BARRON'S
AUGUST 19, 2024

REAL ESTATE | FUNDS

Real Estate Is Staging a Comeback. 6 Ways to Play It.

By Lewis Braham

Fund manager Jeffrey Kolitch has beaten all of his peers in Morningstar's Real Estate fund category in the past five years by being as different from them as possible. That's why it's significant that his latest stock picks now resemble theirs.

The manager of the Baron Real Estate and Baron Real Estate Income funds has recently been making the case for traditional real estate investment trusts in his shareholder letters, even though he had largely shunned the sector in Baron Real Estate, the category's best-performing fund, and was light on it in Real Estate Income, the second-best.

REITs have struggled in recent years for broad macroeconomic reasons, but also because of industry-specific ones having to do with vacancies in office and retail REITs after the pandemic, even though other real estate subsectors remain healthy.

Unlike ordinary stocks, REITs must pay out at least 90% of their cash flows, or "funds from operations," to shareholders to maintain their unique tax status. Because they retain so little cash flow, REITs are largely dependent on the capital markets to fund their operations. That means they often take on more debt than non-REIT stocks—a disadvantage in a rising-interest-rate environment, as we've had in recent years.

Higher borrowing costs make it hard for REITs to sustain their businesses. As a consequence, the popular $35 billion Vanguard Real Estate exchange-traded fund has a three-year annualized return of minus 1.5% versus the S&P 500 index's positive 7.8%. Worse, in the past five years, REITs couldn't keep up with the tech stocks driving the market—the S&P 500 was up an annualized 15%, dwarfing the Vanguard ETF's 3.8%. Baron Real Estate has a 13.4% five-year annualized return; Real Estate Income, 8.7%.

But the worm seems to have turned for REITs, with Federal Reserve interest rate cuts imminent. "Much of public real estate has repriced for a higher cost

Hot Properties

Six ways to play a resurgent real estate market.

Fund / Ticker	1-Year Return	3-Year Return	5-Year Return	Expense Ratio
Baron Real Estate / BREFX	11.1%	-0.9%	13.4%	1.31%
Baron Real Estate Income / BRIFX	11.6	-1.3	8.7	1.05
Schwab U.S. REIT / SCHH	14.5	-0.5	1.7	0.07
TCW Global Real Estate / TGRYX	15.7	-2.6	6.5	1.00
Third Avenue Real Estate Value / TVRVX	15.2	-0.3	5.0	1.40
Vanguard Real Estate / VNQ	13.2	-1.5	3.8	0.13

Note: Returns are as of Aug.12, 2024. Three- and five-year returns are annualized. Source: Morningstar

of capital [from higher debt rates], and we're identifying value in several segments of REITs and non-REITs," says Kolitch. "If you look historically, interest rate cuts have been positive for REITs."

Importantly, the sector is in good shape financially. "Business conditions overall for real estate are pretty good," he says. "We're seeing attractive demand-versus-supply prospects. Vacancies are low; rents and home prices continue to increase. There is very little new construction activity that's coming on over the next few years. Balance sheets are in pretty good shape. If you've been on the sidelines for real estate, now is a good time to reengage."

Another crucial factor: While REITs normally trade at a premium on a price-to-cash-flow basis to other stocks because of their predictable dividend payouts, now many trade at significant discounts.

The REIT sector is now trading at a 10% discount to the S&P 500 in terms of funds from operations, according to Ryan Dobratz, co-manager of the Third Avenue Real Estate Value fund. "If you were to go back over the past 20 years, it has traded at a 30% premium on average," he says. "And we haven't seen the REIT index at a discount really outside of the pandemic, the 2008-09 financial crisis, and the early 2000s."

In 2024's second quarter, Kolitch increased Baron Real Estate Income's REIT allocation from 75.3% to 82.6%. That fund, because of its income focus, can only be 25% in non-REITs, and he previously maxed out his non-REIT exposure. He increased the REIT exposure in Baron Real Estate from 23% to 30.9%, which is about the typical maximum for that fund.

Two recent additions have been multifamily residential apartment REITs AvalonBay Communities and Equity Residential, which operate in coastal real estate markets with what Kolitch calls "very favorable long term demographic trends, given strong population and job growth."

As strong as Baron Real Estate's performance has been, Real Estate Income would make the better choice in a positive REIT environment. Baron Funds is a growth-oriented shop overall. Those looking to bargain-hunt the real estate sector might want to consider the more value-oriented Third Avenue fund, which has beaten 93% of its fund peers in the past five years. Historically, though, Dobratz hasn't favored REITs either, leading his fund to outperform in the rising-rate environment as well. He's been gradually increasing his REIT exposure to a current 30%.

Last year Dobratz purchased residential REIT Sun Communities, which owns manufactured housing communities and marinas. The company made some missteps in recent years with its overseas expansions, but "they own incredibly scarce assets," he says. "Historically, manufactured housing and marinas have been terrific places to be because of they're high barriers to entry."

