Real Assets:

An Increasingly Central Role in Institutional Portfolios

GREENWICH ASSOCIATES

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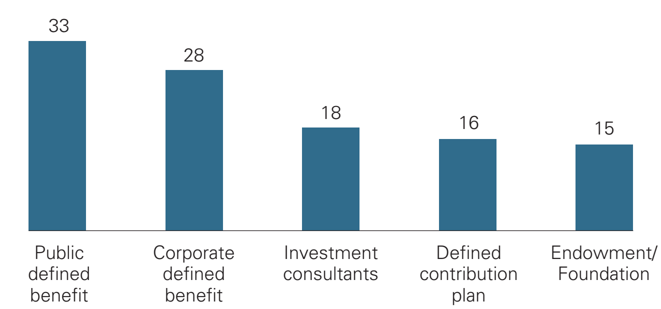
RESEARCH GOALS AND METHODOLOGY

In the first and second quarter of 2014, Greenwich Associates interviewed over 100 fund executives from 28 corporate defined benefit (DB) plans, 33 public DB plans, 15 endowments/foundations, and 16 defined contribution plans, in addition to 18 investment consultants. The goal of this research was to develop a systematic understanding of how real assets are perceived and used by institutional investors.

The funds participating in the research are significant investors in real assets in terms of total dollar amount invested. To reflect the typical real-asset investor base, Greenwich Associates targeted some of the largest U.S. institutional investors and investment consultants.

Number of Respondents by Organization Type



Note: Based on 110 respondents in 2014.
Source: Greenwich Associates 2014 Institutional Real Assets Research

This study was conducted in partnership with Cohen & Steers.

Executive Summary

Real assets are playing an increasingly important role in the investment strategies of U.S. institutions as they look to diversify their portfolios and secure new sources of hard-to-achieve returns.

In order to gain a better understanding of why and how institutions are employing real assets, Greenwich Associates conducted a study of U.S. defined benefit funds, defined contribution plans, endowments and foundations in 2014.

The study revealed that institutions are making sizable investments in real assets like real estate, infrastructure, farmland, timber, and precious metals, and they are planning to increase their level of activity in these asset classes over the next year. Endowments and foundations were the earliest movers. Looking ahead, the strongest future demand likely will come from public DB funds.

These institutions start investing in real assets primarily as a means of diversifying their portfolios. In order to achieve that objective, a majority of institutions set target allocations for real assets in the neighborhood of 10%. However, the study results show over half of institutions are underinvested relative to their targets. Investment consultants estimate that share to be even larger.

Institutions struggling to achieve target allocations sometimes turn to liquid real assets as an alternative to private investments. Liquid real assets are used by all the DC funds participating in the study, frequently as part of a prepackaged, outcome-oriented solution such as target-date funds. However, other institutions generally allocate 5% or less of total assets to liquid real assets, and one-third don't invest in these categories at all.

Due to real assets' unique characteristics and the considerable challenge of finding attractive private investment opportunities, institutions place a premium on external expertise. Institutions give extra weight to consultant recommendations in real assets, and the research results show that the primary driver of institutional investment decisions in real assets is the expertise of individual asset managers.

Data from the Greenwich Associates study indicates that institutional inflows into real assets will continue to grow. Given institutions' appetite for external expertise, investment managers and consultants can facilitate that growth by providing education and support to investors thinking about how best to integrate real assets into their portfolios.

