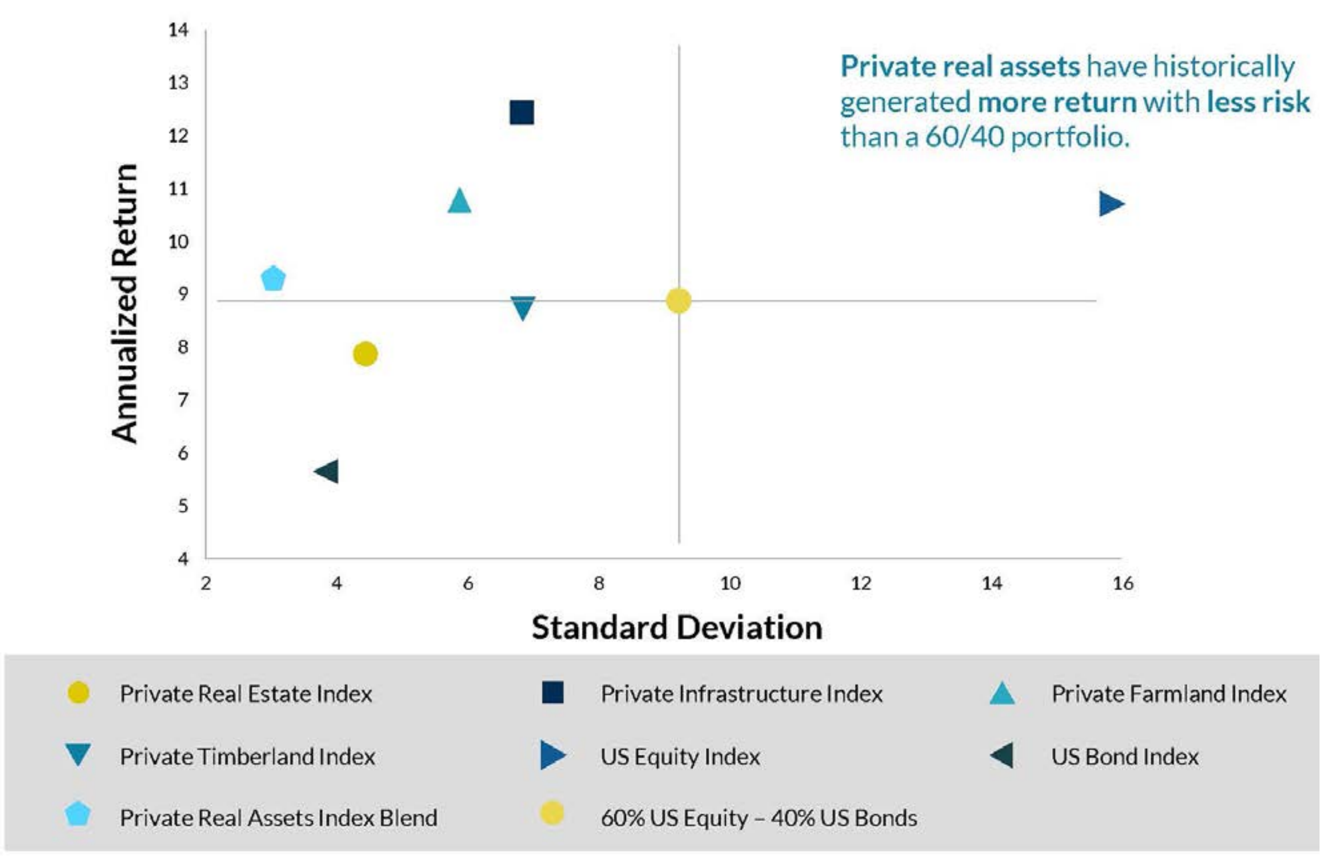
REAL ASSETS: POTENTIAL ALTERNATE SOURCE OF GROWTH AND INCOME?

