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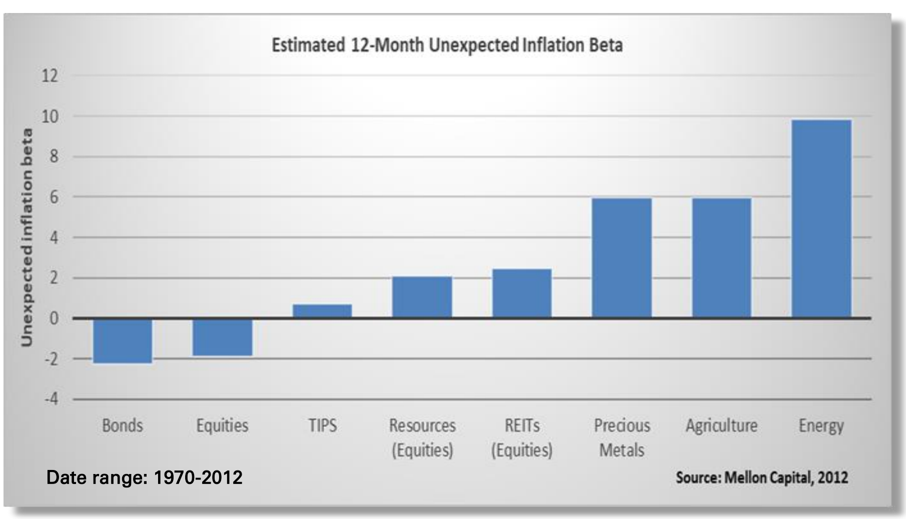
The Case for Liquid Real Assets

At the end of a very strong year in the global stock markets, it is easy to forget that a well-balanced portfolio should own other types of investments in addition to equities. Fixed income (bonds), usually a fairly significant portion of an investor's portfolio, is well understood as a source of interest income and, quite often, downside protection in case of a stock market drop. But many institutional and high net worth investors also hold a separate allocation to "real assets".

What Are Real Assets and Why Should Clients Invest in Them?

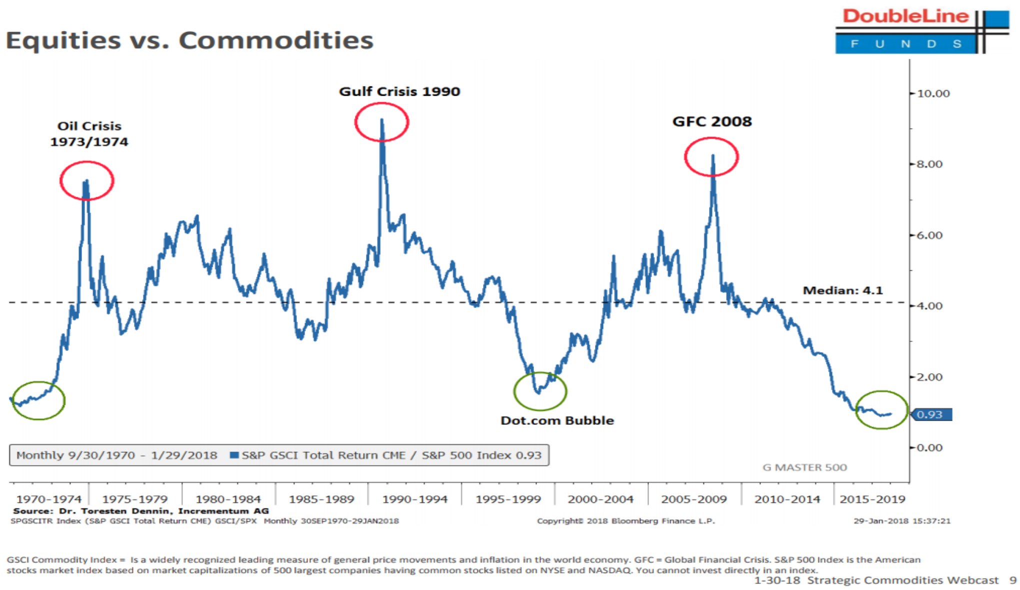
Real assets are primarily physical in nature and tend to be "assets that provide sensitivity to inflation[1]," such as natural resources/commodities (agricultural and forestry products, precious and industrial metals, and energy), natural resource companies, real estate and infrastructure. Global inflation-linked bonds may also be included as a real asset rather than fixed income due to their sensitivity to inflation.

