

### Turning up the heat...

News from economic and real estate corners in the first half of 2011 was quite an improvement over the past three years. And then came the summer...

By the end of June, there was talk of “bubble” pricing for fully-leased real estate assets. And job formation, at least within the real estate industry, for the first time since 2007 as capital began to return – once again acquisition specialists have something to do – and the collective mood improved dramatically.

Unfortunately, it was all too easy to forget that the developed world is undergoing a massive consumer, financial sector and public sector deleveraging that will produce headwinds for years to come, like it or not.

In this issue of *Our View* we start with the tangible effects of fear in the marketplace, a rush toward risk-averse investments – and market avoidance of anything but the most bullet-proof, or seemingly bullet-proof....Then we cover our alternative view, that this is an interesting entry point for real estate, but the most attractive execution is not, as usual, where everyone else wants to be.

### Parallel Universes

What is unusual is that improvements have not been widespread but rather strong in a very narrow sense, and many areas have been left behind – at least for the moment. The following table just skims the surface on this dichotomy.

In Vogue	Out of Vogue
Fully leased assets	Leasing risk
Gateway cities	Secondary cities
China, Australia	Smaller Asian Tiger countries
Brazil	Smaller Latin American countries
London, Paris	Central and Eastern Europe
Low leverage	High leverage
“Core” strategies	“Opportunistic” strategies

### Think twice

Clearly, the herd is currently moving strongly in one direction. While we admit surprise at the strength of the recovery in properties with low operational risk, we note that this is partially fuelled by a “carry trade” of sorts in that monetary policy worldwide remains massively accommodative. And while it is generally good that capital starvation to the industry in general is no longer a risk, you have to ask yourself how often has following the herd has been a successful investment strategy?

In the following pages we outline our thoughts regarding economic and real estate factors influencing our investment decisions. We begin by highlighting much of the good news, and follow by highlighting the uncertainties.

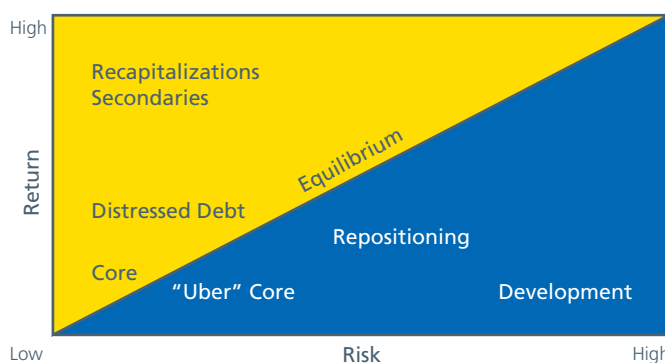
### Cross currents

There is now evidence that the worst of the Global Financial Crisis is over and a global recovery has been gathering pace. GDP gains are evident in virtually all major world markets. By March, global trade was surpassing pre-crisis levels and unemployment is declining in many countries. Inflation is becoming an increasing concern in many regions, particularly in the emerging markets. Despite the horrific natural disaster and nuclear events in Japan and uprisings in the Middle East, the world economy, including the US and Western Europe, seems to be bouncing off the bottom.

Real estate markets have been showing signs of life, although not uniformly. Emerging markets have been strong, in some cases potentially overheating from a value standpoint. Even in the US and UK, real estate prices for top-quality 24-hour city properties (notably New York, Washington DC, and London) spiked upward – albeit from very low valuation levels. Of the world financial centers, only Tokyo, partially as a result of the recent natural disaster events in the region, failed to show considerable valuation recovery.

Figure 1, depicts our view of current market risk and potential reward for a variety of real estate investment strategies. Fundamentally, we believe that the opportunity to acquire interests in high-quality real estate from entities in need of liquidity, by implementing secondary transactions or through recapitalizations has a far superior risk/return profile to most other opportunities in the real estate market today.

Figure 1  
Risk / Reward in March 2011

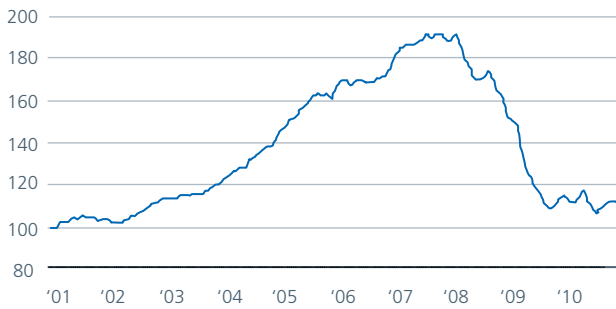


We believe our conclusion is supported by the following factors:

### 1. An attractive real estate valuation entry point

In general, property values remain depressed relative to historic norms and in many cases to replacement cost, so if risk-mitigated investment opportunities can be found, long-term results should be strong. As shown below, commercial real estate prices, as measured by the Moody's/REAL All Property Type Aggregate Index have declined by 30.7% from two years ago and have fallen 42.1% from the October 2007 peak.<sup>1</sup> For investors who purchased properties with leverage, equity values have been decimated. Figure 2 on the following page shows the trend line since 2001 or the US – values are roughly where they were in 2004. Figure 3 shows a similar trend for UK real estate.

