

FUND EVALUATION GROUP
investment consultants

Investing in Real Estate



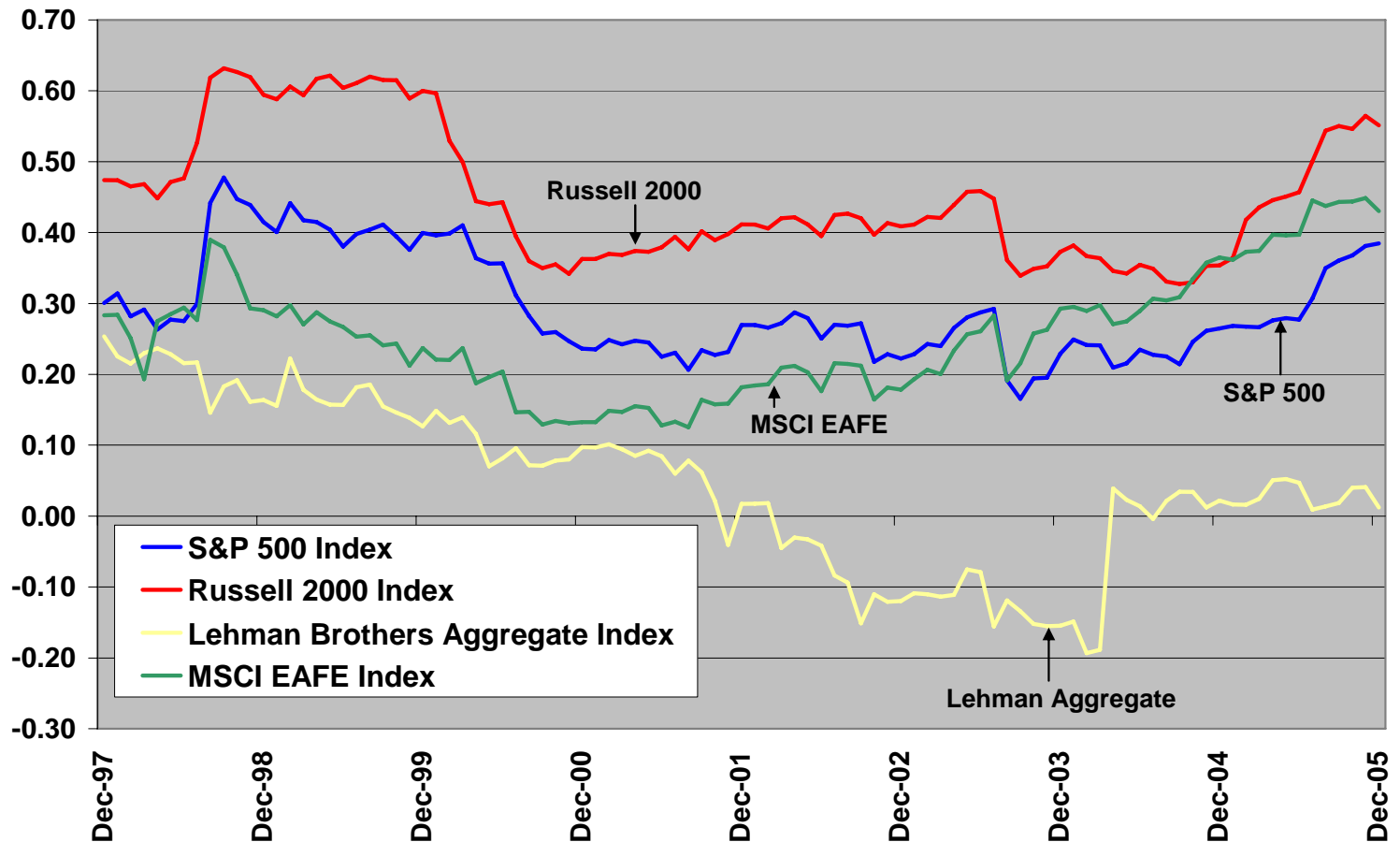
Summary

- FEG recommends that investors maintain a diversified allocation to real estate, which includes exposure to:
 - Real estate securities, both domestic and international
 - Private real estate investments, both domestic and international
- The benefits of a real estate allocation include:
 - Low correlation with other asset classes
 - Attractive long-term yields
 - Protection against inflation
 - Attractive long-term absolute returns
- There are 4 main types of real estate investments:
 - Public Debt
 - Private Debt
 - Public Equity
 - Private Equity
- The global real estate market available for investment is significantly large (nearly \$6 trillion), which includes a significant non-U.S. component (over \$3.4 trillion)

