Russell Investments

Russell Research

By: David L. Brunette, Senior Research Analyst OCTOBER 2010

Revisiting the strategic case for global real estate securities

Demand is local while capital is invested on a global basis

The logical extension of portfolio diversification for real estate is expanding to include cross-border investing.

Real estate securities offer an efficient, robust and attractive means to invest in real estate on a global basis.

Introduction

It was not that long ago (well, the early-1960s) that most real estate activity was conducted by local market participants. Developers went to their local bank or insurance company for loans; upon completion, local tenants would lease space and the building would be added to the developer's balance sheet as an investment or sold to local investors. This cycle repeated itself, time and time again, in cities everywhere. In our Real Estate Report[1] from 1984, we noted that "During the period ending with World War II through the 1960s, real estate development and property ownership was a localized entrepreneurial business that ebbed and flowed with the availability of and cost of debt capital."

In the early 1970s, the cycle changed as pension funds and other institutional investors started to invest in real estate. They viewed real estate to be a risk diversifier when added to a portfolio comprised of only stocks and bonds. As capital started to flow from non-traditional sources, real estate began to transcend its local market roots. Today, some forty years later, while tenant demand for space remains a distinctly local market activity, investing in real estate is now an international business whereby capital flows to those real estate investments that provide the best return prospects, regardless of location. As such, we believe that this is an appropriate time for real estate securities portfolios to move from a domestically oriented focus to a fully global strategy.

INSTITUTIONAL INVESTMENT IN REAL ESTATE

During the 1970s, institutional investors typically employed real estate investment strategies that owned, on an all-cash basis, a geographically diversified portfolio of high-quality, income producing, multi-tenanted properties. These core investment strategies were viewed to be the prudent, logical and conservative way to invest in real estate. Over time, the strategies evolved to include additional property types, development projects and employed varying levels of leverage.

[1] "Real Estate Report." Russell Investments, July 27, 1984.

FIFTY YEAR ANNIVERSARY OF REIT LEGISLATION IN THE U.S.

This year marks the 50th anniversary of when Congress approved the creation of real estate investment trusts (REITs) in the U.S. While 1960 was the year REITs were created, those early REITs were oriented toward lending, rather than owning and operating real estate. It was not until 1991 when Kimco's initial public offering was successfully introduced that the "Modern REIT Era" began.[2] With this IPO, the REIT industry began to transform itself into internally-managed, equity owners of real estate that provided a stable income stream backed by leases in buildings with relatively conservative loan-to-value ratios. As a result, REITs began to offer investment strategies that were previously only available to institutional investors.

Today, the logical extension of portfolio diversification for real estate is expanding to include cross-border investing and thereby create a globally diversified portfolio of real estate. We believe that real estate securities offer an efficient, robust and attractive means to invest in real estate on a global basis.

The case for global real estate securities

In revisiting the case for global real estate securities, we think it's appropriate to take a step-by-step review of the role of real estate.

CASE FOR REAL ESTATE

The strategic case for including real estate in a multi-asset class portfolio includes: total returns driven by high cash yields, low correlations with stocks and bonds and a hedge against inflation. There are two main components which underpin commercial real estate returns. The first component is the stable, bond-like income yield that comes from rents based on contractual property leases, which can have durations of up to seven to ten years. The second is a capital appreciation component that is linked to demand for space, usually derived from economic growth. Russell's strategic planning assumptions for asset allocation currently estimates the correlation of U.S. private market real estate with fixed income to be 0.12 and with U.S. Equity to be 0.49, a clear indication of the diversification benefits of owning real estate.[3]

CASE FOR REAL ESTATE SECURITIES

Real estate securities are an appropriate proxy for direct (private market) real estate. While acting like equity in the short term, the evidence indicates that real estate securities behave more like private real estate in the long-run. REITs are viewed to be real estate because, by law, they must derive most of their income from owning and operating real estate. Further, at least 75% of total assets of the company must be in real property, and the company is required to distribute 90% of its earnings as dividends (these are U.S. regulations; it varies by country).

