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Global REIT white paper | February 2016

REIT allocations: sentiment vs. reality

The global real estate market is currently being impacted by five critical themes. Investors should take notice of these and other factors when deciding whether to make an investment in real estate investment trusts (REITs). We believe these themes provide a floor for asset values, while offering several catalysts for prices to potentially rise.

Introduction

Lately, the marketplace has primarily viewed REITs as an interest rate trade, despite the strong (and strengthening) fundamental backdrop whether it be in the form of improving REIT balance sheets and cash flows, record capital flows into the real estate sector, or companies unlocking shareholder value while utilizing various tools such as spin-offs, asset sales or share buybacks.

When it comes to selecting individual investments, the primary consideration should be the health of long-term fundamentals. Warranted or not, REIT prices do not always reflect fundamentals. As we have seen more recently rising rate fears have provided a major headwind to the asset class and that is what creates opportunities. Even companies with strong cash flow growth and skilled management teams are trading at sizable discounts to underlying net asset value (NAV), and the market has taken notice, whether it is with companies finding ways to create shareholder value or external investors driving more and more capital into the property sector.

We will examine five important themes taking place in the real estate market that we expect to serve as key catalysts in support of REIT investing. We also briefly reiterate some of the basic tenets that indicate why REITs may be worth consideration, including REITs' potential ability to provide attractive income and total returns, to deliver a measure of embedded inflation protection and to help improve diversification—as evidenced by their low correlations to other asset classes. Ultimately, we believe the REIT sector to be inexpensive relative to the private market and broader public market alternatives while demonstrating stronger near-term cash flow growth and positive catalysts in the form of mergers and acquisitions (M&A), privatizations, buybacks, Global Industry Classification Standard (GICS) changes and Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), as discussed within this report.[1]

Outline

Contributor

— Tyler Wilton, CFA, investment specialist, liquid real assets

1 | Real estate capital flows

Substantial capital flows into the private and public real estate market are being driven by a variety of investors, including sovereign wealth funds, private equity, insurance companies, pension funds and retail investors (see figure 2). There is a "wall of capital" being brought to the property market which continues to grow and provide support for real estate valuations. Just as important, in our opinion, the industry is significantly less leverage than in prior cycles, as more core long-term buyers focused on the space are less dependent on using leverage to reach their return expectations.

Currently, we are seeing increased appetite from institutional buyers who are allocating away from fixed income and into top-tier real-estate properties, such as those located in prime locations or markets. The amount of sovereign wealth fund activity was robust in 2015, which stands at $46.1 billion, already surpassing the full 2014 calendar year (See figure 2).

