

In Real Estate Investing, Not All Opportunities Are Created Equal by Rena Morris

This article discusses opportunities outside solely-owned real estate which may be attractive as the local market changes and what investors should look for.

As most apartment owners know from experience, real estate investment offers a unique combination of benefits - leverage, income, depreciation and appreciation. The counterpart of those benefits is declining values, rising expenses and management headaches, yet few of us have had to think seriously of these risks over the past decade.

Institutional Real Estate Performance Is Different

The current declining residential real estate market (Single Family Homes, Condominiums, Four Units or less) contrasts vividly with the performance of the institutional commercial class of real estate. Institutional real estate is a term for real property generally bought and sold among institutions between the ten to several hundred million dollar price range.

Over the past 25 years, according to the National Council of Real Estate Investment Fiduciaries, the average total annual return for institutional property is 13.6%.^{*} This performance encompassed periods of time when the economy suffered from stock market sell-offs, recession, war, and soaring oil prices as well as times of expansion. Institutional property total returns as tracked by the NAREIT Equity REIT Index outperformed the one, five, ten and thirty year average returns of the favorite indices such as the S&P 500, the Dow Jones Industrials, Russell 2000 and the NASDAQ.^{**}

** Past performance is not indicative of future returns. Source: <http://www.ncreif.org/indices/npi.phtml?type=national>. Total Return of Commercial Real Estate Fully Invested from 1998-2007.*

*** Source: <http://www.nareit.com/portfoliomag/06marapr/reit.shtml>. Long Term Performance of Listed U.S. Equity REITs vs. Other U.S. Benchmarks. The S&P 500 Index is an unmanaged but commonly used measure of common stock total return performance. It is composed of 500 widely held common stocks listed on the NYSE, AMEX and OATC markets. Investment return and principal value of stocks will fluctuate with changes in market conditions. The NASDAQ Composite Index is a market-weighted index of all over-the counter common stocks traded on the National Association of Securities Dealers Automated Quote System. The DOW Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks. It is not possible to invest directly in an index.*

Institutional players, such as Real Estate Investment Trusts (REITs), Pension Plans, and State Government Investment Boards, utilize acquisition strategists who are trained to be more disciplined than individual buyers in seeking investment property and have been generally less willing to forego real estate fundamentals for speculative growth.

Baby Boomers

With the 65+ age group as the fastest growing segment of population, 77 million people and \$11 trillion of assets transitioning into retirement, Baby Boomers are moving from the accumulation phase to the distribution phase of their wealth cycle. Wealth transfer into passive investments that replace employment income correlates well to Boomer aspirations for a change of lifestyle.

Financial services advertisements frequently feature the gray-haired, well presented couple at the beach to resonate with this phenomenon. Those boomers who accumulated wealth through real estate investment ownership are seeking to transition actively managed real estate investments into real estate that seeks to provide positive cash-flows with passive management. A significant component of an institutional real estate investor's net worth can be tied to those assets, and so they should make every effort to get it right.

Tenants in Commons (TICs)

Tenants-in-Common offerings belong in the institutional real estate asset class. They are multi-million dollar valued properties, structured for individual property owners who want to exchange, tax-deferred, their sale proceeds from their appreciated, solely-owned real estate to acquire a fractionalized interest in a higher quality property that they do not have to actively manage. In a previous article, I described the superior consumer protections in TIC investments offered in compliance with the Securities Act of 1933 (Truth in Securities Law) was published in the May 2008 AOA magazine. (Source: www.IRS.gov - IRC Section 1031 is a complex tax concept). Consult your legal or tax professional regarding the specifics of your particular situation.

Securities Regulations

In securitized real estate offerings, whether they are TICs, DSTs, REITs or LLCs, the securities rules require truthful financial and other significant information and prohibit fraud, deceit and misrepresentation. These offerings come with abundant disclosure and detailed third party reports.

