Chilton
Capital
Management

1177 West Loop South, Suite 1310
Houston, Texas 77027

TELEPHONE: 713 650 1995
FACSIMILE: 713 650 1739
TOLL FREE: 800 919 1995

For further information,
direct inquiries to Christopher L. Knapp,
Chief Executive Officer

info@chiltoncapital.com
www.chiltoncapital.com

Equity REITs: An Essential Piece in a Diversified Portfolio | November 2014

October's outstanding performance by REITs should be a message to all who were not previously aware of how insulated they are to many typical equity risks. Rent is often the last cost to be cut by a tenant, which provides stability during times of economic stress. Movements in interest rates, European turmoil, and Ebola may cause temporary volatility in REIT prices, but the ability for the underlying rent-payers to write a check every month will be minimally affected. In the 54 years since the creation of the REIT structure, publicly traded equity REITs have proven themselves as an asset class that cannot be ignored in any investor's portfolio.

Equity REIT = Stock

Publicly traded equity REITs are primarily corporations designed to provide investors a total return consisting of dividends and capital appreciation through investment in income producing properties with the potential for appreciation. Dividends are paid from rental income generated from the underlying properties, while growth can come from various sources: increasing rents, increasing values of the underlying properties, or value creation through acquisition, development, and redevelopment.

The success and growth since the dawn of the Modern REIT Era in 1992 has been nothing short of staggering. Based upon the FTSE NAREIT Equity REIT Index data as of October 31, 2014, equity REITs have provided investors with annualized total returns of 19.2%, 8.9%, and 11.5% over the past 5, 10, and 20 year periods, respectively, well above the S&P 500. In 2001, Equity Office Properties (taken private by Blackstone in 2007) and Equity Residential (NYSE: EQR) were the first two REITs to be added to the S&P 500 Index. As of October 15, 2014, there were 20 REITs in the S&P 500 comprising 2.4% of the index. REITs are even more prevalent in other indices as shown in Figure 1. The market capitalization of all equity REITs was over $800 billion as of September 30, 2014, and the average daily trading volume was $4.2 billion in the month of August.

Figure 1: REITs in Common Equity Indices

Index Name	# REITs	% of Index
S&P 500	20	2.4%
S&P 400 Mid-cap*	30	9.8%
S&P 600 Small-cap*	35	8.7%
Russell 1000	64	3.1%
Russell 2000	89	7.6%
Russell 3000	153	3.5%

*Prior to move of Tanger (NYSE: SKT) on 10/17/14 from S&P 600 to S&P 400
Note: S&P 500 represented by SPY, S&P 400 represented by IVOO, S&P 600 represented by SLY, Russell 1000 represented by IWB, Russell 2000 represented by IWM, and Russell 3000 represented by IWV. Data as of 10/15/2014

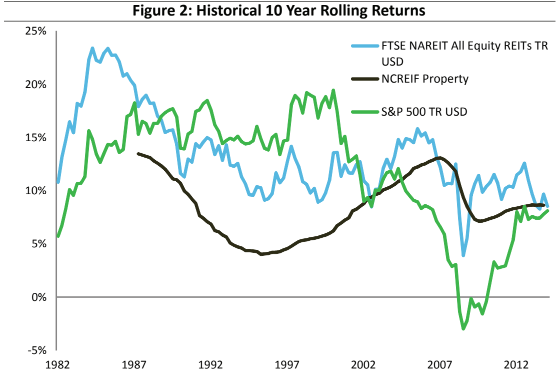
In November, MSCI and S&P Dow Jones Indices may announce that REITs will become the 11th GICS sector, finally separating them from financials. This would be the first change to the top level GICS sectors since they were contrived in 1999, thereby bringing into focus how underweight some strategies are to REITs. The accomplishment would be a celebration of the evolution of the publicly traded equity REIT into an investment that fills a need for all investors: safety, liquidity, and growth.

