Specialty Sectors: From Gold To Infrastructure And Real Estate

Summary:

- Despite more anticipated rate increases, real estate stocks have gone up.
- Weaker dollars, higher inflation rates, and rising debt levels have all positively impacted gold in the past – something that's expected to continue into the future.
- Real asset equities should provide attractive income in this environment as corporate earnings grow, allowing for dividend increases.

CEFA spoke with David Christensen, President, Chief Executive Officer, and Chief Investment Officer — ASA Gold & Precious Metals Limited, Larry Antonatos, Managing Director and Portfolio Manager — Brookfield Investment Management, and Steve Burton, Principal, Co-CIO and Senior Global Portfolio Manager — CBRE Clarion Securities.

David Christensen

Larry Antonatos

Steve Burton

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The following Q&A recaps the conversation that originally took place as part of CEFA's podcast series on February 21, 2018.

Speaker: **Welcome, and thanks for joining the Closed-End Fund Association for another discussion. Today we will hear from an industry expert who shares insight on a timely issue affecting the closed-end fund space.**

LH: **Hi. I'm Libby Hastert, Content Specialist at the Closed-End Fund Association. This morning, we're speaking to Larry Antonatos, David Christensen, and Steve Burton. Before we get started, I'd like to briefly introduce today's speakers so listeners can appreciate what a great group of thought leaders we have on today's call. Larry Antonatos comes to us from Brookfield Public Securities Group, where he serves as a Managing Director and Portfolio Manager on their Real Assets Solutions team. Also on the call is ASA Gold and Precious Metals Limited's David Christensen, who serves as President, Chief Executive Officer, and Chief Investment Officer. And no stranger to the CEFA podcast is our last speaker, Steve Burton, Principal, Co-CIO, and Senior Global Portfolio Manager with CBRE Clarion Securities.**

Representing such different sectors of the investing spectrum, you may wonder what brought us all here. Though each speaker offers a highly technical area of expertise, we've come together for a discussion on special sectors in the areas of infrastructure, natural resources, and real estate.

Now, "market correction," it's a phrase that's sent the bulls running the last two weeks, causing a significant stir in traditional income investments. But with plenty of optimistic market outlooks countering news headlines, this discussion comes at a good time, reminding investors why it's important to consider harnessing specialty sectors for portfolio diversification.

Now, without further ado, I'd like to turn things over to our first speaker Steve Burton of CBRE.
Steve, when we last spoke about eight months ago, you discussed REIT performance in periods of rising interest rates. Since then, we've had significant tax reform, new leadership at the Federal Reserve, and a 10-year Treasury yield nearing three percent. Can you update us on how you see real estate performing in this environment? Especially with the expectation of further rate increases. Steve?

SB: There's no shortage of macro news and political news and drama, kind of top-down, for any investment class. Indeed, the real estate stocks, I think perhaps unfairly by many, kind of get lumped in with assets, which are perceived to be interest-rate sensitive, so they can, they're perceived a little bit like bonds in an environment where rates are going up. But we've studied past time periods when the Fed's raising, the yield curve is shifting up and long-term rates have moved up and researched it with the conclusion that real estate stocks actually perform positively through those time periods and thereafter.

Indeed, if you look at how real estate stocks did in 2017, the Fed raises multiple times. U.S. rates had a sub-par year but they were still up 5.1 percent. A global strategy, which we embrace, was up twice that. The stocks in the Asian Pacific region were up nearly 30 percent, Europe … or Asian Pacific was up nearly 20 percent, Europe up nearly 30percent. So this is an asset class that ultimately responds to the bottom uptrends, and as we all know on this call, kind of the recent macro news is that global growth is increasingly synchronized and the outlook from an ultimate demand point for real estate is good. And that's, in fact, why rates are going up. It's because things are getting better, not worse.

And if you dig into it and ask yourself "okay, why is this true?", it's got a lot to do with the duration of the cash flows coming from the real estate companies, the cash flows coming from the leases, the leases tend to be five-year, seven-year, even longer in duration, so there's stability to those cash flows that endure through these great, rising cycles. And if you layer on that the solid balance sheets of the companies, a lot of these companies have been around a long time, you know, average LTV 30 percent range. The companies are actually well-positioned to benefit from improving economic conditions.

The tax, you know … I pause because I … you know, the tax law that came out in the U.S. is also a little silver lining that a lot of people don't notice out there. You know, REIT dividends, since they pass through to the ultimate shareholder, are taxed as ordinary income. But with the new tax law, the REITs are going to be passed through entities, so although the top marginal rate for the individual investors comes down to 37 percent, investors in U.S. REITs get to deduct 20 percent off of that. So the top marginal rate for REIT dividends actually moves down to 29.6 percent. So that's a little silver lining out there for owners of U.S. REITs, which I think is awesome and underappreciated thus far. To net, the stocks have gone up despite rates going up, and despite rates prospectively going up.

