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Real Estate in a Class of Its Own

How the New Real Estate GICS Sector Classification Could Bring a $100 Billion Influx of Demand and Lower Volatility

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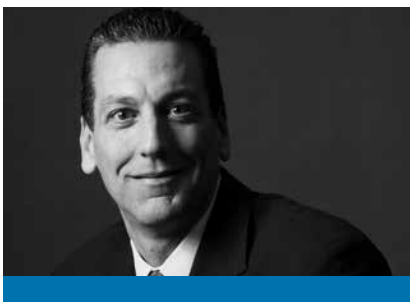


In September 2016, real estate will be separated from financials and given its own GICS sector category—significantly raising the profile of an often misunderstood and under-represented asset class. We believe this will drive greater interest in REIT allocations while potentially reducing volatility.

Highlights

- **Increased demand.** U.S. equity funds have been significantly underweight real estate (Exhibit 3) and would need to buy more than $100 billion in REITs to achieve a market-neutral position in the new real estate sector.[1]
- **Reduced volatility.** We expect REIT volatility to decline due to increased liquidity and the separation of real estate from financials, historically among the most volatile sectors in the S&P 500 (Exhibit 4).
- **Impact on allocations.** Analysis of REITs requires unique valuation metrics and a deep knowledge of local property markets, historically giving REIT specialists a performance advantage over generalist equity managers (Exhibit 5).

Real Estate to Become GICS Sector 11

For the first time since the Global Industry Classification Standard (GICS) was created in 1999, a new sector classification will be added, elevating real estate to become the 11th GICS sector. Beginning September 2016, equity real estate investment trusts (REITs) and real estate management and development companies will be reassigned to the new real estate sector from their current place within financials. This change will have a far-reaching impact, as nearly everyone in the investment community uses GICS as a framework for portfolio planning and analysis. As active investors in real estate securities for the past 30 years, we are particularly excited about what this development means for investors and the future of the industry.

The change represents an acknowledgement by index providers that real estate has distinct characteristics from other businesses, including financials. While property investment companies may share certain similarities with other capital-intensive businesses, their cash-flow-oriented business models and ties to real estate markets have produced a distinctive risk-return profile. In fact, our research shows that REITs have been less tied to broad-market movements than most other sectors of the economy (Exhibit 1). Separating real estate from financials can allow for better performance attribution and analysis.

REIT Milestones[2]

1960: President Eisenhower signs the REIT Act into law
1965: First REIT is listed on the New York Stock Exchange
1969: REITs go global (as of today, 31 countries have enacted REIT legislation, with another 10 underway)
1985: Martin Cohen and Robert Steers launch the first open-end mutual fund focused on U.S. REITs
1986: The Tax Reform Act makes the U.S. REIT structure more compelling for both companies and investors
1991: The modern REIT era begins with the IPO of Kimco Realty
2001: First REIT is added to the S&P 500
2016: Real estate becomes the 11th GICS sector

(1) Source: JPMorgan Research, December 17, 2015.
(2) Source: NAREIT, UBS and Cohen & Steers.

Index Impact

The decision to elevate real estate in equity indexes is a testament to the increasing role of real estate in global equity markets. There are presently 323 companies in FTSE EPRA/NAREIT Developed Real Estate Index, representing a market capitalization of $1.5 trillion. Real estate makes up 3.3% of the MSCI World Index and 2.7% of the S&P 500 Index.(1)

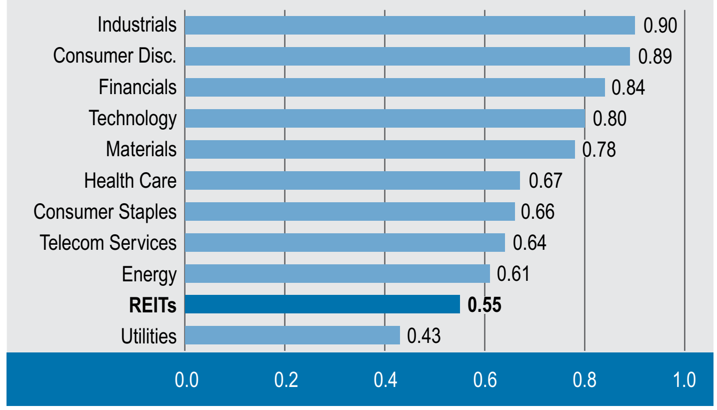
In the U.S., real estate makes up about a fifth of the financials sector, which accounts for 15% of the S&P 500. If the new real estate sector were split out today, it would consist of 27 stocks, with a market cap of $524 billion (Exhibit 2). This is about the same size as the utilities, materials and telecom services sectors. In addition to core REIT sectors, the S&P real estate sector will include several timber and infrastructure REITs and one non-REIT property company, which are not part of the FTSE NAREIT Equity REIT Index.

