Exploring the
Real Benefits of Real Assets

by Vince Childers, CFA, SVP, Portfolio Manager
Edited by Parke Miller Johnson

We believe that the need for investors to diversify beyond traditional allocations to stocks and bonds will take on a greater level of importance in the years to come. Our research makes the case for adding the complementary diversification potential of real assets as a core component of investors’ long-term investable assets.

While many investors have focused almost exclusively on their inflation hedging potential, our research-based framework suggests that real assets are, in fact, likely to offer a far richer array of benefits—regardless of the inflationary backdrop. We recommend an active approach to real assets investing that combines tactical, top-down views with bottom-up fundamental research. We underscore the importance of risk management as an integral part of any real assets investment process.
We believe the likelihood that investors will need to diversify well-beyond traditional stock and bond allocations will rise significantly in the years to come. Our rationale is simple: chances are that the decades ahead will not be buoyed by an extension of the bull market for bonds that spanned the past 30 years. With bonds at an increased risk of delivering returns below their historical averages, a greater reliance will fall on stocks to deliver attractive long-term returns. More worrisome, though, is that a backdrop of sub-par performance from bonds will increase the potential for investors to suffer a greater frequency of periods when both stocks and bonds underperform simultaneously, as they did regularly prior to the 1990s. We view this as a material risk for stock-and-bond-centric portfolios, with potentially damaging consequences for investors relying on their investments to support long-term purchasing power throughout their retirement years.

In our view, investments in real assets—properly diversified and skillfully managed—offer unique diversification benefits that can aid in managing many of the long-term risks associated with a traditional allocation to stocks and bonds. Real assets offer an exceptionally large investment universe made up of diverse subsectors across many different industry groups. However, this complexity calls for a framework that approaches the various categories of real assets as a unique, but coherent, asset class. Our research-based framework emphasizes three key criteria that should be met in building a long-term, strategic allocation to real assets:

1. **Diversification Potential**: The potential to outperform during periods of joint stock and bond underperformance.

2. **Expected Return Potential**: The potential to provide attractive long-term expected returns across a full-market or economic cycle.

3. **Inflation Sensitivity**: The potential to show higher sensitivity than stocks or bonds to “unexpected” inflation accelerations—surprise conditions that can create an especially difficult environment for the investor concentrated in stocks and bonds.

This paper is focused on four core categories of liquid real assets—real estate, commodities, natural resource equities, and infrastructure. Significantly, our research finds that the performance potential of a diversified allocation to real assets is not dependent on the inflationary backdrop, a concern that has preoccupied many investors in the past. However, while inflation is not central to the case for real assets investing, we argue that active management—with respect to both return and risk—is essential to optimizing the investment potential of real assets. In our judgment, both top-down tactical allocation and the fundamental research that drives bottom-up sector and security selection can play powerful roles in the management of a real assets portfolio, provided that the implementation is undertaken as part of a disciplined risk-management process. Properly managed, we believe real assets can serve as an ideal complement to a broader investment portfolio.
Introduction: Common Advice, Uncommon Results

Life is short, or so goes the cliché. But as a practical matter, the opposite could be far more likely, based on the actuarial tables. Data compiled by the Social Security Administration projects that a man aged 65 today can expect to live until 84, while a 65-year-old woman can expect to live until age 86; so both could live for several decades in the years of retirement. And these figures only reflect the average expectation—about 25% of 65-year-olds today will live past age 90, and 1 out of 10 will live past age 95(1). What is more, life expectancies are on the rise. In the years to come, many investors will need to be financially prepared for a retirement horizon expected to represent, on average, about one-quarter of their entire lifespan. Life is long, indeed.

With these expectations in place, the burden on investors to build and grow an asset base that maintains the purchasing power necessary to support a future rate of spending—often tapped in their very-distant-future years of retirement—is paramount. But this argument is not limited to the individual investor. Pension funds must consider unfunded liabilities; endowments and foundations must build sufficient income to fund future obligations. In short, many types of investors depend critically on adequate inflation-adjusted (or “real”) returns to meet their long-term investment and consumption objectives.

Responding to these needs, the industry standard of investment advice has gravitated towards a core strategic allocation based on a balanced stock-and-bond approach for the long-term investor. Unsurprisingly, the history of the past several decades validates precisely this advice. As Exhibit 1 shows, a portfolio divided between stocks (60%) and bonds (40%) over the 30-year period from September 1983 through September 2013 delivered an annualized inflation-adjusted return of 7.3%, with stocks delivering a real return of 7.9% and high-quality bonds returning 5.5% after inflation. Moreover, these returns were achieved very efficiently, with a near-zero correlation(2) of monthly stock and bond returns, indicating substantial diversification benefits, at least on average.

For decades, the industry standard of investment advice has been centered on a balanced approach to stocks and bonds.

Exhibit 1: The Real Returns of Stocks and Bonds
Annualized Real Returns, September 1983 through September 2013

<table>
<thead>
<tr>
<th>Stock Return (%)</th>
<th>Bond Return (%)</th>
<th>60/40 Return (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.9</td>
<td>5.5</td>
<td>7.3</td>
</tr>
</tbody>
</table>


Performance data quoted represents past performance. Past performance is no guarantee of future results. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin.

Stocks are represented by the S&P 500 Index. Bonds are represented by the BofA Merrill Lynch U.S. 7–10 Year Treasury Index. 60/40 refers to a weighted average of index returns, calculated as 60% attributable to the S&P 500 Index and 40% attributable to the BofA Merrill Lynch U.S. 7–10 Year Treasury Index, rebalanced monthly. See page 22 for index definitions.

