GERBER | TAYLOR

GT Roundtable: Real Assets, Time for Another Look?

Part one of our two-part interview series will examine a broad overview of the asset class, Gerber Taylor's history with real assets, and the current opportunity set in the sector.

After years of laying low, inflation certainly has captured the attention of investors and the Federal Reserve alike. Recent headline inflation prints have topped 8% for a few months now. There are certainly some more "transitory" causes, from the COVID-led spending on goods fueled by stimulus checks, related supply chain disruptions, and the impact on energy and food prices from the war in Ukraine. But there are also secular shifts with longer term consequences. Think deglobalization, a lack of workers, and energy supply constraints, just to name a few. Others point the blame directly at the Fed's excessive monetary policies, which they failed to unwind even as the economy and markets recovered, and as pockets of bubbles developed.

The consensus view is that inflation is topping out at present but will likely settle at a modestly higher level than we've become accustomed to since the financial crisis of 2008. Others are less sanguine. In a December 2021 op-ed in the *Financial Times*, Paul Singer, founder and co-CEO of Elliott Management, wrote, "the ability of governments to protect asset prices from another downturn has never been more constrained. The global $30 trillion pile of stocks and bonds that have been purchased by central banks in order to drive up their prices has created a gigantic overhang. With inflation rising, policymakers are reaching the limits of their ability to support asset prices in a future downturn without further exacerbating inflationary pressures."

While we do not pretend to know the future, it is clear that inflation poses a greater risk to investors' portfolios than it has in decades. We have always espoused diversification with real assets being an important piece of an overall allocation. Within real assets, we take a programmatic approach instead of trying to time markets and cycles. Gerber Taylor has an experienced private markets team (Bill Ryan, Kojo McLennon, and Sean Montesi) who cover both private equity and real assets. We recently sat down with the three of them to talk about the role of real assets in a portfolio, Gerber Taylor's approach to the asset class, and where they are seeing opportunities today.

Could you talk broadly, what are real assets and what characteristics make them an important component of a portfolio?

Kojo McLennon: I think about real assets as things that make the real world run. Those tend to always look like real physical assets that are responsible for our commerce and how our everyday life is conducted. To boil it down, it's buildings, real estate, infrastructure assets, ships and ports, and things of that sort. Related to that are the fuels or inputs that we all need to make these physical things run. I am always amazed that real assets are appropriately named because they are, in fact, the real things that we need everyday whether it's in our day to day lives, or in the business world. They are important to a portfolio due to their critical nature and what their uses are. They tend to have return drivers that are distinct from your standard financial assets and, therefore, provide a strong level of diversification to a portfolio.

Sean Montesi: There's categories of real assets that investors talk about sometimes in addition to what Kojo mentioned, but they aren't a huge focus of our investment program. These include treasury inflation-linked bonds and commodities. Most of our focus is on things that have real utility in everyday life.

To pick up on the point that you just made, Sean, people talk about TIPS and put those in the same bucket as real assets and commodities. Why are those not an area of focus for Gerber Taylor?

Sean: For one, I just don't think those areas have been very beneficial from a return perspective. Commodities have not generated very good real returns over long time horizons. I kind of lump TIPS in with bonds, and we aren't generally interested in low-yielding assets. These financial assets don't give the benefits of real assets that Kojo described. No matter what is happening in financial markets, we still need a place to live, we travel on roads, and goods travel by railway and ports. You still have telecom and utility infrastructure…

Bill Ryan: … and your water infrastructure

Sean: …Right, so despite what happens in the macroeconomic environment, these things are used every day.

Gerber Taylor has been investing in real assets since the inception of the firm. Can you talk about your history in the space and how the asset class has evolved over time?

Bill: Our history started out predominantly in real estate, so we would own a number of commercial and residential real estate assets. That has grown to include energy, energy transportation assets, and infrastructure assets, as well as mineral assets. We would be more than happy to buy the defaulting bonds of these real assets if it got us to the equity of the asset. So that has been a strategy that we have employed over time. Our history has been one of high single-digit to low double-digit rates of return across market cycles. Real assets are marked by cyclicality, and we pay a lot of attention to where we think we are in the cycle.

