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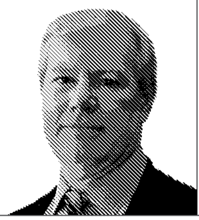
Another arrow in the quiver: DIVERSIFYING INCOME WITH REITs



Mark McAllister, CFA
Portfolio Manager

"While some investors appear fixated on the potentially negative impact of interest rate hikes, we think that REITs today represent very good long-term value."

- As investors turn to a wider range of asset classes for income, REITS may represent a valuable source of both yield and diversification.
- Over the last 20 years, dividend payouts have grown at rates that have consistently outpaced inflation and we expect this to continue.
- REITs turned in a very strong performance in 2014, but have struggled so far in 2015 with the MSCI U.S. REIT Index posting a 7.1% loss through the first eight months of the year.
- However, real estate market fundamentals remain in solid shape in our opinion. New development activity is moderate overall and investor demand for U.S. commercial real estate is robust.
- REIT balance sheets continue to be in excellent shape, with well-laddered debt maturities and plenty of liquidity.

SEP 2015

Taking aim at income

The scarcity of yield that continues to challenge investors has driven many toward new sources of income. Equity investments such as dividend-paying stocks and master limited partnerships[1] have attracted significant inflows despite a generally tepid economic environment.

As investors take aim at their particular investment targets, publicly listed REITs (Real Estate Investment Trusts)[2] represent another arrow in the quiver of potential income solutions. Dividends, of course, are the raison d'etre of the REIT — defined as a company whose primary business activity is the ownership or financing of real estate and which qualifies to make a special election under the federal tax code. As a REIT, most or all of the company's earnings are exempt from corporate income tax and, by law, it must distribute a minimum of 90% of its taxable income to shareholders in the form of dividends.

In today's low-rate environment, it's the strong potential of REITs to deliver income and income growth that continues to draw investors. The trailing dividend yield on the MSCI U.S. REIT Index (RMZ)[3] was 3.8% on December 31, 2014, 4.2% on June 30, 2015, and 4.3% as of the end of August.[4]

For the year to date through August 18, 2015, 77 REITs have announced dividend increases, and their average announced annualized increase over their ending 2014 dividends has been 13.9%.[5] This attractive yield profile, combined with REITs' relative lack of correlation to equity and bond returns, argues for the inclusion of REITs in an overall income strategy.

Allocations to real assets are a fixture of well-diversified model portfolios at both the individual and institutional level, and REITs provide an efficient, liquid and transparent vehicle for investors to access the commercial real estate market, which is estimated to be in excess of $15 trillion.[6]

REITs have a moderate correlation[7] to equity markets and a low correlation to bond markets, and a corresponding ability to enhance risk-adjusted portfolio returns.[8]

Within the real estate asset class, publicly listed REITs have much lower transaction costs, far greater liquidity and better financial transparency than investment vehicles such as real estate private equity funds, limited partnerships, private REITs and non-listed public REITs.

The rise of publicly traded REITs

Since their introduction in 1960, the historical trajectory of REITs has been toward greater transparency and acceptance by both institutional and individual investors.

Initially, federal legislation required REITs' ownership of real estate to be separate from their operational activities (e.g. acquisition, development, leasing and property management). This created an unfortunate bias among the private advisory companies that managed Equity REITs to focus on generating greater fee income, rather than expanding shareholder value.

The Tax Reform Act of 1986 removed this mandatory separation, paving the way for self-managed, self-advised REITs that were not prone to the conflicts of interest that bedeviled externally advised REITs. Until this change, the most popular method for individuals to invest in real estate was through limited partnerships. However, these partnerships often required investors to pay substantial front-end fees and management fees, and liquidity was limited since most partnerships were not publicly traded.

The watershed event in the growth of publicly traded REITs occurred in 1991 with the $128 million initial public offering of Kimco Realty Corp. A year later, Taubman Centers Inc. launched a $295 million IPO and introduced the Umbrella Partnership REIT, which allowed real estate companies to avoid triggering substantial tax penalties when converting from limited partnerships to publicly traded companies. Following these innovations, the market for publicly owned REITs gained momentum and the number of companies grew large enough to attract investments from institutional shareholders. Today, there are more than 150 publicly traded REITs, providing individual as well as institutional investors with diverse and highly liquid access to this unique asset class.

