In a League of Their Own
How Nontraded REIT Performance Varies from Traded

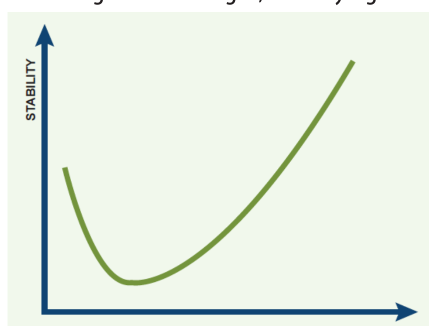
Publicly traded REITs are often considered the gold standard by which to compare and understand nontraded REIT performance. After all, both own and manage commercial real estate properties, mortgages and other real estate related assets. In addition, publicly traded REITs have easily accessible metrics and trading information — so it's a logical leap to expect nontraded REITs to mirror their publicly traded counterparts.

However, publicly traded REITs are typically mature portfolios with longer operational track records while most non-traded REITs are still growing their portfolios and raising capital. Nontraded REITs also have very different performance characteristics from their publicly traded brethren. In fact, nontraded REITs have much in common with direct property investments, private equity, and other illiquid investments which move through distinct stages of development as time progresses. This distinction is critical for assessing nontraded REIT performance — especially as they grow from inception to maturity.

Similarities to Direct Property Investments

One of the selling points of nontraded REITs is that these investments are not subject to the volatility of the stock market. That's not to say that nontraded REIT shares are not volatile. After all, the underlying properties can reflect the cyclicality of the real estate industry — much like direct property investments.

But historically, real estate cycles and the stock market don't typically move up and down together in lockstep. Thus, nontraded REITs and publicly traded REITs are not perfectly aligned when it comes to their performance. Even with similar objectives and underlying assets, traded and nontraded REITs can provide different exposures to real estate. Moreover, pricing of publicly traded REIT shares is based upon a combination of factors that go beyond underlying asset value and can include perceptions of management strength, underlying views of markets and the economy and speculation on the future performance of that particular REIT. Arguably, private market benchmarks, like the NCREIF (National Council for Real Estate Investment Fiduciaries) property index might be a better measuring stick for nontraded REITs than publicly traded REIT indexes.



According to Modern Portfolio Theory, a truly diversified portfolio contains not only a range of different asset types, but also assets that don't behave in tandem with each other. Adding nontraded REITs to a traditional portfolio may provide the added diversification away from the stock market.

Similarities to Private Equity Performance

For both nontraded REITs and private equity funds, the returns are often low or negative in the early years. That's due to the time it takes to acquire portfolio assets and for them to increase in value — and partly due to fees. This lag time for returns is a financial principle called the J curve effect — which means that after an investment is made, an initial loss is followed — hopefully, eventually by a significant gain.

Nontraded REITs are generally valued by the underlying real estate in their life cycle only after their equity offerings have concluded and independent appraisals have been conducted. It can take several years for the portfolio valuations to reflect the strategy and efforts of the sponsor.

Ideally, the real estate portfolio will command a value that is higher than its original cost, resulting in unrealized gains. In the final years of the nontraded REIT, the valuations of the properties are confirmed by the partial or complete sale of the portfolio, or by listing on an exchange. With that in mind, it's misguided to expect an Emerging Stage nontraded REIT to match the performance metrics of a publicly traded REIT or to be equally compared to a closed, Maturing Stage, nontraded REIT. For nontraded REITs — like private equity — real progress is gauged over time.