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## The view from the trough is better than the view from the peak

While the fixed income market and to a more limited extent the equities market rebounded dramatically over mid to late 2009, the commercial real estate market failed to spring back. If public concern with the availability of debt and possible foreclosures wasn't enough to place the asset class squarely in the "too risky" bucket, the fact that leading commercial real estate price indices continued to decline over all of 2009 eliminated any rationale for considering an investment in private equity real estate funds that invest directly in real property.

However, the private commercial real estate market now finds itself at its cyclical trough, and while the trajectory of the economic recovery can be debated, a recovery is what lies ahead, even if only "L+ shaped." As return prospects for direct real estate are linked to economic performance, there is a fair expectation that returns moving forward for real estate may lag those of prior recoveries. However, as this report will illustrate:

- Private real estate fund valuations are just now coming off a steep decline.
- Attractive income yields in the 5% to 8% range underpin total returns for these real estate funds, in a world of reduced return expectations.
- Real property has demonstrated an ability to succeed in both inflationary and disinflationary (or flat-line) market environments.
- Fundamentals are starting to show signs of bottoming or even improvement.

In light of the above, we believe that now is an opportune time to consider an investment in private equity real estate funds.

Perhaps most surprising, our research also indicates that there is a plausible case for real estate investors to start inching up the risk curve, moving from Core (high quality real estate with about 35% leverage) to Core Plus (Core + 50% to 60% leverage) and even Value Added (Core + 50% to 60% leverage + lease up/repositioning/renovation potential).

The rationale:

1. Debt will work for investors again, as spreads between current income yields on real estate and the cost of debt turn positive.
2. Property fundamentals are, arguably, doing better than most investors would expect in two sectors (office and multifamily) that make up about 61% of the assets in private equity real estate funds that report their return results to the National Council of Real Estate Investment Fiduciaries (NCREIF).

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## The Real Estate Cycle has Troughed and Property is Positioned for Whatever the Cycle May Bring

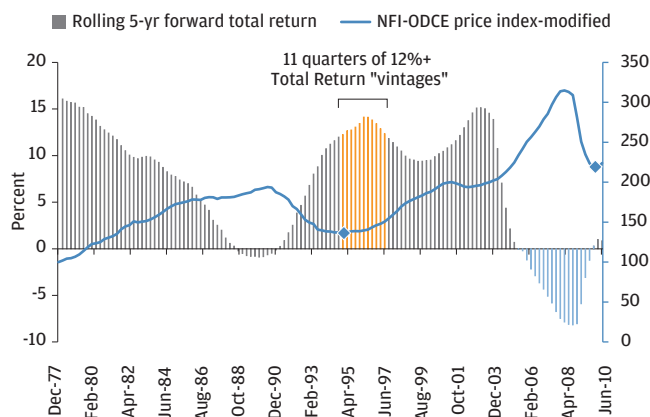
### The window is now open

The real estate cycle has troughed, and investors can now check the box on two key questions: (1) have real estate fund values bottomed? (2) Are expected returns for real estate attractive compared to the alternatives (because if they're not, then real estate hasn't fallen enough)?

After 18.5 years ticked between the last major decline in the early 1990s and the most recent correction, the price recovery in real estate appears to be taking its first steps. In the second quarter of 2010, the NFI-ODCE<sup>1</sup> value index notched a small but much anticipated +2.6% increase after eight quarters of decreases (a cumulative decline of -44.2%). Given the analysis in **Exhibit 1**, this is a strong signal for prospective real estate investors. Using forward 5-year annualized returns for the index, a strong "vintage" effect is apparent. For instance, when the value index bottomed in December of 1994 in the previous cycle, annualized 5-year total returns peaked at over 14% in the first and second quarters of 1996; five-year total return results remained above 12% for almost three years and never dipped below 9% all the way through the first quarter of 2004.

<sup>1</sup> NCREIF Fund Index: Open-End Diversified Core Equity (NFI-ODCE)

**EXHIBIT 1: WITH PRIVATE EQUITY REAL ESTATE FUNDS HAVING FOUND A TROUGH, CURRENT "VINTAGES" OFFER COMPELLING TOTAL RETURN PROSPECTS**



Source: NCREIF, J.P. Morgan Asset Management.

Note: All returns after 9/30/2005 are not full 5-yr returns. The price index shown is the NFI-ODCE price index inclusive of improvements.

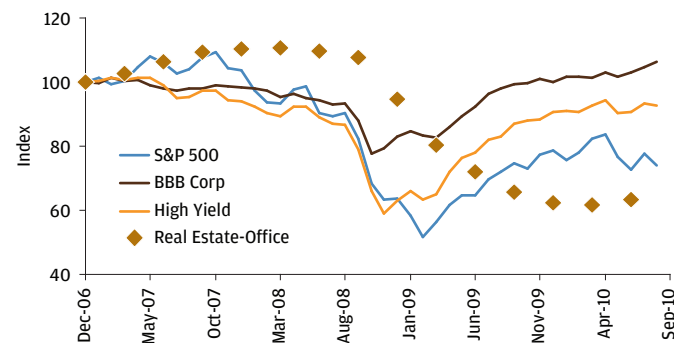
And, while the index starts in 1977, it is clear that the subsequent market increase in the late 1970's and 1980's resulted in a similar peaking of total return potential just as the index begins.

The conclusion: There is a window for maximizing total return prospects for real estate investors and it appears that the window opens now.

