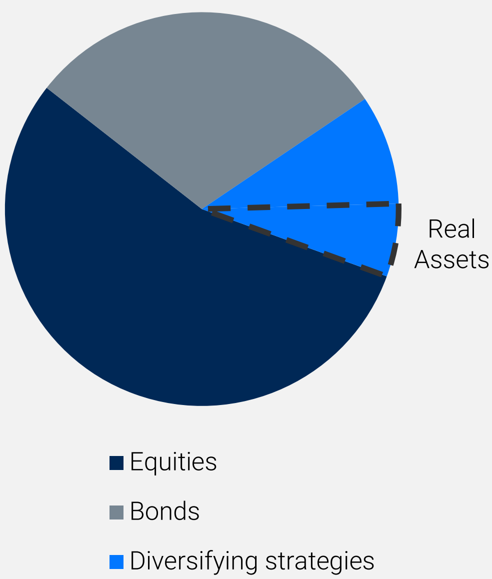
Wealth Building in Uncertain Terrain: The Compelling Case for Real Assets

Oppenheimer Asset Management Research believes that clients should pursue diversification as a means to manage risk and achieve long-term success. This involves allocating across various asset classes such as global equities, global fixed income, and diversifying strategies. In the current investment environment, characterized by potential increases in inflation and heightened volatility in traditional market sectors, we advocate for complementing traditional stocks and bonds with real asset strategies as part of the diversification approach.

Real Assets Defined

Real assets is a broad term that encompasses a number of different underlying asset categories. In general, real assets can be thought of as investments that derive their value from physical assets such as structures or raw materials. OAM considers the following asset categories to be a part of a real asset allocation:



- **Real Estate:** Investments in land or physical structures attached to the land. These can be direct investments in real estate such as purchasing a home or an office building, or indirect investments through the equity or debt of global companies whose cash flows are primarily tied to underlying real estate investments. These can be publicly traded or private investments, and in the liquid market the companies are often structured as real estate investment trusts (REITS).
- **Physical Infrastructure:** Investments in physical structures and networks involved in the production of public goods or processes. These can be direct infrastructure investments or indirect via the equity and debt of companies involved in the ownership and operation of physical assets and networks. Common examples include airports, roadways, railroads, marine ports, utilities, and communication towers.
- **Commodity Supply Chain:** Investments along the commodity supply chain could involve investments in the commodities themselves, in companies involved with the extraction or processing of commodities, or in companies involved in the transportation of commodities such as energy pipelines.

The returns of each of these asset categories are driven by a unique combination of economic factors and supply and demand dynamics. Real estate tends to have longer cycles, and performance is specific to region and by property type. Infrastructure assets benefit from more inelastic demand and thus typically act more defensive, protecting well during times of economic distress. Commodity supply chain investments tend to be highly cyclical, with shorter-term cycles that are driven by supply and demand, economic, and geopolitical dynamics. Adding a diversified allocation of real assets to an investor's portfolio has the potential to provide several benefits while seeking to minimize the risks and volatility of each of the underlying asset categories.

Understanding the Current Landscape and Opportunities

Several indicators suggest that the global economy and financial markets might be transitioning into a new phase of the economic cycle. Following four decades marked by historically low inflation, influenced by the great moderation and increased globalization of goods and labor markets resulting in reduced production costs and consumer prices, it seems we are now on a different trajectory.

