



WHY PRIVATE COMMERCIAL REAL ESTATE?

How Fiduciaries Use Private Commercial Real Estate
In Their Investment Portfolios

DEVONSHIRE | REIT™



60+

Number of years pensions, endowments & foundations have included CRE in portfolios

COMMERCIAL REAL ESTATE IS A CORE INVESTMENT¹

Private commercial real estate has been a core investment for fiduciaries such as pensions, endowments and foundations since the advent of Modern Portfolio Theory in the 1950s. However, commercial real estate ownership was limited to only the largest institutions due to challenges like high capital requirements, lack of transparency, need for local knowledge, property management hassles and illiquidity, that made buying and owning commercial real estate difficult for smaller investors.

This began to change 25 years ago thanks to the S&L Crisis of the mid to late 80s. A dire situation demanded extreme measures, so Congress created the Resolution Trust Corporation (RTC) in 1989 to liquidate the assets of failed thrifts. Between 1989 and 1995, the RTC liquidated almost \$400 billion in assets, mostly real estate, seized from 747 failed thrifts.

But there first had to be a market for those assets, so the government created one. The RTC was the catalyst for both the real estate private equity and CMBS industries - which together helped completely change the face of commercial real estate and make it more accessible to all investors.

At the same time, new lending regulations created in the aftermath of the S&L Crisis encouraged commercial banks to get out of the commercial real estate lending business. With few options left to refinance expiring mortgages, large private commercial real estate holders were forced into the public markets. During the period from 1990

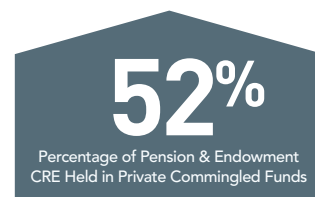
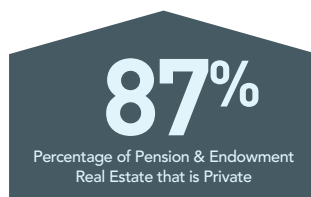
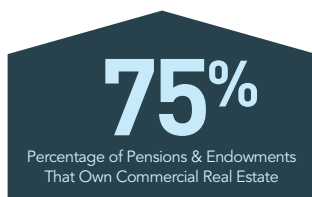
to 1997 the number of public REITs almost doubled and public REIT total market cap increased by 1500%. The "modern REIT era" began, and brought with it added liquidity and transparency to the market.

Additional capital flowed into commercial real estate due to the 30 year decline in interest rates. Pensions, endowments and foundations needed income to survive. The general interest rate decline, and especially the current historically low rates, forced them to look at commercial real estate for its inherent yield. Historically, over 70% of commercial real estate returns are generated from income.

Lastly, technology played a major role in making available information that was formerly only available to the largest investors with proprietary research analytics. Today, companies like CoStar and Real Capital Analytics make it very easy to research and compare properties and markets.

Commercial real estate investing is much less daunting now than 10 or 20 years ago, yet many community bank trusts, private trusts and RIAs still maintain small, or no, allocations to Private Commercial Real Estate. Over the next few pages we offer 5 reasons why they should consider the asset class in their diversified portfolio allocations. To provide perspective, we will first look at how pensions, endowments and foundations are allocating private commercial real estate in their portfolios, and then we will tackle each of the 5 benefits in depth.

¹ Roy Hilton March, "The Making of an Asset Class," *Wharton Real Estate Review* (Spring 2012), 1-3.



HOW OTHER FIDUCIARIES ALLOCATE COMMERCIAL REAL ESTATE

Pensions, endowments and foundations hold commercial real estate in two primary forms - direct investment/ joint ventures and commingled funds. Of the approximately \$1.0T universe of private commingled commercial real estate funds, pensions, endowments and foundations hold \$537B - or over 50%. In fact, the total value of private commingled real estate funds held by pensions, endowments and foundations nearly equals the total market cap of all public equity REITs.²

These fiduciaries believe so strongly in private commercial real estate that they have 8.8% of their total portfolio allocations committed to it. Conversely, only 1.3% is committed to public REITs.³

WHY DO THESE FIDUCIARIES BELIEVE SO STRONGLY IN PRIVATE CRE?

Pensions, endowments and foundations choose private commercial real estate because it provides:⁴

- 1. DIVERSIFICATION**
- 2. INCOME**
- 3. INFLATION HEDGE**

We agree that these are the primary factors to consider, but two additional factors cannot be overlooked:

- 4. SIZE OF MARKET**
- 5. RETURNS**



8.8%

Percentage of Pension &
Endowment portfolios
allocated to Private
Commercial Real Estate.

Percentage of Pension &
Endowment portfolios
allocated to Public REITs.

