Why We Invest In Real Assets

By Josh Hile

In the past year, Laird Norton Wealth Management has increased its portfolio allocation to "real assets" in order to enhance diversification and lower risk at a time of relatively high financial asset prices. In simple terms, the value of real assets lies in their inherent physical attributes, be it an office building or a bar of gold; also, you can invest in real assets directly, as well as indirectly (by purchasing the shares of companies that own real assets, for example). In this paper, we review the benefits and the risks of five types of real assets, and how we use them in LNWM portfolios: Infrastructure; Master Limited Partnerships (MLPs) in the Energy Sector; Real Estate; Commodities; and Natural Resources.

LNWM believes real assets can be used both strategically (as long-term holdings) and opportunistically to improve investment returns. Benefits of an allocation to real assets include:

- **Portfolio Diversification:** Real assets can enhance diversification across sectors, industries, countries, and especially against financial assets such as equities and bonds. Take a look at the correlation matrix below. From 2009 through 2018, the pricing of most real assets had relatively low — and even negative — correlation to major stock and bond indexes. Real assets with the highest correlation to the US stock market (0.75 or higher, with 1 being perfect correlation) were infrastructure and energy equities.

Real Assets Can Boost Portfolio Diversification

Asset Price Correlations 2009 - 2018 (1 = 100% Correlation)

Asset	Stocks	Bonds	Comm-odities	Energy	Agri-culture	Industrial Metals	Live-stock	Precious Metals	Energy Stocks	REITs	Infra-structure	Inflation Linked Bonds	MLPs	Natural Resources
US Stocks														
US Bonds	-0.06													
Commodities	0.54	-0.03												
Energy	0.44	-0.16	0.80											
Agriculture	0.36	0.01	0.74	0.35										
Industrial Metals	0.55	-0.04	0.67	0.37	0.36									
Livestock	0.00	-0.16	0.08	0.17	-0.10	0.00								
Precious Metals	0.09	0.32	0.51	0.20	0.31	0.35	-0.10							
Energy Stocks	0.75	-0.16	0.71	0.67	0.44	0.53	0.05	0.23						
REITs	0.72	0.29	0.33	0.15	0.30	0.39	-0.10	0.09	0.46					
Infrastructure	0.80	0.23	0.58	0.45	0.40	0.52	0.00	0.22	0.66	0.72				
Inflation-Linked Bonds	0.07	0.76	0.18	0.08	0.09	0.11	-0.14	0.44	0.10	0.22	0.31			
MLPs	0.55	-0.01	0.52	0.50	0.29	0.39	0.02	0.21	0.67	0.34	0.52	0.12		
Natural Resources	0.74	-0.10	0.76	0.67	0.45	0.60	0.01	0.38	0.96	0.48	0.69	0.16	0.69	