Kojo: I think the evolution of our program has mirrored what has transpired in the institutional investment markets. It was heavily focused on commercial and residential real estate earlier on, but as other asset classes became more investible like infrastructure, we expanded into a broader set of real assets. Today we describe that as real estate, infrastructure, energy, and some minerals and mining, essentially a more diversified basket. Together, they provide a great deal of diversification against a standard 60/40 portfolio and also against each other within the basket. I think that has proven to be a beneficial way to implement a portfolio of real assets. If you looked back to investing in real estate only, outcomes tended to rhyme with macro environments that broadly supported equities. Diversifying into additional asset types reduces that correlation.

Back when you started the evolution of the program, a big theme was competition for capital, right?

Sean: Yes, I think no matter the strategy — this isn't unique to real assets — but generally speaking, a broader menu of investment options yields a better outcome. Because, as you said, there are more ideas for the capital, so casting a wider net yields benefits. Within that, I'm sure we'll touch on this later, but we've become more active direct investors over time too. That gives us the opportunity to generate higher returns and also makes us more knowledgeable allocators.

What makes real assets compelling right now in your minds?

Bill: Well, first and foremost in everyone's mind is the inflation protection nature of the rents that we get. Many real assets have contractually obligated inflation protection agreements in order to raise rents. This is the case with most infrastructure assets. As far as multifamily, those rents are raised every month as people come in and out of apartments. Hotel rents are raised every day, so the asset class affords you some protection against inflation.

Kojo: For me, it's because of the changing dynamic we have in the capital markets. I don't know what returns are going to look like, but I believe that real assets are going to be more competitive in a portfolio than they have been historically because of the nature of the assets. For the past decade, the S&P Real Assets Index returned 4.4%, versus the S&P 500 of 12.9%. I think we're sitting at a juncture, where the uncertainty is so great, one could argue that signs are pointing to higher rates and higher inflation like Bill and Sean talked about. Maybe this leads to lower returns across the investment landscape overall. Even though real assets weren't as competitive over the last ten years, I think you have a more dynamic portfolio with the inclusion of real assets, and you want a more dynamic portfolio going forward against all of these various headwinds and uncertainties.

Bill: Perhaps a reappreciation of current income. Our portfolio has always thrown off current income. If we're in a lower return environment for other asset classes, investors may really appreciate the fact that you're locking up a portion of your return in the form of income.

Kojo: As you point out though, that was one of the opening questions – what are some of the characteristics that we like – and we've always believed that you can get mid-single digit returns on a current basis on private real assets. I think we've averaged about a 5% current yield in the portfolios. Sometimes, it takes time to get there because the portfolio needs to be stabilized, but by year five or six we've seen the portfolio distribute regular income yield. That's one really attractive component because we've been fighting against 10-year yields or fixed income yields that are sub 2% for a long period of time. Although it's illiquid, this helps to provide a source of income that has been absent in the market for a very long time. It's also an important de-risking component. I've always looked at real assets this way: if you're getting a lot of current income or a decent amount of current income, that means you're taking care of your debt service. That means that the assets are performing well, which means that you're in a solid long-term return-generation position.

What are the important macro considerations, either positive or negative, that your team is thinking about with respect to real assets going forward?

Bill: You can't have a view of real assets without a view of interest rates because it is a levered asset class. We are entering an environment where interest rates could potentially increase and that's obviously a cost to owning real assets. The nice thing is, we get to reprice that because this is with fresh capital…

Sean: … and I think generally, most of our investment portfolios are conservatively levered investments. For groups that have a tendency to take the industry standard or maximum leverage to their deals, rising interest rates is a big problem. I think the way our managers do things is somewhat more insulated from that risk.

Bill: And the reason partly is because we tend to invest in managers who have a lot of their own money in these deals.

Kojo: In addition to rates, liquidity is definitely a consideration too. As rates rise, the market generally becomes less liquid for a period of time. These real assets are generally capital-intensive businesses that do require leverage, and so how that impacts the current owners is a big question mark. I think even if you underwrote a Draconian scenario, it's good to have fresh capital to take advantage of that. I think we're kind of sitting in between a moment where we're still trying to understand how current assets get impacted by these changing macro dynamics. But we foresee greater opportunities coming our way. I also think there's some structural dynamics going on, for example, in the energy markets, with the potential for deglobalization or reshoring. These could make a more favorable environment for real assets. All of these underlying things going on at macro level bring real assets into focus.

