Perspectives

ClearBridge Advisors

Another Arrow in the Quiver: Diversifying Income with REITs

Mark McAllister
Portfolio Manager
ClearBridge Advisors

- As investors turn to a wider range of asset classes for income, REITs represent a valuable source of diversification.

- Over the last 20 years, dividend payouts have grown at rates that have consistently outpaced inflation.

- In the short term, REITS performed well in the first half of 2012, handily outperforming equities overall. While they are not immune to the impact of slower US growth, the outlook remains generally positive.

- Many REITs have taken advantage of current conditions to reduce financing costs, term out debt maturities and issue common stock, strengthening balance sheets in anticipation of new investment opportunities.

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TAKING AIM AT INCOME

The scarcity of yield that continues to challenge investors has driven many toward new sources of income. Equity investments such as dividend-paying stocks and master limited partnerships[1] have attracted significant inflows despite a generally tepid economic environment.

As investors take aim at their particular investment targets, publicly listed REITs (Real Estate Investment Trusts) represent another arrow in the quiver of potential income solutions.

Dividends, of course, are the raison d'etre of the REIT – defined as a company whose primary business activity is the ownership or financing of real estate and which qualifies to make a special election under the federal tax code. As a REIT, most or all of the company's earnings are exempt from corporate income tax and, by law, it must distribute a minimum of 90% of its taxable income to shareholders in the form of dividends.

In today's low-rate environment, it's the strong potential of REITs to deliver income and income growth that is capturing the imagination of a growing number of investors. Dividend yields on REITs averaged 3.7% over the 12 months ending 6/30/12; the average dividend per share increase year to date through 6/30/12 has been 12.7%[2]. That, combined with REITs' relative lack of correlation to equity and bond returns argues for the inclusion of REITs in an overall income strategy.

Allocations to real assets are a fixture of well-diversified model portfolios at both the individual and institutional level, and REITs provide an efficient, liquid and transparent vehicle for investors to access the $11 trillion[3] commercial real estate market.

REITs have a moderate correlation to equity markets and a low correlation to bond markets, and a corresponding ability to enhance risk-adjusted portfolio returns.

Within the real estate asset class, publicly-listed REITs have much lower transaction costs, far greater liquidity and better financial transparency than investment vehicles such as real estate private equity funds, limited partnerships, private REITs and non-listed public REITs.

[1] Master limited partnerships are a type of limited partnership which typically (though not always) are traded on public exchanges, and by law must derive at least 90% of their income from select sources (e.g. energy, natural resources or real estate) and pay out most of their cash flows as quarterly distributions to shareholders.

[2] SNL Securities.

[3] *Slicing, Dicing, and Scoping the Size of the U.S. Commercial Real Estate Market* by Andrew C. Florance, Norm G. Miller, Jay Spivey and Ruijue Peng, Journal of Real Estate Portfolio Management, Volume 16, No. 2, 2010

THE RISE OF PUBLICLY TRADED REITS

Since their introduction in 1960, the historical trajectory of REITs has been toward greater transparency and acceptance by both institutional and individual investors.

Initially, federal legislation required REITs' ownership of real estate to be separate from their operational activities (e.g. acquisition, development, leasing and property management). This created an unfortunate bias among the private advisory companies that managed Equity REITs to focus on generating greater fee income, rather than expanding shareholder value.

The Tax Reform Act of 1986 removed this mandatory separation, paving the way for self-managed, self-advised REITs that were not prone to the conflicts of interest that bedeviled externally advised REITs. Until this change, the most popular method for individuals to invest in real estate was through limited partnerships. However, these partnerships often required investors to pay substantial front-end fees and management fees, and liquidity was limited since most partnerships were not publicly traded.

The watershed event in the growth of publicly traded REITs occured in 1991 with the $128 million initial public offering of Kimco Realty Corp. A year later, Taubman Centers Inc. launched a $295 million IPO and introduced the Umbrella Partnership REIT, which allowed real estate companies to avoid triggering substantial tax penalties when converting from limited partnerships to publicly traded companies.