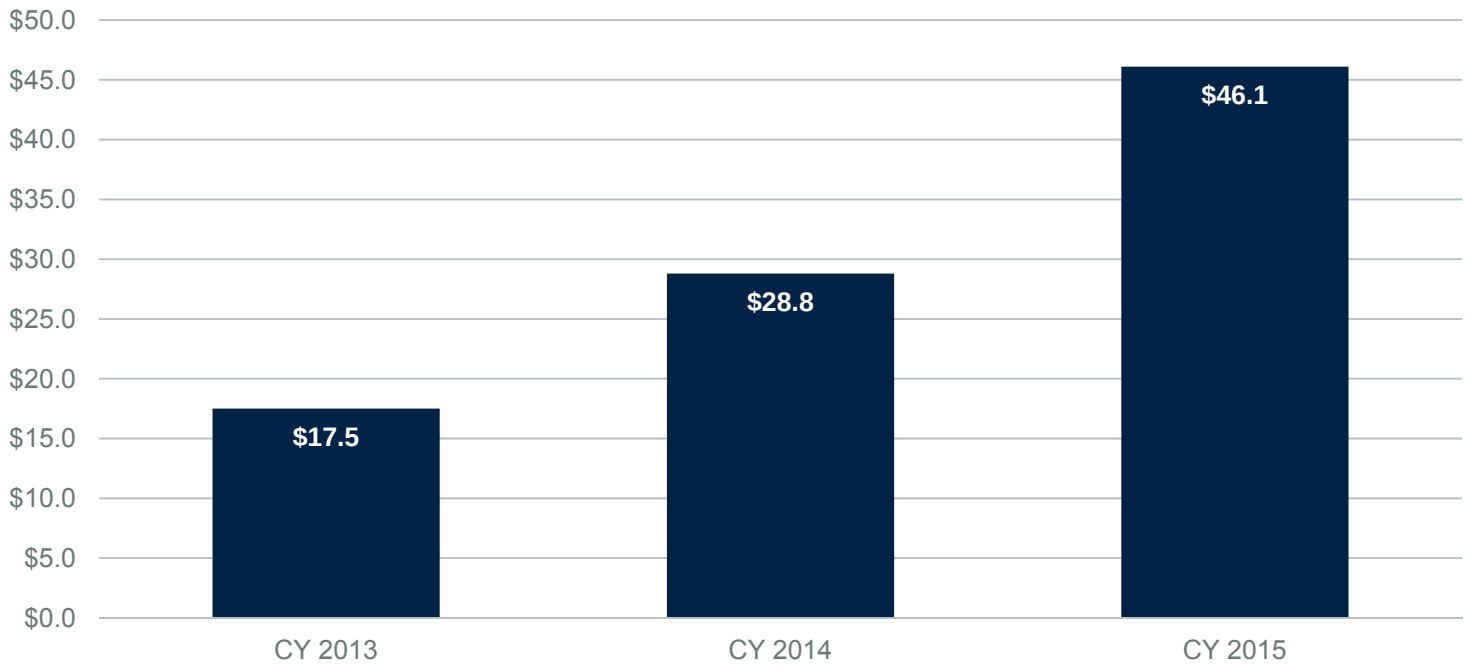
On the private equity side, we have seen record amounts of dry powder raised by global closed-end private equity real estate funds in 2015. Private equity dry powder totalled roughly $252 billion in 2015, which is a 28% increase from 2014 and over 50% higher than pre-crisis levels (See figure 1). The competition for core assets is particularly strong in cities such as New York, Paris, London and San Francisco. Investors are also showing strong interest in second-tier cities such as Madrid, Dallas and Seattle. Importantly, the spread to funding costs remains high, making returns from property attractive.

Fundamentals at a company level and property market level continue to improve and the market is taking notice of this as seen in the level of capital being put to work. The depth and liquidity of the real estate market remains healthy, given the growing interest in the property sector (see figures 1–4). The significant level of investor activity is one of the more important factors we expect to continue to provide support for asset values, even as interest rates begin to rise.

Figure 1: Global closed-end private equity real estate funds dry powder (U.S. dollars (USD) in billions)

Source: Prequin, Morgan Stanley Research as of 12/31/15.

Figure 2: Sovereign wealth funds' direct real estate transactions (USD in billions)



Source: Deutsche Asset Management and Real Capital Analytics as of 12/31/15.

