PRINCIPAL SMA REAL ESTATE EQUITY SECURITIES

Quarterly commentary

FOURTH QUARTER 2023

Market review

United States property stocks rose strongly to finish the year (MSCI US REIT, +15.8%), outperforming broader equity markets (S&P 500, +11.7%), as the sector was more sensitive to the sizeable decline in interest rates during the quarter. Equity and bond markets rallied on increased confidence that the Federal Reserve (Fed) will soon pivot to rate cuts and optimism that the economy will avoid a recession. Yields rose to start the quarter with 10-year yields touching 5% on deficit and term premium concerns, however, the trend reversed for the remainder on disinflation momentum and Fedspeak. Lower inflation readings enhanced beliefs that the tightening cycle is over, and the Fed's updated projections call for 75 basis points (bps) of easing in 2024. Fed Chairman Jerome Powell did not push back on markets' pricing in even greater cuts and acknowledged risk of policy remaining too high for too long. Meanwhile, employment and retail sales resiliency helped steer muted economic growth forecasts for the year ahead slightly higher.

Real estate stocks outperformed with lower interest rates as the primary driver. 10-year yields declined nearly 70 bps, helping alleviate their overhang on the capital-intensive asset class. While broader private transaction markets remained sluggish, real estate investment trusts (REITs) mergers and acquisitions (M&A) picked up with public-to-public deals announced in the net lease and health care sectors and a large development joint venture struck in the data center space. The friendlier and potentially more predictable rate environment also spurred hope for increased trading activity in the quarters ahead. Post the rally, consensus estimates peg U.S. REITs trading in-line with private market values.

All property types in the region were higher during the quarter with the strongest performance from malls, hotels, self-storage, and office. Leadership reflected greater risk appetite and expectations for lower debt costs, with healthy fundamentals from malls and hotels also contributing. Self-storage outperformed on optimism that lower mortgage rates will lead to greater housing transaction volumes (a demand driver). On the other end, residential REITs were relative laggards on signs that U.S. apartment rental rate growth is starting to feel the impacts of elevated supply, especially in Sunbelt markets.

Portfolio Performance

The portfolio underperformed the MSCI U.S. REIT Index on a gross basis in the fourth quarter. While stock selection was additive, allocation decisions pulled down relative performance.

Detraction came mainly from the underweight to cyclical property types such as retail and hotels, which rallied harder during the quarter end risk on bounce. Retail performed well on a more resilient than expected U.S. consumer. Hotel selection detracted as the portfolio owned a stock that was negatively impacted by execution issues around a product transition. An overweight to single family rental was also detractive, as the sector underperformed on negative property tax news and being less of a relative beneficiary from lower rate expectations.

The main contribution came from holding an out-of-index tower company which had lagged earlier in the year but saw a strong comeback on a better than expected earnings update. Apartment selection also delivered thanks to our preference for coastal over Sunbelt apartment REITs, with continued concerns regarding elevated supply in the latter market.

Outlook

After lagging equities through most of 2022 and 2023, REITs appear to offer an attractive investment opportunity heading into 2024. First, the headwind of higher bond yields and central bank rate hikes is likely to abate and may turn into a tailwind if our view about an impending economic slowdown and decelerating inflation trends is correct. Second, REIT valuations look very cheap when measured against public equities and private real estate. On inflation, there are some encouraging signs that the steep central bank rate hikes are starting to bear fruit. The U.S. economy has started to show more marked signs of deceleration in the fourth quarter of 2023. Lead indicators published by the Conference Board are now in recessionary territory. U.S. non-farm payrolls and inflation have recently surprised to the downside.

It is hard to predict with any certainty the timing of a recession. Our base case is for more visible signs of a conventional U.S. economic recession to emerge in 2024 with rates likely to fall in a more sustained fashion, taking a medium term 6–18-month view. We believe the recent and numerous signs of decelerating economic growth following a period of vigorous monetary tightening are leading indicators of more economic weakness to come. That said, the chance of a soft landing has certainly increased following the dovish signals from the Fed's December Federal Open Market Committee meeting. The Fed now appears to be more willing to be pre-emptive in cutting rates to ward off downside risks to the economy. Either way, the economy appears to be in the late innings of the economic cycle; rates have likely peaked, and the prospect of rate cuts is now forthcoming.

REITs tend to perform better against equities in the later stages of the rate hike cycle with their relative outperformance becoming more marked as rates peak and fall. Admittedly, absolute returns may be negative if the economy enters recession even if relative returns are in the green. On the positive, a soft-landing could mean the best possible outcome of positive absolute and relative returns for REITs. Historical evidence suggests that REITs have, more often than not, delivered strong positive returns in the 12 months after real yields have peaked. Given our cautious view of the world, we continue to maintain a core of select a) structural growth stocks which we believe have pricing power given strong demand supply fundamentals and to b) avoid companies with bad balance sheets. This should position us well to weather any growth slowdown or other unforeseen economic shocks.

Top 5 contributors

Relative performance versus the benchmark

American Tower Corporation - An overweight to this tower company contributed. The tower group outperformed broader markets driven by decline in real interest rates. In addition, commentary related to domestic carrier macro-tower leasing appears to be better than feared.

Extra Space Storage Inc. - An overweight to this storage REIT contributed to performance. Increased hopes for an economic soft landing plus small improvements in operating trends and increased hopes of extracting higher synergies from a recent M&A deal helped drive outperformance.

Omega Healthcare Investors, Inc. - An underweight to this health care REIT contributed to performance. The company lagged after reporting continued tenant issues and expected rent disruption in the conference circuits.

Mid-America Apartment Communities, Inc. - An underweight to this apartment REIT contributed to performance. Concerns over elevated supply in Sunbelt markets and faster deterioration of operating metrics put heavy pressure on the stock.

Equity Residential - An underweight to this apartment REIT contributed to performance. Concerns over weaker demand in the west coast tech centers, as well as not participating in the rally caused by the expectation of an end to Fed interest hiking, had the stock underperforming the REITs index.

Top 5 detractors

Relative performance versus the benchmark

Simon Property Group, Inc. - An underweight to this mall REIT detracted from performance. The company released favorable earnings that featured a beat and raise and healthy core portfolio trends. Greater risk appetite following optimism for a Fed pivot and soft landing also contributed.

Marriott Vacations Worldwide Corporation - An overweight to this timeshare stock detracted from performance. Concerns over selling the new Abound brand and overall management execution concerns continued to weigh on the stock, with soft landing tailwinds benefiting other sectors more.

American Homes 4 Rent - An overweight to this single-family rental stock detracted from performance. Although not showing incremental pressure from property taxes as its close peer, the stock was also left behind by the year-end rally due to it being less sensitive toward lowering interest rates.

Sabra Health Care REIT, Inc. - An overweight to this health care REIT detracted from performance. The biggest issue appears to be rent disruption risk from tenant, Landmark, which is still struggling.

Prologis, Inc. - An underweight to this industrial REIT detracted from performance. The company issued positive 2024-2026 guidance at its investor day and highlighted growth opportunities from solar and data center developments.

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