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Real Assets

Combating inflation—Real Assets as a viable solution

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Historically, Real Assets have been an attractive long-term investment option, given the unique investment characteristics of these securities. They have offered a fundamentally sound investment thesis predicated on providing exposure to underlying assets that have generated stable and predictable cash flows while also providing the ability to offset rising inflation. The attractive investment capabilities of Real Assets merits consideration when constructing an overall portfolio.

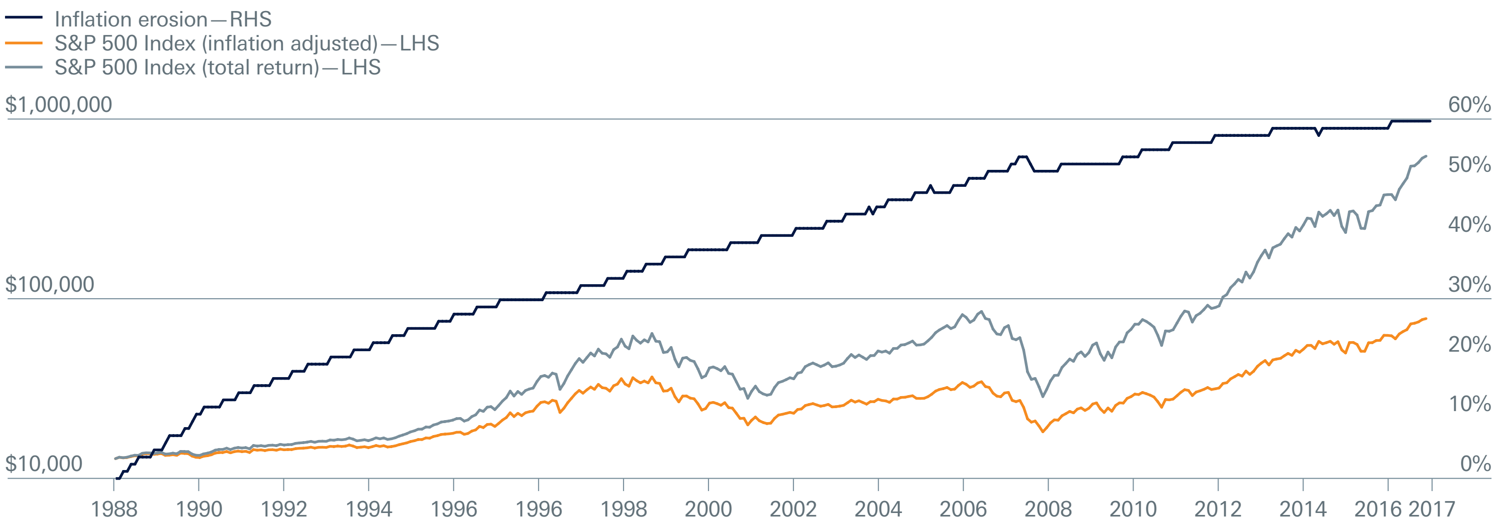
When constructing a diversified portfolio, a "risk-based" methodology allocates risk across various asset classes according to current and expected macro factors. In order to make the most appropriate asset allocation decisions, we believe consideration of macroeconomic risk conditions is essential, especially given the rapidly evolving global economic and political landscape, which shapes forward-looking risk-return expectations. Two of the most important macro factors are inflation and economic growth, which can both meaningfully impact investment returns across asset classes. We believe economic growth and inflation expectations are critical components to understand when making investment decisions. While economic growth is more easily understood in terms of the impact it may have on various asset classes, inflation is somewhat opaque as to what effect it may have on a portfolio.

Inflation is a significant market force that has the potential to slowly deteriorate the real value of a diversified investment portfolio consisting simply of traditional stocks and bonds. The chart on the following page depicts the effect inflation can have on a long-term investment in traditional equities, using the S&P 500 Index as a proxy.

This brief study focuses on the inflation risk factor and how to potentially hedge a portfolio against inflation. Specifically, we will look into how a strategic allocation to Real Assets may be a viable solution to not only hedge against inflation, but also enhance diversification, relative to traditional stocks and bonds.*

* Diversification cannot protect against a loss.

Figure 1: Growth of $10,000—Inflation impact over long run



Source: Bloomberg, as of 6/30/17. (latest data available)

As you can see, the impact inflation has historically had on nominal total returns is clearly evident. It has resulted in roughly 52 percentage points of "inflation erosion," significantly decreasing the "real" investment value on a cumulative basis.