Correlation
Less Correlated
More Correlated

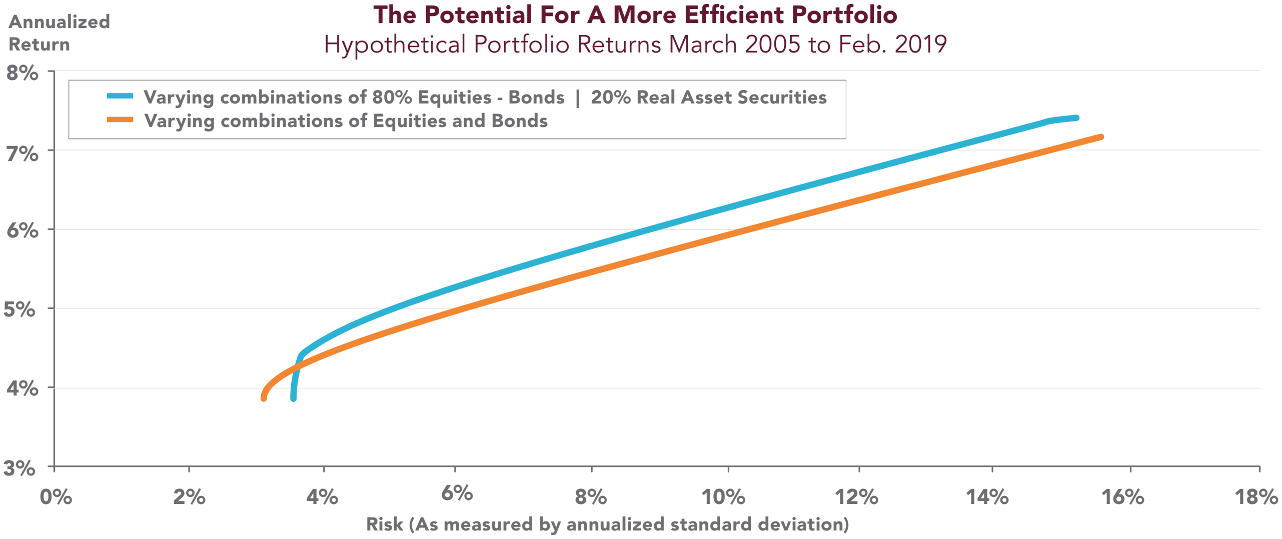
From January 1, 2009 – December 31, 2018. Daily data in US dollars. Equities = S&P 500 Total Return Index; Bonds = BB Barclays US Agg Total Return Value Unhedged USD; Commodities = S&P GSCI Total Return Index; Agriculture = S&P GSCI Agriculture Total Return Index; Livestock = S&P GSCI Livestock Total Return Index; Precious Metals = S&P GSCI Precious Metals Total Return Index; Industrial Metals = S&P GSCI Industrials Metals Total Return Index; Energy= S&P GSCI Energy Total Return Index; Energy Stocks = S&P Energy Sector Total Return Index; REITs = FTSE NAREIT All Equity Total Return Index;Infrastructure = DJ Brookfield Global Infrastructure Index Total Return; Linkers = BB Barclays Global Inflation-Linked Total Return Index Value Unhedged USD; MLPs = Alerian MLP Index; Natural Resources = S&P North America Natural Resources Sector Total Return Index.

Source of Data: Bloomberg.

- **Additional Source of Income:** Some real assets – including infrastructure, real estate and energy production – tend to pay relatively high dividends, providing an additional source of income outside of bonds and dividend-paying stocks.

- **Inflation Hedge:** Many types of real assets increase in market value and/or their earnings rise (either contractually or through regulatory allowances) as inflation increases.

- **Potentially Higher Risk-Adjusted Returns:** The relatively low price correlations that real assets have with traditional stocks and bonds can potentially lower risk and enhance risk-adjusted returns over a full market cycle. The chart below shows an efficient frontier, the combination of assets that will result in the highest return for a given level of risk. The blue line on the chart indicates that during the past 14 years, an efficiently managed portfolio consisting of three asset classes (equities/bonds/real assets) would have produced a higher return for less risk than an efficient portfolio with just stocks and bonds (represented by the orange line).



March 1, 2005 through February 1, 2019. Equities & Bonds represented by the MSCI All Country World Index and Bloomberg Barclay's (BBgBarc) Capital Global Aggregate Bond Index, respectively. Within Real Asset Securities, Real Estate Equities are represented by the FTSE EPRA/NAREIT Developed Market Index, REIT Preferreds represented by the ICE BofAML REIT Pref TR USD, Infrastructure Equities represented by the S&P Global Infrastructure NR USD, MLPs represented by the Alerian MLP Index, Real Asset High-Yield Debt represented by the real asset sectors utilizing 50/50 proxy based on BBgBarc HY Energy and Metals and Mining Indexes. Real Estate Equities & REIT Preferreds, combined are constrained to maximum 10% of the portfolio, infrastructure Equities & MLPs, combined, are constrained to maximum 10% of the portfolio. Real Asset High Yield Debt and Real Asset investment Grade Debt, combined, are constrained to maximum 5% of the portfolio. Past performance is not indicative of future results. The performance results do not represent actual trading or represent the performance of any LNWM strategy or composite. Actual trading may produce different results.

Source of Data: Bloomberg.

