INFLATION, RISING RATES, RECESSION, OH MY!

REITs AS A ROAD TO OUTPERFORMANCE

JUNE 2023

In the classic, Academy-Award-winning film "The Wizard of Oz," the Tin Man warns Dorothy and the Scarecrow that they may encounter fearsome risk as they follow the Yellow Brick Road toward the gleaming green safety of the Emerald City.

"Lions?" Dorothy asks with alarm. "And tigers?" follows the Scarecrow. The Tin Man answers with a solemn nod, "And bears."

In the real world, bearish sentiment is abundant as investors assess converging risks. During the last 15 years, the Federal Reserve's quantitative easing (QE) and zero interest rate policy (ZIRP) had created a comfortable environment for investors, with low volatility, ultra-low interest rates and, until recently, benign inflation. Now, faced with the swirling headwinds of sticky inflation, rising interest rates, and potential recession, many investors sense that the economy is not in proverbial Kansas anymore. However, markets with comparable backdrops over the decades provide useful reference, and areas of opportunity are visible through the current turbulence.

Looking across the investment landscape, we observe that REITs possess particularly strong fundamentals – contrasting favorably with other sectors – and are well-positioned to provide a safe harbor of comparative stability.

An important caveat is that we view economic conditions, interest rates, and capital markets as the three most significant risks with respect to the case we make in the following pages. With regard to economic conditions, a deeper recession or harder landing than expected would likely be a headwind for REIT performance, especially in more cyclical property sectors. If interest rates stay higher for longer than expected or expectations for future Fed hikes become more hawkish – or both – negative sentiment will weigh on REIT returns. Lastly, further deterioration of the commercial real estate lending market would pressure pricing of underlying property values and negatively affect performance.

Market Backdrop

Since the onset of the COVID-19 pandemic in 2020, rising inflation has been an ongoing concern. With massive government spending and continuous supply chain bottlenecks, annual inflation in the U.S. reached a 40-year high of more than 9% in June 2022 before closing out the year at approximately 6.5%. To tamp down on surging inflation, the U.S. Federal Reserve ("the Fed") made several rate hikes, beginning in March 2022, of 25-75 basis points to raise the upper policy rate to 5.25% as of May 2023. The overall rate change represents the largest move since the 1980s.

Other reserve banks around the world have followed the Fed, with the Bank of Japan a notable exception. The rapid pace of this cycle has led to return of volatility across all market sectors, and 2022 yielded one of the lowest 60/40 portfolio 12-month returns on record. Growth-oriented stocks and REITs underperformed broad markets, and this has led to lower relative valuations, deeper discounts to net asset value (NAV) and, ultimately, higher dividends.

We think this positions REITs to outperform in the future and – given that further substantial moves by the Fed are anticipated – regain their role as an inflation hedge investment.

Historically, REITs Have Protected Against Inflation and Rising Interest Rates

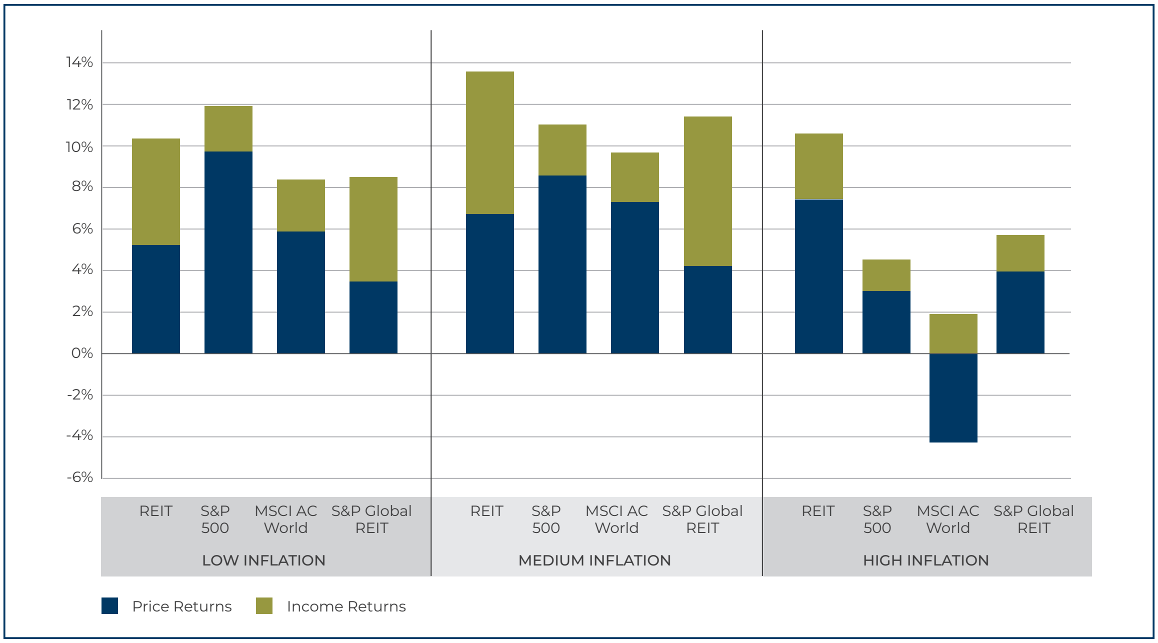
Given current conditions, it is important to recall that REITs have proven to perform well in past inflationary environments. Historically, REITs have provided inflation protection with their unique ability to increase revenue through rent repricing, as well as via inflation-linked growth of their portfolio values, since replacement cost value increases exhibit strong correlation with inflation. REITs are also total return investments offering high dividend yields, stable cash flow growth, and long-term price appreciation. These fundamentals, combined with presently discounted valuations, mean that REITs are poised to provide good value for investors in the current economic environment. In the following paragraphs, we will examine why and how REITs have been an effective inflation hedge.