(1) http://www.ssa.gov/planners/lifeexpectancy.htm.
(2) Measured correlation of monthly returns over this period is 0.02. Correlation is a statistical measure of how two securities move in relation to each other.
In our view, these are impressive results by virtually any standard. However, we maintain several concerns about the use, or misuse, of this historical record. First, while we agree that traditional stocks and bonds both should play a material role in the asset allocations made by most investors, we caution against extrapolating guidance too readily from these data on how to build long-term allocations going forward. In behavioral finance terms, this mindset is called recency bias—the preference of using our recent experience as the baseline for what will happen in the future.

It may seem surprising to some that we would consider 30 years of historical returns to be insufficiently deep. But the reality is that the return picture is altered materially by simply extending the return history an additional decade, to January 1973.\(^{(1)}\)

- Over the more than 40-year period from January 1973 through September 2013, stocks delivered an annualized real return of 5.8%; the real return from bonds was 3.7%, and the 60%/40% stock-bond blend returned an inflation-adjusted 5.3%. While these are still very respectable inflation-adjusted returns, they are materially lower—200 basis points lower for the 60%/40% portfolio—than the history described earlier using the early 1980s as a starting point.

- More importantly, when we extend our analysis to examine the frequency of periods when stocks and bonds both underperformed their respective long-term averages at the same time—periods that clearly represent substantial risks to stock-and bond-centric allocations—the picture is even more surprising.

Exhibit 2 shows rolling 12-month real returns for the 60%/40% blend of stocks and bonds from January 1973 through September 2013. The highlighted periods in green represent one-year periods in which stocks and bonds simultaneously delivered below-average inflation-adjusted returns. We expect many investors will be surprised to find that across the entire sample, these fluctuations turned out to be relatively common. In fact, they occurred in 22% of all rolling one-year periods and resulted in average annualized inflation-adjusted returns that were meaningfully negative for stocks, bonds and the 60%/40% blend of the two.

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Exhibit 2: A “Real” Risk to Stock-Bond Allocations

Periods When Both Stocks and Bonds Underperform at the Same Time Typically Result in Negative Real Returns for 60/40 Portfolios

| Frequency: 22% of rolling one-year periods |
| Bonds: (2.1%) real return |
| Stocks: (0.8%) real return |
| 60/40 Blend: (1.0%) real return |


Performance data quoted represents past performance. Past performance is no guarantee of future results. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin.

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(1) Data for both the S&P 500 and BofA Merrill Lynch U.S. 7–10 Year Treasury Index were available beginning in 1973.
Much lower is the 11% frequency of such periods over the past 20 years. Notably, since 2006 there have been no periods in which the real returns of stocks and bonds simultaneously fell below their long-term averages. What concerns us about these trends is that the shorter the historical look-back period, the easier it is for investors to become complacent about the likelihood—and therefore the attendant risks—associated with periods when both stocks and bonds simultaneously deliver below-average returns.

In our view, overlooking this risk is particularly problematic today given that, in large part, the exceptionally low frequency of joint stock and bond underperformance in recent years is attributable to the relative strength of bond returns, compared with longer-term averages. In our assessment, the longstanding bull market for bonds, which has been in place since the early 1980s, has represented a monumental “free lunch” for investors, stemming from a massive secular decline in bond yields. As Exhibit 3 illustrates, 10-year U.S. Treasury yields peaked above 15% in September 1981. This marked the beginning of a multi-decade decline in yields and corresponding increases in price for U.S. Treasury Securities. The result was a return measured by the BofA Merrill Lynch U.S. 7–10 Year Treasury Index, that topped 6.5%—nearly twice the return realized over the entire history since 1973.

We believe that today’s historically low bond yields increase the likelihood of future periods of joint stock-bond underperformance.
In our view, a logical course of action against this backdrop is to seek investments with the potential to provide a ballast for core stock-bond portfolios during such periods of joint stock-bond underperformance. As we explore in the pages ahead, our research suggests that a skillfully diversified and actively managed portfolio of real assets can support this objective, while also providing additional benefits to the broader investment portfolio.

Redefining Diversification: The Core of a Coherent Real Assets Investment Framework

As noted earlier, a portfolio allocated 60% to stocks and 40% to bonds over the past 40 years has, on average, delivered negative inflation-adjusted returns during periods when these asset classes were simultaneously underperforming their long-term averages. Outside of these periods, annualized returns have been significantly higher at about 6.5%, after inflation. This gap illustrates just how damaging periods of simultaneous stock and bond performance can be on long-term returns, suggesting that investors would be well-served by adding allocations with the potential to buoy returns under these circumstances.

Historically, as our research demonstrates, real assets have shown this potential. However, we recognize there are other important criteria that can contribute meaningfully to the risk and return objectives of a diversified long-term asset base and, thus, should also be considered. In our view, there are three common-sense criteria that should be met in building a long-term, strategic allocation to real assets.

Building a Strategic Allocation: Three Common-Sense Criteria

1. **Diversification Potential:** The potential to outperform during periods of joint stock and bond underperformance.
2. **Expected Return Potential:** The potential to provide attractive long-term expected returns across a full-market or economic cycle.
3. **Inflation Sensitivity:** The potential to show higher sensitivity than stocks or bonds to “unexpected” inflation accelerations—surprise conditions that can create an especially difficult environment for the investor concentrated in stocks and bonds.

Our research points to four core categories of liquid real assets that have scored relatively well across these criteria: real estate, commodities, natural resource equities and infrastructure. However, as Exhibit 4 on the following page indicates, our research does not uncover a single, “silver bullet” category that can deliver the perfect investment complement. In effect, we find inherent tradeoffs associated with each of these asset classes, based on the three investment criteria above. Moreover, as single asset class solutions, they have each alternatively excelled or fallen short across one dimension or another. A superior approach, we have concluded, is to combine each of these categories into a single, diversified real assets portfolio. In this way, we believe investors can better navigate these tradeoffs to build a more balanced framework for long-term investing.
In the following sections, we provide an overview of our research, which studied the risk and return profiles of various real asset categories over the period for which public index data were available, from May 1991 through September 2013.

