The Benefits and Importance of Commercial Real Estate

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Abstract

The economic climate of late has battered investment classes across the board, including commercial real estate. Aside from the usual arguments about including real estate in a well-diversified portfolio, there are compelling reasons to invest in commercial real estate in the current environment. Though the risks are real, income and return characteristics of commercial real estate investment provide a buffer through annuitized cash flow, and savvy investors who "dollar cost average" into the real estate cycle maybe able to acquire assets at prices that will deliver attractive returns over the long time. The Islamic dictum stands side by side on this notion and with the Shariah compliant version in form of 'i-REITS', it has indeed made its presence felt, but still it leaves a lot to be explored in this sector which mars an ideal potential for a new found.

INTRODUCTION

Until recently, real estate to most people was something you lived in, played on, went to work in, or pulled food out of. It is only in the last 30 years or so that investors began to consider real estate as a real investable asset, and only 20 years or so that mass investors could buy commercial real estate as part of their overall portfolio. Given current economic and capital markets conditions and the uncertain outlook, an especially cautious and well thought out investment strategy is needed[1]. Nonetheless, one believes that the benefits of commercial real estate for investors with a long-term horizon remain as strong as ever. The article identified will examine in vast array the importance and benefits of commercial real estate investment. The script will be divided into six sections. The first section will lucidate the concept of 'real estate' alongside the different types of it. Following it would be section two which will examine the 'risk and return character of it, dotted along with the quality of diversification. Section three will take into account the cyclic nature of such investments trenching to section four which will

[1] See, for example, Martha Peyton, "Why Invest In U.S. Commercial Real Estate When Capital Markets Are In Turmoil?". TIAACREF Asset Management, Summer 2008.

justify the magnetic pull of this sector by putting forward the reasons which we believe remain especially compelling during these turbulent times to invest in commercial real estate. Section five will take the parlance to the Islamic dictum of it where the debate will take an Islamic angle before going into section six which contain some concluding remarks.

1. WHAT IS REAL ESTATE?

The definition of real estate is "land and the improvements associated with it," be it structures (buildings), crops, or even mineral rights. It is part of the class of investment vehicles known as "real assets," which include things like commodities and natural resources. The reason these get lumped together is that they tend to have many of the same characteristics – they are a "real asset" in that we can touch and feel them, they tend to be more long-term in nature, and they guard against inflation [2](more on that later).

1.1. Types of Real Estate.

Real estate can be further broken down into the following core groups[3]:

Residential Real Estate – usually refers exclusively to single-family housing.

Commercial Real Estate – almost always involves a landlord and tenant and always has a business purpose, verses personal use. Commercial real estate comes in the following flavors:

- **Retail** – shopping centers, malls, etc., property that is used by a business which facilitates daily shopping by individuals.
- **Industrial** – manufacturing plants, warehouses, etc., used by businesses for production and storage of goods.
- **Multi-family** – apartments, usually refers to a residential property with more than 4 units.
- **Office** – office buildings, from large urban towers (Empire State Building) to suburban office parks.
- **Hospitality** – hotels and resorts.

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[2] Bond, M. and Michael Seiler, "Real Estate Returns and Inflation: An Added Variables Approach", *Journal OfReal Estate Research*, Vol. 15, No. 3, 1998.

[3] Kallberg, J. and C. Liu, "The Role of Real Estate in the Portfolio Allocation Process", *Real Estate Economics*, Vol. 24, No. 3, 1996.

- **Land** – typically includes “raw” land (without any buildings or “improvements”) that is either in a continuously undeveloped state (agricultural property) or is predevelopment.

These are the core classes of real estate and fairly describe the bulk of real property. Within these groups, however, are smaller, niche areas of real estate: senior and student housing (multi-family), self storage (industrial), youth hostels (hospitality), flex office (office) and agricultural property (land). With the exception of raw land, real estate can be further categorized by its current state (raw land can also be broken down but that’s for another paper). Other than purely raw land, real estate must be “created,” and therefore assets will fall along a continuum[4]:

• **Entitlement** – property is in the process of being planned and approved. No construction has yet occurred. Depending on the type of real estate and its location, the entitlement process can take anywhere from a month or two to decades.[5]

• **Development** – property has been approved and is being prepared for construction. Sometimes called “horizontal development,” utilities are installed, building sites are cleared, and mitigations are completed (like adding an off-ramp to a freeway or creating a reservoir).

• **Construction** – property “goes vertical,” structures (buildings or houses) are built and prepared for occupancy.

• **Lease-up -** (for commercial property) – buildings are largely completed but not fully occupied. Final improvements are made; “kinks” are worked out. In the case of residential housing, homes are starting to be completed and sold, buyers are starting to close.

• **Stabilized** – for commercial property, property is fully leased and operational. For residential housing, property is sold out, and responsibility for things like maintenance of the common areas and operating the homeowners’ association is transferred from the developer to the homeowners.

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[4] Hartzell, D., J. Hekman and M. Miles, “Diversification Categories in Investment Real Estate”, *Journal of the American Real Estate and Urban Economics Association*, Vol. 14, 1986.