U.S. REITs Performance in Inflationary Environments

REITs have been an attractive haven for investors seeking protection against inflation.

During historical periods of medium-to-high inflation and rising interest rates, REITs have generated positive total returns and outperformed equities, as compared to the S&P 500 and the MSCI AC World Index. As shown in the following chart – which incorporates several different inflation regimes over three decades – REITs have delivered attractive returns during periods of low, moderate, and high inflation.

REIT vs. Equity Market Returns During Different Inflation Periods



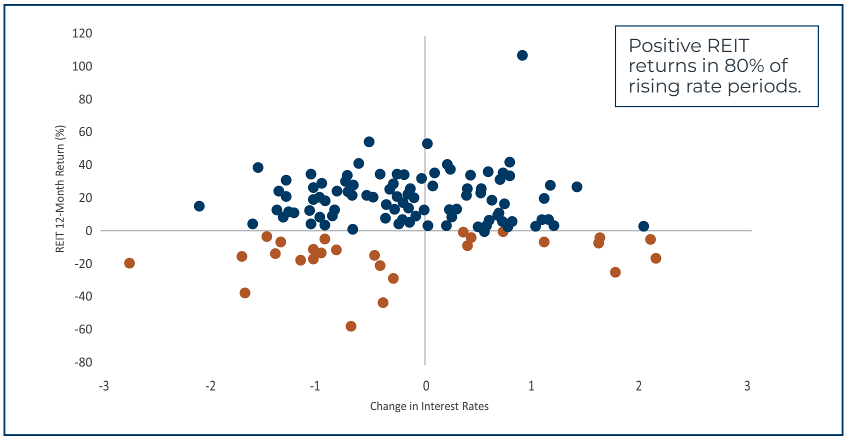
Note: Low inflation includes the years where inflation was 2.5% or lower, moderate inflation is between 2.5% and 7.0% (one standard deviation over the average), and high inflation is for years with inflation of 7.0% and higher.

Source: NAREIT analysis of quarterly 12-month returns for the FTSE Nareit All Equity REIT Index and S&P 500 Index; 1990Q3-2023Q1; inflation measured for all items, all urban consumers. Indices are not available for direct investment and index returns do not reflect the deduction of any fees.

U.S. REITs Performance in Periods of Rising Rates

Contrary to common perception, REITs – in contrast to other investments – have shown little correlation with interest rates, as indicated by the blue points in the chart, along with the ability to perform well in most markets, as highlighted in the table following the chart.

