REIT Asset Class and Active Management Review

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What is a REIT?

- REITs are trusts that operate like corporations:
  - Governed by Board of Directors
  - Who are elected by shareholders
  - With executive management
  - To finance real estate
  - May be publicly-traded or privately-held
- With one significant difference:
  - No taxation at corporate level if the corporation meets prescribed IRS tests

What is a REIT?

- Internal Revenue Code requirements
  - Invest at least 75% of the total assets in real estate assets
  - Derive at least 75% of gross income from rents from real estate property, or interest on mortgages on real property
  - Pay dividends of at least 90% of REIT taxable income
  - Cannot be a financial institution or insurance company
  - Derive no more than 30% of gross income from sale of real estate held less than four years

Characteristics of REITs

- Favorable tax treatment
  - Dividends distributed free of corporate tax
- Liquidity
  - Higher liquidity than direct real estate investment because REITs can be publicly-traded
- Corporate governance
  - Management stock ownership
  - Board of Directors
- Income distribution leads to high dividend yield and source of cash flow for tax-exempt institutional investors

Annual REIT Returns

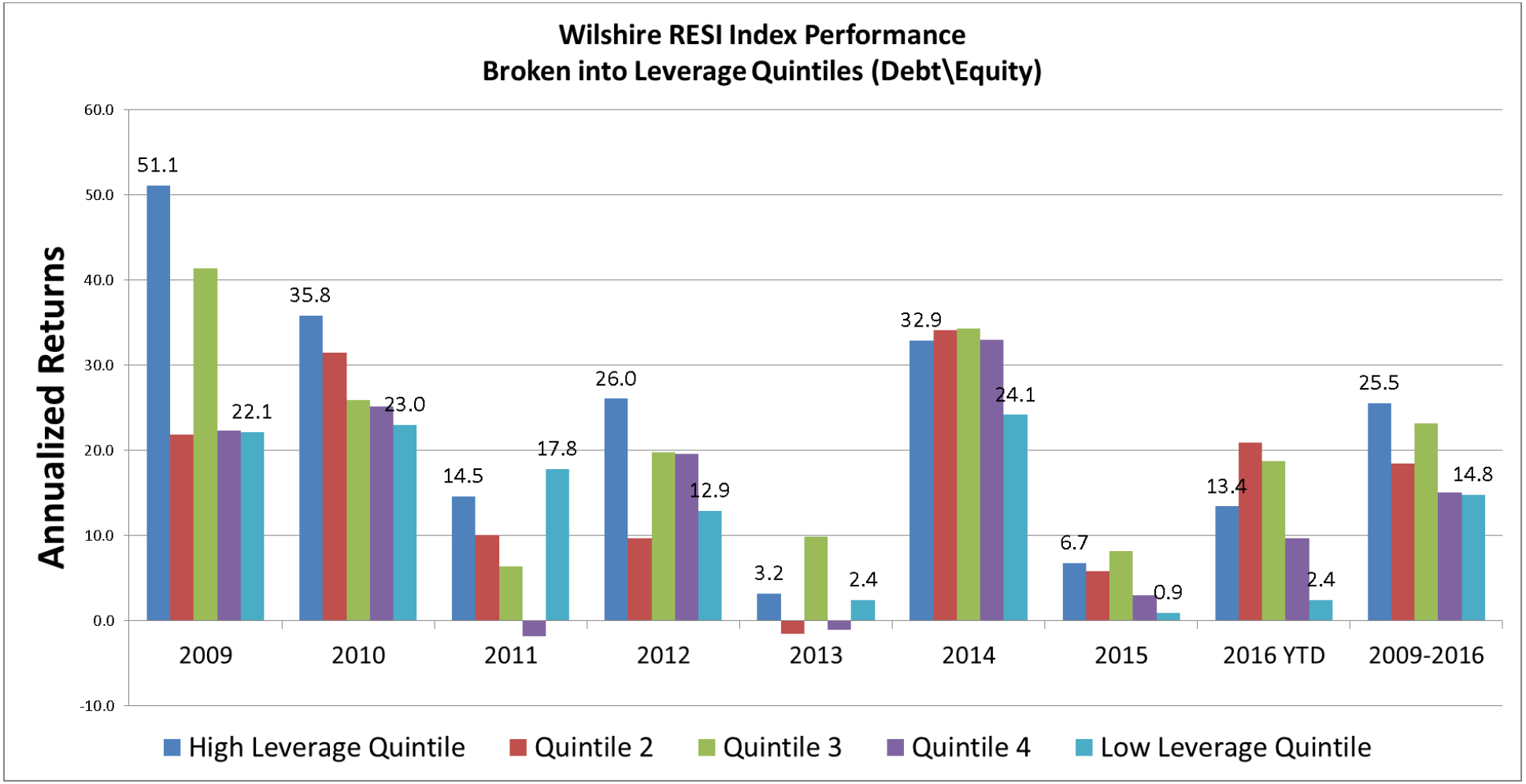
Wilshire

Annual Asset Class Returns - Best to Worst

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	YTD 2016	Annualized 5-Year as of June '16	Annualized 10-Year as of Mar. '16
Emrg Mrkts 56.3%	REITs 33.2%	Emrg Mrkts 34.5%	REITs 36.0%	Emrg Mrkts 39.8%	Core Bond 5.2%	Emrg Mrkts 79.0%	MLPs 35.9%	MLPs 13.9%	Emrg Mrkts 18.6%	U.S. Equity 33.1%	REITs 31.8%	REITs 4.2%	MLPs 14.7%	REITs 12.5%	MLPs 7.7%
MLPs 44.5%	Emrg Mrkts 25.9%	Commodities 21.4%	Emrg Mrkts 32.6%	Commodities 16.2%	T-Bills 2.0%	MLPs 76.4%	REITs 28.6%	U.S. TIPS 13.6%	Developed 17.9%	MLPs 27.6%	U.S. Equity 12.7%	U.S. Equity 0.7%	Commodities 13.3%	U.S. Equity 11.6%	High Yield 7.0%
