In recent months, all three of you have been voicing your belief that the commercial real estate market has reached its bottom and appears to be poised for an upturn. Is that a fair summation?

**Joel Beam:** Yes, I'd say so. The real estate cycle is all about supply and demand. In a nutshell, we see a new cycle beginning because demand appears to be on the upswing and, at the same time, supply is relatively less because there's so little new construction. A typical five- to seven-year upswing ends when enough new square footage is delivered to take momentum away from the existing inventory.

If you look at commercial real estate occupancy and rent growth figures, you can see slight improvement in 2010 and a modest uptick in rents in the estimated 2011 numbers (Figure 1). Meanwhile, the growth in supply is at a historical low because of the credit crunch and general economic weakness (Figure 2).

**Ian Goltra:** When you put it all together, we believe the recovery has already begun and the stage is set for a slow, steady improvement over the next five years or so. It's important to bear in mind, though, that the aggregate occupancy and rent data roll up the five major property sectors across all U.S. markets. What the averages don't reflect is the potential for a much more robust recovery in some markets, particularly the coastal gateway cities.

How does this rather optimistic picture square with the continuing tide of bad news about housing foreclosures and price deflation?

**Joel Beam:** When you say “real estate,” most people immediately think “my house,” and U.S. households have experienced substantial deflation in housing prices in the last three years. A home is also a consumer purchase—one that ties into the buyer’s self-image, hopes, aspirations and sense of community. It’s a deeply personal thing. So it’s no surprise that the ongoing troubles in the housing market are tainting investors’ views of real estate in general.

But the fact is that the dynamics of the residential market are fundamentally different from those on the commercial side. In essence, housing prices have plummeted because for several years the credit markets offered too much financing. U.S. consumers became over-levered, home prices were bid up to unsupportable levels, and then the music stopped. But commercial real estate didn’t have the same kind of debt-fueled bubble.
Michael McGowan: That’s not to say that there were no excesses in commercial real estate, but it never reached the same level. Prices went up, but after they fell from their peak levels in 2007 and early 2008, they recovered relatively quickly in good markets, based on per-square-foot prices, whereas residential real estate is still in the weeds. It’s also true that, as a general rule, commercial properties aren’t as highly levered as residential purchases.
We’re seeing a wall of private equity money going into commercial real estate.

Property Operations Are Improving
Growth in Same-Property Net Operating Income* (1/1/94 – 12/31/16)

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Property Type</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simon Property Group, Inc.</td>
<td>Regional Malls</td>
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<td>$5.63</td>
<td>$6.13</td>
<td>$5.33</td>
<td>$5.01</td>
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<tr>
<td>Equity Residential</td>
<td>Apartments</td>
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<td>2.39</td>
<td>2.13</td>
<td>2.12</td>
<td>2.07</td>
</tr>
<tr>
<td>HCP, Inc.</td>
<td>Health Care</td>
<td>1.82</td>
<td>2.14</td>
<td>2.24</td>
<td>1.50</td>
<td>2.02</td>
</tr>
<tr>
<td>Ventas, Inc.</td>
<td>Health Care</td>
<td>2.38</td>
<td>3.07</td>
<td>2.95</td>
<td>2.58</td>
<td>2.67</td>
</tr>
<tr>
<td>Public Storage</td>
<td>Storage</td>
<td>3.57</td>
<td>4.97</td>
<td>5.07</td>
<td>5.61</td>
<td>4.72</td>
</tr>
</tbody>
</table>

Source: Bloomberg, as of 9/30/11.

**Ian Goltra:** Let’s not forget that real estate companies generally didn’t suffer as much as many others did during the financial crisis. Vacancy rates were up, but they peaked at a lower point than they did in the last major down cycle in 1990–’92. Back in 1991, vacancies hit 19%, while the most recent peak in early 2010 was below 17%.1 And it’s not as though buildings were empty. By the same token, asking rents dropped, but companies were only leasing a portion of their space at those lower rates. Yes, share prices were hurt, and dividends were down because companies were holding on to their cash. But for the larger REITs—real estate investment trusts—cash flows weren’t that bad (Figure 3).

**Joel Beam:** The point is, housing, at the onset of the crisis, was a massive, $22 trillion asset class—three-and-a-half times the size of the commercial property market—and it gave the economy a heart attack.4 But investors need to distinguish between that reality and the very different dynamics of the commercial market. If you’re looking at real estate from an investment standpoint, you’ve got to wring out the emotional factors and look purely at the fundamentals of the income stream you’re buying.