REIT Total Returns and Rate Changes: 1992 to 2023-Q1
12-Month Return and Change in 10-Year Treasury

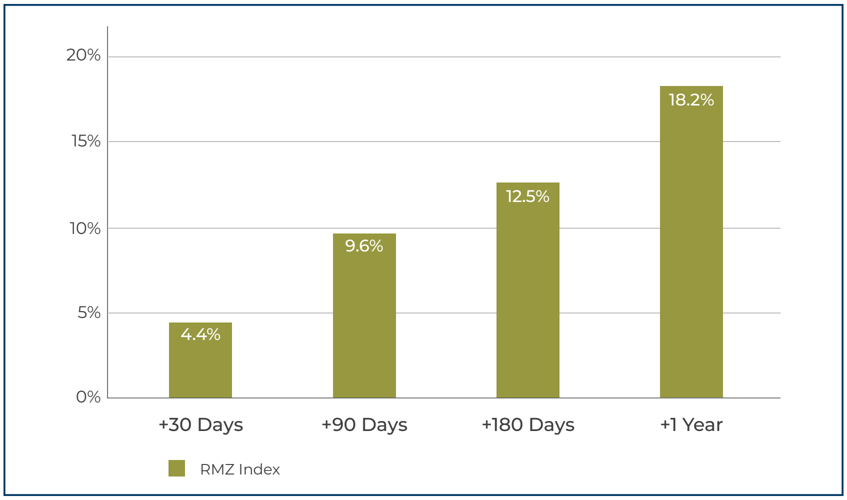


Source: *Nareit analysis of Nareit All Equity REIT Index via FactSet. 10-Year Treasury Constant Maturity Rate via FRED. Quarterly intervals of 12-month rolling returns.*

U.S. REITs Performance Following Fed Tightening Cycles

REITs have performed well in periods after the Fed stops tightening. On average, as shown in the following chart, REITs have returned 18.2% in the 12 months following a Fed tightening cycle.

RMZ Average Return - Post Fed Tightening



Source: *Duff & Phelps, Factset, Evercore ISI Research "A Deeper Dive Into REIT Subsector Performance Post Fed Tightening Cycle," 9/7/2022. RMZ is the MSCI US REIT Index. Post Fed tightening periods are the 12 months following: February 1, 1995; May 30, 2000; June 29, 2006; and December 27, 2018. Indices are not available for direct investment and index returns do not reflect the deduction of any fees.*

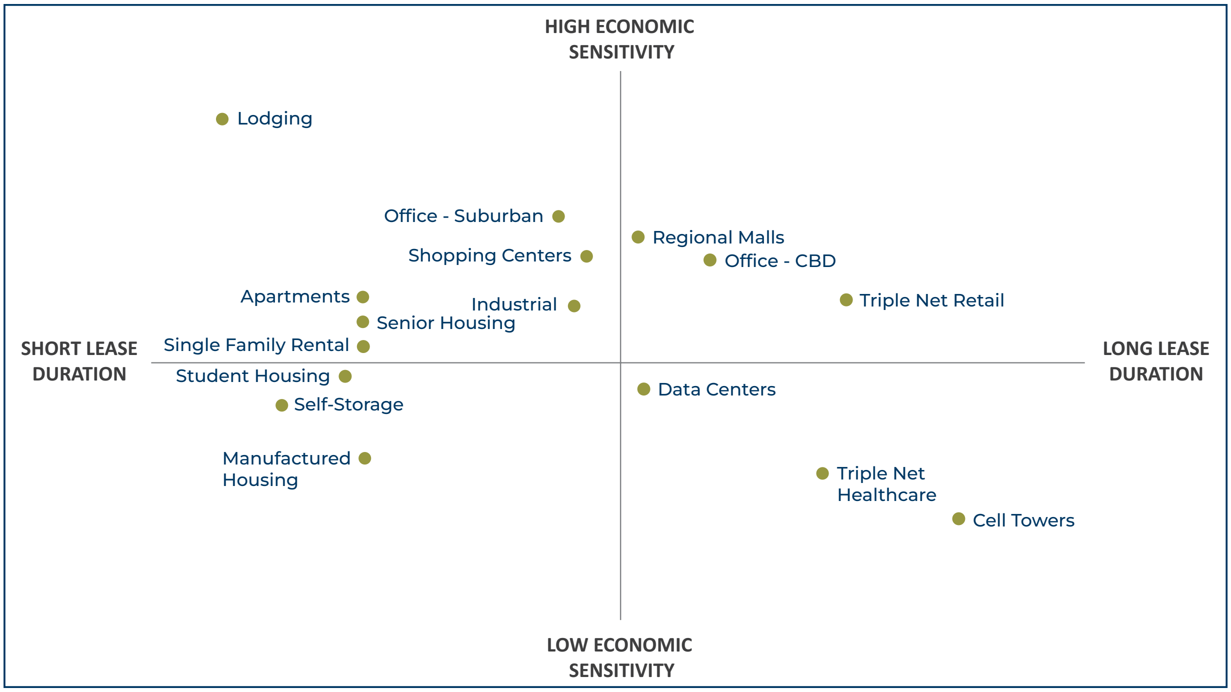
U.S. REITs Are Structured to Perform in Inflationary Environments