The Great Moderation

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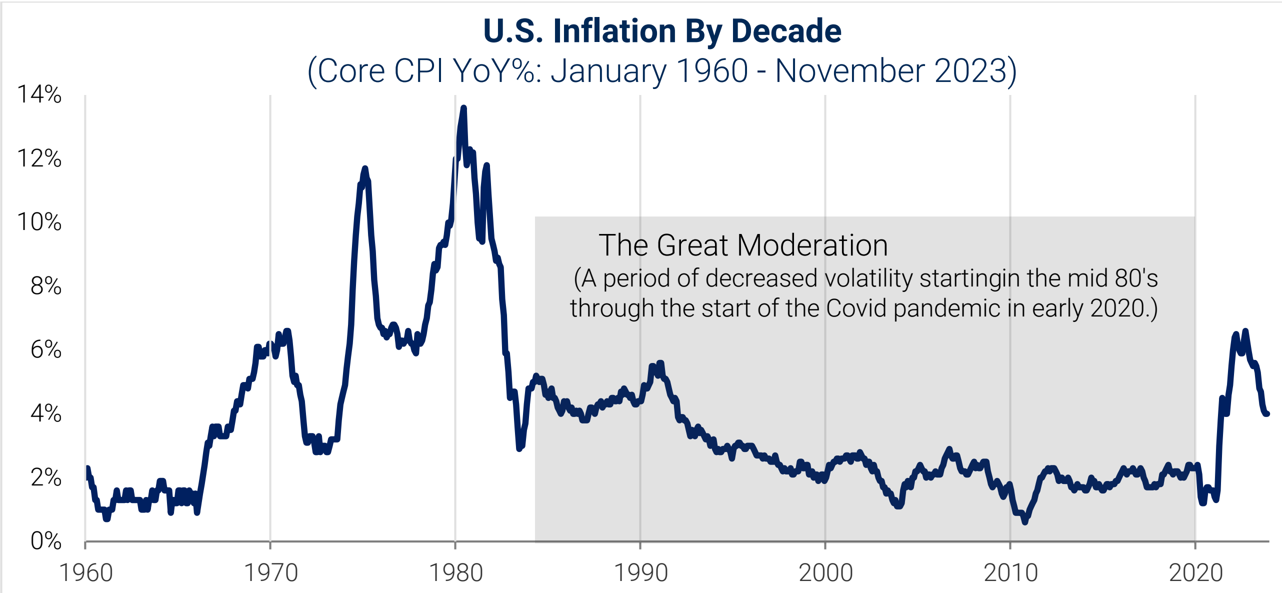


Source: Bloomberg

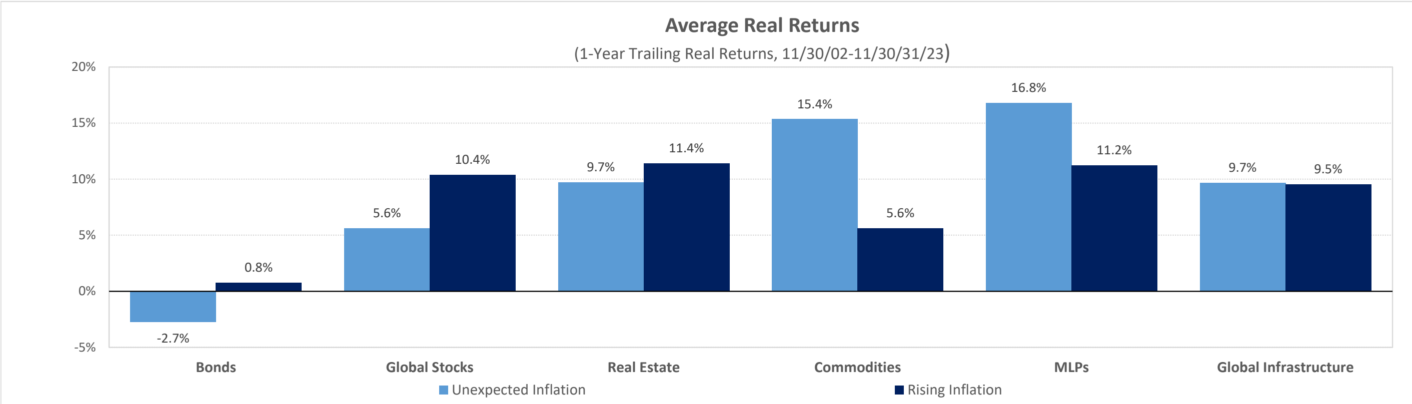
Numerous Factors are Triggering Inflationary Concerns

- Recent shifts in geopolitical sentiment are intensifying focus on trade tariffs and escalating tensions between trade partners. Moreover, after a prolonged period of stability, current geopolitical concerns are driving commodity price volatility.
- Businesses are swiftly reorienting global supply lines in response to pandemic disruptions and evolving geopolitical risks.
- Reshoring and friendly-shoring of production and supply chain components away from the lowest-cost labor markets are gaining traction.
- Post-pandemic domestic labor supply challenges and associated wage increases are impacting businesses.
- Significant fiscal pandemic support and other major spending bills have created unprecedented budget deficits and debt levels.

Historical Outperformance of Real Assets During Rising and Spiking Inflation

Real assets have historically outperformed traditional equities and fixed income during periods of unexpected inflation spikes. Commodities and MLPs tend to perform strongest during periods of unexpected inflation, as several energy and agricultural commodities can be a cause or early sign of rising inflation. Companies along the commodity supply chain also tend to perform strongly in inflationary environments, as their revenues are largely tied to the underlying commodities.

