

A Case for REITs as a Hedge Against Inflation

Is the U.S. headed for higher inflation? It's a question on the minds of investors, who are concerned about the burgeoning federal debt and signs that food, energy and commodity prices are on the rise.

Scott Crowe, Senior Vice President and Global Portfolio Manager, sees this as an opportune time to invest in commercial real estate, which is a time-tested hedge against inflation.⁽¹⁾ But that's not the only reason. Following the sharp downturns in 2008–2009, commercial real estate values are very attractive, with many assets trading well below replacement cost. What's more, there is limited new supply in the pipeline, as the expansion cycle takes shape. In the following Q&A, Scott frames these issues, while comparing REITs to other investments that can hedge against inflation, like Treasury Inflation-Protected Securities (TIPS) and commodities.

1. Do you think we will see a significant increase in inflation in the next two years?

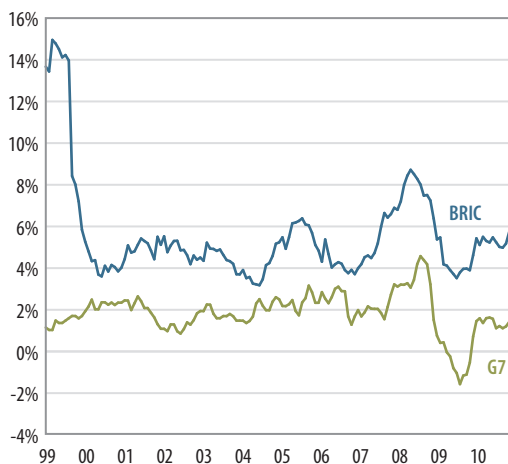
There are a number of indications that inflationary expectations are increasing—the high price of gold, for example. There has also been a run-up in the prices of global agricultural commodities, petroleum, food and metals, which increased by 45%, 30%, 34% and 30%, respectively, from April 2010 to April 2011.⁽²⁾ We are already seeing signs of inflationary pressure in the BRIC countries—Brazil, Russia, India and China—which may ultimately lead to appreciation in their currencies. That, in turn, could pass on higher costs to their trading partners in more developed economies. You can see this trend in Exhibit 1, which compares the consumer price index (CPI) for developed countries with that for the BRIC countries, on average.

Having said that, I don't think global consumer price indexes will rise sharply in 2011—at least in the developed world, where pressures will take more time to build. Given the stubbornly high unemployment in the United States, slack in capacity utilization and still-fragile recoveries around the world, I also think central banks will be tentative about raising interest rates. But it's also important to acknowledge that inflation will be a characteristic of the next growth cycle. Given this realization, smart investors will take steps to prepare.

2. TIPS and commodities have long been traditional inflation hedges. How does commercial real estate compare?

There are advantages to all three. With TIPS, the principal value fluctuates daily, based on the CPI-U index,⁽³⁾ but with

EXHIBIT 1. CONSUMER PRICE INDEX IN BRIC COUNTRIES vs. G7 COUNTRIES
1/31/99–12/31/10 (weighted by GDP)
(year-over-year % change)



Source: Cohen & Steers, Bloomberg. G7 countries include Canada, France, Germany, Italy, Japan, United Kingdom and United States. There is no guarantee that any historical trend will be repeated in the future, and no way to predict precisely when such a trend will begin.

(1) See Exhibit 3 for a 30-year comparison of commercial real estate return vs. inflation.
 (2) Source: IMF.
 (3) CPI-U is the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers.

a three-month lag. Coupons are calculated on the variable principal amount and paid semiannually, which means investors must wait for their inflation bump-up. When TIPS mature, investors are paid the higher of the adjusted or original principal. What is often overlooked, however, is that investors are taxed annually not only on the interest they receive, but also on the accretion of principal, which is not realized until they are repaid or sell their TIPS.

Commodity prices are closely tied to inflation and the value of the U.S. dollar, primarily because they are expressed in dollars. They also have a meaningful impact on inflation measures—directly, as many are included in inflation indexes such as the CPI-U, and indirectly, because commodities are part of the production costs of food, energy and hard goods that are likewise measured. Commodities have historically had high, but volatile, returns.

