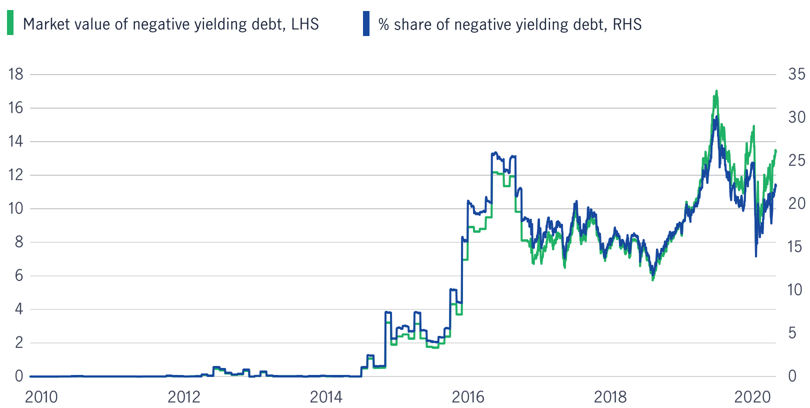
Real assets can offer an income alternative to low bond yields

When it comes to seeking investment income, market participants typically turn to bonds. But alternative sources of income are becoming increasingly important as more investors discover that debt just doesn't yield enough to meet their portfolio distribution needs now. In working with clients around the world, we're seeing private real assets play a bigger role in generating robust investment income that's built to last.

Expected returns across global bond markets remain low

The 10-year U.S. Treasury note yields a nominal 0.5%, and that's about as good as it gets for high-quality government bonds these days: Comparable issues from Canada, yielding 0.4%, Japan, yielding 0.0%, and Germany, yielding negative 0.5%, appear even less likely to live up to their historical levels of income generation[1]. In fact, our global chief economist expects major central banks to keep policy rates at or below zero until at least 2025, "a development that could push investors further out on the risk spectrum, swapping traditional government bonds for higher-yielding alternative assets."[2] If low bond yields have rendered portfolio distribution levels insufficient, then where might investors turn for income enhancement and stability? We see four distinct possibilities—and private real assets play a role in each case.

Share of global investment-grade bonds that are negatively yielding



Source: Macrobond, Bloomberg, as of June 18, 2020. LHS refers to left-hand side; RHS refers to right-hand side. The Bloomberg Barclays Global Aggregate Bond Index tracks the performance of global investment-grade debt in fixed-rate treasury, government-related, corporate, and securitized bond markets. It is not possible to invest directly in an index.

We favor private real assets generating robust, recurring cash yields

Private real assets include investments as diverse as airports, apartments, dams, farms, forests, and warehouses, yet they all share two defining features. First, they're not publicly traded, and therefore they offer the potential to earn an illiquidity premium over mainstream markets. Second, their intrinsic value is rooted in what's concrete, enduring, and essential, which, unlike more cyclical financial assets, tends to make real assets less vulnerable to unexpected changes in inflation, consumer preferences, and global growth. When chosen carefully, certain private real assets—real estate, timber, agriculture, and infrastructure—can also generate lots of income.

1 Real estate

Nimbleness has never been more important for real estate investors in search of attractive and stable sources of income. On the whole, structural shifts in commercial property appear to be helping industrial markets and hurting retail markets. While office markets represent an open question, the demand outlook for multifamily housing remains stable. Some segments remain better positioned than others, and we expect the global pandemic will alter the way people perceive, use, and invest in virtually all property types from this point forward. Real estate managers with narrow mandates and legacy assets might not be able to transact quickly enough to accommodate changing circumstances. Strategies with more flexibility could be better positioned to take advantage of shifting income streams on the horizon.

2 Timber

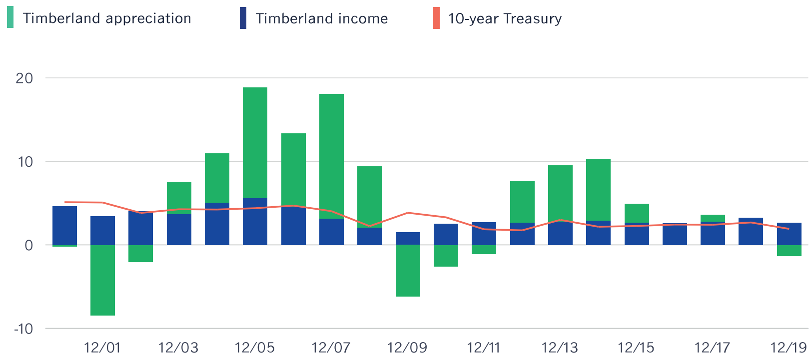
Timberland's long history of delivering competitive and consistent cash yields, inflation protection, and long-term capital appreciation has provided a strong incentive for investors to include the asset class in their portfolios. But timber's best days don't necessarily lie in the past. Today, the long-term outlook is no longer tied exclusively to revenues from the sale of unprocessed logs. The historical emphasis on commercial, production-oriented plantation forestry could broaden into new strategies focused on achieving the most cost-efficient capture and storage of carbon to meet the environmental goals of new tiers of capital focused on impact investment objectives. A growing and increasingly broader base of demand is likely to strengthen forest property values as voluntary carbon offsets continue to reshape the timberland market. Any rise in carbon prices may increase income opportunities for timber investors, a dynamic that might still be underappreciated by the market.

