REIT Insight

Newsletter — May 2014

REIT Insight *is a monthly market commentary by Resource Real Estate's Global Portfolio Manager, Scott Crowe. It discusses our perspectives on major events and trends in real estate securities.* **REIT** Insight *is a viewpoint from an investment practitioner with a unique focus on both publicly traded and non-traded REIT markets.*

In this month's *REIT Insight*:

- Interval Fund Investing - Mutual Fund Access to Alternative Investments
- Replicating an Institutional Approach to Real Estate Investments
- Analyzing Interval Funds

Interval Fund Investing - Mutual Fund Access to Alternative Investments

The global financial crisis has caused an important structural shift in investor preferences towards alternative investments and away from more volatile equity markets. In addition, bond yields have plummeted in the aftermath of the crisis leaving investors without the ability to generate income. In essence, the crisis highlighted a flaw in the way many investors approach portfolio diversification – having simply a range of mutual funds with access to different "sectors" may not be enough to create appropriate diversification. For instance, while the underlying investment of a publicly traded REIT may include real estate, an investor's allocation can behave very much like the S&P500.

Institutions have implicitly acknowledged the limitations of equity market investments for decades, with most maintaining a large allocation to private investments, including real estate.[1] The benefits of these allocations have been a decrease in portfolio volatility, lower correlations with equity markets and often increased returns from income. Historically, access to alternative private investments has been for the exclusive use of large institutional investors, but this is changing rapidly. The "mass affluent"[2] are now demanding more sophisticated investment products.

Recognizing this trend, investment sponsors have developed new ways for individual clients to access alternative investments, including real estate equity and debt through non-traded REITs[3] as well as corporate credit through Business Development Companies (BDCs).[4] Now, a new product type, the Interval Mutual Fund (the "iFund©"),[5] is providing the next evolution in alternative investment products.

As mutual funds did for equities, iFunds have the potential to unlock alternative investments to the widest possible investor base while simultaneously providing greater price transparency and liquidity. In addition, iFunds may increase the efficiency and lower the expenses of investments in alternative assets by aggregating capital, thus decreasing costs as a percentage of assets—a significant benefit given the imminent rule changes for commission and fee transparency on client statements for non-traded REITs and BDCs.[6]

1 The Yale Endowment Fund is an example of a private investment platform with $20.8B AuM on June 30, 2013. The Endowment targets up to 90% in alternatives including private equity, absolute return, and real estate. http://investments.yale.edu/images/documents/Yale_Endowment_12.pdf http://investments.yale.edu/

2 The mass affluent segment generally refers to U.S. individual investors or households with $100,000 to $1M in investable assets. http://www.wikinvest.com/wiki/Mass_Affluent

3 A form of real estate investment method that is designed to reduce or eliminate tax while providing returns on real estate. A non-traded REIT does not trade on a securities exchange, and because of this it is quite illiquid for long periods of time. http://www.investopedia.com/terms/n/non-traded-reit.asp

4 A company that is created to help grow small companies in the initial stages of their development, similar to venture capital funds. Many BDCs are set up much like closed-end investment funds and are actually public companies that are listed on the NYSE, AMEX and Nasdaq. http://www.investopedia.com/terms/b/bdc.asp

5 While technically a continuously offered closed ended fund, the Interval Fund can also be described as a mutual fund which offers daily purchase for investment but liquidity for redemptions at specific intervals (usually quarterly).

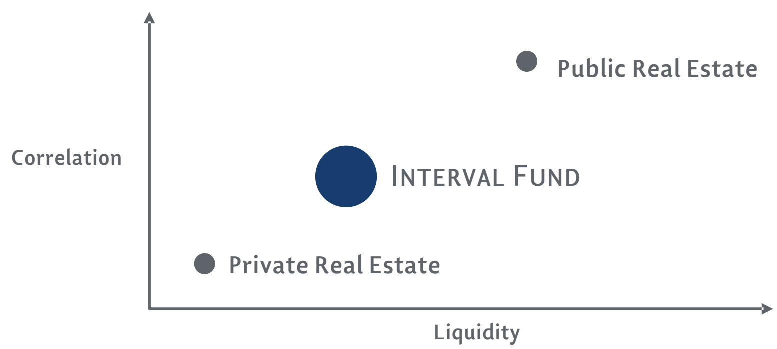
6 On February 3, 2014, the Financial Industry Regulatory Authority (FINRA) proposed changes to NASD Rule 2340 which would increase disclosure on the fees and commissions paid to brokers who sell non-traded REITs.

