2CHYP Analytics 3Q18 Update

On July 1st 2016, we commenced trading in 2CHYP, our high yield REIT portfolio, with the explicit goal of maximizing total return. These analytics will detail the holdings of 2CHYP heading into the 4th quarter along with the diversification, high yield and deep value of the portfolio in absolute terms and relative to the index. First, however, I want to discuss why maximizing total returns was chosen as the goal for this portfolio and how intelligent diversification is crucial to achieving this goal.

Total Return Focus

Total returns are the Holy Grail of investment.

High yield strategies that lack a total return focus often get most of the dividends from a return of capital. The high initial yield may seem nice at first, but over time the principal erodes and eventually there is not enough capital left to fuel the income the investor was seeking.

Low volatility or low beta strategies seem appealing as the historic stability of value makes it appear less risky. However, historic stability has little bearing on future stability, so low beta or low volatility investments can become high volatility when things change.

- Treasuries are low volatility until interest rates spike
- General Electric was low volatility until its collapse

Even if these instruments work as intended, I would argue they do not accomplish an investor's goal. None will help an investor increase their purchasing power. None of these will help an investor retire comfortably.

Total return is the only way to reliably increase purchasing power through investment and more total return is better than less. Therefore, 2CHYP is focused on maximizing total return.

As a means of generating return we have set up a dividend engine that is fully supported by the high FFO yield that comes with investing in undervalued securities. Without further ado, here is our portfolio heading into the 4th quarter.

2CHYP Portfolio 9/30/18								
Stock	Weight	Shares	Price	Market Value	FFO/share*	P/FFO	Indicated Dividend $	Yield %
CBL-E	5.78%	500	$ 15.01	$ 7,505.00	n/a	n/a	$ 828.13	11.03%
CTT	3.26%	370	$ 11.43	$ 4,229.10	$ 0.63	18.14	$ 199.80	4.72%
CXW	9.80%	523	$ 24.33	$ 12,724.59	$ 2.32	10.49	$ 899.56	7.07%
FPI	4.75%	1000	$ 6.17	$ 6,170.00	$ 0.53	11.64	$ 200.00	3.24%
GNL***	2.41%	150	$ 20.85	$ 3,127.50	$ 2.06	10.12	$ 319.50	10.22%
IRM***	8.64%	325	$ 34.52	$ 11,219.00	$ 2.94	11.74	$ 763.75	6.81%
JCAP****	5.80%	390	$ 19.29	$ 7,523.10	$ 2.81	6.86	$ 546.00	7.26%
KIM	5.48%	425	$ 16.74	$ 7,114.50	$ 1.45	11.54	$ 476.00	6.69%
MPW	9.19%	800	$ 14.91	$ 11,928.00	$ 1.40	10.65	$ 800.00	6.71%
PLYM	3.58%	300	$ 15.50	$ 4,650.00	$ 1.30	11.92	$ 450.00	9.68%
RLJ	10.18%	600	$ 22.03	$ 13,218.00	$ 2.31	9.54	$ 792.00	5.99%
STAG	4.49%	212	$ 27.50	$ 5,830.00	$ 1.78	15.45	$ 300.96	5.16%
UMH	10.24%	850	$ 15.64	$ 13,294.00	$ 0.77	20.31	$ 612.00	4.60%
UNIT***	7.76%	500	$ 20.15	$ 10,075.00	$ 2.53	7.96	$ 1,200.00	11.91%
WPG	7.03%	1250	$ 7.30	$ 9,125.00	$ 1.47	4.97	$ 1,250.00	13.70%
CASH	0.07%			$ 96.00	$ -		$ -	
Dividends receivable	1.52%			$ 1,967.95				
Portfolio Total**	100.00%	n/a	n/a	$ 129,796.74	$ 11,983.47	10.03	$ 9,637.69	7.55%
*FFO/share is the 2018 consensus estimate provided by SNL Financial.								
**Totals include cash and dividends receivable. P/FFO is calculated as portfolio common stock value over portfolio FFO.								
*** IRM GNL and UNIT earnings figures are consensus 2018 AFFO								
****JCAP earnings figure is 2018 consensus EPS								
Deep Value								
Quality Value								

We have color coded the stocks in 2CHYP (yellow and green) with deep value referring to those which are subject to real headwinds which we believe are already priced in and quality value referring to those that are industry leaders or are high growth.

