Real estate investment opportunities in a rising interest rate environment—pardon me?

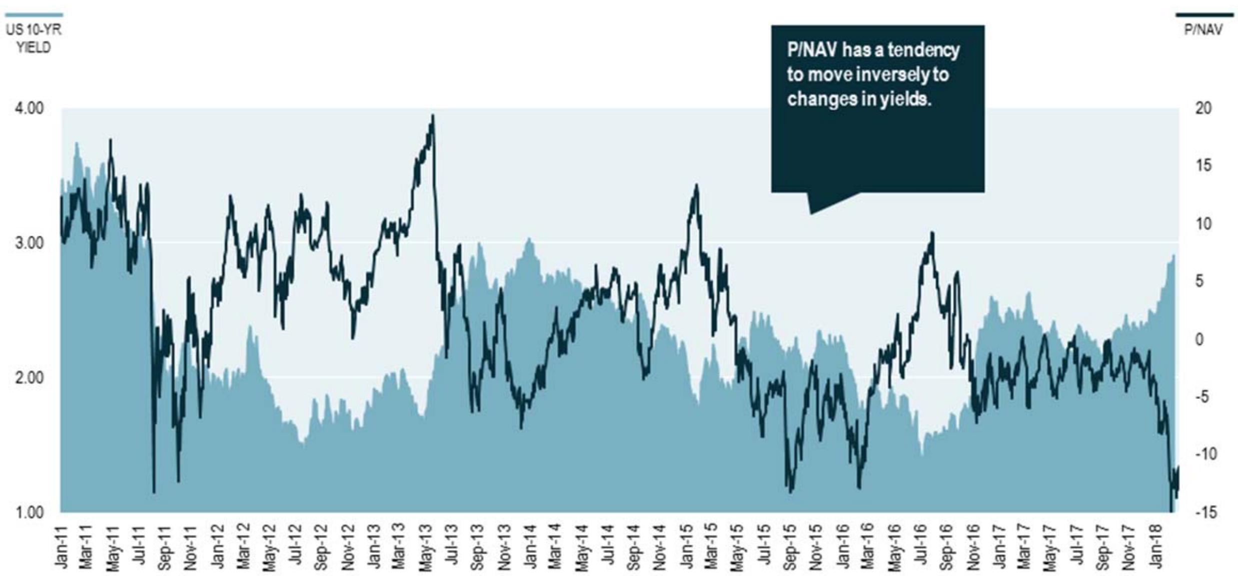
The challenges of REITs, rising interest rates, and inflation

Investment in real estate mutual funds and real estate investment trusts (REITs) have been seen as a diversifying opportunity to a well-balanced portfolio and one that can generate income. REITs, given that they own or operate real estate assets and typically generate income, can offer benefits of both income and capital appreciation in a portfolio. However, despite the benefits, REITs can also be correlated to equity and fixed income markets, due to their exposure (and dependence) on both.

In particular, REITs can be highly sensitive to interest rate changes. It can be observed that, over the short-term, prices of REITs may be inversely correlated to interest rate yields [FIGURE 1].

REIT Price/Net Asset Value (P/NAV) has a tendency to move inversely to changes in yields.

FIGURE 1. **Changes in 10-year Treasury Yields versus SNL Equity REIT Index P/NAV** | Jan 01, 2011–Feb 10, 2018



Past results are not indicative of future performance. The referenced index is shown for general market comparisons and is not meant to represent any particular Fund. An index is unmanaged and not available for investment. Source: SNL Financial as of 02/28/18.

Diversification does not ensure profit or protect against loss in a positive or declining market.

P/NAV is an industry standard metric that shows valuation levels in real estate. **Correlation** is a statistical measure of how two securities move in relation to each other.

Why is this? A few fundamental reasons:

- **Leverage.** Many REITs are levered, and thus depend on debt to boost returns. As the cost of servicing the debt rises, the income generating potential is diminished.

- **Rising rates.** More importantly, even REITs that have low leverage can still be affected by rising rates or inflation. This is because not only are bonds impacted by rising interest rates, but, in fact, all bond-like instruments are impacted. That is, any instrument with an up-front capital cost and fixed dividends with no adjustment for growth or inflation will see a drop in value in a rising rate environment. Real estate fits this category very well, as the cost of properties is typically paid up front, and although lease amounts can be adjusted, the landlord's ability to adjust the rent is proportional to lease length, which may be several years long.

