Citi Property Investors
Pinnacle Global Real Estate Securities Fund
First Quarter 2009

It is springtime. At this time of the year hope "springs" eternal. The clock "springs" ahead. Green shoots "spring" out of the recently frozen ground. Kids "spring" outside to ride bikes and play baseball. And apparently, share prices roar upwards with the momentum of severely compressed "springs".

This analogy may seem as worn as an old sofa (with a spring poking through the fabric, of course). However, it may be more valid than it appears. As winter turns to spring, we perceive a precipitous change in the weather. In fact, no dramatic change occurs. Instead, an accumulation of gradual shifts reaches a tipping point that we perceive as significant. This perception shapes our behavior. The recently concluded winter was dreary from a meteorological perspective. It was worse from an economic perspective. We witnessed an unremitting barrage of dismal economic statistics. Indeed, the negative sentiment gathered momentum as the massive stimulus provided by the world's governments had little impact. However, as winter turned to spring the news flow became less ominous. Select reports were less negative than expected. U.S. existing home sales actually ticked upward. Chinese residential development showed surprising resilience. Momentum began shifting and the market noticed. The rebound in share prices experienced since the market lows in early March are among the strongest on record. Might this impact consumer and business confidence? (Yes.) Could this improved confidence lead to individual consumer and business decisions to take on additional risk? (Yes.) Will this be enough to turn the economy to an upward path? (We don't know.) Whereas we are more optimistic than we have been in many months, we remain extremely cautious.

Global real estate securities have acted like general equities on steroids for much of the past two years. They began declining eight or nine months before other equities in 2007 and experienced 1200 basis points greater peak-to-trough declines as well. Since the trough (on March 9, 2009), the sector has outperformed the broad equity market by 1400 basis points (through the close on Friday April 17, 2009). In fact, real estate securities have looked and acted like financial service companies on steroids. In the middle years of this decade the correlation between banks and real estate stocks in the United States was approximately 0.3. In the past year this correlation has run at more than double that level.

During the March 2009 quarter global real estate securities declined 21.1% as measured in the suite of local currencies in which they trade. Although there were significant fluctuations in currency valuations during the period, they had little overall impact as the G.R.E.S. Index declined 22.1% as measured in U.S. dollars in the period. The sector's return significantly lagged those of global equities and government bonds in the period. They declined 11.3% and 4.8%, respectively, in the March quarter.

This 22% decline for global real estate securities makes the recent quarter the second worst on record. And it could have been worse. The sector was off almost 36% through March 9. It has since rebounded 40%, including a 21% rise through quarter end. We have frequently stated the view that real estate securities were suffering from a valuation vacuum. In the face of poor liquidity and weakening fundamentals it has been difficult to determine a “fair” price for the property portfolios owned by the public companies. Consequently, it has been challenging to value the companies themselves. This has led to frequent opinion changes and violent volatility. This began to change in the quarter as direct market transactions increased and private funds began writing down assets. This led to a reemergence of a valuation context for the public companies. And we saw this valuation context validated in the marketplace by an increasing level of share issuance by companies that have been perceived to be “high quality” in Europe, Asia, Australia and North America. It feels a lot like spring.

Of course, spring is not equally advanced in all regions of the world. Mainland Asia is in full bloom. Property share prices in Hong Kong and China rose marginally in the March 2009 quarter. UK and Australian property companies suffered share price declines of over 20% during the same period. The United States fared even worse, experiencing a 33% decline. Industrial and hotel properties have higher correlation to economic activity than do other property types. Companies that specialize in these two sectors produced results that lagged those of other sectors during the quarter. Conversely, office, retail and residential companies produced the strongest results in the period. This was especially true in Asia.

The portfolio lost 19.4% of its value in the quarter compared to a decline of 20.6% for the FTSE benchmark as measured in Canadian dollars. Stock selection was a minor positive as we outperformed the local benchmarks in Europe, Australia and Canada but underperformed in Asia and, to a lesser extent, the U.S. regional selection and out-of-benchmark (emerging markets) exposure added value to the portfolio during the period. From a sector perspective, our retail exposure helped relative performance whereas low residential exposure hurt us. Overall, we raised cash early in the quarter (after the December 2008 rally) and redeployed it more recently.

During the quarter we added exposure relative to the benchmark in North America and reduced exposure to Hong Kong. Most of this shift occurred after the North American companies underperformed dramatically in the first 10 weeks of the quarter. We added three new investments in the period. These included Silic (a French diversified property owner), Global One (a Japanese office owner) and Capitamall Trust (a Singaporean retail owner). These are all well capitalized, conservative companies that should be able to benefit from the unraveling of the markets around them. We eliminated three other investments during the quarter. By and large, these were companies that outperformed their peer sets during the period and, consequently, no longer sported superior expected returns. We ended the quarter with 69 investments.

We ended the quarter with 37% of the portfolio invested in North America, 15% of the portfolio in Europe, 32% in Asia and 10% in Australia. The remaining 5–6% of the portfolio remains in cash pending investment in opportunities too good to pass up.

The strong relative performance we generated during the quarter reflected our generally defensive posture early in the period. We came into the quarter with a relatively high cash position and stock selection that reflected our belief that the primary determinant of relative performance would be a company's ability to survive through the current depressed credit cycle. Notwithstanding the scope of the ongoing rally, we believe that this view remains correct. On-the-ground fundamentals continue to weaken. Company cash flows are becoming increasingly distressed. Survivability will continue to matter more than valuation, in our opinion.

However, the valuation context for listed real estate companies is becoming more transparent. We are beginning to witness private market transactions and fund write-downs. We also see companies issuing equity at prices that were unthinkable a year or two ago. The confirmation of a rational clearing price in both the private and public markets has been an important (yet missing) precondition for recovery.

In conclusion, we think things are moving in a positive direction. This does not mean we think that volatility and risk have evaporated. To the contrary intra-day, -week and -month volatility remain well above "normal" levels. The danger is not passed. The risk has not dissipated. We are, however, more optimistic about near-term economic events than we have been in the recent past.