Store of Value

Though REITs' liquidity subjects them to trade at prices that can differ from the value of their underlying real estate, the real estate itself has most often increased in value over a full real estate cycle. Green Street Advisors has been calculating the unleveraged expected returns for investments in commercial real estate going back to 1986, which have stayed within a range of 6-12%. The typical real estate cycle is 7-10 years, and, impressively, the rolling 10 year returns for the NCREIF National Real Estate Index, an index that tracks US commercial real estate values, has averaged 8.4% since 1996, almost in the middle of Green Street's projections. Over the same period, the FTSE NAREIT All Equity REITs Index has averaged 10 year rolling returns of 11%, which makes sense as

REITs use leverage of 30-50%. Most importantly, as seen in Figure 2, the rolling 10 year total returns of neither real estate index ever dropped below 4% annualized since their respective inceptions. In comparison, the S&P 500 has had much more volatility in its 10 year rolling returns, even falling below zero for a few years.

Figure 2: Historical 10 Year Rolling Returns



Source: Chilton Capital Management LLC. Bloomberg. Data through 9/30/14. NCREIF data through 6/30/14.

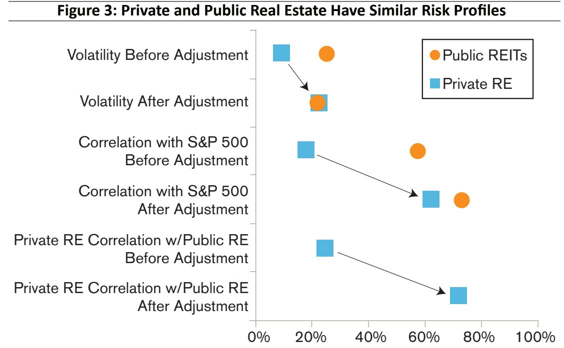
One observation that may stick out from Figure 2 is the smoothness of the NCREIF line compared to that of the NAREIT All Equity REIT Index. Some investors use those two lines to make the claim that private real estate is less risky than public real estate. They can also point to a lower correlation between the NCREIF and the S&P 500 to conclude that private real estate provides more diversification benefits than public REITs. Both conclusions are far from the full truth. Due to the periodic reporting for private real estate, lack of leverage in the index, and a lag in appraisals to reflect actual values, the volatility and correlation of private real estate are extremely understated. This point can be proved in several ways, but we have highlighted two below.

NAREIT made their apples-to-apples adjustment by creating the FTSE NAREIT PureProperty Index which backs out leverage from underlying public REIT performance. For the private real estate index, they use the NCREIF Transaction Based Index (or NBTI), which averages the change in price for commercial real estate transacted during a quarter. Because the NBTI only reports quarterly numbers, a comparison is made between the NAREIT PureProperty Index price on the final day of the quarter versus the prior quarter end. In the period from Jan 1, 2000, to June 30, 2014, the FTSE NAREIT PureProperty Index had a standard deviation of 10.6%, which compared to 10.7% for the NBTI. If an average of daily prices for the quarter were used for the FTSE NAREIT PureProperty Index (which is essentially what the NBTI does), the standard deviation would be below 9%!

"Due to the periodic reporting for private real estate, lack of leverage in the index, and a lag in appraisals to reflect actual values, the volatility and correlation of private real estate are extremely understated."

A study by PIMCO in 2011 makes the comparison by going the other direction. Instead of adjusting the public REITs to be on the same playing field as private real estate indices, the authors adjust the private real estate returns to be even with the public REITs. By adjusting the returns of the NCREIF Townsend Fund Index, an index that compiles returns for real estate private equity funds (classified by core, value, and opportunistic), for liquidity, equity risk, credit risk, and several other relevant risk factors, the authors conclude that public REITs (as measured by the Dow Jones US REIT Index) exhibited similar volatility to the Townsend Fund Indices from January 1989 to June 2011. Similarly, public REITs have only a slightly higher correlation to the S&P 500 due to their presence in the S&P 500. Finally, the adjustment shows that public REITs follow the performance of the underlying real estate, as the correlation between public REITs and private real estate rises from 20% to close to 80%. Therefore, an investment in public REITs should track the performance of its underlying assets while providing stock market liquidity and a sizable dividend stream.