As noted above, it is the hedge against inflation, which can often negatively impact both stocks and bonds, that investors find attractive for investment portfolios. As we can see in the study below, during times of unexpected inflation, real assets have exhibited a positive sensitivity while both equities and bonds have responded poorly to unexpected inflation. This makes real assets an attractive diversifier in a typical asset allocation.



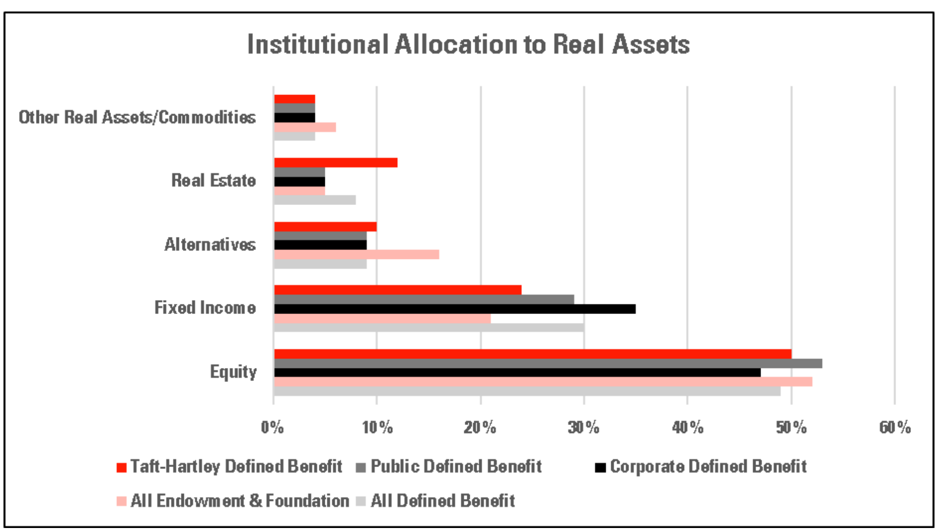
[1] William W. Jennings and Eugene L. Podkaminer, *Portfolio Management: Overview of Asset Allocation*, (2020 CFA Program, Level III Reading, 2019), 21

Real assets also have the potential to enhance returns within a client's portfolio. As we can see in the graph below, the relative performance of commodities vs. US equities can fluctuate dramatically. We would argue that the underperformance of commodities relative to US equities over the last decade provides potential for better relative returns for commodities compared to equities at this point in the cycle. The recent downtrend in commodities performance continued through 2019.



Source: MarketWatch 2018

Real assets have generally been a small part of institutional investment portfolios, as exhibited by the chart shown below. While this data is from several years ago, we have not seen any noticeable increase anecdotally, though a recent Blackrock survey in 2019 indicated that it was the most likely area of increase within institutional portfolios that year[2].



Source: InvestorForce, 2016 Study

[2] Blackrock, 2019 Global Institutional Survey

Not surprisingly, due to the underperformance of commodities in this latest downcycle, overall investor interest appears to have diminished. Morningstar notes that the number of Natural Resources mutual funds peaked at 169 in 2014 and dropped 25% to 126 by the end of 2019[3].

Private Real Assets vs. Liquid Real Assets

Once a decision has been made to invest in real assets, the next question is how? Traditionally many endowments and institutions have chosen to buy real assets privately. Real estate has been a staple of most portfolios for decades. Some leading endowments and foundations have expanded their investments over the years into timberland, farmland, pipelines, roads, property and a host of other real assets. Investing in real assets directly has traditionally only been possible for large endowments or institutions with the staff and time to appropriately analyze and monitor such investments. Others have had to rely on retaining outside managers.