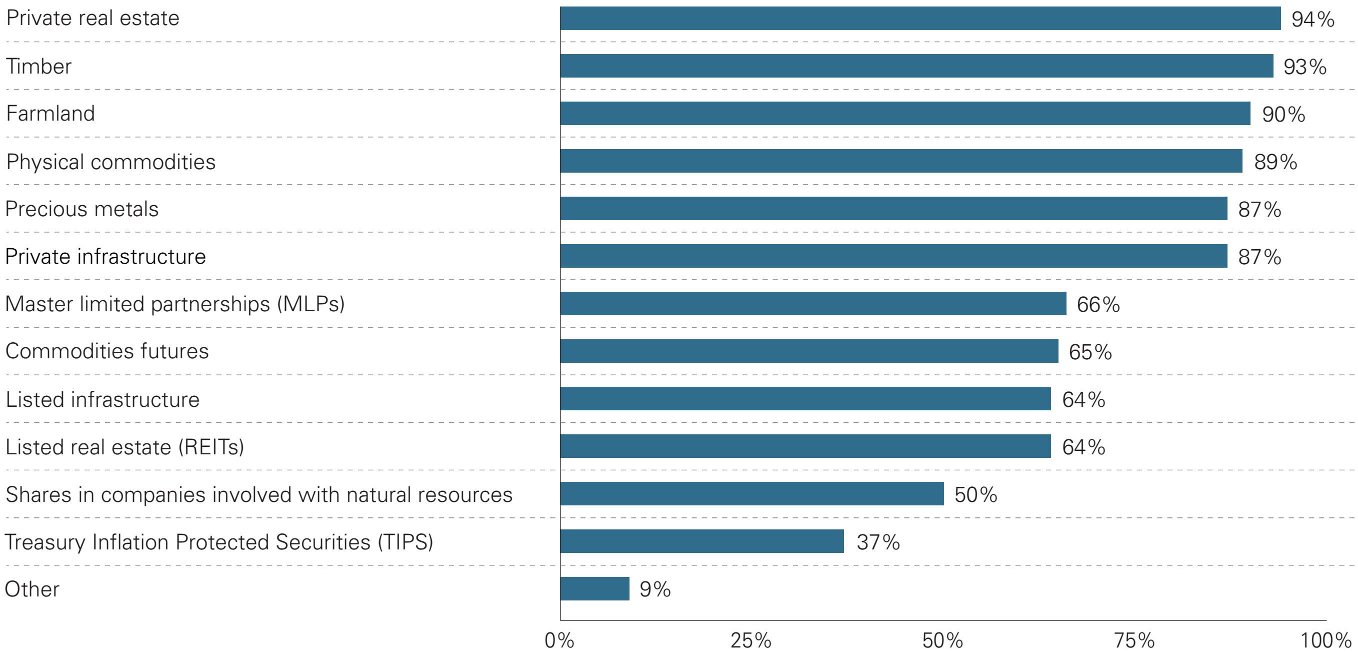
Defining Real Assets

In trying to understand how and why institutions are using real assets, the first point to address is the simple question of, "What is a real asset?" From a definitional perspective, a real asset is a physical or tangible asset that has intrinsic value due to its substance and utility.

In the institutional investment world, there is some variation in defining a real asset. There is strong consensus that six categories of investments qualify: timber, private real estate, farmland, private infrastructure, physical commodities and precious metals. As the accompanying table shows, 87% or more of the institutions count these items as real assets.

In addition, some two-thirds of investors use a broader definition. These institutions include other categories of more liquid and sometimes even listed assets, including master limited partnerships, commodities futures and listed infrastructure or REITs.

Perceptions of Real Asset Categories



Note: Based on 110 respondents in 2014.
Source: Greenwich Associates 2014 Institutional Real Assets Research

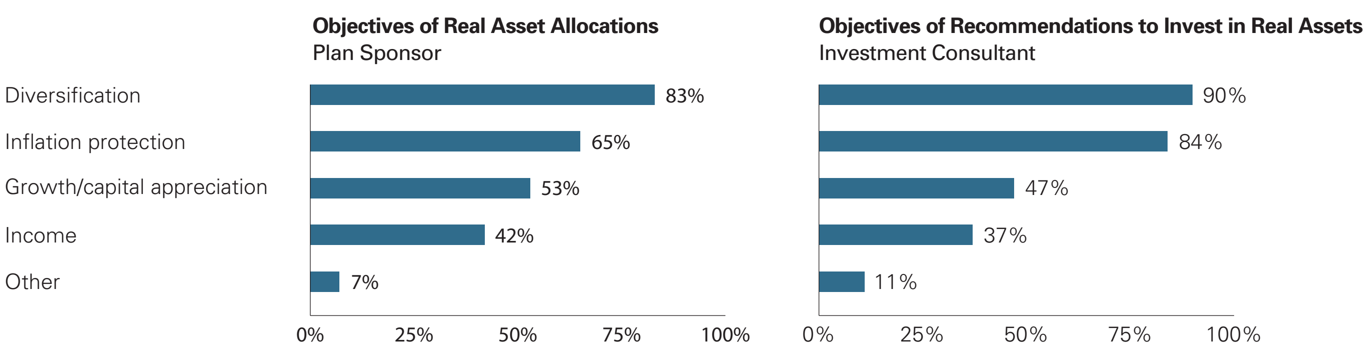
Why Do Institutions Use Real Assets?

Portfolio diversification is the primary objective of most institutions that invest in real assets. Four out of five real asset users in the study cite diversification as an important goal, and nearly 90% of investment consultants that recommend real assets to institutions say they do so as a diversification measure. This finding makes sense, given that one of the fundamental characteristics that often attracts investors to real assets is a relatively low correlation to the performance of other financial assets.

A secondary goal—and one that could take on more prominence in coming years—is inflation protection. Given concerns about potential inflation, close to 84% of investment consultants recommending real assets to clients name inflation protection as an important objective, as do 65% of institutions that actually invest in the asset class.

Among the other main reasons cited by institutions and consultants for using real assets are growth/capital appreciation and income.

