When we look at real assets, we see opportunity.
SPONSOR DIRECTORY

Cohen & Steers
280 Park Avenue
New York, NY 10017
Steve Dunn
Director of Institutional Global Distribution
212.446.9187
sdunn@cohenandsteers.com
www.cohenandsteers.com

CoreCommodity Management, LLC
680 Washington Boulevard, 11th Floor
Stamford, CT 06901
Eliot H. Geller
Partner; Product Manager
203.708.6500
egeller@corecommodityllc.com
http://corecommodityllc.com

Deutsche Asset Management
101 California Street, 24th Floor
San Francisco, CA 94111
415.262.2003
laura.gaylord@db.com
www.institutional.deutscheam.com

Morgan Stanley
522 Fifth Avenue
New York, NY 10036
Global Listed Real Assets Team
reclient@MorganStanley.com
www.morganstanley.com/im

PGIM Real Estate
7 Giralda Farms
Madison, NJ 07490
Dennis Martin
Head of the Americas Business Development
973.734.1593
Dennis.Martin@pgim.com
Pgrimrealestate.com

Visit www.pionline.com/realassets for exclusive featured content, white papers and webinar

4
The Attraction of Tangible Assets

6
Where Do Real Assets Fit in a Portfolio?

8
Finding Value and Income

10
Can Commodities Come Back?

12
Infrastructure Spreads Its Wings

14
The Potential for Privatizing U.S. Infrastructure Assets

This special advertising supplement is not created, written or produced by the editors of Pensions & Investments and does not represent the views or opinions of the publication or its parent company, Crain Communications Inc.

Photo credits: Bloomberg.

For information on participating in P&I Content Solutions projects, please contact Richard Scanlon @ rscanlon@pionline.com or 347.454.0044
Thanks to the current geopolitical uncertainty, real assets are having a moment. Or maybe it’s because diversification is so hard to come by. Perhaps it’s the stable income streams real assets can provide that investors so welcome.

Whatever the reason, there is no question that institutional investors are attracted to investments that they can see, touch and visit. The segment of the investing universe known as real assets focuses on that which is tangible — land, buildings and natural resources.

“Real assets may provide an opportunity for attractive risk-adjusted returns relative to equities, as well as attractive current income,” said John Vojticek, head and CIO of liquid real assets — alternatives at Deutsche Asset Management. “This is important when bond returns are so low and plan sponsors are struggling to meet their required rates of return.”

“Real assets serve a variety of purposes for clients,” said Matt King, a managing director at Morgan Stanley Investment Management (MSIM). “Two of the most common uses are diversification and inflation protection. As a diversifier to a broader, multi-asset class portfolio, real assets can offer attractive characteristics from a risk-return perspective and can help improve the efficient frontier in that context.” For a global equity and fixed-income portfolio, for instance, adding infrastructure can increase annualized returns while decreasing volatility, based on historical data.

The other benefit is traditional — inflation protection. In infrastructure and real estate, maintaining a real return is often a characteristic of contract, regulation or lease terms; for more market-based assets, pricing power generally moves alongside inflation.

DEFlation A WORry

But deflation has been more of a worry for some investors in recent years than inflation, and infrastructure can provide something of a deflation hedge, though that usually isn’t a primary reason for investing in the asset class. If deflation is accompanied by lower interest rates, that tends to have a positive impact on all long-duration cash flow real assets such as infrastructure.

“Real assets can also be a deflation hedge,” said Peter Hayes, global head of investment research at PGIM Real Estate. “It’s the idea of buying income-producing assets when you are worried about the pricing outlook. That’s been a key trend and has driven demand for real estate in a weak or zero inflation environment.”

Deutsche Asset Management’s Vojticek said one of the critical components driving returns in real assets is the cost of capital used to fund projects. “In a deflationary environment, we would expect companies to have a lower cost of capital driven by falling borrowing costs,” he said. “This should act as a hedge to mitigate the impacts of falling asset prices.”

According to MSIM’s King, infrastructure and real estate “may also provide a relatively stable long-term asset-liability matching cash flow that many plan sponsors find attractive.” These stable cash flows can either substitute for or complement...
a fixed-income portfolio.

Evan Rudy, a portfolio manager within the liquid real assets team at Deutsche Asset Management, concurred.

