

# Diversified Real Estate

Investing in stocks and bonds has been accepted as a diversification strategy and now increasingly real estate has been regarded as a way to diversify investment portfolios. Investing in real estate companies requires understanding of management, hard assets and cash flows at the property and company levels. Joel Beam at Kensington Real Estate Securities Fund looks for high quality real estate and management teams that have demonstrated track records.

**Q:** What is your investment philosophy?

**A:** We believe that real estate offers compelling returns, diversification benefits, and compelling volatility characteristics. We think that we can deliver value based upon our experience and research expertise in the field. Over the long-term, real estate investors are going to get a return driven by the fundamentals of the business. Those fundamentals have great characteristics in terms of visibility and predictability that make great sense to investors.

We have an income-oriented, value-driven philosophy. We invest in companies that have hard assets whose value is identifiable. We invest alongside talented management teams who have the ability to underwrite investments and manage value. Ultimately, our approach to investing in real estate is about understanding the quality of cash flows and assets and the acumen of management in terms of adding value.

**Q:** What are the key elements of your investment process?

**A:** We have a bottom-up process. We approach underwriting from both a net asset value (NAV) and a discounted cash flow point of view. We look at the liquidation value of a company and its value as a going concern. One is more of a real estate break-up value analysis based on current assets, and the other is more of a securities analysis, where we look at a discounted cash flow valuation based on earnings and dividends projections. We reconcile those two and determine what we regard as a fair value for the securities.

We cover a universe of securities that numbers up to 1,200 companies, including domestic and international securities. We follow common as well as senior securities. From that universe, we come up with a targeted list of securities that is appropriate for each of our four distinct investment strategies. At any given time, we maintain coverage of about 100 companies for the Real Estate Securities Fund, which uses our core strategy.

**Q:** What exactly do you mean by "core strategy"?

## Kensington Real Estate Securities

### Fund Facts

Symbol	KREAX
Website	<a href="http://www.kig.com">www.kig.com</a>
Address	Kensington Investment Group 4 Orinda Way, Suite 200C Orinda, CA 94563
Tel. No.	800-253-2949
Inception	12/31/2002

### Portfolio

Total Net Assets *	\$ 74.2
Avg Mkt Cap (\$ Weighted) *	\$ 7,966
Average Price/FFO Ratio (2007E)	16.05
Average Price/NAV(E)	0.99
Turnover Ratio **	75.4

### Investment Information

New Investment	Open
Min Initial Investment	\$ 2,000
Min Subsequent Investment	\$ 25
Min Initial IRA Investment	\$ 2,000

### Risk (Against MSCI U.S. REIT Index - 3 Years)

Alpha	1.75
Beta	0.90
R-Squared	0.98
Ann Std Deviation	14.77
Sharpe Ratio	1.59

### Returns vs. MSCI U.S. REIT Index

	KREAX	Index
1 Year (Cum.)	21.80 %	19.65 %
3 Year (Ann.)	25.83 %	26.19 %

### Returns vs. S&P 500

	KREAX	Index
1 Year (Cum.)	21.80 %	8.63 %
3 Year (Ann.)	25.83 %	11.22 %

### Fees and Expenses

Max Sales Charge - Front	5.75 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	1.00 %
Total Expense Ratio	1.45 %

### Portfolio Manager

Joel Beam	12/31/2002
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\* millions \*\*Annualized Q206 Turnover

Data through: 6/30/06

Source: Callan & Associates; Kensington



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**A:** The core strategy aims to invest in institutional quality assets and management teams. By institutional quality assets we mean assets with secure cash flows that a pension fund or an institutional investor would seek to own. They typically have limited leverage, a history of sustained demand, and no deferred maintenance or “turnaround” characteristics.

We are interested in companies that have strong balance sheets, have access to capital and management teams with a demonstrated ability to create value. This strategy does not use any margin debt and doesn't have the hedging and other sort of versatility that our other mutual funds have at their disposal.

**Q:** *What makes real estate investing different from investing in traditional stocks?*

**A:** Real estate has a different risk return profile. Typically, real estate hasn't had a lot of volatility and it has generated compelling risk-adjusted returns – differentiating it from stocks.

It's also predictable. If, for example, you buy stock in a biotech company where the core value is intellectual property as opposed to real property, you make a bet on the development and the exploitation of intellectual property. We are in a business where you do research and understand property markets, supply and demand, quality assets and the benefits or drawbacks of a particular financing strategy. When you have developed an ability to identify attractive assets and talented management, you can underwrite real estate in a way that allows you to sleep at night.

**Q:** *What are the key characteristics you focus on?*

**A:** We have a long history of underwriting real estate from a net asset value as well as discounted cash flow point of view. We focus on two key

characteristics – cash flow and dividends. The going concern value is essentially based on those two key metrics. We determine appropriate discount rates based on our estimates, given the market discount rates, and any adjustments that are warranted. Three broad categories that we adjust for are cash flow, property, and management characteristics. For example, we adjust our discount rates related to property characteristics including tenant credit quality, trends in leasing activities, and specific market exposure and any issues affecting projected supply and demand.

