May 2013

Monthly Investment Commentary –

CBandT Domestic REIT Outlook | 5/22/13

Commonwealth Bank & Trust Company

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RECENT RANKING = 2 (1 IS EXTREMELY OVERVALUED; 5 IS EXTREMELY UNDERVALUED)

EXECUTIVE SUMMARY

REIT performance remains strong this year, and accelerated into the second quarter.

Over the past few years, REIT fundamentals in aggregate have improved, but at a sluggish pace. While growth has been tepid, REITs have benefited from persistently low interest rates. This rate environment has enabled REITs to turn what was going to be a refinancing headwind following the credit market collapse into a tailwind during what has proved to be a weak economic recovery.

We see a number of concerns on the horizon for the asset class, including a diminishing benefit from the low interest-rate environment, and valuation metrics that are approaching or already at historical peak levels.

We recognize that if rates remain at unprecedented current levels through 2015, it's quite possible that REIT valuations could remain at elevated levels. That's a risk we are willing to take. Investors should remember that a decision to buy REITs is not done in a vacuum, but rather in the context of other investment options, which in this case, is domestic equities. And given our return expectations for domestic equities, we are comfortable with an underweight rating REITs.

REVIEW OF REIT FUNDAMENTALS

REIT performance remains strong this year, and accelerated into the second quarter. After lagging the broader equity market (S&P 500 Index) in the first quarter, REITs gained a noteworthy 6.7% in April (compared with a 1.9% gain for equities) and another 1% through mid-May. REITs are now up 16.7% through the middle of May, compared with 15.4% for the broader equity market. Within the REIT universe, there are significant return differences among sectors. Office and retail sectors have gained 17.8% and 19.3%, respectively, through mid-May, while multi-family is up roughly 6%.

Over the past few years, REIT fundamentals in aggregate have improved, but at a sluggish pace While there are small pockets of strength, most segments have seen only modest incremental property demand. As a general rule, landlords are not able to increase rents without incremental demand. Offsetting this sluggish demand is the favorable fact that the supply of new property remains low. (This has been the case since the 2008 financial crisis.) Therefore, any incremental demand is dropping to REITs' bottom line.

While growth has been tepid, REITs have benefited from persistently low interest rates. This rate environment has enabled REITs to turn what was going to be a refinancing headwind following the credit market collapse, into a tailwind during what has proven to be a weak economic recovery. As interest rates have remained low, REITs have been able to save on interest expenses as they refinance higher-cost debt at lower rates. According to one source, the weighted-average interest rate for REITs' fixed-rate debt has declined from 6% in 2009 to 5.5% in 2012. This has been a tailwind to REIT earnings. As REITs have restructured their balance sheets, many have increased dividends (after drastically cutting or eliminating dividends during the financial crisis), leverage levels have declined to below-average levels of nearly 35%, and interest-coverage ratios have increased to 3x. For comparative purposes, REITs' debt-to-equity levels at the market bottom in March 2009 was 66.3%, and coverage ratios were 1.9x, according to NAREIT.

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Low interest rates are also resulting in higher property valuations. Property values continue to increase as there's been an increasing acceptance of lower expected returns in today's low interestrate environment. Property investors have been willing to accept high-single-digit rates of return, whereas historically, property investors have typically sought low-double-digit returns. REITs have been among the aggressive bidders for property, as low financing costs enabled REITs to make accretive acquisitions as they earn a positive initial spread over their low debt cost.

Low interest rates have also resulted in a search for yield, creating demand for the income-oriented REIT asset class. REITs are currently yielding a historically low 3.2%, yet this level of dividend is approximately 130 basis points above the 10-year Treasury rates. REITs' relatively attractive yield could continue to attract income-oriented investors, both domestic and foreign. It is important to note that equity REITs are a relatively small asset class (slightly less than $600 billion), and flows can have a meaningful impact on REIT stock prices. (For context, toward the end of 2012, the market cap of Apple Inc. was larger than the entire equity REIT universe.)

Despite these positives, there are a number of concerns. One concern is that REITs are in what we consider the late innings as far as the above positives are concerned. For example, given the prolonged low interest-rate environment we have experienced, we expect that the benefit of low rates has largely run its course, and going forward it's unlikely that REITs will experience a significant boost as a result of further-reduced debt costs. Additionally, while REITs have benefited from accretive acquisitions—but not to the extent anticipated by some coming out of the financial crisis—REITs are losing share of acquisitions to private investors. This is increasingly the case now with what looks to be the reemergence of the CMBS market—this debt capital has largely been out of the market since the financial crisis. This creates additional competition in the acquisitions market, and will likely limit this "external" growth option for REITs. Lastly, while property values are increasing, cap rates are approaching historical low levels. While it's possible that property values move higher, as they have reached higher levels relative to NAV in previous cycles, the upside is increasingly limited.

Importantly, in our ongoing analysis of the asset class, we have strongly considered the benefit of low lower debt costs, the growth of dividends, as well as external growth areas such as acquisitions. During the crisis of late-2008/ early-2009, we studied REIT dividend cuts and dividend eliminations made during the collapse, the dividend growth of prior REIT recovery cycles, as well as the historical benefit of property acquisitions, all of which was valuable in our subsequent analysis of dividend growth estimates. In fact, our income growth estimates for REITs have been well above historical averages for our more optimistic scenarios, and our estimates have been in line with the outcomes. We continue to forecast above-average dividend growth, with estimates ranging as high as 15% for 2013, and 9% for 2014, but declining in the last three years of our five-year forecast period.

