Global Real Assets – A New Asset Class is Forming

Tangible and operating assets that offer a natural hedge against inflation are no longer a minority investment. As investors look for more effective ways to manage inflationary pressures and market volatility, sectors that tap into the global demand for natural resources and more efficient infrastructure are set to become a major asset class of their own.

The news that global inflation is on the rise is something that no pension fund with any inflation-linked liabilities wants to hear. Year-on-year inflation in both the Eurozone and the US has exceeded 4% and some commentators believe rising food and energy prices could push the US Consumer Price Index (CPI) above 5%.

Rising prices in the West have not yet fed through to wages, but rocketing inflation in Asian markets such as Japan and emerging markets have made analysts particularly nervous. While long-term expectations are mixed, one thing is certain: inflation is now a real and growing concern for investment portfolios.

The natural inflation hedge

Pension funds have a number of tactics at their disposal to manage their asset-liability risks in inflationary times. Inflation-linked swaps can be used to exchange a fixed income for an inflation-linked one. Index-linked bonds can deliver returns pegged to an inflation benchmark. But high-quality index-linked bonds are scarce, expensive and therefore low-yielding. Also, inflation swaps can be complex and so far have encountered only limited take-up among pension funds.

The simplest way to manage inflation is to gain exposure to assets where value and returns are directly linked to rising prices – what we refer to as 'real assets.'

Partly because of pressures on inflation – and partly because of the phenomenal global demand for the assets that we categorise in this class – we believe that real assets are ready to move into the mainstream in a dramatic way. For any pension fund keen to continue delivering positive real returns, careful attention now needs to be paid to this area of asset allocation.

What do we mean by 'real assets'?

By our definition, 'real assets' refers to operating assets, hard or 'tangible' assets as well as financial securities that provide an implicit or direct hedge against inflation. Within this asset class, we include the main sub-sectors, right.

By their very nature, all these assets are directly linked to – indeed in some cases are even the key drivers of – domestic and global inflation. As such, they can provide the simplest and most effective protection against inflationary risks.

Other beneficial features for pension funds

The advantages of real assets are not limited to inflationary protection; their investment benefits can also include:

i 'Equity-like' growth – commodities, real estate and infrastructure have all demonstrated their ability to deliver long-term growth that's comparable to equities. Over the last 20 years annualised returns from commodities and real estate have exceeded 12% compared to 8% from global equities. Since infrastructure indices do not go back very far, we have constructed a proxy by measuring the growth rate of cash flows in more than 250 infrastructure assets/companies in OECD countries over 20 years. On average that growth rate of cash flows has been 5%. Together with their natural inflation hedge, this offers the potential to maintain strong 'real' returns over the long term.

ii Strong, steady cashflows – infrastructure and real estate can both generate highly reliable cashflows through, for example, rentals on office space, tolls on bridges and roads, and the regulated pricing on utilities. This can provide a pension fund with the opportunity to use real assets to deliver bond-like income to match their liabilities.

iii Low correlation with other assets – commodities and infrastructure have both demonstrated very low correlation with equities. Since 1970, the S&P Goldman Sachs Commodity Index and the MSCI World Index have delivered negative returns in the same year only twice, in 1981 and 2001. As for infrastructure, our own analysis has shown us that the correlation co-efficient between cashflows from US equities and US infrastructure from 1986 to 2006 was just -0.1. Sustained low correlations suggest that real assets can act as a powerful form of diversification within an equity-focused portfolio, helping to lower overall risk.

iv Reduced volatility – Long-life stable assets with growing cashflows such as real estate and infrastructure have shown they can offer comparable returns to equities, yet their stable cashflows mean they deliver these returns with significantly less volatility.

In other words, real assets can provide a compelling combination of investment attributes: equity-like real growth combined with bond-like cashflow generation, plus the opportunity to reduce overall portfolio risk without any corresponding fall-off in investment returns.

An asset class borne out of globalisation

So why the attention on real assets now? The potency of real assets lies in their direct links with the twin phenomena of urbanisation and globalisation.

