A Wide Range of Global Opportunities To Strengthen Portfolios

Today many institutional investors are looking for opportunities to boost portfolio returns in a low-rate financial environment. Other investors are seeking steady income to cover their liabilities or looking for ways to address inflation risk.

By Richard Westlund

Allocations to real assets—like real estate, agriculture, timber, energy and infrastructure —can potentially help with many investment goals, while adding valuable diversification to a traditional stock and bond portfolio.

"Investors have been increasing their allocations to this space for some time," says Stephen Dunn, executive vice president and director of institutional marketing, Cohen & Steers. "But investors need to weigh their objectives and decide what they want to achieve with their real asset allocations."

Dunn notes that in the past five years the number of listed real asset strategies has increased 55 percent, according to eVestment Alliance, a widely used nonproprietary consultant database.

That wide range of strategies is possible because each real asset class has different characteristics and responds to different market forces. Natural resource equities, for instance, are affected by financial markets, while agriculture and timber values respond to supply and consumption trends.

"In general, real assets are not correlated to the other assets in an investor's portfolio," says Jose Minaya, senior managing director, TIAA-CREF Asset Management. "Adding agriculture or timber, for instance, improves a portfolio's efficiency frontier and Sharpe ratio [returns in excess of the risk-free rate]. Also, the different types of real assets are not correlated with one another, further increasing the diversification benefit of the asset class."

Private or listed?

Investors can gain exposure to real assets through private ownership or listed strategies that may focus on a specific class, such as real estate, or a multi-asset package.

Private investments in relatively illiquid categories of real assets—farmland, timberland and commercial real estate—have generated higher returns than traditional investments, with significantly lower volatility, according to a TIAA-CREF report. However, it can be difficult for smaller investors to access the private market without the support and resources of a large institution, notes Minaya.

"Traditionally, many investors have turned to a private equity fund that invests in real assets," he says. "However, those investments typically are driven by a short-term exit strategy rather than a long-term hold that generates continuing cash flows from an asset."

Because private real assets are not a large part of an investor's portfolio, the challenge is spending the time to understand the nuances of each asset, says Jim Gasperoni, head of real assets, Aberdeen Asset Management. "We believe specialized managers are best suited for investing in areas like timber, agriculture, mining and oil and gas," he says. "When looking at newer strategies like renewable energy, managers who can look at those fields, along with traditional power assets like gas-fired plants, may be best suited for understanding the underlying economics of these strategies."

While private strategies may be well suited

REITs: A Long-Term Allocation to Real Estate

Institutional demand for real estate has been exceptionally strong in recent years, driven by a desire for broader diversification and the need for yield in an environment of economic uncertainty and ultra-low interest rates. Managers who oversee private real estate funds have been raising capital at a rapid clip and can't put the money to work fast enough. According to alternative assets data provider Preqin, idle capital targeting real estate purchases recently hit record levels, totaling more than $250 billion.

And yet, despite a bull market in real estate fundamentals both in the U.S. and in many overseas markets, we have seen a shift away from listed REITs over the past year, driven in part by concerns of rising interest rates. However, history shows that REITs tend to perform well over full market cycles, even as rates head higher, provided an expanding economy continues to drive stronger demand for real estate.

For long-term investors, we believe U.S. REITs can be an attractive way to allocate to real estate, offering the potential for competitive risk-adjusted returns, along with attractive income and diversification benefits. In fact, due to the unique supply-and-demand cycles of commercial property, REITs have exhibited a relatively low 0.55 correlation to the broad market since 1990—less than any of the major sectors in the S&P 500 Index except utilities.

This distinctive risk/return profile is based on the relationship between REITs and the physical property market. As listed entities, REITs tend be more correlated to other stocks than to private real estate in the short term. However, a REIT's long-term capital appreciation and dividends are tied directly to the cash flows of its real estate holdings. As a result, returns for listed REITs should generally track the returns of the underlying real estate market over full market cycles, adjusted for differences in leverage.

This concept is important because it is sometimes easy for REIT investors to become too focused on the short-term swings of the stock market, while losing sight of the underlying real estate fundamentals that drive long-term performance.

To examine the relationship between listed and physical property, the Cohen & Steers Quantitative Strategies team studied nearly 40 years of quarterly returns for REITs and private real estate funds. Comparing returns first requires an adjustment to account for the inherent smoothing of private real estate returns, which can result in artificially low measured volatility. Our research showed that this smoothing can be parsimoniously modeled using a simple moving average of five to six periods (each period is one quarter). In other words, the return profile of private funds is consistent with a rolling average of about a year and a half.

