DEUTSCHE ASSET MANAGEMENT

Combating inflation — Real Assets as a viable solution

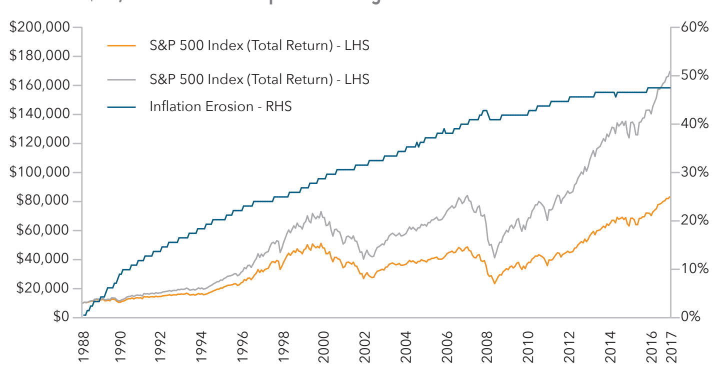
Tyler Wilton, CFA, Investment Specialist, Liquid Real Assets

This brief study focuses on the inflation risk factor and how to potentially hedge a portfolio against inflation. Specifically, we will look into how a strategic allocation to real assets may be a viable solution to not only hedge against inflation, but also possibly serve to enhance diversification, relative to traditional stocks and bonds.

Historically, advisers have looked at real assets as an attractive long-term investment option, given the investment characteristics of these securities. To date, we believe that this asset class has typically generated stable and predictable cash flows, with the potential to offset rising inflation. The attractive investment attributes of real assets merit consideration when constructing an overall portfolio.

When constructing a diversified portfolio, a risk-based methodology allocates risk across various asset classes according to current and expected macro factors. In order to make more informed asset allocation decisions, we believe consideration of macroeconomic risk conditions is essential, especially given the rapidly evolving global economic and political landscape, which shapes forward-looking risk-return expectations. Two of the most-important macro factors are inflation and economic growth, which can both meaningfully impact investment returns across asset classes. We believe economic growth and inflation expectations are critical components to understand when making investment decisions. While economic growth is more easily understood in terms of the impact it may have on various asset classes, inflation is somewhat opaque as to what effect it may have on a portfolio. Inflation is a significant market force that has the potential to slowly deteriorate the real value of a diversified investment portfolio consisting simply of traditional stocks and bonds. The chart below depicts the effect inflation can have on a long-term investment in traditional equities, using the S&P 500 Index as a proxy.

Growth of $10,000 – Inflation impact over long run



Source: Bloomberg as of 9/30/17

Past performance is not indicative of future results
Diversification does not remove investment risk

As you can see, the impact inflation has historically had on nominal total returns is clearly evident. It has resulted in roughly 52 percentage points of "inflation erosion," significantly decreasing the real investment value on a cumulative basis.

Importance of hedging against inflation

Regardless of the market environment, a strategic allocation to asset classes that may hedge against the risk of inflation, without sacrificing total returns, should be considered. For the past several years, we have been in a market environment of extremely low interest rates around the world, coupled with slow growth, which has essentially reduced the near-term threat of inflation. Since the Global Financial Crisis in 2008, inflation has become less of a factor when making short-term asset allocation decisions, as central banks have flooded the market with liquidity to spur growth, while also pushing yields lower. To cope with low rates and moderate economic growth, investors have sought alternative investment strategies to potentially enhance total returns and/or current income.

We are currently moving into an environment with the prospect of higher interest rates, leading to a corresponding concern over inflation. Therefore, now may be the time to re-assess existing portfolio allocations in order to adapt to changing market conditions. There are asset classes and investment strategies that are often overlooked as potential solutions to not only help preserve real investment values, but also may provide stable, equity-like total returns, as well as attractive bond-like income. In the short run, it is easy to ignore the impact of inflation, but the threat inflation poses to the majority of traditional investments in the long run, not only requires attention, particularly when making asset allocation decisions.

We believe a comprehensive real assets strategy may be an effective and efficient way to gain defensive exposure to securities that have generated attractive risk-adjusted total returns throughout various market cycles.

Real assets may be the solution

Real assets provide exposure to essential physical assets, such as office buildings, toll roads and precious metals, which have historically offset the effect of rising inflation, while also providing exposure to equity market beta. While the marketplace has no clear definition of what constitutes real assets, our definition includes global real estate, infrastructure and commodities.

