Our High Yield REIT Portfolio Designed to Outperform: 4Q Update

2CHYP is a value REIT portfolio with a goal of beating the REIT index through a combination of stock selection, opportunistic trading and fundamental diversification. We will open with why 2CHYP was formed and follow with the contents of the portfolio. Each stock is carefully selected and the portfolio curated to provide what we view as a superior mix of value, growth and dividend yield.

Impetus for creation

With each update of our 2CHYP portfolio I have talked about why we created this platform. Essentially, it boils down to a dissatisfaction with the ever growing trend of index based investing. In previous updates I laid out arguments for the advantages of active investing over passive investing including capture of mispricing, special situation analysis and the tendency of indexes to overweight the overpriced stocks. These active advantages are real and growing. As the market share of passive investing increases, the benefits of active investing will be split between fewer active investors, meaning more outperformance potential is available for each.

I believe in these arguments as strongly as ever, but today I want to discuss the emotional impetus for 2CHYP. Conventional wisdom says emotions and investing do not mix and one should only trade in a cold, calculated manner. True, but that does not mean emotions cannot be used as motivation to get up each day and grind out the research.

Ever since I was a kid I have loved competition. It began with basketball in the driveway and progressed to chess and tennis. There was never any financial benefit except perhaps a dinky little trophy for winning a local tournament. It wasn't about prizes, it was about the process. Training, improving and competing is a self-perpetuating cycle where each performance inspires the next level of training.

At a visceral level, I find the idea of passive investing to be disappointing as it is anti-competitive. Passive investing is voluntarily accepting average which I find unacceptable for myself, but the idea of accepting average on someone else's behalf is truly revolting. There is an ever growing swarm of so called "active managers" and roboadvisors who will place their clients in a slew of ETFs or other such vehicles that essentially match the benchmark with only minor differences. Not only are they accepting average on their client's behalf, but they are collecting a fee to do so. Such a platform basically guarantees negative alpha to the client in the magnitude of the fee.

True active investing involves position sizes that differ significantly from market weights based on some analysis which attempts to identify potential for superior returns. 2CHYP is truly active with trades

made as often as market opportunity presents itself. Historically, this has been an average of a few trades a week with substantial variance. As of 9/30/17 the portfolio holdings look like this.

The portfolio

Shown below are the stocks in 2CHYP with vital information including dividend yield and valuation.

2CHYP Portfolio 9/30/17								
Stock	Weight	Shares	Price	Market Value	FFO/share*	P/FFO	Indicated Dividend $	Yield %
BDN	4.55%	300	$ 17.49	$ 5,247.00	$ 1.36	12.86	$ 192.00	3.66%
CBL	6.92%	950	$ 8.39	$ 7,970.50	$ 2.20	3.81	$ 1,007.00	12.63%
CXW	4.65%	200	$ 26.77	$ 5,354.00	$ 2.44	10.97	$ 336.00	6.28%
GNL	8.47%	446	$ 21.89	$ 9,762.94	$ 2.13	10.28	$ 949.98	9.73%
GPT	7.88%	300	$ 30.25	$ 9,075.00	$ 2.08	14.54	$ 450.00	4.96%
IRT	5.74%	650	$ 10.17	$ 6,610.50	$ 0.75	13.56	$ 468.00	7.08%
JCAP*	6.96%	390	$ 20.55	$ 8,014.50	$ 1.56	13.17	$ 546.00	6.81%
KRG	1.76%	100	$ 20.25	$ 2,025.00	$ 2.05	9.88	$ 121.00	5.98%
MPW	9.12%	800	$ 13.13	$ 10,504.00	$ 1.30	10.10	$ 768.00	7.31%
PLYM***	6.32%	400	$ 18.21	$ 7,284.00	$ 1.74	10.47	$ 600.00	8.24%
SOHO	5.11%	1000	$ 5.89	$ 5,890.00	$ 1.06	5.56	$ 440.00	7.47%
STAG	8.11%	340	$ 27.47	$ 9,339.80	$ 1.69	16.25	$ 479.40	5.13%
UMH	8.10%	600	$ 15.55	$ 9,330.00	$ 0.75	20.73	$ 432.00	4.63%
UNIT*	9.20%	723	$ 14.66	$ 10,599.18	$ 2.53	5.79	$ 1,735.20	16.37%
WPG	4.70%	650	$ 8.33	$ 5,414.50	$ 1.75	4.76	$ 650.00	12.00%
CASH	1.03%			$ 1,181.47	$ -		$ -	
Dividends receivable	1.41%			$ 1,621.00				
Portfolio Total**	100.00%	n/a	n/a	$ 115,223.39	$ 12,648.17	8.89	$ 9,174.58	8.16%