While REITs will be removed from the financials sector, they will not be removed from the S&P Financial Select Sector Index, avoiding the need for related financial exchange-traded funds (ETFs) to sell their REIT holdings. Instead, two new sector indexes will be created: the S&P Financial Services Select Sector Index, which will not include real estate, and the S&P Real Estate Select Sector Index.

As it stands today, the S&P real estate sector would consist of 26 REITs and one non-REIT that are currently classified as financials, representing 2.7% of the S&P 500.

We see three areas in which REITs are likely to benefit from the change of address, both in the short and long term: increased demand, reduced volatility and potential effects on investor allocations.

Exhibit 1: Correlations of S&P Sectors to the S&P 500 Index
1990–2015



At December 31, 2015. Source: Morningstar and Cohen & Steers.

Performance data quoted represents past performance. Past performance is no guarantee of future results. Based on monthly returns. REITs represented by the FTSE NAREIT Equity REIT Index; all others based on S&P sector indexes. See page 8 for index definitions and additional disclosures.

Exhibit 2: If the S&P Real Estate Sector Were Split Out Today

Companies: **27**	Market Cap: **$524B**	% of S&P 500: **2.7%**

S&P real estate sector constituents, in descending order of market capitalization

Simon Property Group	Realty Income
Public Storage	Essex Property Trust
American Tower[(a)]	Weyerhaeuser[(a)]
Crown Castle International[(a)]	Host Hotels & Resorts
Equity Residential	Macerich
General Growth Properties	Kimco Realty
AvalonBay Communities	Extra Space Storage
Welltower	Federal Realty Investment Trust
Prologis	SL Green Realty
Ventas	CBRE Group[(a)]
Boston Properties	UDR
Equinix	Iron Mountain
Vornado Realty Trust	Apartment Investment and Management Co.
HCP	

At March 4, 2016. Source: FactSet and Cohen & Steers. All companies listed above are REITs except CBRE Group.

(a) Included in the S&P 500 Index, but not represented in the FTSE NAREIT Equity REIT Index, as the FTSE index does not include timber or infrastructure REITs or non-REIT property companies. See page 8 for index definitions and additional disclosures.

(1) At March 4, 2016. See page 8 for index definitions.

Increased Demand

Despite the importance of real estate to the economy, investors have generally shied away from REITs and other real estate stocks. With the new classification, real estate will likely see a significant lift in its profile, leading to increased media coverage and greater awareness of its performance. We believe the attention will drive a higher level of demand, attracting more capital to the sector from both professional and individual investors.

Long-only equity funds in the U.S.—representing $5 trillion in assets—have a 2.1% underweight in real estate on average. This implies potential inflows of more than $100 billion into REITs if managers were to bring their real estate allocations in line with their benchmarks.[2]

The appeal of real estate stocks is based on their record of strong total returns, low correlations with broad equities and bonds, and high dividend yields. As of year-end 2015, real estate companies in the S&P 500 had an average dividend yield of 3.2%. On a standalone basis, this would make real estate the fourth-highest-yielding sector in the S&P 500 after telecom services, utilities and energy.[1]

The creation of a new real estate sector will shed light on the fact that generalist equity investors are significantly underweight real estate, especially in value-oriented strategies. In Exhibit 3, we show the average real estate weighting in U.S. open-end mutual funds for different Morningstar categories compared with the weight of each category's most common benchmark. Across all styles and market capitalizations, equity funds are deeply underweight real estate on average—a pattern that has persisted throughout history. The trends are similar for global equity funds.

According to JPMorgan Research, long-only 1940-Act equity funds have an average real estate weight of 2.3%, compared with 4.4% for their benchmarks, representing a 2.1% underweight.[2] Based on $5 trillion in assets under management, it would take over $100 billion to move to a market-neutral position. To put that into context, this represents more than 12% of the total value of the U.S. REIT market.