Liquidation value is very much a fundamental break-up value approach,



through which we analyze properties, market cap rates and supply and demand fundamentals. We maintain relationships with third-parties, including professionals and industry research services, and we use information from those services in part to develop appropriate capitalization rates. Then we determine a net asset value, which is basically a break-up value of the companies' assets, accounting for all the possible costs that could be involved in liquidation.

One aspect that sets us apart is that we put a lot of value on management. You will find situations, for example, where we will materially increase our discount rates for a management team that we don't think has the ability to add value or, perhaps we think that a management team might be responsible

for some deterioration of value. A significant element of our research process involves understanding the management team's talents, motivation and track record.

**Q:** *How does an idea become a holding in your portfolio?*

**A:** The process starts with idea generation and screening. Then, through valuing companies based on both liquidation value and a going concern value, we determine a fair value of securities in our universe and compare those values relative to one another and current market pricing. We then determine what the best opportunities are at any given moment.

An example of how an idea gets into the portfolio is our investment in an apartment company called Home Properties. It's one of the bigger companies in our space with a \$1.75 billion market cap. This company has been going through changes, rotating their portfolio and selling some assets that are earnings detractors. They missed their earnings for the second quarter of '05 and investors punished the stock. As both our net asset value and discounted cash flow approach are used in our screening process, it showed up as an opportunity and we invested 4% of the portfolio in it, made good money and still own a position.

We are looking for companies that can grow earnings and dividends in a way that is consistent, predictable and in excess of inflation. If you can do that in a way that doesn't increase leverage on the balance sheet and grows net asset value – that is a home run formula. Our guiding philosophy is that if you can run real estate assets in a way that is modestly leveraged and more or less leverage neutral, where you can grow your earnings at a greater rate than your dividends, and your dividends at a level greater than inflation, you're going to do really well. We look

for management teams that are able to deliver that.

**Q:** *Can you talk about the benchmark for the fund?*

**A:** The fund is benchmarked against the MSCI US REIT Total Return Index (RMS). We are mindful of the fact that the index has a certain complexion to it in terms of the property types and while we aim to diversify the portfolio, we also try to run a targeted portfolio of 30 to 50 names. Diversification within that list of names is very important. Our major sectors are retail, office, industrial and multifamily and we also have substantial exposure to diversified companies that might own all of the above. There are some smaller sectors, too. For instance, now we have some good exposure to the hotel stocks as that happens to be a compelling theme right now. There are also companies that specialize in healthcare and storage assets, and other niche property types.

**Q:** *Recently there has been a trend where people invest in infrastructure, counting as real estate airports or sea-ports or core properties like mining properties.*

**A:** Yes, we are aware of those companies, though none have found a way into this fund. We have always offered the fund as a commercial real estate-driven investment return and we want to offer investors the kind of return that's driven by apartment buildings, office buildings, shopping malls, warehouses, and the like.

I think home building, for instance, is a fascinating business and we all know that a lot of money has been made there. I am sure power plants and port assets are interesting and lucrative businesses as well, but as of yet, we have not invested there.

Like many mutual funds, the Real Estate Securities Fund does have some

ability to invest in companies that are a little different. We have an ability to put 20% of the fund into companies that don't fall squarely into our sector but it just hasn't been a focus of what we do.

**Q:** *As far as the portfolio construction is concerned, what is the upper limit to holding a security?*

**A:** No investment may be over 7% of the fund without being approved by our investment committee. We could go beyond it if we needed to, but I don't believe we've ever done that.

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about

Joel Beam

**Joel S. Beam**, Executive Vice President, Portfolio Manager, is responsible for securities investment decisions on behalf of Kensington's portfolios. A partner of the firm, Joel joined Kensington in 1995 as a Senior Analyst and has worked in real estate securities research and investment management since 1994.

**Q:** *What has been your historical turnover?*

**A:** In recent years it has ranged from roughly 90% to 120%, which is a little more than we would like it to be. We aim for the strategy to be in the 60% to 80% range. In the past it's been a little higher because there has been more volatility in the markets and we have more actively traded the portfolio in an attempt to preserve gains.

**Q:** *What kind of risks do you monitor and how do you measure them?*

**A:** From a systemic perspective, we view the primary risks as a recession, overbuilding and a prolonged and significant rise in interest rates. Our investment team works on a day-by-day basis together to monitor and mitigate risk in the portfolio. For example, we actively track construction trends in all major markets and property types and reduce our exposure to companies with concentrations in markets we believe may be producing too much supply. Additionally, we eliminate from consideration those companies whose dividends are unsustainable or whose balance sheets are unhealthy.

We have a process by which we are constantly monitoring our portfolios and evaluating price changes and developments in the underlying businesses. We will look to sell on overvaluation. We will look to sell if there has been a change in the business. We'll sell when we have achieved a price target. We use all of these to manage risk.

We also have an Investment Strategy Committee which meets monthly to review the portfolios, and our firm's Investment Committee, comprised of the three senior most investment team members, meets regularly to monitor the portfolios, as well as review and set risk management policies and procedures. ■

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