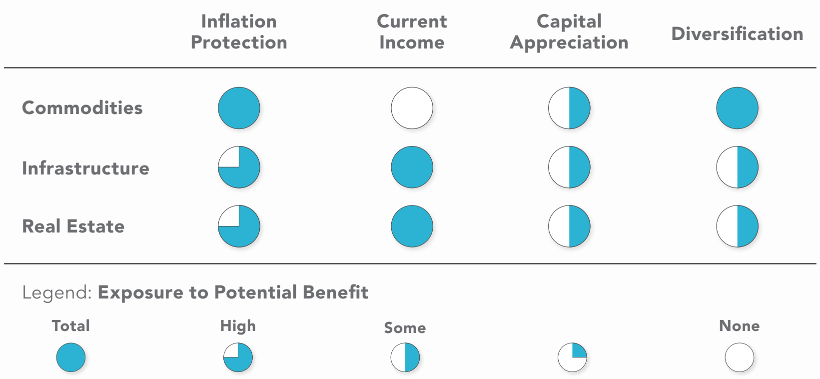
When/How we Invest in Real Assets

We currently view infrastructure as a long-term, strategic holding because it is likely to lose less value during market downturns and also acts as a hedge against inflation, should that rise. Both of these attributes should be additive to risk-adjusted portfolio returns over time. By contrast, in the other four real asset categories – Energy MLPs, Real Estate, Commodities, and Natural Resources – we take short-term, tactical positions that are likely to shift depending on the market environment and valuations. We now consider real estate slightly overvalued (even though it has been a long-term holding for us in the past), and we have some concern about how real estate will perform in the next recessionary environment.

How We Invest in Real Assets

In most cases, LNWM invests in real assets through actively managed mutual funds whose managers specialize in the sectors we're targeting. Because we sometimes take short-term positions in certain real asset classes, we especially value the liquidity offered by fund investing (ease of buying and selling), as well as the sector expertise of the managers.

Potential Benefits of Real Asset Investments



Source of Data: Bloomberg, Lazard.

In infrastructure, we currently prefer publicly traded funds for two major reasons: (1) We think valuations in the private sector are inflated, given the large influx of private capital for infrastructure projects that has yet to be invested; and (2) because of their relatively large asset base and higher liquidity, public funds have the ability to diversify across sectors/regions, hold higher-quality assets overall, and can act quickly to take advantage of pricing discrepancies or new opportunities.

A Closer Look

The following is a closer look at the merits and concerns we see in each real asset class.

INFRASTRUCTURE

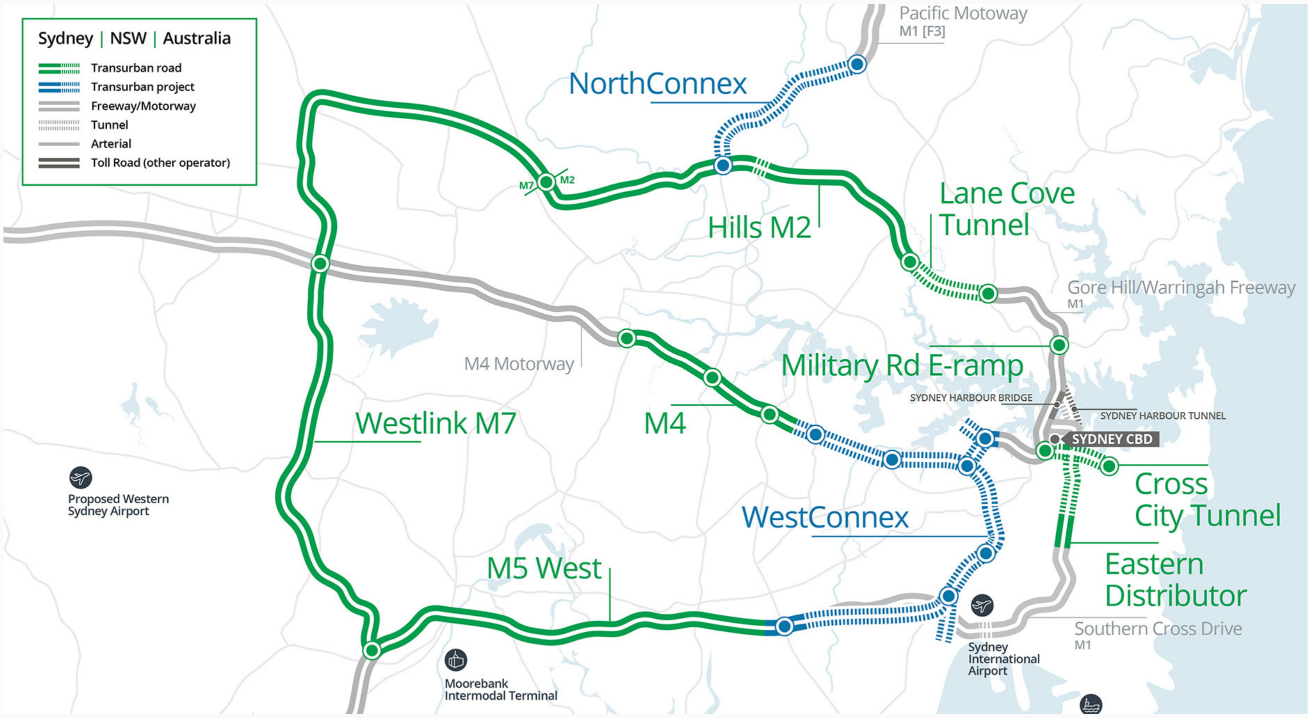
Infrastructure comprises a variety of investments that share many of these characteristics:

