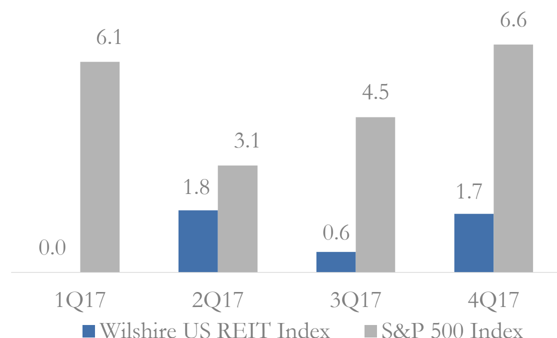
Risk On and On. Risk assets enjoyed a smooth upward ride in Fourth Quarter. Investors are learning to ignore short-term political volatility and any suspense surrounding the next chairman of the FOMC or the passage of the Republican tax plan seemed manufactured at best. There was some passing of the baton back and forth between secular growth (FANG stocks) and cyclical (airline, oil stocks, etc.) but, in reality, there was just too much money chasing too few goods as amply demonstrated by the meteoric rise of cryptocurrencies, breathlessly covered by CNBC reporters.

Economic data released during the quarter was good. The third estimate of Third Quarter GDP growth came in at 3.2%, compared to 3.1% for Second Quarter 2017 and average GDP growth of 1.9% and 2.0% in 2016 and 2015, respectively. According to the Bureau of Labor Statistics, changes in total nonfarm payroll in the past three months were 211,000, 252,000 and 148,000, respectively, an average of 204,000 compared to an average of 157,000 for the 12 months prior. The yield on the 10-Year Treasury Note rose from 2.326% to 2.405%.

The Wilshire US REIT Index ("Index") was up 1.7% in Fourth Quarter, lagging both the S&P 500 and Russell 2000 Indices which advanced 6.6% and 3.3%, respectively; this is the sixth consecutive quarter and second consecutive year of REIT underperformance. For the year, the majority of the constituents in the Index did produce positive returns. Not surprisingly, M&A targets led their sectors, including DuPont Fabros, the best performing REIT for the year (+53.7%). Retail REITs dominated the laggard board with CBL & Associates posting the worst returns for the year (-44.2%).

REITs vs. S&P 500 Index (%)

Total Return



Source: Bloomberg and Wilshire Associates.

Sector Performance of the Wilshire US REIT Index

Ranked by Fourth Quarter 2017 Performance

Sector	4Q17	Trailing 1-Year	Current Yield
Factory Outlets	10.2%	-22.3%	5.2%
Retail-Regional	9.6	-2.4	4.4
Hotels	5.4	6.5	5.1
Mfd. Housing	5.0	20.2	1.9
Retail-Local	4.4	-10.7	4.5
Storage	3.2	3.7	3.8
Office	3.2	3.0	2.9
Wilshire US REIT	**1.7**	**4.2**	**3.7**
Industrial	1.0	22.8	2.6
Industrial Mixed	0.4	10.4	3.1
Diversified	-1.3	4.1	2.7
Apartments	-1.5	3.5	3.3
Health Care	-6.0	-0.4	5.7

Source: Wilshire Associates.

Reversion to the mean. As suggested in the prior quarter's REITView, improved readings of the economy and positive fourth quarter seasonality did lead to outperformance of Value over Price Momentum. All three Retail sectors outperformed, aided in no small part by a flurry of M&A activity and speculation (reported investment by large, well-known activist hedge funds) surrounding a number of regional mall companies. Perhaps shares of the retail REITs have priced in record store closings in 2017 (and more anticipated in 2018)? Interestingly, none of the M&A activity involved landlords of lower quality assets despite 30%+ discounts to Net Asset Values, suggesting that investors are making a real distinction between value and value traps. An investment case for high quality retail real estate trading at double digit discounts to private market valuations does not rely solely on M&A; a tightening labor market should lead to wage growth and increased consumption accruing to the benefit of retail tenants and landlords.