1. Diversification Potential

Exhibit 5 on the next page compares the performance of stocks, bonds and real assets from May 1991 through September 2013 during rolling 12-month periods when stocks and bonds underperformed their respective long-term averages at the same time. Notably, stocks, bonds and a 60%/40% blend of the two eked out positive real returns, even during joint periods of stock and bond underperformance. These results are in contrast to the negative returns seen in the deeper 1973–2013 history, as we showed in Exhibit 2 on page 4, providing yet another testament to the powerful tailwinds enjoyed by stocks and bonds over this period. But more telling is the performance of the four core classes of real assets in our study. Each of these real asset categories—real estate, commodities, natural resource equities and infrastructure—historically outperformed the blended stock-bond allocation during these episodes.

Real estate, commodities, natural resource equities and infrastructure all have distinct fundamental merits. But we believe a superior approach is to combine multiple real asset categories into a single, diversified portfolio.
The Diversified Real Assets Blend performed well when stocks and bonds underperformed their long-term averages.\(^{(1)}\)

However, we would caution investors against seeking a one-size-fits-all solution and relying on these results to conclude, for example, that natural resource equities will always outperform commodities during such episodes. Undoubtedly, future market dynamics may differ from those of the past, and there is no guarantee that any given real asset category will exactly repeat its past performance. As such, we believe a diversified real assets approach—represented here by the Diversified Real Assets Blend\(^{(1)}\)—stands a higher likelihood of meeting the first of our criteria on a forward-looking basis. As the display indicates, such an allocation materially outperformed stocks and bonds during these episodes, delivering an annualized average 8.3% inflation-adjusted return.

Furthermore, we find that the frequency of outperformance of the Diversified Real Assets Blend over the 60% stocks/40% bonds allocation during the periods of joint stock and bond underperformance studied here showed a historical success rate in excess of 90%. In short, our research reveals that there are very few one-year periods in which stocks and bonds both delivered below-average returns and the Diversified Real Assets Blend failed to outperform the stock-bond blend. This confirms that the magnitude of outperformance shown above is not somehow driven by just a handful of extreme outcomes. Overall, we believe these results provide powerful support for the long-run diversification potential of a variety of real asset categories, with particularly strong indications in favor of a diversified real assets allocation.

\(^{(1)}\) Performance data for the Diversified Real Assets Blend is represented by an equally weighted blend of Real Estate, Commodities, Natural Resource Equities, and Infrastructure. Real Estate is represented by the FTSE NAREIT Equity REIT Index through February 2005 and the FTSE EPRA/NAREIT Developed Real Estate Index thereafter. Commodities are represented by the S&P GSCI through July 1998 and the Dow Jones-UBS Commodity Index thereafter. Natural Resource Equities are represented by a 50/50 Blend of the Datastream World Oil & Gas Index and Datastream World Basic Materials Index through May 2008 and the S&P Global Natural Resources Index thereafter. Infrastructure is represented by a 50/50 Blend of the Datastream World Pipelines Index and Datastream World Gas, Water, & Multi-Utilities Index through July 2008 and the Dow Jones Brookfield Global Infrastructure Index thereafter. See page 22 for index definitions.
2. Expected Return Potential

While we find that the spectrum of real asset categories considered herein meets our initial diversification potential criterion, we would call into question the value of those benefits if the price paid—as measured by the opportunity cost in terms of foregone return potential—is too high. Moreover, we believe the full-cycle performance characteristics of real assets should be sufficient to allay the concerns of investors who deem them viable as investments only in periods of elevated inflation, a worry that has emerged in recent years. In this sense, our 1991–2013 study period—an era characterized by the decided absence of inflation problems(1)—provides an ideal environment to test this common concern.

Exhibit 6 below summarizes the annualized real returns, volatilities and risk-adjusted returns (as measured by the Sharpe Ratio(2)) of stocks, bonds and the four real asset categories in our study. As pointed out earlier, the strong performance of the 60% stock/40% bond blend is greatly enhanced by the exceptional returns—and elevated Sharpe Ratio—of bonds over the study period.(3) Perhaps more interesting, however, is that the standalone real assets categories, other than commodities, exhibited returns generally on a par with those of broad-based equities. This was also the case with the Diversified Real Assets Blend, but with an important difference: the blend exhibited far lower volatility than any of its standalone components, thanks in large part to the diversification benefits of the lower-correlated allocation to commodities.

Overall, we find little evidence to justify concerns about the long-term return potential of real assets in non-inflationary regimes—at least when it comes to a portfolio diversified across the underlying real asset categories. In our view, the returns delivered by the Diversified Real Assets Blend over our study period—which were on a par with equities and achieved with lower volatility—should dispel a common misconception about this asset class: that elevated inflation is necessary for real assets to perform. In fact, these long-term returns were achieved amid average inflation of about 2.5%. More consistent with our findings is that real assets tend to experience above-average returns during periods when inflation surprises to the upside. This sensitivity to unexpected inflation is discussed in the next section.

(1) From May 1991 through September 2013, the annualized inflation rate was 2.5% according to the U.S. CPI-U index.

(2) The Sharpe Ratio, which measures risk-adjusted performance, is calculated by subtracting the risk-free rate from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns. For this analysis, the risk-free rate used was the Citigroup 3-Month Treasury Bill Index.

