Market Environment

The third quarter started off on a bounce in both global equities and bonds following the surprise Brexit vote in the U.K. to leave the European Union, and ensuing market sell-off. As markets continued to digest the shocking outcome of the BREXIT vote and the ensuing market volatility associated with the decision, the U.S. 10-year Treasury bond yield peaked intra-day on July 6th. Two days later, a strong U.S. payroll report for June came in well above expectations. In the next week, months before a new U.K. Prime Minister was expected following the resignation of Mr. David Cameron, Ms. Theresa May was appointed the Prime Minister of the U.K. on July 11th, following ballots in her favor on the 5th and 7th. It became apparent Article 50, a two year negotiating process for the U.K. to leave the E.U., would not be engaged anytime soon.

The markets responded accordingly with an increased appetite for risk and a desire to source it with what had been the outperforming more defensive areas. This led to some lower quality and cyclical outperformance in equities this quarter, including in listed global real estate. As examples in the U.S., an increased appetite for risk was sourced from more defensive industry sectors like utilities, consumer staples and ultimately real estate, which had thus far been outperforming on the year. Conversely, financial shares, which were year-to-date underperformers, began to outperform on a relative basis.

Another tone shift also became more evident during the quarter and it came courtesy of the major global central banks. Based on the rhetoric leading up to their respective September policy meetings and the meetings themselves, the BOJ, ECB and FOMC to varying degrees seem to be questioning the efficacy of current monetary policy to achieve their medium term inflation goals. More than ever, the central banks appear to be indicating that it will be difficult to achieve their inflation goals without an assist from fiscal policy and structural economic reforms.

Additionally, there seems to be a greater recognition of some of the negative consequences of current monetary policy, particularly on the banking sector. Although no coordinated message has been announced, based on recent comments and policy actions it appears that all three central banks would like to see steeper yield curves. Not surprisingly, the yield curves in each respective market did steepen over the course of the third quarter. Moreover, while the FOMC did not raise rates at its September meeting, they did provide fairly clear guidance that the case for a rate increase was growing. As a result, the probability of a rate increase at the December FOMC meeting increased significantly.

Global Real Estate Market Review

Given the change in tone in the markets during the quarter to a more risk-on environment and the shift in interest rate expectations, particularly post early July, we would expect global real estate shares to lag broader global equities and they did. While the performance of global real estate equities was positive during the quarter, they underperformed global equities, as demonstrated by the 0.2% increase in the FTSE EPRA NAREIT Developed Rental Index ("the Benchmark") versus the 4.9% increase in the MSCI World Index, both expressed in U.S. dollar terms. Global real estate equities also trailed U.S equities during the quarter, as represented by the 3.9% rise in the S&P 500 Index during the quarter.

The movement of the U.S. dollar during the quarter was rather benign and was a small tailwind for international real estate equity returns in U.S. dollar terms, given its 0.7% depreciation as measured by the U.S. Dollar Spot Index. Two notable currency moves to highlight would be the nearly 3% appreciation of the U.S. dollar relative to the U.K. pound and the 6% increase in the U.S. dollar relative to the Mexican peso, which has in recent months become highly correlated to the movement in Donald Trump's poll numbers. As we go to print the U.K. pound has continued to weaken and the Mexican peso has lifted.

Taking a closer look at the performance of the individual countries that are represented within the FTSE EPRA NAREIT Developed Rental Index, the top-performing countries during the third quarter on a total return basis measured in U.S. dollars included Norway, Finland, Austria, Hong Kong and France. While Norway has a small representation in the Benchmark with only two listed companies, they continued their winning ways during the quarter, elevating Norway to the best performer on the year as well. The Norwegian economy and commercial real estate market have benefited from the improvement in the price of oil this year and the fiscal stimulus provided by the government. Additionally, the performance of one of the listed companies continues to benefit from a creeping takeover of the company by one of the wealthiest individuals in Norway. Hong Kong was one of the top performers for the second consecutive quarter as its real estate shares benefited from the growing exchange linkages with mainland China and the flow of capital into the Hong Kong equity market.
The five bottom-performing countries during the third quarter were Italy, Canada, Australia, Switzerland and the U.S. Italian real estate shares came under pressure during the quarter not because of underlying property fundamentals, but because of growing concerns regarding the solvency of the Italian banking system. While initial steps have been taken to shore up capital at some of the banks, the markets have yet to be convinced that enough has been done at this point. Additionally, uncertainty regarding the outcome of a referendum on economic reforms that is to be voted on during the fourth quarter and could cause political turmoil depending on the results, also weighed on the Italian market. Canada and Australia gave back some of their gains during the quarter, though remain outperformers on a year-to-date basis, as their markets digested the shifting interest rate environment.