Underperforming sectors in Fourth Quarter included two of the best performers for the year, Industrial and Industrial-Mixed, as investors took a breather chasing these names. Apartments underperformed as investors reassessed valuations in a sector with the highest level of anticipated supply and Health Care underperformed due to fears of interest rate sensitivity of long-dated leases.

M&A Heating Up in Malls. On November 9, Third Point LLC disclosed a 1.2% interest in Macerich, which position has apparently now increased to nearly 5%. On November 13, Starboard Value LP also disclosed a position in Macerich. It is probably no coincidence that investment by this new batch of atypical REIT investors follows Macerich's 10-Q filing on November 3 disclosing a Change in Control Severance Pay Plan valued at over $32 million for its top four executives, theoretically making management more amenable to a sale of the company. On November 13, Elliott Management announced a 3.8% interest in Taubman Centers with media reports indicating that the hedge fund hired advisors to explore a sale of the REIT. Also on November 13, Brookfield Property Partners (BPY), the listed real estate vehicle of Brookfield Asset Management and 34% owner of GGP Inc., offered to acquire the remaining shares of the mall REIT for 50% cash/50% BPY units, or total consideration of $14.8 billion. The $23.00 per share offer represented a 21% premium to GGP's unaffected share price a week earlier, before rumors of a potential deal surfaced. On December 12, Pan-European mall owner Unibail-Rodamco announced a 35% cash/65% stock offer for Westfield Corp., with the $7.55 per share offer representing a 17.8% premium to the prior day's closing price and valuing the US/UK mall owner at $27.4 billion.

Successful M&A has certain commonalities, including disparities in cost of capital, earnings accretion, cost synergies, etc. There have been willing buyers in the REIT space but not always willing sellers as management teams are reluctant to forgo their lofty compensation and high profile positions; boards are also often unwilling to go against entrenched but underperforming teams. Most recently, agency problems contributed to Simon Property Group's failed bid for the aforementioned Macerich in March 2015, an offer more than 50% higher than its most recent share price. The current crop of potential mall targets may follow along this unenviable track record with possibly only one of the three M&A candidates in another owner's arms despite the possibility of a sharp drop in share prices should the acquirers be driven away. One in three is a good enough batting average to make Cooperstown but a sad reminder of some management's adherence to poor corporate governance and the conflict of interest inherent in all of Corporate America. Maybe not-so-coincidentally, this M&A frenzy comes at a time when mall combinations make even greater sense as the global growth of e-commerce necessitates scale and quality among owners of physical retail - foresight on full display for certain global mall executives yet still fuzzy for some entrenched and underperforming US mall REIT CEOs.

Observations from the Field – Benjamin Yang, CFA

We recently visited the Southern California headquarters of the largest self-storage REIT, Public Storage (PSA), including its call center and nearby property. This tour was similar in scope to due diligence HQ, call center & property visits we conducted with Extra Space Storage (EXR) and CubeSmart (CUBE) over the past year. PSA's call center was unsurprisingly large and well-staffed, with more than 100 sales/service agents present during peak/daytime hours to field an average 4,000 calls a day, totaling nearly 1.4 million calls during the year. More impressive than the massive call volume for a relatively small piece of the US self-storage industry (PSA owns ~2,400 facilities out of an estimated 43,000+ total) was PSA's efficiency; 99% of calls are answered with an average wait of 4 seconds, where each additional second translates into lost business given the need for (and ability to receive) instant gratification on line.

