Real Assets: A Nimble Option for Institutional Investors

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A real asset allocation encompasses a wide range of subasset classes — from real estate to currencies to commodities and precious metals — providing a variety of risk and return profiles. The ability to determine different levels of exposure for each subasset class makes a real asset allocation a nimble option for institutional investors' overall asset allocation. A close look at two of those subasset classes, infrastructure and gold, exemplifies how investments seen as on opposite ends of the real assets spectrum can be part of one allocation. *Pensions & Investments* discussed these issues with Jared Gross, head of institutional portfolio strategy, J.P. Morgan Asset Management; John Tanyeri, head of infrastructure/project finance, MetLife Investment Management; and Joseph (Joe) Cavatoni, head of Americas, global sales and ETFs, World Gold Council.

Pensions & Investments: What role does real assets serve as a single asset class?

JARED GROSS: You have to recognize that there's a broad range of investment categories that can be folded into the term "real assets." You can go from the more liquid end of the market: TIPS, commodities, currencies — particularly emerging market currencies with a high degree of commodity export exposure — gold, and even REITs, though they tend to have a lot of equity risk exposure in them. Then, as you get into the less liquid end of the spectrum, there are sectors like real estate, transportation and infrastructure.

Conceptually, I would segment real assets into two broad categories. You can think of one category as strategies used in a portfolio to serve as a liquid market hedge against rising prices; that would be kind of the first few that I mentioned such as TIPS or gold. In a second category, you've got real assets that provide long-term exposure to high quality asset-backed cash flows that have the potential to reset higher as prices and inflation rise. Generally speaking, few investors need to directly hedge inflation in the short term. Longer term, there's a need for portfolios to maintain value and outperform inflation over a long horizon. And I think that opens up the opportunity set to a lot of the less liquid real asset categories.

JOHN TANYERI: When we look at private assets we're traditionally thinking about private corporates and private infrastructure investments as well as real estate, which is comprised of commercial loans, residential loans and real estate equity. In regard to infrastructure, we're talking about investment-grade assets that typically have some compelling economics in that there's a historical spread premium over comparable public corporate bonds, yielding incremental income. In addition, infrastructure assets usually exhibit historically lower credit losses vs. those comparable public bonds.

From an asset-liability management perspective, this asset class can help companies immunize their long-term liabilities, given that maturities can range anywhere from 10 to 30 years, and you can structure it as either amortizing or bullet in nature, fixed or floating. Also, the asset class provides a fair amount of diversification by currency, region and sector.

JOE CAVATONI: Going back to where Jared started us off, with cash flows, annuity streams and expected

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return profiles, clearly gold does not fit into that category for one main reason: It's no one's credit risk. It's actually a real asset that preserves its value, and price appreciation is how you will achieve the return profile. When we consult with institutions about adding gold to their portfolios, the discussion often centers on gold's strategic drivers — market risk and uncertainty and economic expansion, which are the factors most likely to move gold in the long term and influence price appreciation.

More broadly, the characteristics of gold are returns, the right type of correlations and liquidity that's global in nature and very deep in the market. And that all culminates in a long-term portfolio impact that improves portfolio performance. Significant state-level pension plans are increasingly embracing gold, averaging around a 3½% to 5% portfolio allocation.

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P&I: Most large institutional investors have components of real assets in other asset categories, such as gold in a commodities portfolio, or as stand-alone asset classes, as is often the case with infrastructure. What's your view of that in terms of what a large institutional investor should do?

GROSS: At the end of the day, all of these real asset categories can have some value in a portfolio and that can vary across time. The most important thing is for investors to include real assets in a portfolio and scale that exposure relative to their need for long-term inflation-sensitive obligations on one hand, and potentially against the need to hedge against a surprise uptick in inflation on the other hand. Whether they gather them into one large bucket or not is less important, I would say. Most sophisticated large institutional investors will probably bifurcate those, and the less liquid cash flow-driven long-term segment will wind up in the return-seeking portfolio alongside things like real estate or other private assets.

CAVATONI: Investors are digging in deep and really getting their head around how gold and real assets can play a more substantive role in their portfolios. What we can demonstrate to the market is that even within commodities, gold is a standout asset because of its dual nature. Consumer demand, combined with investment demand, means that gold is well-positioned to perform across varying market environments. However, what people often don't realize is that commodity indexes only consist of a 3%-12% allocation to gold, depending on the index. So, if one is seeking greater exposure to gold, they may want to consider other vehicles like gold-backed ETFs or bullion.

P&I: Does it serve the same kind of role on the infrastructure side?

TANYERI: It's very similar. We see a number of institutions — pension funds, insurance companies — actually breaking out a number of these asset classes and looking at them separately. Having said that, the asset class is comprised of real hard assets that can help act as an inflation hedge while providing diversification. Infrastructure is a very expansive asset class. It covers a wide range across the risk spectrum. The risk, the return, the cash flows that you're expecting from these investments depend primarily on the asset's maturity, the region, the demographics, political risks, regulatory risk, sector and ultimately the underlying credit. When you take into account sector, geography and capital structure, you participate in something relatively safe, or take a little more risk in hopes of getting a higher return.

