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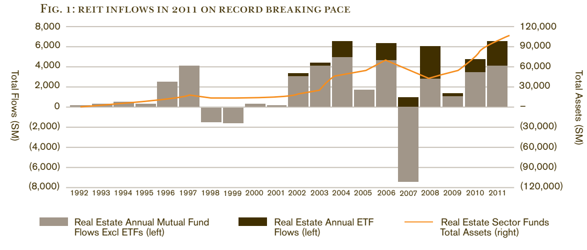
# Role of REITs in Investor Portfolios

*2nd Quarter 2011*

The month of June produced a -3.3% total return based on the MSCI REIT Index (RMS). Year to date, the index is up 10.3%, which compares favorably to the S&P 500 at +6.0%. After running up over 200% from the trough of the market in March 2009, REIT valuations appear stretched over the short term as pricing reflects high future growth in fundamentals. However, our view becomes much more positive longer term, as fundamentals will catch up to pricing and dividends are restored to pre-crisis payout levels. Equity REITs are well positioned to be major beneficiaries of the current recovery cycle underway in commercial real estate.

REITs could not be in the position they are in today without gaining acceptance as investment tool linked to economic conditions and portfolio risk diversification. Though there is still room for further penetration to become a 'must-have' investment no matter the location in the cycle or portfolio goals, the progress made in the last 20 years is nothing short of phenomenal. Since the start of the modern REIT era 20 years ago, the market capitalization of equity REITs has increased from $5.5 billion to $338.9 billion, as of December 31, 2010. With the additional equity raised year to date in 2011, coupled with appreciation, the market capitalization is nearing the $400 billion milestone. This suggests that the average equity REIT has a portfolio of income producing assets of about $6 billion. The popularity in this asset class can be seen in the growth of REIT mutual funds (Figure 1) that have experienced inflows of $4.5 billion year to date as of May 19, versus $3.5 billion in all of 2010. REIT ETFs have had inflows of another $2.4 billion. Although REIT indices are trading 33% below peak pricing, assets under management for REIT dedicated funds totals $101.4 billion, exceeding the peak of $87 billion from February 2007.

FIG. 1: REIT INFLOWS IN 2011 ON RECORD BREAKING PACE




The record inflows into the asset class validate the reasons that REITs have become an attractive investment. The principles that make REITs attractive are: 1) low correlation with bonds and equities lowers portfolio risk and increases total return; 2) returns are linked to economic (inflation) growth and value added by management; 3) increased predictability of returns due to dividend stream; and 4) diversification by geography, sector, property, and tenant.

**The Addition of REITs to a Traditional Investment Portfolio**

In addition to possessing now impossible-to-ignore size, REIT returns deserve investor's attention. REITs have outperformed the S&P 500 over the last 1, 3, 5, 7, 10, 15, and 20 year periods. As one would expect, adding a REIT allocation to a traditional 60% equities 40% bonds (60/40) portfolio over all of those periods increases the portfolio's overall return. However, the commensurate increase in risk is lower than the incremental increase in return. Therefore, the addition of REITs increases the risk-adjusted return (Sharpe Ratio) over the comparable period. Even though REITs by themselves have a higher volatility than the S&P 500, they have a low correlation with equities and bonds that stabilizes the portfolio. In fact, an investor adding a 10% allocation to REITs for any 10 consecutive years since the start of the modern REIT era in late 1990 through September 2008 experienced less risk and more return (see Figures 2 and 3).

FIG. 2: 10 YEAR ROLLING STANDARD DEVIATION OF PORTFOLIO WITH AND WITHOUT REITS

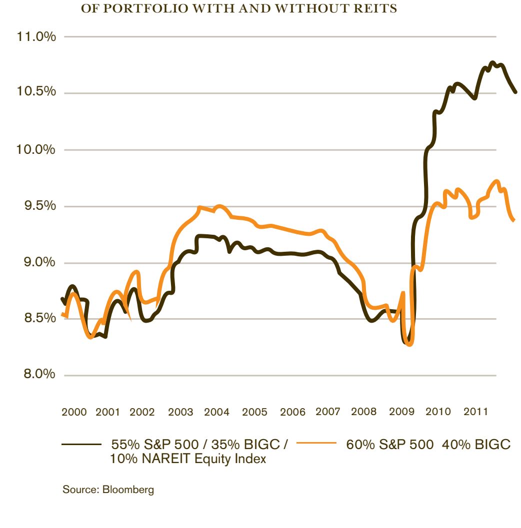
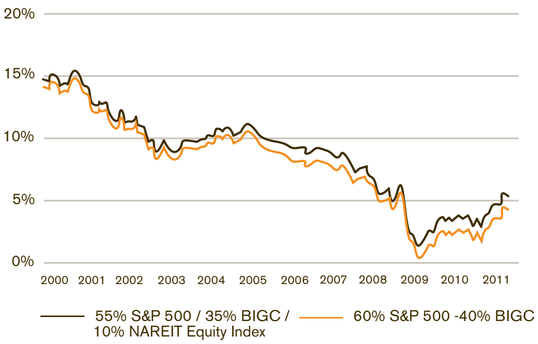


