage has been a benefit to listed REITs. As an illustration, we leverage-adjusted the FTSE NAREIT Equity REIT Index (NAREIT) by assuming the index was 22% leveraged like the NFI-ODCE Index for the 10-year period from 2002 through 2012. Holding all else constant, the NAREIT outperformance of 493 basis points for the past 10 years would have been reduced by approximately 110 basis points. As such, higher leverage appears to explain less than one-quarter of the outperformance over the long run.

Exhibit 1: Annualized Total Returns Through 2012
Listed REITs vs. Diversified Core Equity Funds

	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years	30 Years
Listed REITs[a]	18.1%	17.8%	5.5%	11.6%	8.8%	11.1%	11.8%
Core Private Real Estate Funds (gross)[b]	10.8%	14.4%	-1.1%	6.7%	8.1%	8.1%	7.1%
Listed vs. Core Private Real Estate Performance (bps)	726	348	657	493	70	301	476

At December 31, 2012. Source: Cohen & Steers, NAREIT and NCREIF.

Performance data quoted represents past performance. Past performance is no guarantee of future results. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin.

(a) Listed REITs are represented by the FTSE NAREIT Equity REIT Index.

(b) Core Private Real Estate Funds are represented by the NCREIF Fund Index—Open-End Diversified Core Equity Index (NFI-ODCE).

See page 13 for index definitions.

Listed REITs outperformed core private real estate funds over all periods analyzed in our 30-year study.

Listed REITs vs. Core, Value-Added and Opportunistic Funds

Core funds have the longest index history among private real estate fund categories. For this reason, our performance comparison of value-added and opportunistic funds covers a shorter history of returns. In 2012, value-added and opportunistic private real estate funds had total returns of 12.3% and 12.6%, respectively, compared with 18.1% for listed REITs. Exhibit 2 compares the longer-term performance of these categories through December 31, 2012.

Exhibit 2: Annualized Total Returns Through 2012
REITs vs. Core, Value-Added and Opportunistic Strategies

	5 Years	10 Years	15 Years
Listed REITs (net)[a]			
Active	6.6%	12.3%	9.4%
Passive	5.1%	11.3%	8.5%
Private Real Estate Funds (net)			
Core Private Real Estate Funds[b]	-2.0%	5.7%	7.1%
Value-Added Private Real Estate Funds[c]	-7.1%	4.3%	5.8%
Opportunistic Private Real Estate Funds[d]	-6.0%	10.6%	10.4%

At December 31, 2012. Source: Cohen & Steers, eVestment Alliance, NCREIF and The Townsend Group.

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(a) Active REIT manager returns are based on data from eVestment Alliance. Returns listed under Passive REITs reflect the FTSE NAREIT Equity REIT Index returns, less 30 basis points as a proxy for passive management fees. (b) Core Private Real Estate Funds are represented by the NCREIF Fund Index—Open-End Diversified Core Equity Index (NFI-ODCE). (c) Value-Added Private Real Estate Funds are represented by the NCREIF Townsend Value-Added Fund Index. (d) Opportunistic Private Real Estate Funds are represented by the NCREIF Townsend Opportunistic Fund Index.

See page 13 for index definitions.

Rolling-Return Analysis

Another accepted performance analysis technique is to base the comparison on rolling-period returns. This addresses any bias in the selection of period endpoints and the lead/lag measurement differential between private and public real estate return series. Exhibit 3 compares historical rolling returns for listed REITs and the three private real estate fund strategies. A four-quarter time lag between the return series of listed-REIT and private-fund performance was used to account for the measurement differences of appraisal-based private-fund performance.

Listed REITs outperformed core and value-added funds at least 75% of the time over all time periods. Looking at the past 15 years, REITs outperformed core real estate funds 97% of the time and value-added funds 96% of the time. Compared with opportunistic funds over the past 15 years, REITs outperformed just 21% of the time.

Listed REITs consistently outperformed core and value-added private real estate over rolling-year periods.

