Multi Dimensional
The Case for Real Assets

We believe real assets are an opportunity for investors in a changing and uncertain market environment. Real assets—which include real estate, infrastructure, and natural resources—offer a range of investment characteristics. They can potentially provide a portfolio with inflation protection, current income, capital appreciation, and diversification. As we explain in this paper, we take a dynamic approach to real assets, seeking to deliver the full potential of the asset class as well as seeking related investment opportunities through the inclusion of global inflation-linked bonds and pricing power equities.
The Opportunity in Real Assets

Real assets are traditionally defined as tangible investments that have value because of their physical attributes. The asset class encompasses a broad range of categories, such as real estate, infrastructure, industrial and precious metals, agricultural goods, and other natural resources. Because real assets have a wide variety of characteristics, skilled investors typically avoid concentration in one type. Instead, they seek to combine them into an optimal allocation that seeks to deliver the asset class’s many potential benefits, including:

- inflation protection
- current income
- capital appreciation
- diversification

In addition, inflation-linked bonds and equities offer inflation protection as well as exposure to growth should inflation remain low. In this paper, we explore real assets and detail their potential benefits and challenges. We describe our investment approach to the asset class, including its differentiating factors and why we believe it is suited to the current environment.

Real Assets: Real Benefits

Inflation Protection

In the United States, persistently high peacetime inflation has only occurred once in the past half century, during the “Great Inflation” of the mid-to-late 1970s. Consumer price inflation moderated significantly after this period and, since the mid-1990s, has been relatively low and stable. In our view, however, inflationary pressures are growing enough to warrant consideration from investors. Inflation expectations have bottomed (Exhibit 1), wage growth is accelerating, and many deflationary effects—from lower oil prices, for example—are fading.

While inflation has not been a major concern for decades, it is important to note that it can corrode purchasing power even at moderate rates. A 0.25% month-on-month increase in the consumer price index (CPI)—or about 3% annualized—compounds to a 14% loss in purchasing power over five years.

For this reason, we recommend that investors consider inflation-protecting assets for their portfolios. Current inflationary pressures are far more complex than they were in the 1970s, when investors turned to gold, oil, and domestic large cap stocks. In our view, not only is a wider range of assets needed to effectively fight inflation today, but the approach must be more flexible and nimble, particularly given the global inter-connectedness of the economy.

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Real assets have historically offered a hedge against inflation for a variety of reasons. Some types of real assets, such as infrastructure, are positively correlated with inflation because they tend to have monopolistic pricing power and exhibit relatively inelastic demand. Infrastructure investments often have the ability to maintain margins by passing on price increases to consumers. Regulated infrastructure investments, such as US utilities, have worked particularly well in periods of higher inflation due to the indexed nature of their tariff contracts. As such, they typically are less subject to the fluctuations of economic cycles (unlike unregulated real assets such as airports and toll roads).

Other real assets are positively correlated with inflation as they are sources of inflation themselves. Commodities, for example, are included directly or indirectly in most measures of inflation, e.g., the Consumer Price Index. As a result, commodities have historically outperformed equities and bonds¹ during periods of rising inflation.

Many real asset strategies hold inflation-linked bonds—though they are not physical assets—because of their inflation-hedging properties. These instruments (otherwise known as “linkers”) provide a real yield for investors—that is, yield which takes inflation into account by contractually linking principal and interest payments to inflation. As inflation-linked bonds are largely issued by government entities, they are usually seen as low-risk diversifiers in a real assets portfolio.

Different sources of inflation require different investment responses. In our view, an ideal real assets solution should have the flexibility to deliver on this.

Exhibit 1
An Inflection Point? Inflation Expectations Have Been Rising since Mid-2016

<table>
<thead>
<tr>
<th>Inflation Rate (%)</th>
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</thead>
<tbody>
<tr>
<td>2.5</td>
</tr>
<tr>
<td>2.0</td>
</tr>
<tr>
<td>1.5</td>
</tr>
<tr>
<td>1.0</td>
</tr>
</tbody>
</table>

2013 2014 2015 2016 2017

As of 24 May 2017

a The breakeven inflation rate is the 10-year Treasury Yield at Constant Maturity minus the 10-year inflation-indexed Treasury Yield at Constant Maturity.
Source: Federal Reserve Board, Haver Analytics
Current Income
Income generation is another potential benefit from holding real assets. They can offer stable and significant cash flows as some—e.g., real estate and infrastructure—have lease structures in place. These cash flows have exceeded the yield provided by traditional assets. Over the last several years, the dividend yields of US equities and US fixed income have averaged 1.96% and 2.20%, respectively. In contrast, the dividend yields of REITs and listed infrastructure have been 3.63% and 4.13%. Thus, portfolios can potentially generate returns from real assets even if inflation is absent—in effect, investors can be paid to wait.