Objectives of Real Asset Allocations/Recommendations



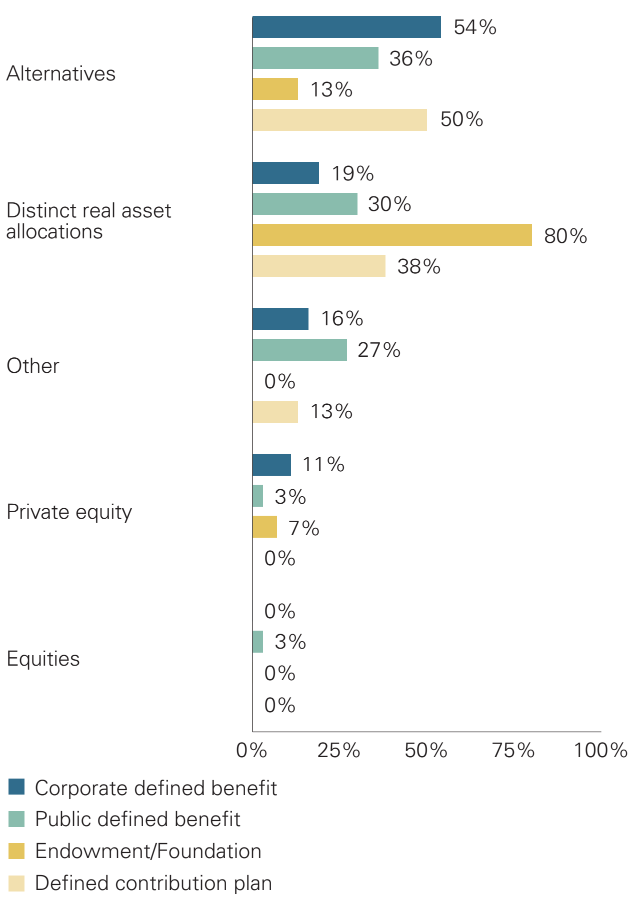
Note: Based on 92 plan sponsor and 18 investment consultant respondents in 2014.
Source: Greenwich Associates 2014 Institutional Real Assets Research

Where Do Institutions Place Real Assets in Their Portfolios?

Institutions disagree about how real assets should be categorized within their portfolios. Approximately 40% of the institutions in the study include real assets in their "alternatives" allocations, while 34% maintain discrete allocations for real assets.

The vast majority of endowments and foundations—approximately 80%—choose the latter course and maintain a distinct allocation bucket for real assets. A majority of corporate defined benefit funds and half of defined contribution funds include real assets in their broader "alternatives" allocations. Public DB plans, meanwhile, are divided, with 36% categorizing real assets as alternatives and 30% maintaining a separate allocation. Roughly 1 in 10 corporate DB plans include real assets in private equity allocations.

Fit of Real Asset Allocations in Investment Portfolio by Type of Plan Sponsor



Note: Based on 28 corporate defined benefit, 33 public defined benefit, 15 endowment/foundation, and 16 defined contribution respondents in 2014.
Source: Greenwich Associates 2014 Institutional Real Assets Research

Although investment consultants are not unanimous in their views on which is the best approach, a solid majority of 59% favor advising clients to maintain a separate allocation for real assets. As a result, it is likely that an increasing proportion of institutional investors will move in this direction.

Measuring Institutional Investment

It's not easy to estimate how much money institutions are investing in real assets. However, a look at inflows into listed real asset strategies can give some indication of general trends and the pace of growth for real assets as a whole. Over the past five years, investment in these strategies has increased 325%, according to eVestment Alliance. That overall growth spans a near-doubling of investment in commodities, a quadrupling of investment in U.S. REITs, and explosive levels of growth in global-listed infrastructure, master limited partnerships and multi-strategy real asset funds.

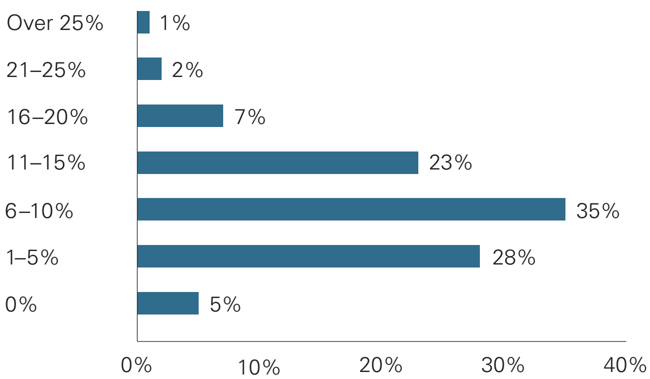
These inflows have fueled a spike in the number of investment managers offering real asset strategies. In 2009, the eVestment Alliance database captured 135 real asset managers. By 2014, that number had grown to 265.

Greenwich Associates study results point to continued growth ahead as institutions work to achieve existing allocation goals and increase targets as part of changes in investment strategy. Investment consultants have a general rule for investing in alternative asset classes: Plan to invest at least 5% of total assets or skip them altogether. Given the costs of due diligence, manager selection and ongoing maintenance in an unfamiliar and relatively opaque asset class, investments of less than 5% will drain resources and staff attention without being large enough to have a meaningful impact on the overall portfolio.

When it comes to real assets, investment consultants advise clients to think even bigger. Sixty percent of consultants advise clients who start investing in real assets to target an ultimate allocation of 6–10% of total assets. The remaining 40% of consultants recommend even larger allocations of greater than 11% of total assets.

Almost 68% of the institutions in the study have followed those guidelines in their real asset

Percentage of Target Allocation in Real Assets



Note: Based on 107 respondents in 2014.
Source: Greenwich Associates 2014 Institutional Real Assets Research

investments by amassing allocations of 6% of total assets or more. About 35% of the institutions have real asset allocations of 6–10% of total assets, and nearly a quarter report allocations of 11–15%.

