J.P.Morgan
Asset Management

Global core real assets as a strategic portfolio allocation

Investors are currently facing several challenges—lower expected total return, market concentration and a lack of stable income—an allocation to core real assets can help alleviate these issues.

09/30/2020
Jason DeSena

The challenges inherent in financial markets today have made it increasingly difficult for investors to achieve their portfolio objectives through the public markets alone. Following a steep sell-off in the first quarter of this year, developed market public equities have rebounded, benefiting from the global monetary and fiscal stimulus measures enacted, and are largely back to pre-crisis levels. In some ways this recovery has been at odds with the broader global economy, as the equity rally has preceded a normalization of the economy which is still in the early stages of a tepid recovery from the COVID-19 crisis. Core fixed income, the traditional safe haven public market asset class, also faces challenges given the declines in interest rates which has occurred this year in an effort by central banks to combat the economic slowdown stemming from the COVID-19 crisis. Ultra-low (and in some cases negative) interest rates have served to both reduce the current yield available to fixed income investors but also diminish its viability in diversifying equity risk, as the capacity for further interest rate reductions from current levels is more limited.

Investors confined to the public markets are left with the unenviable task of choosing between increasing risk exposure in pursuit of higher returns, or opting for a more conservative portfolio allocation and forgoing returns in exchange for greater relative downside protection. It is because of this conundrum that investors are increasingly turning to real assets as a viable solution to the challenges faced in public markets, whether that be increased portfolio total return, diversification, stable income or some combination of all.

Defining Real Assets

In its simplest form, real assets can be defined by what they are – tangible “hard” assets with low functional obsolescence. By this definition we include real estate, infrastructure, transportation, and natural resources. More important than their functional definition is the role that real assets can play in a portfolio, whether that be as a complement to fixed income, equities, or both. Furthermore, the investment characteristics provided by real assets sectors will depend on a number of variables but can largely be grouped according to their risk profile and associated sources of return. On one end of the spectrum, “core real assets”, which are the focus of this paper, can play a role in diversifying equity risk in a portfolio while also providing a stable source of income and the potential for appreciation over the long-term. This can be contrast with non-core, or more opportunistic, real assets investments, which have greater upside potential but exhibit a wider dispersion of performance outcomes over time given that returns are predominately driven by capital appreciation. Relative to financial assets, private real assets are typically accessed through investment vehicles with more limited liquidity profiles, although some core investment structures offer semi-liquid structures (i.e. quarterly or semi-annual).

What Makes Real Assets Core?

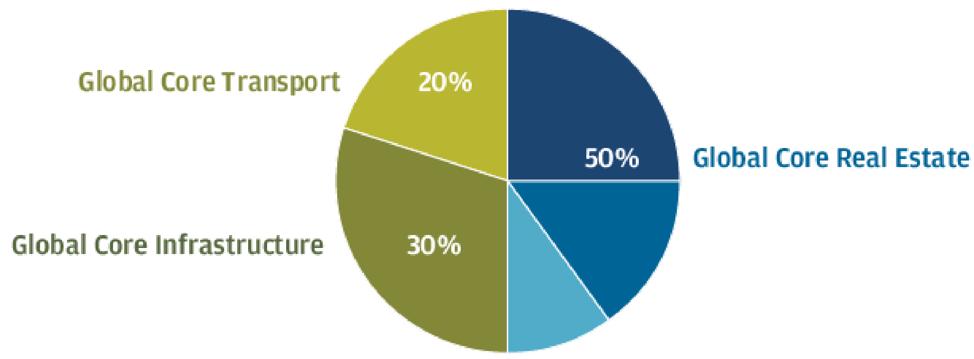
In further exploring the role that core real assets can play in an investment portfolio, it is important to first identify the investment characteristics inherent in assets which are “truly core”. This is particularly relevant for private real assets where the risk classification can be somewhat subjective in nature and in some instances difficult to measure. Included in our core definition are assets that provide stable sources of income through contracted cash flows, have high quality counterparties (i.e. the lessee in the transaction), operate in the developed markets, employ minimal to moderate leverage, provide some degree of inflation protection, and operate in sectors with the scale and transaction volumes to provide both price discovery and relative liquidity.

These characteristics have been included because they are contributing factors to the risk and return profile of core real assets. Real assets which are core can be expected to improve the long-run risk/return profile of a portfolio of financial assets, dampen downside risk during periods of market stress, and improve the overall stability of portfolio return outcomes. This can be achieved through assets which generate returns over the long-term that have lower volatility relative to public risk assets, in large part due to a return profile which is anchored in income that is highly forecastable with a low margin of error. Furthermore, these returns are achieved through differentiated exposures to demand drivers and risk factors providing an added benefit of diversification.

Identifying Opportunities in Global Core Real Assets

Narrowing the scope of private real assets according to our core investment attributes, we find opportunities in sectors within real estate (well-leased properties in major developed markets), infrastructure (regulated utilities, and other infrastructure sectors with transparent, predictable cash flows) and backbone transportation assets (maritime, energy logistics, aircraft, etc.) operating on long-term contracts with high credit quality counterparties. While core investments in these sectors are unified by their investment attributes, as outlined above, they exhibit differentiation in the markets that they operate, and importantly, the factors which contribute to their returns. Because of this, there is an added benefit of constructing an allocation diversified across global core real assets, as opposed to concentrating on just one real assets sector. **Exhibit 1** provides an illustrative allocation diversified across global core real assets. The investment attributes shown in the second exhibit are based on this portfolio allocation.