During the quarter we traveled to several U.S. cites as well as to the U.K and France, where we attended the European Public Real Estate Association’s annual conference in Paris. From our time spent in London it was difficult to detect any negative ramifications from the fallout of the Brexit vote. On the contrary, the anecdotal observations were positive as it related to tourist activity and retail spend, both of which have benefited from the dramatic fall in the U.K. pound since the June vote. However, based on the limited amount of commercial real estate transaction activity that occurred during the quarter, we know there has been a small negative impact to real estate values, particularly City oriented offices, and that rental levels have softened a bit. Moreover, tenants are seeking shorter-lease terms and termination options to protect against future uncertainty.

On-the-other-hand, Central Paris offices are currently the highlight of the French commercial real estate market, demonstrating strong occupier demand and modestly growing rental levels, with limited new supply. While there was no evidence of a Brexit related benefit yet, that could be an incremental demand driver in the future. However, Paris would have to compete with the likes of Frankfurt, Dublin and New York for some of the possible relocations from London depending on how the future Brexit negotiations shake out. As a whole, new development would be needed in any of the cities to accommodate a significant move, were it to occur, from the City of London.

### Global Real Estate Portfolio Review

Overall, our global real estate securities strategy underperformed its Benchmark during the third quarter. Security selection was a detractor from performance, while country allocation delivered a positive contribution to performance.

#### What Helped Third Quarter Performance:

Combining country allocation and security selection, the top positive contributors to performance for the quarter were Finland, Germany and Norway.

From a country allocation perspective, our overweight exposures to Finland and Norway were the most positive drivers of performance. Finnish real estate shares reversed their negative performance from the prior quarter and may have been a beneficiary of capital reallocation following the Brexit vote. The Norwegian economy and commercial real estate market have benefited from the improvement in the price of oil this year and the fiscal stimulus provided by the government. Additionally, the performance of one of the listed companies continues to benefit from a creeping takeover of the company by one of the wealthiest individuals in Norway.

At the security level, our overweight exposure to a U.S. office REIT with a west coast geographic concentration was the largest positive contributor for the quarter. The company’s shares performed well following positive second quarter earnings results and positive employment market reports during the quarter. The next most positive contributor to security selection for the quarter was our underweight exposure to a large-cap U.S. shopping center REIT. The performance of the shares benefited by confidence in a new management team, solid execution and organic growth, and improved free float of its shares.

#### What Hurt Third Quarter Performance:

Combining country allocation and security selection, the top detractors were the U.S., Japan, Hong Kong and Sweden.

From a country allocation viewpoint, detractors were modest and no more than a few basis points. Modest underweight exposures to Sweden, Singapore and Hong Kong were detractors on their outperformance.

At the security level, our overweight exposures to two U.S. based Data Center REITs were the largest negative contributors to security selection for the quarter. Data Centers lagged after demonstrating strong performance through the first half of the year and into the start of the third quarter, as they became one of the sources of funds for an increased risk-on appetite following strong payrolls and the announcement of Ms. May as the U.K.’s Prime Minister. In addition, one of these holdings experienced lumpiness in leasing, and the market was reluctant to give it credit that the leasing pace had improved in the third quarter; while the other announced its CEO was
going to retire. Data Centers continue to experience positive demand driven by the robust growth in IT infrastructure outsourcing and the rapid adoption of cloud computing.