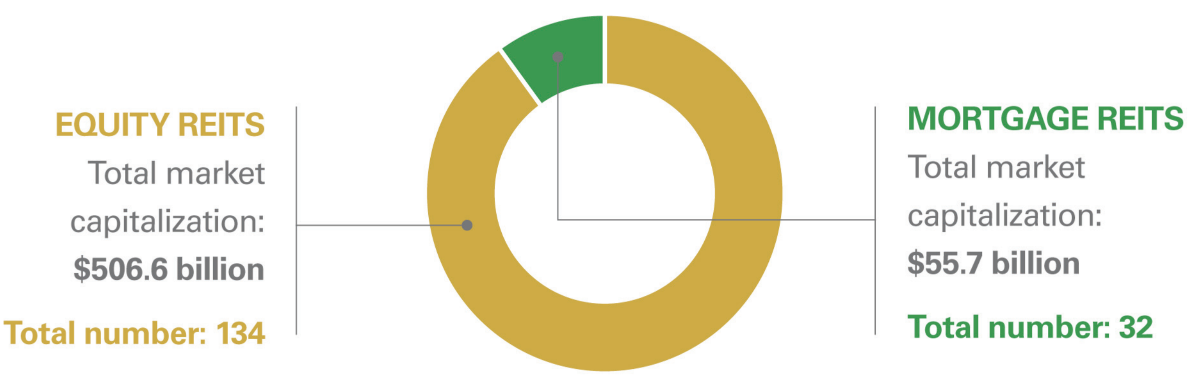
Following these innovations, the market for publicly owned REITs gained momentum and the number of companies grew large enough to attract investments from institutional shareholders. Today, there are more than 150 publicly traded REITs, providing individual as well as institutional investors with diverse and highly liquid access to this unique asset class.

Sidebar: Types of REITS

Equity REITs primarily make equity investments in a wide variety of property types, including office buildings, regional malls, multifamily apartments, shopping centers, hotels, self-storage facilities, freestanding retail properties, health care facilities and warehouse/distribution facilities. This type of REIT dominates the market, accounting for the great majority of market capitalization.

The other category is **Mortgage REITs,** which include the Home Financing Mortgage REITs and Commercial Financing Mortgage REITs subsectors. The home mortgage subsector is primarily engaged in the financing of home mortgages through purchases of residential mortgage backed securities issued by government-sponsored entities such as Fannie Mae and Freddie Mac as well as companies such as banks. Commercial Financing Mortgage REITs engage in mortgage financing of commercial property investments.

Equity REIT vs. Mortgage REIT market capitalization



Source: NAREIT, based on FTSE NAREIT All REITs Index, June 30, 2012

STATE OF THE MARKET

U.S. real estate market fundamentals are making a cyclical recovery from the recessionary levels of 2008-09.

Occupancy rates and market rents are up across virtually all property types and there is little current development activity outside of the apartment sector. Real estate financing markets continue to improve, which should deepen the liquidity pool available for new investments.

REIT company balance sheets are generally healthy with regard to leverage and liquidity.

The 2008-2009 economic downturn left many REITs suffering as capital markets froze and companies scrambled to maintain liquidity. However, only one equity REIT was forced to seek bankruptcy protection (General Growth Properties) – and that was due to specific liquidity issues related to the company's debt structure.

Since then, many REITs have taken advantage of low interest rates to refinance outstanding debt on attractive terms and position themselves to seize potential investment opportunities. Others have strengthened their financial position through the issuance of additional common stock. The debt ratio of equity REITs (total industry debt as a percentage of its total debt and equity market capitalization) as of December 31, 2011 was 38.6% -- significantly lower than the 51% that prevailed at the end of second quarter 2008, prior to the "Great Recession."

A better capitalized REIT sector would appear well positioned to leverage market opportunities should investment opportunities accelerate – as well as weather a temporary economic slowdown in the U.S.

After suffering during the post-financial crisis recession, REITS have bounced back and delivered relatively strong returns into 2012.

The total return for the MSCI US REIT Index for the first half of 2012 was 14.9% compared with 9.5% for the S&P 500 Index and 9.3% for the Russell 3000 Index. This performance was primarily driven by improving fundamentals, a 3.4% dividend yield for equity REITs[4] coming into 2012 and the prospect of robust dividend growth — all enough to turn heads in the current low-rate environment.

Though not immune to the impact of an economic slowdown, REITs' earnings potential remains resilient.

REIT revenues are primarily derived from recurring, contractual sources such as rents, rather than from sales transactions. This provides a stabilizing influence on the income potential REITs can offer investors. And actively managed REIT investment portfolios can exploit differences in relative sector and company valuations, providing another lever of returns.

Slower growth in the US could result in decreased lending activity and a corresponding reduction in new commercial real estate development. If interest rates were to decline and

[4] Source: Bloomberg Yield for MSCI US REIT Index, 12/31/11

prices languish, landlords would have an incentive to recapitalize properties they own and defer sales activity until pricing improves. In addition, cash flows would rise more slowly.

