Global Real Assets Attract Jittery Investors

Political upheaval, sluggish growth, and concern over possible bubbles in some emerging economies are just a few of the bigger developments combining to give institutional investors the jitters. In the search for an anchor to windward, “we have seen a significant uptick in investor interest in listed real assets this year compared with 2015,” says Steve Dunn, executive vice president and head of global distribution at Cohen & Steers. Sponsors of 401(k) and other defined contribution plans are among those taking a closer look at real asset solutions, typically as a sleeve in a target date or target risk fund.

Because real assets — including real estate, infrastructure, precious metals, commodities, timber, and farmland — typically have low correlation to stocks and bonds, they can reduce portfolio volatility while offering potentially higher yields, a hedge against inflation, and steady cash flows.

**Commercial real estate**

Commercial real estate continues to attract strong inflows. One factor is the blistering growth rate of global cities themselves. United Nations projections have the population of Beijing growing 18.7 percent by 2020, Kuala Lumpur by 14.7 percent, and even developed-nation metropolises like Washington and London adding a substantial 5 percent or more each. A recent study, “Global Cities: The 2017 Report,” by Knight Frank, a residential and commercial property consulting firm in London, ranked Manhattan, London, Los Angeles, San Francisco, and Paris as the top cities in investment volume for the first six months of the year.

A low correlation to stocks and bonds means real assets can both reduce volatility and offer potentially higher returns.

The election of Donald Trump could lead to higher growth as well as inflation in this sector. Nora Creedon, managing director and portfolio manager at Goldman Sachs, speaking as a panelist at the National Association of Real Estate Investment Trusts (NAREIT) annual convention in November, said that the consensus outlook was for potentially higher growth at 5.5 to 6 percent cap rates.

The November election results could also prompt some investors to reallocate capital to industries likely to benefit from increased U.S. infrastructure spending, says Steve Sakwa, senior managing director and a senior equity research analyst at Evercore ISI. The incoming Trump administration is expected to consider an infrastructure bill to stimulate the economy in 2017.

Investors may also be able to capitalize on worldwide infrastructure opportunities. A recent KPMG report, “Global Infrastructure: 10 Emerging Trends,” points to new sources of capital and new funding approaches as one of the factors that will change the infrastructure sector over the next five years. Other trends include the “growing boldness of governments” seeking economic and social benefits and better alignment of government’s interests with the “microdecisions” of consumers.

**A wide range of strategies**

Real assets are a diverse category, both in the range of assets themselves and in the ways in which they can be packaged. Institutional investors can take their pick of a variety of strategies, including publicly traded assets or private investments, a variety of sectors from timberland to energy, and an assortment of geographic regions.

Multistrategy funds can also play a role. “There are very diverse global opportunity sets within the real asset class,” says Dunn, noting the importance of finding solutions aligned with investors’ goals and mandates. Some investors need liquidity, while others are more focused on steady income, higher returns, or reduced volatility, he adds.

Looking ahead, Vince Childers, senior vice president and real assets portfolio manager at Cohen & Steers, says many institutional investors are still underallocated to real assets, based on their investment policy statements. “During this recent commodity downturn, being underweight there has served them well,” he says. “But now they are looking to increase their allocations to real asset classes.” — Richard Westlund
The Commodities Comeback

Cohen & Steers

With stock prices near record highs and bond yields not far from record lows, commodities may offer an opportunity to unlock value in a depressed asset class. The Bloomberg Commodity Index Total Return value is just one third of what it was in 2008, despite having rallied approximately 15 percent from its bottom in January 2016. After five years of falling commodity prices, many producers are no longer able to operate profitably, with about 70 percent of the market trading below production cost (see chart, below). Since early 2015, companies have been slashing capital spending, abandoning projects, or cutting output.

In this prolonged low-price environment, these measures have had a material impact on global supply. Our data show the imbalance between supply and demand resolving while excess inventories are gradually being drawn down. The recent gains in commodities appear to be part of a broader, sustainable recovery in commodity fundamentals that should see supply and demand largely rebalanced by the end of 2017, driving spot prices significantly higher.

Commodities typically go through bull and bear periods that can persist for years, progressing along a series of distinct phases: High prices drive greater production and lower demand, eventually leading to a surplus that puts downward pressure on prices. Lower prices, in turn, spur demand and make producing less profitable, eventually resulting in supply reductions; inventories drop and prices rise, continuing the cycle.

Other factors may also affect commodity prices and the longevity of the cycle, including global economic activity, weather conditions, natural disasters, geopolitical events, and investor sentiment. In the current environment of below-trend global growth, the task of rebalancing an oversupplied market falls on producers. To achieve this rebalancing, prices must cut deep enough into production costs to force a supply response. This is generally what has occurred over the past 12 to 18 months. Analysis suggests that a supply-demand rebalancing is gaining momentum across all commodity sectors, forming the basis for stabilization of inventories and a sustained recovery in prices.

Amid continued improvement in fundamentals, commodities have generally made progress through the normalization phase of the cycle — the key inflection point at which supply and demand begin to adjust and prices begin to bottom. Certain markets such as natural gas, cotton, gold, and zinc appear to have moved firmly into the rebalancing phase, marked by a narrowing of the supply-demand gap and a recovery in prices. The rebalancing of the overall commodities market is likely to be largely achieved by the end of 2017.

Recoveries in supply-demand fundamentals have historically been associated with sizable returns. Based on the commodity universe’s current position in the recovery cycle and our analysis of historical patterns, an approximate 25 percent rise in spot prices through the rebalancing phase seems likely. By year-end 2017, this would translate to a 21 percent annualized spot return, or an estimated 17 percent annualized total return after factoring in estimated roll yield and return on collateral.

The rebalancing process for commodities can be bumpy at times, of course. The recovery could be delayed should global growth slow, for instance. However, an uptick in global economic activity appears to have stabilized demand for many commodities. Moreover, positive catalysts that could accelerate the recovery have begun to materialize, including a coordinated OPEC production cut, stabilization in the Chinese economy and commodity consumption, and the prospect for global fiscal stimulus. These potential tailwinds outweigh the risks to the commodity recovery.

If the current cycle follows the typical path, investors can expect to see an environment of higher prices for years to come as the market transitions from today’s commodities oversupply to a balanced market and eventually to an undersupplied market.

—Ben Ross, Commodities Portfolio Manager

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