HEALTH WEALTH CAREER

ALLOCATING TO REAL ASSETS

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INTRODUCTION

Both the property and the infrastructure markets have changed dramatically over the last 20 years and continue to do so as the population ages and the ways people work and live evolve. All these factors affect the profile of the services on which we rely and the landscape for housing and places of work.

Infrastructure currently has a huge funding gap, with demand outstripping supply globally.[1] Governments are increasingly looking for private infrastructure investment to help fund diverse projects. Similarly, different types of traditional corporate owners of infrastructure are turning to partial and, in some cases, full asset sales to re optimize balance sheets and address regulatory ownership concerns. This is increasing the volume of opportunities available to institutional investors, but there is still a long way to go in closing the gap. These assets and projects are hugely important to the success of economies around the world, and the essentiality of the services they provide helps to underpin earnings profiles of specific assets, which can translate into a defensive risk profile for many infrastructure investments.

The real estate environment has changed markedly over the last few years. The demand for commercial real estate has changed, as the increase in online shopping has driven demand for industrial space (at the expense of retail) and flexible working — meaning employers often need less office space. Growth in the residential sector as an institutional asset class is nascent but hugely important, and new sectors are emerging all the time as changing demographics are addressed (for example, more senior living, healthcare and childcare facilities).

Finally, the development of institutional-quality natural resource investments has increased the scope for investors to make allocations in their real assets portfolios to energy, timberland, agriculture and mining and minerals.

Given all these trends, many investors should be rethinking their approach to these asset classes. Investors should no longer simply decide to invest in real estate, infrastructure or any other category. Instead, they should consider the characteristics they need from such assets to enhance their investment strategy and then determine how real assets can be used to meet those objectives. This paper provides ideas on the various characteristics that can be delivered by real assets and how they can be incorporated into an investment strategy.

Investors with existing allocations should consider whether the characteristics of those assets are properly matched to their strategic needs. Investors considering making new allocations to real assets should consider their strategic needs first and carefully select the real assets that best match those needs.

1 McKinsey Global Institute. *Bridging Global Infrastructure Gaps*, June 2016, available at https://www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/bridging-global-infrastructure-gaps.

REAL ASSETS DEFINED

Real assets are physical in nature and include real estate, infrastructure and natural resources. The unifying characteristic is that the investor has access to a defensible earnings stream and/or storage of value through a set of difficult to replicate underlying physical assets. This connection may be through direct ownership of assets (for example, owning rental properties) or through debt secured against assets (for example, making a loan to the owner of a toll road that is secured against the road should the borrower default).

The specific assets purchased and the way the holdings are structured allow investors a great deal of flexibility. This means that real assets can exhibit different combinations of growth potential, value creation or reliable income streams.

Fund managers can tailor real asset portfolios to suit the needs of different investors. For example, we have seen real estate funds aiming to provide very secure inflation-linked income with minimal expected capital gain, and we have also seen real estate funds redeveloping vacant properties with high capital gains as the primary objective. Similar variations can be seen in other categories of real assets. Because of this flexibility, investors are able to allocate real asset exposure to either the growth or matching part of their portfolio or use them to bridge the gap between these two categories. We have seen real assets being used in a variety of ways, especially over the last few years as fund choice has broadened.

This breadth of choice means that investors should first think about the characteristics they need real assets to contribute to their investment strategy. This can then help inform the choice of category (for example, real estate or infrastructure), choice of structure (for example, equity vs debt), return target, risk level and other considerations.

Against this, it is rare that a single fund can deliver across a range of asset types and investment profiles, giving rise to investor level diversification and portfolio construction challenges that need to be overcome so an investor can effectively tap into the benefits real assets can deliver.

This paper focuses primarily, although not exclusively, on unlisted real assets. For a more detailed summary of our thoughts on listed real assets, please also see our recent paper entitled ‘Listed Real Assets’.

