Introduction

Real asset

A physical asset with an intrinsic value.

A popular source of investment for institutional investors who are looking to achieve inflationary growth and steady sources of long term income, whilst also diversifying away from traditional return drivers.

Real assets are anything where there is a tangible/physical asset being traded. Typically these are private market assets which yield long-term income that may be linked to inflation. For a portfolio, real assets bring diversification from the traditional asset classes and will often benefit from an illiquidity premium.

The most common real asset class held by pension schemes is property, with two main types of fund being balanced and long lease property (LLP). Balanced property funds invest in a diversified range of UK commercial real estate. Long lease property funds also invest in commercial property, but focus on longer lease lengths (which may be up to 25 years) and inflation linked income. Both offer low correlation to fixed income and equity markets.

These funds have dominated the landscape of the real assets universe and with recent market volatility and inflationary pressures, the demand has grown and more funds have been created to access this market. The effect for investors is that typical queues have lengthened and in some cases it can take 2 years or more to invest capital. Other sub-asset classes have, in comparison, been underutilised. This paper introduces four sub-asset classes and provides our view on the opportunities available.

Infrastructure equity

Historically, many infrastructure projects have been funded by governments globally, however, ageing infrastructure and decades of underinvestment have led to an increasing need for infrastructure. Governments are not in a position to provide all of the required capital, needing private investors to bridge the funding gap. If investors are comfortable with the inherent illiquidity, we believe that infrastructure offers a good opportunity for accessing long term, real income streams.

Private rented sector (PRS)

Supply shortages, stamp duty changes and low interest rates have supported steady increases in the UK property market over a number of years, making it more difficult for first time buyers to get onto the property ladder. As a result long-term renting is becoming increasingly commonplace in the UK’s major cities. PRS looks to cater to this need with purpose built, professionally managed residential developments designed to take the advantage of economies of scale. We think that the sector has strong characteristics which might fit with an investor’s needs.

Timberland

The biological aspect of Timberland investments makes the asset class resilient in economic downturns and provides a true diversifying factor. Timberland funds buy and manage forestland with the aim of producing a return by maximising harvest yields, and selling the timber to the construction and paper/soft goods industries. While the investment characteristics of Timberland are developing, existing fund structures are the biggest hurdle for many investors.

Global real estate secondaries (GRES)

Following the global financial crisis, distressed sellers provided opportunities for GRES funds to purchase assets at significant discounts. Whilst funds have delivered strong returns on the back of these strategies, they are now needing to evolve to operate in a more stable economic environment. Investors will need to re-assess whether expected returns will meet their objectives.
Infrastructure equity

Infrastructure assets are broadly defined as assets required for economic and social development. Traditionally, financing has been provided via public spending and still is to varying degrees in countries around the world.

Since the Global Financial Crisis, private money has increasingly become an alternative source of capital for infrastructure projects, creating opportunities for institutional investors to earn contractual returns from assets with often unique cashflow profiles.

Investment strategy
There are a variety of available pooled funds taking a global, regional or sector specific investment approach. Due to the scale and/or location of projects, barriers to entry such as government approval/regulation reduce competition for assets and hence increase the yield. Strategies that we favour seek contracted assets due to political and regulatory risk, thus reducing reliance on current regulation or subsidies granted.

Investments can be designated brownfield or greenfield. The former are assets already operating and generating cashflow whilst the latter are assets still in the development stage. Funds with high allocations to greenfield assets face additional development risk but expect to be compensated for this with a return premium.

Fund structure
For the majority of institutional investors the most suitable vehicle to invest in infrastructure equity is through a pooled fund.

Closed ended funds will not create shares for new investors and so interests can be purchased on the secondary market. These funds tend to have lives of ten years or so meaning managers will be purchasing and disposing of underlying assets throughout the fund’s life cycle. As such, transactions will heavily influence performance and it is crucial managers possess the skill to price such illiquid assets.

Open ended funds will typically operate for 20-30 years and invest across the complete life of the underlying assets. Cashflows are therefore more predictable and more suited to match the liability profile of many pension schemes.
Risk return profile

Pension schemes and other long term investors are well placed to capture the resulting illiquidity premium factored into infrastructure returns. Additionally, as asset cashflows are often linked to inflation, pension schemes are able to benefit from a degree of hedging of their inflation linked liabilities.

The essential nature of most infrastructure assets implies demand and performance should be relatively stable across all economic cycles. Nevertheless, returns can vary markedly from debt to equity financing.

Debt ensures asset cashflows are more certain although equity signifies ownership of the underlying assets allowing for greater asset control and the potential for asset management initiatives to add significant value. As an equity holder within a leveraged fund, the potential for additional upside exists but any returns will be diluted by cashflows to creditors.

