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When Energy Won't Cut It: Inflation Protection and Diversification

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If there ever were an asset class that could make the world of indexing feel more tangible, it would be real assets. Many investors agree that what makes these assets "real" is intrinsic value resulting from their physical properties (think gold, buildings, and bridges). However, other popular views more strongly associate real assets with their "real return," often linked to inflation.

When the S&P Real Assets Index launched in 2015, S&P Dow Jones Indices became the first index provider to define real assets around the world as property, natural resource and infrastructure securities, commodities futures, and inflation-linked bonds.

Historically, investors seeking inflation protection flocked to a subset of real assets—natural resources. But given the relatively weak performance of natural resources (due to energy price declines), many investors are now looking to diversify the inflation-sensitive portion of their portfolios. The broader category of real assets has attracted interest, given its previously documented capacity to protect against inflation and enhance returns when added to a mix of U.S. stocks and bonds. But do these attributes apply around the world, and if so, which real assets in particular have the greatest inflation-protecting, diversifying characteristics? Is using one subset of real assets enough?

To figure that out, we looked at three metrics: inflation beta, excess returns, and diversification. Inflation beta measures sensitivity to inflation increases; the higher the inflation beta, the greater the sensitivity and potential to protect against inflation. Rounding out our perspective on inflation, excess returns essentially equate to the magnitude of inflation protection. To understand the diversification that real assets provide in each country or region, we considered the Sharpe ratios of portfolios composed of real assets and locally relevant stock and bond markets.

We discovered a wide dispersion of inflation betas across the countries we looked at, confirming that—much like financial assets—real assets respond differently to inflation in different parts of the world. But we can still draw some conclusions that apply broadly. While the natural resources sector is most sensitive to inflation globally and inflation-linked bonds also provide some extra inflation protection, the excess return over inflation for each of these real asset sectors is relatively weak.

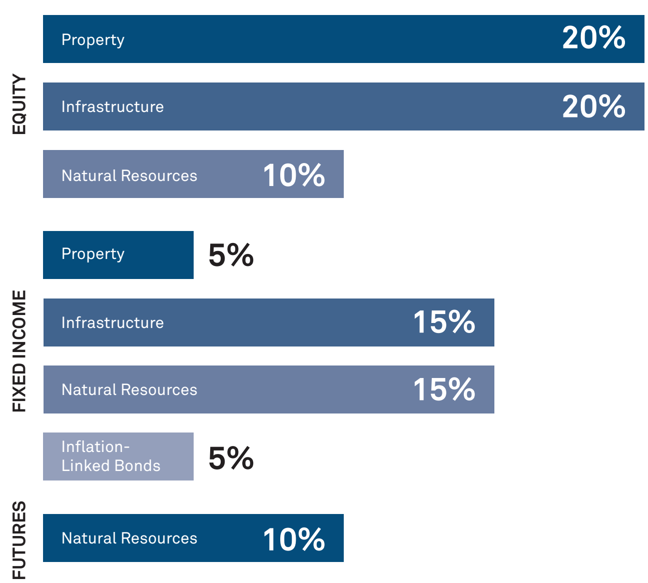
On the other hand, while infrastructure and property have been shown to improve risk-adjusted returns in most markets around the world, they lack the inflation protection power required to satisfy the risk management needs of today.

The bottom line? As previously demonstrated in the U.S., the S&P Real Assets Index may provide inflation protection and enhance diversification around the world by combining not just the equities of property, infrastructure, and natural resources, but also fixed income, inflation-linked bonds, and commodity futures. It seems that, generally speaking, when it comes to real asset investing, more is more.

The Environment We're In

In recent years, inflation levels have remained fairly low across most countries compared with their long-term average (with the exception of Brazil). In fact, Japan has had little or negative inflation. But current low inflation levels may provide a false sense of security and render some investors unprepared for potential surprise increases. In many cases, even a mild increase in inflation can meaningfully erode the purchasing power of wealth and a portfolio's value. Knowing this, it's important to compare the effectiveness of different types of real asset investments to determine their ability to protect in case of an uptick in inflation levels.

S&P REAL ASSET ASSETS INDEX COMPONENTS AND WEIGHTS



Source: S&P Dow Jones Indices LLC. Chart is for illustrative purposes. Index target weights are rebalanced to these percentages every April and October.

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Past performance of the Index is not an indication of future results. Prospective application of the methodology used to construct the Index may not result in performance commensurate with the back-test returns shown. The back-test period does not necessarily correspond to the entire available history of the Index. Please refer to the methodology paper for the Index, available at www.spdji.com for more details about the index, including the manner in which it is rebalanced, the timing of such rebalancing, criteria for additions and deletions, as well as all index calculations.

Another limitation of using back-tested information is that the back-tested calculation is generally prepared with the benefit of hindsight. Back-tested information reflects the application of the index methodology and selection of index constituents in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities (or fixed income, or commodities) markets in general which cannot be, and have not been accounted for in the preparation of the index information set forth, all of which can affect actual performance.

Additionally, it is not possible to invest directly in an Index. The Index returns shown do not represent the results of actual trading of investable assets/securities. S&P Dow Jones Indices maintains the Index and calculates the Index levels and performance shown or discussed, but does not manage actual assets. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the Index or investment funds that are intended to track the performance of the Index. The imposition of these fees and charges would cause actual and back-tested performance of the securities/fund to be lower than the Index performance shown. For example, if an index returned 10% on a US $100,000 investment for a 12-month period (or US$ 10,000) and an actual asset-based fee of 1.5% was imposed at the end of the period on the investment plus accrued interest (or US$ 1,650), the net return would be 8.35% (or US$ 8,350) for the year. Over a three-year period, an annual 1.5% fee taken at year end with an assumed 10% return per year would result in a cumulative gross return of 33.10%, a total fee of US$ 5,375, and a cumulative net return of 27.2% (or US$ 27,200).