In recognition of the growth of the industry and real estate's distinct investment and operating characteristics, in November 2014 S&P Dow Jones Indices and MSCI Inc. announced that a new Real Estate sector was being added to the Global Industry Classification Standard (GICS) used to categorize publicly traded companies. Equity REITs and other non-REIT real estate companies will be moved from the Financials sector to the new Real Estate sector after the market close on August 31, 2016. This is the first new sector to be added to the GICS classification scheme since its inception in 1999. Mortgage REITs will remain within the Financials sector.

1 **Master limited partnerships** are a type of limited partnership which typically (though not always) are traded on public exchanges, and by law must derive at least 90% of their income from select sources (e.g. energy, natural resources or real estate) and pay out most of their cash flows as quarterly distributions to shareholders.

2 **Real Estate Investment Trusts (REITs)** invest in real estate or loans secured by real estate and issue shares in such investments, which can be illiquid.

3 The **MSCI US REIT Index** is a market capitalization weighted index comprised of equity Real Estate Investment Trusts ("REITs") that represents approximately 85% of the U.S. REIT universe. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

4 Source: Bloomberg

5 SNL Securities, Bloomberg, ClearBridge Investments.

6 Forbes, December 2014.

7 **Correlation** is a statistical measure of the relationship between two sets of data. When asset prices move together, they are described as positively correlated; when they move opposite to each other, the correlation is described as negative or inverse. If price movements have no relationship to each other, they are described as uncorrelated.

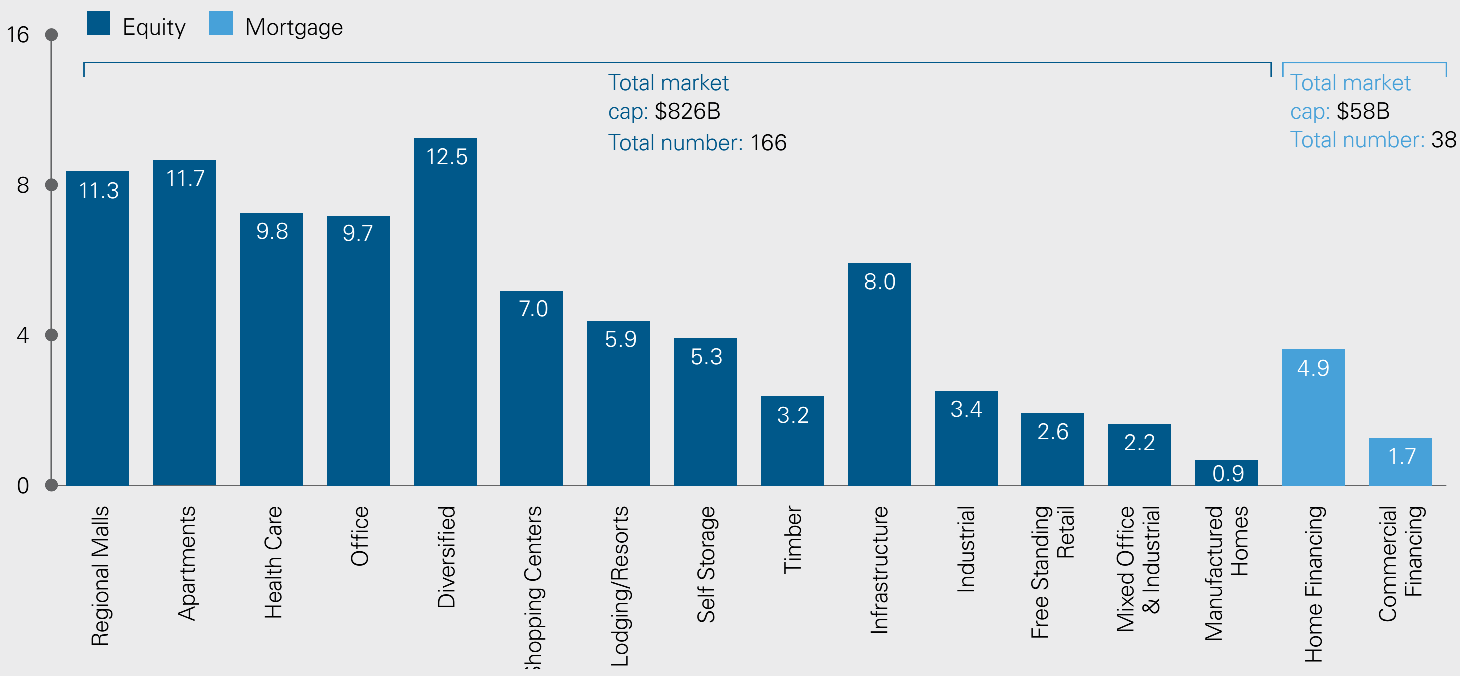
8 A **risk-adjusted return** is a measure of performance relative to its level of risk exposure over a given period of time.