(3) Over the longer-term 1973–2013 period, real returns for stocks, bonds and the 60% stock/40% bond blend averaged 4.8%, 3.7% and 5.3%, respectively. Historical volatilities are 15.6% (stocks), 7.5% (bonds), and 10.1% (60% stock/40% bond blend); historical Sharpe Ratios are 0.36 (stocks), 0.36 (bonds), and 0.44 (60% stock/40% bond blend).
3. Inflation Sensitivity

While we earlier dispelled the notion that inflation problems are a prerequisite for real asset performance, we do recognize that the tail risk of an inflation spike is a possible (and high-risk) catalyst for simultaneous periods of stock and bond underperformance. Importantly, the focus of our inflation-related research is based on measuring the sensitivity of asset prices to unexpected inflation changes—what we call “inflation beta.” In conducting our analyses, we examined the sensitivity of rolling 12-month inflation-adjusted asset returns to the difference between the current year-over-year realized inflation rate (actual inflation) and the prior year’s consensus inflation expectation, thus identifying the gap between these two measures as unexpected inflation.\(^1\) Exhibit 7 below summarizes the indicated inflation betas resulting from this analysis.

![Exhibit 7: Inflation Sensitivity Criteria Satisfied by Real Assets](image)

Exhibit 7: Inflation Sensitivity Criteria Satisfied by Real Assets
Inflation Betas\(^1\) for Stocks, Bonds and Real Assets, May 1991 through September 2013

At September 30, 2013. Source: Bloomberg, Thomson Reuters Datastream and Cohen & Steers. Performance data quoted represents past performance. Past performance is no guarantee of future results. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above.

Stocks are represented by the S&P 500 Index. Bonds are represented by the BofA Merrill Lynch U.S. 7–10 Year Treasury Index. 60/40 refers to a weighted average of index returns, calculated as 60% attributable to the S&P 500 Index and 40% attributable to the BofA Merrill Lynch U.S. 7–10 Year Treasury Index, rebalanced monthly. The Diversified Real Assets Blend is represented by an equally weighted blend of Real Estate, Commodities, Natural Resource Equities, and Infrastructure. Real Estate is represented by the FTSE NAREIT Equity REIT Index through February 2006 and the FTSE EPRA/NAREIT Developed Real Estate Index thereafter. Commodities are represented by the S&P GSCI through July 1998 and the Dow Jones-UBS Commodity Index thereafter. Natural Resource Equities are represented by a 50/50 Blend of the Datastream World Oil & Gas Index and Datastream World Basic Materials Index through May 2008 and the S&P Global Natural Resources Index thereafter. Infrastructure is represented by a 50/50 Blend of the Datastream World Pipelines Index and Datastream World Gas, Water, & Multi-Utilities Index through July 2008 and the Dow Jones Brookfield Global Infrastructure Index thereafter. See page 22 for index definitions.

\(^1\) Our measure of expected inflation reflects median inflation expectation from the University of Michigan Survey of 1-Year Ahead Inflation Expectations. Inflation Beta was determined by calculating the linear regression beta of 1-year real returns to the difference between the year-over-year realized inflation rate and lagged 1-year ahead expected inflation, including the level of the lagged expected inflation rate. Linear regression is a statistical method that models the relationship between a dependent variable and one or more explanatory variables.
Not surprisingly, we find that over our 1991–2013 study period, the inflation betas for the real returns of stocks, bonds, and the 60% stocks/40% bonds blend were all negative. For example, our analysis of bonds indicated an inflation beta of negative 1.0, implying that, for a 1-percentage-point overshoot in realized inflation versus what was expected 12 months earlier, the inflation-adjusted returns for bonds have tended to be about 1 percentage point below average. The same 1% gap between realized and expected inflation for commodities, with an inflation beta of 8.1, tended to result in real returns 8.1 percentage points above their study-period average. By extension, these numbers would imply that a positive two-percentage-point difference between expected and subsequently realized inflation would, for example, be consistent with commodity returns a full 16.2% above average. While such inflation betas represent statistical expectations rather than definitive point estimates, we find it significant that the inflation sensitivities of all of the real asset categories—as well as the Diversified Real Assets Blend—were all positive, indicating a tendency to outperform or deliver above-average returns in precisely those periods when inflation surprises are likely to weigh on the returns to traditional stock-bond allocations. We view this as confirmation of the potential of real assets to show higher sensitivity than stocks and bonds to unexpected inflation.

Crucially, while an inflationary outbreak could very well be the catalyst that delivers the feared stock-bond outcomes we have cautioned against, inflation risk is not the central theme of our case for allocating to real assets. Rather, it is the broad satisfaction across all three criteria in our research framework that supports a strategic allocation to real assets, ideally diversified across multiple categories.

A diversified approach to real asset investing can mitigate complexity, while optimizing the inherent tradeoffs of the underlying asset-class components.

In the next section we extend our analysis to explore some of the attributes that make real assets investing particularly compelling from an active management perspective. Our research delves into the fundamental characteristics of real estate, commodities, natural resource equities and infrastructure.
Why Active Management Matters:  
A Deeper Dive into the Fundamentals of Real Assets

Our research framework has been focused on four real asset categories—real estate, commodities, natural resource equities and infrastructure—all of which share something essential in common: each reflects exposure to tangible real assets. Yet, each also has distinct drivers of risk and return, which generally lead to relatively low correlations with one another and with stocks and bonds. As a result, different real asset categories often perform well at different stages of economic, inflation and interest rate cycles. For the skilled investor, these relationships can make real assets especially attractive from an active management perspective, in terms of both top-down tactical allocation potential and more traditional bottom-up sector and security-selection opportunities.

Volatility is often seen as the enemy of the concentrated investor. However, to the extent that it creates dispersion\(^{(1)}\) in returns among the core real asset categories, volatility can be positively transformed into the ally of the skilled tactical asset allocator. Exhibit 8 on the next page illustrates the total returns over the past 10 years for real estate, commodities, natural resource equities and infrastructure. For this analysis, we also included the returns for gold and short-term fixed income—potential real asset portfolio diversifiers that we discuss further in the sidebar on page 19. Notably, at different points in the decade, each provided attractive, valuation- and momentum-based opportunities for investors seeking to add top-down allocation alpha.

