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GICS Change Validates the Investment Merits of REITs | May 2016

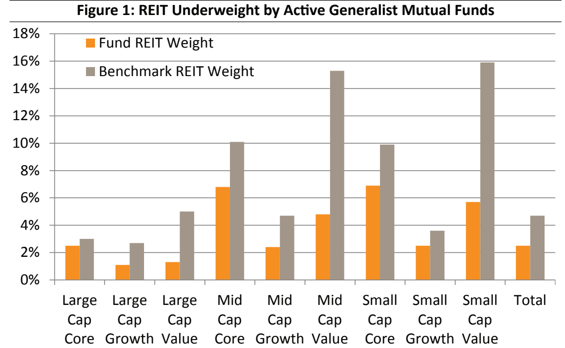
In 1999, the Global Industry Classification Standard, or GICS, was created in tandem by MSCI and Standard & Poor's to provide a consistent classification system for companies across the world. Today, GICS is the leading classification system for stock exchange listed equities worldwide and is used as the basis for all S&P Dow Jones and MSCI market indexes. On August 31st of this year, S&P Dow Jones and MSCI will reclassify all listed equity REITs and Real Estate Management and Development companies into their own sector. Called the 'Real Estate Sector', it will be the first new sector created since the development of the framework in 1999. Prior to the creation of the sector, equity REITs have been included in the Financials sector, which has somewhat obfuscated investment merits that would've otherwise gained broader attention.

The separation of equity REITs from Financials is a positive affirmation of stellar historical performance, the recognition of a unique set of investment characteristics, and an appreciation of the positive trajectory for the industry, both by market capitalization and among institutional investor portfolios. The creation of an 11th sector is likely to draw new investors to the space that may have historically ignored it being tucked in with Financials, while also disassociating REITs with some of the risks that apply only to Financials. While it's difficult to predict by how much and when REITs will benefit, the decision by S&P Dow Jones and MSCI is yet another catalyst that supports our long term positive outlook.

Under-Owned Sector by Professional Sector-Pickers

GICS weightings are an important factor for investment research, product / fund development, media coverage, and investment strategies. The continued increase in the profile of REITs should assist additional capital in finding its way to the asset class as investors seek to gain or add exposure. As REITs have historically been part of the financial sector, investment managers and other institutions could allocate to insurance companies, banks, or REITs (both mortgage and equity) to achieve the desired sector weighting. Going forward, managers and institutions will have to invest specifically in REITs if they would like to be inline with the index weight.

Figure 1: REIT Underweight by Active Generalist Mutual Funds



Source: Factset, Morningstar. As of 3/29/2016

Historically, active equity managers have underutilized REITs for their exposure to Financials. As shown in **Figure 1**, as of March 29, 2016, active equity managers were about 50% underweight to REITs as compared to their respective benchmarks. Though we can't claim to know the reason for each manager's decision to underweight the sector, we do know that the separation from Financials will require managers to at least address their relative weighting which could result in additional flows.

In fact, mutual fund managers would have to purchase over $100 billion in REITs just to get to equalweight with their respective benchmarks. JPMorgan assumes that separately managed accounts (which are not reported to Morningstar) would have to similarly purchase about $25-50 billion to get to equalweight. In

