

The Rationale for Investing in Global Real Estate

Topics of Interest

August 2011

In our discussions with institutional investors over recent years, they have told us of their increasing desire to spread their real estate exposure over wider geographic areas or even globally. The purpose of this paper is to explore the rationale for allocating away from one's home market as part of an investor's overall real estate portfolio.

There are many reasons for allocating to real estate. It can serve as a partial inflation hedge and may have lower correlations to other asset classes, potentially improving the efficiency of the overall portfolio. In the U.S. and U.K., it is typical to allocate between 5% and 10% to real estate.¹ However, even many institutions with long experience investing in real estate have shown some reluctance to invest outside their home market. For example, the 2010 Plan Sponsor Survey by Kingsley Associates found that on average U.S. Plan Sponsors' target allocation for non-U.S. real estate represented only 5% of their total real estate allocation.²

Investors' reluctance is understandable given the challenge of selecting the best managers, and the increased complexity of investing globally, including increased transaction costs, taxes, and complex regulations. However, a home market bias may introduce unintended concentration in the real estate portfolio and could deny the investor access to the best managers and opportunities globally.

The potential for unintended concentration is illustrated in *Exhibit 1*, which outlines Morgan Stanley Real Estate's estimate of each major market's share of the global commercial real estate universe.³ In communicating this analysis, we have found that many investors are surprised to learn that, with one exception, no country represents more than 10% of the world's total. Based on this estimation, the U.S. is the largest, but it represents approximately only 23% of the total universe, and therefore a U.S.-only real estate strategy excludes 77% of the investable real estate universe. A U.K.-only strategy excludes approximately 96% of the investable universe.

This Topic of Interest was jointly authored by members of the Alternative Investment Partners Real Estate Team and the Portfolio Solutions Group.



David Boyle
Executive Director



Ryan Meredith, FFA CFA
Executive Director



Andrew Robinson
Vice President



Joseph D. Stecher
Managing Director



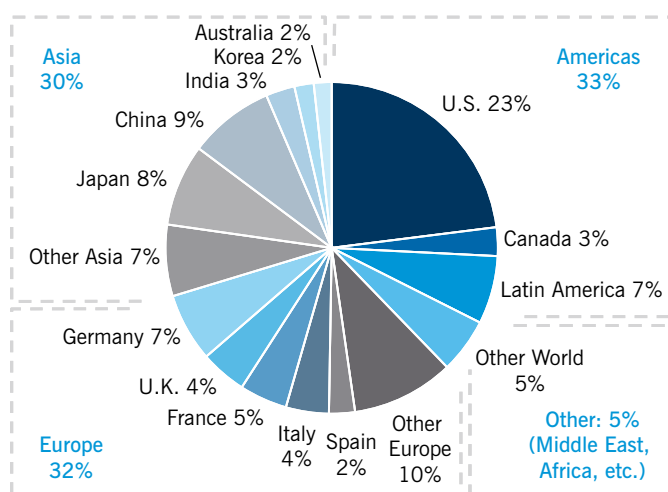
Dr. Rui de Figueiredo

¹ Source: 2010 U.S. Plan Sponsor Survey, Kingsley Associates, 2010 UK Pension Funds Online

² Source: 2010 Plan Sponsor Survey, Kingsley Associates, On average U.S. Plan Sponsors' target allocation for non-U.S. real estate represented only 5% of their total real estate allocation

³ Morgan Stanley estimated real estate values as of Q4 2010, which are based upon a ratio of the real estate market capitalization to nominal GDP, which is believed to range between 40% and 50% during full real estate cycles. Ratio developed through a series of calculations using more transparent markets to increase the value of the estimates. These ratios were used for a wide variety of real estate markets with Emerging Markets receiving a lower percentage of real estate to GDP and developed markets receiving a higher percentage of real estate to GDP. Sources include Jones Lang LaSalle, MF, PPR, Smith Travel and Morgan Stanley Research. The statements above reflect the opinions and views of AIP as of the date hereof and not as of any future date and will not be supplemented or updated.