1.3%

² Towers Watson, *Global Alternatives Survey* (July 2013), 2.

³ Pension Real Estate Association, *Investor Report* (2013), 3-5.

⁴ Aleksander Andonov, Nils Kok, Piet Eichholtz, "A Global Perspective on Pension Fund Investments in Real Estate," *Journal of Portfolio Management*, Special Real Estate Issue (2013), 34.

⁵ Source: National Association of Real Estate Investment Trusts (NAREIT), as of 5/31/2014.



PRIVATE COMMERCIAL REAL ESTATE PROVIDES TRUE DIVERSIFICATION

According to *Fiduciary360*, diversification of assets is one of the seven “Global Fiduciary Precepts”.⁶ It is no accident that pensions, endowments and foundations overwhelmingly choose private commercial real estate as opposed to public REITs as a diversifier for their investment portfolio allocations.

Unsurprisingly, the addition of public REITs to the S&P 500 index in 2001 mitigated much of their diversification benefit. The correlation of Public REITs to the S&P 500 for the 10 year period ending on 3/31/2004 was only .237. In contrast, the correlation for the 10 year period ending on 3/31/2014 was .934. That’s a game changer.

1.1 Correlation Matrix⁷ (annualized for 10 year period as of 3/31/2014)

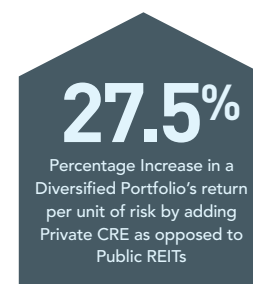
	S&P 500 Index	Private CRE	Public REITs	Small Cap Stocks	Bonds	Consumer Price Index
S&P 500 Index	1.000					
Private CRE	0.177	1.000				
Public REITs	0.934	0.440	1.000			
Small Cap Stocks	0.961	0.092	0.943	1.000		
Bonds	0.172	-0.119	0.290	0.052	1.000	
Consumer Price Index	0.385	0.720	0.361	0.287	0.327	1.000

HOW DOES THIS AFFECT A PORTFOLIO?

As seen below, adding Private Commercial Real Estate (CRE) to a diversified portfolio is more beneficial than adding public REITs for both absolute and risk-adjusted returns. Adding Private CRE to a portfolio already containing public REITs also benefits both absolute and risk-adjusted returns. Note: we have only used a 10% allocation to Private Commercial Real Estate while the most efficient optimized portfolios as allocated by portfolio optimization programs typically contain 15 - 30%.

1.2 Hypothetical Portfolios (10 year annualized as of 3/31/2014)

	Returns	Standard Deviation	Sharpe Ratio
60% Stocks/ 40% Bonds	6.52%	13.57%	.48
60% Stocks/ 30% Bonds 10% Public REITs	6.92%	17.12%	.40
60% Stocks/ 30% Bonds 10% Private CRE	6.97%	13.60%	.51
50% Stocks/ 30% Bonds 10% Public REITs/ 10% Private CRE	7.12%	15.00%	.47



⁶ Fiduciary 360, *Prudent Practices for Investment Stewards* (2007), 10.

⁷ Note: On this page and throughout the remainder of this brochure, *Private CRE* is represented by the National Council of Real Estate Investment Fiduciaries (NCREIF) National Price Index, *Public REITs* are represented by the FTSE/NAREIT National Real Estate Index, *Small Cap Stocks* are represented by the Russell 2000 Index, and *Bonds* are represented by the Barclays US Aggregate Bond Index. S&P 500®, NCREIF®, FTSE/NAREIT®, Russell 2000® and Barclays® are registered trademarks of their respective organizations and are not associated in any way with Devonshire REIT, Inc.

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**89%**Percentage of Advisors Citing
Income as Primary Focus**73%**Average Percentage of CRE Returns
Attributable to Income

PRIVATE COMMERCIAL REAL ESTATE DELIVERS INCOME

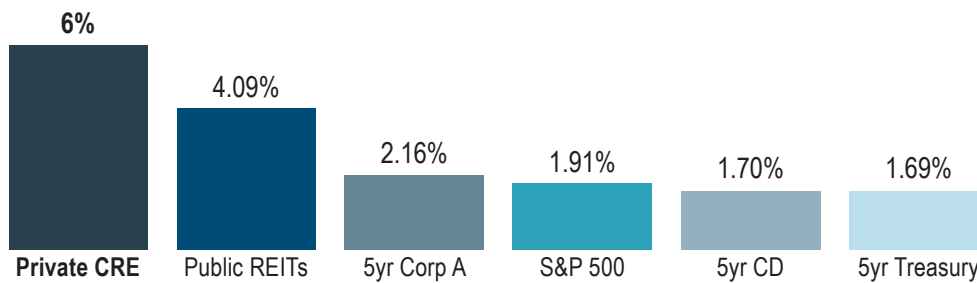
In a recent survey of financial advisors, 89% cite income generation as their primary focus when considering investment options for their clients today.⁸

With interest rates still hovering near all time lows, where can sufficient income be found to pay beneficiaries, or for retiree clients to sustain their standard of living, without dipping into principal?