The third inflation tool is real estate securities, which, until the financial crisis, were less volatile than commodities and which have yields that are substantially higher than those of TIPS. Over the last 10 years, REITs—both U.S. and global—have outperformed TIPS and commodities. (See Exhibit 2)

Commercial real estate—the primary asset of REITs—has been an effective inflation hedge for the last 30 years, as Exhibit 3 shows. The scattergram tracks the NCREIF Property Index⁽¹⁾ return against year-over-year changes in the Consumer Price Index from 1979 to 2010, showing a positive correlation, particularly at higher rates of CPI.

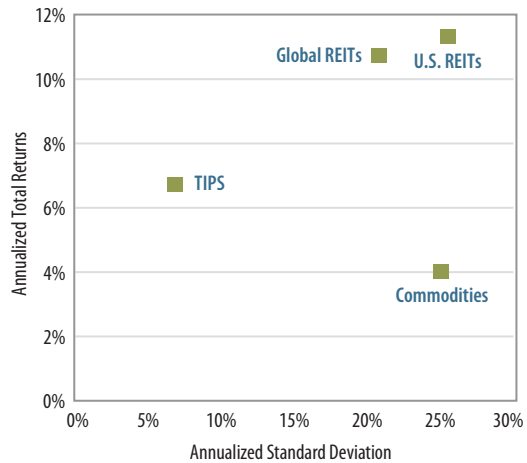
3. REITs declined sharply during the financial crisis, but commodities rose. Doesn't that make commodities a better short-term hedge than real estate?

Because it took such a beating during the financial crisis, real estate may be the cheapest real asset available. It is also an interesting way to invest in fully valued commodities at below-market prices.

The reason I say this is that, in its simplest form, anywhere from 60% to 80% of commercial real estate's replacement cost value is the sum of the commodities and energy needed to build it (the balance is primarily land). It's true that commodity prices increased dramatically over

(1) See index definitions at the end of this publication.

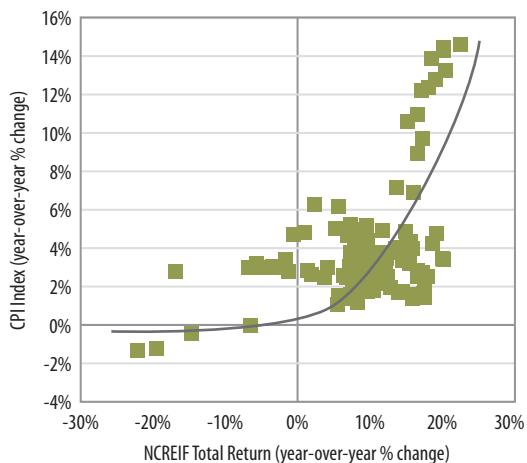
EXHIBIT 2. 10-YEAR RISK/RETURN OF INFLATION-HEDGING TOOLS 2001–2011



As of March 31, 2011. Barclays U.S. Government Inflation-Linked Bond Index (TIPS), MSCI U.S. REIT Index (U.S. REITs), FTSE EPRA/NAREIT Developed Real Estate Index (Global REITs), S&P GSCI Total Return Index (Commodities). See last page for index definitions.

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EXHIBIT 3. COMMERCIAL REAL ESTATE TOTAL RETURNS VS. INFLATION 1979–2010



Source: ISI Group, NCREIF, U.S. Dept. of Labor (Consumer Price Index): quarterly data 1/1/79–12/31/2010. See last page for index definitions.

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the past two years, and that commercial real estate values fell—and that’s where the investment opportunity lies.

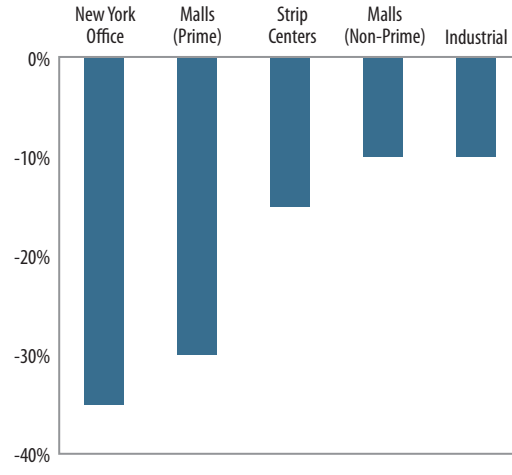
Commercial real estate properties are currently trading at significant discounts to their replacement cost, as Exhibit 4 illustrates. In essence, buying commercial real estate at today’s prices is an indirect means of buying the constituent commodities at a deep discount.