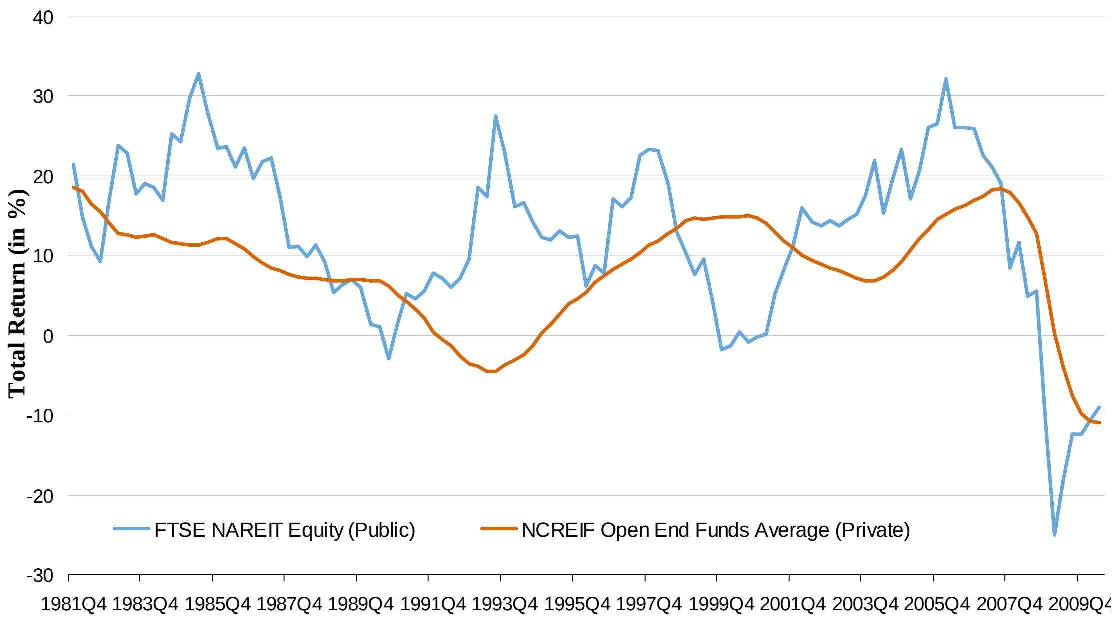
Key differences that can impact the returns in the public and private markets include the mix of property types, the amount of leverage, pricing mechanisms and management. One of the more pronounced differences is the pricing mechanism: private real estate is based upon appraised values while public real estate is priced daily in the equities market. Historically, there has been a lag in recognizing value changes in the private market;

[2] National Associate of Real Estate Investment Trusts (NAREIT) and Russell Investments.
[3] Russell Investments. Correlations based on cumulative returns over a 10-year horizon, data through September 30, 2010.

however, over the last few years, this lag has dissipated such that the returns during the recent market cycle are relatively close.[4]

In Exhibit 1, the returns are presented for public real estate, as measured by the FTSE NAREIT Equity REIT Index, and private real estate, as measured by the NCREIF Open-end Funds Average (these commingled funds are available to institutional investors and utilize an appraisal process for valuing properties). The chart, which displays annualized returns for rolling three-year periods, shows a pronounced lag between the two indexes. For example, public real estate hit a cyclical low for the period ending third quarter 1990, while for private real estate, the low occurred for the period ending second quarter 1993 (about a three-year lag). However, during the most recent market decline the chart shows the cyclical lows were just a few quarters apart.

Exhibit 1: Public versus private U.S. real estate; annualized returns
Rolling three-year periods, fourth quarter 1981 through second quarter 2010



Source: FTSE, NCREIF and Russell Investments

Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results

Exhibit 1 is a good illustration of the relationship between public and private real estate and how the relationship is much more aligned today. Many industry researchers believe that the daily pricing of real estate in the public markets is providing valuable information to private market participants, thereby influencing the pricing trend of real estate in the private market.

There are several key factors which Russell believes allow publicly listed real estate companies to successfully compete with private market real estate organizations in many markets, globally:

[4] Among the earliest and most comprehensive research on appraisal lag, please see "On the Reliability of Commercial Appraisals: An analysis of Properties Sold from The Russell-NCREIF Index (1978-1992)," *Real Estate Finance*, Spring 1994.