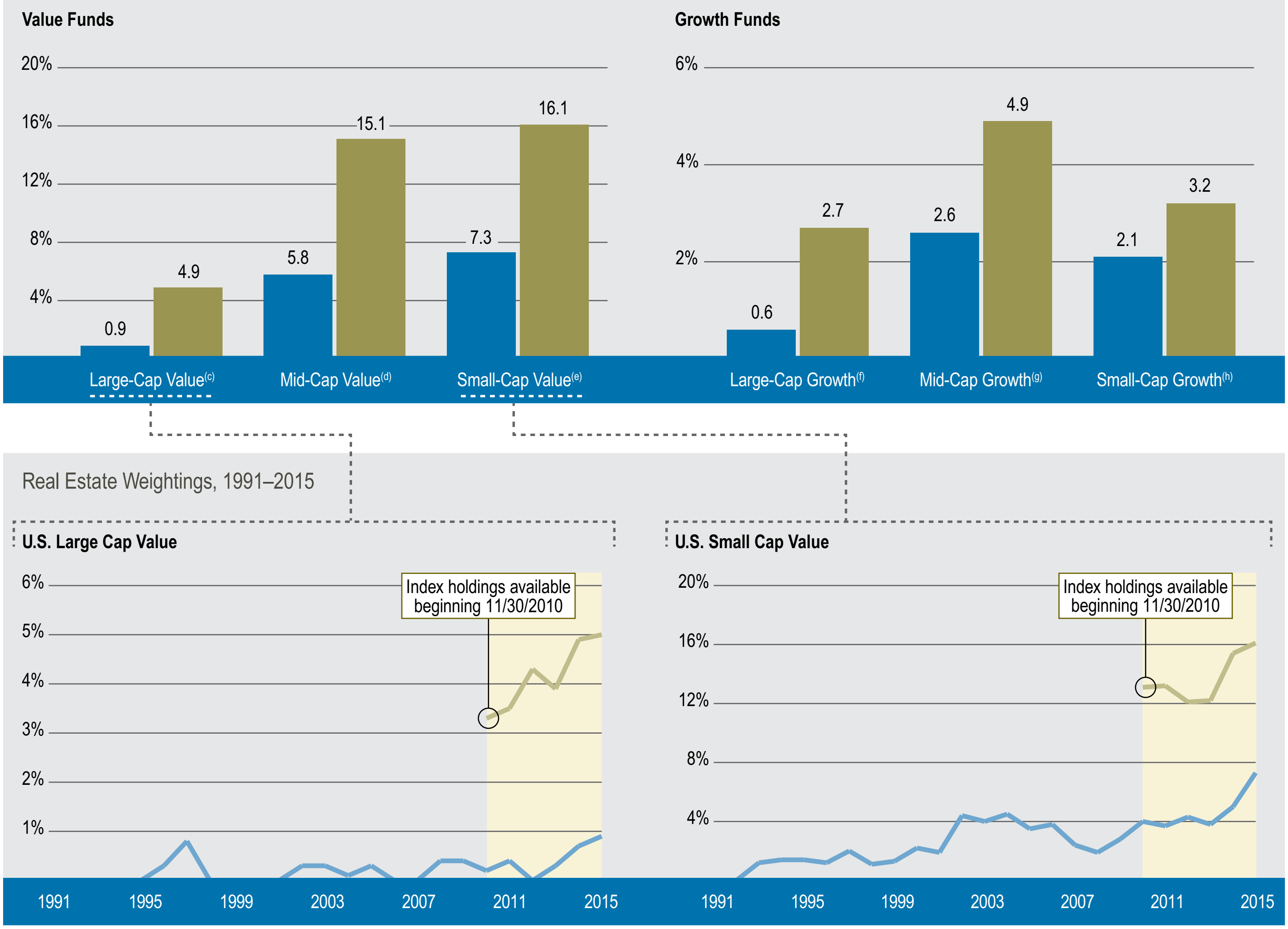
We do not expect generalists to suddenly change decades of learned behavior. However, with the added transparency in sector performance, managers may want to consider the potential consequences of being underweight an asset class that has outperformed the S&P 500 over the trailing 10-, 20- and 30-year periods, as well as in 7 of the past 10 calendar years.[3] We expect managers and individual investors will gradually seek to increase their allocations to real estate, which could be a significant tailwind for the asset class.