- **Higher yield requirement for risk.** When interest rates rise, REIT investors also require a higher rate of return. Because there are additional risks in investing in REITs versus corporate bonds rated BBB- (which are the lowest investment grade tier, and typically used as a reference point for REITs), then REIT dividend yields must be higher to accommodate for this risk premium. Since the REIT yield cannot be adjusted upwards, the REIT price thus adjusts downwards to create a higher dividend yield. [1]

Because of a combination of these reasons, REITs are hit especially hard in a rising interest rate or inflationary environment.

Can any REIT lessen the impact?

So how does one find opportunities in the REIT space that mitigate the effects of interest rates or inflation? We believe that the **Altegris/AACA Opportunistic Real Estate fund (RAAAX)** is one such investment opportunity. Broadly speaking, the Fund's investment philosophy is centered on seeking investments where the landlord has leverage over tenants. This leverage manifests itself via more favorable lease terms for the landlord, and such investments by their nature have less of the characteristics previously mentioned.

Real estate companies that RAAAX seeks to buy have adjustments for inflation and should be less impacted by rising rates. For example, the largest cell phone tower company, which leases its network to mobile phone companies, has clauses in their contracts that adjust the lease amount by either 3% or an inflation index. As inflation in the U.S. has consistently been at or below 3% for the last 10 years, this company has benefitted from the higher 3% rent escalation. If inflation exceeds 3%, we believe that they will be protected, nonetheless. [2]

There are real estate companies that either reinvest a portion of their income, are growing faster than the economy and their cost of debt, or both. For example, the sole public property company that leases laboratory space to pharmaceutical companies and is held in the Fund has experienced same store net operating income growth of 5% per year for the past 10 years. [3]

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1 *Dividend yield is only one component of REIT returns, along with the dividend growth rate and capital appreciation. In this example, we use them interchangeably as the yield is a large component of returns.* ***2*** *Source: Public company filings.* ***3*** *Source: SNL Financial.*

Altegris/AACA Opportunistic Real Estate Fund

Thus, the Fund is not only better insulated from the impact of rising rates, but also demonstrates other characteristics beneficial to generating investor returns. More specifically, the Fund seeks real estate investments with several unique, growth-oriented characteristics:

- **Monopolistic characteristics.** For example, there are only three companies that have cellular tower networks. Competition is light in this subsector; especially when compared to the residential leasing subsector, which has hundreds of residential apartment providers.

- **Barriers to participant entry.** A cell tower start-up would need to have the infrastructure, capital, and technological know-how to build 60,000 new cellular towers. By contrast, most anyone with a pick-up truck and an easily obtainable construction license can build apartments in Texas.

- **Barriers to tenant exit.** The largest wireless phone provider has a strong marketing campaign based on the strength and reliability of their network. We believe that they are unlikely to switch tower providers for marginal lease savings, especially if it puts their reliability (and reputation) at risk.

- **Secular tailwinds/demand drivers.** Consumers are voraciously data-hungry; Cisco recently did an analysis and estimated that data consumption in the US will increase 20% year-over-year for the next five years. [4] Increasingly, consumers are using their mobile devices to consume this data, which subsequently increases demand for data centers. In contrast, residential apartments typically grow in the long-term at about the US economic growth rate of 2%-3%.

In addition to those mentioned, there are multiple sub-sectors within real estate that meet most or all of these characteristics, such as infrastructure, gaming, and ski resort companies, that help to lessen the effect of interest rate rises.

