STRATEGY PAPER

Consider real estate as part of your wealth management strategy

Is your portfolio missing a crucial element?

Your disciplined investment strategy includes a well-diversified portfolio of the familiar asset classes: stocks, bonds and cash. Perhaps you also hold nontraditional investments such as long-short funds or maintain exposure to commodities. But have you considered the role that real estate investments could play in your portfolio?

Although diversification is a fundamental strategy, some investors overlook commercial real estate, an asset class that may offer diversification, attractive growth prospects and the potential for regular income. The category includes investment properties such as:

- Office buildings
- Retail
- Apartment buildings
- Industrial
- Ranches and farms
- Timberland
- Owner-occupied commercial properties

As you work toward your most important goals, you'll want to consider every strategy at your disposal. If your portfolio doesn't currently include commercial real estate, you may wish to consider if it is right for you, as well as the best way to pay for it.

Real estate conveys multiple benefits

Adding real estate investments to your personal balance sheet offers the potential to generate income and participate in capital appreciation. Other benefits of investing in real estate may include:

- **Cash flow.** Real estate investment can create stable cash flow for retirement and other needs.
- **Wealth transfer.** Typical ownership structures for commercial real estate are conducive to many of the most common wealth transfer strategies.
- **Diversification.**[1] Real estate has unique investment attributes and performance characteristics, including low or negative correlations to most major traditional asset classes (stocks, bonds and cash).
- **Inflation hedge.** Real estate may serve as a better long-term hedge against inflation than traditional asset classes such as equities and fixed income.


HOTEL


WAREHOUSE


OFFICE

Comparing direct real estate purchases to investing in REITs

To gain exposure to commercial real estate, you can invest privately through direct ownership, or publicly, through real estate investment trusts (REITS). REITs are companies that purchase or finance a portfolio of income-producing properties. Some of the advantages of owning a share in a REIT are that they are publicly traded, offer daily liquidity and pay regular dividends. Buying properties directly, though it results in a less liquid investment, may offer several potential advantages:

1. **Control.** Direct ownership offers opportunities to increase the value of a property, thus enhancing its investment performance. As a direct owner, you must manage the property, tenants, etc.
2. **Enhanced diversification.** Private commercial real estate has historically been less correlated with the equity and fixed income markets than REITs, which are financial vehicles.
3. **Tax treatment.** Private real estate investors may have opportunities to mitigate the impact of taxation on their investment in a way REIT holders do not.[2]

Consider your options for executing a commercial real estate strategy

If you and your advisors determine commercial real estate could enhance your portfolio, the next step will be deciding the best way to fund your purchases. Liquidating other investments to buy a property outright avoids an additional liability on your balance sheet, but it can have several negative consequences:

- Capital gains taxes when selling an appreciated asset
- Opportunity costs from being out of a market sector or security
- Reduced liquidity of your portfolio

Financing the acquisition of real estate rather than buying with cash on hand can help you avoid an important cause of wealth erosion: the liquidation of strongly performing assets to seize another investment opportunity. Just as it can magnify the return on stocks and other financial assets, leverage can also boost the total return on commercial real estate investments. (Note, however, that it can also increase the magnitude of any losses.) Secured financing has certain risks and obligations, including interest payments, covenants, potential of default and increase in the magnitude of any losses. Commercial markets can be cyclical and volatile.

Should you liquidate securities to buy commercial real estate?

This hypothetical example compares two ways to purchase the same $8 million income-producing property.