Low Correlation

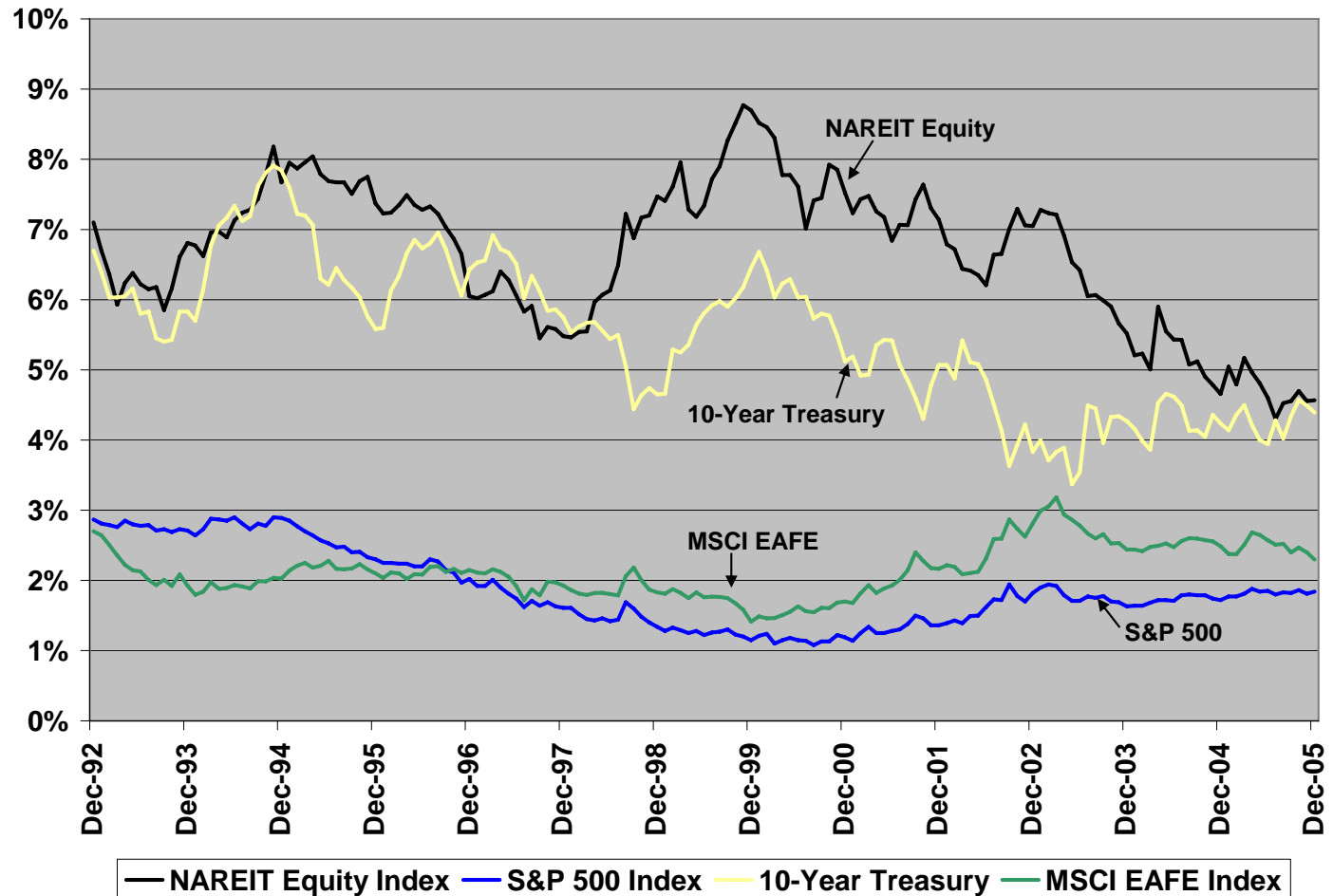
REITs have a low correlation with other major asset classes, particularly fixed income

National Association of Real Estate Investment Trusts (NAREIT) Equity Index - Rolling 5-Year Correlations