LH: Now David, if we could turn things over to you. Steve touched on this, but the U.S. is experiencing a strengthening economy and rising interest rates. With this in mind, we're likely to experience a growing national debt, and there are indications that inflation may pick up. So what macroeconomic factors have most impacted your outlook for gold and precious metals?

DC: Thank you, Libby. That's obviously a very timely question, given what's going on in the marketplace today. Historically, the kind of "Goldilocks economy," that overused term that we hear a lot, is one that hasn't lasted for very long. Recent data from the Federal Reserve Bank in Cleveland indicated that the median CPI rose at an annualized rate now, 4.2 percent in January, which was quite a surprise to Wall Street. It's the single largest one-month increase in inflation since March of 2005. Wall Street's new concern has been for rising inflation, the potential of the Fed to increase rates now at a faster clip than they had been expecting, and a weakening dollar have all set the stage for potentially higher gold prices over the coming year. Weaker dollars, higher inflation rates, and rising debt levels have all positively impacted gold in the past. We expect that to continue into the future. In all, it would seem to be a good time to look at things like gold and real estate and hard assets, if you will, because of the potential for these things to occur going forward.

LH: **David, taking a closer look at gold, we know it's been trading at a range of $1200 to $1400 dollars per ounce. Are these favorable levels for exploration mining companies and do you expect increased investment and production? Also, do you see better value in other metals?**

DC: Well, you know it's interesting. When I started my career, gold was $250 dollars an ounce, and $450 would have seemed like an absurdly high level, and everybody would be profitable. Today, at a range of $1200 to $1400 dollars an ounce, the mining industry is largely marginal in terms of its ability to generate cash flow and earnings for a gold mining company. Prices today are simply just not quite high enough to incentivize a gold producer to develop a new mining project. As a consequence, we're beginning to see mining projects age and deteriorate with the ongoing time, as most of these companies only last about 10 years, in terms of their reserves. Lower grades throughout the industry, lower recoveries because of the processing of more sulfatic ores, have all negatively affected production rates.

What we have seen, however, since there's been a significant improvement in capital allocation throughout the mining industry, and especially in the gold industry, meaning that the mines that they are building are of a higher quality, and are generating a more positive return than we've seen in the past. Moreover, in the last couple of years, the mining companies both in copper and in gold, have made a significant improvement in their balance sheets throughout the sector. As a result, while gold production is actually declining globally in terms of output, we're starting to see improvements in cash flow, dividends and earnings throughout the industry, which we think that could translate into better valuations for the gold mining companies going forward.

At the same time, ASA's been investing in a number of newer, higher quality single asset companies, which are growing, and are new projects that we believe will promise to increase in value over time, or potentially be acquired by these more senior companies, since they need to supplement their own production and reserves. Libby, as for the other metals, ASA is not traditionally a gold fund, but it's also invested in copper, palladium, platinum, diamonds and other strategic and precious metals over time. Palladium has been a very good area for ASA over the last couple of years, and the loss of one of our significant positions in the portfolio due to an acquisition last year resulted in a nice capital gain for our shareholders. But the company also presently has a relatively small position in diamonds, about four and a half percent of the portfolio, and we are also actively pursuing a number of copper projects around the world for their individual asset qualities, not just for the positive spectrum momentum in copper.

LH: **Thanks, David. Now Larry, if we could turn things over to you, taking a look at real assets. In recent weeks, investors have been reminded that market volatility is again something we need to be aware of. How do the characteristics of real assets fit in the long-term investor's portfolio, as they try to navigate this market volatility? Larry?**

LA: Many people think of real assets as, first, real estate. Second, commodities such as metals, and we just heard about those, too. At Brookfield, we also invest in infrastructure equities, we invest in high yield bonds of real asset companies, infrastructure, real estate, and natural resources companies and we also have investments in securitized credit, residential mortgage-backed securities, and commercial mortgage-backed securities.

I want to highlight just for a moment, two of those asset classes that I think have some interesting characteristics that can benefit total portfolio volatility.

First, if we think about infrastructure. Infrastructure equities tend to be a low-volatility asset class. They offer historically attractive volatility and draw-down metrics, with approximately 75 percent of the volatility of global equities, and 75 percent of the draw-down of global equities.

This ability is driven by the supply, demand and pricing fundamentals of infrastructure, which are unlike most other businesses. First, let's talk about supply. The supply of infrastructure assets is constrained, frequently constrained by regulation. And many infrastructure assets, therefore, are monopolies or semi-monopolies. That's a terrific place to be in a monopoly or semi-monopoly position.