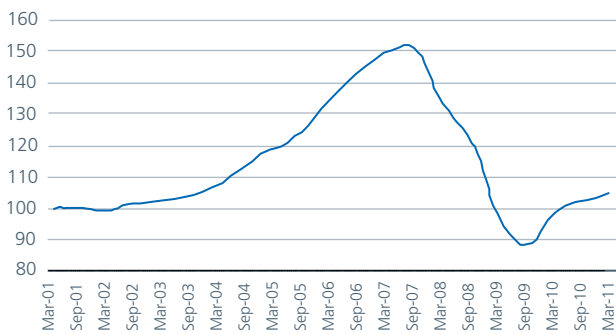
Figure 2  
Moody's / Real National - All Property type Aggregate



December 2000 = 100 Based on data through end of December 2010 Updated February 2011

Source: Real Capital Analytics

Figure 3  
IPD Quarterly Index - All Property Capital Values



December 2000 = 100

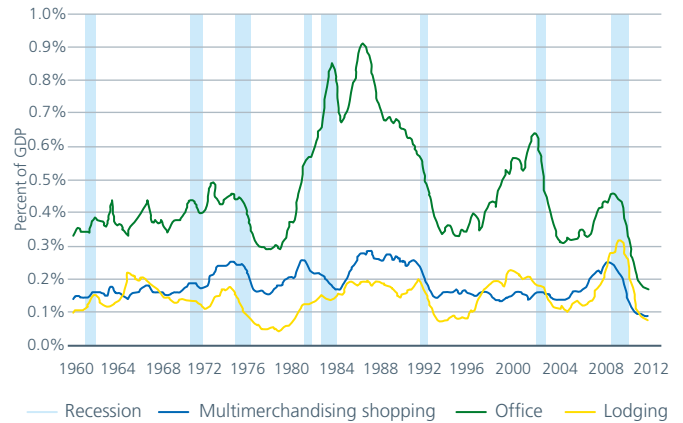
Source: IPD

Another way to look at real estate activity is to compare aggregate investment in relation to GDP. This is depicted in Figure 4 on the following page, which shows US data related to investment in offices, retail malls and lodging as a percent of GDP. Office investment as a percent of GDP peaked at 0.46% in Q1 2008 and has declined sharply to a new low (since 1959). Investment in multi-merchandise shopping structures (malls) peaked in 2007 and has fallen by two-thirds and is also at a series low (as a percent of GDP).

The activity bubble in lodging investment was particularly stunning. Lodging investment peaked at 0.32% of GDP in Q2 2008 and has since fallen by over 70%.

We note that investment for all three categories typically falls for a year or two after the end of a recession, and then usually recovers very slowly (flat as a percent of GDP for two or three years). We believe that there will not be a recovery in these categories until the vacancy rates fall significantly.

Figure 4  
Private Fixed Investment in Offices, Lodging and Malls

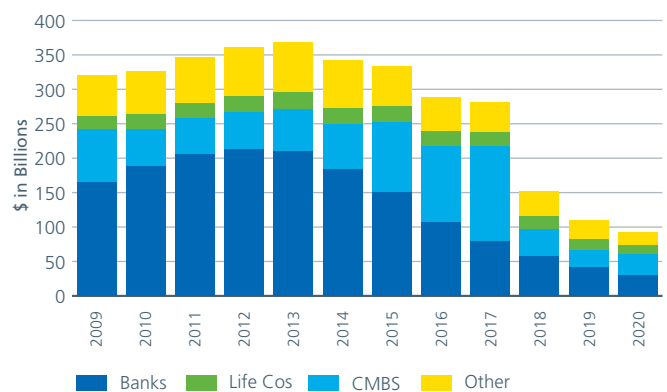


Source: Calculated Risk Blog, April 2011

### 2. A global real estate mortgage overhang

While property valuations have declined precipitously, outstanding mortgage debt balances remain largely unchanged, outstanding and approaching maturity. Debt placed on commercial property during the peak years was already at historically high loan-to-value (LTV) levels. With valuation declines, the resulting LTV ratios are extremely high and must be reduced to rebalance capital structures. In some cases, where there is no equity value remaining in the properties, debt must be written down; in other cases new capital must be injected into the ownership structures. This phenomenon exists in all the major developed markets including the US, UK, Western Europe and Japan.

Figure 5  
Commercial Mortgage Maturities by Lender Type



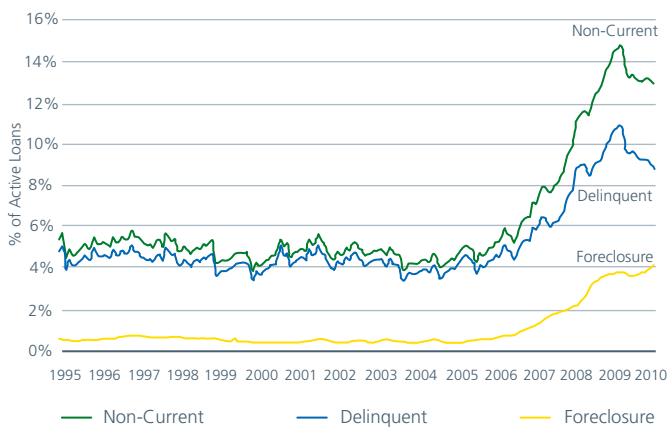
Source: Foresight Analytics, Q3 2010

1. Calculated Risk Blog

In the US, \$1.4 trillion in maturities is coming due through 2014 – including over \$700 billion in the 2011-2012 time period (see Figure 5 on preceding page). Moreover, with valuations down significantly and stricter lending standards in place, equity shortfalls are magnified. Given the short-term nature of bank debt (3-5 years), the bulk of maturities in 2011-2014 will affect banks. CMBS debt maturities will peak in 2014-2017.<sup>2</sup>

The stress at the property level shows up in banking statistics. As of year-end 2010, the average loan in foreclosure had been delinquent a record 507 days. This is up from 406 days at year-end 2009. And while mortgage delinquencies dropped nearly 18% in 2010, foreclosure inventories were up almost 10%, and are now at nearly 8x historical averages. “First-time” foreclosures are on the decline, but over 30% of new foreclosures have been in foreclosure before. Figure 6 depicts Total Delinquent and Foreclosure Rates by month since 2001.

