

Alternative Investment Opportunities in Real Estate for Individual Investors

by

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Submitted to the Program in Real Estate Development in Conjunction with the Center for Real Estate in Partial Fulfillment of the Requirements for the Degree of Master of Science in Real Estate Development

at the

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ABSTRACT

This thesis will evaluate whether an unsatisfied need to access private commercial market real estate investment opportunities exists on the behalf of individual investors via their Individual Retirement Accounts (IRAs) and 401(k)s and, if so, what the optimal investment structure is to accommodate that need given certain investment parameters.

Institutional Investors, with few exceptions, maintain some percentage of their investment portfolios in commercial real estate assets. That allocation to real estate assets can be achieved in any combination of the following investment vehicles: direct ownership (separate accounts), public real estate investment trusts (REITs), closed and open-ended commingled private equity funds, and joint ventures with local partners or developers. According to the Pension Real Estate Association (PREA), the average institutional investor currently allocates approximately 9% of its investment portfolio to real estate, with public REITs only serving as 5% of that allocation. The remaining 95% is composed of direct investment, closed and open-ended commingled funds, and joint ventures. Institutional investors have a long time horizon and a myriad of resources at their disposal to optimize their asset allocations. But can individual investors with similar long-term liabilities replicate institutional real estate strategies within their own retirement portfolios?

Individual investors are increasingly becoming their own fiduciaries through defined contribution programs; defined benefit plans' percentage of total retirement assets in the US has been in significant decline for decades, with no sign of reversal. Real estate is an important asset class for pension plans in terms of providing current yield, inflation protection and diversification; it should be equally important in individual investors' portfolios. This thesis argues that one way for individual investors to efficiently gain private market commercial real estate investment exposure is through a multi-manager core fund held within a collective investment trust.

Thesis Supervisor: W. Tod McGrath

Title: Lecturer

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Introduction

Assuming 10% of individuals' retirement assets will be directed towards real estate, the potential demand for real estate related products by individual investors is \$850 billion dollars. Yet, relative to institutional investors, individuals do not have equal opportunities to gain commercial real estate investment exposure on their own behalf. The two main investment vehicles available today are Publicly Traded REITs and Non-Traded Public REITs; however, the total market capitalization of both is only about \$460 billion. This represents 50% of the potential demand by individual investors, assuming no institutional investors have an appetite for the two investment vehicles. Additional options available to most individual investors (those without \$5m+ to invest in any given fund) are limited to Tenancy-in-Common ownership structures, 4-Plexes (small scale direct ownership) and, in certain cases - local developers. Each of these vehicles has various pitfalls. Among these are high fees, a low diversification factor, little choice between sponsors, and a high correlation with the public markets (public REITs only). These factors lead me to ask: how can the average investor more effectively allocate retirement funds to commercial real estate? This thesis argues for one structure that would give individual investors access to institutional quality private real estate investments otherwise unavailable to them.

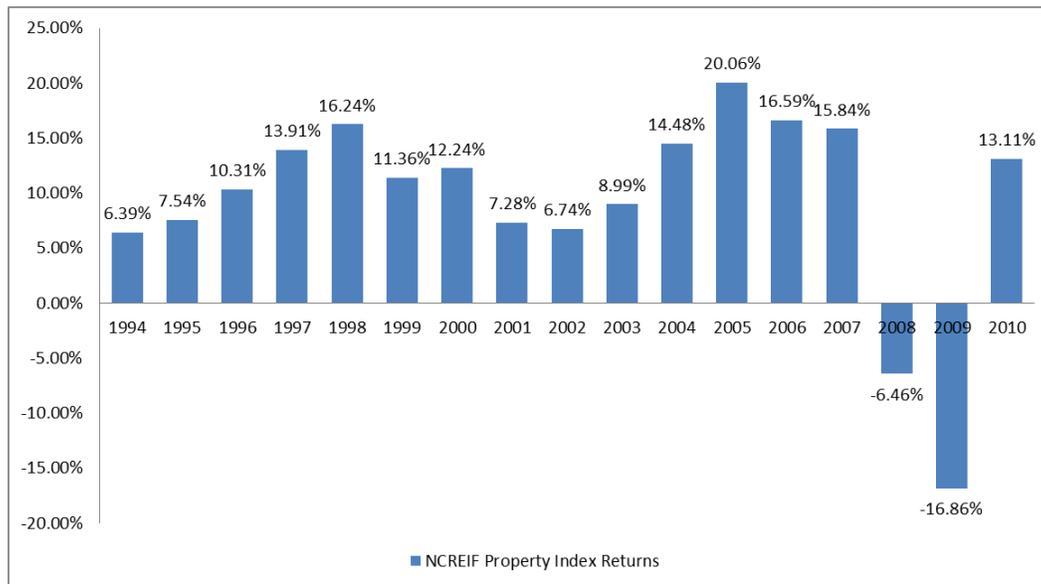
Chapter 1: Why Real Estate?

What are the benefits of owning real estate within a portfolio?

Real estate is one of many potential asset classes an investor can choose within his portfolio: stocks, bonds, hedge funds, private equity, and cash equivalents. Certain aspects of real estate relative to those other asset classes make it an appealing investment choice, which is why it is included in most institutional portfolios. This chapter will describe the characteristics of commercial real estate investments as an asset class.

Total Return

Figure 1: NCREIF Property Index Annual Returns (94 - 2010)



Average annual total return over the period from 1994 to 2010 was reported to be 9.28%¹ by the National Council of Real Estate Fiduciaries (NCREIF) Property Index Returns.

Volatility

Annual volatility based on annual NCREIF Property Index Returns was 8.98% from 1994 to 2010.

¹ Unlevered and excluding fees over a 16 year time horizon.

Relative Risk Adjusted Performance

On a risk adjusted basis, private real estate investments outperformed all alternative investment classes – except for hedge funds which ‘beat’ real estate with an incremental .01 excess return per unit of risk².

On an absolute basis, however, real estate’s quarterly volatility over the given period of 2Q94 through 2Q10 is nearly 70 basis points less than that of hedge funds. This is as one might expect given the lower compensating return over the period.

Table 1: Returns, Volatility and Risk Adjusted Performance (Quarterly 2Q94 to 2Q10)

| | Quarterly Return | Risk Free Rate | Excess Return | Standard Deviation | Sharpe Ratio |
|---------------------|------------------|----------------|---------------|--------------------|--------------|
| Private Real Estate | 2.13% | 0.90% | 1.23% | 3.58% | 0.35 |
| REITs | 3.14% | 0.90% | 2.24% | 11.37% | 0.20 |
| Equities | 2.19% | 0.90% | 1.29% | 8.96% | 0.14 |
| BBB Corporates | 1.80% | 0.90% | 0.90% | 3.09% | 0.28 |
| Treasuries | 1.79% | 0.90% | 0.89% | 3.55% | 0.25 |
| Hedge Funds | 2.42% | 0.90% | 1.52% | 4.26% | 0.36 |

Source: PREA Private real estate and REITs are measured with same property type weighting; private real estate is net of fees. The other asset classes are represented by the Russell 3000, B of A Merrill Lynch BBB Corp. Index, B of A Merrill Lynch 7-10 year Treasury Index, and the Dow Jones Credit Suisse Hedge Fund Index.

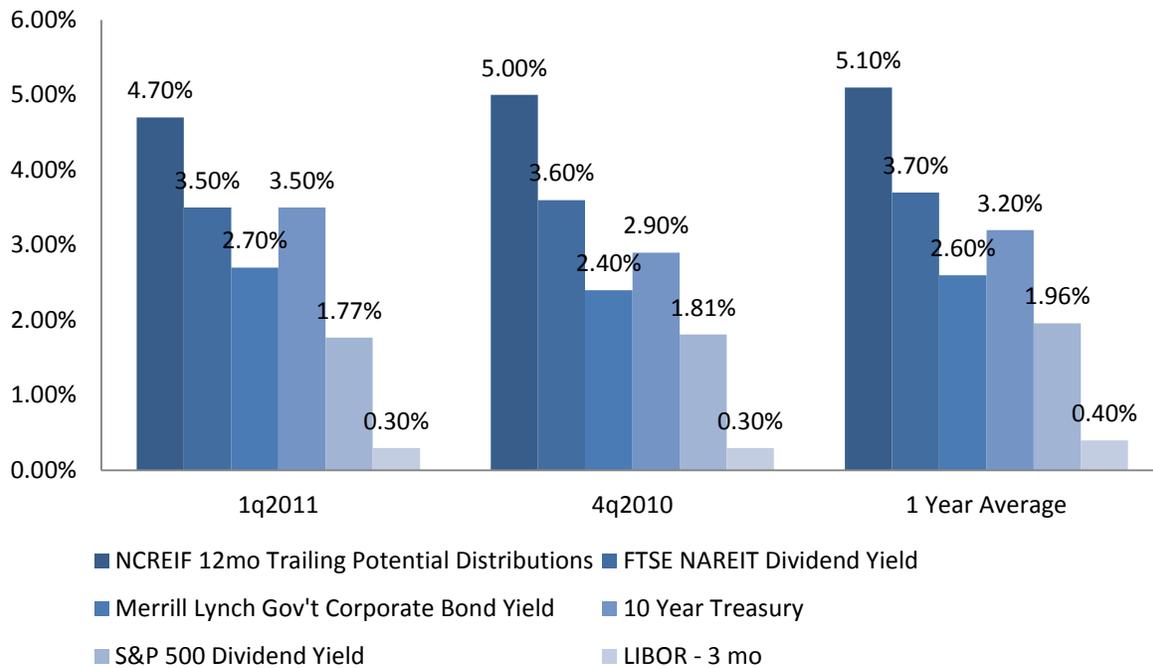
Current Yield

Any investment return is composed of three components: return of capital, return on investment (cash flow), and appreciation. Real estate dominates the investment spectrum in terms of cash flow (current yield). Core real estate investments have achieved 85% of their total return from current yield since the tracking began in 1978 (NCREIF), producing a current yield of 6.6% as of 1Q11. Value-add and

² This calculation refers to a Sharpe Ratio: (Total Return – Risk Free Rate)/Total Standard Deviation. The resulting numbers are a gauge of return per unit of risk, enabling investors to compare assets on a risk-adjusted basis.

opportunistic³ real estate strategies tend to produce less cash flow until the properties' operations are stabilized.

Figure 2: Current Yield Component



Source: Cornerstone Real Estate Advisors

Appreciation

Appreciation in the value of real estate investments is derived from two sources: income growth and changes in investor return requirements (cap rates⁴). Income growth: all else equal, as net income increases, so will values. Changes in investor return preferences: as demand for real estate assets increases, cap rates will decrease, effectively increasing the value of the assets.

³ Value-add returns are driven by a combination of capital gains and cash usually related to re-leasing or repositioning. Opportunistic returns are driven by high risk strategies, almost entirely composed of capital gains related to development or distressed assets.

⁴ A capitalization rate (cap rate) is the initial current cash return (before capital expenditures and debt service) accepted by investors. For any given level of property net operating income, a lower cap rate implies that investors are willing to pay a higher price for the property. The Cap rate is calculated by dividing Net Operating Income by the Purchase Price.

Inflation Protection

Real estate assets provide inflation protection to investors in several ways. First, most leases include contractual rent increases which increase the gross revenue of the property; many times these increases are tied to the consumer price index. Second, it is common for landlords to offload inflation risk to their tenants by making the tenants responsible for increases in operating expenses. The combination of these two components often increases net operating income by an amount close to the annual rate of inflation. Assuming no change in investor return requirements, the real value of the asset should be preserved through these mechanisms. Third and finally, construction costs tend to increase much in the same way as consumer prices do. “Exempting land, the commodities and labor involved in construction tend to accelerate their price increases when inflation surges and slow their increases when CPI growth weakens. To the extent that values need to keep up with these replacement costs, ‘replacement rents’ that justify new construction need to match the levels of the previous building boom plus this inflation element. This also helps explain why rents can diverge from inflation in the short term. If supply and demand dictate no need for new buildings, rents do not need to keep up with inflation in the period where supply needs to slow” (CBRE Econometric Advisors, 2011); however, the opposite can be said for the periods when demand exceeds supply, but construction activity has not yet delivered product to satiate that demand; and, thus, rents spike drastically.

Diversification

Real estate provides diversification to a portfolio in a number of ways. The addition of non-correlated asset returns to a portfolio, per the Markowitz efficient frontier,⁵ minimizes portfolio risk for a given target return level. The chart below details real estate correlations with alternative asset classes. It is

⁵ The capital asset pricing model (CAPM) assumes that the risk-return profile of a portfolio can be optimized—an optimal portfolio displays the lowest possible level of risk for its level of return. Additionally, since each additional asset introduced into a portfolio further diversifies the portfolio, the optimal portfolio must comprise every asset, (assuming no trading costs) with each asset value-weighted to achieve the highest return per risk level (assuming that any asset is infinitely divisible). All such optimal portfolios, i.e., one for each level of expected return, comprise the efficient frontier.

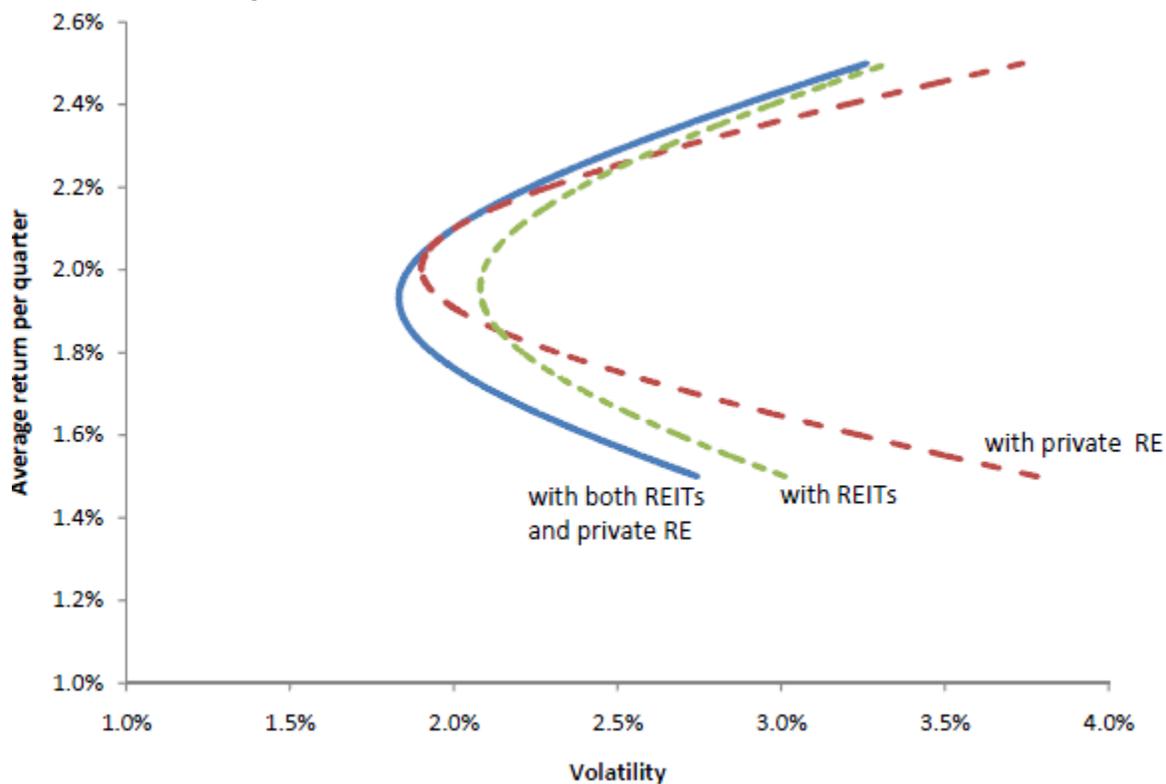
worth noting that real estate's correlation is below .25 with all assets and close to zero in the case of treasuries and corporate bonds. Thus, the addition of real estate to an investment portfolio should produce higher portfolio returns at all levels of risks (or portfolio risk should be minimized at any given level of expected portfolio return).