We believe these stock picks and weightings position 2CHYP better than the broader REIT market with vastly deeper value and a larger dividend yield that is well covered by FFO. Specifically, 2CHYP's P/FFO is 10.03X compared to 18.12X for the broader market.

	2CHYP	SNL US REIT index
P/FFO*	10.03	18.12
Dividend yield	7.55%	4.00%
Payout ratio**	73.5%	72.5%

*2CHYP P/FFO is portfolio's common stock market value over aggregate FFO of holdings
As aggregate FFO is not readily available for the SNL REIT index P/FFO is the forward estimate provided by SNL Financial.
**Payout ratio calculated as indicated portfolio common stock dividends
over indicated FFO of aggregated holdings in the portfolio
Data as of 9/30/18 for 2CHYP and SNL index

This higher FFO yield supports our current 7.55% dividend yield with a comfortable payout ratio of 73.5%. In comparison, the SNL REIT index has a 4.00% dividend yield with a similar payout ratio of 72.5% (calculated by inverting the multiple of the index to get FFO yield).

I posit that these metrics have been achieved in an intelligently diversified portfolio and this requires avoiding the pitfalls to which many fall victim.

The fallacies of diversification

Financial academia as well as financial media have presented a rather biased view of diversification in which it is presented as unequivocally good. This is incorrect, as it is fundamentally neutral. There are good characteristics along with bad ones and only by understanding both can one truly use diversification to their advantage. For clarity, let us define diversification as referring to the exposure of a portfolio to various factors. The smaller a portfolio's largest exposure to a single factor, the more diversified it is.

Diversification has 4 effects:

1) Reduction in magnitude of harm from adverse change in a factor
2) Increase in frequency of harm from adverse change in a factor
3) Reduction in magnitude of benefit from favorable change in a factor
4) Increase in frequency of benefit from favorable change in a factor

Of these 4 effects, number 1 is the only effect that gets any substantial coverage in financial media or academia, but all 4 of these effects are precisely equal in magnitude and mathematically sum to zero.

To illustrate this concept, consider 2 portfolios: 1 with equal exposure to 100 factors and the other with exposure to only 10. For simplicity, let us say that there are only 100 total factors.

If something goes wrong in one of the factors, the more diversified portfolio is guaranteed to get hit by it. The magnitude of impact will be rather small as it only has a 1% exposure to any given factor, but the portfolio will be hit by something just about every day.

Conversely, the less diversified portfolio in this example has a 90% chance to fully evade the troubled factor. However, if it gets hit, the harm is 10X greater.

The point I am trying to make here is that the absolute level of risk is the same in both portfolios it just comes in different styles.

The more diversified portfolio has a 100% chance of damage of magnitude 1 while the less diversified portfolio has a 10% chance of damage of magnitude 10. The net risk to each portfolio (magnitude of harm multiplied by frequency of harm) is identical.

Humans are risk averse by nature which causes investors to almost universally prefer the more diversified portfolio. I also prefer to have a well-diversified portfolio, but there are good and bad ways of going about it. The key is to attain said diversification as efficiently as possible.

More stocks ≠ more diversification

Most of you have probably seen the statistics showing how weak the performance of active stock managers has been in recent years. A big cause of this weakness is too many stocks. Even the greatest minds are limited in the number of home runs they can find, so one really needs to get milage out of the great picks. If the home runs are 2% positions diluted into a monstrosity of a portfolio with 60 holdings, they simply will not move the needle enough. Inevitably, the performance of the 60 stock portfolio will look somewhat like the index and that is before fees.

