STARLIGHT GLOBAL REAL ESTATE FUND

Real estate outperforms as investors go on the defensive

Dennis Mitchell, MBA, CFA, CBV
CEO & CIO

Michelle Wearing, CA, CPA, CBV
Associate Portfolio Manager,
Real Estate

Key takeaways

- Year-to-date, global real estate has generated a total return of 12.3%[1]
- In May, global real estate outperformed global equities and U.S. equities (0.6%, -4.9% and -5.6% total returns[2], respectively)
- One of the top contributors to Fund performance in May was Equinix Inc., with a total return of 7.9%[3]

Macroeconomic update

In our January commentary we spoke about elevated volatility in equity markets driven by positive economic fundamentals (low unemployment, wage growth) contrasting with deteriorating economic output trends (GDP growth, earnings growth). We also expressed the opinion that policy risks remain the greatest risks to the market in 2019. So far, our thesis has been correct as market volatility has been driven by the on-going trade dispute between the U.S. and China. The U.K.'s inability to establish the terms of its exit from the European Union has added to market volatility. Both conflicts put global growth in jeopardy as 60% of global GDP growth is tied to global trade. The concerns around global growth have seen global treasuries yields collapse as German and U.S. 10-year bond yields have dropped to -0.2% and 2.1% respectively. Given this development it is no surprise that the market is now pricing in a 50% probability of a rate cut in June rising to a 99% probability of a rate cut in December.

After a strong start to the year, the S&P 500 fell 5.6% over the month of May. Much of this decline was tied to increasing U.S. and China trade tensions. More recently, the U.S. has threatened to extend tariffs to Mexico and the European Union, putting additional downward pressure on global growth forecasts. In April, the International Monetary Fund (IMF) cut it's forecast for global GDP growth for the fourth time in nine months to 3.3%. In May, the World Bank followed suit, cutting its forecast for global GDP growth for the third time in six months, to 2.6%.

[1] As of May 31, 2019. Source: Bloomberg LP. Global real estate represented by FTSE EPRA NAREIT Developed Total Return Index (CAD).

[2] As of May 31, 2019. Source: Bloomberg LP. Global real estate, global equities, and U.S. equities represented by the FTSE EPRA/NAREIT Developed Total Return Index (CAD), MSCI World Index (CAD) and S&P 500 Index (CAD), respectively.

[3] Source: Bloomberg LP.

As expected, May global Purchasing Managers Indices (PMIs) continued their downward trajectory, with the Composite at 52.1 but Manufacturing falling to 49.8. Given the Federal Reserve Bank increased the Federal Funds Rate by 100 bps last year, we anticipated continued PMI weakness in 2019. U.S. Manufacturing PMI fell to 52.1 but this was concentrated in Inventories, while Services PMI rose to 56.9. Eurozone PMIs were flat with Manufacturing at 47.7 and Services at 52.9 and the periphery continuing to lead the core. Chinese PMIs were also flat but with the tremendous amount of stimulus taking place since June of 2018, including rate cuts, PMIs should begin to recover in the second half of the year.

Q1 S&P 500 EPS growth came in at 2.7% and the 2019 full year EPS growth forecast has moved to 3.9%. However, the Q2 EPS growth forecast is -0.3% as Energy and Materials drag the average down. The 2020E P/E multiple for the S&P 500 has come down to 15.3x and the current dividend yield is 2.0%. Mid to high single digit total returns from this point would seem to be in order, but with a continued uptick in market volatility. A strategic allocation to lower volatility, higher yielding real assets would seem to be a winning strategy in that market environment.