Stock dividends, CDs, bonds, and even public REITs do not offer yields high enough to provide satisfactory income to clients who planned their retirements or trust sustainability around 5 - 7% yields.

Private Commercial Real Estate is the solution. It is estimated that over 70% of CRE returns are attributable to income generated by the properties.⁹ Commercial real estate doesn't make, sell or service widgets, but what it does is sit there and generate income.

1.3 Yield Comparisons Of Asset Classes as of 6/20/2014



PRIVATE COMMERCIAL REAL ESTATE IS AN EXCELLENT INFLATION HEDGE¹⁰

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In 2013 the inflation rate was 1.5%, and the average for the last 3 years is 1.66%. So, is inflation something to be concerned about? It is if we look at history.

The average annual inflation rate for the 100 year period ending on 12/31/2013 is 3.22%. Even if we leave out all years up to and including the double digit inflation years of the mid 70s and early 80s, the annual average is 2.68% over the last 33 years. The recent averages seem relatively low, but a 2.68% inflation rate will eat away at a portfolio if all the investment principle is necessary to generate income to cover living expenses, and yield on the investment is below the inflation rate.

The correlation matrix on the previous page shows that Private Commercial Real Estate has exhibited a positive correlation to the Consumer Price Index over the last 10 years of 0.72 - meaning it provides an excellent hedge against inflation. This makes sense logically because most long term commercial leases include automatic increases, and shorter term leases offer flexibility to raise rents to help offset the effects of inflation.¹¹

0.72Correlation of Private CRE to the
Consumer Price Index

⁸ Natixis/CoreData Research, *Global Financial Survey of Financial Advisors* (2013), 12.

⁹ Leola Ross, John Mancuso, *Structuring a Private Real Estate Portfolio* (Russell Research: April, 2011), 5.

¹⁰ John D. Benjamin, G. Stacy Sirmans, Emily N. Zietz, "Returns and Risk on Real Estate and Other Investments: More Evidence", *Journal of Real Estate Portfolio Management*, Vol. 7, No. 3 (2001), 183.

¹¹ Sean Ruhmann, Claire Woolston, *US Private Core Real Estate Investing* (NEPC: September, 2011), 4.

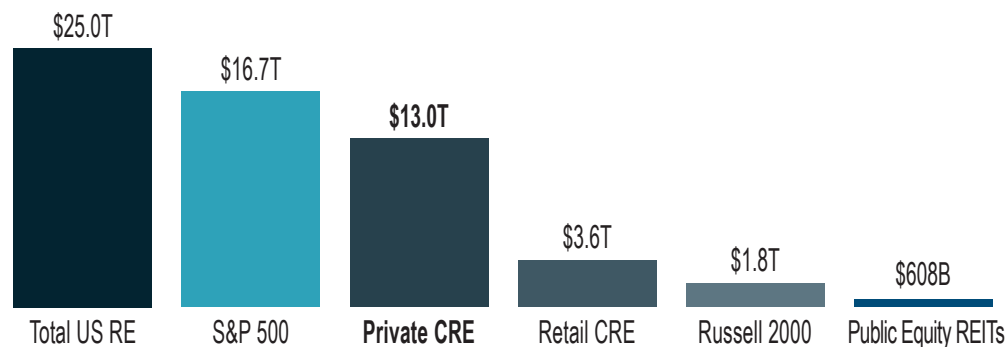
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THE REAL ESTATE ASSET CLASS IS TOO BIG TO IGNORE

Real Estate has been estimated to account for approximately one-half of the world's total economic wealth.¹² Non-government, developed property represents over \$25T in total value in the United States making it the single largest asset class.¹² Of that, approximately \$13T¹³ is Private Commercial Real Estate - which approaches the entire market cap of the S&P 500. The US Retail Commercial Real Estate sector alone is twice as large as the Russell 2000.