### But is direct real estate cheap enough?

To ask the very direct question "Is property cheap enough?" is really to ask whether its expected returns are compelling versus (1) the alternatives, and (2) its own history. While, basically, all sectors and asset classes offered compelling valuations (whether they were compelling risk-adjusted returns is a debate for another time) at one point or another during the 2008/09 market decline, most have already rebounded sharply leaving real estate as one of the last asset classes to offer value (**Exhibit 2**).

**EXHIBIT 2: REAL ESTATE LAGGED THE OVERALL MARKET, AND HAS YET TO REBOUND FROM ITS TROUGH**

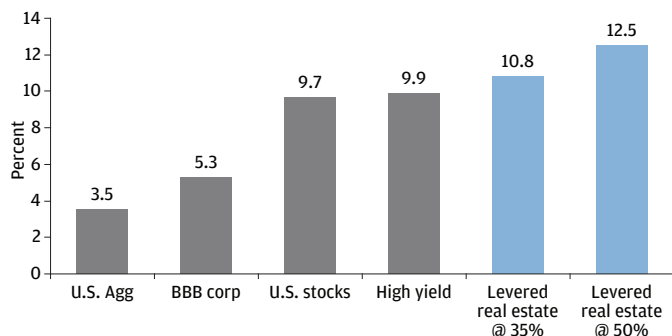


Source: Standard & Poors, Barclays, NCREIF, J.P. Morgan Asset Management.

In fact, expected returns (Internal Rates of Return, IRR) for stocks and some currently very popular fixed income alternatives undershoot our own estimate of a 12.5% total return to equity for an investment in a private real estate fund at 50% leverage (**Exhibit 3**). Even at 35%, a fair estimate of the leverage for a core fund, the return to real estate is compelling, and, therefore, we believe, "cheap enough" on this measure of peer comparison.

Just as important, a look at historical valuations for real estate suggests the current pricing of real estate is not only reasonable but may offer significant upside embedded in what we believe are essentially trough valuations.

**EXHIBIT 3: EXPECTED LONG-TERM RETURNS FOR LEVERED REAL ESTATE EXCEED THOSE OF MAJOR ALTERNATIVES**



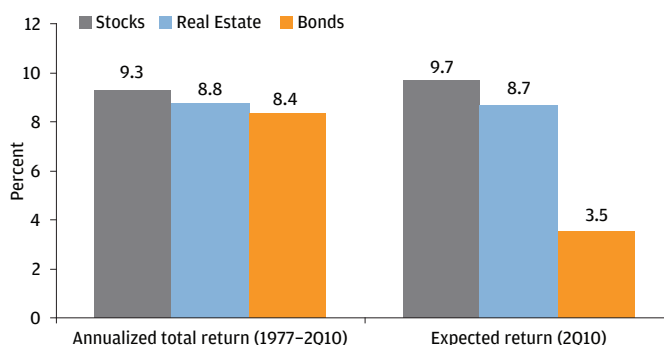
Source: J.P. Morgan Asset Management (U.S. Stocks, Levered Real Estate) Barclays, Bloomberg. Real estate investor survey Korpacz, NCREIF.

Levered real estate expected returns are estimates of appraisal-based discount rates levered at both 35% and 50% LTV using whole loan mortgages at rates surveyed from our third party lenders. Note: The formula of Bond OAS + 10-year Treasury Yield (USGG10YR Bloomberg ticker) is treated as the discount rate for each bond index, but actual discount rates, especially for high yield and BBB bonds may be lower due to expected defaults. U.S. Stock discount rates are derived from dividend discount rate models of J.P. Morgan Asset Management buy side stock analysts.

Since the inception of the NCREIF Property Index (NPI) (December 1977), private equity real estate funds returns have averaged, unlevered, about 8.8% per year (Exhibit 4), falling almost exactly in the midpoint between S&P 500 total returns and bond returns, as measured by the Barclays Aggregated bond index. Current J.P. Morgan estimates of the IRR for both equities and real estate are not only in line with historical returns, but are reasonable in a relative sense. If there is a disconnect it is that the anticipated returns for bonds are very depressed, suggesting that bond valuations may need to reprice to the downside (thus increasing expected returns). However, two things should be noted here: (1) bond prices would likely reprice downwards (yields up) significantly in the case that the U.S. economy returns to a sustained and above-trend recovery, and there is much debate on whether the recovery will be strong enough over the foreseeable future to qualify as “above trend,” (2) given that expected returns for both stocks and real estate seem rational when compared to historical performance, it is certainly not a foregone conclusion that real estate IRRs would need to shift very dramatically even given a repricing of bonds.

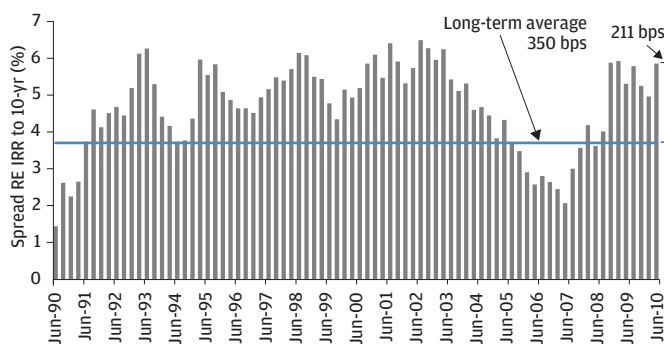
Another way to judge whether current real estate valuations are appropriate is to compare the current and historical average spreads of real estate anticipated returns (i.e., the unlevered IRR) to risk free rates and a proxy for the cost of debt. In Exhibit 5, we show the spread of a series of real estate

