NEUBERGER | BERMAN

STEVE SHIGEKAWA
Senior Portfolio Manager—The REIT Group

BRIAN JONES
Portfolio Manager—The REIT Group

How Are REITs Positioned in a Rising Interest Rate Environment?

Co-portfolio managers Brian Jones and Steve Shigekawa, Neuberger Berman Real Estate Securities Group, provide context for recent market turbulence, discuss the impact of rising rates on real estate investment trusts (REITs) and share their outlook for the asset class.

U.S. property stocks have underperformed YTD in 2018. Why?

U.S. property stocks have trailed the S&P 500 year-to-date through 5/31/18, generating a -2.8% return, compared to the S&P 500 Index, which has generated a 2% total return. We would point to a few factors driving the poor results of property stocks. First, the rise in the bond yields has hurt sentiment in the group as 10-year Treasury yields have risen over 45 basis points (bps) since the beginning of 2018 through 5/31/18. Second, REITs are presumed to receive fewer benefits from the Tax Cuts and Jobs Act of 2017 relative to most corporations because REITs are already exempt from most federal corporate taxes. Finally, and related to the first two factors, we have seen roughly $6.8 billion of outflows from U.S. REIT mutual funds and U.S. REIT ETFs so far this year.

How have REITs performed during rising interest rate environments?

Our research indicates that while, in the short term, REIT share prices have been influenced by the direction of interest rates, when measured over longer time periods REIT total returns historically have not tended to be correlated to interest rates. In the current period, REITs' underlying fundamentals and access to capital have not declined. Furthermore, many REITs have used low borrowing costs and the capital markets to strengthen their balance sheets.

Our analysis for the period January 1990–May 2018 suggests that, during periods when 10-year Treasury yields rose sharply, REIT total returns generally underperformed broader equity market returns in the short term, but generally outperformed after the initial period of weakness.

We measured three-month rolling periods from 1990 to May 2018 to identify periods when the 10-year Treasury bond yield rose by at least 50 bps. We identified 40 periods in which 10-year Treasury bond yields rose over 50 bps in a three-month period. We then measured the performance of REITs relative to the S&P 500 both during the period of spiking rates and six and 12 months after the rise in Treasury yields. The data below shows that while REITs generally underperformed during the three-month periods of rising 10-year Treasury yields, REITs recovered and generally outperformed the S&P 500 in the subsequent six- and 12-month time periods.

REIT PERFORMANCE DURING AND AFTER PERIODS OF RISING RATES[1]

January 1990 – May 2018

3-Month Scenario (50bps Rise in 10-Year Treasury Yield)	Number of Periods	3-Month Returns		Subsequent REIT Return		Subsequent S&P 500 Return	
	1990–2018	Rate Rise Period (FNER)	Rate Rise Period (S&P 500)	180 Days	1 Year	180 Days	1 Year
Average Return	40	0.3%	3.4%	6.7%	15.7%	4.8%	12.7%

Source: FactSet.

[1]Analysis based on periods between January 1990 through May 2018 when the rise in the 10-year Treasury yields negatively impacted REITs over the same time period. REITS are represented by the FTSE NAREIT Equity REIT Index. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. The performance of asset classes following interest rate hikes has varied significantly and is no indication of how the markets may perform following any future interest rate increases. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Unless otherwise indicated, returns shown reflect reinvestment of dividends and distributions. **Past performance is no guarantee of future results.**

Recently, REITs have underperformed the S&P 500 meaningfully. In the period from December 13, 2017 to March 13, 2018 the 10-year Treasury yield rose 50 bps and REITs underperformed the S&P 500 by more than 1,100 bps. Below, we look at similar periods when a three-month spike in Treasury yields has led to material REIT underperformance (at least 10% REIT underperformance) and the subsequent six- and 12-month REIT returns relative to the S&P 500. In the periods shown, REITs generated strong returns in the six- and 12-month periods after the interest-rate-driven underperformance.

REIT PERFORMANCE AFTER PERIODS OF SHARP INTEREST RATE-RELATED UNDERPERFORMANCE[1]

January 1990 – May 2018

3-Month Scenario (50bps Rise in 10-Year Treasury Yield)	3-Month Returns		Subsequent REIT Return		Subsequent S&P 500 Return	
REITS underperformance by at least 10%	Rate Rise Period (FNER)	Rate Rise Period (S&P 500)	180 Days	1 Year	180 Days	1 Year
Sept 1999 – Dec 1999	3.2%	14.9%	13.2%	26.4%	-0.4%	-9.1%
Mar 2009 – June 2009	-3.7%	15.9%	45.8%	53.9%	22.6%	14.4%
Average Return	**-0.3%**	**15.4%**	**29.5%**	**40.1%**	**11.1%**	**2.7%**
Current Period: 12/13/17 – 3/13/18	**-7.2%**	**4.3%**	—	—	—	—

Source: FactSet.

