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REITs have been extremely volatile for the past two months after reaching their post-Lehman peak near the end of July. As measured by the MSCI US REIT Total Return Index (RMS), REITs took a nosedive of 23% from the peak to the August trough, occurring over the span of only 12 trading days. However, the markets rallied to end the month only down 5.5%. September carried the same volatility without the late month rally, finishing the month down 10.9%. From the peak in late July to September 30, the decline stands at 18.8%. Year-to-date, the index is down 5.7%, which compares favorably to the S&P 500 at -8.7%. Though this correction may bring back memories of 2008, the recent drop in value pales when compared to the 75% decline from February 2007 to March 2009. In fact, we view this recent correction as an opportunity as prices move back into attractive territory based upon the normal valuation benchmarks. The price to FFO multiple using 2012 numbers now stands at 13.2x and compares with a seventeen year average of 12.0x, which was a period where interest rates were considerably higher. Importantly, our analysis suggests that multiples on 2013 earnings are 12.3x based on current prices. Real estate fundamentals continue to demonstrate a rebound in net operating income and occupancy rates despite headlines suggesting that current economic conditions that these metrics could witness a moderation in growth in the short term.

Another metric we have been watching is the 10 year US treasury yield, specifically how it compares to the REIT common and preferred dividend yield. As of September 30, the 10 year US Treasury yield stood at 1.9% as further uncertainty about the economy drives risk dollars to safety. Concurrently, the dividend yield on the common REITs stood at 4.1% and the weighted average dividend yield on our managed preferred REIT portfolios was 7.75%. As mentioned last month, the REITs continue to look attractive as a yield instrument due to the historically large spread over the 10 US Treasury yield.

Manhattan Office Market

One of the temperature gauges we watch the most as analysts is the Manhattan office market. Historically, Manhattan has been the last to fall into a recession and the first to come out of a recession. Manhattan has the highest concentration of “trophy properties”, and REITs are dominant in the space thanks to their superior access to capital in the last 20 years. In fact, the top three office landlords in Manhattan are all publically traded equity REITs (see Figure 1). Boston Properties (BXP), Vornado Realty Trust (VNO), SL Green (SLG), and Brookfield Office Properties (BPO) own about 70 million sqft in the city, easily placing these companies among the top ten landlords in the 378 million sqft New York City office market. As part of our analysis of these companies, we recently made a trip to Manhattan for property tours and to meet with management.

FIG. 1: TOP 5 OFFICE LANDLORDS IN MANHATTAN

SL GREEN (NYSE: SLG)
VORNADO REALTY TRUST (NYSE: VNO)
BROOKFIELD OFFICE PROPERTIES (NYSE: BPO)
TISHMAN SPEYER
BOSTON PROPERTIES (NYSE: BXP)

SOURCE: CBRE AS OF SEPTEMBER 1, 2011

We began with an overview of the NYC office market presented by CBRE, one of the leading commercial real estate firms in the US. Year to date, leasing volume has been the most since 2006. Lease rates are up nicely in 2011 after steep declines in 2009 and 2010. See Figure 2 for statistics on how YTD 2011 stacks up against the last ten years. However, CBRE noted the slowing velocity that has been felt for the past two months. No impact on pricing has been evident yet, but it looks like we are at an inflection point as the upward trend in rents appears to have stopped. Importantly, new supply remains almost non-existent except for the World Trade Center where WTC 1 and WTC4 will add 4.7 million sqft to the city supply in 2013 and BXP’s

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Fig. 2: MANHATTAN OFFICE LEASING STATISTICS

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011*
LEASING ACTIVITY (MSF)	33.1	27.9	18.8	20.7	29.6	26.4	29.9	22.9	17.6	16.8	24.2	19.4
ABSORPTION (MSF)	9.1	(18.1)	(9.0)	(4.8)	7.3	5.1	5.3	1.9	(12.6)	(11.0)	5.3	5.3
AVAILABILITY RATE	4.4%	9.8%	12.3%	13.7%	11.6%	10.0%	8.5%	7.9%	11.3%	14.2%	12.0%	10.9%
AVERAGE ASKING RENT	$53.24	$49.45	$43.92	$41.79	$40.09	$44.82	$54.56	$68.69	$67.20	$49.01	$48.32	$51.83

* AS OF SEPTEMBER 1ST
SOURCE: CBRE

new tower now under construction in midtown. Hines is also planning a 500,000 sqft office development at 7 Bryant Park. On a positive note from the demand side, WTC 1 is already over 50% leased as of September 30, 2011 despite being two years away from delivery. BXP observed that the high quality of its buildings has served as a major benefit to both keeping and attracting tenants. VNO noted that the New York office market has done better relative to national averages as the city has gained back 50% of jobs lost since 2008 versus only 20% nationwide. Manhattan occupancy rates for the three companies we visited average over 95%. VNO also noted that 30 percent of leases signed over the past few years include tenants either expanding or first time tenants in Manhattan. Tenants taking up slack from the shrinkage in the financial sector include media and technology firms.