Exhibit 1: Regional Breakdown of Total Estimated Commercial Real Estate Value⁴



So while a home market bias may lead to unintended concentration regardless of the size of the home market, the question is whether investing beyond one’s home market adds benefits (beyond inflation hedging and lower correlations with other asset classes) that are worth the added challenges.

It is AIP’s belief that there are two main reasons for allocating outside of one’s home market: diversification and broad exposure. We believe the benefit of diversification is added efficiency within the real estate portfolio, while the benefit of broad exposure is a larger opportunity set and therefore more access to alpha.

Diversification – “reducing risk”⁵

In order to examine the degree of diversification across real estate markets, we turn to one of the core measures of investment: correlation. In *Exhibit 2* we show AIP’s estimates of the correlations between various real estate markets around the globe.⁶

⁴ Morgan Stanley estimated real estate values as of Q4 2010, which are based upon a ratio of the real estate market capitalization to nominal GDP, which is believed to range between 40% and 50% during full real estate cycles. Ratio developed through a series of calculations using more transparent markets to increase the value of the estimates. These ratios were used for a wide variety of real estate markets with Emerging Markets receiving a lower percentage of real estate to GDP and developed markets receiving a higher percentage of real estate to GDP. Sources include Jones Lang LaSalle, MF, PPR, Smith Travel and Morgan Stanley Research. The statements above reflect the opinions and views of AIP as of the date hereof and not as of any future date and will not be supplemented or updated.

⁵ Diversification does not assure a profit or protect against loss in a declining market.

⁶ Source: International Property Databank, Mitsubishi Trust and Banking Real Estate Index, National Council of Real Estate Investment Fiduciaries National Property Index. For detail on the model please refer to: The Journal of Portfolio Management, Winter 2005, “How Risky Are Illiquid Investments? - A practical approach to estimating volatilities and correlations of non-traded assets” by Dr. Rui de Figueiredo, Jr. and Vineet Budhraj. It should be kept in mind that the AIP Portfolio Solutions Group’s proprietary model is estimating markets, not individual properties. Additionally in many of these markets, real estate indices do not exist; where representative indices do exist, the nature of the underlying investments in the index are not necessarily investable, or the underlying bucket may be a hypothetical cross section of real estate properties in that region. This technique demonstrates the broad potential for divergence between the performance of a given real estate portfolio and our estimates of the regional market of its domicile—a potential that cannot be estimated prospectively or, in cases where a market index does not exist, even retrospectively. In addition to this divergence, there is the “forecasting error” of the index, which can be significant given the data deficiencies.

Exhibit 2: Regional Real Estate Correlations Estimates

	North America	U.K.	Europe Ex-U.K.	Japan	Developed Asia Pacific Ex-Japan	Latin America	Emerging Asia
North America	1.00						
U.K.	0.39	1.00					
Europe Ex-U.K.	0.46	0.50	1.00				
Japan	0.25	0.27	0.43	1.00			
Developed Asia Pacific Ex-Japan	0.20	0.24	0.33	0.32	1.00		
Latin America	0.37	0.36	0.58	0.39	0.52	1.00	
Emerging Asia	0.26	0.28	0.38	0.41	0.38	0.44	1.00

Source: Data from International Property Databank, Mitsubishi Trust and Banking Real Estate Index, National Council of Real Estate Investment Fiduciaries National Property Index, and data analysis from Morgan Stanley AIP Portfolio Solutions Group.

The generally low expected correlation of real estate returns across the various regions illustrates the asynchronous nature of the global real estate markets. Creating a diversified real estate strategy that can access the different markets may therefore improve the risk adjusted returns of an investor's real estate allocation. Our estimates are subject to many qualifiers and uncertainties, particularly around data collection, but our analysis has resulted in low correlations (.20 to .58) that even if our estimates are somewhat "off", we believe that an actual regionally diversified real estate portfolio could realize benefits from lower correlations, thereby lowering risk at various levels of return.