Second, thinking about demand. The demand for essential services provided by infrastructure assets tends to be very steady. Whether the economy is strong or weak. For example, we all use energy infrastructure when we turn on the lights every morning, water infrastructure when we brush our teeth every morning, and communications infrastructure when we check our iPhones first thing in the morning and 100 times a day. Transportation infrastructure, which is the fourth major group of the infrastructure asset class, and includes airports, seaports and toll roads, does have GDP sensitivity and tends to perform better in times when GDP is accelerating.

Now, if you think about most investments, supply and demand will intersect to determine pricing. That's not necessarily the case with infrastructure. The pricing of infrastructure services is frequently regulated, rather than driven by supply and demand. When the government allows a monopoly, the government generally regulates price. The good news is, frequently this regulation is tied to inflation, providing inflationary growth in revenues. So you have an asset class that has very attractive volatility characteristics, and very attractive draw-down characteristics relative to the broad market, and it's driven by the fundamentals of the business.

Secondly, if I talk about securitized credit, what's really appealing about securitized credit is its low correlation to equities and it's low correlation to fixed income. So by adding securitized credit to your portfolio, mortgage-backed securities have a correlation to global equities of 24, and a correlation to global fixed income of .2. That low correlation as an addition to your portfolio can reduce overall portfolio volatility, and these bonds provide very attractive yield and very attractive total return.

LH: Thanks, Larry. Now, Steve, your perspective is reasonably unique among closed-end funds, in that you invest in global real estate markets. What advantages do you see in managing a global real estate portfolio, and where are you finding the best opportunities today?

SB: Last year 2017, as mentioned, was the year where the non-U.S. real estate stocks really shone. I mentioned that Europe was up almost 30 percent, APEC almost 20 percent. And I mention those numbers again because part of that was currency. The U.S. dollar has been weakening, so part of that global or international exposure has afforded the opportunity to gain some benefit from that currency movement. For anyone looking year-to-date if I go real time, U.S. rates have gotten killed, and we believe it's way overdone. They're down nine, ten percent. Non-U.S. is down half that, and some markets are even up. Japanese real estate stocks are positive year-to-date, so we believe there's a current opportunity right now from this dislocation, especially in the U.S., and that there's opportunity outside the U.S. Last year was the first year in four where the non-U.S. or international, from the U.S. standpoint, real estate stocks outperformed the U.S. rates.

We believe the pendulum has swung, and it's probably going to hang out here for a while with non-U.S. performing ... Well, of course, by going global there is natural diversification, by being in the many different markets, many different property types. There's benefit from some, M&A is the private capital. In the world there's about an estimated 250 billion with a '"b," dry powder among the private equity and other investors on the direct side, so sooner or later that capital notices that the listed stocks are looking too cheap, and indeed, there's been some M&A both outside the U.S. and in the U.S., particularly, and it's still unfolding, in the retail sector via the Class A malls. A lot of news was coming out late last year. So diversification, a global growth that's increasingly synchronized, access to parts of the world that act differently at different times, we, of course, being in a dynamic fund can allocate capital accordingly to geographies and property types that we believe will outperform in this environment.

LH: And Steve, I think it's important that you talked about how the fund can adapt to climate conditions. So for investors that are concerned about that, inflation could begin to pick up from low levels of recent years. What benefits would an allocation to real estate provide in that period of rising inflation?

SB: I previously mentioned, all three speakers today are talking about asset classes that can benefit from inflation. There's a classic argument about whether or not it is good inflation, or bad inflation. Bad inflation being cost. Push inflation, good inflation being just a reflection that things are getting better. And I think we very, very much have the latter, and like infrastructure, like commodities, real estate, clearly benefits from any inflation through the top line by rents going up.

Whenever they roll, it depends on the asset class and the timing, but real estate indeed is an asset class that over time can reflect and benefit any inflationary trends, which to some extent, are welcome. We're in a world with liabilities that are fixed. So if we've got a little bit of inflation coming back, that's a good thing, not a bad thing for all types of asset classes including the listed real estate stocks.

LH: And with that in mind, Steve, what advantages could investors see in harnessing a closed-end fund for their real estate exposure?

SB: The closed-end fund has some features that an open-end fund would not have. We use leverage tactically and in a positive market. That certainly helped us through last year. We can toggle it back or toggle it up to not only gain greater capital appreciation, but higher current yield via the dividend. Also, we don't have to kind of react to any inflows or outflows into the fund, since it is a closed-end fund. And for an investor looking at value, I mean this is classic, and it's true with a lot of closed-end funds.

