ONE WAY TO ACCESS JAPAN TODAY: REAL ESTATE

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We recently highlighted why Japanese real estate is one standout area in Japan that is benefiting from the record-low interest rate environment in Japan. It has secular, long-run forces at play, in addition to cyclical forces. The discussion below with Chris Konstantinos, International Portfolio Manager at RiverFront Investment Group, highlights why his company is currently attracted to Japanese real estate and how they consider it in a broader portfolio context. ***Chris, why are you optimistic about Japanese real estate?*** There are numerous drivers of real estate for Japan. One of the things that is not well understood is that the quality of commercial real estate in Tokyo is not up to the standards of other major developed markets. If you go into a boardroom in Tokyo for a publicly traded corporation—for companies that would be equivalents to Walgreens in the U.S or Amazon—it seems to me like you are walking into class B office space. The finishes are run down, there are low ceilings, and you are wondering what is going on. What is going on: Japan was in a deflationary environment for much of the past two decades. The desire, or "animal spirits," to engage in any type of capital expenditures has been very, very low for a very long period. What is going to turn that around, in my opinion, is a number of things. Many of these buildings are not built up to seismic code. In the early 1980s there was a uniform seismic code that was instituted for commercial real estate,[1] and my understanding is that many buildings built before 1985 have yet to be retrofitted. We've seen two devastating earthquakes in Japan over the last five years, including one just very recently. We know that bringing buildings up to seismic code is very important. We know the Olympics are coming up in 2020, and Tokyo wants to put its best foot forward to showcase what Japan is capable of. On top of this, you have very cheap lending rates, and a very tight labor market. This means employment is expanding in Tokyo, particularly in the urban places, and they are going to need places to put these people. You put these forces together, and you have a secular growth trend in earnings for these major Japanese real estate companies. ***Let's talk about the fundamentals of Japanese real estate from your perspective, Chris.*** Japanese real estate companies are the only segment of the world we monitor—among 40 groups of global markets—that actually grew earnings year-over-year in our analysis.[2] This feat was not true for the S&P 500, for the Eurozone[3] or the UK[4], and it was not true for Japanese exporters.[5] It was just true for Japanese real estate companies. If you look out ahead for 2016, we believe we could see 5%-plus earnings-per-share (EPS) growth for Japanese real estate when many indexes are struggling to see earnings growth.[6] From a relative perspective, it was particularly stunning that this group could generate positive earnings when that was nowhere to be found. The average EPS number beat the consensus estimates for this latest quarter also by 5%, at a time when positive EPS surprises were hard to find.[7] ***Chris, how does Tokyo real estate compare to global real estate opportunities?*** I will make a broad comment and then a specific one: We are in a low-interest-rate environment in general across the developed world. All else being equal, that should be good for real estate. However, in the U.S., we feel that ship has sailed. U.S. real estate investment trusts (REITs) had a tremendous few years when interest rates first plunged with quantitative easing. People were scrambling for yield, and the value of hard assets was driven up. But now with the Federal Reserve on the path toward raising rates, we believe U.S. REITs are yesterday's story. Another place with a lot of real estate is the United Kingdom. We feel the UK is also closer to the end of its easing cycle than the beginning, and real estate, particularly in the urban areas of the UK, has been bid up to almost crazy levels. We are starting to see signs of weakening there in the London housing market. So to RiverFront, global real estate is an interesting theme, but Japanese real estate looks the most attractive among global opportunities. ***How would Japanese real estate fit into your global portfolio allocations?*** Looking at our all-equity portfolio, developed international makes up approximately half our portfolio. That may look radical to a U.S. investor, but if you look at a market cap-weighted index, the U.S. makes up half of the global markets, so that is just reflecting a neutral allocation. The reason we have that type of allocation to developed international is that there is significantly more upside to developed international than the U.S. This is not to say we think the U.S. is dramatically overvalued or is set to crash, but rather we are just predicting average returns over inflation for U.S. stocks. We are seeing several-percentage-points-above-inflation better returns available in international markets and see that as a better pond to be fishing from looking forward. Real estate may be a smaller part of allocations; we view it almost as an alternative asset class. But Japanese real estate now makes up 2% to 4% of our entire global equity portfolios and is making up the majority of our Japanese exposure. We happen to be under-weight Japan relative to a world benchmark, but we are over-weight Japanese publicly traded real estate. [1]Sources: RiverFront and James Simms, "Japan's Authorities Move to Impose Tougher Building Standards." FT.com, 4/26/15. [2]Source: RiverFront Investment Group proprietary research. [3]MSCI EMU Index universe. [4]FTSE 100 Index universe. [5]Source: Bloomberg, for period from 5/31/15 to 5/31/16 for the S&P 500, MSCI EMU, FTSE 100 and WisdomTree Japan Dividend Index universes. [6]Source: RiverFront Investment Group proprietary research. [7]Source: RiverFront Investment Group proprietary research.

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DEFINITIONS

Deflation : The opposite of inflation, characterized by falling price levels.

Capital expenditures : Spending by a company typically made to enhance longer-term productive capacity.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

Earnings per share : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Real estate investment trust (REIT) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages. Returns predominantly relate to changes in property values and income from rental payments.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Inflation : Characterized by rising price levels.