A COMPLICATED LANDSCAPE

We have mentioned that investors have a wide array of real assets being made accessible through an explosion of different types of products offered by fund managers. For example, available investments in real assets have moved on from core commercial real estate to include residential property, value-add/opportunistic property funds and real estate debt strategies. Similarly, the access routes available to investors have increased materially over the last five years or so. Historically, investors have tended to favor the unlisted, asset-ownership approach. However, the private debt market has become more accessible for institutional investors, and investing in listed securities is an approach that some regions and investor types have embraced. The exhibit below illustrates the amount of choice being faced by investors.

FOUR INVESTMENT QUADRANTS

PUBLIC EQUITY

- Property — real estate investment trusts and real sstate operating companies
- Infrastructure — investing in the shares of infrastructure companies
- Risk and return characteristics similar to equity markets in the short term

PRIVATE EQUITY

- Property — core, value add, opportunistic
- Infrastructure — greenfield and brownfield
- Leveraged exposure and subject to more volatile cash flows
- Some liquidity premium, but correlation with the property and infrastructure markets

PUBLIC DEBT

- Property — commercial mortgage backed securities
- Infrastructure — network rail bonds
- Low volatility of returns
- Stable and secure cash flows

PRIVATE DEBT

- Property and infrastructure — senior, junior and mezzanine loans
- Often unlisted and unrated
- Less volatile than private equity, with more stable and secure cash flows
- Illiquidity is a strong driver of returns

Our advice to investors is to try to avoid thinking about categories too early in the process of considering real assets. Focusing on categories tends to skew decisions based on past experience of asset classes or incomplete knowledge. Instead, we encourage investors to focus on their return requirements, risk tolerances and specific objectives (such as income generation) that can dictate the choice of real assets. In the next section, we look at the characteristics of different real assets that should affect an investor’s choice about a potential investment and how to proceed with implementing that investment.

CONSIDERATION FOR INVESTING IN REAL ASSETS

Allocations to real assets can play many roles in investment strategy design. To be successful investing in real assets, investors must be clear about what they are trying to achieve and how they are trying to achieve it. The exhibit below shows a number of issues for consideration. Investors with existing allocations to real assets may find it useful to assess portfolio holdings against these considerations.

KEY ISSUES WHEN INVESTING IN REAL ASSETS

PHYSICAL OWNERSHIP

- Downside protection
- Positive effect on credit risk

INCOME GENERATION

- Steady income stream
- Implicit inflation linkage

DIVERSIFICATION

- Risk management
- Potential for higher risk-adjusted returns

VALUE CREATION

- Potential for enhanced return–illiquidity premium
- Alpha potential through active asset management

