In brief

- Real assets have found a place in the strategic asset allocation mix of most institutional investors and can play multiple roles in a diversified portfolio—including total return potential, diversification from low correlations, and inflation sensitivity.

- These benefits vary across the sub-asset classes, and it’s important for investors to gain a better understanding of the benefits and risk profiles of each when building the components of an overall real assets strategy.

- Adding real assets requires a well-defined investment objective, as well as a clear plan for implementation, including the size of the real assets allocation within the overall portfolio, the mix of real assets exposures, and the vehicles by which these exposures will be delivered.

- Whether a real assets allocation is attained through direct exposures or through a liquid real assets portfolio, skilled asset allocation capabilities are required to maintain portfolio objectives and react to changing market regimes over time.

- Liquid real assets can provide more efficient implementation for a wider range of institutional investors and can complement and enhance the private real assets strategies of the industry’s most sophisticated investors.

Real assets are an important and growing presence across the institutional landscape, and are increasingly embraced as a foundation asset class along with stocks and bonds. As a very broad grouping representing different sub-sectors and industries, real assets offer attractive benefits as part of a diversified portfolio due to their low correlations to other asset classes and inflation-hedging potential. Indeed, real assets are gaining acceptance with a range of investor types, including defined benefit plans, foundations, and defined contribution plan participants. But implementing an allocation to real assets comes with some unique challenges: how to allocate, how to fund the allocation, and whether to source real assets directly, through a diversified liquid fund of real assets, or some combination of the two.

The merits of a strategic allocation

When introduced to an overall strategic asset allocation, real assets, such as real estate, commodities, infrastructure, natural resources, and gold, have historically improved returns while providing protection from some of the risks to which portfolios are most vulnerable—in particular, unexpected inflation, rising rates, and drawdowns in down markets. As a group they can play multiple roles in helping build more flexible and resilient portfolios. But it’s also important to understand that each sub-asset class comes with a unique benefit and risk profile and may serve changing roles within the real asset portfolio as market conditions such as rates, inflation, volatility, and risk appetites change over time.

RETURN POTENTIAL

As shown in figure 1, real assets have historically provided attractive returns on a risk-adjusted basis. Some, such as real estate and infrastructure, have also enjoyed yields in the form of steady cash flows. Others, such as commodities, offer exposure to economic global growth and development opportunities in emerging economies such as China, India, Brazil, and elsewhere.

1 / ANNUALIZED 10-YEAR REAL ASSETS RETURNS

![1 / ANNUALIZED 10-YEAR REAL ASSETS RETURNS](image)
DIVERSIFICATION

Real assets have historically offered a range of correlations to traditional investments and generally low correlations to each other. Individually, correlations can vary widely, as seen in figure 2. While often they exhibit volatility individually, their combined diversification characteristics can play a low-beta (defensive) role in an asset allocation strategy, smoothing performance and increasing overall portfolio efficiency. Figure 3 shows that including 20% real assets into a traditional portfolio results in higher returns 70% of the time. Because markets seldom stay static over time, it’s important to hold a diverse group of sub-asset classes that may perform differently in different market regimes. For example, in low risk appetite regimes, TIPS and gold tend to outperform. When risk is being rewarded, sub-asset classes with higher correlations to equities such as REITs tend to benefit.

2 / MOST REAL ASSETS HAVE LOW CORRELATIONS TO BONDS— AND LOW TO MODERATE CORRELATIONS TO STOCKS

Correlation to Barclays U.S. Aggregate Bond Index

Correlation to S&P 500 Index

Source: QMA. Calculated by eVestment using data presented in eVestment and Morningstar software products. Time period: 7/1/2005 to 6/30/2015. In this table, real assets are represented by these indexes: S&P GSCI® Index (commodities), S&P Global Natural Resources (natural resources), S&P Global Infrastructure Index (infrastructure), FTSE NAREIT All Equity REITs Index (U.S. real estate), S&P Developed ex-U.S. Property Index (international real estate), LBMA Gold Price PM Index (gold), Barclays U.S. TIPS Index (U.S. TIPS), and Alerian MLP Index (MLPs). The indexes used for illustrative purposes only. All indexes are unmanaged. An investment cannot be made in an index. Past performance does not guarantee future results.