Attractive Yield

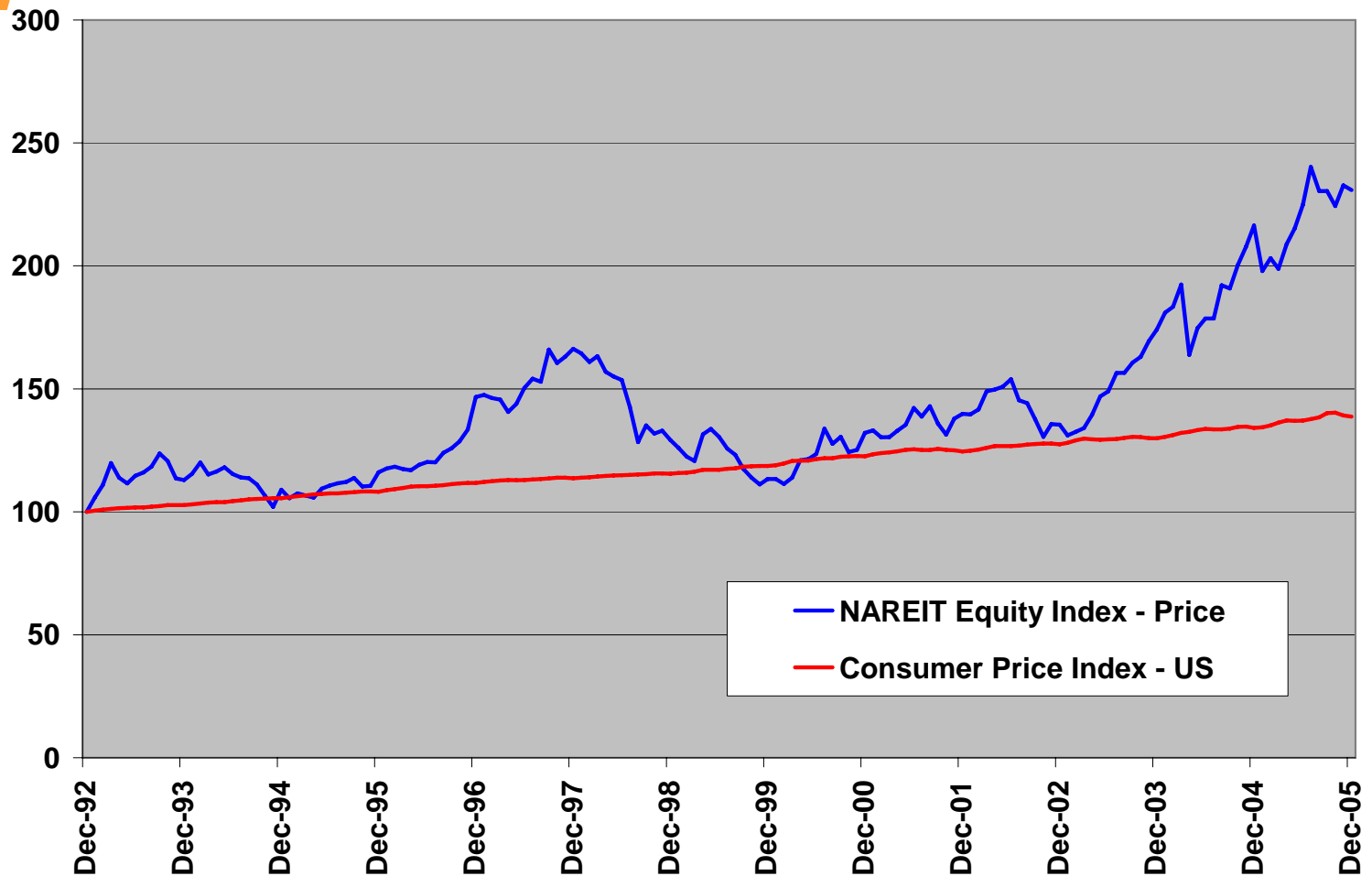
Real estate yields are higher than those of traditional equity investments and are more similar to those of fixed income investments



Inflation Protection

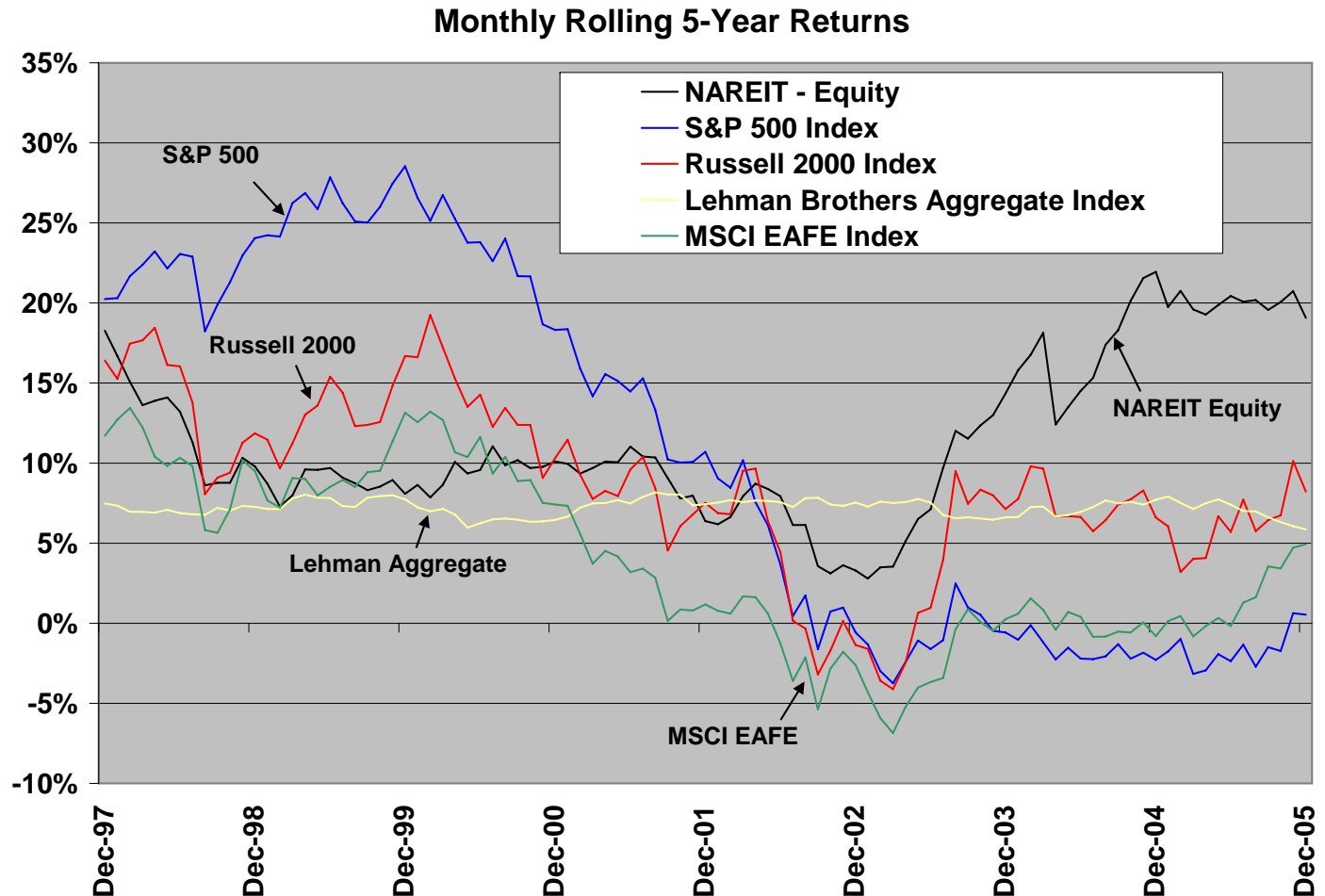
Real estate prices generally increase along with inflation