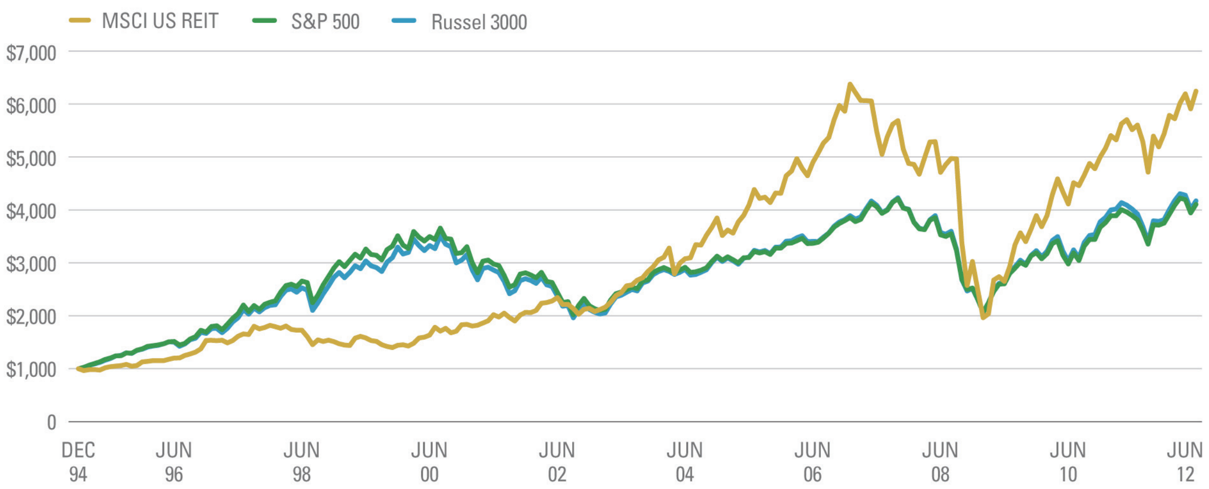
However, commercial construction is at a historic nadir as a percentage of existing stock; except for apartment buildings, construction financing is hard to obtain, limiting supply and supporting the prices of existing inventory. And given the relatively strong state of many REITs' balance sheets (good to very good asset quality, good liquidity, moderate leverage with laddered maturities), any reduction in prices has the potential to result in substantial acquisition activity.

A DISTINCT PATTERN OF PERFORMANCE

Strong long-term returns: REITs have delivered strong returns over the past two decades, particularly since the end of the 2001-2002 economic downturn. While the 2008 financial crisis brought REIT returns down to the same level as those of equities, they have rebounded smartly going into mid-2012.

Average return MCSI US REIT, S&P 500 and Russell 3000, 1/1/95 through 6/30/12, indexed to 1000

Growth of $1,000 for MCSI US REIT, S&P 500 and Russell 3000 ($) 1/1/95 through 6/30/12

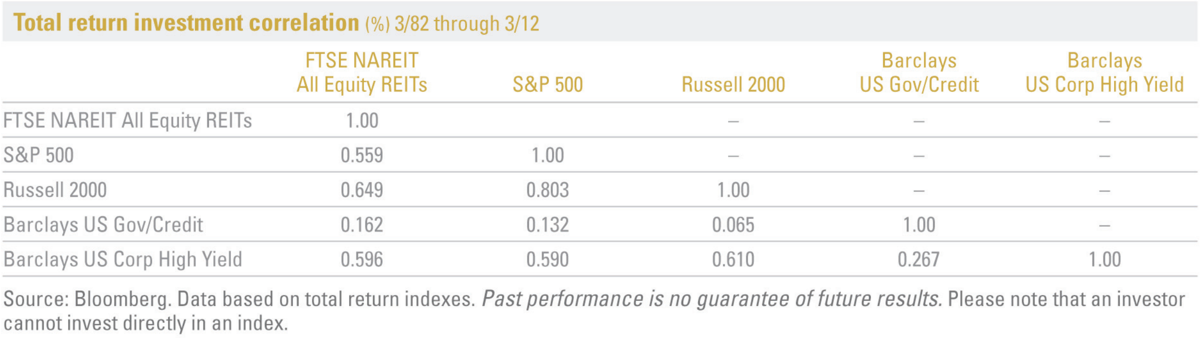


Source: Zephyr. *Past performance is no guarantee of future results.* Investors cannot invest directly in an index

Low correlation with traditional asset classes: With a relatively low correlation to bond market performance and a moderate correlation to equity market performance, REITs offer a meaningful level of diversification against other investments as well as the potential to enhance risk-adjusted returns.