"Investors may use real assets as an inflation hedge, but that is not the only potential benefit," he said. "They offer the potential for attractive risk-adjusted returns and above-average income compared to a traditional 60/40 equity and fixed income portfolio, in addition to diversification benefits.

That's not to say macroeconomic events don't affect real assets, it's just that real assets often react in different ways to economic shifts than equities and bonds do. This can make real assets particularly attractive at certain points in the business cycle.

**THIS CYCLE IS DIFFERENT**

"There is a cyclical element to all real asset classes," said Eric Adler, CEO of PGIM Real Estate. "I come to this from a real estate perspective, but there is always a moment in every cycle when returns just feel very compelling."

That moment, which is where the market is today, is often when investors who are not natural real estate investors come in. This time is no different.

"But," Adler continued, "this cycle is different in two structural ways. One is the persistence of low interest rates, which makes real estate returns much stronger. The other is the lack of income provided by other, more mainstream asset classes. These attributes are also contributing to the success of infrastructure and agriculture investments.

Take commodities, for another example. "Many commodities are trading very close to their marginal production costs, which implies a very strong value proposition," said Adam De Chiara, co-founder and portfolio manager at CoreCommodity Management.

Macro global trends are feeding the demand for investment in many real assets. The global growth in the middle classes has fueled the need for more productive agriculture. Increasing urbanization has meant more transportation and energy infrastructure. Marry these trends with the pressures on government and the public finance available, and it's easy to see why institutional investment is needed.

"It's an obvious place to go for those investors looking for ways to diversify their portfolios without taking on too much risk in the wake of quantitative easing ending," said Hayes at PGIM Real Estate.

Investors can pursue a variety of strategies in the real assets space. Only some segments will offer inflation or deflation protection.

"Long-duration segments, including health care and utilities, have the most bond-like characteristics of all real assets," said Deutsche Asset Management’s Vojticek. "If discount rates are falling significantly, these long-term assets with stable income should benefit from higher valuations."

He added that rising interest rates can have a negative impact on income-oriented real assets, but can benefit segments that are more commodity-driven, such as natural resource equities, as well as those with shorter-dated cash flows, such as hotels.

"Our longer-term view suggests any intermediate-term interest-rate surge would be transitory, partly due to the aging demographic profile of most developed economies," Vojticek said.

Infrastructure holds a particular place in the real assets spectrum.

"The energy beta of infrastructure is much lower than with either commodities or natural resource equities," said Ben Morton, a senior vice president at Cohen & Steers. "Relative to real estate as an asset class, infrastructure offers moderately lower economic sensitivity."

But, he continued, some of that impact is attributable to certain infrastructure subsectors, such as utilities, which are by nature defensive and have a large, idiosyncratic presence in infrastructure portfolios. Cell towers are also defensive, with little economic impact. By contrast, transportation in the form of airports, railroads, marine ports and toll roads does have some economic sensitivity but forms a smaller part of infrastructure portfolios.

The split between public and private investments in real assets can depend on the overall size of the investor and its liquidity needs over time.

**PUBLIC AND PRIVATE INVESTMENTS**

"Large investors often prefer direct investments in infrastructure in order to avoid the volatility in listed infrastructure investments," Deutsche Asset Management’s Rudy said. "In real estate, it’s more accepted thanks to REITs, but nonetheless you are likely to have periods of dislocation relative to the private market."

"We think it is important to have both public and private real asset investments," said Eliot Geller, partner and product manager at CoreCommodity Management. "Having public investments allows an investor to fine-tune, rebalance and potentially make material changes up or down in response to major events."

Deutsche Asset Management’s Vojticek pointed out, "that’s a large part of why we founded a listed business." A listed allocation can provide investors with the ability to get more effective diversification, as they can hold stakes in many more assets. A number of Deutsche Asset Management investors that have not been able to execute on their direct infrastructure plans have topped up their holdings using the listed market, according to Vojticek.

Being in liquid real assets gives investors the chance to be tactical, an opportunity that they may have to forgo in a five- to 10-year private vehicle.

"Inflation can be transitory," Rudy said. "Therefore, a tactical approach can take advantage of changing market environments. For instance, natural resource equities have historically performed well in times of accelerating inflation."
Mapping into the potential returns that real assets can provide, not to mention the diversity benefits, has been an attractive strategy for institutional investors for some time. But many can get bogged down in the nuts and bolts of carving out that allocation.

