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Real Assets: The Role of Intrinsically Valuable Assets in Diversified Portfolios

Investors face many challenges in the decades ahead. However, one clear and present danger outshines others. As of early 2011, annualized U.S. federal government budget deficits exceeded $1.5 trillion, and the total U.S. federal government debt-to-GDP ratio had rapidly accelerated to 100 percent. The total U.S. government debt is more than $14.5 trillion. Possible remedies for this unsustainable fiscal condition include confiscatory tax increases (which would impair economic growth), significant spending cuts to entitlement programs (that risk political instability), or default either explicit or implicit. (Debt monetization by the Federal Reserve is a form of implicit default.) The ultimate remedy may include all three elements. Too often, countries that cannot muster the political will required to reign in unsustainable deficits and debt have turned to debasing the currency (and the nominal value of debt) through inflationary monetary policy. Unsustainable deficits can force the Federal Reserve to finance debt with printed money as an alternative to explicit sovereign default. Quantitative Easing (QE I and II) is a euphemism for such money “printing.”

Real assets can be tremendous diversifiers. Unlike stocks, bonds, and other financial assets, real assets have intrinsic value, which is not derived from claims on an institution’s future cash flows. Because intrinsic value is not based on nominal cash flow, real assets are more impervious to inflation shocks, irresponsible governmental economic policies, or geopolitical crises. In the most extreme case, real assets retain value even if fiat currencies become valueless (to the extent ownership rights are protected under such a dire circumstance). A bond interest payment or a stock dividend has no value if the money has no value.

TIPS

Strictly speaking, Treasury Inflation-Protected Securities (TIPS) are not a real asset because they have no intrinsic value. Value is derived from a contractual obligation between borrower and lender, the classic definition of a financial asset. However, they do have some unique properties giving them a closer association to real assets. The principal amount of TIPS adjusts to reflect changes in inflation as measured by the Consumer Price Index for All Urban Consumers. Since the coupon or stated interest rate for TIPS is applied to the principal amount, the semiannual coupon payment varies as the principal amount fluctuates in response to inflation or deflation. So the TIPS’ stated rate is a real (after inflation) interest rate. The final principal amount repaid to the TIPS owner at maturity equals the greater of the original principal amount or the inflation-adjusted principal. Therefore, while coupon payments can decline because of deflation, the principal is shielded from deflation.

TIPS are a relatively low risk asset class that protects investors from unanticipated inflation. U.S. Treasury debt investors can theoretically lose two different ways over the full life of investment. The first is if the U.S. Treasury explicitly defaults and debt holders are not repaid. The second is if inflation wipes out the real value of the bond. Nominal U.S. Treasuries are subject to both risks because inflation can decay the par value of the bond in real terms. On the other hand, TIPS are only subject to the risk of explicit sovereign default. TIPS investors are protected from skyrocketing inflation because the bond’s par value keeps pace with inflation.

Commodities

Commodities are major inputs in the production process. Therefore, the prices of commodities, which are determined primarily by near-term events, should be positively related with the inflation rate. Specifically, higher commodity prices should ultimately result in higher inflation. Stock and bond prices that are based upon discounted cash flow expectations can react negatively to inflation, especially in the short term. Therefore, commodities can help protect a portfolio from the adverse impact of unanticipated inflationary pressures.

Due to relatively low correlations with stocks and bonds, commodities provide significant diversification benefits. Instability in the Middle East, wars, and supply disruptions due to natural disaster like hurricanes, earthquakes, droughts, and floods may adversely impact the supply of certain commodities driving prices up. Meanwhile, most of these events adversely impact stock prices.

Real Estate

While real estate is a real tangible asset, many commercial and residential properties derive significant value from their ability to generate cash flows from the rents of residential and commercial customers. Over time, those rents are expected to rise with inflation providing a rising nominal cash flow.

When economies enter traditional recessions, the relatively long life of real estate leases can provide a revenue buffer; the economy hopefully recovers before many leases expire or renters default. However, the earnings generated by most real estate properties are still tied to the sustainability of healthy economic activity. Commercial and residential lease contracts only have value to the extent that businesses and residential tenants have the capacity to honor their leases.

Energy Infrastructure Master Limited Partnerships (MLPs)

MLPs mainly own midstream energy infrastructure assets like pipelines that generate “tariffs” for the transportation of crude oil and refined petroleum products (jet fuel, gasoline, and distillate fuel oil). Approximately 70 percent of the MLP market is dedicated to the (midstream) transportation of petroleum products and natural gas. As of December 2010, the 50 largest MLPs represent a total market cap of $206 billion.

Most pipelines that cross state lines are regulated by the Federal Energy Regulatory Commission (FERC). The FERC regulates the rates that pipelines can charge, building in annual inflation adjustors. Therefore, the fees generated are usually not tied directly to changes in the price of the transported commodity, but rather simply to the quantity and distance of the transported good. This fee income tends to be fairly stable over time. As the volume of the commodity transported increases with demand growth (and inflation rises), the fee revenues increase. Looking forward, MLPs offer distributions (or yield), plus the potential for distribution growth. Combining the current 6.8 percent distribution yield (as of September 30, 2011) with a potential 3 to 5 percent distribution growth rate means an expected 9.8 to 11.8 percent annual return does not seem unreasonable. In an era of low interest rates and relatively low equity risk premiums, this return potential is attractive.

Timberland

Timberland differs from virtually all other investable assets in that its primary source of total return is derived from organic growth. Trees grow as long as rain falls and the sun shines. As an investable real asset class, timberland offers several attractive characteristics, including historically attractive risk-adjusted returns compared to traditional asset classes and significant diversification benefits independent of capital market forces.

As trees grow, the value of their product classes increases as well. The negative impact of waiting to harvest (the time value of money) can be offset by the increasing size and value of the trees. When timber prices fall due to adverse economic forces, the timber investor can simply delay harvesting. This is very different than growing an agricultural commodity which must be harvested each year regardless of market prices.

Illiquidity is a prime risk; cash commitments typically exceed 10 years and some investments may take up to 20. Therefore, investors must carefully consider their cash-flow requirements before investing. Natural disasters like fire and insects pose another risk, but these losses for industrial managed forests in the United States have historically been less than one half of one percent per year. Another risk is that timber prices can fall, but that risk is mitigated long-term by "storing the timber on the trunk" (delaying harvesting until conditions improve). Supply shocks are possible if governments create new legislation to protect threatened or endangered species. The spotted owl crisis of the early 1990s is a prime example (although bad for loggers, it was actually good for aggregate timberland investors because it led to higher timber prices). While illiquidity can be an issue and timberland is full of esoteric risks, effective timberland investment offers returns competitive with equities as well as significant portfolio diversification benefits, especially protection against rising inflation. Timberland is most appropriate for investors with very long time horizons and manageable liquidity needs.

Conclusion

Real assets can serve multiple purposes within a diversified portfolio. Most investors have spending needs that are implicitly or explicitly tied to inflation. While each underlying real asset class has its own unique risks, the inflation-protected nature of intrinsically valuable assets can improve portfolio diversification, especially when a portfolio is heavily allocated to financial assets like stocks and bonds.

If you would like more information about investing in real assets, ask your DiMeo Schneider & Associates, L.L.C.'s investment consultant or visit our Research & Resource Center at www.dimeoschneider.com for a copy of our comprehensive paper: Real Assets: *The Role of Intrinsically Valuable Assets in Diversified Portfolios*.