REIT Preferred Stocks

An Income Solution Often Overlooked

Forward Thinking

Summer 2011

EXECUTIVE SUMMARY

With fixed-income markets displaying high volatility and five-year Treasury rates barely nudging 1%, many investors are feeling frustrated in their search for stable, reliable sources of income.[1] The preferred stocks of Real Estate Investment Trusts (REITS) may not leap to their minds as a solution, given the housing market's continuing troubles. But as companies that develop, own, and operate commercial properties, REITs operate within a real estate sector very different from residential markets. Moreover, REIT preferred stocks offer a number of advantages to income-seeking investors:

Stable cash flow. REITs derive their cash flow from the rental income on properties such as office buildings, retail centers, medical facilities and industrial warehouses. REIT preferred dividends are generally well covered by cash flows of underlying issuers. By law, REITs must distribute at least 90 percent of their taxable income to shareholders in the form of annual dividends.

Priority claim on cash flow. Preferreds are senior to common stocks in the REIT capital structure. That means they have a priority claim on the company's cash flow [Figure 1]. Preferreds represent about 10% of the typical REIT's outstanding debt and equity shares [Figure 2].

Compelling current dividends. As of June 30, 2011, U.S. REIT preferreds were yielding 7.38%--nearly four times the yield of the S&P 500 and more than double that available from U.S. government bonds, global real estate, and U.S. REIT common stocks [Figure 7].

Portfolio diversification. REIT preferreds historically have had a low correlation to interest-rate movements and to other asset classes including corporate bonds and U.S. equities [Figure 8].

Upside potential. The spead between REIT preferred securities and the 10-year Treasury remains relatively wide [Figure 8], pointing to the potential for outsized returns if spreads revert to historical averages.

These characteristics make REIT preferred stocks an attractive option for investors who are primarily seeking income. While REIT preferreds historically have tended to offer lower appreciation and total return than REIT common stocks, they typically pay higher current dividends. Investors who wish to harness the income-generating potential of REIT preferreds today have access to many opportunities and to expert, specialized investment management in mutual fund form.

What are REIT Preferred Securities?

Real Estate Investment Trusts (REITs) are companies that develop, own and operate commercial properties, such as office buildings, retail centers, medical facilities and industrial warehouses. Supported by the rental income of their underlying properties, REITs typically benefit from relatively stable cash flow and offer compelling current dividends.

Established in the United States in 1960, REITs have gained wide investor acceptance due to the increased transparency, liquidity and income the structure provides. Over the last 15 years, the publicly traded U.S. REIT market has substantially evolved into a group of 160 companies, with an equity market capitalization totaling nearly $455 billion.[2]

Publicly-traded companies, like REITs, may issue several types of securities—common shares, preferred shares, corporate bonds, convertible securities and secured mortgages—each with a different claim on the company's cash flow and assets, providing varying opportunities for investor participation.

Preferred stocks are senior to common shares within the capital structure and offer a priority claim on the company's cash flow.

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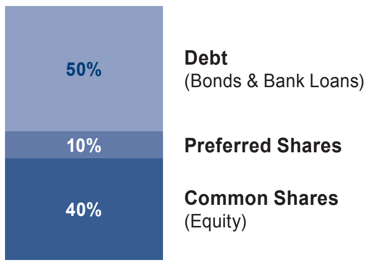
Figure 1
Capital Structure Hierarchy
Source: Forward Management, LLC

Seniority	Credit Class
Higher	Senior Secured Bank Loans
	Secured Debt
	Senior Unsecured Debt
	General Trade Creditors / Subordinated Debt
	Hybrid Preferred Securities / Junior Subordinated Debt
	Traditional Perpetual Preferred Securities
Lower	Common Stock

As of August 31, 2011

REITs can benefit from issuing preferred securities as they are perpetual in nature and offer a more flexible financing option than bonds. The lack of a mandatory call date on the security can effectively provide permanent financing or, if the company chooses, be redeemed at a pre-established value (usually after a five year period). The typical REIT capital structure is comprised of approximately 10% preferred equity.