In a multi-asset portfolio, large investors often commit 10% to 15% to real assets, with about 75% of that committed to real estate, according to Peter Hayes, global head of investment research at PGIM Real Estate. “Over the last six or seven years, we’ve seen a slow, steady increase in this allocation,” he said. “The availability and pricing of assets will affect how fast that allocation will grow in the future.”

Most investors hold all their real assets exposure together in a single bucket, even though the skills required to manage real estate, infrastructure and commodities, for instance, are very different. Hayes chalked this up to resourcing.

“Given the current size of the allocation for most institutional investors, having one team is probably necessary,” he said. “However, over time that might change.”

ALTERNATIVES BUCKET

“The two key pillars in our real assets portfolios are listed real estate and listed infrastructure,” said Evan Rudy, a portfolio manager within the liquid real assets team at Deutsche Asset Management. “Throughout the cycle, the majority of our real asset portfolios will be invested in listed real estate and infrastructure, however the growth and inflation environments will result in varying levels of allocations to commodities and natural resource equities.”

Real assets often are held in an investor’s alternatives bucket. Managers suggest that these, on average, make up about 8% to 12% of the overall portfolio. In most cases, real estate — the original real asset investment — still makes up a significant portion of the portfolio. Whether that holding is listed or unlisted often depends on the size of the investment portfolio.

“In countries like Canada and Australia, pension funds have similar or sometimes larger allocations to infrastructure as they have to real estate,” said John Vojticek, head and CIO of liquid real assets – alternatives at Deutsche Asset Management. “U.S. and European investors will have less infrastructure investment in general. The important issue for all these investors is getting the necessary amount of diversification.”

ABSOLUTE-RETURN STRATEGIES

Conceptually, alternatives can cover almost any investment that isn’t a stock or a bond. “Mostly though, alternatives mean absolute-return strategies,” said Adam De Chiara, co-founder and portfolio manager at CoreCommodity Management. “Typically, higher volatility absolute-return strategies that are uncorrelated with traditional asset classes. We would contend that real assets are more of a separately identifiable asset class.”

What often sets real assets apart is the fact that there is an underlying physical market: commodities, for example, or a tangible asset, as in infrastructure or real estate. “There are absolute-return strategies in real assets,” De Chiara said, “but there are also long-only, actively managed strategies in the same arena.”

Interest in real assets is growing from defined contribution plans, though not from sponsors looking to add a real assets option to the investment lineup. Rather, there is a growing trend to add real assets to target-date funds. Even here though, many are diversifying from what had been just a real estate segment into infrastructure. •
Experience. Leadership. Commodities.

CoreCommodity Management, LLC is an independent asset management firm, whose singular focus is to provide commodity exposure to investors globally via commodity futures and natural resource equity strategies. The firm was founded in 2003 by an experienced team of professionals who helped pioneer commodities as an institutional asset class.

CoreCommodity Management has provided commodity exposure to sovereign wealth funds, public and corporate pension plans, endowments and foundations, not-for-profit organizations, religious institutions, insurance companies, asset managers and other prominent institutional clients. The firm is located in Stamford, Connecticut and manages approximately $5 billion in assets.

Assets as of June 30, 2017, and are measured at agreed upon notional amount for managed accounts, net asset value for pooled vehicles, and do not include anticipated subscriptions or redemptions in a subsequent period.

CoreCommodity Management is a registered investment adviser, commodity trading advisor, commodity pool operator and a member of the National Futures Association.

©2017 CoreCommodity Management, LLC
For many investors, real estate is probably their first and most long-lived exposure to real assets. Whether they invest in real estate directly or through listed real estate securities such as real estate investment trusts, or REITs, investors are at home here.

That said, property markets are never boring. Falling interest rates and quantitative easing have propelled capital values upwards while protecting investors from the potential effects of global and economic uncertainty. As a result, investment capital is still flowing into real estate globally — even though rates are slowly on the rise — on the back of a steady economic outlook, although after many years of sticking to core markets, investors are gradually taking on more risk.

Fundamental growth trends worldwide tend to fuel interest in real estate. Investors see the growing need for housing, office space and food as drivers. “If you are a long-term investor, the one thing you’re never going to get more of is land,” said Eric Adler, CEO of PGIM Real Estate. “There is less and less land that is attractive.”