On average, endowments and foundations have the largest allocations. Close to three-quarters of these institutions active in the asset class report allocations of 6% or more of total assets, and 47% report allocations of 11% of total assets or more.

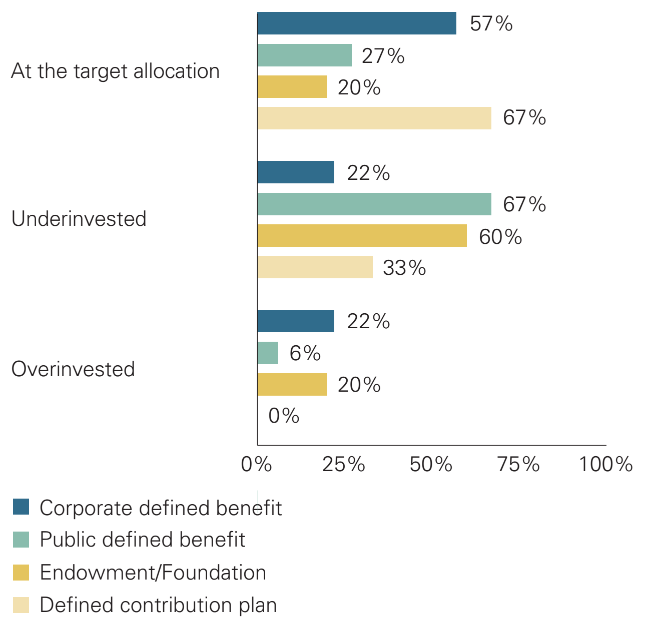
In terms of absolute dollar amounts, public DB funds are the largest real asset investors among the institutions in the study. Approximately 35% of participating public DB funds have real asset investments of more than $500 million, including 15% with real asset investments valued north of $1 billion.

Projections of Growth

What most of the institutions have in common is the fact that they are underinvested relative to their target allocations for real assets. Over half of institutions overall and two-thirds of public DB funds have current allocations that fall short of targets. Those numbers could even understate the extent to which institutions are short of their investment targets industrywide. Investment consultants estimate that nearly 8 of 10 of their clients are underinvested relative to targets in the asset class.

These findings suggest that even if allocation targets were to remain stable, institutional inflows into real assets would continue to increase in coming years as investors seek opportunities to put allocated dollars to work.

Over/Underinvested in Real Assets Relative to Target Allocation by Type of Plan Sponsor



Note: Based on 27 corporate defined benefit, 33 public defined benefit, 15 endowment/foundation, and 14 defined contribution respondents in 2014.
Source: Greenwich Associates 2014 Institutional Real Assets Research

However, approximately 1 in 5 of the institutions in the study expect to adjust their real asset allocations in the coming year. This share could increase as funds begin annual strategy reviews, since 43% of investment consultants plan to adjust their recommendations on allocation levels in the next 12 months.

Changes to real asset allocations will be driven by shifts in market conditions, portfolio performance and investment strategies. Fund executives and consultants explained why they expect to make changes:

*"We are currently evaluating allocations to real assets. We are positioning the portfolio for an inflation environment, building our portfolio for a diversification benefit." **~Public Fund***

*"Typically, we are in 20% growth and 80% income-producing investments. If we move more toward an LDI approach, we would have to ask if we wanted to be in all equities or whether real estate might make some sense." **~Corporate Fund***

*"It would be for more diversification and inflation protection." **~Public Fund***

"Our clients are underinvested in real assets currently. It's also a fundamental supply/demand question. Long-term, there must be an attractive opportunity. The yield component must be attractive. There also needs to be institutional opportunities." ***~Investment Consultant***

The research results indicate that the majority of institutions making changes will increase allocations. This is especially true in infrastructure, in which roughly 1 in 5 of participating institutions are planning to increase allocations in the next year, and less than 10% expect to reduce. In private real estate, about 1 in 10 institutions expect to increase allocations versus 5% expecting to cut. Institutions will be encouraged to up their allocations by investment consultants, a large majority of which are advising clients to maintain or increase their level of investment in real assets.

Increases in allocations among existing users tell only half the growth story for real assets. Sizable numbers of institutions will also begin using new categories of real assets for the first time. Roughly 1 in 5 participating institutions say they will consider using each of the following categories in the next two years: private infrastructure, MLPs, timber and farmland. Between 10% and 15% of the institutions would consider adding listed real estate, listed infrastructure, and commodities futures.