Having too many stocks dilutes returns. The alpha of the best picks is spread too thin and the whole motivation to build a 60 stock portfolio is predicated on the faulty notion that more stocks translates to more diversification.

The Vanguard Real Estate ETF (VNQ) holds 185 stocks, so common wisdom suggests it must be really diversified, but consider the following question.

How much diversification is the 15th office REIT adding?

I would argue almost none as its fundamental exposures are nearly the same as the other 14. If macro events happen that harm demand for office space, it will lose value along with the rest. The VNQ's fundamental exposures are as follows:

Equity sector diversification

	Real Estate ETF as of 08/31/2018
Diversified Real Estate Activites	0.20%
Diversified REITs	4.60%
Health Care REITs	9.10%
Hotel & Resort REITs	5.80%
Industrial REITs	6.30%
Office REITs	10.70%
Real Estate Development	0.50%
Real Estate Operating Companies	0.30%
Real Estate Services	2.70%
Residential REITs	13.50%
Retail REITs	14.80%
Specialized REITs	31.40%

Source: investor.vanguard.com

For having 185 stocks, it has some significant concentrations, and there are some fundamental exposures it is almost completely ignoring.

It has almost no exposure to corrections, farmland or manufactured housing. From a fundamental exposure perspective, I would argue that despite having only 15 stocks as of 9/30/18, 2CHYP is just as diversified with the following exposures.

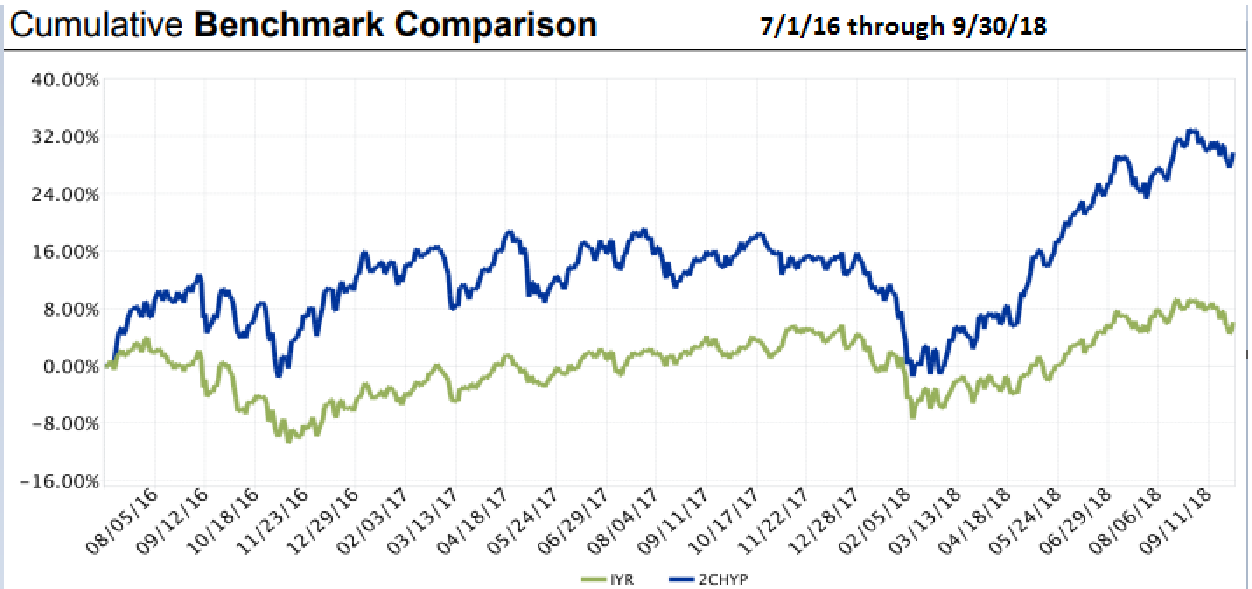
Fundamental exposure	Positions	Weight
Corrections	CXW	9.80%
Manufactured housing	UMH	10.24%
Retail	WPG, KIM, CBL-E	18.29%
Office	GNL	2.41%
Telecom	UNIT	7.76%
Industrial	STAG, PLYM	8.07%
Self Storage	JCAP	5.80%
Healthcare	MPW	9.19%
Hotel	RLJ	10.18%
Data security	IRM	8.64%
Timberland	CTT	3.26%
Farmland	FPI	4.75%
Cash		0.07%
Dividends receivable		1.52%
Total		100.00%