Here, as in infrastructure, investors often divide their allocations between the listed and direct markets. John Vojticek, head and CIO of liquid real assets — alternatives at Deutsche Asset Management, said listed real estate provides a good complement to direct investment.

“One example is self-storage. It’s long been available in the public space but only recently have core funds been buying in.” Other areas include single-family housing, student housing, data centers and assisted living facilities, all of which are stalwarts of public markets.

LISTED VS. UNLISTED
Investors forging into real estate must remember that returns from listed and unlisted real estate won’t always track one another.

“Over the intermediate term, there can be big divergences in returns from public listed real estate vs. the NCREIF Property Index,” Vojticek said, referring to the National Council of Real
Estate Investment Fiduciaries’ Property Index, which provides a quarterly, unleveraged composite total return for private commercial real estate properties held for investment.

“Although there is no guarantee of future performance, over the long term,” he said, “public real estate securities have historically generated positive real returns in line with private real estate investments.”

The combinations can be creative.

“Some more sophisticated European investors — private real estate investors — go to selected sectors or regions for what they call completion strategies,” PGIM Real Estate’s Adler said. “If they really think that shopping centers in the U.S. are attractive, then they might look at shopping center REITs to get that exposure.”

Other investors design their ideal real estate allocation and then implement it through private or public means, depending on availability and pricing.

Core real estate assets — those good-quality buildings in great locations, fully let with predictable income — have been the dominant theme since 2009.

Many investors believe that core real estate markets are tapped out.

MOVING OUT THE RISK CURVE

“Many plan sponsors are moving out the risk curve to the margins and focusing on value-add and core-plus real estate,” Deutsche Asset Management’s Vojticek said. “However, we think that core markets are pretty attractively priced, particularly when you think about the cost of capital that is available to support this asset class.”

He boiled it down to investment alternatives, specifically fixed income. “We don’t think interest rates are going to rise significantly,” Vojticek said. “This is important because although cap rates in private real estate are basically where they were at the peak in 2007, long-term interest rates are 150 to 200 basis points lower. So the cost of capital has fallen significantly. Comparing fixed income to cash-on-cash returns for real estate, that spread is still very attractive.”

For global real estate managers and investors, correlations between markets are always important. “At this point in the cycle, we have less correlation between global markets than we’ve had historically,” said PGIM Real Estate’s Adler. “If you look at supply-demand fundamentals, there are areas that aren’t moving in sync, most prevalently in Asia.

“If you are only a capital value player, you will be uncomfortable everywhere because of the low interest rate environment,” he continued. “But if you are thinking about cash flow and relative value between markets, then there’s more choice and more ability to be selective.”

“Listed real estate is a mature market in the U.S.,” added Deutsche Asset Management’s Vojticek. “While we’ve seen increases in allocations in Europe, for instance, where pension funds were probably underinvested, we expect U.S. investors to maintain their exposure.”

It isn’t enough just to identify the right markets and buy the right real estate assets. “Don’t underestimate the need to operate and manage the asset,” Adler said. “Buildings aren’t securities that you can sell if things go wrong. You need a certain level of expertise to manage through difficult moments.”

Establishing benchmarks and objectives is also important. “We want to be judged on performance,” Adler said. “But you have to have a very sophisticated approach to all aspects of that performance.”

The primary bogey is usually an absolute-return target for a real estate fund. But as investors often have different requirements for this allocation, it’s also important to look at market performance benchmarks and income targets, always keeping in mind risk-return and volatility constraints.

Real estate investing does involve political and regulatory risks. “Directionally, these risks have the same effect as they do on infrastructure assets,” Adler said. “But the effects will be more granular, where local politics or local regulation are likely to present more of a challenge.” However, a well-constructed, diversified real estate portfolio can weather these impacts.

Like other real assets, real estate is benefiting from the concerns about the current macroeconomic and political environment.

“Geopolitical uncertainty is sending investors toward owning something tangible,” Adler noted. “So we expect, even at this cyclical high point, that there will be continued interest in real estate. The other traits — income and inflation protection — are also highly valued.”•
With equities looking expensive in many markets and bonds not far behind, investors are looking farther afield for opportunities. Some are finding them in the commodity sector, where the Bloomberg Commodity Index has risen 17% since its low in January 2016.

