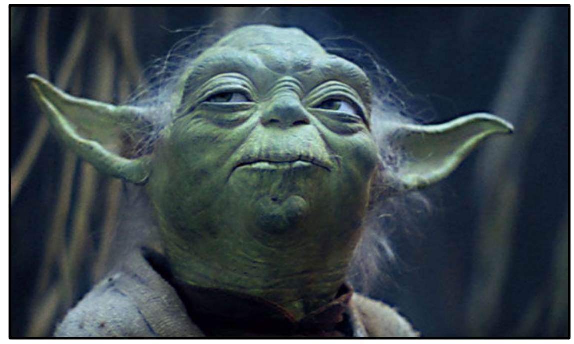
SERENITY
ALTERNATIVE INVESTMENTS



Evaluating REITs in 2020: Patience, Perspective, Opportunity

"Patience you must have" - Yoda

- **PERFORMANCE** - Serenity Alternatives Fund I returned +3.7% in March bringing YTD returns to -0.2%. The MSCI US REIT index returned +8.25% bringing YTD returns to -21.0%.
- **PROCESS** - REIT fundamentals continue to deteriorate. Risk management and patience remain points of emphasis.
- **OPPORTUNITY** - Bargains exist in the REIT market but are not widespread. Having an expert in your corner is important now more than ever.

In our modern world of Zoom meetings, same day delivery, twitter, and streaming video, it's not surprising that many investors lack patience. If my e-mail inbox is any indication, within the last two months, investors have gone from petrified to chomping at the bit, ready to snap up bargains across every asset class.

Investing, unfortunately, is not as easy as just buying things when they go down. The stock market tends to zig just when you are sure it's going to zag, manipulating investors emotions, and then punishing those without an investment process.

To succeed over the long term takes emotional discipline and patience, something the OG jedi-master Yoda tried to impart to Luke Skywalker. Part of the reason Star Wars remains so socially relevant is that these core tenants are still difficult to master, maybe today more than ever.

So if you find yourself licking your lips imagining the epic returns you are going to generate buying distressed assets during the current recession…take a minute and consider the Jedi master's advice. We are only two months into a period of significant economic distress and buying a security when even the people running the business don't know what is going on is extremely risky.

Performance: +3.7% in March, -0.2% YTD

Serenity Alternatives Fund I returned +3.7% in March with an average net exposure of 1.2%. The fund's Sharpe ratio for the month was 4.52, illustrating a large amount of return per unit of risk delivered to our investors. The fund is now down -0.2% for the year, while the REIT index is down –21.0% YTD. From here REITs have to achieve a +25% return to get back to even, while our fund is back to its high-water mark. From this position we can continue to grind out low risk returns while waiting for fundamentals to stabilize.