Table 2: Asset Class Correlation (Quarterly 2Q94 to 2Q10)

| | Private RE | REITs | Equities | BBB Corporate | Treasuries | Hedge Funds |
|---------------|---------------|-------|----------|------------------|------------|----------------|
| Private RE | 1 | | | | | |
| REITs | 0.24 | 1 | | | | |
| Equities | 0.18 | 0.59 | 1 | | | |
| BBB Corporate | -0.09 | 0.5 | 0.36 | 1 | | |
| Treasuries | 0.03 | -0.23 | -0.47 | 0.2 | 1 | |
| Hedge Funds | 0.21 | 0.48 | 0.7 | 0.35 | -0.37 | 1 |

Source: PREA Private real estate and REITs are measured with same property type weighting; private real estate is net of fees. The other asset classes are represented by the Russell 3000, B of A Merrill Lynch BBB Corp. Index, B of A Merrill Lynch 7-10 year Treasury Index, and the Dow Jones Credit Suisse Hedge Fund Index. Sources: NAREIT, MIT Center for Real Estate, Thomson Reuters Datastream and author's calculations.

Figure 3: Efficient Set with REITs, Private Real Estate and Both



Source: PREA

Real estate also produces diversification within a portfolio through some idiosyncrasies of the asset class. Most obvious of these characteristics is the illiquidity of the assets that causes pricing lags. The major industry index used to report returns, the NCREIF Property Index (NPI), is an appraisal-based index. This type of index is hindered by a temporal lag. “Temporal lagging does not change the long run expected value of the period return. However, in any finite sample of time, temporally lagged returns will be ‘conditionally’ biased. That is, the direction of the bias depends on the direction in which the true returns have been trending, if any” (Geltner, Miller, Clayton, & Eichholtz, 2007).

Additionally, the term structure of leases, specifically for commercial properties, is long term – ranging from 5 to 20 years. This trait creates an income stream that will, in many cases, not follow the general

economic trends on an annual basis and provides an extra layer of diversification (CBRE Econometric Advisors, 2011).

Chapter 2: Institutional Investors' Allocation to Real Estate

According to the PREA Sponsor Survey 2010, over 50% of Institutional investors surveyed (representing \$1.9 trillion in assets) have a target real estate allocation of 10% or higher. The current average real estate allocation of the sample group is 8.9%. Real estate is an attractive asset class to institutional investors for many of the reasons listed in Chapter 1. In addition, the long-term investment horizon needed for real estate assets matches well with the structure of liabilities held at most pension funds and endowments; most institutional investors are investing for capital preservation, longevity risk,⁶ inflation risk, and current yield. The long-term perspective allows them to overlook (to a degree) the illiquidity of the asset class with the expectation that they will earn higher risk adjusted returns as compensation. Finally, the asset class is viewed as an inefficient marketplace due to lags in pricing, opaqueness (non-transferability) of pricing, and the relationship-centric nature of the business. The combination of these factors produces the potential for outsized returns, if executed skillfully.

Real Estate by Vehicle Types

Institutional investors are afforded a full menu of investment vehicles whereby they can achieve real estate investment exposure.

All vehicle definitions provided by PREA except REITs, Private REITs and Non-Traded REITs provided by NAREIT:

Direct (Separate Accounts)

Direct investments involve the outright purchase of properties not done through other investment vehicles and include any co-investments: 1) Co-investment occurs when two or more pension funds or

⁶ Longevity risk is a financial and actuarial term used to describe the potential risks attached to the increasing life expectancy of pensioners and policy holders, which can eventually translate in higher than expected pay-out-ratios for many pension funds and insurance companies or, in the case of an individual investor, the risk that an individual outlives his or her assets.

groups of funds share ownership of a real estate investment. There are several ways that co-investment can occur: (a) a commingled fund investing with a single investor, a group of investors, an individual fund, or a group of funds; or (b) operating companies (such as a qualified REIT or limited partnership) investing with commingled funds, individual funds, or other operating companies. 2) Also refers to an arrangement in which an investment manager or advisor co-invests its own capital alongside the investor, either on an equal (*pari passu*) or a subordinated basis (Source: Institutional Real Estate, Inc.).

Public REITs

A real estate investment trust, or REIT, is a company that owns, and in most cases, operates income-producing real estate. Some REITs also engage in financing real estate. The shares of many REITs are traded on major stock exchanges.

To qualify as a REIT, a company must have most of its assets and income tied to real estate investment and must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends. A company that qualifies as a REIT is permitted to deduct dividends paid to its shareholders from its corporate taxable income. As a result, most REITs historically remit at least 100 percent of their taxable income to their shareholders and, therefore, owe no corporate tax. Taxes are paid by shareholders on the dividends received and any capital gains. Most states honor this federal tax treatment and also do not require REITs to pay state income tax. Like other businesses, but unlike partnerships, a REIT cannot pass any tax losses through to its investors.

Public, Non - Traded REITs

These vehicles are similar in structure to public REITs with the exception that shares are not traded on public stock exchanges. Redemption programs for shares vary by company and are limited. Generally a minimum holding period for investment exists. Investor exit strategy is generally linked to a required

liquidation after some period of time (often 10 years) or, instead, the listing of the stock on a national stock exchange at such time.

Private REITs

Private REITs are not registered with the SEC nor do their shares trade on national stock exchanges. Shares are not traded on public stock exchanges. Existence of, and terms of, any redemption programs vary by company and are generally limited in nature. These vehicles tend to be used by institutional investors more often than Non-Traded REITs.

Commingled Funds

Commingled funds can be open-end or closed-end pooled investment vehicles designed for institutional tax-exempt investors. A commingled fund may be organized as a group trust, a partnership, a corporation, an insurance company separate account, or another multiple ownership entity.

Closed ended funds are commingled funds with a stated maturity (termination) date with few or no additional investors after the initial formation of the fund. Closed-end funds typically purchase a portfolio of properties to hold for the duration of the fund and, as sales occur, typically do not invest the sales proceeds (Source: Real Estate Information Standards).

Open ended funds are commingled with no finite life that allows continuous entry and exit of investors and typically engages in ongoing investment purchase and sale activities.

Joint Ventures with local partners and developers

Institutional investors form a venture with an entity that is a developer or private investor.

Mortgages

Fixed or floating rate mortgage loan on a commercial property without provisions for yield enhancement beyond the stated loan rate.

All style definitions provided by ING Real Estate Investment Management

Core fund

A fund is a core fund if the fund assets provide stable income returns, which are a key element of the total return; its overall target (post tax and fees) return is up to 11.5% per annum; its permitted capital leverage ratio is below 60% of gross asset value.

Core funds are seen as low risk funds that invest in stabilized, income-producing properties which are held typically for 5-10 years and have little acquisition/disposal activity after the fund has been invested. Assets in such a fund are typified by stable income returns with less capital growth.

Core-plus

A core-plus fund invests in similar style assets as a core fund but adopts a more aggressive management style. A core-plus fund is a core fund with a target return at the upper end of the core range.

Opportunistic fund

A fund is an opportunistic fund if returns are driven primarily through capital return; its target (post tax and fees) return is in excess of 18.5% per; its capital leverage ratio is in excess of 70% gross asset value.

Opportunistic funds are generally of a high-risk nature that can involve developments without pre-leases, acquisition of distressed assets, large portfolio acquisitions and re-packaging in similar lot sizes.

Opportunistic funds generally have shorter holding periods for assets.

Value-Added fund

A fund is a value-added fund if returns are driven by a combination of income and capital return; Its target (post tax and fees) return is between 11.5% and 18.5% per annum or its target return (post tax and fees) is 1-3% above a specified property or peer group benchmark; Its permitted capital leverage ratio is between 30% and 70% of gross asset value.

Value added funds contain higher risk. The higher risk is borne from assets that often require some refurbishment, active asset management and, in some cases, development.

Allocations by Vehicle Types

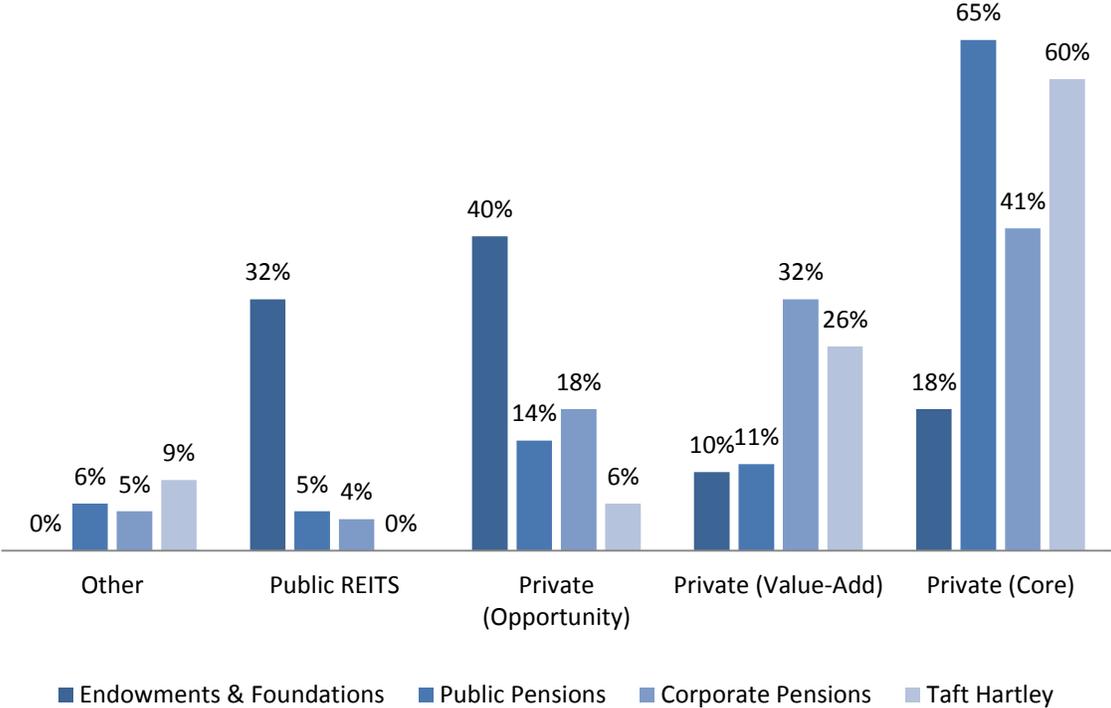
On average, US institutional investors allocated 5% (32% on the high end) of their real estate portfolio to REITs; the remainder is allocated mostly to direct investment vehicles and closed-ended commingled funds. Looking at allocations on a style basis, endowments and foundations lean toward the higher risk end of the spectrum (opportunity funds), while pension funds tend to have higher core allocations. This potentially could be explained by pension plans, in general, having a lower risk tolerance and lower target annual return than their counterparts in endowments.

Table 3: PREA U.S. Members Only—Real Estate Investment Structure (% Private Only)

| Year | 2009 | 2008 |
|--------------------------|------|------|
| Direct Investment | 40.3 | 43.2 |
| Commingled Closed | 34.2 | 31.6 |
| Commingled Open | 7.9 | 8.4 |
| Joint Venture | 10.5 | 11.5 |
| Other | 7.1 | 5.3 |
| Total Private Investment | 100 | 100 |

Source: PREA

Figure 4: US Institutions' Real Estate Allocation (% of Total)



Source: Cohen and Steers

Non Accredited Investor with \$50,000 for
Real Estate Investment

Qualified Puchaser with \$5,000,000 for
Real Estate Investment

| | Quarterly Liquidity or Better | Low Upfront Fees | No Incentive-Based Fees | Frequent and Fair Valuation | Non-Correlation to Public Markets | Low Standard Deviation | Diversification of Geographic Risk | Diversification of Asset Specific Risk | Diversification of Product Type | Diversification of Sponsor Risk | Diversification of Strategy | Quarterly Liquidity or Better | Low Upfront Fees | No Incentive-Based Fees | Frequent and Fair Valuation | Non-Correlation to Public Markets | Low Standard Deviation | Diversification of Geographic Risk | Diversification of Asset Specific Risk | Diversification of Product Type | Diversification of Sponsor Risk | Diversification of Strategy | |
|-----------------------------|-------------------------------|------------------|-------------------------|-----------------------------|-----------------------------------|------------------------|------------------------------------|--|---------------------------------|---------------------------------|-----------------------------|-------------------------------|------------------|-------------------------|-----------------------------|-----------------------------------|------------------------|------------------------------------|--|---------------------------------|---------------------------------|-----------------------------|---|
| Separate Accounts | | | | | | | | | | | | | | | | | | | | | | | |
| Open-Ended Core Fund* | | | | | | | | | | | | X | X | X | X | X | X | X | X | X | | | |
| Closed-Ended Private Equity | | | | | | | | | | | | | X | | X | X | X | X | X | X | | | |
| Fund of Funds | | | | | | | | | | | | | X | | X | X | X | X | X | X | X | X | X |
| Joint Ventures w/ Developer | | | | | | | | | | | | | | | | | | | | | | | |
| Mortgages | | | | | | | | | | | | | X | X | X | X | X | | | | | | |

Note: All Vehicles could potentially be held in a Self-Directed IRA or 401(k)

*TIAA CREF and Principal Insurance offer this product in 401(k) accounts

Chapter 3: Current Opportunities for Individual Investment in Real Estate:

This chapter explores the advantages and disadvantages of the various investment opportunities currently available to individual investors looking for commercial real estate investment exposure. Noticeably, there are several omissions from this list in comparison to the potential investment vehicles used by institutional investors. Other options, while seemingly the same, are significantly different due to higher fees structures for individual investors. This chapter concludes that individual investors are arguably left with no suitable real estate investment choices, and consequently a new vehicle is necessary.

Public REITs

Summary

REITs are the predominate method for individual investors to obtain real estate exposure. They have no minimum investment, are highly liquid, pay relatively high dividend yields, and do provide some diversification from public equities and bonds.

However, most real estate professionals interviewed for this thesis do not consider REITs a real estate pure play. “They are tainted by the public markets, and tend to be a crude approximation of the public’s view towards real estate rather than an investment in the actual asset class,” says Peter Merrigan, CEO of Taurus Holdings. They also seem to move more closely with public equities than hoped, especially in the latest downturn. Currently, the dividend yields are paltry compared to the current yield from private real estate. Many of these issues are in contrast to the earlier incarnations of REITS, but as Mark Quam, CEO of Versus Capital Advisors argues, “REITs have gotten caught up in pleasing Wall Street with quarterly earnings growth.” This evolved as REITs became more closely followed by analysts, and now heavily traded as a proxy for real estate exposure.

Returns

Using the National Association of Real Estate Investment Trusts (NAREIT) All Equity index (No Mortgage REITs) as a proxy, average annual returns have been 14.05% with annual volatility of 23.05% over the period 1994 to 2010. Average dividend yield over the same period of time was 6.14%, but this figure has declined significant to 3.44% as of June 2011.

Fees

REITs are very fee efficient. Properties not managed by the REIT itself may still pay a market property management fee, but for institutional quality service. There are no asset management fees, but the investor is paying for the general administration and payroll of a whole company: that should be contemplated in an investor's gross to net fee calculation. Also, worth mentioning is executive compensation which would be dilutive to investor's position whether paid in stock options or cash, but unlike with a fund, these payments are for the potential growth opportunities that management offers. Additionally, if REITs are held in an Electronic Traded Fund (ETF) or mutual fund, a small asset management fee (typically around 50 basis points) will be associated with owning the assets.

Diversification

REITs are loosely correlated to private real estate; at best, over the long run, the correlation is .50, but more like .25 in the short run (Greg MacKinnon, 2010). It is very easy and cost effective to achieve real estate diversification within REITs due to their lower minimum investment requirements. An investor could either own a portfolio of REITs with different product type specialties, each usually has geographic diversification already, or could buy an index or mutual fund that allocates for the investor.