SOCIETAL/ESG IMPACT

- Sustainable infrastructure
- Residential strategies
- Low carbon funds

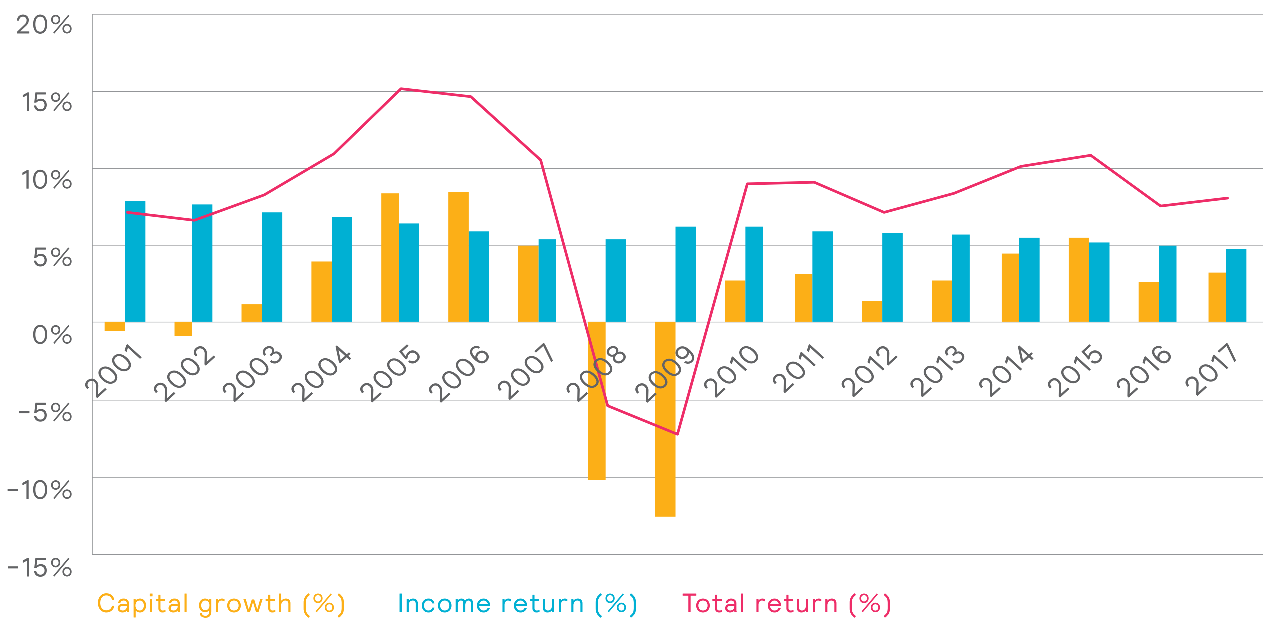
PHYSICAL OWNERSHIP

As discussed earlier, a unifying characteristic of all real assets is access to a defensible earnings stream and/or storage of value via a direct connection to a physical asset. Investors will best be able to determine the fit of an investment, specific to their own needs and objectives, by gaining an understanding of the type of physical assets, the basis of their earnings generation or growth outlook, and the nature of the connection with those assets. It is important to properly understand these issues and make conscious choices rather than rely on first impressions or blanket, generalized categorizations. For example, the fund may own a series of properties with high-quality tenants, but high leverage could mean that there is material downside risk. Or a fund might own infrastructure assets with material operational risks, but effective asset management and/or outsourcing, perhaps combined with insurance, may create the potential for a more reliable income stream.

INCOME GENERATION

Many investors are attracted to real assets because of their potential to generate attractive levels of income. However, investors should make active decisions about the type of income that they need. For example, is a high degree of stable income important, or is some variation tolerable? Is direct inflation linkage important, or would fixed rate income be acceptable? Is income generation in currencies other than the investor's base currency tolerable, within the context of the investor's wider approach to foreign currency management? Investors should also be conscious that the choices and preferences they have regarding income may also carry a cost. The chart below shows the nature of the income and capital gains on an index of global property.

FIGURE 1: GLOBAL PROPERTY RETURN COMPONENTS



Source: MSCI

This illustrates the amount of variation in income and capital growth from this kind of "middle of the road" real asset. Would this meet your needs? Would you accept lower capital gains in return for a more stable income? Would you accept lower income rates in exchange for higher capital gains?

DIVERSIFICATION FROM TRADITIONAL ASSETS

Many investors wish to increase their portfolio's diversification away from traditional assets, such as listed equities. Diversification can be gained through an allocation to appropriately selected real assets. Although real assets will, to varying degrees, exhibit a positive correlation with equities (due to common return drivers, such as discount rates and changes in growth/inflation expectations), they also offer diversification benefits due to the different underlying source of cash flows and dependence on return drivers not available to investors in listed equity markets. For example, illiquidity and complexity premiums typically will be available to investors in private markets, thereby introducing return drivers not typically found in portfolios dominated by equities and bonds. In addition, the ability to shape the return stream due to having control of the underlying asset (for example, by refurbishing a property) offers significant potential for adding value from active management (what we term "hands-on value creation").

However, it is important to note that different real assets provide varying degrees of diversification from traditional assets. For example, in the UK, ground-lease funds during the financial crisis provided much better protection than core property funds. Investors allocating to real assets primarily for diversification should consider this carefully. And, as with income preferences discussed earlier, investors should consider what other tradeoffs are involved in gaining diversification benefits.