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4 *Source: Cisco.*

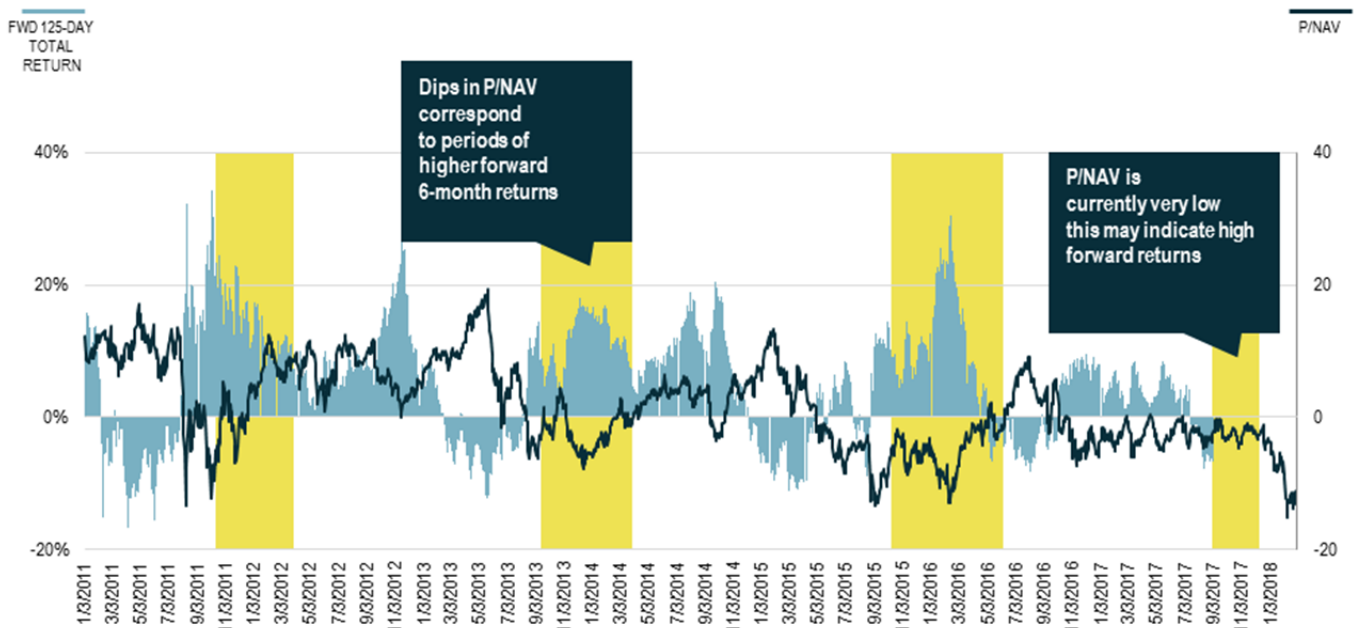
An additional opportunity to buy

Overall, current prices in the real estate sector present an opportunity that has historically favored investors. A key metric, price/net asset value (or P/NAV), has historically shown marked cyclicality.

When P/NAV of the SNL Equity REIT Index has been low, subsequent returns have historically been positive [FIGURE 2].

Historically, positive returns have occurred during and after periods where the P/NAV is below the long-term average.

FIGURE 2. **P/NAV and SNL Equity REIT Index Forward Total Returns since 2011** | Jan 01, 2011–Feb 28, 2018



Source: SNL Financial as of 02/28/18.

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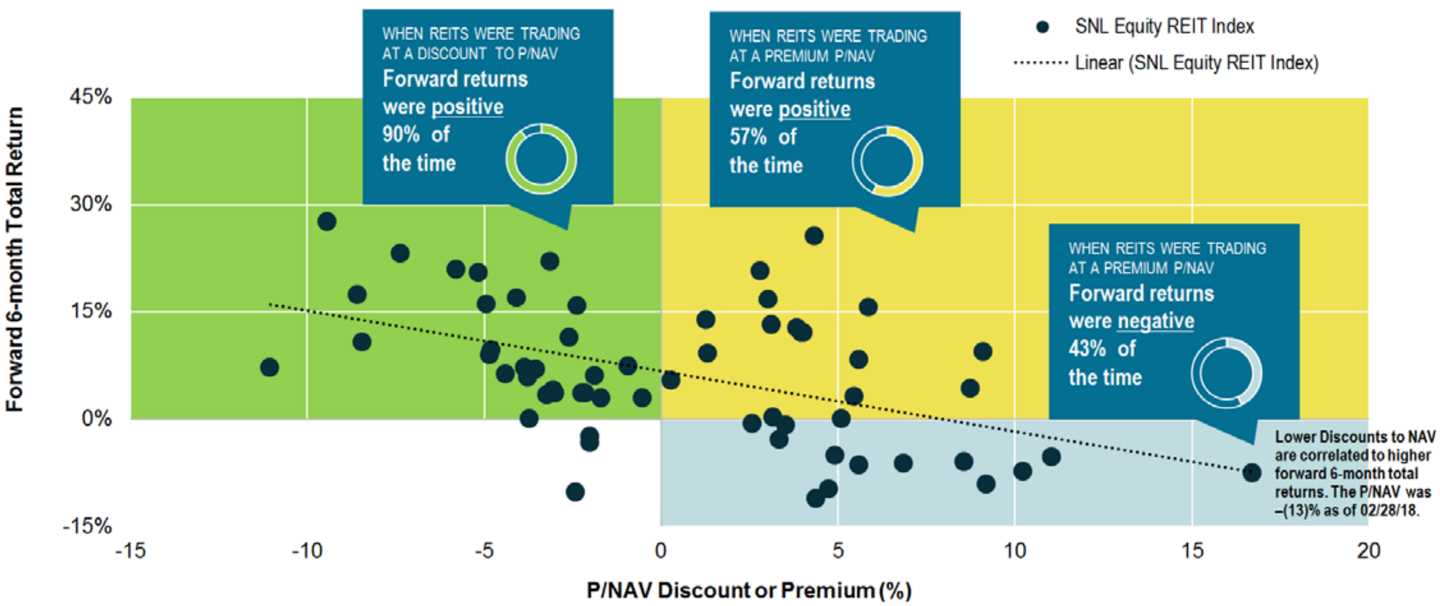
More specifically, the forward six-month returns of the REIT Index were positive 90% of the time during these discounted periods [FIGURE 3]. Alternatively, when P/NAV has been high, subsequent returns have mixed—some have been positive (57% of the time), while others were negative (43% of the time).