Figure 6  
Total Delinquent and Foreclosure Rates by Month



Source: Calculated Risk Blog, December 2010

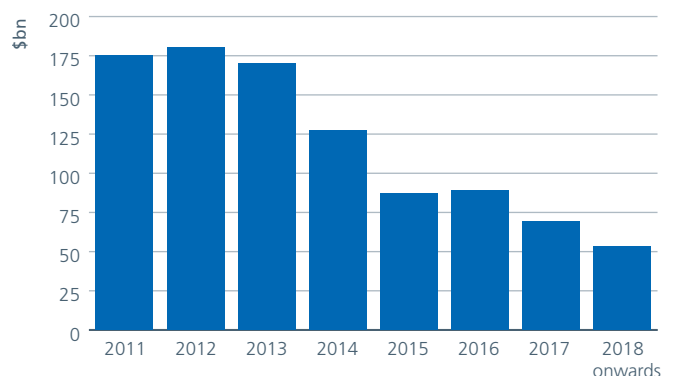
Close inspection of the graph shows something interesting, foreclosures are finally increasing and delinquencies are declining, and those loans that are non-current are flat. Up to recently, the US financial industry has largely been pretending that there is no Japanese-style loan problem, much like the Japanese did at the beginning of their financial collapse 20 years ago. We believe the pressure is growing for write-downs. If you look at Japan, eventually write-downs did occur, five years after the crisis. When this happens, the gates are opened to rebalance the capital structure of the real estate industry.

We believe that over \$500 billion is a reasonable, if rough, estimate of the gap equity capital required to rebalance debt outstanding in the US market to current lending standards. This is an extremely large opportunity that is playing out month-by-month as lenders and operators come to terms with reality. Investors who can seize this opportunity by providing needed liquidity should achieve attractive risk-adjusted investment returns. A simple way to estimate the capital required for deleveraging or write-offs, in the US alone, is as follows:

Calculation of capital injection required to rebalance US commercial real estate	Value (trillions)	Formula
<b>A. 2011 – 2014 commercial mortgage maturities</b>	\$1.40	
<b>B. Original gross property values assuming original LTV of 75%</b>	1.87	A / .75
<b>C. Market value decline, 30%</b>	0.56	B * .30
<b>D. New gross property value</b>	1.31	B – C
<b>E. New first mortgage debt capacity at 65% LTV</b>	0.85	D * .65
<b>F. Required deleveraging capital or loan write-offs</b>	0.55	A – E

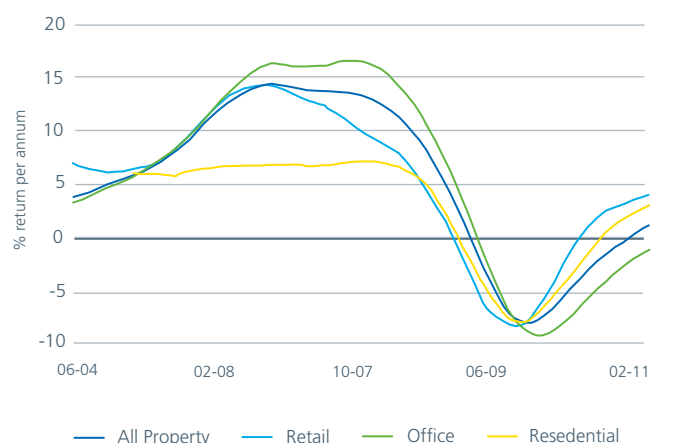
In Europe the case is similar, as shown in Figure 7, with significant commercial mortgage debt coming due in the next three years, and Japan faces a similar challenge as well. The gap in Japan widened to \$84 billion towards the end of Q1 2011 from \$70 billion at the end of Q3 2010. The added difficulty in Japan is that the values have not been recovering. In Figure 8 the performance of the Japanese markets are demonstrated. The latest benchmark figure is end of February and hence does not include the recent natural disaster events.

Figure 7  
European Commercial Real Estate: Debt Maturity Profile



Source: CB Richard Ellis, De Montfort University

Figure 8



Source: IPD Japan Monthly Property Index 28 February 2011

2. The Brighton Group

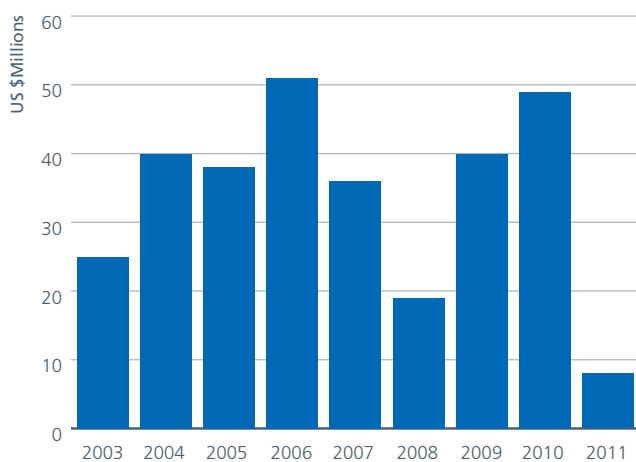
### 3. Public companies pose a competitive threat

Adding to the problems many owners are already facing, competitive pressure to fund tenant improvements and capital expenditures to maintain tenancy sets in. Within the real estate market, the listed Real Estate Property Trusts are generally well-capitalized, and prepared to lure top-quality tenants with aggressive tenant concession packages. If private real estate investors are not sufficiently well capitalized, they will suffer from severe tenant attrition and the potential to lose whatever equity value remains in their investment. The rational choice between the potential for total loss, due to tenant attrition, as opposed to a partial recovery through recapitalization, is attractive once understood.