Exhibit 3: Rolling-Return Performance Analysis Through 2012
REITs vs. Core, Value-Added and Opportunistic Funds

	Rolling 5 Years	Rolling 10 Years	Rolling 15 Years
Number of Periods Starting Q1 1978	117	97	77
Listed REITs[a]	11.3%	12.3%	12.3%
Core Private Real Estate Funds (gross)[b]	7.8%	7.5%	7.4%
% of Periods Listed REITs Outperform	79%	96%	97%
Number of Periods Starting Q2 1983	96	76	56
Listed REITs[a]	10.8%	11.5%	11.3%
Value-Added Private Real Estate Funds (gross)[c]	7.2%	8.1%	8.5%
% of Periods Listed REITs Outperform	75%	78%	96%
Number of Periods Starting Q4 1988	74	54	34
Listed REITs[a]	11.3%	11.5%	11.8%
Opportunistic Private Real Estate Funds (gross)[d]	14.1%	15.5%	15.7%
% of Periods Listed REITs Outperform	39%	14%	21%

At December 31, 2012. Source: Cohen & Steers, NCREIF and The Townsend Group. Returns are simple averages of compounded annual return snapshots.

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Insights on Volatility and the Cost of Illiquidity

The Absence of Illiquidity Premiums in Asset Allocation Models

The cost of illiquidity is rarely factored into asset allocation decisions.

Despite the well-publicized woes of many investors during the financial crisis, the cost of illiquidity remains an under-appreciated factor in the allocation process. We believe most investors would agree that liquidity is worth something. However, a formal illiquidity return premium is rarely applied to asset allocation models and has not been well executed in practice.

Since most investors buy real estate for the long term, daily or quarterly liquidity is not deemed to be of considerable value. We concur, and recognize that different investors have varied investment horizons or levels of visibility on their long-term funding needs. As such, there is no single return premium for illiquidity. Even though a one-size-fits-all premium does not exist, this factor should not be ignored when quantitatively assessing investment options. We believe that, for most institutions, this illiquidity return premium ranges from 150 to 500 basis points per year.

- Our discussions with asset consultants and clients indicate that the expected annual returns from private real estate should be 300 basis points more per year than from public investments to compensate for the lockup period. This return premium should be a function of 1) the duration of the lockup period, and 2) the riskiness of the underlying investment.
- Applying the illiquidity return premium to actual 10-year historical results helps illuminate what we see as a mispricing in the market. Over the past 10 years, listed REITs outperformed core private real estate funds by 493 basis points. When combined with the 300-basis-point return premium expected by private real estate investors, this gap in performance would rise to 793 basis points.

In our view, this mispricing has to do with perceptions, as well as some misconceptions, about volatility and liquidity.

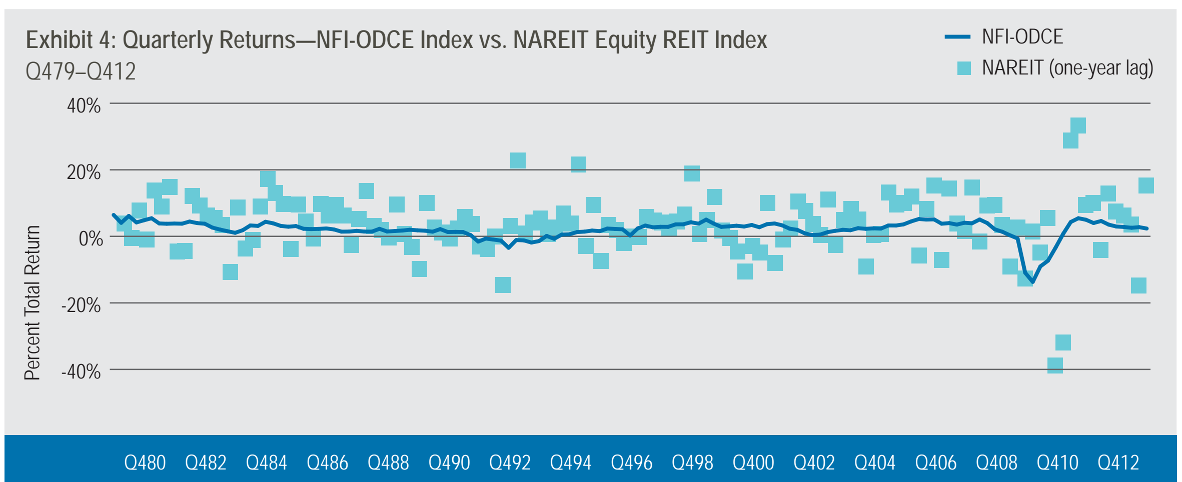
The Distortions of Appraisal-Based Valuations in the Risk-Measurement Process