[5] Depending on the location and type of development being considered, getting a project “entitled” or fully approved, can be an exhausting, and in many cases bankrupting process. Approvals can take as little as a few months to decades or more, which can have significant effects on investor returns as timelines can be unexpectedly lengthened. Entitlement risk is something investors are keen to understand when looking at undeveloped properties, as the time frame for approvals can be significant. Santa Barbara Ranch in California (shown at left) is a good example of a difficult entitlement process. The first development plan for residential housing was requested in 1888 (autos were still 20 years away), and the county just issued its approval in February 2009 (the Coastal Commission hasn’t yet ruled).

2. REAL ESTATE RISK-RETURN AND DIVERSIFICATION PROPERTIES.

The properties of real estate return distributions are of importance for the portfolio manager as they provide key inputs into the assets allocation process. Lizieri and Ward (2000) review the literature on return distributions and return generating processes of physical and financial real estate investment in the U.S. and the UK. Much of the existing research has focused on testing for normality in real estate returns. Generally, normality is rejected in terms of skewness and kurtosis both domestically and internationally for both the direct market (e.g. Young and Graff (1995), Miles and McCue (1984), Hartzell (1986) and the indirect market (Lizieri and Satchell (1997), Sieler, Webb and Myer (1999), Mei and Hu (2000). Further, the direct market exhibits a high degree of autocorrelation, while the indirect market does not. This can be explained partly by the appraisal-based construction and smoothing of direct market benchmarks and the equity-like nature of much of the indirect market. Lizieri and Ward (2000) argue that much of the non-linearity and autocorrelation of direct market returns remain even after corrective procedures. They suggest that a better explanation can be found in the fact that many return observations are close to zero as a result of the illiquid market and slow arrival of information.

A body of research has focused on non-linearity in real estate returns. Maitland-Smith and Brooks (1999) use a threshold autoregressive (TAR) method to identify two different regimes in direct real estate returns conditioned on real interest rates. Then they perform tests on fitting a mixture of normal distributions to the data. Results indicate that normality is not as easily rejected within each regime. Lizieri et. al. (1998) also employ TAR to conclude that a regime-switching models is superior to a linear model as a representation of indirect market returns in the U.S. and the U.K. The results show that in lower interest environments indirect real estate returns follow a mean reverting process around a positive trend while they oscillate randomly around a falling trend when rates are high. Lizieri and Ward (2000) find that out of a number of alternatives – extreme value, error function, logistic and Student’s t – the logistic distribution provides the best fit to U.K. securitized real estate returns.

2.1. Real Estate Risk.

Investors today have the option to invest in virtually any type of real estate and at any point in its development. Properties will have different risk and reward characteristics depending on a) the type of property, b) the location of the property, and c) the status of the property in terms of its development; S.M. Giliberto, (1993)

- **Low Risk (also called "Core" real estate)** – stabilized property in major metropolitan areas with predictably stable long-term cash flow. Fully leased office buildings in big cities are an example. Office properties tend to be less risky as their cash flow tends to be more predictable – tenants are usually signed to multi-year leases[6].

- **Moderate Risk ("Value-Added")** – properties with less predictable cash flows, either as a result of their location, their type or their status. A shopping center in the process of being leased up; an older mall in need of complete renovations and re-leasing; etc. Hospitality properties usually fall into this category as their cash flow is less predictable – essentially the "tenants" in a hotel are signing very short-term "leases" when reserving a room.

- **High Risk ("Opportunistic")** – properties with limited or no cash flow, either as a result of its status (currently under development) or type (raw land). Opportunistic investments tend to be longer term in nature and to require a greater degree of skill in execution. They also tend to provide the greatest return over the long term.

[6] Eichholtz, P. and D. Geltner, "Four Centuries of Location Value: Inplication for Real Estate Capital Gain in Central Places", Working Paper, 1997.

Real Estate Risk & Return

3. REAL ESTATE CYCLES.

Like all investments, real estate experiences its own cycle and over the years has become somewhat predictable. The real estate cycle is a direct result of overall economic activity (increased hiring creates greater need for housing and office, more people shop, etc.) and therefore tends to follow a similar cycle to the general economy. However, real estate usually lags behind the broad economic cycle due to the nature of the asset: real estate fundamentals tend to stay strong for some period in the beginning of a general economic downturn, and tend to stay weak for some period even after the economy has recovered[7]. This is due to the fact that decisions made about real estate (building a building, signing leases, etc) are more long-term in nature and therefore decisions are made well in advance of actual construction or move-in[8].