Duff & Phelps has long recognized real estate's provision of inflation protection and, as shown, real estate has proven to be a beneficial investment during periods of rising inflation. Key attributes of real estate providing inflation protection characteristics include increases in real estate replacement costs that come with rising inflation, along with the ability to raise rents and, in turn, cash flows. In inflationary environments, long-term lease sectors typically have inflation adjustments built in, while shorter term lease sectors can quickly reprice to current price levels in the economy.

An important factor driving attractive REIT returns is the ability that landlords have to increase rents and thereby transfer inflation costs to properties' end users. Having the ability to reprice leases more frequently is a significant advantage, particularly in property sectors with typical lease durations of one year or less, which include the lodging, apartments, single-family home rentals, manufactured home communities, student housing, senior living, and self storage sectors. Given the wide variety of property sectors available in the listed real estate market today, lease durations can range from as short as a day to over a decade, and just as bond portfolio managers can adjust the effective duration of their portfolios, active managers can do the same through a selection of listed real estate securities with shorter or longer average lease duration.

REITs Offer a Diversified Property Mix with Unique Characteristics

In the following chart, we identify the diversified mix of REITs sectors available and explore their individual sensitivity to economic conditions, which impacts valuation, and their lease duration, which indicates the length of time before price changes. Lease duration is key to building price sensitivity into a REITs portfolio, similar to duration-based price sensitivity in a bond portfolio.



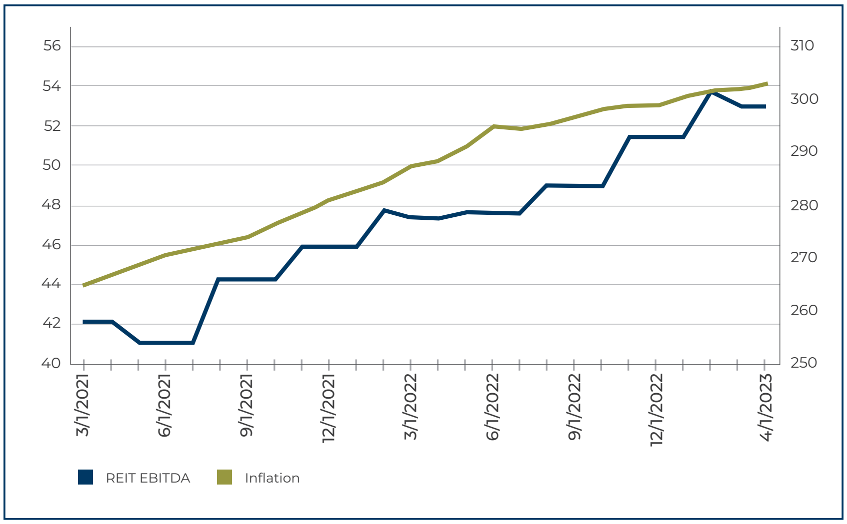
Note: Lease duration and economic sensitivity reflect trends observed in the U.S.

Source: Duff & Phelps Investment Management Co., as of March 2023.

REIT Earnings Show Strong Correlation to Inflation

Despite the lag of performance versus inflation, earnings tell a different story. Earnings have shown resiliency and have kept steady pace with inflation since inflation eclipsed 3% in Q1 2021 (see graph). During this recent spike in inflation, REITs earnings (EBITDA) have kept pace well, exhibiting a 95% correlation.