The biggest "miss" we see in the market is that investors place too much emphasis on short-term volatility as a measure of investment risk. Unfortunately, for the purpose of asset allocation, the relative volatilities of listed REITs and private real estate cannot be compared using traditional methods. This has led some to conclude erroneously that 1) private real estate is not volatile and 2) listed REITs are much more volatile than private real estate.

Most asset allocation models are structured to capture the risk of an asset class through the standard deviation, or volatility, of either monthly or quarterly returns. In our view, however, using this methodology to determine allocations between private and listed real estate is fundamentally flawed and will bias results toward an over-allocation to private real estate.

Simply put, the volatility figures are not comparable. For listed REITs, returns are derived from a true transaction-based, market-clearing price, while for private real estate, returns are based more on a long-term, appraisal-based equilibrium price. We illustrate this point in Exhibit 4, which compares quarterly returns of the NFI-ODCE Index and the NAREIT Index from 1979 (the inception date of the NFI-ODCE Index) through 2012. Note that the quarterly returns for public real estate are lagged by four quarters to more accurately coincide with the appraisal-based returns of the NFI-ODCE Index.

Investors tend to place too much emphasis on volatility and not enough on liquidity risk.



	Listed REITs[a]	Core Private Real Estate Funds[b]
Mean Quarterly Return	3.5%	2.0%
Minimum Quarterly Return (quarter)	-38.8% (Q4 2008)	-13.7% (Q1 2009)
Maximum Quarterly Return (quarter)	33.3% (Q3 2009)	6.4% (Q4 1978)
Range (from min. to max.)	72.1%	20.1%
Total Observations	136	136
Standard Deviation of Quarterly Returns	9.2%	2.8%

At December 31, 2012. Source: Bloomberg, NAREIT and NCREIF.

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(b) Core Private Real Estate Funds are represented by the NCREIF Fund Index—Open-End Diversified Core Equity Index (NFI-ODCE).

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Measuring short-term volatility is appropriate for short-term investors, but less so for long-term investors.

While listed REITs provided a higher average quarterly return (3.5%), there was clearly greater volatility, as reflected in a much wider range in the Index's minimum to maximum return, and its higher standard deviation of quarterly returns (9.1%). Thus, from a quarterly vantage point, the NAREIT Index has been much more volatile than the NFI-ODCE data series, with a mean return of 2.0% and volatility of 2.8%—if appraisal shortcomings are not taken into account.

We would be remiss not to acknowledge that the volatility of U.S. listed REITs was particularly high during the financial crisis. The true depreciation in unlevered asset values from convulsing capital markets and an economy in severe decline created historically high volatility. Thus, for investors with a short-term, 12–24 month time frame, quarter-to-quarter market volatility may be the appropriate measurement period. However, we believe investors without such investment horizon constraints should balance quarterly volatility with other longer-term metrics in order to quantify true risk.