Importance of hedging against inflation

Regardless of the market environment, a strategic allocation to asset classes that hedge against the risk of inflation, without sacrificing total returns, is crucial. For the past several years, we have been in a market environment of extremely low interest rates around the world, coupled with slow growth, which has essentially reduced the near-term threat of inflation. Since the Global Financial Crisis in 2008, inflation has become less of a factor when making short-term asset allocation decisions as central banks have flooded the market with liquidity to spur growth, while also pushing yields lower. To cope with low rates and moderate economic growth, investors have sought alternative investment strategies to potentially enhance total returns or provide a greater level of current income.

We are currently moving into an environment with the prospect of higher interest rates, leading to a corresponding concern over inflation. Therefore, now may be the time to re-assess existing portfolio allocations in order to adapt to changing market conditions. There are essential asset classes and investment strategies that are often overlooked as viable solutions to not only preserve real investment values, but also provide stable, equity-like total returns, as well as attractive bond-like income. In the short run, it is easy to ignore the impact of inflation, but the threat inflation poses to the majority of traditional investments in the long run, not only requires attention, particularly when making asset allocation decisions.

Real assets may be the solution

Real assets provide exposure to essential physical assets, such as office buildings, toll roads and precious metals, which have historically offset the effect of rising inflation while also providing exposure to equity market beta. While the marketplace has no clear definition of what constitutes Real Assets, our definition includes global real estate, infrastructure and commodities. Historically, these securities have displayed the ability to deliver not only attractive risk-adjusted total returns over the long run, but also may provide greater sensitivity to inflation, compared to traditional stock and bond investments.[1]

> We believe a comprehensive real assets strategy is among the most effective and efficient ways to gain defensive exposure to securities that have generated attractive risk-adjusted total returns throughout various market cycles.

We believe the most appropriate way to gain exposure to real assets is through a diversified mix of publicly traded securities, specifically:

— Global Real Estate: apartments, office buildings, self- storage, shopping centers, healthcare facilities, hotels, industrial, student housing, data centers, lab space and property developers

Asset class	Definition and characteristics	Inflation hedging
Global Real Estate	— Publicly traded companies that own and operate income-producing physical commercial real estate — Include real estate investment trusts (REITs) and real estate operating companies (REOCs)	— Varying degrees of contract duration with inflation hedging mechanisms built into rental agreements — REIT dividend payments typically grow along with inflation
Global Infrastructure	— Publicly traded companies that derive the majority of operating income from owning and operating physical infrastructure cash flow producing assets — Inelastic demand profile and monopolistic assets provide stable, predictable, inflation-linked cash flows	— Essential infrastructure assets with long duration contacts and embedded inflation hedging — Cash flows adjust to inflation, having explicit or implicit inflation pass-through ability
Commodities (futures and equities)	— Publicly traded companies linked to natural resources and commodities — Physical exposure to commodities through purchasing futures contracts	— Commodity futures are generally the strongest natural hedge against inflation — Equities are a solid hedge against inflation from indirect exposure to commodities
TIPS*	— Treasury notes where the principal is adjusted for (positive) inflation as measured by CPI	— Suitable hedge against U.S. inflation, but lacks upside potential when inflation is not a major risk factor

*TIPS are not generally categorized as a real asset class, but used as a defensive tool that also offers a hedge against inflation.

- Global Infrastructure: energy pipelines, toll roads, cell towers, airports, seaports, railroads, gas distribution utilities, water utilities, satellites, waste facilities and renewable energy
- Commodities (futures and/or equities): global natural resource equities, base metals, precious metals, mining, chemicals, agriculture, livestock and energy
- TIPS: government issued notes with varying degrees of duration, linked to Consumer Price Index (CPI)

Sensitivity of real asset classes to inflation

The chart below depicts the "inflation beta" of various asset classes, or, in other words, how sensitive an asset class is to changes in inflation. A higher inflation beta means the asset class has historically responded more quickly to changes in inflation.

As you can see, Commodities provide the highest hedge to inflation, which we would view as the primary inflation hedging component within a real assets strategy. Elsewhere, Global Infrastructure and Global Real Estate have an embedded long-term inflation hedging mechanism.

