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Why Invest in Real Assets?

Reasons Real Assets Warrant an Allocation

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- Inflation is an economic event that can deteriorate long-term purchasing power and erode the ability to fund long-term projects as well as maintain one's desired standard of living in retirement.
- Professional investors have a dismal record of predicting inflation, which leads us to conclude a strategic allocation to inflation-related assets is the best form of protection.
- The tangible investment properties of real assets have a better track record of protecting portfolios against rising inflation than do stocks and bonds.
- Real assets not only add value to portfolios during periods of rising inflation, but they also provide diversification for traditional portfolio allocations of fixed income and equity.

Imagine three groups of investors coming together back in 1972 to determine their goals over the next decade and how to allocate their assets. The mock groups 1) a hospital system seeking to fund a new wing, 2) a foundation providing scholarships and 3) a couple planning for retirement – chose different allocations of stocks and bonds to achieve their objectives. At the time they chose the investments, none considered the effect inflation could have on their objectives. A decade later, the real allocation outcomes of each hypothetical group is presented below.

	Investment Allocation	Cumulative Nominal Return	Cumulative Real Return
Hospital – Funding New Wing	100% Equity	91%	(39%)
Foundation – Providing Scholarships	50% Equity / 50% Fixed Income	112%	(18%)
Individuals – Planning retirement	100% Fixed Income	116%	(14%)

Assessing the nominal returns, each group should be pleased with their outcomes, having roughly doubled their money in the 10-year period. By contrast to most environments, fixed income outperformed equities during the period (10-year Treasury Bonds yielded over 14% in 1981). Each of the investment committees exited the ten year period finding everything was more expensive. While their investments realized gains, their purchasing power actually declined and they were further away from achieving their financial goals than when they started.

Professional economists have correctly predicted the direction of inflation only 44% of the time since 1981; a track record worse than flipping a coin.[1]

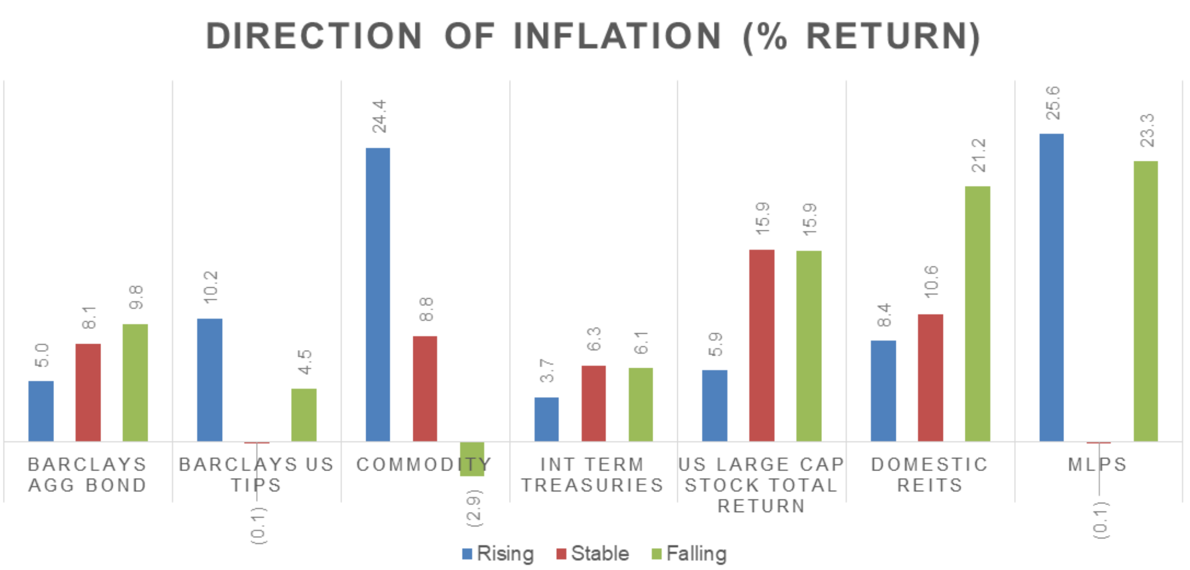
The challenge faced by the three invented groups is indeed a real scenario that too often isn't even considered or is discounted when making long-term investment decisions. Frequently, investors only take into consideration the absolute investment return; turning a blind-eye to the fact that you cannot spend returns – only dollars. At the end of the day, it's real returns that matter most. Inflation is one of the most difficult economic measures to forecast. Since

[1] Data compiled from Bloomberg

1981, professional investors have correctly predicted the direction of inflation (higher or lower) only 44 percent of the time. That is worse than flipping a coin![1] The percentage is even lower, 18 percent, when inflation changes direction from a downward trend upward or vice versa[1]. If inflation is an integral factor to a portfolio's success and professional investors are terrible forecasting it, how can we help safeguard portfolios against the risk?

Real Estate
Commodities
MLPs
Broad Infrastructure
Timberland
Farmland
Collectibles
Water
Natural Resource Equities
TIPS
Renewables

Real assets. These derive their worth from physical value – you can touch, see and maybe even smell. This is compared to stocks and bonds which derive their value from future cash flows and residual claims on a balance sheet. The tangible characteristics of real assets creates a foundation of protection against inflation. Real assets also provide stability during geopolitical uncertainty involving currency fluctuations or major turmoil. The chart to the right illustrates various assets often considered in the real assets category. Some assets, such as real estate, are common in portfolios while collectibles infrequently populate account statements. Regardless of the diversity, they carry the common thread of being tangible. The chart, "Direction of Inflation," shows several of those real asset categories alongside stocks and bonds. Despite the opaque link between some real assets, outperformance of the group broadly coincides with inflationary periods in the United States. The chart illustrates that by showing the historical returns of assets during periods of rising, stable and declining inflation.