Our largest factor weights are in retail, manufactured housing and hotels and these higher weights are intentional. All 3 of these sectors are cyclical in nature and we are of the belief that the economy is likely to remain strong for at least a year.

The idea is that we have high exposure to idiosyncratic, company specific risk and a reduced exposure to factor risks. The company specific risk is an exposure we want because we have researched these stocks and believe the reward to risk is favorable in each of them.

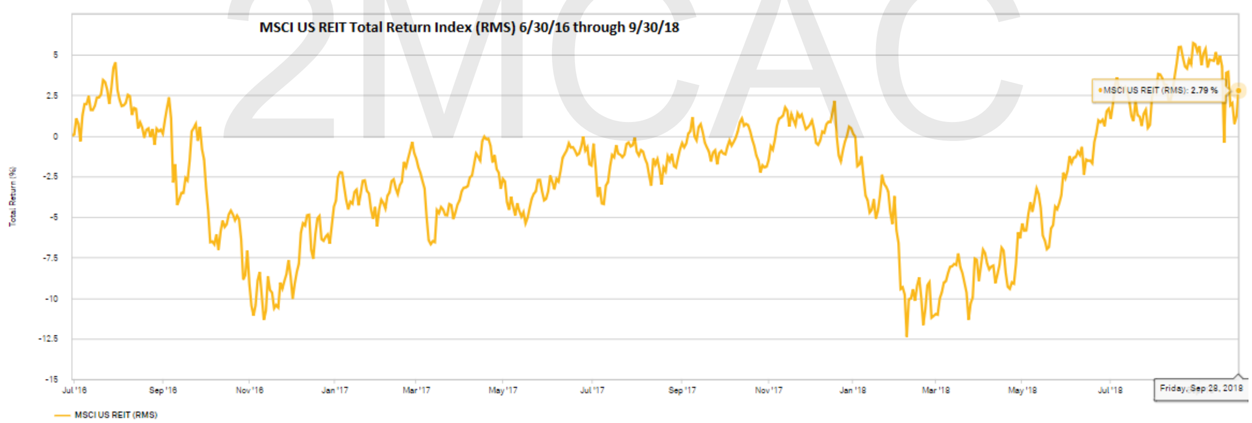
We will undoubtedly be wrong about some of them, with a goal of being right more than wrong.

A variety of stocks have in aggregate produced a total return of 29.8% from inception on 7/1/16 to 9/30/18. Over the same time period, our benchmark, the iShares US Real Estate ETF (IYR), has returned 6.07%.



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 reasonable comparison would be the MSCI US REIT index (RMS) which returned 2.8% over the same 9 quarters ended 9/30/18.

