Global REIT Review and Outlook with Duff & Phelps
Call Conducted on August 4, 2016
Transcript edited for clarity

Barry Mandinach: *Good afternoon, I'm Barry Mandinach, Executive Vice President and Head of Distribution at Virtus Investment Partners, and it's my pleasure to welcome you to our call today. Joining me are Tom Wagner, Virtus Product Specialist for the REIT strategies; and Geoff Dybas and Frank Haggerty from our affiliated manager, Duff and Phelps Investment Management, who manage the firm's dedicated REIT strategies.*

Liquid real estate securities have a central role in any diversified portfolio. It's an asset class that's distinct from stocks and bonds. REITs have delivered attractive low correlated returns to investors for decades. And they're really known as the original alternative investment. Duff and Phelps is uniquely positioned to deliver compelling results in this space. The firm was founded more than 80 years ago and has a focus on real assets, with expertise in global real estate, global listed infrastructure, and MLPs. The REIT strategy began in 1995, and among the portfolios Geoff and Frank manage are the Virtus Real Estate Securities Fund which is domestic; Virtus International Real Estate Securities Fund; and Virtus Global Real Estate Securities Fund. So you have a domestic, an international, and a global real estate fund. Geoff is the founder of the REIT strategy and is the Global Head, Global Real Estate Securities and a Senior Portfolio Manager at Duff and Phelps. He has been with the firm since 1995. Frank Haggerty is Senior Managing Director and Portfolio Manager for all dedicated REIT strategies managed by Duff and Phelps and has been with the firm since 2005.

At Virtus we are committed to driving better client outcomes, and we believe that insightful market perspective is key to helping you and investors meet their objectives. It is my pleasure to turn the call over to Tom Wagner.

Tom Wagner: *Thanks Barry. Geoff, let's dive right into the focus of the call. There's a new real estate GICS sector. Can you give us some of the detail and color around the new sector slated for the end of this month?*

Geoff Dybas: The recognition of real estate as an asset class in the equity markets has arrived. The MSCI and S&P indices will break out real estate into its own classification at month-end, with respective effective dates of August 31 and September 16, 2016. Looking at the S&P 500® Index, real estate is measured by the equity REITs we invest in. [Real estate will] become the eleventh GICS sector and the ninth largest in size. The breakout will come from within the financials sector.

The paradox is this is happening at a time when real estate is demonstrating pricing power in the form of higher rents. At the same time, financials are seeing their growth curtailed by some of the regulatory changes such as Basel III. Basel III has imposed higher capital ratio requirements for banks that are required [to be implemented] by 2019. It's reduced their effectiveness and the ability to lend and provide construction and financing to the same degree they did in prior cycles. The benefit for real estate is this has helped contain new supply.

We think the enhanced organic growth for REITs in a moderately growing economy has been benefiting from this contained new supply based upon the Basel III requirements for the financials. And effectively, we as landlords of high quality commercial real estate across a number of property sectors and markets are benefiting from having less new supply – and, said another way, less competition. We believe this breakout of real estate into its own GICS sector, indeed recognizes it as its own asset class, increases visibility to it, and will increase demand to listed REITs.

Tom Wagner: *As a follow-up question for Frank, can you give us some of your insights on the potential impact. There have been a lot of research reports out there that range from anywhere from $20 billion to as much as $100 billion potential demand because of this breakout. Can you just give us some thoughts and insights why that would occur?*

Frank Haggerty: Sure. As it relates to some of the potential positive implications of this breakout, I'll highlight a couple. First, as Geoff alluded, we expect the visibility of real estate as an asset class will increase, particularly among generalist equity investors, from where it stands today.

Why would visibility increase and why would this potentially lead to increases in allocations? You have to look at the context that historically, generalist equity investors across capitalization sizes and strategy investment style tilts have historically been underweight real estate. This varies by market capitalization range and by investment style.

