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The Case for Investing in Real Assets

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Summary

- Real assets, which include commodities, precious metals, real estate, and infrastructure, have several unique factors and investment considerations that set them apart from traditional financial assets.
- For many investors, the most viable way to get the benefits of real assets exposure will be through publicly traded companies and funds rather than a direct investment in a physical asset.
- With broader market indexes becoming increasingly weighted to technology, real assets can provide diversification in a portfolio.
- Real assets traditionally offer higher dividend yields than what can be found in broader equities or fixed income.
- A shift in the Federal Reserve's long-term approach to inflation emphasizes the importance of including an inflation hedge in a portfolio, and real assets tend to outperform the S&P 500 in years of relatively high inflation.
- Energy infrastructure can provide real asset exposure with higher yields, an inflation hedge, and leverage to North American energy.

Real assets offer unique benefits within a portfolio that set them apart from traditional financial investments like equities and fixed income. Most investors are familiar with using precious metals, such as gold, as a hedge against a weak economy, but what other benefits can an allocation to real assets provide? This white paper discusses real asset investment considerations and how the asset class, and energy infrastructure in particular, can play an important role in a diversified portfolio.

Real assets overview

While financial assets like stocks and bonds derive their value from a contractual right, real assets differ in that their worth comes from the intrinsic value of a physical asset. These include commodities, precious metals, real estate, and infrastructure, which encompasses broad listed infrastructure, energy infrastructure, utilities, and more. Owning these physical assets outright may be the most direct way to get real asset exposure, but assets like pipelines or real estate are not necessarily easy to own for individuals. For those wanting real asset exposure, there are other, more convenient options besides direct investment – namely publicly traded companies owning real assets and funds leveraged to real assets. In addition to ease of use, the vehicles that invest in real assets often provide more liquidity than a direct investment in something like a piece of property. For example, there are exchange-traded funds that aim to reflect the performance of gold which have significant trading volumes and assets under management. Public companies that own or operate real assets, such as REITs, energy infrastructure companies, or miners, can also provide liquid real asset exposure. For many, investing in these companies and exchange-traded products focused on real assets will be the most viable way to add this exposure to their portfolios.

The benefits of real asset investing

When paired with a traditional allocation to equities and fixed income, real asset exposure can benefit investors in a few key ways. For starters, real assets have historically offered low correlations to the S&P 500 and bonds, as seen in the table below. Real assets have typically provided more stability than the broader market given that the intrinsic worth of a physical asset like real estate or infrastructure does not normally fluctuate as much as some equities, resulting in weaker correlations and defensive exposure. Precious metals, represented by the Dow Jones Precious Metals Index (DJGSP), have the lowest correlation to equities among the group. Note that the Alerian MLP Infrastructure Index (AMZI) and Alerian Midstream Energy Index (AMNA) are used throughout to represent midstream, with the AMZI used in cases where a longer history was required.

With more and more money allocated to funds tracking broader market indexes, diversifying into real assets could be beneficial. At the end of August, the S&P 500 had rebounded 56.4% off its March low and was trading above the highs from February thanks to gains in technology shares. Roughly 24%[1] of the index is concentrated in the five largest companies, which are all tech names. A 11.4% correction in the S&P 500 Information Technology Index (S5INFT) from September 2 to 8 weighed heavily on the S&P 500, with the broader index falling 7.0% over that same timeframe. Even after a 5.8% decline month-to-date through September 25, valuations remain elevated relative to history with the S&P 500 trading at 13.2x 2021 EBITDA compared to its ten-year average forward EV/EBITDA multiple of 10.1x. For investors seeking diversification away from the S&P 500 and its largest constituents or defensive exposure in case of another market pullback, a rotation into real assets can potentially provide both.