Many infrastructure assets have their cash flows tied directly to inflation measures, allowing these companies to protect their margins during periods when traditional companies may struggle with cost pressures. In terms of real estate, many property types have rent escalators that adjust with inflation, allowing companies to pass along price increases to their customers. Although real estate has underperformed more recently due to sharp upward moves in interest rates, the category is expected to perform better if interest rates stabilize but inflation remains elevated.



Source: Federal Reserve Bank of St. Louis, Morningstar Direct, Bloomberg

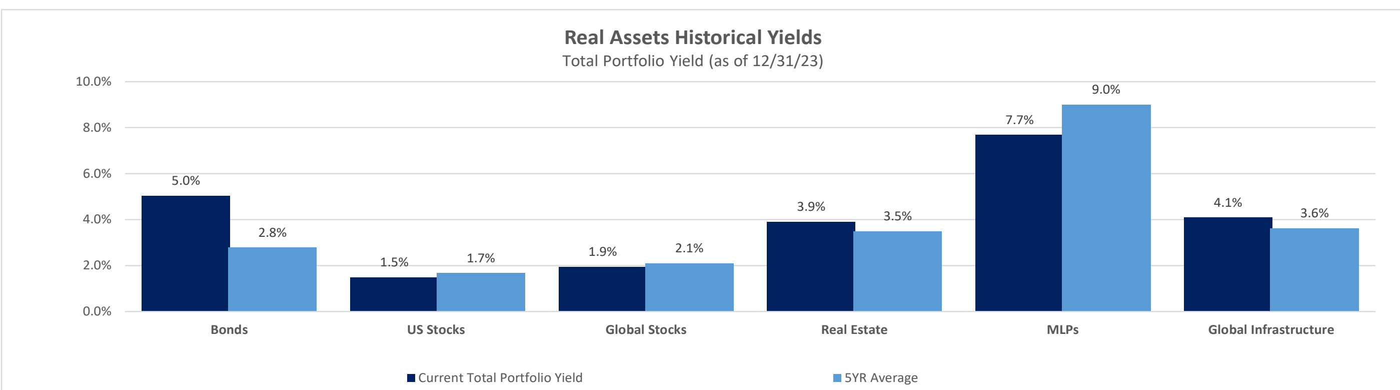
The bars represent the average 1-year trailing real return for each asset class during periods of "unexpected inflation" and "rising inflation" during the period from 11/30/02 through 11/30/23. The returns for each asset class are represented by the following benchmarks: Bonds - Bloomberg US Agg, Global Stocks - MSCI ACWI, Real Estate - FTSE Nareit All Equity REIT, Commodities - Bloomberg Commodity, MLPs - Alerian MLP, Global Infrastructure - S&P Global Infrastructure. "Real returns" for each asset class are calculated by subtracting the average rate of inflation for the 1-year period (measured by CPI) from the 1-year nominal return for the benchmark. Periods of "unexpected inflation" are defined by a positive difference between the realized inflation rate (CPI YoY%) and lagged 1-year-ahead expected inflation, as measured by the University of Michigan survey. Periods of "rising inflation" are defined by a positive increase in inflation rate (CPI YoY%).

Real Assets Generated Competitive Returns with Lower Volatility

Real assets have historically delivered attractive total returns over a full market cycle, adding the most value during periods in the cycle when inflation is elevated. Over the long-term, a strategic real asset allocation has generated returns that are competitive with global equities but with lower levels of overall volatility.[1]

For investors seeking income, certain segments of real assets have historically paid above-average dividends. Midstream energy tends to be among the highest yielding categories, and infrastructure and real estate investments have historically carried higher than average yields.

Diversification is Essential During Periods of Heightened Volatility



Source: Morningstar Direct. The dark blue bars represent the current total portfolio yield for each asset class as of 12/31/23. The current total portfolio yield represents either the forward dividend yield (for equities) or the yield to maturity (for fixed income). The light blue bars represent the average total portfolio yield for each asset class over the trailing 5-year period as of 12/31/23. The yields for each asset class are represented by the following benchmarks: Bonds - Bloomberg US Agg, U.S. Stocks - S&P 500, Global Stocks - MSCI ACWI, Real Estate - FTSE Nareit All Equity REIT, Commodities - Bloomberg Commodity, MLPs - Alerian MLP, Global Infrastructure - S&P Global Infrastructure.