A study done by JP Morgan Research earlier this year put out one of those higher numbers that you alluded to as the potential positive impact of new allocations to real estate. They did an analysis that looked at over 7,500 1940 Act mutual funds with AUM of roughly $5 trillion as of March 29 this year. This universe of funds covered all size categories—small-, mid-, and large-cap—and style buckets of core, growth, and value. [Their analysis] found that relative to their respective benchmarks, these funds were on average roughly 200 basis points underweight the real estate sector. If you were to do a simple analysis of these funds and go to a benchmark weight in real estate to see what the impact would be, that's how you get to this higher number, roughly $100 billion on that $5 trillion of AUM.

Within the capitalization ranges and style tilts, what we find is the greatest underweight exists in the small- and mid-cap investment style ranges. And so we would expect at the margin, some of the larger potential demand increases will come from managers who operate within those investment styles.

But you also reference a lower number. There has been another study done by Goldman Sachs, and in their estimation, they find that the impact could potentially be much less than that $100 billion. It could be something closer to $20 billion. To cut to the chase, their analysis basically assumes the impact would really just come from those strategies that don't own any real estate stocks today, and if they were to increase their allocations, that potential impact would be closer to that $20 billion.

The net point is we view this as being positive for real estate allocations over time. Less important to us is what the actual number is and the debates around that. It's really about will this positively impact potential flows to the sector? We believe it will, and it could be anywhere between that $20 to $100 billion number.

Tom Wagner: *Geoff, taking a step back, you've been [investing in REITs] as Barry alluded to, through many different cycles. And you've dealt with many different investors. Why are investors typically allocating to the REIT space?*

Geoff Dybas: Big picture, I would say, three points. REITs allow us to play the wealth creation in high quality commercial real estate. REITs have historically delivered the returns. And REITs not only diversify a portfolio, but they've been shown to reduce risk and lift returns when allocated to a portfolio.

Tom Wagner: *Frank, What do you think causes that diversification benefit? We see it in the correlation numbers. We see it in the data we run. But what is actually causing that diversification?*

Frank Haggerty: That's a good question. As it relates to the diversification benefits you allude to over time, REITs have definitely demonstrated lower correlations to broader equities. Recent numbers on a trailing 3-year basis are close to .5 on average. We believe one factor in these lower correlations has to do with the high quality real estate that these companies own – the leased space cash flow growth that comes from the commercial real estate that these equity REITs own, and the fact that the duration of the leases are not 100% in synch with the economic cycle over time. And because you have leases in place that provide stable, growing cash flows over time that aren't 100% synchronized with the broader economic cycle, you can see real estate providing good diversification benefits to a portfolio over time.

Tom Wagner: Geoff, we've heard a lot about a number of different asset classes from fixed income to equity, including REITs that have been what people think are a little bit long in the cycle. What are your thoughts on where we stand in the current REITs cycle? And what are some of your outlooks for the space in general?

Geoff Dybas: When we look at the big picture, we continue to operate in an environment where there's minimal new real estate supply. I noted earlier that's there less development overall with the Basel III curtailments, the restrictions. It's putting us effectively as landlords in a stronger position. And so the demonstrable pricing power that we have in the form of higher rents is lifting revenues and it's driving visible contractual-based cash flows.

We also continue to see a very strong private market bid. The demands for real estate among institutions, sovereign wealth funds, is global in nature and it is very robust. And so while we are further along in the cycle, effectively one could argue because of things like Basel III and the reduction in available construction financing, it's extending the normal cycle to make it longer.

And certainly we can all appreciate we have not been in an overheated economy but one that is growing moderately. And one where the organic growth that we offer in listed real estate is so distinctive compared to broader equity earnings.

Tom Wagner: Frank as a follow up to that, we've also heard a lot of discussion around interest rates. Obviously they've been going the other way – they keep getting lower and lower. But what are the potential impacts if rates do eventually rise?

