AN INTRODUCTION TO REAL ASSETS

Real Asset investments are increasingly in the financial news headlines today given that valuations of traditional asset classes show signs of overheating, something which leads investors to search for the next source of return that could maintain the portfolio's performance on the same level as that achieved over the last decade thanks to equities and bonds.

WHY CONSIDER REAL ASSETS?

While this asset class started to become popular with institutional investors back in the early 2000s, it has been whetting private clients' appetites only since a couple of years. Why? The main reason is probably the extremely low yield environment engendered by Central Banks' unorthodox monetary policies since 2009 and the consequences thereof. Over the last 10 years, the traditional roles of fixed income and equities have totally changed; people have looked to the equity markets for bond-like yields, and most fixed income instruments have produced unusually positive returns that equity players would still envy today.

"The traditional 60/40 portfolio is no longer applicable!"

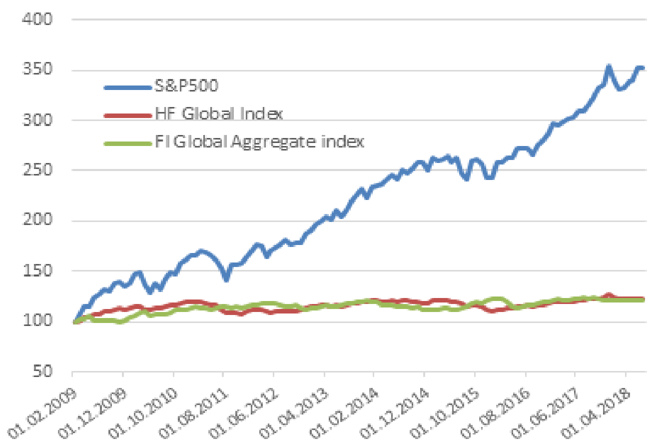
Today portfolio managers have to deal with both the extreme valuations reached within the traditional asset classes (equities and bonds have not been coincidentally so expensive since the roaring 20s) and the newly introduced and increasingly tightening measures deployed by Central Banks. The traditional 60/40 portfolio is therefore no longer applicable!

Modern Portfolio Theory (MPT), elaborated by Harris Markovitz in 1952, introduced the concept of the efficient frontier which provides the set of optimal portfolios that offer the highest expected return for a defined level of risk (risk aversion). In other words, if we had to add a new asset within the current portfolio (60/40) with the aims of a) mitigating the risk of being exposed solely to the expensive Equity and Fixed Income asset classes, b) maintaining or even improving the returns we got over the past years while c) keeping about the same level of risk, which one would we choose?

From a private investor's point of view, cash cannot be considered as an alternative, especially for EUR or CHF denominated accounts where Money Markets are still posting negative returns thanks to the never ending negative interest rate policies. Hedge Funds? While the use of Hedge Fund strategies within a portfolio has demonstrated their usefulness in the past, clients are still concerned by what happened within the industry following the Madoff scandal in 2008. Furthermore, the low interest rate environment has led most of the strategies to generate poor performances over the last years. The HFRX global index has posted a shiny 25% return since 2009, well below the +250% performance of the S&P500, and close to the global aggregate bond index!

"Furthermore, the low interest rate environment has led most of the strategies to generate poor performances over the last years. "

PERFORMANCE SINCE MARCH 2009 (NET RETURN)



SOURCE: BLOOMBERG, BANQUE HERITAGE, 2018

Having said that, it becomes easier to understand why private investors are now considering Real Assets to navigate within this new environment which could last several years.

MAIN CHARACTERISTICS

Real Assets can be defined as physical or tangible assets which provide ownership of a store of value. This asset class includes mainly Real Estate, infrastructure, shipping and natural resources. Interestingly, these sub-categories share the same characteristics which are much appreciated by institutional investors (mainly Family Offices and Pension funds), namely:

- Low correlation versus stocks and bonds. The fundamental factors that drive real assets' prices are usually different from the ones observed within the traditional asset classes (agriculture prices rely on climate, temperature, etc.). Another explanation of the low correlation is the relative illiquidity of these assets which protects them from speculative trading.

CORRELATION BETWEEN ASSET CLASSES

	Real Estate	Infrastructure	Timberlands	Agriculture	Stocks	Bonds
Real Estate	1.00	0.55	0.23	0.12	0.19	(0.10)
Infrastructure	0.55	1.00	0.17	0.08	0.64	0.37
Timberlands	0.23	0.17	1.00	0.64	(0.11)	0.07
Agriculture	0.12	0.08	0.64	1.00	0.09	(0.15)
Stocks	0.19	0.64	(0.11)	0.09	1.00	0.23
Bonds	(0.10)	0.37	0.07	(0.15)	0.23	1.00

