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TalkingPoints

The Role of Real Assets in Portfolio Construction

Jodie Gunzberg, CFA
Managing Director
Product Management
S&P Dow Jones Indices

To watch this interview from S&P DJI's Annual Thought Leadership Seminar in Hong Kong watch: The Role of Real Assets in Portfolio Construction

In periods of rising interest rates and inflation, commodities tend to perform the best out of the real assets, but they can be volatile. Real asset combinations may reduce that volatility while still providing some inflation protection. See how the U.S. and Europe have learned to diversify in order to hedge against potential losses and preserve capital, and how market access to index-based real asset strategies is evolving in Asia.

What are some of the key forces influencing real asset performance in the current climate?

What we're really watching right now are some of the key macroeconomic factors, like increasing rates, inflation, and the U.S. dollar. So, in the environment we're in, where interest rates and inflation may be rising, the kinds of real assets that have historically performed the best are commodities, In particular, energy generally does the best, but it's also the most volatile component of the CPI. As interest rates rise, producers may pull back, which could even be a greater catalyst for energy. In general, real estate doesn't do quite as well as infrastructure does in rising-rate environments, and agriculture may do well, but it may be driven more by individual supply shocks, like the weather.

How do real assets fit into a portfolio?

It depends what kind of portfolio it is, and the asset allocation style will determine how real assets fit in. There are two major asset allocation styles; one is securities based, which would be traditional assets, like stocks and bonds, and then something additional, like alternatives. In that case, real assets would fit into the alternatives bucket. The other kind is called risk-based portfolio allocation, where you could have growth, inflation, income, or cash as separate risk exposures or asset classes. In that case, real assets fit into the inflation bucket.

How do real asset combinations contribute to inflation protection, diversification, and volatility reduction?

A main goal of real assets is inflation protection, and you tend to get solid inflation protection from commodities, but the problem is that they can be volatile, so combining commodities with property, infrastructure, and inflation bonds can reduce that volatility but still provide some inflation protection. But what's even more important for reducing volatility and improving diversification is to include not just the equities of real asset companies but fixed income and commodities futures as well.

Have you observed any implementation trends by asset owners and advisors in the U.S. and Europe that may inform Asian market participants as they become more familiar with the potential benefits of real assets?

There are liquid real assets and there are illiquid real assets. For illiquid real assets, some market participants have longer-term horizons and may not have the appetite for some of the volatility that can come with publicly listed real assets. A lot of the market participants that we hear from like the public real assets because of their increased transparency and liquidity, but that does come with higher volatility, since those assets are priced more often. However, the returns converge over a long period of time, if you look at maybe a five-year period or longer. The period drives the convergence of the private versus public assets. What's the lesson from the U.S. and Europe that Asian market participants can learn? It seems the evolution of investing in alternatives and real assets starts out with trading opportunities and volatility, and that's very much where Asia is right now. But what the U.S. and Europe have learned is that along with volatility and trading opportunity come the potential for large drawdowns. So, they learned to diversify in order to hedge themselves against the potential losses and preserve their capital.

How is market access to index-based real asset strategies in Asia evolving and is there more room for growth?

I think that the future holds more choices. We are seeing huge growth in listed products in Asia right now, particularly in gold, oil, and silver, along with two-times leveraged and inverse strategies. That seems to be the first step in getting comfortable with the strategies in the real asset space. Again, as the market evolves and participants learn more about the diversification, inflation protection, and capital preservation that combining assets may bring, there may be an evolution in more well-diversified offerings.

For more research and education on real assets, please visit spdji.com/indexology/real-assets.