

PRINCIPAL SMA REAL ESTATE EQUITY SECURITIES

Quarterly commentary

FIRST QUARTER 2025

Market review

United States real estate stocks returned +2.75% (FTSE NAREIT All Equity REITs) during the quarter and outperformed broader equity markets which fell 4.3% (S&P 500) on policy uncertainty and lost momentum from the U.S. exceptionalism narrative.

Equity markets were pressured as the quarter progressed by fears of potential impacts from policy decisions of the Trump administration and related stagflationary concerns. Tariffs headlines were pervasive, yet details remained light and ever changing. Investors await more clarity on April 2 when reciprocal tariffs plans are scheduled to be announced, however, uncertainty is likely to linger regarding the severity and duration as negotiations continue. In response, many economists increased their inflation outlook and reduced forecasted economic growth in the year ahead. Revisions were supported by softer economic data such as declining consumer and business confidence levels; hard economic data (e.g. labor, inflation, retail sales) has not yet displayed much weakness.

The Federal Reserve (Fed) kept rates unchanged. The Fed updated Summary of Economic Projections shifted lower, with commentary from Chair Jerome Powell noting greater uncertainty and higher inflation expectations from tariffs. 10-year bond yields moved down by 36 basis points.

Real estate outperformance was driven by defensive rotation and lower bond yields. Within the group, leadership favored more secularly driven and resilient segments. Health care owners posted the strongest returns with seniors housing exposed names performing best on a robust supply-demand outlook. Net lease owners also rallied given the downward shift in yields and more bond-like income stream that were in greater demand. Conversely, office and hotel owners suffered from greater economic sensitivity given rising concerns over growth prospects. Data centers also trailed on several events that raised debate on the magnitude and duration of artificial intelligence driven demand that has fueled strong leasing activity for the property type in recent quarters.

Portfolio Performance

The portfolio outperformed the index on a gross basis due to positive allocation. Amidst the risk off environment, the tilt toward defensive structural growth sectors such as health care and towers paid off whilst the underweight to data center exposed themes and cyclical retail also contributed. The overweight to single family was also additive. Detraction came from selection in apartments and the underweight to net lease.

Outlook

The macroeconomic and political landscape is shifting towards a more uncertain and potentially bearish outlook to start 2025. Rising geopolitical tensions, trade war fears, and concerns about slowing economic growth are increasing volatility across financial markets. Recently, the Trump administration's sweeping tariff announcement is likely to depress growth whilst stoking inflation. Bond markets have voted with their feet with long bond yields tumbling and yield curves flattening, suggesting the market is more concerned over the negative growth implications of tariffs than the one-off impact on inflation. Clearly, the risks of a marked economic slowdown, if not recession, have risen.

Whilst the Fed is for now still more concerned about sticky inflation, it also has to juggle its dual mandate of maintaining employment. Given the view that tariffs

have a transitory impact on inflation, the Fed is likely to respond to weakness in the labor market with rate cuts, vindicated by longer term market driven measures of inflation expectations which remain anchored. This biases real interest rates downwards and should continue to be supportive for defensive asset classes like REITs, which have outperformed year-to-date. We continue to believe that the defensive REIT sector offers an attractive investment opportunity with valuations looking very cheap when measured against public equities. REITs are also relatively insulated from any direct impact on tariffs and any potential de-risking away from America. With steady fundamentals and durable cash flows, they provide a compelling way to diversify risk in portfolios today, but a prolonged stagflationary environment poses a risk.

Our portfolio strategy will continue to emphasize bottom-up stock selection and company fundamentals to drive excess returns. With a preference for quality and overweights to key positions that offer resilient long-term growth in earnings we expect the portfolio to be positioned well for economic weakness and lower yields ahead. If markets pivot back to a risk-on, then we could expect some headwinds to relative performance.

Top 3 contributors

Relative performance versus the benchmark

Ventas, Inc. - An overweight to this U.S. health care REIT contributed to performance following a better-than-expected earnings update that showcased strong operating portfolio performance and continued momentum in external investment activity.

Iron Mountain Incorporated - An underweight in this U.S. storage and information management REIT contributed to performance. Stock performance was hurt with earnings falling short of high expectations, concerns over hyperscale data center demand following the release of open-source AI models, and reports of a major technology company pulling back on data center leases and slowing leasing activity.

American Tower Corporation - An overweight in this U.S. tower REIT boosted performance with in-line results and guidance exceeding lowered expectations. Management's optimism about domestic carrier leasing and reduced churn positions the company for accelerated revenue growth in 2026 and beyond, further supported by a drop in long-term interest rates.

Top 3 detractors

Relative performance versus the benchmark

Crown Castle Inc. - An underweight to this U.S. tower REIT detracted from performance as the stock saw re-rating post an announced sale of the company's fiber business favorable valuations. Further, industry commentary was more bullish on domestic carrier leasing activity while the dip in longer-term interest rates is also supportive of upside to the tower segment.

Equinix, Inc. - An overweight to this U.S. data center REIT detracted from our performance as the data center group remained pressured by the release of open-source AI news and reports that a major technology company is scaling back its leasing activity.

Realty Income Corporation - An underweight to this U.S. net lease REIT detracted from performance. As a bellwether of a defensive sector, the stock benefited from the concern of overall economy uncertainty.

Risk considerations

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility. Real estate investment options are subject to risks associated with credit, liquidity, interest rate fluctuation, adverse general and local economic conditions, and decreases in real estate values and occupancy rates.

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