To see why this conclusion may be so, we compared initial unleveraged yields ("cap rates") in the Frankfurt CBD (Central Business District) to those of Hong Kong from 1991 to 2011 in *Exhibit 3*. Whilst Hong Kong tends to have shorter and more volatile cycles, Frankfurt tends to have less pronounced movements within a tighter range, owing to specific differences in property cycles and investor behavior. We believe that the actual uncorrelated returns observed between Frankfurt and Hong Kong may be observable among other markets as well.⁷

⁷ Source: Property Market Analytics ("PMA"). Based on PMA net initial yields for 1991-2011, the correlation between Frankfurt and Hong Kong is 0.1.

⁸ Long-term average initial yields include all years from 1991 to 2011 for Hong Kong and Frankfurt. Initial yield is the annualized net rent generated by a property expressed as a percentage of the property value. Here prime initial yield is defined as net initial market yield on a fully let prime building excluding costs on the acquisition date. Past performance is not indicative of future results.

Broad Exposure – "Accessing more opportunities for Alpha"

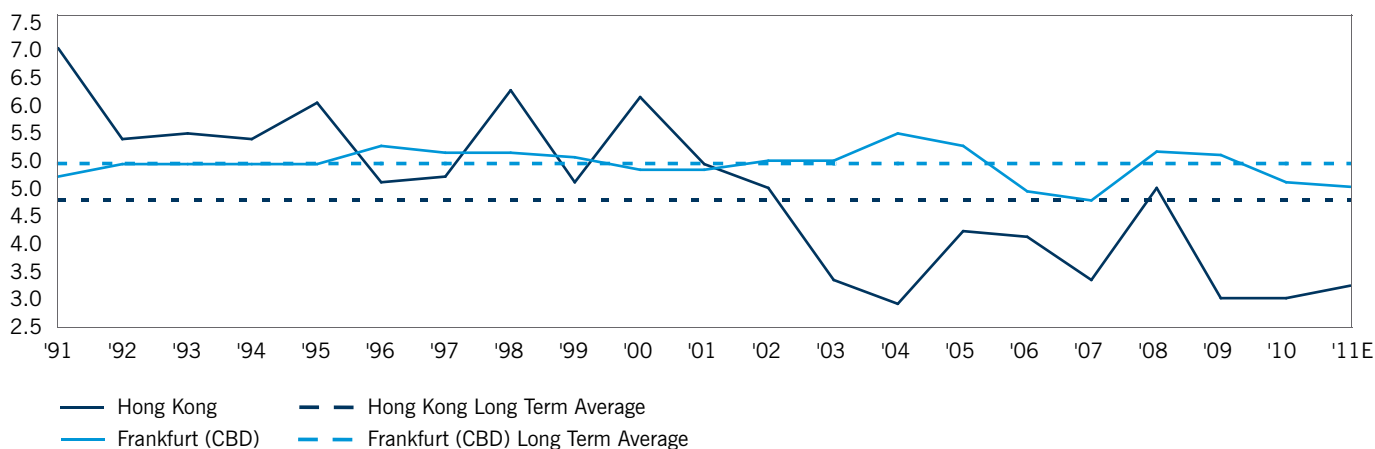
A second reason to invest in real estate globally is that investors may gain broad exposure to more managers, markets and strategies. We believe that by broadening the target set beyond the home market, an investor may gain access to better managers at the margin who may have fewer competitors and a different set of opportunities, particularly as different markets recover from the financial crisis at different paces, and as emerging markets grow at a faster pace than do developed markets.

Narrowing the universe down to a single country or even a single region necessarily reduces the number of managers in the investor's portfolio and, we believe, unnecessarily reduces access to alpha, because the investor may unintentionally reject any number of great managers or opportunities outside the home market.

