Morgan Stanley

INVESTMENT MANAGEMENT

Unprecedented Valuation Disparities in REITs Creates Opportunities for Active Managers

REAL ASSETS | GLOBAL LISTED REAL ASSETS TEAM | INVESTMENT INSIGHT | 2019

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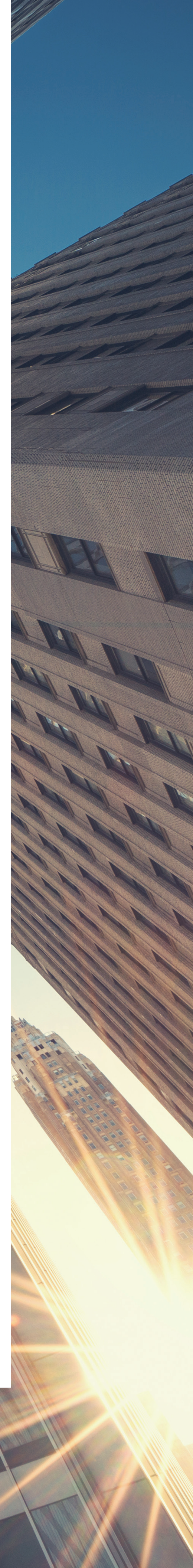
Key Takeaways

- As passive investing grows, stock picking becomes all the more important. REITs have surged in value so far in 2019, but that recovery has not been uniform.
- Many REITs are trading at significant discounts relative to the index and comparable privately-held real estate assets.
- We believe several factors could cause these valuation gaps to narrow, including renewed interest in fundamentals, activist investing and take-private transactions.

The rise of passive investing and private real estate funds has created unprecedented valuation disparities in REITs, but these gaps tend not to last indefinitely. Now may be an opportune time for investors to consider actively-managed real estate strategies that have the potential to capitalize on this situation.



Introduction

Over the last several decades commercial real estate has gone from a nascent asset class to a portfolio staple, with U.S. institutions now allocating an average of 10.6% of assets to real estate as shown in *Display 1*.

Among the biggest beneficiaries of this shift are passively-managed funds, which have grown to represent roughly 25% of assets allocated to real estate investment trusts (REITs),[1] and private real estate funds, which have accumulated record levels of undeployed capital as seen in *Display 2*.

These trends have helped contribute to unprecedented valuation disparities among REITs, both relative to their net asset values (NAVs) and comparable privately-held assets—and therein lies the opportunity.

Spotting Growing Disparities

PASSIVE FUELS VALUATION GAP

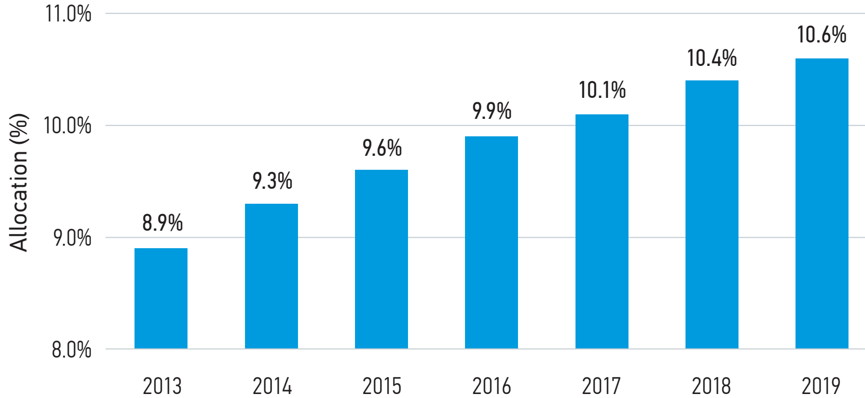
Index-based investing has made its mark on virtually every asset class, and real estate is no exception. Passively-managed strategies recently accounted for one in four dollars invested in REITs,[1] and that share is steadily growing.

