REITs in a Rising Interest-Rate Environment

March 26, 2015

It's a challenging time for investors who want to maintain a diversified, income-oriented portfolio.

Higher US interest rates appear to loom on the horizon, although bond yields in most of the developed world are low and some central banks continue to pursue easing measures. Potential inflation is a concern in the United States, given the Federal Reserve's six-year history of manufacturing money through quantitative easing (QE) (which lasted from 2008 through 2014).

Wilson Magee, director of global real estate and infrastructure securities, Franklin Real Asset Advisors®, believes this environment is causing many investors to search for alternative investments that can add an income-oriented asset to their portfolio as well as gain exposure to global economic growth potential. He outlines why he thinks it's an opportune time for many investors to consider diversifying into global real estate through an actively managed investment vehicle.

Diversifying into REITs in a Rising US Interest-Rate Environment

Given expectations for a rising interest-rate environment in the United States in 2015, and what is likely to be another volatile year for global equities, we think many investors should consider holding a broad and diversified portfolio. While it's true that rising US Treasury rates can make yield-sensitive investments like real estate investment trusts (REITs) appear to be less appealing on the surface, we counter with evidence that adding REIT exposure has its merits—even in a rising-rate environment.

What Are REITs?

A REIT is a type of publicly traded company that invests directly in real estate and related assets. Many REITs specialize in a specific type of property, such as shopping centers, warehouses, apartments, hotels, office buildings or self-storage units. Many also concentrate in a specific geographic zone, such as the United States, Japan, the United Kingdom or other nations. In most countries that have REITs, companies that qualify generally are exempt from normal corporate taxes. In markets where REITs or REIT-like structures do not exist, other publicly traded real estate companies are often available for investment.

REITs primarily offer several potential benefits: diversification from traditional stocks and bonds, income opportunity, and exposure to the real estate sector.

Diversification: REITs have historically had reduced correlations with traditional asset classes such as stocks and bonds.[1] While past performance is no guarantee of future results, if historical correlations[2] to bond returns continue, we think REITs can provide an important element of diversification. (Diversification does not guarantee profit or protect against risk of loss.)

Income Opportunity: To preserve their special tax status, generally REITs must distribute income back to shareholders in the form of dividends. US REITs, for example, are required to distribute 90% of taxable income to shareholders.[3] We think these dividend distribution requirements make REITs an opportunity to consider for investors in search of potential income.

Sector Exposure: Publicly traded REITs offer investors a more liquid way to invest in the real estate sector, compared to purchasing real property directly. Direct real estate investing is generally more illiquid, carries higher transaction costs, necessitates a more active role on the part of the individual investor, and often requires a higher minimum investment. Global REITs investing outside of the United States can offer additional diversification potential by allowing investors to gain exposure to worldwide real estate markets. Direct investment in overseas real estate, by contrast, generally carries much higher barriers to entry. Investing directly in property internationally can involve additional legal and tax complications as well.

Many real estate operating companies are also listed and traded on exchanges, just like REITs. However, they typically are subject to local corporate taxation and aren't required to distribute cash flow back to investors.