2 | Investor activism, M&A activity and share buybacks

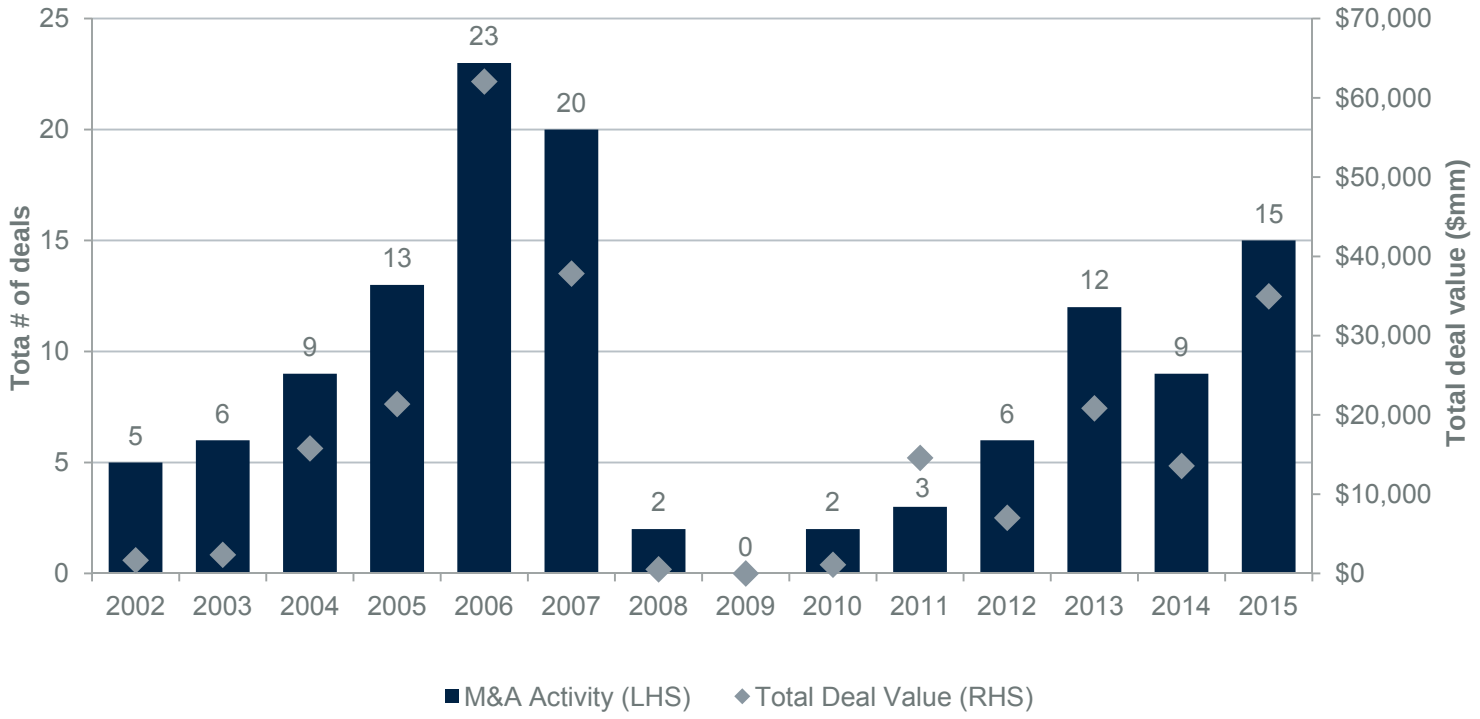
Corporate transformations, M&A activity, and investor activism have also been key performance drivers behind the real estate asset class. Activism and corporate activity has replaced leveraged buyouts in providing downside protection in the current cycle. Corporate transformations are creating value for shareholders, via spin-offs, mergers, asset sales and new management. Meanwhile, investor activism is leading to improved corporate governance, management, strategy, and shareholder returns. In 2015, activist investors have become more pronounced, representing a driving force in pushing companies to unlock value whether it is through REIT spin-offs or forcing management to sell assets to improve their overall property portfolio and/or balance sheet.

In today's market environment where real estate stock valuations have become disconnected from the private market, we have witnessed increased levels of shareholder activism, M&A activity, and share buybacks. All of these factors should further help support share prices and provide a floor for the sector as well as create a catalyst for prices to move higher.

M&A activity, which includes spin-offs, has been healthy in the United States over the past three years. A total of 15 deals have taken place in 2015 at a total deal value of nearly $35 billion, the highest level since 2007 and in-line with the pre-crisis levels witnessed in 2004 and 2005 (See figure 3). Of the 15 M&A deals taken place in 2015, five publicly traded REITs that were taken private delivered a one-day average return following the acquisition announcement of +5.1%, that is 475 basis points greater than the overall average return of the MSCI U.S. REIT Index on those acquisition dates (source; SNL Financial LLC as of 12/30/15). Lastly, global real estate companies have bought back more stock in 2015 than they have in any full calendar year dating back to 2001 to the tune of nearly 3.5 billion shares (See figure 4).

