Market Insight

and business commentary, Issue 19 – February 2016

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Dear Investor:

Groundhogs and Planets

Punxsutawney Phil did not see his shadow on February 2, it was reported, portending an early spring. The annual ceremony is the centerpiece of the 1993 philosophical comedy "Groundhog Day" starring Bill Murray and Andie McDowell. In the Harold Remis film, Phil (who else?) Connors, an arrogant Pittsburgh weatherman, is assigned to cover Groundhog Day in nearby Punxsutawney and finds himself trapped in a time loop, endless reliving the day which begins repeatedly at 6:00 a.m. with the clock radio playing "I Got You Babe" by Sonny and Cher. Only a hard-gained awareness of his circumstances permits Murray's character to eventually escape the endless repetition.

Also in early February, a rare planetary alignment appeared to those looking not at Gobbler's Knob in Pennsylvania but to the sky. Observers in the northern hemisphere just before dawn saw five planets—Mercury, Venus, Mars, Jupiter and Saturn—appearing in a nearly straight line for the first time in a decade. The New York Times referred to the alignment as a "Celestial Spectacle."

We were reminded of Bill Murray's Groundhog Day and the flat celestial line when the Commerce Department reported recently that estimated 2015 GDP growth came in at 2.4%. The year 2014 ended at exactly the same number. Indeed, since the recession ended in 2009, the key measurement of US economic activity has been déjà vu over and over again, repeating itself in a basically straight line—averaging 2.1%, never falling below 1.5% or rising above 2.5%. We have been in a long-term growth deficit, the slowest recovery in the modern period.

With growth narrowly channeled during the past six years, the usual pressures that arise from an expansion are muted. A new study shows that regulation of banks has soared since 2011, increasing costs, reducing lending, and reducing GDP by nearly USD 900 billion over the next decade. New bank formation has effectively ended. Between 2011 and 2014 just one new commercial bank and no new savings banks were chartered. In the commercial real estate space, construction lending has remained constrained. Recently the Federal Reserve reported that overall lending conditions in the commercial real estate sector are tightening. Commercial real estate bonds have fallen significantly in value from the beginning of the year as

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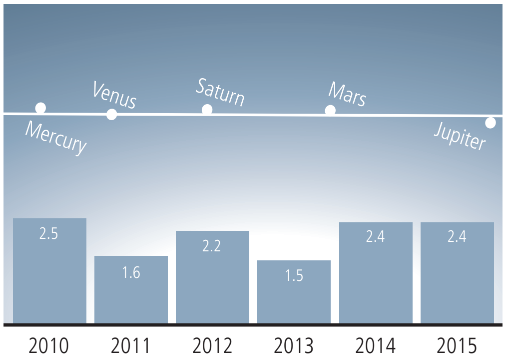
2016 planetary alignment vs. annual GDP growth



It's Groundhog Day all over again

"...the consumer is active and housing is supporting further growth so we do not expect the slow-growth US economy to slide into recession in the near term. Our long repeated expectation of slow, continuing growth remains intact."

Cover photo: 2 Bayshore Apartments, Tampa, FL (TPF)

risk premiums have jumped 2.75 percentage points, nearly a 20% drop in pricing. Banks are increasingly unwilling to hold credit positions on the balance sheets—more fallout from regulation. Although other credit channels remain robust, particularly life insurance companies, the CMBS shadow is concerning.

As unprecedented negative interest rates spread around the globe, the Federal Reserve's December increase in interest rates to 37.5 bps (mid-point) looks incongruous. Although there is widespread slowing in growth around the world and the domestic manufacturing sector is already in recession, the consumer is active and housing is supporting further growth so we do not expect the slow-growth US economy to slide into recession in the near term. Our long repeated expectation of slow, continuing growth remains intact.

All of this shows the limits of central bank policy, which is described in Mohamed El-Erian's recent book-length treatment, "The Only Game in Town: Central Banks, Instability, and Avoiding the Next Collapse."[1] Quantitative easing and low or negative interest rates are not a substitute for broader and more effective growth policies. Neither has proved useful at actually increasing productivity, which leads to higher and sustainable growth, which in turn leads to greater and more widespread prosperity. Is it too much to think that the Fed will reconsider its 2% inflation target and the US will actually reform its globally non-competitive tax structure? After all, eventually Bill Murray's Phil does develop true insight and he gets the Andie McDowell character eventually. Maybe that's not just a Hollywood ending.