“When you compare where commodity prices are relative to stocks and bonds on a long-term basis, there is a real relative value gap,” said Adam De Chiara, co-founder and portfolio manager at CoreCommodity Management.

That value gap, he said, is a positive sign given that the world is moving toward more normalized global economic activity. As real world demand picks up and interest rates normalize, plan sponsors will look again at commodities as both a diversifier and as a source of a relatively attractive valuation.

Commodities can provide diversification to a real assets portfolio, but the performance has been lackluster.

Over the past decade, the diversification benefits of a commodities allocation have been outweighed by its poor performance, and that had been a problem,” said Evan Rudy, a portfolio manager within the liquid real assets team at Deutsche Asset Management.

“Importantly, however, they do provide inflation protection and diversification benefits, and thus shouldn’t be ignored going forward.”

Given the cyclical nature of commodity investing, De Chiara advocated a diversified approach by creating portfolios that involve exposure to all major commodity sectors: energy, industrial metals, precious metals and agriculture.

“Today, though, all these commodity sectors are trading at steep discounts to their historical highs” he said. “As opposed to the equity and bond markets, which are essentially at all-time highs.”

ECONOMIC ACTIVITY ON THE RISE

What’s more, the fact that central banks are comfortable normalizing interest rates suggests that underlying economic activity is increasing, he said.

“We expect to see real assets consumption increasing as both a function of population growth and increasing per capita utilization,” he continued. “Increases in per capita energy consumption, steel consumption—and even per capita food consumption as diets become more protein-based rather than carbohydrate-based.”

When investors first started incorporating commodities into institutional portfolios in the 1990s, most used futures-based approaches but today, “investors are more willing to incorporate exposure to upstream commodity-producing companies,” De Chiara said.

This approach expands the opportunity set since there are not liquid commodity futures contracts for a number of very significant global commodities, such as coal, steel, iron ore and uranium, to name a few.

Investors are able to have a much more diversified commodity portfolio by incorporating natural resource equities,” De Chiara said. Commodity managers point out that investors should focus on stocks that offer the purest of plays on commodity sectors.

“We focus on broad distribution, both in terms of sectors and market capitalization. We include diversified exposure to energy, agriculture, industrials and precious metals,” De Chiara said. “Also, while paying close attention to minimum liquidity thresholds, we look for broad diversification in terms of the capitalization scale.”

Commodities also stack up well in relation to other real assets. “We also see commodities as looking attractive relative to real estate, where on a relative valuation basis, these assets are somewhere north of the 90th percentile in terms of trailing 10-year valuation,” De Chiara said.

The question of volatility is one that investors have been asking, particularly in light of the extended period of low volatility in traditional asset classes such as stocks.

“The volatility has been quite low over the past decade—typically in the low- to mid-teens—and sometimes even in single digits,” De Chiara said, referring to commodities. “Even compared to broad equity indexes, it tends to be quite low.”

So is now the right time to pull the trigger on commodities?

“We draw parallels with the late 1990s, when commodities were not a favoured investment,” De Chiara said. “The price of oil dropped from $35 a barrel to $12 a barrel. Real assets in general were out of favor partly because of the dotcom surge that became the bubble and partly because investors tended to focus on recent price behavior instead of longer-term trends.”

“Like today, commodities were trading at very close to their long term marginal production costs,” he said. “No one was advocating for them then and no one is now. But over the next seven or eight years, we saw dramatic increases in commodity prices. Oil went from $12 a barrel to over $100 a barrel.”

Past performance is no guarantee of future results but in commodities, perhaps institutional investors can learn some lessons from history.
Deutsche Asset Management is delighted to be a winner of Asia Asset Management’s 2016 Best of the Best Awards in the Global Real Estate category:

**Best Performance—**

Global Real Estate Securities Composite

3 years and 10 years

Deutsche Asset Management’s Liquid Real Assets business has been investing in real estate securities, infrastructure securities and commodities since 1993. Our investment approach focuses on active stock selection by local investment teams, with a focus on strategic allocation and risk management. We create global and regional strategies leveraging a network of analysts and portfolio managers around the world.

Deutsche Asset Management manages approximately €21.2 billion in these asset classes for investors around the world as of 31 March, 2017.
Infrastructure has long been a significant part of the real assets lineup despite the fact that investors have always allocated more assets to real estate.