Exhibit 1: Global core real assets a foundation

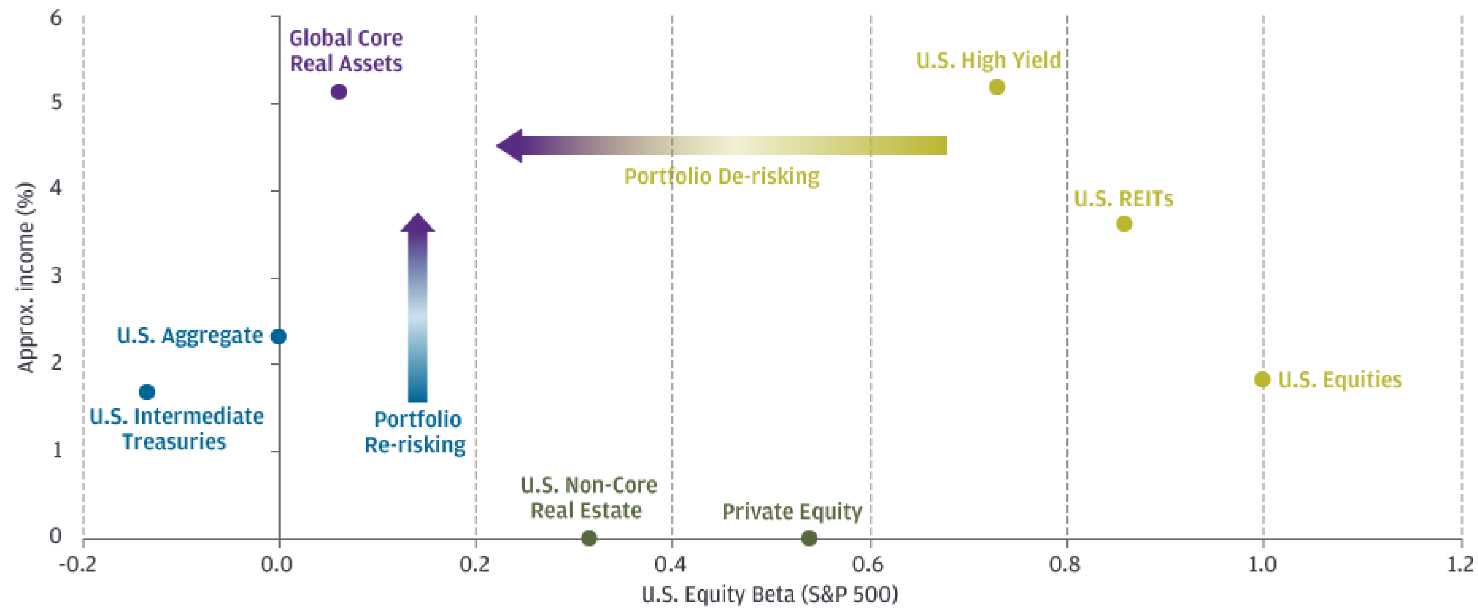


Source: J.P. Morgan Asset Management, Global Alternatives, data as of 3Q 2020

Global Core Real Assets Offer a Solution

In addressing the challenges in the public markets today, a diversified portfolio of global core real assets can serve to provide enhanced cash yield potential while also diversifying equity risk. These characteristics—as shown in **Exhibit 2**—compares the cash yield and historical equity beta of various public and private asset classes with a diversified allocation of global core real assets. Notably, global core real assets provide similar income as high yield but with significantly lower equity beta that is more in line with that of core fixed income. Because of this, investors should consider the appropriate funding source for an allocation to core real assets in light of their primary objective, whether that be to reduce portfolio risk (funding from public equities or other risk assets), increase returns (funding from core fixed income), or a combination of both. Regardless of the approach, there is a case to be made for including global core real assets as part of a long-term strategic portfolio allocation.

Exhibit 2: Global core real assets—greater income and diversification to financial assets



Source: Bloomberg, MSCI, S&P, NCREIF, INREV, ANREV, Cambridge, Clarksons, NAREIT, J.P. Morgan Global Alternatives. The allocation for global core real assets consists of 25% to U.S. core real estate, 15% to Europe core real estate, 10% to APAC core real estate, 30% global core infrastructure and 20% global core transport. Yields for each public fixed income asset class are the yield to worst, as of 12/31/19. Yields for each public equity asset class are based on trailing 12-month dividend yields, as of 12/31/19. Yields for each real estate category are based on J.P. Morgan LTCMA starting NOI net of capital expenditures. Yields for other real assets categories are based on J.P. Morgan LTCMA starting yield net of maintenance expenses. Betas for all asset classes are based on annual returns from 2005 to 2019.

0903c02a82a05cdb

Article Tags: Defined Benefit, Diversifying Risks

READ IMPORTANT LEGAL INFORMATION.

The value of investments may go down as well as up and investors may not get back the full amount invested.