1.4 Asset Class Size Comparisons

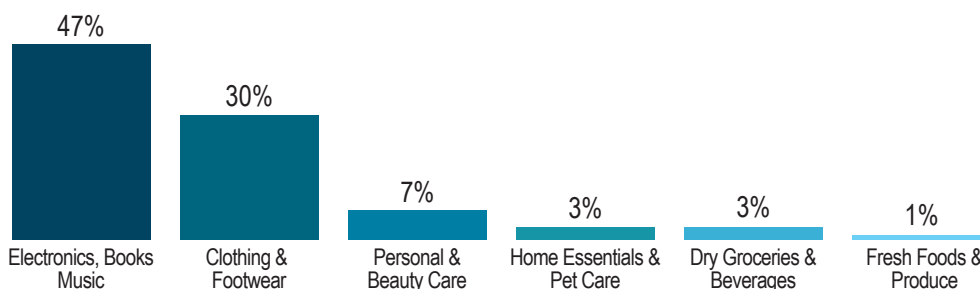


US COMMERCIAL REAL ESTATE DEMAND FORECASTED TO REMAIN STRONG

As of 2013 there were 43 million US households representing over 104 million people living in rented dwellings.¹⁴ The current US apartment vacancy rate is at a 13 year low and while new demand is expected to be between 400,000 to 700,000 per year, the current new construction rate is less than 300,000 new units annually.¹⁵

In retail, many have forecasted the doom of bricks-and-mortar stores, and ecommerce has definitely changed the way consumers shop, but some categories are less threatened than others. Electronics, books and music have been the hardest hit, but standard grocery categories not so much.

1.5 Shoppers Who Regularly Make Purchases Online By Category¹⁶



¹² *The Nature of Real Estate and Real Estate Markets* (McGraw-Hill/Irwin, 2008), 2-7.

¹³ Andrew C. Florance, Norm G. Miller, Jay Spivey, Ruijue Peng, *Slicing, Dicing and Scoping the Size of the U.S. Commercial Real Estate Market* (CoStar: April, 2010), 1.

¹⁴ Joint Center for Housing Studies of Harvard University, *America's Rental Housing: Evolving Markets and Needs* (2013), 1.

¹⁵ Cassidy Turley, *U.S. Multifamily Forecast Report* (Summer, 2013), 6.

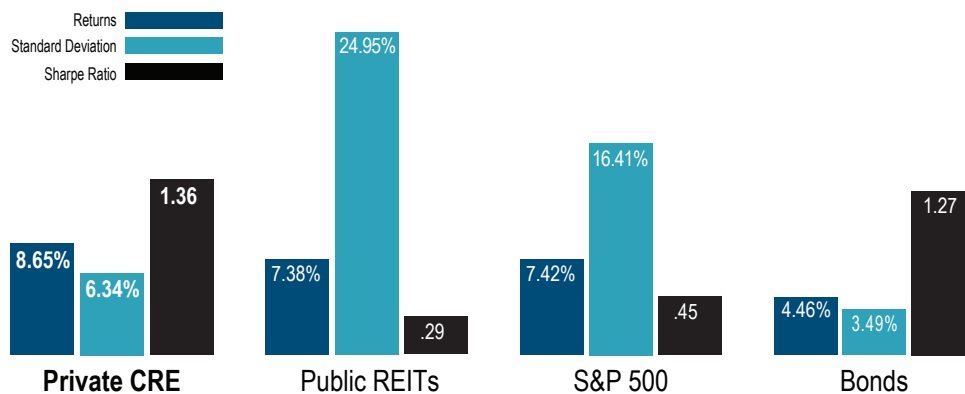
¹⁶ Food Marketing Institute, *US Grocery Shopper Trends: Executive Summary* (2012), 13.



PRIVATE COMMERCIAL REAL ESTATE OFFERS MARKET BEATING PERFORMANCE

We've seen how adding Private Commercial Real Estate to a portfolio increases returns and decreases volatility due to non-correlation with public markets, but part is also due to its outstanding risk vs return characteristics. Over the last 10 years, unlevered Private CRE has outperformed stocks, bonds and Public REITs* in both risk adjusted and absolute returns. This in spite of Public REITs carrying an average of 50% leverage.⁷

1.6 Asset Class Performance (10 year annualized as of 3/31/2014)



CONCLUSION

For over 60 years pensions, endowments and foundations, as fiduciaries, have included Private Commercial Real Estate as an integral part of their portfolio allocations. They do this because the asset class provides true diversification, offers an attractive income stream, and is an excellent hedge against inflation. In addition, the size and performance of the asset class make it hard to ignore.

Historically, other fiduciaries like community bank trusts, private trusts and RIAs have not made nearly as extensive use of Private Commercial Real Estate in their portfolios. We believe the asset class offers benefits that few, if any, other asset classes provide and would help achieve both fiduciary and client goals in a diversified portfolio.

¹⁷ Martha Peyton, Thomas Park, Fabiana Lotito, *REITs and Real Estate: Complementary Through the Cycle* (TIAA-CREF: Summer, 2012), 4.

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