REITs are more highly correlated to the public markets than private real estate (Table 2), but they still provide some diversification from equities and bonds.

Choice of Sponsors

There is a plethora of choices in the REIT world. It is relatively easy to evaluate management's effectiveness, their incentive packages, as well as insider ownership. Additionally, all REITs are followed by stock analysts who give an investor an excellent base of knowledge to begin evaluating investments. Green Street Advisors, an independent REIT specific research firm, is notable in providing REIT research.

Liquidity

Shares are traded on public exchanges. This feature of REITs is especially attractive to smaller investors as well as smaller institutions that have historically held higher proportions of REITs than larger Investors (Joseph L. Pagliari, Scherer, & Monopoli, 2005).

Governance

Each shareholder has proportionate voting rights. This gives each investor a voice in the operation and management of a company.

Equity Required

Some REIT mutual funds will require a \$2 – 3,000 minimum investment but, in general, an initial investment can be as low as one share of stock, approximately \$25.00.

Leverage

REITs do use leverage – on average 40% (per NAREIT). One advantage REITs have over private real estate funds is their ability to access the public debt markets for leverage. It is not uncommon for REITs to use their balance sheets rather than specific properties to collateralize their debt obligations. This lowers the average interest rate by spreading the risk for the lender. REITs also have covenants in their indentures that limit overall leverage, and thus limit the investment risks associated with using too much debt.

Available in IRA or 401(k)?

REITs are available to investors in IRAs, but few 401(k) plans offer REIT funds.

Non-Traded Public REITs

Summary

Non-Traded Public REITs have gained the reputation as less than scrupulous within the real estate industry. Most real estate professionals see these vehicles as a fundraising mechanism only – not as a real estate operating company. They are a current day version of syndicated Limited Partnerships from the 1980's. The fees are very high, often hitting 15% of initial capital invested (half going to broker dealers), plus costs of operation (acquisition, asset management, etc.). It is clear that management incentives are not aligned with their investors as the majority of management's revenue is not performance based, but simply a reward for assets under management. The Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) have recently focused on these inherent issues and plan to investigate further.⁷ One concern is the high brokerage fee paid to raise the capital; it is higher than most other products on the markets. And while real estate can be considered more complex, it is also clear that this fee incentive may cause a hard-sell to clients who do not understand the product. One of the major ideas purveyed by these broker dealers is the lower volatility of returns. This is true, but only because the share price valuation is completely under the control of the REIT management.

Late 2007 was among the worst times ever to invest in real estate, and those who did so have losses to show for it.

⁷ On May 31st, 2011, FINRA charged David Lerner Associates, sole underwriter of Apple REITs, with a host of violations related to misrepresenting returns and volatility; exorbitant fees; and targeting clientele for whom the investments weren't suitable. FINRA also sent a letter of investigation to all brokers/promoters of Non Traded REITs in 2009. www.FINRA.org

And yet some people who purchased an investment in hotels then have received comforting account statements from their broker, David Lerner Associates. If you believe those statements, the value of their real estate investment trust has never wavered.

Unfortunately, that is nonsense. The real estate investment trust, Apple REIT Eight, is facing significant problems. It has failed to make mortgage payments on four hotels it owns, and says it may have to surrender the properties to the lenders. Yet it has not written down the values of those hotels on its financial statements.

It has made monthly payouts to investors, but much of the money needed to make those payments was borrowed. At first, borrowing was easy, but it seems to have become more difficult. The last loan was made after the trust's chief executive agreed to personally guarantee repayment (Norris, 2011).

FINRA, in an attempt to correct these untruths, will be issuing a regulatory notice⁸ that share prices must be netted for the upfront load costs immediately upon issuance. Previously, even though \$8.50/share⁹ went towards asset purchases, shares would be 'valued' at \$10/share. This change will assumedly have a significant psychological effect on those who buy shares that are marked down significantly on their first brokerage statements.

Additionally, while liquidity is offered, it is more of an illusion of liquidity than reality. The end goal (exit strategy) for Non-public REITs is to become a publicly traded. This strategy, however, has been realized by few who have tried over the years. "Dogs try to pass themselves off as diamonds to escape their

⁸ FINRA July 15th Board of Governors' Meeting Notes

⁹ Assuming a 15% front-end load

earned oblivion—that’s the motivation behind some announced IPOs, and when the dogs are exposed, that’s the reason for their failure” (Brad Case, 2011).

Returns

Non-public REITs do not publish their returns. One could assume that their returns are similar to those of NCREIF, but for the difference in fee load. However, there are several issues with that assumption.

1) In examining the property holdings of American Realty Capital Trust, both the size and location of the average asset (Free Standing IHOP in Buford, GA?) would suggest they are not “institutional quality” and thus the NCREIF Property Index would not be an acceptable return benchmark. One mitigating factor is that they do have a roster of many credit tenants, which would help the stability of the portfolio’s cash flow.

2) A massive transparency issue exists with the valuation methodology: the original offering price is the stated “share value” for at least 18 months after the last shares are sold. This means valuations have no relation to the underlying assets. Additionally, once valuations are based on underlying assets the “advisors” have significant latitude to determine asset pricing using any number of methods – but never using appraisals.

A former Non-traded REIT executive explained that it is impossible for investors to make money (have a positive net return) in an average market – much less get all their capital back in deals; the fee drag is just too significant.

3) Current yields are artificially high as the sponsor will typically pay dividends using paid-in capital if current cash flow does not generate enough to cover distributions (Is it still a Ponzi scheme if the sponsor tells you upfront they’re paying you back with your own money?).

Fees

The following are examples from three of the largest Non-traded REITs in the industry to illustrate the fee load: Cole Core REIT 3, American Realty Capital Trust (ARCT), and Behringer Harvard Opportunity Fund 3.

Table 4: Fee Schedule of Non – Traded REITs

| | Cole Core REIT 3 | American Realty Capital | Behringer Harvard OP 3 |
|----------------------------|-------------------------|--------------------------------|--|
| Front End Load | 10.5% of Capital | 11.5% of Capital | 11% of Capital |
| Acquisitions | 2.5% of Asset Value | 1.5% of Asset Value | 2.6% of Capital |
| Financing Fee | 1% of Debt | 1% of Debt | 1% of Debt |
| Development Fee | Market | N/A | Market |
| Property Management | 2% to 4% of EGI | 2% to 4% of EGI | 4.5% of EGI / YR |
| Asset Management | .5% of Total Assets/YR | 1% of Total Assets / YR | 1% of Total Assets / YR |
| Disposition Fee | 3% of Sales Price | 3% of Sales Price | N/a |
| Incentive Fee | 15% over an 8% Return | 15% over a 6% Return | Lesser of 20% over a 10% return or 15% over a 6% return |

Diversification

Investors can obtain fairly good diversification both within a real estate portfolio and with the broader public markets with Non-Traded REITs. Most Non-Traded REITs are highly diversified by geography, some by product type, and all own many assets which diversifies asset specific investment risk.

The shares do not trade on the public market; therefore their returns are not susceptible to the same market forces which drive the volatility of REIT shares. Consequently, they have a low correlation with public equities.

Choice of Sponsors

There are at least fifteen Non-Traded REIT sponsors currently listed on NAREIT's website; several of the sponsors have multiple active vehicles. Cole Real Estate Investments is currently working to produce a lower fee model (in for SEC Registration as of 7/2011).

Liquidity

ARCT will annually redeem 5% of outstanding shares at current value.

Behringer Harvard requires a one year lockout, only then paying 90% of the most recent valuation upon redemption (as long as it is less than the original price paid) minus distributions since that valuation; however, the repurchase program can be amended at any time without approval of the shareholders and is currently suspended.

Cole Core REIT 3 requires a one year lockout, redeeming 5% of outstanding shares a year thereafter. Redemptions can only be funded through dividend reinvestments of other investors. Proceeds will be 95% of most recent valuation if after one year, 97.5% after two years, and 100% after three years.

In addition to sponsor repurchase programs, there are several secondary trading platforms that deal in non-traded REIT shares, but it is not certain how much volume they produce or the discount to fair value.

Governance

The Non-traded REIT is typically controlled by its sponsor and shareholders have little to no influence over the management of the company, with the exception electing the Board of Directors and approving a liquidation of the company.

Equity Required

Two attractive features of Non-traded REITs are the low minimum contribution (\$2,500) and the acceptance of non-accredited investors.¹⁰

Leverage

These vehicles do use leverage in varying amounts.

Available in IRA or 401(k)?

These investment vehicles are available in IRAs.

Tenants in Common (TIC)

Summary

Tenant in Common investments are an outgrowth of demand from investors with 1031¹¹ tax deferred exchanges to complete. This vehicle allows retired owners of direct real estate to parlay their sales proceeds into a more institutional type property with professional management. Since the vehicle's creation in 1994, however, it has been tested vigorously by the downturn in the real estate markets, and failed miserably.

Returns

Returns from tenancy in common sponsors are not published, so a return metric is difficult to estimate. Many TIC investments over the decade have held ownership of properties located in secondary and tertiary metropolitan areas. These properties would be purchased at higher cap rates, promising higher current yields for the owners; however, along with higher returns came higher risk.

¹⁰ An investor who has less than \$1,000,000 in net worth (excluding equity in primary residence), or has earned less than \$200,000 (\$300,000 jointly with spouse) over each of the last two most recent years.

¹¹ To qualify as a Section 1031 exchange, a deferred exchange must be distinguished from the case of a taxpayer simply selling one property and using the proceeds to purchase another property (which is a taxable transaction). Rather, in a deferred exchange, the disposition of the relinquished property and acquisition of the replacement property must be mutually dependent parts of an integrated transaction constituting an exchange of property. Taxpayers engaging in deferred exchanges generally use exchange facilitators under exchange agreements pursuant to rules provided in section 1031 of the Internal Revenue Code and the regulations promulgated thereunder.

Fees

Similar to Non-Traded REITs, TIC investments can carry significant front-end loads and other continuing fees that will reduce an investor's ability to earn a return on his or her capital.

Diversification

The minimum capital investment with the majority of TIC sponsors (at least \$50,000) causes investors to have little diversification throughout their real estate strategy. Many times they will be invested in one property that exposes them to asset specific, geographic, and product type risk. If the property has a single tenant, then the credit risk of the property is also very concentrated.

TICs will, however, provide returns that are less correlated to the public equity and debt markets than REITs. But, the multitude of other risks inherent in owning only one property will produce higher volatility of returns, in general, than ownership of a diversified real estate portfolio.

Choice of Sponsor

There are very few originations of new real estate investment in this type of vehicle, mostly because it is become known as a broken model. Lawsuits against two of the formerly largest TIC sponsors, Sunwest and DBSI, as well as a high level of scrutiny by the SEC and FINRA will cause remaining sponsors to dwindle further. Nevertheless, as appreciation in real estate values returns, investors with capital gains will look for alternative to managing their real estate portfolios themselves. This will continue some level of demand for TICs, but it is doubtful they will continue operating under the same fee heavy models.

Liquidity

TIC investments have little to no liquidity. An investor has fee simple ownership of an undivided interest in a real estate investment property, so it is technically saleable. But, there is a very small secondary

market demand for this type of investment. Furthermore, any demand will typically be at deeply discounted pricing.

Governance

Governance of TIC investments is challenging. It is difficult, if not impossible, for up to 35 investors to commit to a unanimous decision on sales, leasing, refinancing, or a change in management. This circumstance can make the removal of the imbedded management (usually the Sponsor's management firm) nearly impossible except under fraudulent conditions.

Leverage

TICs are effectively owned by up to 35 separate ownership entities. This fractured ownership structure creates a nightmare for refinancing purposes, because banks will need to underwrite each individual owner separately.

Available in IRA or 401(k)

TIC investments *could* be owned within an IRA, but only if ownership of the relinquished property (sold property) was also owned by the investor's IRA.

Direct Ownership

Summary

For many investors, this is the first and only place they look for real estate exposure – especially when considering 4-plexes. Smaller scale apartment ownership may seem relatively basic, (we've all lived in apartments) but the reality is more expertise and time is needed to manage real estate than most investors think (most investors do not want to leave the Red Sox game when they receive a tenant call that the water heater has burst). If they do use professional management, it is usually very expensive due to the lack of scale.

More worrisome is the concentration of risk – asset specific, geographic specific, and returns highly correlated with the residential market. Nonetheless, the advantage of direct ownership is that an investor is in control of the asset and, consequently, their destiny.

Returns

Returns for small scale direct real estate investments are difficult to determine. The most often cited direct investments, 4-plexes and single family home rentals, have values that tend to be more highly correlated to housing prices than apartments alone, because of their financing advantages. Cash flow is typically lower for 4-plexes because they are priced above normal yields for apartments due to demand and financing.

Smaller commercial properties have a lower chance of having credit tenancy, thus more innate default risk as a consequence. Additionally, there can be a less liquid market place since individuals are often saddled with higher financing requirements for commercial properties.

Diversification

It is difficult to obtain much diversification within an investor's real estate allocation using small scale real estate ownership. This concentrated risk is the consequence of typically owning one asset (asset specific risk), of a single product type (product type risk), in a single geographic area (geographic risk), as well as a strong correlation to the housing markets (if a 4-plex or single family home).

This type of real estate investment does provide some diversification to public markets, but as has been shown in the most recent recession; residential values can be highly correlated to the equity markets. This isn't necessarily true with apartment buildings of more than four units (multi-family has in fact outperformed the general real estate market).

Fees

There are very few fees associated with direct ownership unless an investor opts to use professional management rather than manage the property themselves. For a 4-plex, management fees can be as high as 10% of Gross Revenue in addition to leasing fees, and repairs/maintenance mark-ups; those fees are reflective of the fact that few managers are even willing to service a 4-plex.

Choice of Sponsors

The question of sponsor with direct ownership is a rhetorical one. It is truly a question of whether or not an investor trusts himself to manage his own real estate investments.

Liquidity

Liquidity is limited to how quickly an investor can make a property available for sale, and find a buyer at an acceptable price: this can take anywhere from 30 days to many years depending on the market conditions and the specific asset.

Governance

Self-governance is one of the most advantageous aspects of direct ownership for the average investor. The investor makes all relevant decisions, and thus, has only himself to blame or reward for the performance of the investment.

Equity Required

The minimum investment depends on the market, and quality of the asset, but an investor can probably start with as little as \$50,000 if using leverage.

Leverage

Loans for small scale direct ownership are not available through many of the conduits available to larger commercial properties i.e. life Insurance companies and CMBS¹² loans. This leaves regional banks as the lender of last resort for small properties. Most bank loans require personal guarantees or full recourse loans.

Available in IRA or 401(k)?

Yes, direct real estate investment is available in retirement accounts, but only within self-directed IRAs and 401(k)s (discussed further in Chapter 5).

Local Developers

Summary

Investments with local developers usually arise from being within the “family and friends circle” of said developer. These investments would typically be high risk, high reward deals within the same metropolitan area that the investor lives, thereby giving him the comfort in knowledge of the market. These investments are often “institutional” quality assets in nature with developers similar to, or the same as, those with whom an institutional investor would partner.

One characteristic that appeals to individual investors regarding these development deals is that they are investing in a specific property or development deal. This is additional comfort to the average investor who has difficulty conceptualizing a strategy that ‘aims to acquire’ assets as opportunities become available.

Returns

The returns of development deals would be typical of an “opportunistic” investment strategy, so one would suggest the NCREIF Townsend Opportunistic Index as a proxy for returns and volatility. The

¹² Commercial Mortgage Back Securities

average annual return for the index over the period from 1994 to 2010 was 15.7% with 21.25% annual volatility.

Diversification

As a consequence of the “family and friends circle,” investors tend to use one developer in one market that is typically in the same metropolitan area as the investor’s residence. This tendency creates risk that is very concentrated within a real estate allocation – even if more than one development deal is included in an investor’s portfolio. The primary non-diversified risks an investor is exposed to are sponsor risk and geographic risk.