*FFO/share is the 2017 consensus estimate provided by SNL Financial JCAP estimate is EPS guidance and UNIT is 2017 AFFO guidance
**Totals are for the entire 2CHYP portfolio including cash and dividends receivable. P/FFO is portfolio stock value over portfolio FFO
*** PLYM FFO reflects stabilization of recent purchases and full deployment on IPO proceeds

Deep Value
Quality Value

The basic idea of 2CHYP is that each stock is hand selected for its individual ability to outperform and then we aggregate these potential outperformers in a way that produces significant diversification. We do not hold any positions strictly for diversification benefits because the pool of undervalued stocks is sufficiently large and broad that we can achieve significant diversification without majorly sacrificing returns.

Positioned to outperform

Future performance can never be known, so please do not interpret this section as a promise. Instead, it is merely an explanation of why we think 2CHYP will materially beat the index going forward. In a nutshell, we think 2CHYP has a superior combination of value, growth and dividends. Let's put some numbers around this statement.

	2CHYP	SNL US REIT index
P/FFO*	8.89	19.00
Dividend yield	8.16%	3.84%
Payout ratio**	72.5%	73.0%

*2CHYP P/FFO is portfolio's value over aggregate FFO of holdings
the SNL REIT index P/FFO is the forward estimate provided by SNL Financial
**Payout ratio calculated as indicated portfolio dividends
over indicated FFO of aggregated holdings in the portfolio
Data as of 9/29/17 for 2CHYP and SNL index

The value of 2CHYP is extreme with the portfolio trading at a P/FFO of only 8.89X. That is less than half of the REIT index which has a P/FFO of 19.00X. Along with higher FFO comes the ability to pay larger dividends. 2CHYP has a dividend yield of 8.16% as compared to 3.84% for the index. Importantly, the higher yield does not come through aggressive payout ratios, as 2CHYP's FFO payout ratio is actually slightly lower than that of the index.

With more than double the FFO yield and dividends, one might think we are sacrificing growth or taking on extreme risk. I do not see either as the case. 2CHYP is littered with growth stocks at an individual stock level and at a sector level with overweights in industrial, telecom and manufactured housing which are the growthier REIT sectors.

Regarding the risk, an often misunderstood aspect of value is that the cheaper a stock gets the lower its risk is. Ceteris paribus, a lower market price for any given set of fundamentals both increases the upside potential and reduces the downside. Quite simply, if a stock is already trading near the liquidation value of its assets, a large portion of a negative outcome is already priced in. Most of the stocks in 2CHYP trade at discounts to NAV with some at massive discounts like CBL which trades at less than half of NAV.

The other risk mitigating aspect of 2CHYP is economic diversification. The portfolio holdings share minimal sensitivity to any single economic factor, with each subsector of REITs having materially different drivers. In the chart below, we have organized our holdings by fundamental exposure such that those in each group may move together but the groups should move uncorrelated from the other groups.

Fundamental exposure	Positions	Portfolio weight
Corrections	CXW	4.65%
Manufactured housing	UMH	8.10%
Retail	CBL, KRG, WPG	13.37%
Office	BDN, GNL	13.03%
Telecom	UNIT	9.20%
Industrial	STAG, GPT, PLYM	22.30%
Self Storage	JCAP	6.96%
Healthcare	MPW	9.12%
Hotel	SOHO	5.11%
Multifamily	IRT	5.74%
Cash		1.03%
Dividends receivable		1.41%
Total		100.00%

The only major economic factor exposure in the portfolio is industrial, but this is an intentional overweight and a risk I am happy to take in light of the fundamentals.

Industrial

The e-commerce boom may be hurting our 13.37% retail positions, but it is helping our 22.30% weight in industrial. Warehouses have excellent same store growth as the supply of properties is not fully keeping

up with the pace of demand growth. For e-commerce, roughly 3X (according to Prologis research) as much logistics space is needed per sale as compared to brick and mortal retail sales.