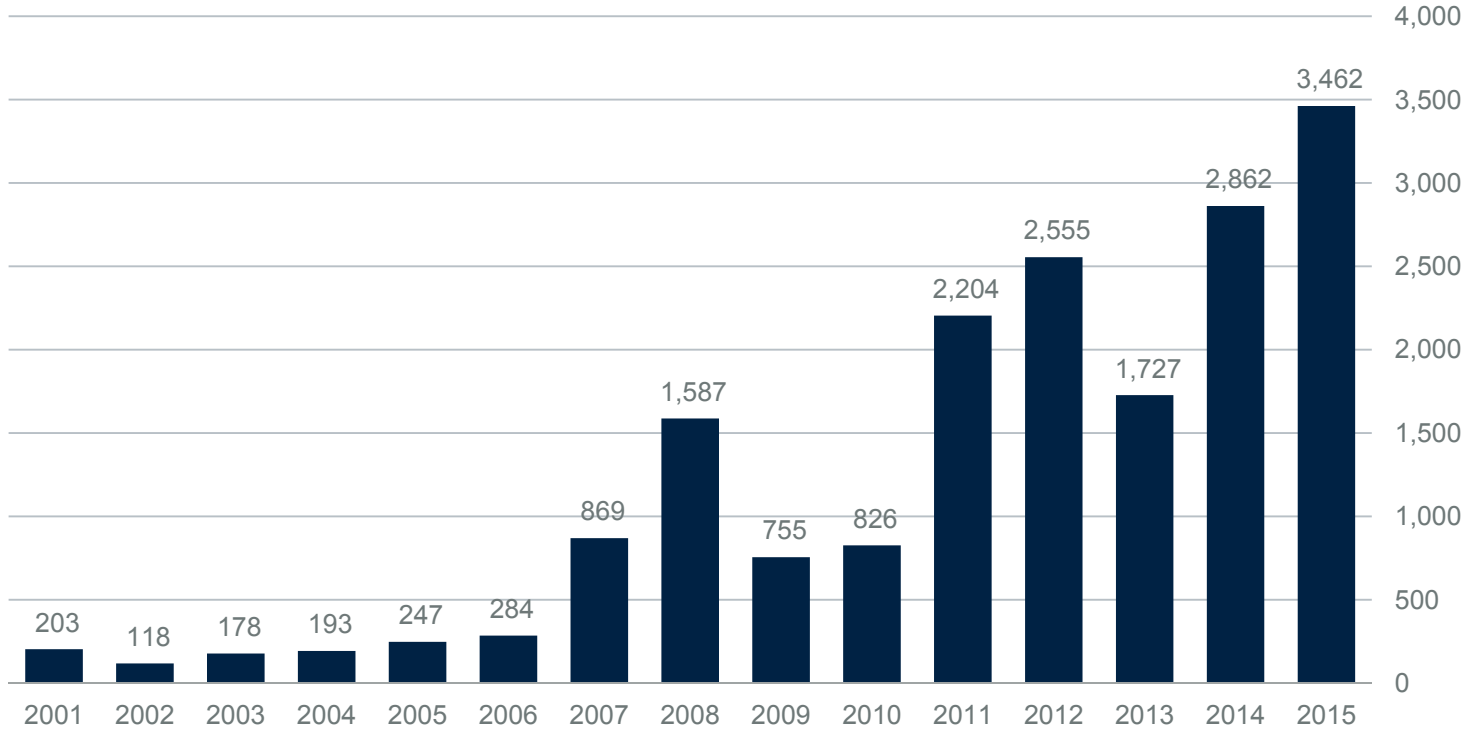
More recently, foreign investment in U.S. real estate was given additional support by reforms made to FIRPTA. The amendments to FIRPTA will now allow non-U.S. investors to hold up to 10% of a publicly traded REIT from the previous threshold of 5% and also receive favorable tax treatment for investments in U.S. REITs or direct real estate property. The more favorable backdrop for foreign investment in U.S. real estate further supports the outlook for A-quality assets.