Development deals do help an investor create diversification to the public markets. These opportunistic returns are less correlated to public equities and debt than REITs are. However, due to the risk level and speculative nature of development deals, the average volatility of returns is also significant.

Fees

Fees charged by developers vary widely, but an average fee structure might be contemplated as: an asset management of 1% of invested capital, an acquisition fee of 1% of the purchase price, plus an incentive fee equal to a 15% carried interest in returns above a 15% compounded annual return to investors.

Choice of Sponsors

There are many quality developers in any given market, but because of the social aspects of this type of investment (friends and family money, also known as a ‘country club deal’) investors often continue investing with the same developer without diversifying sponsor risk.

Liquidity

There is very little liquidity in these types of assets. The timing and strategy of the investment typically necessitates that capital isn't distributed until the project is complete and sold. This is especially true in single asset club deals.

Governance

Given the smaller dollar amounts that the average individual investor will contribute to a development deal, one will have very little discretion over the investment after capital is deployed.

Equity Required

The equity required by a local developer depends on the size of the development and the reputation of the developer, but initial equity investments range from \$50,000 to \$500,000.

Leverage

Development deals are nearly always leveraged; however, the amount of leverage used in current market conditions has fallen significant due to LTV constraints of lenders.

Available in IRA or 401(k)?

Investors can allocate retirement fund from Self-Directed IRAs and 401(k) to development deals. Otherwise, these investments are not available within retirement accounts.

Non Accredited Investor with \$50,000 for
Real Estate Investment

Qualified Puchaser with \$5,000,000 for
Real Estate Investment

| | Quarterly Liquidity or Better | Low Upfront Fees | No Incentive-Based Fees | Frequent and Fair Valuation | Non-Correlation to Public Markets | Low Standard Deviation | Diversification of Geographic Risk | Diversification of Asset Specific Risk | Diversification of Product Type | Diversification of Sponsor Risk | Diversification of Strategy | Quarterly Liquidity or Better | Low Upfront Fees | No Incentive-Based Fees | Frequent and Fair Valuation | Non-Correlation to Public Markets | Low Standard Deviation | Diversification of Geographic Risk | Diversification of Asset Specific Risk | Diversification of Product Type | Diversification of Sponsor Risk | Diversification of Strategy | |
|-----------------------------|-------------------------------|------------------|-------------------------|-----------------------------|-----------------------------------|------------------------|------------------------------------|--|---------------------------------|---------------------------------|-----------------------------|-------------------------------|------------------|-------------------------|-----------------------------|-----------------------------------|------------------------|------------------------------------|--|---------------------------------|---------------------------------|-----------------------------|---|
| Separate Accounts | | | | | | | | | | | | | | | | | | | | | | | |
| Open-Ended Core Fund | | | | | | | | | | | | X | X | X | X | X | X | X | X | X | | | |
| Closed-Ended Private Equity | | | | | | | | | | | | | X | | X | X | X | X | X | X | | | |
| Fund of Funds | | | | | | | | | | | | | X | | X | X | X | X | X | X | X | X | X |
| Joint Ventures w/ Developer | | | | | | | | | | | | | | | | | | | | | | | |
| Mortgages | | | | | | | | | | | | | X | X | X | X | X | | | | | | |
| Publicly Traded REITs** | X | X | X | X | | | X | X | X | X | | X | X | | X | | | X | X | X | X | | |
| Non-Traded Public REITs | | | | | X | X | X | X | X | | | | | | | X | X | X | X | X | X | X | X |
| Private REITs | | | | | | | | | | | | | | | X | X | X | X | | | | | |
| Tenancy-In-Common | | | X | | X | X | | | | | | | | X | | X | X | X | X | X | X | X | X |
| Direct Ownership (4-Plax) | | X | X | | X | | | | | | | | X | X | | X | | X | X | X | X | X | |
| Local Developers*** | | X | | | X | | | | | | | | X | | | X | | X | X | X | X | X | |

Note: All Vehicles could potentially be held in a Self-Directed IRA or 401(k)

*TIAA CREF and Principal Insurance offer this product in 401(k) accounts

**Assuming a REIT Mutual Fund or ETF

***Any Developer or Fund can raise equity from up to 35 non-accredited individual without registering with the SEC

Chapter 4: Opportunity for a new vehicle?

The major investment issues from an investor's perspective are returns, liquidity, valuations, fees and diversification of risk (geographic, product type, sponsor, and strategy). Chapter 3 outlined the characteristics of the currently available real estate investment products in the market. No one investment vehicle matches the needs of individual investors, thus a new vehicle is arguably necessary.

Ask the experts; Results of interviews with Family Offices, Trust Attorneys, PERE Executives

The Managing Principal of a private equity firm candidly states, "This issue is *critical*; probably bigger than anyone thinks. There is, and has been, a major shift from defined benefit to defined contribution, and with that the ownership of the major real estate assets will also shift from institutional to individual. That means there will be a huge need for vehicles that can provide that exposure." He continues, "There will be an increased flow of funds toward real estate in general. Allocations of 8 – 10% will go higher."

A fundraising executive of an international real estate fund manager says, "Everyone is trying to get ahead of the curve in regards to making inroads with defined contribution plans. Investment consultants want a new real estate product too, as they're also cognizant of the shift."

Two separate individuals stated they had spent more than two years of their life devoted to the creation of a new investment product for individuals. The market is "massive," and "someone will figure it out," they both said.

Hillary Graves, a former fundraising executive at CommonFund adds, "For those investors with \$500,000 [to allocate to real estate], they shouldn't have a problem finding a home for their money. The issues arise from sponsor-specific risk, because those with \$500,000 are probably only going to one private equity group. They may also face higher fees."

An investment professional leading a major family office states, "We're frustrated with the standard investment dashboard that our bank offers us. We have difficulty getting to the underlying assets

without a lot of hassle. Additionally, it is irresponsible to allocate our entire real estate allocation to one manager. There are many other family offices like us that are teaming up to get access to multiple funds and still meet their minimums.”

Even while expressing their obvious concerns for the individual investor, every executive interviewed reverberated the same crucial problem: individual investors are a higher servicing burden. That burden is inversely proportionate to investors’ wealth (and/or sophistication, which is not necessarily correlated, but often times is). The recent Dodd-Frank Act¹³ has changed the regulatory landscape by increasing oversight and registration costs. This change along with a turbulent market over the past few years is causing several funds to move in the opposite direction by increasing their minimum capital contributions. They would rather have few investors with larger contributions who “get it” than spend hours hand-holding as investors grow comfortable with investment decisions.

One needs to look no further than recent SEC filings to see that many Wall Street firms and fund sponsors understand the potential of the market. Fidelity, Cole, Clarion, and Blackrock/Merrill Lynch all have either have a new and improved non-traded REIT models in process with the SEC or have pulled their approved filings over market-condition based, not demand-based concerns.

Results of Entrust Survey

The Entrust Group, the world's premier provider of account administration services for self-directed IRAs and real estate IRAs, graciously allowed a survey of their account holders on a number of matters related to this thesis (see Appendix 1 for full questionnaire and results).

The survey has biases that influence its results. The survey results are not assumed to be statistically significant, but are simply data points to which we can point as potential for an overall trend.

¹³ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 changed the registration requirements for investment managers. It also increased the requirements to achieve “Accredited Investor” status.

- 50,000 Investors surveys were sent out, only 60 responses were received.
- The vast majority of account holders were located in California – an area that has seen tremendous fallout from the bursting of the real estate bubble. Many of the notes I received from respondents indicated feast or famine. “You’re kidding right? I live in California and there are plenty of opportunities,” or “My ~\$500,000 used to be several million before RE went in the tank (and that's after I had sold many properties in anticipation of what was going to happen).”
- 100% of the respondents owned direct real estate within their self-directed IRA. This indicates they were largely do-it-yourselfers who may shun investment advice.
- The median respondent had a rather astounding 75% of the equity in his or her investment portfolio allocated to real estate.

The Results:

- The median respondent had an investment portfolio of between \$250,000 and \$500,000.
- 52% of respondents either would be interested investing in real estate private equity (REPE) if the fees are same/better than their current opportunities, or already invested in real estate private equity.
- 52% of respondents either would be interested in investing with local developers if the fees are the same/better than their current opportunities, or have already invested with local developers.
- The median respondent was willing to ‘lock up’ capital for five to seven years, with 35% of respondents saying they would lock up their capital for ten or more years.
- 35% would prefer performance-based fees, 22% were indifferent to flat or performance-based
- 35% either need additional investment vehicles or would consider additional investment opportunities, assuming fees were in line/or better than their current investment opportunities.

Interpretation:

There are individuals investors who are going outside the normal investment channels to obtain real estate exposure, but even these 'self-directed' investors would be interested in more institutional quality real estate opportunities were they given access to them. Inherent in that response is the sentiment that investors are fee conscious. Also of note, is the average time horizon that investors responded that they would "lock up" their capital: five to seven years with 35% reporting ten or more years. This suggests that investors who understand the illiquidity of real estate will not require daily or even monthly liquidity in a newly structured product. Their goal is instead to obtain the best possible real estate investment exposure.

How big is the market?

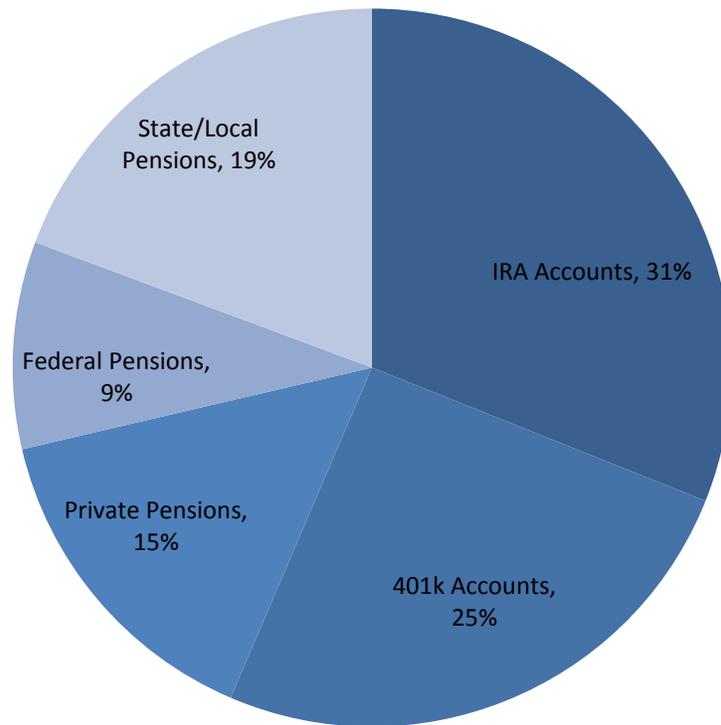
Figure 5: Retirement Assets by Source

| Account Type | Federal Reserve* | | Median ** Account | Average** Account |
|----------------------------|------------------|------------------|----------------------|----------------------|
| | 4Q2005 | 4Q2010 | | |
| IRA Accounts | \$3.65 Trillion | \$4.71 Trillion | \$20,046 | \$69,498 |
| 401k Accounts | \$3.11 Trillion | \$3.85 Trillion | \$59,381 | \$109,723 |
| Private Pensions | \$2.28 Trillion | \$2.26 Trillion | | |
| Federal Pensions | \$1.07 Trillion | \$1.42 Trillion | | |
| State/Local Pensions | \$2.72 Trillion | \$2.93 Trillion | | |
| Total Defined Contribution | \$6.76 Trillion | \$8.56 Trillion | | |
| Total Defined Benefit | \$6.07 Trillion | \$6.61 Trillion | | |
| Total Retirement Assets | \$12.83 Trillion | \$15.17 Trillion | | |

*Per Federal Reserve Flow of Funds Report 6/2011

**Per Employee Benefit Research Institute (11.1m IRA Accounts , 20.7m 401k Accounts)

Figure 6: Retirement Assets by Source (%)



Potential Allocation to Real Estate

Assuming that institutional investors have the “right” asset allocation due to their access to great advice, investment tools, and investment products then, individual investors with similar investment horizons and return/risk thresholds should arguably have a similar asset allocation. According to PREA, the average institutional investor has an 8.9% allocation to real estate. Looking at only 401(k)s and IRAs (total of \$8.56 trillion) this suggests a need for \$850 billion in real estate products (before leverage).

REITs and Non-traded REITs together only account for half of that need,¹⁴ and that is if institutional investors have no appetite for REITs all together, which is highly unlikely.

¹⁴ REITs = \$389 Billion Market Capitalization (NAREIT), Non-Traded REITs = 57 vehicles with \$70 Billion of Assets (NAREIM)

According to the 2009 Survey of Consumer Finance, the median household surveyed has \$69,000 in equity in “non-residence property,” and \$150,000 in residential property – not including their primary residence. For many households, the residential property could amount to a second residence, a vacation home, or a 4-plex. Many people view all three assets types as investments. The specific dollar amounts are not important, but what they suggest is that there is undoubtedly a demand for real estate investments. The key question then becomes: are these investments appropriate and adequate. The answer would be “no” due to the reasons discussed regarding direct real estate investments in Chapter 3 – that is unless an investor is diversified in his or her real estate holdings.

Impending Death of Pension Funds

The balance of retirement funds is undergoing a drastic shift that started decades ago. Private sector workers covered by a private pension plan have fallen from 88% in 1975 to 33% in 2005 (Alicia H. Munnell, 2007). The balance of total retirement assets has shifted 9% from defined benefit to defined contribution (including IRAs) in the last decade (Towers Watson, 2011). The figure now stands at 56% of retirement assets being held in consumer directed accounts.¹⁵

Federal, state, and municipal plans are not excluded from this changing dynamic. Several states are working to introduce defined contribution plans in order to limit their future liability for their workers retirement incomes.

The change in custody of these assets also has repercussions for capital users. Any investment manager whose primary investors are defined benefit pension plans needs to begin to diversify their capital sources now. Those that are not on track to move in this direction will likely regret it in a decade as the universe of pension plans that are a going-concern continues to dwindle. In order to make this change, however, it is clear that the real estate industry needs to evolve in product development to satisfy

¹⁵ Per Federal Reserve Flow of Funds 6/2011

future demand. Current products will not be suitable for individual investors, nor will investment managers be willing to accept the additional regulatory and servicing burden within their existing vehicles.

Become your own fiduciary

This slow unraveling of defined benefit plans is also putting the onus of growing a retirement portfolio squarely on the individual. Individuals, first, need to educate themselves on alternatives. Real estate needs to play a part in their investment portfolio for the reasons presented in Chapter 1; capital preservation, current yield, inflation protection, high Sharpe ratio, and diversification from the public markets. Less sophisticated individuals may gravitate towards an all-in-one solution, such as Target Date Funds (TDFs), which will allocate an increasing portion of their portfolio to real estate automatically as they age. Most, however, will build a portfolio themselves or with the help of an advisor or financial planner. This produces the need for standalone real estate investment products that will provide adequate and appropriate exposure given their risk tolerance and individual circumstances.

Baby Boomers at retirement age

For baby boomers near or in retirement, real estate is crucial for their investment goals: avoiding longevity risk, inflation-indexing, and current yield. As a person ages, he or she inherently become increasing risk adverse: he will want to move assets into a more conservative asset allocation that focuses less on growth and more on inflation-indexed income. The primary method of achieving that goal (per Markowitz's Efficient Frontier) is to decrease one's allocation to equities and increase real estate as well as Treasury Inflation Protected Securities (TIPS), bonds, and possibly some commodities.

Chapter 5: Self-Directed IRAs & 401(k)s; the panacea for individual investment in real estate.

