THE CASE FOR REAL ESTATE INVESTING

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Excerpts from comments made at Legg Mason's Investor Day, on Friday, January 21, 2016, by Dave Gilbert, President & Chief Investment Officer of Clarion Partners.

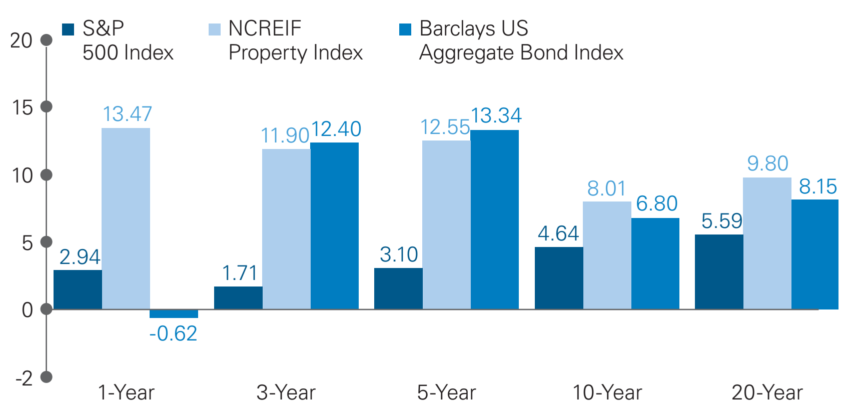
Why should investors consider private equity real estate today? Returns, for sure. Income, for sure. A nice element of that is current cash flow.

It's a diversifier. It's 5 to 10 percent of virtually every institutional mixed asset portfolio in the world, certainly in the U.S. Those are our investors, institutional investors.

It's an inflation hedge. You don't hear much about that anymore, but it still plays that role.

If you look back over time, the goal for real estate performance was to be somewhere between equities and bonds. There's an element of both in real estate: fixed income is long duration leases; and the rest is like equity.

As the chart below shows, if you look back at the performance of real estate over any one of these time periods, it significantly outperformed expectations. But performance is only one element.



Source: Bureau of Labor Statistics, NCREIF, Clarion Partners Investment Research, Q3 2015. Q4 data not yet available.

Note: Inflation is calculated using the Consumer Price Index For All Urban Consumers (CPI-U), excluding Food and Energy; past performance is not indicative of future performance.

The other is a diversification benefit: potential for low correlations. Good returns, with income — and low stock correlations, and negative bond correlations — makes real estate pretty unique. It plays a unique role in a mixed asset portfolio, and has done it consistently over a very, very long period of time.

But: are we at the top of the market?

No. This is a fantastic time to be a landlord; if you're a tenant we're raising your rents as fast as we can possibly do it.

Real estate has been a meaningful part of institutional portfolio allocations since the mid-1970s. From the 1980s you can see target allocations to real estate have grown. Why? It has worked.

We are demographers and sociologists; we are investors deep into the capital markets.

Where we are in the current cycle starts with demand: our outlook is 2 to 2.5 percent GDP growth. The preeminent question we ask ourselves is about job growth — which has been great. In 2015, 221,000 jobs per month average compared to about 120,000 jobs per month over the long-term average.

Then it gets more challenging. Where are those jobs being created? What kind of quality of jobs? What kind of spending will occur in the economy, both on the corporate and the consumer side?

If that wasn't hard enough, we try to figure out among property types. This includes hotels — yes, how spending patterns and growth patterns will impact demand there too.

The slow pace of job growth took us twice as long to get back to peak jobs in this cycle than it had in the prior cycle. That's hugely frustrating. The good news is that slow and steady has proven to win the race, and to generate very good returns, in part because of very low supply.

When you get really fast growth in the real estate world, there's been at least one instance — and it can happen by market — where you get an over-exuberant response: too much supply.

How has this played out across the U.S.? Very differently. We've had slow growth, a little frustrating. Many markets have a high technology component to job growth. People ask, “Aren't things selling for more than they did in the last peak?” The answer may very well be yes. Then the question is why? If it's based on high-quality jobs that are sustainable, that's a good reason. In the U.S. alone, we are 3.5 percent above the prior peak. We're sitting in a very, very good point.

It should come as no surprise that technology jobs have led. By number: 920,000, up 29 percent. They are high-paying jobs with a very significant multiplier effect, hugely powerful as they ripple through the economy.

A cycle we did not see coming — in energy — is a huge boon to the U.S. economy, like a tax reduction in low energy prices. One of the downsides can be a local market can suffer; that happens to be Houston. Houston is still way above prior peak and doing well. The energy fallback has hurt a bit and we think it's temporary.

What are the fundamentals driving the big four property types, the vast majority of our business?

Multifamily/Apartments: Millennials. One-third of the 75 million aged 20 to 34 live with their parents. That's 4 million more kids living with their parents today than in 2009, who will ultimately rent and then buy a home. That's powerful and aberrational, higher than virtually any time in history. And rents are going up. Part of the reason is 6 million new renters were created by the remarkable drop in the homeownership rate to 63.4 percent, which arguably was too high at 69 percent.

Industrial: U.S. consumer spending is strong and e-commerce is huge. Think logistics, buildings where we store goods that have come from the back of brick and mortar stores and are now in an Amazon warehouse. Amazon is our number one tenant. It’s really powerful: 20 percent of total industrial demand in the last five years has come from new e-commerce tenants. It's exciting.

Office: slow growth. Think insurance companies and accounting or law firms. It is starting to pick up, becoming much broader across markets, but technology has been remarkably strong.

Retail: sales are up 19 percent over prior peak. But there's a story of bifurcation within retail demand: dominant malls are great; high street is great; and there is weakness for everything else in the middle.

That brings us back to supply, and I am not worried about it, at all. Since 2010, we have built only 0.8 percent of existing stock nationally, compared to an average of 2.3 percent over the prior 34 years. About 1 to 1.5 percent is obsolescence. We should knock those buildings down and start over again.

What about demand? We calculate 1.7 times greater demand than supply since 2010.

These fundamentals drive vacancy rates down and give us pricing power. That's why we're able to increase rents.

Rents translate into NOI — Net Operating Income, our metric for earnings. NOI growth is accelerating, not declining. These are our earnings and they are going up, and the growth rate is accelerating. That results in good solid fundamental driving value, when earnings go up.

What about values? In real terms, we are back to about prior peak.

Isn't that logical when there are a lot more jobs? There's an inherent huge number of blessings living in this country, but one of them compared to a lot of the rest of the developed world is demographics. Four million new births last year, with 1.7 million immigrants. That's not what's happening in Japan. That's certainly not what's happening, at least in births, in Western Europe.

Our economy is growing. Demographics grow. Rents are up, as are jobs. Naturally, prices go up.

There are markets where growth is even much higher: technology markets most typically. If it's based on solid fundamentals, meaning rents, we think it's sustainable.

On interest rates, we are not focused on what the U.S. Federal Reserve does. We focus on the 10-year Treasury. We borrow long. Most real estate investments are made with a 5- or 10-year duration.

So what should we worry about? Where is the risk? The risk is in recession.

Systematic risk is going to affect the real estate market like every other investment. Weak demand means declining earnings, a correlation we saw in the last three recessions — certainly the global financial crisis.

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* As of December 31, 2015.

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The **Federal Reserve Board ("Fed")** is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

NCREIF Property Index (NPI) measures the total rate of return of individual commercial real estate properties acquired in the private market for investment purposes only.