For these categories, the past decade witnessed numerous changes in performance leadership, with each taking the lead or lagging at one point or another. There were also stretches when cyclical trends took hold, resulting in enduring underperformance or outperformance for each category (real estate in the aftermath of the financial crisis, for example). Overall, the annual return dispersion across these assets averages more than 13% over the past decade, giving us confidence that the drivers of risk and return across the real asset space are diverse enough to generate ample opportunities for top-down asset allocators.

From a bottom-up active management perspective, the opportunity set is arguably richer still. In the following section, we explore each of our core real asset categories individually, focusing on unique fundamentals that support the case for active allocations as part of a real assets investment framework.

\(^{(1)}\) Dispersion is calculated as the standard deviation across returns in each year.
Exhibit 8: Dispersion of Returns Creates Tactical Allocation Opportunities

Returns of Real Assets and Portfolio Diversifiers, 2003–2012

<table>
<thead>
<tr>
<th>Year</th>
<th>Natural Resource Equities</th>
<th>Real Estate</th>
<th>Gold</th>
<th>Short-Term Fixed Income</th>
<th>Real Estate</th>
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Annual Dispersion of Returns

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<td>2012</td>
<td>11%</td>
</tr>
</tbody>
</table>


Performance data quoted represents past performance. Past performance is no guarantee of future results. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above.

Real Estate is represented by the FTSE NAREIT Equity REIT Index through February 2005 and the FTSE EPRA/NAREIT Developed Real Estate Index thereafter. Commodities are represented by the Dow Jones-UBS Commodity Index. Natural Resource Equities are represented by a 50/50 Blend of the Datastream World Oil & Gas Index and Datastream World Basic Materials Index through May 2008 and the S&P Global Natural Resource Index thereafter. Infrastructure is represented by a 50/50 Blend of the Datastream World Pipelines and Datastream World Gas, Water, & Multi-Utilities Index through July 2008 and the Dow Jones Brookfield Global Infrastructure Index thereafter. Short-Term Fixed Income is represented by the BoA Merrill Lynch 1–3 Year U.S. Corporate Index. Gold is represented by gold spot prices in the commodities market. Returns over the study period are compound annual returns. See page 22 for index definitions. Dispersion is calculated as the standard deviation across returns in each year.

Real Estate

Commercial real estate has shown the potential to perform well across various stages of economic, inflation and interest rate cycles. One reason is that some commercial real estate sectors are more economically sensitive than others, based on differences in lease durations, local supply factors and specific economic factors affecting demand, such as employment growth or consumer spending. For example, as shown in Exhibit 9 on the following page, sectors such as hotels and apartments, which have comparatively short-lease structures, tend to be more cyclical. In contrast, those with long-lease structures, such as health care facilities and freestanding retail, feature more bond-like cash flows. For the active manager, this level of diversity across the real estate investment market enhances the potential for finding exploitable active management opportunities across the business cycle.

For active managers, the diverse lease structures of real estate sectors can drive opportunities throughout the business cycle.
Additionally, listed real estate (including REITs and real estate operating companies) has a long history of attractive dividend growth. The barriers to entry for many property types has led to pricing power, which in turn, has led to a consistent history of rising dividends, with the exception of the financial crisis when payouts were cut to manage debt maturities, and some companies issued a portion of dividends in common stocks. As shown in Exhibit 10, dividends have grown by an average annual rate of 5.9%, which compares favorably with the 2.3% average inflation rate since 1992. We believe these companies will continue to increase dividends at an above-trend rate over the next several years, growing 6.8% per year on average through 2017. However, these levels of growth are, of course, not shared uniformly across the real estate universe, thus enabling active managers to identify those companies and securities expected to deliver superior growth potential.

At September 30 2013. Source: Cohen & Steers.
Commodities

In our view, commodities lie in the sweet spot of 21st century megatrends. A secular bull market for basic resources has been in place for more than a decade, primarily driven by the relatively strong growth and political liberalization of emerging economies. In these regions, populations have been rapidly urbanizing and standards of living have been rising. Per capita incomes are rising, which is leading to more resource-intensive diets that are rich in meat and dairy. In our view, it stands to reason that the consumption of commodities—energy, metals, food and agricultural products—will grow as a natural byproduct of these trends.

However, history shows that commodities are prone to periodic cyclical lulls as well as to sometimes extreme short-term price swings, often brought on by conditions driven by drought, war or natural disasters. Exhibit 11 highlights some examples of events in recent years that meaningfully impacted certain commodities.

For the bottom-up investor, such asset-specific or idiosyncratic risks can open up exceptional active management opportunities. In contrast to passive strategies, active managers can use fundamental analysis to make investment decisions and set active weights on a market-by-market basis, according to the underlying fundamentals at the commodity level. Typically, these decisions hinge on an accurate assessment of what are often delicate supply/demand balances. For example, many commodities are today trading near their marginal cost of supply—often the “tipping point” of price support driven by the dynamics of supply and demand. When prices fall below these levels, it is not uncommon to see production cuts serve to place a floor under the commodity’s price. For example, the marginal cost of production for West Texas Intermediate Crude Oil is driven by high cost drilling in ultra-deep water, Canadian Oil Sands and U.S. Shale Oil. Lower production costs are found in the Middle East; however, the funding of social programs and government budgets tend to raise the “floor” in these regions to the $90–$100 per barrel range. In our view, understanding these types of fundamentals is critical to the success of the active commodities manager.