For individual investors who want to own direct real estate or partnerships within their retirement accounts, there is hope. Self-Directed IRAs and 401(k)s are available for investors to circumvent the typical restrictions of their current providers, such as the limitation of owning only stocks, bond, and mutual funds. The custodians of these self-directed retirement plans give individuals full control over their investment mandates, enabling ownership of direct real estate or real estate in partnership. There are restrictions that one must be mindful of, but they mostly relate to self-dealing. These “prohibited transactions,” thoroughly detailed later in the chapter, range from living in a house owned by your IRA to granting credit to your IRA by guaranteeing a loan.

Why one cannot own real estate or partnerships in his current IRA and 401(k)?

The big secret that no one wants investors to find out is that *it is possible to own real estate or partnerships in an IRA and 401(k)* – but any number of entities (Employer-401(k) Sponsor, IRA custodian, 401(k) Provider) do not want that to happen.

Employers who provide 401(k) plans are bound by a fiduciary duty to provide a ‘diversified menu’ of assets from which participants can choose. The general wisdom in providing this diversified menu is to choose the best in class funds in each sector (Large Cap, MidCap, Small Cap, TIPS, International, Growth, Value, Etc), not to give participants options from the entire universe of funds. This mentality is a response to two separate, but equally frustrating individual behaviors: 1) faced with too many investment options, individuals will either feel paralyzed with the decision in front of them or think diversification means buying a little bit of everything, and 2) few investors fall in the middle of the risk tolerance spectrum. Left to their own devices, investors tend to choose investments either wildly unsuitable for them, or terribly conservative.

IRA custodians and 401(k)s have a separate consideration: profit. They want participants to choose from the products that they exclusively distribute. Only when one asks very nicely (and has some significant leverage) will IRA custodians relax this practice.

Employee Retirement Income Safety Act, 1974 (ERISA)

Hugh Bromma, CEO of the Entrust Group, writes, “When ERISA became effective, 1/1/75, all qualified plans [401(k)s, SEP IRA, etc] and IRA contributions and deferrals could be invested in anything permitted by law. This included any asset anyone could sell or buy in the market place. Because of the abuse by sellers of certain investments, legislation that took effect on 1/1/81 prohibited certain specific investments: gems, stamps, coin collections, works of art, and antiques. All other investment opportunities were not excluded. These other permissible investments included real estate [fee simple], notes [mortgages], options on real estate, private placements, investment partnerships, and operating businesses” (Bromma, 2006) .

How Self-Directed Accounts work?

Self-Directed IRA custodians may allow investments in any type of asset that is not prohibited by ERISA or by law. It is relatively simple to setup an account: rollover 401(k) or IRA balances, or begin funding a new self-directed IRA with post-tax dollars. Contribution limits and distribution timing are the same as with any other IRA. Most custodians also offer both Roth (tax-free) and traditional (tax-deferred) account options.

Self-Directed 401(k)s are slightly more complicated, because one must be self-employed to qualify. One would need to go through the appropriate documentation for his company to become a plan sponsor. The Entrust Group is also a provider that can help navigate investors through this process – and ensure the legality of the structure.

Restrictions and obstacles

Self-directed IRAs can be an effective way to create wealth through real estate, but participants must abide by strict use (prohibited transactions) and self-dealing (disqualified persons¹⁶) restrictions for the IRA to keep its status (Bromma, 2006). Internal Revenue Code Section 4975(c)(1) defines prohibited transactions to include:

- A sale, exchange, or leasing of any property between the plan and a disqualified person.
- The lending of money or other extension of credit between the plan and a disqualified person.
- Furnishing of goods, services, or facilities between a plan and a disqualified person.
- Transfer to, or use by or for the benefit of, a disqualified person of the income or assets or the plan.
- An act by a disqualified person who is a fiduciary in which the person deals with the income or assets of the plan for his or her own interest or own accounts.
- The receipt of any consideration for his or her own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

In summary, an investor cannot buy a residence for their own (or family's) use, nor can they receive any management fee (compensation) from the property. These prohibitions should not be too restrictive for an individual that is truly looking for an investment rather than a loophole to buy a vacation home with retirement funds.

Also inherent in the prohibited transactions is the need for non-recourse debt. Individuals cannot extend credit (including by way of personal guarantee) to their IRA. This limitation makes obtaining leverage for properties within Self-Directed IRAs very difficult especially in the wake of the most recent mortgage

¹⁶ Section 4975(e)(2) defines a disqualified person to include the IRA owner, certain of his or her family members, a business in which he or she has a 50% or greater interest, fiduciaries, and a person providing services to the plan.

crisis. Responses from the Entrust Survey suggest that about 1/3 of respondents have been able to obtain leverage on properties they purchased. Furthermore, debt financing within an IRA may not be worthwhile once Unrelated Business Income Tax¹⁷ (UBIT) is included in the analysis, but it depends on the scenario. Unrelated Debt Financing Income (UDFI), a form of UBIT, is essentially a tax on the prorated share of the income and capital gain related to financing. Thus, if a property has a 75% LTV mortgage, 75% of the taxable income will be taxed under UBIT, the remaining 25% will be tax-free within a Roth IRA or deferred with a traditional IRA. Depreciation and interest expense can still be deducted (as usual) from pretax income. Accordingly, an investor must analyze the after-tax return of the investment on a leveraged and unleveraged basis, both within an IRA and within a non-tax advantaged account. Results of the analysis will vary by investment and by account type (Bromma, 2006).

401(k)s are regulated by a different section of the tax code that does not subject the plans to UDFI in many cases. Munzer Ghosheh, Business Development Manager at Entrust Administration, asserts, “If one can qualify, individual self-directed 401(k)s will be more advantageous for investors who plan to use leverage as a key component of their real estate strategy. Otherwise, there is one way to eliminate UDFI within an IRA – pay off the existing debt twelve months and a day before you intend to sell the property.”

¹⁷ 512(a) and 513 of the Tax Code define UBTI as (i) gross income received by a tax-exempt entity from the conduct of a trade or business that is not substantially related to the exercise or performance by such tax-exempt entity of the purpose or function constituting the basis for its tax-exempt status, less (ii) deductions that are directly connected to such unrelated trade or business. UBTI is subject to federal income taxation and, depending on the jurisdiction may be subject to state and local income taxation. The Code specifically provides that UBTI includes a ratable percentage, based on leverage, of gross income (less the same percentage of applicable deductions) derived from debt-financed property where there is “acquisition indebtedness.” (Mitchell L. Berg, 2003)

Ghosheh also suggests creating a newly formed limited liability company (LLC) that is owned entirely or in part by an individual's IRA. The LLC can then purchase properties with greater ease of transaction. "But – be very careful. Anything owned in an LLC is still considered 'plan assets' and thus the same prohibited transaction rules apply," he says.

In summary, Self-Directed IRAs and 401(k)s are a very effective and tax efficient way for individuals to invest in real estate within their retirements accounts; however, diversification rules still apply; investors need to stay cognizant of risks related to owning too few assets, and concentration in one geographical area or product type.

Chapter 6: Obstacles and Objections

In evaluating potential new real estate investment vehicles, there are a host of complex obstacles and objections that come into play; some of these issues affect investors more than the sponsors, and vice versa. To complicate things further, several issues are interrelated, which create tradeoffs – for example, between volatility, liquidity, and the duration of the real estate strategy employed. This chapter evaluates the many competing constraints in the creation of a real estate investment vehicle including, but not limited, to: liquidity, valuation, securities regulations, ERISA, tax considerations and investor credit.

Liquidity needs

“As a group, surveyed plan sponsors and investment advisors scored the availability of daily pricing and daily trading as the two most important criteria when selecting or marketing investment options for plan menus” (Robert L. Johnson & Shepard, 1996). This sentiment matches very closely with responses received from current industry participants: the number one priority of individual investors in evaluating real estate investment products is liquidity. This desire for liquidity, however, introduces a severe mismatch between the duration of assets (the properties) and liabilities (the capital sources) for any given real estate vehicle¹⁸. Further, this perceived “need for liquidity” is counterintuitive and may well be to the investors’ detriment. Retirement accounts have a long-term time horizon – and are not meant to be traded. They are meant only to be rebalanced as one’s stage in life evolves. Wall Street even has two indicators that focus on this tendency of individual investors to trade based on emotion: the dumb money indicator¹⁹ and its antithesis, the smart money indicator.²⁰ While the indicators themselves are

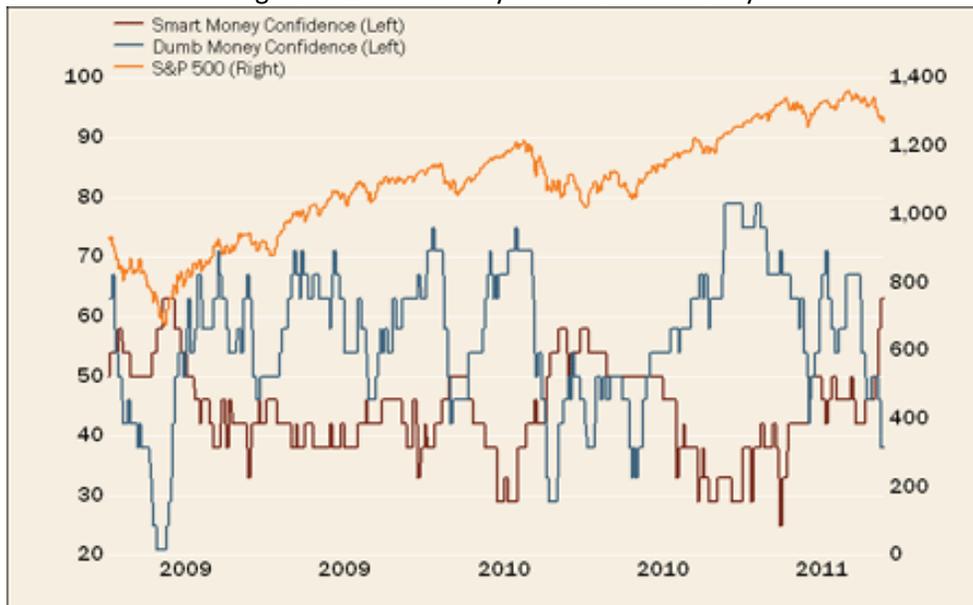
¹⁸ Real estate assets typically have a long holding period; 7 – 10 years. If the equity sources requires liquidity on a quarterly basis, then the liquidity needs of investor does not match the holding period of the asset.

¹⁹ Dumb money indicator is a contrarian indicator based on a survey of investors, the equity-only put/call ratio, the flow into and out of the Rydex series of index mutual funds, and small speculators in equity index futures contracts. Additionally odd-lot stock and option transaction indicate small investor transaction activity.

²⁰ Smart Money indicators include the OEX put/call and open interest ratios, commercial hedger positions in the equity index futures, the current relationship between stocks and bonds, and the ratio of short interest from the public versus short holdings by market makers and NYSE specialists.

not directly applicable to real estate, the psychology behind them is. They are a graphical depiction of the countless stories of individual investors who say they are investing for the long term; yet, their reactions to the immediate term are obviously guiding their actions. Unfortunately for them, their reactions are typically in the wrong direction because fear and greed motivates the average investor driving him to buy when prices are up (greed that prices go up more), and sell when prices are down (fear that prices go down further). In the chart below the blue line represents “dumb money.” Dumb money was extremely bearish in 2009, missing one of the best buying opportunities since the Russian Ruble Crisis in 1998 and Black Monday in 1987. Smart money, however, was bullish.

Figure 7: Dumb Money versus Smart Money



Source: Charles Schwab

The argument above does not suggest that liquidity on the whole is a bad thing, but that retirement account investments, defined by their long term time horizon, should be evaluated within the time frame of both the duration of the asset and investment horizon of the investor.

A Vice President of investor relations for a large fund manager suggests, "Within a 401(k) plan, we would like to offer quarterly liquidity – at worst – but not daily. The liquidity need does force you to consider a 'portion' of the fund being in REITs or maybe even derivatives once there's a functioning market."

Mark Quam, CEO of Versus Capital Advisors and a member of the Financial Industry Regulatory Authority's (FINRA) corporate finance committee advises that, "Frequency of liquidity is undoubtedly an important factor, but just as important for investors is inability of the sponsor to change the redemption policy." Quam's new fund, Versus Global Multi-Manager Real Estate Income Fund LLC, follows that formula by offering redemptions of up to 5% of outstanding shares per quarter – a shareholder's right not subject to change without an affirmative vote by shareholders.

Reducing or eliminating redemption policies has been an all too frequent occurrence over the past few years, as investors who assumed they had liquidity learned they only had the illusion of liquidity. In addition to the six largest non-traded REITs, the Principal US Real Estate Separate Account suspended its redemption policy until an orderly market liquidation of properties was possible.

Principal's spokeswoman, Terri Hale, defends the decision, "To sell property at inappropriately low prices in order to generate cash for a few would hurt the majority of investors and violate our fiduciary obligations" (Laise, 2009). She makes an important point. For example, if a \$1 billion fund has \$10,000,000 of redemption requests, but their smallest saleable asset would fetch \$20,000,000 in current market conditions or \$25,000,000 in an orderly market, the fund locks in a \$5,000,000 opportunity cost of which only 1% would be allocated to the redemptions and the remainder allocated to the investors remaining in the fund.

Armed with the above arguments for and against liquidity, one can evaluate the options:

REITs shares are very liquid. There is a functioning market for those shares on an on-going basis. This liquidity is enabled by the shares being traded on a public market at market price, but their pricing also tends to be much more volatile.

Clarion Property Trust, a new Non-traded REIT model that is in for SEC registration as of 7/2011, will offer daily liquidity at the current Net Asset Value (NAV) of the fund – funds are paid within three days of request. Proceeds to fund redemptions can come from any source available to the trust at the time – including cash; sales of securities or assets; or drawing on a line of credit. Although daily liquidity is available, the product is meant for long term holding and as such, redemptions less than 365 days from purchase will be hit with a 2% discount to NAV. Redemptions are also limited to 5% of total outstanding shares per quarter and 20% of outstanding shares in any twelve month period. Additionally, the trust can suspend redemptions should “in the business judgment of our board of directors, [redemptions] place an undue burden on our liquidity, adversely affect our operations or risk having an adverse impact on non-redeeming stockholders.”²¹

In the TIAA-CREF Real Estate Account, a variable annuity real estate product, investors have access to liquidity once per quarter (with certain limitations). Transfers occur at the end of the first business day after the request is received and at that day’s NAV. The product limits trading and round-trips, stating in the prospectus that it is not meant for market timing – and such activities will hamper the returns of all participants.

Versus Global Multi-Manager Real Estate Income Fund LLC, as previously stated, offers redemptions up to 5% of the outstanding shares every quarter at the current Net Asset Value (NAV). If redemptions are over-subscribed, investors are given their pro-rata share of the proceeds available, or the fund may increase the repurchase offer by up to 2% of the outstanding shares. Shareholders may tender their

²¹ Clarion Property Trust Prospectus

shares for repurchase within the first year of ownership, but they will be penalized 2% of the current NAV by doing so. Versus intends to keep a portion of their assets in cash and publicly traded securities as well as maintain a line of credit up to 25% of gross asset value to accommodate redemptions. Distributions will occur between 21 and 63²² days after the quarterly Repurchase Offer is sent to shareholders.

Some liquidity provisions on other Non-Traded REITs have previously been covered in Chapter 3, but it is worth repeating within this context. Many Non-Traded REITs have liquidity provisions that provide for no true liquidity option at all. Shares repurchased, in some cases, must be funded from the dividend reinvestments of other investors. Share repurchase prices are also often at discounted values.

On the opposite end of the spectrum from REITs is the Closed Ended Fund. Typically, an investor's capital is "locked up" for a finite period of time, often five to ten years, with no provision for liquidity from the fund sponsor. Value-add and Opportunity funds are most likely to use this structure as their strategies are based on market timing and the availability of investment opportunities. Therefore, fund managers must have confidence that the capital investors have committed to their fund will be available when they have the opportunity to deploy it. Capital is then returned to investors during the liquidation period of the fund. There are secondary markets for limited partnership interests (LPs), but there is typically very little volume, and deep discounts should be expected. There are also third party trading platforms (such as REliquid.com or Secondmarket.com) that specialize in providing liquidity for LPs, but one should not anticipate results much more favorable than finding an independent purchaser of their interest.

