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IAS PORTFOLIO INSIGHTS

THE FOUR ELEMENTS OF SUCCESSFUL REAL ASSETS INVESTING

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CIOs construct their real assets portfolios with many possible investment objectives in mind: inflation protection, low-growth protection, or overall portfolio diversification. In practice, however, what's often missing is a consistent framework to select and allocate across a remarkably diverse set of real assets to meet the desired investment objective. In addition, constructing a real assets portfolio for one objective may, in fact, add unintended economic exposures. For example, a pension CIO seeking inflation protection might select energy assets for their real assets portfolio. While on the surface this seems reasonable, this allocation may increase the overall portfolio's exposure to economic growth, which may not be intended. When constructing real assets portfolios there is no one size that fits all. Selecting and allocating to real assets depend on each investor's specific investment criteria.

There are four elements to successful real assets investing:

1. Get the sensitivities right: Sensitivities (*i.e.*, betas) of real assets to macroeconomic (inflation and economic growth) and financial market (stocks and bonds) variables differ widely. For example, the beta of energy commodities to inflation is large compared to energy midstream MLPs (Master Limited Partnerships), 4.7 vs. -0.3, respectively. So, a CIO seeking inflation protection from real assets may wish to select energy commodities but pass on midstream MLPs.

2. Know your investment horizon: Relationships of real assets to macroeconomic and market variables vary with the CIO's investment horizon. For example, the correlation of commodity returns to inflation differ considerably at a one-month horizon vs. a three-year horizon, 0.2 vs. 0.6, respectively. So, for a short-term trend follower, commodities may not provide inflation protection in any given month, but for a long-term investor like a pension CIO, commodities may offer the desired inflation protection.

3. Incorporate estimation uncertainty: Be wary of those who say they know an asset's sensitivity to growth or inflation. Betas are estimated with error, and this uncertainty generally increases with the horizon. However, this uncertainty should and can be accounted for when constructing a real assets portfolio. For example, infrastructure equities have a wide estimated 3y inflation beta range of [-0.8, 1.8] with an average of 0.4, while TIPS have a narrower estimated beta range [0.2, 1.7], with an average of 0.9. So, while a CIO may select both infrastructure equities and TIPS for their inflation-protection portfolio, the CIO would wisely give infrastructure equities a lower allocation in the portfolio in recognition of not just its lower average inflation beta but also the greater uncertainty in its estimated beta.

Be wary of those who say they know an asset's sensitivity to growth or inflation; it can be quite uncertain, particularly at a long horizon

4. Embrace your economic environment outlook: Equity volatility is greater in a stagnation environment (low growth and low inflation) compared to an ideal environment (high growth and low inflation). The estimated sensitivities of real assets to inflation, growth, stocks and bonds also differ depending on the economic environment. So, if a CIO has a view that stagflation is likely then a stagflation-focused real assets portfolio can be constructed, and that may look quite different from, say, an overheating-focused portfolio.

RASA® (i.e., Real Assets Sensitivity Analysis) is an application that brings together these four elements for successful real assets investing to the CIO's desktop. RASA uses special regression analysis to measure each real asset's sensitivity to macroeconomic and market variables. Betas are estimated based on a CIO's specific horizon, say 1y or 3y. RASA uses these estimated betas and their standard errors to construct a real assets portfolio that targets the CIO's specific investment objective. This asset allocation solution rightly penalizes those real assets with high inflation beta uncertainty.

CIOs can use RASA in many other ways. Since real asset funds can differ considerably in terms of their inflation exposure and underlying performance benchmarks, investors can use RASA to identify and select only those funds which are likely to provide strong inflation protection. CIOs can also use RASA to construct customized commodity benchmarks tuned to their own investment objectives, rather than an off-the-shelf benchmark that is typically based on simplistic production weights. CIOs can then give this custom benchmark to their active management teams as their performance benchmark.

Today's higher inflation environment has turned the spotlight on real assets. By following the four elements of real assets investing, a CIO can help ensure that their real assets portfolio will meet the intended objectives.

All values in the article are as of 12/31/2021. Analysis period from April 1973 to December 2021. Betas are estimated at 3y horizon.

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