**EXHIBIT 4: EXPECTED RETURNS FOR REAL ESTATE ARE IN LINE WITH HISTORICAL PERFORMANCE... WHILE LOWER RISK BONDS LOOK MISPRICED**

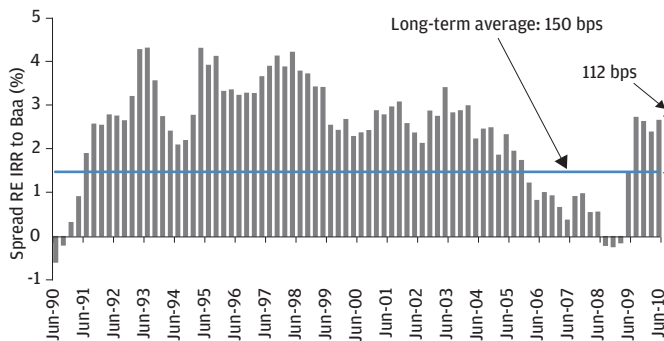


Source: Standard & Poors, NCREIF (NPI), Barclays (Lehman Aggregate Bond Index), J. P. Morgan Asset Management

**EXHIBIT 5: SPREADS BETWEEN REAL ESTATE YIELDS AND BOTH THE 10-YEAR U.S. TREASURY AND Baa SUGGEST THERE IS ROOM FOR YIELD COMPRESSION**



**Baa BOND SPREAD**



Source: Bloomberg, Barclays, Korpacz, NCREIF, J.P. Morgan Asset Management. Uses J.P. Morgan estimates of private real estate appraisal-based discount rates for the IRR series, the USGG10YR 10-year Treasury index on Bloomberg and the 2788 Baa credit yield index from Barclays. Past performance does not guarantee future results.

# Why Real Estate Now

unlevered expected IRRs as estimated by J.P. Morgan Asset Management to both the 10-year Treasury yield and the Baa credit yield over the last 20 years. We also show the long-term historical average, about 350 basis points over the 10-year Treasury, and 150 basis points over the Baa bond.

In both cases the current spread is comfortably above the long-term average, and suggests that the real estate IRR could compress about 100-200 basis points before achieving equilibrium valuations. Given our current estimate of an 8.7% IRR, 7.5% would seem a reasonable expectation for equilibrium valuation.

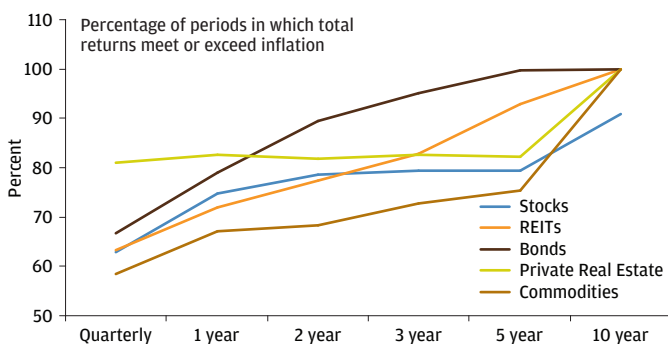
Finally, there is concern that the current 10-year yield is unsustainable, particularly if inflation does indeed, as expected by some, rear its ugly head in the future. J.P. Morgan's current long-term (10-15 years) assumption for the 10-year Treasury is 4%. If we use a 4% to 5% range, and then add the long-term spread of real estate expected return IRRs to the 10-year Treasury yield of roughly 350 basis points (Exhibit 5), the result is an expected equilibrium valuation range of 7.5%–8.5%. Private equity real estate fund valuations, per our estimates, currently sit above that range.

## What about inflation... or disinflation?

But to be fair, there is real uncertainty over the trajectory of the economic recovery, and thus any recovery in real estate returns. Is the U.S. economy facing inflation or a long-term

<sup>2</sup> The formal definition of “disinflation” is a slowing in the rate of increase in price levels, e.g., a decline from 1.1% to 1.0% inflation, not to be confused either with continued low (flat-line) inflation or “deflation,” a period in which price levels actually fall (i.e., the inflation rate is negative).

**EXHIBIT 6: PRIVATE REAL ESTATE EQUITY IS, ARGUABLY, THE MOST CONSISTENT INFLATION HEDGE... AND SHOULD SUFFER MINIMAL “RESET” IN AN INFLATIONARY ENVIRONMENT.**



Source: NCREIF, Equal Weighted Commodity index, Barclays Capital Aggregate Index, NAREIT Equity Index, S&P 500 Total Return.

Based on quarterly total returns, 1978 Q1 to 2010 Q2. 130 quarters are represented; as a result, there are 127 rolling 1-year results, 123 rolling 2-year results, etc.

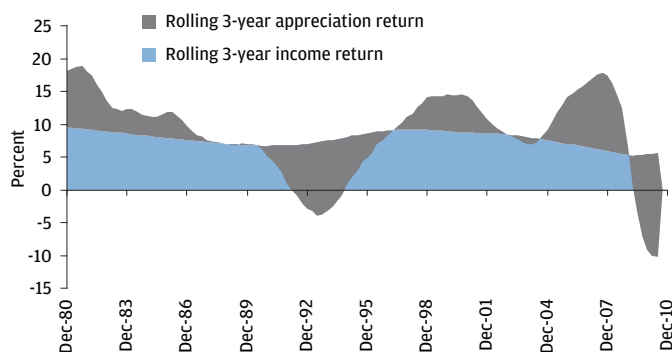
disinflationary<sup>2</sup> environment (or perhaps more precisely, a non-inflationary “L+ shaped” recovery—very weak but still incrementally positive) with a low-return market environment for all asset classes? Our research demonstrates that private equity real estate funds should serve as a hedge in just this set of circumstances as it has characteristics that would underpin its investment performance in either scenario.

