Why read on?

As investors have moved towards “real asset” portfolios rather than segregated sector-specific buckets, three significant trends have emerged.

The heart of this often-discussed shift is a mindset that is less focused on labels and prioritizes core characteristics or risk factors, such as inflation sensitivity, diversification from equity and yield. Yet, as is becoming increasingly clear late in the cycle, these characteristics are not hard-wired to real assets in the way that the equity risk factor is hard-wired into equities. In addition, different sub-sectors possess these traits to varying degrees.

The first trend: while unlisted real estate and infrastructure often sit at the heart of real asset portfolios, investors are becoming increasingly sophisticated and granular in their approaches to these two asset classes, and more cognizant of drifts in managers’ risk exposures and characteristics.

Trend two: holistic approaches have facilitated diversification into niche sectors that may not sit within the old buckets, such as agriculture. High valuations in mainstream real assets have helped to encourage both of these trends, although pricing pressure has spilled into the niches and ‘uncharted territory’ is ever-more elusive.

The third and newest development is the rise of multi-real-asset investment strategies. Asset managers are launching strategies or structuring wrappers that offer breadth across multiple sectors. They can include conventional or more esoteric investments, while structures range from “funds of in-house funds” to true diversified pooled funds. There are powerful reasons why a
number of bfinance clients have sought broader mandates in 2017-18. Investors should be aware that those principles don't necessarily translate into real-life practices.

In some ways this latest step was a logical extension to major shifts in the asset management industry. Many firms have built or branded “real asset” divisions and the pattern continues into 2018. Some have bought boutiques in sub-sectors where they are historically weak, such as CBRE’s acquisition of Canadian infrastructure manager Caledon or Hamilton Lane’s purchase of RAPM. Many have built new teams to flesh out their real asset suite. Others have consolidated existing teams under a new unit.

The managers and consultants arguing that diversified real asset portfolios outperform real estate or infrastructure during weaker periods in the cycle may be correct in theory. Indeed, today’s investment climate may have strengthened the case for a broader approach. Yet implementation, as is so often the case in private markets, represents the critical challenge.

The Rise of the Real Asset Portfolio

The concept of the “real asset,” “tangible asset,” or “inflation-sensitive” portfolio, firmly established in certain asset owner circles, has gained ground in recent years.

Among U.S. endowments, a portfolio comprising real estate, natural resources and TIPS has long been popular. Canadian and Australian institutional investors, leaders in infrastructure, were also early to institute real asset units. The trend reached its zenith in 2016, when CalPERS instituted a Real Assets division and CPPIB appointed a Head of Real Assets.

For European asset owners, this approach has been slower to gain traction. To some extent this is a side effect of portfolio composition. Real assets other than real estate seldom featured until the post-global financial crisis wave of infrastructure investment.

Timberland, a U.S. staple, has only recently become popular. Master Limited Partnerships (MLPs), used in the U.S. for some traditional energy-related investing, do not have an international equivalent.

Yet the rise of infrastructure investment has been a catalyst for change. Infrastructure can be grouped with real estate due to its similarities, creating a bedrock for a real asset portfolio founded on core characteristics rather than labels.

While the post-GFC phase was marked by diversification towards real assets, later years have seen greater emphasis on diversification within real assets.

A summary of real asset segments, arranged by risk/return profile and market size, is provided in Exhibit 1. Their common theme: values based on contractual claims on physical assets. Exhibit 2 shows how attractive traits are available to varying degrees in the different sub-sectors, making a combination potentially beneficial.

At bfinance, demand for the more “niche” sectors increased substantially during the past three years. This has been encouraged by a compression in returns for core/core-plus real estate and infrastructure. Likewise, within real estate and infrastructure what was niche is now mainstream. Infrastructure funds are tapping into sectors that would not have previously been included, such as energy storage or data centres. UK pension fund real estate portfolios often now include Private Rented, Long Leased and Emergent sectors.