3 / THE ADDITION OF A 20% REAL ASSETS EXPOSURE HAS LONG-TERM STRATEGIC BENEFITS

Real Assets Rolling 5-Year Returns

Source: QMA. Calculated by OMA using data presented in eVestment and Morningstar software products. Time period: 9/30/1996 to 6/30/2015. In this chart, Real Assets represents an equally weighted (12.5%) static allocation to: Commodities - S&P GSCI® Index; Natural Resources - S&P Global Natural Resources Index from 12/31/2002 to 6/30/2015, and S&P North American Natural Resources TR Index from 9/30/1996 to 11/31/2002; Infrastructure - S&P Global Infrastructure Index from 12/31/2001 to 6/30/2015, and S&P 500 Utilities Sector Index from 9/30/1996 to 11/31/2001; U.S. Real Estate - FTSE NAREIT All Equity REITs Index; International Real Estate - S&P Developed ex-U.S. Property Index; Gold - LBMA Gold Price PM Index; U.S. TIPS - Barclays U.S. TIPS Index; and MLPs - Alerian MLP Index. Stocks are represented by the S&P 500 Index. Bonds are represented by the Barclays U.S. Aggregate Bond Index. The indexes used for illustrative purposes only. All indexes are unmanaged. An investment cannot be made in an index. Past performance does not guarantee future results.
INFLATION SENSITIVITY

While real assets are valuable diversifiers in any economic environment, they have performed especially well in periods of high inflation, as illustrated in figure 4. Since accurately predicting the timing of a sudden spike in inflation is difficult, investors may benefit from a real assets allocation even in periods of low inflation, which can erode purchasing power over long periods.

4 / REAL ASSETS MAY PROVIDE PROTECTION WHEN INFLATION RISES

Gaining real assets exposure—a disciplined framework

Adding real assets, like any other asset class, requires a well defined investment objective as well as a clear plan for implementation, including the size/percentage of the real assets allocation within the overall portfolio, the mix of real assets exposures, and the vehicles by which these exposures will be delivered.

DEFINING THE OBJECTIVE

Investors should be clear in their investment objective(s) while maintaining or building their real assets allocation. Do they seek additional sources of long-term positive returns? Protection from drawdowns through greater diversification to traditional assets? A hedge against future rising interest rates and inflation? Or perhaps a combination of the three? These objectives will drive the mix of real assets chosen to solve for these investment challenges. As we have seen, the real assets universe is comprised of a group of sub-asset classes each with its own expected return, diversification, and inflation sensitivity characteristics. Choosing the right mix of real assets to meet these challenges requires a keen understanding of each and skilled asset allocation capabilities as investment objectives and market conditions change over time.

HOW MUCH AND FROM WHERE

The next decision is how large an allocation will be made to the real assets bucket. This will depend in large part on the diversity and composition of the existing portfolio, the risk budget and returns expectations of the investor, and their time horizon and sensitivity to downside risk. While there is no “optimal” number, a meaningful and reasonable range could be anywhere from 5% to 20% of the overall portfolio.

Deciding where in the traditional portfolio to allocate from will also depend on the objective defined above. Here, the tradeoffs of reducing equity and/or fixed income exposure in favor of real assets will need to be carefully considered. For example, in the case where the objective is to deliver real returns and preserve purchasing power, an investor might favor preserving more of their equity exposure based on expectations of the higher expected returns of stocks over bonds. However, one consequence of reducing the portfolio’s fixed income allocation may be an increase in portfolio volatility beyond plan guidelines. In this case, managing the tradeoffs involved may require a mindful allocation away from a combination of both stocks and bonds.

BUILD YOUR OWN

Investors can choose to build their own real assets portfolio through a combination of direct exposures—such as direct real estate or natural resources ownership—and/or more liquid, listed vehicles such as REITs in the case of real estate. For larger institutional investors with the expertise and staff required to source, diversify, and oversee direct investments, one benefit is the ability to gain more “pure,” fundamental exposure to certain sub-asset classes. The classic example of this is the prevalence of direct natural resources ownership by several of the larger endowments. However, many institutional investors require greater liquidity and prefer the flexibility and daily pricing of listed real asset exposures when building and managing their own real asset portfolios. But even when building a portfolio of mostly listed securities, achieving meaningful diversification across real assets requires multiple decisions, including; which sub-asset classes and why, how much to allocate to each, how to allocate—strategic or tactical, and if tactical, does the investor have the in-house expertise to address a wide range of allocation issues.
BUYING A MANAGED FUND

For other investors, it makes more sense to buy a professionally managed fund that provides a mix of real asset exposures. Such funds are generally built on a multi-manager platform providing investors diverse exposure to managers and sub-asset classes. Allocating to such a strategy offers greater liquidity, improved diversification, and a single fee structure as compared to a portfolio built from individual components.