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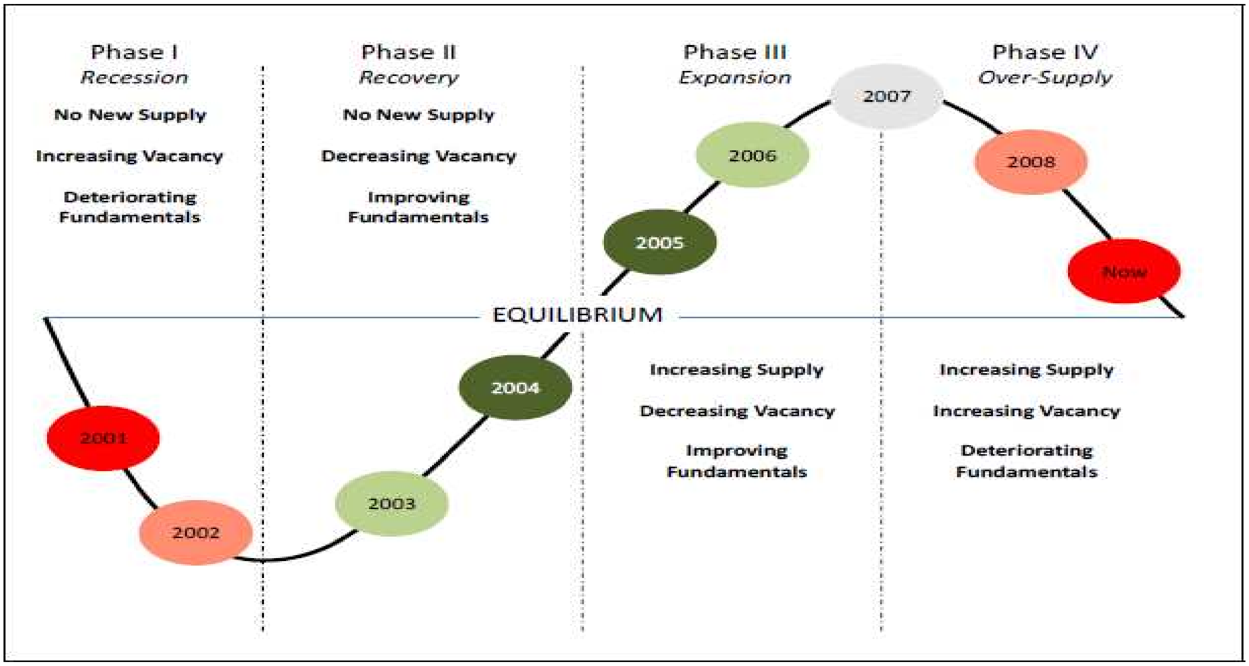
[7] Case, B., W. Goetzmann and K. G. Rouwenhorst, "Global Real Estate Markets – Cycles and Fundamentals", Working Paper, NBER, 2000.

[8] Ibid

Real Estate Cycles



Phase I: Recession. Real estate fundamentals are deteriorating as the economy suffers through the recession and job losses and restricted consumer spending work through the system. No new supply is coming on line, but vacancies are increasing.

Phase II: Recovery. Fundamentals begin to improve as job losses are stemmed and spending resumes. Vacancies are reducing at the same time supply is held constant (no new supply) so occupancy begins to rise and prices improve.

Phase III: Expansion. New construction begins to accommodate increased occupancy and lower vacancy rates. Fundamentals continue to improve as the macro-economy reaches its peak.

Phase IV: Over-Supply. New construction continues even as vacancies are increasing and fundamentals start to deteriorate.

Cycles typically last from 7 – 10 years but that can vary depending on the market. And while all real estate goes through this cycle, different types of property will be at different points in the cycle, thereby making it important to remain diversified across property type[9]. Chinloy P.T (1996).

4. WHY INVEST IN REAL ESTATE?

Real estate generally provides a somewhat slow and steady return to investors, and in many instances it will under-perform other asset classes. We say generally because, just like other asset classes, real estate is susceptible to the occasional bubble-and-burst phenomenon (1985-1993, 2003-2008, etc) Chan S.H et al (1993). This usually occurs as a result of two factors:

• Other asset classes are out of favor.

• Access to capital is cheap and easy.

Historically, real estate tended to produce slow and steady (read boring) returns to investors, notwithstanding the occasional bubble-and-burst phenomenon mentioned above. Although the REIT market has created a liquid version of real estate, most property investments are illiquid and long-term (multi-year) in nature, providing little flexibility to investors seeking to exit an investment at any particular time. So why invest in real estate? Two reasons: 1) real estate tends to move in a different direction than the rest of the market and 2) real estate acts can be a natural hedge against unanticipated inflation[10].

4.1. Relative Non-Correlation to Other Asset Classes.

Historically, real estate has been relatively un-correlated to the broader stock and bond market. Said differently, investments in real estate typically didn't fluctuate based on the broader market, and therefore real estate provided a dampening or diversifying effect on a portfolio. Liang, Y & J.R Webb (1996). There are several reasons for this, the most important of which is the stock and bond markets' high level of liquidity, which allows them to react faster to short-term fluctuations

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[9] Chinloy, P. T., "Real Estate Cycles: Theory and Empirical Evidence", *Journal of Housing Research*, Vol. 7, No. 2, 1996.

[10] One of the reasons many investors get into real estate is the appeal of the physical asset – high-end resorts, oceanfront property, etc. Unfortunately, there tends to be a negative correlation between the physical attractiveness of an asset and its investment performance. Such "trophy" assets garner a lot of press attention and usually attract a number of well-known bidders at a sale, but they rarely live up financially to expectations. See Chan S.H et al (1993).

in the economy or investor emotion. (In other words, people can buy and sell stocks and bonds any time they like, and usually do base on something going on at that particular time.) Because of the generally illiquid nature of real estate, investors cannot make knee-jerk buy and sell transactions when they want, which provides a greater stability to the asset class and therefore makes it less correlated to the rest of the portfolio[11].