[1]Analysis based on periods between January 1990 through May 2018 when the rise in the 10-year Treasury yields negatively impacted REITs over the same time period. REITS are represented by the FTSE NAREIT Equity REIT Index. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. The performance of asset classes following interest rate hikes has varied significantly and is no indication of how the markets may perform following any future interest rate increases. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Unless otherwise indicated, returns shown reflect reinvestment of dividends and distributions. **Past performance is no guarantee of future results.**

Why can REITs perform well in a gradually rising interest rate environment?

Commercial real estate, and therefore REITs, can perform well during a period of modestly rising interest rates. An increase in interest rates often accompanies economic growth, employment gains and an increase in inflation—all of which tend to bode well for the owners of existing commercial real estate. Rising inflation may enable landlords to raise rental rates charged to existing and new tenants. In particular, shorter-lease-duration sectors such as apartments, hotels and self-storage have the ability to quickly increase rents if economic trends support higher rental rates. As REIT cash flows improve, REITs typically increase their dividend distributions, which can offset the potential valuation impact of higher interest rates.

What is your outlook for the U.S. REIT market?

We expect to see solid economic growth for the U.S. in 2018. We believe the Federal Reserve will likely take a measured approach in terms of further rate hikes. The tax cuts signed into law in late 2017 will likely positively impact corporate profitability while also increasing disposable income for most consumers. Improved consumer confidence, accelerating nonresidential fixed investment and modest inflation should benefit tenant demand for real estate space. We are monitoring the potential impact of recently proposed trade tariffs, possible changes related to the Affordable Care Act, government deregulation and infrastructure initiatives that may affect the real estate sector.

What is your outlook from a regional and sector perspective?

Advances in technology, such as 5G cellular, cloud computing, autonomous driving and artificial intelligence should lead to significant investments in network and IT infrastructure over the next few years. Data centers and infrastructure REITs, particularly those that own high-quality assets in key hubs of connectivity, are perhaps best positioned to benefit from these secular tailwinds.

The rapid growth of Amazon and e-commerce is altering retail supply chains. The changes have positive implications for the industrial/warehouse sector (e-commerce fulfillment is three times as warehouse-intensive as store distribution), but have hurt demand for physical store locations. However, we believe that omnichannel retailing strategies have strengthened the market positions of the high-quality retail locations. Additionally, recent M&A activity has highlighted the value of the top-tier retail assets.

Regionally we believe the Sun Belt markets remain attractive due to above-average job growth in the Southeast and meaningful development restrictions, coupled with technology/social media/entertainment-driven demand growth on the West Coast. The Southeastern markets are also positioned to benefit from tax reform due to low local tax burdens and generally moderate housing costs. While New York City has attractive long-term demand drivers, new supply in the office and residential segments has resulted in flat rental rate trends.

This material is provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice. This material is general in nature and is not directed to any category of investors and should not be regarded as individualized, a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. Investment decisions and the appropriateness of this material should be made based on an investor's individual objectives and circumstances and in consultation with his or her advisors. Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. All information is current as of the date of this material and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole. Neuberger Berman products and services may not be available in all jurisdictions or to all client types. This material may include estimates, outlooks, projections and other "forward-looking statements." Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Diversification does not guarantee profit or protect against loss in declining markets. Investing entails risks, including possible loss of principal. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

Real estate investments are subject to greater potential risks and volatility than a more diversified portfolio, and the share values may decline due to events affecting the real estate industry. The properties held by REITs could fall in value for a variety of reasons, such as declines in rental income, poor property management, environmental liabilities, uninsured damage, increased competition or changes in real estate tax laws. There is also a risk that REIT stock prices overall will decline over short or even long periods because of rising interest rates.

The FTSE NAREIT All Equity REITs Index is an unmanaged free float-adjusted market capitalization weighted index that tracks the performance of all Equity REITs currently listed on the New York Stock Exchange, the NASDAQ National Market System and the NYSE Amex. REITs are classified as Equity REITs if 75% or more of their gross invested book assets are invested directly or indirectly in real property. Please note that indices do not take into account any fees and expenses of investing in the individual securities that they track, and that individuals cannot invest directly in any index. Data about the performance of this index are prepared or obtained by the Manager and include reinvestment of all dividends and capital gain distributions.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance. As of September 16, 2005, S&P switched to a float-adjusted format, which weights only those shares that are available to investors, not all of a company's outstanding shares. The value of the index now reflects the value available in the public markets.

This material is being issued on a limited basis through various global subsidiaries and affiliates of Neuberger Berman Group LLC. Please visit www.nb.com/disclosure-globalcommunications for the specific entities and jurisdictional limitations and restrictions.

The "Neuberger Berman" name and logo are registered service marks of Neuberger Berman Group LLC.

©2018 Neuberger Berman Group LLC. All rights reserved.

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com

T0158 06/18 218251 ©2018 Neuberger Berman Group LLC. All rights reserved.