In the case of a return to aggressive and persistent inflation—this is difficult to define, but certainly means inflation above the longer-term average of 4% per year—real estate assets should prove to be consistent, if not perfect, inflation hedges, i.e., generating returns that keep up with inflation. In Exhibit 6, we show a batting average for various asset classes, computing rolling returns for different hold periods (ranging from quarterly to 10 year) and calculating the percentage of periods in which total returns for each asset class met or exceeded inflation over the same period. Unlike the other asset classes shown here, direct real estate equity fund returns have very consistently achieved 80%+ success rates over any hold period. It is particularly important to note its impressive performance over the quarterly hold period; it is likely that any return to above-average or “high” inflation will start with a shock, and while publicly-traded vehicles will likely trade down with the shock (e.g., bonds, stocks), the lagged appraisal-based valuation methodology of private real estate equity funds results in a short-term resiliency to these shocks, i.e., there is no “reset.”

Another possible scenario is the “L+ shaped” economic recovery in which inflation stays low, the 10-year Treasury yield remains depressed, debt is available at low cost, yields on most vehicles compress in reaction, and expected total returns are not only low compared to history, but expected by investors to be underpinned by yield as growth (appreciation) disappoints.

Real estate equity funds, and their investors, are advantaged in three ways in such a scenario: (1) the yield, currently at 6.8% (as given by the (NPI) as of 2Q10), becomes even more compelling as an attractive starting point for expected returns, (2) the value gains for real estate, relatively measured outside of inflection points (Exhibit 7), are stabilized by predictable cash flow, debt and capitalization rate estimates (Note: values for real estate will move most sharply when abrupt changes in debt costs result in significantly higher or lower capitalization and, thus, discount rates), and (3) the return on equity (ROE)—a topic to be discussed further in the next section—is amplified by positive financial leverage, a state in which the cost of debt is lower than the current yield for the fund. In

**EXHIBIT 7: STABLE YIELD UNDERPINS STABLE TOTAL RETURNS, WHICH HAVE EXPERIENCED SIGNIFICANT DECLINES ONLY TWICE OVER 33+ YEARS (DECEMBER 1977-JUNE 2010)**



Source: NCREIF, J.P. Morgan Asset Management. Use NPI-ODCE Index which is roughly 35% levered.

Exhibit 7, the stability of the income return for these private equity real estate funds is clearly discernible, and it is also worthwhile to note that only twice in almost 34 years of return history have the values of these funds declined enough to overwhelm the yield.

### If the time is right, where along the risk curve should I invest?

Since the market crash, investors have proven, understandably, very risk averse; real estate investors are no exception. While fund flows to real estate equity funds have picked up, they appear to be focused on core funds which hold very high-quality properties and use approximately 35% leverage. Given our thoughts on valuation, vintages and the cycle, these are, we believe, good investments; but we also believe there is a case for moving up the risk curve, taking steps up to Core Plus, Value Added and Opportunistic. Why?

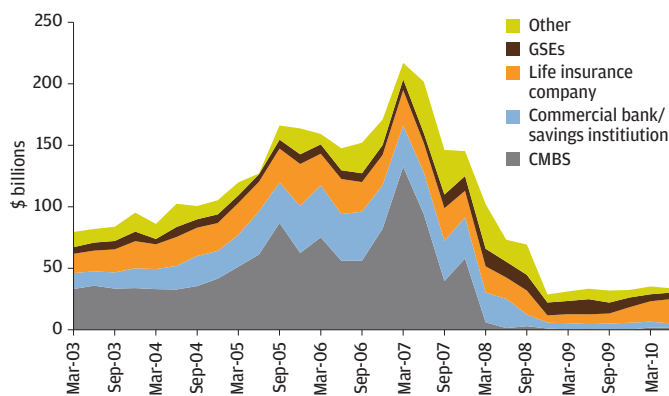
### Debt Works Again... Which Means Investor Returns on Equity Benefit

*Debt was the enemy in the market decline but can be our friend in the upturn:* The 2008/09 market decline was precipitated by a financing availability crisis, which translated into a debt crisis for real estate owners. For example, REITs, publicly-traded owners of real estate, were in the cross hairs of a market focused on their ability (or perceived inability) to access capital, and the MSCI U.S. REIT price index (RMZ) ended almost -77% down from its peak. Given what happened, it is certainly understandable that investors are wary of any investment

alternative that proposes to use debt. However, two things have changed since the market crisis: (1) debt capital is, once again, available for institutional-quality property, and (2) the cost of that debt is exceedingly reasonable; spreads have come down to historical average levels, and the depressed 10-year Treasury yield results in very compelling coupons. This combination of lower debt costs and a revaluation of private equity funds means real estate has returned to the state of “normalcy”—which we all heard about in our Real Estate 101 classes but haven’t seen for awhile—namely, a condition of positive financial leverage in which current property yields exceed the cost of debt, amplifying returns for equity holders.

