The Case for Income Producing Real Assets

By
Scott Crowe
Chief Investment Strategist

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Executive Summary

In the post Global Financial Crisis investment world, a distinct asset class called “Real Assets” has emerged, primarily motivated by the desire of investors to increase diversification and income while reducing volatility. In the current low yield, low growth investment environment, we recommend a more defined focus on "Income Producing Real Assets" (IPRA) in an effort to meet these objectives. The major components of IPRA - real estate and infrastructure - have historically been excluded from many investor portfolios due to a large minimum investment requirement and lack of liquidity in their direct forms. However, over the last two decades the growth of listed real estate and infrastructure globally has expanded the opportunity to smaller institutions and individual investors. While many investors today have already included an allocation to listed real estate, we believe there are attractive opportunities to enhance risk adjusted portfolio returns and income by including global listed infrastructure as part of a holistic IPRA allocation.

Commercial Real Estate and Economic Infrastructure - Symbiotic Investment Classes

Real estate and infrastructure enjoy a symbiotic relationship. Real estate comprises the structures in which life and work take place and infrastructure connects and powers that life and work. Both are familiar and recognizable asset classes for both retail and institutional investors. If we reflect on an average day, our economic and social activities are intertwined with the use of both real estate and infrastructure assets. The essential nature of these asset classes - the inelasticity of demand - bestows them with their attributes of growing income and capital stability.

These assets are also driven by many of the same underlying factors from an investment performance perspective. Both real estate and infrastructure derive their value from economic rents generated by the ownership of tangible assets. Both investment classes focus on tangibility, which provides an element of downside protection. And both asset classes may provide long term cash flow stability via economic rents.

Enhancing the Traditional Investment Model with Real Assets

Following the Global Financial Crisis, investors sought to repair the deficiencies in the traditional equity/bond investment portfolio with a broader adoption of alternative investments. This has included a myriad of vehicles such as private equity, real estate and hedge funds, grouped by their lower correlation of returns to traditional asset classes. However, while these investments may improve portfolio diversification, they have extremely different fundamental drivers of risk and return.
More recently, the investment community has recognized the distinct subset of alternative investments called “Real Assets” (See Figure 1). Real Assets derive their value from tangibility and permanence, and they generally include precious metals, commodities, real estate, infrastructure, and agricultural land. Real Assets have a history of providing not only diversification, but in many cases also improved returns, income, inflation protection, and alignment with long-duration liabilities.

This trend of identifying and allocating specifically to Real Assets has manifested in a number of ways, particularly with institutions and consultants that had previously designated separate Real Estate, Infrastructure, and Commodities professionals, now consolidating into teams of Real Assets specialists to allocate to the asset class in a holistic manner.

**Income Producing Real Assets**

The universe of Real Assets incorporates everything from a simple commodity to an airport. The nature of the underlying fundamentals is important to the long term investment characteristics of each Real Asset type. With that in mind, we believe most investors are attracted to Real Assets for two main reasons: 1) enhanced income and 2) lower volatility. Certain Real Assets, such as commodities and derivative natural resource equity investments, are ineffective at improving these portfolio characteristics. In comparison, Income Producing Real Assets such as real estate and infrastructure, through the virtue of being tangible, permanent, and with a related long term economic rent associated with the underlying asset, can create higher income and greater capital stability.

The investment vehicle utilized to gain exposure to Real Assets is also an important consideration. Direct Real Asset investments can be illiquid and present high investment minimums, which have historically excluded the majority of investors from these opportunities. In this paper, we focus on listed options - global listed real estate and global listed infrastructure - as they present the opportunity for investors of all sizes and sophistications to capture specific characteristics in high demand in the current market – stable and predictable cash flows that are often inflation-linked, high relative yields, downside protection, and potential for growth via leverage to an improving economy and meaningful secular trends.

**The Opportunity to Include Infrastructure**

Listed real estate, namely Real Estate Investment Trusts (REITs), use the pooled capital of many investors to own income producing commercial real estate. In addition to the expected growth in the market value of the...
One of the defining characteristics of listed infrastructure is its downside protection. As shown by Figure 3, listed infrastructure has historically offered a low downside capture ratio relative to global equities. Together, listed real estate and infrastructure represent a $5.3 trillion market capitalization and over 7% of global equity markets1. Listed infrastructure enjoys a substantial existing investable universe with significant growth potential as governments look to privatize existing infrastructure assets, and as the private sector increasingly undertakes new infrastructure investment. In addition, listed infrastructure is experiencing many of the structural developments that benefited listed real estate over the last two decades. The opportunity has led to the creation of distinct investment strategies focusing on global listed infrastructure by investment managers, many of which can benefit from their experience investing in real estate due to the similarities of the asset classes – with valuations driven from long term economic rents generated by the ownership of a tangible asset.

asset class with a permanent allocation in investor portfolios, most efficiently accessed through the listed markets – a similar trend that benefited listed real estate over the last two decades.