In the US, the listed REIT market has largely recapitalized, and is cannibalizing tenants from the less well-capitalized private owners – private equity needs to recapitalize to fund tenant improvements and capital expenditures, or risk losing tenants and property value. Figure 9 shows capital raised by US Listed Real Estate Investment Trusts from 2003 to 1Q 2011.

Figure 9

#### Equity Capital Raised by US REITS



Source: NAREIT

While the European and Asian markets do not have the same level of competition from the listed markets, the need to maintain property up to quality standards is as high.

### 4. Traditional real estate private equity players are capital constrained

The most aggressive private real estate investors of the 2003 - 2008 time period remain on the sidelines as distributions from both operations and property sales have been anemic – they have little capital to help themselves. And while there are a number of new entrants seeking to take advantage of recapitalization opportunities, all are seeking high returns, resulting in a level competitive playing field.

The chart on the following page, Figure 10, shows the amount of capital raised by private equity real estate funds over the past three years. You will note how little has been raised since the 2007 peak. In our view this reflects the fact that the most aggressive players have little capability to invest at this time. In addition, many of the institutions that do have capital to invest have reduced their risk tolerance level significantly and are opting to invest in stable income-producing real estate as opposed to complex recapitalizations.

Figure 10

Private Equity Real Estate Fund Raising			
	Funds	Capital (\$ bn)	Avg Size (\$ bn)
2008Q1	54	33.5	0.620
2008Q2	74	42.7	0.577
2008Q3	70	42.5	0.607
2008Q4	62	20.5	0.331
2009Q1	35	15.3	0.437
2009Q2	32	14.5	0.453
2009Q3	30	9.9	0.330
2009Q4	46	11.8	0.257
2010Q1	22	16.6	0.755
2010Q2	23	7.6	0.330
2010Q3	26	10.3	0.396
2010Q4	19	3.6	0.189
2008 Total	260	139.2	0.535
2009 Total	143	51.5	0.360
2010 Total	90	38.1	0.423

Source: Prequin, Real Estate Spotlight, February 2011

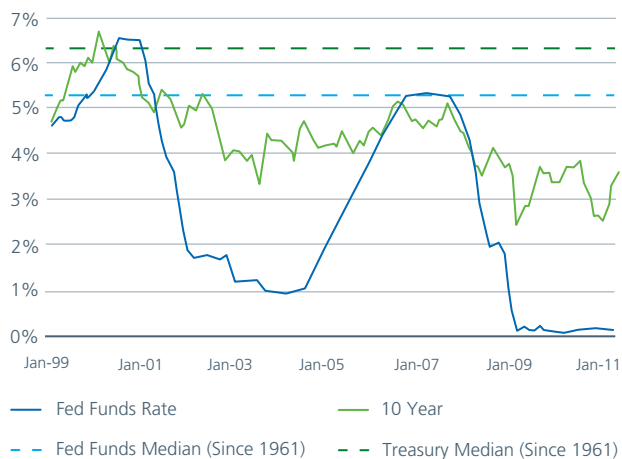
### 5. The end of “extend and pretend”

In our view, the period of “extend and pretend” is coming to an end as a result of the confluence of two forces. Just in time, banks, which hold the vast majority of real estate debt outstanding, have built up enough equity capital to take necessary write-offs on commercial real estate loans, at the very moment that short-term interest rates are about to rise due to the end of monetary stimulus. This is going to cause a number of loans to become non-performing as the base index rates ratchet up.

Thanks to accommodative monetary policy in virtually every developed world market, banks have utilized large lending spreads in order to build up equity, which will allow them to begin crystallizing loan losses this year. In the developed markets, many owners have been able to delay financial restructuring or foreclosure because debt service payments indexed off of extremely low short-term rates allowed them to keep payments current. Figure 11 shows just how accommodative these rates have been in the US.

Figure 11

### Key Interest Rates at Historic Lows



Source: Board of Governors of the Federal Reserve System

Europe has already begun to raise interest rates as inflation is becoming a threat. If this trend continues, and potentially spreads to the UK or the US, the number of opportunities coming to market will grow dramatically. As noted below, however, our economic view is very cautious and we would be surprised to see any increases in interest rates, particularly in the US, prior to mid-2012. The following graph, Figure 12, shows the implied forward interest rates as of May 17, 2011, for 3 Month LIBOR (London Interbank Offered Rate), an often-used benchmark for setting commercial mortgage interest rates.

Figure 12

### Implied Forward 3 Month LIBOR



Source: Bloomberg

## Investment Underwriting Must be Cautious

We are of the view that the economic recovery in the developed markets of the world will remain very weak by historic standards, an important factor when considering the drivers to real estate fundamentals. The developed world is still recovering from a severe balance sheet crisis rather than a typical recession, which will result in a sub-par, U-shaped recovery rather than a V-shaped one. Accordingly, our valuation models tend to result in lower pricing than those of many operators or sellers.