Private real asset investments also pose liquidity issues. Once in, it may be very difficult to exit a position at a reasonable price or even at all. A recent Bloomberg article noted the difficulty the Harvard University endowment had with regard to private agriculture investments in Brazil[4]. When its $270 million investment in private farmland encountered difficulties, it was unable to find a single buyer for the project. In the end, the endowment ended up writing off $200 million of the investment.

Liquid real assets can mitigate some of the downside risk to investments in real assets. Commodity futures, natural resource equities, REITs, listed infrastructure funds, exchange traded vehicles, mutual funds and master limited partnerships are available to give reasonable access to a broad range of real asset sectors, without tying up capital for a long period of time as well as providing greater ability to exit positions. Within the equity universe for example, of the 3,050 stocks within the MSCI ACWI, roughly 16% (500+) of those are in areas that may offer investors exposure to real assets (energy, materials, REITs, and utilities)[5].

Another advantage of liquid real asset investments is that they generally require much lower initial investments than illiquid, private market real asset investments. This allows managers to build a diversified real asset portfolio with much lower dollar amounts. And the daily liquidity that most of these investment vehicles offers allows investors to make investments in a more timely manner and take greater advantage of the sector's inherent volatility.

While studies show that liquid real assets are more volatile than illiquid real assets, we believe this apparent difference is primarily a result of the appraisal-based methods used to value illiquid real assets. Appraisals are often done only annually and prices in most private asset benchmarks are available only quarterly. This results in an artificial smoothing of returns relative to the daily trading values of liquid investments. The underlying fundamentals are generally no different and returns over time, as the chart below shows, are not significantly different.

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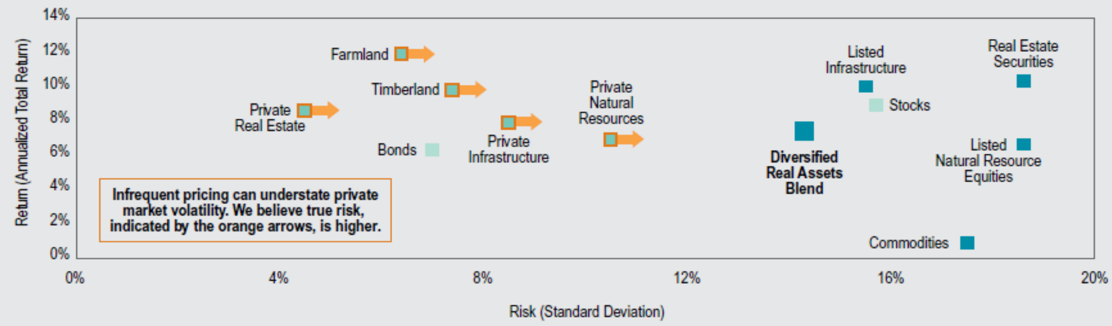
[3] Morningstar.com, 2020

[4] Bloomberg, *Harvard Was 'Freaking Out': How a $270 Million Brazil Bet Tanked,* 10/24/19

[5] MSCI.com, 2020

Exhibit 6: Private Real Assets: Downplaying the Risks
Listed and Private Risk and Return, 1992–2015



	Traditional		Listed					Private				
	Bonds	**Stocks**	**Diversified Real Assets Blend**	**Com-modities**	**Natural Resource Equities**	**Infra-structure**	**Real Estate Securities**	**Natural Resources**	**Infra-structure**	**Real Estate**	**Timberland**	**Farmland**
Annualized Return	6.4%	9.0%	7.5%	0.9%	6.7%	10.1%	10.4%	7.0%	8.0%	8.7%	9.9%	12.0%
Volatility (Standard Deviation)	7.0%	15.7%	14.3%	17.5%	18.6%	15.5%	18.6%	10.5%	8.5%	4.5%	7.4%	6.4%

At December 31, 2015. Source: Bloomberg, NCREIF, Preqin, Thomson Reuters Datastream, Cohen & Steers.
Data quoted represents past performance, which is no guarantee of future results. (a) Beginning January 1992 for all categories except private natural resources and private infrastructure, which begin on January 2006 and January 2008, respectively. (b) Private real asset volatilities based on smoothed appraisal valuations, which result in understated volatility. See page 11 for index associations, definitions and additional disclosures.