**Still, it’s understandable why people might be saying, “Why bother with real estate at all?”**

**Ian Goltra:** Understandable, yes, but smart investors should take a cue from institutions and look past the noise. Real estate assets are long-lived, and their cash flows are somewhat predictable. That’s been reflected in pretty competitive risk-adjusted performance over time. How many asset classes can you name that have returned more than 11% annually over the last 30 years (Figure 4)?

**Michael McGowan:** The other reason not to ignore real estate is that right now, it’s inexpensive compared to other asset classes, based on its overall risk/reward profile. U.S. commercial real estate values have rebounded 48% from their low point in August of ’07, but are still 9% below their peak.5 Meanwhile, it’s likely that replacement costs will keep going up. I should point out that our team’s view is more bullish than what you’ll get from the oft-quoted Moody’s property index, which covers all markets and grades of real estate. Our assessment reflects the better performance of institutional-grade real estate in primary markets, which is in line with the holdings of most U.S. REITs.

These are some of the reasons why we’re seeing a wall of private-equity money going into commercial real estate. Industry reports are saying that fund raising for private real estate pools hit an all-time high in 2011—$150 billion or so is the figure I’ve seen.6 For instance, Blackstone has recently completed several billion-dollar transactions and reportedly has $10 billion of dry powder for real estate acquisitions as of the third quarter of 2011.7 On the international front, several listed property companies have been taken private recently. This certainly helps bolster confidence that a recovery is underway, as do institutional flows.
So let’s get more specific about the signs of recovery that you’ve been seeing.

**Ian Goltra:** By no means is the recovery happening in every market. But in gateway cities like New York, Washington, D.C., and San Francisco, we’re seeing a growth in demand and little or virtually no new supply. We can see it happening right in the vicinity of our San Francisco office. As of October, 2011, buildings in the city’s financial district were being quoted at a rate 70% higher than the leases signed less than two years earlier. We’re also seeing healthy commercial market activity in Silicon Valley and other tech corridors. As vacancy rates flatten or improve, so do effective rents. In other words, the good markets are getting better.

**Michael McGowan:** On the international front, key gateway cities like London, Paris, Hong Kong, Beijing, Shanghai and Singapore are seeing good leasing activity and low vacancy rates. On the sales front, there has been a definite rise in demand for well-located, quality office properties. On my recent trip to Beijing, for example, I found that in stark contrast to the problems in China’s residential market, asking rates for prime office buildings in the central business district had gone up by as much as 50% in just the previous couple of months. The demand is coming from U.S. and European companies as well as Chinese firms, and we believe it will be another two to four years before any significant new supply comes online.

**Joel Beam:** That said, the pattern of prior recoveries tells us that as the gateway markets recover and real estate prices and rents go up, higher prices will drive activity out to suburban job centers and secondary markets. You could think of it as progressive waves of real estate demand that will ripple outward as the recovery proceeds. Whether it will reach the lower-tier markets anytime in the foreseeable future is the question.

Are you seeing big differences between real estate sectors?

**Ian Goltra:** Yes, because different sectors have different lease duration and economics. Right now, we’re really enthusiastic about apartments and lodging. Both have short-duration leases, which means that as the economy recovers, the performance of those assets will be most responsive. Retail and office assets tend to have longer lease terms, so they react more slowly.

Past performance does not guarantee future results.
Source: NAREIT.com, as of 9/30/11.

**FIGURE 4**

Long-Term Returns Are Compelling

<table>
<thead>
<tr>
<th></th>
<th>FTSE NAREIT Equity REIT Index Returns</th>
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<tr>
<td>15%</td>
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Past performance does not guarantee future results.
Source: NAREIT.com, as of 9/30/11.
What’s the best way for individual investors to access commercial real estate? After all, they’re not going to be buying major commercial properties outright as private-equity funds do.

Joel Beam: We are big believers in investing through publicly traded REITs and real estate development or operating companies. The first reason is liquidity, which you don’t get with limited partnerships or private REITs.

We also like the predictability of cash flow that’s based on long-term leases, and the fact that U.S. REITs are required to distribute 90% of their taxable income to shareholders if they want to avoid paying corporate income taxes. That dividend stream makes REITs a pretty attractive option for retirees or anyone else looking for income. Another advantage is that REITs have had a low correlation to the S&P 500—lower, in fact, than any other equity sector over holding periods of five years or more.8 On top of all that, there’s profit potential in appreciation of properties as well as merger and acquisition activity.

At this point, should investors be looking to REITs focused on the U.S. market, or are the opportunities better abroad?

Michael McGowan: Despite some tough quarters in 2010 and 2011, you can make a strong case for investing in international real estate going forward. That’s based on higher economic growth rates of emerging nations, the generally lower use of leverage overseas, and the benefits of non-dollar-denominated investments. In short, international real estate gives you diversification potential as well as exposure to faster-growing markets.