- Essential or necessary product or service
- Long useful lives
- Monopoly/Quasi-monopoly market position
- Operate in regulated environments and/or are less affected by economic cycles
- Lower variation in annual cash flow and earnings
- Difficult to impose price decreases given high-fixed asset costs and/or scarcity of resources (i.e. land, planning restrictions)

Infrastructure assets are typically found in the following sectors:

Energy	Water	Transport	Comms	Social
• Power generation • Transmission • Distribution • Renewables	• Water and waste water networks • Desalination plants	• Ports • Rail • Airports • Roads • Bridges • Parking	• Cable networks • Telecom lines • Towers • Satellites	• Hospitals • Prisons • Schools • Courts • Public housing

An Example: Toll Roads in Sydney Australia



Income and Growth

LNWM has invested in a diversified infrastructure fund, one of whose holdings is the stock of Transurban Group, a large multinational with interests in 15 urban toll roads, mostly in Australia. Transurban toll projects have become essential to the infrastructure of major cities such as Sydney, Melbourne and Brisbane (see blue and green lines above). The projects benefit from long-term agreements that allow yearly increases at the rate of inflation or higher, in addition to benefiting from growth in traffic over time. Given the high cost of creating new roads, these projects are quasi-monopolies and are likely to have stable earnings growth over time.

Many utilities, airports, railroads and other infrastructure assets have already been privatized in an attempt to reduce government debt levels. The companies that end up owning and/or operating the assets might have publicly traded stock, even though they continue to be regulated by the government to varying degrees. We expect the trend toward privatization to accelerate as governments around the world look to private-market participants to help build, operate and repair infrastructure, given the complexity of these projects and the significant costs involved.

We currently view infrastructure investments as attractive for these key reasons:

- **Good Fundamentals:** Infrastructure assets are finite and limited at a time of rising demand. Global economic and population growth means more need for things like cell phone towers, railroads, and energy. Additionally, the general availability of funding for major private sector investment, should it continue, will benefit such long-term, highly capital-intensive projects.

- **Fiscal Policy Tailwinds:** McKinsey Global Institute estimates that $49 trillion needs to be spent on infrastructure worldwide before 2030[1]. As countries transition from monetary to fiscal policies to stimulate their economies and increase productivity, this should translate into higher infrastructure spending.

- **Reasonable Valuations:** Publicly traded infrastructure assets appear to be reasonably priced relative to current stock and bond market valuations, and cheap compared to infrastructure pricing in the private market, where $150 billion has been raised that has yet to be invested[2]. Another positive is that recent changes to the US tax law now allow foreigners to buy US real assets more tax-efficiently.

Benefits

- **Growth Opportunity:** Most of the $49 trillion estimated in global infrastructure spending over the next decade will likely come from private markets, since governments with already stretched budgets will not have sufficient resources for massive new investment. The majority of these investments will be for essential services (i.e. power, roads, telecom, water) and therefore not as dependent on economic cycles.

- **Enhanced Income Potential:** Most infrastructure investments provide a relatively high dividend yield, given their more predictable cash flows.