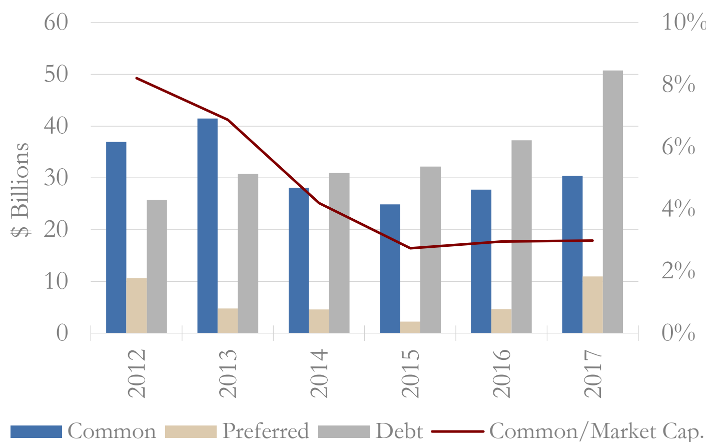
Underlying this impressive ability to service its customers is PSA's data/analytics platform. PSA effectively knows who's calling, from which market, if prompted by mobile search/link, whether new, existing or has inquired in the past. We shadowed a few calls, noting the reps often had some customer data and always had relevant facility information on their screens when they picked up the call. PSA's unending calls also enable the REIT to constantly refine its volume forecasts to have appropriate staff on hand and to identify best and worst reps at closing deals in order to properly compensate or train as needed. Though nuances exist, the PSA call center was not unlike EXR or CUBE as all were impressive and dependent on data. The sophisticated call center is part of the growing technological arsenal for the self-storage REITs along with revenue management and internet search.

We also met with several private owners during our Southern California tour. All were experienced and well run, but all compared poorly against the REITs from a technology perspective. Average call times for some were counted in minutes not seconds, and one had store managers fielding calls with the ability to "multi-task" seemingly a key ingredient for success. Our visit highlighted the yawning gap between the public companies and smaller owners in the fragmented US self-storage industry. REITs can significantly improve operations for acquired properties given their more robust toolkits, while smaller owners will always be tempted to sell given their inability to compete against more sophisticated, better-capitalized peers – a recipe for continued success and external growth for the storage REITs.

Capital issuance is down slightly. According to NAREIT, $18.2 billion in capital was raised in Fourth Quarter 2017, significantly less than the $29.8 billion raised in the prior quarter but more than the $10.5 billion raised a year ago in Fourth Quarter 2016. Almost all the capital activity took place in the issuance of unsecured bonds (there were 33 offerings totaling $13.5 billion during the quarter, on par with the $15.6 billion issued in the prior quarter and more than double the $6.1 billion issued a year ago). There were only 8 secondary equity offerings totaling $2.2 billion during the quarter, significantly less than the $7.7 billion issued in the prior quarter and on par with $2.9 billion issued a year ago and 17 offerings of preferred equity totaling $2.5 billion, down from $6.3 billion issued in the prior quarter and comparable to $1.5 billion issued a year ago. There were no IPOs during the quarter. As more REITs trade below NAV, expect little activity from equity capital markets.

Historical Offering of Securities

1997 – 2017



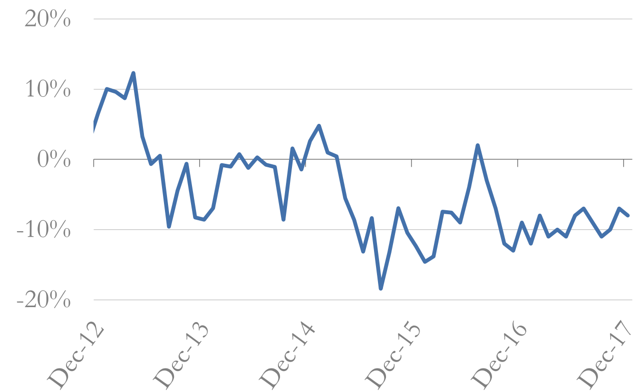
Source: NAREIT.