Yet, as has been the case with other asset classes, this has created a unique dynamic in which assets tend to flow into the largest entities with little differentiation for company fundamentals or valuations.

As more assets flow into market-cap weighted index funds it only serves to exacerbate this disconnect—creating what we think could be passive bubbles. These disparities are evident in market segments globally, but are particularly

DISPLAY 1

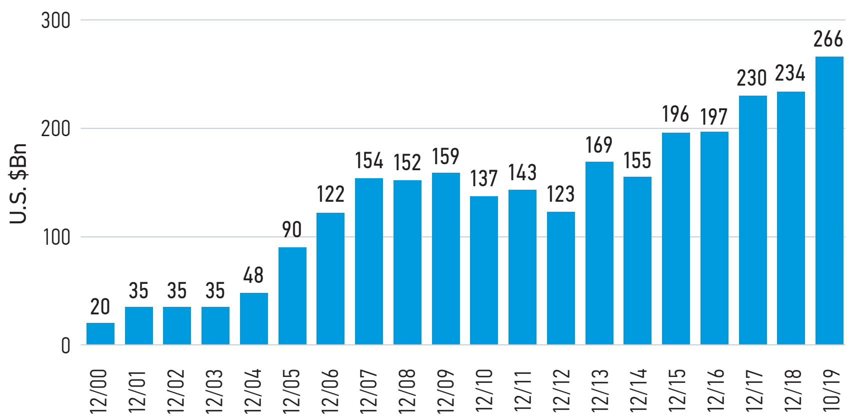
Weighted average target allocation to real estate for US Institutions



Source: Hodes Weill and Associates, IREI. Yearly data as of December 31. 2019 data as of September 30.

DISPLAY 2

Global committed equity capital for closed-end private real estate funds



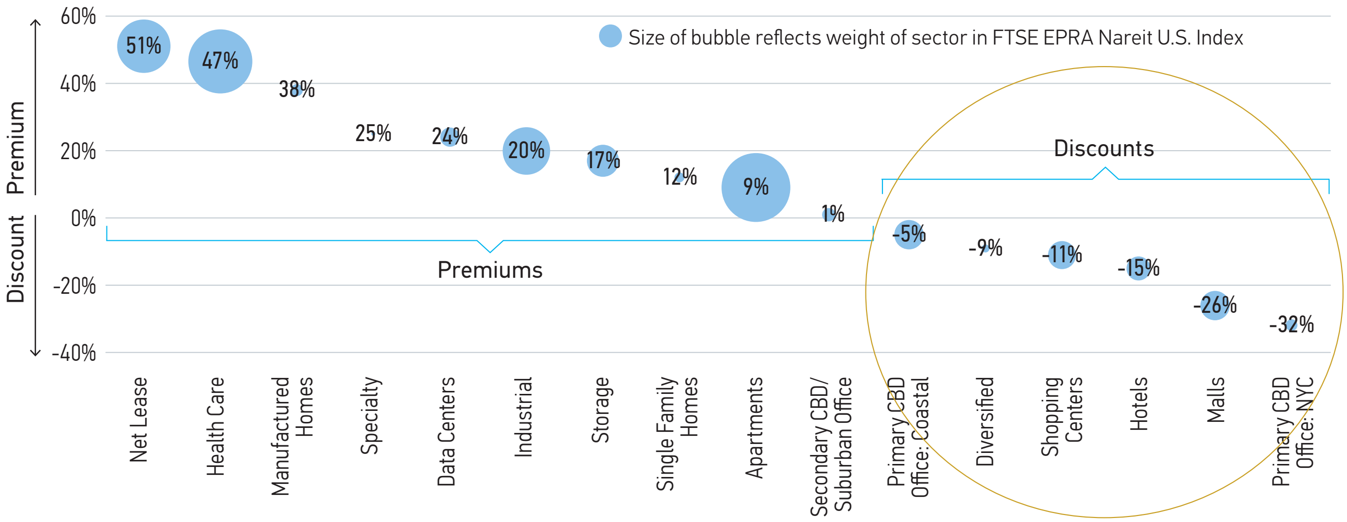
Source: Preqin. Yearly data as of December 31. October 2019 data as of October 1st.