You get the real estate at a double discount. The real estate itself is trading at a discount to what we believe it's worth in the private markets, and we're part of a large private real estate firm. So a very good read on what that is. But then there's another discount just reflected in where the stock trades in the market. And I know this is true of many closed-end funds. For an investor who needs kind of a buffer of knowing that the value is good, many closed-end funds offer that buffer via a discount for the discount, as I described it.

LH: Thanks, Steve. Now David, how do you see an allocation in the precious metal sector, best position in an investor's diversified portfolio? More specifically, what purpose does it serve in the portfolio and how would you underweight or overweight the sector?

DC: All right, thank you. First, I think it was Larry that mentioned some low volatility sectors. Gold is certainly not one of them. Gold is a highly volatile sector and a diversified portfolio such as ASA is perhaps one of the best ways to invest in this sector, as it reduces the risk of any single operation not living up to expectations, or potential political risk issues, making it a way of affecting your individual mining stocks. We've always been a bit conservative in suggesting allocation to this sector to a generalist, as a consequence of this sector's volatility.

But what traditionally has been useful is gold's low correlation to other asset classes. And as such, it provides a strong diversifier to one's overall portfolio. Think of it as fire insurance, if you will, for one's portfolio. We don't necessarily want to buy our insurance, but at times, it's awfully handy. We don't put all of our money into insurance, either. We allocate a certain portion of our investment portfolio for those days when some things just don't go right. In recent years, one has not needed that insurance in the gold sector, or the insurance that gold provides. But with the markets near all-time highs, interest rates coming off record lows, and sharply increasing volatility, now would be the time to consider reviewing one's portfolio insurance and using something like gold or real estate or hard assets to hedge their overall portfolio position.

We believe that for long-term investors, an allocation of say, four to five percent of one's broader portfolio is sufficient to provide a reduction in overall portfolio volatility, and some point to portfolio insurance with gold. If that four percent allocation later becomes seven or eight because the insurance was needed, or because of overall market volatility, at that point, we'd suggest trimming some of one's precious metal exposure. And likewise, if gold begins to underperform and falls to two percent, we'd move it back towards the four percent allocation. So the four percent provides sort of a long-term median, if you will, and we would trim the peaks in that because gold is performing, or in periods when gold isn't performing, we'd add to those positions just as you might with one's fire insurance.

LH: Thanks, David. And, Larry, if we could look at closed-end funds from your perspective... Obviously, a lot of investors look to closed-end funds as an attractive income component in a portfolio. So what advantages do the different sectors of real assets have in supporting this attractive cash flow? Especially at this stage of the market cycle?

LA: This stage of the market cycle seems to be defined by three factors. Modestly rising growth, modestly rising inflation, and modestly rising interest rates. Real asset equities should provide attractive income in this environment as corporate earnings grow, allowing for dividend increases. Current yield on natural resource equities, real estate equities and infrastructure equities are all roughly four percent. In addition, U.S. energy and LP equities offer yield approaching eight percent, which is very attractive. And again, because these are equities, as earnings grow, dividends should increase.

Second, turning to real asset high yield, this should also provide attractive income, driven also by that corporate earnings growth. Earnings growth will improve credit quality and reduce default risk of high yield bonds. Our current yield on high yield is approximately five and a half percent.

Finally, securitized credit should also provide attractive income. Our current yield here is five percent, but one area that we're particularly focused on is floating rate securities where the coupon will rise as interest rates rise, providing some protection from rising rates. In addition, in the residential mortgage-backed securities market, we are very positive on the strength of housing fundamentals, which should be very supportive for residential mortgages.

LH: **And Larry, you also have a unique perspective in that you follow a broad range of sectors and investments for the portfolios you manage. Could you tell us where you're finding the most interesting opportunities and the best values in the market environment?**

LA: Sure. I think the single most interesting opportunity is U.S. energy and LP equities. We find them interesting for three reasons. First, these MLPs offer a very attractive yield approaching eight percent, as I just mentioned. Second, MLPs are attractively valued at both an absolute basis relative to historical values, and a relative basis relative to broader equities currently. And third, we think that MLPs should continue to benefit from strong fundamentals driven by growing U.S. oil and gas production. We think these are a very attractive component of a diversified real asset securities portfolio, because of their yield, valuation, and strong fundamentals.

LH: **Well Larry, David, Steve, I think you've given investors a lot to think about today. That's all the time we have for today's discussion, but for all those listening in, you can hear more from some of today's speakers in future discussions around closed-end funds. Thank you.**

Speaker: **Thank you for joining us. We hope you will stop by again for news on this ever-changing space. Until next time, connect with us on Twitter at CEF Association or by searching for the Closed-End Fund Association on LinkedIn and YouTube.**