US Interest Rates Likely to Rise

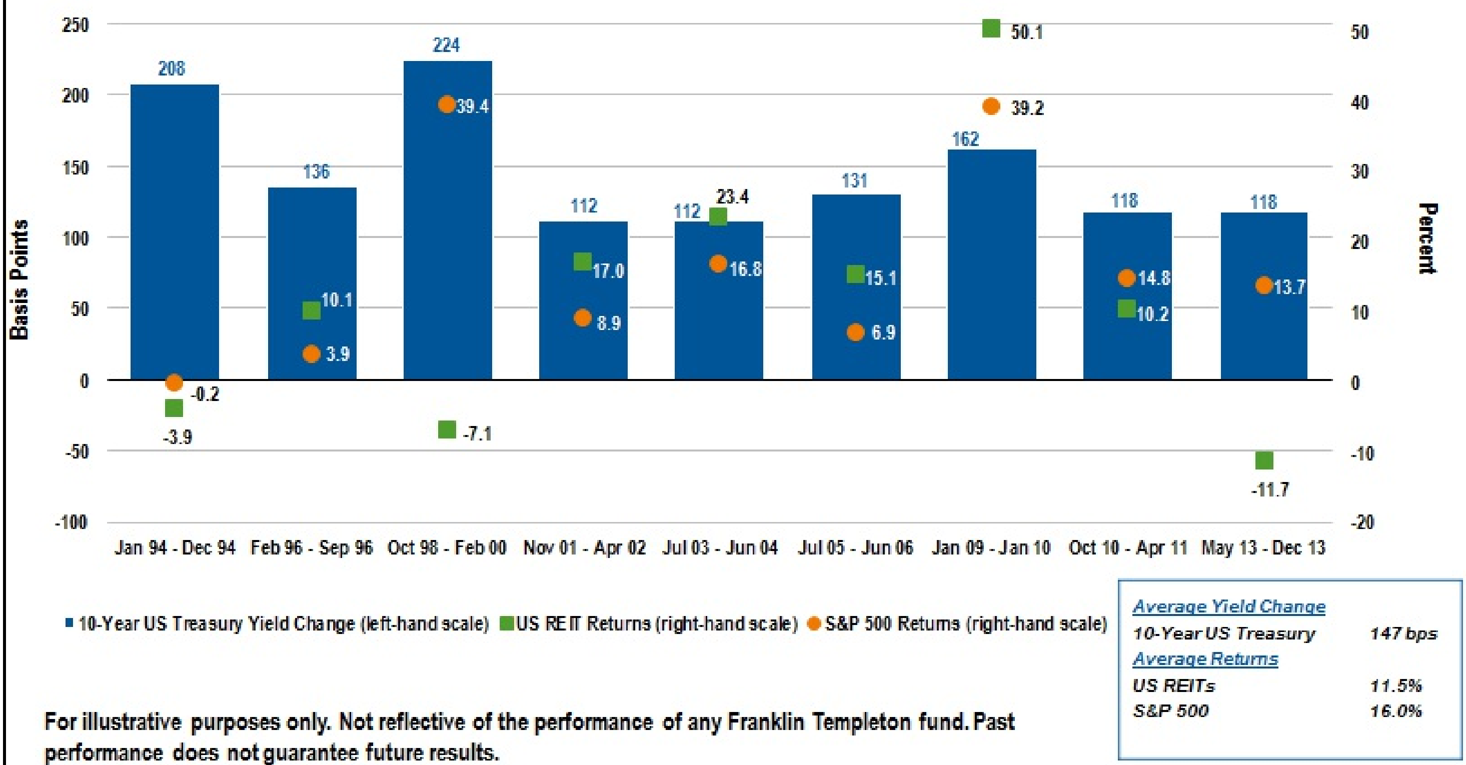
US interest rates remain near historic lows but are likely to rise as the economy begins to feel the impact of the conclusion of the Federal Reserve's six-year quantitative easing program.

Federal Reserve (Fed) Chair Janet Yellen has remarked that the Fed will eventually tighten the monetary supply by raising short-term interest rates rather than selling off bonds. This is a strong indication to most market watchers that higher US interest rates loom in the near future—although the exact timing and pace of Fed tightening are still subject to speculation.

US REITs (as represented by the FTSE NAREIT Equity REITs TR Index) have historically performed well in periods of rising interest rates.[4] Between 1994 and 2013, the United States experienced nine distinct time periods when interest rates rose (as measured by the 10-year US Treasury note yield) by greater than 100 basis points (1%). During six of these nine time periods, REITs provided positive returns, while in three, REITs provided negative returns, as illustrated in the chart below.

US REITs and Stocks

Periods of Increasing Rates: January 1994–December 2013



For illustrative purposes only. Not reflective of the performance of any Franklin Templeton fund. Past performance does not guarantee future results.

Sources: Citi Research, Franklin Templeton Investments. US REITs are represented by FTSE NAREIT Equity REITs TR Index; REIT and S&P 500 returns include dividends. The average yield change is the sum of the changes in yield (the blue bars), divided by the number of periods. Indexes are unmanaged, and one cannot directly invest in an index.