Figure 2: Historical Sector Total Return Ranking

Rank	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2000-2015 Average Rank	2000-2015 Average Return
1	Utilities	**REITs**	**REITs**	Info Tech	**REITs**	Energy	Telecom	Energy	Cons Stap	Info Tech	**REITs**	Utilities	**Financials**	Cons Des	**REITs**	Cons Des	**REITs**	**REITs**
2	Healthcare	Materials	Cons Stap	Materials	Energy	Utilities	**REITs**	Materials	Healthcare	Materials	Cons Des	Cons Stap	Cons Des	Healthcare	Utilities	Healthcare	Cons Des	Utilities
3	**REITs**	Cons Des	Materials	Cons Des	Utilities	**REITs**	Energy	Utilities	Utilities	Cons Des	Industrials	Healthcare	Telecom	Industrials	Healthcare	Cons Stap	Healthcare	Healthcare
4	**Financials**	Industrials	Energy	**REITs**	Telecom	Healthcare	Utilities	Info Tech	Telecom	**REITs**	Materials	**REITs**	**REITs**	**Financials**	Info Tech	Info Tech	Cons Stap	Energy
5	Cons Stap	Cons Stap	**Financials**	Industrials	Industrials	**Financials**	**Financials**	Cons Stap	Cons Des	**S&P 500**	Energy	Telecom	Healthcare	**S&P 500**	Cons Stap	Telecom	Utilities	Cons Stap
6	Energy	**Financials**	Healthcare	**Financials**	Cons Des	**S&P 500**	Cons Des	Industrials	Energy	Industrials	Telecom	Cons Des	**S&P 500**	Info Tech	**Financials**	**REITs**	Energy	Cons Des
7	Industrials	Energy	**S&P 500**	**S&P 500**	Materials	Materials	Materials	Telecom	**S&P 500**	Healthcare	**S&P 500**	Energy	Industrials	Cons Stap	**S&P 500**	**S&P 500**	Materials	Materials
8	**S&P 500**	**S&P 500**	Cons Des	Utilities	**Financials**	Cons Stap	**S&P 500**	Healthcare	**REITs**	**Financials**	Cons Stap	Info Tech	Info Tech	Materials	Industrials	**Financials**	Industrials	Industrials
9	Materials	Healthcare	Industrials	Energy	**S&P 500**	Industrials	Cons Stap	**S&P 500**	Industrials	Cons Stap	**Financials**	**S&P 500**	Materials	Energy	Cons Des	Industrials	**Financials**	**S&P 500**
10	Cons Des	Telecom	Utilities	Healthcare	Cons Stap	Info Tech	Industrials	Cons Des	Info Tech	Energy	Info Tech	Industrials	Cons Stap	Utilities	Materials	Utilities	**S&P 500**	**Financials**
11	Telecom	Info Tech	Telecom	Cons Stap	Info Tech	Telecom	Info Tech	**REITs**	Materials	Utilities	Utilities	Materials	Energy	Telecom	Telecom	Materials	Info Tech	Info Tech
12	Info Tech	Utilities	Info Tech	Telecom	Healthcare	Cons Des	Healthcare	**Financials**	**Financials**	Telecom	Healthcare	**Financials**	Utilities	**REITs**	Energy	Energy	Telecom	Telecom

Source: Bloomberg. Sector Returns represented by S&P 500 Sector Indexes, except REIT returns which are represented by the MSCI US REIT Index (Bloomberg: RMS G)

total, the $125-150 billion in potential flows compares to $846 billion of equity market capitalization for the FTSE NAREIT All Equity REITs Index (Bloomberg: FNER) as of February 29, 2016.

The Re-Introduction of REITs

Figure 1 shows the prominence of REITs within the broad equity indexes, which makes it surprising that they are so often ignored. Some of the reasons we have heard are: 1) REITs perennially appear expensive relative to other equities, 2) the nomenclature and valuation metrics are different than all other sectors, and the time to become familiar with the sector can be a deterrent, 3) REITs are beholden to the capital markets, both debt and equity, due to the distribution requirement. While we can understand these surface-level observations, these managers have forgone a deeper look at the sector at their own peril: equity REITs, as measured by the MSCI US REIT Index (Bloomberg: RMZ), have outperformed the S&P 500 in 13 of the past 16 years, and outperformed the S&P 500 Financial Sector Index (Bloomberg: S5FINL) in 14 of the past 16 years (see Figure 2 for year by year rankings).

With the weight above many popular sectors such as Telecom, Materials, and Utilities, we are hearing anecdotal evidence that generalist managers are increasing their due diligence on Real Estate to get in front of the change. Hopefully, this process will refute some of the surface-level prejudice that has resulted in the current underweight to REITs. Namely, that REITs should trade at a more expensive multiple than the average S&P 500 company with similar growth given the higher predictability of future revenues via the contractual nature of leases.

In addition, the use of multiples to value REITs is not the most accurate measure of intrinsic value. Due to the availability of private market valuation data, the use of Net Asset Value, or NAV, has been a better predictor of REIT pricing. As shown in our June 2015 REIT Outlook titled "Multiple Problems with Claims that REITs are Expensive", public REITs have traded at approximately a 1% average premium to their NAVs since 1995 according to Bank of America Merrill Lynch research. In contrast, using historical multiples for REITs today does not account for property type, location, quality, or management prowess.