Real Asset	Inflation hedge created by:
Real Estate	Cost of construction, materials and labour
Infrastructure	Tolls and rates of regulated industries – often pegged to core inflation
Commodities, Timber & Agriculture	Direct link to basic materials, food staples and the energy sector
Clean Energy	Direct link to product/delivery of renewable & sustainable energy
Shipping	Direct link to global growth and movement of goods and materials

The astounding rate of urban development in emerging markets such as China and India is placing huge demands on the world's resources and infrastructure. Oil, iron ore, copper and staple foodstuffs have already seen massive price rises over the last five to 10 years. Yet faced with statistics such as the fact that China's middle classes are increasing by almost the size of California's population every year, we believe that competition for the world's resources can only intensify even further. The only certain way to hedge effectively against the inflationary pressures these demands might create, is to gain exposure to the assets in demand.

But this isn't simply an emerging market story. The developing world's hunger for new roads, bridges, airports and hospitals is well documented - but western markets have equally urgent infrastructure needs. An estimated US$16 trillion is required to modernise and expand water, electricity and transportation systems in the US, Canada and Western Europe over the next 25 years (source: Booz Allen Hamilton, Strategy + Business, issue 46, Spring 2007). Over the same period, OECD countries are expected to spend $500-600 billion annually on electricity, road, rail and water (source: OECD Study 2006). This level of investment cannot be achieved without the private sector.

Private infrastructure investments have increased threefold over the past two years, from US$40 billion in 2006 to US$120 billion in 2008 [source: Standard & Poor's]. There is a concern that there is already too much money chasing too few quality assets - but we disagree.

The opportunity set for infrastructure is huge compared to the level of investment to date (a lot of which has been driven by the strong movement from public financing to public-private partnerships). Moreover, while capital inflows into infrastructure have been strong, the quality and stability of infrastructure assets and cashflows remain deeply underpriced by our measures. The potential rewards for early movers into this asset class remain substantial.

Real assets in a pension portfolio

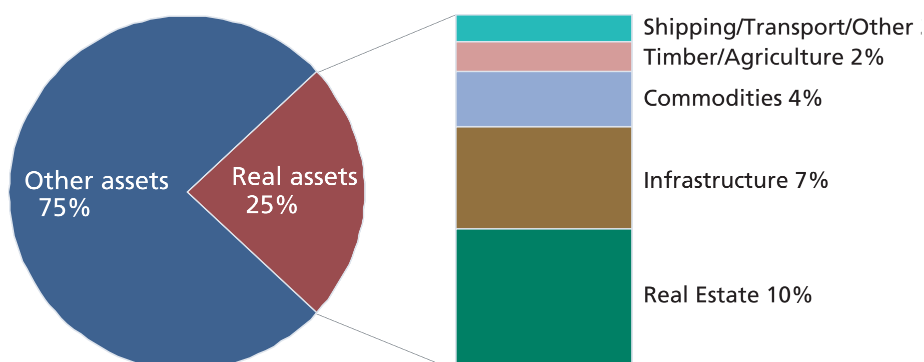
Until now, assets such as commodities, energy and real estate have tended to be grouped with other non-core investments like private equity and hedge funds under the banner of 'alternative assets'. Treated as an adjunct to the core equity/bond portfolio, these assets have typically received an investment allocation of 10% or less.

However, as the features that characterise real assets (inflation protection, strong cashflows, low correlation) become more highly prized by investors, we believe they will become a more dominant feature of the investment landscape and treated as their own discrete asset class. Over the next decade, we anticipate average exposure to real assets rising to 25% of the typical institutional portfolio, primarily funded by money coming out of equities and bonds.

In short, global economic trends are driving a dramatic transformation in portfolio allocation. To make the most of this shift in thinking, investors need to choose their asset managers carefully. As more institutional money flows into real assets, it is vital to seek out those investment groups that have specific experience within the different sub-sectors and the necessary local networks of relationships and joint-venture partnerships to source and secure the most attractive assets.

Real assets are set to be the most important new investment class of the 21st century – be sure your pension fund is ready.

Anticipated allocation to real assets in an institutional portfolio by 2018 *



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Please note that there are risks, including real estate, commodity, emerging market and currency risks, associated with investments in global 'real assets' which prospective investors should familiarise themselves with. The opinions expressed here are the authors' and should not be relied upon to support an investment decision.