Figure 3: Historical number of M&A deals and deal value (USD in millions)



Source: SNL Financial LLC as of 12/31/15.

Figure 4: Global real estate share buybacks (in millions of shares)



Source: SNL Financial LLC as of 12/31/15.

3 | Rising interest rates — perception vs. reality

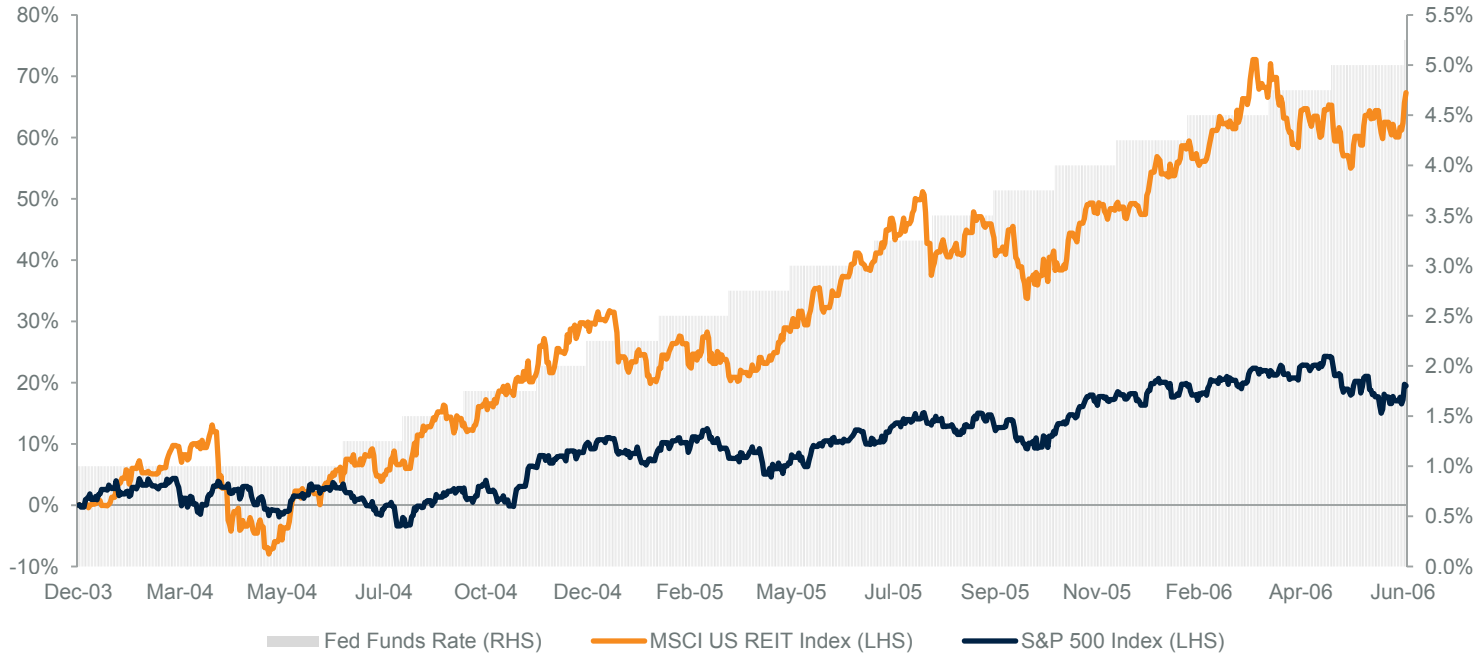
The macroeconomic environment, notably a lack of visibility on the direction of interest rates, has been a key driver of REIT performance in recent periods. While each scenario is unique, some investors may be surprised to learn that REITs have historically performed relatively well in a steadily rising interest rate environment, and have meaningfully outperformed both traditional equities and bonds the year after a rise in interest rates. Generally speaking, higher interest rates imply an improving economic backdrop in the form of higher GDP growth and a strengthening job market which is beneficial for commercial real estate returns.