We concede that traditional GAAP accounting is essentially useless for REITs, and it requires time (or hiring a 'REIT-dedicated' portfolio manager) to understand new metrics such as FFO (Funds from Operations), AFFO (Adjusted FFO), implied cap rate, and NAV. However, NAREIT (National Association of REITs), the trade association for REITs, and the REITs themselves produce data via quarterly "supplementals" that is more than sufficient to decipher company and industry fundamentals. In fact, we would argue that REIT disclosures rank near the top of all sectors, making them extremely transparent to investors. Upon spending the time to understand some of these new metrics, we believe that market participants will determine that REITs are *less* complex than the average company, and FFO estimates, dividend forecasts, and valuations are *more* accurate.

Finally, a cursory review of the REIT rules brings to light the mandate for REITs to pay out 90% of taxable net income as dividends. This rule has generated the misperception that REITs have no capital leftover each year after paying dividends, and must therefore rely on the capital markets for growth. The operable phrase is *taxable net income*, which is a GAAP term. Due to the GAAP rule to expense depreciation (a non-cash charge) of fixed assets (excluding land), REIT net income is much lower than its cash flow, the principal metric used by real estate investors worldwide.

While we assume most REITs pay out 100% or more of taxable net income, REITs are currently only paying out 72% of AFFO as dividends. AFFO is the most conservative measure of

REIT cash flow and is derived by subtracting from FFO non-cash GAAP revenues such as straight line rent and maintenance capital expenditures. Therefore, they are retaining 28% of every dollar to reinvest in the company. This free cash flow is a source of internal growth since it can be used for development, redevelopment, acquisitions, share buybacks, or paying down debt. Additionally, REIT leverage is near an all-time low at only 30% of gross asset value, and weighted average debt maturity is near an all-time high, which means that REITs today are the least beholden to the capital markets in their 55 year history. Regardless of the mechanics that REITs use for funding growth, we would point to the historical total returns in **Figure 2** as evidence that REIT management teams have not been restricted by the dividend requirement.

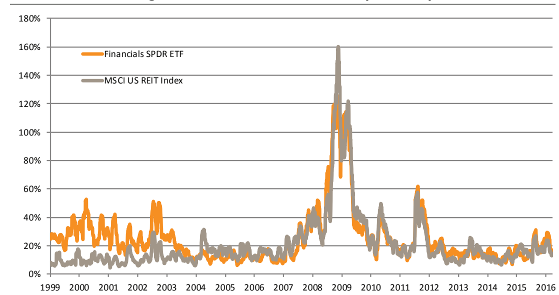
REIT Reactions

While we can't guarantee that the creation of a new GICS sector for REITs will result in higher allocations from generalist managers, we feel confident that the sheer size of the sector will force them to take a deeper look. For example, Real Estate will be the 2nd largest GICS sector in the Russell 2000 Value and the Russell MidCap Value Indexes. At a minimum, passive investors that mimic index exposure through ETFs will have to add to the new sector to maintain exposure. In addition to garnering more attention and capital flows, the creation of a new GICS sector for Real Estate should diversify the investor base, spawn new investment products, and could lower volatility.

As of December 31, 2015, over 700 generalist mutual funds representing over $1 trillion in assets had exactly zero allocation to REITs. Even if such managers should choose to remain underweight to the sector, we believe that the new sector will draw in many new entrants so that they could show at least *some* exposure. The expansion of the breadth of the investor base will be important for maintaining the positive trajectory of the sector for years to come.

The S&P will launch two new indices that will split Financials and Real Estate, alongside the original S&P Financials Select Sector. To track the new GICS sector, State Street Global Advisors ("SSGA") will also create two new ETFs. We would also expect that other ETF managers will follow suit. An initial concern was that REITs would come under some short term selling pressure due to the re-balancing of portfolios by Financials ETFs and dedicated Financials funds. In October 2015, S&P announced that the S&P Financials Select Sector Index, of which many ETFs track, will remain unchanged and unadjusted. In response to the announcement, SSGA, the manager of XLF – the world's largest Financials ETF – announced that all REITs in the S&P 500 will remain in the ETF as is. While investors could migrate to the newly formed ETFs over time, the concern over the potential volatility at the outset of the change has been alleviated.