Investors are drawn to the long-term nature of infrastructure assets, which often provide stable income streams, as is the case with real estate. In recent years, this interest has turned from a trickle to a flood. And that has left some investors seriously stymied.

Enter listed infrastructure managers.

“Increasingly, mature U.S. plan sponsors are at a point in their life cycle where money going out in benefit payments is roughly equal to what is coming in, leading to further emphasis on income,” said John Vojticek, head and CIO of liquid real assets – alternatives at Deutsche Asset Management. “This means we expect to see significant growth in infrastructure overall, with a bias toward listed because of the difficulties in accessing direct infrastructure investments.”

Matt King, a managing director of Morgan Stanley Investment Management, added that roughly $150 billion of “dry powder,” or investor funds in private infrastructure funds, is waiting to be deployed and is having a hard time accessing infrastructure assets in a timely fashion. “So some investors are looking at that backlog and saying, ‘Maybe I’ll investigate listed as an alternative,’” he said.

But that doesn’t mean that investors are pulling out of direct infrastructure.

“Many investors view infrastructure as a private equity asset class and have historically used it for absolute returns,” said Eric Adler, CEO of PGIM Real Estate. “That is still important, but the income component is also very attractive today.”

Many institutional investors are looking at adding listed infrastructure to their existing unlisted allocations, partly to add liquidity. That shouldn’t affect returns over time.

VOLATILITY

Although infrastructure investments originally were private vehicles, investors today are more likely to hold both private and listed investments. But that has raised the perception of volatility.

“The listed companies are often investing in the same assets as the private players, so it’s the fact that public companies are valued every day, while private holdings are valued perhaps once or twice a year, that introduces the perception of volatility,” said Ben Morton, a senior vice president at Cohen & Steers.

Still, having listed infrastructure in a portfolio offers investors advantages such as, primarily, liquidity, as managers are able to move in and out of positions quickly and cost-effectively.

“Investors that were burned during the financial crisis because they were long private infrastructure welcome the liquidity that listed infrastructure can bring,” Morton said. “It’s also one way to put money to work quickly when there is lots of dry powder in the private infrastructure market unable to invest.”
Listed infrastructure can offer other benefits as well. “With private markets, a manager is captive to the deals that present themselves at any point in time,” Morton said. “There is no easy way to access a variety of global themes in the various subsectors or geographies that you might want.” Equally, a private portfolio may only consist of five to 10 assets at any one time, while a listed one could own between 25 and 75 different securities.

The definition of infrastructure differs from manager to manager. “We think about infrastructure as assets that provide essential public services that facilitate growth,” Morton said. “We invest in the owners and operators of these assets that collect fees for usage.”

Infrastructure assets share other characteristics that produce the stable cash flows prized by investors. These tend to be businesses that are monopolistic or duopolistic and often operate in regulated industries. If they’re not strictly regulated, the stable cash flow can come from a concession, such as a toll road or an airport, or a long-term contract for pipeline usage. MSIM’s King said his firm’s listed infrastructure strategy invests in four broad categories: utilities, energy, communications and transportation. “We also look at social infrastructure, such as health-care facilities, hospitals and schools, which offer a smaller universe in the listed space, but are important on the private side,” he said.

STYLE DRIFT

While the core of a listed infrastructure portfolio will include utilities, telecommunications, transportation and midstream energy companies, Cohen & Steers’ Morton warned about a style drift among managers. “Some construction-related businesses or materials companies could benefit from infrastructure stimulus spending,” he said. “But these businesses and assets have a very different cash flow and performance profile than what we would consider core infrastructure holdings. They will be more cyclical, have higher betas and be much more correlated with the broader equity markets.”

Institutional investors looking for a core infrastructure allocation typically turn to developed markets—usually Australia, Canada, the U.S., continental Europe, the U.K. and Japan. That is fewer countries than would typically be held in a core fixed-income allocation. All offer a stable regulatory environment and rule of law, and concession contracts are strong.

Core infrastructure generally includes what MSIM’s King called brownfield assets—fully operational infrastructure with a long operating history that allows an investor to project the stability of the cash flow. Investors would probably also include some so-called yellowfield assets—similar to brownfield but probably in need of some additional resources to solve a particular issue or capital investment.