An actively managed approach also has the potential to add alpha by managing what is called the “roll yield,” generated as investors replace an expiring contract with one that is longer-dated. Roll yield can be positive or negative depending on market conditions. Generally, passive strategies are structured to hold only the front-month contract for a commodity. However, a skilled active manager can potentially mitigate negative roll yields based on how they time and position these transactions on the commodity curve.

---

**Exhibit 11: Event Risk Highlights and Effects on Short-Term Commodity Futures Prices**

<table>
<thead>
<tr>
<th>Event</th>
<th>Location</th>
<th>Date</th>
<th>Sector</th>
<th>Commodity</th>
<th>% Move</th>
<th>Duration (days)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hurricane Katrina</td>
<td>Gulf of Mexico</td>
<td>8/05</td>
<td>Energy</td>
<td>Natural Gas</td>
<td>+46%</td>
<td>60</td>
</tr>
<tr>
<td>Swine Flu Pandemic</td>
<td>U.S.</td>
<td>3/09</td>
<td>Livestock</td>
<td>Lean Hogs</td>
<td>-33%</td>
<td>157</td>
</tr>
<tr>
<td>Earthquake</td>
<td>Chile</td>
<td>2/10</td>
<td>Base Metals</td>
<td>Copper</td>
<td>+14%</td>
<td>39</td>
</tr>
<tr>
<td>Arab Spring</td>
<td>Middle East</td>
<td>12/10</td>
<td>Energy</td>
<td>Brent Crude Oil</td>
<td>+36%</td>
<td>111</td>
</tr>
<tr>
<td>U.S. Drought</td>
<td>U.S.</td>
<td>6/12</td>
<td>Agriculture</td>
<td>Corn</td>
<td>+45%</td>
<td>49</td>
</tr>
<tr>
<td>Civil Unrest/Stikes</td>
<td>South Africa</td>
<td>8/12</td>
<td>Precious Metals</td>
<td>Platinum</td>
<td>+23%</td>
<td>30</td>
</tr>
</tbody>
</table>

Source: Cohen & Steers.
Managers employing a long-biased approach to investing in commodities may also have the added flexibility to take short positions. Often, transactions are executed as spread trades, which involve the purchase of one commodity futures contract against the sale of another in a risk-controlled manner. For example, through calendar spreads, the manager seeks to benefit from an expected shift in the curve structure of a commodity. A fundamental spread is designed to exploit relative fundamental dislocations between commodities, while a product spread seeks to capture, for example, refiner/producer margins in the crude oil complex.

In our view, an active approach deeply-rooted in fundamental analysis can aim to parse the eventual outcomes and repercussions of these kinds of market dynamics, thus providing the potential to generate alpha versus passive approaches, which are designed to simply mirror the performance of a commodities index.

**Natural Resource Equities**

Natural resource equities represent ownership interests in companies involved in the production of tangible assets facing capital intensity requirements and barriers to supply that are linked to critical and often depleting commodity-related resources. Broadly speaking, this sector includes energy producers, mining companies and agriculture-based businesses, along with access to investments not available through commodities futures. For example, unlike the commodities futures market, natural resource equities offer access to investments linked to iron ore, coal, potash and uranium.

Similar to commodities, as Exhibit 12 illustrates, natural resource equities are impacted by recurring and significant asset-specific fundamental and event risks. Numerous factors, including the size and scale of operations, labor relationships, asset complexity and geopolitical risks can impact longer-term value assessments and can lead to timely entry and exit points. As with commodities, supply and demand economics of the underlying natural resources can play a large role in determining which stocks are expected to perform better or worse at any given point in time. Active management in natural resource equities also allows for better risk/return controls to be put in place, especially when evaluating larger companies that may have significant exposure in a passive index (for example, oil majors, diversified miners, and chemical companies) simply due to size or market capitalization.
Importantly, we feel that both commodities and natural resource equities have a place in a diversified real assets framework, at least partly due to the complementary performance characteristics of these two asset classes, which tend to perform well at different points in the economic cycle. Historically, natural resource equities have shown a lead/lag relationship with the economic cycle, while commodity prices respond more to near-term levels of economic activity. As such, the equities tend to underperform late in the business cycle when a slowdown is being discounted, and they tend to outperform early in the investment cycle when a recovery is anticipated.

### Infrastructure

The infrastructure universe comprises a diverse group of industries that spans the transportation, energy, utilities and communications sectors, as outlined in Exhibit 13 below. From an allocation perspective, this asset class offers the combination of real asset characteristics and the potential to enhance portfolio stability. The underlying assets, which include transportation networks, energy grids and wireless towers, tend to be long-lived, and are often engaged in businesses with high barriers to entry and monopolistic and regulated structures. Due to the essential services they provide, infrastructure assets tend to be relatively resistant to economic downturns. But they have also shown the potential to perform when the economy is expanding, given business models that, in some cases, are correlated with local economic conditions, and in many cases, generate cash flows linked to inflation. Examples of the latter can be found in the automatic escalations of many tariffs or tolls indexed to benchmarks, such as the U.S. Consumer Price Index or Eurozone Harmonized Index of Consumer Prices.

From a bottom-up active management perspective, a number of powerful secular themes currently in place are expected to drive return dispersion among infrastructure-related companies in the coming years. Infrastructure spending stands to grow substantially over the next few decades based on the critical (but distinct) needs of developed and emerging economies.

- In developed economies, energy, communications and transportation networks are in need of critical upgrades to operate efficiently and meet rising demand after decades of under-investment.
- The story is quite different in emerging economies, where massive transportation, energy transmission and communications investments are underway to provide basic services to growing and increasingly wealthy and urban populations. However, as Exhibit 14 on the next page attests, achieving the infrastructure access enjoyed by developed market economies is a long way off for much of the emerging world.
Exhibit 14 below highlights the wide gap in the access of developed vs. emerging economies to basic infrastructure services.

