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FOCUS ON: VIRTUS DUFF & PHELPS GLOBAL REAL ESTATE SECURITIES FUND

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Adding global real estate to a portfolio offers both growth and diversification potential. This asset class stands to benefit from the tailwinds of positive global economic growth and minimal new real estate supply. Plus, its returns tend not to move in lockstep with other investments. This edition of our Focus On series makes sense of this lesser-known market opportunity.

What is driving the global opportunity in real estate?

The investment opportunity in listed real estate investment trusts (REITs) is often thought of as primarily U.S.-centric. In reality, the opportunity has become increasingly global, for several reasons: the ongoing introduction of REIT-like legislation overseas; lower levels of securitized real estate in many developed countries allowing for faster growth in the asset class; and increased investor demand for these types of securities.

The REIT structure was first introduced in the U.S. in 1960, and, today, there are approximately 40 countries with approved REIT legislation. We believe the on-going securitization of commercial real estate is a secular trend that will continue to mature and evolve in the coming decades.

The robust growth in the listed real estate markets of Spain, Ireland, and Mexico are just a few recent examples of this trend at work. Investors can gain exposure to key global markets, tenant demand, and the rental cash flow streams from many properties, including where people want to live, work, shop, store, and distribute consumer goods. Moreover, the global listed real estate markets generally provide access to superior quality real estate, aligned management, strong governance, and greater liquidity than is readily available to investors in the global private commercial real estate market.

Why invest in global real estate securities?

An allocation to global real estate may tangibly improve an investor's portfolio by delivering compelling risk-adjusted returns with lower correlations to other investments. Returns stem primarily from exposure to high-quality, lease-based cash flow as well as dividend growth from many different types of commercial real estate, spread across numerous countries.

Generally, the global listed real estate universe offers an attractive, large, and growing list of traded real estate equities, including many mid- and small-cap names, which may not be well covered by the Street. This light coverage creates an opportunity to add value through a fundamentally oriented and rigorous investment process.

Over the last five years, performance leadership in the global real estate domain has at times been led by U.S. REITs while non-U.S. names have led in other years. In 2017, for example, non-U.S. real estate securities easily outpaced U.S. REITs after a string of three consecutive years of clear U.S. leadership. Thus, a global approach can help to smooth out some of the cyclicality associated with individual countries' commercial real estate markets.

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What is distinct about your approach to investing in this opportunity?

Duff & Phelps was a pioneer in listed real estate investing. More than a decade ago, we were early to recognize that overseas investment opportunities were far more diverse than just U.S.-listed REITs with investments abroad. While some competitors dove into overseas companies focused on for-sale residential development (even though they historically did not invest in U.S. homebuilders), we concluded that the international investment opportunity should be thematically consistent with the business profile of companies we historically found compelling in the U.S.

We determined that a focus on an investment universe composed of "rental" real estate companies would be the best approach. These companies are true owner-operators of commercial real estate, generating 70% or more of their revenue from the rents of their underlying investment properties. Historically, they have delivered superior risk-adjusted returns compared to "non-rental" companies and we believe they offer the investment characteristics that investors seek when making an investment allocation to real estate. These characteristics include:

- stable cash flow and dividend growth;
- lower correlation to other asset classes; and
- a degree of inflation protection.

In structuring our research coverage, we recognized there would be many cross-border benefits to having analysts cover both U.S. REITs with property investments in other countries, and global ex-U.S. names abroad. This distinctive approach to research coverage has facilitated true global portfolio construction.

Can you share insights into your investment process and the attributes you look for in the companies included in the portfolio?

A consistent investment philosophy and process underpins our listed real estate strategies, including global securities. In fact, the initial framework was put in place more than two decades ago, although it has been refined over the years. Our investment process comprises five distinct steps, which build upon one another to ultimately drive the construction of a high-conviction portfolio with explicit risk-management guidelines.

Step 1—Identify real estate market and sector opportunities via three dimensions:

- the macro environment
- real estate fundamentals (supply and demand of rental space utilized by tenants)
- real estate capital markets (the transaction market between buyers and sellers)

Our research and analysis of these three areas help drive our initial considerations and focus for assets by property sector, geographic location, and lease duration, to name a few variables.

Step 2—Delve into and filter the listed investment universe of real estate securities on liquidity and proprietary fundamental and valuation factors.

We identify potential investment opportunities and prioritize our research efforts. Our dynamic proprietary screening process seeks to rank companies on the fundamental and valuation characteristics we believe are key to a potentially attractive investment opportunity and are representative of a growth-at-a-reasonable-price, or GARP, investment style:

- above average cash flow and dividend growth;
- strong balance sheet;
- healthy return on invested capital; and
- an attractive relative valuation.

Step 3—Assess a company's intrinsic value.

This is the core of our research process. We thoroughly analyze the companies that rank well through our filtering process across five key areas:

- management analysis
- property portfolio
- cash flow drivers
- future growth prospects
- proprietary multi-valuation process (the Duff "MVP")

We strive to identify companies that have management teams with a strong capital allocation track record and governance, clear strategy, appropriate staffing levels to implement their strategy, a well-located and competitively positioned real estate portfolio, and a balance sheet that will support the future growth of the business. Ultimately, we want to invest in companies at prices that we believe are at a discount to the intrinsic value of the business.

Step 4—Portfolio construction with oversight and monitoring by our risk management team.