In contrast, emerging market infrastructure often consists more of greenfield assets—new builds with no operating history in jurisdictions with less proven regulatory and legal systems. As a general rule, investors look for higher returns from emerging market assets than those in developed markets.

“If an investor does consider emerging market infrastructure, it is likely to be in a different bucket than more conventional real assets because of the higher risk-return profile,” MSIM’s King said. Listed infrastructure offers an increasing number of opportunities in both developed and emerging markets.

“As a core infrastructure investor, we focus on the owners and operators of infrastructure assets, maintaining an emphasis on a stable cash flow profile where economic returns on invested capital can be preserved over long periods of time,” King said. “Moreover, we believe it’s important to apply the same criteria for investment in both developed market and emerging market companies.” Conversely, listed real assets portfolios often have only minimal exposure to emerging markets. “We find that institutional investors can be particularly concerned about the environmental and social aspects in these markets,” said Deutsche Asset Management’s Vojticek. “In emerging markets, the regulatory and governmental risks can be higher for infrastructure. For example, you can see the wholesale repatriation of assets in a country without a stable regulatory regime. We would want to avoid companies that face those kinds of risks.”

As with any asset class, investors need to understand all the risks associated with infrastructure. Some are obvious: Economic, political and regulatory risks feature on everyone’s lists. Peter Hayes, global head of investment research at PGIM Real Estate, suggests one more. “Technological change can impact the performance of an infrastructure asset,” he said. “How the market responds to these changes can have an effect on the demand for the asset.”

“Most infrastructure assets have a baseline level of growth embedded in the asset in the sense that they are providing an essential service to society or an economy,” MSIM’s King said. “This is usually tied to the level of GDP growth in the region where the assets are domiciled.” This element of growth is not found in pure fixed-income securities, such as Treasury inflation-protected securities, or TIPS. Infrastructure can provide a measure of inflation protection and growth.

IMPACT OF RISING INTEREST RATES

Many investors think a rising rate environment will have a negative impact on infrastructure but that’s not universally true. If nominal rates are rising because inflation is increasing and the economy is improving, certain infrastructure assets are likely to benefit from rising cash flows for usage. As a general rule, investors look for higher returns from emerging market assets than those in developed markets.

“As a core infrastructure investor, we focus on the owners and operators of infrastructure assets, maintaining an emphasis on a stable cash flow profile where economic returns on invested capital can be preserved over long periods of time,” King said. “Moreover, we believe it’s important to apply the same criteria for investment in both developed market and emerging market companies.” Conversely, listed real assets portfolios often have only minimal exposure to emerging markets. “We find that institutional investors can be particularly concerned about the environmental and social aspects in these markets,” said Deutsche Asset Management’s Vojticek. “In emerging markets, the regulatory and governmental risks can be higher for infrastructure. For example, you can see the wholesale repatriation of assets in a country without a stable regulatory regime. We would want to avoid companies that face those kinds of risks.”

As with any asset class, investors need to understand all the risks associated with infrastructure. Some are obvious: Economic, political and regulatory risks feature on everyone’s lists. Peter Hayes, global head of investment research at PGIM Real Estate, suggests one more. “Technological change can impact the performance of an infrastructure asset,” he said. “How the market responds to these changes can have an effect on the demand for the asset.”

“Most infrastructure assets have a baseline level of growth embedded in the asset in the sense that they are providing an essential service to society or an economy,” MSIM’s King said. “This is usually tied to the level of GDP growth in the region where the assets are domiciled.” This element of growth is not found in pure fixed-income securities, such as Treasury inflation-protected securities, or TIPS. Infrastructure can provide a measure of inflation protection and growth.
The Potential for Privatizing U.S. Infrastructure Assets

Many governments are actively seeking private capital investment in large-scale infrastructure projects. And around the world, many projects are being funded through privatizations and public-private partnerships. The one country where this isn’t a significant feature is the U.S. There is hope that this picture may be changing.

It couldn’t come too soon. Spending on infrastructure in the U.S. has been on the decline for many years. According to the American Society of Civil Engineers, this neglect could lead to about $3.6 trillion of pending need by the year 2020.

The pace of privatization in the U.S. has always been slow when compared to other developed economies. Matt King, a managing director at Morgan Stanley Investment Management, attributed this to the reluctance of state and local politicians to endorse such projects.