Real Estate Prices vs. Inflation



Positive Absolute Returns

Rolling 5-year returns for real estate were positive for every month between December 1997 and December 2005



Broad Types of Real Estate Investments

Real estate investments can be classified into 4 broad types

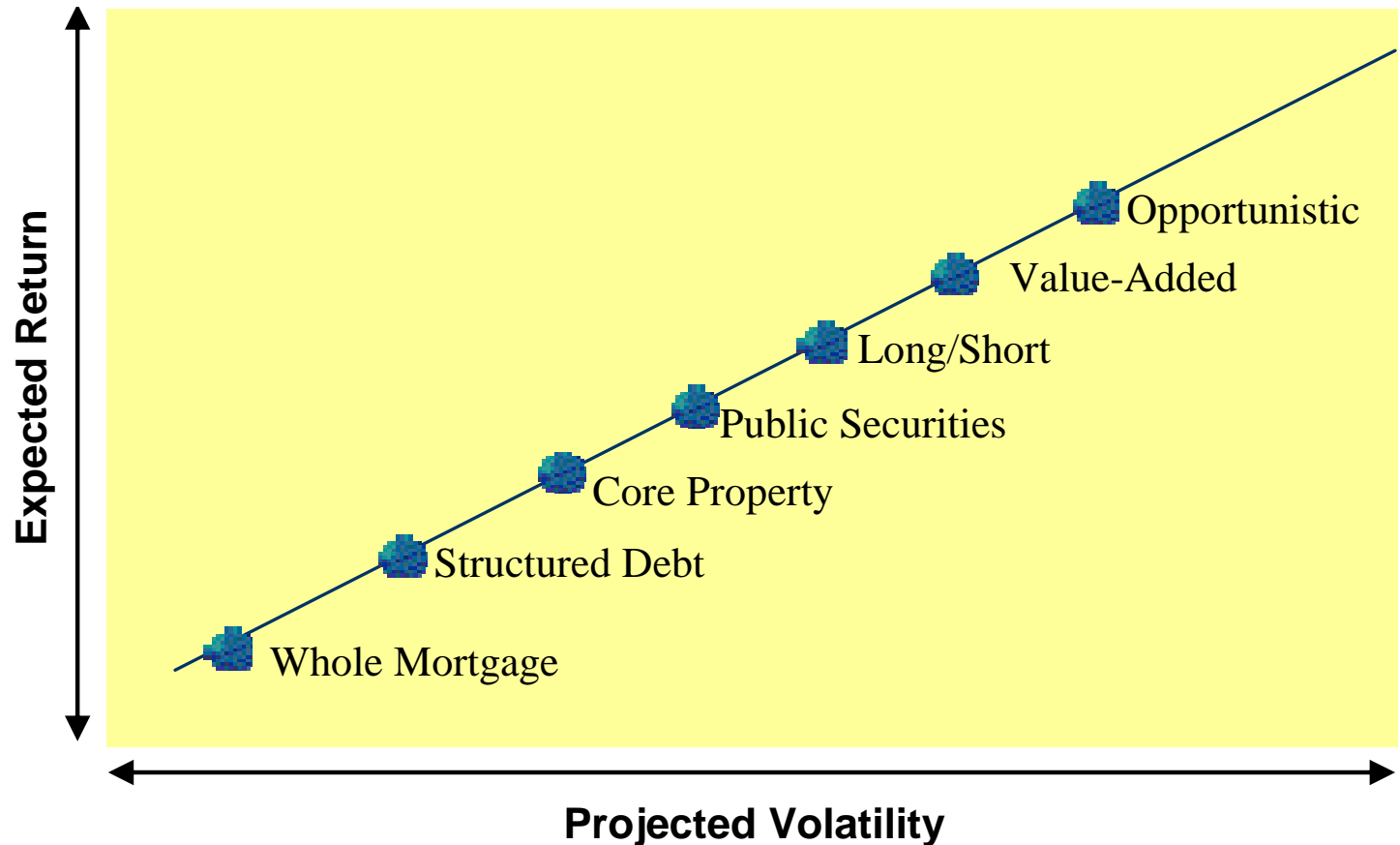
Four-Quadrant Model

	Private	Public
Equity	Direct Property Investments	Real Estate Securities
Debt	Whole Mortgages	Structured Debt

