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EYE ON THE MARKET

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COMMENTARY ON SPECIFIC MARKET ISSUES AND ACTIONABLE IDEAS TO CONSIDER

REAL ESTATE – A SECTOR OF ITS OWN: Old Crooner or Fresh Boy Band?

Effective August 31, 2016, real estate will become a sector of its own rather than falling under financials. Per the National Association of Real Estate Investment Trusts ("NAREIT"):

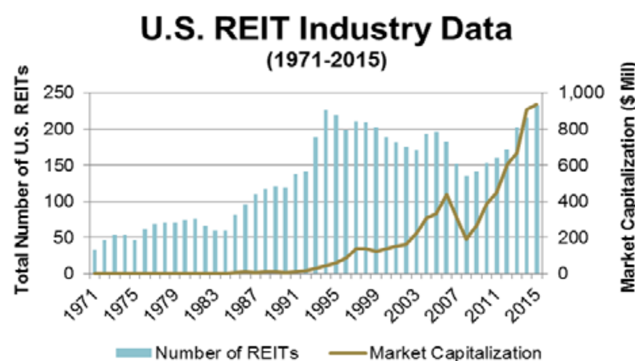
> *In 2016, S&P Dow Jones Indices and MSCI will reclassify and elevate stock-exchange listed real estate companies (including listed equity REITs) from under the Financials Sector to a new 11th headline Real Estate Sector in the Global Industry Classification Standards (GICS®). GICS is the leading classification system for stock-exchange listed equities worldwide. The change will be effective on August 31, 2016, and is the first new headline Sector since GICS was created in 1999.*

With this change unfolding in the coming months, Eye on the Market ("EotM") will examine what developments have taken place to get here, and how this may impact investors. Only time will tell if this represents a new kid on the block.

THE RIGHT STUFF OR BREAKING YOUR HEART?

Real Estate Investment Trusts ("REITs") were developed in in the early 1960s when President Dwight D. Eisenhower signed legislation that paved the way for the modern REIT structure. Since that time, the REIT industry in the United States has expanded rather dramatically. As Chart 1 indicates, both the number and market capitalization of REITs in the U.S. has grown significantly since 1971. Over this period of time, the number of REITs grew from 34 in 1971 to 233 as of the end of 2015. The growth in market capitalization has been even more dramatic, growing from $1.5B to approximately $939B, over the same period.

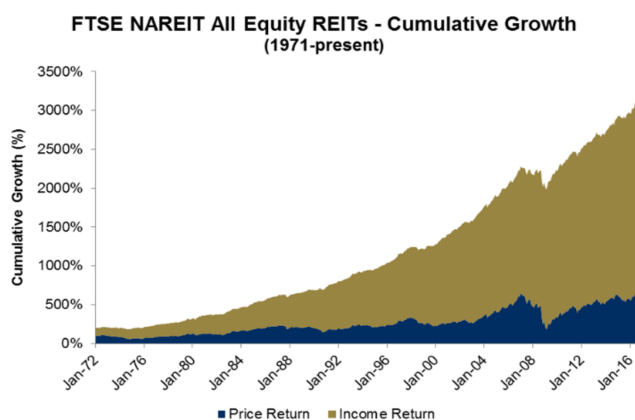
Chart 1



Source: NAREIT and Raymond James

As the industry expanded, so too did investor awareness of the asset class. REITs possess a unique characteristic that is attractive for income-seeking investors in that they are required to distribute 90% of earnings to shareholders. This is evidenced on Chart 2 as the income component of REITs total return has been a significant source of the returns. With REITs getting their own dedicated sector, their popularity will likely Increase.

Chart 2



Source: NAREIT and Raymond James

BECOMING *NSYNC

With the approaching classification change, investors may ask, "How does this impact me?" To quote a friend and colleague, "It depends." The immediate impact will be on diversified packaged products, including mutual funds and exchange-traded funds. For index-based products, many portfolios will be required to fill allocations to the new sector. Table 1 highlights the potential impact on U.S. actively-managed portfolios, as defined by Morningstar category, and each category's primary reference index.