"This is a very important year for REITs. I think it's a terrific opportunity for us to market to a wider set of people whose eyes are open to the benefits of owning real estate in a public format. We do intend to be pretty aggressive this year in reaching out to generalists, to people who don't own."

– David Neithercut, President and CEO of Equity Residential, 2/3/2016 conference call

(1) At December 31, 2015. Source: FactSet. (2) At December 10, 2015. Source: JPMorgan Research. Calculated based on all 1940-Act mutual funds classified by Morningstar as Core, Growth and Value across Large Cap, Mid Cap and Small Cap equity, representing $5 trillion in total assets. (3) At December 31, 2015, as represented by the FTSE NAREIT Equity REIT Index. *Performance data quoted represents past performance. Past performance is no guarantee of future results.* The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. See page 8 for index definitions and additional disclosures.

Exhibit 3: U.S. General Equity Mutual Funds Are Underweight Real Estate
Real Estate Weightings at December 31, 2015



At December 31, 2015. Source: Morningstar and Cohen & Steers.

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(a) Mutual fund weights based on the median real estate weighting of all funds in their respective Morningstar category that reported holdings data on the date of analysis, based on oldest share class. (b) Index weight as represented by the most common benchmark for funds in each category. (c) 276 funds/Russell 1000 Value Index. (d) 100 funds/Russell Mid Cap Value Index. (e) 95 funds/Russell 2000 Value Index. (f) 304 funds/Russell 1000 Growth Index. (g) 165 funds/Russell Mid Cap Growth Index. (h) 171 funds/Russell 2000 Growth Index. See page 8 for index definitions and additional disclosures.

The consistent, significant underweight to real estate among equity funds suggests to us a systematic avoidance of REITs by generalist managers—a fact that will become apparent once real estate is split out as a separate GICS sector. Some managers may seek to close this underweight over time, potentially driving additional capital into the REIT market.

Reduced Volatility

Broader ownership of real estate stocks should lead to greater liquidity, in our view. When you have better price discovery as a result of greater liquidity, this tends to reduce volatility, potentially improving the risk side of the risk-return relationship.

In addition, the financials sector has historically been among the most volatile sectors in the S&P 500 (Exhibit 4). Over time, the separation of real estate from the financials sector may reduce trading linkages between REITs and other financial companies such as banks, insurance companies and brokerage firms, thereby removing a potential source of volatility.

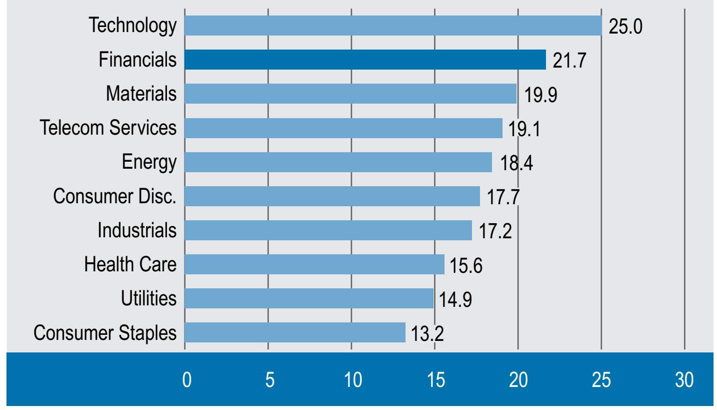
Investors may also be less inclined to use REITs as a way of expressing their views on interest rates. Within the context of a financials allocation, anecdotal evidence suggests that generalist managers often shift away from REITs and into bank stocks if they believe interest rates will rise, and then swing the other way once interest rates appear likely to fall. (This occurs despite ample historical evidence that REITs can perform well in a rising-rate environment.) In our view, this rotation within the financials sector has contributed to interest-rate-related volatility, which we expect to diminish once real estate is split out from financials.

Impact on Real Estate Allocations

From an asset-allocation perspective, it is important to distinguish between the real estate weighting in an index fund or managed stock portfolio and an investor's overall target allocation. Generalist equity managers could move to a market-neutral weight of 4.4% (the average of all U.S. mutual fund benchmarks) and real estate would still represent only a small portion of an investor's overall portfolio. By contrast, many institutional investors, plan sponsors and advisors target a sizeable allocation to alternatives, including real estate. For example, investors with 50% in equities may have only about 2% of their overall portfolio in real estate. To achieve a 10% total allocation, they would need to invest an additional 8% in a dedicated real estate portfolio.

