NOTE TO INVESTORS: IN A RISING MARKET, NEW ACQUISITIONS MAY LAG

Douglas M. Poutasse, NCREIF Executive Director

The past three years have clearly qualified as the best of times for investors in Real Estate. With a trailing one year total return of 17.3% and a three year annualized total return of 18%, the NCREIF Property Index has recorded its highest returns since its initial four years from 1978 to 1981. And just in case all you younguns didn't learn this in school and us oldtimers have forgotten, the high teens total returns in 1979 and 1980 barely kept up with inflation, so truly these are the best times for institutional real estate investors in the nearly 30 year history of the NPI.

The strong performance has been very broadly based, with three year annualized total returns above 16% in every property type and in three of the four regions. Only the "weak" 13.2% return in the Midwest breaks the pattern. Clearly this extraordinary period of solid operating fundamentals and significant cap rate compression has been an excellent time to be a real estate investor.

But, as in any period, not all investors have shared equally in this performance. While it is always true that the idiosyncratic risks of property investment can and will cause significant deviation from the mean for individual portfolios, this time there is a "class" of investor who seems to have underperformed. This summer we received several inquiries from investment managers asking us to produce the NPI returns for recent acquisitions. In one case it was for properties acquired since 2005, in another it was for properties acquired since 2003. In my conversations with portfolio managers, I am also hearing about separate account investors who are wondering why their portfolios are significantly underperforming the NPI, questioning whether their managers have failed to deliver strong performance.

Now those of you who know me know that there is nothing I love more than to "dive into the numbers" to answer questions. Okay, those who know me really well know that I first give an answer and then dive into the numbers to determine if that is right, but in either case my favorite answer to such questions is "its an empirical question, let's look at the data". Of course, this summer and fall there have been a few other minor pulls on my time (little things like an entire new submission system for our members and the most significant changes to the accounting for real estate investments in at least a decade, but that is not the point of this article) so we delivered the data requested and I frankly let it "sit on the shelf" for a couple months. But the need for an article for this quarterly finally got it "off the shelf" this week and, as usual, there is quite a story in that data!

First, let me explain what we did. We were asked for and thus aggregated the returns by acquisition date, not by when the properties entered the NPI. In most cases, properties enter the NPI in the quarter immediately following their acquisition, since we require full quarter operating results. But in many cases properties do not enter the index in the first full quarter after acquisition. Properties under development or redevelopment do not enter the index until they meet the index qualification criteria. Since the NPI history was frozen in 2003, properties submitted by new members are added to the index in the first quarter of membership, with no historical quarters added. While these are the principal reasons properties do not enter the index in the first full quarter after acquisition, there are other reasons as well.

Before discussing the data, it is important to note that while we know the quarter every property enters the NPI, we do not have acquisition dates for all properties. While the vast majority of properties are reported with acquisition dates, we have accepted properties without acquisition dates since this field is not critical for the calculation of the NPI. I do not believe the omission of these properties biases the results, but it must be noted.

In order to simplify the results, we aggregated properties by reported acquisition year. By definition, there can be no return for an acquisition year in the first quarter of that year, since no property can be held from the beginning of the quarter. The second quarter return only reflects results for properties acquired in the first quarter which entered the index in the second quarter, and thus will always reflect a very small number of properties. By the first quarter of the following year, all of the properties which were acquired during the year and which immediately qualify for index inclusion will be included in the index but properties can continue to be added to the "acquisition year index" in subsequent quarters as they either meet the inclusion criteria or are reported by new members. Properties leave the index as they are sold or otherwise become ineligible for index inclusion.

Table 1 displays the number of properties and market value for the 2003 acquisition year properties as an example of the pattern which results, with a peak of 466 properties in the Index in the first quarter of 2004 declining by half to 230 properties by the second quarter of 2007. While the number of properties in the index declines in every quarter after 2004Q1, some properties acquired in 2003 were still added to the index in subsequent periods.

Table 2 gives a snapshot of the composition of the NPI in the second quarter of 2007 by acquisition year. Note that because not all properties have acquisition years, because we only pulled properties with acquisition dates since 1990 and because we only create and thus report indices in quarters with at least four properties, the total reported by acquisition year represents roughly 63% of the NPI total of $279 billion.