Investors in infrastructure must be aware of certain risks less common to other real assets. Due to the high level of due diligence required for each underlying investment, funds typically choose to invest across fewer assets and are hence less diversified than traditional real estate funds.

KPMG’s Investment Advisory team view

Infrastructure investment will always be a foundation for economic growth and with sovereign debt passing levels previously considered unsustainable, governments will likely become increasingly keen to facilitate private investment from institutional investors. We favour investing in the equity capital on the basis of a strong risk-adjusted return in the current environment. For pension schemes, the liability matching benefit from investing with a long life open ended pooled fund would be more attractive than shorter life closed ended funds and could provide a suitable alternative to a Balanced or LLP allocation.

Expected return

- Low: Low
- High: High
- Gilts: +4.6%

Expected volatility

- Low: Low
- High: High
- c. 12% p.a.

Income yield

- Low: Low
- High: High
- c. 5% p.a.

Shape of outcomes

- 0%: Low
- 100%: High
- Similar to contractual

Inflation-linked income

- Low: Low
- High: High
- Moderate

Fees

- Low: Low
- High: High
- c. 0.5% annual fees

Past performance cannot be relied upon as a guide to the future.
Private Rented Sector (PRS) investments may range from urban regeneration to private student accommodation. Opportunities are opening up to institutional investors as more asset managers provide an access route through PRS funds.

The opportunities are driven by a mixture of the supply and demand imbalance of housing in the UK (with demand far outweighing supply); and increasing house prices, resulting in historically low levels of home ownership. This is contributing to a cultural shift in the 20-35 age bracket towards apartment style living.

**Investment strategy**

PRS funds invest in residential property looking to cater to increased demand for long-term rental properties. These are purpose built, professionally managed residential developments designed to take advantage of economies of scale.

The overall aim is to reduce vacancy rates thereby maximising the rental yield. Longer and more flexible tenancy contracts contribute to this.

Typically, investments are brownfield sites, where full planning permission and relevant legal and regulatory permissions have been granted. Investors seeking an Environmental, Social and Governance (ESG) focus may be attracted to this asset class, where asset managers incorporate these considerations into their process. For example, where energy saving initiatives are taken into consideration.

A PRS fund may outsource the property management activities to a third party. These are actively managed to maximise Net Operating Income (NOI).

**Fund structure**

A number of asset management firms are now capitalising on this opportunity in PRS and have formed pooled investment vehicles structured as Property Unit Trusts (PUTs), similar to the fund structures of Balanced and Long Lease Property. The advantage of PUTs is that, when closed ended, they provide an illiquidity premium to compensate for the long term nature of the investments.

Compared to directly owning real estate, PUTs can provide tax benefits for pension schemes and family offices. Funds are typically closed ended during the development phase, but may become open ended during the operating phase.
Private rented sector (PRS) continued

Risk-return profile
Typical funds in this space may target annual total returns of 7-9%. These types of investments are suitable to investors looking for stable sources of long term contractual income. The rental component of income may also have a degree of inflation linkage as some tenancy contracts are periodically renewed with an inflation uplift.

Analysis suggests that the residential property market has low correlations to traditional asset classes such as equities and also Balanced/LLP. This implies that PRS could be a strong diversifier within a portfolio with income driving total return.

PRS funds share some similarity in risk characteristics to traditional Balanced and LLP funds, but due to the residential aspect, there is additional exposure to factors such as house prices and interest rates.

KPMG’s Investment Advisory team view
Investors looking for contractual income and/or receiving an illiquidity premium for their investment would be suited to PRS. Additionally, the inflation linkage of income streams may be attractive to a pension scheme looking to hedge movements in their liabilities. The opportunity for strong risk-adjusted returns along with low correlation to other asset classes means that a small allocation (c.5%) could be considered within a portfolio. Given the relatively new market, PRS is an attractive proposition to keep an eye on.

<table>
<thead>
<tr>
<th>Expected return</th>
<th>Low</th>
<th>High</th>
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<tbody>
<tr>
<td>Expected volatility</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Income yield</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Shape of outcomes</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Inflation-linked income</td>
<td>0% Contractual</td>
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<td>Fees</td>
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<td>High</td>
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Timberland funds buy and manage forestland with the aim of producing a return by maximising harvest yields, and selling the timber to the construction and paper/soft goods industries. At the end of the fund’s life, the land may be sold.

This particular type of real asset is prominent in the US, South America and Australia. It became particularly popular after legislation was passed in the USA in 1974 to encourage pension schemes to diversify their portfolios away from traditional fixed income and equity securities.

**Investment strategy**

Timber Investment Management Organisations (TIMOs) primarily aim to invest in assets that have a high productive capacity of the land and seek opportunities where land use can be optimised. Given the active nature of these funds, specialised agricultural professionals are employed in harvest operations and forest management to maximise the yield on the investment.