It seems likely to me that online sales will continue to increase in both market share and absolute volume. This suggests the demand boom for industrial space will continue. This is a fairly mainstream forecast which is why the industrial REITs, which stand to benefit from the trend, trade at premium multiples. With the sector trading expensively, I think a good portion of the upside is priced in so our the sector should perform in-line with the market.

However, 2CHYP stock selection is bottom up. There is no reason to pay the expensive multiples of the sector when we don't have to. Check out the valuation difference between our industrial and that of the market.

Stock	P/FFO 2018 est.
Plymouth Industrial (PLYM)	10.6X
Stag Industrial (STAG)	15.2X
Gramercy Properties Trust (GPT)	13.6X
Industrial REITs	19.2X

Source: SNL Financial, estimate is Capital IQ consensus

Through STAG, GPT and PLYM we get a similar exposure to the logistics boom that is presently occurring, but at a significantly reduced price. The blended multiple of our industrial REITs is 13.1X which is only 68% as expensive as the average industrial REIT.

Retail

The primary tailwind for industrial is the main headwind for retail as brick and mortar sales continue to move to online. While I believe some of the stress is real, the doom and gloom forecasts of the death of retail are greatly exaggerated in my opinion.

Rather than killing retail, the pressure from e-commerce will simply force retail REITs into a costly transition in which substantial capex needs to be invested to maintain revenue. We see this with REITs like CBL & Associates (CBL) and Washington Prime Group (WPG) using nearly half of their distributable cashflow for capex as they transition properties to become entertainment destinations.

The market seems to be viewing this as the new runrate for capex, but it is finite. Once the properties are transitioned they should be stable without the need for additional capex. At that time, the cashflows will be unlocked for investors and given the FFO yield of CBL and WPG around 20%, the upside is material.

Kite Realty Group (KRG) is a lighter version of CBL and WPG in that it is suffering far less currently due to the grocery anchored nature of its properties which conveys resilience against e-commerce. On the flip side KRG is not quite as cheap so the upside is smaller as well.

With extremely low stock prices there is often a hysteria or stigma that clouds the market's perception of fundamentals, so I want to emphasize the actual numbers of these companies over recent quarters and years.

- CBL - sales per square foot are slightly up and same store NOI is about flat
- WPG – sales per square foot are slightly up and same store NOI is about flat
- KRG – FFO/share and same store NOI are growing materially

Importantly, the quality of each of these companies' portfolios has increased as most of the lower quality assets have been sold or turned back to the lenders.

Retail is not a growth sector, but its actual numbers are decent. Overall, we are significantly underweight retail, but this is merely a snapshot in time and not an intentional positioning. Essentially, the underweight is due to our recent sale of Whitestone REIT (WSR) which had a sizable price increase which allowed us to take profits. I would not be surprised to see another retail stock enter the portfolio in the near term.

Office

We are generally bearish on office due to the high TI and LC upon tenant turnover as well as the current supply and demand dynamics which favor the tenants over the landlords. However, GNL and BDN are exceptions as detailed below:

Global Net Lease (GNL) has a roughly 10 year remaining lease term so tenant turnover will not be an issue for quite some time. The currently contracted revenues exceed the entire value of GNL's stock and these are with the highest percentage investment grade tenants of any triple net REIT. GNL's dividend is higher than other NNNs and its FFO multiple is lower which allows the nearly 10% yield to be fully covered.

Brandywine Realty (BDN) has found a way to circumvent the problems of the office sector by having a truly dominant market share of the trophy class properties in Philadelphia. This affords it far better negotiation power on tenant turnover, significantly reducing TIs and perhaps capture of higher rents as well. For our full buy thesis on BDN, please feel free to check out this article.

Mulfifamily

We are neutral on the multifamily sector overall as strong demand drivers are being balanced out by high supply. Our opinion changes a bit at a regional level in which we are bearish on the top MSAs as these cities have the most supply growth and we are bullish on the portions of the country which have stronger job and population growth.

Independence Realty Trust (IRT) is in these MSAs with its property locations boasting higher growth than the national average and rents significantly lower as a percentage of household income. This affords a greater degree of organic growth than in other areas where rents may be topping out. Additionally, IRT trades at a significantly discounted multiple relative to peers.

Hotels

Those who were following my work back in 2013 may recall that I was quite bullish on hotels, but more recently, I have become bearish. Quite frankly, I lacked an understanding of the industry vertical which is quite unfavorable to hotel owners, causing profits to largely be allocated to the online travel agencies and the major brands. These structural problems already existed in 2013 so I regrettably have to admit that my analysis was wrong.