Source: Prudential Real Estate Investors

Risk / Return of Real Estate Investment Strategies

Whole mortgages (private debt) tend to be the lowest risk / return real estate investment strategy, while opportunistic (private equity) tends to be the highest risk / return real estate investment strategy



FEG's Long-Term Real Estate Strategy

- FEG recommends focusing on real estate equity investments, as the returns and diversification benefits are attractive
- An allocation to public real estate securities should serve as the core real estate allocation and provide the liquidity to tactically manage an investor's exposure to real estate
- Investors should utilize private real estate to generate excess returns for the real estate portfolio, focusing primarily on value-added and/or opportunistic funds
- Investors can allocate to private real estate funds that focus on a single property type because an allocation to U.S. public real estate securities provides diversification by both property type and region
- The real estate portfolio should include exposure to both U.S. and international real estate due to the size of the international real estate market, the relatively low level of publicly traded real estate in many foreign countries, and the low correlation between real estate in different regions of the world

Investment Characteristics

Public Real Estate Equity

- Publicly traded shares held directly, managed in a separate account or mutual fund
- Real estate investment trusts (REITs) must pay out 95% of taxable income as dividends to shareholders; real estate operating companies (REOCs) do not
- REITs must derive at least 75% of their income from real estate activities; REOCs have no minimum requirement
- No corporate income tax; however, income is taxed at the shareholder level

Private Real Estate Equity

- Ownership structures include direct, commingled funds, or limited partnerships
- Funds may be open-ended or have defined investment and liquidation periods
- Objectives and restrictions are stated in the partnership agreements
- May generate Unrelated Business Taxable Income (UBTI)

Public vs. Private Real Estate Equity

Public Equity Advantages

- Publicly traded (liquid)
- Lower fees
- No minimum size limitations

Public Equity Disadvantages

- Theoretically, lower returns due to liquidity premium
- Performance often driven by capital flows and other non-real estate related factors
- Higher correlation to public stock markets

Private Equity Advantages

- Access to broader array of investment opportunities
- Lower correlation to public stock markets

Private Equity Disadvantages

- Illiquid
- Higher fees
- Appraisal-based valuations
- Difficult to benchmark
- High dispersion of returns in value-added and opportunistic sectors

Global Commercial Real Estate Market

Nearly 60% of the global commercial real estate market is outside of the U.S., which provides a significant opportunity for U.S. investors looking to diversify their real estate allocation

The percentage of publicly traded real estate securities in Europe ex-U.K. is well below that of the U.S. and other regions, which creates an opportunity for growth in European real estate securities markets as more countries introduce REIT-like structures

Global Investable Institutional Property Market As of December 31, 2004

Region	Size (US\$, billions)	Share of Global Market	% Publicly Traded
U.S.	2,525	42%	12%
Europe (ex-U.K.)	1,500	25%	4%
Japan	705	12%	10%
Hong Kong/China	540	9%	13%
U.K.	490	8%	17%
Australia	100	2%	52%
Other Asia	88	1%	10%
Total	5,948	100%	11%

Source: Prudential Real Estate, Principal, AMP Henderson, UBS

International Diversification

International diversification within public real estate equities is beneficial due to the low correlations of public real estate equities between various global regions

Correlation of Public Property Securities Markets (1993-2005, in U.S. dollars)

	U.S.	Europe	Asia	Australia
U.S.	1.00	0.50	0.32	0.40
Europe	0.50	1.00	0.34	0.52
Asia	0.32	0.34	1.00	0.44
Australia	0.40	0.52	0.44	1.00

Source: Morgan Stanley, Global Property Research

International Return/Risk

Returns and risk for public real estate securities in various regions around the world are similar to those of the U.S

Returns for Asia are lower than other regions due to problems the region has faced, including a weak Japanese real estate market for more than a decade and the SARS outbreak in 2003

Historical Returns & Risk of Public Property Securities (1993-2005, in U.S. dollars)

	Historical Return	Standard Deviation
U.S.	13.6%	14.9%
Europe	13.9%	14.4%
Asia	7.4%	33.2%
Australia	16.6%	18.2%