	Cash purchase	Financed purchase
Current value of diversified stock investment portfolio	$20,000,000	$20,000,000
Investment assets sold to purchase real estate[a]	$8,000,000	$2,000,000
Remaining diversified stock portfolio value after real estate purchase	**$12,000,000**	**$18,000,000**
Financed portion of real estate purchase[a]	$0	$6,000,000
Net operating income from real estate purchase over five years[b]	$3,048,000	$3,048,000
Interest expense from real estate financing over five years[c]	$0	$1,433,920
After-tax cash flow from real estate purchase over five years[d]	**$2,260,328**	**$1,328,280**
After-tax average annual cash flow yield on real estate	**5.7%**	**13.3%**
Value of diversified stock investment portfolio after five years[e]	$17,455,187	$26,182,780
Value of real estate after five years, net of financed amount[f]	$10,318,204	$5,012,857
Combined value of investment portfolio and real estate	$30,033,719	$32,523,918
Change from initial diversified stock-only investment portfolio value	**$10,033,719**	**$12,523,918**

This example is intended for hypothetical illustration only, and is not intended to be representative of the past or future performance of any particular investment.

Assumptions

[a] Twenty-five percent equity down payment or 75% loan to value for the financed purchase scenario.

[b] Using a long-term average capitalization rate of 7.62%.

[c] Five-year fixed-rate loan at 5.00%, amortized over 25 years using mortgage-style equal payment amortization.

[d] Assuming a 35% tax rate.

[e] Using the S&P 500® 40-year compounded annual growth rate of 7.78%, including appreciation and dividends.

[f] Using the Green Street 18-year commercial real estate prices compounded annual growth rate of 5.22%.

Borrowing against real estate produces potential tax advantages.[2] In addition to typical depreciation benefits associated with investor real estate, you may be able to deduct interest expense on a loan used to purchase an investment property. This can further enhance the after-tax returns on your real estate investment.

Advice, guidance and deep financing capabilities

Real estate financing should be tailored to your balance sheet, asset allocation, cash flow, tax considerations and general wealth-building objectives. A lender should be willing to create a credit strategy that effectively complements the other components of your wealth management plan.

Your credit strategy should take into account all aspects of your personal situation, including:

Asset class considerations

- Correlations with other asset types
- Income and appreciation characteristics
- Risk attributes
- Capital requirements
- Cash flow generation
- Appropriate diversification opportunities within the asset class

Investment considerations

- Portfolio diversification requirements
- Time horizon
- Risk tolerance
- Debt tolerance
- Tax situation
- Cash flow and appreciation objectives

In addition, your lender should have a sufficient capital base to fund sizable loans while offering competitive terms and interest rates. You may wish to work with a lender that has the capability and expertise to assist you with more than just facilitating the loan.

When considering financing and investment in commercial real estate, you and your Merrill advisor can access the experience of a credit executive at Bank of America. They will take the time to understand the goals you're working toward and will advise you about the role borrowing can play in getting you there and also discuss the risks associated with investing in commercial real estate.

The credit executives go beyond evaluating the potential cash flows of an investment property to assess your entire financial picture. They are committed to developing an optimal credit structure for your needs, with customized, flexible loan terms.

Bank of America has extensive expertise underwriting a wide variety of real estate property types. Because time may be a critical factor, our credit executives are local to the markets they serve to facilitate personal interaction and competitive turnaround times.

Note: Merrill advisors don't offer or provide recommendations regarding customized lending products from Bank of America, N.A. Your advisor will refer you to a Bank of America credit executive, who can work with you regarding options to address your credit needs.

Consider investing in real estate to diversify your wealth and meet your goals

Contact your Merrill advisor to learn more about how we can help you pursue your goals on your terms.

[1] Diversification does not ensure a profit or guarantee against loss. Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

[2] Neither Merrill nor any of its affiliates or financial advisors provide legal, tax or accounting advice. You should consult with your legal and/or tax advisors before making any financial decisions.

Please note that nonfinancial assets are not suitable for all investors. Nonfinancial assets, such as real estate, are complex in nature and involve risks including total loss of value. Special risk considerations include natural events (for example, earthquakes or fires), complex tax considerations and lack of liquidity.

Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties, such as rental defaults.

This material is designed to provide general information about ideas and strategies. It is for discussion purposes only, since the availability and effectiveness of any strategy are dependent upon your individual facts and circumstances.

Always consult with your independent attorney, tax advisor, and investment manager for final recommendations and before changing or implementing any financial, tax, or estate planning strategy.

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