Investors can think of real assets in terms of the ‘four quadrants’ traditionally applied to real estate: unlisted/listed; debt/equity. Some vehemently argue against the inclusion of listed infrastructure and REITS (#fakeinfra), but we urge a focus on contents rather than labels. Although they are correlated with stocks, correlation is also evident in some unlisted sectors. There is a similar divergence over the inclusion of ‘debt’ strategies, which can offer yield and downside protection at a time of aggressive pricing.
### Exhibit 2: Characteristics of Real Asset Sub-Sectors (Excludes Overall Risk and Return Shown in Exhibit 1)

**Source:** bfinance, Deutsch Bank, JPM Hamilton Lane, Partners Group, Preqin, Bloomberg

<table>
<thead>
<tr>
<th>Asset Class (core/core+ profile unless otherwise stated)</th>
<th>Definition</th>
<th>Diversification to equities</th>
<th>Diversification to bonds</th>
<th>Inflation sensitivity</th>
<th>Cashflow / income</th>
<th>Liquidity</th>
<th>ESG</th>
<th>Costs</th>
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<tbody>
<tr>
<td><strong>Private Equity / Unlisted</strong></td>
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<tr>
<td>Real Estate - Traditional</td>
<td>Main commercial sectors inc. office, retail, industrial and (Germany, Netherlands, U.S.) multifamily</td>
<td><img src="#" alt="Red" /></td>
<td><img src="#" alt="Red" /></td>
<td><img src="#" alt="Green" /></td>
<td><img src="#" alt="Red" /></td>
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<tr>
<td>Real Estate - Resilient</td>
<td>Resilient to real estate cycle eg. long lease, inflation linked, demographically oriented</td>
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<td><img src="#" alt="Green" /></td>
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<tr>
<td>Infrastructure - Economic</td>
<td>GDP linked infrastructure with strong contractual underpinning</td>
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<tr>
<td>Infrastructure - Social/Environmental</td>
<td>Supported by availability payments or subsidy. Not geared to economic cycles</td>
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<tr>
<td>Transportation</td>
<td>Transportation and energy operations inc. aviation or maritime leasing rather than physical assets</td>
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<td><img src="#" alt="Green" /></td>
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<tr>
<td>Real Assets Private Equity</td>
<td>Value Added or Opportunistic real estate/infrastructure etc. turn-around, development, high asset-specific risk</td>
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<tr>
<td>Agriculture/Timber</td>
<td>Traditional strategies to generate cashflow as well as improvements in NOI and value through better productivity</td>
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<tr>
<td><strong>Public Equities</strong></td>
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<tr>
<td>REITs</td>
<td>Publicly listed real estate operating companies and REITs</td>
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<tr>
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<td>Publicly listed Infrastructure companies</td>
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<tr>
<td><strong>Debt</strong></td>
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<tr>
<td>Real Estate Debt</td>
<td>Loans secured against real estate assets, generally senior, unitranche or mezz</td>
<td><img src="#" alt="Red" /></td>
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<td><img src="#" alt="Green" /></td>
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<tr>
<td>Infrastructure Debt</td>
<td>Loans secured against infrastructure assets, generally senior, unitranche or mezz</td>
<td><img src="#" alt="Red" /></td>
<td><img src="#" alt="Red" /></td>
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Does Diversification Among Real Assets Really Add Value?

Today’s investment climate has, in theory, strengthened the case for a more diversified real asset portfolio. The late stage of the cycle has compressed returns in traditional sectors. It has also increased the tensions between certain key traits, such as “returns” and “diversification vs. stocks.” With investors creeping towards “value-add” end of the spectrum in infrastructure and real estate, for example, they may also increase sensitivity to cyclical risks.

Readers should remember that Exhibit 2 involves considerable oversimplification. In agriculture and timber, for example, available strategies span a broad range of risk/return profiles, as illustrated in a snapshot from a recent manager selection exercise (Exhibit 3).

Over the past year, we have observed multiple managers and consultants advocating a ‘diversified real assets’ approach. This argument takes many forms: advocacy for listed infrastructure or real estate, marketing of multi-real-asset strategies, marketing of niche sub-sectors and more. A recent paper from Cohen and Steers, for instance, indicated that diversified real asset portfolios outperformed standalone infrastructure, real estate or agriculture portfolios in periods when market returns were lower than usual (The Benefits of Real Assets Diversification in Defined Contribution Plans). Such arguments should be handled with care.

Firstly, it is critical to remember the main objective: the end investor’s priority is not (except in cases of poor institutional governance!) to have a resilient real asset bucket; the priority is to have a resilient total portfolio. Intra-asset class diversification is not valuable if its results can be mirrored by adding stocks or bonds to the mix: that’s where inter-asset class diversification should come into play. Secondly, these arguments tend to overlook the most significant challenge: implementation.

A Changing Industry Landscape

Build it, buy it or brand it, many asset managers have now established Real Assets units in a bid to take advantage of industry trends.

Ten years ago, it would have been hard to name a Head of Real Assets at a major asset management firm. Today, the role is a common one as divisions bearing this label have sprung up at most global asset managers. This nominal change has frequently been accompanied by the establishment of new asset classes and products: although many firms had historic expertise in at least one sub-sector, additional teams have been developed or acquired to flesh out the wider suite.

