

Real Estate In Focus

Although John Wenker manages a portfolio that invests only in real estate, his goal is to build a balanced portfolio diversified across property types and driven mainly by stock selection. He believes that the long-term success in the REIT space is driven by industry expertise, a bottom-up approach that requires hard work on each name, and a focus on quality.

Q: What's the investment philosophy behind managing the First American Real Estate Securities Fund?

A: There are three important aspects to our philosophy. First, we invest on a relative value basis. That approach requires a consistent investment process and enough knowledge of the individual companies to appropriately value them. If you're confident in your price targets, then you have the ability to trade around those targets.

Second, we believe that the industry expertise is crucial because we aim to understand the increasingly complex companies better than our peers. We also dig into companies that are not widely followed by the Street as that knowledge provides first-strike capacity. So we have deep industry contacts and strong relationships with REIT management teams.

The third important aspect is the focus on quality companies. In the commercial real estate space, the quality companies are the ones that can grow their cash flow over time. We prefer companies with consistent focus and track record of growing cash flow because they get better multiples and provide downside protection.

I would like to point that we have a team whose background provides the multi-disciplinary view necessary for understanding the REITs. My career related to real estate valuation goes back to the early 1970s, and I have been in the publicly traded real estate

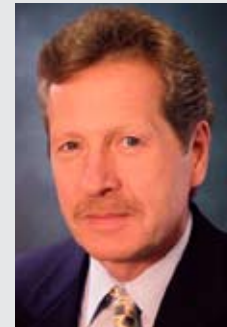
space for more than seven years. My partner Jay Rosenberg has more than seven years of experience in REITs, plus fixed-income background, and experience with a development company.

Overall, the philosophy is based on the belief that performance is equal to people plus process. It is a simple formula, but the difficult part is getting both pieces right. The goal is consistent outperformance versus the real estate indices but within the appropriate risk framework.

Q: What strategy and process do you follow for achieving this goal?

A: The portfolio has two distinct parts. The core holdings, which represent about 75% of the portfolio, are continuous holdings, where only the weights fluctuate depending on fundamental and technical factors. The remaining 25% of the portfolio consists of opportunistic holdings, or companies that present trading opportunities.

The core group exhibits compelling fundamentals based on long-term cash flow. We use the funds-from-operations (FFO) approach, which is the REIT metric for earnings. It defines the cash flow from operations and is calculated by adding depreciation and amortization expenses to earnings to get the true picture of the earnings. Our valuation takes into account the capital expenditures necessary to operate the real estate, or the true cost of running the business.



JOHN G. WENKER

is co-lead manager of the Real Estate Securities team, which invests primarily in equity real estate investment trusts. He is also lead manager of the real estate debt product, which invests primarily in commercial real estate

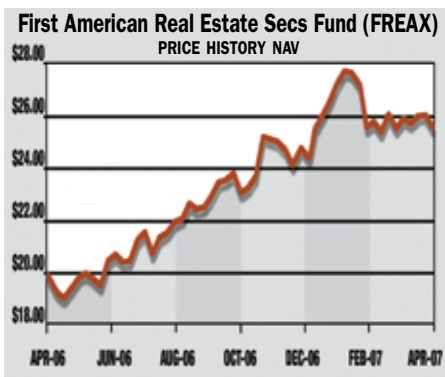
debt. He is responsible for the investment process and performance of the Real Estate Securities team. He is also a member of the firms' Asset Allocation Committee and Investment Strategy Committee. John began working in the financial industry in 1983 and became a portfolio manager in 1992. He joined the firm in 1992 as a managing director of the Fixed Income department. John has a B.A. in public administration from Metropolitan State University and an M.B.A. in finance from the University of St. Thomas.



JAY L. ROSENBERG

is co-lead manager of the Real Estate Securities product, which invests primarily in equity real estate investment trusts. He began working in the financial industry in 1995. Prior to joining

the firm in 2005, Jay was a vice president and real estate portfolio manager for Advantus Capital Management. He also served as a real estate fixed-income analyst for Sit Investment Advisors, a development manager for office and office/warehouse products for the Welsh Companies, and a land use planner at Siemon, Larsen & Marsh in Chicago. Jay received a B.S. from the University of Wisconsin—Madison and a Master's degree in urban planning and public policy from the University of Illinois, Chicago.