[1] Source: Morgan Stanley Investment Management

DISPLAY 3

Various market segments are trading at deep discounted valuations versus private real estate valuations

U.S. Price vs. NAV by Sector



Data as of September 30, 2019. Based on FTSE EPRA Nareit U.S. Index. Source: Morgan Stanley Investment Management

Past performance is not indicative of future results. This should not be deemed as a recommendation or offer to buy or sell any security within the sectors referenced, or to participate in any trading strategy.

pronounced in the U.S. REIT market. The overall U.S. Real Estate sector ended the third quarter trading at a +15% premium to net asset values, and yet many segments—including retail, hotel assets and central business district (CBD) office—continued to trade at deeply-discounted valuations. (See *Display 3* and the sidebar on New York City office space.)

PRIVATE ASSETS ADD TO THE SCHISM

Coincident with the increased interest in passive funds, institutional investors have shifted a greater share of their real estate allocation to private investments in search of higher yields and lower correlations to equity markets. As a result, private real estate equity funds recently held $266 billion of committed but uninvested capital, with approximately 61% of this "dry powder" earmarked for North American real estate.[2]

This is notable for a couple of reasons. First, it shows a disconnect between how investors view active investing strategies in the public and private markets. While private investments have potential benefits, they typically come with the tradeoff of higher fees, more leverage and less liquidity.

It also underscores differences in how investors in private and public markets size up real estate. In recent years, generalist investors—who represent the marginal REIT investor today—have placed a great deal of focus on traditional stock market metrics, such as earnings multiples, dividend yields and earnings growth rates when evaluating publicly traded REITs. In our view, these investors have not been looking through to the underlying real estate assets held by REITs and evaluating them on real estate-specific metrics such as occupancy rates, net operating income growth, etc., which private market investors tend to focus on. Generalist investors have also bid up REITs with perceived defensive characteristics or ties to secular investment themes, such as the growth of cloud computing and e-commerce. As a result, the value of real estate assets held in publicly traded vehicles has become unmoored from the private market valuation of similar assets.

[2] Source: Preqin. Data as of October 1st, 2019.

NEW YORK OFFICE SPACE: A TALE OF TWO CITIES

To understand the stark differences in how public and private markets are pricing real estate, consider New York City (NYC) office space. This segment of the market has been enveloped in a cloud of worry as investors assume that new inventory, such as at Hudson Yards, and more flexible work arrangements will likely put downward pressure on rents. Consequently, public NYC office REITs were recently trading anywhere from 30% to 40% less than what private investors are paying.

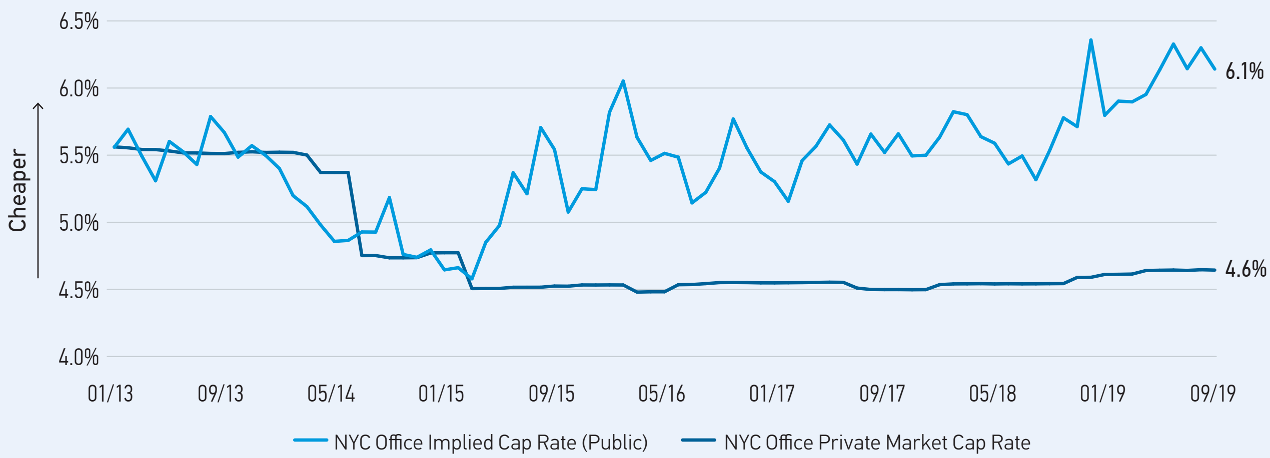
Private investors appear to have a very different outlook and have had a healthy appetite for NYC office assets. In 2018 they acquired nearly $19 billion in assets and year to date through September 2019 they acquired over $12 billion in assets. Moreover, private buyers have been buying 'Big Apple' office space at par value—versus a 32% discount to NAVs for NYC office REITs.