There is also a focus on sustainable investing, an attractive feature given the increasing awareness of ESG investing, as TIMOs take advantage of sustainable forest management initiatives such as the UN Reducing Emissions from Deforestation and Degradation Scheme (REDD) which provide subsidies in order to preserve habitats and forestry and prevents deforestation.

**Fund structure**

TIMOs are specialised entities which are set up with the sole purpose of investing in timberland on behalf of institutional clients, such as pension schemes, insurance companies and university endowment funds. Timberland had been historically owned by private forestry companies, however, these assets were sold off to TIMOs, which in turn gave rise to the prominence of this fund structure.

TIMOs can be accessed primarily via closed ended funds, with some open ended and listed vehicles available.

Closed-end pooled funds typically require minimum investments of £5m and have long-term lock-ups. These funds are therefore more suitable for investors with assets in excess of £100m.
Timberland continued

Risk return profile

Timberland investments are expected to provide a steady stream of returns with low correlation to traditional asset classes and low volatility, but positive correlation with inflation. This feature allows the investment to add diversification to a portfolio and provide a potential hedge against inflation. Typical funds in this space typically achieve a net Internal Rate of Return (IRR) of 8-10% p.a.

Timberland returns are unique in the sense that there are three key drivers to returns: timber value (c.30% returns); land value (c.10% returns); and biological growth (c.60% returns).

Timber and land value are subject to capital appreciation, much like an investment in the balanced/LLP space and bear the bulk of the systematic risk. The biological aspect of Timberland Investments is what makes the asset class resilient in economic downturns and provides the true diversifying factor.

When the timber price is unfavourable, a TIMO may strategically withhold harvesting it, commonly known as storing it “on the stump.” The timber, however, will continue to yield value over time, and then may be harvested when timber prices change favourably. This means that TIMOs can smooth returns over time, a factor in the lower volatility seen in this asset class. Asset valuations are sporadic and are based on appraisals of the land and timber. These can often be subjective, introducing an element of uncertainty of the intrinsic value of this investment.

Returns are exposed to price risk of the trees on the land, not to mention the risk of a natural disaster, such as fire or disease, that could potentially damage the crops and the land. There is market risk on the supply and demand balance, where the price may be affected by the output of the construction industry of major economies such as the US or China.

KPMG’s Investment Advisory team view

Timberland can provide two main benefits to a portfolio; diversification and an inflation hedge. These funds are more suited to investors with a long-term investment horizon and, given the active governance around this asset class, it would be more suitable for larger investors. The market for these types of funds is evolving and as a consequence, there is improving accessibility for UK investors. A small allocation to Timberland investments could provide a steady stream of returns with low volatility and low correlation to traditional asset classes such as fixed income and equities, however at present, fees, long lock-in and currency exposure are limiting factors.

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<thead>
<tr>
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<th>High</th>
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<tr>
<td></td>
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<td>Low</td>
<td>High</td>
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<tr>
<td></td>
<td>Income yield</td>
<td>Low</td>
<td>High</td>
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<tr>
<td></td>
<td>Shape of outcomes</td>
<td>0% Contractual</td>
<td>100% Contractual</td>
</tr>
<tr>
<td></td>
<td>Inflation-linked income</td>
<td>Low</td>
<td>High</td>
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<tr>
<td></td>
<td>Fees</td>
<td>Low</td>
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Global real estate secondaries (GRES)

GRES funds emerged during the distressed selling environment and global market volatility post the global financial crisis. The asset class has since been a means for institutional investors to access high returns through real asset exposure.

In the less volatile market environment of recent years GRES strategies have had to evolve, with the disappearance of discounts once experienced.

Investment strategy
Traditional GRES managers tend to incorporate a mix of strategies. They identify and acquire existing property fund units selling at discounts to their net asset value on the secondary market, and also directly invest or co-invest in large, usually completed property developments.

Regardless of the strategy mix, most Funds are based in the US and adopt a global outlook – achieving diverse geographic exposure with their underlying assets.

Looking at deals on the secondary property market in the UK, it becomes clear that pricing is no longer driven by distressed sellers. Instead, pricing for fund units is often at a premium to net asset value suggesting GRES managers should be struggling to source attractive deals.

There is a resulting sentiment that the best time to invest in GRES was post global financial crisis and the market opportunity is now less obvious. However, managers will point to current factors which drive supply to outweigh demand and create opportunities for relative value deals for example through ‘tail-end solutions’; where assets in maturing vehicles are bought by GRES funds to provide time and capital for redevelopment or repositioning.

Fund structure
The global market for GRES funds is concentrated with the largest closings reaching near to £2bn. Funds are typically structured much like those in the private equity space with the investor as a limited partner facing a notably long lock in period of up to 10 years as committed capital is drawn down.