Interval Funds: the meeting point of alternative investments and mutual funds

The iFund is simply a mutual fund that offers daily investment opportunities and limited redemptions at specific intervals (usually quarterly).[7] This change to the mutual fund structure creates large advantages however; it allows the fund to simultaneously invest both in private and public assets— with a structure that has both liquidity and a daily net asset value (NAV). In turn, the sponsor may create a portfolio of investments with high yield and low correlation to equities, but without the usual limitations of private investments (illiquidity and lack of price transparency).

The liquidity feature and price transparency, in conjunction with sufficient portfolio diversification, can make iFunds suitable for a large pool of investors. This also allows interval funds to be held in both fee-based and commission-based accounts—an important benefit given the growth of fee-based assets and the advisors' need to access alternative investments that complement existing mutual fund options.

Graph 1: Interval Funds - intersection of alternatives and mutual funds



Graph 1: Interval funds offer higher liquidity than private real estate, but reflect market fluctuations. Private investments can offer higher yield and less correlation to the market, but they lack pricing transparency and liquidity. Interval Funds can capture the yield and correlation characteristics of private investments, but also provide liquidity and transparency.

[7] Redemptions are shares bought back from the shareholder/investor by the fund under a program referred to as the Share Redemption Program (SRP), to provide investors with a limited form of liquidity.

Replicating an Institutional Approach to Real Estate Investments

Individual investors' access to real estate has traditionally been limited to only publicly traded REITs and non-traded REITs. However, these products represent only a portion of the available access points to real estate investments that large institutions enjoy. Simultaneously accessing different real estate investment types can optimize a real estate allocation by capturing the benefits of listed and non-listed investments, while mitigating their individual disadvantages. For example, investing directly in real estate through institutional private equity can produce moderate yields, growth and sector diversity, but not liquidity. Publicly traded REITs are liquid and give access to global investment opportunities, non-traditional asset types and growth—but come with a lower yield and higher equity market correlation. Debt can give yield and principal protection, but can fall short on interest-rate hedging ability.

Chart 1: Characteristics of real estate investment types

	Direct Real Estate		Publicly Traded REITs		Real Estate Debt	
	Private Equity	Non-traded REITs	US REITs	International REITs	Preferred REITs	Real Estate Debt
Income	◑	●	◔	◑	●	●
Capital Stability	●	◑	○	○	◕	●
Growth	◑	○	●	◑	○	○
Interest Rate Hedge	◕	○	◑	◕	○	◕
Liquidity	◔	○	●	●	●	◑

Chart 1: Breakdown of advantages and disadvantages of the three main types of real estate investments. Shaded circles indicate favorability towards the relevant characteristic.

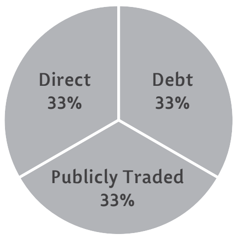
In the following example, replicating an institutional real estate allocation by including equal weights of direct real estate, credit investments (debt) and publicly traded REITs would have produced a yield of 5.7% and a total return of 8.1%, with a volatility of 8.0%[8] over the last thirteen years. The Sharpe Ratio would have been 1.02.[9]

* Diversified Real Estate Income is made up of 1/3 Direct Real Estate (NCREIF); 1/3 Publicly Traded REITs (FTSE EPRA NAREIT Global Developed); 1/3 Debt (Wells Fargo Preferred REIT Index).

8 The underlying data for equity markets used in this analysis was based on the S&P500 index that produced a yield of 2.0%, total return of 4.64% and a volatility of 17.99%; the data for publicly traded REIT markets used was the FTSE EPRA NAREIT Global Developed Index (RUGL) which produced a yield of 4.53%, total return of 9.43% and a volatility of 22.61%.