AIP believes that there is a "declining marginal utility" to investing with several managers in the same geography. If an investor were to invest with several real estate fund managers concentrated in the home market to gain property exposure, then at some point the managers may execute similar strategies and may possibly compete for the same transactions. The marginal or penultimate home market manager may be weaker than some of the best managers in a "foreign" market, or there may be better opportunities in other markets. Conversely, if the investor chooses to avoid declining marginal utility by investing in one or two managers in one geography, then the investor has assumed manager concentration risk in addition to home market risk.

*Exhibit 3: Regional Real Estate Correlations Estimate*⁸

Prime Office Yields



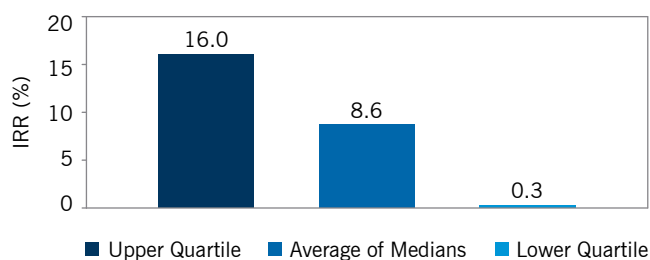
Source: Property Market Analytics (July 2011)

We believe that the potential for alpha generation may be most apparent in emerging markets, where private equity real estate managers generally operate in growth markets with fewer competitors than do their developed market counterparts; however, these managers and markets can be particularly difficult to assess. Morgan Stanley Real Estate’s analysis in *Exhibit 1* shows that approximately 30% of the world’s investable commercial real estate may be in emerging markets, yet it is our observation that few investors are comfortable allocating to such markets and managers at all. While we do not advocate a “neutral” 30% weighting to emerging markets, we do believe that effectively “deselecting” these markets may negatively impact the risk/reward dynamics of the overall real estate portfolio.

Some Risks to Consider

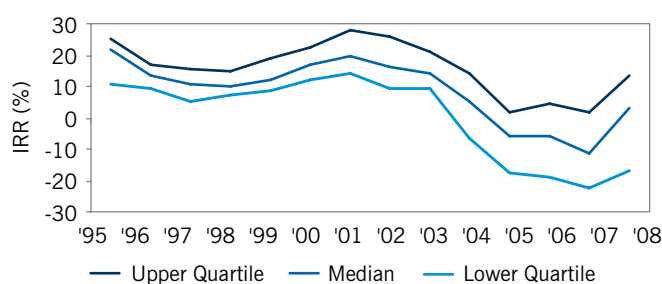
As time has progressed and more funds have launched in all markets, the dispersion of returns among managers has tended to widen, as *Exhibits 4* and *5* demonstrate, so the quest for low correlations and alpha may introduce manager selection risk as well. The investor may mitigate this risk through rigorous manager selection, which may require developing the skill in-house, or engaging an external expert with a global footprint. The broad dispersion of returns in this asset class means that manager selection skill may create the opportunity to realize alpha generation, but with execution risk. There are over 500 fund managers in the global value-add and opportunistic real estate investment universe.⁹ In *Exhibit 4*, we show the average of the median returns, for the lower, median and upper quartiles, for value-add and opportunistic private equity real estate firms from 1995 to 2008, the period with the most robust data. The data shows that there is a wide dispersion of returns among managers, as exemplified by the average of more than 700 basis points per annum excess return between the top quartile managers and the average of the median performing managers. We also note that these results are based on limited data sets and other issues raised in footnote 10 below, but we believe it to be a reasonable approximation.

Exhibit 4: Preqin Real Estate Average of Median Net IRR Fund Performance^{10,11}



Source: Preqin (1995-2008)
Past performance is not indicative of future results.

Exhibit 5: Median Net IRR Return Quartiles Dispersion – Global Real Estate^{10,11}



Source: Preqin (1995-2008)
Past performance is not indicative of future results.