It is important to note, however, that the amount of income generated by real assets varies. The income growth from real estate alone, for example, has generally exceeded CPI (Exhibit 2). Commodities, on the other hand, are usually purchased through futures contracts, which generally do not produce income.

Capital Appreciation
Capital appreciation also draws many investors to real assets because they offer absolute returns. Real assets tend to appreciate in part because they are based on physical assets subject to the forces of supply and demand. Some real assets, such as non-renewable natural resources, have relatively inflexible supply because they require significant capital investment to be exploited. Demand, in contrast, may have the secular tailwind of a rising population. As a result, real assets may generate solid long-term returns (between those of equities and fixed income) but with lower overall volatility compared to equities (Exhibit 3).

Diversification
Real assets can be strong portfolio diversifiers as they have historically generated negative or low correlations to traditional assets. Studies have found that equities and commodities generate differentiated performance during each phase of the business cycle, often because commodities reflect current supply and demand dynamics, while stocks and bonds reflect long-term expectations. Infrastructure also performs differently from traditional assets during the business cycle, though this is because infrastructure investments often command pricing power and thus are largely unaffected by negative economic environments.

Another characteristic of real asset performance is that real assets are generally not correlated to one another (Exhibit 4). Even within a category, investments exhibit diversification properties. For example, within commodities, agriculture and livestock have a correlation of only 0.21. As a result, an allocation to a broad mix of real assets within a portfolio may improve an investor’s risk-adjusted returns and potentially protect capital over time.
Equities with Real Asset–Like Characteristics

Equities typically attract investors for their capital appreciation potential, but some offer real asset–like characteristics as well. By investing in companies with pricing power, a portfolio can provide inflation protection because they provide goods and services with few or no alternatives in the marketplace. In effect, they can pass on price increases directly to customers without losing market share. Companies with pricing power may include those with a trusted and popular brand or a monopoly. Equities also have exposure to economic growth and consequently can generate returns even if inflation is dormant. They provide flexibility in a complex inflation environment, allowing the manager to adjust a portfolio when components of inflation (e.g., health care) are growing at different rates. This approach is differentiated from many real asset strategies.

Drawbacks and Challenges

While real assets have many strengths, they can be relatively inflexible or difficult to directly access. Physical real assets are generally not divisible—that is, they are difficult to buy and sell in sizes that meet an investor’s specific needs or target asset allocations. For example, a direct real estate investor must purchase an asset in its entirety, regardless of its effect on the portfolio. In contrast, share-based stock and bond investments can be easily tailored to the investor’s desired asset allocation.

In addition, because physical real assets are generally not traded on exchanges, they tend to be illiquid. Such investments are generally characterized by infrequent trading and high transaction costs, which makes understanding the true value of an investment more challenging. While illiquidity often raises an investment’s return potential, it also increases its risk profile. For many investors, the potential illiquidity premium of real assets is outweighed by the investor’s need for liquidity and transparent pricing.
As discussed, real assets are also heterogeneous, and holdings within a real asset category itself may be highly differentiated. In real estate, for example, large variations in returns can be caused by location, design, property age, and lease structure. Real assets are also prone to information asymmetries, which occur when market participants have different levels of knowledge of investments and the state of the market. Consequently, many real asset investors rely on professional managers.

For those investors holding physical real assets for shelter or uncorrelated investment purposes, a tradable strategy may operate as a liquidity sleeve to complement their less liquid exposure. Its characteristics will align more closely than those of Treasury bills or equity, so it can be used for diversification purposes or to fund more physical assets as they become available.

**Lazard Real Assets and Pricing Opportunities**

Lazard Real Assets and Pricing Opportunities is designed to give investors exposure to real assets in a single, liquid vehicle. We invest directly in securities with daily liquidity that offer direct exposure to underlying real assets. In addition to traditional real assets—commodities, real estate, and infrastructure—the portfolio holds inflation-linked bonds and equities of companies that exhibit pricing power. We dynamically manage the portfolio’s allocations of physical real assets to deliver the asset class’s potential benefits—e.g., inflation protection, current income, capital appreciation, and diversification—while avoiding its potential drawbacks. Our approach seeks to exploit the range of benefits that can exist across real assets (Exhibit 5), thus merging the parts into a diversified whole.