An Alternative Approach to Volatility as a Measure of Risk

While the NAREIT Index data provide a valid reflection of listed REIT market-based quarterly volatility, the NFI-ODCE data are not accurate bellwethers of core private real estate volatility on a short-term basis. The reason is that appraisers inherently take a long-term view of values, guided principally by comparable sales and discounted cash flow models. In fundamentally volatile times for the economy or capital markets, appraisal values do not reflect true transaction-based volatility. The fact pattern for comparable sales may take many months, or even more than a year, before it is reflected in appraisals. Thus, our positions on this issue are simple:

- The appraisal-based nature of the NFI-ODCE series renders the volatility of quarterly returns a poor proxy for true risk.
- Any comparison of NFI-ODCE with the NAREIT Index or any liquid security will bias one to over-allocate to core private real estate.
- As such, a better, less systematically biased, measure of risk must be considered.

We believe appraisal-based valuations understate true volatility.

Measuring Fundamental Risk for Long-Term Investors

In evaluating how to measure risk, we must recognize that private real estate is a long-lived, typically less-liquid, real asset. As such, most investors understandably take a long-term approach, which may explain, in part, why some may de-emphasize liquidity in their process. Our position, here again, is simple:

- If real estate is a long-term investment, then why measure risk in months or quarters?
- Instead, we believe investors should compare their real estate choices and the distribution of outcomes experienced over longer periods of time.

To illustrate, we compared the experience of a "buy-and-hold investor," who held both U.S.-listed REITs and core private real estate funds over 10-year periods, spanning 26 initial investment years from 1978 through 2002. In our view, the longer-term 10-year holding periods served to reduce the flaws in the appraisal measurement. Moreover, by focusing less on quarter-to-quarter returns and more on the internal rates of return (IRRs) and the range of potential IRRs over the holding period, the analysis more effectively compared fundamental risk over long-term holding periods.

Put into a different context, investors intuitively recognize that their venture capital or private equity allocations are their riskiest allocations. We do not believe investors in such funds examine the volatility of quarterly mark-to-market values to confirm their intuition. Rather, they need only compare the near-triple-digit venture capital IRRs of 1996 to the negative IRRs of the early 2000s to appreciate true volatility or risk. Our comparison of the NFI-ODCE and the NAREIT Indexes is summarized in Exhibit 5.

Longer-term IRRs can more effectively compare the returns of listed REITs and private real estate.

Exhibit 5: Internal Rates of Return: Listed REITs vs. Core Private Real Estate Funds

	Listed REITs[a]	Core Private Real Estate Funds[b]
Mean Internal Rate of Return Over 26 10-Year Periods	12.4%	7.8%
Minimum Internal Rate of Return (initial investment year)	7.4% (1999)	3.0% (1986)
Maximum Internal Rate of Return (initial investment year)	18.2% (1979)	13.0% (1998)
Range (from min. to max.)	10.8%	10.0%
Total Observations	26	26
# of Observations Within +/-2.5% of Mean	20	9
% of Observations Within +/-2.5% of Mean	76.9%	34.6%
Standard Deviation of Annualized 10-Year Returns	2.6%	3.4%

At December 31, 2012. Source: Cohen & Steers, Bloomberg, NAREIT and NCREIF. Returns represent the average over the 26 years of observations.

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See page 13 for index definitions.

The conclusions we drew from this analysis are as follows:

- Listed REITs have meaningfully outperformed core private real estate over time. The average annual return over the 10-year holding periods was 12.4% for REITs, compared with 7.8% for core private real estate funds.
- Listed REIT investors had a modestly wider range of outcomes, with a 10.8% difference between their best vintage year of performance (1979) and their worst vintage year (1999), compared with a slightly narrower range of 10.0% for core private real estate funds.
- Despite the wider range from best to worst, the dispersion of returns from listed REITs was much lower, as reflected by the fact that in 20 out of the past 26 years (76.9% of the time), listed REIT investors realized a return that was +/- 250 basis points of the mean return.
- Surprisingly, in only 9 out of the 26 years observed, or about one-third of the time, did core real estate funds deliver a return that was +/- 250 basis points of the mean. Listed REIT performance was generally more normally distributed than core private real estate funds performance.
- The standard deviation of 10-year returns was 2.6% for listed REITs versus 3.4% for core private real estate funds. This lower volatility in 10-year returns is not adjusted for leverage; in other words, adjusted for leverage, listed REITs would look even more favorable than core private real estate funds on this measure of volatility.