In almost all instances where the P/NAV was at a discount, the forward 6-month returns were positive.

FIGURE 3. Forward 6-month Total Return and P/NAV Premium or Discount | Trailing 5 years 09/01/12–08/31/17



Source: SNL Financial as of 02/28/18.

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Although this is no guarantee of future performance, all else being equal, we believe it to be prudent to invest in REITs when they are trading at a discount P/NAV.

Opportunistic real estate

The unique, growth-oriented and inflation-protected characteristics of real estate investments made within the Altegris/AACA Opportunistic Real Estate Fund may prove to be useful in a rising rate environment. Furthermore, the current discount within the real estate sector has proven beneficial in the past to investors who have purchased at these lower P/NAV valuations.

Index Descriptions

SNL Equity REIT Index. A market capitalization-weighted index that included all U.S. domiciled publicly traded (NYSE, NYSE MKT, NASDAQ, OTC) Equity REITs in SNL's coverage universe.

KEY RISKS: Stock market risk—stock prices may decline; Industry risk—adverse real estate conditions may cause declines; Interest rate risk—prices may decline if rates rise.

Risks and Important Considerations

Please carefully consider the investment objectives, risks, charges and expenses of the Altegris/AACA Opportunistic Real Estate Fund. This and other important information is contained in the Fund's Prospectus, which can be obtained by calling (888) 524-9441. Read the prospectus carefully before investing.

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MUTUAL FUNDS INVOLVE RISK INCLUDING POSSIBLE LOSS OF PRINCIPAL.

Equity securities such as those held by the Fund are subject to market risk and loss due to industry and company news or general economic decline. Equity securities of smaller or medium-sized companies are subject to more volatility than larger, more established companies. The concentration in real estate securities entails sector risk and greater sensitivity to overall economic conditions as well as credit risk and interest rate risk.

The Fund will engage in short selling and short position derivative activities, which are considered speculative and involve significant financial risk. Short positions profit from a decline in price so the Fund may incur a loss on a short position if the price increases. The potential for loss in shorting is unlimited. Shorting may also result in higher transaction costs which reduce return. The use of derivatives, such as futures and options involves additional risks such as leverage risk and tracking risk. Long options positions may expire worthless. The use of leverage will cause the Fund to incur additional expenses and can magnify the Fund's gains or losses.

Foreign investments are subject to additional risks including currency fluctuation, adverse social and economic conditions, political instability, and differing auditing and legal standards. These risks are magnified in emerging markets. Preferred stock and convertible debt securities are subject to credit risk and interest rate risk. As interest rates rise, the value of fixed income securities will typically fall. Credit risk, liquidity risk, and potential for default are heightened for below investment grade or lower quality debt securities, also known as "junk" bonds or "high-yield" securities. Any ETFs held reflect the risks and additional expenses of owning the underlying securities.

Higher portfolio turnover may result in higher costs. The manager or sub-adviser's judgments about the value and potential appreciation or depreciation of a particular security in which the Fund invests or sells short may prove to be inaccurate and may not produce the desired results. The Fund is non-diversified and may invest more than 5% of total assets in the securities of one or more issuers, so performance may be more sensitive to any single economic, business or regulatory occurrence than a more diversified fund.

About Altegris

Altegris Advisors, LLC is a CFTC-registered commodity pool operator, NFA member, and SEC-registered investment adviser that sponsors and/or manages a platform of alternative investment products.

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