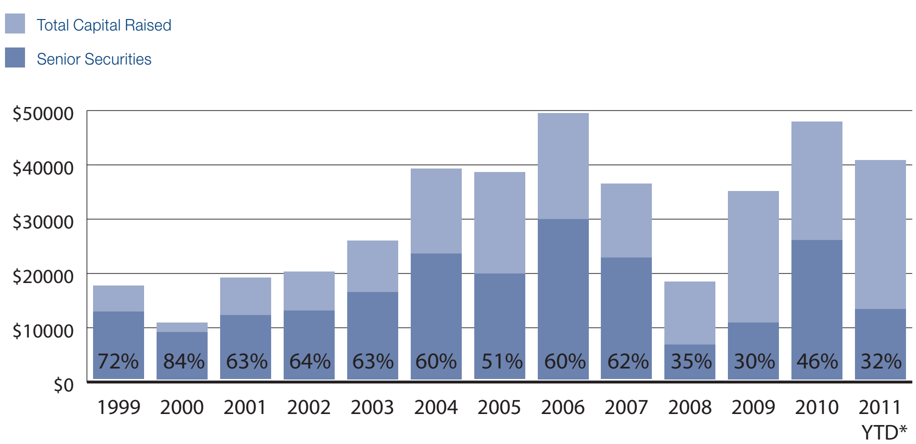
Figure 2
Typical REIT Capital Structure
Source: Forward Management, LLC



As of August 31, 2011

The REIT industry's initial growth was supported by the issuance of common equity. There was a limited supply of senior securities (preferred equity and unsecured debt) outstanding prior to 1997. Today, senior securities have become a more significant portion of REIT capital structures, representing over 60% of the capital raised over the past nine years.[3]

Figure 3
Historical Senior Securities Offerings in Millions
Source: NAREIT. *YTD as of 7/31/11.



REIT Preferred Market Characteristics

With approximately 164 issues totaling $22.0 billion in market capitalization, REIT preferred securities currently comprise 7% of the total preferred stock market and are well diversified across property types.[4]

REIT preferreds represent about 7% of the overall preferred market.

Figure 4
Overall Prefered Market - Industry Diversification
Source: Merrill Lynch, 7/12/11. Data as of 6/30/11.

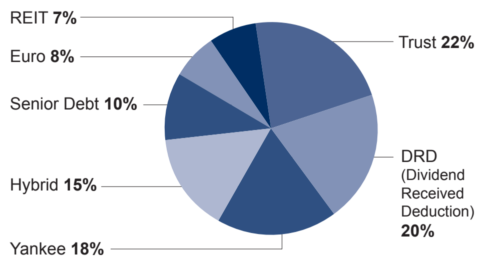
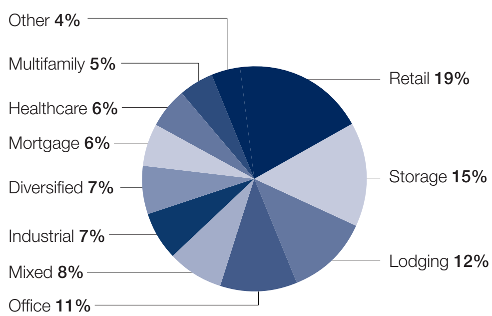
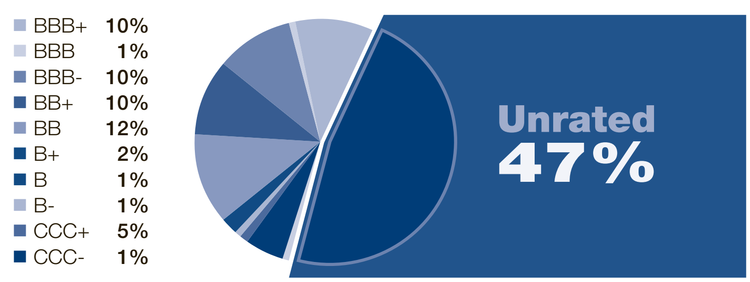


Figure 5
REIT Preferred Market - Property Type Diversification
Source: BMO Capital Markets REIT Preferred Universe, 7/26/11.



While preferred securities are eligible to receive credit ratings, in the case of REIT preferreds, 47% is currently unrated—a reflection of the relatively small size of these issues.[5] The typical issue size of all preferred securities is $556 million, while REIT preferred issues are often smaller in size, averaging approximately $134 million per issue.[6]

Figure 6
REIT Preferred Credit Ratings[7]
Source: BMO Capital Market, 7/26/11.