We estimate how companies grow value over time, which components are growing, and what is the time period for unlocking that value. We focus on assets, location, and management teams. We also focus on markets with high barriers to entry, which are, typically, the coastal markets. Among the most extreme examples are the offices in New York and Manhattan, where rents are pushing over \$100 a foot and vacancy rates are at 3% versus 15% around the country. In real estate, it is important to look for tight markets, where the supply is constrained and where the economic cycle favors the particular region.

In the opportunistic part of the portfolio, we look for attractive short-term valuations relative to the peers or historic measures. There also has to be an identifiable catalyst that can close the gap to fair value. That catalyst can be restructuring or an improvement of the portfolio or the leverage.

Q: What companies are included in your investment universe?

A: We start with approximately 200 stocks and that's a potentially broader universe

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than that of our peers. Through quantitative screens, we narrow down that universe to about 80 to 85 stocks. Then, through in-depth analysis, we build a portfolio of about 60 to 70 stocks.

In addition to the REITs, we also invest in operating companies, such as hotel managers and franchisers like Hilton, Starwood, and Marriott, as well as in healthcare facility operators. The facility operators have more leverage and are better positioned in the up part of the cycle. Typically, the owners have a set lease with the operators, so the operators can gain more of the upside. Our universe also includes real estate development companies, service companies that lease or sell space, and multi-property management firms like Jones Lang and CB Richards.

Q: Do you also consider housing companies?

A: Yes, but we haven't invested in homebuilders for two years because we feel that they got ahead of themselves. Also, we invest in the commercial mortgage REITs but we avoid the residential mortgage market because of the higher risk. Providing loans to people that have poor credit and aren't putting any dollars into the home is a prescription for trouble. I don't know why the developments in this market surprise anybody; it is common sense from a credit standpoint.

Q: What are the key elements of your research process?

A: It has three important aspects: economic research, quantitative and qualitative analysis. Although we are a bottom-up shop, we consider the economic research and the sub-sector property analysis very important for understanding the REIT space. The REITs represent a \$400 billion sector that is part of a \$3 trillion commercial real estate sector. You have to be very conscious of the opportunities for any given property type within the REIT space.

The quantitative screening takes into account about 40 variables that we can weight individually. The most important ones are the screens related to growth expectations,

earnings momentum, return on invested capital, and balance sheet strength. Then we value the non-income producing assets, such as land holdings, which have become more important over the past years.

The next step is making a judgment about the earnings quality. The REITs have become more involved in venture relationships and sales transactions, so we examine the companies through several different lenses. Should a dollar derived from a joint venture be valued in the same way as a dollar derived from organic growth? How repeatable is that? Our price targets are based on a couple of different metrics, including NAV, FFO after capital expenditure, and discounted cash flow. We don't stick to any specific type of analysis, but for a given company at a point of time, we decide on the most appropriate metric.

The third aspect of the process is the qualitative screening. We rank five different aspects in terms of quality to assign the franchise value. We rate the management team, the business plan, the geographic location, the quality of the properties, and the M&A potential. Our investments aren't driven by mergers and acquisitions, but it is wise to keep them on the radar screen, particularly since so many companies have been taken out in the REIT space in the last couple of years.

Q: Could you give us some specific examples that illustrate your research process?

A: Last year Jay Rosenberg found a company in the healthcare space called American Retirement Corporation, which was a very small-cap name. Jay found it through our proprietary screens and did a lot of work on the company. He got to know management and the portfolio, and we made a relatively big investment to this very small-cap name. Then Brookdale Senior Living bought out the company at a premium of about 33%, but we believed that it had even more room for growth. That was a company followed by only a couple of analysts and none of our peers owned it.

Another example is Kilroy Realty, a West coast office development company. The stock is a bit expensive because of the land holdings and the attractive markets in and north of San Diego. The company has been excellent over the years at making land purchases and moving forward with development as the market allows. We like the business plan and the management team in terms of execution and concern about investor capital. On the other hand, they get beat up often because they like to pay the top managers very well. Any time they come out with a new compensation plan, some investors sell off, but for us that's an opportunity.