Annual returns averaged for each regime since the inception of the index (see disclosure at end for list of index used). Rising inflation is considered a 30 bp increase from prior year's measure of CPI while falling inflation is determined by a 30 bp decline. Stable inflation is considered any year-over-year change that is less than 30 bps on an absolute basis.

The trend is clear, financial assets including stocks or bonds, perform better in stable or declining inflationary environments than when it is rising. By comparison, tangible assets shone brightest when inflation rose; as we would expect. The return

[1] Data compiled from Bloomberg

difference can be significant given the inflation regime. It is important to keep in mind, the direction of inflation matters more than its absolute level. When inflation's absolute level is established, the market and economy can adjust the impact from inflation. Inflation rises more frequently than we think. Since 1926 there have been 35 periods, during which it was definitively higher, the same number when it was lower and 21 periods when it remained stable. Historically, real assets are additive during periods of rising inflation while stocks and bonds were shown to underperform.

However, owning an investment solely for its inflationary properties is not enough. As shown in the above chart, inflation is a transitory phenomenon and therefore the assets, without an inflationary boost, must stand on their own. Traditionally, stocks have amassed allocations within portfolios because of their growth potential. Likewise, bonds too are a staple to providing stability and income. While both play a role, each stands on its own merit. Real assets are no different. Beyond their relationship to inflation, real assets are often associated with cash flows which have greater stability than many other assets. The inherent stability comes from the contractual obligation associated with real assets. This can provide consistency for dividends which is important to long-term returns. For example, commercial real estate, office and retail, routinely carry five to ten year lease terms. The payments prevail despite moderate fluctuations in the revenue and profitability of the tenant. Similarly, contracts for oil transportation within a Master Limited Partnership (MLP) are established over a long period and provide stable revenues and cash flows. Many MLP contracts are linked to inflation and offer a step-up in rates as inflation rises. The combination of long-term stable cash flows with inflation-adjusted contracts are linked to real returns.

The tangible nature and cash flow attributes make a strong case for an allocation to real assets. Also, their distinctive qualities make them an excellent complement to traditional assets. The theory behind uncorrelated returns (i.e. good complements) is the expectation that portions of a portfolio will zig when others zag. This approach reduces a portfolio's volatility without sacrificing return. The chart, "20 Year Correlation" shows the correlation of real assets to stocks and bonds. Since very few investors own just stocks or bonds, we included the correlation of returns to a diversified portfolio of 60 percent stocks and 40 percent bonds. The majority of the correlations are low, representing the benefit of diversification. Real assets with the lowest correlation to equities and fixed income are Timberland, Farmland and Private Real Estate. These three opportunities are illiquid investments with price levels marked quarterly by appraisal rather than a daily mark-to-market; used in public markets. Investments, including REITs and MLPs, had very slightly higher correlations to a 60/40 portfolio because of their shares characteristics with both stocks and bonds. Despite the slightly higher correlation for these liquid assets, the upside of diversification is compelling.

20 Year Correlation

	Bonds	Stocks	60/40
TIPS	0.69	-0.28	-0.19
REITs	0.02	0.58	0.61
Commodities	-0.10	0.23	0.24
MLPs	0.06	0.35	0.38
Global Infrastructure	0.04	0.85	0.89
Timberland	0.00	0.00	0.00
Farmland	-0.13	0.14	0.12
Private Real Estate	-0.13	0.17	0.16

Quarterly returns, ending 12/31/2017

Global Infrastructure inception 4/1/2007

60/40 portfolio represents 60% S&P 500 and 40% Barclays Agg

Global Infrastructure is the out-of-character opportunity within real assets. We have written on its high degree of overlap with equity portfolios and high correlation to stocks.

While many investors do not account for inflation risk, failing to do so, can materially erode the realization of achieving long-term financial goals. It is our conclusion strategic allocations are the best way to protect portfolios against inflation given professional investors' poor track record of timing inflation. However, strategic allocations to assets based solely on their inflation merit, is an inefficient use of capital. Real assets, beyond their inflation fighting attributes, possess intrinsic benefits for a diversified, successful long-term portfolio.

Explanation of indexes used:
Barclays Agg Bond – Bloomberg Barclays US Agg Bond
Barclays US TIPS – Bloomberg Barclays US Treasury US TIPS
Commodities – Bloomberg Commodity Index
Int Term Treasuries – Ibbotson Associates SBBI US IT Govt Index
US Large Cap Stock Total Return – Ibbotson SBBI US Large Stock Index
Domestic REITs – FTSE NAREIT Equity REITs
MLPs – Alerian MLP Index

<u>About the Author</u>

Michael researches and performs operational due diligence on core and real asset investment managers. Mike is a member of the firm's Core Investment Strategy Group and Real Assets Research Team. Prior to joining the firm in 2015, Michael was a Financial Analyst at General Growth Properties and a Research Analyst with Caldera Investment Group. Michael graduated from the University of Chicago with a BA in Economics and was a star point guard on the basketball team. Michael is a CFA® charterholder. His jump shot is still best in the office.

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