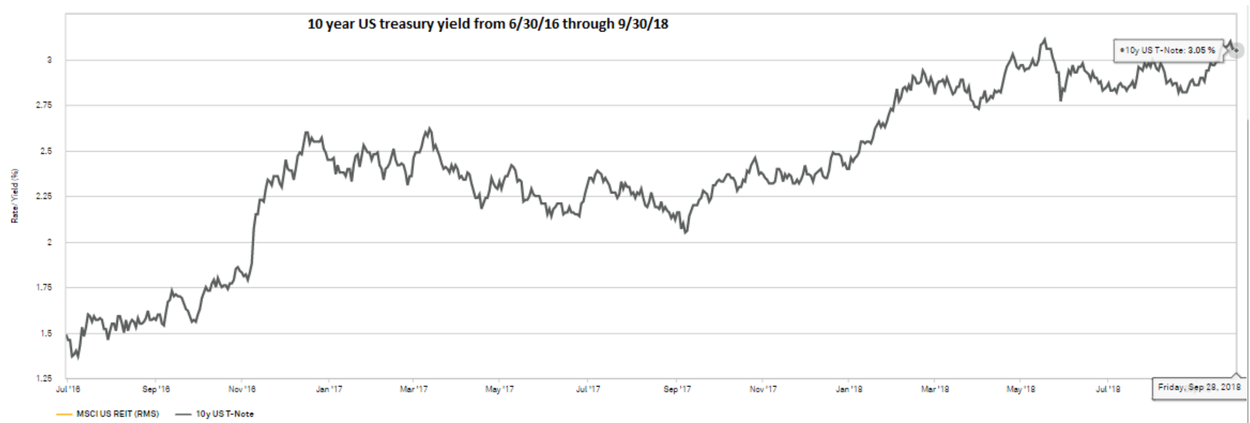


Source: SNL Financial

We are proud of this track record and will work tirelessly to improve upon it going forward.

REIT outlook

It has been a weak 9 quarters for REITs with just above flat performance as shown by the RMS above. The primary reason for this has been rising interest rates which the market believes to hurt REITs. Specifically, the 10 year yield moved from 1.49% on 6/30/16 to 3.05% on 9/30/18.



Source: SNL Financial

Despite the market voting with its feet, there is little evidence to suggest this has harmed REIT fundamentals. The primary risk to REITs would be debt becoming more expensive as interest rates rise, but even with 10 year treasury rates increasing 156 basis points, revenue growth outpaced interest expense growth.

In 2Q16, recurring EBITDA coverage of interest expense was 3.97X and in 2Q18, recurring EBITDA coverage was 4.31X (data from SNL Financial).

The reason behind this is quite simple. REITS are operating businesses and when the economy is broadly growing, they grow too. Rental rates across most REIT sectors have increased materially and occupancy rates are healthy.

We view the dismal market price performance as an opportunity to invest in improved REIT fundamentals without having to pay for the strength. It is this disparity between fundamentals and price that affords the opportunity to build a portfolio with a nearly 10% FFO yield that comfortably covers a 7.55% dividend yield. There are presently many REITs trading at deep values and high yields which allows us to be picky about which ones we own. Each of the REITs in 2CHYP has been hand selected for its individual potential to outperform.

Industry leaders

Value investing is not often associated with industry leaders, but unusual pricing has brought these market dominating REITs to value multiples.

Iron Mountain (IRM) is the global leader in physical data storage and is leveraging their position to accretively move into the data center space. Data center cap rates are typically low, but IRM can achieve higher IRRs through their synergies of being able to convert existing physical data customers into digital data customers. They get paid to upload files and a higher margin upon completion. Data center REITs trade at high multiples, yet IRM is available at under 12X AFFO. I consider this clear mispricing.

Core Civic (CXW) is the leader in private correctional facilities with nearly a 50% market share. At a Federal level they have replaced BoP tenancy with ICE and US Marshalls which have historically been far stickier tenants. Its growth comes at the state level with a build-to-suit facility with Kansas and similar ventures in the pipeline. We see opportunity for organic growth through lease-up of existing space along with a sizable acquisition and development pipeline. CXW is presently at trough FFO with significant upside to normal earnings.

CatchMark Timber (CTT) has a dominant market share of the southeast lumber market and is using its scale to achieve consistently higher stumpage price realization than the southwide averages. Over recent history there has been an imbalance between mills and timberland with too few mills which has allowed the millers to capture excess profits at the expense of timber. This dynamic is changing with many new mills coming on line. This should improve profitability for the timber companies, causing EBITDA accretion for CTT.

Medical Properties Trust (MPW) is the leading hospital landlord and has demonstrated itself to be one of the most reliable healthcare REITs. Even as difficulties hit the sector causing blue-chips like Ventas to falter, MPW has continued to grow FFO/share. Keys to its success have been high EBITDAR coverage of its tenants and a focus on real estate first. The high EBITDAR ratio has reduced the number of tenant bankruptcies they have had to deal with relative to the rest of the sector, and the real estate focus has facilitated swift replacement of tenants when bankruptcies have occurred.