Yet, we have underestimated REIT returns. Where we have been "wrong" is assuming that valuation multiples would reach current levels at a time when we would argue that fundamentals are on a slower-than-average recovery track, economic growth is subpar, while Europe and the U.S. continue to deal with debt conundrums. While we can't say for sure, we suspect investors' demand for yield is playing a meaningful role in REITs' strong upward move, especially over the last 12-24 months. We are seeing this search for yield in most income-oriented asset classes. A prime example is high-yield bonds, where yields for below-investment-grade companies have fallen to an all-time low of below 5%.

Specific to investor demand for REITs, year-to-date inflows through the middle of March were nearly $8 billion. While only a two-and-a-half-month period, this level would be the second highest level of annual inflows into U.S. real estate mutual funds since 2002, the period for which we have data. As pointed out above, equity REITs

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are a relatively small asset class at nearly $600 billion in size, and inflows can have a material impact on returns. Importantly, demand in not only U.S. investors, but foreign investors. For example, several REIT managers are pointing to significant inflows from Japanese investors in April as a key contributor to REITs' strong relative gains for the month.

Valuation is our primary reason for underweighting REITs and we believe REITs have recently gone from expensive to more expensive. It is worth pointing out that REITs have gone from record low valuations in early 2009 to record high valuation levels in early 2013. At current price levels, almost all REIT valuation metrics are at or approaching historical peak levels, and therefore do not qualify for a tactical weighting in portfolios. We are unlikely to own REITs unless they become undervalued relative to the broader equity market—from which we would fund a REIT allocation—or provide a unique way of hedging risk without compromising return potential.

Walking through the primary valuation metrics we monitor, REITs' Price/AFFO multiple was recently 22.5x, according to Citibank Research. The last time this metric was at current levels was during the property peak in early 2007. The average P/AFFO over nearly 20 years is 15.3x, implying a decline of 32% to get back to that norm. This ratio is similar to a P/E ratio, but instead of earnings, Funds From Operations (FFO) are used, and are "adjusted" to account for ongoing maintenance costs associated with upkeep of the properties. Looking at the FFO multiple, REITs are at peak levels of 18.2x, compared to nearly 20-year historical average of 12.5x.

Looking at the P/NAV ratio, which compares the market value of a REIT to the estimated value of its underlying assets, also suggests that REITs are overvalued. REIT prices are currently trading at a 20.5% premium to estimated underlying property values, compared to an average mid-single-digit premium.

Implied cap rates, which is essentially the inverse of a cash-flow multiple, has historically averaged 7.6%, peaking at 5.1% in early 2007. Today, implied cap rates are 5.6%, well below average, and approaching the historical low levels of early 2007.

Compared to 10-year Treasury yields of 1.9%, REIT yields spreads are 130 basis points. This yield premium is in line with the historical average spread of 120 basis points, suggesting that REITs are fairly valued on this metric. However, we would argue that Treasury yields are being artificially suppressed.

We believe that at current prices, REIT investors are anticipating a meaningful and persistent rebound in fundamentals. With some of the tailwinds winding down, REITs will have to generate greater fundamental, organic growth. This is not a problem per se, but we think it will likely play into how real estate is being valued or what happens in the market when going from double-digit FFO growth to more reasonable mid-single digit expectations.

In addition to rich valuations, another potential technical risk is if the economy shifts to a "normal" recovery. In this scenario, it may be difficult for REITs to keep pace with other economically sensitive areas of the stock market when investors are more focused on growth than income. The late-1990s was an extreme example of this. During this period, REITs posted strong earnings during this period but the stocks suffered losses as investors rotated into higher-beta technology stocks. While we are cognizant of technical supply/demand factors, we do not hang our hat on these types of forecasts.

We also expect higher interest rates over our five-year investment horizon. Today's low interest-rate environment will not last forever and, when rates rise, the low cap rates we are seeing today will be tested, putting downward pressure on property values, and therefore REIT prices. In all of our economic scenarios we estimate that interest rates will increase over our five-year horizon, with the magnitude of rate hikes dependent upon the economic

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scenario. We don't pretend to know when rates will rise or what the magnitude of the increase will be, which is why we ground ourselves in an investment process that protects us against getting lulled into complacency or "giving in" when things don't go as expected. We recognize that if rates remain at unprecedented current levels through 2015, it's quite possible that REIT valuations could remain at elevated levels. That's a risk we are willing to take. Investors should remember that our decision to underweight REITs is not done in a vacuum, but rather in the context of other investment options, which in this case, is domestic equities. And given our return expectations for domestic equities, we are comfortable not owning REITs.

PERFORMANCE SUMMARY AS OF 4/30/13

	NAREIT Equity Index
YTD	15.04%
3 Month	10.89%
1 Year	19.15%
3 Year	16.73%
5 Year	6.80%
10 Year	12.57%

– *CBandT Investment Team (5/13)*
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Chief Investment Officer

Sources: Litman/Gregory, NDR, BCA