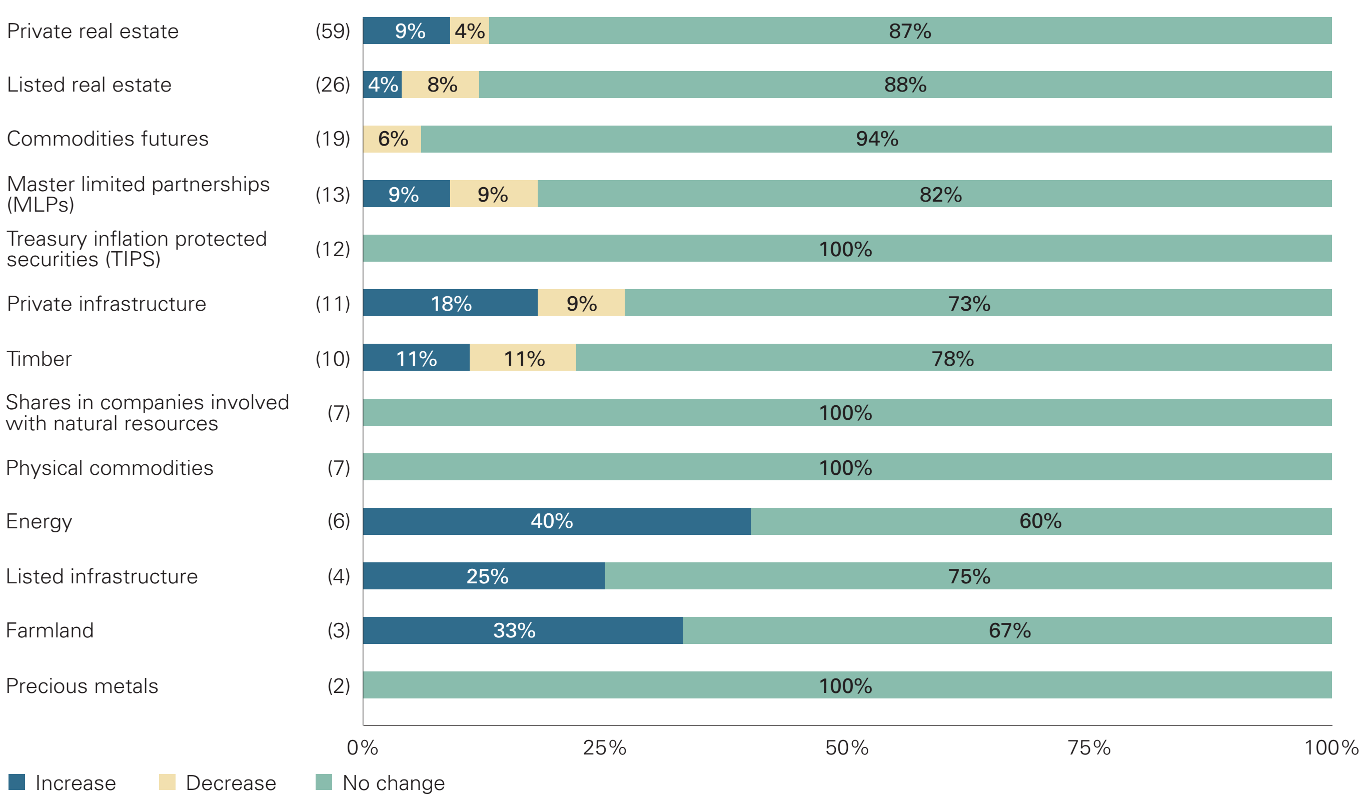
Institutional adoption of real assets will be given a boost by consultants. Nearly 80% of consultants are recommending private real estate to their clients, while close to half are recommending listed real estate. Approximately 40% are recommending private infrastructure and shares in companies involved with natural resources.

Over the next two years, the biggest institutional demand likely will come from public DB funds. Thirty-six percent of participating public DB funds say they would consider adding farmland investments to their portfolio during that period, and 30% each would consider adding timber and private infrastructure.

All of these trends point in the same direction: toward continued growth in institutional activity and inflows.

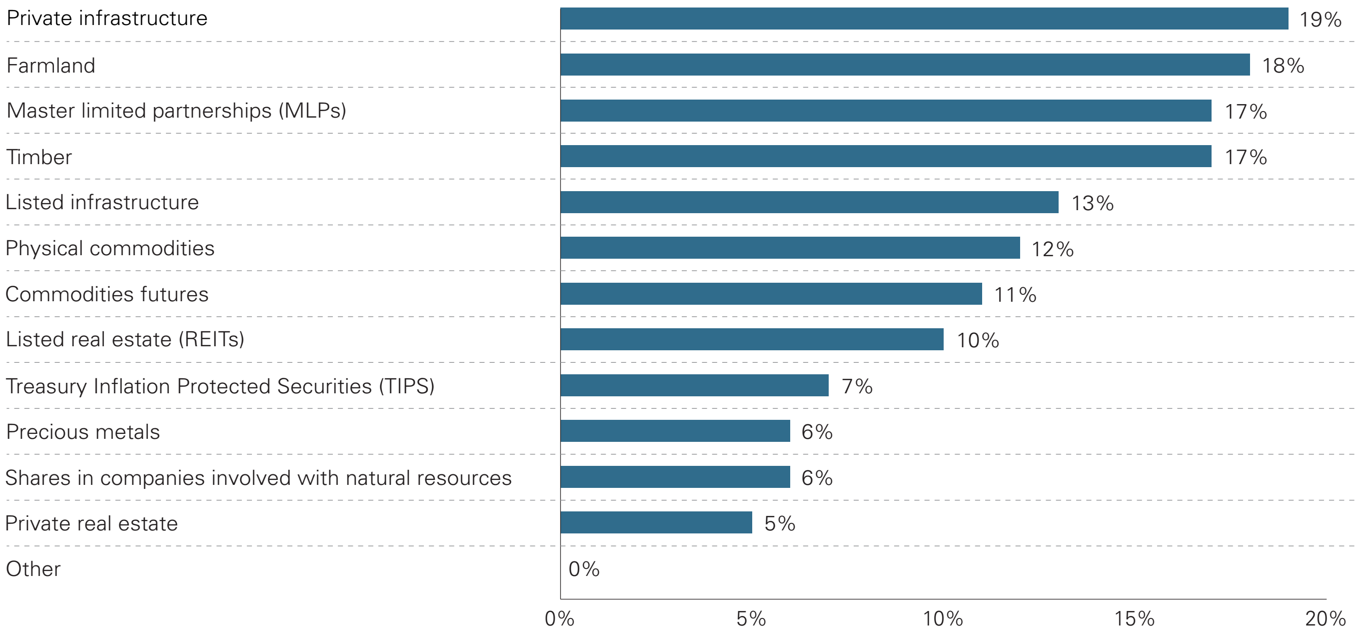
Expectation to Change Target Allocations to Real Assets Over the Next Year

