

What Income-Seeking Investors Should Know About REIT Preferreds

A Q&A with senior portfolio manager Joel Beam and senior investment analyst John Palmer of the Salient Real Estate Team

Salient Select Income Fund offers exposure to a potential income solution that is often overlooked: the preferred stocks of real estate investment trusts (REITs).

How is your fund differentiated in the preferred space?

Joel: Salient Select Income Fund differs from many other mutual funds and exchange-traded funds (ETFs) that focus on preferred share investments due to our industry focus and flexible mandate. By prospectus, we focus on senior securities in the real estate sector, with a specific focus on REIT preferred stocks. We also have the flexibility to maneuver around the capital stack and make money from common stock and bond investments as well. So, unlike a lot of competing preferred stock products that invest across the waterfront of preferred issuers, we focus on one sector—real estate—where we have career tenure and expertise. And whereas many other products own only preferred stocks, our fund owns mostly preferreds but we are also able to pursue income and value across the capital stack.

Why do you focus specifically on REIT preferreds?

John: Salient Select Income Fund focuses on REIT preferred investments for several reasons. First, REIT preferreds have the potential to offer superior risk-adjusted returns when judging risk as the likelihood of losing capital. But for a small handful of exceptions, the real estate sector has had solid long-term credit performance. Secondly, REITs offer greater transparency as it relates to the composition of their balance sheets relative to other traditional preferred issuers such as banks and insurance companies. Third,

the revenue streams associated with REITs are highly predictable given that most tenants (outside of lodging and apartments) have long-term leases that reduce the volatility of the top line of these companies. Lastly, REITs typically operate with lower leverage than other preferred issuers.

What's unique about the way REIT preferreds are structured?

John: From a structural point of view the real estate industry has largely avoided the complexity of preferred instruments that exist outside the real estate sector. While real estate investing is not simple, the industry by and large has avoided many of the esoteric structures we have seen in other industries.

Almost all REIT preferred stocks are structured such that dividends are cumulative (meaning, if an issuer fails to pay a dividend at one time, the issuer is obligated to pay that dividend at some point in the future), whereas many of the other preferred stocks out there do not offer cumulative dividends. It's also true that REIT preferreds generate mostly ordinary income whereas many other preferred stocks often have some potential tax advantage in the characterization of income.

The structure for the issuer is also important to note. REITs are pass-through entities that do not pay corporate income tax; to keep that structure a company must pay out at least 90% of its pretax income in the form of dividends. Given that REIT

preferred stocks are senior to common stocks, the preferred shareholders are first in line for those dividends. We feel an inherent structural support exists in this type of security that is not present in other types of preferred securities.

What are some other differences between REIT preferreds and other types of preferred securities?

Joel: In a few words, debt levels (leverage), transparency and universe of issuers.

In the REIT sector the level of corporate debt is much lower than it is in the banking and insurance sectors. For example, REITs typically have 45%–55% common equity in their overall enterprise values, whereas banks typically only have 7%–10% common equity. The transparency of an issuer’s cash flow and assets is also greater. One is better able to “see under the hood” of a real estate company than a utility or a bank. We think this transparency makes REIT preferreds compare very favorably with other types of preferred shares.

Another big difference is the size of the marketplace. The real estate preferred market is a relatively small part (under 10%) of the total preferred market. While it’s a smaller pond in which to swim, it allows for a tighter universe of issuers and a deeper understanding of their businesses.

What about interest rate risk?

Joel: A fixed-rate perpetual preferred, whether a REIT preferred or another type of preferred, can have substantial interest rate risk. Pricing and spreads in the marketplace often reflect this risk. Recently the market has priced a current yield in the 5%–7% range—which is attractive relative to how these investments have been priced historically and attractive compared to many other fixed-income opportunities. Nevertheless, interest rate risk is a key risk to evaluate when considering these securities.

It’s important to remember that Salient Select Income Fund is actively managed—it’s not a static portfolio. We make decisions every day to steward the portfolio in light of interest rate risk (and other risks as well). This is one reason we believe in having a professionally managed portfolio if you’re going to invest in this space.

What is your outlook on REIT preferred stocks?

Joel: Overall, we remain very constructive on REIT preferred stocks. The asset class has performed very well over time with little correlation to the overall stock or bond markets. At present, we anticipate a stable market environment for the foreseeable future. We expect REIT preferred stocks to generate returns consistent with the long-term results in the sector with competitive yields. Further, we expect the industry’s strong credit performance to continue.

You should consider the investment objectives, risks, charges and expenses of the Salient Funds carefully before investing. A prospectus with this and other information may be obtained by calling 800-999-6809 or by downloading one from www.salientfunds.com. It should be read carefully before investing.

Salient Select Income Fund seeks high current income and potential for modest long-term growth of capital.

RISKS

There are risks involved with investing, including loss of principal. Past performance does not guarantee future results, share prices will fluctuate and you may have a gain or loss when you redeem shares.

Borrowing for investment purposes creates leverage, which can increase the risk and volatility of a fund.

Concentration in a particular industry will involve a greater degree of risk than a more diversified portfolio.

Debt securities are subject to interest rate risk. If interest rates increase, the value of debt securities generally declines. Debt securities with longer durations tend to be more sensitive to changes in interest rates and more volatile than securities with shorter durations.

Derivative instruments involve risks different from those associated with investing directly in securities and may cause, among other things, increased volatility and transaction costs or a fund to lose more than the amount invested.

Investing in lower-rated ("high yield") debt securities involves special risks in addition to those associated with investments in higher-rated debt securities, including a high degree of credit risk.

Mortgage and asset-backed securities are debt instruments that are secured by interests in pools of mortgage loans or other financial instruments.

Mortgage-backed securities are subject to, among other things, prepayment and extension risks.

Investing in the real estate industry or in real estate-related securities involves the risks associated with direct

ownership of real estate which include, among other things, changes in economic conditions (e.g., interest rates), the macro real estate development market, government intervention (e.g., property taxes) or environmental disasters. These risks may also affect the value of equities that service the real estate sector.

Investing in smaller companies generally will present greater investment risks, including greater price volatility, greater sensitivity to changing economic conditions and less liquidity than investing in larger, more mature companies.

There is no guarantee the companies in our portfolio will continue to pay dividends.

Definition of Terms

Capital stack is a description of the total capital invested in a project, including pure debt, hybrid debt and equity. The stack is described as containing the most risk at the top, with least risky positions at the bottom.

Cash flow is a revenue or expense stream that changes a cash account over a given period.

Correlation is a statistical measure of how two securities move in relation to each other.

Fixed-rate perpetual preferred stock is a financial instrument that has characteristics of both debt (fixed dividends) and equity (potential appreciation).

Interest rate risk is the risk that an investment's value will change due to a change in interest rates.

Volatility is a statistical measure of the dispersion of returns for a given security or market index.

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