Funds flow out. According to AMG Data Services, net flows out of dedicated real estate funds, excluding ETFs, totaled $9.0 billion in 2017 compared to outflows of $5.5 billion and $6.1 billion in 2016 and 2015, respectively; REIT ETFs saw inflows of $1.9 billion for the year compared to flows of $2.2 billion and -$0.2 billion in 2016 and 2015, respectively. According to Bloomberg, almost a quarter of all REITs are owned passively, the most of any sector. Flows out of US and Global mutual funds registered in Japan totaled $10.7 billion, compared to inflows of $17.9 billion in 2016 and $8.2, $18.1 and $11.8 billion in 2015, 2014 and 2013, respectively. Fund flows from Japan reversed in Fourth Quarter 2016 as a result highly publicized reductions in distributions; there is currently a vicious cycle in place with outflows negatively affecting US REIT performance leading to more outflows, etc. The appreciation in the Japanese Yen is also a contributing factor to the downside.

Premium/Discount to Net Asset Value

REIT Universe

December 31, 2007 to December 31, 2017



Source: Adelante Capital Management and Green Street Advisors.

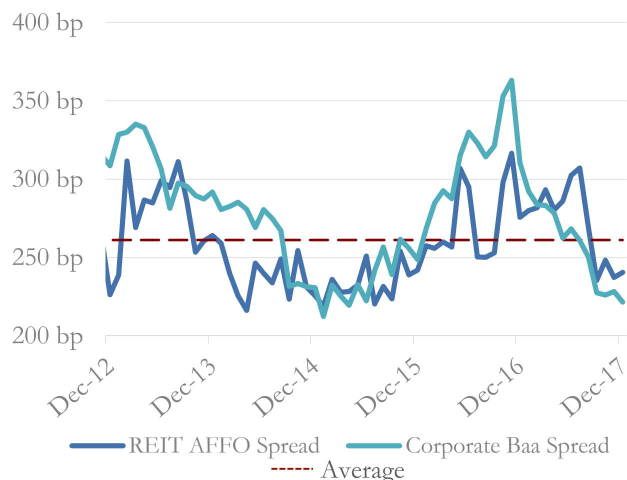
Risk premium below the ten-year average. The risk premium for owning commercial real estate, as represented by the spread between REIT cash flow yields and the riskless rate of return, trades below the 10-year average of 261 bps. The cash flow yield for REITs declined 22 bps to 4.69% and the yield on the 10-Year Treasury Note rose 8 bps and, as a consequence, the spread between REIT cash flow yields and the 10-Year Treasury Note yield decreased from 258 bps to 228 bps. However, as of December 31, there was still a healthy yield premium for taking the risk of owning commercial real estate via REITs. In Fourth Quarter, the Corporate Baa spread ticked down to 184 bps, well below the 10-year average of 297 bps; bond markets are still favoring tenants over landlords, underwriting an improving credit profile as the economy improves.

Spread Comparison

REIT Cash Flow and Corporate Baa Yields vs.

10-Year Treasury Note Yield

December 31, 2007 to December 31, 2017



Source: Adelante Capital Management and Green Street Advisors.

OUTLOOK

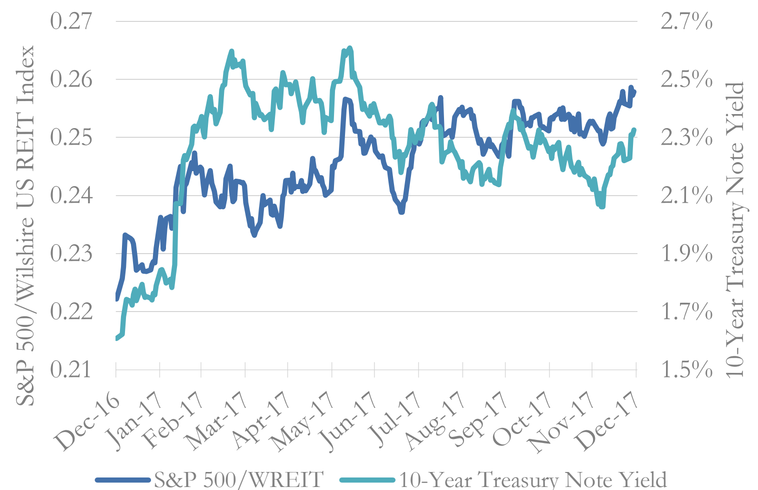
> With regard to financial markets, some participants observed that financial conditions remained accommodative, citing a range of indicators including low interest rates, narrow credit spreads, high equity values, a lower dollar, and some evidence of easier terms for lending to risky borrowers. In light of elevated asset valuations and low financial market volatility, a couple of participants expressed concern that the persistence of highly accommodative financial conditions could, over time, pose risks to financial stability. Participants also noted that term premiums on longer-term nominal Treasury securities remained low. A number of factors were seen as possibly contributing to the low levels of term premiums, including large holdings of longer-term assets by major central banks, persistently low global inflation, and substantial global demand for assets with long durations.
>
> *Minutes of the Federal Open Market Committee ("FOMC"), December 12-13, 2017*