Source: Cohen and Steers, 2016

It should also be noted that liquid, publicly listed real asset equities are supervised by government regulatory bodies, such as the SEC, and follow governance standards required of public entities.

Costs for publicly-listed real asset investments are also generally lower as well. Private market investments often have higher fees (ranging from 1.5% to 2.0% per year as noted in a recent study[6]). They also often have performance fees that further reduce investor returns. On the other hand, many liquid vehicles are managed for fees under 1% with no performance fee.

Even for those institutions that have the time, resources and inclination to invest directly in private real assets, liquid assets provide a complementary addition to the illiquid portfolio. In addition to providing overall exposure to the real assets space, the wealth of liquid investment options offers additional opportunities to gain exposure to a greater variety of real asset sectors and return opportunities. Furthermore, the liquid characteristic of such investments makes it easier to adjust overall investment portfolios depending on market cycles and fund flows.

High Pointe's Global Real Assets Strategy

At High Pointe, our Global Real Assets Strategy is designed to take advantage of the opportunities provided in the liquid real assets space in order to add enhanced risk-adjusted return potential and hedge against unexpected inflation.

Our strategy of investing across a broad array of real asset sectors (agriculture and forestry, metals and mining, energy, real estate, infrastructure and treasury inflation-protected securities (TIPS)) provides a range of opportunities to generate returns. No single sector will provide a total solution. We also set minimum and maximum ranges for each sector to ensure that the portfolio remains properly diversified, as seen in the chart below.

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[6] Meketa Investment Group, *Natural Resources*, 2018

	High Pointe Current	High Pointe Range
Sector/Asset		
Agriculture	25%	5-30%
Hard Commodities	28%	5-30%
Energy	9%	5-30%
Real Estate	12%	5-30%
Infrastructure	13%	5-30%
TIPS	10%	0-10%
Source: High Pointe Capital		

The Strategy is also designed to take advantage of our stock-picking experience to potentially add value. Real asset sectors, particularly natural resources, have been out of favor for quite some time and the amount of attention and research has remained low. It is also important for real asset investors to invest on a global basis, which we do. Many of the best real assets or companies with real asset exposure are found outside the United States.

Our focus primarily on publicly listed equities, rather than commodity futures, is important and worth explaining. While equities are generally thought to be more volatile due to their leverage to underlying real asset prices, companies have a number of levers to pull during periods of declining or low real asset prices. The ability to cut costs, refocus investments, benefit from new technologies, develop new products, open new markets, among other things, can lead to steady or improving returns throughout the cycle. And companies, for the most part, pay a dividend which adds to shareholder returns.

Commodity futures, which only provide exposure to prices and not to any valued added management activities, also incur "roll" costs as futures expire and are rolled to the next contract. In a seminal study by proponents of commodity futures strategies, it was found that "roll" costs during the period of 2004-2015 for a broadly diversified commodity futures strategy was a staggering 7% per year.[7]

Conclusion

As investment advisors and portfolio managers, we are continually looking for opportunities to add to risk-adjusted returns in client portfolios and to hedge against adverse financial environments. As a result, we have been taking advantage of the opportunities in the real asset sector by adding some liquid real asset positions in clients' asset allocations and continue to look for additional opportunities.

Chris Olson and Gautam Dhingra
January 22, 2020

[7] Claude B. Erb and Campbell R. Harvey, *Conquering Misperceptions about Commodity Futures Investing*, 2016