- **Portfolio Diversification and Downside Protection:** The market prices of infrastructure assets have had relatively low correlation to stocks, bonds and real estate. Because infrastructure assets tend to have more stable earnings streams over time (i.e. utilities, cell phone towers, toll roads), this tends to cushion them from downside volatility.

Risks

- **Political and Regulatory:** Investments in infrastructure can be hurt by changes in how these assets are taxed and regulated. Infrastructure assets have at times been nationalized, or completely taken over by the government, which can dramatically hurt their market value. Additionally, returns may be dampened by onerous new regulations, including a lower cap on rate increases.

- **Economic Sensitivity:** Certain types of infrastructure, including toll roads and other types of transit, have attractive risk/reward characteristics, but they are not really essential services and could be vulnerable to downturns in the economy.

- **Lack of Technical/Political Know-How:** Owners and managers must be highly skilled in operating infrastructure projects, which tend to be complex and large in scope. Further, management must also be able to work successfully with local governments.

MASTER LIMITED PARTNERSHIPS (MLPS)

The majority of MLPs operating in the US are owners/operators of pipelines that transport oil and gas, and they have benefited handsomely from the tremendous rise in US oil and gas production, driven by new extraction techniques. In fact, within the past five years, the US has surpassed

Saudi Arabia as the world's largest oil producer and has become for the first time an exporter of substantial amounts of crude oil, liquified natural gas (LNG) and natural gas liquids (butane and propane).

Benefits

- **High Yields & Consistent Distributions:** MLPs usually offer high dividend yields, generally in the range of 6% to 7%. Dividends tend to be consistent over time, since they are based on longer-term contracts that lock in a price for services provided.
- **Tax Advantage:** While recent changes to the tax code have reduced the tax advantages of some MLPs, there continue to be many whose distributions are taxed only at the shareholder level, which results in an overall lower tax rate.
- **Lower Cost of Capital:** Given limited or no taxation at the corporate level, MLPs have a lower cost of capital than corporations, which allows them to initiate projects that would be unprofitable for fully taxable entities.

Risks

- **High Correlation to Energy Prices:** Many MLPs have contracts for a specific price, regardless of where energy prices are at the time. Despite this, MLP pricing tends to move in line with current energy prices, which can generate high levels of volatility at times.
- **Tax Changes:** Changes in US tax law have reduced the tax advantages of MLPs, and many have restructured as corporations.
- **Industry Consolidation:** Mergers and acquisitions among existing MLPs have significantly reduced the number of MLPs we consider to be investment-worthy.

REAL ESTATE

The least costly and fastest way to invest in real estate is through Real Estate Investment Trusts (REITs), thousands of which have cropped up during the 10-year global bull market in residential and commercial real estate.

Benefits

- **Attractive Yield:** By law, REITs must distribute 90% of their profits as dividends, which are usually paid quarterly.
- **Defensive:** REITs typically have long-term leases on the properties they manage, meaning they can ride out a certain amount of economic stress. While REIT profits would be hurt in a recession, many of them are buffered somewhat by the fact that there are penalties for breaking a lease and most people and companies prefer staying put during times of economic turmoil.
- **Inflation Hedge:** During times of rising prices, rents and property values tend to increase.

Risks

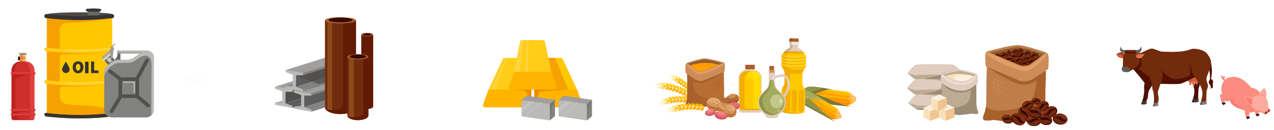
- **Interest Rate Risk:** REITs are highly sensitive to changes in interest rates, for two key reasons: 1) Rising interest rates decrease the appeal of REIT dividends, which are relatively stable; and 2) REITs tend to have significant levels of debt, which becomes more expensive to service or issue when interest rates are rising.