Developed 39.2%	Developed 20.7%	Developed 14.0%	Developed 26.9%	MLPs 12.7%	U.S. TIPS -2.3%	High Yield 58.2%	Emrg Mrkts 19.2%	REITs 9.2%	REITs 17.6%	Developed 23.3%	Core Bond 6.0%	Core Bond 0.6%	REITs 11.1%	High Yield 5.8%	U.S. Equity 7.0%
REITs 36.2%	MLPs 16.7%	REITs 13.8%	MLPs 26.1%	U.S. TIPS 11.6%	High Yield -26.2%	Developed 32.5%	U.S. Equity 17.2%	Core Bond 7.8%	U.S. Equity 16.1%	High Yield 7.4%	MLPs 4.8%	T-Bills 0.1%	High Yield 9.1%	Core Bond 3.8%	REITs 6.3%
U.S. Equity 31.6%	U.S. Equity 12.5%	U.S. Equity 6.4%	U.S. Equity 15.8%	Developed 11.6%	Commodities -35.6%	REITs 28.6%	Commodities 16.8%	High Yield 5.0%	High Yield 15.8%	REITs 1.9%	U.S. TIPS 3.6%	Developed -0.4%	Emrg Mrkts 6.6%	MLPs 3.2%	Core Bond 4.9%
High Yield 29.0%	High Yield 11.2%	MLPs 6.3%	High Yield 11.9%	Core Bond 7.0%	MLPs -36.9%	U.S. Equity 28.3%	High Yield 15.1%	U.S. Equity 1.0%	U.S. TIPS 7.0%	T-Bills 0.1%	High Yield 2.5%	U.S. TIPS -1.4%	U.S. TIPS 6.2%	U.S. TIPS 2.6%	U.S. TIPS 4.6%
Commodities 23.9%	Commodities 9.2%	T-Bills 3.1%	T-Bills 4.8%	U.S. Equity 5.6%	U.S. Equity -37.2%	Commodities 18.9%	Developed 8.2%	T-Bills 0.1%	MLPs 4.8%	Core Bond -2.0%	T-Bills 0.0%	High Yield -4.5%	Core Bond 5.3%	Developed 2.1%	Emrg Mrkts 3.3%
U.S. TIPS 8.4%	U.S. TIPS 8.5%	U.S. TIPS 2.8%	Core Bond 4.3%	T-Bills 5.0%	REITs -39.2%	U.S. TIPS 11.4%	Core Bond 6.5%	Developed -11.7%	Core Bond 4.2%	Emrg Mrkts -2.3%	Emrg Mrkts -1.8%	Emrg Mrkts -14.6%	U.S. Equity 4.0%	T-Bills 0.1%	Developed 2.3%
Core Bond 4.1%	Core Bond 4.3%	High Yield 2.7%	Commodities 2.1%	High Yield 1.9%	Developed -43.1%	Core Bond 5.9%	U.S. TIPS 6.3%	Commodities -13.3%	T-Bills 0.1%	U.S. TIPS -8.6%	Developed -4.5%	Commodities -24.7%	T-Bills 0.1%	Emrg Mrkts -3.4%	T-Bills 1.1%
T-Bills 1.2%	T-Bills 1.3%	Core Bond 2.4%	U.S. TIPS 0.4%	REITs -17.5%	Emrg Mrkts -53.2%	T-Bills 0.2%	T-Bills 0.1%	Emrg Mrkts -18.2%	Commodities -1.0%	Commodities -9.5%	Commodities -17.0%	MLPs -32.6%	Developed -4.0%	Commodities -10.8%	Commodities -6.2%