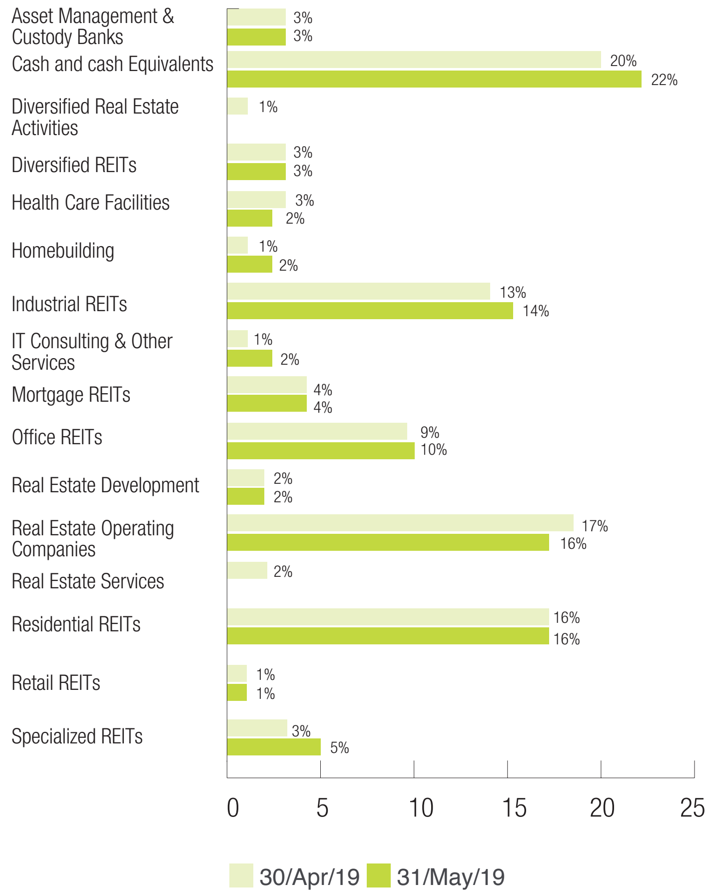
In May, global real estate outperformed global equities and U.S. equities (0.6%, -4.9% and -5.6% total returns[4], respectively). This continues the long-term trend of global real estate outperformance and underscores the need for advisors to have a strategic allocation to real estate in their clients' portfolios.

Starlight Global Real Estate Fund Overview

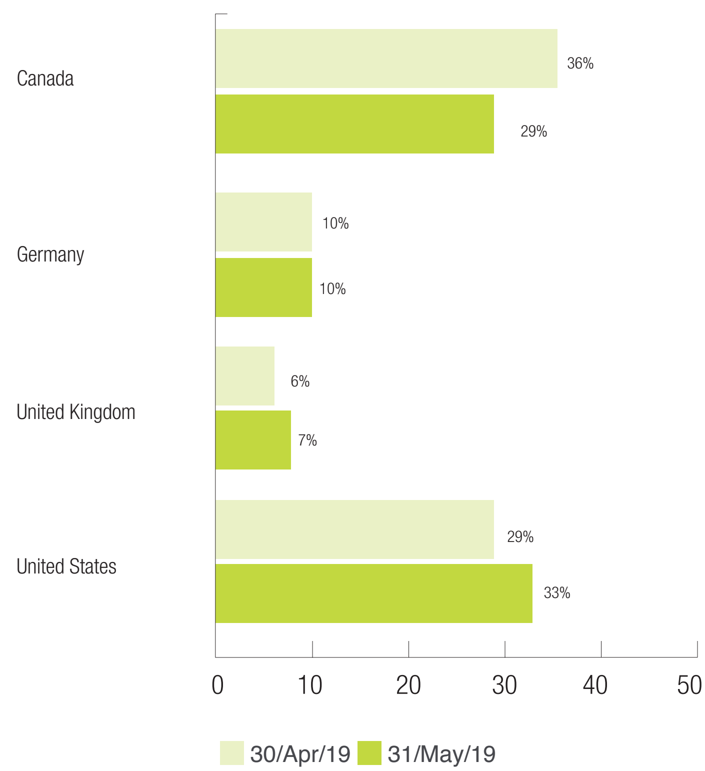
The Fund's geographic and sector allocations are shown (adjacent) here. Assets Under Management (AUM) rose 11% in May. Incremental new capital was largely allocated to our existing U.S. positions. In May we added one new position and four positions were eliminated. The Fund's cash weighting reflects our lag in deploying lumpy capital inflows as the market continued to rise.

[4] As of May 31, 2019. Source: Bloomberg LP. Global real estate, global equities, and U.S. equities represented by the FTSE EPRA/NAREIT Developed Total Return Index (CAD), MSCI World Index (CAD) and S&P 500 Index (CAD), respectively.