Uniti Group (UNIT) is one of the largest owners of fiberoptic cable in the US. Occupancy works differently with fiber in that the use of different frequencies affords simultaneous transmission from many different sources. This causes much of Uniti's fiber to be able to take on additional tenants even when it is already leased. When additional tenants rent fiber that is already used, there is minimal extra cost, causing rent to flow directly to the bottom line. The Windstream debacle is causing UNIT shares to trade at a multiple well below where tech REITs typically trade. Our analysis suggests this scenario is likely to play out favorably for UNIT, but it is still a higher risk security.

UMH Properties (UMH) is the dominant provider of manufactured housing in the rust belt. Manufactured housing is ideal for America's workforce as it provides the best value in terms of quality and square footage relative to price. For many Americans, housing is taking up over 35% of annual income, while others simply cannot afford to leave their parent's basement. Manufactured housing is the solution and UMH has figured out the best way to deliver this value. Through buying up poorly managed communities and outfitting them with services and standards of conduct, UMH can attract workers who are on their way up. Over time, this improves the public perception of these communities and facilitates rental rate and occupancy growth which have led to a long track record of nearly double digit same store NOI growth for UMH.

Blood in the streets

These REITs have legitimate headwinds that are adversely impacting earnings or growth. However, the price reaction has been so severe that we believe they represent opportunity despite the somewhat difficult operating environment.

CBL Properties (CBL) Preferred E (CBL-E) represents a safer tranche in the capital stack where things would have to go severely wrong before it loses value. We did a sensitivity analysis to determine the breaking points where common value drops to zero. Using a 9% cap rate, NOI would have to drop an additional 18% before Preferreds start to lose value. From a cashflow standpoint, revenues would have to drop by nearly 34% before coverage of the Preferred dividend drops below 1X. CBL is a messy stock, but the seniority of the preferred adds a layer of protection that we think is sufficient to make the over 11% yield worth the risk.

Kimco (KIM) has not traditionally been considered a risky stock, often viewed as a gold standard for shopping center REITs. Only recently has its multiple dipped to ranges where we would even consider owning it. Kimco appears to have been caught in the general downdraft of retail REITs, as its fundamental performance has remained strong. Despite the challenges facing retail in recent quarters, KIM has consistently had positive same store NOI growth. This resilience does not match an 11.5X multiple and we believe it makes KIM opportunistically priced.

Farmland is facing some real headwinds. Trade concerns have made distribution routes challenging for US farmers and particularly for soybean farmers. When this is layered onto low commodity prices and the reduced farm income of recent years, farmers are having some tough times. However, farmland is a perpetual asset. It is not valued on how much income it can produce this year or next year. It is valued on its perpetual income generation potential and this has not changed. Global food demand continues to rise and is even accelerating as 3rd world countries get wealthier and their people begin to want more protein based diets. Commodity prices have always been volatile and they have always normalized. I do not see an inflection point strong enough to break a multi-century long trend. Farmland is almost never available at huge discounts to USDA value estimates and it still isn't in the private market. The only way I can find to buy farmland at a roughly 30% discount to NAV is through Farmland Partners (FPI) shares. Paul Pittman is a good manager and executing a sizable buyback which should amplify the value realization of shareholders beyond the existing NAV discount.

Washington Prime Group (WPG) is a mall REIT and has fallen with the group. It has been particularly tied to CBL, dropping substantially on the day CBL cut its dividend as if that somehow had a bearing on WPG. This is what I call a false coupling and false couplings are often a source of massive mispricing. Quite simply, WPG has traded down with CBL despite differentiating its fundamentals. WPG is ahead of the tenant cleansing game having started the move toward being an entertainment destination rather then an apparel outpost many years ago. Its lifestyle tenant roster has kept foot-traffic strong which supports demand for space. It will be subject to the same vacancies as the rest as big-boxes continue to close, but I believe it will have a far easier time re-leasing that space.