- *Liquidity* – It's easier and more efficient to trade shares of real estate securities than buy and sell individual properties or non-listed private real estate funds. Trading volume in shares of real estate securities have grown significantly over the last several years and now provides nearly instant liquidity.[5] For example, in the US, the average daily trading volume has grown from $365 million in 2000 to $3.4 billion today.[6] We see similar growth in other markets as well.
- *Transparency* – Listed real estate companies provide earnings statements, annual reports and other information regarding the operations of their businesses. This transparency allows investors to make knowledgeable investment decisions. Similar information on private market investment is tantamount to finding the proverbial needle in a haystack.
- *Access to capital* – There are many avenues a listed real estate company can pursue to raise capital, including secondary equity offerings (both common and preferred shares), corporate bond offerings, bank lines of credit; and mortgage debt.
- *Proven management teams* – Many listed real estate companies have been in existence ten years or more. Over this time, Russell has seen these management teams guide their companies through different economic, stock market, and real estate cycles thereby strengthening their management expertise.
- *Strong corporate governance* – Under the direction of the National Association of Real Estate Investment Trusts (NAREIT), the industry has strived to improve corporate governance structures. With firms like Institutional Shareholder Services, a research firm that monitors corporate governance practices, REITs are subject to the same scrutiny as other listed companies; there really isn't anything comparable for private market investments.

CASE FOR MOVING TO GLOBAL REAL ESTATE SECURITIES

The key considerations for moving to global real estate securities include:

- *Improved diversification (relative to U.S. REIT only portfolio) due to lower correlations between regions*. Portfolios of global real estate securities are often less volatile than more narrowly focused country or regional strategies.[7] Generally, real estate offers perhaps the most direct exposure to a local economy. In a recent paper[8], J.P. Morgan estimated that among the top ten largest real estate stocks in the world, only 13% of their earnings came from markets outside of their home country. Conversely, in the broader equity market, among the top ten largest equities, 56% of their earnings came from overseas markets (for example, Microsoft has 40% of its earnings coming from overseas markets). As such, real estate securities can offer a purer play to local economies versus other listed equities since most of the earnings for real estate securities are generated from their home markets.

[5] NAREIT trading volume statistics.
[6] NAREIT.
[7] Using market indices as a proxy for investment strategies, real estate securities on a global basis are often less volatile than more narrowly focused country or regional strategies; this is clearly evident in Exhibit 2 where the risk level (as measured by standard deviation) of global real estate is less than U.S. and Asia and equal to that of Europe.
[8] Michael Hudgins, J.P. Morgan Asset Management "*Brave New Worlds*" April 2010.

Exhibit 2 shows that global real estate securities have a lower risk level than U.S. real estate securities (as measured by standard deviation) over the past fourteen years, a period that covers several different market environments. Over this time period, the correlation of U.S. real estate securities with real estate securities in Asia and Europe was a relatively low 0.45 and 0.72, respectively. We believe that the portfolio diversification is enhanced by implementing a real estate securities strategy that is invested globally.

Exhibit 2: Return, risk and correlation – 14 years ending September 30, 2010

	Return	*Risk*	*Global Real Estate*	*US Real Estate*	*Asia Real Estate*	*Europe Real Estate*	*Global Equities*	*US Equities*
Global Real Estate	7.7	19.8	1.00					
US Real Estate	9.7	22.4	0.85	1.00				
Asia Real Estate	5.7	26.6	0.83	0.45	1.00			
Europe Real Estate	8.5	19.8	0.80	0.71	0.52	1.00		
Global Equities	5.9	16.8	0.79	0.59	0.71	0.67	1.00	
US Equities	5.8	16.8	0.72	0.56	0.64	0.57	0.97	1.00

Source: For Global, US, Asia, and Europe Real Estate, the FTSE EPRA/NAREIT Developed Real Estate series of Indexes are used. For Global Equities and US Equities, the Russell Developed Index and Russell 1000 Index are used, respectively. Returns and risk (as measured by standard deviation) are annualized and are calculated from monthly returns. Correlations are also based on monthly returns.

Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results.