Figure 3: Private and Public Real Estate Have Similar Risk Profiles



Source: PIMCO Solutions/Client Analytics. January 2012. "Modeling the Risk Characteristics of Real Estate Investments" by Niels Pedersen, Ph.D. Private RE is represented by the equal-weighted average of the Core, Value-Added, and Opportunistic NCREIF Townsend Fund Indices. Public REITs are represented by the DJ US REIT Index. Based on data from 1989-2011.

Old Reliable

Whereas tenants may come and go over a full cycle as trends change, landlords have the benefit of leasing to the next tenant in line, sacrificing very little cash flow and likely no long term value. Over the next 10 and 20 year periods, we can be almost sure that the values of the underlying properties will be worth more, not less, than they are today. Factoring in the annual rental (or dividend) income, it would be very difficult to imagine a scenario where an investor could lose money over a full cycle on a diversified portfolio of quality commercial real estate (or REITs) in today's market.

Figure 4 shows that only extreme scenarios produce a negative return over a 10 year cycle. Given Green Street Advisors' projections for 3.4% annualized NOI growth from 2015-2018, long term NOI growth of 1.5% annually, and a current implied cap rate of 6%, returns on the underlying real estate of REITs should be comfortably in the mid to high single digits over the next full cycle, with a lot of room for error.

Figure 4: 10 Year IRR Assuming Entrance Cap Rate of 6%

NOI Growth	Exit Cap Rate						
	4.5%	**5.0%**	**5.5%**	**6.0%**	**6.5%**	**7.0%**	**7.5%**
-6.0%	2.0%	0.9%	0.0%	-0.8%	-1.6%	-2.2%	-2.9%
-4.5%	3.7%	2.6%	1.7%	0.9%	0.1%	-0.6%	-1.3%
-3.0%	5.4%	4.3%	3.4%	2.5%	1.8%	1.1%	0.4%
-1.5%	7.1%	6.1%	5.1%	4.3%	3.5%	2.8%	2.1%
0.0%	8.9%	7.8%	6.9%	6.0%	5.2%	4.5%	3.8%
1.5%	10.7%	9.6%	8.7%	7.8%	7.0%	6.2%	5.5%
3.0%	12.6%	11.5%	10.5%	9.6%	8.8%	8.0%	7.3%
4.5%	14.5%	13.3%	12.3%	11.4%	10.6%	9.8%	9.1%
6.0%	16.4%	15.2%	14.2%	13.3%	12.5%	11.7%	11.0%

Source: Chilton Capital Management LLC.

Built to Last

Because public REITs have an infinite life, they have to focus on the exit cap rate on their properties, not just the annual yield. As such, they tend to have a high quality bias. REIT properties are heavily concentrated in the largest cities of the United States where the job growth is most prolific. For example, equity REITs are in the top 10 list of office building owners in New York City with over 75 million square feet of leasable area. Upon visiting a REIT property, one will usually find that the REITs own the highest quality assets judging by location, upkeep, architecture, and construction quality. In addition, public REITs have been industry leaders in sustainability initiatives as they strive to distinguish their properties from competition while driving the bottom line at the same time.

Wide Moat

One of the key features of a high quality location is the inability to duplicate the product. Increasingly, we are seeing powerful restrictions on new supply. Examples include: a limit to office building construction to 875,000 square feet per year in San Francisco; in Los Angeles, developers are typically unable to get permits to build office buildings unless the parking ratio is 2 or less per 1,000 sqft where the normal tenant requirement is 4 per 1,000 sqft; new cell phone towers are increasingly restricted by cities due to the familiar 'not in my back yard' (or NIMBY) outcry from citizens. Rising land costs and heightened requirements such as pre-leasing conditions from capital sources are helping to keep a lid on new construction as well.