Depressed multiples

Just like Rodney Dangerfield, these REITs can't get no respect from the market. Each is trading at a sizable discount to peers despite favorable fundamental performance.

Plymouth Industrial (PLYM) and STAG Industrial (STAG) trade at ~12X FFO and ~15.4X FFO while the rest of the industrial sector trades closer to 20X. The discounting is related to their focus on tier 2 markets rather than the coastal cities, but this difference has not manifested in weaker growth. Both STAG and PLYM have been getting sizable rental rate rollups along with the rest of the sector. FFO/share is growing with the difference being that the growth is not priced in to STAG and PLYM like it is for the rest. The market is rightfully excited about the growth of e-commerce and they have rightfully identified that last mile delivery is a demand generator that will primarily impact the logistics facilities of big cities. It seems to have flown under the market's notice that we are also in a manufacturing renaissance which is a great demand generator for warehouses and light manufacturing of middle America.

Global Net Lease (GNL) is still subject to the stigma of coming from the American Realty Capital family which has looked bad ever since the accounting scandal at ARCP (now VEREIT). This is causing it to trade at deeply depressed multiples relative to peer NNN REITs and relative to the quality of its properties and tenants. Its leases represent the pinnacle of NNN leases with among the longest lease terms and among the highest portion of tenants being investment grade. Additionally, GNL has access to extremely low cost capital through its Euro bonds with some fixed in the 3% range. I consider GNL to be a clean cashflow stock where rent from investment grade tenants becomes my dividends.

Jernigan Capital (JCAP) has the highest quality properties among any self-storage REIT. The properties are freshly built in prime locations and professionally managed by reputable companies like CUBE and EXR. Thus far, leasing and rental rates are ahead of what was underwritten at the start of development. I believe JCAP's discount is due to the difficulty of assessing its value. It is still in its transition from mREIT to equity REIT which makes its accounting unusual. Its earnings come primarily from mark-to-market value accretion as its properties transition from developments to operations. Some of its properties are already in the operating and fully owned at equity stage, but this remains a small percentage of JCAP's portfolio. Over the next few years, more properties will be completed and JCAP will become a full equity REIT with standard FFO like its peers. This will allow it to trade on FFO multiple and we anticipate significant multiple expansion as it begins to price with its peers.

RLJ Lodging (RLJ) is doing everything right and getting punished for it. The market is seeing the recent guidance cut as indicative of problems, but it is much simpler than that. RLJ cut its proforma 2018 hotel EBITDA guidance by $3mm due to massive asset sales. Since December of 2017, RLJ sold $630mm of assets so of course their hotel EBITDA is dropping. Importantly, these assets were sold at EBITDA multiples over 16X which represents a cap rate far lower than where RLJ is trading. They are taking advantage of the gap between public and private hotel markets and arbitraging it by selling assets at expensive prices and buying back stock at cheap prices. This is exactly what hotel REITs should be doing in this environment. We are impressed by the direction Leslie Hale (new CEO) is taking the company and I believe it will trade at a higher multiple in the long run.

Important Notes and Disclaimer

The holdings presented were the entire holdings of 2CHYP as of 9/30/18, 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.

Benchmark Comparison: 2CHYP portfolio is compared to the iShares REIT ETF (IYR) and Vanguard REIT ETF (VNQ) because these are common methods for investing in a portfolio of REITs and we view these as competitors or alternatives to 2CHYP. Both IYR and VNQ have 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 VNQ's and IYR's dividends are paid but not reinvested.

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: Partial year return for the period 7/1/16 through 9/30/18, unaudited. Dividends in 2CHYP are reinvested.

Conflicts of Interest. We routinely own and trade the same securities purchased or sold for advisory clients of 2MCAC. This circumstance is communicated to clients on an ongoing basis. As fiduciaries, we prioritize our clients' interests above those of our corporate and personal accounts to avoid conflict and adverse selection in trading these commonly held interests.