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. The lift in equities included listed real estate and continued into August. In the case of U.S. Treasuries, their rally peaked intra-day on July 6th, two days before strong payrolls were released for the month of June. 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 the REIT market.

By August 15th, the S&P 500 peaked for the quarter at 2,190, and finished the quarter at 2,168 for a return of 3.85%. By comparison, the S&P Utilities Index peaked for the quarter on July 6th, and finished with a -5.91% return for the quarter. REITs peaked on August 1st, and finished the quarter with a -1.43% return as measured by the FTSE NAREIT Equity REITs Index (“the Benchmark”).

While equities were lifting into August, the opposite could be said for oil. However, an OPEC accord became a possibility in Algiers by quarter end. As we go to print, the price of oil, as measured by the current West Texas Intermediate contract, has returned to its high of since June 23rd, the last day of trading before the Brexit vote, and finished the quarter at 160 basis points.

The most significant piece of news late in the quarter was the cluster of hawkish comments relative to interest rates, quantitative easing and associated asset purchases or curtailment thereof, whether by ECB President Mario Draghi, the BOJ, or the FOMC along with dovish Fed Presidents becoming hawkish. By September 13th, the US 10 Year Treasury Yield lifted to 175 basis points, a level not reached since June 23rd, the last day of trading before the Brexit vote, and finished the quarter at 160 basis points.

REIT Market Review

The widely discussed GICs sector break out for real estate became effective in September, an appropriate recognition considering real estate is its own asset class.

As mentioned earlier, the FTSE NAREIT Equity REITs Index returned -1.43% in the quarter. While the Benchmark lagged the S&P 500 during the quarter, returns remained strong year-to-date at 11.75% compared to 7.84% for the S&P 500.

REIT second quarter earnings, which were reported in the third quarter, were solid and reinforced our constructive view on the asset class. The REIT sector, as measured by Evercore ISI, overall posted 4.6% same store net operating income growth in 2Q16 which was healthy, yet a bit of a deceleration from the current cycle high of 5.7% experienced in 1Q16. These results reflect the REIT sector’s current pricing power which has resulted from several years of low supply growth and solid tenant demand.

Taking a closer look at the performance of the individual property sectors that are represented within the FTSE NAREIT Equity REITs Index, the top-performing property sectors during the third quarter on a total return basis included Industrial, Office and Single Family Homes. The performance of the Industrial sector is benefitting from healthy demand for warehouses from companies who compete in the fast growing world of ecommerce. ProLogis led the industrial names in the quarter. Office outperformance commenced with the earlier mentioned strong payrolls for June released on July 8th and ensuing increased risk-on appetite. Lodging did the same, but faded in September more than any other sector. Two Single Family Home rental company shares performed well, American Homes 4 Rent and Silver Bay Realty Trust, on the back of positive earnings reports, which demonstrated continued growth in occupancies and rents and the well managed integration of recent company acquisitions by two of the larger public players.

The three bottom-performing property sectors during the third quarter were Self Storage, Specialty and Data Centers. The Self Storage property sector, which has been one of the best performing sectors over the last five years, underperformed during the quarter on concerns regarding slowing market rent growth. Same store net operating income growth slowed to 8.7%, which was still the highest level of any property sector, and over 400 basis points above the average REIT sector, as measured by Evercore ISI. One year ago, the same store net operating income in 2Q15 was 9.4%, 70 basis points higher. Specialty was adversely impacted by the underperformance of two Prison REITs after contract risk loss became a real issue. 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 the larger companies in the space experienced lumpiness in leasing, and the market was reluctant to give it credit as to whether the pace had improved in the third
quarter. Another company 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.

REIT Portfolio Review

Overall, our U.S. REIT strategy lagged the Benchmark during the third quarter. Security selection and property sector allocation detracted from performance.

What Helped Third Quarter Performance:
Considering both property sector allocation and security selection, Specialty, Office, Single Family Homes and Lodging were the largest contributors.

Specialty was zero weight in the portfolio, and benefited from a lack of exposure to the poor performing Prison REITs. Office benefited from our overweight allocation, while losing a few basis points on security selection as one of our outperforming names in the first half lagged during the risk-on window, yet still outperformed the Benchmark. Single Family Homes benefited from both our overweight allocation and security selection.

From a pure allocation perspective, Specialty at zero weight, and Industrial and Office at overweight, were the largest contributors.

We have been overweight the industrial property sector for some time given our positive view on the cyclical recovery of industrial real estate fundamentals and the secular demand for warehouse space that is being driven by the growth in ecommerce retail sales. These dynamics continue to be positive for occupancies and rental rate growth.

At the security level, our overweight exposure to a shopping center REIT which outperformed both Shopping Centers and the Benchmark, and zero weight to a multifamily REIT were the largest positive contributors.

What Hurt Third Quarter Performance:
Considering both property sector allocation and security selection, Health Care, Data Centers, and Self Storage were the largest detractors.

From a pure allocation perspective, our overweight to Data Centers and Self Storage, and underweight to Health Care were the largest detractors from performance.

Last quarter we had written how our overweight allocation to Data Centers had been a contributor and was supported by the strong growth in IT infrastructure outsourcing and the rapid adoption of cloud computing. In particular, healthy demand is being driven by hyperscale users such as Amazon’s AWS and Microsoft’s Azure. Data Centers became a detractor in the third quarter.

Security selection added to the detraction in Health Care and Data Centers. In one instance, after a significant period of underperformance to peers and the Benchmark, the CEO of a company we did not own resigned, which was followed by strong performance versus its peers and the Benchmark. In another case, outperformance at the start of the quarter turned for one holding, first as a source of funds in a risk-on environment, and then as its CEO announced retirement. Both events more than offset an earnings beat and guidance raise in the short term as one would expect.

At the security level, our overweight exposure to a mid-cap Industrial REIT was the largest detractor in the quarter, reversing its role as largest contributor last quarter. While performance exceeded the Benchmark, and it has been positively impacted by the healthy industrial trends mentioned above and its prudent capital allocation track record, it lagged its Industrial peers.

Investment Outlook

From our perspective the U.S. 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 this year and into 2017.

In aggregate, we view a backdrop of low, but positive U.S. economic growth and manageable new real estate supply as positive fundamental tailwinds for U.S. REITs going forward. Should U.S. 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 U.S. real estate securities in 2016.

After the market close on August 31, 2016, Real Estate became the 11th GICs Sector and the first additional Sector added to the GICS structure since the 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

Portfolio Managers

Geoffrey Dybas, CFA
Group Head
Senior Portfolio Manager
26 years investment experience

Frank Haggerty, CFA
Portfolio Manager
20 years investment experience

For more information contact
Robert Hiebert, CFA
Senior Relationship Manager
Robert.hiebert@dpimc.com
Tel: 312-917-6560
Composite Performance

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 Benchmark is the FTSE NAREIT Equity REITs Index, a free float market capitalization-weighted index measuring equity tax-qualified real estate investment trusts, which meet minimum size and liquidity criteria and are traded on the New York Stock Exchange, the American Stock Exchange, and the NASDAQ National Market System.

The S&P 500 Index is a free-float market capitalization-weighted index of 500 of the largest U.S. stocks and is generally representative of the performance of larger companies in the U.S.

The Global Industry Classification Standard (GICS) are developed by and the exclusive property and a service mark of MSCI Inc. (MSCI) and Standard & Poor’s, a division of the McGraw-Hill Companies, Inc. (S&P).

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