- *Expanded investment opportunity set*. With the introduction of the tax-efficient REIT structure in over 20 countries and nearly a dozen more countries considering implementing REIT legislation, there is a large and growing pool of investable real estate securities around the world. According to the European Public Real Estate Association (EPRA) the universe of publicly-listed real estate securities is now over $1 trillion, of which the U.S. is less than 35%. The access to a wider universe of real estate companies should provide a more robust environment for active securities investment management. Many real estate companies in Europe and in Asia have been in existence over 20 years and have both high quality real estate portfolios and very experienced management teams.[9]
- *Consolidation in the U.S. Market*. The U.S. real estate securities market has experienced consolidation over the last several years. From 2005 through 2007, the U.S. REIT market experienced a significant amount of merger and acquisition activity with approximately $88 billion of M&A transactions resulting in 30 companies leaving the market. Combined with other corporate activity, the number of U.S. equity REITs declined from 150 at year-end 2004 to just 112 at September 30, 2010. This contraction has allowed existing REITs to become larger: the average market capitalization of $2.7 billion on September 30, 2010 is up from $1.8 billion on December 31, 2004. The unintended consequence of fewer U.S. REITs is that the FTSE NAREIT Equity REIT Index is more concentrated. Today, the top five equity REIT stocks, as measured by market capitalization, represent about 27% of the U.S. REIT industry. Historically, it's been in the 20% range. We believe that the consolidation and concentration in the U.S. real estate securities market creates a very challenging stock selection environment for dedicated REIT investment managers, a situation we don't see changing in the foreseeable future.[10]

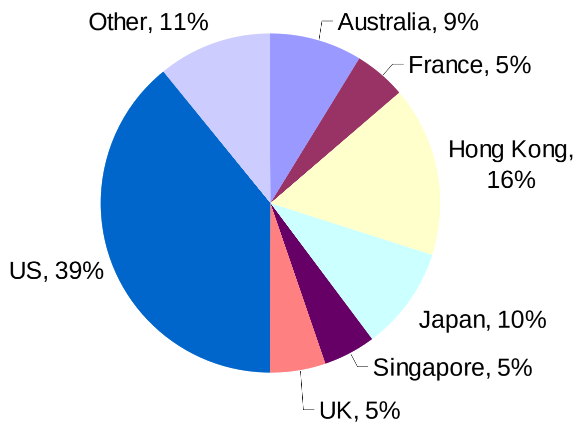
[9] European Public Real Estate Association (EPRA) and Russell Investments.
[10] NAREIT and Russell Investments.

- *Dedicated real estate investment managers are now global*. Most dedicated U.S. REIT investment managers have transitioned their businesses to a global model and are fully capable to research and make allocations to real estate securities across the globe. This effort to create a global investment platform started nearly 10 years ago. Many investment organizations have experienced teams of portfolio managers and analysts located in Europe and Asia. Implementing a global real estate securities investment program is now a standard activity in the industry.[11]

Composition of the global real estate securities market

Most global real estate securities investors are using the FTSE EPRA/NAREIT Developed Index as a market proxy against which to measure their investment performance.[12] This index is free-float weighted and includes only real estate securities that are traded on an official stock exchange. There are several rules regarding minimum market capitalization and trading requirements. Presently 279 stocks from 20 countries are included in the FTSE E/N developed Index. The Index includes stocks that are governed by the various REIT legislations around the world, as well as non-REIT companies that have at least 75% of their earnings derived by real estate activities. A company is only included if it provides an audited annual report in English.

Exhibit 3: Country allocation of global real estate securities



Source: FTSE EPRA/NAREIT Developed Index; Allocations are based on market capitalization of each country as of September 30, 2010

FOR FINANCIAL PROFESSIONAL USE ONLY.

[11] EPRA and Russell Investments.

[12] EPRA and Russell Investments.

An additional perspective on the composition of the global real estate securities marketplace is displayed in Exhibit 4 where we present the top twenty real estate securities, as measured by market capitalization, in the FTSE EPRA/NAREIT Developed Index:

Exhibit 4: Largest-twenty real estate securities globally as measured by market capitalization, at September 30, 2010