Overall, we are bearish on the sector, yet remain bullish on Sotherly Hotels (SOHO) due to 2 differentiating factors:

1) Extreme value: SOHO's NAV, using an 8% cap rate, is about $12 compared to a price around $6
2) SOHO is successfully transitioning its properties to be independently flagged which circumvents brand fees.

It could take a while for SOHO's value to be realized in its market price, but a well covered 7.5% yield makes waiting acceptable to us.

Healthcare

Healthcare REITs are a tricky place to invest right now. MOBs are expensive, senior housing has excessive supply growth, skilled nursing facilities are having reimbursement issues and the legislative future remains uncertain.

I believe hospitals are the way to go for 3 reasons:

1) Hospitals are unequivocally essential to the wellbeing of their communities
2) Supply is kept in check through certificates of need
3) Tenant EBITDAR coverage ratios remain quite strong

Medical Properties Trust (MPW) stands alone as the only pure play hospital REIT. It has a stellar record of FFO/share growth and currently trades at a multiple less than 10X. We have met with management and consider them to be the best healthcare REIT management. This has been a long term holding and will likely remain in the portfolio unless something changes significantly.

Self-Storage

When it comes to investing and punditry, far too much importance is placed on the second derivative of earnings with growth (first derivative) and FFO getting overlooked. Specifically, the fears surrounding self-storage are related to the deceleration of growth and no one seems to care that growth remains fairly strong. Just because growth was 15% 2 years ago and 10% last year does not make the 5% this year a bad thing (these are rough numbers and vary company to company). In fact, 5% same store growth is better than nearly any other REIT sector.

The pundits seem to be extrapolating the rate of change of the rate of change in a straight-line fashion as if growth will be 0% next year and -5% the next.

History says something different. Even in the worst recession of recent history, self-storage same store growth went only slightly negative. In this cycle, I estimate it will drop to about 0%-3% as the fundamentals are substantially better with the only real problem being supply coming in.

Jernigan Capital (JCAP) represents the beneficiary of that supply growth as it is a financier of self-storage development. Through this "downturn" in the self-storage cycle JCAP will continue to collect the interest on its loan assets and it can come out the other side as an equity REIT since JCAP has options to purchase the properties at cost as the loans mature. Its asset portfolio is significantly higher in quality than that of Public Storage with nearly all of its properties climate controlled and very new.

Manufactured Housing

MH fundamentals are quite strong due to the sheer economic viability of the product for the end user. Houses are expensive at the moment and apartment rents are over 30% of household income in many places. MH is the obvious alternative with high living standards relative to the cost. Whatever apartment or home a customer can normally afford, MH will give that customer more square footage in a newer facility for a cheaper price. Sure it might use laminated particle board instead of solid wood, but for large swaths of the economy, this is a worthy tradeoff. As the stigma surrounding MH continues to lessen, we anticipate demand rising.

MH REIT fundamentals are taken to the next level when this demand growth is paired with limited supply due to zoning restrictions. The NIMBY (not in my back yard) nature of MH makes new permits difficult to obtain, thereby protecting the value of those areas already zoned for MH.

Any of the 3 MH REITs will be strong fundamentally, in my opinion, but 2 of them are just too expensive. UMH Properties stands alone as a means of investing in these fundamentals at a value price. Additionally, we think UMH has relatively more growth ahead of it as it is still shifting to the rental model. It is a true growth REIT with potential for double digit FFO growth annually for at least 5 years, yet its current multiple is quite reasonable.

Corrections

Core Civic (CXW) is an excellent diversifier as its fundamentals are tied to factors that are entirely unrelated to other REITs. Additionally, we think CXW is a good value play on its own due to a low P/FFO multiple of just 11X. Further, CXW may be at trough earnings as the adverse impact of the former Attorney General ruling to not use private prisons rolls off.

Presently the dynamics are such that publicly owned prisons are overcrowded with occupancy in many cases over 100%, meaning more prisoners than the facilities were designed to house. Simultaneously, there are significant vacancies in privately owned prisons. Going forward, with the new AG being far friendlier to private prisons, I think the path of least resistance is for the occupancy levels to even out. This means new contracts for CXW and more revenues from the facilities it already owns.