4.2. Inflation Protection.

Real estate also acts as an inflation hedge, much like other real assets (natural resources in particular). When inflation is rising or is expected to rise, investors tend to seek out investments that they can "touch and feel" – investments whose shape and fundamental characteristics change far less than other asset classes[12]. Stocks are somewhat of an inflation hedge but that's only if companies can pass along increased production prices to consumers. Bonds aren't an inflation hedge at all as they are conversely linked to interest rates – rising inflation produces higher interest rates, which drives down the value of most fixed income investments. Inflation has the opposite effect on real estate, and so it is sought after by investors in times of current or anticipated inflation. Having real estate in a portfolio will help offset the effects of inflation over time, thereby preserving an investor's purchasing power.[13]

5. REAL ESTATE INVESTMENT: THE ISLAMIC ANGLE

Real estate in its various guises has managed to monopolize Islamic finance and the Islamic investment banking industry for some years to such an extent that there are many Islamic investment banks that do nothing but real estate investment. Some banks have relied almost exclusively on real estate as their primary business tool, investing in property, developing real estate projects and lending to others engaged in the real estate sector A.Wajidi Dusuki, (2009).

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[11] Kallberg, J. and C. Liu, "The Role of Real Estate in the Portfolio Allocation Process", *Real Estate Economics*, Vol. 24, No. 3, 1996.

[12] Bond, M. and Michael Seiler, "Real Estate Returns and Inflation: An Added Variables Approach", *Journal Of Real Estate Research*, Vol. 15, No. 3, 1998.

[13] Chatrath, A. and Y. Liang, "REITs and Inflation: A Long-Run Perspective", *Journal of Real Estate Research*, Vol. 16, No. 3, 1998.

This carries the inherent risk that when the property market takes a downturn there is little chance of the bank performing well. This is not a problem that is unique to the real estate sector since putting all of one's eggs in the same basket has long been identified as a risky investment strategy. The result of Islamic banks preferring to hold physical asset-backed investments means that many of them have increased their real estate exposure far beyond safe levels and far beyond the level that their conventional counterparts would ever countenance.

Excess property exposure is beginning to look like a rather short-sighted strategy now that the property bubble has been pricked across much of the globe. The argument that was used most frequently during the boom times for an over-dependence on real estate was that it was virtually impossible to replicate the returns that real estate offered through using any other combination of asset classes. For a number of years this was quite true as property prices across the world increased and across the Gulf sky rocketed, fuelled by excess liquidity, negative real interest rates and a massive influx of expatriates.

One of the main reasons for the ubiquity of real estate throughout the Islamic financing matrix is that real estate as a term covers a wide range of assets: from warehouses to timeshare, serviced offices to luxury condominiums, student accommodation to shopping centers and hospitals. As long as the property itself is not used for a haram activity such as brewing or gambling then it has the potential to be used in a Shariah capital structure. Mughees Shaukat, (2010).

5.1. The dangers of overreliance on real estate.

One of the concomitant effects of falling property prices is the destabilization of the banking sector in the Gulf as falling real estate prices leads to an erosion of the equity of the banks funding property purchases. Leading ratings agencies in the region are on alert to the potential need to downgrade some of the region's smaller banks that are most exposed to the pricking of the property bubble[14]. With non-performing loans and investment losses on real estate on the rise

[14] Young, M. and R. Graff , "Real Estate is Not Normal: A Fresh Look at Real Estate Return Distributions", *Journal Of Real Estate Finance and Economics*, Vol. 10, 2008.

the industry is faced with the prospect that some Islamic banks will, inevitably, move into loss, possibly irreparably for the banks themselves.

As Robert Thursfield, director of Fitch Ratings, said 'While all GCC banks are exposed to real estate, Islamic banks have historically been more exposed as they were the only ones able to directly own real estate assets; however classifications remain opaque for all banks. Although direct ownership avoids the complication of making repossessions using untested legal frameworks, it does leave Islamic banks with significant real estate exposures. Following the reversal of the recent boom in regional real estate values, particularly in Dubai, Islamic banks could suffer higher impairments, although conventional banks could also suffer given the recent rapid growth in their indirect exposures'. As with most other aspects of property investment it is not likely that an investor will be interested in any real estate exposure unless he believes in the macro picture of the country or region in which the real estate is situated.

For example, if the investor believes that the Indian economy is going to tank then there is little prospect of luring him into Indian real estate investment no matter how appealing the story surrounding the individual development. The reality is that property is a cyclical investment which means that investors with a crystal ball should invest at the bottom of the cycle and exit at the top. Undoubtedly the reason that real estate is such a core part of Islamic finance investing is that, cycles aside, property prices always go up eventually[15].