REIT Market Attribution

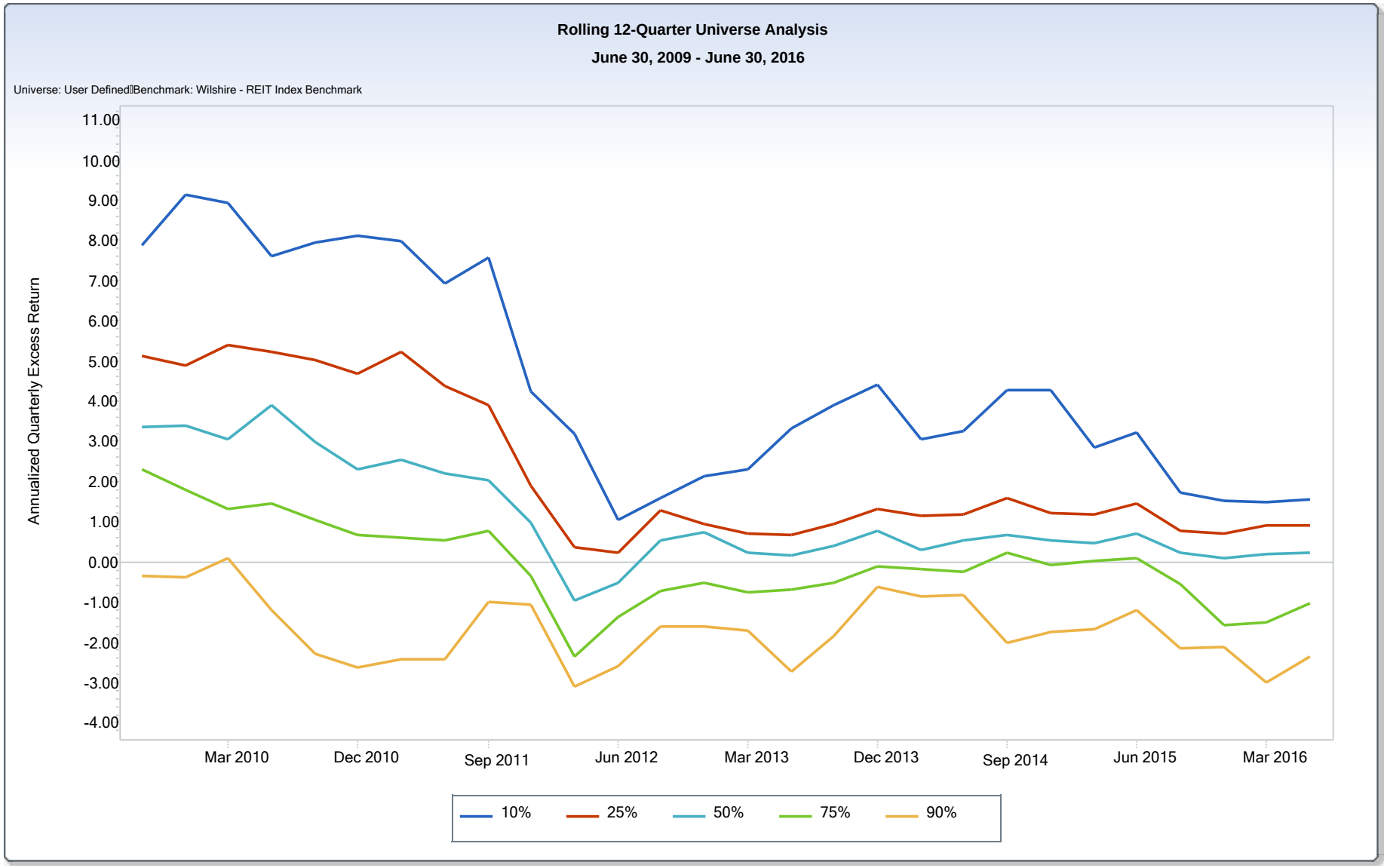
- Since the credit crisis, the REIT market has rewarded more highly leveraged firms and penalized lower leveraged firms on a relative basis
- Managers willing to take on more balance sheet risk would likely be rewarded during this environment