The important point is that in addition to the screening process and the analysis, we also spend time in their headquarters, scrutinize their analysis of the markets, and investigate what other people say about them. Overall, the process is a combination of numbers, detective work, being on the ground and talking to people, looking at the properties, and understanding the sub-markets.

Q: What are the key elements of the portfolio construction process?

A: We don't make property sector bets and our portfolio is well-balanced across property types. Our goal is to pick the best companies within each property type. We do not place our bets according to the economics cycles. Instead, our strategy is to be invested in the best companies across the spectrum of property types. Since the best companies will always rise to the top, that's our way to drive long-term shareholder value.

In the open-end fund, we manage about \$1.1 billion assets to the MSCI U.S. REIT Index. But we also have separately managed accounts that use a variety of real estate indexes, and we target consistent outperformance to all of them.

Q: How do you make your sell decisions?

A: We are very active traders, particularly in the opportunistic part of the portfolio. We establish a specific price target for each


holding and we're not afraid to trade around it. Since the opportunistic holdings are meant to take advantage of valuation, once the catalyst is realized, we would reap the benefits and move on.

Regarding the core holdings, we sell mainly when we see problems on the qualitative side. If we don't feel good about a company, we wouldn't stick with it. Specific sell triggers are deterioration of the fundamentals versus the peer group, a change in the demand and supply outlook, failure of the management to consistently execute the business plans, and a valuation that is way out of track relative to the fundamentals or the peers.

Q: What's your view on risk management?

A: As a corporation, we have a risk management committee chaired by our Chief Investment Officer, which provides an additional layer of analysis and monitoring. Our quant group assesses the risk dynamics across all the portfolios and then we have quarterly meetings to discuss our bets, performance, and risks. The incentives also make sense from a risk management perspective - we get paid relative to our placement in the Lipper peer group and we're incentivized to be better than the average, yet not swing for the fences.

We monitor benchmark risk and review the quantitative factors versus the real estate industries. Then we look at our investment process, which we continuously try to refine. Based on how we did versus the benchmarks and the peers, we critically assess what we do right and what we do wrong.

Our asset attribution analysis shows that stock selection has always been the key for us. For example, in 2006 we outperformed the MSCI Index with 474 basis points but we had 508 basis points from stock selection and we lost 33 basis points from sector allocations. So the performance comes from stock selection that is spread across all the property types, and there is no outlier. The idea is to be diversified and to manage a balanced portfolio driven by stock selection. 

First American Real Estate Secs Fund

Symbol	FREAX
Website	www.firstamericanfunds.com
Address	FAF Advisors Inc, US Bancorp Center 800 Nicolet Mall Minneapolis, MN 55402
Tel. No.	800-677-3863
Inception	09/29/1995

PORTFOLIO	
Total Net Assets*	\$260.00
Avg Mkt Cap (\$ Weighted)*	\$10,054
Average Price/Earnings Ratio	35.9
Average Price/Book Ratio	3.23
Turnover Ratio	1.97%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$500

RISK (AGAINST S&P 500 - 3-YEARS)	
Alpha	1.41
Beta	1.02
R-Squared	0.29
Ann. Std Deviation	13.03
Sharpe Ratio	2.19

RETURNS VS. S&P 500 DAILY REINV INDEX		
	FREAX	Index
1 Year (Cum.)	25.58%	15.24%
3 Year (Ann.)	31.97%	12.25%
5 Year (Ann.)	23.80%	8.54%

RETURNS VS. S&P REIT COMP P INDEX		
	FREAX	Index
1 Year (Cum.)	25.58%	21.97%
3 Year (Ann.)	31.97%	23.29%
5 Year (Ann.)	23.80%	15.36%

FEES AND EXPENSES	
Max Sales Charge - Front	5.50%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee*	0.00%
Total Expense Ratio	1.23%

PORTFOLIO MANAGER	
John G. Wenker	1999
Jay L. Rosenberg	2005

*millions

Data through: 04/30/07

Source: Company Documents; Morningstar Direct

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