²² 21 to 42 days between Repurchase Offer and Request deadline, up to 14 days to Price the NAV, plus 7 days to make a funds transfer per Versus Global Multi-manager Prospectus

This range of liquidity options leaves investors and fund sponsors with many choices. To complicate this decision, the actual favorability of the liquidity method depends on the valuation method and timing – not to mention the fact that not all strategies are available throughout the spectrum of liquidity options.

Valuations

Valuation methodology and frequency were collectively the single most important issue spoken of in discussions with industry professionals. The problem of valuation arises from several innate qualities of real estate as an investment product: 1) Real estate assets are unique – and thus cannot be priced as a commodity by a public market (if one existed). Additionally, each buyer and seller has a unique reservation price that when met will produce a sale. That reservation (market) price can only be estimated – until an actual transaction closes. 2) Because of the physical nature of the asset and significant level of due diligence necessary for a real estate transaction to be consummated, often several months will pass between a contract price being agreed to and the transaction closing (pricing become public). The repercussion of this passing of time is that an appraiser is using stale pricing even if all comparable sales used closed *yesterday*. Prices could have been agreed to three to six months prior to the appraiser's valuation date, the appraisal could be stale itself immediately upon its completion.

The methodology proposed to be used by the Fidelity Property Income Trust is probably as close as a manager can get to current valuations. It had planned to appraise each property at least once a quarter with those appraisals equally spread over the quarter. This would produce values that, on average, were only 45 five days lagged. Additionally, they would update the valuation on any property that had a material event (leasing, capital expenditures, etc.) between appraisal dates. These appraisals would be combined with the daily valuations of publicly traded securities to create a Net Asset Value for the trust every day. A similar methodology is used by Clarion and Cole for their newly registered Non-Traded REITs.

A more current valuation, however, is possible. Professor David Geltner of the MIT Center for Real Estate, in conjunction with NCREIF, has created several tools to assist in more real time valuations similar to stock and bond markets. In correcting for these appraisal based lags, however, Professor Geltner explains “I think monthly is the maximum frequency for any sort of meaningful update of private-market based valuations. Even at that frequency there is not a whole lot of ‘new news’ (i.e., real news) in each monthly update. There is a fierce noise versus lag trade-off at that frequency. Our transactions-based regression-based indices [TBI] are probably as good as can be done (better than individual appraisals at the aggregate level), and we see high 1st-order autocorrelation at the monthly frequency once we filter out most of the noise, i.e., much of the individual monthly returns is ‘old news’. The private market just really literally doesn't move any faster than that.”

A correction for these lagged valuations *or* a delay in redemptions (i.e. approximately as long as the valuation lag) is necessary to prevent “unintended wealth transfers” as Lee Redding describes in *Persistent Mispricing in Mutual Funds: The Case of Real Estate*. He states that “the 1.5% figure [of annual return] is a rough estimate of the mean error resulting from valuing US commercial real estate using the periodic assessment method common to the NPI and TIAA CREF Real Estate Account...average pricing error to the account of 120 basis points [not all assets are in private real estate]” (Redding, 2006). Redding concludes that in a down market this “unintended wealth transfer” will benefit net sellers of the account to the detriment of long term holder. In contrast, in an up market, net buyers will essentially earn arbitrage profits (even if they don't realize it), again to the detriment of long term holders.

It becomes evident that, with the combination of pricing and asset liquidity, investment managers have decided to place some limits investor liquidity: it is in the best interest of the remaining investors of the fund. German Open-Ended funds have actually enforced significant changes to both their valuation

methodology and the availability of liquidity post-crisis. Their system was setup with unrealistic valuations – and investors took advantage by selling at artificially high prices, which in turn created not only a liquidity crisis but also a deficit for the funds.

Securities Regulations

Anytime a new investment vehicle is considered, the sponsor must carefully consider the consequences of how it is structured and who the sponsor is targeting as the end user. The SEC has carefully prepared regulations to protect the public with more stringent disclosure and reporting requirements for less sophisticated and broader audiences.

The two significant pieces of legislation governing securities law were passed over seventy years ago: The Securities Act of 1933 and The Investment Company Act of 1940. To this day, both pieces of legislation have immense effect on the way investments are structured and funds are raised.

Securities Act of 1933 (Securities Act)

The SEC website describes the purpose of this act as to “require that investors receive financial and other significant information concerning securities being offered for public sale; and prohibit deceit, misrepresentations, and other fraud in the sale of securities. A primary means of accomplishing these goals is the disclosure of important financial information through the registration of securities. This information enables investors, not the government, to make informed judgments about whether to purchase a company's securities. While the SEC requires that the information provided be accurate, it does not guarantee it. Investors who purchase securities and suffer losses have important recovery rights if they can prove that there was incomplete or inaccurate disclosure of important information.”²³

As is normal practice with SEC regulations, several exemptions are provided from registration under Regulation D 504, 505, and 506. In general, these exemptions require the fund raise to be a “private offering.” The most often used of the three exemptions is 506, which has the following qualifications²³:

- The company cannot use general solicitation or advertising to market the securities;
- The company may sell its securities to an unlimited number of “accredited investors”²⁴ and up to 35 other purchases. Unlike Rule 505, all non-accredited investors, either alone or with a purchaser representative, must be sophisticated—that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment;
- Companies must decide what information to give to accredited investors, so long as it does not violate the antifraud prohibitions of the federal securities laws. But companies must give non-accredited investors disclosure documents that are generally the same as those used in registered offerings. If a company provides information to accredited investors, it must make this information available to non-accredited investors as well;
- The company must be available to answer questions by prospective purchasers;
- Financial statement requirements are the same as for Rule 505; and

²³ Per SEC.gov website

²⁴ The federal securities laws define the term accredited investor in Rule 501 of Regulation D as: a bank, insurance company, registered investment company, business development company, or small business investment company; an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million; a charitable organization, corporation, or partnership with assets exceeding \$5 million; a director, executive officer, or general partner of the company selling the securities; a business in which all the equity owners are accredited investors; a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds \$1 million at the time of the purchase, excluding the value of such natural person’s primary residence ; a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

- Purchasers receive “restricted” securities, meaning that the securities cannot be sold for at least a year without registering them.

1940 Investment Company Act (40 Act)

The SEC website describes the purpose of the 40 Act as a law that “regulates investment advisers. With certain exceptions, this Act requires that firms or sole practitioners compensated for advising others about securities investments must register with the SEC and conform to regulations designed to protect investors. Since the Act was amended in 1996, generally only advisers who have at least \$25 million of assets under management or advise a registered investment company must register with the Commission.”²³

“The reach of the 1940 Act is broad, and it establishes a regulatory framework that imposes extensive substantive requirements on any company required to register. The failure to successfully navigate the exemptions and exclusions provided by the 1940 Act could lead to onerous regulation and prohibitive costs on the real estate program” (Richard P. Cunningham & Thomas G. Voekler, 2011). This suggests that, whenever possible, a real estate company or fund sponsor should avoid the purview of the 40 Act. Similar to the Securities Act, the SEC provides for several exemptions with the aim to protect less sophisticated investors and the general investing public – but at significant cost to the investment advisor. The exemptions to the 40 Act are as follows:

- Section 3(c)(1): Fewer than 100 beneficial owners, all of whom must be accredited investors
- Section 3(c)(7): All of the beneficial owners are qualified purchasers²⁵ (a higher standard than accredited)

²⁵ This definition of Qualified Purchaser refers to the Investment Company Act of 1940, as amended.

(A) Individuals is a qualified purchaser because he/she (alone, or together with his/her spouse, if investing jointly) owns not less than \$5,000,000 in investments***.

- Section 3(c)(5)(C): A real estate program if it is “primarily engaged” in purchasing or acquiring mortgages and other liens on, and interests in, real estate; generally meaning less than 40% of the assets are held in securities. Securities under this definition would include partnership interests without having substantial control of the entity (Richard P. Cunningham & Thomas G. Voekler, 2011)

(B) "Family" Corporations, Trusts or Other "Family" Entities was not formed for the specific purpose of investing in the products offered; owns not less than \$5,000,000 in investments; and is owned directly or indirectly by or for: (a) two or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption; (b) spouses of such persons; (c) the estates of such persons; or (d) foundations, Section 501(c)(3) organizations or trusts established by or for the benefit of such persons.

(C) Trusts (Other Than Trusts That Qualify under Sections (B) or (D) hereof) was not formed for the specific purpose of investing in the products offered; and each trustee (or other authorized person) that is authorized and required to make decisions with respect to this investment is a person described in (A), (B) or (D), at the time the decision to purchase Interests is made, and each settlor or other person who has contributed assets to the trust is a person described in (A), (B) or (D) at any time such person contributed assets to the trust.

(D) Other Entities was not formed for the specific purpose of investing in the products offered; and is an entity, acting for its own account or the accounts of other qualified purchasers, which in the aggregate owns and invests on a discretionary basis, not less than \$25,000,000 in investments (as defined above).

*** For these purposes, the term "investments" means any or all: (i) securities (as defined in the Securities Act), except for securities of issuers controlled by the Investor ("Control Securities"), unless (A) the issuer of the Control Securities is itself a registered or private investment company or is exempted from the definition of investment company by Rule 3a-6 or Rule 3a-7 under the Company Act, (B) the Control Securities represent securities of an issuer that files reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, (C) the issuer of the Control Securities has a class of securities listed on a designated offshore securities market under Regulation S under the Securities Act, or (D) the issuer of the Control Securities is a private company with shareholders' equity not less than \$50 million determined in accordance with generally accepted accounting principles, as reflected in the company's most recent financial statements (provided such financial statements were issued within 16 months of the date of Investor's purchase of an Interest); (ii) futures contracts or options thereon held for investment purposes; (iii) physical commodities held for investment purposes; (iv) swaps and other similar financial contracts entered into for investment purposes; (v) real estate held for investment purposes; and (vi) cash and cash equivalents held for investment purposes.

Note: In determining whether the \$5 million or \$25 million thresholds are met, investments can be valued at cost or fair market value as of a recent date. If investments have been acquired with indebtedness, the amount of the indebtedness must be deducted in determining whether the threshold has been met.

There are many implications of the Securities Act and 40 Act. The Acts are in place to serve as a protective force for the investing public, but in doing so they also limit the product selection. The costs of compliance and operating restrictions force many fund managers and investment advisers to avoid registration all together. For the investment vehicles that do register and comply, the costs of a restrictive regulatory environment are ultimately passed on to investors. Those investors that are served through safe harbor exemptions will continue to enjoy a broader menu of investment selections with lower fees.

- The combination of the Securities and 40 Acts makes it nearly impossible for an investment company to target non-accredited investors without registration – this is by design.
- REITs are a primary method of eliminating UBTI²⁶ for investors; however, the 40 Act essentially forces registration as a security due to the REITs' requirement for at least 100 shareholders.
- Funds that invest in securities (including limited partnerships) cannot qualify for exemption.

Blue Sky Laws

State regulators have additional oversight of securities via Blue Sky Laws, aptly named to ensure that securities are not backed solely by the “blue sky” and nothing tangible. These regulations require that most offerings be registered with each state individually. The complication inherent in this practice is that laws vary widely from state to state (even laws written similarly can be interpreted differently). The SEC does provide exemptions for Regulation D 506 securities, government offerings, and securities listed on national exchanges. This, however, leaves real estate securities, most of which will not be listed on an exchange, in the precarious position of answering to 50 additional regulators.

²⁶ Dividends are excluded from the definition of UBTI. REITs convert normal operating income that would be considered UBTI and distributes it as dividends, which eliminates the tax burden. Additionally, REITs are required to distribute 90% of net income and able to deduct those distributions vs. taxable income, thus very little tax is due at the corporate level.

Blind Pool

Peter Merrigan, CEO and President of Taurus Holdings, says one of the tricky issues of raising money from individual investors is that they are skeptical of the “aim to acquire” business plan of a fund, “whereas with a club deal, investors can see the asset – and become comfortable with the strategy.”

This sentiment is evidenced by failed launches of several new REITs in the past few years. “Some of the failed IPOs were for ‘blind pool’ REITs that hope to gain access to capital for real estate investing, but do not yet own any assets. That means investors have to judge the quality of the management team and its business plan without having any evidence as to how well that management team has executed its real estate investment mandate in the past. That’s not necessarily a problem--some blind REITs are going to be successful—but it exposes potential investors to a lot more uncertainty” (Brad Case, 2011).

Credit

The credit worthiness of individual investors is not a trivial matter when it comes to any investment with delayed capital calls. Three separate fund managers regarded credit as one of their top two concerns with accepting individual investors to invest alongside institutions (the other being sophistication level). Several other professionals concurred that credit is an issue recommending, instead of opportunistic and value-added strategies, that individuals would pair better with a Core Open-Ended model as delayed capital calls are nearly unheard of.

Two other strategies in combating the credit issue are possible. First, the fund could call all committed capital at closing of the fund. The problem with this strategy becomes that, unless the fund is able to fully invest the capital in a relatively short period of time, there is a lot of un-invested cash at the fund level that drags down returns. If (once) a functioning derivatives market is existent, a fund manager could create synthetic exposure to real estate until sufficient opportunities are located.

Alternatively, investors could keep their capital until it is called by the fund, but could enhance the credit of their commitment through the use of surety bonds²⁷. Premiums can range anywhere from 1 to 4% (at which point it is probably not worthwhile) and will reduce an investor's total return.

Tax Considerations

When commingling funds, an investment manager must stay cognizant of not only from whom, but from what type of account the capital originated. In discussing funds from individual investors, there are at least three tax regimes involved that relate to: funds from savings, funds from IRAs, and funds from 401(k)s. Both 401(k)s and IRAs are subject to UBTI, funds from savings are not. IRAs are always subject to UDFI, but 401(k)s have exemptions to UDFI taxation.²⁸ Tax regimes that apply to pension funds, endowments, and foundations are substantially similar to those that govern 401(k)s, but some differences do exist.

In order to eliminate UDFI for IRA investors a UBTI "blocker" structure will need to be utilized. "A UBTI blocker will have to be used if a fund is required to avoid UBTI for investors such as charities and private foundations (who, by statute, never can qualify for fractions rule relief from leverage-caused UBTI). The most commonly used structure is a privately held REIT, which can be a fund subsidiary through which all of the fund's assets are held, or alternatively, an entity that is an investor in the fund (i.e., the REIT is "above" the fund) through which the UBTI-sensitive investors will invest" (Ernst & Young LLP, 2005).

²⁷ A surety bond is a promise to pay one party (the obligee) a certain amount if a second party (the principal) fails to meet some obligation, such as fulfilling the terms of a contract. The surety bond protects the obligee against losses resulting from the principal's failure to meet the obligation.

²⁸ 401(k) plans fall under the same tax code as Defined Benefit Pensions plans. These "qualified" plans can avoid UDFI through meeting a series of qualification of the actual investment, plus exemption relating to the status of the assets' ownership. Qualification is not always easy and Investment managers must stay vigilant in meeting the criteria in order for qualified plans to avoid UDFI. The five criteria a plan must meet are: 1) Purchase price is fixed 2) Debt is not a participating loan. 3) The purchaser cannot lease the property back to the seller nor to a party related to the qualified plan. 4) The purchase cannot be acquired from a related party (i.e.: Pension plans buy from Corporate Parent). 5) Neither the seller, nor a related party can provide 'Seller Financing' unless under commercial reasonable terms. In addition to these five criteria, the partnership must also meet one of three additional hurdles: 1) All partners are qualified organizations, 2) All allocations of tax items are 'qualified allocations', or 3) Allocations must satisfy the fractions rule (essentially equal distribution of income/loss to ownership percentage). (Suzanne Ross McDowell, 2003)

Employee Retirement Income Security Act (ERISA)

ERISA is federal law enacted in 1974 to establish minimum standards for private industry pension plans.