There are specific areas of caution to highlight: (1) we are still digging out of a major financial collapse, (2) weakness in residential housing values will constrain consumer recovery, and (3) public sector austerity will drive further consumer deleveraging.

### 1. Digging out of a major financial collapse

Historically, the recovery process from a severe financial crisis has been very protracted. The impact on housing and employment in particular tends to be quite long-lived. According to Carolyn Reinhart and Ken Rogoff,<sup>3</sup> a severe financial crisis – and the recession that follows – is always preceded by a boom phase during which there is a huge build up of debt. This was certainly the case in the first decade of this century. We are still squarely in the painful and slow process of deleveraging from that debt. As a result, the financial industry is still mired in a huge stock of non-performing loans that have not been written down, and households are mired with debt from the real estate boom.

Historically, what typically transpires after severe financial crises is a period in which there is growth, but not up to the levels of the decade before the crisis. Median growth is approximately 1% lower. Unemployment remains higher, and companies and the government are still paying down debt for about seven years on average. We are not past the three-year mark and governments have taken a variety of steps toward austerity, with the US a notable laggard. Sooner or later the US may adopt fiscal austerity measures and shift toward heavy-handed regulation. Meanwhile, corporate balance sheets are strong, but in our view, the reduction in taxes and transfer payments have slowed consumer deleveraging in 2010. With all levels of government internationally now moving to a greater fiscal constraint, further growth in consumer spending is likely to be restrained.

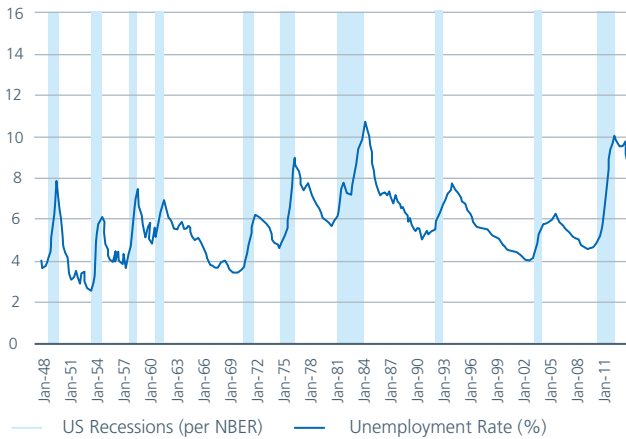
Despite the positive strides the economy is making, unemployment remains at a historically high level. Most recently, US unemployment stood at 8.9% in February, 2011. Figure 13 shows that the unemployment rate has in the past spiked for two to three years during recessionary periods, slowly winding down thereafter.<sup>4</sup> By this gauge, labor will likely take at least a year or two to absorb the jobs lost as a result of the recession.

3. *This Time is Different*, Reinhart and Rogoff

4. *The Brighton Group*

Figure 13

Unemployment Rate (1948-Current)



Source: US Bureau of Labor Statistics & The National Bureau of Economic

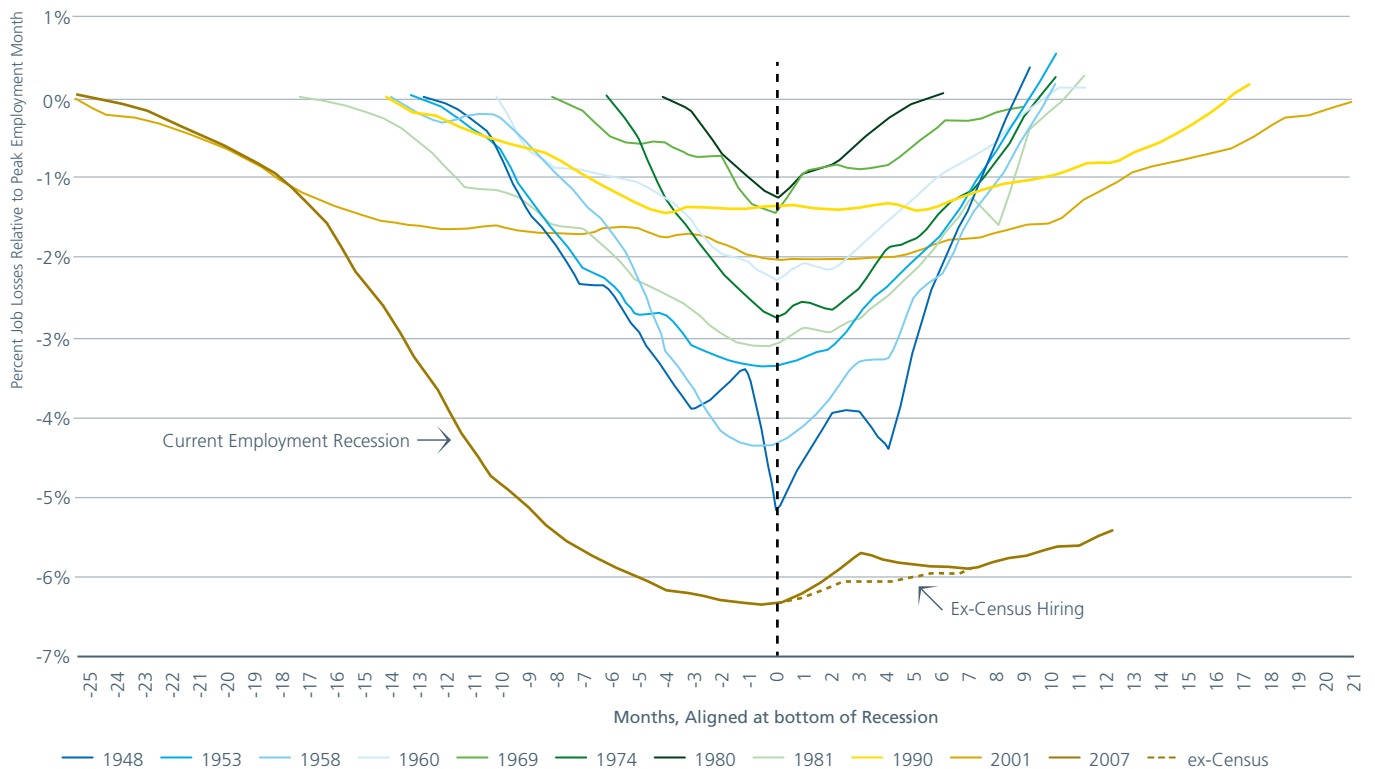
Supporting this view, albeit with greater caution, is graph Figure 14, which documents the number of months elapsed to recover job losses in post World War II recessions.

