PGIM

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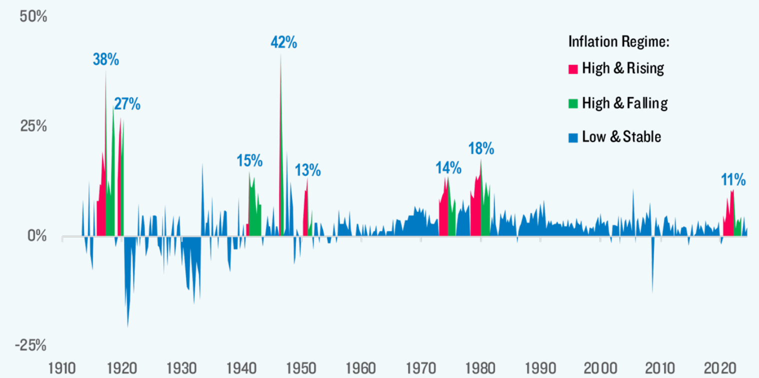
IAS EXECUTIVE SUMMARY

REAL ASSETS, INFLATION & PORTFOLIO PERFORMANCE

Having experienced the first US inflationary cycle since the mid-1970s, how should investors be thinking about inflation risk and their real asset allocations going forward? Looking back over the last 100+ years, if the past is prologue, then investors may experience inflationary cycles lasting 3y a bit less than once a decade.

US CPI Inflation & Inflation Regimes (1913-2024)



Although US headline inflation has moderated since peaking in mid-2022, core inflation has proven sticky, and concern about inflation risk continues to trend higher along with related focus on real assets.

In speaking with institutional investors, there are three general motivations for considering the inclusion of real assets in a balanced portfolio: greater portfolio diversification, as a source of incremental returns, and as a hedge against inflation risk. Indeed, real assets returns are not highly correlated to either stock or bond returns. They tend to co-move with inflation and have relatively stronger returns when inflation is high and rising.

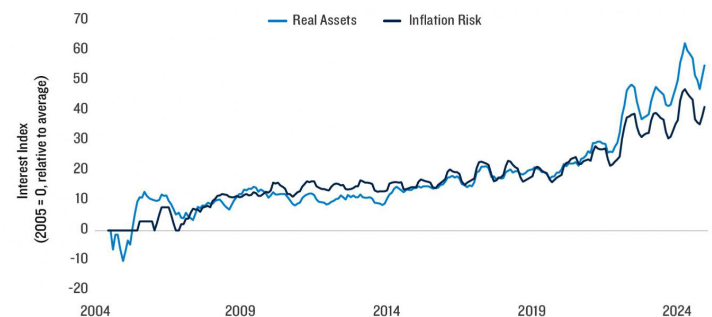
We explore these three *motivations* for adding real assets to a portfolio, each with a related portfolio construction *methodology,* and focus on the impact that inflationary regimes have had on portfolio performance.

Stock/Bond/Real Asset Basket Portfolio Performance by Inflation Regime (annualized, 1971-2024)

Stock/Bond/Real Asset Basket Portfolio Construction Method	Real Asset Basket Allocation	Expected Active Return *vs.* 60/40		
		High & Rising (11%)	High & Falling (7%)	Low & Stable (82%)
3-Asset Mean-Var Optimization	20% cap	5.6%	-0.4%	-0.4%
	36%	10.2%	-0.7%	-0.6%
Mix of 60/40 & Real Asset Basket such that Inflation β = 0	24%	6.3%	-1.9%	-0.7%
Maximize Returns such that Vol ≤ 60/40 Vol	20% cap	5.9%	0.8%	-0.1%
	37%	10.9%	0.2%	-0.5%
60/40	0%	0.0%	0.0%	0.0%

Source: Bloomberg, Bureau of Labor Statistics, DataStream, Federal Reserve Bank of Chicago, Foundation for Intl Business & Economic Research, FTSE NAREIT, Giliberto-Levy, Google Trends, Haver Analytics, Standard & Poor's, U.S. Treasury and PGIM IAS. Provided for illustrative purposes only.

Google Trends: Inflation Risk and Real Assets (2004-2024)



Note: Trailing 6m moving average relative to full sample average. Data are Google trend "all category" US search terms. Source: Google Trends (accessed 04Dec2024) and PGIM IAS. Provided for illustrative purposes only.

Four key takeaways for CIOs, asset allocators, and risk managers:

- Real assets merit the consideration of inclusion in a balanced portfolio due to a "trinity" of real asset characteristics: diversification, return enhancement, and inflation hedging.
- Historically, balanced portfolios that include real assets have had higher average returns, lower volatilities, and better risk-adjusted returns relative to a benchmark portfolio of stocks and bonds alone.
- However, portfolio performance depends on the inflation regime. Historically, stock/bond/real asset portfolios have delivered positive active returns during periods of *high and rising inflation* but were a drag otherwise.
- A dynamic real asset allocation strategy which allocates to real assets only when inflation is high and rising, could generate positive active returns and eliminate portfolio drag during other periods. But, generally, it does so with slightly more volatility and lower risk-adjusted returns relative to a static buy and hold real asset strategy.

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