Active Management within REIT sector

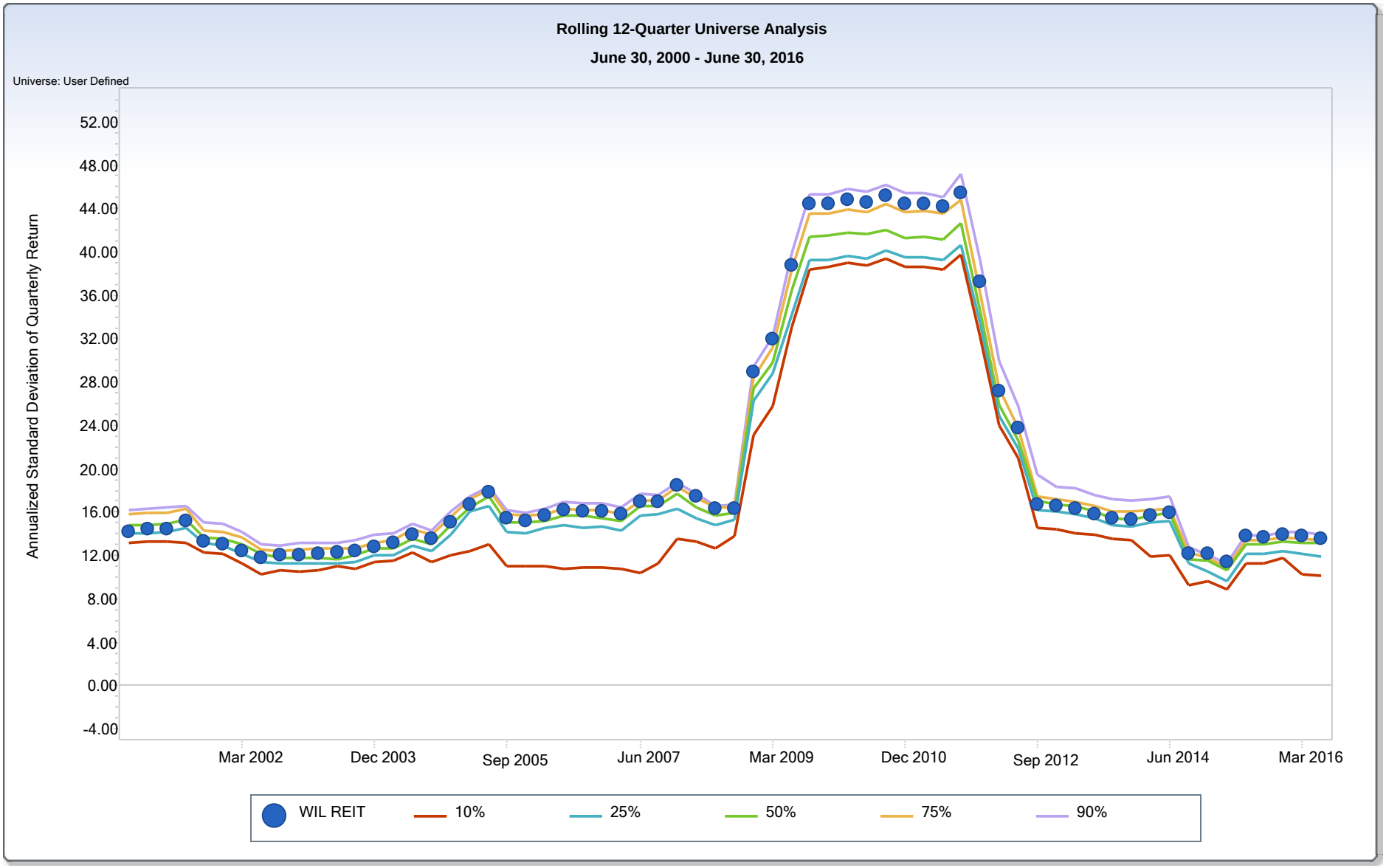
Active Management Returns – REIT Universe