Portfolio Benefits

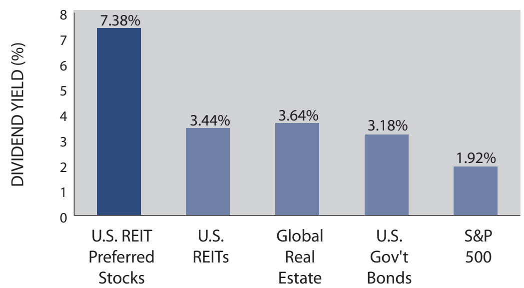
REIT preferred stocks have historically offered favorable portfolio characteristics including low correlations to other asset classes and competitive dividend yields. Notably, REIT preferred securities have a historically low correlation to interest rate movements, offering potential portfolio diversification benefits to income-oriented investors.

REIT preferreds stocks have historically offered competitive dividend yields and low correlations.

Figure 7

Dividend Yield Comparison

Source: Wells Fargo Securities, LLC, Bloomberg and NAREIT. Data represents current yields as of 6/30/11. U.S. REIT Preferred Stocks – Wells Fargo Hybrid and Preferred Securities REIT Index; U.S. REITs – FTSE NAREIT Composite Index; Global Real Estate – FTSE EPRA/NAREIT Global Real Estate Index; U.S. Government Bonds – 10-Year U.S. Treasury Note.

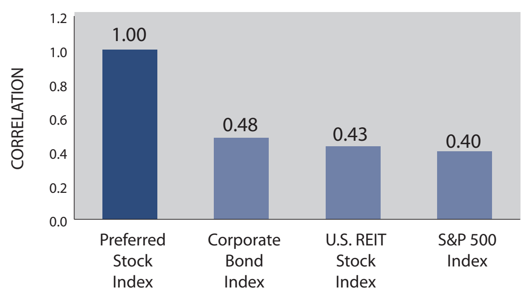


Past performance does not guarantee future results.

Figure 8

Low Correlation to Other Asset Classes

Source: Zephyr Associates, Inc. 10-year time period for all data series used in correlation calculation ended 6/30/11. Preferred Stocks Index – BofA Merrill Lynch Preferred Index; Corporate Bond Index – Citigroup Broad Investment Grade Bond Index; U.S. REIT Stock Index – FTSE NAREIT Composite Index.



Dividends make up a significant portion of the total return typically offered by preferred securities. Currently, REIT preferred dividends are largely well covered by the cash flows of the underlying issuers. On average, REIT preferred stock issuers generate over $2.00 in operating cash flow (often called "EBITDA") for every $1.00 of fixed charges (defined as preferred dividends plus interest on debt), indicating that preferred stock dividend payments appear sustainable.[8]

Excess spread suggests a pricing disparity that could offer the potential for outsized returns if spreads revert back toward historical averages.