Source: Morgan Stanley, Global Property Research

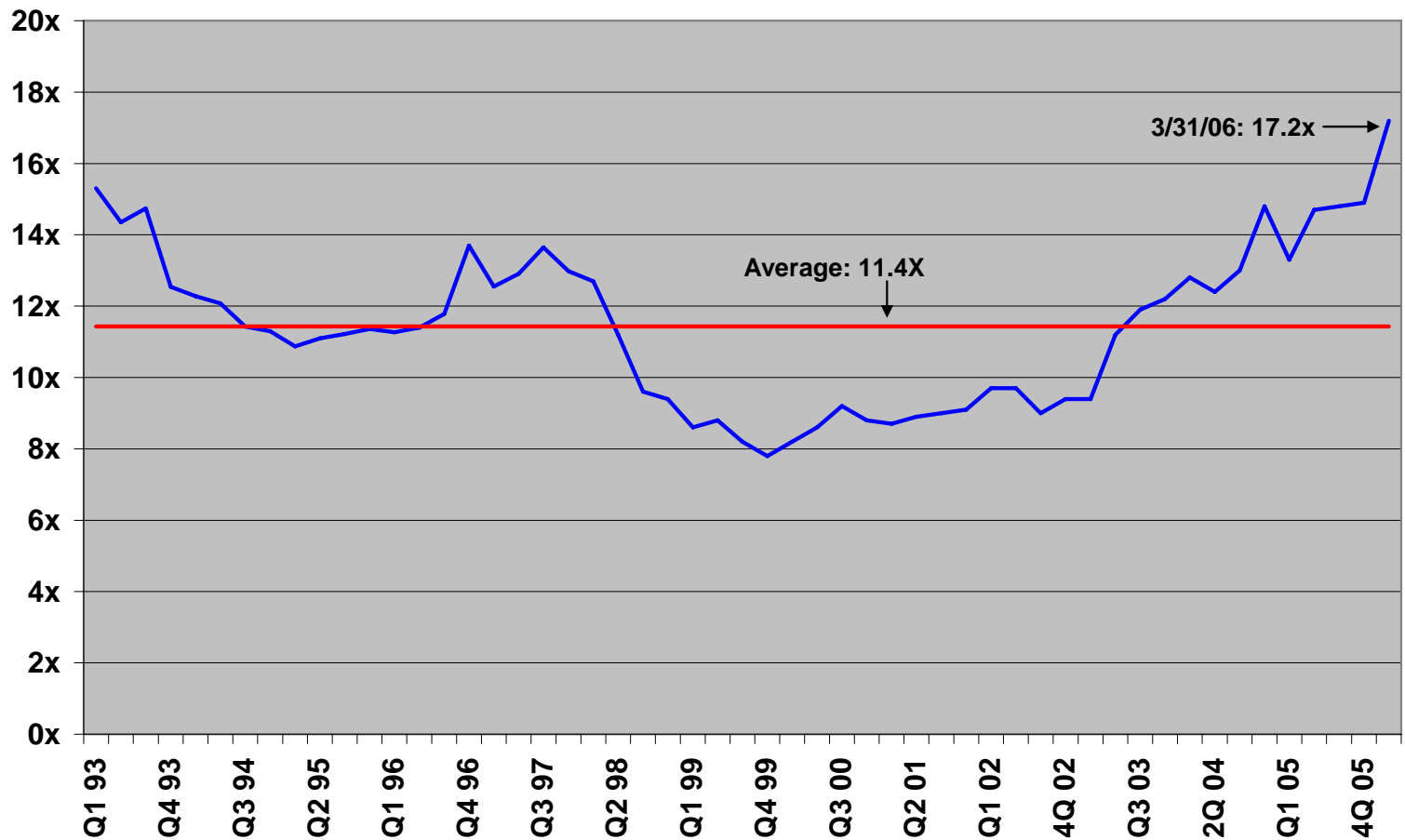
FEG's Recommendation

- Given the current real estate market, FEG recommends that investors make an allocation to global real estate securities as well as value-added and/or opportunistic private real estate funds
- Valuations for U.S. REITs are currently above their long-term averages (see following pages), as REITs returned a cumulative 140% between January 1, 2001 and December 31, 2005; therefore U.S. REITs are not especially attractive
- Capitalization rates are below 6% for the first time in the history of the NCREIF Property Index (January 1978 inception); therefore, core private real estate, which the NCREIF Property Index measures, is not currently attractive
- Valuations for the international public real estate market currently vary widely by region, which provides active international public real estate managers with good opportunities to add value
- The United Kingdom and Germany, both of which are significantly large real estate markets, are expected to come to market with REIT-like structures in 2006 or 2007, which should create an even greater opportunity in international real estate

REIT Prices – Funds from Operations

The price-to-funds from operations (FFO) for real estate investment trusts (REITs) was 17.2x as of March 31, 2006, or 50% higher than its long-term average of 11.4x