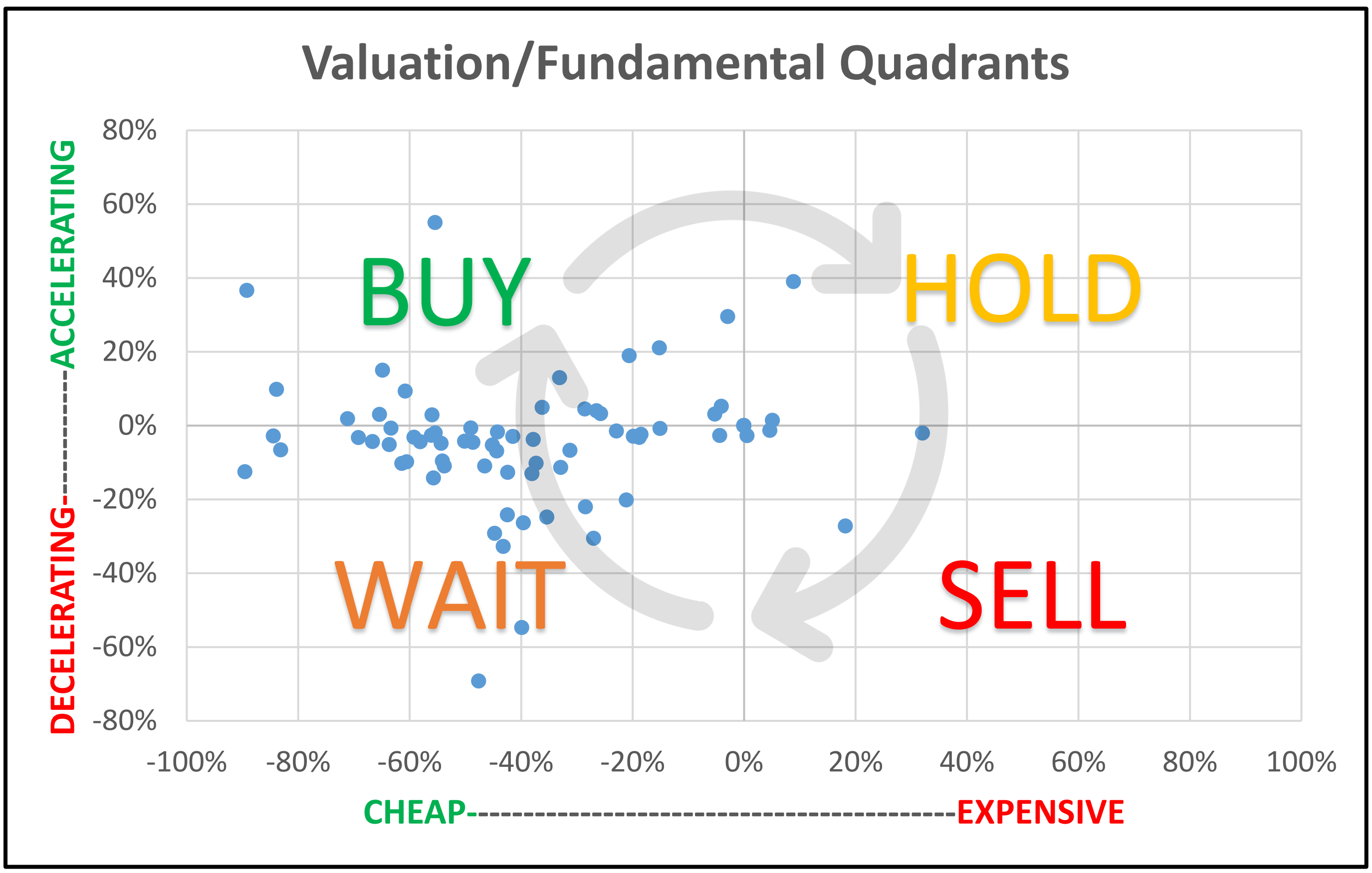
It's rare for our strategy to carry such low levels of risk, but as everyone knows we live in exceptional times. We remain of the opinion that many REITs still have serious downside risk and are happy to wait and watch for more compelling opportunities. As we have previously stated, the fund will continue to increase its exposure to high quality real estate portfolios with fortress balance sheets at highly discounted valuations. The fact that our net exposure remains very low is reflective of the fact that few of these opportunities currently exist.

Process – Value vs. Fundamentals

The reason we are stressing patience this month stems directly from our REIT investing process. While uncertainty is high across the board, one thing we can say for sure is that REIT fundamentals are deteriorating. Asking rents have fallen for almost every property type, development pipelines are paused, acquisition pipelines have dried up, and even the most optimistic REIT management teams are, at best, reiterating guidance (most REITs have pulled their full year forecasts).

This is important because investing in businesses with deteriorating fundamentals is NOT part of the Serenity process. As laid out in the chart below, we only want to be buying REITs when fundamentals are accelerating. This is where investors have the best chance of generating positive forward returns.

The chart below lays out our process philosophy in four quadrants. Value is on the X axis with fundamentals on the Y axis. You'll notice that with fundamentals accelerating, REITs qualify as either a "BUY", or "HOLD". The same does not hold for value. Buying REITs that are cheap only works when fundamentals are moving in the right direction. The bottom left of the chart below is an example of the classic "value trap" scenario. That would be a REIT that looks cheap, but just continues to get cheaper as their business gets worse. Our quant model and investment process are designed explicitly to avoid these types of scenarios. You'll also notice the majority of REITs currently fall into the "value trap" quadrant.



