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The investment case for real assets

Our weekly view on Asset Allocation

31 May 2021

Time to get real: the case for real assets

Real assets typically refer to investments in unlisted real estate and infrastructure. Physical commodities (such as gold) and agriculture-based assets (such as timberland and farming) are also considered real assets.

We place real assets within our 'Alternative Asset' allocation within diversified portfolios. Alternatives are classified under three broad sub-sectors: hedge funds, private equity/private debt and real assets.

What is the role of real assets within diversified portfolios?

A defining characteristic of real assets is that they are 'hard' or 'tangible' assets. They tend to preserve 'real' value in inflationary environments and serve as an effective diversifier within a balanced portfolio, due to typically lower correlations to traditional financial assets (equities and bonds).

While real assets have a significant history within institutional multi-asset portfolios, the ability for private investors to access real asset investment opportunities has grown significantly.

The decision to add real assets to a portfolio depends on an investor's return objectives, risk tolerance and liquidity preferences. However, we believe an allocation to real assets can potentially enhance a diversified portfolio's risk/return characteristics. In this report we discuss the particularly compelling current case for real assets.

Lowering portfolio volatility without sacrificing return

Alternative investments can provide many benefits to investors, ranging from potentially higher returns to lower volatility than may be available from a traditional bond and equity-based portfolio.

With expensive 'absolute' valuations across much of the equity market and the defensive characteristics of fixed interest now coming at a significant 'insurance cost' (given very low current yields), real assets are increasingly worth considering as an additional means to build protection into portfolios.

Moreover, in addition to helping lower portfolio volatility, we believe real assets can provide a relatively attractive income stream, and attractive potential capital gains. Prospective real asset returns are, in many cases, looking attractive compared to listed equity exposure, particularly in risk-adjusted terms.

In an environment characterised by both very low government bond yields, unprecedented monetary and fiscal stimulus, and a heightened degree of inflationary risk, we expect the cash flows associated with real asset income streams to become even more sought-after over the medium-term.

Real assets and the COVID-19 pandemic

The impact of the pandemic on the global and local economy has been somewhat unprecedented in that many "defensive" real assets have seen an unusually large degree of short-term cashflow disruption. This includes, for example, infrastructure assets such as airports and toll roads, and property assets such as shopping malls. Development projects in both the property and infrastructure sectors have also have been impacted.

While there is still ongoing debate around the short-term versus longer-term impact of the pandemic on consumer and business behaviour, progressive global re-opening should restore real asset cashflows, particularly for the highest-quality assets. At present, a number of real asset sectors are still trading at a discount to long-term valuations. This is likely creating opportunities for skilled asset managers and for the end investor.

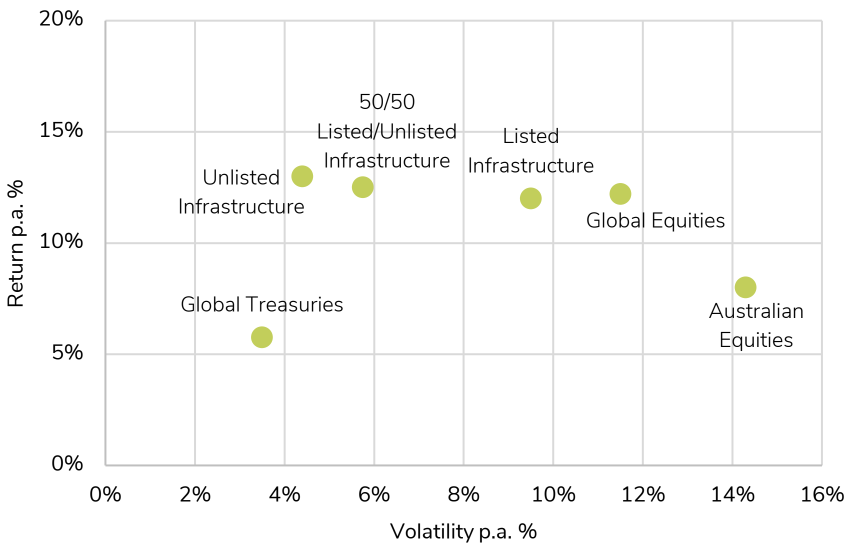
Real assets can provide a valuable inflation hedge

While inflation has been low for many years, it has picked up quite sharply recently. The consensus expectation is that the recent inflation spike is transitory, but the world has previously been through phases of 'surprisingly' high inflation. We are not expecting a return to 'high' inflation akin to the 1970s and 1980s, but the next 5 to 10 years may see significantly higher inflation than the last 5 to 10. At a minimum, we see a significant risk that medium-term inflation outcomes are materially higher than implied by current nominal bond yields.

