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Managing inflation risks with real assets

Nearly two-thirds of institutional investors globally are increasing their efforts to mitigate inflation risk over the next 12 months, according to the Nuveen 2022 global institutional investor survey Equilibrium.

Prices are rising around the world after more than two years of a pandemic that severely disrupted economic activity and triggered an unprecedented fiscal stimulus. In March 2022, U.S. inflation hit 8.5%, while in the euro area it reached an all-time high of 7.4%. Prices are also ticking up in China, and even in Japan, which has struggled with deflation since the mid-1990s.

Against this backdrop, Gwen Busby and Biff Ourso discuss how investors can create more resilient portfolios and manage inflation risks by investing in private real assets.

Gwen Busby

Head of Research and Strategy, Nuveen Natural Capital

Gwen focuses on natural capital market analysis and specialized econometric and stochastic modeling for Nuveen.

How does inflation affect land-based real assets? Does it impact farmland and timberland differently?

Gwen Busby: Over time, land-based assets have done a better job at keeping pace, or even outpacing, inflation compared with traditional asset classes. Historically, in the U.S., which has the most comprehensive dataset, there has been a positive correlation between the consumer price index (CPI) and farmland and timberland performance. That correlation is at a level that consistently exceeds the correlation between CPI and traditional asset class performance. Both farmland and timberland produce goods that are part of the CPI basket, such as food and housing. As the prices of these goods rise, so does inflation, and cash yields from farmland and timberland assets rise with them as well. Eventually these higher prices are baked into valuations, helping to increase the capital appreciation component.

The inflationary environment will affect farmland and timberland differently due to the speed of that impact. Where the link between rising prices and the underlying investment is most direct, the inflation hedge is the strongest and felt most immediately. In farmland, row crops like grains and oil seeds tend to be most sensitive to inflationary pressures, especially compared to permanent crops like almond or citrus investments, for example. Part of that is due to the relationship with energy markets, especially for crops like sugar and oil seeds where the correlation with energy markets helps to support that positive feedback. In timberland, where you see rising prices for lumber or pulp, price increases will be transmitted most quickly and directly to markets for saw logs or pulp logs. In those cases, you're going to see the greatest positive movement with performance linked to inflation.

Biff Ourso

Senior Managing Director, Global Head of Nuveen Infrastructure

Biff is responsible for leading Nuveen's global private infrastructure group and is a member of the firm's Global Investment Committee.

How do infrastructure investments provide protection against inflation?

Biff Ourso: One of the attractive things about private infrastructure investing is its resiliency in inflationary periods. Infrastructure assets typically experience very inelastic demand profiles due to the essential nature of the underlying asset. Asset owners can exert a high degree of pricing power across economic cycles, which is to the benefit of the equity owner. In addition, there are typically long-dated pricing contracts, which in many cases have inflation-protection mechanisms built into the agreement, thereby hedging cash flow.

A subset of infrastructure assets are also regulated in such a way that as costs rise, particularly related to debt, these are pushed through, and there is the ability to adjust the return on equity to compensate and hedge the underlying inflation risk. Because these assets require high capital investment to develop and own, the replacement costs in inflationary periods typically go up. In turn, the underlying asset or residual value goes up as well, providing a stabilizing source of asset protection to an infrastructure investor.

What are the broader benefits of having real assets in your portfolio regardless of inflation?

Gwen Busby: From a portfolio-level perspective, it's about diversification. There's a lack of correlation with capital market cycles and a negative correlation between land-based assets and traditional stock and bond indices. The return profile of land-based investments can also be advantageous. Over time, we see a stable income return from real asset yields, and then a capital appreciation component of return that comes from asset sales. In general, for farmland and timberland, we see higher returns compared to fixed income and lower volatility compared to public equities.

There are also environmental, social and governance (ESG) benefits from land-based assets, including biodiversity, conservation, water quality and carbon sequestration and storage. Compared to traditional asset classes, both timberland and farmland have a low carbon intensity – they generate relatively modest or even net negative CO_2 emissions per USD invested. In addition, timberland and farmland investments have the potential to generate verified carbon credits that come with the traditional financial components of returns and the production of agricultural crops and commercial timber.

Biff Ourso: Similar to farmland and timberland, infrastructure brings beneficial diversification and low to negative correlation compared to other areas of a traditional investment portfolio. There are also global megatrends underlying many of the investable themes in private infrastructure today, including the energy transition. Just looking at the Ukrainian crisis, and the impact that's had on European energy markets, the topic of energy independence for Western Europe is very much at the forefront of every government's mind. One way to achieve energy independence of course is to accelerate the energy transition to clean energy.

What are some of the unique risks of investing in real assets?

Biff Ourso: For certain infrastructure investments, there can be natural disaster risk such as earthquakes and other events that could damage physical infrastructure. Additional areas of risk can include liquidity and operational risk.

Gwen Busby: The key difference when investing in real assets is that you are owning and operating an investment and face a whole set of risks that are unique compared to purely financial investments. Beyond purely financial risk, there are risks related to growth in the yield of the crops or the commercial timber species, market risks, liquidity, operational and foreign exchange risks.

How can institutional investors with long time horizons protect themselves in today's market?

Gwen Busby: Investments in land-based real assets are inherently long-term and focused on sustainable food, fiber and timber production. We view the transition to a low-carbon economy as an opportunity for investors to build climate-resilient portfolios positioned to benefit from rising carbon prices. For example, investing in land-based assets with strong carbon value drivers – achieved through enhancing yields, making operating practices more efficient, and sequestering and storing carbon in soil and trees – will be important for long-term performance and resiliency.

Biff Ourso: We recommend clients stay diversified, not just across the primary asset classes but within asset classes. When constructing portfolios in private real assets, we believe it's important to consider risk mitigation as it relates to fundamental themes, such as the energy transition, telecommunications and data, and the emergence of digital technology. Overall, it's important to have assets that are going to provide a reasonable risk-return profile that can be resilient and also provide yield. Infrastructure and private real assets can be an important tool for long-term investors to help solve for shifting macroeconomic environments.

For more information, please visit nuveen.com.

Endnotes

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A word on risk.

Investing involves risk; principal loss is possible. All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. As an asset class, real assets are less developed, more illiquid, and less transparent compared to traditional asset classes. Investments will be subject to risks generally associated with the ownership of real estate-related assets and foreign investing, including changes in economic conditions, currency values, environmental risks, the cost of and ability to obtain insurance, and risks related to leasing of properties. ESG integration incorporates financially relevant ESG factors into investment research in support of portfolio management for actively managed strategies. Financial relevancy of ESG factors varies by asset class and investment strategy. Applicability of ESG factors may differ across investment strategies. ESG factors are among many factors considered in evaluating an investment decision, and unless otherwise stated in the relevant offering memorandum or prospectus, do not alter the investment guidelines, strategy or objectives.

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