During their last meeting of 2017 held on December 12-13, the Federal Open Market Committee decided to raise the target range for the federal funds rate another 25 bps. There were two dissenters to the decision, Charles Evans and Neel Kashkari, both citing a rate of inflation well below the Committee's 2% target. Governor Kashkari also cited concerns about a flattening yield curve which he speculated was "partly due to falling longer-term inflation expectations or a lower neutral real rate of interest." Counterbalancing those concerns were thoughts and observations that financial conditions are still too accommodative, resulting in elevated asset prices with very little volatility; even the conundrum of the flattening yield curve can be explained by "large holdings of long-term assets by major central banks… and substantial global demand for assets with long duration."

Classic symptoms of demand-pull inflation are being exhibited, albeit selectively. Benefits of the economic recovery from the Great Financial Crisis are accruing unevenly through society resulting in greater disparity in income and wealth; it should come as no surprise to the members of the FOMC that signs of inflation are quiescent across broad swatches of America while $450.3 million is being paid for a Leonardo Da Vinci painting (purchased at an estate sale in 2005 for $10,000) or $17.8 million is being paid for Paul Newman's Rolex Daytona (purchased by Joanne Woodward in 1968 for around $250). If someone is willing to pay almost half a billion dollars for what has been described by Jason Farago in The New York Times (November 15, 2017) as "a proficient but not especially distinguished religious picture from the turn-of-the-century Lombardy put through a wringer of restorations," why don't investors want to buy well located, high quality commercial real estate buildings with an average dividend yield of 3.7%?

Summarizing the view of the naysayers, the research firm Empirical Research Partners writes (January 16, 2018), "Bond Surrogates are the 10% of the equity market with relative returns most tied to the performance of Treasury bonds. More than 80% of them are drawn from the utility, REIT, consumer staples and health care sectors. We've thought that most were overvalued, having been priced off their dividend yield rather than their fundamentals. They've sold at multiples like those of growth stocks despite the fact that they grow their dividends about half as fast." But the yield on the 10-year Treasury Note actually fell from 2.446% to 2.405% in 2017!! During that time, the S&P 500 Index, the Dow Jones Industrial Average and the NASDAQ 100 Stock Index produced total returns of 21.8%. 28.1% and 33.0%, respectively, compared to the meager 4.2% produced by the Wilshire REIT Index. As a result, REITs screen cheap to both bonds and equities. According to Green Street Advisors, as of year-end 2017, REITs trade at a 19% discount to fixed income and 12% discount to the S&P 500. With the rough start to the New Year, well respected heads of REIT research like Steve Sakwa at Evercore ISI and Michael Bilerman at Citi are starting to jump to the defense of the beleaguered asset class, citing discounts to bonds, equities and NAV. In a world where valuation excesses are being exhibited everywhere, doesn't some cheap commercial real estate make sense?

Relative Performance (REITs vs S&P 500) vs. 10-Year Treasury Note Yield
December 31, 2007 to December 31, 2017



Source: Bloomberg and Wilshire Associates.