In our view, rising interest rates that reflect a healthy, growing economy (as opposed to sudden or extreme interest-rate hikes) could be positive for both US stocks and REITs. Both could also benefit as employment, consumer spending, and real estate demand rise. Real estate, in fact, can be—and has been—viewed by many investors as a good barometer of overall economic health.

Exposure to REITs, we believe, can help investors potentially capitalize on an improving economy while still maintaining diversification from traditional assets such as stocks and particularly, bonds as a broad asset class.

Global Exposure

In our view, investing in US REITs has merit in a rising-rate environment, but we also believe in the merits of maintaining a diversified portfolio in general, which we view as requiring exposure to the global economy, including worldwide real estate.

We believe global markets are poised for long-term growth, despite some near-term challenges in select markets. Gross domestic product growth in a number of emerging markets has been robust, particularly in parts of Asia, but global stocks were volatile in 2014, due in part to worries about the health of the European economy as well as geopolitical tensions in the Middle East and Ukraine/Russia.

In fact, global REITs have outperformed global stocks (as represented by the MSCI World GR USD Index) in the previous 5-year and 10-year periods.[5]

The Allocation Case

Asset Class Returns as of December 2014

3 Year	5 Year	10 Year
US Stocks 20.4%	US REITs 16.9%	Global Listed Infra 8.7%
US REITs 16.4%	US Stocks 15.5%	US REITs 8.3%
Global Stocks 16.1%	Global REITs 14.4%	US Stocks 7.7%
Global REITs 16.0%	Global Stocks 10.8%	Global REITs 7.0%
Global Listed Infra 13.3%	Global Listed Infra 8.9%	Global Stocks 6.6%
Non-US Stocks 11.6%	Non-US Stocks 5.8%	Non-US Stocks 4.9%
US Bonds 2.7%	US Bonds 4.5%	US Bonds 4.7%
Global Bonds 0.7%	Global Bonds 2.7%	Global Bonds 3.6%
Cash 0.1%	Cash 0.1%	Cash 1.6%

For illustrative purposes only. Not representative of the performance of any Franklin Templeton fund. Past performance does not guarantee future results.

Source: FactSet, as of December 31, 2014; MSCI; Barclays Global Family of Indexes. Global Listed Infrastructure is represented by S&P Global Infrastructure TR USD Index; Global REITs are represented by S&P Global REIT Index; US REITs are represented by FTSE NAREIT Equity REITs TR Index; Global Stocks are represented by MSCI World GR USD Index; US Stocks are represented by S&P 500 TR Index; Non-US Stocks are represented by MSCI EAFE GR Index; Global Bonds are represented by Barclays Global Aggregate Bond Index; US Bonds are represented by Barclays US Aggregate Index; Cash is represent by Barclays US Treasury Bills. Please see www.franklintempletondatasources.com for additional data provider information.

Indexes are unmanaged, and one cannot directly invest in an index.

Fortunately, as REITs have exploded in popularity since the 1990s, many other nations have enacted legislation to establish REIT structures. The United Kingdom, Singapore, Australia, Canada, France, Finland, Hong Kong, Japan, the Netherlands, New Zealand and South Africa, among others, allow investors from around the world to gain exposure to their growing property markets through REITs.

Potential Alternative Income Opportunity

Many investors look to their bond allocation to provide their portfolios with a strong potential income component, as well as diversification from stocks. But bond yields remained low in the past year in the developed world, and many people expect them to stay that way for some time. Even if the Fed starts raising interest rates this year, we believe it will most likely do so gradually.

REITs can provide income opportunities as well as the potential for long-term capital appreciation. REITs are generally considered yield-oriented investments, and a component of their returns comes from dividends rather than price gains.

Like all yield-oriented investments, REITs will likely exhibit some sensitivity to interest-rate changes, and are not without risks. But unlike bonds, REITs can earn potential profits by making positive investment spreads both acquiring and developing additional properties. REITs also can increase cash flow when property revenues grow faster than expenses, and this cash flow growth often leads to dividend growth.