Ian Goltra: In our view there are real merits to being invested in real estate across both the U.S. and international markets. On the one hand, U.S. real estate is attractively valued. On the other, international companies represent some of the best real estate development and operating companies in the world. Investing in those companies for the long term is a good hedge against the dollar and a nice complement to a global allocation.

Source: Economy.com and RREEF. As of 3/11.

Forecast Return to Peak Employment

Source: Economy.com and RREEF. As of 3/11.
At the risk of sounding overly skeptical... how confident can investors really be about this recovery scenario? Job growth has been tepid. The foreclosure mess is far from resolved. And fears of a double-dip recession keep resurfacing.

Joel Beam: We’ve lived through an unmitigated crisis in the capital markets, and clearly, it’s not yet over. It’s still a challenging environment, but things are improving. Our team continues to believe that the federal government’s extraordinary intervention in the economy will succeed in stanching the crisis and supporting future economic growth. We’ve already seen some proof of that in the resurgence of the credit markets.

That said, the financial crisis doesn’t negate the need for investors to earn a return on their money. If you’re going to take your money out of the mattress, where should it go? With real estate’s relatively predictable cash flow, we believe it’s still a sensible way to invest for the long term. If anything, this crisis has reaffirmed just how sensible it is.

Our expectations for a new real estate cycle are predicated on continued improvement in the economy and job picture. If there’s some unforeseen disaster, all bets are off for equities generally—not just the REITs that our strategies invest in.

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It’s also true that at this point, commercial real estate companies are realizing the benefits of their access to capital, which gives them an important advantage in negotiating for properties. REITs have raised more than $125 billion since April of 2009 and commercial market liquidity is back.9 In the first half of 2011, transaction volumes for commercial properties rose to $74 billion, on track to hit an annual level last seen in 2004.10

What kind of return should investors be seeking from real estate under these conditions?

Michael McGowan: At a time when return expectations are generally down globally, institutions are looking for a 6.5% to 8% unlevered return from institutional-quality real estate. This is in line with long-term returns (Figure 4) and is within the range targeted by industry forecasts for private equity returns.11 The latest return forecasts for public REITs are somewhat higher, given their modest leverage.12

Joel Beam: You’ve got to remember, too, that there’s a big difference between investing in real estate companies through REITs, as our team does, and investing directly in properties. A recent Morningstar study compared the performance of several real estate indexes, and found that from 1989 to 2009, public REITs focused on commercial real estate earned almost double the annualized return of private equity core real estate funds.13

Why is there such a big difference between the performance of public REITs and privately-owned properties?

Joel Beam: First, there’s a time-disconnect between property and equity performance because the stock market always looks forward. By the time the Main Street market is clued into a trend, the stock market may already have discounted it. Secondly, REIT stock values are based as much on perceptions and expectations as on fundamentals. It’s not uncommon to find Wall Street trading at, say, a 30% premium to Main Street, or vice-versa. Those daily pricing anomalies add another layer of opportunity.

Any closing thoughts on the role that commercial real estate can play in investor portfolios?

Joel Beam: We believe that public REITs are a great tool for diversifying portfolios with real assets that offer dividend income, growth potential and a possible inflation hedge. These dividends are likely to rise if you’ve got inflation and rising interest rates in an otherwise sanguine environment. Where international REITs are concerned, you’ve got the added benefits of exposure to rapidly growing economies and a hedge against the dollar.

The continuing troubles in the residential market are making many individual investors wary of real estate, to be sure. But those folks are ignoring the very clear distinction between residential and commercial markets. If our assessment is correct, and the commercial market is just beginning an extended period of recovery, we believe it will be the kind of opportunity that real estate investors see only once or twice in a generation.
References
2. Ibid.
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4. Freddie Mac, Value of U.S. housing stock: Federal Reserve Board’s Flow of Funds Accounts, September 16, 2011. This figure includes homes with and without underlying mortgages.
5. Green Street Advisors, Commercial Property Price Index, Oct 6, 2011
10. RREEF, America REIT III Corp. report, 2nd quarter 2011
11. Green Street Advisors, Commercial Property Outlook, September 8, 2011
12. Ibid.

Definition of Terms
Cash flow measures the cash generating capability of a company by adding noncash charges (e.g. depreciation) and interest expense to pretax income.

Liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset’s price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold, are known as liquid assets.

Index definitions
The FTSE NAREIT Equity REITs Index is representative of the tax-qualified REITs listed on the New York Stock Exchange, the American Stock Exchange and the NASDAQ National Market.

You cannot invest directly in an index.

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