“Politicians don’t want to take the risk that the asset is sold too cheaply to the private market,” he said, “or the potential risk that a new owner might raise fees that would result in an adverse reaction from the politician’s community or constituents.”

King pointed to the fact that private ownership has been proven to be more efficient in many other countries. Yet, he continued, “The calculus is more difficult in the U.S. because there are sufficiently deep tax-exempt municipal markets to raise the capital necessary to leave these assets in government control.”

Ben Morton, a senior vice president at Cohen & Steers, noted the excitement that arose from the new administration’s talk of fiscal stimulus focused on infrastructure, but discounted its usefulness to infrastructure investors. “If there was massive infrastructure spending, then the primary beneficiaries would be peripheral infrastructure service businesses involved in construction and materials,” he said. “That’s not our focus.”

He identified the growing focus on privatization of critical infrastructure as a more interesting development. “The administration seems to be moving down the path toward privatization as a way to fund improvement or development of infrastructure,” Morton said. “It has been citing the Australian example of asset recycling, where states were allowed to privatize critical infrastructure assets only if the funds were reinvested.”

Frank Greyston, a managing director and Co-Head of Listed Infrastructure within the liquid real assets team at Deutsche Asset Management, suggested that there could be an appetite for infrastructure deals in which some of the proceeds are ploughed back into repair and maintenance. “But,” he cautioned, “there are many political hurdles before these deals could come to the forefront.”

“One area that could benefit the most given President Trump’s focus on infrastructure is energy infrastructure, largely through the lessening of regulations,” King said. “Elsewhere within the sector, and assuming the administration successfully implements a broader infrastructure plan, both transportation and social infrastructure may benefit through growth in [public-private partnerships], although this will require more clarification and a more robust mechanism for federal policy to influence state and local policy in this area.”

Midstream energy companies are benefitting from an easing of roadblocks at the federal level for new pipelines,” he said. “The Dakota Access Pipeline is a significant example of a project that was approved very quickly after the [U.S. presidential] election by the Army Corps of Engineers.” That project had been stuck for some time.

“We see public-private partnerships becoming more prevalent in the next one to three years, but it will take three to five years for real privatizations to get going,” Morton added. “We are hitting crisis mode as it relates to the quality of U.S. infrastructure assets and service quality. That’s obviously amplified in some extreme cases, for instance, Amtrak. We need to do something and folks are starting to appreciate that.”
Finding Value in Listed Real Assets for Over Two Decades

Morgan Stanley's Global Listed Real Assets team has specialized in providing investors with core exposure to real assets via publicly traded real estate and infrastructure securities since 1995. By focusing on value-oriented, bottom-up research coupled with local insight from its investment professionals based around the world, the team believes it can provide liquid exposure to real assets that may serve as a complement or alternative to illiquid direct investments strategies.

To find out more, visit morganstanley.com/im.
Rock Solid Innovation.

Prudential Real Estate Investors is now PGIM Real Estate. While the name is new, our track record of innovation in real estate investment is more than 45 years in the making.

From the first U.S. open-end commingled real estate fund and European high-yield real estate debt fund to one of the largest Asia Pacific open-end real estate funds, we uncover new opportunities to deliver attractive risk-adjusted returns for our investors.

Joining deep local knowledge with global scale, we use a research-driven, disciplined investment process to create exceptional value for clients across economic cycles.

Learn more at pgimrealestate.com

$67 BILLION IN GROSS ASSETS UNDER MANAGEMENT*

$12 BILLION+ IN 2016 GLOBAL TRANSACTIONS

575 REAL ESTATE PROFESSIONALS

18 CITIES ACROSS THE AMERICAS, EUROPE AND ASIA PACIFIC

PGIM Real Estate

© 2017 PGIM is the primary asset management business of Prudential Financial, Inc. (PFI). PGIM Real Estate is PGIM's real estate investment advisory business and operates through PGIM, Inc., a registered investment advisor. Prudential, Pramerica, PGIM, their respective logos as well as the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide. PFI of the United States is not affiliated with Prudential plc, a company headquartered in the United Kingdom. Data as of June 30, 2017. *Total net assets under management equal $49 billion. PGIM's total gross real assets under management or supervision, including PGIM Real Estate and PGIM Real Estate Finance, equal $154 billion.