We see consistency and predictability of long-term returns as the best measure of risk.

Exhibit 6 charts annual rolling internal rates of return over 10-year holding periods by vintage year. Visually, the listed REIT returns are clearly more clustered and seemingly consistent. Thus, we would argue that monthly or quarterly volatility is not the best measure of investment risk, just as it is not the best measure in allocating to venture capital or private equity funds. Instead, we believe the best measure of risk lies in the consistency and predictability of long-term returns. On this basis, listed REITs are not riskier than private real estate. In fact, they have proven to be less risky over 10-year rolling periods.

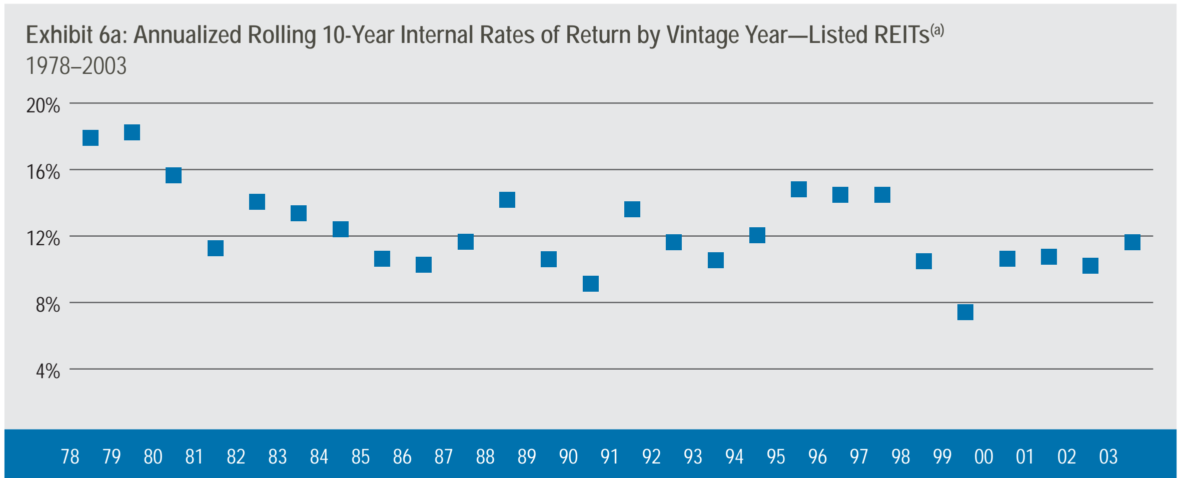

Exhibit 6a: Annualized Rolling 10-Year Internal Rates of Return by Vintage Year—Listed REITs[a]
1978–2003