Against this background, we find that the following three broad themes describe our basic approach and outlook:

– Headline labor market improvements led the Federal Reserve to increase its policy rate during December, and its internal outlook suggests three or four increases during 2016, although the market seriously doubts that more than one increase will take place. Given spreads and global rates, there is little reason to conclude that this belated modest change will move commercial real estate cap rates higher in the near term. At a 5% implied cap rate, appraised portfolios are at an historic low level, but so are global interest rates. The Fed's strategy, however, probably puts a floor under further cap rate compression in the near term.

– Real estate returns continue to show above-trend appreciation as measured by the NFI-ODCE and our own portfolios, driven by both cap rate compression and fundamental growth. In this setting we anticipate that an approach favoring a capital preservation emphasis will be more rewarding than increasing risk, particularly this late into an expansion. The fall in oil prices and reduced growth in China will likely not be offset by the potential increase in investment by Piller Two pension schemes following the FIRPTA change, meaning off-shore demand will be balanced.

– Real estate market fundamentals continue to improve in every segment, generally at higher levels than the overall economy. Demand growth exceeds supply increases in every property type and it is excess supply along with macro-driven recession that usually creates the greatest risk of a real estate downturn. The exceptionally high same-store NOI growth, however, is moderating, but still well above the rate of growth of the economy.

Portfolio positioning

Our portfolios remain well-positioned for the continued, slow expansion with modestly rising interest rates, constricted lending, and other economic growth challenges, but improving real estate fundamentals in a number of critical areas:

– Average leasing of 93.5% in our portfolio increased during the quarter and exceeds that in the NFI-ODCE by about 182 basis points.

– Our commercial asset management teams delivered strong results, with total leasing during 4Q15 of 2.2 million square feet.

– During 2015 our asset management teams completed the renovation of 1,619 units at an average cost of USD 9,235 per unit, earning an average premium of USD 159 per unit or an unleveraged 20.7% return on additional capital, well in excess of available returns from new acquisitions.

– Across property types in our Trumbull Property Fund, the net operating income results on a same-store basis for the 12 months ended 4Q15 exceeded that of the 12 months ended 4Q14 by a stout 8.4%.

" We are pleased to report that we have now delivered six consecutive years of double digit returns."

Transactions

Our transaction teams have underwritten and we have acquired a high and growing volume of quality assets on behalf of portfolios year to date, setting a new record for transaction volume. Through December 31, we have completed 65 transactions totaling USD 3.1 billion and our investment committee has approved 26 transactions having a funding level of over USD 2 billion on behalf of five accounts. Although net buyers in the sixth year of the expansion, we are reshaping portfolios through strategic sales into the strong markets. Through December 31, we have completed 23 dispositions totaling USD 1.3 billion; 2015 will represent the highest annual level of dispositions in our history by far.

Portfolio returns

We are pleased to report that we have now delivered six consecutive years of double-digit returns. The most complete expression of our performance is our Total Composite which comprises our discretionary assets under management. The Total Composite total return increased from a quarter ago and was 3.15% for the quarter and 13.22% for the 12 months ending December 31, 2015. For the quarter, the gap between our Total Composite and the NFI-ODCE closed meaningfully, with only 19 basis points separating the two returns. Providing very attractive risk-adjusted returns, the Total Composite, however, lagged the NFI-ODCE by 180 basis points for the 12-month time period, which continues to show much higher than trend total returns. Our composite, however, still outperformed the NFI-ODCE over the 10-year time period (by 73 basis points per year). Longer periods are a more relevant performance comparison with a long-lived relatively illiquid asset such as real estate. Our composite returns have well exceeded 500 basis points in excess of inflation over the one- and three-year time periods as we seek to provide superior risk-adjusted performance for the level of risk that we have communicated with investors.

Our Composite is driven by the two largest funds, Trumbull Property Fund (TPF) and Trumbull Property Income Fund (TPI). With a core equity strategy and a core participating debt strategy, these funds have delivered excellent risk-adjusted performance over the longer term relative to their peers, as detailed in the fund managers' reports. We have maintained our discipline in pursuing primarily a core strategy in these funds over the years: favoring an income orientation across portfolios (including value-added portfolios), avoiding undue and, particularly, uncompensated risk, as well as not taking on excess leverage.