In our experience, the systemic underweighting of real estate by generalist managers reflects a lack of familiarity with REITs and perhaps an unfounded bias that REITs have inferior return potential. Investing in REITs takes significant resources to effectively track and analyze both the underlying property markets and the real estate securities market. REITs also require the use of specialized terminology and valuation expertise. In place of traditional valuation metrics like earnings per share, price to earnings and price-to-book value, REITs utilize factors such as funds from operations (FFO), net asset value (NAV), capitalization rates and internal rates of return (IRR). These terms are simply not understood by most generalist investors.

Exhibit 4: Removal From Financials May Benefit REIT Volatility
Standard Deviation by S&P Sector, 1990–2015



At December 31, 2015. Source: Morningstar and Cohen & Steers.

Performance data quoted represents past performance. Past performance is no guarantee of future results.

Based on monthly returns. Equity sectors based on sector-level returns of the S&P 500 Index. See page 8 for index definitions and additional disclosures.

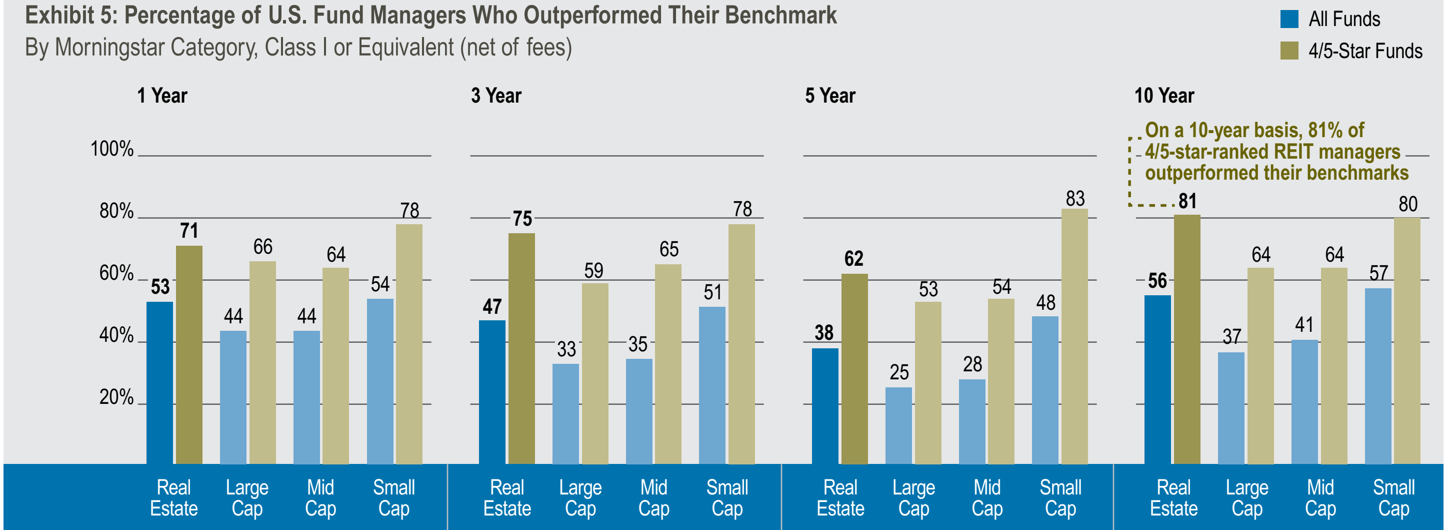
REIT specialists, on the other hand, have a deep understanding of industry-standard valuation methods. They also have dedicated research capabilities for gaining insight about individual property markets and local economic trends. They may conduct on-site property inspections and have discussions with leasing agents, property managers and tenants.

This information advantage has historically translated into better results from stock selection, giving REIT managers a performance edge over generalist investors. According to our analysis of Morningstar fund data (shown in Exhibit 5), REIT managers have distinguished themselves versus the broad equity market, defined by large- and mid-cap equities. If we further refine the universe to just the top managers—screening for 4- and 5-star funds as ranked by Morningstar (represented by the upper bar in each group)—active REIT managers have clearly demonstrated value to investors over full market cycles.