REIT EBITDA vs. Inflation
March 1, 2021 - April 28, 2023



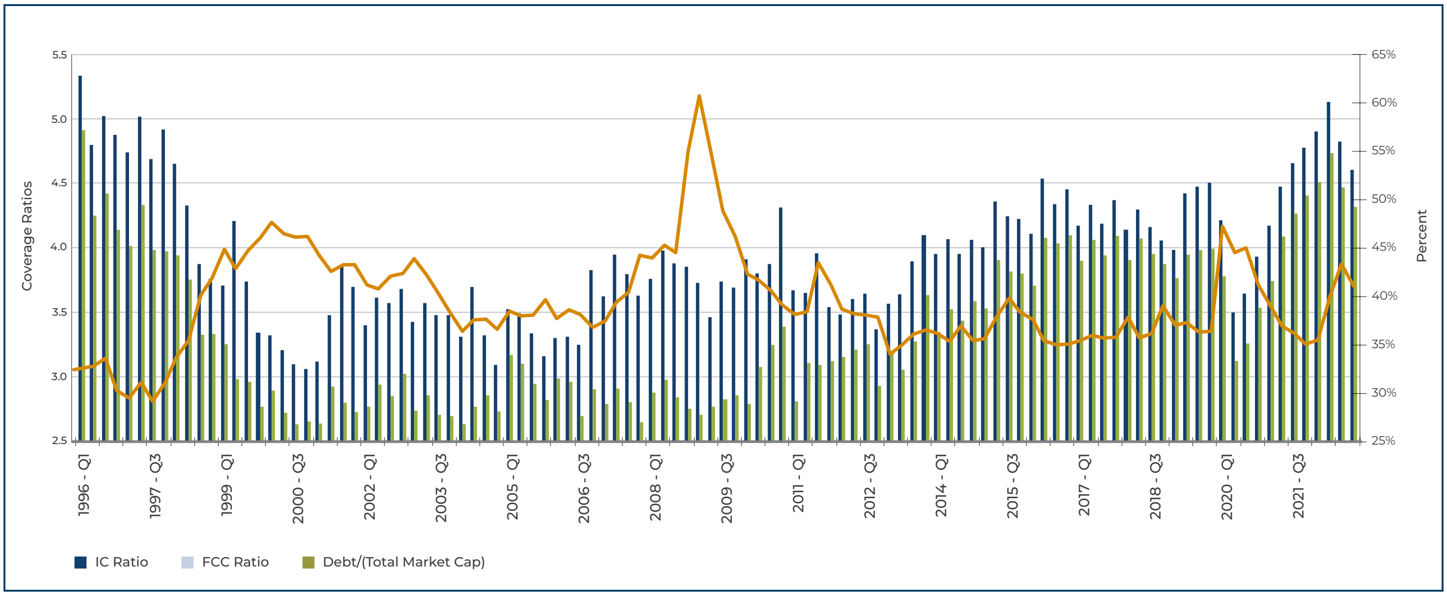
Source: Duff & Phelps, Bloomberg Finance L.P. – REIT EBITDA based on FTSE Nareit Equity REITs Index. Inflation is US CPI Urban Consumers YoY NSA Index.

The Case for Buying REITs Today

Strong Fundamentals and Compelling Value Amid Recession Fears

To compound difficulties for broader equities markets, high inflation and the Fed's seemingly drastic moves to rein it in have together fueled fears that a recession is coming. Despite this, overall REIT fundamentals and balance sheets are close to the strongest they have been in their history, suggesting that REITs would fare comparatively well and serve as a port in the storm if a recession were to actualize. As shown in the following chart, total debt to total capitalization has remained stable, leading to higher coverage ratios and limiting the need for equity offerings or dispositions.

Average U.S. Equity REIT Leverage and Coverage Ratios
Period ending February 28, 2023



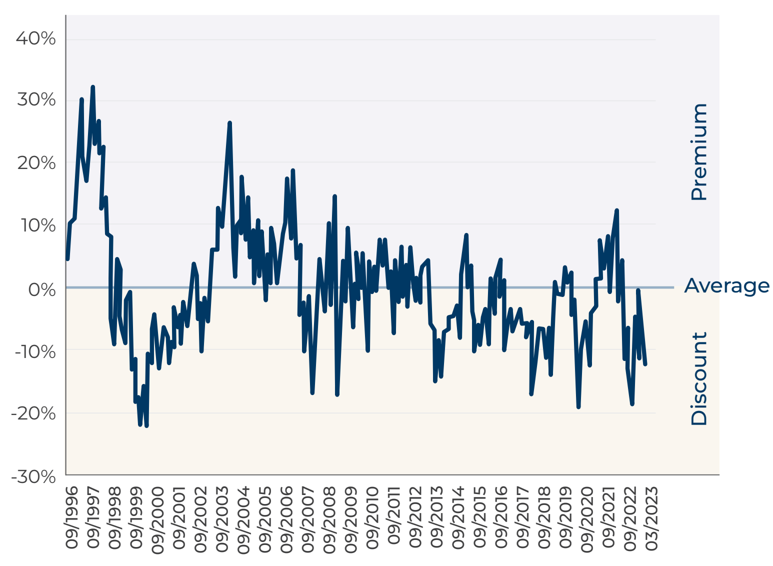
Source: S&P Capital IQ.