We believe this dislocation offers an attractive investment opportunity.

- NYC office REITs have historically traded around par or at premiums to private market values (NAV), but began to trade at discounts in 2015.
- NYC office REITs recently traded at 32% discount to NAVs, or an implied cap rate of 6.1% versus 4.6% for comparable private assets.
- Since 2015, private market cap rates for NYC office assets have been relatively stable and increased modestly, while implied cap rates for NYC office REITs have increased significantly.

DISPLAY A

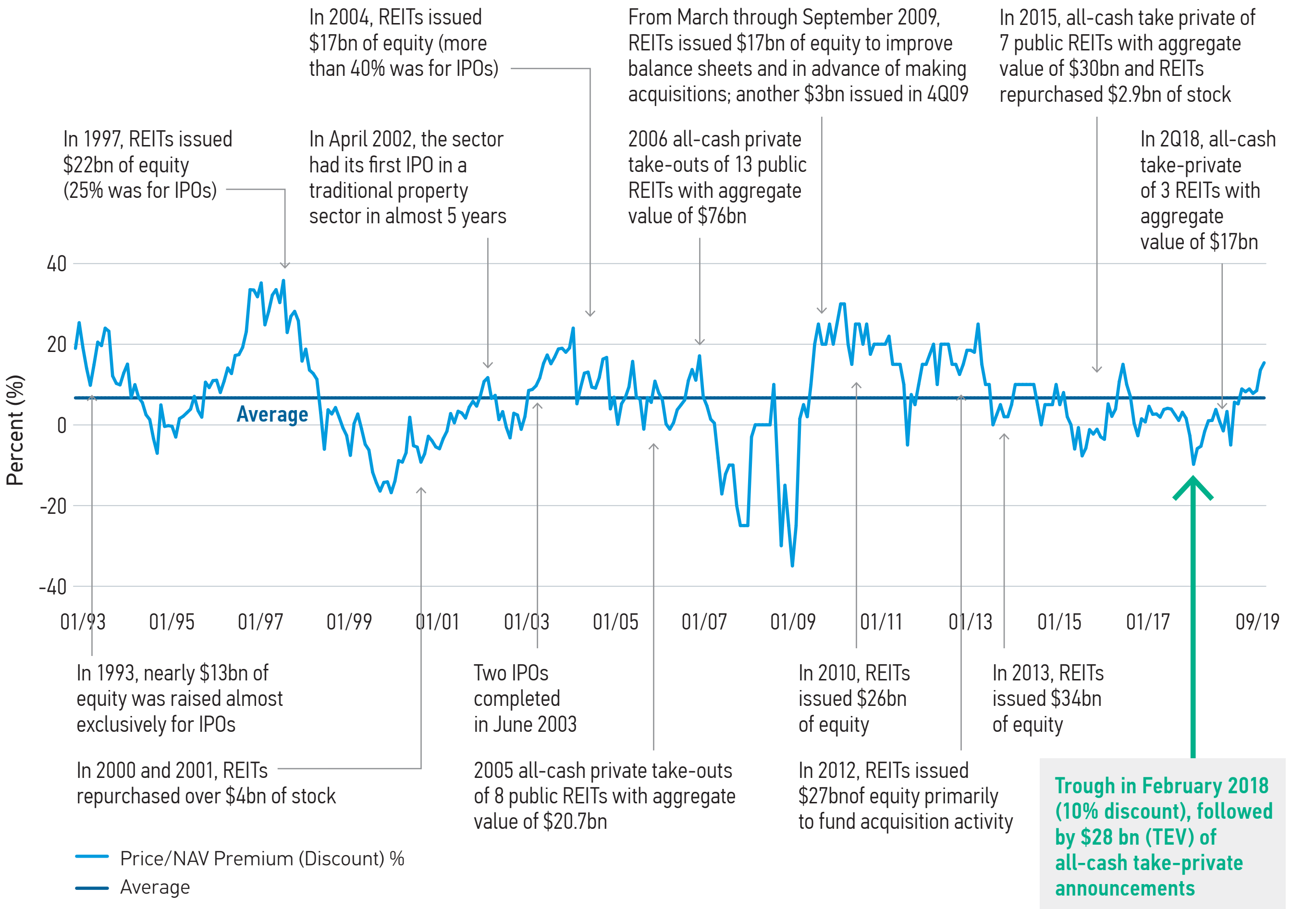
NYC office public implied cap rates and NYC office private market cap rates