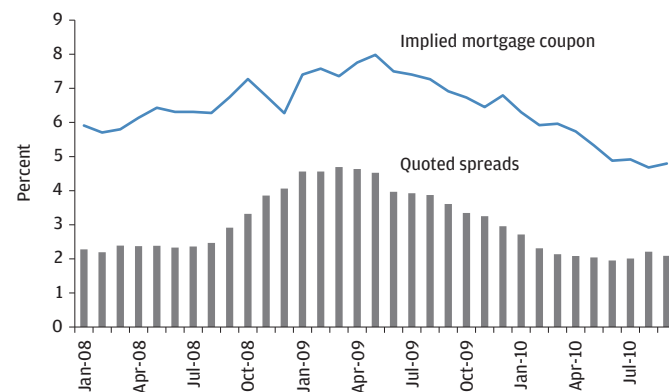
In Exhibit 8, we look at the volume of mortgage originations from various money sources. In Exhibit 9, we show an average of real lender quotes for debt spreads to the 10-year Treasury that J.P. Morgan has tracked since 2008. There are several

**EXHIBIT 8: DEBT ORIENTATION VOLUME FELL SHARPLY FROM ITS PEAK—THE CURRENT LOWER RUN RATE IS LIKELY THE RESULT OF FEWER OPPORTUNITIES FOR LENDERS (Q1 2003-Q2 2010)**



Source: Mortgage Bankers Association, J.P. Morgan Asset Management.

**EXHIBIT 9: COMMERCIAL REAL ESTATE MORTGAGE DEBT IS AVAILABLE AND ATTRACTIVELY PRICED (JANUARY 2008-SEPTEMBER 2010)**



Source: Bloomberg, J.P. Morgan Asset Management. Mortgage coupon is the sum of spreads of 10-year Treasury yields.

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points to make here: First, we have not seen a significant rebound in debt origination volume, but rather a stabilization of the activity. It would be reasonable to assume this indicates a lack of supply. However, debt spreads (**Exhibit 9**) have come down from a peak of 470 basis points to about 200 basis points as of 2Q10, in line with the historical average 189 basis points spread of American Council of Life Insurers (ACLI) mortgage coupons to the 10-year Treasury. If supply were insufficient to meet demand, those spreads most likely would not have come down so dramatically. What this suggests is that the issue is not supply, but rather the fact that opportunities (i.e., “demand”) are scarce, prompting competition among lenders who are perfectly willing to lend on cash-flowing, core property. This may be surprising to many investors but certainly not to the opportunity funds and other well-capitalized real estate investors, like REITs, that are voicing frustration with the lack of buying (thus borrowing) opportunities in the current market.

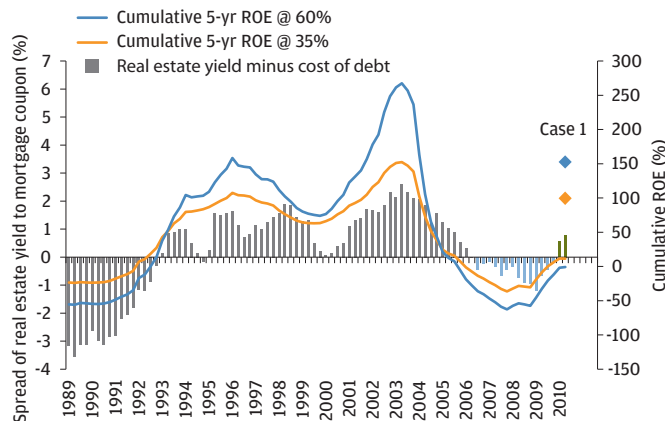
If investors can have confidence that debt is not going to turn tail and run again, then the case for leveraging core real estate total returns by investing in core plus, value add and even opportunistic funds becomes, we believe, a very compelling argument. For instance, in **Exhibit 10** we show the spread of ACLI mortgage coupons to the current yield of NCREIF’s unlevered NPI Index over time. We then calculated rolling 5-year forward total unlevered returns over the period (i.e., the actual

return generated by the index for the following five years at any given point in the period), but made them cumulative rather than annualized to emphasize the total value created. Next, we used those ACLI mortgage coupons to lever the returns at 35% leverage (Core) and 60% (Core Plus), to calculate Return on Equity (ROE). The difference in total value created (cumulative percentage return) is startling over time, and, as we would anticipate, the added value of leverage is particularly poignant during periods of recovery.

The real estate market experienced negative financial leverage in the run up to the crash in the early 1990s and once again starting in 2006 during the run up to the most recent correction. However, the NCREIF current yield has once again gone positive to the ACLI mortgage coupon (6.0% as of 2Q10), and the impact is shown in both **Exhibit 10** (case 1) and **Exhibit 11**, where we calculate levered ROE at 35% leverage and 60% leverage given the current ACLI mortgage coupon<sup>3</sup> and our own estimate of an 8.7% unlevered expected return for real estate equity funds. The results should be compelling for investors, particularly those convinced that the U.S. is headed for an “L+ shaped” recovery and the low-return market environment that such a recovery is expected to bring with it.

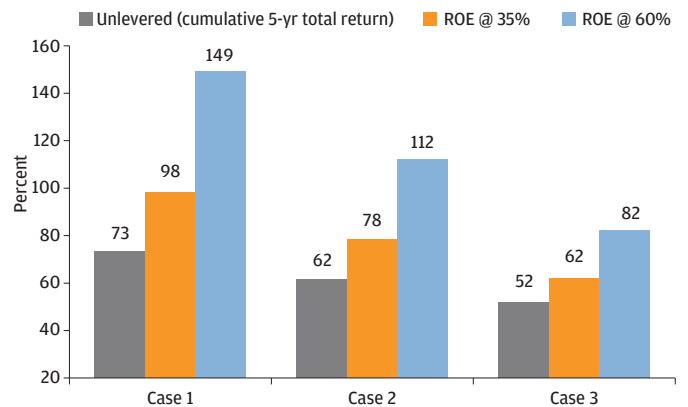
<sup>3</sup> At 6.0% this coupon is probably too conservative for core property, and it should also be noted that there are core plus real estate equity funds that have in place debt that is lower than the 6.0% ACLI coupon.