It is also interesting to note two important features about Shariah compliant real estate investing: the Islamic charitable tax of Zakat is not payable on investments structured around real estate: and secondly, all four schools of Islamic thought (Hanafi, Hanbali, Maliki, and Shafi) treat real estate the same way. Together these two facts help to explain the pervasive presence of real estate investment throughout the Islamic finance spectrum. The following is a brief look at some of the more popular forms of real estate investing used by investors for whom Shariah compliance is a core requisite.

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[15] "The investor's guide to real estate investment trust", (2003). Published by 'NAREIT'.

5.2. Islamic Real Estate Investment Trusts (REITs).

Islamic REITs are a type of real estate fund that are capital market vehicles for owning real estate and deriving income. These collective investments will pool money from a variety of investors to buy, manage, and sell real estate assets of one sort or another. A REIT can invest in income producing Shariah compliant real estate or Shariah compliant SPVs that hold Shariah compliant assets. Investors or unit holders in an Islamic REIT typically receive a proportion of the rental income generated from these assets as their reward for holding the units Mughees Shaukat, (2010).

The benefit of holding such units from the individual investor's point of view is that these collective investments can offer exposure to larger commercial or industrial properties that individual investors would otherwise not have access to. Such investors may also find that these units are far more liquid that the underlying real estate assets themselves. In other words investors can invest in real estate through Shariah compliant capital market instruments that are easily tradable[16].

In many regards the Securities Commission Malaysia is a leading light in issuing guidelines on Islamic REITs and their treatment[17]. As far back as 2005 the commission issued a set of guidelines for Islamic REITs. A brief summary of these guidelines would include:

- Rental income is derived from permissible business activities. Where a portion of the rental is from non-permissible activities, these rentals cannot exceed 20 per cent of the total turnover of the Islamic REIT.
- Islamic REITs cannot own properties where tenants operate non-permissible activities.
- Islamic REIT cannot accept new tenants whose activities are fully non-permissible.
- Only 20 per cent of the floor area of a property can be occupied for non-permissible activities.

[16] Atasya binti Osmadi (2006) *A guide to Islamic finance and Islamic REITs* Australian Property Journal, 212-218

[17] Securities Commission (2005) Guidelines on Real Estate Investment Trusts (REITS).

- All forms of investment, including deposit and financing instruments, are Shariah compliant.
- Property insurance must be based on Takaful except where Takaful schemes do not operate.

Each Islamic REIT must have a Shariah board responsible for ensuring that the Islamic REIT complies with Shariah principles. According to the Securities Commission Al'-Aqar KPJ healthcare REIT was the first Islamic healthcare REIT listed on Bursa Malaysia Securities in August 2006. The second was an Islamic plantation REIT called Al-Hadharah Boustead REIT.

Source: **Global Business Monitor International, Eurekahedge, Zawya, Ernst & Young analysis**

5.3. Judging performance.

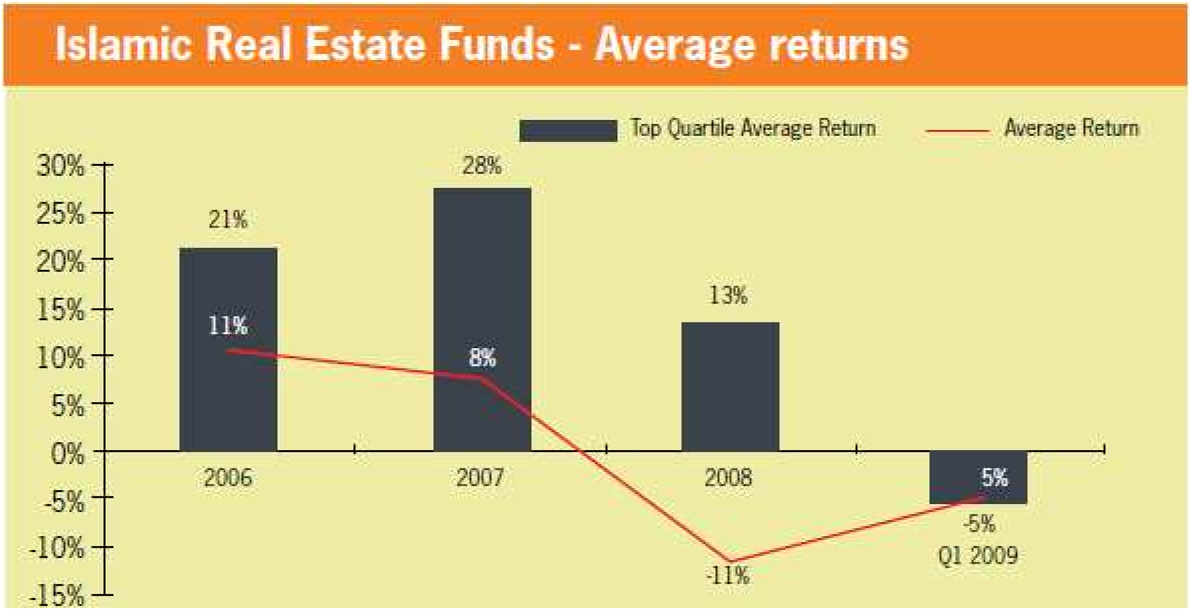
An interesting research study called 'Shariah Compliance in Real Estate Investment' was undertaken by Muhammad Faishal bin Ibrahim and Ong Seow Eng of the Department of Real Estate of the National University of Singapore in 2006 to establish whether Islamic REITs underperform conventional REITs in terms of returns. The exercise had to be theoretical since Islamic REITs were such a new breed that there were not enough real life examples to undertake empirical research. To simulate this exercise Ibrahim and Ong constructed a synthetic portfolio and analysed the returns.