REIT managers have an information advantage that has historically given them a performance edge over generalist investors. Over the past 10 years, 81% of 4/5-star REIT managers outperformed their benchmarks on a net basis.

Exhibit 5: Percentage of U.S. Fund Managers Who Outperformed Their Benchmark

By Morningstar Category, Class I or Equivalent (net of fees)



Number of Funds Represented	1 Year Real Estate	1 Year Large Cap	1 Year Mid Cap	1 Year Small Cap	3 Year Real Estate	3 Year Large Cap	3 Year Mid Cap	3 Year Small Cap	5 Year Real Estate	5 Year Large Cap	5 Year Mid Cap	5 Year Small Cap	10 Year Real Estate	10 Year Large Cap	10 Year Mid Cap	10 Year Small Cap
All Funds	61	877	348	432	57	796	314	387	51	734	291	365	42	616	242	302
4/5-Star Funds	31	338	133	166	31	338	133	165	29	321	126	155	23	275	109	132

At December 31, 2015. Source: Morningstar and Cohen & Steers.

Performance data quoted represents past performance. Past performance is no guarantee of future results. The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. Large Cap, Mid Cap and Small Cap categories based on average percentage of outperforming mutual funds across Growth, Value and Blend styles for each size group as categorized by Morningstar. For each fund with at least a five-year history, Morningstar calculates its ratings based on a risk-adjusted return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive five stars, the next 22.5% receive four stars, the next 35% receive three stars, the next 22.5% receive two stars and the bottom 10% receive one star. The overall Morningstar rating for each fund is based on a weighted average of the number of stars assigned to it in the 3-, 5- and 10-year rating periods. For funds 10 years or greater, the weighting is 50% 10-year, 30% 5-year, 20% 3-year; for funds 5–10 years, the weighting is 60% 5-year, 40% 3-year; for funds 0–5 years, the weighting is 100% 3-year.. See page 8 for additional disclosures.

The FIRPTA Tailwind

New tax incentives for foreign investors in U.S. REITs may drive increased demand.

On December 18, 2015, President Obama signed the PATH Act—Protecting Americans from Tax Hikes. The impact extends not only to individuals, but to real estate securities as well. As part of the PATH Act, changes have been made to the Foreign Investment in Real Properties Tax Act (FIRPTA). FIRPTA was enacted in 1980 to limit equity investments in U.S. real estate at a time when there were concerns about foreign ownership, particularly of strategic assets such as farmland. Decades later, many of those concerns are now antiquated.

With the reforms to FIRPTA, qualified foreign pension funds can now own 10% of listed U.S. REITs, up from 5%. As long as a REIT satisfies the conditions of being domestically controlled (greater than 50% domestic ownership), any foreign ownership would be exempt from FIRPTA, meaning zero withholding tax on stock sales and reduced withholdings on distributions. In addition, foreign pensions and retirement investments in U.S. REITs will no longer be subject to the FIRPTA exit tax.

If you think about how capital has moved to the United States and the types of assets overseas investors have wanted to own, we believe it fits perfectly with the kinds of assets typically held by REITs: properties of the highest quality—not only physically, but in terms of the quality of cash flows. In our view, this is particularly appealing to foreign investors at a time when many may be concerned about their home currency and about the need for diversification.

The changes to FIRPTA represent a potentially tremendous opportunity for foreign investment in U.S. real estate companies—one that we expect will translate into stronger demand for REITs, helping to improve their financing costs and access to capital. When combined with the potential tailwinds that we see coming from the creation of a new real estate sector in the GICS, we believe it offers a powerful addition to the REIT story.

Diversifying With Real Estate

With the reclassification of real estate as a dedicated equity sector, the aura of "niche investment" may continue to fade. For the reasons stated throughout this paper, that is not necessarily a bad thing. Nor does the new sector label alter the fact that real estate has been and continues to be one of the primary ways many investors seek to diversify their portfolios.

In its 2015 survey of institutional investors and consultants, UBS reported that just over half of respondents recommended a real estate allocation of 11% or more, including both listed and private real estate investments.[1] Of the rest, 47% suggested 5–10%, while just 2% indicated 0–4%. For many investors, listed real estate provides a compelling vehicle for accessing commercial property, offering a history of attractive total returns, high and growing dividend income and relatively low correlations with stocks and bonds. As Exhibit 6 shows, the cumulative difference in returns between REITs, the broad stock market and bonds since 1990 has been considerable.