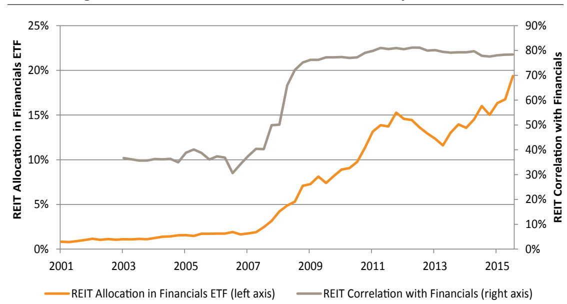
Figure 3: REIT and Financials 30 Day Volatility



Source: Bloomberg. 30 day volatility from 2/1/1999-4/26/2016

Finally, the inclusion with Financials sector has subjected REITs to elevated volatility due to investors using Financials ETFs to express views on the non-REIT Financial companies, which have very different drivers of earnings and valuation. **Figures 3 and 4** show the historical correlation of REITs with Financials, while also showing the volatility of each. Despite occupying less than 1% of the S&P 500 in 2007, REITs were over 2% of the Financials ETFs, which had become popular trading vehicles.

Figure 4: REIT Correlation with Financials Driven by Financial ETFs



Source: Bloomberg. Correlation uses MSCI US REIT Index and S&P 500 Financial Sector Index monthly values. REIT allocation in Financial ETFs uses iShares Financials ETF (IYF) from 9/30/01-6/30/09, and SPDR Financial ETF (XLF) from 9/30/09-3/31/16

Most notably, the non-REIT Financial companies were the subject of extreme speculation during the Great Recession. At a time when banks were failing at a historic rate and we witnessed the collapse of Lehman Brothers, Bear Sterns, Countrywide, Wachovia, Washington Mutual, and anything else tied to mortgage-backed securities, there was only one REIT bankruptcy. REIT cash flows and values did experience a decline, but REITs had nowhere near the leverage employed by the banks, and obviously had much more durable earnings.

Financial ETF ownership of REITs was far more as a percent of REIT market capitalization than it was for non-REIT Financials. As such, REITs actually underperformed non-REIT Financials in 2008, one of only two such calendar years since 2000. We believe the separation of REITs from Financials will allow REITs to trade more on their own fundamentals and investment merits, rather than speculation on non-REIT Financial companies. Given the more predictable nature of future cash flows and high transparency of the values of their underlying properties, we would hope that REIT volatility will return to the pre-ETF days when it was lower than that of traditional equities.

Just the Beginning

The reality is that no one can say for sure how much incremental buying of REITs will occur as a result of the change. It's possible that some funds have already begun to buy in an effort to get in front of the upcoming change. Any projections (we've seen $0-150 billion) are just that: projections. The only thing we can postulate with certainty is the raised profile of the asset class, which *could* bring in an incremental $150 billion (or more!), but over a long period of time.

Considering the GICS change is occurring in the same 12 months that Congress agreed to relax the Foreign Investment in Real Property Tax Act (or FIRPTA), the case for a long term secular shift toward REITs is quite compelling. Prior to December 2015, foreign pension funds were subject to withholding tax on commercial real estate investments, and had restrictions on maximum ownership of a REIT. Following a bill signed by Congress in December, the withholding tax has been waived, and foreign entities may now own up to 10% of a REIT, versus only 5% prior.

Finally, we also would like to point out that most of the developed world is in a low interest rate environment, which had begun a quest for yield. While we hesitate to make direct comparisons of REITs with interest rates, it does seem that fixed income will occupy a diminished role in portfolios for the foreseeable future. Commercial real estate stands ready to fill the void by providing a combination of growth and income that has produced total returns consistently above stocks and bonds.

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RMS: 1819 (4.30.2016) vs. 1753 (12.31.2015) vs. 346 (3.6.2009) and 1330 (2.7.2007)

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