They concluded, ‘The key result is that Shariah compliance seems to create a return trade-off and less restrictive compliance requirements appear to provide better historical returns. However, Shariah compliance does not mean that Shariah compliant real estate mutual funds necessarily under-perform relevant indexes when relevant risk factors are considered and allowing for differing sensitivities to benchmark returns’. The authors concluded with the final word on the subject, ‘the acid test will be empirically possible only with time and as more Islamic REITs and real estate funds become established’. What experience over the past three years since the research study was undertaken shows is that REITs as a whole have not performed well in the cold light of the financial crisis as the following chart makes clear.

5.4. Islamic real estate funds.

According to IFIS, the Islamic finance portal from Euromoney, there are currently 37 Islamic real estate funds either in existence or whose launch has been announced. With the exception of the Ethmaar UK Real Estate Fund from Kuwait Finance House with an investment focus on UK real estate, most of the funds that have disclosed their size are relatively modest. Since the first fund dates from August 2002 this means that over the past seven years an average of just over five funds per year have been launched and are still in existence although the reality of the situation is that the number of funds launched per year has been increasing each year, with eight funds launched in 2008 and most of them in the first half year. The relatively modest Invest Real Estate Investment Trust of $80 million is the only fund to have been launched since August of 2008 when the financial crisis swung into its most debilitating phase.

According to Ernst & Young’s Investment Funds & Investment Report 2009 average returns from Islamic real estate funds fell from 8 per cent in 2007 to minus 11 per cent in 2008 and minus 5 per cent in the first quarter of 2009. It is clear that these funds have been badly affected by the downturn in real estate asset prices.



Source: **Ernst & Young Islamic Funds & Investments Report (IFIR 2009)**

Note: **Data includes returns of 17 funds**

5.5. Direct investment and other uses.

Islamic real estate investment is also a feature of some Islamic investment banks. Savvy banks focus on developing opportunities for investing in recurring income development projects, and invest in operational and real estate assets with substantial added value components. Islamic real estate investments typically involve an active management strategy that might range from a moderate repositioning or releasing of properties to the development or extensive redevelopment of the property.

Real estate also features prominently on the radar screens of many Islamic investors as a direct investment vehicle where properties of varying sizes, values, and locations are secured as part of a Shariah compliant portfolio. Such investments are by their nature illiquid and until recently were viewed as the non-speculative part of a portfolio. The pricking of the property bubble globally has led to a reassessment of the proper place of such investments in a balanced portfolio.

No matter how specialist and focused the real estate investment, the fact is that the performance of these sorts of investments are necessarily at the whim of the local market. Such issues as the prevailing domestic interest rate, domestic supply and demand clearly affect the continued value of any real estate investment. While this can mean that such investments are uncorrelated to performance of the global real estate market, this is not always a positive. The reality, however, is that some sectors of the real estate market are more volatile than others with unit/flat developments often the most volatile and commercial premises rented on long-term leases the least volatile. The message from this may be that international diversification of property investments as well as diversification across sectors makes sense when trying to even out local property market fluctuations.[18]

6. CONCLUSION.

Real estate investments, properly structured, have the long-term ability to generate attractive risk-adjusted returns for portfolios of all types. Recent history suggests that a lot of money can be made (and lost) in very short time periods of time by investing in real estate; we prefer to look at the asset class long-term and not use it as a vehicle to generate outsized short-term returns.

- **Return assumptions should reflect long-term historical averages, not recent performance**.

As with any asset class that experiences a bubble, real estate returns should be measured against long-term historical averages, not recent performance. The bulk of real estate's return comes from the ability of an asset to generate cash flow, verses appreciation (this depends on the asset class, but most real estate consists of income-producing commercial property). Long-term real estate performance, combined with the current market environment and where we are in the cycle, would suggest far more modest target returns (these are unleveraged returns):[19]

- Core Real Estate: 6% - 8%
- Value-Add Investments: 10% - 12%

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[18] Stevenson, S., "International Real Estate Diversification: Empirical Tests Using Hedged Indices", *Journal of Real Estate Research*, Vol. 19, 2000.

[19] Young, M. and R. Graff , "Real Estate is Not Normal: A Fresh Look at Real Estate Return Distributions", *Journal Of Real Estate Finance and Economics*, Vol. 10, 2008.

- Opportunistic Investments: 15% - 18%

- **In general, portfolios should maintain an ongoing exposure to real estate**.

The types of managers we use or the size of the allocation may change depending on current market conditions, but we believe a long-term role for real estate exists in a portfolio. Therefore, real estate should generally be a part of the core asset allocation, rather than merely an opportunistic investment. The size of the allocation depends on an investor's risk/return appetite as well as the rest of the portfolio, but can generally be in the range of 5% - 15%.[20]

- **Investors should generally stick to passive investment options verses direct ownership**.