The unemployment rate typically increases by roughly seven percentage points during a severe financial crisis. At the worst moment in the US, it reached approximately 10%, or approximately six percentage points of increase. History in the advanced economies is that unemployment in the decade following a crisis is still about five percentage points higher than pre-crisis levels. It's not that you don't get improvements, but you don't see these very clear V-shaped recovery patterns that people expect to see. Right now, while non-financial firms are well capitalized, they are hiring more slowly because they see weakness in the consumer sector.

While the economy will continue to show signs of improvement, the recovery in real estate will not be robust as the labor market primarily drives demand for commercial real estate.

Figure 14

Percent Job Losses in Post WWII Recessions, aligned at maximum job losses



Source: Calculated Risk Blog

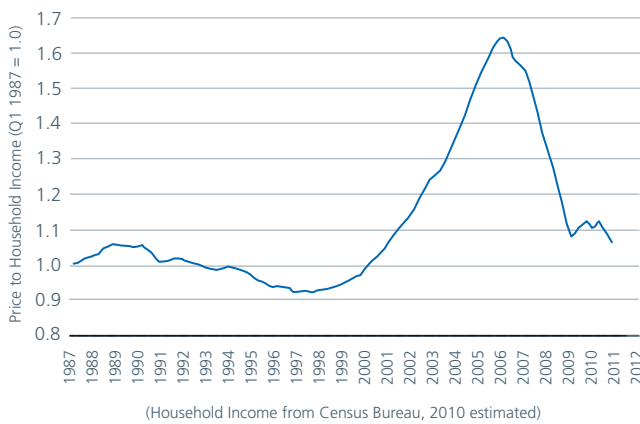
## 2. Weakness in US housing will hamper consumer recovery

The US housing sector is once again in decline and will act as a headwind against consumer-led growth. The housing price and consumption declines (and partial recovery) to date could have been worse, except for the fact that the deleveraging of the household sector has been slowed down by re-leveraging of the public sector. Consumption, despite mediocre labor income growth, has been supported by lower taxes and higher transfer payments, effectively borrowing growth from future years. This will not continue indefinitely and soon the consumer will resume financial deleveraging.

In the US, nationwide house prices are still approximately 10% too high relative to incomes, see Figure 15 on the following page. Further, the considerable inventory overhang could result in prices declining well past where they should be from an income standpoint. Declines in housing and high unemployment imply that losses that banks and financial institutions will incur on their real estate assets will be higher than currently priced by the markets.

Figure 15

### Price to Median Household Income (Q1 1987 = 1.0) using Case-Shiller National Index



Source: Calculated Risk Blog

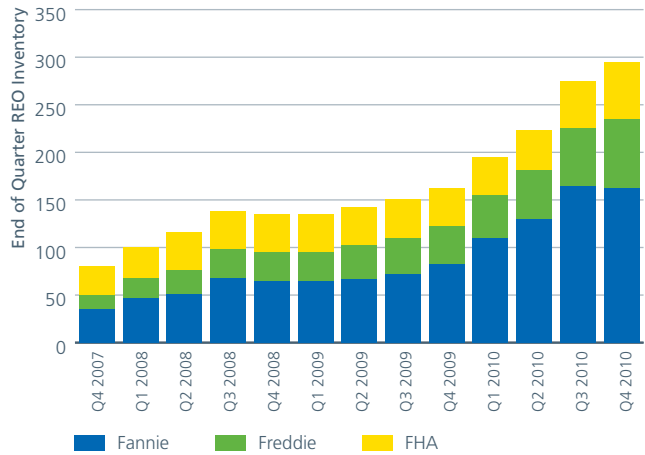
According to Carolyn Reinhart, between 2001 and 2006 housing prices rose by more than they had in the preceding 130 years. Now households are stretched by their mortgages that were sized against these inflated asset values. As American homeowners' share of equity in real estate fell to 38.5% in 2010 from 59.7% in 2005,<sup>5</sup> worries about retirement funding have the American homeowner (particularly the Baby Boomers) continuing to focus on deleveraging their lives and saving more. This won't get better soon. According to Reinhart, median housing prices in the decade after severe crises are typically still about 15% lower than they were before the crash.

All of this excess in terms of valuations and debt financing has resulted in massive foreclosures by banks. These homes, now considered "Real Estate Owned" ("REO") aggregate to an industry-wide inventory that remains at historically high levels, as depicted in Figure 16. Eventually, this inventory has to be sold into the

marketplace – while this is taking place, in our estimation during the 2011 – 2012 time period, negative valuation pressure will remain very strong.