With all the challenges an investor faces accessing these managers, one aspect has made doing so a bit less complex: the growth of local private equity real estate firms with similar governance structures. These structures have benefited investors as they have made it easier to access different markets through familiar structures, but it also creates the challenge of understanding how those global market terms evolve over time. Investors also have to accept new challenges such as increased transaction costs, taxes, and complex regulations.

⁹ Preqin Real Estate, March 2011 Value-Add and Opportunistic fund database search

¹⁰ Performance data from Preqin Real Estate as of July 2011; funds are of all geographic focus types. Average number of funds providing an IRR per annum of 54; however, the number of funds increased from 14 in 1995 to 75 by 2008 with a maximum of 126 in 2007. Data from funds established in 2009–2011 is considered not meaningful due to early stage of investment. The performance information is net of fees, expenses and carried interest of the fund manager. Performance is presented for direct private equity real estate managers and not fund of funds managers, and therefore, does not include a reduction for fees at the fund of funds level.

¹¹ The results above are not intended to predict the performance of any specific investment.

Conclusion

Investors may enhance diversification and alpha generating opportunities by allocating to global real estate and thereby accessing a wider pool of potential investments, strategies, managers and geographies. An unintended home market bias, conversely, may needlessly limit the efficiency and alpha generation of an investor's real estate portfolio for the reasons stated above. These potential benefits introduce the risk of sourcing and assessing numerous managers around the globe who will likely have broadly divergent returns. These further considerations mean that strong manager selection is crucial for a global strategy seeking to mitigate risk and fully realize the benefits.

The information provided herein is strictly confidential and shall not be disclosed to any third-party and shall not be used for any other purpose without the express written consent of Morgan Stanley Alternative Investment Partners LP ("AIP"), except as required by law or regulatory requirements.

The information contained herein reflects the views and opinions of AIP as of July 26, 2011, and not as of any future date, and does not contend to address the financial objectives, situation or specific needs of any individual investor. Of course, these views may change in response to changing circumstances and market conditions and the information will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring after the date hereof. Specific investment information is provided for information purposes only and should not be deemed as a recommendation to purchase or sell any securities or investments mentioned. These comments are not necessarily representative of the opinions and views of any other Morgan Stanley portfolio manager or of the firm as a whole. While the information contained herein is believed to be reliable, we cannot guarantee its accuracy or completeness. Investors should bear in mind that past performance is not indicative of future results. Keep in mind that forecasts are inherently limited and should not be relied upon as an indicator of future performance. The views expressed are subject to change based on market, economic and other conditions. They should not be construed as recommendations, but as an illustration of broader economic themes.

This is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or instrument or to participate in any trading strategy. The terms of any investment shall be governed by definitive agreements. Any decision to invest should be made solely in reliance upon such agreements.

Certain information contained herein constitutes forward-looking statements, which can be identified by the use of terms such as "may," "will," "should," "expect," "anticipate," "project," "estimate," "intend," "continue," or "believe" (or the negatives thereof) or other variations thereon. Due to various risks and

uncertainties, including, but not limited to, those set forth herein, actual events or results or actual performance of any specific investment may differ materially from those reflected or contemplated in such forward-looking statements. Nothing contained in this document may be relied upon as a guarantee, promise, assurance or a representation as to the future.

Morgan Stanley does not provide tax or legal advice. The tax information contained herein is general and is not exhaustive by nature. It was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax laws. Federal and state tax laws are complex and constantly changing. You should always consult your own legal or tax advisor for information concerning your individual situation.

Investors should not construe the contents of this document as legal, tax, accounting, investment or other advice. Each investor should make its own inquiries and consult its advisors as to any investment and as to legal, tax, financial, and other relevant matters concerning any investment.

Alternative investments are speculative, involve a high degree of risk, are highly illiquid, typically have higher fees than other investments, and may engage in the use of leverage, short sales, and derivatives, which may increase the risk of investment loss. These investments are designed for investors who understand and are willing to accept these risks. Performance may be volatile, and an investor could lose all or a substantial portion of its investment. An investor in a private equity fund will not be permitted to transfer its interest without the consent of the general partner of the fund. Furthermore, the transferability of an interest will be subject to certain restrictions contained in the partnership agreement of the fund and will be affected by restrictions imposed under applicable securities laws. There is generally no market for the interests, and it is not contemplated that one will develop.