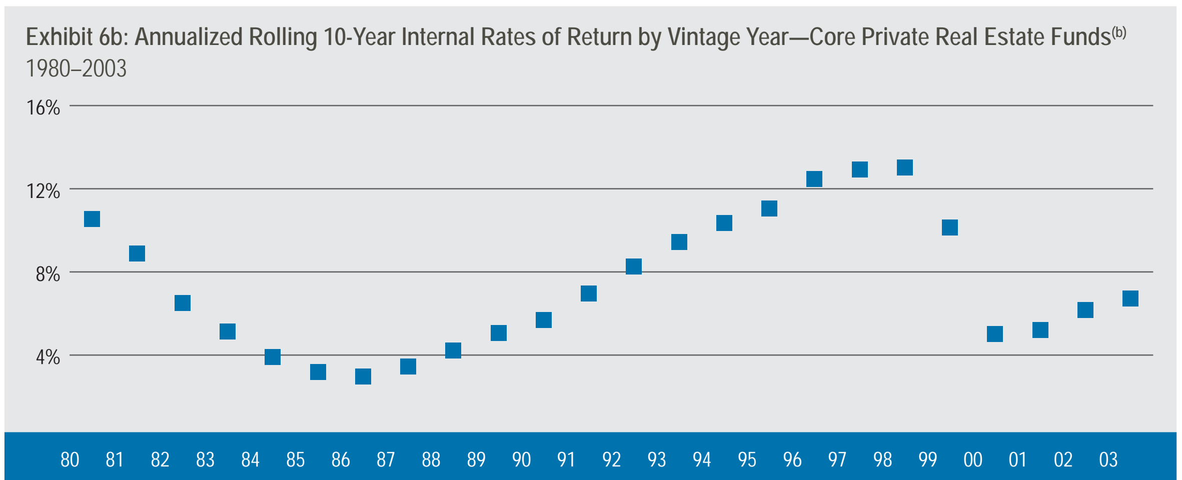

Exhibit 6b: Annualized Rolling 10-Year Internal Rates of Return by Vintage Year—Core Private Real Estate Funds[b]
1980–2003

At December 31, 2012. Source: Cohen & Steers, NAREIT and NCREIF.

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See page 13 for index definitions.

Listed REIT 10-year returns are more clustered and consistent.

The Behavioral Finance Implications of Volatility

We believe that psychological factors, best explained by the study of behavioral finance, play a role in the allocation decisions for real estate. Noted behavioral economists Shlomo Benartzi and Richard Thaler coined the term "myopic loss aversion" to describe the phenomenon whereby investors presented with annual return data for stocks and bonds tend to adopt more conservative strategies with a lower allocation to equities than those presented with longer-term return data, such as 30-year compound returns.[(1)] Despite the fact that the planning horizon is better represented by the long-term return than the one-year return, investors seem to be more focused on the potential for a short-term loss than on planning for the relevant time horizon and accepting short-term volatility.

We believe something very similar occurred in our study on the respective volatility of listed REITs and core private real estate funds. As a smoothed series, the NFI-ODCE Index that tracks private core real estate essentially reflects fewer datapoints of information. This is consistent with our takeaway from studies on myopic loss aversion: most investors unconsciously want less information. In the absence of information, they are more comfortable taking on risk.

As a large investor in publicly traded securities, we certainly understand the desire to avoid the stress of day-to-day volatility. Unfortunately, this desire is not without its damaging consequences. Instead, myopic loss aversion, coupled with the low measured volatility of the NFI-ODCE, has created a systematic misallocation between core private and listed real estate, one characterized by significant systematic underperformance.

Closing Perspective

Since our study on listed and private real estate was first published in 2010, we have received very positive feedback on the research. Today, *The Truth* still holds true; based on our update for 2012 performance, listed REITs continue to outperform most categories of private real estate funds on a long-term and recurring basis.

Yet the dilemma remains. Despite the liquidity offered by listed REITs, and the near-death scare of the global financial crisis, private core real estate is priced at parity with the expected returns of listed REITs, without any adjustment for liquidity. To put this into perspective, core private real estate is currently priced to return about 7% (unleveraged) and about 6% after expenses. With 30% leverage, this net return potential would rise to about 8%—similar to our current expectations for listed REITs. Historically, REITs have returned more than these forecasts, while core private real estate funds have not achieved them.

In our view, the current pricing parity between listed REITs and private real estate fails to justify the high allocations to direct property typically found in corporate and public pension plan portfolios. If the private market is right, then there is likely room for listed REITs to appreciate further. Conversely, if the public market is correct, then private core real estate is likely to disappoint today's buyers.

(1) "Myopic Loss Aversion and the Equity Premium Puzzle," 1995; *The Quarterly Journal of Economics.*

Today, we are seeing more institutional investors re-evaluate the composition of their real estate portfolios, with a greater focus on investing with more liquidity. In our view, the return premium for the illiquidity of private real estate should be an integral part of this assessment, taking into consideration the duration of the lockup period and riskiness of the property type and strategy.