TABLE 1, 2003 ACQUISITIONS

Year	Quarter	Property Count	Market Value
2003	2	86	1,920,239,447
2003	3	183	4,828,299,783
2003	4	390	9,764,692,136
2004	1	466	13,516,925,214
2004	2	456	13,448,154,961
2004	3	451	13,181,639,437
2004	4	438	13,028,890,013
2005	1	393	13,116,199,911
2005	2	388	13,203,603,119
2005	3	367	12,999,930,410
2005	4	352	13,035,700,947
2006	1	338	13,218,721,230
2006	2	334	12,697,951,385
2006	3	259	12,714,751,339
2006	4	250	12,797,665,285
2007	1	235	11,675,546,868
2007	2	230	11,695,583,145

TABLE 2, 2007Q2 NPI BY ACQUISITION YEAR

Acquisition Year	Market Value	Share
1994	304,468,319	0.2%
1995	1,080,526,352	0.6%
1996	674,994,003	0.4%
1997	2,916,635,321	1.7%
1998	3,992,499,052	2.3%
1999	4,895,001,072	2.8%
2000	6,038,987,940	3.5%
2001	7,074,930,797	4.1%
2002	8,429,541,921	4.9%
2003	11,695,583,145	6.7%
2004	26,597,541,614	15.3%
2005	38,521,438,116	22.2%
2006	50,037,065,766	28.8%
2007	11,541,168,827	6.6%
Total	173,800,382,245	

NOTE TO INVESTORS: IN A RISING MARKET, NEW ACQUISITIONS MAY LAG (cont.)

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The tremendous acquisition volumes of the past three years are readily evident in Table 2. 51% of the properties with an acquisition date included in the NPI in the second quarter of 2007 were acquired in 2005 or 2006! Since the 2007 cohort can only reflect first quarter acquisitions which were immediately index eligible it is clear that new properties continue to be added to the index at a very high rate.

I'm sure you are saying by now "Enough on composition and technique, what are the returns for these recent acquisitions? Did my properties meet their peer group even if they did not meet the NPI?" There are many ways to look at the resulting data. To remove some of the "noise" evident in the quarterly data, I calculated four quarter rolling total returns. Table 3 depicts the total return for the four quarters ending with the second quarter of 2007 along with the four quarter compounded excess return, defined as the quarterly return of the acquisition year cohort less the return of the NPI. It is clear that the newly acquired properties (2005 and 2006 acquisitions) underperformed the overall NPI in this period. Since they represented as much as 50% of the NPI, it is no surprise that most of the rest of the acquisition years outperformed the overall NPI in this period.

Figure 1 presents a graphic representation of returns since 2005, to allow for a longer window. Of course the picture gets a little more muddled when presented graphically (the 2004 thru 2006 lines are bolded to make them a little clearer), but it is clear that the returns for the 2005 vintage year (which start in 2006Q1) and for the 2006 vintage year (which start in 2007Q1) are quite a bit lower than the other vintage years. Interestingly, the 2004 vintage year recorded average returns by the end of 2005, while the 2005 vintage year continued to lag behind.

One answer is clear: acquisitions made in 2005 and 2006 did on average underperform earlier acquisitions and thus investors should expect that their portfolios with acquisitions in this period would also underperform the NPI. But that leaves a vital question: is this normal or unusual? If it is normal, you would think that investors would have adjusted to it and not have become alarmed by the effect in this cycle.

While it may seem trivial to test how properties perform in their first years of ownership, it is important not to test absolute performance (by way of example, the 2005 acquisitions have one of the highest first year returns of any cohort!) but rather performance relative to the NPI and to measure that performance in quarters from acquisition. Figure 2, which makes the previous chart look simple, depicts the rolling four quarter excess return over the first 30 quarters after the start of each acquisition year for each of the acquisition years from 1990 through 2006. The 2004 thru 2006 lines are again depicted in bold. It is clear that the last three years are unusual. For most of the acquisition year cohorts, the early returns were equal to or higher than the overall NPI (positive excess return in the initial quarters). The only other years since 1990 which show a pattern similar to the last three years are 1997 and 1998.

There is no mystery to this result: when the properties in the index are appreciating rapidly (1997 thru 1999 and 2004 thru 2007) newly acquired properties will tend to lag as they were both fully valued at acquisition and many managers will wait for several quarters before adjusting market values. It is also clear from the excess returns reported in the initial quarters of by the early 1990s cohorts that the inverse is also true: when the NPI is depreciating, new acquisitions will outperform the index. In either case, Figure 2 also shows that once you get into the fourth and fifth year of ownership the returns "regress to the mean".