In periods of rising rates, we find that investors take a shoot first approach; however, this sentiment is typically disconnected from the reality of the underlying real estate business. A change in interest rates ultimately impacts the cost of capital for all businesses globally, not just the real estate business. This is why real estate stock prices generally recover and perform admirably after initial sell-offs around Fed events and rising rates.

Looking back at the most recent Fed tightening cycle that officially began in June of 2004, we saw U.S. real estate securities sell-off meaningfully beforehand as the market anticipated a Fed rate hike following a strong April jobs report. Roughly three months later, the Fed officially raised rates for the first time since the bursting of the tech bubble in early 2000. Following the first rate hike, the Fed raised rates 16 more times until June 2006 and over this entire period we saw U.S. REITs return roughly +67%, whereas broader U.S. equities posted a return of +19% (See figure 5).

We believe 2015 shared a similar story to previous periods where REITs were dictated by anticipated monetary policy. We believe the reduction in uncertainty around rate expectations should help REIT prices to be less sensitive to Fed commentary and its outlook for rate hikes, and instead be driven by what we believe to be today's robust underlying fundamentals.

Figure 5: U.S. real estate outperformed U.S. equities during the last federal funds rate tightening cycle (12/31/03–6/30/06)



Source: Bloomberg, Deutsche Asset Management as of 12/31/15. **Past performance is historical and does not guarantee future results.** Asset class representation follows: U.S real estate, MSCI U.S. REIT Index; U.S. equities, S&P 500 Index. Index returns assume reinvestment of all distributions and unlike mutual funds, do not reflect fees or expenses. It is not possible to invest directly in an index. This chart is for illustrative purposes only and does not represent any specific Deutsche AM products.

4 | Relative valuation and cash flow growth

Fears around rising interest rates and the impact on REIT performance have been a primary headwind facing the asset class in recent periods. What should matter more to investors than higher interest rates are cash flows. While rising interest rates are not a good sign for most asset classes in the short term, fundamentals are what ultimately dictate returns. Fundamentals are not only strengthening but appear to be taking the driver's seat from a performance perspective as volatility induced rate fears are dissipating and already seem to be factored into valuations.

Cash flow growth remains strong for REITs, while cash flow in the broader equity market has been somewhat constrained during the last several years. Over the last 5 years, REITs have underperformed the S&P 500 Index despite the fact that REITs have posted stronger earnings growth over the same time period. REITs have boasted 5-year cumulative FFO growth of 59% which has exceeded cumulative S&P 500 earnings growth by 19 percentage points. From a longer term perspective, during the last 16 years, REITs have delivered annualized FFO growth of 6.4%, which has exceeded earnings growth of 5.6% for the S&P 500 Index.

From a valuation perspective, real estate stocks remain inexpensive relative to private market valuations, while private market valuations also appear inexpensive relative to U.S. Treasuries in a historical context. According to Green Street Advisors, U.S. REITs are trading at an approximate 6% discount to underlying net asset value as of 12/31/15.

We expect real estate fundamentals to continue to improve as supply remains in check and economic growth sufficient to generate greater demand for space, thus offsetting some of the negative cost of capital headwinds that could appear. Furthermore, REIT balance sheets are healthy with low amounts of leverage, and, as such, are positioned favorably to absorb higher interest rates. The improving economic and fundamental outlook, combined with favorable supply/demand dynamics should continue to drive strong cash flow growth for several years ahead.

5 | REITs becoming a new GICS sector and the universe keeps growing

On 8/31/16, real estate will become the eleventh sector in the GICS and no longer a sub-industry within financials. We believe over time this will lead to lower volatility and correlations relative to the broader equity market. In addition, generalists are estimated to be underweight the REIT sector by approximately $95 billion (more than10% of the REIT index market capitalization), which could provide support for the sector as allocations are made (source: Raymond James and JP Morgan as of November 2015). As the public real estate sector gains more and more recognition, it should benefit from more capital coming into the space while improving liquidity, thus supporting higher valuations.