For Business and Professional Investors Only. Not for distribution to the general public. Issued by Morgan Stanley AIP GP LP and distributed ex-U.S. by Morgan Stanley Investment Management Limited, 20 Bank Street, Canary Wharf, London E14 4AD, England, authorized and regulated by the UK Financial Services Authority. Approved for use in the United Kingdom to those persons who are market counterparties or intermediate customers (as defined in the UK Financial Services Authority's rule) by Morgan Stanley Investment Management Limited, 20 Bank Street, Canary Wharf, London E14 4AD, England, authorized and regulated by the UK Financial Services Authority.

This communication is only intended for, and will be only distributed to, persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations. Not for Distribution to Private Customers as defined by the UK Financial Services Authority

For Business and Professional Investors Only and Not To Be Used With The General Public.

This Financial Promotion has been issued and approved in the UK by Morgan Stanley Investment Management Limited, 25 Cabot Square, Canary Wharf, London E14 4QA, authorized and regulated by the Financial Services Authority, for distribution to Professional Clients or Eligible Counterparties only and must not be relied upon or acted upon by Retail Clients (as defined in the UK Financial Services Authority's rules).

This communication is only intended for and will be only distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

This document has been prepared solely for information purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decisions.

Except as otherwise indicated herein, the views and opinions expressed herein are those of Morgan Stanley Investment Management Limited, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

Alternative investments are speculative and involve a high degree of risk and may engage in the use of leverage, short sales, and derivatives. Derivatives can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. Investments in derivative instruments carry certain inherent risks such as the risk of counter party default and before investing you should ensure you fully understand these risks. Use of leverage may also magnify losses as well as gains to the extent that leverage is employed.

Investments may be in a variety of currencies and therefore changes in rates of exchange between currencies may cause the value of investments to decrease or increase. Furthermore, the value of investments may be adversely affected by fluctuations in exchange rates between the investor's reference currency and the base currency of the investments.

These investments are designed for investors who understand and are willing to accept these risks. Performance may be volatile, and an investor could lose all or a substantial portion of his or her investment.

Past performance is not a guarantee of future performance. The value of the investments and the income from them can go down as well as up and an investor may not get back the amount invested. There can be no assurance that the Fund will achieve its investment objectives.

Emerging country securities; including (1) restrictions on foreign investment and on repatriation of capital (2) currency fluctuations, (3) potential price volatility and lesser liquidity of shares, (4) political and economic risks, including the risk of nationalisation or expropriation of assets and the risk of war (5) settlement systems may be less well organised and less developed and (6) debt may not be rated by any internationally recognised credit rating organisation. There are also varying levels of government supervision and regulation of exchanges, financial institutions and issuers in various countries. In addition, accounting, auditing, financial and other reporting standards are not equivalent to those of more developed countries, and therefore less information may be available than in more developed countries.

Securities of companies engaged in a particular industry; including the cyclical nature of real estate values, risks related to general and local economic conditions, overbuilding and increased competition, increases in property taxes and operating expenses, demographic trends and variations in rental income, changes in zonal laws, casualty or condemnation losses, environmental risks, regulatory limitations on rents, changes in neighbourhood values, related party risks, changes in the appeal of properties to tenants, increases in interest rates and other real estate capital market influences. Generally, increases in interest rates will increase the costs of obtaining financing, which could directly and indirectly decrease the value of the relevant Fund

This page intentionally left blank.

© 2011 Morgan Stanley

Morgan Stanley

www.morganstanley.com/aip

NOT FDIC INSURED	OFFER NO BANK GUARANTEE	MAY LOSE VALUE
NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY		NOT A DEPOSIT

IUJ1-017791-106/11 6836435