Real Assets Can Provide Diversification to Stocks and Bonds

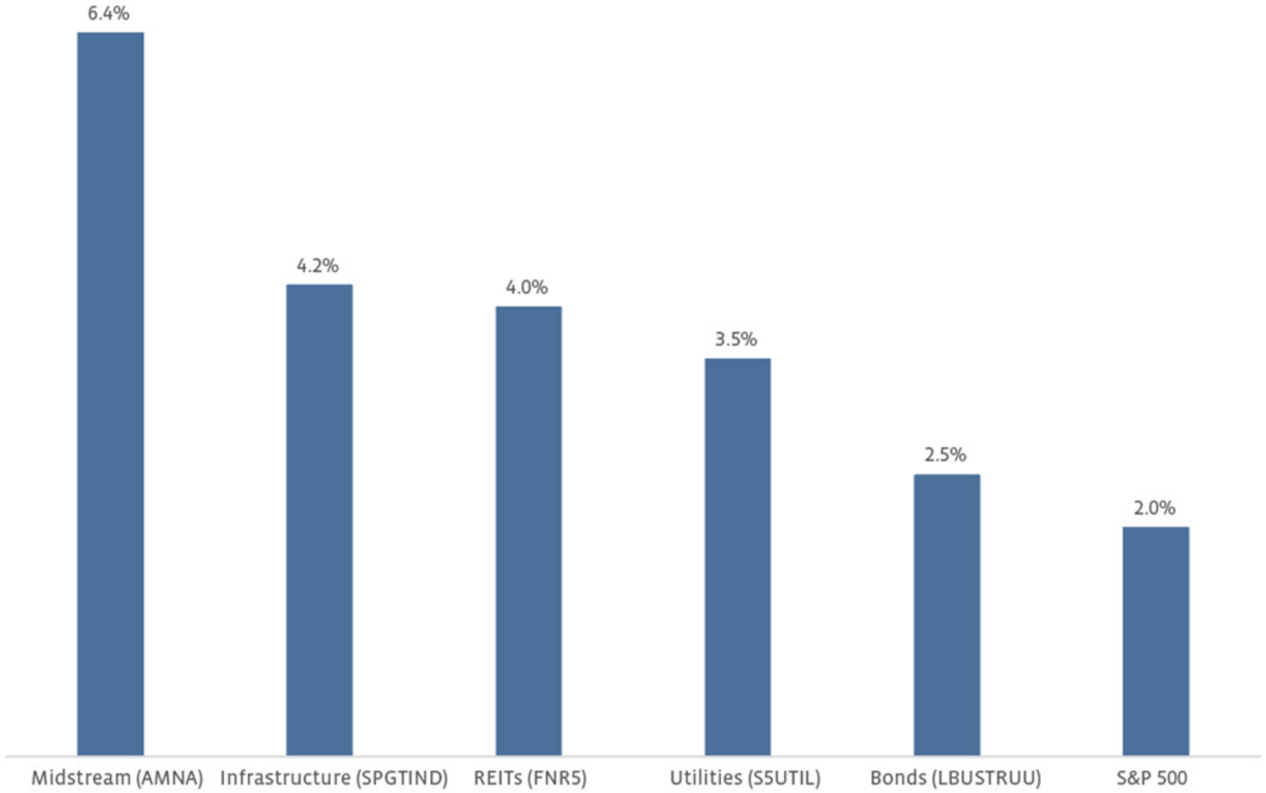
	Precious Metals (DJGSP)	Utilities (S5UTIL)	Commodities (DJCI)	REITs (FNR5)	Midstream MLPs (AMZI)	Infrastructure (SPGTIND)
S&P 500	0.25	0.33	0.54	0.64	0.68	0.78
Bonds (LBUSTRUU)	0.32	0.41	-0.15	0.40	0.07	0.21

Correlations are calculated on a monthly basis for the trailing ten-year period.
Source: Bloomberg as of 8/31/2020