Let’s take it one step further. What's your view of the opportunity set in real estate?

Kojo: In my opinion, there's a lot of capital in real estate right now. Net income yields are probably at their lowest they've been in quite a long time, so real estate assets are not cheap. It's tough to be a buyer today because you’re going to have to pay up in price to get exposure. That said, excluding retail or office— probably two of the most suspect property types — the supply/demand dynamics are favorable. Many owners and landlords can raise rents to overcome some of those headwinds. Replacement costs tend to go up with rising rates which means that it’s difficult to build competitively against your existing product. This barrier to entry in the space means there's a lot of dynamics that would say that values can withstand some of these macro headwinds.

Sean: …We try to look for niches and have found attractive value in senior living, land banking, and until recently, last mile logistics. I think we tend to search around the edges of the sector while large institutional investors tend to search more in the middle of the fairway.

Bill: …And let me just add, real estate also tends to be a pretty localized business. So, what we say about San Francisco and New York may not be the same for Miami, Nashville, and Austin.

What about the other focus areas: energy and infrastructure?

Sean: I think we’re constructive on energy assets these days. When you think about traditional or legacy assets, there’s a dearth of capital given ESG-driven divestments from large pools of capital. This has freed up interesting opportunities to invest in a space that is still very necessary for decades to come. And then, we've also recently been spending time looking at renewables. They have become an institutional asset class as we now need trillions of dollars of future investment in that category.

Bill: So, that goes towards the competition for capital. Just because an asset has the word renewables in it or the word traditional in it, they still have to compete against each other. As Daniel Yergin said, “There is no energy transition without energy security.” We’ve clearly seen that with the Russian invasion of Ukraine and the fact that you can’t just flip the switch and everyone gets to drive an electric car tomorrow.

Kojo: Infrastructure — it's a large opportunity; it's global; there's always a lot to do there, but infrastructure is one of the most opaque segments for its size. They're complex assets and there is no global database of how infrastructure is priced. When we try to invest in the space, we need to see decades worth of experience in it before we allocate capital to a manager there… really long-term proof of capabilities…

Bill: …And that's a great point we've never invested with a manager who hasn't been through a recession…

Kojo: … in this space, yes. We also need to see not only that experience but also their operating capabilities, which tend to be very important because, like I said, infrastructure assets are complex. As part of the broader asset mix, infrastructure is probably on the lower returning side of things. But they have the steadier cash flow, so it makes for an attractive component in a portfolio. And it has some of those built-in inflation protection dynamics through the contracts that we like…

Sean: I think that’s a good point… of the categories, I think we probably see the least volatility of returns in infrastructure. So, you’re giving up a little bit of upside, but taking fairly low risk because these are essential assets. Kojo, regarding your point on opacity, it’s a much newer category and I think it's becoming more and more transparent and easier to categorize. As of late, I think we’ve been focusing more on the value-add segment within infrastructure. There’s ability to improve infrastructure assets that can then be sold to core infrastructure buyers, which is similar to what we do in real estate.

Consumer and work trends in general have been transitioning with work from home clearly here to stay. Online shopping existed before but accelerated during COVID. The United States has aging demographics. How do you account for emerging trends when you're thinking about real asset strategies?

Sean: I think we have raised the bar when it comes to certain categories within real estate because of these dynamics. Getting excited about an office deal takes a lot more than it would have pre-COVID. Also, retail took a lot to be excited about before COVID and even more so now because of the changing retail dynamics.

Bill: We did look at a lot of retail — it was grocery anchored, but it was so competitive because that was really the only retail that offered yield. That yield got priced into what we thought were really low unlevered returns.

We have been investing in real assets since 1995. Even though we've been talking about the potential for inflation, we obviously are not trying to time the market. Can you speak to the programmatic nature of real assets?

Bill: Our Real Assets program by definition is programmatic, so over time we have invested in what we think are the most attractive risk adjusted areas. Historically we have favored multifamily, industrial, energy and infrastructure at the expense of hotels, office and retail. We review all of the available options and try to find the most compelling opportunities at that particular point in time.

Thank you for sharing your time with us today. This concludes part one of our interview with the GT Real Assets team. The second part of our interview series will cover sourcing investment ideas, portfolio allocation and strategy, and a few case studies from historical examples.

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Tara Elliott & Andrew Fox

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