A Road Map for Diversifying With Liquid Real Assets

By Vince Childers

In recent years, alternatives have been gaining traction as they move into the mainstream of everyday asset allocation. Underlying this popularity is the widely held view that diversifying the sources of a portfolio’s risk and long-term return is important. This mix is usually accomplished by adding investments with return profiles that can complement core stock and bond holdings. Real assets—including real estate, commodities, natural resource equities and global listed infrastructure—can help provide this much-needed diversification.

As an asset class, what makes real assets an effective diversifier?

First of all, these categories include an exceptionally large and diverse makeup of subsectors and industry groups, each with distinct sensitivities to the business cycle. Because of these differences, individual categories tend to shine at different points of the cycle, and this is what drives complementary diversification profiles.

Even more important is that this type of outperformance tends to be strongest when both stocks and bonds are underperforming their long-term averages. Our research shows that this happens more than you might think—about 20% of the time over the past 40 years—and these periods can be particularly damaging to long-term investment returns.

Real assets also have a much higher sensitivity to inflation than either stocks or bonds. Though not a problem in today’s near-zero interest-rate environment, we believe that the typical retirement portfolio, which spans multiple economic and market cycles, will likely be eroded by the long-term impact of inflation.

Based on the impact of these characteristics, combined with the potential for long-term return, we believe real assets can go a long way to enhance portfolio efficiency. Of course, even though each category has merit, we would caution there is no single, silver-bullet approach that excels across all dimensions, due to the inherent tradeoffs of the various categories. This speaks to the synergies of a combined, multi-strategy approach as a means of navigating those tradeoffs.

Steps For Building A Real Assets Allocation

Think of real assets as an alternative “Liquid Alt.” As advisors explore real assets, accessing them through liquid securities has the added advantages of liquidity, transparency and real-market pricing. Essentially, they are part of the “liquid alts” universe, which has gained a great deal of investor attention over the past few years. But if you were to ask two investors how they define liquid alts, you’d probably get two completely different answers.

Categorizing this relatively new asset class starts by dividing the universe into two general categories: non-directional and directional strategies. Liquid real assets are directional strategies that target asset classes and sectors with unique underlying asset economics and/or different business-cycle sensitivities. In contrast, non-directional strategies, such as so-called absolute-return strategies, tend to limit equity and fixed-income market exposure, with the goal of keeping volatility and drawdowns to a minimum.

The bottom line? Most directional strategies—like real assets—are designed to take a long-position and tend to pursue higher return objectives than non-directional hedging strategies. As public securities, they carry a higher average level of exposure to broad market risks than that of absolute return strategies, which must offer low market correlations in order to justify their prospectively lower long-term returns.

Consider an objective-based approach. As advisors think through the role of real assets in clients’ portfolios, they are likely to face a common question: Should they sell stocks or bonds to build a real assets allocation? A recent industry study that Cohen & Steers commissioned with Kasina found little consensus among advisors. Of 717 advisors polled, 24 percent would sell equities to build a real assets allocation, while 29 percent would sell bonds.
A smaller number, 21 percent, said they would sell alternatives, and more than a quarter (26 percent) weren’t sure what to sell to make room for real assets.

With such a wide range of survey responses, and the large number of participants in the “don’t know” category, there is clearly no one-size-fits-all allocation approach. Of course, we can make a compelling case for placing a liquid real assets allocation in the alternatives bucket, since these investments are “liquid alts.” But there is also merit in aligning real assets with the equity portion of a portfolio. Here, the advisor would take an objective-driven approach that divides the portfolio into two broad objectives: income and growth. Under this scenario, the bond allocation would be used to generate income, while assets in equities would be focused more on growth with some income generation.

Learn more about Real Assets Diversification. Cohen & Steers has developed a number of educational research papers to explain the investment potential of liquid real assets as a tool for asset-class diversification, long-term return potential and a hedge against inflation. The two examples listed below, which can be downloaded from the Cohen & Steers website www.cohenandsteers.com, can shed some light on this growing asset class and demonstrate how it fits into a long-term investment portfolio. Also available on the website is extensive research that explores the investment case for real assets and clarifies these issues further.

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### Behind The Numbers: What A Recent Survey Told Us About Advisors And Their Allocations to Real Assets(1)

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<tr>
<th>10+ Years Experience</th>
<th>Advisors who use real assets are well seasoned, with the majority having over 10 years of experience, and 40% having more than 20 years of experience.</th>
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<tr>
<td>91% Discretion</td>
<td>Of the survey participants who use real assets, 91% had discretion over client accounts, while only 9% did not have discretion.</td>
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<tr>
<td>5%+ Allocations</td>
<td>About 65% of respondents allocate at least 5% of client assets to real asset categories. Approximately 23% believe that real asset diversification should represent more than 10% of portfolio assets, while about 5% allocate more than 20%</td>
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<tr>
<td>55% Active</td>
<td>About 55% of advisors allocating to real assets employ active strategies, versus 45% who allocate through passive strategies.</td>
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Understanding the Risks of Investing. A real assets strategy is subject to the risk that its asset allocations may not achieve the desired risk-return characteristic, underperform other similar investment strategies or cause an investor to lose money. The risks of investing in REITs are similar to those associated with direct investments in real estate securities. Property values may fall due to increasing vacancies, declining rents resulting from economic, legal, tax, political or technological developments, lack of liquidity, limited diversification and sensitivity to certain economic factors such as interest-rate changes and market recessions. An investment in commodity-linked derivative instruments may be subject to greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. The use of derivatives presents risks different from and possibly greater than, the risks associated with investing directly in traditional securities. Among the risks presented are market risk, credit risk, counterparty risk, leverage risk and liquidity risk. The use of derivatives can lead to losses because of adverse movements in the price or value of the underlying asset, index or rate, which may be magnified by certain features of the derivatives. Infrastructure issuers may be subject to adverse economic occurrences, government regulation, operational or other mishaps, tariffs and changes in tax laws and accounting standards. Foreign securities involve special risks, including currency fluctuation and lower liquidity. The market value of securities of natural resource companies may be affected by numerous factors, including events occurring in nature, inflationary pressures and international politics. Because the strategy invests significantly in natural resource companies, there is the risk that the strategy will perform poorly during a downturn in the natural resource sector.

Futures Trading Is Volatile, Highly Leveraged and May Be Illiquid. Investments in commodity futures contracts and options on commodity futures contracts have a high degree of price variability and are subject to rapid and substantial price changes. Such investments could incur significant losses. There can be no assurance that the options strategy will be successful. The use of options on commodity futures contracts is to enhance risk-adjusted total returns. The use of options, however, may not provide any, or only partial, protection for market declines. The return performance of the commodity futures contracts may not parallel the performance of the commodities or indexes that serve as the basis for the options it buys or sells; this basis risk may reduce overall returns.

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