Appendix

The comparison of listed REITs with private real estate funds in this report was based on the following indexes:

Listed REITs:

- Listed REITs are represented by the FTSE NAREIT Equity REIT Index (NAREIT), a broad-based index consisting of real estate investment trusts (REITs).

Private Real Estate:

- The performance of core private real estate funds was represented by the NFI-ODCE series. The NFI-ODCE Index, short for NCREIF Fund Index—Open-End Diversified Core Equity Index, reports historical and current results of 30 open-end commingled funds pursuing a core investment strategy. The NFI-ODCE Index is capitalization-weighted and is reported gross of fees. Measurement is time-weighted.
- The performance of private valued-added and opportunistic funds was represented by the respective NCREIF Townsend Indexes, through which results are reported for strategies using both open-ended and closed-ended structures.

Index Overview
Listed REITs and Private Real Estate Funds

	Assets (billions)	Equity (billions)	Leverage
Listed REITs	$740	$481	35%
Core Private Real Estate Funds	$116	$90	22%
Value-Added Private Real Estate Funds	$67	$37	46%
Opportunistic Private Real Estate Funds	$200	$107	43%

At December 31, 2012. Source: Cohen & Steers, eVestment Alliance, NCREIF and The Townsend Group.

Important Disclosures

Performance data quoted represents past performance. Past performance does not guarantee future results. There is no guarantee that any historical trend illustrated in this commentary will be repeated in the future, and there is no way to predict precisely when such a trend will begin. There is no guarantee that a market forecast made in this commentary will be realized. The views and opinions in the preceding commentary are as of the date of publication and are subject to change. This material represents an assessment of the market environment at a specific point in time, should not be relied upon as investment advice, is not intended to predict or depict performance of any investment and does not constitute a recommendation or an offer for a particular security. We consider the information in this presentation to be accurate, but we do not represent that it is complete or should be relied upon as the sole source of suitability for investment.

Property values may fall due to increasing vacancies; declining rents resulting from economic, legal, tax, political or technological developments; lack of liquidity; limited diversification and sensitivity to certain economic factors such as interest rate changes and market recessions. The risks of investing in REITs are similar to those associated with direct investments in real estate securities. Foreign securities involve special risks, including currency fluctuations, lower liquidity, political and economic uncertainties, and differences in accounting standards. Some international securities may represent small- and medium-sized companies, which may be more susceptible to price volatility and have less liquidity than larger companies.

This article must be accompanied by the most recent applicable quarterly Cohen & Steers mutual fund factsheet(s) if used in connection with the sale of U.S. mutual fund shares.

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This white paper must be accompanied by the most recent applicable quarterly Cohen & Steers mutual fund fact sheet(s) if used in connection with the sale of mutual fund shares to the general public.

Index Definitions

Investors cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.

FTSE NAREIT Equity REIT Index is an unmanaged, market-capitalization-weighted index of all publicly traded U.S. REITs that invest predominantly in the equity ownership of real estate, not including timber and infrastructure.

NCREIF Fund Index—Open-End Diversified Core Equity Index, or NFI-ODCE, is a capitalization-weighted, gross-of-fees, time-weighted return index, reporting both historical and current results of 30 open-end commingled funds pursuing a core investment strategy.

NCREIF Property Index (NPI) provides returns for institutional-grade real estate held in a fiduciary environment in the United States.

NCREIF Townsend Value Added and Opportunistic Indexes represent average returns to actively managed value-added and opportunistic funds in which NCREIF data-contributing members invest.

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Founded in 1986, Cohen & Steers is a leading global investment manager with a long history of innovation and a focus on real assets, including real estate, infrastructure and commodities. Headquartered in New York City, with offices in London, Hong Kong, Tokyo and Seattle, Cohen & Steers serves institutional and individual investors around the world.

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