U.S. REIT MARKET UPDATE | Q3 2018

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U.S. MARKET OVERVIEW

TOTAL RETURNS OF INDEX	THIRD QUARTER 2018	NINE MONTHS 2018	FULL YEAR 2017	FULL YEAR 2016	FULL YEAR 2015
MSCI US REIT Index	**1.09%**	**2.30%**	**5.07%**	**8.60%**	**2.52%**
Nasdaq Composite	7.41%	17.48%	29.64%	8.87%	6.96%
Russell 2000	3.58%	11.51%	14.65%	21.31%	-4.41%
S&P 500	7.71%	10.56%	21.83%	11.96%	1.38%
Dow Jones	9.63%	8.83%	28.11%	16.50%	0.21%
Dow Jones Utilities	2.10%	2.23%	13.35%	18.18%	-3.06%
Barclays US Govt/Credit Bond Index	0.06%	-1.85%	4.00%	3.05%	0.15%

Source: Bloomberg

MARKET COMMENTARY

The U.S. REIT market, as measured by the MSCI US REIT Index, generated a positive total return of just 1% in the third quarter of 2018. While this return did consolidate and add slightly to the 10% return enjoyed in the prior three-month period, it was well short of broader equity market returns in the third quarter and just somewhat ahead of the Barclays U.S. Government/ Credit Bond Index which was essentially flat. On a year-to-date basis, as reflected in the table above, REITs were up 2.3%, in line with Utilities and over 400 basis points ahead of the broad bond index. Still, over the first nine months of this year, REITs did not keep up with the very strong returns in the broader equity markets as both the S&P 500 and the Russell 2000 were up over 10%, and the Nasdaq Composite was up over 17%. As reflected in the table above, this underperformance versus equities only compounded the even larger underperformance in 2017.

What should REIT investors make of recent REIT performance, and how should they view REITs in the context of their overall portfolios going forward? Should the recent underperformance versus equities signal some break in the value proposition for REITs, or are REITs performing as one might hope and expect? Below we offer some comments on returns as well as the characteristics of those returns.

First, let's look at returns versus individual components of the hybrid nature of REITs.

The following table shows U.S. REIT returns over 1-, 3-, 5-, and 10-year periods versus bonds, versus stocks, and versus private real estate. While REIT returns have exceeded bond returns over all of these timeframes, and have generally been comparable to levered core real estate fund returns over medium- to long-term periods (albeit with some volatility), it is the recent underperformance versus equities that has been most glaring of late. In late 2017 and 2018, part of the cause for this performance gap was the anticipation of and then actual passage of the tax reform bill which did little for REITs but did help stocks by lowering taxes for corporate America. This bill also facilitated additional corporate share repurchases by easing repatriation of funds held internationally. It is hard to quantify this impact in terms of reality or sentiment, but clearly it helped. Also difficult to handicap is whether this tax reform will provide more than a one-time, short-lived boost, or even if it might be reversed in a few years depending on the next few rounds of political elections. Perhaps also somewhat disappointing

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is the amount of REIT outperformance versus bonds; the difference has not been as striking as some might wish, especially as interest rates have started to move back up. However, the same expectations for higher inflation and economic growth that have been driving higher levels of interest rates should (albeit with a lag) also ultimately help REIT earnings growth rates which in turn should lead to more pronounced outperformance versus fixed income. On the other hand, if growth were to stall for whatever reason -- tariffs, tax policy, interest rates, etc. -- then perhaps we'd begin to see more relative pick-up versus equities.

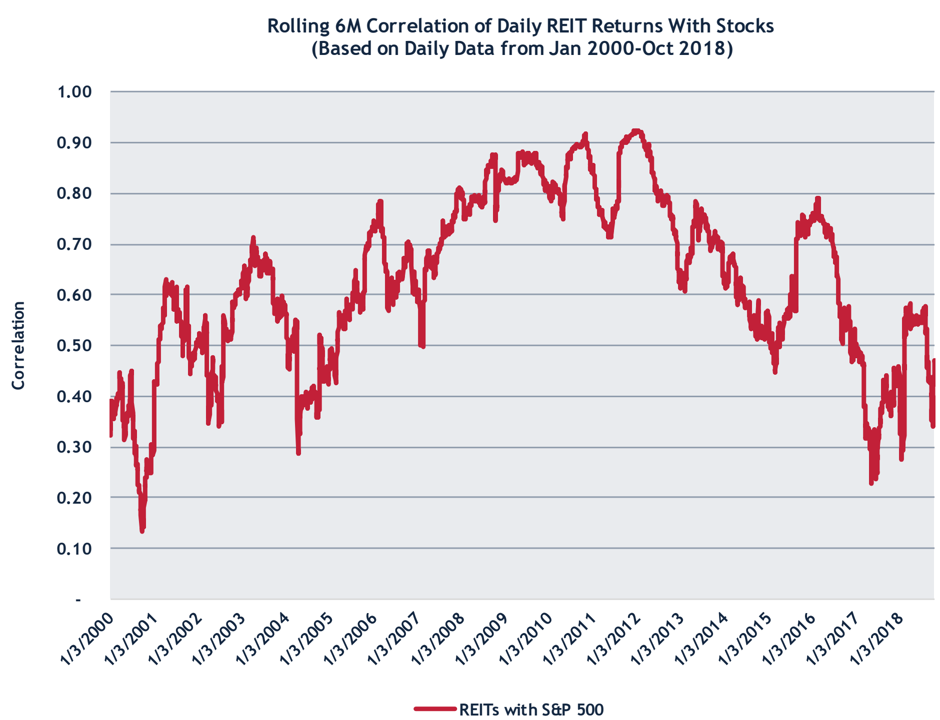
ANNUALIZED TOTAL RETURNS OVER VARIOUS HORIZONS TO SEPTEMBER 2018

	1 Year	3 Year	5 Year	10 Year
MSCI US REIT (US REITs)	3.7%	7.7%	9.2%	7.5%
Barclays US Govt/Credit Bond Aggregate	-1.4%	1.4%	2.2%	4.0%
NCREIF ODCE Index (US Direct Real Estate)	8.7%	8.8%	10.7%	5.6%
S&P 500 (US Equities)	17.9%	17.3%	13.9%	12.0%

**All indices total US $ returns. 2018Q3 ODCE Returns are Preliminary.*

Second, let's look at the correlation benefits that REITs have historically brought to a multi-asset portfolio.