**Exhibit 14: Access to Infrastructure Services by Country**

<table>
<thead>
<tr>
<th>Country</th>
<th>Passenger Vehicles</th>
<th>Road Network Length</th>
<th>Hospital Beds</th>
<th>Rail Line Length</th>
<th>Telephone Subscribers</th>
<th>Internet Users</th>
<th>Air Transport Passengers</th>
<th>Electricity Consumption</th>
<th>Improved Sanitation Facilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>EU</td>
<td>85</td>
<td>45</td>
<td>202</td>
<td>64</td>
<td>118</td>
<td>96</td>
<td>48</td>
<td>47</td>
<td>100</td>
</tr>
<tr>
<td>Japan</td>
<td>73</td>
<td>45</td>
<td>464</td>
<td>29</td>
<td>111</td>
<td>98</td>
<td>33</td>
<td>59</td>
<td>100</td>
</tr>
<tr>
<td>Russia</td>
<td>33</td>
<td>33</td>
<td>322</td>
<td>85</td>
<td>148</td>
<td>51</td>
<td>17</td>
<td>54</td>
<td>93</td>
</tr>
<tr>
<td>Brazil</td>
<td>32</td>
<td>43</td>
<td>32</td>
<td>20</td>
<td>103</td>
<td>32</td>
<td>20</td>
<td>20</td>
<td>87</td>
</tr>
<tr>
<td>India</td>
<td>1</td>
<td>13</td>
<td>30</td>
<td>7</td>
<td>51</td>
<td>4</td>
<td>2</td>
<td>6</td>
<td>54</td>
</tr>
<tr>
<td>China</td>
<td>10</td>
<td>14</td>
<td>74</td>
<td>9</td>
<td>71</td>
<td>46</td>
<td>10</td>
<td>26</td>
<td>58</td>
</tr>
</tbody>
</table>


There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin.

(a) EU as of 12/31/2011.

(b) Brazil, Russia, India and China as of 12/31/2011.

A more U.S.-centric theme lies in the U.S. energy transmission industry, which is benefiting from the North American energy renaissance. By some estimates, the U.S. will spend over $130 billion by 2020 to upgrade and expand its existing energy transmission infrastructure to accommodate the shifting dynamics of energy supply and demand. This shift has been driven in large part by the expanding use of unconventional drilling techniques (particularly horizontal drilling and hydraulic fracturing), which has significantly increased the commercial viability of oil and natural gas production from low permeability shale formations.

Another investment characteristic of energy transmission companies is that they tend to have low direct commodity exposure, while the pipeline tariffs they charge are typically adjusted annually at a rate linked to inflation. In addition, many of these companies have adopted the master limited partnership (or MLP) structure, which can facilitate more efficient capital allocation and income distribution due to favorable tax treatment for both the business and the investor.

Altogether, we view the variety of industries represented in the infrastructure category, as well as the diverse geographical and industry-specific themes impacting these companies, as providing strong support for employing fundamental, active infrastructure strategies.

(1) Source: Interstate Natural Gas Association of America, INGAA.
The Role of Portfolio Diversifiers

Our research shows that gold and a number of fixed-income categories can be used as portfolio diversifiers to enhance the stability of a real assets portfolio.

Short-Term Fixed Income

As a complement to core real asset classes, short-term fixed income instruments—including Treasury bills, short-duration inflation-linked securities (e.g. U.S. TIPS(1)), and short-duration credit—can provide a tool for investors to manage real asset portfolio volatility both strategically and tactically. As shown in Exhibit A to the right, the correlation of short-duration credit returns to those of both bonds and stocks, as well as to the Diversified Real Assets Blend, has historically been relatively mild. Importantly, short-term fixed income can help to curb the sensitivity of the broader portfolio to volatility in economic growth, inflation expectations and underlying real interest rates.

Gold

While over the long-term gold has tended to deliver, on average, relatively low risk-adjusted returns, as a hedge against event risk, gold tends to perform well in periods of expansive monetary policy, economic dislocation and geopolitical instability. Gold has also shown a low historical correlation with other real asset categories, while being recognized by many as a store of value based on its liquidity, portability, and acceptability as a medium of exchange.

Exhibit A: Correlation of Total Returns

May 1991 through September 2013

<table>
<thead>
<tr>
<th></th>
<th>Bonds</th>
<th>Stocks</th>
<th>Diversified Real Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-Term Fixed Income</td>
<td>0.45</td>
<td>0.25</td>
<td>0.39</td>
</tr>
<tr>
<td>Gold</td>
<td>0.16</td>
<td>0.01</td>
<td>0.31</td>
</tr>
</tbody>
</table>


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Stocks are represented by the S&P 500 Index. Bonds are represented by the BofA Merrill Lynch U.S. 7–10 Year Treasury Index. The Diversified Real Assets Blend is represented by an equally weighted blend of Real Estate, Commodities, Natural Resource Equities, and Infrastructure. Real Estate is represented by the FTSE NAREIT Equity REIT Index through February 2005 and the FTSE EPRA/NAREIT Developed Real Estate Index thereafter. Commodities are represented by the S&P GSCI through July 1998 and the Dow Jones-UBS Commodity Index thereafter. Natural Resource Equities are represented by a 50/50 Blend of the Datastream World Oil & Gas and Datastream World Basic Materials Index through May 2008 and the S&P Global Natural Resources Index thereafter. Infrastructure is represented by a 50/50 Blend of the Datastream World Pipelines Index and Datastream World Gas, Water, & Multi-Utilities Index through July 2008 and the Dow Jones Brookfield Global Infrastructure Index thereafter. Correlation is a statistical measure of how two securities move in relation to each other. Note: these are correlations of monthly returns. See page 22 for index definitions.