Analysis points to continuing secular growth for data centers and towers as economic digitalization and demand for communications infrastructure increases. Industrial, logistics, residential, and self storage are also seen as sectors with continuing favorable growth on the horizon because of both cyclical and secular tailwinds.

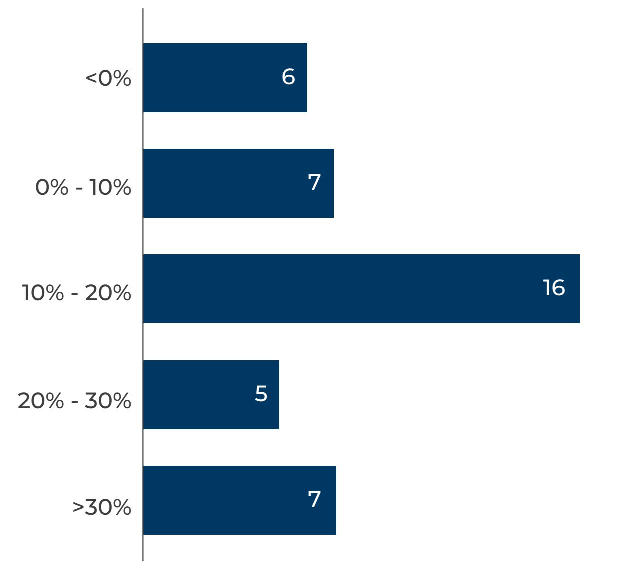
While current REIT fundamentals are remarkably sound, wider uncertainty surrounding equities markets has contributed to the creation of a potential value investment opportunity. On average, REITs have historically traded at 100% price-to-NAV ratios. However, as of the end of the first quarter of 2023, U.S. REITs were priced at a substantial 10%[1] discount to NAV.

Our analysis shows that U.S. REITs have historically provided compelling returns whenever price-to-NAV for REITs has been at a discount of greater than 10%. Price returns for the FTSE Nareit Equity REITs Index in the 12 months following a price-to-NAV discount of more than 10% were positive in 35 out of 41 periods from August 1996 to March 2023, as shown in the following chart. Dividend yield returns provided by REITs, in addition to their current discounted valuations, make REITs an even more attractive investment opportunity.

REIT Trading at Historical Discount
Historical Price-to-NAV*



REIT Performance when Discounts were Greater than 10%
12-Month Forward Returns - FTSE Nareit Equity REITs Index



Source: Duff & Phelps, Evercore ISI, FactSet, data as of 3/31/23. U.S. REIT performance is price only; indices are not available for direct investment and index returns do not reflect the deduction of fees.

**Price to NAV is a metric used to estimate the market value for REIT holdings. It is not a measure of performance. Rather, it is a ratio similar to price-to-book value used when comparing traditional stocks.*

1 *Evercore ISI, as of March 31, 2023.*

Conclusion

Real estate owners' ability to reprice and increase rents, thereby passing on costs to renters, provides REITs with characteristics that protect against inflation. At the same time, REITs today possess strong fundamentals while pricing at a discount to NAV, thus providing a compelling potential value investment opportunity. We believe that these unique factors – amid high inflation, increasing interest rates, and recession fears across equities markets – make REITs a rare road to stability and compelling market performance.

For more information about Duff & Phelps Investment Management Co., please visit www.dpimc.com.

The FTSE Nareit All Equity REITs Index consists of U.S. publicly listed equity real estate investments (REITs). The FTSE Nareit Equity REITs Index consists of REITs not designated as timber or infrastructure REITs. The MSCI AC World Index consists of global developed and emerging market equity securities. The MSCI U.S. REIT Index consists of investable U.S. equity REITs. The S&P 500® Index consists of equity securities of 500 of the largest U.S. companies. The S&P Global REIT Index consists of publicly traded equity REITs listed in both developed and emerging markets.