Our portfolios have embedded less recovery—having declined less during the recession—and we have taken on less risk on average than the majority of the NFI-ODCE members during this expansion, as well as the much lower leverage in our portfolios. Our lower leverage, as well as higher apartment and lower industrial allocations, and our over allocation to the East, were headwinds during the last year. The NFI-ODCE's leverage of 21.7% is over 1.4 times the level of our Composite. Many portfolios are persistently outperforming their custom benchmarks, notably, Trumbull Property Growth & Income Fund (TPG) and TPI. We also continue to favor the "fortress balance sheet" approach taken by TPF that has attracted investors over the decades. The Fund continues to be rated #1 or #2 for three key risk measurements identified by NCREIF over the 10-year period. Nearly all of TPF's debt is at fixed interest rates and this position, along with its lower leverage position, should help the fund perform relatively better in a rising interest rate environment.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Valuation review and sector analysis

Reporting positive appreciation for 23 consecutive quarters, the NFI-ODCE and the markets have entered one of the longest expansions in modern history with total returns driven primarily by property improvement and secondarily by price movement. The total NFI-ODCE quarterly return of 3.34%—appreciation return of 2.20% and income return of 1.14%—is 34 basis points lower than the prior quarter and eight basis points higher than one year ago. Investor yield requirements within our equity portfolio shown by the

"TPG celebrates its fifth anniversary with third-party investors this quarter. We are proud of our newest real estate fund's growth and performance."

weighted average NOI cap rate dropped 10 basis points to 5.0% this quarter, 40 basis points lower than one year ago and 40 basis points lower than the rate used by appraisers to price the assets in September 2007. On an aggregate, capital-weighted basis, the discount rate used by our appraisers this quarter was 6.80%, five basis points lower for the quarter, and 28 basis points lower for the year.

Although equity pricing has exceeded the prior peak, the spread between the overall rate in our managed portfolios and the 10-year Treasury remains wide. Falling to a mere 37 basis points in 2Q07, it was a stout 273 basis points at the end of 4Q15, just under (37 basis points) the average spread over the last 15 years. The spread between real estate pricing to BBB corporate rates however, has narrowed meaningfully during 2015, with the two rates moving in opposite directions, suggesting that capital may follow. However, Real Capital Analytics (RCA) reports that sales of significant US commercial properties climbed 23% year-over-year in 2015 on volume of USD 533 billion, as foreign investors played a significant role in the market, with direct property purchases totaling USD 91 billion. RCA also reports that the 4Q15 sales volume of USD 157 billion represented a 20% increase over 4Q14 sales.

The pricing of our approximately USD 2.9 billion participating mortgage portfolio remained fairly stable, with appreciation driven by underlying property improvement. The average discount rate used by the appraisers for the portfolio stood at 6.31%, only eight basis points lower than the previous quarter, and only 22 basis points lower for the year. The third-party appraisers value both the underlying real estate collateral and the participating debt investment, applying estimates of market pricing they judge to be appropriate for each investment.

In the aggregate, total carrying value increased 2.0% in the quarter, with positive results in our portfolios for all major property types. Apartments led the way, generating 39% of the total quarterly appreciation, with a 2.1% increase in carrying value over last quarter. The first-year NOI return for apartments remained at 4.8%, indicating that operating fundamentals are dominating overall gains. Retail and industrial properties performed strongly, delivering 27% and 17% of the total quarterly appreciation, respectively. Hotel properties delivered 2.7% appreciation, albeit over a relatively small base, while office properties delivered 0.9% appreciation and 12% of the total quarterly gain.

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1 Random House, NY, 2016

Composite returns and NFI-ODCE returns do not reflect the deduction of management fees. Past performance is not indicative of future results.

Source for all data, if not stated otherwise: UBS Asset Management, Global Real Estate – US.

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News

- TPG celebrates its fifth anniversary with third-party investors this quarter. We are proud of our newest real estate fund's growth and performance.
- We expanded the Trumbull Family of Funds program by adding additional fee breaks at the USD 400 and 600 million levels and including balances in the AgriVest Farmland Fund.
- Our 2016 Annual Investor Meeting has been scheduled for Dallas from April 11-13 and invitations were circulated last week. We hope to see you there.

If you have any questions or comments, please feel free to call your portfolio management team, your client relations professional, or me. We appreciate the ongoing opportunity to manage real estate investments on your behalf.

Matt Lynch

Matthew H. Lynch
Managing Director