Meanwhile, specialist real estate or infrastructure managers have spread into each other’s territory and/or other real asset sectors, again through growth, M&A, or a combination of the two. Exhibit 4 illustrates these two variants of real asset managers, alongside two other distinct types: fund of funds and investor-owned houses.

Exhibit 4: The Rise of "Real Assets" Managers
No type is inherently superior but, given the recent organizational overhauls involved, investors should pay close attention to how the real assets function at a prospective manager has evolved. Where the group’s constituents have been brought together, they can face significant challenges in overcoming previous silos, developing a strong single leadership and working together on integrated products (including the real asset strategies with allocations to multiple sleeves that are explored next). In the case of mergers, staff turnover can be a significant problem. With acquisitions come risks around integration and the potential loss of key personnel.

New in Town: Multi-Real-Asset Strategies

A growing number of asset managers are developing a multi real asset capability: delivering several real asset types under one mandate.

With investors creating more holistic real asset portfolios and asset managers developing broader divisions, it is perhaps logical that diversified real asset mandates would be the next step. These can be implemented in a range of different ways.

During 2017-18, bfinance has supported a number of investors with searches for “diversified real assets” managers. These have varied significantly in terms of preferred sub-sectors and implementation approach. A small minority of investors appear to be interested in integrating real estate and infrastructure in this manner. More popular is the single mandate for a range of niche real assets. Such mandates have necessitated fresh approaches to the market, with few “off the peg” solutions.

Structures fall into three primary categories: pooled funds, ‘fund of in-house funds’ and ‘fund of external funds’ (classic fund-of-funds). Pooled funds blending real estate and infrastructure are relatively rare (Exhibit 5), but there is a substantial group of managers offering wrappers around in-house products to achieve this effect. Meanwhile, pooled funds for multiple niche real assets are somewhat more mainstream. Some of these niches were very esoteric indeed: the likes of pharmaceutical intellectual property and music catalogue royalties stretched ‘real asset’ definitions to the limit. The allocation approach for ‘fund of in-house funds’ varies considerably. In some cases, an internal team allocates clients’ assets to the funds. In other cases, managers offer a passive allocation (e.g. 50/50 between two funds).

What are the pros and cons of different ‘multi-real-asset’ structures? Each of the three structures shown in Exhibits 5 and 6 have strengths and pitfalls. ‘Funds of external funds’ tend to be the most expensive, due to the double layer of fees, but the increasing use of secondary and co-investment strategies can help to cut the fee load. When a manager structures a wrapper around its own funds there is generally no additional layer of fees versus a pooled fund (Exhibit 7). Meanwhile, pooled fund charges are on a par with single-sector versions of the strategies.

Analysis of track records and teams can be tricky for ‘fund of in-house funds’, since track records are composites of products and thus not highly representative, while pooled funds tend to have short live track records.

Alignment of interest should be watched with care: where an allocation capability exists, it is not always clear that clients’ assets are being invested in the sub-funds in a manner that best suits their interests as opposed to the manager’s fundraising timeline. In comparison, it is more straightforward to assess alignment of interest for pooled funds.

Customization is critical to real assets; this is a label that means very different things to different investors. Here, fund of in-house funds may have a customization edge. Their ability to piece together chunks of sub-funds can match well with the varying nature of investors’ demands. The potential downside, however, is the narrower opportunity set.

It is worth noting that very few multi real asset strategies exploit one potential advantage of breadth: taking a more tactical view on current market dynamics and pricing. In our analysis, the allocation teams for wrapper products are not generally engaging in this type of decision-making.
As always in this sector, investors should beware of the labels. For example, one real estate manager pitched a strategy incorporating ‘social infrastructure,’ a term traditionally associated with availability-based payments from the public sector but, in this case, applied to nursery site freeholds and urban car parks with long-term corporate leases.

**Client Demand and the Importance of Customization**

Over the past year we have worked with a variety of pension funds, foundations and other clients on implementing real asset investments, either broadly or within particular sectors. They range from institutions with extensive experience across many of the sectors detailed in Exhibit 2 to others that are far less familiar.

In general, where clients are relatively new to the asset class, we do encourage them to start with more traditional property and infrastructure, but with an eye to building potential exposure to other sectors over the long term.

For institutions that are highly advanced in their approaches due to a long experience with different genres of real asset investment, including some Australian and Canadian clients, we could also draw a general conclusion: the main priority has been building complementary niche exposures around the traditional strategies, such as water titles and royalties.