Based on FTSE EPRA Nareit U.S. Index. Source: Morgan Stanley Investment Management. NYC Office Implied Cap Rate (Public) provided by MSIM as implied by company cash flows and share prices. NYC Office Private Market Cap Rate provided by MSIM and based on transactional evidence.

DISPLAY 4

U.S. REITs have demonstrated tendency to revert to par valuations over time



Source: Morgan Stanley Investment Management and Green Street Advisors, Inc. Past performance is not indicative of future results. This should not be deemed as a recommendation or offer to buy or sell any security or to participate in any trading strategy.

Closing the Valuation Gap

History has shown that valuation disparities rarely last. Eventually, markets tend to catch on and as *Display 4* shows, REIT values have in the past reverted to their long-term mean. Several factors could help close the current valuation gap, including: take-private transactions, share buybacks and a renewed appreciation for traditional real estate fundamentals.

INCREASE IN PRIVATE ACQUISITIONS

With private real estate funds having raised record levels of capital—and publicly-traded firms trading at compelling discounted valuations—it's not out of the question that many REITs have the potential to be taken private.

Given the substantial disparities between public and private market valuations that exist within certain market segments, we think there may be increased take-private activity as the private funds look to access real estate at more attractive valuations by buying the public real estate companies instead of buying comparable assets in the private market.

In 2018, investment transaction volume totaled $964 billion on a global basis and represented the third highest annual total on record behind only 2007 and 2015, according to Real Capital Analytics.

U.S. transaction volume, meanwhile, reached a post-Global Financial Crisis peak of $576 billion in 2018, representing an 18% increase over the year prior.

FUNDAMENTALS BACK IN FAVOR

Meanwhile, high-quality REITs continue to make meaningful improvements that ultimately benefit shareholders. They have been strengthening their balance sheets, improving operations, disposing of non-core assets—in many cases selling these assets to private investors at full intrinsic value—and using the proceeds to buy back shares at significant discounts to their associated NAVs.

We've also seen an uptick in activist investors taking long positions in discounted REITs that are underperforming. They are nudging these companies to take meaningful steps toward improvement and, in many cases, put themselves on the auction block for take-private activity.