**Investment Outlook**

From our perspective the global real estate space market cycle still has room for further growth as we expect overall space market demand to exceed supply across most property sectors and major cities. The private real estate asset market varies by property type and location, but is further along in the cycle in terms of valuations. However, we believe the global weight of capital looking for a home in high-quality, core real estate, is meaningful enough to continue to support current real estate asset pricing. The year-to-date decline in interest rates is also supportive of current asset valuations. Nonetheless, we believe additional price appreciation will likely be driven largely by cash flow growth, as opposed to continued cap rate compression. With the significant amount of overseas buyers and private real estate equity capital that has been raised but unspent, we expect M&A activity to continue, for the balance of 2016 and into 2017.

In aggregate, we view a backdrop of low, but positive global economic growth and manageable new real estate supply as positive fundamental tailwinds for global real estate securities going forward. Should global economic growth continue to improve, this would facilitate further increases in real estate operating cash flows and dividends through higher property occupancies and, in cases where occupancy has reached equilibrium, higher rents. In effect, higher rents represent pricing power, a hard-to-find attribute in today’s investment climate. Combined with the supportive tailwind to real estate asset pricing, our base case remains for another positive total return year for global real estate securities in 2016.

After the market close on August 31, 2016, Real Estate became the 11th sector of the Global Industry Classification Standard (GICS) and the first additional sector added to the GICS structure since the global classification system was created in 1999. Importantly, we believe this decision reflects the views of industry participants that real estate is a separate asset class with distinct investment characteristics, particularly relative to other financial companies. We believe there are some potential positive implications that investors should consider. First, we would expect the visibility of listed real estate, particularly among generalist equity investors, to increase from where it stands today. Second, the increased visibility of Real Estate as a standalone sector may lead to higher allocations to real estate by generalist investors than historically has been the case.

**Global real estate 2016 total return drivers**

- 2016E global cash flow growth of approximately 6% to 6.5%, and 6.5% to 7% in the U.S.
- Dividend yield of approximately 4.0%; with above average growth expected in the U.S. given lower payout ratios
- Continued below average new supply and fundamental recovery driving cash flows and dividends
- From a regional perspective, real estate fundamentals remain more attractive in the U.S. and Northern Europe than most anywhere else

**Global real estate upside drivers**

- Inflow on rotation from bonds to listed real estate, FIRPTA (U.S. Foreign Investment In Real Property Tax Act) modifications, and promotion of listed real estate to its own GICS sector
- Greater than expected global economic growth, leading to more robust employment and income growth, key drivers of higher occupancies and rents at company owned properties
- Increased potential for M&A and privatization given listed discounts to private real estate market prices, robust bids, and the ongoing appetite for high quality, core real estate among institutional investors

**Global real estate downside risks**

- A rapid and unexpected change in the current term structure of interest rates
- An acceleration in the pace of new commercial real estate supply
- Cessation of real estate cap rate compression and potential expansion

**Global macro risks**

- Diverging central bank policies, softening in China, a renewed retreat in oil prices and a return of European sovereign credit risk are all potential areas of concern
Composite Performance

As of 9/30/16
Periods over one year are annualized.
Index: FTSE EPRA/NAREIT Developed Rental Index (net)
Inception date is 3/31/2009

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Past performance is not indicative of future results. Returns are expressed in U.S. dollars and include the reinvestment of dividends and other earnings. Indices are not available for direct investment and index returns do not reflect the deduction of any fees. Gross composite returns are net of trading costs. Net composite returns are net of trading costs and our highest separate account investment management fee. Investment advisory fees are described in Part 2A of our Form ADV. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities. Forward-looking statements are necessarily speculative in nature. It can be expected that some or all of the assumptions or beliefs underlying the forward-looking statements will not materialize or will vary significantly from actual results or outcomes.

The FTSE EPRA/NAREIT Developed Rental Index (net) is a free-float market capitalization index measuring developed market global real estate securities that meet minimum size, liquidity and investment focus criteria. The Index is a sub-set of the FTSE EPRA/NAREIT Investment Focus Index Series, which separates the existing constituents into both Rental and Non-Rental Indices.

The MSCI World Index (net) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of global developed markets.

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