Why do REITs exhibit this low level of correlation? Two reasons come to mind. First, REIT returns are substantially based on dividend distributions rooted in ongoing income streams from rents and mortgage payments. These streams tend to be fairly consistent amid economic shifts and offer the prospect of less volatility than provided by equities and a higher rate of return over time than fixed income. In addition, the underlying assets incorporate variables unique to real estate that may impact the stability of the valuations: property locations, proximity to transportation, and the like.

Total Return Investment Correlation: 3/82 through 3/12



Total return investment correlation (%) 3/82 through 3/12

	FTSE NAREIT All Equity REITs	S&P 500	Russell 2000	Barclays US Gov/Credit	Barclays US Corp High Yield
FTSE NAREIT All Equity REITs	1.00		–	–	–
S&P 500	0.559	1.00	–	–	–
Russell 2000	0.649	0.803	1.00	–	–
Barclays US Gov/Credit	0.162	0.132	0.065	1.00	–
Barclays US Corp High Yield	0.596	0.590	0.610	0.267	1.00

Source: Bloomberg. Data based on total return indexes. *Past performance is no guarantee of future results.* Please note that an investor cannot invest directly in an index.

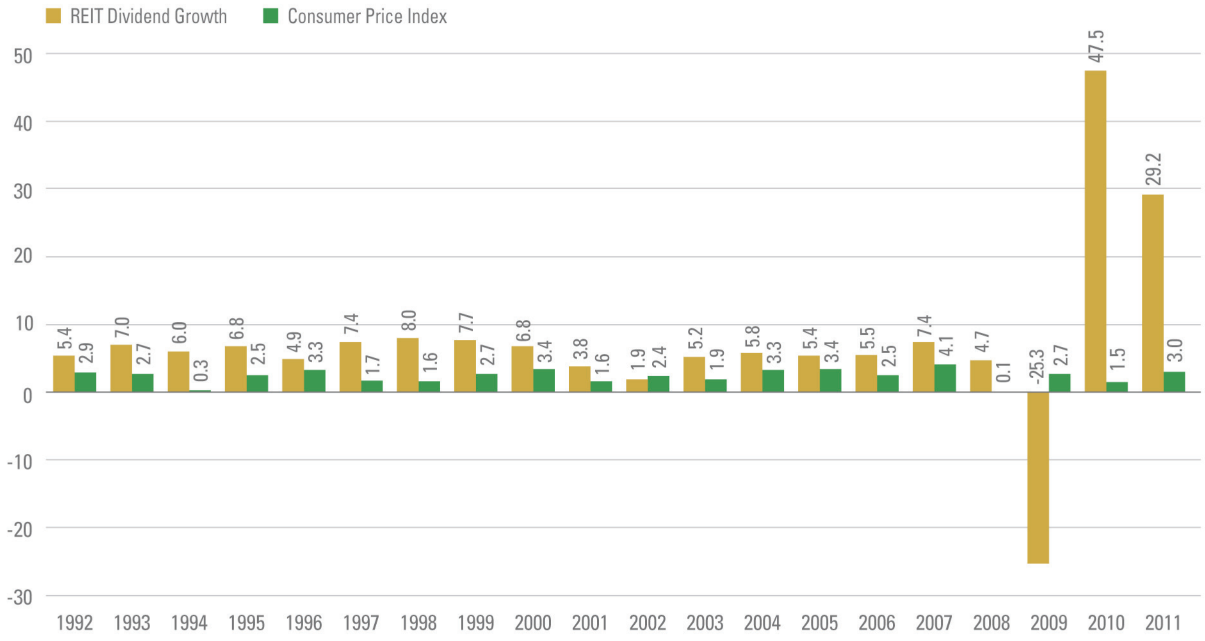
Inflation protection: The commercial real estate business in general is characterized by several features that help support dividend growth that's historically surpassed inflation; the ability to generate regular increases in rental income through contractual increases embedded in leases; the recovery of operating expenses through pass-through clauses; and demand-driven pricing during economic expansion. With the exception of 2002 and 2009, REIT annual dividend growth has exceeded the Consumer Price Index in every year since 1992.