1 // Weightings are based on the SPDR S&P 500 Trust ETF (SPY) as of 8/31/2020

In addition to diversification and potential defensiveness in volatile markets, select real asset investments also offer attractive income. Obviously, directly owning precious metals or commodities doesn't provide investors with dividend income, but infrastructure companies and REITs, which own income-generating assets, offer above-average yields. The chart below compares the five-year average dividend yields to those of the S&P 500 and bonds. The current yield of AMNA is more than 700 basis points above that of the S&P 500 and Barclays US Aggregate Bond Index (LBUSTRUU), respectively. Even utilities, the lowest yielding subsector, offers noticeably higher income than investors can find in the broader market. Current market conditions have left many investors searching for income. For these investors, real asset subsectors are positioned to provide high relative income backed by contracted, income-generating assets.

5-Year Average Real Asset Yields are Well Above Broader Equity and Bond Yields



Source: Alerian, Bloomberg as of 8/31/2020

Finally, real assets provide a hedge against inflation and tend to outperform in years when inflation is high. As seen in the table on the following page, real assets on average outperformed the S&P 500 in four of the last five years where the Consumer Price Index (CPI) topped 3%. The S&P 500 Real Assets Index (SPRAUN), which launched at the end of 2005, has outperformed the S&P 500 in every high inflation year since its inception. Idiosyncratic factors impacted each subsector differently, but most subsectors consistently outperformed both stocks and bonds in the years analyzed. The CPI has not risen more than 2.4% annually since 2011, and the weaker economy will most likely keep inflation in check for now. However, the Federal Reserve's updated approach to monetary policy could mark a turning point in the current low-inflation environment. In late August, Federal Reserve Chair Jerome Powell detailed the central bank's new framework that will focus on maximum employment going forward. As a result, the Fed will target an average inflation rate of 2% over time, showing willingness to let inflation rise above its previous 2% maximum target. While this will not have an impact on the current low-rate policy, it marks a significant shift in the Federal Reserve's long-term approach to handling inflation and underscores the importance of including inflation hedges in a portfolio.

Real Assets Generally Outperform the Broader Market During High Inflation Years

	Inflation	S&P 500	Bonds (LBUSTRUU)	Real Assets Average	Midstream MLPs (AMZI)	REITs (FNR5)	Utilities (S5UTIL)	Precious Metals (DJGSP)	Infrastructure (SPGTIND)	Commodities (DJCI)	Natural Resources (SPGNRUP)
2000	3.4%	-9.1%	11.6%	40.6%	49.2%	28.7%	57.2%	--	--	27.5%	--
2005	3.4%	4.9%	2.4%	18.2%	8.9%	13.7%	16.8%	--	15.0%	28.3%	26.8%
2006	3.2%	15.8%	4.3%	26.4%	34.9%	35.6%	21.0%	9.9%	39.5%	14.4%	29.8%
2008	3.8%	-37.0%	5.2%	-35.3%	-38.5%	-37.3%	-29.0%	-28.8%	-39.0%	-36.0%	-38.3%
2011	3.2%	2.1%	7.8%	0.8%	17.0%	9.4%	19.9%	-17.4%	-0.4%	-8.0%	-14.9%

Data represents total-return performance.
Source: Minneapolis Fed, Bloomberg as of 8/31/2020

To better frame the role of real assets in a diversified portfolio, the table below shows four simulated five-year, fixed-weight portfolios. The base portfolio has a 60% allocation to the S&P 500 and a 40% allocation to bonds represented by LBUSTRUU, and the other three include a 5% allocation to one of three real asset funds. While performance and standard deviation vary slightly in each scenario, a 5% allocation to real assets lowered the overall volatility of the portfolio in all three simulations by as much as 47 basis points on an annualized basis. Yields for each real asset portfolio were either in line with or above the income provided by the 60/40 portfolio. It is also important to note that the time period analyzed has seen a robust bull market and relatively muted inflation, with the CPI only climbing above 2% in 2017 and 2018. Similar trends were observed on a year-to-date basis despite the market volatility. Each portfolio with real assets has underperformed the base portfolio through the end of August, albeit with a lower standard deviation and higher yield. The real assets benchmark, SPRAUN, has underperformed the S&P 500 by over 1,500 basis points year-to-date through the end of August.