Telecom

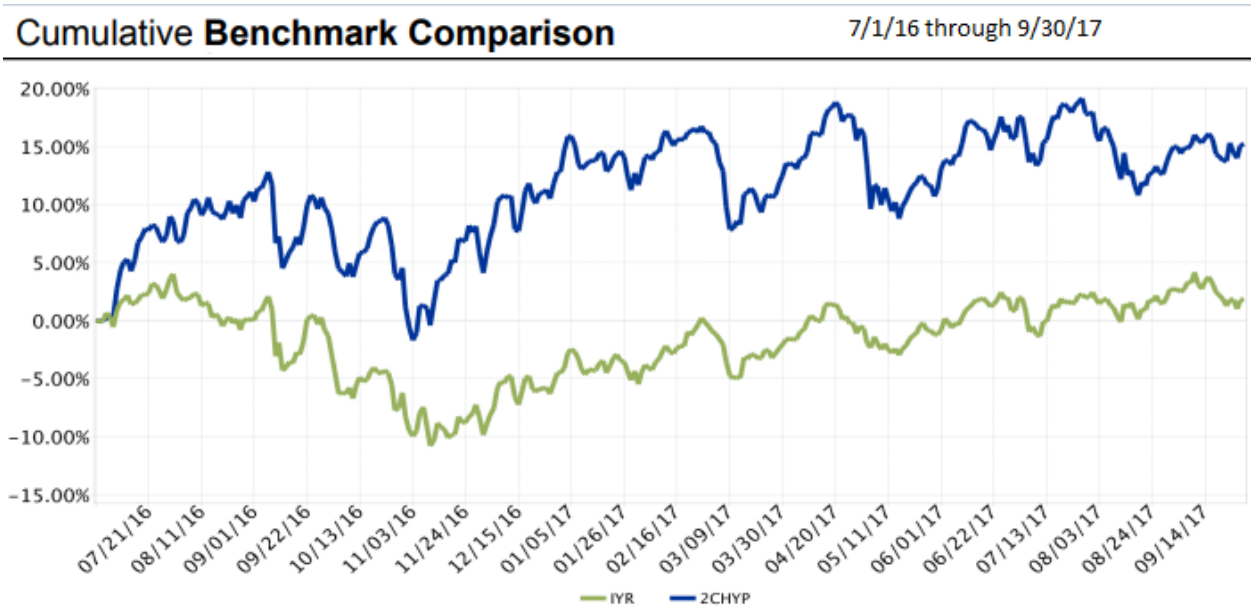
Uniti Group (UNIT) is the subject of much debate as its primary tenant, Windstream (WIN), is in a period of transitioning its business to more enterprise solutions as RLEC (rural local exchange carrier) revenues churn away. We have already discussed our take on Uniti at length so I will refer you to our full thesis and update here and here.

In the fall of Uniti's market price, I think there are certain factors that have been overlooked. UNIT is not distressed. In fact, it just had its best ever quarter and introduced strong guidance for 2018. Windstream is not bankrupt nor anywhere near bankrupt. Its credit rating is B according to S&P which is not investment grade, but it's not CCC- either. WIN has positive OIBDA with about $2B annually with which to pay UNIT's lease. It is at this level that UNIT's lease falls because it is essential to operations. That $2B OIBDA disappears if they were to default on UNIT's lease so even if bankruptcy happens, I think it is likely UNIT will be paid in full.

UNIT's market price is distressed, its business is not.

Performance

Since 2CHYP's inception on 7/1/16, the iShares US REIT index ETF (IYR) has returned 1.87% and 2CHYP has returned 15.22%. We use this benchmark as a basis of comparison because it is a prominent ETF focused on REITs. Shown graphically, our performance looks like this:



Source: Interactive Brokers LLC. Past performance does not guarantee future performance
Markets are uncertain and there is no level of performance we can guarantee.
Trading of equities can result in material or total loss of principal.

another relevant comparison would be the MSCI US REIT total return index (RMS) which returned -1.00% over the 5 quarter period. Since inception we have beaten the IYR by 1335 basis points and the RMS by 1622 basis points.

Performance attribution

As you can see on the chart above, most of our alpha occurred early with peak alpha in the first months of 2017. In the last couple quarters we have been approximately flat relative to the benchmarks. So what happened?

A few of our portfolio positions crashed. SOHO is down over 10% from recent highs, JCAP fell over 15% and UNIT is down nearly 50% from its recent high.

