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Alternatives

Low rates push more pension funds to real assets

Plans' moves supported by manager research on optimal allocations

By ARLEEN JACOBIUS

Investors are boosting their investment in real assets as they search for yield and stable returns in a low-interest-rate environment.

Money managers are nurturing this trend into a major movement of assets by releasing research demonstrating to investors how real assets can be added to both defined benefit and defined contribution plans.

There is no mistaking that more investors are turning to real assets as an alternative to stocks and bonds. A number of pension funds have increased their real asset allocations or hired new real asset managers within the past 12 months. For example:

- The $13.4 billion Public Employees Retirement Association of New Mexico, Santa Fe, increased its real asset allocation by two percentage points to 5%. It plans to commit $200 million to real asset funds this year.
- The $17.2 billion City & County of San Francisco Employees' Retirement System launched a search in May for a real assets consultant. The pension fund has had a 12% target allocation to real assets since 2011, but is invested only in real estate.
- Environment Agency Pension Fund, Bristol, England, appointed The Townsend Group to run a global portfolio of real assets estimated to total about £240 million ($369 million) over the next two years. Within the £2.1 billion pension fund's global real assets portfolio, 5% is allocated to real estate, 3.5% to infrastructure and another 3.5% to forestry and farmland.
- The $1.8 billion Austin (Texas) City Employees' Retirement System added a 5% allocation to real assets.

In a recently released paper, J.P. Morgan Asset Management predicts institutional investors will bump up their allocations to real assets to about 25% as they search for income and inflation protection. Real assets have been defined to include real estate, infrastructure, timberland, farmland and commodities. J.P. Morgan also includes long-life tangible assets such as ships and aircraft.

"I wouldn't recommend a 25% allocation to real estate alone," Joseph Azelby, managing director and head of global real assets at J.P. Morgan Asset Management, said in an interview, adding he would recommend a 25% allocation to a diversified basket that has a real estate anchor, infrastructure as the second-highest suballocation and others to farmland, timber and long-life tangible assets.

Higher income potential

The paper, "Implementing the Realization" asserts real assets have a higher current income potential than stocks or bonds and lower volatility than equities. It is the sequel to "The Realization," a white paper published last year by the New York-based investment management firm.

"Low interest rates have been here for a while," Mr. Azelby said in the interview. "Investors have been staring at their income statements for a few quarters," and they are beginning to realize they are going to have a hard time generating sufficient income when interest rates are so low.

REAL LOOK: Joseph Azelby said executives are studying ways to add real estate to their defined contribution plans.

"The realization is just starting to take hold," Mr. Azelby said.

The implementation paper suggests a broadly diversified portfolio of real assets based on a foundation of developed markets and assets such as core real estate and infrastructure. On top of that, the real asset allocation would include value-added and opportunistic real assets, real estate investment trusts, timber and farmland, and would have global exposure through such investments as emerging markets real estate, Asian infrastructure and global shipping.

The paper suggests several suballocation scenarios depending on goals, risk tolerance and liquidity needs.

Defined contribution plan executives who also oversee defined benefit plans are studying the role real estate played in their DB plans and are looking to add it to DC plans mainly through target-date funds, Mr. Azelby said.

In a recent white paper, REIT manager Cohen & Steers Inc., New York, argued for a real asset allocation in defined contribution plans. "In our view, adding a real assets allocation to a typical stock and bond portfolio has the potential to help participants meet an important retirement savings goal: maintaining the purchasing power of their investible assets, after the long-term toll of inflation," the paper stated.

"There's a lot more interest in real assets. More institutions have gotten a lot more educated on how to implement a real assets solution," said Yigal D. Jhirad, Cohen & Steers senior vice president, portfolio manager and director of quantitative strategies, who co-wrote the white paper.

"Investors need a lineup of diversified real assets that do well in periods of inflation. The diversification provides a more balanced return profile," said Anthony Ialeggio, Cohen & Steers senior vice president, director of global marketing and another co-author.

Cohen & Steers would include global REITs, commodity futures, listed infrastructure, gold and currency such as Australian dollars.

Mr. Jhirad said real assets in DC plans should be a distinct asset class alongside more traditional asset classes such as fixed income. Cohen & Steers would allocate about 80% of the real asset portfolio to commodities, natural resource equities and REITs. The remainder would include portfolio diversifiers such as gold and variable rate notes often denominated in foreign currencies.

Treasury inflation-protected securities have been included in a real asset portfolio in the past, but Mr. Jhirad said TIPS are not attractive right now because they are fully valued.