In Five-Year Simulations, Real Assets Lower Risk but Weaken Returns Given Bull Market and Low Inflation

	60%/40% Equity & Fixed Income	With 5% Real Assets Fund A	With 5% Real Assets Fund B	With 5% Real Assets Fund C
Annualized Total Return	10.84%	10.42%	10.34%	10.21%
Standard Deviation	11.21%	11.09%	10.74%	10.80%
Average Yield	2.23%	2.23%	2.38%	2.23%
Sharpe Ratio	0.93	0.90	0.92	0.90

Equities in the portfolios are represented by the S&P 500 Index.
Fixed income in the portfolios are represented by the Barclays US Aggregate Bond Index.
Real assets funds each have a 5% weighting and are included in the 60% equity portion of their respective portfolios.
Funds used were the Nuveen Real Asset Income Fund, T Rowe Price Real Assets Fund, and Cohen & Steers Real Assets Fund.
Portfolio simulations assume constant weights over the 5-year period.
Source: Bloomberg as of 8/31/2020

Energy infrastructure as a real asset allocation

While the overall investment considerations of real assets are similar, how an investor allocates to real assets can result in dramatically different outcomes. As seen in the charts and tables above, correlations, yields, and performance vary from sector to sector. Additionally, different assets are impacted by macroeconomic events in different ways. For example, gold prices have set new all-time highs this year, surging on the back of the Fed's COVID-19 response, but oil prices have dropped sharply as COVID-19 devastated global oil demand.

With those considerations in mind, why does energy infrastructure stand out among other real asset subsectors? First, as discussed earlier, midstream yields are well above those of both the broader market and its real asset peers. Additionally, provisions built into midstream service contracts provide a hedge against inflation. The fees charged by interstate liquids pipelines are generally subject to the Federal Energy Regulatory Commission's (FERC) Oil Pipeline Index, which is based on the Producer Price Index for Finished Goods plus an adjustment (read more). While somewhat outdated, data from the Association of Oil Pipe Lines presented in Magellan Midstream Partners' (MMP) 2018 Analyst Day presentation shows that an estimated 77% of oil pipelines utilize this indexed rate structure. Oil prices, along with other commodities, also tend to perform well during periods of inflation, which could be supportive for midstream sentiment as it likely incentivizes production growth and creates opportunities for midstream.

An investment in energy infrastructure also provides exposure to macro energy dynamics in spite of fee-based, contracted cash flows. Midstream is dependent on global energy demand and production of oil and natural gas in the US and Canada, which strengthens its correlation to oil prices and the broader energy sector when compared to other real assets. For context, the AMZI had a ten-year correlation of 0.46 and 0.82 to WTI crude and the S&P 500 Energy Select Sector Index (IXE), respectively. While this has been a detriment to midstream so far in 2020 due to the headwinds facing the energy sector, investors who are bullish on the long-term prospects for North American energy can get the dual benefit of energy and real asset exposure through midstream – not to mention generous income. Additionally, with oil prices on more stable footing and the resilient nature of midstream cash flows, energy infrastructure remains well positioned relative to its energy peers.

Conclusion

An allocation to real assets, whether done directly or through a liquid financial instrument, can be an important component of a diversified portfolio. In the current yield-starved and increasingly concentrated market environment, the high relative income and diversification that real assets can provide are especially important. Additionally, the Federal Reserve's recent policy shift could reemphasize the importance of real assets as an inflation hedge. While all subsets of real assets are not created equal, investors also looking for North American energy exposure, higher potential income, and an added inflation hedge should consider real asset exposure through energy infrastructure.

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