At this stage, the portfolio managers synthesize our views on the three dimensions from step 1 of the real estate market with our bottom-up company research. We vet each analyst's recommendation, as well as views of other analysts on the team, before building a portfolio around the highest conviction ideas, taking into account security risks, the fund's risk-management guidelines, and portfolio risk controls.

From a risk management perspective, we seek to have a focused—but not too concentrated—portfolio.

Step 5—An exercise of our sell discipline.

While there are many reasons we may choose to sell or trim a security position, the most common are when a security approaches its intrinsic value, a better risk-adjusted opportunity becomes available, a change occurs in the fundamental thesis underlying the investment, or for considerations of investment guidelines and target weights.

Do you hedge foreign currencies?

To date, we have not hedged currencies because we start with the premise that exposure to foreign currencies is one of the desired attributes of a global investment allocation. It's well known that tactical currency hedging is challenging at best. Additionally, active or passive foreign currency hedging can introduce meaningful transaction costs that might detract from long-term returns. Thus, for investors with a medium- to long-term investment horizon, our view is that the impact of currency movements will likely be negligible if the global portfolio is well diversified.

What is your current outlook for the global listed real estate market?

Overall, we view a backdrop of low—but positive—global economic growth and manageable new real estate supply as positive fundamental tailwinds for global listed real estate going forward. Should global economic growth continue to improve, this would facilitate further increases in real estate operating cash flows and dividends through higher property occupancies and, in cases where occupancy has reached equilibrium, higher rents. Combined with the supportive tailwind to real estate asset pricing, our base case remains for another positive total return year for global real estate securities in 2018.

Global real estate total return drivers for 2018 include global cash flow growth of approximately 5-6%, dividend yield of approximately 4 with above-average growth expected in the U.S. given lower payout ratios, healthy demand, and moderate new supply driving cash flow and dividend growth. From a global perspective, real estate fundamentals remain more attractive for the industrial and data center property sectors with secular tailwinds.

> The diversification benefits of this exposure should not be understated. Unlike many other global industries that have been profoundly impacted by the increase in global trade and are greatly influenced by global supply and demand fundamentals, real estate, by and large, remains a local business that is driven by local supply and demand.

From a balanced perspective, we should note both upside drivers and downside risks. Global real estate upside drivers include greater-than-expected global economic growth, leading to more robust employment and income growth, which are key drivers of higher occupancies and rents at company-owned properties; inflow on rotation from bonds and rebalancing from broader equities to listed real estate; and increased potential for M&A and privatization given listed discounts to private real estate market prices, robust bids, and the ongoing appetite for high-quality, core real estate among institutional investors. On the other end, global real estate downside risks include cessation of real estate cap rate compression and potential expansion; acceleration in the pace of new commercial real estate supply; and increases in interest rates at a faster pace and magnitude than a lift in net operating income growth and replacement costs can absorb. Global macro risks include diverging monetary and fiscal policies as well as ongoing political risks.

To learn more about the Virtus Duff & Phelps Global Real Estate Securities Fund, contact your financial advisor, visit virtus.com, or call 1-800-243-4361.

About the Authors:

Geoffrey Dybas, CFA heads Duff & Phelps' Global Real Estate Securities team. He is senior portfolio manager and co-founder of all dedicated REIT strategies managed by Duff & Phelps, including the Virtus Duff & Phelps Real Estate Securities Fund; Virtus Duff & Phelps International Real Estate Securities Fund; Virtus Duff & Phelps Global Real Estate Securities Fund; Virtus Duff & Phelps Real Estate Securities Series, a series of the Virtus Variable Insurance Trust; the REIT portfolio within the DNP Select Income Fund Inc., a closed-end fund; and separate institutional accounts.

Prior to joining Duff & Phelps in 1995, Mr. Dybas was a corporate banker for Bank One, and began his investment career in 1989.

Mr. Dybas holds a B.S., cum laude, from Marquette University and an M.B.A. from the Kellogg School of Management at Northwestern University. Mr. Dybas is a member of the CFA Institute, the CFA Society of Chicago, the National Association of Real Estate Investment Trusts (NAREIT), and the European Public Real Estate Association (EPRA).

Frank Haggerty, CFA serves as portfolio manager for all dedicated REIT strategies managed by Duff & Phelps, including the Virtus Duff & Phelps Real Estate Securities Fund, Virtus Duff & Phelps International Real Estate Securities Fund, Virtus Duff & Phelps Global Real Estate Securities Fund, Virtus Duff & Phelps Real Estate Securities Series, the REIT portfolio within the closed-end DNP Select Income Fund Inc., and separate institutional accounts.

Prior to joining Duff & Phelps in 2005, Mr. Haggerty served as a REIT portfolio manager and senior analyst at ABN AMRO Asset Management.

Mr. Haggerty earned a B.S. from Illinois State University and an M.B.A. from DePaul University Kellstadt Graduate School of Business. He is a Chartered Financial Analyst® (CFA®) charterholder. Mr. Haggerty is a member of the CFA Institute, the CFA Society of Chicago, National Association of Real Estate Investment Trusts (NAREIT), European Public Real Estate Association (EPRA), FTSE EPRA/NAREIT Global Real Estate Series Americas Committee, and the Board of Directors for the Illinois State University Educational Investment Fund. He began his investment career in 1996.