Table 1

Morningstar Category[1]	Primary Reference Index[2]	REIT Allocation % (6/30/2016) Category Average	Index	+/- Index
Large Blend	Russell 1000	2.57	3.72	(1.15)
Large Growth	Russell 1000 Growth	1.54	2.91	(1.37)
Large Value	Russell 1000 Value	2.37	4.52	(2.15)
Mid Blend	Russell Mid-Cap	6.93	9.35	(2.42)
Mid Growth	Russell Mid-Cap Growth	3.24	4.45	(1.21)
Mid Value	Russell Mid-Cap Value	5.65	13.47	(7.83)
Small Blend	Russell 2000	6.33	6.87	(0.54)
Small Growth	Russell 2000 Growth	3.04	3.76	(0.71)
Small Value	Russell 2000 Value	5.42	10.04	(4.62)

Source: Morningstar Direct and Raymond James Equity Research

As is evident from the table, there will be limited impact on large-cap strategies since the percentage of REIT exposure within these indices is relatively small. The impact does take on a more meaningful presence within mid- and small- capitalization strategies, especially those that are value-oriented. As the table shows, mid-cap value and small-cap value portfolios will have the largest adjustment. The average mid- and small-value mutual funds are under allocated to REITs relative to their primary index by 7.83% and 4.62%, respectively. This does not imply that all active managers will change their allocations and purchase more REITs, especially if their mandate does not require them to stay in line with their benchmarks.

HANGIN' TOUGH

Mutual Fund Research & Marketing ("MFRM") has examined the portfolio construction constraints for several mid- and small-cap mutual funds that are either on the Highly Recommended Funds List or are managed by teams that we have high conviction in. A common theme among these funds is the inclusion of portfolio construction guidelines that limit a portfolio's allocation above or below its primary index. Typically, the constraint is plus or minus 10% of an individual sector allocation within the index. Assuming that this limitation was broadly utilized, the average mid- and small-value mutual fund would not need to modify its allocation given the information referenced on Table 1. Being that these portfolios are actively managed, the investment team may determine that a standalone REIT sector presents an attractive investment opportunity and therefore add it to the portfolio, but may not necessarily need to do so to comply with guidelines.

Over the long term, this could force investment teams that historically have shied away from REITs to consider them for their portfolios. A common management objection for not holding REITs is that these companies are heavily levered, or issue more debt, as compared to non-REIT companies. Will the index changes force investment teams to reconsider their objection? Probably not. It may force them to be frank with shareholders as to why they may be significantly under allocated to the REIT sector. While the new sector will likely prompt professional investors to further evaluate REITs, they still need to develop sound investment ideas and make astute asset allocation decisions so that they can continue hangin' tough.

SIDE NOTE

New Kids on the Block, *NSYNC, and the Backstreet Boys are all famous "boy bands" that popped up over last few decades. The recent all-male groups stem from the popular barbershop quartets as well as groups from the '60s and '70s. From this genre arose still-famous groups like the Monkees and the Jackson Five. In many ways, developing a successful "boy band" is similar to developing a properly-diversified portfolio. It all comes down to having the proper building blocks in place.

[1] **Morningstar's Large Blend Category**: consists of portfolios that are fairly representative of the overall U.S. stock market in size, growth rates, and price. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios tend to invest across the spectrum of U.S. industries, and owning to their broad exposure, the portfolios' returns are often similar to those of the S&P 500 Index.

Morningstar's Large Growth Category: consists of funds that invest primarily in U.S. companies that are projected to grow faster than other large-cap stocks. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields). Most of these portfolios focus on companies in rapidly expanding industries.

Morningstar's Large Value Category: consists of funds that invest primarily in big U. S. companies that are less expensive or growing more slowly than other large-cap stocks. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

Morningstar's Mid Blend Category: these portfolios invest in U.S. stocks of various sizes and styles. Most shy away from high-priced growth stocks but aren't so price-conscious that they land in value territory. The U.S. mid-cap range for market capitalization typically falls between $1 billion and $8 billion and represents 20% of the total capitalization of the U.S. equity market. The blend style is assigned to portfolios where neither growth nor value characteristics predominate.