A securities representative selling institutional real estate should be aware that there are large differences in the respective offerings' potential rewards and risks. Many securities representatives may not have an extensive real estate background, fundamental to a detailed and technical analysis of the asset. Generally, a securities representatives' responsibility is to consult with you to determine your investment objectives, risk tolerance and suitability needs (not every shoe fits all feet), and, if suitable, introduce diverse, institutional real estate investment options. The extent to which the options are analyzed independently of the Sponsors' promotion may be determinative of whether you will reach your goalpost.

Analyzing Offerings

A MAP strategy with grids and guidelines is essential to contrast the offerings' details. The grids should provide a matrix within which the fundamentals of each offering are examined, so that your representative and you, the investor, do not become sold on illusory projections that are more speculative than realistic. Furthermore, your goals

should be clarified so that you and your representative can identify the investments which could help you reach them.

Generally, investors' objectives include, with varying emphasis, investment stability, reliability of income, inflation protection, and growth. My MAP strategy contains over 175 metrics and encompasses the details of the Market (M), the Analysis (A), and the Process (P). I systematically apply the 3 Qs test to challenge the quality of an offering:

Q 1: Quality of the Asset

Q 2: Quality of the Income

Q 3: Quality of the Sponsor

Institutional Property Investment Options

The institutional property investment options that are not structured for 1031 exchange typically have much lower minimum investment amounts and lower accreditation requirements than TICs. Those opportunities include interests in LLC units, Private REITS and Real Estate Opportunity Funds.

LLC Investments

LLC units are undivided interests in a multi-member LLC that, in turn, owns an individual Tenant-in-Common interest alongside other TIC investors. LLC units require a relatively small investment, allowing a larger pool of investors to benefit from the tax advantages and potential appreciation that real estate can provide. With multiple, targeted LLC investments, your representative and you can create a unique portfolio of institutional real estate, executing a strategy that also can include diversification.

Private REITs

Private REITs can be offered by publicly registered, yet not publicly traded, multi-property institutional Real Estate Investment Trusts, packaged each with their own stated investment objective and business plan. Private REITs may be appropriate for investors looking for potentially higher income than traditional fixed income, potential real estate appreciation with a longer-term investment time frames and low correlation to the stock and bond markets. Private REITs can offer diversification and competitive income from a multiple of assets.

Real Estate Opportunity Funds

Real Estate Opportunity Funds raise capital to execute specific real estate business plans that often involve construction, renovation and/or repositioning of real estate opportunities. These may involve higher risk and reward as the desired outcomes are highly correlated with the skills of the business managers engaged in the project.

There are many more years and billions of dollars of residential mortgage resets to come. As inventory builds and prospects wait for further market declines before buying, it may be prudent to diversify equity from solely owned residential real estate into larger, more institutional assets, such as TICs and DSTs, through a 1031 tax deferred exchange.

Diversification of investments across a number of various types of assets and locations in order to increase stability and reduce risk is the cornerstone of a prudent strategy. I believe institutional real estate as an asset class may be an appropriate vehicle for investors who are looking for income with low or no correlation to the volatility of the equity and bond markets. The historical performance of institutional real estate investment has been less volatile and delivered superior returns to most benchmarks. (Source: www.nareit.com). Its general appeal to Baby Boomer goals is undeniable. However, the extent to which these options are analyzed independently of the Sponsors' promotion may be determinative of whether you, the investor, might reach your envisioned goalpost.

The information herein has been prepared for educational purposes only and does not constitute an offer to purchase securitized real estate investments. Such offers are made through the sponsor's Private Offering memorandum (PPM) which is solely available to accredited investors.

There are significant risks involved with real estate investments including but not limited to loss of investment principal, declining market values, tenant vacancy and illiquidity. Rena Morris is a Registered Representative and a California Real Estate Broker. Her real estate experience spans twenty-nine years. She was awarded the honor for the Top Production in 2007 at JRW Investments, Inc., a real estate and tax-focused securities firm. She may be reached at 626 354-4372 or 877 579-1031.