One excellent actively managed fund primarily focused on REITs is TCW Global Real Estate, which has delivered a 6.5% five-year annualized return. Manager Iman Brivanlou has won by having a good balance between the faster growing REIT areas such as cellphone tower owners American Tower, which is benefiting from the rollout of 5G cell connections, and much cheaper fair in the multifamily residential REIT space like Canada's Minto Apartment REIT.

"We've never seen a period like this of pronounced underperformance in REITs," Brivanlou says. "The selloff has been largely indiscriminate." Kolitch is also a big fan of American Tower, which, though it normally trades at a premium valuation to other REITs, is actually cheap now, he says, considering its accelerated growth rate.

The simplest investment strategy might to be to buy Vanguard's index ETF or the Schwab U.S. REIT ETF, which has the lowest expense ratio among REIT ETFs, 0.07%. But some REIT subsectors in indexes such as office and retail properties remain more fragile financially and vulnerable to interest rate pressures than others.

Active funds are probably the best way to go for now.

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Baron Real Estate Fund's annualized returns for the Institutional Shares as of June 30, 2024: 1-year, 6.9%; 5-year, 12.93%; 10-year, 8.88%. The annual expense ratio for the Institutional Shares as of December 31, 2023 was 1.06%.

Baron Real Estate Income Fund's annualized returns for the Institutional Shares as of June 30, 2024: 1-year, 6.77%; 5-year, 8.49%; Since Inception (12/29/2017), 7.63%. The gross annual expense ratio for the Institutional Shares as of December 31, 2023 was 0.96%, but the net expense ratio was 0.80% (net of reimbursements from the adviser).

S&P 500 Index's annualized returns as of June 30, 2024: 1-year, 24.56%; 5-year, 15.05%; Since Fund Inception (12/29/2017), 13.55%.

MSCI USA IMI Extended Real Estate Index's annualized returns as of June 30, 2024: 1-year, 12.31%;
5-year, 8.18%; 10-year, 8.48%.
MSCI US REIT Index's annualized returns as of June 30, 2024: 1-year, 6.25%; 5-year, 2.68%; 10-year, 4.55%.

The performance data quoted represents past performance. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate; an investor's shares, when redeemed, may be worth more or less than their original cost. The Adviser may waive or reimburse certain Fund expenses pursuant to a contract expiring on August 29, 2034, unless renewed for another 11-year term and the Fund's transfer agency expenses may be reduced by expense offsets from an unaffiliated transfer agent, without which performance would have been lower. Current performance may be lower or higher than the performance data quoted. For performance information current to the most recent month end, visit BaronCapitalGroup.com or call 1-800-99-BARON.

Risks: In addition to general market conditions, the value of the Funds will be affected by the strength of the real estate markets as well as by interest rate fluctuations, credit risk, environmental issues and economic conditions. The **Baron Real Estate Income Fund** invests in debt securities which are affected by changes in prevailing interest rates and the perceived credit quality of the issuer. The Funds invest in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and more difficult to sell during market downturns.

For information pertaining to competitor funds, please refer to that firm's website.

Portfolio holdings as a percentage of net assets as of June 30, 2024 for securities mentioned are as follows: AvalonBay Communities, Inc. - Baron Real Estate Fund (3.0%), Baron Real Estate Income Fund (8.1%); Equity Residential - Baron Real Estate Fund (4.3%), Baron Real Estate Income Fund (9.8%).

Baron Real Estate Fund

Top 10 Holdings as of June 30, 2024

Holding Name	% of Net Assets
Toll Brothers, Inc.	6.7
Lennar Corporation	5.6
D.R. Horton, Inc.	5.0
Equinix, Inc.	5.0
American Tower Corporation	4.8
Equity Residential	4.3
Digital Realty Trust, Inc.	4.0
Blackstone Inc.	4.0
Welltower Inc.	3.6
CoStar Group, Inc.	3.5
Total	**46.4**

Baron Real Estate Income Fund

Top 10 Holdings as of June 30, 2024

Holding Name	% of Net Assets
Equity Residential	9.8
Welltower Inc.	8.8
American Tower Corporation	8.7
AvalonBay Communities, Inc.	8.1
Equinix, Inc.	6.1
Digital Realty Trust, Inc.	5.9
Invitation Homes, Inc.	4.9
American Homes 4 Rent	4.8
Prologis, Inc.	4.0
Healthpeak Properties, Inc.	2.9
Total	**64.0**

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

The **MSCI USA IMI Extended Real Estate Index Net (USD)** is a custom index calculated by MSCI for, and as requested by, BAMCO, Inc. The index includes real estate and real estate-related GICS classification securities. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI. The **MSCI US REIT Index Net (USD)** is designed to measure the performance of all equity REITs in the US equity market, except for specialty equity REITs that do not generate a majority of their revenue and income from real estate rental and leasing operations. The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. MSCI is the source and owner of the trademarks, service marks and copyrights related to the MSCI Indexes. The MSCI Indexes and the Fund include reinvestment of dividends, net of foreign withholding taxes, while the S&P 500 Index includes reinvestment of dividends before taxes. Reinvestment of dividends positively impacts performance results. The indexes are unmanaged. Index performance is not Fund performance. Investors cannot invest directly in an index.

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