Real assets can generally serve as an effective portfolio diversifier for traditional 60/40 investors. Historically, real assets have exhibited a lower beta and lower correlation to traditional equities[2]. Allocating a portion of a portfolio to real assets generally have led to improved risk-adjusted performance, driven by a lower portfolio standard deviation[3]. Private real assets generally provide even greater diversification benefits compared to publicly traded equities, though that comes at the expense of decreased liquidity.

OAM Research believes that robust portfolio diversification is essential during periods of heightened volatility. A strategic allocation to real asset strategies has the potential to improve risk-adjusted performance for investors' portfolios through attractive total returns, diversification benefits, and inflation protection.

[1] Source: Cohen & Steers. For the period from 1973 through Q1 2023, a blended real asset portfolio returned 9.2% compared with 8.5% for Global Equities and 10.4% for U.S. Equities. The standard deviation (volatility) of the portfolio was 11.9% compared to 15.1% for Global Equities and 15.5% for U.S. Equities.

[2] Nuveen Asset Management. Over a 20-year period ending June 2022, the Infrastructure and Global Real Estate asset categories had a correlation of less than 0.8 to U.S. equities, while commodities had a correlation of less than 0.4.

[3] Source: Cohen & Steers. For the period from 1973 through Q1 2023, including a blended real asset allocation to an existing 60% equity/40% fixed income portfolio improved the Sharpe Ratio, a measure of risk-adjusted performance. Moving 10% from equity to real assets increased the Sharpe Ratio from 0.39 to 0.41, and moving 20% from equity to real assets increased the Sharpe Ratio to 0.44.

Disclosures:

The performance of a benchmark index is not indicative of the performance of any particular investment; however, they are considered representative of their respective market segments. Please note that indexes are unmanaged and their returns do not take into account any of the costs associated with buying and selling individual securities. Individuals cannot invest directly in an index.

Bloomberg U.S. Aggregate Bond Index - The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The Index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass throughs), ABS, and CMBS sectors. The U.S. Aggregate Index is a component of the U.S. Universal Index in its entirety. The index was created in 1986 with index history backfilled to January 1, 1976. All issues in the Aggregate Index are rated Baaa3/BBB-/BBB- or higher (using the middle rating of Moody's, S&P, and Fitch, respectively) and have at least one year to maturity and have an outstanding par value of at least $250 million.

MSCI ACWI - A market-capitalization-weighted index maintained by Morgan Stanley Capital International (MSCI) and designed to provide a broad measure of stock performance throughout the world. The MSCI All Country World Index includes both developed and emerging markets.

FTSE National Association of Real Estate Investment Trusts (NAREIT) All Equity TR: The index measures the performance of all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria. A REIT is a company that owns, and in most cases, operates income-producing real estate.

Bloomberg Commodity TR USD: The index measures the performance of future contracts on physical commodities which traded on US exchanges and the London Metal Exchange. The commodity weightings are based on production and liquidity, subject to weighting restrictions applied annually.

Alerian MLP Index: The capped, float-adjusted, capitalization-weighted index of energy infrastructure Master Limited Partnerships (MLPs), whose constituents earn the majority of their cash flow from midstream activities involving energy commodities.

S&P Global Infrastructure Index: The index is designed to track 75 companies from around the world chosen to represent the listed infrastructure industry while maintaining liquidity and tradability. To create diversified exposure, the index includes three distinct infrastructure clusters: energy, transportation, and utilities.

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Special Risks of Real Assets

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. Risks applicable to companies in the **energy and natural resources** sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk. **REITs investing** risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions. **The risks of MLPs** include concentration risk, illiquidity, and exposure to potential volatility, tax reporting complexity, fiscal policy and market risk. **Precious metals are speculative investments**, which may experience short-term and long-term price volatility. The value of precious metals investments may fluctuate and may appreciate or decline, depending on market conditions. Unlike bonds and stocks, precious metals do not make interest or dividend payments. Therefore, precious metals may not be appropriate for investors who require current income. **Similarly, commodity prices** (and an investment in commodities) may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. **Investing in the infrastructure sector carries certain risks** such as exposure to adverse economic, regulatory, political, legal and other changes affecting the issuers of such securities. Infrastructure companies may be focused in the energy, industrials and utilities sectors. At times, the performance of securities in these infrastructure sectors may lag the performance of other sectors or the broader market as a whole.

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