ELMTREE FUNDS
PRIVATE EQUITY REAL ESTATE

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TRACKER

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2014 market**Outlook**

Traditionally, the standard silos used to describe real estate investments – core, value-add, and opportunistic – have been viewed as an appropriate way to identify an investor's risk and return profile. Recently, however, these pre-determined categories have generated empirical return data that does not accurately reflect the risk and return profile originally expected by investors. In lieu of these conventional silos, we have seen a shift in investor behavior that considers a more investigative approach that underwrites the manager's expertise and his or her investment performance over time.

In every real estate investment, the underwriting is driven by calculating a predictable and normalized cash flow stream. If this tenet of investment philosophy is true, then the most important factors in assessing a real estate investment are the underlying leases, terms, and cash flows. Matthew Richardson, Director of Research for Fidelity's European Real Estate business, agrees with this sentiment and says,

"The biggest single determinant in diversification and performance is lease structure. It is the length of the lease, the structure of the lease, and the ability of the lease to generate cash flow. We also discovered on a statistical basis that we could diversify away a lot more risk and volatility on the fund performance by mixing and matching different lease lengths and lease structures than we could by buying in different geographic locations."

2014 market**Outlook** (continued)

Core, value-add, and opportunistic real estate investment labels have historically been used to quickly quantify risk and return expectations for potential investors. Core investments typically include stabilized properties with low leverage and predictable cash flows. These assets are viewed as the "safest" in the real estate asset class. Value-add investment is riskier given that such a strategy often involves re-leasing, repositioning, and redeveloping an asset. Opportunistic strategies are viewed as the "riskiest" form of real estate investment. Managers of this strategy invest in land and development, distressed properties, and emerging markets.

To ascertain the effectiveness in investment style labels, IPRE analyzed 706 value-add and opportunistic funds in terms of size, geographic locations, product types, and developments. All the data was provided by Burgiss, a global provider of investment decision support tools.

	CORE	VALUE-ADDED	OPPORTUNISTIC
Target of non-income producing investments as percentage of fund GAV	≤ 15%	> 15% ≤ 40%	> 60%
Target of (re) development exposure as a percentage of fund GAV	≤ 5%	> 5% ≤ 25%	> 25%
Target return derived from income	≥ 60%	N/A	N/A
Maximum LTV	≤ 40%	> 40% ≤ 65%	> 65%

THE KEY FINDINGS ARE HIGHLIGHTED BELOW: Valued-add funds are smaller than opportunistic funds, on average. Value-add funds raised an average of $447 million in committed capital whereas the average opportunistic fund raised $746 million in committed capital. In terms of geography, valued-add funds were more focused in North America while opportunistic funds looked for investments abroad, particularly in Asia. Furthermore, managers of value-add funds were more likely to focus on a single property type. A significant majority of value-add funds in the data set invested more than 75% of their capital in a single property type, compared to only 16% of opportunistic funds. Lastly, opportunistic funds, on average, invested more capital in development than value-add funds. Based on these findings, opportunistic funds are "riskier" in nature and therefore should produce higher returns to compensate the investor for the added risk.

To test the validity of this argument, IPRE used Burgiss' cash flow data to calculate returns on the 706 funds in the sample set. The sample funds were broken into two subsets to account for the Great Recession: The first subset contained funds with inception dates before 2004, while the second contained all funds commencing after 2004. The returns are shown below.

The returns for the pre-2004 value-add funds subset, which are net of fees, closely corresponds with investors' expectations outlined above, while the pre-2004 opportunistic fund subset mean IRR of 9.76% falls well below investors' expectation. However, a large variation in the pre-2004 opportunistic fund subset, highlighted by an 11.90% standard deviation, means there is not conclusive statistical evidence to claim that, on average, value-add funds produced better returns than opportunistic funds.