TYPES OF REITs

Equity REITs primarily make equity investments in a wide variety of property types, including office buildings, regional malls, multifamily apartments, shopping centers, hotels, self-storage facilities, freestanding retail properties, health care facilities and warehouse/distribution facilities. This type of REIT dominates the market, accounting for the great majority of market capitalization.

The other category is Mortgage REITs, which include the Home Financing Mortgage REIT and Commercial Financing Mortgage REIT subsectors. The Home Mortgage subsector is primarily engaged in the financing of home mortgages through purchases of residential mortgage backed securities issued by government-sponsored entities such as Fannie Mae and Freddie Mac as well as other financial institutions. Commercial Financing Mortgage REITs engage in mortgage financing of commercial property investments.

REITs are a diverse asset class (%) REIT breakdown as of June 30, 2015



Source: NAREIT, based on FTSE NAREIT All REITs Index, June 30, 2015. An investor cannot invest directly in an index.

State of the market

U.S. real estate market fundamentals are continuing their recovery from the recessionary levels of 2008–09.

Occupancy rates and market rents are up across virtually all property types. Development activity continues to be relatively restrained, which is supportive of cash flow growth and valuations. Real estate financing markets are strong, and there is plentiful liquidity available for investments.

REIT company balance sheets remain healthy with regard to leverage and liquidity.

The 2008–2009 economic downturn left many REITs suffering as capital markets froze and companies scrambled to maintain liquidity. However, only one equity REIT was forced to seek bankruptcy protection and that was due to specific liquidity issues related to the company's debt structure.

Since then, many REITs have taken advantage of low interest rates to refinance outstanding debt on attractive terms and position themselves to seize potential investment opportunities. Others have strengthened their financial position through the issuance of additional common stock. The debt ratio of equity REITs (total industry debt as a percentage of its total debt and equity market capitalization) as of March 31, 2015 was 32.3%[9] — significantly lower than the 51% that prevailed at the end of second quarter 2008, prior to the "Great Recession" — and fixed charge coverage is a strong 4.1x.

The REIT sector is well capitalized today and ready to take advantage of acquisition and development opportunities as they present themselves. However, the investor demand for U.S. commercial real estate is very powerful, with institutional and non-institutional and domestic and international buyers quite active. While we think REITs will continue to make selected acquisitions, we also believe they will sell more assets than they have in the recent past to overly aggressive non-REIT buyers, and use the proceeds to fund accretive development pipelines and/or further reduce their financial leverage.

REITs returns have lagged year-to-date through the end of August with the MSCI U.S. REIT Index (RMZ) posting a -7.1% total return compared to -2.9% for the S&P 500 Index[10] and -2.6% for the Russell 3000 Index.[11] While REIT share prices appeared reasonably valued coming into 2015, investors seem concerned about the impact of a potential Fed Funds rate increase(s) on the group. We think this is misguided and we still see them as being priced at quite attractive valuations relative to their net asset values. While we believe that the cash flow multiples on U.S. commercial real estate assets are near their peak for this cycle, REIT net asset values should be driven higher primarily via strong leasing efforts and diligent expense controls abetted by accretive development activity and selected acquisitions.

