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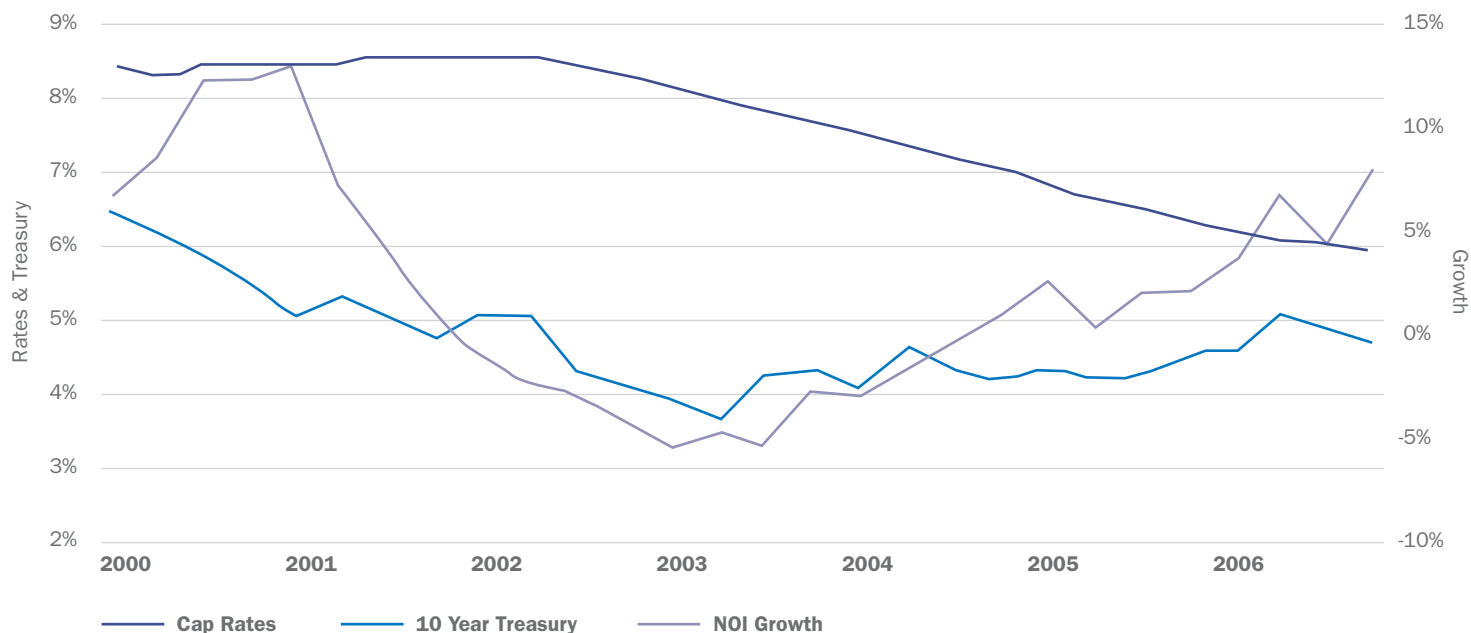
REAL ESTATE INVESTMENT PERFORMANCE: SPECIAL FORCES WANE

The stellar double-digit investment returns generated by commercial real estate during the last three years have captivated investors and stimulated hope that the asset class can generate yet another double-digit year for 2007. While first quarter real estate investment returns have not yet been released, 2007 has so far produced economic and capital markets foundations for real estate that are positive.

The U.S. economy generated slow but solidly positive economic growth during the first quarter accompanied by job growth. In addition, inflation has been well behaved enough to keep monetary policy steady, and interest rates have gyrated in a narrow range since the end of last year. Capital continues to be abundant as well, providing the commercial real estate market with ready liquidity as well as ongoing stiff competition for investment opportunities.

While these essentially benign economic and capital markets conditions are a solid foundation for real estate market performance this year, they are not powerful enough to generate double-digit total returns without the help of strong positive real estate specific factors. In fact, the strong total returns for real estate for the entire five-year period since the 2001 recession were produced by combinations of positive economic and capital markets conditions and powerful real estate specific factors. The chart on the following page illustrates what happened.