Conclusion

For more than 30 years, the returns from a traditional portfolio construction—generally balanced between equities and fixed income—have been buoyed by the great bull market for bonds. But now, the ultimate withdrawal of quantitative easing and other factors are pointing to a far less certain future for fixed income markets. Should interest rates stabilize (or eventually move higher), bonds may become less effective in offsetting the inherent volatility of stocks. What may prove damaging are periods in which both stocks and bonds underperform their respective long-term averages at the same time—conditions that, in our view, could occur more frequently given the current backdrop of extremely low interest rates.

(1) TIPS are Treasury Inflation Protected Securities.
As illustrated in this paper, real assets have shown the potential to perform well in periods when both stocks and bonds simultaneously underperform. However, this is not the only criterion that supports an allocation to real assets. Liquid real assets have also demonstrated the potential to provide attractive long-term returns across full-market or economic cycles. And contrary to the common notion that inflation is a prerequisite for this performance, real assets generated returns on a par with equities over our 1991–2013 study period, a time characterized by the absence of inflationary problems. That said, we would add that real assets have historically shown attractive, positive sensitivities to unexpected accelerations in inflation—surprise conditions that can be especially difficult for portfolios concentrated in stocks and bonds.

At the core of our research are the four real asset categories highlighted in this paper—real estate, commodities, natural resource equities and infrastructure. Importantly, the fundamental characteristics that define each of these categories—the drivers of risk and return—are not static through time. Historically, their correlations, volatilities and return potential have been highly variable over short- and medium-term (or cyclical) horizons. As such, we believe that any strategy that involves investing in real assets—whether passively or actively managed—should, at its core, adhere to a diversified approach.

However, while risk is a steady presence in real assets investing, compensation for risk is constantly changing. This is, of course, what drives the active management opportunities both within and among the various categories of real assets explored in this paper. Ultimately, our research supports an approach to real assets that is grounded in active management, through a process combining top-down tactical views with bottom-up fundamental analysis, provided that risk management is elevated as an important and ever-present part of the equation.

As Exhibit 15 on the following page illustrates, we believe implementation of an active real assets investment framework should ideally incorporate both top-down and bottom-up “alphas” alongside the “betas” coming from the real asset categories themselves. However, it’s also our view that a rich, multifaceted risk framework that explicitly factors in the cross-correlations and risk contributions of both top-down and bottom-up insights is essential to this process. Indeed, we would suggest caution to investors who have only limited influence or insight into the processes, positioning, and risk budgeting in effect throughout an entire real assets portfolio—at both the top-down and the bottom-up “sleeve,” or asset category, levels. In our judgment, real assets should ultimately be approached as a single, coherent asset class, and ideally, managed under a shared umbrella (or within a single portfolio) that integrates all aspects of the investment process. Only then, we argue, does it make sense to bring more active views into the equation.

Our research supports a risk-managed approach to real assets that is grounded in active management, through a process combining top-down tactical views with bottom-up fundamental analysis.
Exhibit 15: Risk Management Is Key to Active Real Assets Investing

In closing, despite their many benefits, we caution investors not to underestimate the complexity of optimizing the investment potential of real assets. Success in real assets investing is likely to depend on broad diversification, an active approach and a focus on risk discipline.

**Index Definitions**

An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes.

The BofA Merrill Lynch U.S. 7–10 Year Treasury Index is composed of U.S. Treasury Notes with a 7-10 year maturity.

The BofA Merrill Lynch 1–3 Year U.S. Corporate Index is an unmanaged index that tracks the performance of the U.S. dollar-denominated investment-grade public debt issued in the U.S. domestic bond market.

The Dow Jones Brookfield Global Infrastructure Index measures the stock performance of publicly listed infrastructure companies. The index intends to measure all sectors of the infrastructure market.

The Dow Jones-Brookfield Global Infrastructure Index measures the stock performance of publicly listed infrastructure companies. The index intends to measure all sectors of the infrastructure market.

The Dow Jones-UBS Commodity Index is a broadly diversified index composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metals Exchange.

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The FTSE NAREIT Equity REIT Index is an unmanaged, market-capitalization-weighted index of all publicly traded REITs that invest predominantly in the equity ownership of real estate.

The FTSE EPRA/NAREIT Developed Real Estate Index (net) is an unmanaged market-weighted total return index which consists of many companies from developed markets who derive more than half of their revenue from property-related activities.

The S&P Global Natural Resources Index includes 90 of the largest publicly traded companies in natural resources and commodities businesses that meet specific investability requirements, offering investors diversified, liquid and investable equity exposure across three primary commodity-related sectors: Agribusiness, Energy, and Metals & Mining.

The S&P GSCI Commodity Index is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities.

The S&P 500 Index is an unmanaged index of 500 large-capitalization, publicly traded stocks representing a variety of industries.

Gold is represented by gold spot price.

The CPI-U Index is the U.S. Consumer Price Index for all urban consumers.

Correlation is a statistical measure of how two securities move in relation to each other.

Sharpe Ratio is a measure of risk-adjusted return, calculated by subtracting the risk-free rate from a return and dividing that result by the standard deviation. The higher the Sharpe Ratio, the lower the risk. In the Sharpe Ratio calculation, the risk-free return is represented by the Citigroup 3-Month Treasury Bill Index. The Citigroup 3-Month U.S. Treasury Bill Index tracks the performance of U.S. Treasury bills with a remaining maturity of three months.

Standard Deviation is a commonly used statistical measure of volatility.
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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. 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.

About Cohen & Steers

Founded in 1986, Cohen & Steers is a leading global investment manager with a long history of innovation and a focus on real assets, including real estate, infrastructure and commodities. Headquartered in New York City, with offices in London, Hong Kong, Tokyo and Seattle, Cohen & Steers serves institutional and individual investors around the world.

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