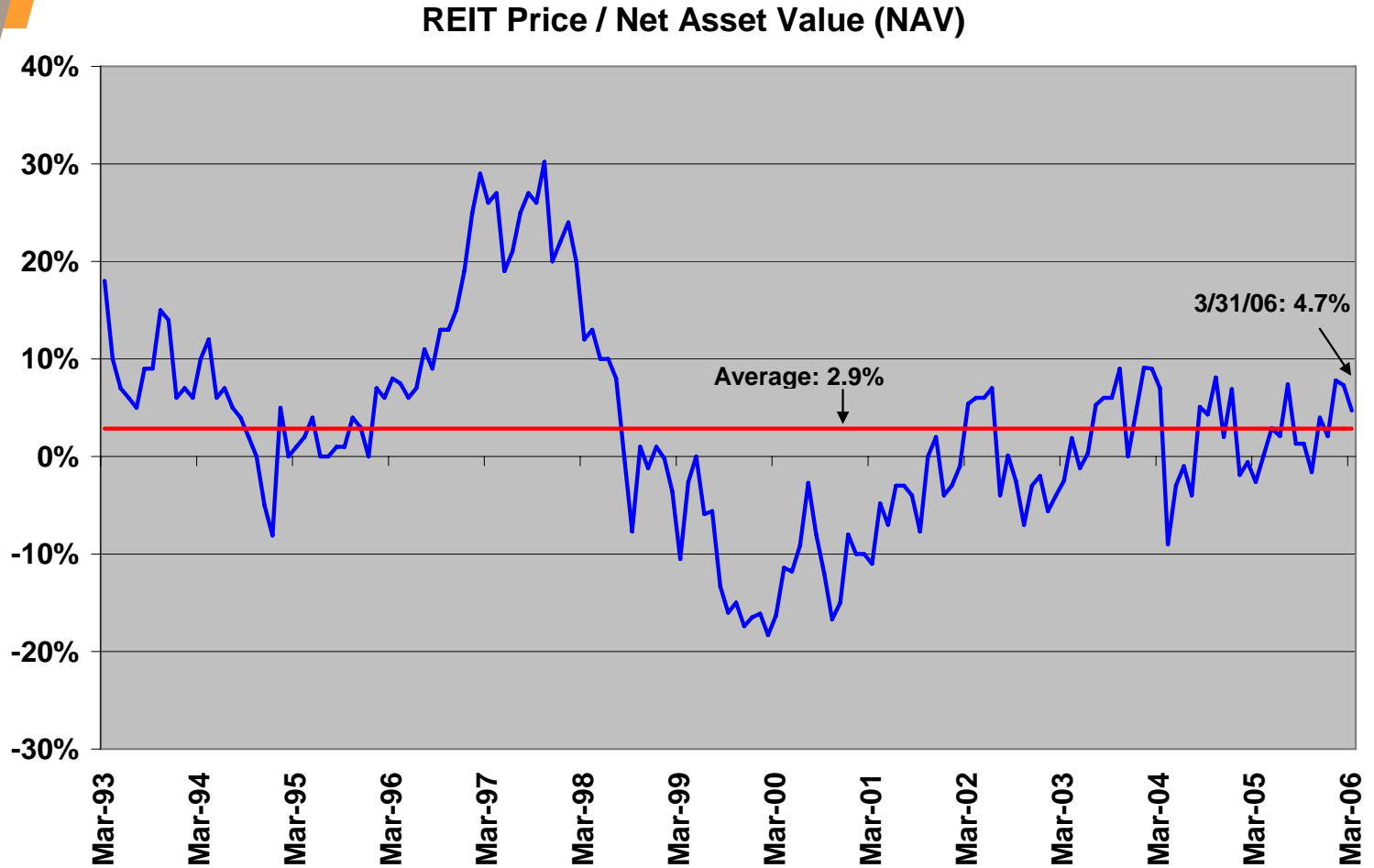
REIT Price / Forward 12-month Funds from Operations (FFO)



Source: Goldman Sachs & Co., ING Clarion

REIT Prices – Net Asset Value

As of March 31, 2006, REITs were trading at a 4.7% premium relative to the net asset value (NAV) of their underlying real estate, which is higher than the long-term average of 2.9%