Frank Haggerty: Well what we've observed over time is that REITs have outperformed in most rising interest rate environments. There's been a number of studies done on this topic by NAREIT and others in the industry that looked at prior interest rate cycles and the returns from REITs relative to other alternatives, let's say, general equities. And what we find is in most of those periods, REITs have actually gone on to outperform in a rising interest rate cycle.

One factor behind this would be the fact that typically a rising interest rate cycle occurs at the same time that we're experiencing a positive and growing economic cycle. It's during those periods of time that REITs continue to be able to offer pricing power via higher rents, which is a predominant revenue driver of the assets in the portfolio.

As well as what we see is rising replacement costs during those periods of time. You may have a hiccup in inflation, but REITs offer protection on a relative basis to this rising replacement cost.

So, overall, while there may be in the early stages of a rising interest rate cycle, somewhat of a knee-jerk negative impact to the REITs sector, what we do find is as that plays out over months and quarters, REITs tend to go on to outperform relative to other asset classes.

Tom Wagner: *Geoff, this will be a trickier question. Barry alluded to our domestic real estate fund (Virtus Real Estate Securities Fund) that has a 21-year track record, an international fund (Virtus International Real Estate Securities Fund) that has a 9-year record; and a global fund (Virtus Global Real Estate Securities Fund) with a 7-year record. What are your thoughts, based on what you just covered about the cycles, on where to invest in REITs, whether it's global, domestic, or internationally?*

Geoff Dybas: From the standpoint of global versus domestic [REITs], it's a question that comes up regularly. I would highlight number one, the diversification benefits are compounded with global REITs. Two, I would state that investors gain exposure to key global markets, tenant demand, and the retail cash flow streams from more properties. Finally, the global universe does offer a larger and growing list of equities, including many mid- to small-cap names that are less covered by the Street.

Tom Wagner: *That's a good segue to my next question for Frank. We've seen an influence of passive management across the board and domestic REITs, probably a little less so in the international REIT market. What gives active managers an edge in the REIT market?*

Frank Haggerty: One aspect of that clearly speaks to Geoff's last point in the sense that when you think about active management and our capabilities, we are a bottom-up fundamental research-oriented shop. The fact that, particularly when you look at things on a global basis, you have this larger universe of securities, a number of smaller mid-cap names that aren't as well followed by Street research analysts, that allows us as active managers to get on the ground, do our own fundamental research, and source idea generation for the portfolios. So active management offers a degree of flexibility, particularly for somebody or a firm that is focused on bottom-up security selection.

Being active allows us the opportunity to see specific target exposure, whether by a country or region or property sector. In particular, it allows us to run fairly tight, more concentrated portfolios that ultimately we believe can deliver better risk-adjusted returns than a passive alternative.

Tom Wagner: *Geoff, one additional question. You've been at Duff most of your career. What do you think it is about Duff that differentiates you from your competitors?*

Geoff Dybas: I think number one, we operate as a global team, with cross-border research coverage and portfolio construction from a centralized location. Two, we maintain consistency over a philosophy or process and people over time. And then three, our rental approach on owner/operator [REITs] specifically we feel offers more stable and defensive cash flow growth and returns for our clients.

Related Reading: "Focus On: Virtus Global Real Estate Securities Fund" (April 2016) – A comprehensive Q&A with Geoff Dybas and Frank Haggerty on the opportunities within the global REIT space

Virtus Real Estate Securities Fund (A: PHRAX; I: PHRIX)
Virtus Global Real Estate Securities Fund (A: VGSAX; I: VGISX)
Virtus International Real Estate Securities Fund (A: PXRAX; I: PXRIX)

IMPORTANT RISK CONSIDERATIONS

Virtus Real Estate Securities Fund: Risk notes 1, 2, 3, 6
Virtus Global Real Estate Securities Fund: Risk notes 1, 2, 3, 4, 6
Virtus International Real Estate Securities Fund: Risk notes 1, 2, 3, 5, 6

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6. Prospectus: For additional information on risks, please see the fund's prospectus.

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