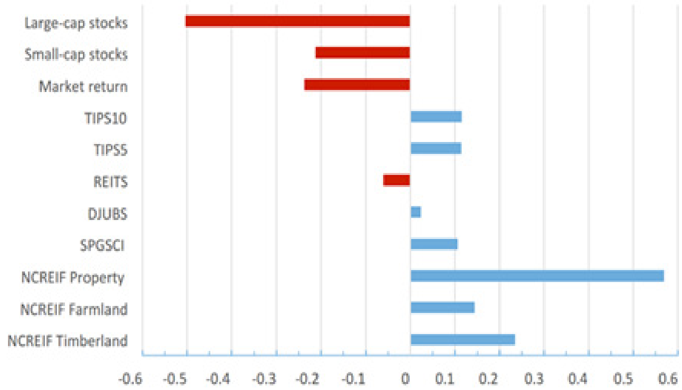
SOURCE: AMUNDI, 2017

- Predictable and steady streams of cash flows: most tangible assets are linked to contractual revenues (long-term lease or concession agreements) that ensure predictable returns over time. As a result, these cash flows are subject to lower volatility than income streams generated by traditional assets (dividends for instance).

- A hedge against inflation: real assets have a proven record of being positively correlated with inflation since they are investments in physical resources that represent the value of goods and services. When consumer prices rise, their prices rise too. For example, a short term apartment lease will benefit from frequent resets based on the variation in inflation, while a longer-term contract often includes regularly scheduled rent increases linked to inflation.

"When consumer prices rise, their [real assets] prices rise too. "

CORRELATION BETWEEN INFLATION AND ASSETS (1987 – 2013)



SOURCE: PARAJULI AND CHANG, 2015

- Capital appreciation potential represents a significant part of an investment's total return in real assets. The value of hard assets tends to increase over time, especially when assets belong to markets with barrier-to-entry and significant replacement cost.

Over the last 5 to 10 years, accessibility to real asset investments has improved, thus allowing private investors to consider it as a new investment opportunity. Until the 2000s, access to such strategies was only feasible through offshore structures. The investment's characteristics were somewhat restrictive with a time horizon often longer than 8 years combined with a long period of capital calls, and minimum investment sizes were usually not suited for individuals.

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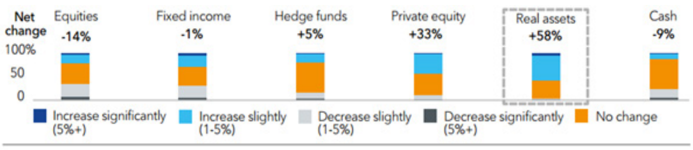
Fortunately, access democratized itself with the emergence of more regulated investment structures (Reserved Alternative Investment Fund in Luxembourg for instance). Investment processes have also improved and now offer investment opportunities combining attractive IRR, a better shape of the J-Curve thanks to improving cost management and capital call processes, and a time horizon which is more acceptable from a private client's point of view, even though it still represents a hurdle in a private client's portfolio.

EFFICIENT PORTFOLIOS WITH REAL ASSETS

Investing in real assets not only requires a deep knowledge of the underlying (Real Estate, Infrastructure, etc.), but also necessitates paying particular attention to the type of instrument (Debt, Equity) as well as to the investment structure (Club Deal, Closed end fund, etc.). Valuation is also a key element the client needs to integrate into the equation before any investment decisions as this asset class (like Private Equity) has seen some of the strongest allocation growth of all asset classes in recent years and should experience the same trend in the near future.

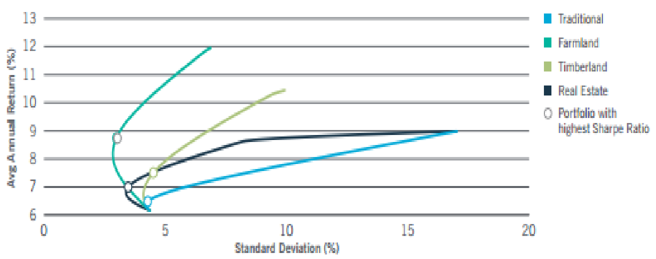
2018 CAPITAL FORMATION OUTLOOK



SOURCE: 2018 BLACKROCK GLOBAL REBALANCING SURVEY

Despite the technicality of these investments, it has been acknowledged for a couple of decades that adding Real Assets in a traditional portfolio improves the overall return while mitigating the risk. This asset class is now recognized by the financial community as an essential element in a portfolio, irrespective of the market environment.

REAL ASSET'S PERFORMANCE IMPACT – INDIVIDUALLY AND COMBINED (1992 – 2016)



SOURCE: NUVEEN, PRIVATE REAL ASSETS, JULY 2017

Notably, however, the magic combination of traditional and real assets obviously does not exist. First and foremost, the client's investment profile needs to be properly determined and taken into account in the portfolio construction process. The client's risk aversion, his liquidity needs, and his tax obligations are among the key factors that need to be analyzed before starting to think about including real assets within his current portfolio.

High barriers to entry continue to make it difficult to undertake investments in real assets. Gaining access and managing complex issues related to this topic require proven capabilities.

Should you wish to explore this fascinating asset class, it is important to ensure that you are correctly advised by professional experts who will help you to navigate in this crowded environment and select the appropriate investment opportunity.

Jean-Christophe Rochat , CIIA

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