Real Assets "Inception": Diversification within Diversification

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Central Issue of the Paper

If the movie *Inception* taught us anything, it's that Leonardo DiCaprio would likely approve of multiple levels of diversification in a portfolio. Institutional investors have long seen the benefits of including real assets in a portfolio, as they can provide diversification benefits to traditional allocations containing stocks and bonds, while also providing protection against unexpected inflation. But are institutions truly diversified? In other words, is simply owning real assets as a part of a portfolio enough?

In *Inception* terms, if proper real asset allocations were analogous to dreams, they would have three levels: (1) allocating to real assets in the first place, (2) allocating within real assets to different subcategories, and (3) diversification of underlying securities. In "Rethinking Real Assets," the authors acknowledge that institutions have executed the first and third levels fairly well, but have recently begun to focus on the second level of diversifying within real assets.

Approach Employed by the Paper

The authors first walk us through the history of real assets allocations, discuss the rise of the real asset portfolio and how diversification amongst real assets has become more important for investors, and finish with how the asset management industry has adapted to these changes.

The History

Real assets allocations have tended to differ depending on where investors are located. For example, a typical U.S. endowment portfolio's real asset allocation has historically consisted of real estate, natural resources, and Treasury Inflation Protected Securities (TIPS), while Canadian and Australian institutional portfolios have had heavy allocations to infrastructure investments. Adoption of real assets strategies have been slower in the European market. While some of these categories sit at the heart of real asset allocations, investment managers have become more granular in their desired exposures to real assets.

The Rise of the Diversified Real Assets Portfolio

The evolution of demand for these sub-categories has caused "niche" categories to be on the rise. For example, Timberland and Master Limited Partnerships (MLPs) have found themselves in more real asset portfolios. This sudden rise in demand has likely been due to institutional investors facing a prolonged period of low interest rates. With almost half of the world's outstanding risk-free debt yielding negative interest rates, investors have been forced to look elsewhere for diversification and income generation.

As investors have shifted allocations away from traditional fixed income and into other asset classes, valuations for legacy real assets, such as core real estate, have become somewhat extended. Allocators are then given a choice: move out on the risk spectrum or find other real assets that might accomplish the portfolio's goals. It's worth noting that many of these subcategories of real assets don't offer a similar risk profile as traditional fixed income.

To combat this, investors have moved to diversify within their real asset allocation. As a result, real assets sleeves in institutional portfolios no longer include of one or two subcategories but could include as many as eleven! The authors find that many of these sub-categories, such as agriculture, timberland, real estate debt, and infrastructure debt, can actually help diversify a portfolio away from public equities, perhaps acting as a complement to core fixed income. The additional benefit is the fact that combining these subcategories can bring diversification benefits within the sleeve itself.

Demand, Meet Supply: The Rise of Multi-Real Asset Managers

As demand has surfaced, supply has come to meet it. Many asset managers have scrambled to resource and staff dedicated Real Assets teams in an attempt to bring diversified real asset strategies to market in many different fund structures. The authors warn allocators to make sure proper due diligence is done on these new funds. Many of the underlying portfolios differ, and many of these strategies have limited track records due to lack of resources. They also suggest that managing the allocation in house might bring an advantage – teams will have a better idea of what exposure they want and will have the ability to hire the best managers in each subcategory.

Findings of the Paper

The authors conclude the paper by making the following three points:

1. Allocations to real assets have evolved from "diversification toward real assets" to "diversification within real assets"
2. Allocators to real assets are changing their mindset from labeling sub-categories to prioritizing risk exposures.
3. Diversification within real assets is useful in theory but implementation can be challenging in practice.

In summary, we've seen a proliferation of real assets strategies in the past decade. Not only is it important for investors to determine the appropriate allocation within their real assets sleeve, but those who outsource must perform proper due diligence on third parties since these strategies are relatively new.

Is this more complicated than putting a simple real estate portfolio together? Possibly, but "you mustn't be afraid to dream a little bigger, darling."