Fig. 3: 10 year rolling annualized returns of portfolio with and without REITs




Source: Bloomberg

Admittedly, the volatility of REITs spiked in recent years from the lower levels that persisted until 2008. We view the last three years as somewhat of an aberration due to all the financial dislocations that occurred. While volatility may never return to the low levels witnessed in the first 15 years of the modern REIT era, we certainly expect it to moderate to a more acceptable range to the benefit of REIT investors going forward. Even with the added volatility since the Lehman collapse and the 70% price drop from February 2007 to March 2009, the 10 year Sharpe ratio for a portfolio comprised of 10% REITs, 55% equities, and 35% bonds was 0.29, while a traditional 60/40 portfolio had a Sharpe ratio of 0.21 as of April 30. We would argue that REITs have held up well to a real world stress test!

**REIT Management Teams Have Proven Themselves as Capable**

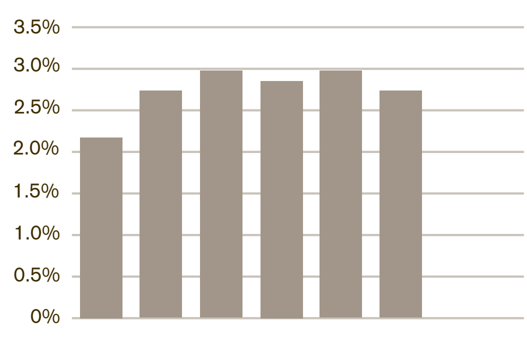
One of the reasons behind the stellar returns for REITs is the skill, experience, and instincts of REIT management. One only has to look at how successful the REITs have been in navigating through the financial turmoil since 2008 to grasp the significance of this point. In the peak years of the market in 2006 and 2007, public REITs were net sellers of real estate; when the transaction market came back in 2010, public REITs were the first buyers to begin snapping up properties at discounts to net asset value. Now, with the economy on a path to a slow recovery, the current conditions have ironically produced one of the best environments in the 50 years since the REIT legislation was passed by Congress. One of the main competitive advantages that is driving the fundamental growth for REITs is easy access to capital, both equity and debt. We thought conditions were good for the REITs in the early 1990s but overall circumstances are even better today all things considered. Since the bottom of the market in 2009, REITs have raised over $90 billion in equity and unsecured debt. To put that in perspective, the total market cap of all publicly traded REITs was $129 billion on February 28, 2009.

**REIT Performance is Linked to Economy**

An investment in equity REITs is not only a bet on the ability of management, but also a derivative of consumer spending, tenant credit quality, employment growth, and the inflation-propelled race between rents and borrowing and construction costs, amongst other things. When the economy is improving, higher spending leads to higher corporate profits, which leads to higher employment and need for rental space, thereby driving rent. In addition, REITs provide inflation protection in the form of increased rents from tenants and higher replacement costs for buildings. Last, the availability of capital has proven to increase demand for property and drive up values.

The link to the economy also can drag down REIT performance when property values decrease and/or demand for space is reduced. Uppermost on the minds of most REIT investors is the perceived vulnerability of stock prices to rising interest rates. The yield of the REIT index is about 3.4%, a level considerably below historical averages but still 30 basis points above the 10 year US Treasury Bond. To be fair, investors should give credit to the REITs for the low payout ratios that enhance predictability of future dividend growth. The first line of

Fig. 4: same store NOI growth projections 2011-2016

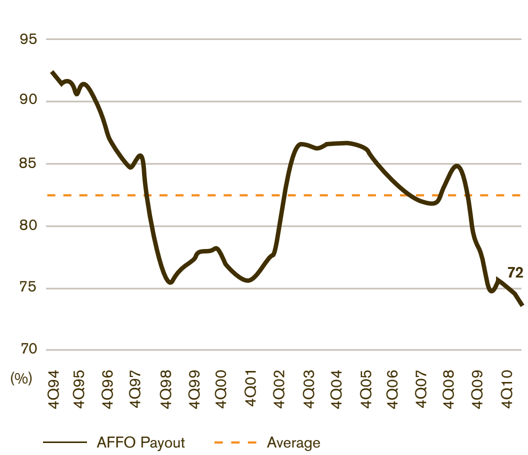



Source: Green Street Advisors

defense to rising rates will be the ability to increase dividends both from the growth in earnings, or same store NOI, (see Figure 4) and a modest increase in the payout ratio. Our analysis suggests that dividends should rise 40-50% over the next five years. Second, rising interest rates would normally indicate better economic growth, so the REITs could be beneficiaries of higher rent as leases turnover. Although an unexpected rise in rates would be negative for REITs over the short term, the inflation hedge that real estate provides protects the fundamentals and attracts investors after the initial shock. And, though cap rates have historically risen during times of increasing rates, REITs benefit from fixed rates on debt, higher rental revenue, and lower competition in the form of reduced new construction levels. In the two most recent periods of rising rates from June 2003 to June 2006 and from December 2008 to March 2010, REITs produced annualized returns over 25%. Third, the REITs have done a respectable job of laddering maturities of fixed rate debt well into the future. Fourth, the lack of new supply coupled with the inevitable inflation in building costs should inure to the benefit of property sectors once they achieve equilibrium between supply and demand. Above average rent increases are already being recorded by apartments, for example.