Once this process is understood, REIT returns can be similarly adjusted to obtain a more accurate correlation reading. We can also reverse the moving-average process for private real estate to estimate the actual investment risk of the underlying assets. The results: adjusted correlation increased to 0.58 compared with 0.14 on an unadjusted basis, while volatility for private real estate increased significantly, from 5.5% to 12.8%, in range with listed REITs on a risk-return basis.

Furthermore, using an econometric technique called cointegration, we found strong evidence that listed and private real estate converge around an equilibrium level. Cointegration is particularly useful in identifying long-run relationships in assets that may appear to move independently in the short term. We believe the existence of a cointegrating relationship with a 90% confidence level offers a powerful indication that the real estate exposure is the principal driver of return and volatility in both the listed and private markets. This analysis also helps reaffirm to us that REITs are compelling based on their own merits as well as compared with private real estate.

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for long-term investment objectives, listed real asset strategies provide flexibility to adjust to changing market conditions or other factors.

"More institutional investors are adding liquidity to their real asset portfolios," says Dunn. "When you invest in listed real assets, you have daily valuation and daily liquidity with no lockups. That makes it easier to build a global portfolio and allows you to make tactical adjustments more quickly. However, you need to be comfortable with the equity wrapper around the assets."

Brad Case, senior vice president for research and industry information, National Association of Real Estate Investment Trusts (NAREIT), says REITs typically provide 11 to 12 percent long-term returns through a typical real estate cycle. "The best performance has been by self-storage REITs, which are often overlooked by institutional investors," he says. "They have averaged 17.5 percent annual returns for the past 22 years."

Case notes that there can be a difference in values between publicly traded real estate and privately held properties. "Changes in investor sentiment show up on the public side of the market first, because of its higher liquidity," he says. "It can take a half year or more before those valuation changes are reflected in transaction prices in the private market, and another quarter or two for appraisals to catch up."

However, many investors are not seeking immediate returns in real estate, Case adds. "We are seeing a continuing inflow of capital from international investors looking for a safe place to park their money," he says. "Rather than maximizing returns, they are very happy to purchase illiquid assets, regardless of valuation issues. Capital preservation is the big motivating factor, and real estate can help them meet that goal."

Case adds that the U.S. real estate market should see continued growth in 2016. "We're at a good stage in the cycle," he says. "The macro economic indicators point to slow and steady growth. Construction remains low in virtually every type of commercial property, and a limited amount of new supply will support improvements in occupancy rates and rental growth for several years."

Evolving opportunities in real assets

Real estate continues to dominate the real asset sector, as investors feel comfortable with the ownership fundamentals of both private and listed properties.

For example, New York-based Tunbridge Partners recently raised $500 million to invest in established managers who focus on real estate and real assets.

But there are many opportunities to acquire other types of real assets that can generate income, protect against inflation and provide return opportunities. Dunn says master limited partnerships (MLPs) that invest in natural-resource infrastructure may be an undervalued asset at this time.

"Until last year MLPs were the fastest-growing segment in the asset class," says Dunn. "But with the dislocation in the energy markets, investors have been reassessing their positions. We believe that the long-term fundamentals for MLPs remain strong and lower valuations make them attractive, despite lower growth projections. Today they have an appealing risk-return profile with potentially higher yields than other investment strategies."

Gasperoni also sees opportunities to take advantage of lower prices in the oil and gas sector. "With our focus on the private markets, we look for high-quality assets that can fare better in lower commodity price environments," he says.

Minaya points to farmland and timber as other real asset categories with long-term potential. "By owning real assets, an investor is growing or producing an essential need for society, such as food, shelter, clothing or energy," he says. "That production can continue in perpetuity, potentially increasing in value while delivering ongoing income. One fact we can count on is that there will be more people on the planet needing more resources, so the long-term trend for real assets is favorable."

Many investors are using multi-asset strategies to gain exposure to this class in a way that can reduce overall portfolio risk. For instance, Dunn says a mix of global and U.S. REITs and listed infrastructure, combined with commodities and natural-resource equities, can provide important diversification benefits to an investment portfolio, as well as offer an attractive risk-return profile.

"There are many ways to invest in multi-asset solutions, so you have to determine your priorities," adds Dunn. An investor with a separate allocation to inflation-linked fixed income might prefer a more equity-oriented multi asset strategy. On the other hand, an investor without an allocation to TIPS might look for strategies that include such an allocation as a more significant part of a real asset solution.

Dunn believes multi-asset strategies will gain more traction in the defined contribution (DC) market. "They are much easier for participants to understand."