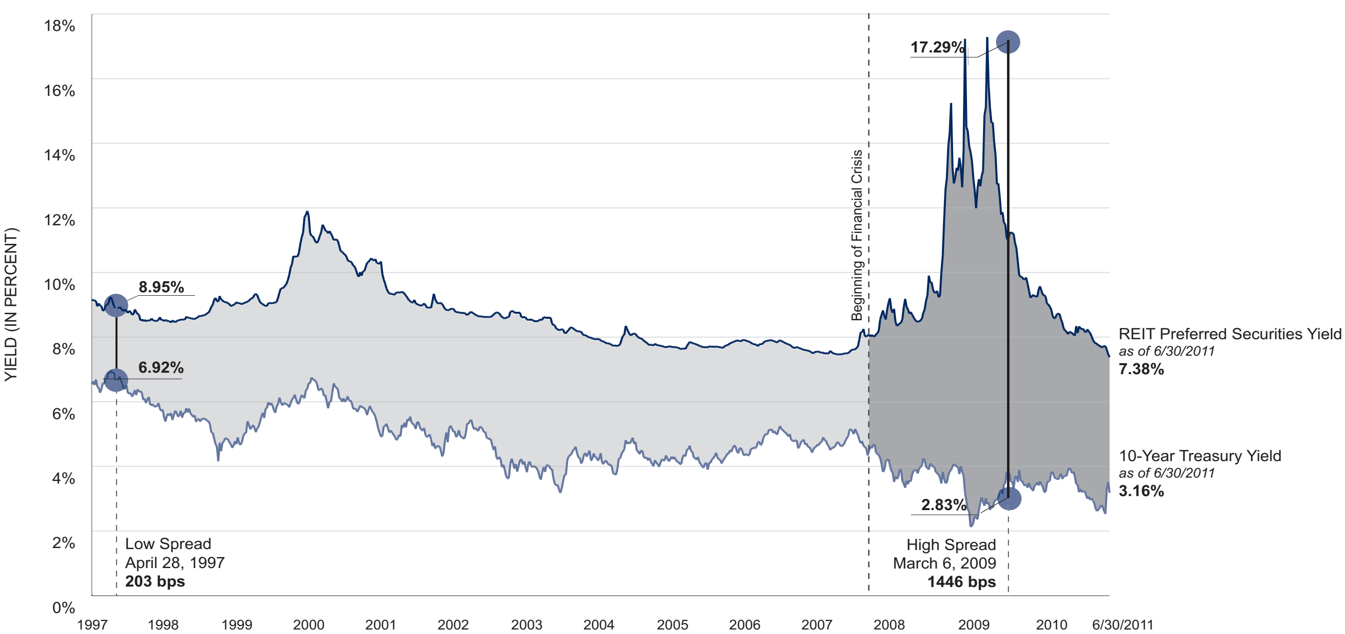
Despite the robust price appreciation of REIT preferred securities in late 2009 and early 2010, the yield spread between REIT preferred securities and the 10-Year Treasury remains relatively wide from a historical standpoint. As shown in the chart below, the yield spread was at its narrowest in late April 1997 at 203 basis points and in early March 2009 the spread widened to 1,450 basis points over the 10-Year Treasury, a historic high.

Spreads today stand at 422 basis points (4.22%) over the 10-Year Treasury. Despite recent price appreciation in the securities and compression in spreads, the current spread compares favorably with the long-term averages of 366 bps (pre-crisis) and 431 bps (including the financial crisis). With REIT preferred securities currently offering yields near 8% and with spreads well above the historical average, there is the potential to generate attractive current income and realize significant capital appreciation if spreads revert back toward their historical averages.

Figure 9

Real Estate Preferred Securities and the 10-year Treasury Yields[9]

Source: Wells Fargo Securities, Bloomberg and Forward Management, LLC. The REIT Preferred Securities Yield is measured for all periods after October 28, 2002 by the Wells Fargo® Hybrid and Preferred Securities REIT Index, primarily based on weekly data. Please see footnote on the following page for more important information.



Past performance does not guarantee future results.

Conclusion

We believe that REIT preferred securities provide a compelling income-oriented investment alternative, offering:

- Exposure to high quality real estate companies through senior securities
- Attractive dividends versus other fixed income alternatives that are generally well covered by cash flow
- Portfolio benefits including low correlation to other asset classes

FOOTNOTES

[1] As of August 31, 2011

[2] FTSE NAREIT All REIT Index, June 30, 2011.

[3] NAREIT, July 31, 2011.

[4] BMO Capital Markets, July 26, 2011; Merrill Lynch, July 12, 2011.

[5] Merrill Lynch, July 12, 2011; BMO Capital Markets, July 26, 2011.

[6] Weighted average market cap. Source: Merrill Lynch Preferred Index, March 31, 2010; BMO Capital Markets, July 26, 2011.

[7] Credit ratings are credit quality evaluations of bonds and notes made by independent rating services. A higher bond rating generally lowers the interest rate that borrowers must pay, and therefore overall capital costs. The rating agency used here is S&P.

[8] Weighted average fixed charge coverage ratio for the BMO Capital Markets coverage universe, 7/26/11.

[9] REIT Preferred Yield: Wachovia Capital Markets, 6/30/11. Performance measured by the Wachovia REIT Preferred Stock Index. Spreads: Wachovia Capital Markets, Bloomberg and Forward Management, LLC. Based primarily on weekly data, 6/30/11.