But perhaps most importantly, they provide investors the advantage of the manager’s expertise in asset allocation. The managers of these funds can play a key, value-added role by making active allocation and rebalancing decisions in response to changing market regimes—employing their market insights and knowledge of the sub-asset classes to make overweight and underweight allocations to best position the portfolio over time.

COMBINING BOTH

Though building your own portfolio and buying a managed portfolio are distinctly different ways of gaining exposure to real assets, there can be a place for both. Investors can consider a number of scenarios where combining both approaches could be beneficial. For example, a managed strategy could act as a core real assets allocation supplemented by additional sleeves of individual real assets securities or direct investments to meet certain investment objectives of the investor—such as additional inflation protection.

For investors with the expertise to manage their own real assets portfolio, a managed strategy could serve several complementary functions for managing liquidity, exposures, and cash:

– As a tool to balance liquidity needs while maintaining desired real asset exposures,
– As an anchor in these exposures when scaling into additional positions, and
– When deploying cash flow from or to direct investments.

LIQUID REAL ASSETS HAVE AN IMPORTANT ROLE TO PLAY

The introduction of liquid real asset funds has opened the asset class to a wider audience, including mid and small institutional investors and participants of defined contribution plans. These funds also provide even the industry’s most sophisticated investors new ways to complement and enhance private real assets strategies they may have had in place for decades.
Explanation of Indices

S&P 500 Index- Covers 500 industrial, utility, transportation, and financial companies of the U.S. markets. The value-weighted index represents about 75% of the NYSE market capitalization and 30% of the NYSE issues. The S&P North American Natural Resources Sector Index-S&P North American Sector Indices provide investors with a suite of equity benchmarks that represent U.S. traded securities across seven broadly defined economic sectors: Consumer, Cyclical, Financial Services, Health Care, Natural Resources, Technology, and Utilities. S&P Indices uses GICS® to determine a company’s sector classification. Each index is modified-capitalization weighted, where a stock’s weight is capped at a level determined on a sector basis. S&P Global Infrastructure Index is an index that consists of 75 companies from around the world that represent the listed infrastructure universe. To create diversified exposure across the global listed infrastructure market, the index has balanced weights across three distinct infrastructure clusters: utilities, transportation, and energy. The Wilshire 5000 Total Market Index℠ represents the broadest index for the US equity market, measuring the performance of all US equity securities with readily available price data. A number of securities are over-the-counter and small companies. Barclays U.S. Aggregate Bond Index- composed of U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities, and commercial mortgage-based securities. Barclays U.S. TIPS Index includes all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade, and have $250 million or more of outstanding face value. Barclays Intermediate Government/Credit Index is comprised of U.S.-dollar denominated fixed-income securities that are rated investment grade (BBB or higher by Standard and Poor’s), including U.S. government, corporate, and sovereign debt, which have 5-7 years to final maturity. U.S. Real Estate Index measures the performance of the real estate sector in the stock market in the United States. FTSE NAREIT Equity REITs Index measures the performance of all real estate investment trusts listed on the New York Stock Exchange, the NASDAQ National Market, and the American Stock Exchange. S&P Developed ex-U.S. Property Index measures the investable universe of publicly traded real estate companies domiciled in developed countries outside of the United States. Lipper Global Natural Resources Funds Index includes funds that invest primarily in the equity securities of domestic and foreign companies engaged in natural resources. The S&P GSCI® provides investors with a reliable and publicly available benchmark for investment performance in the commodity markets. The index is designed to be tradable, readily accessible to market participants, and cost efficient to implement. The S&P GSCI is widely recognized as the leading measure of general commodity price movements and inflation in the world economy. LBMA Gold Price: London Fixings P.M. London Bullion Market Association (LBMA). Fixing levels are set per troy ounce. The price is set twice daily (at 10:30 and 15:00 London GMT) in US dollars. Alerian MLP Index is an Index composite of the 50 most prominent energy Master Limited Partnerships (MLPs) that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index is calculated using a float-adjusted, capitalization-weighted methodology. An investment cannot be made directly in an index or average. All indexes and averages are unmanaged.