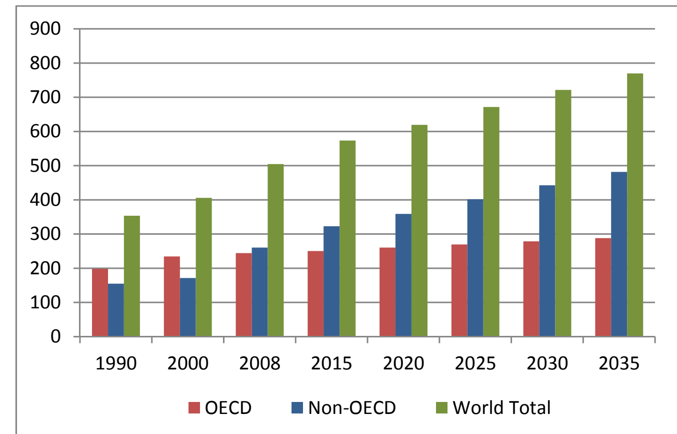
Real Assets' Down-to-Earth Appeal: Supply, Demand, Inflation

The world is using up its natural resources at an alarming rate, and this has caused a permanent shift in their value.

– Jeremy Grantham, GMO letter, April 2011

Getting Real. Jeremy Grantham, co-founder and Chief Investment Strategist of GMO in Boston, did not build his reputation as a successful investor by believing that "this time is different." Indeed, he has long relied heavily on the principles of value investing and has repeatedly demonstrated his core belief in the mean-reversionary traits of financial instruments to generate attractive returns for his clients. Thus, his suggestion that this time is indeed different struck us as remarkably bold. Of course, Grantham isn't the first to highlight the inevitable decline in the Earth's supply of natural resources; indeed, many critics of "peak anything" point to a long line of Chicken Littles who have predicted the end of the coal, oil, and other eras. The recent boom in unconventional oil and gas production in North America, for example, coupled with recent large offshore discoveries in the Gulf of Mexico and off the coast of Brazil, appear to support their argument that we have plenty of supply to go around. And to an extent, they are correct. It looks like fossil fuels will be around for the next 100 years. The critical question is, at what price? As we write, the price of a barrel of crude oil is about $85 on futures markets. Natural gas, at least here in the US, remains well under $4 per million BTUs. Are those prices sufficient for producers to supply global demand in coming decades? We believe the answer is no. Increasing demand for energy, indeed all natural resources, coupled with the increasing scarcity of these resources and the exponentially higher cost to find and extract them, will likely force commodity prices upward over the coming years and decades. In our view, those price increases are likely to be dramatic. While short-term demand will always be volatile, it is our belief that long-term trends will continue to put upward pressure on prices. As the charts indicate, current energy consumption is dominated by carbon-based supplies. Moreover, as global demand increases in coming decades, most strategists agree that it will continue to be met primarily by traditional sources of energy, even as alternative sources grow. There is no doubt that alternative energy – be it nuclear, solar, wind, geothermal, or biomass – will play an increasingly important role in the long-term energy puzzle.

World Energy Consumption, 1990-2035
(quadrillion Btu)



Source: US Energy Information Administration, International Energy Outlook 2011. The 34 OECD nations are US, Canada, Developed Europe, Developed Asia, Chile, Czech Republic, Estonia, Hungary, Iceland, Ireland, Israel, Mexico, Poland, Slovak Republic, Slovenia, and Turkey.

Nevertheless, our conclusion is that natural resources in the ground, and the equipment and services needed to extract them, remain fertile investment territory.

Shifting Ground. Whether by design or coincidence, exactly one year after Grantham's essay, J.P. Morgan published a research paper citing a "tectonic shift" in institutional asset allocation to a higher "structural" – read long-term – allocation to real assets. The piece concluded that those investors who implement this shift in their own portfolios are likely to enjoy higher returns than those who don't. They suggested that over the next decade, 25% portfolio allocations to real assets could become commonplace. The rationale is three-fold: the attractive yields available in real assets, the potential for equity-like appreciation, and the potential for hedging unanticipated inflation. That was certainly the message TIFF Members heard at our annual Investment Forum on October 3 in Philadelphia. Keynote interviewee Jane Mendillo, CEO of Harvard Management Company (HMC), stated that the most attractive areas of investment for Harvard were real estate and natural resources. In particular, Mendillo noted the alpha-generation potential of opportunistic, operator-driven investment models employed by sector specialists within the increasingly broad and capital intensive real assets sector. As a result, Mendillo argued, HMC can realize more attractive returns in real assets than it can with the low yields offered by most traditional financial instruments. Harvard has long been a savvy,