It forms parameters that guide how advisors managing funds from qualified plans must act, operate, and report. In doing so, ERISA regulations can cause managers to expend significant sums to comply with bookkeeping and administration requirements. Additionally, a list of 'prohibited transactions', not dissimilar from those applicable to IRAs, were instituted. However, a fund only needs to comply with the most rigid of these regulations (prohibited transactions, prudent man, diversification, limits on fees) if the fund's assets are considered "plans assets" – and there are exemptions even with the plan assets designation. A fund's assets are considered "plans assets" if 25% or more of the equity capital comes from private pension plans, defined contribution plans or IRAs. In the affirmative case, a fund has the following exemptions available to it:

- Real Estate Operating Company: 50% or more of the fund's assets are invested in real estate over which the fund has significant management control. Limited partnership interests without management control do not qualify for this exemption i.e. fund of funds.
- Venture Operating Company: *Primarily* invested in operating companies which are under the control of the fund.
- Qualified Plan Asset Manager Designation: By using this exemption, an investment manager can engage in otherwise prohibited transactions.
- Become a registered 40 Act security under the scrutiny and purview of the SEC

Distribution

Distribution channels for raising equity for any investment vehicle become a major cost and complication as the average investment contribution gets smaller, and the number of investors in a vehicle increases. The typical distribution channels are financial planners, investment advisers, investment banks and brokers. Not only must these players be made aware of a new investment

product, but they also need to understand it (so as to explain it to their clients) and receive fair compensation for its distribution. Compensation may be the hardest objection for a new product to overcome due to the astronomical fees and commissions that advisors have come to expect from Non-Traded REITs (5-10% of capital). Everyone would love to believe that advisors act in best interest of their clients, but the wide distribution of Non-Traded REITs would suggest otherwise: Brokers are often greedy or they do not understand the product themselves (which is entirely possible).

Advisory Needs

The proliferation of a new real estate investment product will succeed on a large scale only with the help of brokers and advisors. Individual investors often rely on their advisors to create asset allocations and fund selections for many aforementioned reasons; overwhelmed by choice, misunderstanding of products, and being unsuitably aggressive or conservative. This would be especially true with real estate managers as there is very little information guiding an investor towards good managers. Several fund raising executives discussed the potential of “Morningstar Ratings” for real estate investment managers as being helpful in the selection process. Ratings could, at very least, provide some measuring stick with which an investor could compare managers. Presumably this type of service is exactly what pension fund advisors, such as Townsend or PCA, provide to their institutional clients.

Fees

According to the Entrust Survey, and contrary to logic, investors prefer flat fees to performance fees (see Appendix 1). The sentiment is shared by the SEC. The SEC states that only the accredited investors can be charged performance-based fees by Investment Advisers. There is a high likelihood that, even with extensive disclosures, non-accredited investors will not understand the full dollar amount of the fees they are paying to their advisor. As SEC rules currently stand, a registered investment adviser cannot charge performance fees unless an individual has \$1million under management with the adviser

or it can be reasonably ascertained that the individual has a net worth in excess of \$2million²⁹ excluding equity in their primary residence. This standard is separate from the accredited investor definition, although its definition is substantially similar.

Current real estate industry practice runs in opposition to investors' desires with incentive-based fees the norm. In most instances, this would align interests between investment managers and investors more closely, but the SEC's concerns remain.

²⁹ Section 205(a)(1) of the Investment Advisers Act of 1940

Chapter 7: New Product Development: What is Next?

The prior chapters have argued why a new real estate investment vehicle is necessary for individual investors; one has no compelling choices in the current menu of investment options. Chapter 7 first analyzes several new vehicles in development, then proposes a vehicle for 401(k)s; giving investors a newfound ability to allocate capital to appropriate and adequate real estate investments structures.

New Vehicle: Web-based Self-allocation

A new breed of electronic trading platforms has emerged over the last year. These platforms are structured such that developers and funds sponsors interested in raising new equity or debt: or limited partners seeking to divest their partnership interests; (collectively capital seekers) can list their capital needs online. The investors (capital providers) search through the listed capital requests and are able to allocate their capital to specific deals, mortgages, or funds. Reliquid.com describes the product as the following:

Reliquid empowers Capital Seekers to efficiently source capital for their commercial real estate, saving time, costs and fees. Capital Seekers can utilize Reliquid to obtain debt, bridge, mezzanine debt and preferred equity financing by connecting directly to capital sources. Reliquid encourages direct investor-sponsor communication to facilitate the formation of new capital relationships.

Through Reliquid, Capital Providers can directly source commercial real estate lending and investment opportunities. Capital Providers can build direct relationships with sponsor, enhance their deal flow and ensure market coverage at no cost.

Through its transaction management platform, Reliquid also enables both parties to efficiently manage direct investor-sponsor communication, due diligence, negotiation and transaction execution. Reliquid facilitates debt, mezzanine debt and preferred

equity financings for commercial real estate that are greater than \$2 million

(www.REliquid.com).

3% of respondents from the Entrust Survey reported having used any sort of capital matching website (REliquid.com, Principalsmarket.com, or Caplinked.com) to source deals. While this suggests that there is a massive population from which these businesses can grow their platforms, it may also suggest that there is little interest from individual investors doing real estate deals over the internet. Unfortunately for the platforms themselves, it will be difficult to build individual investor clientele who are not already familiar with their capital seekers. This is for two reasons discussed earlier in this thesis:

- 1) Unsophisticated investors (even those with significant wealth) can be overwhelmed by choice.
- 2) Without the benefit of third party assessments of the management of each capital seeker (historic returns, tenure, experience in proposed sector), it will be difficult for the average investor to compare investment opportunities with any objective metrics.

This is not to say these platforms will not be successful. To the contrary, they provide a needed information service that developers and investors will both value, but it is more likely that institutional and professional investors will be most active on the capital provider side. Additionally, this platform would only work with self-directed 401(k) accounts; IRA accounts would not be able to shelter UDFI within this structure – unless the investor is only providing debt financing.

New Vehicle: Direct Investment

Interest in creating a new real estate investment vehicle for individual investors has accelerated in the last year. Prudential Insurance, Clarion Partners, CBRE Investors (only available in UK currently), and Cole Real Estate Investments have all introduced new products for registration with the SEC or have made strategic hires to aide in development of such products. Prior to this recent surge of activity, Fidelity Investments paved the way and refined the model with its Fidelity Property Income Trust. A

source with knowledge of the product states “It was approved by the SEC and all state regulators, but Fidelity did not want to release the product in 2008 as the real estate market was collapsing. This model would have made all the Non-Traded REITs run for cover.” Merrill Lynch/Blackrock was in the same position with their NorthEnd fund that is still active on the SEC website. Interestingly enough, Non-Traded REIT sponsors, such as Cole, are reassessing their products anyway – and working to develop lower fee models in response. Cole Real Estate Income Trust’s prospectus is suspiciously similar to Fidelity’s – perhaps it is because Cole has hired the same attorney as listed on Fidelity’s prospectus.

“Though there is no desire to introduce stock market volatility to the Non-Listed REIT vehicle, we believe there is a movement among Non-Listeds to more accurately reflect real estate market values in real time. A number of new Non-Listed REIT structures, including Clarion Property Trust and NorthEnd Income Properties, will attempt to issue and redeem shares at an estimated net asset value (NAV) reviewed on a daily basis. Presumably significant property transactions and major lease announcements could move the valuation needle and would be captured by this valuation process. These valuation mechanisms remind us of those incorporated in the proposed Fidelity Property Income Trust several years ago, which never got off the launch pad” (Paul E. Adornato, 2010).

Fidelity Property Income Trust³⁰

Fidelity Investments began the development of the, now shelved, Fidelity Property Income Trust in 2006. The SEC and all state regulators had approved the updated version of an open-ended Non-Traded REIT as of 2008, but the company decided to indefinitely delay the release of the security to the public. This product has become the mold from which several imitations have been cast.

The trust was planned to invest up to 75% to 90% of capital in a diversified portfolio of core properties. The remaining capital would be allocated to publicly traded securities (REITs and CMBS), and cash.

³⁰ <http://sec.gov/Archives/edgar/data/1368075/000119312507265800/ds11a.htm>

The innovations of the Fidelity product include an annual 1.1% of NAV advisory fee with no upfront load, nor any costs of organization passed on to the investors. Additionally, the trust had daily liquidity available to investors at same NAV that one would buy shares at that day. NAV, as mentioned earlier, was based on the closing price of public securities, plus the most recent appraised values (not more than 45 days old on average) net of any outstanding debt, plus cash. They also had a credit line equal to 25% of capital to use for acquisitions or redemptions (so asset sales weren't immediately needed). Fidelity's plan was to seed the offering with properties owned by a limited partner assumed to be \$500,000,000, so the offering would not be a blind pool in its entirety.

This product was contemplated as a vehicle that could be accessed by any level of investor within a 401(k), but separate state regulations determined who could invest in the trust through taxable accounts. Minimum investment was stated as \$2,500.

Cole Real Estate Income Trust Inc.³¹

The new Cole open-ended Non-Traded REIT product is substantially similar to Fidelity's product in a number of ways including liquidity, NAV, front-end load (underwriting and distribution costs up to \$2,000,000 are paid out of first year's cash flow), and availability to investors. There are, however, several important differences:

1. Cole can pay dividends using capital contributions.
2. 0.9% of NAV annual advisory fee
3. Cole's advisor has many conflicts of interest including that it's advising several other, higher fee, Non-Traded REITs that have performed badly over the last few years.
4. Cole's advisor receives an annual incentive fee equal to 25% of the return above a 6% annual return (not to exceed 10% of the total return)

³¹ <http://sec.gov/Archives/edgar/data/1498542/000095012311050361/g24423a2sv11za.htm>

5. The shares that are marketed to any given investor may depend on which broker advises the investor. These shares will presumably pay a much lower commission than other Cole Non-Traded REIT products.
6. This is a blind pool offering.

This product represents a major advance for Cole, but investors should still be wary due to management's conflicts of interest and an incentive fee based on a return threshold that is unreasonably low – the NCREIF NPI return over the last 16 years was 9.28% annually with *no leverage*. Thus, assuming no leverage the advisor would earn \$32,000,000 in incentive fees in an average year (3.28% X 25% X \$4,000,000,000 Total offering), in addition to their advisory fee. These incentive fees also are not netted out for years that the trust performs below the 6% threshold as would be typical in a private equity fund.

Clarion Partners Property Trust Inc.³²

The Clarion Partners Property Trust Inc. is also an open-ended Non-Traded REIT that is fundamentally similar to the model formulated by Fidelity. Clarion Partners, the advisor to the trust, is a highly regarded real estate investment advisor, but because they manage several competing funds they will also have conflicts of interests. Other differences to the Cole and Fidelity offerings include:

1. 3% Front-end load, plus 0.55% dealer manager fee, 0.9% of NAV annual advisory fee.
2. Liquidity is limited to 5% of outstanding shares per quarter and 20% per 12 month period.
3. Dividends can be paid using capital contributions.
4. This is a blind pool offering.
5. \$10,000 minimum investment.
6. Target leverage ratio of 35% (vs. 25% for Fidelity).

³² <http://sec.gov/Archives/edgar/data/1476886/000104746911005127/a2203964zs-11a.htm>

7. Clarion’s advisor receives an annual incentive fee equal to 25% of the return above a 6% annual return (not to exceed 10% of the total return).

Some of the same concerns levied against the new Cole product also exist for Clarion’s product: management conflicts of interest, and an incentive fee that has an unjustifiably low threshold.

New Vehicle: Fund of Funds

VERSUS GLOBAL MULTI-MANAGER REAL ESTATE INCOME FUND LLC³³

Versus Capital Advisors has created a new vehicle that embodies many of the characteristics of an institutional quality fund, but it has been developed with the individual investor in mind.

“According to the firm’s SEC filing, the Versus fund of funds offers a distinct advantage to retail investors: the ability to circumvent the prohibitive minimum investments required by institutionally-managed real estate funds — and get much better liquidity. The minimum equity investment has been set at just \$10,000, with the average commitment expected to be between \$50,000 and \$75,000, and the fund will offer to repurchase between 5 percent and 25 percent of outstanding shares four times per year, although people familiar with the matter said it likely would be closer to the 5 percent mark [5% per quarter in the current SEC registration]. That is in stark contrast to the \$5 million to \$10 million minimum investment and five- to seven-year capital commitment for shares in top institutional real estate funds” (Kolb, 2011).

The fund does not charge a front-end load (although, distribution costs are levied in an annual fee), and total fees, including those of the underlying fund, are 3.10% of NAV annually. While, at first blush 3.15% number may seem high in comparison to Cole and Clarion’s new vehicles, the Versus Capital fund charges no performance fees at the upper level or the underlying fund level. Additionally, sponsor risk is diversified significantly by using multiple managers, all of whom are top of class investment advisors such as AEW and Heitman, and Invesco.

³³ http://sec.gov/Archives/edgar/data/1515001/000110465911038711/a11-7870_4n2a.htm

Non Accredited Investor with \$50,000 for
Real Estate Investment

Qualified Puchaser with \$5,000,000 for
Real Estate Investment

| | Quarterly Liquidity or Better | Low Upfront Fees | No Incentive-Based Fees | Frequent and Fair Valuation | Non-Correlation to Public Markets | Low Standard Deviation | Diversification of Geographic Risk | Diversification of Asset Specific Risk | Diversification of Product Type | Diversification of Sponsor Risk | Diversification of Strategy | Quarterly Liquidity or Better | Low Upfront Fees | No Incentive-Based Fees | Frequent and Fair Valuation | Non-Correlation to Public Markets | Low Standard Deviation | Diversification of Geographic Risk | Diversification of Asset Specific Risk | Diversification of Product Type | Diversification of Sponsor Risk | Diversification of Strategy | |
|------------------------------------|-------------------------------|------------------|-------------------------|-----------------------------|-----------------------------------|------------------------|------------------------------------|--|---------------------------------|---------------------------------|-----------------------------|-------------------------------|------------------|-------------------------|-----------------------------|-----------------------------------|------------------------|------------------------------------|--|---------------------------------|---------------------------------|-----------------------------|---|
| Separate Accounts | | | | | | | | | | | | | | | | | | | | | | | |
| Open-Ended Core Fund | | | | | | | | | | | | X | X | X | X | X | X | X | X | X | | | |
| Closed-Ended Private Equity | | | | | | | | | | | | | X | | X | X | X | X | X | X | | | |
| Fund of Funds | | | | | | | | | | | | | X | | X | X | X | X | X | X | X | X | X |
| Joint Ventures w/ Developer | | | | | | | | | | | | | | | | | | | | | | | |
| Mortgages | | | | | | | | | | | | | X | X | X | X | X | | | | | | |
| Publicly Traded REITs** | X | X | X | X | | | X | X | X | X | | X | X | | X | | | X | X | X | X | | |
| Non-Traded Public REITs | | | | | X | X | X | X | X | | | | | | | X | X | X | X | X | X | X | X |
| Private REITs | | | | | | | | | | | | | | | X | X | X | X | | | | | |
| Tenancy-In-Common | | | X | | X | X | | | | | | | | X | | X | X | X | X | X | X | X | X |
| Direct Ownership (4-Plex) | | X | X | | X | | | | | | | | X | X | | X | | X | X | X | X | | |
| Local Developers | | X | | | X | | | | | | | | X | | | X | | X | X | X | X | | |
| Reliquid.com | | | | | | | | | | | | | X | | X | X | | X | X | X | X | X | X |
| Fidelity Property Income Trust**** | X | x | X | X | X | X | X | X | X | | X | X | x | X | X | X | X | X | X | X | | | X |
| Clarion Property Trust***** | X | X | | X | X | X | X | X | X | | X | X | X | | X | X | X | X | X | X | | | X |
| Cole Property Trust***** | X | X | | X | X | X | X | X | X | | X | X | X | | X | X | X | X | X | X | | | X |
| Versus Multi Manager Fund | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X |

Note: All Vehicles could potentially be held in a Self-Directed IRA or 401(k)

*TIAA CREF and Principal Insurance offer this product in 401(k) accounts

**Assuming a REIT Mutual Fund or ETF

***Any Developer or Fund can raise equity from up to 35 non-accredited individual without registering with the SEC

****SEC Registration has been withdrawn

*****Not yet available on 401(k) platforms

Proposed Vehicle: Collective Investment Trust Core Fund for 401(k)s

After considering the many qualities desired and objections associated with creating a new commercial real estate investment vehicle, I propose to create a new product that concentrates on the following:

401(k) Assets

Many of the vehicles listed throughout this thesis are available via an IRA (or at least a Self-Directed IRA); however, few are available within 401(k) plans. These defined contribution retirement plans account for \$3.85 trillion of the \$15 trillion in total retirement assets. Those that may soon be available, such as Clarion's or Cole's product, would violate the plan sponsor's fiduciary responsibility to provide their participants with low fee investment options.