Another thing to point out is that the value trap quadrant is labeled with the word "WAIT." i.e. wait until fundamentals turn positive, then push your chips into the middle. We do NOT believe REIT fundamentals have bottomed, thus the theme of patience.

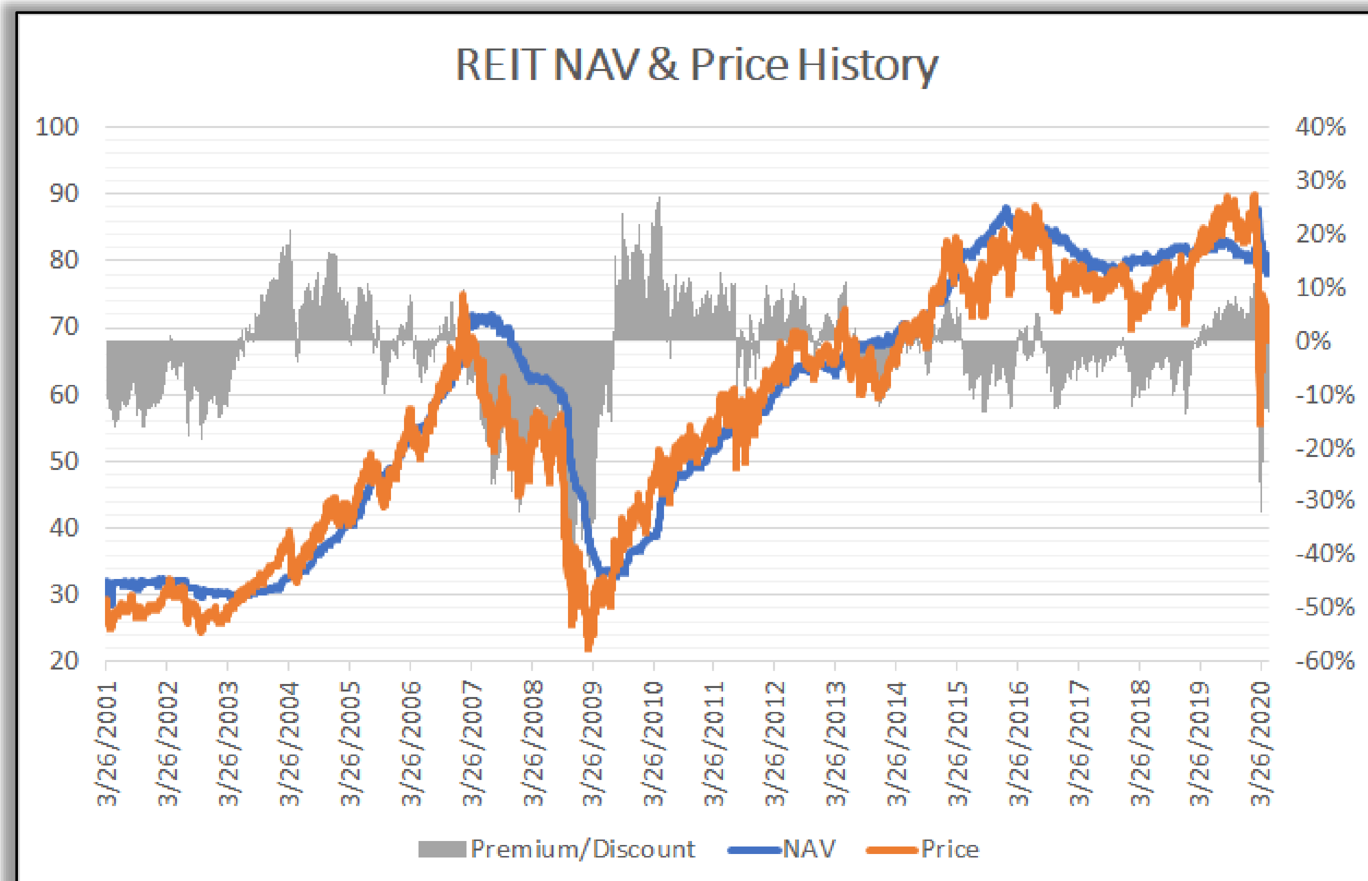
Perspective – NAV's in the age of the coronavirus

There are a plethora of reasons that we believe fundamentals have further to fall before bottoming out and creating a more investable scenario for the REIT market. A massive surge in unemployment is likely to pressure consumer facing landlords across the REIT universe (apartments, self-storage, retailers), as consumers ability and willingness to pay rent decreases meaningfully. Similarly, on the corporate side, continued uncertainty and falling revenues have put most corporate capex expenditures on ice, which will lead to lower leasing velocity and reduced pricing power for landlords of corporate tenants (office, warehouse, data center).