Plan Sponsor



Note: Numbers in parentheses represent respondent count. Respondents could answer up to three real asset categories. Not all respondents answered for each category.
Source: Greenwich Associates 2014 Institutional Real Assets Research

Would Consider Using Real Assets in the Next Two Years



Note: Based on 92 respondents in 2014.
Source: Greenwich Associates 2014 Institutional Real Assets Research

Liquid Real Assets

As shown in the previous section, underinvestment represents a real challenge for institutions active in real assets. In private markets like infrastructure, timber, farmland, and others, an inability to find opportunities is often one of the main impediments to achieving target allocations.

For institutions experiencing difficulty sourcing attractive investments, liquid real assets can provide an effective alternative. Over 60% of institutions participating in the study consider liquid investments like REITs, commodities futures, global-listed infrastructure to be real assets. Nearly half see equity investments in natural resource companies as real assets as well.

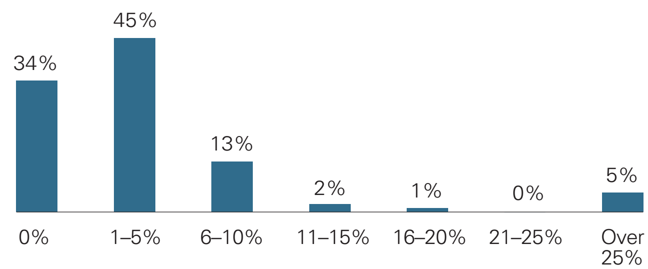
Although portfolio diversification is the No. 1 goal of institutions investing in liquid real assets, almost 20% of institutions using liquid real assets employ these investments as replacements for private real assets. Fourteen percent of institutions say they use liquid assets as a "placeholder" until a direct investment can be implemented, and 11% say they use liquid assets to secure access to targeted investments they have been unable to achieve with private assets.

Nevertheless, nearly 45% of the institutions allocate between 1–5% of total assets to liquid real assets, and roughly a third don't invest in liquid real assets at all. Given this relatively low level of investment, even moderate increases to allocations in liquid real asset categories could help institutions approach and even achieve their target allocations for the asset class.

Defined contribution plans are the one type of institution that has widely embraced liquid real assets, primarily due to their need for liquidity. All 16 of the DC plans participating in the study invest in liquid real assets. Even among this group, however, 88% allocate 5% or less of total assets.