The global REIT opportunity set continues to expand and evolve. In 20 years, REITs have grown rapidly, with their presence rising from four countries in 1994 to 37 at present. Growth has been supported by governments, and from investors looking for alternative investments. The impact has been a transfer of real estate assets from direct to listed ownership. Looking forward, we believe increasing securitization, companies seeking to unlock/realize value (via conversions or spin-offs) and the roll out of REIT legislation will offer attractive future investment opportunities.

Conclusion

Over the long term, REITs may provide a powerful proposition from a strategic perspective: access to real estate, low correlations to other asset classes, income, attractive total return potential, a measure of embedded inflation protection and liquidity. REITs have historically also provided a measure of potential inflation protection in the form of higher dividends relative to general equities. Historically, dividend yield tends to make up over half of REIT total returns.

The aforementioned themes taking place in the real estate sector today are important to understand, giving further credence for investing in REITs now as opposed to waiting on the sidelines. However, the primary point that should be emphasized is that over the long term, listed real estate acts like private real estate as the underlying cash flows of both are driven by owning or operating commercial real estate assets.

Past performance is historical and does not guarantee future results.

The table below depicts long-term cumulative performance for public REITs and the private real estate market as represented by the NCREIF Property Index. REITs tend to carry higher leverage and will typically lead private market returns by six to 12 months. As such, we have taken out the effects of leverage and lagged REIT market returns by 12 months, providing what we believe to be a more-balanced representation of how REITs can complement or supplement an investment in direct real estate.

While there are several benefits to investing in public and/or private real estate, the listed aspect of REITs (vs. private real estate) allows for lower transaction costs to the investor and provides immediate access to professional REIT management teams.

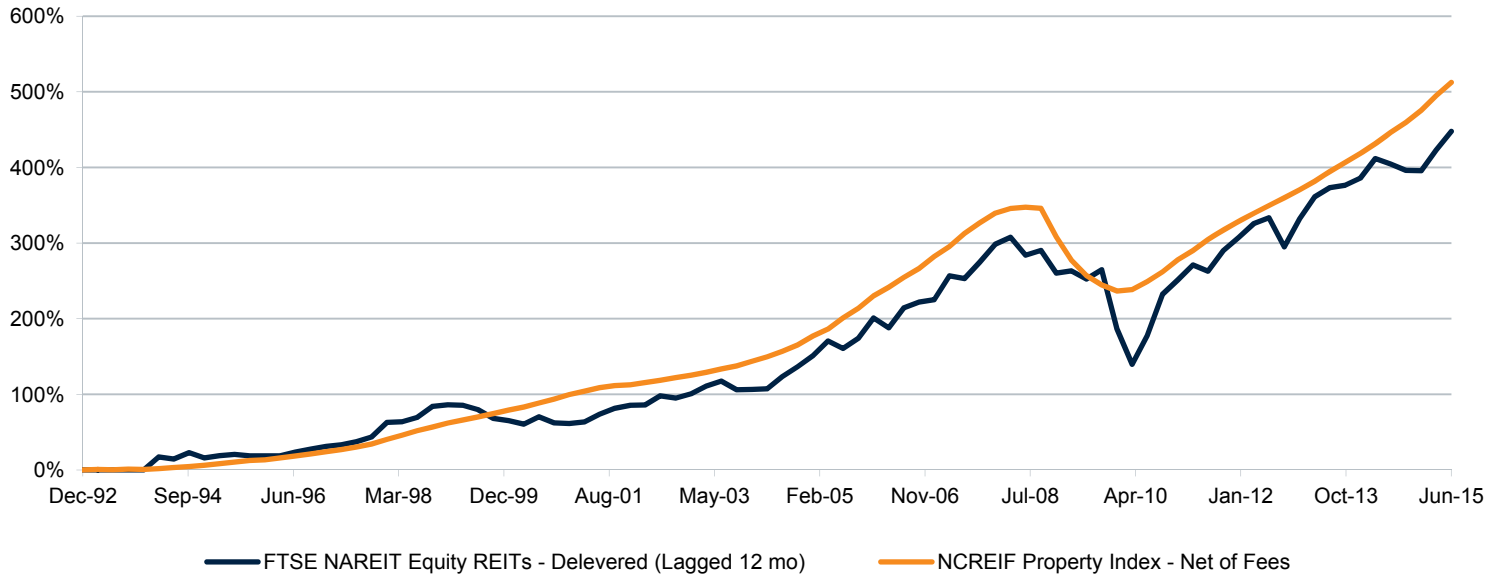
Private real estate tends to deliver more stable returns as it's not subject to equity market volatility.While public REITs are inherent with equity market volatility, they have historically outperformed private real estate over the past 20 years, primarily as a result of leverage as well as other property mix factors, such as access to different sub-sectors and regions (See figure 6).