Another aspect of portfolio quality that is gaining importance is the growing trend of transit oriented 'live, work, play' developments that are favored by the millennial generation. The equity REITs have been leaders in this type of development, both in urban and suburban locations. We have long favored commercial real estate in cities where the above-mentioned traditional barriers to new supply exist; but we also see favorable supply and demand dynamics where limited land availability and tough entitlement processes are restrictive. Going forward, it is easy to predict that mixed use projects will provide a competitive advantage to REIT landlords for a long time.

Public REITs in Our Lives

Possibly without knowing it, everyone who reads this publication has likely had their lives touched by a public REIT. Going to the local grocery store, working in an office building, ordering something online, using a smart phone, going to the hospital or doctor, shopping at a mall, staying at a hotel, renting a storage unit, or living in an apartment, student housing facility, or even retirement home, are all things that the average American will do at some point in their lives. In many large US cities, there is potential for someone to do all of the above via a REIT-owned property.

Let's meet Reita, for example. She is a married 50 year old living with her husband in the West University submarket of Houston, Texas. She has two children, one who is in college at UT-Austin, and the other living and working in Houston. Her husband works at nearby Greenway Plaza, a 4.4 million sqft office park owned by Cousins (NYSE: CUZ), while she has taken up working part time at Phoenix Tower, a class A office building owned by Parkway Properties (NYSE: PKY). The three closest and highest quality grocers are on properties owned by Regency Centers (NYSE: REG) and AmREIT (NYSE: AMRE), while her favorite restaurant is located in River Oaks Shopping Center owned by Weingarten Realty (NYSE: WRI). She likes shopping at the Galleria owned by Simon Property Group (NYSE: SPG), but sometimes avoids the hassle by shopping online. With 4 of the top 5 industrial warehouse owners in Houston being REITs, chances are that her product passed through a REIT warehouse. Also, whether she shopped online or from her smart phone, her data most likely used a REIT-owned data center and/or cell tower; over half of the country's cell towers are owned by REITs. Her son at UT-Austin lives at the new Callaway House, owned by American Campus Communities (NYSE: ACC), while her older daughter lives just close enough to home at the Camden Greenway (NYSE: CPT). She uses a REIT-owned storage facility to keep her son's things while he's at college, as six out of the eleven closest self storage facilities are either owned or managed by REITs.

All Weather Investments

Importantly, Reita could not function in her everyday life without REIT properties. By focusing on the highest quality, most necessary properties in the best locations, public REITs provide investors a predictable and safe income stream, while also employing their expertise to create value through appreciation. As such, REITs are an 'all-weather' investment that should be in all portfolios, all the time. Investors have the ability to choose 151 equity REITs that specialize in fifteen different property types and various regions, which allows an active management strategy to rotate into the most attractive areas throughout the cycle.

Combining the high quality nature of current REIT portfolios with the lowest risk balance sheets and most conservative payout ratios in REIT history, it is clear that the long term risk of investing in REITs has never been so low. With new construction still below the obsolescence rate and positive, albeit slow, demand growth, institutional investors across the world are adding to the US commercial real estate allocations. CalPERS, the second-largest pension fund in the country, announced in October its plans to add $7 billion to the sector, while Norges Bank, the world's largest sovereign wealth fund, plans to invest $10 billion per year for the next three years. Though most of their investments will be through direct ownership, public REITs have proven that they are able to produce a risk-return profile that is as good or better than direct ownership, while maintaining the same liquidity as the stock market.

Matthew R. Werner, CFA
mwerner@chiltoncapital.com
(713) 243-3234

Bruce G. Garrison, CFA
bgarrison@chiltoncapital.com
(713) 243-3233

Blane T. Cheatham
bcheatham@chiltoncapital.com
(713) 243-3266

RMS: 1645 (10.31.2014) vs. 1312 (12.31.2013) vs. 346 (3.6.2009) and 1330 (2.7.2007)

Please feel free to forward this publication to interested parties and make introductions where appropriate.

Previous editions of the Chilton Capital REIT Outlook are available at www.chiltoncapital.com/reit-outlook.html.