Figure 16

### REO Inventory: Fannie, Freddie and FHA through Q4 2010



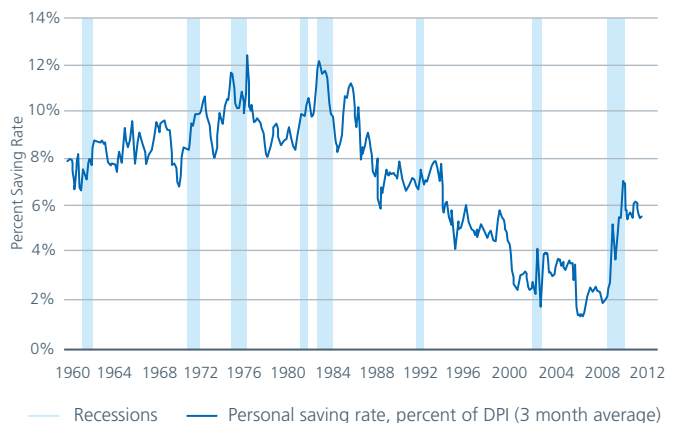
Source: Calculated Risk Finance & Economics

This weakness in housing could be made worse by inflation pressures emanating from Asia and volatility in the Middle East. Persistent growth in Asia will continue to pressure food and metals commodity prices worldwide. Volatility in the Middle East has the potential to hugely impact oil prices (and by extension inflation and global growth), thereby reducing real disposable income.

With unemployment high, pressure on housing valuations and the imminent threat of inflation, it is no wonder that consumers are concerned about the future and have increased their rate of savings. This is evident in Figure 17 which depicts the savings rate which is now hovering around 6% of disposable income, a significant increase from the recent past – and yet a reduced level relative to longer-term history.

Figure 17

### Personal Saving as a Percentage of Disposable Personal Income



Source: Calculated Risk Blog

5. The Wall Street Journal, March 15, 2011 - Vital Signs

### 3. Weakness in the public sector(s)

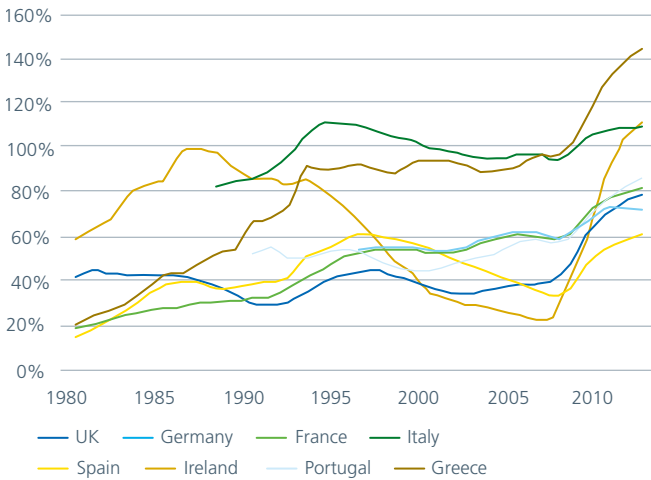
For the past two years sovereign risks have been a focus of our interest and analyses. While Iceland, Greece, Ireland and Portugal have had notable sovereign debt issues, it's the "big dogs" of the US, Japan, the UK, and Spain that have direct practical implications to our current and future real estate investment portfolios.

This is not to diminish the potential impact of a hard-landing default (as opposed to a "soft-landing" default) of the sovereign debt of one of the more peripheral European countries that could disrupt capital markets worldwide, as well as real financial and estate markets in northern Europe. European banks, still overleveraged and under-provisioned for losses from the 2008-2009 credit crisis, have massive exposure to both Current Account Deficit economies which are facing deflationary spirals and to CAD sovereign debt, which was considered "risk free" under EU regulations.

The euro as a single currency is largely a political project, which sought to get away from centuries of conflict within the region. Nevertheless, there is clearly an inherent inconsistency between having a common currency with full authority for monetary policy but without coordinated fiscal policy. While mechanisms are in place to keep member nations from deviating with regards to interest rates, debt, deficits and inflation, these have largely been sidestepped, even by the large and powerful nations. However, a new debate is taking place: what mechanism should European Union members implement, and should penalties be harsher for non-compliance. Or should the region consider issuance of Pan Eurozone bonds backed by the stronger countries?

Figure 18

#### Debt to GDP Select European Countries



Source: International Monetary Fund

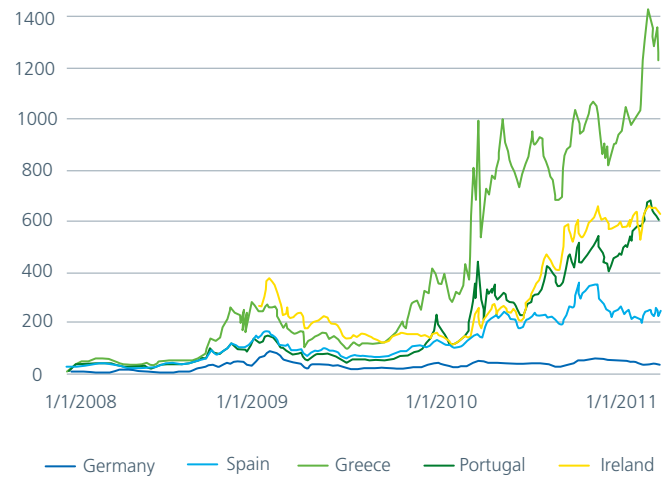
There isn't much persuasive evidence that you can simply grow your way out of this level of debt. The usual way to deal with it is a combination of fiscal austerity, debt restructuring, or a financial repression, which will clamp down and regulate the financial system so that interest rates remain low.