Though not immune to the impact of an economic slowdown, REITs' earnings potential remains resilient.

Equity REIT revenues are primarily derived from recurring, contractual sources such as rents, rather than from sales transactions. This provides a stabilizing influence on the income potential REITs can offer investors. By actively managing REIT investments it may be possible to exploit differences in relative sector and company valuations, providing another lever of returns. Slower growth in the U.S. could result in decreased lending activity and a corresponding reduction in new commercial real estate development. If interest rates were to decline and prices languish, landlords would have an incentive to try to recapitalize properties they own and defer sales activity until pricing improves. In addition, cash flows would rise more slowly. Given the relatively strong state of many REITs' balance sheets (good to very good asset quality, good liquidity, moderate leverage with laddered maturities), we believe any reduction in prices has the potential to result in substantial acquisition activity.

Commercial real estate construction continues to be at moderate levels as a percentage of existing stock. However, construction financing is more accessible than it was earlier in the cycle, though developers do need to put up substantial equity to get projects financed. While the rate of supply growth may rise a bit in coming quarters, we do not see it derailing the ongoing real estate recovery.

[9] Source: July 2015 NAREIT REITWatch.

[10] Source: Bloomberg. The **S&P 500 Index** is an unmanaged index of common stock performance.

[11] Source: Bloomberg. The **Russell 3000 Index** is an unmanaged index of the 3,000 largest U.S. companies.

A distinct pattern of performance

Strong long-term returns: REITs have delivered strong returns over the past two decades, particularly since the end of the 2001–2002 economic downturn. While the 2008 financial crisis brought REIT returns down to the same level as those of equities, they have rebounded smartly since then.

Low correlation with traditional asset classes: With a relatively low correlation to bond market performance and a moderate correlation to equity market performance, REITs can offer a meaningful level of diversification against other investments as well as the potential to enhance risk-adjusted returns.

Growth of $1,000 for MSCI U.S. REIT, S&P 500 and Russell 3000 ($) December 31, 1994 through June 30, 2015

Source: Factset, as of 6/30/15. Data based on total return indexes. **Past performance is no guarantee of future results**. Investors cannot invest directly in an index.

Why do REITs exhibit this low level of correlation? Two reasons come to mind. First, REIT returns are substantially based on dividend distributions rooted in ongoing income streams from rents and mortgage payments. These streams tend to be fairly consistent amid economic shifts and offer the prospect of less volatility than provided by equities and a higher rate of return over time than fixed income. In addition, the underlying assets incorporate variables unique to real estate that may impact the stability of the valuations: property locations, proximity to transportation, and the like.

Inflation management: The commercial real estate business in general is characterized by several features that help support dividend growth that's historically surpassed inflation; the ability to generate regular increases in rental income through contractual increases embedded in leases; the recovery of operating expenses through pass-through clauses; and demand-driven pricing during economic expansion. With the exception of 2002 and 2009, REIT annual dividend growth has exceeded the Consumer Price Index[12] in every year from 1992 to 2014.

What's more, according to an analysis by NAREIT covering January 1978 through April 2014, equity REIT total returns equaled or exceeded the inflation rate in 67.9% of the 6-month periods when inflation was above average.[13]

Conclusion

Real assets represent an important source of diversification for investors, particularly given the persistence of the risk-on/risk-off trading patterns that continue to generate short-term volatility in both stock and bond valuations. Publicly traded REITs provide investors with a convenient means to access the real estate asset class marked by transparency as well as liquidity. Long term, the relative stability of REIT cash flows and their strong performance in inflationary periods supports a dedicated allocation to this asset class.

Perhaps even more important in today's low-yield environment, REITs also represent an intriguing potential source of current income as well as future income growth and capital appreciation — one that may be easily overlooked by investors who maintain a traditional focus on the bond markets for income. Given that many REITs are in excellent financial condition, are trading at attractive valuations, and are experiencing rising cash flows as well as select acquisition and development opportunities, they appear to be well-positioned to grow their future cash flows and distributions to shareholders.