9 Sharp Ratio determines an investment's return per unit of risk, and is calculated as total return divided by volatility.

Figure 1: An institutional real estate allocation[10]

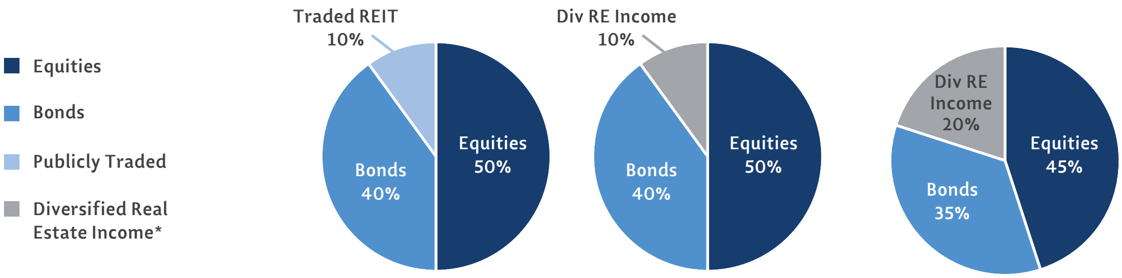


	100% Diversified Real Estate Income*
Income pa	5.7%
Capital Appreciation pa	2.4%
Total Return pa	8.1%
Volatility	8.0%
Sharpe Ratio	1.02

As shown below, the inclusion of either (1.) an ordinary publicly traded REIT allocation in a diversified portfolio of real estate, equities and bonds (first pie chart below in Figure 2) or instead (2.) the above institutional real estate allocation (middle pie chart) would have had a significant impact on an investor's return outcome. Implementing an institutional approach, an investor would have enjoyed a higher income yield and improved risk adjusted return.[11] Further increasing the institutional real estate allocation to 20% (the far right pie chart) would have further improved these metrics for the investor's portfolio.

Inclusion of an institutional real estate allocation in a balanced portfolio

Figure 2: Hypothetical Portfolio Allocation: 2000-2013[12]



	Publicly Traded REITs	Diversified Real Estate Income	Diversified Real Estate Income +
Income pa	3.6%	3.8%	4.0%
Capital Appreciation pa	3.2%	2.8%	2.8%
Total Return pa	6.8%	6.5%	6.7%
Volatility	9.0%	7.8%	7.7%
Sharpe Ratio	0.76	0.84	0.87

Figure 2: The Diversified Real Estate Income Fund replicates the institutional approach of blending various forms of real estate investments to help increase returns while reducing volatility. In the example scenario above, the three sample portfolios allocate various levels of investment to Equities, Bonds, Publicly Traded REITs, and the Diversified Real Estate Income Fund. As more of the portfolio is allocated to the Diversified Real Estate Income Fund, returns increase and volatility decreases.

* Diversified Real Estate Income is made up of 1/3 Direct Real Estate (NCREIF); 1/3 Publicly Traded REITs (FTSE EPRA NAREIT Global Developed); 1/3 Debt (Wells Fargo Preferred REIT Index).

10 To create a hypothetical institutional real estate allocation portfolio, we blended equal segments of direct real estate (NCREIF Property Index (NPNCRE); debt (Wells Fargo Preferred REIT Index (WHPSR); publicly traded REITs (FTSE EPRA NAREIT Global Developed Index (RUGL). Date time period: 12/31/13 to 12/29/00; source: Internal RREDX data.

11 Shown by an increased Sharpe Ratio.

12 Data time period: 12/31/13 to 12/29/00; source: Bloomberg Indices (S&P500; USG5PR; NPNCRE; RUGL; UNGL; WHPSR & internal RREDX data.

A tool for new FINRA client statement rules

The non-traded REIT industry faces a significant change with the expected implementation of new rules to client statement reporting.[13] The changes for fee and commission transparency should have a significant impact on the non-traded REIT market and, in particular, its fee and commission structures. Coupled with an increase in transparency on the net value of client positions, this change is likely to make interval funds, which have return profiles similar to non-traded REITs, more attractive for both advisors and clients.