We believe that Spain remains the big question mark, with uncertainty as to whether it will require a bail out, and if it does, the German and Nordic banks will be affected. Because Spain is not a strong exporter it is not benefitting from a weak Euro or strong Asian demand. Further, the business and financial sectors are very weak financially. A strong government austerity plan is necessary, but what is planned may fall short of what is needed.

It is difficult to imagine an outcome in Europe that doesn't involve restructuring of public and private debts, and restructuring is partial default. Ireland's gross public and private debt is ten times GDP. Greece has implemented significant austerity measures but austerity measures don't yield immediate results – and things often get worse before they get better. The debate will play itself in the near term with time pressure exerted by the need to resolve the situation before Spain, Europe's fifth-largest economy, becomes an issue.

Figure 19

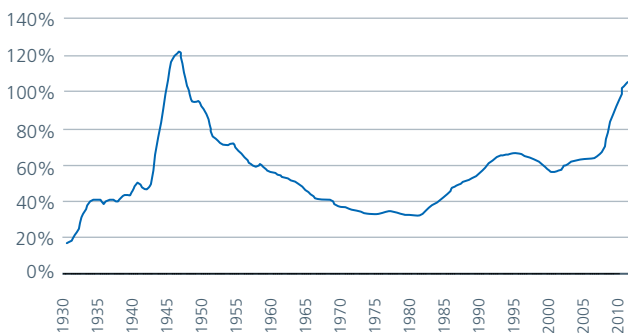
#### CDS Spreads relative to German rates for Spain, Ireland, Greece and Portugal since January 2008



Source: Bloomberg

Sooner or later the US has to get its fiscal house in order – potentially affecting all manner of global support for international and domestic programs. In 2011 the deficit may be close to \$1.5 trillion. 2012 is an election year when structural fiscal adjustment is unlikely to occur, and whoever is President in 2013 will inherit a budget decided in 2012. So 2014 is the first year that the fiscal deficit can be addressed – presuming that the bond markets stay sanguine until then. A bond market revolt is something very difficult to predict, but potentially devastating if Treasury rates rise markedly.

Figure 20  
US Debt to GDP



Source: [usgovernmentspending.com](http://usgovernmentspending.com)

Equally troubling, if action can be taken to prevent bond markets weakening the US, this necessarily means public sector deleveraging is in the works, which will act as a drag on GDP. In a way the developed world economies are in a “damned if you do – damned if you don’t” scenario where either you reduce economic growth or potentially suffer an economic collapse. The repercussions of severe austerity budget are already becoming clear in the UK where retail sales in the UK plunged 3.5% in March, the sharpest monthly downturn in Britain in 15 years.

Municipal bond defaults (more likely at the city/county level than the state) would put upward pressure on interest rates. Further, government cutbacks will reduce disposable incomes and lower consumer confidence.

### A few thoughts about Japan

As we began to emerge from the depths of the financial crisis, we had anticipated that there would be an opportunity for recapitalization investment in real estate entities in the Tokyo market. After all, it is a huge market with a substantial overhang of commercial real estate debt. However, the triple crisis of earthquake, tsunami and nuclear accident that occurred in March 2011 has us taking a step back for the moment. While the human toll of the crisis is horrific, the long-term economic toll may not be

particularly negative as far as the earthquake/tsunami is concerned. However a nuclear catastrophe would have long-term negative effects, and while the probability thereof as of this writing has diminished, the ultimate resolution is not clear. We will continue to monitor this market and opportunities carefully. Since the values are not recovering yet and the funding gap has widened, we believe there will be interesting opportunities.

### Conclusion

Mid-year 2011 leaves us quite uncertain as to the future course of events. In one sense, this is a more healthy situation than when all market participants have a similar optimistic or pessimistic view of the marketplace. In another, it seems as if real estate market participants have herded into two camps, the risk averse, and the non-participants.

As we have discussed in the past, Core strategies are often pursued as a conservative approach – but as we have argued here, we believe the most conservative strategy is a value oriented one, which may not perfectly match historical definitions of core real estate. As we live in parallel investment universes for now – core and everything else – this will not last forever. We suggest investors think more broadly than recent experience.

There is much going for us, real estate valuation entry points are still attractive, and a global mortgage overhang will keep prices from running away across the real estate spectrum, for now. Further, the private sector needs recapitalization funding – in our view one of the most attractive investment opportunities – because traditional real estate private equity players are capital constrained, or playing “conservatively”.

The most encouraging sign is that we sense the end of the “extend and pretend” activities the majority of real estate lenders have pursued. 2011-2012 may be the period where real estate finally finds a true market-clearing price.

Our hope is that the clearing price reflects a realistic, and somber, view about future events. Continuing to dig ourselves out of a financial collapse will take time, particularly on the labor front. And housing in the US and Europe remains soft. Layered on top of this, governmental fiscal positions in the developed world are weak and in a consolidation mode – this will be a strong headwind to economic growth and job formation.

Our view – keep a very close eye on real estate fundamentals and valuation metrics.



As always, we look forward to your comments.

**Ed Casal**

Chief Investment Officer  
Real Estate Multi-Manager

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