In conclusion, recent acquisitions have on average lagged the NPI. This is both to be expected during a period of strong property appreciation and unusual in the history of the index.

TABLE 3

Acquisition Year	Total Return 2006Q3-2007Q2	Excess Return 2006Q3-2007Q2
1994	31.9%	13.0%
1995	26.4%	8.1%
1996	16.1%	-1.0%
1997	19.0%	1.5%
1998	23.0%	5.1%
1999	20.0%	2.4%
2000	21.6%	3.8%
2001	19.1%	1.6%
2002	17.8%	0.4%
2003	19.0%	1.5%
2004	16.9%	-0.4%
2005	14.2%	-2.8%
2006	10.3%	-6.2%

FIGURE 1: Rolling 4 Quarter Returns

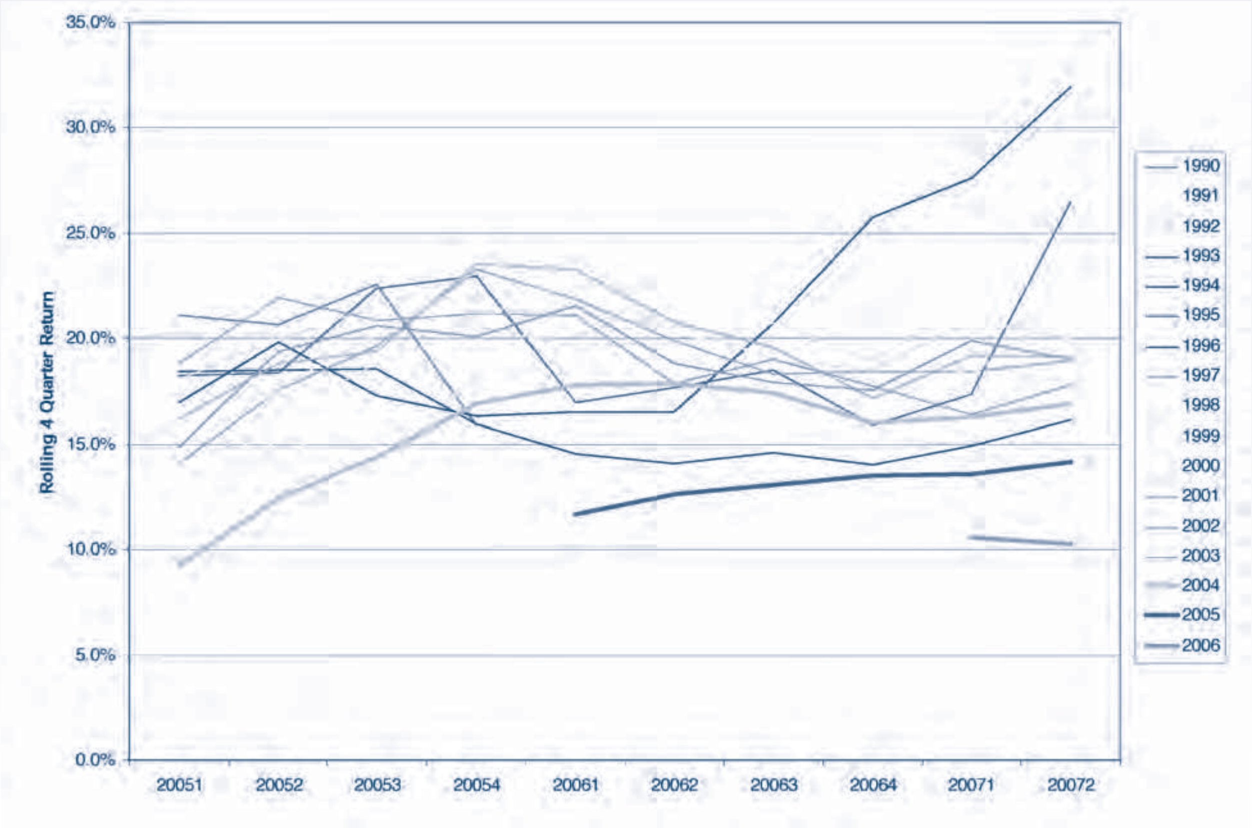

FIGURE 2: 4 Quarter Rolling Total Returns