Play More Than The Illiquidity Premium With Real Assets

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Real assets help achieving different needs through diversification, from inflation hedge, volatility dampener, to substitute to fixed income. We believe the macro economic and financial conditions appear very favourable to real assets in 2018.

In the institutional world, we have witnessed an impressive shift toward unlisted illiquid assets, with $700 billion of capital raised in 2017 for private equity, real estate, private debt and infrastructure. The assets under management of those asset classes have reached a record high of $8,3 trillion in 2017[1] and PwC estimates that so called 'alternative' assets will reach between $13.6 and $15.3 trillion in 2020[2].

Unconventional monetary policies and low rates have had a significant impact on institutional portfolios. The economic cycle is now moving to a late phase and the bull market is in its maturity phase with very pricey equities. In that context, real assets are appealing to those investors with long-term horizon, not only as a mean to capture the famed illiquidity premium, but also as a source of income enhancement (i.e. stable predictable return) or as a tool for diversification (i.e. low correlated return to traditional asset classes).

Beyond markets, prudential regulation (Solvency II for insurers, Basel III for banks) and demographic shifts (such as ageing population or urbanisation) are boosting the demand for alternative sources to finance the real economy in a post-2008 world where bank disintermediation has gained traction quickly. It is estimated that disintermediation represents between 75 and 80% of funding volumes on the US market, and about 20 to 25% of all funding in Europe – with a fast growth in the latter market.

Today, with a shared prospect of interest rates trending higher in the medium term (in 2018-2019), as a reflection of stronger and resilient economic growth and inflation, real assets can be seen as an effective hedge, particularly thanks to the recurrence of their cash flows. In fact, some real assets (core/core+real estate, infrastructure, private debt) have a pattern of very predictable and steady cash flows, quite similar to fixed income, notably on the back of a stringent contractual framework. With that in mind, real estate and infrastructure are the most appealing inflation-hedged strategies. Let's focus on them below.

Real estate: navigating European market divergences

The economic recovery is supporting real estate investment in the Eurozone and should make 2018 another good year for rental growth. In fact, rent evolutions are likely to become the new driver of real estate performance, which will no longer be essentially driven by low rates as it was the case in the past five years. However, the European real estate sector is expected to grow at different paces between countries: in the last five years, house prices have risen sharply in some countries, while they have been contained in others. For example, France could offer interesting opportunities, as the economic recovery is not yet in full swing, which means there is still room for improvement. In addition to premium locations in Paris or La Défense, which offer solid returns, investors could exploit opportunities with moderate risk profiles in major French provincial cities. In that changing and challenging environment, we think that active, selective investment strategies are key to taking advantage of expected adjustments in rates, rents, property values. It is also time to move up the value chain with very active asset management (e.g. leasing-up, renovating or total refurbishing of properties) in order to deal with present high prices and prospect of raising interest rates. Establishing strategic partnerships could be another strategy to quickly penetrate several European markets with the required nimbleness, and take advantage of local skillsets and evolving situation in rates, rents or values.

Figure 1. **Assets Under Management by Asset Class, Dec 2010 to June 2017**

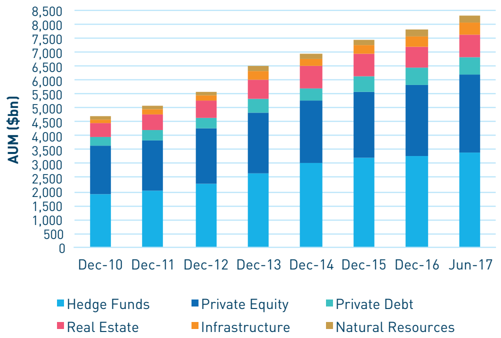
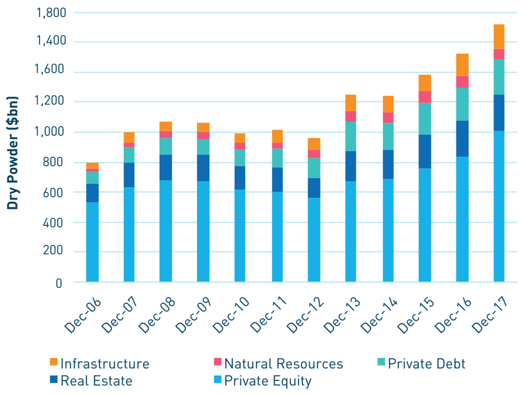


Figure 2. **Private Capital Dry Powder, 2006-2017**



"The European real estate sector is expected to grow at different paces between countries. Active, selective strategies will be key to taking advantage of new trends."

Infrastructure and long term view: best friends

As the need for a transition from cyclical to a more structural economic recovery will be at the forefront for policy makers in the years to come, we believe that infrastructure investing may provide an interesting opportunity to diversify risks and capture steady source of income. Taking a long-term view on investments makes infrastructure's typical stable cash flows more attractive than short-term (potentially volatile) gains. This is particularly relevant for insurers, as a part of their liabilities are rather long to very long term. In reasonable proportions, insurers can integrate more low-liquidity to illiquid assets into their portfolios, which may help them reach their target level of risk-adjusted return.

Diversification is also important, both against other investment risks (e.g. credit risk, equity-related risk,...) and against the underwriting risks taken by the insurers. Regulators do assess infrastructure-related risks more favourably than they do for other types of assets. Thanks to a good protection in terms of regulation, volumes or tariffs, infrastructure may generate more secure cash flows than other assets. For instance, this attractive risk profile is the reason for preferential prudential standards under the Solvency II regulation. The new capital rules enacted by the European Commission in June 2017 may reduce by up to 30% (vs. 49%) the capital charge for qualifying and eligible investments in infrastructure projects. Similarly to real estate, selection is of great importance as the asset class is very heterogeneous. Some infrastructure solutions are risky by nature because they are linked to economic cycles or commodities price (e.g. airports, oil sector...). Whereas some others provide excellent predictable cash flows – thanks to a very strong and long term contractual framework (e.g. French energy transition).

Local knowledge and global connections are key

As a conclusion, real assets or private assets generally provide a very high satisfaction to investors, and it's not only a question of illiquidity premium but also a matter of diversification, inflation hedge, reliable income. Amundi believes – independently of regulatory constraints – that an optimal institutional portfolio should contain today 30% of those alternative assets – which is higher than what we observe in today's portfolios.

The growth of real and private markets is ahead. Having that in mind, we believe it is important to highlight two repetitive key concerns when institutional investors consider those markets: accessing good deals at fair value (sourcing) and soon after they have committed capital (J-curve effect). One can easily concur to those concerns when looking to "dry powder" figures which, year after year, are reaching all-time highs. Non-invested private capital stood at $1,700 billion as of December 2017 [1].

In that context, we think that the ideal manager in real and private assets needs to combine the advantages of both a global and specialist player. It could be classed as a 'glocal' company: i.e. only managers that can take advantage of a global scale and a local footprint can align their interests more closely with those of investors. As an example, the European market remains highly fragmented. One needs long-term business and banking connections which gives access to assets and deals that boutique specialist managers struggle to find.

FOOTNOTE

(1) All data extracted from Preqin Global Alternatives Reports 2018 – Source of graph: Preqin.

(2) PwC Market Research Centre analysis based on Preqin, HFR and Lipper data. PwC report published in June 2015: Alternative Asset Management 2020 – Fast forward to centre stage