Morningstar's Mid Growth Category: Morningstar defines mid cap growth portfolios as those that target U.S. firms that are projected to grow faster than other mid cap stocks, therefore commanding relatively higher prices. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

Morningstar's Mid Cap Value Category: Morningstar's Mid Cap Value peer group focuses on the U.S. mid-cap range for market capitalization between $1 billion and $8 billion and represents 20% of the total capitalization of the U.S. equity market. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

Morningstar's Small Blend Category: consists of portfolios that favor U.S. firms at the smaller end of the market-capitalization range. Some aim to own an array of value and growth stocks while others employ a discipline that leads to holdings with valuations and growth rates close to the small-cap averages. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate.

Morningstar's Small Growth Category: consists of portfolios that focus on faster-growing companies whose shares are at the lower end of the market-capitalization range. These portfolios tend to favor companies in up-and-coming industries or young firms in their early growth stages. Because these businesses are fast-growing and often richly valued, their stocks tend to be volatile. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

Morningstar's Small Value Category: invest in small U.S. companies with valuations and growth rates below other small-cap peers. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

[2] **Russell 1000 Index**: consists of the 1000 largest companies within the Russell 3000 index. Also known as the Market-Oriented Index, because it represents the group of stocks from which most active money managers choose. The returns for the index are total returns, which include reinvestment of dividends. Frank Russell Company reports its indices as one-month total returns.

Russell 1000 Growth Index: is a market-capitalization weighted index of those firms in the Russell 1000 with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 includes the largest 1000 firms in the Russell 3000, which represents approximately 98% of the investable U.S. equity market.

Russell 1000 Value Index: is a market-capitalization weighted index of those firms in the Russell 1000 with lower price-to-book ratios and lower forecasted growth values.

Russell Mid Cap Index: is a subset of the Russell 1000 Index that measures the performance of the mid cap segment of the U.S. equity universe. It includes approximately 800 of the smallest securities based on market cap and current index membership.

Russell Mid Cap Growth Index: is a market-weighted total return index that measures the performance of companies within the Russell Midcap Index having higher price-to-book ratios and higher forecasted growth values.

Russell Mid Cap Value Index: is a market-weighted total return index that measures the performance of companies within the Russell Mid-cap Index having lower price-to-book ratios and lower forecasted growth values.

Russell 2000 Index: is a consists of the smallest 2000 companies in the Russell 3000 Index, representing approximately 7% of the Russell 3000 total market capitalization. The returns we publish for the index are total returns, which include reinvestment of dividends.

Russell 2000 Growth Index: is a market-weighted total return index that measures the performance of companies within the Russell 2000 Index having higher price-to-book ratios and higher forecasted growth values.

Russell 2000 Value Index: is a market-weighted total return index that measures the performance of companies within the Russell 2000 Index having lower price-to-book ratios and lower forecasted growth values.

Investors should carefully consider the investment objectives, risks, charges and expenses of mutual funds and ETFs before investing. The prospectus contains this and other information about mutual funds and ETFs. The prospectus is available by contacting the fund family and should be read carefully before investing.

Diversification and strategic asset allocation do not ensure a profit or protect against a loss. The process of rebalancing may carry tax consequences.

The views expressed in this newsletter are subject to change, and no forecasts can be guaranteed. Information contained in this report was received from sources believed to be reliable, but accuracy is not guaranteed. Material is provided for informational purposes only and does not constitute recommendations, investment advice or an indication of trading intent. Investing always involves risk and you may incur a profit or loss. No investment strategy can guarantee success.

Past performance does not guarantee future results. There is no assurance these trends will continue.

REITs are financial vehicles that pool investors' capital to purchase or finance real estate. REITs involve risks such as refinancing, economic conditions in the real estate industry, changes in property values and dependency on real estate management.