Figure 1 (Trailing Risk Reward Chart from 6/30/1991 to 6/30/2021) [1]



[1] **Source: Versus Capital Research, Morningstar Direct, NCREIF, JP Morgan, MSCI.**

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To support the US economy coming out of the COVID-19 recession, the Federal Reserve and the US Congress took aggressive monetary and fiscal action. As a result, the short-term federal funds rate approached 0% and equities rebounded to new all-time highs. The rapid resurgence of the economy has created price increases not seen in decades, mostly attributed to pent-up consumer demand and access to easy money, global supply chain disruptions, and skyrocketing commodity prices. The combination of low bond yields, above-average equity valuations, and historically high inflation point to the difficulty of a traditional stock and bond portfolio generating strong future returns while mitigating downside risk. This dilemma has caused investors to look for alternative asset classes to meet their long-term return objectives. Investing in real assets may provide a potential solution. Real estate, commodities, and the energy sector often come to mind when considering real assets. However, additional sub-asset classes that merit consideration include infrastructure, timberland, and farmland. These investments offer the opportunity to improve a portfolio's risk/return profile, access attractive cash flows, participate in equity-like capital appreciation, and help to hedge against inflation risk.

Potential Real Asset Investments and Their Advantages

1. Infrastructure

Infrastructure assets include toll roads, airports, railways, wireless towers, and data centres. These investments offer relatively stable and predictable income through long-term fixed contracts and provide some monopolistic characteristics with high barriers to entry. The key return drivers for infrastructure are the free cash flow yield, inflation escalators, organic growth, and leverage. Further, the historical correlations between the MSCI Global Infrastructure Index and the S&P 500 Index and the Bloomberg Aggregate Bond Index are quite low, around 0.01, showing the diversification benefits of infrastructure.

2. Timberland

Timberland assets include pulpwood (for paper and packaging materials), softwood (for building materials), and precious hardwood (for furniture and remodelling). The key return drivers include income from harvesting, inflation from the value of the timberland, and biological tree growth. Timberland has historically provided a hedge against inflation, and the correlations of the NCREIF Timberland Index between the S&P 500 and the Bloomberg Aggregative Bond Index are also quite low at around 0.04.

3. Farmland

Farmland assets are comprised of row crops (corn, soybeans, cotton, rice, vegetables, wheat, and potatoes) and permanent crops (almonds, walnuts, pistachios, apples, wine grapes, cranberries, and macadamia nuts). The key return drivers come from the income received from selling the crops, inflation of land value, productivity growth, and crop price growth. Farmland is a highly fragmented market with minimal institutional ownership, which creates numerous opportunities for potential investors.

4. Additional Portfolio Advantages

Diversified real asset funds often target annualized returns of 5% to 7%, significantly higher than bonds, yet with a volatility profile closer to bonds than stocks. Additionally, these strategies are positioned well to appreciate in inflationary environments.

The Potential Drawbacks of Real Asset Investing

1. Illiquidity

When investing in real assets, especially in the private space, liquidity is usually limited. Infrastructure, timberland, and farmland are physical, tangible assets that require time to transact. Therefore, redemptions from this asset class may take three months or a year in some cases. This scenario is significantly different from what is experienced in fixed income, where the market is highly liquid. However, limited liquidity is a potential trade-off in the search for higher income and higher total return.

2. Fees

When allocating to funds of real assets, the fees are usually higher relative to an equity or fixed-income strategy. The median expense ratio for active equity and fixed income manager is between 0.60% and 0.90%, while fees are typically above 1.00% for a real assets manager. As real asset funds attempt to access the best opportunities, they usually demand a higher fee for not only identifying but also managing these investments.

3. Track Record

Allocating to real assets can be beneficial, especially if an investment strategy is broadly diversified across infrastructure, timberland, and farmland. However, these diversified real assets strategies are limited in number and usually do not have long-term performance track records.

Therefore, it is important to perform thorough due diligence on these managers that may be relatively new to the space. The environment of stretched equity valuations in some areas, low bond yields, and high inflation point to the merits of real assets. Overall, diversified real assets can enhance the probability of meeting long-term return objectives while enhancing portfolio diversification and managing downside risk.