**EXHIBIT 10: WHEN REAL ESTATE YIELDS EXCEED THE COST OF DEBT, ROE IS AMPLIFIED**



Source: American Council of Life Insurers, NCREIF, J.P. Morgan Asset Management. Note: returns from 4Q2005 are not full 5-year forward annualized returns.

**EXHIBIT 11: DEBT IS NOW THE INVESTOR’S FRIEND—THE JUDICIAL USE OF LEVERAGE CAN RESULT IN COMPELLING EXPECTED ROE**



Source: J.P. Morgan Asset Management, NCREIF, ACLI.

General assumptions: 8.7% unlevered appraisal-based discount rate (IRR) for private equity funds as of 2Q10. Yield is 2Q10 NPI current yield of 6.78%. Growth is delta or 1.92%. Hold period is 5 years. Residual value is calculated in three cases: Case 1: Assumes 8.7% unlevered IRR compresses 100 bps to 7.7%, in line with J.P. Morgan long-term assumption of 4% 7-10-Treasury yield plus historical average spread of roughly 350 bps of real estate expected returns (IRRs) over the 10-year Treasury Yield (USGG10YR Index); Case 2: Assumes 50 bps of compression; Case 3: Assumes no further compression.

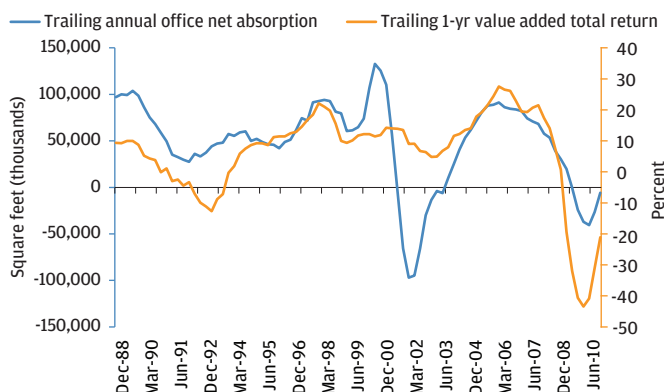
## Value Added is the Next Frontier

Value added real estate investment can be defined as investments in core property levered like core plus, with a lease up/repositioning/renovation opportunity that allows the manager to create value for investors. To invest in a value added fund, the investor must, of course, have confidence that their manager can actually lease up the vacancy they buy. Given the concern of a limpid recovery, most investors are worried that the demand isn't there for lease up, while also concerned about the use of leverage. We have hopefully provided a strong case for leverage moving forward, but then we come to the difficult question: In an "L+ shaped" recovery, is there any hope that real estate fundamentals will be sufficiently strong, in any sector, to enable the successful execution of a value added strategy? The answer: Yes, even with an incremental economic recovery, property sectors making up 61% of the NCREIF Index (2Q10) are positioned, we believe, to surprise to the upside. However, the opportunities will, admittedly, be more limited than in a robust recovery so the quality of the investor's chosen fund manager will be of critical importance.

## And Value Added Fund Returns Will Likely Follow Along With—NOT LAG—Net Absorption

In **Exhibit 12**, we compared trailing historical total return data for value added private real estate equity funds (The Townsend Group) to trailing 12-month cumulative net absorption for the U.S. office market. What the exhibit shows is a striking contemporaneous relationship with value added fund returns and net absorption. What this exhibit implies is that if investors have any confidence that 12-month national office net absorption will be cumulatively positive over the next two years, then returns for value added funds will follow along with essentially no lag, per our analysis. And, while it is too early to get too optimistic, net absorption for the U.S. office sector was positive in 2Q10. This suggests that the window for investing in value added funds, at least for those investors who want the most compelling vintages, may be sooner than most think, particularly given our findings in the next section that office fundamentals may enjoy a rebound that betters most investor expectations.

**EXHIBIT 12: VALUE-ADDED PRIVATE EQUITY REAL ESTATE FUND TOTAL RETURNS IMPROVE CONTEMPORANEOUSLY WITH FUNDAMENTALS**



Source: J.P. Morgan Investment Management, CBRE Econometric Advisors, Townsend, NCREIF.

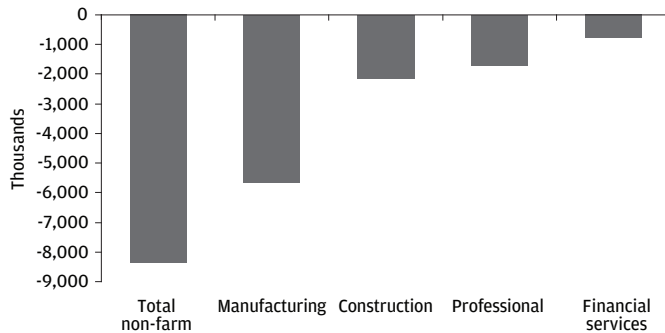
### Case 1: Office—Fundamentals may surprise to the upside

The Office sector made up 36% of the NCREIF Property Index universe as of 2Q10, and is the largest sector in the index. Its fortunes are largely understood to be linked to job growth. With most investors focused on the frankly depressing prospects for job growth in the U.S., the office sector has been written off, except for the best “brick-backed bond” properties in a handful of markets. However, there are some early indications that there is enough demand to prompt a revival in the fortunes of the property type, offering some hope that viable value added opportunities will be available.