Put these together, and the result is likely to be lower occupancy, falling asking rents, negative same-store results in both revenue and NOI across the board for the REIT market. Some of these phenomena have already been confirmed in first quarter earnings, many of which contained updates that included the month of April. And this was BEFORE the second order effects of massively higher unemployment and our new socially distant working environment had truly taken hold.

To add a bit of perspective, we can examine the history of one of our favorite data series: Consensus Net Asset Value (NAV) estimates.

During the 2008-2009 crisis, NAV's for the broad REIT industry fell 51% from peak to trough. That was accompanied by a 60% drop in REIT equity prices. In the current environment, NAV's have fallen 11% from their February peak, while REIT prices are off 22%. The unemployment rate peaked at 10% in 2009, while it has already hit 14.7% in 2020.



Now there are numerous puts and takes here when trying to triangulate where REIT NAV's shake out. During the last crisis, REITs carried significantly more leverage, more development risk, and faced higher amounts of over-supply in many product types. That would suggest NAV's should not fall as much in this downturn. Then again, unemployment is already significantly WORSE in this episode than it was in 08-09, which is not a positive leading indicator for REIT demand, and thus net asset values.

The point here is that the current 10% draw-down in REIT NAV's may be only the beginning. Any "discounted" valuation being cited as a reason to buy REITs may evaporate over the course of the next 6-12 months as NAV estimates continue to fall.

If we say hypothetically that REIT values fall 25% during this recession, and at the bottom trade at a 10% discount to NAV, that means the entire space is at risk to fall an additional 15%.

Bottom Line: <u>The direction of fundamentals is extremely important when evaluating REITs</u>, as it can be the difference between buying a value stock and a value trap. With NAV's moving in the wrong direction, we prefer to wait and watch for more fundamental stability before wading into REITs with two feet.

Opportunity – Difficult, distressed investing is…

We would like to make one more point on valuation based on the questions I field every day. It's important to understand what is actually cheap in the REIT space currently, and what is not. Many investors have extremely quickly developed an appetite for "distressed assets," which in their view may include the REITs. When I inform them that distressed valuations are only truly available in lodging and retail REITs, they quickly decide to look elsewhere.

In my view, this attitude completely misses the point of distressed investing. Finding bargain basement prices requires investors to dig deeply into areas that the majority of investors hate (cough, retail, cough). But I digress…

For context regarding the chart on the next page, most REIT property types traded to AFFO multiples (cash flow multiples) in the 10-15x range during the 08-09 downturn. What you can clearly see is that the only property types in this bucket currently are healthcare, regional malls, and shopping centers (Lodging as well, if you substitute in 2021 AFFO estimates). That's it. The remainder of the REIT space trades in the 15-25x multiple range, which tends to be the normal range from the 2010-2020 cycle. Said another way, most REIT sectors are slightly cheaper than normal, but not significantly so.

Add to this the fact that some REITs are <u>more expensive than any time in their history</u>. Infrastructure, manufactured housing, and data centers continue to trade near all-time highs from both a price and multiple perspective. The chart below is from a recent blog post of ours exploring the question "Are REITs Cheap?"