Total return investment correlation (%) February 1989 through June 2015[14]

	FTSE NAREIT All Equity REITs	S&P 500	Russell 2000	Barclays U.S. Government/ Credit	Barclays U.S. Aggregate Corporate High Yield
FTSE NAREIT All Equity REITs (total return)	1.00	–	–	–	–
S&P 500 (total return)	0.55	1.00	–	–	–
Russell 2000 (total return)	0.64	0.81	1.00	–	–
Barclays U.S. Government/Credit	0.17	0.09	-0.01	1.00	–
Barclays U.S. Aggregate Credit Corporate High Yield (1983)	0.59	0.59	0.62	0.20	1.00

Source: Factset, as of June 30, 2015. Data based on total return indexes. **Past performance is no guarantee of future results.** Please note that an investor cannot invest directly in an index.

12 The **Consumer Price Index (CPI)** measures the average change in U.S. consumer prices over time in a fixed market basket of goods and services determined by the U.S. Bureau of Labor Statistics.

13 NAREIT proprietary analysis of data from Interactive Pricing Data, via FactSet.

14 The **FTSE NAREIT All Equity REIT Index** is a market capitalization weighted index that includes all tax qualified REITs listed in the NYSE, AMEX, and NASDAQ. The **Russell 2000 Index** is an unmanaged list of common stocks that is frequently used as a general performance measure of U.S. stocks of small and/or midsize companies. The **Barclays Government Bond Index** is a broad-based index of all public debt obligations of the U.S. government and its agencies that have an average maturity of roughly nine years. The **Barclays U.S. Corporate High-Yield Bond Index** is a broad-based universe of fixed-rate, noninvestment grade corporate debt.

Appendix: Understanding REIT valuations

Traditional measures of securities value (such as price/GAAP[15] earnings ratios for stocks or enterprise value/cash flow for corporations) do not work when valuing REITs. This is primarily due to the disconnect between GAAP standards for the depreciation of commercial real estate and the actual useful life of a commercial property, which tend to be far longer (in practice, 40 years or more). Two principal approaches to REIT valuation are:

Premium/Discount to Net Asset Value. This method uses estimates of the market value of tangible assets, less tangible liabilities, to calculate a REIT's intrinsic value. This measure keeps the company's valuation closely aligned to the underlying value of its primary assets. It also removes the distorting effect of leverage by netting it out of the company's value; after all, stocks can look cheap on an earnings basis because they are benefiting from using large amounts of low-cost debt, yet that debt introduces additional risks. Further, this method of valuation removes some of the accounting distortions inherent in other valuation methodologies.

Adjusted Funds from Operations (AFFO). This is analogous to estimating free cash flow from operations. Generally, it is calculated as Net income + Real Estate Depreciation +/– Other Non-Cash Income and Expense Adjustments — Recurring Capital Expenditures (e.g. costs required to keep the properties leased at their current level and in a good state of repair). The result is divided by the fully diluted shares outstanding and the per-share amount is divided by the share price to get the AFFO yield, which is akin to a cash flow yield. The strength of this method is that it incorporates estimated recurring capital expenditures and better reflects a company's ability to generate recurring cash flows.

Investment risks

The opinions and views expressed herein are those of the portfolio manager and may differ from those of other managers and are not intended to be relied upon as a prediction or forecast of actual future events or performance, or a guarantee of future results, or investment advice.

REITs are subject to illiquidity, credit and interest rate risks, as well as risks associated with small-and mid-cap investments.

Discussions of individual securities are not intended and should not be relied upon as the basis to buy, sell or hold any security. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies should consult their financial professional.

Equity securities are subject to price fluctuation.

Dividends and yields fluctuate and are subject to change.

Yields and dividends represent past performance and there is no guarantee they will continue to be paid. While dividends may cushion returns in down markets, investments are still subject to loss of principal amount invested.

Fixed income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Asset-backed, mortgage-backed or mortgage related securities are subject to prepayment and extension risks.

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[15] **GAAP (Generally Accepted Accounting Principles)** refers to the prevailing set of standards and procedures used by US accounting professionals in the preparation of corporate financial documents.

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