These activities could prompt generalist investors to pay closer attention to the underlying private market valuations of REITs, recognizing that in real estate, intrinsic value does matter. At present they appear willing to ignore the distinction in multiples used to value assets in the private real estate sector and, therefore, are indifferent about the quality of the real estate cash flow when buying stocks.

Benefitting from Active Management

In any market environment, active management can play a prominent role in helping to improve overall returns while managing downside risk. Given the significant differences in macroeconomic and secular trends across regional markets, most investors will likely want to seek broad exposure across a wide range of sectors, while understanding the importance of liquidity in an asset class that is in and of itself not liquid.

This is likely true for any market environment, but in light of current valuation disparities we think there is a strong case to be made for active management. Now may be an opportune time for investors to shift their allocations into actively-managed REIT strategies that focus on high-quality assets trading at discounted valuations.

To be sure, certain market segments are exceptionally discounted, opening the door for active management to take advantage of wider than typical valuation disparities. We believe investors stand to benefit from multiple expansions––as the broader market spots these disparities––and potential take-private activities.

Meanwhile, a focus on quality and attractive entry points can serve as a buffer in market declines. Actively-managed REIT strategies have the leeway to tilt portfolios away from overvalued segments and toward those trading at significant discounts.

BUILD: CONSIDER INVESTING IN MSIM'S GLRA STAND ALONE FUNDS

GLOBAL REAL ESTATE PORTFOLIO

The Global Real Estate Portfolio seeks attractive long-term, risk-adjusted returns by investing in publicly traded real estate securities, primarily in developed countries worldwide. The fund combines a value-oriented, bottom-up-driven investment strategy and a global top-down allocation that seeks diversified exposure to all major asset classes with an overweighting to property markets that the team believes offer the best relative valuation.

AVAILABLE SHARE CLASSES

Class A (MRLBX)	Class I (MRLAX)	Class IS (MGREX)
Class C (MSRDX)	Class IR (MRLEX)	Class L (MGRLX)

US REAL ESTATE PORTFOLIO

The US Real Estate Portfolio seeks attractive long-term, risk-adjusted returns by investing in publicly traded U.S. real estate securities. The fund combines a value-oriented, bottom-up-driven investment strategy and a top-down allocation that seeks diversified exposure to all major asset classes with an overweighting to property markets that we believe offer the best relative valuation.

AVAILABLE SHARE CLASSES

Class A (MUSDX)	Class I (MSUSX)	Class IS (MURSX)
Class C (MSURX)	Class IR (MRETX)	Class L (MSULX)

CONSIDER: MSIM'S TURNKEY SOLUTION

REAL ASSETS PORTFOLIO

The Real Assets Portfolio seeks total return, targeted to be in excess of inflation, through capital appreciation and current income. Investments primarily include global listed real estate and infrastructure securities, inflation sensitive equities, inflation-linked fixed income securities and commodity-linked investments.

AVAILABLE SHARE CLASSES

Class A (MRJAX)	Class I (MRJIX)
Class C (MRJCX)	Class IS (MRJSX)