CHART SOURCE

Real Estate Preferred Securities and the 10-year Treasury Yields (Figure 9) chart source: Wells Fargo Securities, LLC, Bloomberg and Forward Management, LLC. "Spread" is the difference in yield between two different investments. In this example, we use "spread" to refer to the difference between the yield offered by REIT preferred issues and the 10-year Treasury rate. The price of yield-oriented investments is based on both credit quality and spread (the current price moves inversely to the yield). A wide spread-to-Treasury typically indicates more attractive relative pricing.

The pre-crisis average spread is 366 bps measured from the beginning of our time series through June 30, 2007. Experts will differ on exactly when the financial crisis of 2007-2010 began. Readers will recall that problems in sub-prime mortgages and structured finance investments were gathering momentum through the first half of 2007 and June 2007 saw the beginning of influential ratings downgrades by both Moody's and Standard & Poors. It was also in June 2007 that Bear, Stearns first experienced challenges with influential hedge funds that it managed. We believe in our best judgment that the crisis began in earnest around the close of the second quarter of 2007 and have used June 30, 2007 as a determination date for the purposes of establishing the pre-crisis average spread.

Gross spread data is as of June 30, 2011. In order to achieve the longest possible time series, the gross spread was calculated using two data sources. The data set is generally weekly data with some daily data. The source for data from January 1, 1997 through October 28, 2002 is Forward Management and is based on an examination of all real estate companies (including, but not limited to, REITs) and excluding mortgage companies. Data for all periods thereafter is from the Wells Fargo® Hybrid and Preferred Securities REIT Index, which is an index of preferred stocks issued by REITs (including mortgage companies).

The Wells Fargo® Hybrid and Preferred Securities REIT Index is designed to track the performance of preferred securities issued in the US market by Real Estate Investment Trusts. It is a modified market capitalization-weighted index composed exclusively of $25 par perpetual preferred shares and depositary shares listed and traded on either the New York or American stock exchanges.

The yield for the 10 Year U.S. Treasury Note is an index of constant maturity rates published by the U.S. Department of the Treasury and sourced from Bloomberg. Yields are interpolated by Treasury from the daily yield curve. This curve, which relates the yield on a security to its time to maturity, is based on the closing market bid yields on actively traded Treasury securities in the over-the-counter market. These market yields are calculated from composites of quotations obtained by the Federal Reserve Bank of New York.

GLOSSARY

A **basis point** (bps) equals one onehundredth of one percent. For example, 20 basis points equal 0.20%.

Cash flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.

Correlation is a measure of the interdependence of two random variables that ranges in value from –1 to +1, indicating perfect negative correlation at –1, absence of correlation at zero, and perfect positive correlation at +1.

Dividend yield is the sum of the trailing 12 months of cash distributions, excluding capital gains distributions, divided by the most recent net asset value.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) is an indicator of a company's financial performance.

Liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can by easily bought or sold, are known as liquid assets.

Transparency is the extent to which investors have ready access to any required financial information about a company such as price levels, market depth and audited financial reports.

INDEX DEFINITIONS

The **Citigroup 10-Year Treasury Index** is an unmanaged index composed of ten-year Treasury bonds and notes.

The **Citigroup Broad Investment Grade Bond Index** is a composite of all institutionally traded US Treasury, agency, mortgage, and corporate securities. The issues must be rated at least BBB- or better, have remaining maturities of one year or longer, and have at least $25 million principal outstanding. The index is capitalization weighted.

The **FTSE NAREIT Composite Index** consists of all REITs included in the FTSE NAREIT All REITs Index that also meet the minimum size and liquidity criteria. The FTSE NAREIT Composite Index is free float adjusted.

The **Merrill Lynch Preferred Index** tracks the performance of fixed rate US dollar denominated preferred securities issued in the US domestic market.

Standard and Poor's (S&P) 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **Wachovia REIT Preferred Index** is composed of REIT preferred shares. Wachovia's Index Review Committee, which meets monthly, determines whether a security is included in the index. According to Bloomberg, yields on Treasury securities at constant maturity are interpolated by the US Treasury from the daily yield curve. This curve, which relates the yield on a security to its time to maturity, is based on the closing market bid yields on actively traded Treasury securities in the over-the-counter market. These market yields are calculated from composites of quotations obtained by the Federal Reserve Bank of New York.

You cannot invest directly in an index.

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