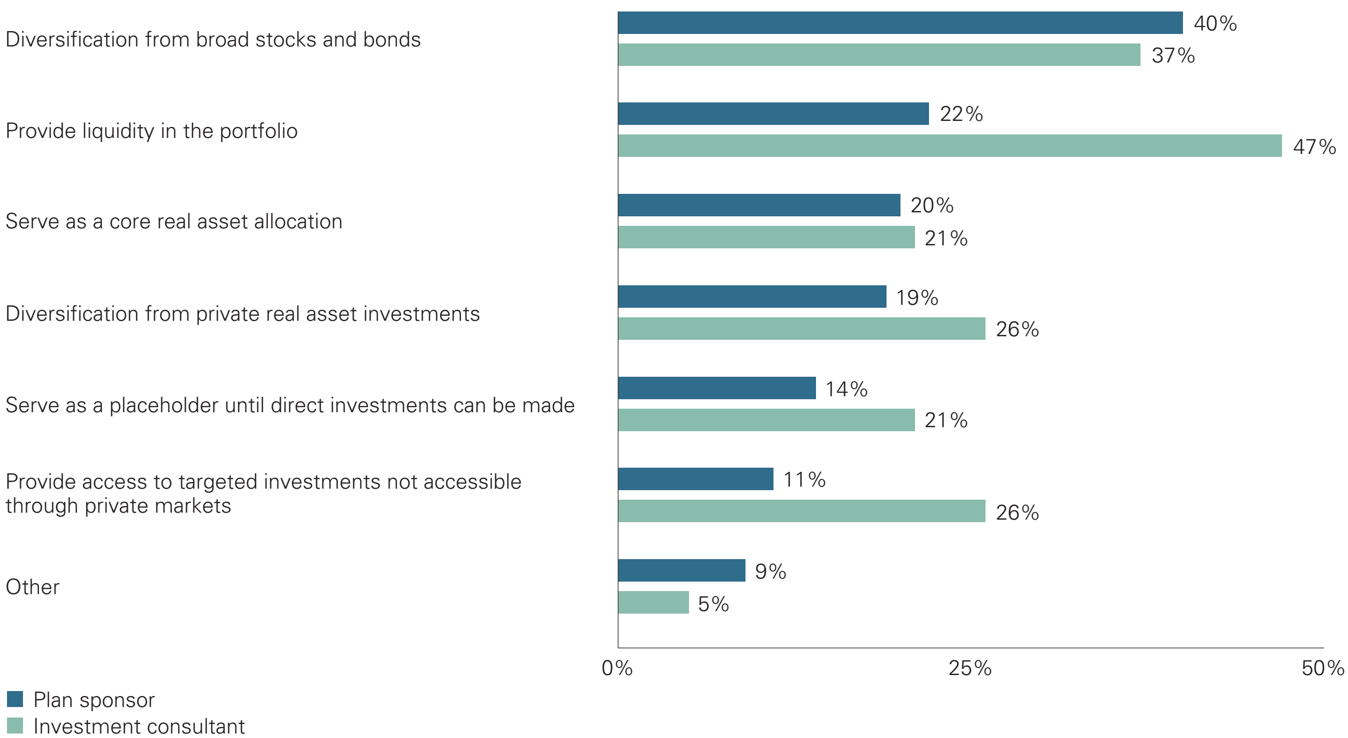
DC funds and other institutional users of liquid real assets invest most commonly in REITs, commodities

Percentage of Assets/Clients' Assets Allocated to Liquid Real Asset Strategies



Note: Based on 104 respondents in 2014.
Source: Greenwich Associates 2014 Institutional Real Assets Research

Goals of Liquid Real Asset Investments



Note: Based on 92 plan sponsor and 18 investment consultant respondents in 2014.
Source: Greenwich Associates 2014 Institutional Real Assets Research

futures and natural resource equities. While overall these investors prefer to make component allocations, fully one-quarter would consider a bundled approach with allocations to multiple real asset categories.

In light of the continuing challenges institutions face in achieving target allocations in real assets and mounting demand in DC funds for alternative investment structures with low correlation to equities and fixed income, Greenwich Associates projects continued growth in institutional inflows into these and other liquid real assets.

A Premium on Manager Expertise

Institutions list three main concerns that would make them hesitate before increasing their level of investment in real assets:

1. Risk-return trade-off
2. Timing
3. Liquidity

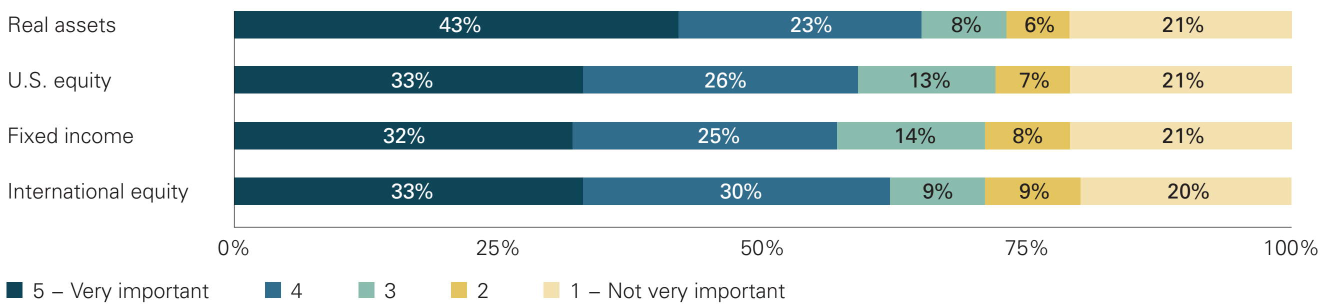
Underlying all three of these concerns is a single factor: Institutions worry about their ability to accurately assess factors like the risk-return trade-off, timing of the market cycle and investment liquidity in an asset class in which objective and reliable market data can be hard to find.

Due to these very real concerns, institutions place a premium on external expertise. As the accompanying chart shows, institutions view consultant recommendations in real assets as more important than those in any other asset class.

When it comes to investing in real assets, institutions value the expertise of their asset managers more than any other factor. In fact, manager expertise is prized by institutions in real assets to an extent rarely seen in other asset classes. The premium on expertise reflects both institutions' unfamiliarity with real assets, and the inherent complexity associated with these investments.