Interval Funds may be part of the solution for advisors impacted by the potential of lower commissions following the implementation of these new rules. iFunds already enjoy liquidity and transparency in pricing through a daily NAV. Advisors who have been reluctant to make use of more opaque alternative instruments[14] may find iFunds suitable for more clients by virtue of their liquidity and transparency; and hence expanding the use of alternatives by their clients.

The ability to aggregate capital through iFunds provides a further advantage to the industry. Economies of scale and mutual fund implementation can help decrease costs related to due diligence, research and distribution. Just as mutual funds led to the broadening of equity investment over the last two decades (with simultaneous fee compression *and expansion* of the industry), iFunds may prove a similar catalyst for expanded market penetration by alternatives.

Analyzing Interval Funds

iFunds' attractiveness to investors depends on the content of their portfolios. Strategies will differ, and indeed, some will include a range of alternative assets in addition to real estate. However, we believe there are a few essential aspects investors should consider when examining an iFund's merits:

- Investment strategy: Understand what asset classes the portfolio comprises as well as the largest positions in the fund.
- Internal investment management versus fund of funds approach: Does the iFund outsource investment management or keep this function "in house"? We believe this important function should be performed by the fund's sponsor, as it allows better risk control and more accountability, in addition to potentially lower costs.
- Level of liquidity and transparency: The liquidity feature of the iFund structure is an important characteristic; a significant level of liquid assets will ensure the ability to meet redemptions. Further, the allocation to liquid assets improves pricing transparency.
- Conflicts of interest: Conflicts can arise if the portfolio manager is allowed to invest in other funds of the sponsor.[15] The most transparent way to ensure no conflicts is to preclude the iFund from investing in other funds of the sponsor.

[13] On February 3, 2014, the Financial Industry Regulatory Authority (FINRA) proposed changes to NASD Rule 2340 which would increase disclosure on the fees and commissions paid to brokers who sell non-traded REITs. Under the new rules, it is proposed that NTR client statements will display the per-share price net of the REIT's expenses, with statements showing the share value after the deduction of fees and any expenses related to organization, offering and property acquisitions. Mutual Funds and Interval Funds tend to have lower fees and expenses and report a price plus commission cost basis on the client statement as opposed to the NTRs current net investment structure. We believe fuller disclosure will benefit both customers and the industry, and may lead to a more mutual fund-like fee structure, with different share classes.

[14] Only one in five of their clients are invested in non-traded REITs, at present. [Stanger Survey of Advisors 2013].

[15] This is the case even if the fund board appoints a third-party sub advisor, if the board is composed of the sponsor's representatives. In such an instance, the sponsor can effectively hire and fire the manager, which does not ensure impartiality when investing in the sponsor's other products.

Conclusion

The demand for uncorrelated income is leading to new ways for advisors and their clients to access alternative investments. iFunds help meet this growing demand through a portfolio of alternative investment securities. Such an approach can replicate the benefits of an institutional approach to real estate investment for an expanded set of investors. In addition, the flexibility of the mutual fund structure can help advisors adapt to an evolving regulatory landscape. Important aspects to consider when assessing the merits of an interval fund include the investment strategy, internal management, liquidity and lack of conflicts. As the demand for uncorrelated yield continues to increase, iFunds can offer an important tool to gain the widest possible access by the widest possible audience to alternative investments.

Scott Crowe, Global Portfolio Manager

Scott Crowe is the Global Portfolio Manager for Resource Real Estate. Previously, he was the lead Global Portfolio Manager for Cohen & Steers, where he led the investment and research team of over 20 portfolio managers and analysts. Mr. Crowe was accountable for over $10B in FuM across the firm's global, international and emerging market portfolios. Prior to this, Mr. Crowe held the position of Head of Global Real Estate for UBS Equities Research where he built and managed the US REIT division while leading a global team of more than 40 analysts.

Scott began his career at Paladin Property Securities and was also an Associate Lecturer at the University of Technology Sydney. Scott holds an Honors Finance Degree from the University of Technology Sydney and a Bachelor of Commerce from the University of NSW/National University of Singapore.

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