FIRST CAPITAL FINANCIAL

"I just got damn well fed up with being formal all the time."

Like penguins and the melting ice cap, investors' natural habitat is changing. Inflation is typically bad new for mainstream assets such as stocks and bonds, because it reduces the present value of future earnings and dividends. Yet this is where, after a decade of slow growth and sluggish inflation, investors have parked much of their trillions. As consumer prices rise uncomfortably fast in much of the world, they are scrambling to protect their portfolios from the changing economic climate.

A growing cohort is placing its faith in "real" assets -the physical sort, including property, infrastructure and farmland. Could these prove a haven in times of change? Investors certainly have good reasons to deem them safe places to park. Inflation often coincides with rises in the price of these assets. An economic expansion tends to fuel consumer-price growth as well as demand for floor space and transport or energy infrastructure.

Moreover, these assets produce cash flows that usually track inflation. Many property leases are adjusted annually and linked to price indices. Some -those of hotels or storage space- are revised even more often. The revenue streams of infrastructure assets are typically tied to inflation through regulation, concession agreements or long-term contracts. Meanwhile the rising maintenance or energy costs associated with these assets are often either passed through to tenants (for property) or fixed for long periods of time (infrastructure). And debt raised against them, -often fixed rate, and in copious amounts, becomes cheaper to repay.

As a result, real assets have done well during inflationary periods. Total returns for privately held property and infrastructure assets have beaten those of main stock and bond indices when inflation was above 2.5%. Pension funds are flocking to real assets, with the Ontario Teachers Pension Fund, which manages $228 billion CAD, looking to increase its allocation there from 21% to 30%.

That might all sound very alluring, but it should come with warnings. For one, performance has become harder to predict: think of retail space and office blocks (under recent threat from e-commerce and remote work), airports and power plants (exposed to decarbonization) and even farmland (vulnerable to climate change).

Another difficulty is that real assets are hard to access. They are typically private, meaning that only the most sophisticated investors have the resources and patience to find gems on their own. The rest might gain exposure in public markets, through real-estate investment trusts, infrastructure stocks or exchange-traded funds. But these tend to be closely correlated with equities, defeating the point of investing in them.

In any case, real assets cannot insulate an investor's entire portfolio against inflation. Their merit is that they present their own value when inflation is high. But to protect all of their capital investors must seeks assets that do more than just tread water, but gain value more quickly during inflationary bursts than their other holdings depreciate. And there is not a lot of consensus over which ones fit the bill. Gold, commodities, inflation-linked bonds, derivatives: each has champions and detractors.

Perhaps the biggest danger though, is that real assets fall victim to their success. Many investors already turned to them over the past decade as they hunted for stable yields and sought diversification. Between 2010 and 2020 private real assets under management more than doubled to $1.8 trillion USD. Finding things to buy is getting harder. Some $538 billion USD raised by funds since 2013 remains unspent. Finally, the definition of a real asst may become stretched, and some have already argued it needs to exclude exotic fare such as non-fungible tokens -digital media recorded on a blockchain. Rather like penguins that huddle every closer on a shrinking bit of ice, some investors mights find themselves falling into treacherous waters.

Be safe, be well!

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