Another way that REITs are protected in a slowing economy is through diversification. We have often stated that one of the major differentiating characteristics of REIT investing is the diversification achieved by tenant, by property, and by geography. It is uncommon, for example, for a single tenant to represent more than 1% of revenues except for REITs specializing in net leases, such as the health care REITs. When this is coupled with the large number of properties within portfolios and the ability to tailor investor portfolios to the cities/regions exhibiting the best economic conditions, it stands to reason that cash inflows into dedicated REIT mutual funds are at a record pace in 2011.

Fig. 5: AFFO payout ratio at record low



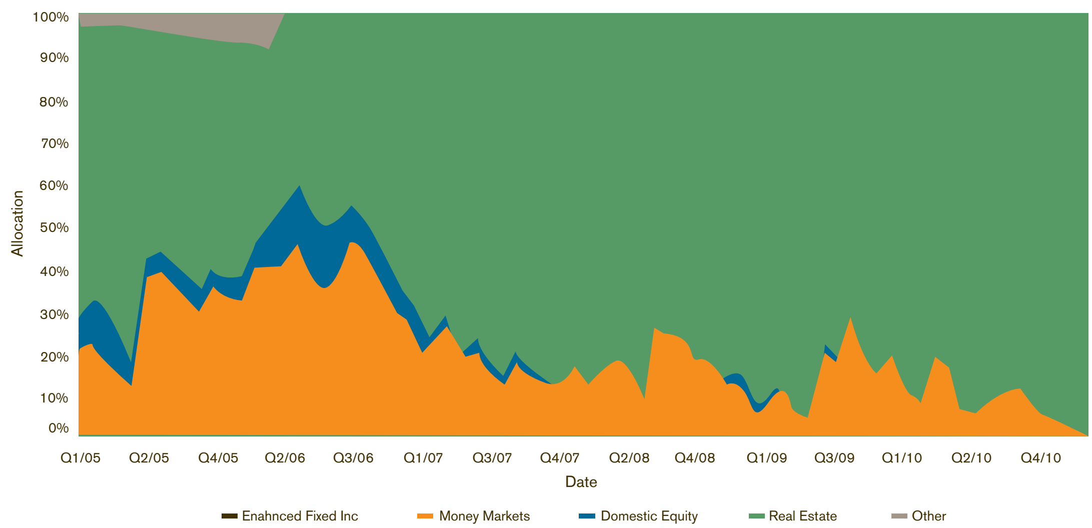

Source: Citi Investment Research & Analysis

Last, investors are attracted to dividends for many different reasons, but most often because of the current income, flexibility, and predictability of receiving cash distributions. Since 1972, two thirds of the total return of REITs has been explained by dividends. With payout ratios as a percent of Adjusted FFO (AFFO) at record lows, REITs have a lot of room to increase the dividend to get back to historical averages (see Figure 5). In fact, some REITs are going to be forced to increase the dividend to retain REIT classification because of the rule to pay out at least 90% of taxable income. Adjusted FFO, simply stated, is earnings before non-cash charges such as depreciation less dollars allocated for capital expenditures, tenant improvements, and leasing commissions and non-recurring items. As such it is often referred to as distributable cash flow by some REITs. Dividend growth rates over the last decade have outpaced inflation, and we expect this trend to continue for the next decade.

**Composite Update**

All of these attributes have not been lost by investors leaving few catalysts to support even higher valuations, which is why we have used cash in short term periods to manage downside volatility. In Figure 6, we demonstrate how we navigated through the past five years to produce sector leading performance. Observe the movement in the allocation to REIT investments in green first going down (money markets in orange going up) during the period leading up to the financial crisis and how, beginning in the fourth quarter of 2008, we began reinvesting back into the space and now are fully invested. In addition to assisting with cash allocation, we use a top down approach to come up with appropriate sector and geographic allocations. From there, we use a bottom up approach to generate a

Fig. 6: Jan 2005 - April 2011 Composite Asset Class Allocation Drift




Source: Black Diamond. Uses Composite Accounts as of 3.31.2011

portfolio of 20 to 25 REITs that will generate the best risk-adjusted return for our clients on a go-forward basis. After creating the initial portfolio for a client, we continue to focus on creating value for investors through relentless due diligence, constant economic data scrubbing, poignant questioning of management and sell side analysts, adherence to proprietary models, and controlling risk where appropriate through diversification and the use of cash. We appreciate your support through our transition to Chilton Capital and welcome any questions through our new contact information below.

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RMS: 1103 (6.30.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 993 (9.30.2008) and 1330 (2.7.2007)