Historically, these asset classes have not only displayed attractive sensitivity to inflation compared to traditional stocks and bonds, but they are typically viewed as the primary "total-return" driver within a real assets strategy. Lastly, while TIPS do provide inflation hedging characteristics, they can also be used as more of a defensive portfolio construction tool to preserve capital in down markets.

An active and dynamic portfolio that strategically and tactically allocates across and within these asset classes may be an effective way to fight inflation, while also providing exposure to the benefits real assets may provide.

Figure 2: Inflation beta

Source: DWS, Bloomberg. For period 12/31/02 – 3/31/18. Global Infrastructure data shown from 9/30/2008 through 3/31/2018. Asset class representation: **commodities**, Bloomberg Commodity Index; **commodity equities**, S&P Global Natural Resources Index; **global infrastructure**, DJ Brookfield Global Infrastructure Index; **global real estate**, FTSE EPRA/NAREIT Developed Index; **TIPS**, Bloomberg Barclays U.S. TIPS Index; **global equities**, MSCI World Index; **global bonds**, Bloomberg Barclays Global Aggregate Index.

A combination of essential real asset classes may be used to hedge against inflation while potentially generating stable risk-adjusted returns. Below is a summary of how each asset class may be utilized within a comprehensive real assets strategy:

— Commodities: An allocation to futures has historically provided an attractive hedge to inflation, while global natural resource equities may also deliver an inflation hedge due to their direct correlations.
— Global Infrastructure: Infrastructure can be viewed as the total-return component, but also responds to changes in inflation. Revenues for "pure-play" infrastructure are typically stable and predictable because of the long-dated underlying contracts and monopolistic assets. These types of companies typically have the ability to pass on higher costs often linked to inflation, which can result in real earnings growth.
— Global Real Estate: Similar to Global Infrastructure, Real Estate serves as more of a total-return component with the potential to deliver more stable current income. Inflation hedging ability is usually embedded in rental agreement structures, which generally include inflation-linked adjustments or fixed percentage increases in rents. This gives Real Estate (i.e. REITs) the potential for positive real rates of return during inflationary environments.
— TIPS: TIPS may provide a hedge against inflation and may also help offset equity market beta in "risk-off" environments.

The table below is a basic summary of the potential benefits of each real asset class, sorted by inflation hedging ability.

	Inflation hedging	Revenue stability	Volatility	Income component	Diversification
Commodities (futures)	●●●	N/A	●●●	●	●●●
Global infrastructure	●●	●●●	●●	●●	●●
Global real estate	●●	●●●	●●	●●	●●
TIPS	●●	N/A	●	●	●●●
Global equities	●	●●	●●●	●	N/A
Global bonds	X	N/A	●	●●	N/A

●●● High ●● Medium ● Low X Weak

Source: DWS, Bloomberg. As of 3/31/17 (latest data available). This table is based on the subjective opinions of DWS while taking into account the characteristics these asset classes have historically demonstrated. Category measurements: **inflation hedging** uses inflation beta; **revenue stability** uses revenue sources; **volatility** uses standard deviation; **income component** uses dividend yields; and **diversification** uses correlations relative to global equities and global bonds.

Conclusion

Inflation is a real and ongoing threat that should be addressed in order to preserve capital over the long-term. While there are stand-alone securities or asset classes that help provide some inflation hedging benefits, a dynamic approach that uses various real asset classes may be an efficient and effective way to hedge against inflation, while also providing a diversified equity market beta.

A comprehensive real assets strategy has the potential to satisfy specific client goals, such as providing higher beta to inflation and stable dividend yields. Instead of allocating to multiple funds and stand-alone real asset classes, an approach that encompasses the various real asset classes previously discussed under one umbrella may be an optimal solution for investors to consider.

Given our long-term track record and dedication to investing in Real Assets, we are well-equipped to provide a long-term core real assets solution to hedge inflation, while also providing the potential for diversification and improved risk-adjusted returns.

[1] Source: Bloomberg, as of 3/31/18. Asset class representation: **commodities**, Bloomberg Commodity Index; **global infrastructure**, Dow Jones Brookfield Global Infrastructure Index; **global real estate**, FTSE EPRA/NAREIT Developed Index; **global bonds**, Bloomberg Barclays Global Aggregate Index; **global equities**, MSCI World Index.

The opinions and forecasts expressed herein do not necessarily reflect those of DWS, are as of 3/31/18, and may not come to pass.

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