Starlight Global Real Estate Fund – Sector Allocation (%)



Starlight Global Real Estate Fund – Geographic Allocation (%)*



*excludes cash & cash equivalents

Portfolio review

Two of the top contributors to Fund performance in May were Vonovia SE., with a total return of 8.8% and, Equinix Inc., with a total return of 7.9%[5].

Vonovia SE ("Vonovia") is Europe's leading residential landlord. Vonovia owns approximately 395,000 residential units in attractive cities in Germany, Austria, and Sweden. Vonovia reported strong Q1/19 results in May, with like-for-like rental growth of 4.0%, funds from operations (FFO) per share growth of +13.5%. We expect to see a strong uplift to net asset value (NAV) when Vonovia revalues its portfolio with Q2/19 results. We believe German residential offers an attractive risk/return profile. We expect German residential rents and asset value growth to exceed inflation, driven by a very favourable supply-demand imbalance and a positive macro backdrop (10-year German bond yields in negative territory). We continue to see upside to Vonovia's share price, despite the strong performance in May.

Equinix Inc. ("Equinix") is a leading operator of data centres in North America, Europe, and Asia-Pacific, providing colocation, interconnection, and managed services to a variety of enterprises, content companies, system integrators, and telecom network service providers. Equinix operates 202 data centres across 52 metros and 5 continents, serving more than 9,800 customers. Equinix reported strong Q1/19 results, beating consensus and raising its 2019 guidance across revenue, EBITDA, and AFFO. Equinix also discussed further details on its hyperscale initiative and management expects to announce its first joint venture partner in Q2 followed by another in Japan. We continue to hold the name and see further share price upside over the long-term.

One of the top detractors from Fund performance in May was Brookfield Property Partners ("BPY"). BPY is one of the world's premier commercial real estate companies, with approximately USD $85 billion in total assets. The firm manages a diversified portfolio of premier office and retail assets, as well as opportunistic global investments in other asset classes.

Year-to-date, 18 companies in the **Starlight Global Real Estate Fund** increased their dividends or distributions by an average 6.7%, and one company initiated a dividend.

Weakness was driven by three factors 1) on May 13th the MSCI announced the pending removal (effective May 28th) of Brookfield Property REIT (BPR) shares from all indexes, 2) a downgrade to Outperform from Top Pick at a broker, and 3) Q1/19 earnings slightly below expectations. BPY remains a core holding for the Fund, and we believe the current unit price is attractive, yielding over 7% and trading at over a 30% discount to its own NAV.

Year-to-date, 18 companies in the Starlight Global Real Estate Fund increased their dividends or distributions by an average 6.7%, and one company initiated a dividend.

[5] Source: Bloomberg LP.

Portfolio outlook

The Starlight Global Real Estate Fund now holds 31 positions. Longer-term the portfolio should reach a targeted strategic allocation of 30% each to Europe, the U.S. and Canada supplemented by opportunistic investments in Asia and Australia. As Europe works through its legislative calendar, we expect to increase allocations to European real estate firms.

The industrial sector has generated double-digit returns driven by the rise of e-commerce and the need for fulfillment centres, last-mile delivery and logistics facilities. We believe industrial businesses are still compelling on valuation while providing strong dividend growth.

We remain optimistic with respect to the multi-family sector and believe stock selection will be key to generating strong returns. We believe multi-family REITs offer an attractive risk/return profile driven by favourable supply-demand imbalances in many urban cities globally. We look for companies that generate strong cash flow, have a defensive balance sheet and provide exposure to markets with high barriers to entry.

Conversely, we remain cautious on the retail sector as we expect the negative sentiment from e-commerce to continue. Globally, we continue to see retailers reducing their square footage and retail rents declining. Appraisers are reducing retail valuations as the asset class remains out of favour with investors. We believe there continues to be too much supply, and the investment risk remains to the downside.

Overall, we believe the Fund is well positioned to participate in continued up-markets while providing downside protection. We will closely monitor the investment environment and actively manage the Fund's positioning by carefully selecting individual businesses in-line with Starlight Capital's proven investment philosophy.

Starlight Capital
1400–3280 Bloor Street West,
Toronto, Ontario, Canada M8X 2X3
info@starlightcapital.com
1-833-752-4683
starlightcapital.com