3 Agriculture

From a finite supply of arable land, the planet needs to nourish and sustain a global population that's already grown to 7.8 billion and is expected to reach 9.8 billion by 2050[3]. Recognizing the increasing challenge to feed the world, there's been growing investor interest in farmland for permanent crops—such as apples, pistachios, and wine grapes—and row crops—such as corn, potatoes, and soy beans. While many independent factors drive income returns for farmland, the relatively inelastic demand for food products keeps the industry comparatively insulated from downturns

Timberland has offered dependable cash yields, capital appreciation, and limited drawdowns

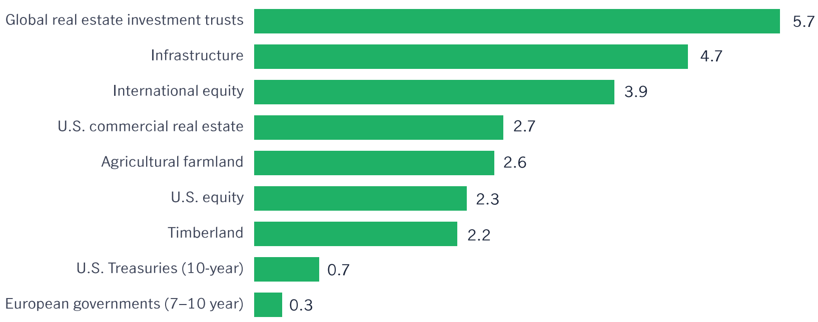
U.S. timberland and U.S. Treasury annualised returns (%)



Source: NCREIF, Macrobond, Hancock Natural Resource Group, December 2019.

Investors need to look beyond bonds for today's best yields

Yields (%) by asset class, March 31, 2020[4]



Source: Bloomberg, Hancock Natural Resource Group, J.P. Morgan Asset Management, March 31, 2020.

in the economic cycle. In fact, we've seen food purchases surge as people react to COVID-19 containment efforts by stockpiling their pantry shelves at home. Food and agriculture still function as defensive sectors, remaining less vulnerable to consumer spending curtailment than most goods and services.

4 Infrastructure

Infrastructure enterprises engaged in providing essential public goods and services — through electric, gas, and water networks; power-generation plants; transportation networks, including highways, railroads, and ports; and telecommunication towers — may benefit from limited competition and stable demand from consumers. While the capital appreciation component of infrastructure's total return can be volatile from one period to the next, long-term contracted cash flows, or regulated inflation adjusted rates of return, tend to underpin the income component, which has remained relatively stable over time. As the asset class continues to evolve and expand, network data centers, renewable energy, and other enduring assets tied to technological innovation are creating new income opportunities for infrastructure investors.

Diversified real assets can help build portfolio resilience

Relative to mainstream markets, allocating to any one type of private real asset may enhance a portfolio's yield profile while reducing its price volatility. Still, in our experience, real assets work best when they work together. But just gaining access to these categories can be challenging enough. Without the right partner, building a diversified portfolio of direct commercial real estate, infrastructure, farmland, and forest properties can be challenging for most investors. Even among the largest and most sophisticated players, few have expertise across all the major private real asset sectors. Select outsourced chief investment officer (OCIO) programs now make it easier to have a one entry point into a globally diversified allocation across a variety of private real assets. As the next chapter in the search for yield begins, we believe it's time for alert income investors to boost both the level and longevity of portfolio income by lightening up on lower-yielding bonds—and leaning into a diversified allocation of private real assets.

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FOOTNOTE

1 Wall Street Journal, YCharts, August 6, 2020.
2 "The three stages of the global economic recovery," Manulife Investment Management, July 24, 2020.
3 worldpopulationhistory.org/map/2020/mercator/1/0/25/, 2020.
4 Figures represent trailing 12-month cash yields as of March 31, 2020. Global real estate investment trusts represented by the FTSE EPRA/NAREIT Global Real Estate Index, which captures general trends in eligible real estate equities worldwide. Infrastructure represented by the MSCI World Infrastructure Index, which captures the global opportunity set of companies that are owners or operators of infrastructure assets. International equity is represented by the MSCI All Country World Index (ACWI) ex-U.S. Index, which tracks the performance of publicly traded large- and mid-cap stocks of companies in 22 developed markets and 23 emerging markets. U.S. commercial real estate is represented by the NCREIF Property Index (NPI). Agricultural farmland is represented by the NCREIF Farmland Index. U.S. equity represented by the MSCI USA Index, which tracks the performance of publicly traded large- and mid-cap stocks of the U.S. market. Timberland is represented by the NCREIF Timberland Property Index. U.S. Treasuries (10-year) represented by the 10-Year Treasury Constant Maturity Index, published by the U.S. Federal Reserve tracks the performance of a range of U.S. Treasuries, reflecting maturities that have been adjusted to the equivalent of a 10-year security. European governments (7–10 year) represented by the Bloomberg Barclays Euro Aggregate Treasury 7-10 Year Index. It is not possible to invest directly in an index.