Governance requirements are potentially much higher compared to balanced or long lease property funds. Not only do investors have to manage drawdowns and redemptions but the variety of sources of returns and the use of the secondary market requires more time and effort to fully understand the associated risks of GRES funds.

Sourcing and striking deals is crucial to performance and so managers must be backed by global research teams assessing, often sparse, secondary deals. High quality, experienced deal makers should be supported by in house lawyers and other advisors to push through deals. Comprehensive due diligence is vital to ensure GRES funds have the appropriate team in place to drive performance.
Global real estate secondaries (GRES) continued

Risk return profile

Given the ranging mix of strategies GRES managers pursue, risk return profiles also vary. Nevertheless, all funds are expected to deliver markedly higher returns when compared to balanced or LLP funds.

Returns are often accessible early as purchasing units of established property funds will provide an immediate source of operating income for young GRES funds. Moreover, by-passing the particularly risky property development phase will help to reduce risk across the fund’s life.

While absolute volatility is high, with returns going negative at times, GRES funds can add diversification across managers and ownership structures unlike traditional property funds. Since relative value deals are typically driven by market distress and volatility, GRES markets often weather downturns well and are able to smooth performance across the economic cycle.

KPMG’s Investment Advisory team view

Despite being backed by real assets, GRES funds hold more similar risk, return and governance characteristics to private equity and lock-up credit funds. As such, investors should not consider GRES as a direct alternative to balanced or LLP funds but for allocations to higher return seeking mandates. GRES strategies have evolved since the period directly following the global financial crisis and the more common ‘tail-end solutions’ strategies of recent times are unlikely to achieve the double digit returns previously experienced by this asset class. The investment case for GRES will always be weaker when global economic conditions are strong, and so in the current environment, investors will need to carefully assess expected returns against their objectives.

Expected return

<table>
<thead>
<tr>
<th></th>
<th>Low</th>
<th>High</th>
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<tbody>
<tr>
<td>Gilts</td>
<td>+6.0%</td>
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<tr>
<td>Expected volatility</td>
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<tr>
<td>Low</td>
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<tr>
<td>High</td>
<td>c. 30% p.a.</td>
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<tr>
<td>Income yield</td>
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<tr>
<td>Low</td>
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<tr>
<td>High</td>
<td>c. 2% p.a.</td>
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<tr>
<td>Shape of outcomes</td>
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<td>Low</td>
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<tr>
<td>High</td>
<td>0%</td>
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<tr>
<td>Inflation-linked income</td>
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<tr>
<td>Low</td>
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<tr>
<td>High</td>
<td>100%</td>
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<tr>
<td>Fees</td>
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<tr>
<td>Low</td>
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<tr>
<td>High</td>
<td>c. 1.0% annual fees with 10-15% p.a. performance fee with 8% hurdle</td>
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</tbody>
</table>

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Conclusion

So there are a variety of potential real asset allocations to be made, but why now?

An increasing number of good alternative opportunities are coming to market.

With potentially shorter queues, these ideas could provide a superior speed of capital commitment, granting investors quicker access to higher yielding asset classes, and a number of further benefits – notwithstanding the risks presented in this paper.

The table below sets out the role of these real asset classes in a strategic allocation.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Benefits?</th>
<th>Drawbacks?</th>
<th>Why now?</th>
</tr>
</thead>
</table>
| Infrastructure | • Illiquidity premium  
• Inflation-linked cashflows  
• Unique opportunities (location and type of asset) | • Lower diversification across sectors  
• Transactional risk heavily influencing performance of closed ended funds | • Government encouraging private infrastructure equity investment  
• Funds now exist with reasonable track records  
• National demand for infrastructure improvements |
| PRS | • Stable source of long-term contractual income  
• Inflation linkage with annual rental uplifts  
• Low correlation to equities and Balanced/LLP funds | • Exposure to factors such as house prices, interest rates, and planning risk  
• New market and so limited track records | • Lower queues – speed of commitment  
• Similar risk/return profile to a balanced/LLP allocation  
• UK shift in urban areas to ‘apartment style living’ |
| Timberland | • Resilient in economic downturns  
• Low correlation to traditional asset classes  
• Positive correlation with inflation | | • Increasing availability of vehicle to invest in (TIMOs)  
• Low volatility  
• Provides an ESG focus to a portfolio |
| GRES | • Returns in excess of other real asset classes  
• Investment after the riskier property development phase  
• Likely outperformance in an economic downturn | • Sourcing and striking deals is crucial to performance  
• High volatility | • Maintained strong performance even in an economic upturn  
• Relative value deals available as investors seek to exit real asset investments on the secondary market  
• Range of choice in manager strategy and risk profile |
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