VALUE CREATION

Investors should understand the extent to which their chosen real assets fund managers are aiming to add value above broad market returns. The value creation is often uncorrelated to other forms of alpha an investor may have in its portfolio (for example, stock-picking in listed equities), and high-quality managers will typically have a track record of successful value creation that should give confidence in terms of repeatability. Value creation can derive from a number of potential sources, including:

- Inefficient markets — landlords often are unable to manage assets effectively, resulting in stock that is, in some way, broken
- Different risk appetites among investors — some investors are effectively forced (or at least motivated) sellers on the basis of risk.
- Investors' perception of risk — despite the quality of the asset, other factors can mean that value has eroded over time and can be re-added if well-managed; an example of this in real estate is short leases or weak tenants, as the investment market prices differ greatly for long leases and strong tenants, often regardless of the building in question
- Gearing resulting in stressed capital structures — this can create buying opportunities for good-quality stock that has been owned through an inappropriate capital structure
- A broad array of market participants working in discrete parts of the market, from early stage developers to end-user income investors
- Differentiated asset-sourcing angles in specific regions or sectors
- Injecting greater risk management or earnings enhancement expertise into an existing asset management team

- Reshaping an asset's capital structure, thereby delivering greater financing efficiency
- Successfully managing and navigating a construction program, in the case of a new build (or "greenfield" project)
- Repositioning an asset so it is more readily accessible by, and attractive to, a wider range of buyers, thereby increasing its resale value

Again, we stress that investors choosing to allocate to real asset funds with the goal of adding value through active management should consider the impact on other factors in this section of the paper. Does the value-creation method reduce income or diversification from traditional assets and/or carry an increased risk profile, for example?

SOCIETAL/ESG IMPACT

The environmental, social and governance (ESG) aspects of any investment are becoming increasingly important to many investors. Real assets, by definition, have a heavy responsibility in this regard, in terms of both their effect on the environment and their effect on society. For investors wishing to incorporate a positive impact on ESG issues into their strategy, real assets may provide an attractive route. In real assets, it is challenging to ignore ESG considerations and any fund manager doing so is at risk of destroying value for clients. The corollary is also true: Managers with a strong ESG focus have the potential to add material value to the assets they own.

During the last few years, a number of new strategies have been launched with the aim of providing investors explicit exposure to sustainability themes, over and above the extent to which these would be prevalent in a more traditional real asset strategy. These include:

- Low carbon development funds — These aim to acquire old properties and retrofit them to create highly sustainable real estate with low energy usage, high employee engagement and low absence levels.
- Social impact funds — These vary in strategy but include residential strategies (social housing, shared ownership and even open-market rented housing) and social infrastructure (nurseries, healthcare, education).
- Renewable-energy infrastructure funds — These provide exposure to one or more "alternative" power-generation technologies (for example, solar, wind or biomass).

Investors with existing allocations to real assets should ensure they understand the extent of ESG integration into the management of their assets and consider whether value is being created or lost by the fund manager. Investors considering new allocations to real assets should make ESG integration a key part of their assessment of different options.

CONCLUSION

We believe that real assets, on average, remain under-represented in investor portfolios (when considering industry-wide data). As the market continues to evolve, investors will likely find an increasing volume of opportunities to take advantage of across the spectrum of real assets. We challenge all investors to look at their investment strategies and ask themselves the following questions:

1. How recently did you review the size of your real asset allocation, and should that now be reconsidered?
2. Do you know why you have selected the specific types of real asset that you hold?
3. Do you know why you have excluded other types of real assets?
4. Do you understand the choices you have made on our five characteristics of real assets (direct connection, income generation, diversification, value creation and ESG impact)?
5. Have previous decisions about real assets been influenced by the availability of fund manager products? Could evolution of available products mean that you should reconsider past decisions?
6. Is the portfolio you have created truly diversified in nature?
7. Have you afforded yourself the opportunity to access a broad suite of top-tier managers that may be in the market at differing points in time?

The real assets landscape can be as simple or as complex as an investor needs it to be. The most appropriate solution often is not the simplest, but the market caters for various governance models. In an increasingly complex world, the need for clarity around investor objectives and the range of strategies available to meet those objectives is crucial.

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