What makes this investment story even more appealing is the favorable tilt to the commercial real estate supply/demand curve. While the residential market has seen a dramatic increase in supply, creating excess capacity that would soak up any price inflation, commercial real estate has not. In fact, many commercial sectors have not seen a major supply cycle in a generation, which sets the stage for rental growth and price appreciation when demand increases. (See Exhibit 5)

As replacement costs have been high and demand weak, there is very little new construction in the supply pipeline. But once demand improves and vacancies diminish, rents will increase and close the gap between valuations and replacement costs.

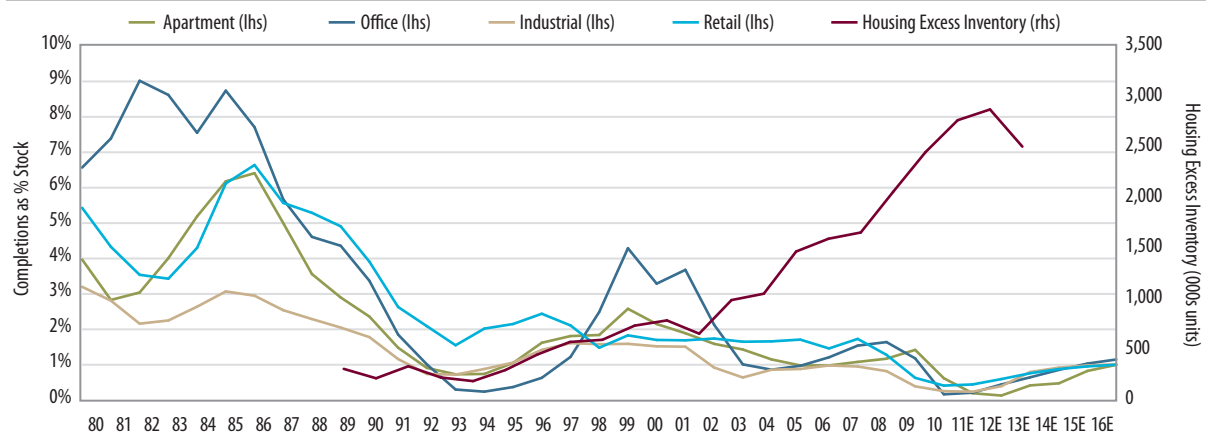
Land, like gold, is a finite resource that appreciates in times of inflation, when more dollars chase limited assets. So while land values and construction costs are now at cyclical lows, that will inevitably change as the economy recovers. Employment costs will rise, higher commodity prices will filter through to material prices and land values will increase as development returns improve.

EXHIBIT 4. REIT MARKET IMPLIED DISCOUNT TO REAL ESTATE REPLACEMENT COST



As of April 30, 2011.
Source: Cohen & Steers estimates.

EXHIBIT 5. COMMERCIAL vs. RESIDENTIAL SUPPLY



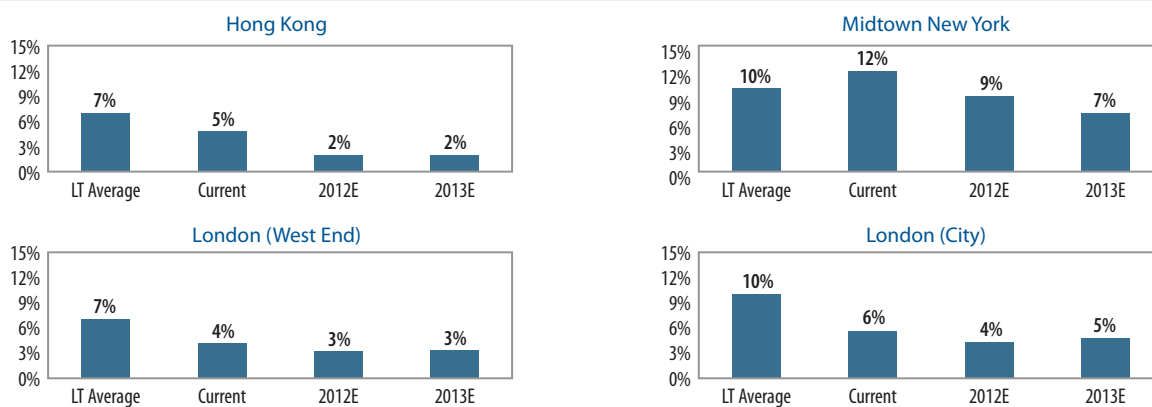
As of April 30, 2011.
Source: Reis, U.S. Census.
There is no guarantee that a market forecast will be realized. There is no guarantee that any historical trend will be repeated in the future, and no way to predict precisely when such a trend will begin.