Reflecting on the advantages of allocating to real assets, Minaya says: "It really comes down to the exposures investors are seeking and how they play out in a broader portfolio. Different real asset strategies provide different levels of benefits, depending on how the investments are structured." ■

Inflation and the Case for a Strategic Allocation to Real Assets

WELLINGTON MANAGEMENT®

Scott Elliott

Ken Baumgartner

Historically, consensus inflation forecasts have not been very accurate, in part because inflation is highly susceptible to market and macroeconomic shocks. Portfolio Manager Scott Elliott and Investment Director Ken Baumgartner contend that investors are better served by maintaining permanent strategic allocations to inflation-hedging real assets than risking tactical misfires.

Why do investors need a strategic allocation to real assets?

Elliott: The majority of institutional investors' capital and risk budgets are in growth assets — equities and other assets that have generally performed best when economic growth has been rising and inflation has been falling. This environment is captured in the top-left quadrant of our Think Function, Not Form asset allocation framework (Figure 1). This is understandable. Capitalism strives to increase growth and limit inflation, and so we would expect growth assets to have the most attractive long-term returns. But equity bear markets exist, driven either by recessions, when high-quality government bonds (bottom-left quadrant) have been the best defense, or by inflationary regimes, when assets on the right side of the matrix have often performed the best. We view real assets as a hedge for inflationary regimes, just as government bonds have been a hedge for economic slowdowns.

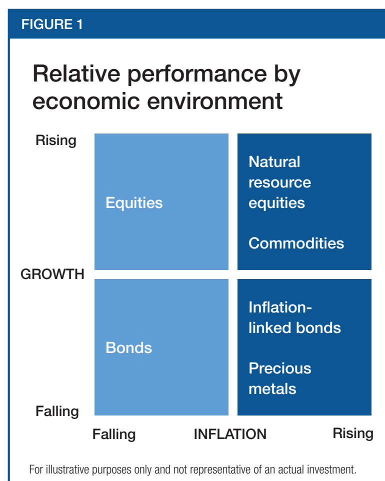
A second critical point in favor of a strategic allocation is that the future is difficult to predict. There are many potential sources of inflation, including monetary expansion, commodity supply shocks, and positive changes in demand. Inflation can emerge quickly from any of them, and investors attempting to time diversification have often been unsuccessful.

What assets are best suited to a structural inflation hedge?

Baumgartner: Among the assets on the right side of Figure 1, there is no silver bullet. Natural resource equities have generally had the most attractive long-term expected returns with meaningful inflation sensitivity (beta to inflation). Commodities typically have the higher inflation beta — not surprising since commodity prices are direct and volatile components of inflation — but their returns may trail those of natural resource equities over time. Inflation-linked bonds offer modest inflation sensitivity while potentially providing a degree of stability to overall returns due to their lower volatility. In addition, they are one of the few assets that have done well in the bottom-right quadrant of Figure 1.

FIGURE 1

Relative performance by economic environment



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The performance of commodities and natural resource equities has been challenging recently. How should investors balance this reality against the need for inflation hedging?

Elliott: From a strategic asset allocation perspective, assets with a high sensitivity to inflation have performed at least directionally as one might expect in an environment where US headline CPI has moved from nearly 4% to zero over the past four years. While traditional equities and nominal bonds excelled over this period, real assets were a drag on overall portfolio performance. However, we think investors must recall the role of real assets in an asset allocation framework and fight the urge to shed diversifying exposures, something they often do at the worst times.

In addition, due to recent challenging fundamentals and general complacency about inflation, valuations for many inflation-sensitive assets are at extremely depressed levels. As with any hedge, it is generally best to buy when the assets are cheap. Returning to the issue of timing, it is unlikely that we will see both cheap valuations and inflation pressures simultaneously, since financial assets should start discounting a stronger inflation environment well in advance of the actual economic evidence. This reinforces the importance of a strategic allocation to the area.

What about fundamentals?

Baumgartner: In addition to assessing inflation sensitivity, expected long-term returns, and current valuations, we evaluate forward-looking supply/demand fundamentals and the likelihood of inflation across our real-asset opportunity set. Fundamentals have been a headwind for some time now, but we are seeing signs of a base being built that will allow fundamentals to transition to a tailwind in the future. For example, the energy sector has provided real-time evidence of the self-correcting nature of natural resources, with declining oil prices driving capital expenditure cuts across the industry. In our view, current oil prices are too low to meet future global demand expectations. While no one is predicting outsized inflation in the near term, a move up from current near-zero levels to a more normalized rate should be enough to provide a tailwind for these assets that are currently unloved by the majority of investors.

To learn more about this topic, visit:
www.wellington.com/case_for_real_assets

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