REIT Group	2020 AFFO Multiple	Market Cap
Big 4 Tech REITS	**27.2x**	**$ 275,870**
REIT Simple Average	**14.2x**	**$ 1,008,290**
REIT Weighted Average	**20.7x**	**$ 1,008,290**
Retail Average	**9.5x**	**$ 85,170**
Lodging Average*	**9.3x**	**$ 21,689**

From that blog post "*The divergence within the REIT industry shown in this table is glaring. The top 4 tech focused REITs in our universe (AMT, CCI, DLR, EQIX) make up almost 30% of the REIT industry's market cap, and they trade at a 13x premium to the average REIT. Lodging and Retail REITs meanwhile, trade at less than 10x cash flow, and have shrunk to make up just 11% of the industry's market cap.*"

Property Sector	EV/2020 EBITDA	P/2020 FFO	P/2020 AFFO	Prem/Disc to Consensus NAV
Apartments	19.3x	16.3x	18.3x	(21.39%)
Data Centers	25.4x	28.3x	24.1x	17.73%
Diversified	15.6x	12.0x	13.0x	(25.72%)
Free Standing Retail	17.5x	15.1x	17.1x	(2.77%)
Health Care	13.7x	9.1x	10.6x	(15.61%)
Warehouse	26.0x	23.6x	27.1x	4.07%
Infrastructure	27.2x	31.1x	27.9x	
Lodging	37.2x	5.5x	27.7x	(45.33%)
Man. Homes	26.5x	27.8x	30.6x	10.84%
Office	18.8x	16.5x	17.6x	(27.67%)
Regional Malls	11.0x	5.7x	7.4x	(61.94%)
Self Storage	18.7x	16.8x	18.2x	(7.89%)
Single Family Rental	18.7x	16.8x	18.2x	(7.89%)
Shopping Centers	13.7x	8.9x	11.8x	(48.15%)
Specialty	12.7x	9.1x	9.6x	(28.30%)
Timber	19.3x	0.0x	0.0x	(35.94%)

This all illustrates that serious context is needed when discussing whether or not REITs are truly "cheap". If you focus on property types that are mostly empty, then yes, REITs are cheap. If you would rather invest in REITs with secular tailwinds such as data centers or warehouses, then the answer is a resounding "He#@ NO".

Finding Serenity – Unlearn what you have learned

Investing takes patience. Especially during a global pandemic, when 1/5 of the country has become recently unemployed. Investors would be best suited to ignore the ever-changing narrative, conquer their inner FOMO (fear of missing out), and embrace the ~~force~~ data.

REIT NAV's are moving in the wrong direction, macro-economic data is moving in the wrong direction, and many "cheap" REITs have a high probability of getting "cheaper". At Serenity, we continue to monitor high quality REITs with strong management teams for truly distressed pricing (which has been rare since mid-March). We also continue to be active on the short side, finding plenty of opportunities to hedge our portfolio using extremely expensive REITs with fundamentals teetering on the edge of deterioration.

As the current crisis unfolds, we will be patient and vigilant, consistently monitoring the REIT universe for signs of fundamental stabilization. As our favorite Jedi Master said "You will know (the good from the bad) when you are calm, at peace. Passive." Sounds like Serenity to me.

May the ~~force~~ data be with you,

Martin D Kollmorgen, CFA

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2020	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
Gross Returns	5.48%	(2.97%)	(5.70%)	3.75%									0.1%
Net Returns (1% &10%)	4.86%	(2.77%)	(5.58%)	3.67%									(0.2%)
Net Exposure	74%	65%	38%	1%									45%
REIT Index	1.16%	(7.93%)	(21.62%)	8.25%									(21.0%)

**All charts generated using data from Bloomberg LP, S&P Global, and Serenity Alternative Investments

References to the past performance of other private investment funds or the Manager are for informational purposes only. Other investments may not be selected to represent an appropriate benchmark. The Fund's strategy is not designed to mimic these investments and an individual may not be able to invest directly in each of the indices or funds shown. The Fund's holdings may vary significantly from these referenced investments. The historical performance data listed is for informational purposes only and should not be construed as an indicator of future performance of the Fund or any other fund managed by the Manager. The performance listed herein is unaudited, net of all fees. YTD returns for all indices are calculated using closing prices as of Jan 14th, the first day of the funds operation. Data is subject to revision.

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Our investment program involves substantial risk, including the loss of principal, and no assurance can be given that our investment objectives will be achieved. Among other things, certain investment techniques as described herein can, in certain circumstances, maximize the adverse impact to which the Fund's investment portfolio may be subject. The Fund may use varying degrees of leverage and the use of leverage can lead to large losses as well as large gains. Investment guidelines and objectives may vary depending on market conditions.