Unless investors have the experience and knowledge to actively manage real property assets, they will be better served investing with managers who do the heavy lifting. Direct real estate ownership and operation requires a high level of skill and knowledge about that particular asset class, and while the fees tend to be higher in real estate than other asset classes, the cost can be offset by the benefit of the manager's ability to produce above-average returns.

- **Strategy-specific funds are preferred compared to global 'all-asset" managers**.

Real estate has numerous subcategories of property types and investment vehicle options. It is also a local investment; unlike other asset classes, a high level of geographical expertise is required. We tend to look for managers who are narrower in their focus – experts at one or two things verses familiarity with many.

- **Holding a diversified property portfolio is important**.

Similar to private equity, it's important to be diversified across asset types and vintage years (thereby diversifying the economic cycle risk). In addition, it's important to diversify geographic

[20] Parsa, A. (2006) *Current trends in Shariah property investment* FiBRE, RICS Research

risk, as different parts of the country (and by extension the world) can provide different entry points along the cycle[21].

- **Private investments tend to work better than public vehicles**.

REITs and other publicly traded real estate companies are good options for retail investors who do not have the capital to access private partnerships, but as we saw earlier the correlation between public vehicles and the broader market is much higher. [22]This means that one of the main reasons for real estate investing low correlation to the rest of the market is negated. We do believe those correlations will reverse themselves and eventually come back to historical averages, but for the time being we tend to see publicly traded vehicles as being more closely correlated with broader equity markets and less with private real estate.

- **Funds of Funds make sense – for smaller investors.**

For clients whose real estate allocations are too small to build a high-quality diversified portfolio of private real estate investment managers, real estate fund of funds are a good option, provided the additional layer of fees is justified by the fund of fund manager's ability to invest in the best underlying funds. Real estate generally does not have the same problem of access into quality funds that private equity does, so investors need to be diligent in avoiding "aggregators" (funds that simply push money out to other funds) and focus on fund of funds managers who can build a complementary and high-quality portfolio of investment funds.

- **Manager skill is key.**

As mentioned above, real estate is a management-intensive business that requires very specific skill in identifying, acquiring, financing and operating properties. Because of the nature of real estate investments, many quantitative measures used to screen managers may not apply, and there are many cases where managers need to be evaluated even though their track record is still

[21] Wheaton, W., "Real Estate "Cycles": Some Fundamentals", *Real Estate Economics*, Vol. 27, No. 2, 1999.

[22] Worzala, E., E. Norman and G. S. Sirmans, "Portfolio Allocations of Insurance Companies: An Exploration of Investment Decision Making Techniques for Both Mixed-Assets and Real Estate Portfolios", Working Paper, *Center for Real Estate and Urban Economic Studies*, University of Connecticut,2008.

in progress (due to the significant duration of most real estate funds). It is therefore critical when evaluating investment opportunities that the bulk of the effort be spent on evaluating the manager's skill in selecting assets and executing on operating plans.

ANNEXURE

ISLAMIC REAL ESTATE FUNDS

As of June 2009

ID	Date	Fund Name	Fund Manager	Domicile
612	9/4/09	Inovest Real Estate Investment Trust	Inovest	Bahrain
496	25/8/08	SHUAA Saudi Hospitality Fund	SHUAA Capital Saudi Arabia	Saudi Arabia
592	11/6/08	Al Imtiaz Real Estate Fund	Al Imtiaz Investment	Kuwait
619	27/5/08	Waed Real Estate Investment Fund	Al Dhow Investment Company	Kuwait
536	13/3/08	Emirates Islamic Global Property Fund - Institutional	Emirates Fund Managers (Jersey) Limited	Jersey
535	13/3/08	Emirates Islamic Global Property Fund - Retail	Emirates Fund Managers (Jersey) Limited	Jersey
409	28/2/08	Danat India RIA Fund	Khaleeji Commercial Bank	India
407	18/2/08	Islamic Turkey Real Estate Fund	Wafra Investment Advisory Group	Cayman Islands
529	2/2/08	Taibah KSB Real Estate Fund	KSB Capital Group	Saudi Arabia
403	22/8/07	OSK-UOB Asian Real Estate Fund	OSK-UOB Unit Trust Management Bhd	Malaysia
505	11/7/07	Amar Real Estate Fund	Amar Finance and Leasing	Kuwait
233	23/5/07	Markaz Real Estate Opportunities Fund	Kuwait Financial Centre (Markaz)	Kuwait
330	1/5/07	Al Islami US Properties III Fund	Investcorp Bank B.S.C.	United Arab Emirates
94	15/2/07	Samba Real Estate Fund	Samba Asset Management	Saudi Arabia
289	1/12/06	U.S. Development Opportunities Fund	Shamil Bank	Cayman Islands
169	30/11/06	Islamic European Real Estate Fund	Wafra Investment Advisory Group	Cayman Islands
178	16/9/06	Boubyan Global Real Estate Fund	Boubyan Bank	Kuwait
75	1/8/06	Global Asia Real Estate Fund	Global Investment House	Cayman Islands
45	1/5/06	Asian Real Estate Fund	Kuwait Finance House	Kuwait
608	1/3/06	Prime Industrial Real Estate Fund 2	Kuwait Finance House	Kuwait
230	24/1/06	China Realty Modaraba Fund	CIAM-Shamil Asset Management Ltd.	Cayman Islands
229	24/7/05	Global US Real Estate Fund	Global Investment House	Cayman Islands
601	1/7/05	Emirates Real Estate Fund - AED	Emirates Fund Managers (Jersey) Limited	Jersey
448	1/7/05	Emirates Real Estate Fund - Income	Emirates Fund Managers (Jersey) Limited	Jersey
138	1/7/05	Emirates Real Estate Fund - Accumulation	Emirates Fund Managers (Jersey) Limited	Jersey
74	14/6/05	GCC Real Estate Fund	Global Investment House	Bahrain
424	17/4/05	Awaed Real Estate Fund	Aayan Leasing & Investment Co	Kuwait
85	1/2/05	Amlak First Real Estate Fund	Amlak Finance	United Arab Emirates
18	1/11/04	Solidarity European Real Estate Fund	Solidarity BSC(c)	Bahrain
279	31/7/04	Ethmaar UK Real Estate Fund	Kuwait Finance House	Kuwait
148	30/5/04	Islamic Asian Real Estate Fund	Wafra Investment Advisory Group	Cayman Islands
52	1/5/04	Al Islami French Property Fund	Dubai Islamic Bank	United Arab Emirates
16	20/4/04	Solidarity International Real Estate Fund	Solidarity BSC(c)	Bahrain
606	1/3/04	Shuawaikh Real Estate Fund	Al Madar Finance & Investment	Kuwait
563	28/5/03	Makaseb Real Estate Fund (Previously Aayan 1st Real Estate Fund)	Aayan Leasing & Investment Co	Kuwait
232	1/2/03	Markaz Real Estate Fund	Kuwait Finance Centre (Markaz)	Kuwait
221	29/8/02	Al Dar Real Estate Fund	Al Dar Asset Management	Kuwait