- Median active REIT managers generally outperformed on a gross of fee basis, but net of fee returns are more mixed over the last few years.



Active Management Risk – REIT Universe

- Active managers have broadly exhibited a lower level of volatility versus the index



Adelante Evaluation

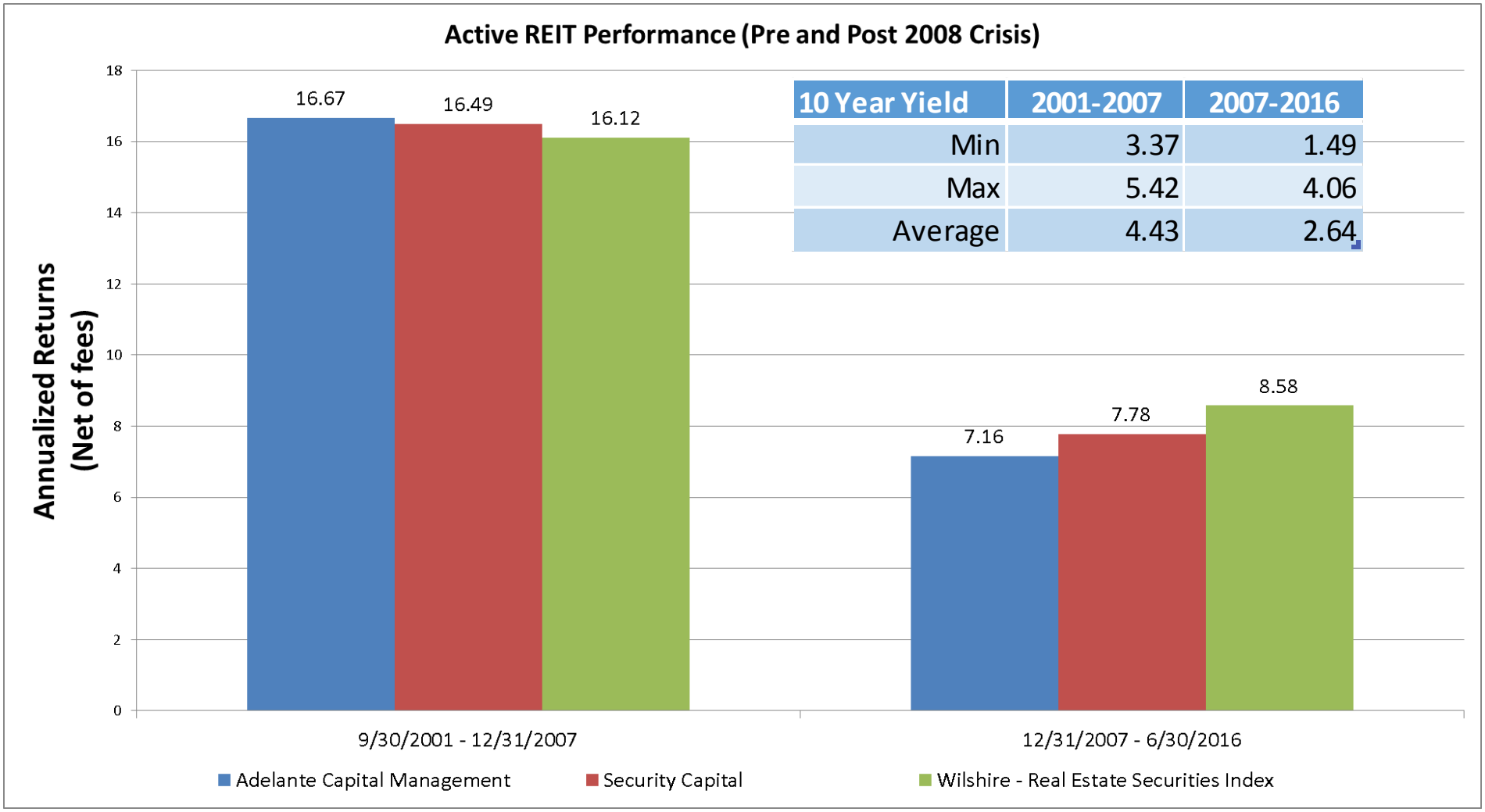
- The Adelante Total Return strategy, typically concentrated with 25-35 positions, strives to outperform the Wilshire US REIT benchmark by 100 bps annually with a tracking error of 200-400 bps.
- Value-oriented portfolio has historically protected on the downside
- While the portfolio has historically performed strongest during prolonged down markets, the strategy underperformed by almost 600 bps in 2008's sharp downturn.
- As expected given the concentration in the portfolio (25-35 holdings), stock selection has been the largest driver of historical returns.
- Going forward, we would expect the portfolio to outperform during periods of stable economic conditions when security prices are driven by fundamentals, as well as during down markets. Conversely, we would expect the strategy to underperform during periods of significant financial crisis that impair estimations of NAV (i.e. - 2008).

Security Capital Evaluation

- Security Capital Research & Management's Growth & Income product is a concentrated, valuation-focused REIT strategy that, at times, tends to be contrarian in positioning.
- Security Capital's core investment philosophy is that cash flow is the ultimate driver of value.