I think the stability of 2CHYP's returns in the face of 3 positions with significant weights crashing illustrates 2 things:

1) Our stocks are quite asynchronous with idiosyncratic fundamentals. With minimal fundamental similarities, drops in one stock are not contagious to others. While these drops occurred, other areas of our portfolio were doing quite well.

2) Active management can mitigate risk simply by paying attention. New Senior Investment Group (SNR) fell to the low $9 range, but we sold for a profit at $10.14 before the fall as weak fundamental news came out relating to tenant EBITDAR coverage. Other strong trades which helped to keep our

portfolio's returns healthy include an arbitrage of Felcor Lodging's merger with RLJ and a quick purchase of WSR after the hurricane drop.

When market pricing is not playing nicely with us we will attempt to mitigate damage and hopefully slingshot out when things normalize. Presently I think there is a tremendous disparity between the intrinsic value of our portfolio holdings and the market prices. Eventually, the prices will reflect intrinsic values, so I think there is an upward draft under 2CHYP's holdings.

That being said, it remains quite possible that I am simply wrong about the intrinsic values. History shows that I bat nowhere near 1000. I will almost certainly be wrong about some of these stocks and perhaps wrong about many of them.

Important Notes and Disclaimer

The holdings presented were the entire holdings of 2CHYP as of 9/30/17, but may not represent the holdings for other time periods. We do not intend presentation of 2CHYP's holdings as a recommendation, but rather as a statement of historical fact.

We cannot determine whether the portfolio holdings presented are suitable for any given reader. Readers are encouraged to contact their financial professional to discuss the suitability of any strategies or holdings prior to implementation in their portfolio.

The specific securities identified and described herein do not represent all of the securities purchased or sold for advisory clients of 2nd Market Capital Advisory Corporation (2MCAC). It should not be assumed that investments in the securities identified and described were or will be profitable.

A list of all prior purchases and sales made by the investment advisor representative (Dane Bowler) in the 2CHYP portfolio is available upon request. It should not be assumed that purchases and sales made in the future will be profitable or will equal the performance of the securities in this list.

All content that relates to 2CHYP's future performance are considered forward-looking statements. These forward-looking statements involve uncertainties that could cause actual performance or results to materially differ, and readers are cautioned not to place undue reliance on them.

Benchmark Comparison: 2CHYP is compared to the iShares U.S. Real Estate ETF because it is a common method for investing in a portfolio of REITs and we view it as a competitor or alternative to 2CHYP. IYR has fees that are factored into performance, while 2CHYP does not have a fee aside from trading commissions which are factored into performance. 2CHYP's dividends are reinvested, while IYR's dividends are paid but not reinvested. We also compare 2CHYP to the RMS which has no fees and reinvests its dividends.

Strategy and market conditions: 2CHYP uses a bottom up stock selection process which may fare better in certain market conditions than in others. It may perform better when value is in favor or worse when value is out of favor.

Expenses: Returns reflect the deduction of any transaction expenses. There are no costs or management fees charged nor deducted.

Past performance does not guarantee future results. Investing in publicly held securities is speculative and involves risk, including the possible loss of principal. Historical returns should not be used as the

primary basis for investment decisions. Although the statements of fact and data in this article have been obtained from sources believed to be reliable, 2MCAC does not guarantee their accuracy, and assumes no liability or responsibility for any omissions/errors.

Calculation Methodology: 5 quarter return for the period 7/1/16 through 9/30/17, unaudited. Dividends in 2CHYP are reinvested.

Disclosure: 2nd Market Capital and its affiliated accounts are long BDN, CXW, CBL, GNL, GPT, IRT, JCAP, KRG, MPW, PLYM, SOHO, STAG, UMH, UNIT and WPG. I am personally long BDN, CXW, CBL, GNL, GPT, IRT, JCAP, MPW, PLYM, SOHO, STAG, UMH, UNIT and WPG. This article is for informational purposes only. It is not a recommendation to buy or sell any security and is strictly the opinion of the writer. Investing in publicly held securities is speculative and involves risk, including the possible loss of principal. The reader must determine whether any investment is suitable and accepts responsibility for their investment decisions. Commentary may contain forward looking statements which are by definition uncertain. Actual results may differ materially from our forecasts or estimations, and 2MCAC cannot be held liable for the use of and reliance upon the opinions, estimates, forecasts and findings in this article.