The investment case for real assets

The current market environment is presenting numerous challenges to navigate, leading investors across the globe to seek alternatives to enhance overall returns whilst striving to mitigate volatility and risk. Low returns from cash and bonds have left investors struggling to achieve the need for a rising income with the potential for capital growth while considering the possibility of higher inflation in the future.

By Tom Croft, Chartered MSCI,
Investment Director,
Ramsey Crookall & Co Ltd

Against this backdrop, interest in real assets is growing as they can offer bond-like income streams, relatively stable absolute returns, and the ability to capture equity upside with lower volatility and global exposure. In addition, real assets can provide important diversification benefits arising from a lack of correlation with other assets and with each other as well as a hedge against rising prices.

Real Assets are often defined as physical or tangible assets that tend to provide a "real return", often linked to inflation. This definition encompasses a wide range of potential investments including real estate, infrastructure, commodities, and to a lesser extent, timberland and farmland (agriculture). Additionally, real-return financial instruments, such as inflation-linked bonds, are often included in this asset class. Each category of investment carries with it unique characteristics such as the source of returns, duration, liquidity, whether the assets are accessible, and whether the available instruments are bonds, equities or somewhere between. These factors influence the success of real assets when it comes to providing effective diversification and generating a real return over inflation throughout the economic cycle.

An essential component of the global economy, **property** is an established asset class and is typically the favoured form of investment for exposure to tangible real assets. The global market is substantial and incorporates a range of sectors including commercial, retail, industrial and residential. These assets offer investors relatively steady income streams, a potential hedge against inflation, as well as leverage to economic growth.

When talking about real estate, it is important to differentiate between actually owning physical assets and owning securities that represent an interest in real estate assets. While physically owning property can provide an excellent store of value and a hedge against inflation, they are also fairly illiquid markets making it difficult for investors to raise cash if necessary. Furthermore, direct purchase often requires a substantial initial investment, which can make it difficult for smaller investors to build a diversified portfolio.

The asset class is also accessible through the more liquid, indirect instruments, such as real estate investment trusts (REITS) and property companies.

Infrastructure is the collective term for the physical assets, facilities or systems of a country or entity. They are generally long-lived, capital-intensive assets that provide essential products or services and, as such, are vital to economic development and benefit from relatively inelastic demand. The monopolistic nature of the resulting entities leads to sustained cash-flow generation that increases with inflation. The operating environment for infrastructure is often regulated, adding to the predictability of income streams.

Importantly, the need for infrastructure spending is global in nature, spanning developed and emerging markets alike. While the risk and return profile for investment will vary by market, the demand for capital to fund infrastructure development is a common theme heard around the world.

The main divisions in **commodity** markets are energy, metals (industrial and precious), and agriculture. From an investment perspective, commodities have shown a low correlation with stocks and bonds, which points to the diversification potential of this asset class. Since commodities respond directly to levels of economic activity, they tend to perform well when inflation is rising or high and capital appreciation tends to account for the bulk of the total return.

A plethora of low-cost index-tracking products and funds has improved access to the asset class for both institutional and retail investors.

Timberland and **farmland** share some features with both real estate and commodities and it is possible to access these markets through either listed companies or collective schemes.

Inflation-linked bonds, meanwhile, provide a hedge against rising prices as returns are linked to a measure of inflation. UK index-linked gilts make up about 31% of the global market and a number of corporates also issue debt in this way.

In summary, real assets tend to have low correlations to traditional stocks and bonds, they often provide a hedge against inflation and in many cases offer valuable diversification benefits to an investment portfolio.

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