Assets Type	Geofocus	Base Currency	Fund size in USD (Million)	Type	Total Returns
Real Estate	Gulf Cooperation Council (GCC)	BHD	79.81		
Real Estate	Saudi Arabia	SAR	240	Closed Ended	
Real Estate	Gulf Cooperation Council (GCC)	KWD	Not disclosed	Open Ended	-2.50%
Real Estate	Gulf Cooperation Council (GCC)	KWD	Not disclosed	Open Ended	
Real Estate	Global	USD	Not disclosed	Open Ended	
Real Estate	Global	USD	Not disclosed	Open Ended	
Real Estate	India	AED	57.18	Closed Ended-(Renewable)	
Real Estate	Turkey	USD	Not disclosed	Closed Ended	
Real Estate	Saudi Arabia	SAR	52.01	Closed Ended	20.75%
Real Estate	Asia Pacific	MYR	Not disclosed	Open Ended	22.75%
Real Estate	Kuwait	KWD	Not disclosed	Closed Ended-(Renewable)	-12.90%
Real Estate	Middle East and North Africa	USD	200	Closed Ended-(Renewable)	
Real Estate	United States	USD	Not disclosed	Closed Ended	4.28%
Real Estate	Global	SAR	Not disclosed	Open Ended	
Real Estate	United States	USD	48.42	Closed Ended-(Renewable)	
Real Estate	Europe	EUR	Not disclosed	Closed Ended	
Real Estate	Global	KWD	Not disclosed	Open Ended	
Real Estate	Asia	USD	100	Closed Ended	-1.82%
Real Estate	Asia	USD	250	Open Ended	
Real Estate	United States	USD	Not disclosed	Open Ended	
Real Estate	China	USD	150	Closed Ended	
Real Estate	United States	USD	100	Closed Ended-(Renewable)	90.24%
Real Estate	UAE	AED	Not disclosed	Open Ended	
Real Estate	UAE	USD	Not disclosed	Open Ended	
Real Estate	UAE	USD	262	Open Ended	
Real Estate	Gulf Cooperation Council (GCC)	USD	100	Closed Ended-(Renewable)	5.94%
Real Estate	Gulf Cooperation Council (GCC)	KWD	Not disclosed	Closed Ended-(Renewable)	30.27%
Real Estate	UAE	USD	75	Closed Ended	-0.07%
Real Estate	Global	EUR	10.07	Open Ended	26.52%
Real Estate	GB	GBP	5073.22	Open Ended	
Real Estate	Asia	USD	Not disclosed	Closed Ended	
Real Estate	France	EUR	39.6	Closed Ended	
Real Estate	Global	USD	15.65	Open Ended	16.79%
Real Estate	Kuwait	KWD	Not disclosed	Open Ended	16.10%
Real Estate	Kuwait	KWD	Not disclosed	Closed Ended-(Renewable)	45.31%
Real Estate	Kuwait	KWD	103.15	Closed Ended	3.39%
Real Estate	Gulf Cooperation Council (GCC)	KWD	Not disclosed	Closed Ended	-3.61%

Source: IFIS-Islamic Finance Information Service.

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