Company Name	***Country***	***% of Global***	***% of U.S.***
Sun Hung Kai Properties	Hong Kong	4.50	
Westfield Group Australia	Australia	3.72	
Simon Property Group	United States	3.65	9.11
Unibail-Rodamco S.A.	France	2.75	
Mitsubishi Estate Co. Ltd.	Japan	2.30	
Vornado Realty Trust	United States	2.11	5.27
Mitsui Fudosan Co. Ltd.	Japan	2.02	
Equity Residential	United States	1.82	4.54
Public Storage	United States	1.68	4.19
Boston Properties Inc.	United States	1.56	3.90
HCP Inc.	United States	1.51	3.78
Hong Kong Land Holdings	Hong Kong	1.42	
Hang Lung Properties Ltd.	Hong Kong	1.37	
Sumitomo Realty	Japan	1.33	
CapitaLand Ltd.	Singapore	1.33	
Host Hotels & Resorts	United States	1.28	3.20
Stockland Australia	Australia	1.20	
AvalonBay Communities	United States	1.20	3.00
Wharf (Holdings) Ltd.	Hong Kong	1.20	
China Overseas Land	China	1.17	
Total		39.14	36.99

Source: Factset. The % of global column uses the FTSE EPRA/NAREIT Developed Index and the % of U.S. column uses the FTSE NAREIT Equity REIT Index.

Note: China Overseas Land is listed in Hong Kong and by rule is included in the index.

Among these top twenty securities, seven countries are included, with the U.S. having the largest representation. In aggregate, the top twenty represent 39% of the overall global real estate securities index. There are two companies which are larger than Simon Property Group (the largest U.S. real estate stock): Sun Hung Kai and Westfield Group. Simon, which is 9.1% of the U.S. market, is 3.6% of the global market, and therefore is less impactful for managers to take an active position in the security versus the benchmark.

Final thoughts

It may be too lofty of an objective for the centerpiece of a real estate strategy to "own the best real estate in the best markets," but we do think owning high quality, income-producing real estate assets is as critical today as it was in the early 1970s when investors began adding real estate to their portfolios. Expanding a real estate securities portfolio to include companies listed on exchanges across all developed markets we believe is a meaningful way to diversify the portfolio by having exposure to well-managed, high quality properties located in London, New York, Sydney, Washington D.C., Tokyo, Boston, Hong Kong, Singapore, Amsterdam and Paris, to name just a handful of the key markets.

*****

Real Assets and the Russell Global Real Estate Securities Fund

In October 2010, Russell announced the formation of a real assets category, which includes the Russell Global Real Estate Securities fund, the Russell Global Infrastructure Fund, and the Russell Commodity Strategies Fund; and added the category to its asset allocation models. These types of investments are called “real” assets because they are tangible, or physical assets, that typically have intrinsic value.

As part of the real assets category, the Russell Global Real Estate Securities Fund provides the opportunity for improved diversification due to historically low correlations between regions around the world. As discussed in this article, most developed and many developing markets have a growing pool of investable assets, providing access to quality properties and real estate management teams.

The Fund seeks to provide current income and long-term capital growth. The Fund invests primarily in securities of companies, known as real estate investment trusts (REITs), that own interests in real estate or real estate related loans.

To learn more about the funds in the real asset category or the Russell Global Real Estate Securities Fund, call 800-787-7354.

For more information:

Call Russell at **800-787-7354** or
visit **www.russell.com**

Important information

Fund objectives, risks, charges and expenses should be carefully considered before investing. A prospectus containing this and other important information can be obtained by calling 800-787-7354 or by visiting www.russell.com. Please read the prospectus carefully before investing.

Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth.

Specific sector investing such as real estate can be subject to different and greater risks than more diversified investments. Declines in the value of real estate, economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments. Fund investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation.

FTSE EPRA/NAREIT Developed Index is a global market capitalization weighted index composed of listed real estate securities in North American, European and Asia real estate markets.

On October 1, 2010, the Russell Real Estate Securities fund was renamed the Russell Global Real Estate Securities Fund.

Diversification does not assure a profit and does not protect against loss in declining markets.

Russell Investment Group, a Washington USA corporation, operates through subsidiaries worldwide, including Russell Investments, and is a subsidiary of The Northwestern Mutual Life Insurance Company.

The Russell logo is a trademark and service mark of Russell Investments.

Bond investors should carefully consider risks such as interest rate, credit, repurchase and reverse repurchase transaction risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield (“junk”) bonds or mortgage backed securities, especially mortgage backed securities with exposure to sub-prime mortgages. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries

Securities products and services offered through Russell Financial Services, Inc., member FINRA, part of Russell Investments.

First used: November 2010

RFS 10-4239

FOR FINANCIAL PROFESSIONAL USE ONLY.