Nine out of 10 institutions rate manager expertise as an important driver of their investment decisions in real assets—including two-thirds ranking it

Importance of Investment Consultant's Recommendation in Decision to Invest in Asset Classes



Note: May not total 100% due to rounding. Based on 90 respondents in 2014 who were asked to rate how important their investment consultant's recommendation was in their decision to invest in asset classes, using a 5-point scale in which "1" is "Not very important" and "5" is "Very important."
Source: Greenwich Associates 2014 Institutional Real Assets Research

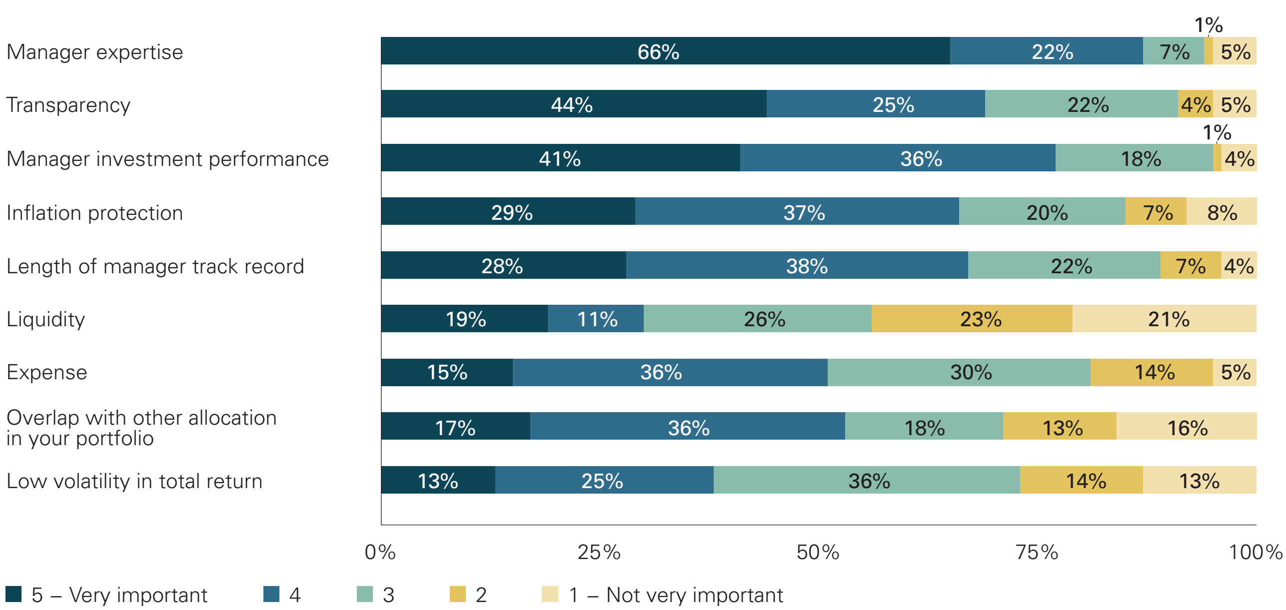
"very important." In fact, along with expertise, characteristics of potential investment managers make up 3 of the top 5 drivers of institutional investment in real assets, with manager investment performance ranking No. 2 and length of manager track record coming in tied with "inflation protection" at No. 4. Even the final factor placing in the top 5—transparency—can be tied to the behaviors and practices of individual investment managers.

Other considerations such as liquidity and expense are considered much less important by institutions in the study.

These results suggest that institutions' investment decision-making process in real assets differs substantially from that employed in other asset classes, and that investment managers have an opportunity to both differentiate themselves from competitors and contribute to the overall growth of real assets in institutional markets by helping institutions meet their important demand for external expertise. Managers can do so by demonstrating their capabilities through initiatives designed to educate institutions and support their activity in the space.

For institutions considering entering real assets or increasing their level of investment, the message

Importance of Characteristics in Relation to Use of Real Assets



Note: May not total 100% due to rounding. Based on 90 respondents in 2014 who were asked to rate how important the each characteristic is as it relates to their use of real assets, using a 5-point scale in which "1" is "Not very important" and "5" is "Very important."
Source: Greenwich Associates 2014 Institutional Real Assets Research

is more clear. The experiences of institutions with significant investments in real assets strongly suggest that institutional investors will be more satisfied with their results if they invest with managers with high levels of demonstrated expertise. In many cases, these will be specialist managers with long track records in specific real-asset categories.

Conclusion

Although institutions differ on how they define real assets, the search for products that can help diversify institutional portfolios is stoking demand for infrastructure, real estate, farmland, timber and other investments generally labeled as real assets. Allocations to real assets are growing, and sizable numbers of institutions are considering investments in new categories of real assets.

Underinvestment remains a significant challenge. Institutions struggling to find attractive investment opportunities and achieve target allocations are finding liquid real assets including REITs, commodities futures, and global-listed infrastructure as an effective alternative to private investments.

Because many institutions lack hands-on experience in this unique asset class, investors place a premium on outside expertise. Given this demand for external assistance, investment consultants and managers have a unique opportunity to attract growing levels of institutional inflows to real assets by providing educational initiatives and objective ideas and advice. ■

Consultant Andrew McCollum advises on the investment management market in the United States.

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