4. How quickly do REITs respond to inflation?

That depends on the amount of excess capacity (existing vacancies and new supply) going into the period of inflation. If the supply of commercial real estate is low, as it is now in many global markets, excess vacancy is absorbed quickly once demand picks up. Because building new supply can take years, landlords in a tight market have the power to increase rents significantly.

Capacity varies by market, of course. We can see in Exhibit 6 that Hong Kong office vacancies are already well below the long-term average, and by our estimates, are poised to decline rapidly over the next few years, reflecting strong demand both from China and Western businesses. London office vacancies in both the West End and the City are also well below their long-term averages. As new supply is at a 30-year low, vacancies will almost certainly drop when the economy strengthens. Midtown offices in New York are likely to see vacancies return to their long-term average by 2012. Our projections for these three cities make a good case for global diversification within REITs when hedging against inflation.

EXHIBIT 6: OFFICE VACANCIES IN HONG KONG, NEW YORK AND LONDON



As of March 31, 2011.

Source: Cohen & Steers, Green Street Advisors, Jones Lang LaSalle, PMA and REIS.

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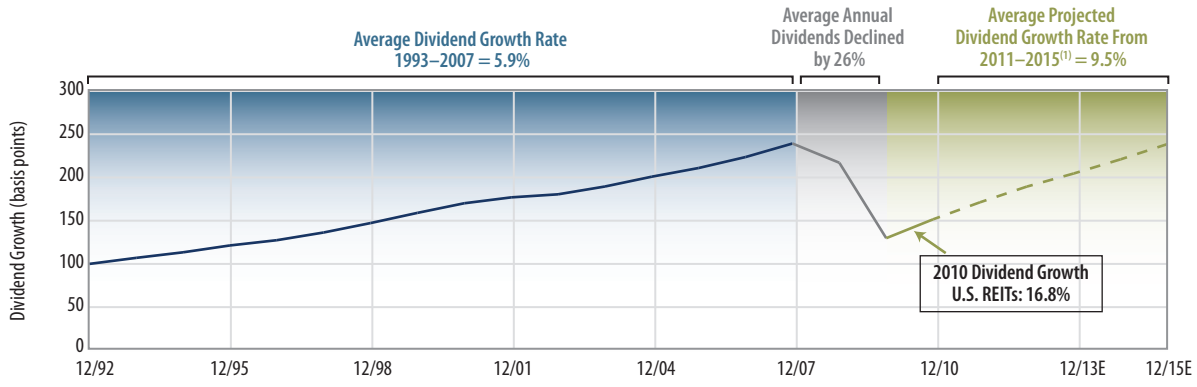
5. When are REITs most efficient as an inflation hedge, and what role do dividends play?

REITs are particularly effective when their dividends grow faster than the rate of inflation, which has been the case in 18 of the past 24 years. Over this period, from 1987 through June 2011, the compound average growth rate of REIT dividends has been 5.7%, compared with 3.1% for CPI inflation. This above-trend growth has made REITs a good place to invest during periods of rising inflation.⁽¹⁾

The near-term outlook for dividend growth is particularly encouraging. During the financial crisis, U.S. REITs cut their dividends to a record-low payout level of just over 50%. Dividend growth resumed in 2010, increasing by 16.8% over 2009 levels. We expect this growth to continue at a rate of about 9% in 2011 and 9-10% annually through 2015. These estimates are well above our forecast for inflation.

(1) REIT dividend levels and inflation are as of June 30, 2011 and are based on yearly data provided by NAREIT (REIT Dividend Growth) and U.S. Department of Labor (Consumer Price Index). FTSE NAREIT has reported dividend data since 1987.