Yet generalizations should always be treated with caution. Investors’ needs from real asset investments vary widely, even for institutions of the same type and size in the same country with an equivalent level of experience. For example, we have recently assisted very similar UK institutional clients with nominally similar projects targeting Diversified Real Assets (as in Exhibits 5 and 6). These institutions have been seeking real assets as part of their equity diversification strategy and looking for decent returns, with ESG as an important consideration. Yet the resulting implementation has been very different depending on the investor.

In that example, it was particularly helpful to research a large universe of managers that offered a wide range of strategy types and flavors, ranging from more traditional and well-established sectors to niches such as agriculture, timberland, transportation assets and even leisure parks. As well as ensuring breadth of choice, we worked closely with each client to understand their preferences and answer the key questions: “how is this going to fit with my existing portfolio?”, “how will this achieve our objectives?”

The project reinforced what is perhaps the most important lesson in this sector: ‘real assets’ is only a label; what’s inside the tin is what matters.

**Conclusion**

- The concept of the “real asset,” “tangible asset” or “inflation-sensitive” portfolio, firmly established in certain asset owner circles, has gained ground in recent years. While the post-GFC phase was marked by diversification toward real assets, later years have seen greater emphasis on diversification within real assets.

- The new mindset prioritizes characteristics or risk factors rather than labels. Yet, as is becoming increasingly clear late in the cycle, these characteristics are not hard-wired to real assets. Current conditions have produced greater tensions between particular traits, such as ‘yield’ and ‘low correlation to equities.’

- Diversification within real assets can be useful in theory. Yet implementation is the critical challenge. Many investors are building out diversified real asset exposures directly. Managers are changing the way they deliver these strategies, including taking advantage of their new organizational breadth across this space.
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bfinance

Peter Hobbs is Managing Director of Private Markets and a member of the Senior Management Team. His division covers Real Estate, Infrastructure, Private Equity and Private Debt, providing a range of services including portfolio design, manager selection and due diligence. Peter has over 25 years of both principal investing and research experience. He joined bfinance from MSCI where he was Managing Director for Real Estate Research and Key Global Accounts, responsible for portfolio analysis, benchmarking and risk services. Prior to this, he held roles with IPD, RREEF (the alternatives asset management division of Deutsche Bank) and Property & Portfolio Research. In 2015 he was shortlisted for Outstanding Industry Contribution at the IPE Real Estate Global Awards. Peter has a PhD and is a member of the Royal Institution of Chartered Surveyors (MRICS).

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Guy is a Senior Associate within the Private Markets team, having joined bfinance as an Associate in June 2016. He joined from JLT Investment Consulting, where he was an Investment Consultant and Head of Alternatives Manager Research, advising clients on portfolio construction and manager selection across alternative asset classes. Guy is responsible for manager research, evaluating investment proposals and analysing track records and other financial information provided by fund managers. He primarily focuses on infrastructure, real estate and other real asset strategies such as agriculture and timber. Guy graduated with an Economics degree from Rollins College in the US having also spent part of his course studying in Shanghai, China.

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bfinance

Anish Butani joined bfinance in April 2017 to provide specialist coverage to clients seeking to deploy capital to the Infrastructure sector and support initiatives in Real Estate and Private Equity Markets. Anish has over 10 years of experience in total, which included 8 years with KPMG Corporate Finance based in London, where he was a senior member of the infrastructure corporate finance team. Anish has significant experience acting as an M&A and valuations advisor to global infrastructure fund managers across all sub-sectors in the asset class, including renewable energy, regulated utilities, transport and social infrastructure.

Prior to joining bfinance, Anish was at John Laing Group plc, the international investor in infrastructure, where he was responsible for leading and shaping divestment processes of their infrastructure project portfolio. Anish has a degree in Economics, Politics and International Studies from Warwick University.

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bfinance

Kathryn joined bfinance in 2016 and oversees the firm’s publications, thought leadership and investment content. An experienced writer, editor and researcher focused on investment management and institutional investors, Kathryn was previously a Managing Editor at Euromoney Institutional Investor. She holds a BA (Hons) and an MA from the University of Cambridge. Other previous roles include Editor of the Institutional Investor Networks, Director of the Sovereign Investor Institute and Associate Director of the European Institute. She has spoken and moderated at various industry conferences (OECD, World Bank Group, AVCA, IRN, Institutional Investor), been quoted occasionally in the press (Financial Times, Responsible Investor, Citywire) and been interviewed by the BBC on sovereign wealth fund trends.