

How real assets can help investment portfolios weather inflation

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As higher inflation rears its head once more and potentially threatens to stick around for a while, the risks to investors are widespread.

During times of rising inflation, businesses face higher costs and borrowing rates, affecting their stocks in the process, while conventional bonds lose purchasing power as their fixed payments are worth less.

That's driving many advisors and their clients to consider other asset classes in the search for diversification, portfolio protection, long-term growth and yield. Real assets are one, comprising sectors such as real estate, utilities, infrastructure and resources.

Part of real assets' appeal stems from the fact that they're less correlated to financial markets. Many real assets include critical services with fees that are often tied to inflation. For example, toll road contracts typically contain elevator clauses that are pegged to the Consumer Price Index. And electricity transmission contains built-in (and usually) inflation-linked charges to customers in the form of hydro bills.

That ensures a smooth, inflation-adjusted income stream. These cash flows give investors a way to diversify beyond corporate earnings growth and fixed interest payments.

Publicly traded securities and private funds offering exposure to real assets have multiplied in recent years, providing different routes into assets that once sat largely within institutional portfolios.

"Clients now have access to what before was just [for] pension funds," says Darius Muica, portfolio manager and advisor with Lakeview Wealth Management at Wellington-Altus Private Wealth Inc. in Burlington, Ont.

Advisors and investors can also obtain exposure through investment trusts and infrastructure ETFs.

The challenge is to select exposures that respond differently to market and economic conditions, while fitting an investor's needs for income, growth and liquidity.

Theresa Shutt, chief investment officer at Harbourfront Wealth Management Inc. in Toronto, says infrastructure can draw its value for clients from the durability of its cash flows. A toll road, airport or pipeline may earn revenue through long-term agreements, with high barriers to competing assets being built.

The diversification benefits depend on the investment, but infrastructure has long provided predictable contractual payments that offer a different exposure compared to profits tied to either cyclical or growth stocks.

Many Canadian clients believe they already own "real assets" such as their home and resources stocks, Mr. Muica says. "What [many Canadian investors] do not have is contracted and regulated infrastructure, which resides largely outside of Canada."

He treats real assets as an allocation drawn from the existing stock-and-bond mix, with both sides of the portfolio funding a third, long-oriented sleeve dedicated to international infrastructure and other real assets. For all but longtime retirees, he recommends reinvesting income from that sleeve. "It's not a bond replacement."

Public vehicles offer readily tradable access, but their prices remain exposed to day-to-day volatility and market sentiment. Private funds provide access to assets without daily exchange trading, but come with provisions around redemption limits and other capital requirements.

Ms. Shutt favours a blend of public and private exposure. She also looks for diversification within asset classes, noting that some private offerings concentrate on a sub-asset class or a small geographic area.

Inflation protection is one of the clearest potential benefits of owning real assets, particularly alongside bonds, for which payments remain fixed. Ms. Shutt looks for infrastructure agreements that link charges to inflation. Where those provisions exist, rising prices can translate into higher revenue, helping preserve the purchasing power of the investment's income.

Allocators should be attuned to those agreements in the investment, she says. "Not every infrastructure asset has inflation protection."

Real estate provides another route, although the inflation adjustment can lag. Rents may increase as leases renew, subject to market conditions.

Ms. Shutt and Mr. Muica both see long-term and potentially substantial opportunities in electrification and digital infrastructure. Power generation and data centres can connect portfolios to expanding demand for compute, electricity capacity and power demand. That adds a growth dimension to the sleeve alongside income.

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