GROSS: There are two things in relation to the broader opportunity set. One is that when we think about core real assets, infrastructure is a big piece, but you can also look at real estate and core transportation assets. These share some key characteristics, including long-term high-quality contractual cash flows, credit risk that can be underwritten to a high degree of confidence, and diversification and inflation protection at a relatively high level of yield. If you segment the market in terms of quality and risk, the core/core-plus space is where most people will want to think about infrastructure as a real asset.

The more equity beta risk one takes on, the more one is shedding some of those characteristics that make infrastructure attractive as a diversifying real asset. That doesn't mean it's a bad investment, it just looks more like listed equity — or in the case of private value-add, private equity. As an example, in the transportation space, owning shares in a shipping company is not the same as owning the ship and leasing it to the shipping company. They're very different investments, and investors should not make the mistake of thinking that owning equity in a transportation company is a core infrastructure investment.

P&I: With gold, is there that kind of variation in risk?

CAVATONI: Probably not. Investors are asking about understanding gold's performance under different forward-looking scenarios, whether it's an inflation environment, a large market correction with the need for liquidity or they're just looking at balancing out some of their concerns around geopolitical risks or concerns on a more global scale. That's something we were highlighting even before 2020. To help investors understand how gold may perform under a number of macroeconomic scenarios, we've developed Qaurum, a web-based analytic tool predicated on how demand and supply may react in certain environments.

P&I: How did real assets perform when the pandemic broke, as equity markets fell and the Fed injected so much liquidity? Were there any surprises as a result of that?

TANYERI: The infrastructure asset class is made up of essential hard assets that have stable cash flows over a very long period of time. Typically, those assets have high barriers to entry and will benefit from some indirect government support. So, when we look at the overall asset class during this pandemic, like most asset classes, we saw spreads widen out immediately. And within the infrastructure asset class, there's a fair amount of differentiation with regards to performance. For example, when we look at what has really been affected primarily by COVID, we see demand-based assets such airports and roads as sectors that have really suffered or have probably performed worse. We have seen equity sponsors engage with us in an effort to seek some covenant relief. We have partnered with equity sponsors to help provide incremental liquidity and temporary convenant relief in an effort to lessen the economic impact of the pandemic and help projects continue to survive during this time. Ultimately, the structure that you've put in place will provide lenders with time and protection.

Having said that, we were surprised because this asset class is built to survive slowdowns. I don't think any asset class that you see out there was primed and ready for a complete economic shutdown. While it's really tested a number of infrastructure sectors, especially on these demand-based assets, performance of these assets seem to be bouncing back rather quickly.

CAVATONI: The reality is that gold has performed as we've expected it to. The market risk and uncertainty, monetary policy, central bank behaviors around the globe, geopolitical risks and trade tensions throughout the course of 2019 into 2020 — and clearly COVID-19 — have amplified risk concerns, which have propelled gold to be one of the best performing assets from the close of 2019 through 2020.

P&I: Along with gold's performance, it's also been more volatile. Are institutions concerned about that?

CAVATONI: I think they're understanding it quite well. Part of what we've seen over the last six months has been that as a source of potential liquidity, gold can often get pulled down a bit with asset sell-offs that are pretty substantial. We saw that, I think, back in May. But ultimately, people are very clear in understanding how gold's going to perform, and actually, there's not a lot of concern around volatility, just a lot of the right questions around finding the mix with what they hold and what their expectations are and what they're trying to achieve by allocating to it.

P&I: With a U.S. presidential election less than two months away, what will be the effects on real asset investments after a Trump re-election or in a Biden administration?

GROSS: What really is going to drive the distinction between the two is whether the Senate goes Demo-

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cratic, because I think divided government in either direction is going to place very significant limits on how much policy can change. In the event that you get a Biden administration with a Democratic Senate, and presumably the House stays Democratic, you would have full Democratic control of Washington. Biden has already put out a $2 trillion infrastructure plan with a number of green energy and sort of green infrastructure proposals. It's highly likely that that goes through and could even be expanded. Also presumably in the policy realm, you'd see less of a focus on a China trade war and more reconciliation there which, broadly speaking, would be good for international trade flows. So in the context of infrastructure, ports and ships, rail, trucking, anything sort of trade related would presumably get a little bit of a lift from a Biden administration. A pure Republican sweep — win in the House, keep the Senate and Trump retaining his seat — is, I think most investors would say, a very low probability. So I think it's really kind of either status quo or a tilt toward more infrastructure friendliness via a Biden administration.

TANYERI: If President Trump were to win re-election, I think it'll be a bit of the status quo and, unfortunately, while both Democrats and Republicans have recognized that infrastructure is an initiative that is extremely important and needed to spur economic and job growth, there's been very little compromise to build a comprehensive plan. The fundamental difference I think we see with Democrats is they would like to finance assets more on the government's balance sheet by transitioning the funding of infrastructure to the public domain. Democrats are focused on targeting lower carbon emissions by increasing investments in renewables and other industries such as use of electric vehicles, all of which are intended primarily to be on balance sheet. I think with President Trump, there is a fair amount of thought given to the fact that we need to have increased private investment if the infrastructure effort is to succeed. Given that we are most likely to have divided government again, I think it will probably fall primarily on states and their budgets and how they're able to finance infrastructure, whether through municipal bonds or public/private partnerships.