REAL ESTATE FINDS A PLACE IN INVESTOR PORTFOLIOS

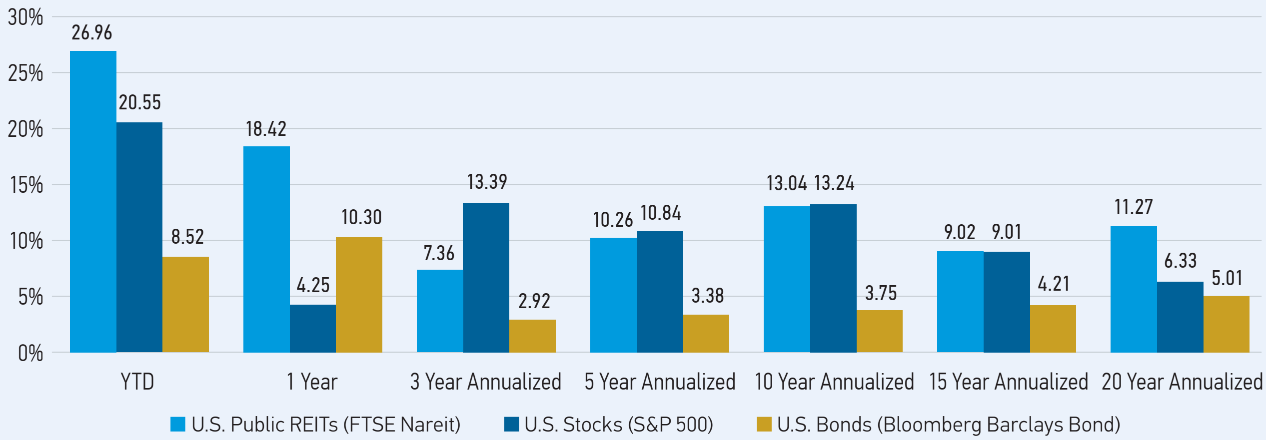
In any market, we believe REITs can help improve risk-adjusted returns in a portfolio. That said, in the current environment of low—and in some cases negative—interest rates, they are particularly appealing as income-generating assets that don't typically move in lock step with stocks and bonds.

Over the medium to long term, we expect returns for REITs to fall between equities and fixed income while offering an attractive income component.

DISPLAY A

REITs returns have been attractive over the long term

Annualized Returns (%) in USD



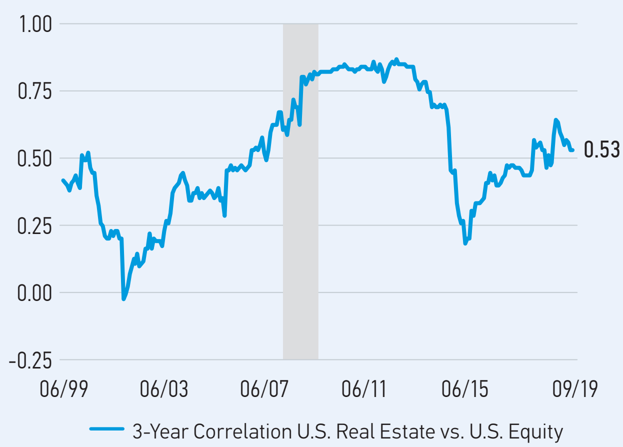
Data as of September 30, 2019. Sources: FTSE Nareit, Bloomberg Barclays, S&P Dow Jones, and MSIM. **Past performance is not indicative of future results.** Diversification does not eliminate the risk of loss. In general, equity securities are move volatile than fixed income securities. For additional risk considerations, refer to the disclosure section.

At the same time, REITs should continue to provide diversification benefits—thanks to historically low correlations with stocks and bonds—while offering a buffer against inflation. In fact, dividend returns for the sector have outpaced inflation over the last 15 years. Meanwhile, different global markets and sectors provide no shortage of options for active managers to achieve above-average returns and income.

DISPLAY B

Rolling 36-Month correlation of U.S. Listed Real Estate vs. Equities as of September 30, 2019

FTSE Nareit Equity REITs vs. S&P 500 Index Returns

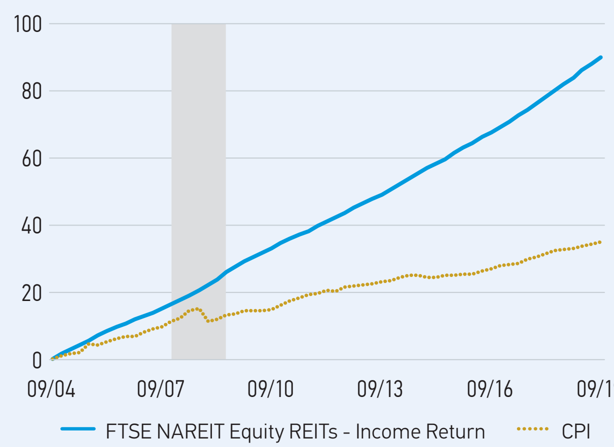


Source: Vendor, FactSet on behalf of FTSE Nareit, S&P and Citigroup. **Past performance is not indicative of future results.**