Given the 35-year bull market in bonds and recent interest-rate decisions by the Federal Reserve, investors and advisors continue to look for assets that provide the potential for attractive, growing income and capital appreciation. We believe the search for income alternatives will continue to drive interest in listed real estate allocations, which will only be magnified as real estate takes on a higher profile this year.

Exhibit 6: REITs Have Been a Compelling Source of Attractive, Differentiated Returns
1990–2015

	Annualized Return	Cumulative Return	Standard Deviation[a]	Sharpe Ratio[b]	Correlation to U.S. REITs[c]	Yield at 12/31/15[d]
U.S. REITs	**10.9%**	**1,381.8%**	**18.8**	**0.41**	**–**	**4.0%**
U.S. Stocks	9.3%	907.3%	14.6	0.42	0.55	2.2%
U.S. Bonds	6.3%	384.7%	3.6	0.86	0.19	2.6%

At December 31, 2015. Source: Morningstar and Cohen & Steers.

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(a) Standard deviation is a statistical measure of volatility, representing the dispersion of returns from the mean. Calculation based on monthly data. (b) Sharpe Ratio is a measure of risk-adjusted return and assumes a risk-free rate of zero. (c) Correlation is a statistical measure of how two data series move in relation to each other. (d) Dividend yield for REITs and stocks based on trailing 12-month dividend distributions; yield for bonds based on yield to maturity.

REITs represented by the FTSE NAREIT Equity REIT Index; stocks represented by the S&P 500 Index; bonds represented by the Barclays Capital U.S. Aggregate Bond Index. See page 8 for index definitions and additional disclosures.

Our research has shown that a separate allocation to REITs has historically helped to enhance total returns, reduce portfolio volatility and boost investor income.

(1) Published May 7, 2015. The UBS survey included 48 institutional investors and consultants with more than $230 billion invested in real estate securities.

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Index Definitions

An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes.

Barclays Capital U.S. Aggregate Bond Index is a broad-market measure of the U.S. dollar-denominated investment-grade fixed-rate taxable bond market, and includes Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities, and commercial mortgage-backed securities. FTSE NAREIT Equity REIT Index contains all tax-qualified REITs, except timber and infrastructure REITs, with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria. FTSE EPRA/NAREIT Developed Real Estate Index is an unmanaged market-capitalization-weighted total-return index, which consists of publicly traded equity REITs and listed property companies from developed markets. MSCI World Index is a free-float-adjusted index that measures performance of large- and mid-capitalization companies representing developed market countries. Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe in the Russell 1000 Index that have higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe in the Russell 1000 Index that have lower price-to-book ratios and lower expected growth values. Russell 2000 Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe in the Russell 2000 Index that have higher price-to-book ratios and higher forecasted growth values. Russell 2000 Value Index measures the performance of the small-cap value segment of the U.S. equity universe in the Russell 2000 Index that have lower price-to-book ratios and lower forecasted growth values. Russell Midcap Growth Index measures the performance of the 800 smallest companies in the Russell 1000 Index with higher price-to-book ratios and higher forecasted growth values. Russell Midcap Value Index measures the performance of the 800 smallest companies in the Russell 1000 Index with lower price-to-book ratios and lower forecasted growth values. S&P 500 Index is an unmanaged index of 500 large-capitalization stocks that is frequently used as a general measure of U.S. stock market performance. S&P sector indexes represent constituents of the S&P 500 Index based on sector classifications as defined by GICS.

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Risks of Investing in Real Estate Securities. Risks of investing in real estate securities include falling property values due to increasing vacancies, declining rents resulting from economic, legal, tax, political or technological developments, lack of liquidity, limited diversification, and sensitivity to certain economic factors such as interest rate-changes and market recessions. The risks of investing in REITs are similar to those associated with direct investments in real estate securities. Foreign securities involve special risks, including currency fluctuations, lower liquidity, political and economic uncertainties, and differences in accounting standards. Some international securities may represent small- and medium-sized companies, which may be more susceptible to price volatility and lower liquidity than larger companies.

This commentary must be accompanied by the most recent Cohen & Steers fund fact sheets if used in connection with the sale of mutual fund shares.

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