Low Fees

The assets of the vehicle will be held in a collective investment trust (CIT). A CIT is exempt from registration with the 40 Act per Section 3(C)(11).³⁴ CITs are instead governed by the Office of the Comptroller of the Currency. By virtue of exemption from SEC registration, reporting, and disclosure, a new fund can significantly reduce its fees. Many mutual funds have migrated to a CIT platform recently to become more competitive in fee structure. Most banks who provide these custodial services are already registered investment advisors, so they can act as Qualified Plan Asset Managers with a sub-advisor to whom they would delegate the choice of fund real estate fund managers.

³⁴ Any employee's stock bonus, pension, or profit-sharing trust which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1986 [26 USCS § 401]; or any governmental plan described in section 3(a)(2)(C) of the Securities Act of 1933 [15 USCS § 77c(a)(2)(C)]; or **any collective trust fund maintained by a bank consisting solely of assets of one or more of such trusts**, government plans, or church plans, companies or accounts that are excluded from the definition of an investment company under paragraph (14) of this subsection; or any separate account the assets of which are derived solely from (A) contributions under pension or profit-sharing plans which meet the requirements of section 401 of the Internal Revenue Code of 1986 [26 USCS § 401] or the requirements for deduction of the employer's contribution under section 404(a)(2) of such Code [26 USCS § 404(a)(2)], (B) contributions under governmental plans in connection with which interests, participations, or securities are exempted from the registration provisions of section 5 of the Securities Act of 1933 [15 USCS § 77e] by section 3(a)(2)(C) of such Act [15 USCS § 77c(a)(2)(C)], and (C) advances made by an insurance company in connection with the operation of such separate account.

Additionally, the fund would be structured with flat fees on for the underlying funds. Thus, investors will have full understanding and disclosure of the fee load they will be charged.

One fund raising executive representing an open-ended core fund suggested that their fees are anywhere between 0.80% and 1.25% of NAV depending on total capital invested with the fund. Together with no acquisition fee, no exit fee, and lower administration fees, total fees could potentially be around 2.5% with no front end load on a multi-manager platform.

Core Multi Manager Strategy

Core real estate has a reputation of outperforming higher yield strategies on a risk-adjusted basis, so this fund would concentrate on only Core product in 'A' locations via Core Open-ended Funds.

The fund would invest in multiple core open ended funds to diversify sponsor risk. Based on the results from the Entrust Survey, in combination with many conversations with industry participants, the investor demand is most evident in wanting to access to the best and brightest fund managers to whom they otherwise would not have access.

Liquidity

Most opened ended core funds, such as the ones contemplated as the underlying funds for this vehicle, already provide quarterly liquidity. That may be sufficient, but in the case it is not, but fund could use two different methods to provide extended liquidity:

1. The underlying funds will have leverage, but typically core funds use low leverage, thus the CIT would endeavor to acquire a line of credit for redemptions. A maximum loan to value would need to be in place at around 50% of total gross asset value.
2. A functioning derivatives market does not currently exist. But, when liquidity is available in the derivatives market, it could be used to synthetically remove exposure to the underlying funds.

The fund would take a short position and use the proceeds for redemptions (until liquidity is available from the underlying funds – at which time the fund would take an offsetting long position). There will be some chance of basis risk³⁵ between the underlying funds and the associated index, thus this strategy should be used sparingly – and removed as soon as funds are available to offset the position.

Valuations

The underlying funds would be required to value each property quarterly (all valuation evenly spread throughout the quarter) with intra-valuation updates for any ‘material’ changes to a property’s value.

Summary

The combination of these characteristics in one real estate investment vehicle creates a new and compelling product for individual investors who would otherwise not have access to high quality institutional real estate products; in other words, it fills a gap in the market.

³⁵ The risk that offsetting investments in a hedging strategy will not experience price changes in entirely opposite directions from each other. This imperfect correlation between the two investments creates the potential for excess gains or losses in a hedging strategy, thus adding risk to the position.

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| Separate Accounts | | | | | | | | | | | | | | | | | | | | | | | |
| Open-Ended Core Fund | | | | | | | | | | | | X | X | X | X | X | X | X | X | X | | | |
| Closed-Ended Private Equity | | | | | | | | | | | | | X | | X | X | X | X | X | X | | | |
| Fund of Funds | | | | | | | | | | | | | X | | X | X | X | X | X | X | X | X | X |
| Joint Ventures w/ Developer | | | | | | | | | | | | | | | | | | | | | | | |
| Mortgages | | | | | | | | | | | | | X | X | X | X | X | | | | | | |
| Publicly Traded REITs** | X | X | X | X | | | X | X | X | X | | X | X | | X | | | X | X | X | X | | |
| Non-Traded Public REITs | | | | | X | X | X | X | X | | | | | | | X | X | X | X | X | X | X | X |
| Private REITs | | | | | | | | | | | | | | | | X | X | X | X | | | | |
| Tenancy-In-Common | | | X | | X | X | | | | | | | | X | | X | X | X | X | X | X | X | X |
| Direct Ownership (4-Plex) | | X | X | | X | | | | | | | | X | X | | X | | X | X | X | X | | |
| Local Developers | | X | | | X | | | | | | | | X | | | X | | X | X | X | X | | |
| Reliquid.com | | | | | | | | | | | | | X | | X | X | | X | X | X | X | X | X |
| Fidelity Property Income Trust**** | X | x | X | X | X | X | X | X | X | | X | X | x | X | X | X | X | X | X | X | | | X |
| Clarion Property Trust***** | X | X | | X | X | X | X | X | X | | X | X | X | | X | X | X | X | X | X | | | X |
| Cole Property Trust***** | X | X | | X | X | X | X | X | X | | X | X | X | | X | X | X | X | X | X | | | X |
| Versus Multi Manager Fund | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X |
| Collective Investment Trust | X | X | X | X | X | X | X | X | X | X | | X | X | X | X | X | X | X | X | X | X | X | X |

Note: All Vehicles could potentially be held in a Self-Directed IRA or 401(k)

*TIAA CREF and Principal Insurance offer this product in 401(k) accounts

**Assuming a REIT Mutual Fund or ETF

***Any Developer or Fund can raise equity from up to 35 non-accredited individual without registering with the SEC

****SEC Registration has been withdrawn

*****Not yet available on 401(k) platforms

Conclusion

This thesis has argued that individual investors have neither appropriate nor adequate options for investment in commercial real estate. Furthermore, given the similarities of an individual's retirement liabilities to a pension fund's liabilities, individuals' portfolios should more closely mirror the investment allocations of pension funds. Thus, in order to meet this goal new real estate investment products are necessary in order to provide individuals with more appropriate real estate investment options. In contemplating new vehicles, one must weigh many trade-offs. The product that meets many of investors' priorities with few tradeoffs is a multi-manager core fund held within a collective investment trust. This structure provides investors with access to a low fee, liquid real estate investment that eliminates many of the risks, such as high correlation to the public equity markets or sponsor specific risk, commonly associated with existing real estate investment products available today.

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Appendix 1: Entrust Survey Questions and Responses

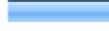
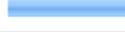
Alternative Investment Opportunities in Real Estate for Individual Investors



1. What is the approximate size of your investment portfolio?

| | | Response Percent | Response Count |
|--------------|--|-------------------|----------------|
| <\$100,000 | | 18.3% | 11 |
| <\$250,000 | | 20.0% | 12 |
| <\$500,000 | | 21.7% | 13 |
| <\$1,000,000 | | 16.7% | 10 |
| <\$2,500,000 | | 13.3% | 8 |
| <\$5,000,000 | | 5.0% | 3 |
| >\$5,000,000 | | 5.0% | 3 |
| | | answered question | 60 |
| | | skipped question | 0 |

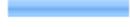
2. What percentage of the equity in your investment portfolio is allocated to real estate?

| | | Response Percent | Response Count |
|------|---|--------------------------|----------------|
| 0% |  | 3.3% | 2 |
| 5% |  | 3.3% | 2 |
| 10% |  | 8.3% | 5 |
| 25% |  | 20.0% | 12 |
| 50% |  | 16.7% | 10 |
| 75% |  | 25.0% | 15 |
| 100% |  | 23.3% | 14 |
| | | answered question | 60 |
| | | skipped question | 0 |

3. Is that allocation above or below your ideal allocation?

| | | Response Percent | Response Count |
|------------|---|--------------------------|----------------|
| Above |  | 13.3% | 8 |
| Below |  | 26.7% | 16 |
| Just Right |  | 60.0% | 36 |
| | | answered question | 60 |
| | | skipped question | 0 |

4. Which products do you use to obtain Real Estate exposure?

| | | Response Percent | Response Count |
|-------------------|--|--------------------------|----------------|
| Public REITs |  | 8.3% | 5 |
| Private REITs |  | 1.7% | 1 |
| Private Equity |  | 11.7% | 7 |
| Local Developer |  | 3.3% | 2 |
| Tenant-In-Commons |  | 6.7% | 4 |
| Direct Ownership |  | 80.0% | 48 |
| Mortgages |  | 23.3% | 14 |
| Other |  | 16.7% | 10 |
| | | answered question | 60 |
| | | skipped question | 0 |

5. Have you bought real estate directly via your self-directed IRA?

| | | Response Percent | Response Count |
|-----|--|--------------------------|----------------|
| Yes |  | 100.0% | 60 |
| No | | 0.0% | 0 |
| | | answered question | 60 |
| | | skipped question | 0 |

6. Were you able to obtain leverage?

| | | Response Percent | Response Count |
|-------------------|---|------------------|----------------|
| Yes |  | 37.7% | 20 |
| No |  | 62.3% | 33 |
| answered question | | | 53 |
| skipped question | | | 7 |

7. How do you source investments?

| | | Response Percent | Response Count |
|---------------------|---|------------------|----------------|
| Real Estate Brokers |  | 67.8% | 40 |
| Securities Brokers |  | 6.8% | 4 |
| Developers |  | 8.5% | 5 |
| Loopnet/CoStar |  | 6.8% | 4 |
| Personal Network |  | 44.1% | 26 |
| other |  | 25.4% | 15 |
| answered question | | | 59 |
| skipped question | | | 1 |

8. Have you sourced deals or made introductions to fund sponsors/developers through online capital matching websites? ie: Reliquid.com, Principals Market, Caplinked.com

| | | Response Percent | Response Count |
|-------------------|--|------------------|----------------|
| Yes |  | 3.4% | 2 |
| No |  | 96.6% | 57 |
| answered question | | | 59 |
| skipped question | | | 1 |

9. Assuming no fee disadvantage, would you invest in Real Estate private equity if you had access to the Best in Class sponsors?

| | | Response Percent | Response Count |
|-------------------|---|------------------|----------------|
| Yes |  | 46.6% | 27 |
| No |  | 48.3% | 28 |
| Already do |  | 5.2% | 3 |
| answered question | | | 58 |
| skipped question | | | 2 |

10. If you already invest with real estate private equity funds, how many have you invested with in the past?

| | | Response Percent | Response Count |
|--------------------------|--|------------------|----------------|
| 1 | | 0.0% | 0 |
| 2 - 5 | | 50.0% | 1 |
| 6 - 10 | | 50.0% | 1 |
| > 10 | | 0.0% | 0 |
| answered question | | | 2 |
| skipped question | | | 58 |

11. What was the average minimum capital contribution?

| | | Response Percent | Response Count |
|--------------------------|--|------------------|----------------|
| < \$50,000 | | 50.0% | 1 |
| < \$100,000 | | 0.0% | 0 |
| < \$250,000 | | 0.0% | 0 |
| < \$500,000 | | 50.0% | 1 |
| < \$1,000,000 | | 0.0% | 0 |
| < \$2,500,000 | | 0.0% | 0 |
| < \$5,000,000 | | 0.0% | 0 |
| > \$5,000,000 | | 0.0% | 0 |
| answered question | | | 2 |
| skipped question | | | 58 |

12. Assuming no fee disadvantage, would you invest with local developers if you had access?

| | | Response Percent | Response Count |
|------------|---|-------------------|----------------|
| Yes |  | 48.3% | 28 |
| No |  | 48.3% | 28 |
| Already do |  | 3.4% | 2 |
| | | answered question | 58 |
| | | skipped question | 2 |

13. If you already invest with local developers, how many have you invested with in the past?

| | | Response Percent | Response Count |
|--------|--|-------------------|----------------|
| 1 |  | 0.0% | 0 |
| 2 - 5 |  | 100.0% | 2 |
| 6 - 10 |  | 0.0% | 0 |
| > 10 |  | 0.0% | 0 |
| | | answered question | 2 |
| | | skipped question | 58 |

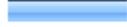
14. What was the average minimum capital contribution?

| | | Response Percent | Response Count |
|--------------------------|--|------------------|----------------|
| < \$50,000 | | 0.0% | 0 |
| < \$100,000 | | 50.0% | 1 |
| < \$250,000 | | 0.0% | 0 |
| < \$500,000 | | 50.0% | 1 |
| < \$1,000,000 | | 0.0% | 0 |
| < \$2,500,000 | | 0.0% | 0 |
| < \$5,000,000 | | 0.0% | 0 |
| > \$5,000,000 | | 0.0% | 0 |
| answered question | | | 2 |
| skipped question | | | 58 |

15. How long would you be willing to "lock up" your capital in an investment?

| | | Response Percent | Response Count |
|--------------------------------------|--|------------------|----------------|
| < 1 Day, I need constant liquidity | | 3.5% | 2 |
| < 1 Year | | 5.3% | 3 |
| 1 - 3 Years | | 17.5% | 10 |
| 3 - 5 Years | | 22.8% | 13 |
| 5 - 7 Years | | 12.3% | 7 |
| 7 - 10 Years | | 7.0% | 4 |
| > 10 Years, I'm a long term investor | | 35.1% | 20 |
| answered question | | | 57 |
| skipped question | | | 3 |

16. Assuming average total fees are equal, would you prefer to pay performance based fees, or flat fees?

| | | Response Percent | Response Count |
|--------------------------|---|------------------|----------------|
| Performance |  | 35.1% | 20 |
| Flat |  | 42.1% | 24 |
| Indifferent |  | 22.8% | 13 |
| answered question | | | 57 |
| skipped question | | | 3 |

17. What would access to Best in Class Private Equity Real Estate Funds and a diverse selection local developers be worth to you?

| | | Response Percent | Response Count |
|--|---|------------------|----------------|
| A lot – I need additional investment vehicles |  | 8.8% | 5 |
| I'd be interested if fees were in line/better than with my current opportunities |  | 26.3% | 15 |
| Little, I'm satisfied with my current real estate opportunities |  | 64.9% | 37 |
| answered question | | | 57 |
| skipped question | | | 3 |

18. Any additional comments regarding the availability of real estate investment opportunities?

| | Response Count |
|--------------------------|---------------------------|
| | 13 |
| answered question | 13 |
| skipped question | 47 |