A Growing CEF Opportunity in Real Assets and Alternatives?

Michael Hedstrom, director of the Closed-End Fund Association (CEFA), spoke with Larry Antonatos, managing director and portfolio manager at Brookfield Asset Management to discuss his thoughts on real assets and alternative investing, and potential opportunities for closed-end fund investors.


Larry Antonatos


Michael Hedstrom

The following Q&A recaps the conversation that originally took place as part of CEFA's podcast series on May 30, 2017, which can be heard at CEFA.com.

MH: Let's start with a brief overview. How would you define "real assets" and what areas are included in your investment universe?

LA: We define real assets as investible assets with five characteristics. Hard assets, long life, stable cash flows, high current income, and inherent inflation sensitivity.

Real assets include three principal asset classes. First, real estate. Real estate includes income producing rental property across four main sectors: office, industrial, retail, and apartments. In addition, real estate includes residential mortgage-backed securities.

The second real asset class is infrastructure, which includes four main sectors: utilities, such as electric, water, and gas utilities; energy pipelines and storage; communication infrastructure, such as cell phone towers; and transportation infrastructure, such as airports, seaports, and toll roads.

Infrastructure has supply, demand, and pricing drivers that are different from most other businesses. The supply of infrastructure assets is limited frequently by government regulation, and many infrastructure assets are monopolies or semi-monopolies. The demand for the essential services provided by infrastructure is generally steady and predictable. The pricing for the services provided by infrastructure assets is frequently regulated and frequently tied to inflation.

The third real asset class is natural resources, which includes three main sectors: energy, metals and mining, and timber and agriculture.

Across all real assets, both equity investments and fixed income investments are available. Within public securities, the market capitalization of real asset equities and fixed income is over 10 trillion dollars.

MH: **Larry, you often talk about that investing in real assets offers four important potential benefits. Can you elaborate and talk a little bit about why investors and advisors should consider including real assets in their portfolio?**

LA: The four potential investment benefits of real assets are diversification, inflation protection, capital appreciation, and income. Let's address these one by one.

First, diversification. Real assets have drivers of investment return, which may differ from those of traditional equities in fixed income. Accordingly, real assets have historically exhibited low to moderate correlation to traditional equities in fixed income. Including real assets in a multi-asset investment portfolio may reduce total portfolio volatility, resulting in a smoother pattern of investment returns over time.

Second, inflation protection. Real asset investment returns may provide inflation protection because many real asset revenues are sensitive to inflation. For example, in real estate, contractual lease rental revenues frequently escalate with inflation. In infrastructure, government regulators frequently allow price increases tied to inflation. In natural resources, commodity prices, specifically energy prices, are a significant component of inflation.

The third potential investment benefit of real assets is capital appreciation. Real asset cash flows have historically grown over time, driving long-term capital appreciation.

The fourth potential investment benefit of real assets is income. Real assets frequently generate meaningful free cash flow, and they tend to distribute this cash flow to investors.

MH: **The choice between active and passive management is no longer an either/or question for most investors. Both can — and do— play important roles in building diversified portfolios to meet long-term goals. Yet there are some places where active management may be especially beneficial. Why does an active management approach make sense when investing in, say, infrastructure?**

LA: Infrastructure is a specialized asset class where specialized knowledge can drive excess returns. Historically, actively managed listed infrastructure equity funds have outperformed their benchmarks more frequently than actively managed general listed equity funds.

By the way, this is also true for actively managed listed real estate funds. Real estate is also a specialized asset class where specialized knowledge can drive excess returns.

MH: You manage both closed-end and open-end funds. Why should investors consider using a closed-end fund structure for these strategies?

LA: Closed-end funds have a specified pool of capital with no inflows and outflows. Closed-end structures are particularly beneficial when investing in less liquid assets, such as smaller capitalization equities, lower liquidity corporate bonds, floating rate loans, and mortgage-backed securities. These less liquid assets may offer attractive risk/reward opportunities and the stable capital of a closed-end fund gives the manager greater ability to pursue these opportunities.

In addition, closed-end funds frequently utilize leverage, which can amplify investment returns. I note leverage is a positive when investment returns are positive, but leverage is a negative when investment returns are negative.

MH: Let's turn to the market environment. We've been in an environment with a long period of low inflation, low interest rates and relatively low growth. After years of monetary policy serving as the primary stimulus, there is new focus in 2017 on fiscal policy including, as we've seen in the headlines, infrastructure spending. What's your outlook, and what implications does a changing market environment have on real assets?

LA: From a macro-economics perspective, my outlook considers four factors. First, economic growth. I expect global growth to continue to improve, but remain modest.

Second, inflation. I expect U.S. inflation to increase as the U.S. labor market approaches maximum employment. However, other drivers of inflation, particularly energy and commodity prices, appear well contained.

Third is interest rates. I expect long term interest rates to be volatile but remain range-bound following the significant move higher we had in the fourth quarter of2016. At the same time, I expect short-term interest rates to rise as central banks across the globe reduce monetary stimulus.

This leads into my fourth factor, government policy and regulation. I expect reduced monetary stimulus will be replaced with increased fiscal stimulus, such as infrastructure spending or tax cuts. It's important to note that tax cuts are fiscal stimulus because it puts more cash in the hands of consumers to spend.

This economic outlook is supportive for real assets as the combination of diversification, inflation protection, capital appreciation, and income offered by real assets should remain attractive relative to traditional equities and traditional fixed income. The biggest risk to real assets is an economy with rapidly accelerating growth and rapidly rising interest rates. I do not expect this environment in the near term.

MH: Given your outlook, where are some potential opportunities for closed-end fund investors looking to invest in the real asset space?

LA: Brookfield offers the Brookfield Real Assets Income Fund. This fund includes real asset corporate credit, securitized credit such as residential and commercial mortgage backed securities, and real estate equities and infrastructure equities. The Brookfield real assets income fund trades under the ticker RA.

The historical correlation of each of these real asset classes to traditional equities in fixed income has been low to moderate. In particular, securitized credit, such as residential and commercial mortgaged-backed securities, has very low correlation to traditional equities in fixed income. Accordingly, adding the Brookfield real assets income fund has the potential to reduce volatility of a total portfolio, as well as the potential to improve return.

MH: Larry, any final thoughts before we wrap up?

LA: Adding alternative asset classes, such as real assets, through closed-end fund structures has the potential to improve the risk-adjusted return of a total portfolio. This potential improvement may come through a potential reduction in volatility, as well as a potential improvement in return. In addition, it's important to note that closed-end funds tend to pay meaningful distributions, which can enhance the income of a total portfolio. For example, the Brookfield Real Assets Income Fund pays a monthly distribution which, as of April 30, 2017, was a 10.22% return on market price.[1]

You can find more insight from Brookfield on their website at Brookfield.com. Information is also available on CEFA.com – your comprehensive resource for education, data, and timely insight on closed-end funds.

Disclosure

[1]The distribution rate is calculated by dividing the last distribution per share (annualized) by the market price.

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