![Exhibit 5](https://via.placeholder.com/150)

**Dynamic Management Can Exploit a Range of Potential Benefits in Real Assets**

<table>
<thead>
<tr>
<th></th>
<th>Inflation Protection</th>
<th>Current Income</th>
<th>Capital Appreciation</th>
<th>Diversification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodities</td>
<td>![Circle]</td>
<td>![Oval]</td>
<td>![Triangle]</td>
<td>![Circle]</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>![Semi-Circle]</td>
<td>![Circle]</td>
<td>![Oval]</td>
<td>![Semi-Circle]</td>
</tr>
<tr>
<td>Real Estate</td>
<td>![Oval]</td>
<td>![Circle]</td>
<td>![Triangle]</td>
<td>![Semi-Circle]</td>
</tr>
<tr>
<td>Pricing Power</td>
<td>![Triangle]</td>
<td>![Semi-Circle]</td>
<td>![Oval]</td>
<td>![Circle]</td>
</tr>
<tr>
<td>Real Yield</td>
<td>![Circle]</td>
<td>![Semi-Circle]</td>
<td>![Oval]</td>
<td>![Triangle]</td>
</tr>
</tbody>
</table>

Legend: Exposure to Potential Benefit

- Total: ![Circle]
- High: ![Semi-Circle]
- Some: ![Oval]
- Low: ![Triangle]
- None: ![Oval]

For illustrative purposes only.

Source: Lazard, Bloomberg

The portfolio is managed in line with an investment process that is implemented across Lazard’s multi-asset platform. We combine our top-down asset allocation with the bottom-up investment analysis carried out in different real assets categories by individual teams, who research and select securities. We overweight those asset classes that we believe will outperform based on our market forecast. At the same time, we employ risk controls holistically across the portfolio to avoid unintended risks—such as stock, sector, or factor concentration—that can lead to significant drawdowns. By dynamically managing exposure to different real assets, each with different risk/return characteristics, we seek to neutralize different sources of inflation while generating income and capital appreciation.
The performance of investments in real estate and real estate related securities may be determined to a great extent by the current status of the real estate industry in general, or by other factors (such as interest rates and the availability of loan capital) that may affect the real estate industry, even if other industries would not be so affected. The risks related to investments in realty include, but are not limited to: adverse changes in general economic and local market conditions; adverse developments in employment; changes in government administration, and economic and monetary policy. Derivatives transactions, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps substantially. Forward currency contracts, and other derivatives investments are subject to the risk of default by the counterparty, can be illiquid and are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related currency or other reference asset. As such, a small investment could have a potentially large impact on performance. Use of derivatives transactions may, intended for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

Securities and instruments of infrastructure companies are more susceptible to adverse economic or regulatory occurrences affecting their industries. Infrastructure companies may be subject to a variety of factors that may adversely affect their business or operations, including additional costs, competition, regulatory implications, and certain other factors. The performance of investments in real estate and real estate related securities may be determined to a great extent by the current status of the real estate industry in general, or by other factors (such as interest rates and the availability of loan capital) that may affect the real estate industry, even if other industries would not be so affected. The risks related to investments in realty include, but are not limited to: adverse changes in general economic and local market conditions; adverse developments in employment; changes in government administration, and economic and monetary policy. Derivatives transactions, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps substantially. Forward currency contracts, and other derivatives investments are subject to the risk of default by the counterparty, can be illiquid and are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related currency or other reference asset. As such, a small investment could have a potentially large impact on performance. Use of derivatives transactions may, intended for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

Emerging markets carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging markets countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in these countries. The performance of the strategy is largely dependent on the performance of the team and efforts of certain individuals. There can be no assurance that Lazard’s investment professionals will continue to be associated with Lazard and the fail to retain such investment professionals could have an adverse effect on the strategy. An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond’s maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make future income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one’s home market. The values of these securities may be affected by changes in currency rates, application of a country’s specific tax laws, changes in government administration, and economic and monetary policy. Small- and mid-capitalization stocks may be subject to higher degrees of risk, their earnings may be less predictable, their prices more volatile, and their liquidity less than that of large-capitalization or more established companies’ securities.