- Their investment process attempts to accurately determine these cash flows by seeking to fully understand the underlying properties generating the cash flow streams.
- Wilshire views the Security Capital Growth & Income strategy as a strong investment option for a client's core U.S. real estate allocation.
- The goal of the portfolio is to outperform the Wilshire Real Estate Securities Index by 200 bps over a full market cycle (3-7 years), making the strategy suitable for clients with a long-term perspective.

A tale of two periods….

- Prior to the credit crisis, both active managers were outperforming on a net of fee basis
- Both managers have consistently had a lower Debt\Equity ratio than the index over time, consistent with a lower risk/higher quality approach



10 Year Yield	2001-2007	2007-2016
Min	3.37	1.49
Max	5.42	4.06
Average	4.43	2.64

Summary

- REIT market performance since the credit crisis has been led by firms that were more highly leveraged
- Low rate environment and ability to cheaply refinance debt may be one of the causes of this
- Both Adelante and Security Capital, as part of their investment process, have focused their active risk in lower leveraged segments of the market
- Lower risk\leveraged firms may be poised for rebound if interest rate environment normalizes and investors renew focus on underlying REIT fundamentals such as strong balance sheets
- Rising interest rate environments have had a mixed impact on REIT performance historically
  - Impacts from economic growth tend to trump the impact of rising rates

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