Jobs should not be equated with “office-using employment,” i.e., those jobs that actually require the use of an office. During the downturn, in fact, many jobs were lost in non-office-using sectors like construction and manufacturing, while losses in representative office-using sectors—professional/business services and financial services—were relatively muted (**Exhibit 13**). Furthermore, while the economy has only added about 723,000 net total jobs as of August 2010, the professional/business services sector has added 365,000, 50% of the total new jobs created, or 21% of the sector's peak-to-trough losses over 2008 and 2009. Construction and manufacturing, conversely, have only added back about 4% of the jobs lost total for both sectors.<sup>4</sup>

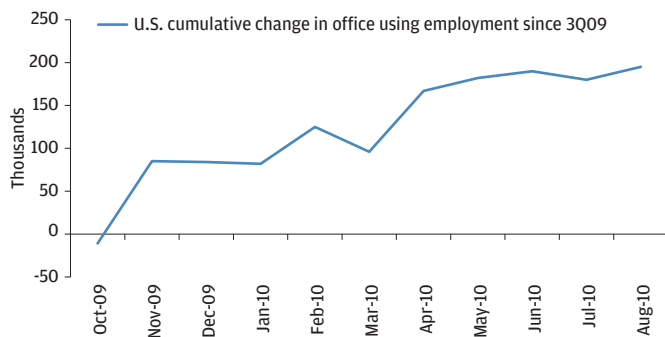
<sup>4</sup> U.S. Bureau of Labor Statistics.

**EXHIBIT 13: JOB LOSSES HAVE COME LARGELY IN SECTORS THAT ARE NON-OFFICE-USING**



Source: U.S. Bureau of Labor Statistics, J.P. Morgan Asset Management.

**EXHIBIT 14: OFFICE-USING EMPLOYMENT IS IN RECOVERY AND DEMAND FOR OFFICE IS PICKING UP IN THE U.S.**

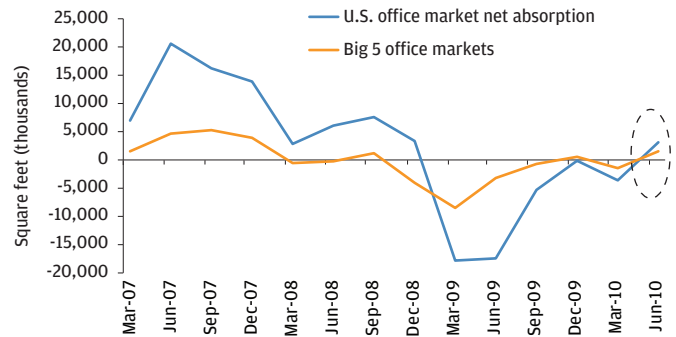


Source: U.S. Bureau of Labor Statistics, J.P. Morgan Asset Management.

Office-using employment growth for the U.S. is now positive (**Exhibit 14**) and, perhaps most surprising, so is net absorption for the U.S. office sector with over three million square feet of additional space leased over the second quarter 2010, with just over half of that result coming from the Big 5 office markets of Boston, New York, Washington D.C., San Francisco and Los Angeles (**Exhibit 15**).

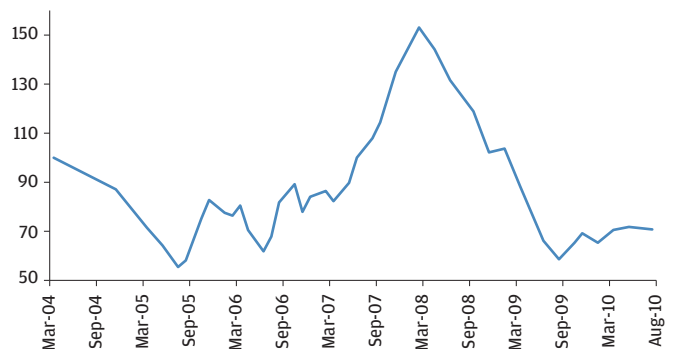
The return of demand, albeit measured and fragile, combined with the much discussed lack of new supply in the office and other property sectors is already, per our research, putting upward pressure on effective rents. **Exhibit 16** shows our own

**EXHIBIT 15: IN THE "BIG 5" OFFICE MARKETS**



Source: CBRE Econometrics, J.P. Morgan Asset Management.

**EXHIBIT 16: NET EFFECTIVE OFFICE RENTS BOTTOMED IN EARLY 2009 AND ARE IN THE MIDST OF MEASURED RECOVERY**



Source: J.P. Morgan Asset Management. Net effective rent level from J.P. Morgan office properties indexed to the 2009 trough.

proprietary analysis of Net Effective Rents, a hedonic index of rents data from buildings managed by J.P. Morgan Asset Management. Per this analysis, Net Effective Rents actually bottomed in July of 2009, and have returned to steady growth earlier than initially expected. The combination of this encouraging improvement in effective rents with better than anticipated prospects for office-using employment and, finally, extremely low levels of supply (i.e., new office building construction) provides some evidence that rents could increase much more robustly than most investors think possible in 2011 and 2012.