CAVATONI: As it relates to the gold market, there are two key issues to watch irrespective of the administration. First, the ongoing handling of trade tensions will impact the outlook for gold. Second, ESG is already a priority for many investors and will continue to grow in importance as geopolitical and social dynamics evolve. Along with our member firms, we've been at the forefront of developing the Responsible Gold Mining Principles (RGMPs), an overarching ESG framework for the gold mining industry. All World Gold Council member companies have committed to adopting the RGMPs, which require participating companies to provide independent assurance of compliance. Moreover, we have undertaken extensive external research around gold's performance as a climate risk mitigating asset. The outcomes suggest that gold can lower the carbon footprint of an investment portfolio over time and is likely to perform better than most mainstream asset classes under various long-term climate scenarios.

P&I: How do U.S. institutional investors generally allocate to infrastructure? Are they on the right track going forward?

GROSS: In the U.S., public pension plans have been leading investors in infrastructure, but as awareness grows, we expect to see much broader adoption. They perceive this as being, over the long horizon, an appropriate hedge to their real liabilities and it offers the prospect of generating returns that are at or above their long-term expected return on assets. So, it's actually a uniquely effective component of their portfolios. Rather than doing this investing directly, infrastructure funds are the best way for an investor to get asset diversification and, frankly, access to the necessary skill sets. Deal origination, control and management of the underlying enterprises, and execution of new investments — these are very specific skills that require dedicated expertise and experience to deploy effectively. We expect to see interest in this space continue to grow, and there's a positive feedback loop as more and more sophisticated investors are able to take assets from other balance sheets.

TANYERI: I agree this asset class continues to gain momentum and I don't see that changing. Institutions are growing their infrastructure allocation for a number of reasons, but one primary reason is increased awareness around growing a sustainable investment portfolio. ESG and infrastructure go hand in hand, specifically when you're talking about assets such as renewables. So, there has been an initiative by a number of international insurance companies first and now domestic insurance companies to continue to grow that sustainability book. In addition, another trend is the number of corporate pension plans and equity sponsors that have moved up in the capital structure to diversify their portfolio and move from equity investments to participating in debt investments in an effort to get a higher allocations and diversify their portfolios more quickly.

One of the risks in increased carbon emissions goals is the decreasing appeal of fossil fuel assets as an investment in the future. For example, oil storage,

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pipelines and other fossil fuel investments are becoming more difficult to finance; people are questioning whether those assets should be part of a long-term portfolio. From a regional perspective, we're seeing a fair amount of opportunity in Latin America, the Middle East and, potentially in the next 10 years, in Africa and in some Southeast Asian countries.

P&I: Concerning the future of gold investments among U.S. institutions, have central banks' stimulus programs during the COVID-19 pandemic changed how institutions should look at gold in their portfolios?

CAVATONI: Monetary and fiscal policy have had a direct impact on how gold is viewed by the investment community at large. In terms of the opportunity right now for gold in a world of negative real rates, fiscal policy has had a huge impact on the gold market and in understanding that gold can be an added benefit to a portfolio. So that's item No. 1. In addition to that, central banks have been a large part of what's driving up the demand in the consumption of gold, and that is simply because they are adding in as they diversify away from some of the traditional assets they've held in their reserve portfolios. And that's not only central banks. Significant state-level pension plans are actually making the same types of allocations at the same percentage level; 3½% to 5% portfolio allocation is what we're seeing.

GROSS: As someone whose focus is on asset allocation for the institutional community, I generally do not view gold as a core holding in most circumstances for the simple reason that it doesn't provide a source of long-term return. Having said that, gold does have some attractive characteristics. It generally has low to negative correlations with most financial assets. It has reasonable liquidity and it provides access to one very distinctive value-add that you can't get easily anywhere else, as a disaster hedge. When the market is contemplating some sort of structural breakdowns in the economy and the financial system, gold is certainly at its finest as an asset class.

Yet gold hedges certain risks but not others. It is not a particularly attractive substitute for fixed income duration as a portfolio hedge. The correlation between gold and equities is much more variable and it doesn't follow easily definable trends. It tends to be driven a lot by retail flows and other kinds of market noise functions that make it tougher to embrace as a strategic hedge solution. So I think what you see is a lot of people who are holding it in modest size as a diversifying asset. And it gives them some flexibility in the event of a crisis to monetize it and reallocate to something more opportunistic.

CAVATONI: Gold is well known and utilized as a safe haven asset and diversifier. What we're focused on is educating investors that gold also delivers long-term returns of approximately 8%, which is comparable to other asset classes. The combination of returns, liquidity, correlations and risk mitigating attributes makes gold a strategic portfolio asset for various economic environments. ■

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