DISPLAY C

REITs dividend returns have outpaced inflation over the last 15 years as measured by the CPI

REIT Income vs. Inflation - Last 15 Years



Source: Vendor, FactSet on behalf of FTSE Nareit and the U.S. Department of Labor (CPI through 3/31/2019). **Past performance is not indicative of future results.**

IMPORTANT INFORMATION

INDEX DEFINITIONS

The **FTSE EPRA Nareit Developed Real Estate Index - Net Total Return to US Investors** is a market capitalization weighted index designed to reflect the stock performance of companies engaged in the North American, European and Asian real estate markets. The performance of the Index is listed in U.S. dollars and assumes reinvestment of dividends. "Net Total Return to US investors" reflects a reduction in total returns after taking into account the withholding tax on dividends by certain foreign countries represented in the Index. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

The **Bloomberg Barclays Aggregate Bond Index** is an index comprised of approximately 6,000 publicly traded bonds including United States government, mortgage-backed, corporate and Yankee bonds with an average maturity of approximately 10 years.

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The indices do not include any expenses, fees or sales charges, which would lower performance. The indices are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

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Asset Allocation/Diversification does not protect you against a loss in a particular market; however it allows you to spread that risk across various asset classes. There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed countries. Companies within the **infrastructure industry** are subject to a variety of factors that may adversely affect their business or operations, including high interest, leverage and regulatory costs, difficulty raising capital, the effect of an economic slowdown or recession and surplus capacity, and increased competition. Other risks include technological innovation, significant changes in the number of end-users, an increasing deregulatory environment, natural and environmental risks, and terrorist attacks. Stocks of **small- and medium-capitalization companies** entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. **Real estate investments,** including **real estate investment trusts (REITs)**, are subject to risks similar to those associated with the direct ownership of real estate and they are sensitive to such factors as management skills and changes in tax laws. The risks of owning real estate directly as well as the way **Real Estate Operating Companies (REOCs)** are organized and operated will affect the Portfolio. They require specialized management skills, causing a Portfolio to indirectly bear the costs of such skills. In addition, foreign real estate companies may be subject to the laws, rules and regulations governing those entities and their failure to comply with those laws, rules and regulations could negatively impact the performance of those entities. Trading in, and investment exposure to, **the commodities markets** may involve substantial risks and subject the Portfolio to greater volatility. Investments in securities of **natural resources companies** may be affected by a variety of factors, including global political and economic developments, natural disasters in major natural resource areas, fluctuations in demand caused by, among other things, rising interest rates, general economic conditions and energy conservation efforts. Individual **Master Limited Partnerships (MLPs)** are publically traded partnerships that have unique risks related to their structure. These include, but are not limited to, their reliance on the capital markets to fund growth, adverse ruling on the current tax treatment of distributions (typically mostly tax deferred), and commodity volume risk. The potential tax benefits from investing in MLPs depend on their being treated as partnerships for federal income tax purposes and, if the MLP is deemed to be a corporation, then its income would be subject to federal taxation at the entity level, reducing the amount of cash available for distribution to the fund which could result in a reduction of the fund's value. MLPs carry interest rate risk and may underperform in a rising interest rate environment. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds (ETFs), the portfolio absorbs both its own expenses and those of the ETFs it invests in. Supply and demand for ETFs may not be correlated to that of the underlying securities. When investing in **value securities**, the market may not have the same value assessment as the manager, and, therefore, the performance of the securities may decline. The Fund's **allocations** to the various underlying and independently managed investment strategies may cause the Fund to underperform a particular individual strategy or other funds, including those with a similar investment objective. It is possible that Fund assets could be allocated to underlying and independently managed investment strategies that perform poorly or underperform other investments under various market conditions. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. **Restricted and Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).

Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes.

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