While many investors currently allocate to real estate, we believe that infrastructure can represent an attractive addition to investor portfolios as part of a holistic Income Producing Real Assets allocation. The universe of listed infrastructure is comprised of companies that engage in the management of utilities, transports, energy, and telecommunications. These companies are also traded on public exchanges with high levels of liquidity and transparency. Listed infrastructure shares many of the characteristics and benefits of real estate, including portfolio diversification and income. In addition, infrastructure appears to be on the cusp of being accepted as a distinct

1Source: Bloomberg, as of April 30, 2016

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If we compare listed real estate and listed infrastructure performance to equities and bonds over a 20 year period as of March 31, 2016, we see that historically they have offered potentially attractive risk adjusted returns (see Figure 5), especially for listed infrastructure. This highlights the potential benefit of including infrastructure alongside an existing allocation to listed real estate as a part of an Income Producing Real Assets allocation. In addition, one of the major appeals of both listed real estate and infrastructure is the relatively high levels of income versus other asset classes, as shown in Figure 6.

Examining returns over a 20 year period, we see that the inclusion of Income Producing Real Assets in a portfolio of traditional investments has produced improved risk adjusted returns and current income of an investor’s portfolio (see Figure 7).

**Conclusion**

Income Producing Real Assets have the potential to significantly contribute to portfolio income, return and diversification, particularly in the current investment environment. These investments offer not only the ability to reduce volatility, but also a sensible way to produce income in a world where investors are often forced to choose between historically low government bond yields and more risky high yield alternatives. While many investors have allocated to listed real estate, we believe the introduction of an allocation to listed infrastructure can further enhance diversification and income.

**Including Income Producing Real Assets in a Balanced Portfolio**

If we compare listed real estate and listed infrastructure performance to equities and bonds over a 20 year period as of March 31, 2016, we see that historically they have offered potentially attractive risk adjusted returns (see Figure 5), especially for listed infrastructure. This highlights the potential benefit of including infrastructure alongside an existing allocation to listed real estate as a part of an Income Producing Real Assets allocation. In addition, one of the major appeals of both listed real estate and infrastructure is the relatively high levels of income versus other asset classes, as shown in Figure 6.

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Within this document, asset class risk and returns are presented using established indices as proxies. A full list of these indices is below:

- Global Equities: MSCI ACWI Index
- Global Bonds: Barclays Global Aggregate Index Unhedged
- Global REITs: FTSE EPRA/NAREIT Developed Index
- Global Listed Infrastructure: For periods after 12/31/2005, FTSE Global Core Infrastructure Index. For periods prior to 12/31/2005, UBS 50/50 Infrastructure & Utilities Index
- Natural Resources: S&P North American Natural Resources Index
- Real Assets: A blend of 50% Global REITs and 50% Global Listed Infrastructure

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FTSE EPRA/NAREIT Developed Index
The FTSE EPRA/NAREIT Developed Real Estate Index Series covers both the FTSE EPRA/NAREIT Equity REITs Index and the FTSE EPRA/NAREIT Developed ex-U.S. Index. Designed to track the performance of listed real estate companies and REITs worldwide, the series acts as a performance measure of the overall market. The Index changed names on March 23, 2009 and was formerly known as the FTSE EPRA/NAREIT Global Real Estate Index.

FTSE Global Core Infrastructure Index
The FTSE Global Core Infrastructure Index is a subset of the FTSE Infrastructure Index Series, a comprehensive set of nine cap-weighted indices, diversified across six FTSE-defined infrastructure sub-sectors, to reflect the performance of infrastructure and infrastructure-related listed securities worldwide. The FTSE Global Core Infrastructure Indices are comprised of companies from the core sectors which generate a minimum of 65% of their revenue from infrastructure. FTSE defines core infrastructure as companies which own, operate, manage or maintain physical structures or networks used to process or move goods, services, information, people, energy and/or life essentials.

MSCI ACWI Index
The MSCI ACWI Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes.

S&P 500
The S&P 500 is an index that is considered to be a gauge of the U.S. equities market. The index includes 500 leading companies spread across the major sectors of the U.S. economy. The index focuses on the larger cap segment of the U.S. market and represents approximately 75% of the market capitalization of U.S. securities. The index is the most notable of the many indices owned and maintained by Standard & Poor’s, a division of McGraw-Hill Companies.

Mr. Scott Crowe is the Chief Investment Strategist at CenterSquare Investment Management and joined the firm in 2015. Scott is a member of CenterSquare’s listed real estate, listed infrastructure and private real estate investment committees. In this capacity he works with each team’s portfolio managers and investment professionals in the leadership of the investment process, with a particular focus on thought leadership by synthesizing our real asset views across the business. Scott is the portfolio manager of the Global Concentrated real estate securities strategy. Scott also works directly with CenterSquare’s clients, providing education and guidance on the market and helping them execute their investment goals. Prior to joining CenterSquare, Scott was CIO of Liquid Alternatives at Resource Real Estate where he built and led a global investment and distribution platform. Prior thereto, Scott was the lead Global Portfolio Manager for Cohen & Steers, where he was responsible for $10B in assets under management and led the investment and research team of over 20 portfolio managers and analysts. Prior to this, Mr. Crowe held the position of Head of Global Real Estate for UBS Equities Research, where he built and managed the U.S. REIT division while leading a global team of more than 40 analysts. Scott began his career at Paladin Property Securities and holds an Honors Finance Degree from the University of Technology Sydney and a Bachelor of Commerce from the University of NSW/National University of Singapore.

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FOR MORE INFORMATION, PLEASE CONTACT:
Scott Maguire, CFA, CAIA
Managing Director, Global Head of Client Service & Marketing
630 West Germantown Pike
Suite 300
Plymouth Meeting, PA 19462
(610) 818-4612
SMaguire@centersquare.com

www.centersquare.com