What's more, according to a recent analysis by NAREIT covering January 1978 through February 2012, equity REIT total returns equaled or exceeded the inflation rate 66.3% of the 6-month periods when inflation was above average.[5]

[5] NAREIT proprietary analysis of data from Interactive Pricing Data, via FactSet.

REIT Dividend Growth per Share vs. Consumer Price Index, 1992-2011

U.S. REIT Dividend Growth per Share vs. Consumer Price Index (%) 1992-2011



Source: NAREIT. Reflects publicly listed US REIT growth/decline in regular dividends per share, weighted by market capitalization.
Past performance is no guarantee of future results.

CONCLUSION

Real assets represent an important source of diversification for investors, particularly given the persistence of the risk-on/risk-off trading patterns that continue to generate short-term volatility in both stock and bond valuations. Publicly traded REITS provide investors with a convenient means to access the real estate asset class marked by transparency as well as liquidity. Long term, the relative stability of REIT cash flows and their strong performance in inflationary periods supports a dedicated allocation to this asset class.

Perhaps even more important in today's low-yield environment, REITs also represent an intriguing potential source of current income as well as future income growth and capital appreciation – one that may be easily overlooked by investors who maintain a traditional focus on the bond markets for income. Given that many REITs have taken advantage of recent conditions to strengthen their "war chests" to facilitate future expansion they appear to be well-positioned to grow their future cash flows and distributions to shareholders..

Appendix:
Understanding REIT Valuations

Traditional measures of securities value (such as price/GAAP[6] earnings ratios for stocks or enterprise value/cash flow for corporations) do not work when valuing REITS. This is primarily due to the disconnect between GAAP standards for the depreciation of commercial real estate and the actual useful life of a commercial property, which tends to be far longer (in practice, 40 years or more). Two principal approaches to REIT valuation that we prefer are:

Premium/Discount to Net Asset Value

- This method uses estimates of the market value of tangible assets, less tangible liabilitities, to calculate a REIT's intrinsic value. This measure keeps the company's valuation closely aligned to the underlying value of its primary assets. It also removes the distorting effect of leverage by netting it out of the company's value; after all, stocks can look cheap on an earnings basis because they are benefiting from using large amounts of low-cost debt, yet that debt introduces additional risks. Further, this method of valuation removes some of the accounting distortions inherent in other valuation methodologies.

Adjusted Funds from Operations (AFFO)

- This is analogous to estimating free cash flow from operations. Generally, it is calculated as Net income + Real Estate Depreciation +/– Other Non-Cash Income and Expense Adjustments – Recurring Capital Expenditures (e.g. costs required to keep the properties

[6] GAAP (Generally Accepted Accounting Principles) refers to the prevailing set of standards and procedures used by US accounting professionals in the preparation of corporate financial documents.

leased at their current level and in a good state of repair). The result is divided by the fully diluted shares outstanding and the per-share amount is divided by the share price to get the AFFO yield, which is akin to a cash flow yield. The strength of this method is that it incorporates estimated recurring capital expenditures and better reflects a company's ability to generate recurring cash flows.

Index definitions

The S&P 500 Index is an unmanaged index of common stock performance. The Russell 2000 Index is an unmanaged list of common stocks that is frequently used as a general performance measure of U.S. stocks of small and/or midsize companies. The Russell 3000 Index is an unmanaged index of the 3,000 largest U.S. companies. The FTSE NAREIT All Equity REIT Index is a market capitalization weighted index that includes all tax qualified REITs listed in the NYSE, AMEX, and NASDAQ. The MSCI US REIT Index is a market capitalization weighted index comprised of equity Real Estate Investment Trusts ("REITs") that represents approximately 85% of the U.S. REIT universe. The Barclays Capital Government Bond Index is a broad-based index of all public debt obligations of the U.S. government and its agencies that have an average maturity of roughly nine years. The Barclays Capital U.S. Corporate High-Yield Bond Index is a broad-based universe of fixed-rate, non-investment grade corporate debt.

What should I know before investing?

REITS are subject to illiquidity, credit and interest rate risks, as well as risks associated with small-and mid-cap investments.

Equity securities are subject to price fluctuation. Dividends and yields fluctuate and are subject to change. Yields and dividends represent past performance and there is no guarantee they will continue to be paid. While dividends may cushion returns in down markets, investments are still subject to loss of principal amount invested. Fixed income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Asset-backed, mortgage-backed or mortgage related securities are subject to prepayment and extension risks. Diversification does not guarantee a profit or protect against a loss. There is no guarantee investment objectives will be met.

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