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Exploring the role of real assets

Pensions Age Editor-in-Chief, Francesca Fabrizi, joins Nuveen Real Assets Head of Strategic Insights, Abigail Dean, to explore the role real assets can play in pension fund portfolios

What are the benefits of real assets within a pension fund portfolio?

There are several specific attributes that pension fund investors in real assets will be looking for, the first of which is diversification. These real assets, because of the nature of their illiquidity and their absence from public trading, do tend to offer very low or even negative correlation with public markets, with stocks and bonds and also with each other. So, in an era of volatility, that's particularly beneficial to investors who can look to diversify through these different attributes.

The other attribute is inflation hedging, which is particularly relevant at the moment, given the inflationary environment that we've been through in recent years. These assets tend to be linked to lease income, to commodity prices, and that means that they can act as a natural inflation hedge. They're more linked to those factors that tend to rise with inflation.

We've also done some research looking at the risk-adjusted returns of these asset classes on a long-term basis. Looking back over the last 30 years, they may offer superior risk-adjusted returns. So, what we see looking over the long term is that these different asset classes may offer the same or enhanced risk-adjusted returns when compared to stocks and bonds. Again, that's because of the different nature of these assets, their illiquidity and the fact that they're out of time with some of the public assets classes and they tend to bring lower volatility to an investment portfolio.

What we see is even adding a relatively modest exposure to real assets, say five to ten per cent, can enhance the risk-adjusted return of a standard portfolio.

Finally, the key thing that many pension fund investors will be looking to these asset classes for is income resilience. So, even when capital appreciation is not as strong, you have the potential to receive steady income from leased revenue and commodity sales.

What are the most compelling opportunities you see within real assets today?

There are a number of opportunities at the moment that we're excited about and that we would point investors towards. The first is European levered real estate debt. This type of investment benefits from an asymmetric interest rate floor mismatch, and this means it has the potential to deliver risk-adjusted returns regardless of the direction in interest rates. There's an additional benefit here, which is that the underlying asset class – real estate – has gone through a substantial price correction over recent years. This means that it's de-risked and, even given the current environment which we find ourselves in, it is reasonable over the length of a loan made now for investors to expect that loan-to-value ratio to come down. That makes this a potentially quite low-risk investment with still reasonable risk-adjusted returns, which might be suitable for any scheme looking for those lower risk investments at the moment.

Another opportunity I'd point towards is nature-based solutions. This is investment in natural capital, in farmland and timberland, but with the added benefit that this can bring additional income streams from areas such as biodiversity credits, carbon credits, mitigation banking and wetland restoration, for example, also through the leasing out of unproductive land for renewable energy, for example.

Within real estate, I'd also point to resilient needs-based types of real estate. These are real estate segments where demand and leasing income in particular may be more resilient to fluctuations and consumer and business confidence. Particularly good examples of this are living, and particularly more affordable living, also grocery-anchored retail, which tends to be less at risk from online shopping and also less at risk from

fluctuations in consumer demand.

I'd also point to real estate sectors where structural growth and demand are much more built in. These tend to be sectors that are linked to, for example, demographic trends. A good example would be anything linked to the aging population – we see particular opportunities for healthcare, real estate in the US, senior living as well.

Finally, at this point in time, we see opportunity in anything where value creation can be delivered. So, rather than being reliant on the market to deliver growth, actually building that value creation through the addition of CapEx where that's going to deliver a risk-adjusted return. The refurbishment of buildings would be a good example of this.

How can geopolitical risks impact real assets investment?

There are a number of geopolitical risks that all investors are going to be acutely aware of that may have an impact on real assets. Clearly there is the potential for inflationary pressures and that linking through to the interest rate environment. We see the Iran conflict at the moment and the impact that's had on oil prices, and it has had a direct impact on inflation around the world.

That has also directly led to the higher potential for rate rises. Earlier this year, we were expecting possibly to have interest rates holding or cutting. We are in a different situation now where we are expecting them to potentially rise yet further. That does have an impact on real assets, particularly any that are taking on leverage. So, we can see that impacting real estate for example, in particular, and investors should be mindful of that with respect to their investment strategies.

Also, anything that impacts the consumer and impacts that demand needs to be considered. So, again, inflation and the general macroeconomic environment may lead to a fall in consumer confidence. We actually haven't seen that too much in Europe recently, but it's reasonable to assume that the current environment could filter through to a general weakening of consumer and business confidence, which could have a negative impact on the willingness of consumers to shop and spend money.

Finally, I would point to the ongoing situation around tariffs and the potential impact on trade – that has the potential for particular impacts on natural capital, for example, and anything related to supply chains or industrial logistics and global trading goods.

These are all risks that could be front of mind. What's most important for schemes is that they're aware of these geopolitical risks, are building an appreciation of them into their investment strategies, and are looking to invest in those segments that may be best placed to weather geopolitical storms in the future.

What actions can schemes take to protect themselves from these risks?

There are several strategies that all schemes can deploy to ensure their portfolios are best placed to weather these storms. The most obvious one is diversification – across asset classes, geographies and sectors within those different asset classes. So, diversification across real estate sub-sectors, for example – that means that investors' risks are well spread and leaves them best set up for success.

I would also focus on asset quality. When we think about the last cycle for real estate, for example, what we saw there was a real spread in the performance between different real estate sectors. For example, we saw industrial logistics performing incredibly well, benefiting from that structural shift towards online shopping. Conversely, we saw retail suffering and that was exacerbated by the Covid pandemic and people not going out and shopping in physical stores. We also saw some impact on office markets.

We're seeing that much less at the moment – whilst there certainly will be some differences in how sectors perform at the moment, more will be seeing a bifurcation within sectors. In this instance, it's really important to focus on the individual asset quality, location, the attributes of the individual assets and the sub-sector – so which niche sectors are likely to perform well in this environment.

It's also important for investors to focus on income. When capital appreciation is less certain, income can offer that real resilience. So, looking at those sectors where income is least likely to be disrupted by current macroeconomic events. Living, resilient retail, healthcare, for example.

What's also essential is that, given wider risks at the moment, investors focus on underwriting the physical impacts of climate change as well as the impact of the transition to the low carbon economy; and to do so explicitly rather than implicitly because that is another area of risk that investors should be aware of that is particularly heightened in the area of real assets but which may also offer opportunities.

Finally, I would say, really think about the managers that you're working with, partner with experienced managers with detailed knowledge of those areas and also local knowledge of how different real asset sectors may behave given current economic conditions.

This is an edited summary.
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