Being 'physical' or 'tangible', real assets can provide valuable 'real' or inflation-protected returns.

We believe this trait could potentially serve investors well in the coming years, given the potential for elevated inflationary risks, primarily due to the massive amounts of fiscal and monetary stimulus that governments and central banks have injected into the global economy in light of the COVID-19- pandemic. For this reason, long-term investors could benefit from allocations that generate cashflows with an intrinsic positive sensitivity to changes in inflation.

Exhibit 1: Infrastructure has delivered solid returns with lower volatility than equities (10 years to June 2020)



Source: Refinitiv, AMP

Infrastructure as an inflation hedge

Infrastructure based investment options also cover a large range of sub-sectors, including; some utilities, renewables generation, various transport assets (e.g. toll-roads and airports), energy transmission (e.g. pipelines) and communication infrastructure.

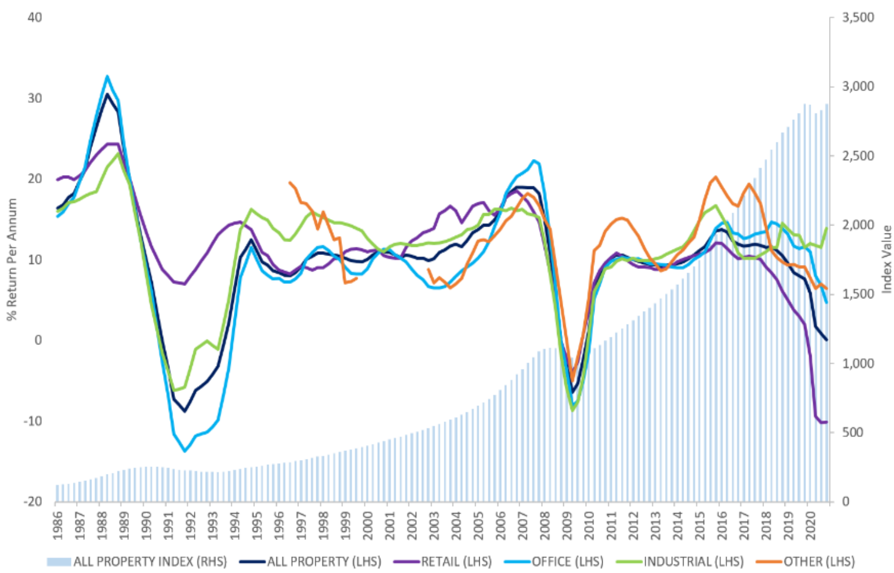
Most infrastructure assets have an explicit link to inflation through regulation, concession agreements or customer contracts. This reflects the fact that many infrastructure assets operate in monopoly-like competitive positions and typically enjoy relatively inelastic demand patterns. That is, they can increase prices, at least in line with inflation, without impacting demand.

Real estate as an inflation hedge

Real Estate investment options cover an extensive range of sub-sectors including residential (passive and development assets), office, retail, and industrial/logistics. Investments can be relatively passive, opportunistic or development based.

Over the long-term, real estate may provide some protection against inflation because real estate revenue—which is derived from periodically resetting contractual rental payments—will adjust to changing external market conditions, such as rising price levels. Furthermore, in an inflationary environment, the replacement cost of real estate increases, therefore boosting the value of existing buildings. Replacement cost is the cost to rebuild at current market prices, and incorporates factors such as land value, labour and construction materials.

Exhibit 2: Australian real property index



Source: The Property Council of Australia/MSCI Australia Annual Property Index

Commodities/Agriculture as an inflation hedge

Gold has shown a tendency to act as a long-term inflation hedge with particularly strong returns evident in the high inflation of the 1970s and early 1980s. Similarly, farmland returns over the long-term positively correlate with inflation, providing a potential inflation hedge. The supply of farmland is fixed or shrinking despite the growing demand for food. Studies note that with limited potential for new supply, high-quality farmland may become increasingly valuable.*

** The Inclusion of Farmland in a Diversified Investment Portfolio – Literature Summary (Brookvine PTY December 2016).*

Conclusion: Time to get Real

In the current, arguably unprecedented economic and financial market environment, we believe increased allocations toward real assets have the potential to be very beneficial.

We see a range of potential benefits, including:

- Portfolio diversification/volatility reduction.
- The ability to provide a degree of inflation protection in diversified portfolios.
- Attractive valuations, relative to listed global bonds and equities.
- Significant opportunity for excess return generation (alpha) through skilled active management.
- Potentially attractive income generation in a low interest rate world.
- Exposure to structural themes that will likely play an increasingly important role in the global economy—i.e., growth in infrastructure spending, increased data usage, e-commerce/logistics, as well the transition to a low carbon economy.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures

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All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

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