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Keeping it real

Last year proved challenging for investors as the inflationary aftermath of the pandemic and the war in Ukraine left them very few places to hide. Fahad Kamal, Chief Investment Officer, Kleinwort Hambros suggests real assets could be one attractive option for the year ahead.

In 2022, traditional balanced portfolios – consisting of 60% stocks and 40% bonds – suffered a disastrous double whammy. Equity markets were hit by lingering supply chain issues, shifting demand and tightening financial conditions, while bonds struggled with the reversal of the ultra loose monetary policy that had lasted more than a decade.

Among other assets, gold rallied during the initial stages of the war but then fell, given the increased attractions of interest-bearing assets. Meanwhile, cryptocurrencies plummeted, with many losing 50% or more of their value.

In an environment of rising inflation and declining markets, investors needed prudent positioning and maximum diversification. One possible solution: real assets, such as property, commodities and infrastructure.

Unlike most financial assets, their value is largely defined by their inherent physical worth. The most basic example is property: a building which generates a steady cash flow from the rent charged to its occupier.

These days, however, investors can take a much more nuanced approach to real assets. Within property, they can invest specifically in hospitals, schools, prisons, affordable housing or care homes. They can also take advantage of attractive opportunities in infrastructure, such as toll roads and bridges, trainlines, smart grids, waste-to-energy plants and digital infrastructure. Many of these assets derive their value from their intrinsic worth to society: they are fundamental to all aspects of modern life.

While the value of real assets is not decoupled from financial market movements, their risk profiles tend to be markedly different from those of other risk assets, such as equities. This gives them the diversification benefits investors desperately need when equities and bonds are falling in tandem.

Crucially, cash flows for real assets are often based on long-lasting contracts, and hence are less sensitive to short-term economic factors than equities. This dependability of cash flows also allows their managers to pay out a large proportion of revenues to investors with regularity once projects are up and running.

This greatly reduces swings in the capital value of the investment. For example, over the past three years (which includes the pandemic), the simulated volatility of a diversified portfolio of infrastructure and specialist property assets averaged 10.8% (measured by its annualised standard deviation of returns), well below the 18.5% for the MSCI All Country World Equity Index.*

Real assets can also provide an element of inflation protection. That is because contracts for the usage of real assets often include clauses that periodically adjust cash flows to account for inflation.

Naturally, investing in real assets comes with its own challenges, notably liquidity. Even the more liquid vehicles, such as open-ended REITS, traditionally employ gates to prevent large outflows at times of market distress when managers would not be able to liquidate holdings fast enough to meet redemptions.

However, during this time of uncertainty and slower global economic growth, we believe real assets are a valuable diversifying investment for the same reasons that we rely on them in real life. They are dependable pillars of society whose value is less affected by short-term economic issues.

*Bloomberg – September 2022.

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