EXHIBIT 7. CASH DIVIDEND GROWTH OF U.S. REITs IS ACCELERATING



As of June 30, 2011.

Source: FTSE NAREIT actual results through 2007; Cohen & Steers calculated results 2008-2010; Cohen & Steers estimates for 2011-2015.

Past performance is no guarantee of future results. The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. There is no assurance that any historical trend illustrated above will be repeated in the future or any way to know in advance when such a trend might begin. There is no guarantee that any market forecast set forth in this commentary will be realized.

(1) The five-year dividend growth projection was compiled by Cohen & Steers, based on a statistical model using historical dividend payout ratios and cash earnings growth as inputs. The projection of equity REITs was then derived by averaging the model's projected dividend growth rates from 2011-2015.

Actual annual dividend growth through 2007 was compiled using the methodology of and data provided by NAREIT. Annual growth rates represent a market cap-weighted average on the year-over-year percent change in cash-only income distributions for the constituent companies in the FTSE NAREIT All REIT Index. Accordingly, any stock dividends paid by index constituents are not included. This methodology overstates the importance of large percentage changes in dividends by the largest index constituents. Therefore, Cohen & Steers estimates of dividend growth rates from 2008 through 2010 were calculated based on actual dividend yields and price values for the FTSE NAREIT Equity REIT Index.

6. So, in conclusion, let's review how REITs can help an investment portfolio keep pace with inflation.

The primary asset of REITs is commercial real estate, which, under the right circumstances, can act as a very effective inflation hedge. We believe that those circumstances are in effect today. At this time, real estate assets are very attractive from a valuation perspective. Following the steep declines of the financial crisis, many real estate assets are still selling at prices below their replacement value, which continues to rise with the price of commodities. In the context of limited new supply in many commercial sectors, the stage is likely set for multi-year rental growth and appreciation as demand increases.

As noted earlier, we believe that REITs are especially attractive when their dividends are growing faster than the rate of inflation. In our view, dividends will grow at a near double-digit pace over the next five years or so, well above our forecast for inflation.

Index Definitions

You cannot invest directly in an index, and index performance does not reflect the deduction of any fees or expenses.

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities (“TIPS”) market. The index includes TIPS with one or more years remaining maturity with total outstanding issue size of \$500MM or more.

FTSE EPRA/NAREIT Developed Real Estate Index is an unmanaged market-weighted total return index which consists of many companies from developed markets whose floats are larger than \$100 million and who derive more than half of their revenue from property-related activities.

FTSE NAREIT Equity REIT Index is an unmanaged market-capitalization-weighted index of all tax-qualified equity REITs listed on the NYSE, AMEX and Nasdaq that have 75% or more of their gross invested book assets invested directly or indirectly in the equity ownership of real estate.

MSCI U.S. REIT Index is a free float-adjusted market capitalization weighted index that is comprised of equity REITs that are included in the MSCI U.S. Investable Market 2500 Index, with the exception of specialty equity REITs that do not generate a majority of their revenue and income from real estate rental and leasing operations. The index represents approximately 85% of the U.S. REIT universe.

NCREIF Property Index is a measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only.

S&P GSCI Total Return Index measures the returns accrued from investing in fully-collateralized nearby commodity futures.

The views and opinions in the preceding commentary are as of the date of publication and are subject to change. There is no guarantee that a market forecast made in this commentary will be realized. This material represents an assessment of the market environment at a specific point in time, should not be relied upon as investment or tax advice and is not intended to predict or depict performance of any investment. Investors should consult their own advisors with respect to their individual circumstances.

The Risks of Investing In Global Real Estate Securities

Investing in any equity market presents risks. The risks of investing in global real estate securities typically include: (i) oversupply of real estate due to new construction, (ii) decline in demand due to economic recession and (iii) reduction in capital availability, which could cause prices to decline. Foreign securities also involve special risks, including currency fluctuations, lower liquidity, political and economic uncertainties, and differences in accounting and disclosure standards. Some international securities may comprise small- and medium-sized companies, which can be more susceptible to price volatility and illiquidity than larger companies.

Past performance is no guarantee of future results. There is no guarantee that any historical trend presented in this commentary will be repeated in the future, and no way to predict precisely when such a trend will begin. Index performance is not representative of the performance of any Cohen & Steers account and no such account will seek to replicate an index. You cannot invest directly in an index.

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