Sustainable buildings will be a major requirement for office landlords in 5-7 years due to tenant preferences. VNO believes that tenants will blacklist buildings that are not environmentally friendly citing the analogy to "asbestos removal" that occurred several years ago. Making environmentally-friendly changes to existing buildings can produce favorable financial results for both the tenants and the landlord, as well. Reducing energy consumption is foremost on the list. For new construction, new designs include the latest in energy star savings and tenant comfort, such as floor heights that are in the 13.5-14.5 ft range, up from the typical building that has only 10.5-12 ft ceilings. Design elements will also include less columns

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interfering with interior floor plates and better window visibility with the use of more narrow mullions on the typical glass exterior curtain wall. BXP has recently re-started construction of a new tower (989,000 sqft) at 250 W55th at Broadway incorporating these and many more cutting edge design elements at an estimated cost of $1.1 billion or $1060/sqft. REITs with superior access to low cost capital, strong leasing and operations teams, and superb locations will be beneficiaries of these evolutionary changes in office ownership.

Preferred REIT Downside Protection and Current Dividend Yield

Our research of REIT common stocks gives us a significant advantage when selecting REIT preferred stocks for investor portfolios. Whereas the question with common REITs is "what is the upside potential?", the question with preferred REITs is "what is the downside protection?". Once we have performed our due diligence on management, financial metrics and property type, a REIT is added to our internal watch list. The extra step we add for preferred stocks is the analysis of the leverage ratio of each REIT including both debt and preferred and the dividend payout ratio assuming only the preferred dividend. Each series is then plotted against the current yield of the preferred stock to provide a more graphic presentation of preferred stocks that screen attractive. These tools enable us to have the conviction to go beyond investment grade issues and thus, consider preferred issues with the higher yields. We only invest in issues with an acceptable amount of reward (yield) for the amount of risk (payout and leverage ratios). We populate an account with 10-15 names that allow for not only geographic dispersion and diversification by property type but also to increase the liquidity of the portfolio in the event of distribution requests. Preferred stocks are typically issued in $100 million increments so often it can be hard to sell large dollar amounts efficiently.

As a group, the blended yields of our portfolios approximate 7.75%, but the individual preferred stocks have yields that range from 6.3% to 9.0%. With the 10 year US Treasury yield

Fig. 3: PREFERRED REIT PORTFOLIO PROJECTED 2 YEAR ANNUALIZED RETURNS

10 YEAR TREASURY YIELD \ SPREAD	4.00%	4.25%	4.50%	4.75%	5.00%	5.25%	5.50%	5.75%
1.25%	23.69%	22.17%	20.62%	19.06%	17.47%	15.87%	14.24%	12.58%
1.50%	22.17%	20.62%	19.06%	17.47%	15.87%	14.24%	12.58%	10.91%
1.75%	20.62%	19.06%	17.47%	15.87%	14.24%	12.58%	10.91%	9.20%
2.00%	19.06%	17.47%	15.87%	14.24%	12.58%	10.91%	9.20%	7.47%
2.25%	17.47%	**15.87%**	**14.24%**	**12.58%**	**10.91%**	**9.20%**	**7.47%**	5.71%
2.50%	15.87%	**14.24%**	**12.58%**	**10.91%**	**9.20%**	**7.47%**	**5.71%**	3.92%
2.75%	14.24%	**12.58%**	**10.91%**	**9.20%**	**7.47%**	**5.71%**	**3.92%**	2.10%
3.00%	12.58%	**10.91%**	**9.20%**	**7.47%**	**5.71%**	**3.92%**	**2.10%**	0.25%
3.25%	10.91%	**9.20%**	**7.47%**	**5.71%**	**3.92%**	**2.10%**	**0.25%**	-1.64%
3.50%	9.20%	**7.47%**	**5.71%**	**3.92%**	**2.10%**	**0.25%**	**-1.64%**	-3.56%
3.75%	7.47%	5.71%	3.92%	2.10%	0.25%	-1.64%	-3.56%	-5.53%
4.00%	5.71%	3.92%	2.10%	0.25%	-1.64%	-3.56%	-5.53%	-7.53%

SOURCE: BLOOMBERG ESTIMATED RETURNS CALCULATING ASSUMING MODIFIED DURATION OF 15 AND CURRENT DIVIDEND YIELD OF 7.75%

currently at 1.9%, the current yield spread is 585 bps. Historically, this spread has averaged 480 bps. For our analysis of the downside protection offered by the current yield spread, we projected two-year annualized returns for the preferred REITs based on different yield spreads and 10 year US Treasury rates. In Figure 3, we show that the 10 year US Treasury rate could rise to 4%, and the preferred REITs would still generate positive returns assuming the spread returns to historical averages.

In a yield starved investment world, a popular portfolio strategy for retail oriented clients has been to blend REIT common stocks and preferred stocks in one portfolio. We design the mix to suit the income needs of the client. This technique provides the portfolio with some dividend growth from the common stocks to offset the fixed, but higher dividend yields applicable to the preferred stocks. Blended yields currently exceed 5% with a 60/40 mix of common and preferred, respectively.

Something for Everyone

We remain committed to enabling our clients to achieve their financial goals while staying within their risk tolerance. For the long term investor, we still believe that REIT common stocks will produce the highest total return. However, we understand that each client has individual needs and different time horizons. We believe our current suite of strategies has something for every investor, regardless of his or her unique financial goals. In each case, we stand behind our research and due diligence techniques to produce a portfolio of REITs with strong management teams, a competitive advantage over peers, and total return potential commensurate with business risk.

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RMS: 943 (9.30.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 993 (9.30.2008) and 1330 (2.7.2007)