According to data from NAREIT, US REIT dividend growth averaged over 7% per year from 1994–2012.[6] This potential for dividend growth also means that REITs are fundamentally different from fixed income investments. In general, fixed income investments have fixed coupons with regular payments; the purchaser of a bond receives regular monthly, quarterly or annual coupon payments that do not change. REITs have been able to grow their dividend over time.

So, it is important for investors to keep in mind that changes in interest rates can impact real estate investments in a wide variety of ways, some negative and some positive. Changes in interest rates are only one piece of this puzzle. However, in general, we have found that higher interest rates can be a net positive for the REIT sector.[7] We believe investors who are seeking exposure to a growing global economy, and diversification from traditional asset classes like stocks and bonds, in their portfolio may want to consider REITs.

The comments, opinions and analyses are the personal views expressed by the investment manager and are intended to be for informational purposes and general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not *constitute legal or tax advice. The information provided in this material is rendered as at publication date and may change without notice, and it is not intended as a complete analysis of every material fact regarding any country, region, market or investment.*

This information is intended for US residents only.

To get insights from Franklin Templeton delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_US and on LinkedIn.

What Are the Risks?

All investments involve risks, including possible loss of principal.

Franklin Global Real Estate Fund

The fund concentrates in real estate securities that involve special risks such as declines in the value of real estate and increased susceptibility to adverse economic or regulatory developments affecting the sector. The fund's investments in REITs involve additional risks; since REITs typically are invested in a limited number of projects or in a particular market segment, they are more susceptible to adverse developments affecting a single project or market segment than more broadly diversified investments. Foreign investing, especially in emerging markets, involves additional risks such as currency and market volatility, as well as political and social instability.

These and other risks are described more fully in the fund's prospectus.

Franklin Real Estate Securities Fund

The fund concentrates in real estate securities that involve special risks such as declines in the value of real estate and increased susceptibility to adverse economic or regulatory developments affecting the sector. The fund's investments in REITs involve additional risks; since REITs typically are invested in a limited number of projects or in a particular market segment, they are more susceptible to adverse developments affecting a single project or market segment than more broadly diversified investments. The fund is a "non-diversified" fund, and investing in a non-diversified fund involves the risk of greater price fluctuation than a more diversified portfolio. These and other risks are described more fully in the fund's prospectus.

Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN®/342-5236, or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.

---

1. Source: FactSet, based on data from 2005–2014. Global REITs are represented by the S&P Global REIT Index; US REITs are represented by the FTSE NAREIT Equity REITs TR Index; Global Stocks are represented by the MSCI World GR Index; US Stocks are represented by the S&P 500 TR Index; Non-US Stocks are represented by the MSCI EAFE GR Index; Global Bonds are represented by the Barclays Global Aggregate Bond Index; US Bonds are represented by the Barclays US Aggregate Index; Cash is represented by Barclays US Treasury Bills.

2. Correlation is a statistical measure of how two securities move in relation to each other. Negative correlation indicates a relationship in which one increases as the other decreases.

3. Franklin Global Real Estate Fund and Franklin Real Estate Securities Fund dividend frequency is quarterly in March, June, September and December. All fund distributions will vary depending upon current market conditions, and past distributions are not indicative of future trends.

4. Sources: Citi Research, Franklin Templeton Investments. Indexes are unmanaged, and one cannot directly invest in an index. Past performance does not guarantee future results.

5. Source: FactSet, as of December 31, 2014. Annualized basis. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged, and one cannot directly invest in an index. Past performance does not

guarantee future results.

6. Source: The National Association of Real Estate Investment Trusts®.

7. Past performance is no guarantee of future results.

Posted in Equity, Perspectives Tagged actively managed mutul funds, Franklin Global Real Estate Fund, Franklin Real Asset Advisors, Franklin Real Estate Securities Fund, investing in global real estate funds, investing in reits, mutual funds and REITs, rising US interest rates and REIT performance, wilson magee

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

Franklin Templeton Distributors, Inc.