Once upon a time, REITs provided steady correlation benefits as they essentially zigged when other asset classes zagged. As the number and market cap of REITs rose, and as the sector became more broadly invested, the correlations with equities gradually began to rise, but it was really only after the Federal Reserve embarked on years of Quantitative Easing in the aftermath of the Global Financial Crisis (GFC) that correlations across almost all asset classes rose quite sharply. During this time, the REIT market was highly correlated to equities for reasons beyond fundamentals. Now that the Fed has become considerably less accommodative, it would seem reasonable that correlations would begin to shrink back in the direction of previous norms. The chart below would seem to indicate that we have already started this process.



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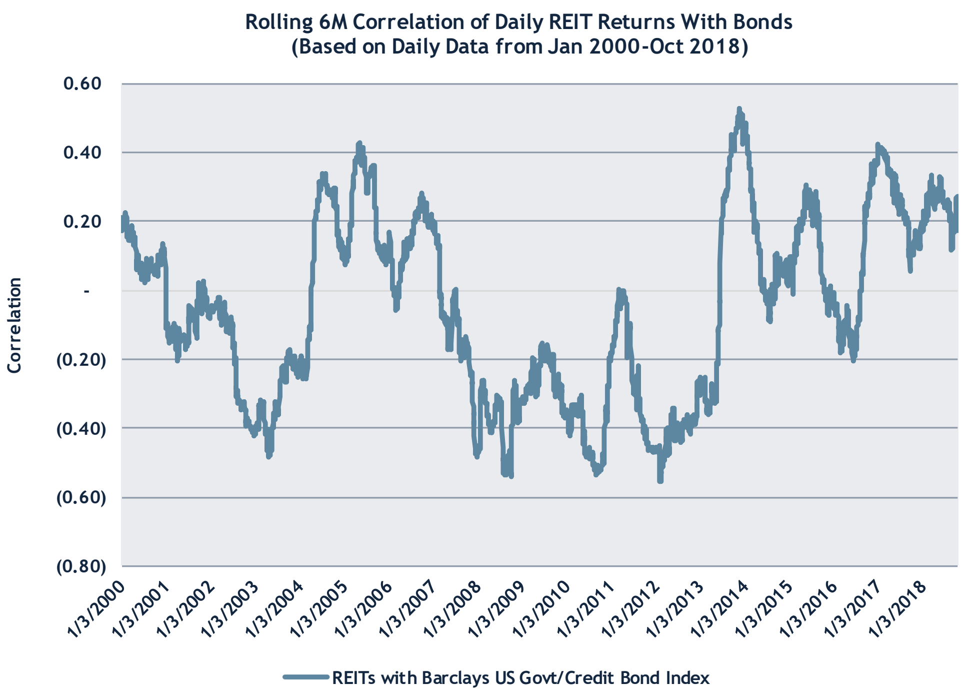
Indeed, this rolling six-month view of daily correlations of the NAREIT Equity Index to the S&P 500 shows that correlations with general equity markets have already reverted to something close to pre-GFC levels, with the average being roughly 0.45 over the past two years. Certainly a high correlation over the past two years would have been better for returns, but would and should also have raised questions as to whether listed property can serve as a proper portfolio diversifier.

Investors with limited experience with REITs may be surprised to know that the long-run average correlation of daily returns with bonds is below zero. The returns on the NAREIT Equity REIT index and the Barclays U.S. Government/Credit Bond Index have had a -0.15 daily correlation since 2000. In recent years, correlations have moved slightly above those levels but are still quite low. The uptick in REIT-bond correlations coincided almost exactly with the Bernanke "taper tantrum" speech on May 22, 2013. In the fixed income world, this sensitivity to higher interest rates makes perfect sense – existing income streams are fixed, after all. In the "non-fixed income" REIT world, with time REIT incomes will exhibit growth in the kind of strong economy where interest rates are most likely to be rising, and this income growth can offset at least part of any detrimental impact of higher rates from both financing costs and more competitive yields in other asset classes. Moreover, even since May 2013, daily REIT correlations with bonds still average only 0.17 despite the rate sensitivity investors have displayed during this era, and we believe the long-term average may be lower than that as the Federal Reserve continues to get closer to neutral policy. For many income-oriented investors, a REIT allocation should remain a powerful diversifier that provides both additional income growth and inflation protection relative to bonds.



SUMMARY

In terms of returns, in a sense REITs generally have been acting as could be expected; returns have been ahead of bonds and below equities. The backdrop has simply included an extraordinarily strong broader equity market w hich has made comparisons difficult. Going forward, one would also like to see the return spread to bonds expand and the return spread to equities narrow, and there is an argument to be made for each such possibility. Meanwhile, the correlation benefits of REITs in a multi-asset portfolio seem to be heading back towards more beneficial levels as the Fed retreats.