We believe an appropriate way to gain exposure to real assets can be through a diversified mix of publicly traded securities, specifically:

- **Global Real Estate:** apartments, office buildings, self-storage, shopping centers, healthcare facilities, hotels, industrial, student housing, data centers, lab space and property developers
- **Global Infrastructure:** energy pipelines, toll roads, cell towers, airports, seaports, railroads, gas distribution utilities, water utilities, satellites, waste facilities and renewable energy
- **Commodities (futures and/or equities):** global natural resource equities, base metals, precious metals, mining, chemicals, agriculture, livestock and energy
- **TIPS:** government-issued notes with varying degrees of duration, linked to Consumer Price Index (CPI)

Sensitivity of real asset classes to inflation

According to research, commodities provide the highest hedge to inflation, which we would view as the primary inflation-hedging component within a real assets strategy. Elsewhere, global infrastructure and global real estate have an embedded long-term inflation-hedging mechanism.

Historically, these asset classes have not only displayed attractive sensitivity to inflation compared to traditional stocks and bonds, but they are typically viewed as the primary "total-return" driver within a real assets strategy. Lastly, while TIPS do provide inflation hedging characteristics, they can also be used as more of a defensive portfolio construction tool to preserve capital in down markets.

An active and dynamic portfolio that strategically and tactically allocates across and within these asset classes may be an effective way to fight inflation, while also providing exposure to the benefits real assets may provide. It is important to note, however, that an allocation to real assets may not achieve an investor's investment objectives.

A combination of real asset classes may be used to hedge against inflation, while potentially generating stable risk-adjusted returns. Following is a summary of how each asset class may be utilized within a comprehensive real assets strategy:

- **Commodities:** An allocation to futures has historically sought to provide a hedge to inflation. Global natural resource equities may also deliver an inflation hedge due to their direct correlations to inflation drivers.
- **Global Infrastructure:** Infrastructure can be viewed as the total-return component, but also responds to changes in inflation. Revenues for "pure-play" infrastructure are typically stable and predictable because of the long-dated underlying contracts and monopolistic assets. These types of companies typically have the ability to pass on higher costs often linked to inflation, which can result in real earnings growth.
- **Global Real Estate:** Similar to global infrastructure, real estate may serve as more of a total-return component with the potential to deliver more stable current income. Inflation-hedging ability is usually embedded in rental agreement structures, which generally include inflation-linked adjustments or fixed percentage increases in rents. This gives real estate (i.e., REITs) the potential for positive real rates of return during inflationary environments.
- **TIPS:** TIPS may provide a hedge against inflation and may also help offset equity market beta in "risk-off" environments, where investors seek safety through defensive investment positions.

Conclusion

Inflation is a real and ongoing threat that should be addressed in order to preserve capital over the long-term. While there are stand-alone securities or asset classes that help provide some inflation hedging benefits, a dynamic approach that uses various real asset classes may be an efficient and effective way to hedge against inflation, while also providing a diversified equity market beta.

A comprehensive real assets strategy may be part of a larger strategy designed to address specific client objectives, such as providing higher beta to inflation and stable dividend yields. Instead of allocating to multiple vehicles and stand-alone real asset classes, an approach that encompasses the various real asset classes previously discussed under one umbrella may be a potential solution for investors to consider.

Given our experience and dedication to investing in real assets, we are well-equipped to provide real assets strategies to hedge inflation, while also seeking diversification and risk-adjusted returns.

CORPORATE OVERVIEW

Deutsche Asset Management – Alternatives

Deutsche Asset Management's alternatives investment business has been investing in the asset class for more than 45 years. With more than 600 professionals worldwide and $91 billion in assets under management as of Sept. 30, 2017, we offer a range of strategies across the alternatives spectrum, including direct real estate and infrastructure, real estate and infrastructure securities and commodities, sustainable investments, private equity, and hedge funds.

Deutsche Asset Management

With about $840 billion of assets under management (as of Sept. 30, 2017), Deutsche Asset Management[1] is one of the world's leading investment management organizations. Deutsche Asset Management offers individuals and institutions traditional and alternative investments across all major asset classes.

CORPORATE CONTACT

Laura Gaylord
Managing Director
laura.gaylord@db.com
www.institutional.deutscheam.com

This article presents the author's present opinion reflecting current market conditions, which are subject to change without notice. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product.

[1]Deutsche Asset Management is the brand name of the Asset Management division of the Deutsche Bank Group. The respective legal entities offering products or services under the Deutsche Asset Management brand are specified in the respective contracts, sales materials and other product information documents.

(11/17) 1-053328-1