Source: NCREIF (Cap Rates & NOI), Bloomberg (U.S. Treasury)

In 2002, the U.S. economy was digging out of the double-whammy of the 2001 recession and the aftermath of 9/11. The Federal Reserve had begun loosening the federal funds rate in January 2001 and, by the beginning of 2002, a total of 475 basis points of easing had been applied. By June 2003, the federal funds rate would reach its cycle low of 1.0%. Longer-term interest rates dropped as well; the 10-year Treasury rate averaged 5.15% over January 2001 and reached a cycle low of 3.32% over June 2003. The commercial real estate market, like the rest of the economy, was adversely impacted by the recession. Net operating income (NOI) declined in 2002 for the properties in the NCREIF-NPI real estate index which serves as an industry barometer. However, the bright spot was retail properties where NOI showed solid growth, pushing property values up and generating a double-digit total return. On the whole, real estate total return in 2002 was 6.7% as measured by the NCREIF Property Index.

In 2003, solid NOI growth and resulting property value appreciation for retail continued and was accompanied by the lagged influence of declining interest rates. Real estate capitalization rates, which are the inverse of the price/earnings ratio well known to stock investors, dropped significantly as shown in the chart. A decline in cap rates

means that investors are valuing each dollar of NOI more dearly in determining real estate market value. The decline in cap rates, along with the continuing improvements in retail property, produced a 9.0% total return as measured by the Index.

In 2004, the real estate recovery produced another year of solid NOI growth for retail property and growth in apartment property NOI as well. In addition, the decline in office and industrial property NOI was much less pronounced in 2004 showing that recovery was taking hold throughout the real estate sector. Investor interest soared, cap rates declined further, and real estate total return for the year was a stunning 14.5% according to the Index.

In 2005, the fundamental economic and capital markets forces that drove real estate returns for the prior three years continued and improved. NOI growth was positive for all major real estate property types except industrial which suffered a very small decline. At the same time, these fundamental drivers were accompanied by another force applied by “condo converters.” Condo conversion involves the purchase of rental apartment properties for the purpose of converting them to condominium ownership. Attractively low residential mortgage rates and rising prices of single-family homes buoyed demand for condos

and stimulated conversion activity materially in 2005. For that year, 34% of all apartment purchases involved condo converters, up from 24% in 2004. This activity helped to push the capital appreciation component of apartment total return to 14.8% and contributed to overall real estate total return of 20.1% as measured by the Index.

Last year, the environment for condo converters deteriorated. The Federal Reserve switched monetary policy into tightening mode in June 2004. By June 2005, the fed funds rate reached 3.25% and by June 2006, 5.25%. Residential mortgage rates rose as well and choked off demand for single-family homes and condos too. In 2006, condo conversions declined by 70%. Further, roughly 5,000 units held by condo converters were reportedly sold for reversion back to rentals. Cap rates on apartment properties were essentially stable in 2006 and total return dropped back to 14.6% according to the Index.

As condo converters were leaving the scene in 2006, their special influence on real estate returns was replaced by another special force—REIT privatization. In 2006, REITs, which are tax-favored stock companies organized for the purpose of owning commercial real estate, became the target of investors interested in “de-reiting.” De-reiting is a fancy term for removing real estate from the REIT form of ownership to private ownership. Opportunities for de-reiting were attractive last year because the stock market was

pricing REIT stock less richly than the private market was pricing real estate. In 2006, de-reiting transactions totaled \$31.2 billion, a substantial sum when compared to the \$330.7 billion market value of REITs at year-end 2005. The process reached a frenzied peak with the privatization of Equity Office Properties earlier this year. Aided by de-reiting, real estate total returns amounted to 16.6% last year as measured by the Index.

This year, private market pricing of real estate appears to be much more in line with public market REIT pricing than last year. As a result, de-reiting should not be counted upon to drive up real estate returns. At the same time, it is a good bet that condo conversions from prior years will continue to revert back to rentals especially in light of the tightening in residential mortgage requirements as sub-prime mortgages disappear. Without these special forces, commercial real estate performance will depend more heavily on real estate fundamentals than in the past two years. Fundamentals are solid across all major property types; NOI is growing and vacancy rates are generally falling. But, interest rates are not falling as they were in 2004; condo converters are not scrambling to buy apartment properties as they were in 2005, and private equity investors are probably not plotting as many strategic takeovers of REITs as they were in 2006. Fundamentals will rule real estate returns this year and may bring returns back to historical norms.

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