Importantly, we continue to see strengthening fundamentals in real estate across the globe. Fundamentals remain very healthy, given tight supply across most major markets. The demand situation also remains positive, with employment on the rise. The result is increasing occupancy and upward pressure on rents. Not only are fundamentals expected to remain supportive, but we see a level of support to underlying property values, given the accommodative lending environment and strong flow of funds into the commercial real estate transaction market.

We end with a recent quote from Jon Gray from the San Francisco PREA conference in October 2015.

"Stock investors are too bearish on U.S. real estate, and the market's decline probably will lead to more takeovers of publicly traded landlords, along with asset sales, said Jon Gray, global head of real estate at Blackstone Group LP, the largest private equity investor in property worldwide. "There's a disconnect, and that creates opportunity," Gray said Thursday at a conference sponsored by the Pension Real Estate Association in San Francisco."

Figure 6: Public REITs have historically outperformed private real estate (12/31/92–6/30/15)



Source: Bloomberg, NAREIT, NCREIF Property Index, Deutsche Asset Management as of 6/30/15; latest data available.

[1]There are special risks associated with an investment in real estate, including REITS. These risks include credit risk, interest rate fluctuations and the impact of varied economic conditions. In contrast to a REIT investment, an investment in private real estate investment vehicles is highly speculative and involves a significant degree of risk. Because private real estate, like many other types of long-term investments, historically has experienced significant fluctuation and cycles in value, specific market conditions have resulted in and may in the future result in occasional or permanent reductions in the value of those investments. Investments in real estate are subject to various risks, including without limitation: (i) the cyclical nature of the real estate market and changes in national or local economic or market conditions; (ii) the financial condition of tenants, buyers and sellers of properties, (iii) changes in supply of, or demand for, properties in an area; (iv) various forms of competition; (v) fluctuations in lease rates; (vi) changes in interest rates and in the availability, cost and terms of financing; (vii) promulgation and enforcement of governmental regulations, including rules relating to zoning, land use and environmental protection; (viii) changes in real estate tax rates, energy prices and other operating expenses; (ix) risks due to leverage and dependence on cash flow; (x) changes in applicable laws; (xi) various uninsured or uninsurable risks and losses; (xii) acts of God and natural disasters; and (xiii) civil unrest, acts of war or terrorism.

The opinions and forecasts expressed herein by the fund managers and product specialist do not necessarily reflect those of Deutsche Asset Management, are as of 1/31/16 and may not come to pass.

Important risk information

Any fund that concentrates in a particular segment of the market will generally be more volatile than a fund that invests more broadly. Investing in derivatives entails special risks relating to liquidity, leverage and credit that may reduce returns and/or increase volatility. Emerging markets tend to be more volatile than the markets of more mature economies, and generally have less diverse and less mature economic structures and less stable political systems than those of developed countries. Investing in foreign securities presents certain risks, such as currency fluctuations, political and economic changes, and market risks. There are special risks associated with an investment in real estate, including REITS. These risks include credit risk, interest rate fluctuations and the impact of varied economic conditions. The fund may lend securities to approved institutions. Stocks may decline in value. See the prospectus for details.

Obtain a prospectus

To obtain a summary prospectus, if available, or prospectus, download one from www.deutschefunds.com for more information regarding the fund's objectives, risks, charges and expenses.

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