## Case 2: Multifamily—Not a question of if or when... occupancy and rents are already growing

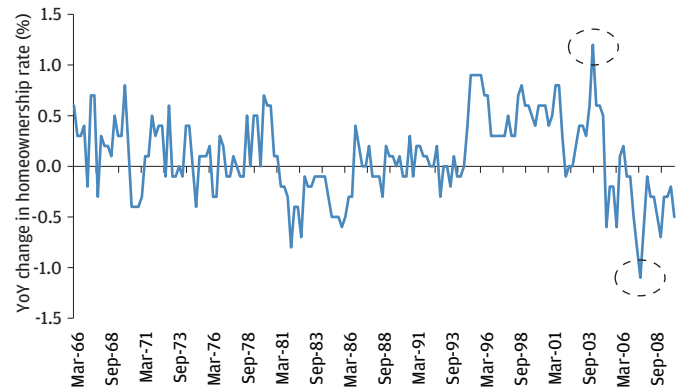
The multifamily (apartment) sector made up 25% of the NCREIF Index universe as of 2Q10. The story for multifamily is well known: Low supply + large renter-age demographic cohorts finally hitting the market + household ownership declining for the nation as more households opt to rent over own + low debt costs supported by Fannie Mae/Freddie Mac implies occupancy growth, rental growth and even development starts in select markets.

While the improvement may actually seem too good to believe—and there is an argument that rosy forecasts of rental growth will be ameliorated as development does, inevitably, ramp up again—the positive impact of what is a historically unprecedented change in home ownership (**Exhibit 17**) both upwards in the early 2000's and downwards since the peak in 2004 should not be underestimated.

In (**Exhibit 18**), we tried to quantify the impact on rental demand as measured by the increase in rental households, and found that the impact was significant. While the number of rental households has grown significantly since the end of 2006, home-owning households has remained flat. Most importantly, however, the relationship would have been turned on its head if the peak homeownership rate had persisted, in effect sending more new households to the housing market over the rental market.

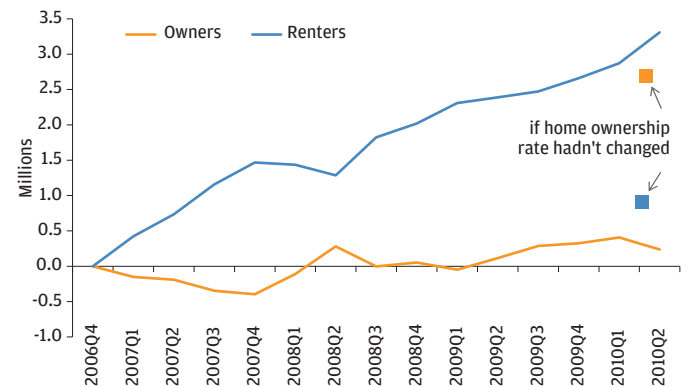
That shift, in itself, has provided startling levels of support for rental demand. And rents have responded: Per monthly, seasonally-adjusted data from Axiometrics (**Exhibit 19**), apartment rents bottomed at the end of 2009, and are settling at an annualized growth rate just under 5%.

**EXHIBIT 17: WE HAVE JUST SEEN THE LARGEST DECREASE IN THE HOME OWNERSHIP RATE IN OVER 45 YEARS—A BOON FOR RENTAL DEMAND (Q1 1965-Q2 2010)**



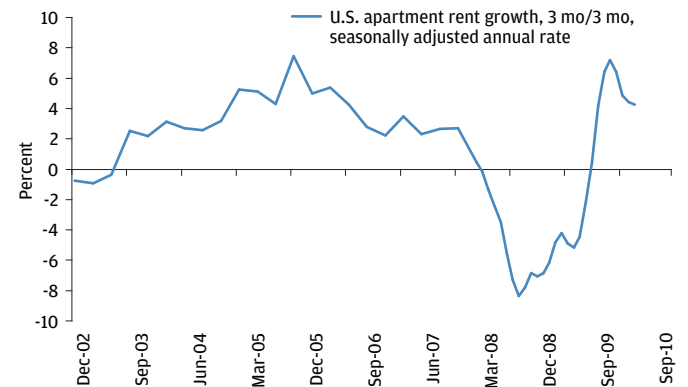
Source: U.S. Census Bureau, J.P. Morgan Asset Management.

**EXHIBIT 18: CHANGE IN NUMBER OF HOUSEHOLDS**



Source: U.S. Census Bureau, Moody's, J.P. Morgan Asset Management.

**EXHIBIT 19: HOME OWNERSHIP RATE DECLINE = MORE RENTERS AND IMPRESSIVE RENT GROWTH**



Source: Axiometrics, J.P. Morgan Asset Management.

### Conclusion

Responding to the sharpness of the downturn in 2008/2009 and fears of a “new normal” in which growth and therefore market returns remain low relative to history, many investors shifted toward higher-yielding fixed income and, to a lesser degree, equity investments. As a result, while these markets, particularly fixed income, rebounded dramatically over mid to late 2009, the commercial real estate market, still experiencing value declines over 2009, was understandably moribund.

However, with: (1) private real estate fund valuations just coming off a steep decline (while other asset classes have already rebounded), (2) an attractive current yield of 6.8% (per NCREIF

as of 2Q10) or higher underpinning total returns in a world of reduced return expectations, (3) real property’s ability to succeed in both inflationary and “flat-line” market environments, and (4) real estate fundamentals showing signs of bottoming or even a rebound, it is fair to argue that now is the time to consider an investment in private equity real estate funds. Moreover, it is very likely time, despite investor reservations, to start inching up the risk curve, moving from core private real estate equity funds to core plus and even value added and opportunistic funds, as debt once again to support returns on equity, and property fundamentals fare better than most investors may have expected.

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