- **Supply/Demand Risk:** Given a strong US economy, the building of new apartment buildings and office complexes has increased dramatically. An economic slowdown could lead to reduced pricing and rent concessions.

- **Higher Correlation to Equities:** REITs, in general, have a higher correlation to equities, in that they are likely to underperform when the economy is weak (and vice versa).

Commodities

Commodities are any raw material or agricultural product that can be traded globally, usually at a set price, often in US dollars. They're usually grouped into six main categories:



Energy	Base Metals	Precious Metals	Agricultural	Softs	Live Stock
• Oil	• Aluminum	• Gold	• Corn	• Cocoa	• Cattle
• Natural Gas	• Coffer	• Silver	• Soybeans	• Coffee	• Hogs
• Byproducts	• Lead		• Soybean Meal	• Cotton	
	• Nickel		• Soybean Oil	• Sugar	
	• Zinc		• Wheat		

Benefits

- **Inflation Hedge:** As measures of inflation rise, commodity prices tend to as well.

- **Diversifier:** Commodities have had relatively low correlation with other asset classes and even with each other.

- **Value additive:** While stock market valuations are above historical averages, most commodities are priced below their long-term averages. Additionally, demand for commodities will likely trend with global population and economic growth, which we believe will be a positive for commodity prices over the long run.

Risks

- **Supply/Demand:** Commodities tend to perform poorly when global supply is expected to outstrip demand, as when there is a global economic slowdown, or there is overproduction. After nearly a decade of overbuilding in China, for example, a wide variety of commodity prices crashed several years ago as demand forecasts plummeted.

- **Price Volatility:** Commodity price swings can be severe, as traders' price in new information almost immediately.

Risks

- **Political and Economic Risk:** Commodity prices are exposed to global political and economic risks, including currency fluctuations. A stronger dollar, for example, tends to reduce demand for commodities traded in dollars. Other events that could significantly impact prices include tariffs and other types of import controls, cartel pricing such as that by OPEC, and government regulations.

- **Lack of diversification:** Most commodity funds have relatively few holdings. As such, changes in the market value of a single investment can cause great fluctuations in the fund price.

NATURAL RESOURCES

Unlike commodities, with which there is great overlap, the market value of natural resources is less standardized and can vary depending on how they are processed and marketed. Investment is usually through companies that hold, collect and/or refine specific natural resources – from trees to coal to gold.

Benefits and Risks

As with commodities, natural resource prices benefit from rising inflation and rising demand due to global economic and population growth. Natural resources can also act as a store of value and become more valuable as inflation eats into investor returns in other asset classes.

The risks are also similar to those of commodities. However, the valuations of natural resource companies depend not just on the market price of the resource being processed, but also on the ability of management to operate profitably by leveraging new technology and opening up new markets.

Summary

At LNWM, we invest in real assets to enhance portfolio diversification, reduce risk, and seek valuation discrepancies that present opportunities for above-average risk-adjusted returns, in the short run or over longer periods of time. We think of real assets as a key building block in achieving targeted risk and return in client portfolios, especially in a global market environment that could be moving into an era of lower returns.

Active vs. Passive Investing: Why We Do Both

Index funds are great but so are the right types of actively managed funds.

Find out why

Sources:

1. Bughin, Jacques, et al. *Bridging Global Infrastructure Gaps*. McKinsey & Company, June 2016, www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/bridging-global-infrastructure-gaps.

2. Howard, Hinds. "Week Thoughts: OMG! FERC TBT 4 MLPs." MLPGuy, 22 July 2018, mlpguy.com/archive/omg-ferc-tbt-4-mlps/.

ABOUT THE AUTHOR

Josh Hile is a Senior Investment Analyst within Laird Norton Wealth Management's Investment Strategy and Research Group. He is responsible for analyzing developments in global equities markets and providing recommendations to LNWM's Chief Investment Officer, as well as conducting ongoing due diligence and monitoring of equity asset managers, including mutual funds, separately managed accounts and limited partnerships. Josh is a Chartered Financial Analyst® (CFA®) and a Certified Public Accountant. He earned his MBA at the University of Washington.

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801 Second Avenue, Suite 1600, Seattle WA 98104   206.464.5100   800.426.5105   lairdnortonwm.com

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