Return statistics by class and period

Vintages 1980-2003

Value add (N=79)	**IRR**	**Multiple**	**AME**
Mean	12.09%	1.70	1.11
St. Dev.	10.73%	0.61	0.34
25th%	6.44%	1.36	0.93
Median	11.32%	1.59	1.10
75th%	15.46%	1.97	1.29

Opportunistic (N=115)			
Mean	9.76%	1.51	1.05
St. Dev.	11.90%	0.45	0.29
25th%	4.43%	1.23	0.86
Median	9.58%	1.52	1.06
75th%	16.27%	1.80	1.24

Vintages 2004-08

Value add (z=133)	**IRR**	**Multiple**	**AME**
Mean	-2.28%	0.98	0.85
St. Dev.	17.51%	0.40	0.34
25th%	-7.50%	0.67	0.69
Median	-0.44%	0.98	0.87
75th%	6.88%	1.27	1.11

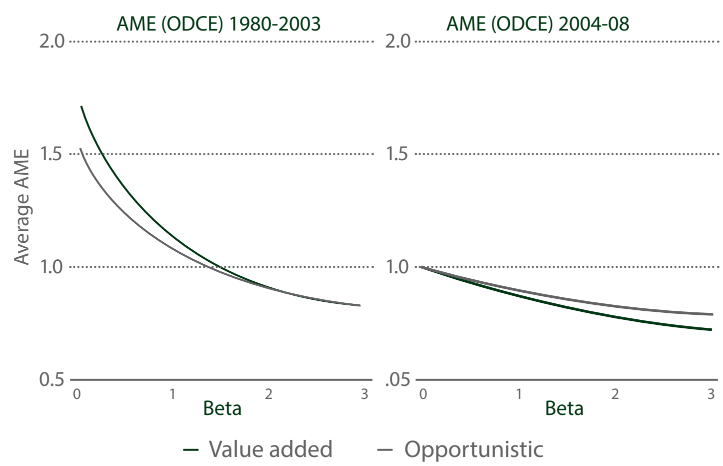
Opportunistic (N=184)			
Mean	-1.74	0.97	0.88
St. Dev.	18.30%	0.43	0.43
25th%	-8.38%	0.71	0.64
Median	-0.22%	0.99	0.87
75th%	7.47%	1.28	1.10

2014 market**Outlook** (continued)

Furthermore, it is necessary to judge value-add and opportunistic fund returns in terms of relative performance to core assets and the real estate cycle as a whole. To do so, both value-add and opportunistic fund returns for vintages pre and post 2004 were compared to the "Open End Diversified Core Equity (ODCE) Index." This is also called the "alternative market equivalent (AME)." An AME greater than 1 implies that the subset outperformed the benchmark index, and conversely, an AME less than 1 implies that the subset underperformed the index. The results: During times of rising returns, both value-add and opportunistic funds outperformed the core asset benchmark index. However, both these strategies underperformed relative to the index during the Great Recession. Such a result is not surprising considering the "riskier" nature of value-add and opportunistic fund strategies. More importantly, as shown to the right, opportunistic funds did not significantly outperform value-add funds in times of rising returns or significantly underperform in times of declining returns. If labels accurately depicted risk and return profiles, then opportunistic funds would have significantly outperformed value-add funds in the pre-2004 subset and significantly underperformed in the post-2004 subset. Investors have been using investment labels to rationally apply risk and return expectations for potential real estate investments. The evidence outlined above suggests that these labels do not indicate the true risk and return profiles of real estate investment strategies.

In conclusion, as investors evaluate different real estate investment choices, they should put less emphasis on investment labels, and instead focus on the value of the underlying cash flows, which are generated by the income and capital returns. Creating consistent positive cash flow is the responsibility of the investment manager. Managers can create recurring cash flows by carefully constructing portfolios with various types of lease structures. A portfolio of this nature produces a diversified cash flow stream and normalizes income returns over time. By analyzing underlying cash flows and investigating investment managers, investors can accurately assess the risk and return profile of a particular investment and will be better suited to make an informed and educated decision.

AME vs beta by class and period



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