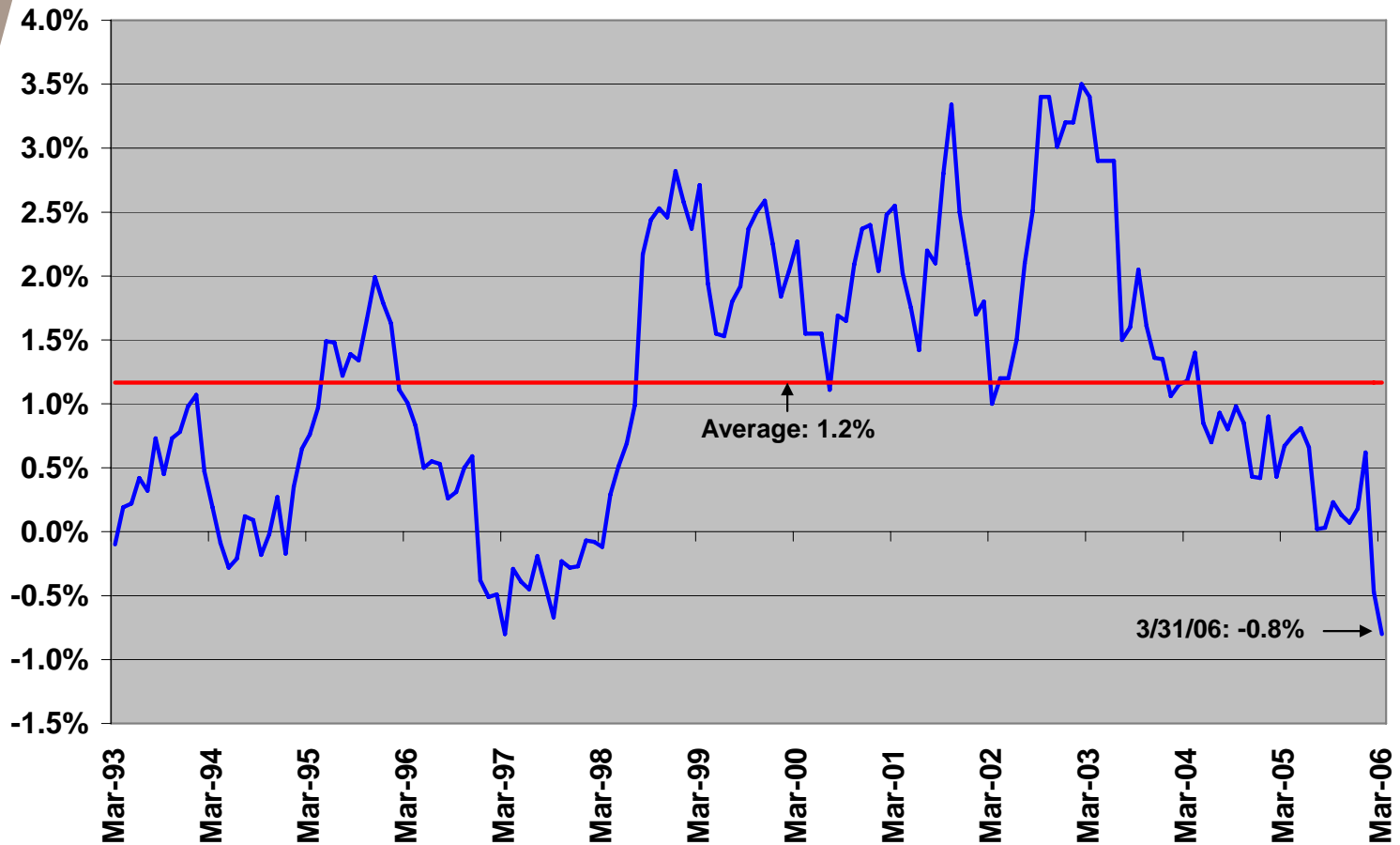


Source: Green Street Advisors, ING Clarion

REIT Yields – 10-Year Treasury

The yield spread between REITs and the 10-year Treasury was -0.8% points as of March 31, 2006, which was below the long-term average spread of 1.2% points; REIT yields were nearly double those of the 10-year Treasury 3 years ago

REIT Yield vs. 10-Year Treasury Yield



Source: ING Clarion, NAREIT

Conclusion

- FEG recommends that investors maintain a diversified allocation to real estate, which includes exposure to:
 - Real estate securities, both domestic and international
 - Private real estate investments, both domestic and international
- Real estate securities provide the liquidity needed to tactically manage the real estate allocation and provide exposure to core real estate in a diversified manner (e.g. office, retail, residential, and industrial)
- The real estate securities allocation should include an exposure to international markets due to low correlations between U.S. and international real estate securities and the size of the non-U.S. real estate securities market
- An allocation to value-added and/or opportunistic private real estate should provide the alpha for the real estate component of the portfolio and can be sector specific because real estate securities provide diversification
- Given the high current valuations of core private real estate and U.S. real estate securities (REITs), FEG recommends that investors focus on international real estate securities and value-added and/or opportunistic private real estate funds

Appendix

Key Real Estate Terms

- Capitalization Rate – is determined by dividing a property's net operating income by its purchase price; generally, higher capitalization rates indicate higher returns and higher perceived risk
- Core Real Estate – high quality, existing private real estate equity investments with little to no leverage that require no substantial lease-up or redevelopment whose primary source of return is a stable stream of income
- Funds From Operations (FFO) – the most commonly accepted and reported measure of REIT operating performance, FFO is equal to net income, excluding gains or losses from property sales, plus real estate depreciation
- Lease-up – the period of time when a property owner signs leases with new tenants for a building that is not fully leased
- Long/Short Real Estate – hedge fund portfolios with both long and short positions in REITs and REOCs; most have a long bias and use from 0-2x leverage
- Net Asset Value (NAV) – the net market value of all assets for a REIT, including but not limited to its properties, after subtracting its liabilities and obligations

Key Real Estate Terms

- Opportunistic – highest risk/return private real estate equity investments with major redevelopment or repositioning risk or new developments, typically with leverage of 65% or more
- Public Securities – domestic or international publicly traded real estate equity securities, either real estate investment trusts (REITs) or real estate operating companies (REOCs), which typically utilize 35-40% leverage within the REIT capital structure
- Structured Debt – publicly traded real estate debt securities that consist of commercial mortgage-backed securities (CMBS), synthetic mortgages, and hybrid vehicles such as mezzanine investments
- Value-Added – private real estate equity investments with some lease-up, development, or repositioning risk and 60-65% leverage whose primary source of return is capital appreciation
- Whole Mortgage – private real estate debt investments with loan-to-value ratios typically ranging from 50-80% and with yields 100-200 basis points above comparable Treasuries; investments in whole mortgages typically require a significant amount of capital

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6. Performance analysis is calculated using monthly and/or quarterly market values.
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