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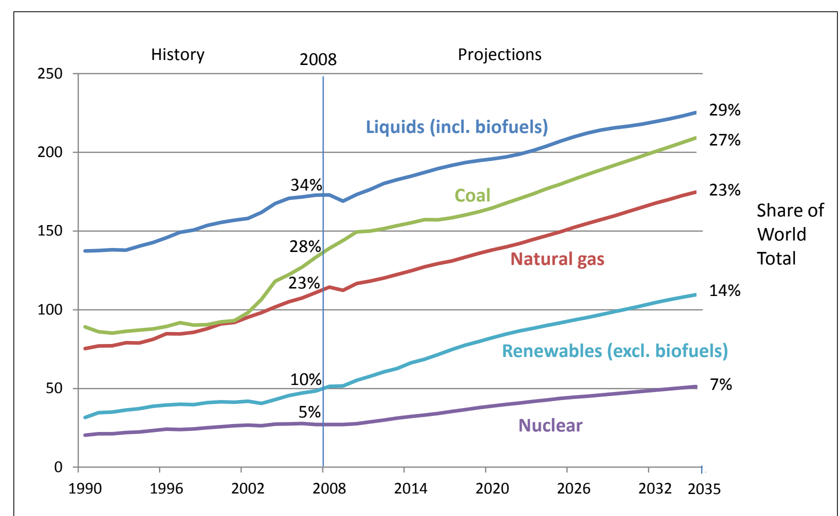
opportunistic resources investor, so its embrace of real asset strategies is not surprising. But the market is clearly responding to institutional investors' desire for more "in the ground" assets. Global generalist fund managers such as KKR, Blackstone, and Goldman Sachs have all raised multi-billion-dollar natural resources private equity funds recently. Indeed, it's the strong flow of private equity capital that is funding much of the nascent drilling activity across North America, especially in unconventional shale plays.[1] That fact alone should give us pause. Too much capital is the death knell of any investment strategy. The funds identified above, and other mega-generalist funds, are whale hunters – always looking for the big deal to make an immediate impact and gain significant market share. To the extent that these big funds drive up pricing in the sector, opportunities to put capital to work at attractive valuations could be compromised. We are currently not concerned about a pricing bubble, but certain sectors (land acreage prices around shale gas plays, for example) have seen some eyebrow-raising transaction prices of late. We'll continue to watch carefully.

What Have You Done for Me Lately? The context for all this fuss about real assets is worth examining. Real yields in conventional fixed income are distressingly low and projected to remain so for the foreseeable future. And global equities remain fickle; until some major global economic and political issues are resolved, it is unlikely that this dynamic will change. We believe that these capital market conditions make it incredibly difficult, if not impossible, to generate 5% real returns from traditional investments. And we fear that structural issues will persist regardless of who occupies the White House. More importantly, however, are concerns over rising inflation. After a prolonged period of historically low interest rates amid sluggish GDP growth, inflation is on everyone's mind. Real asset returns have historically shown positive correlation during periods of rising unanticipated inflation. Of course, the issues and causes surrounding inflation are inherently complex, as are the ways in which different sectors respond to it. For example, real estate behaves differently from commodities. We don't have the space here for an extended analysis, but suffice it to say that there are no guaranteed inflation hedges. In general, however, real assets have been solid performers when inflation has reared its ugly head, most recently during the 1970s and early 1980s. The question is whether these assets will continue to provide meaningful portfolio protection in the future. In our view, it is essential when battling inflation via real assets to carefully manage the cost structure to ensure that costs come in at the low end of the spectrum. Whether it is a commodity extracted from the earth or an office suite in downtown Washington, the owner's ability to offer a product at a competitive price will provide a significant margin of safety and better allow the asset to generate inflation-beating returns, especially when costs are escalating. That means disciplined buying and selling -- and knowing when the time is right to strike on both counts. Having such disciplined underlying managers is critical.

World Energy Consumption by Fuel, 1990-2035
(quadrillion Btu)



Source: US Energy Information Administration, International Energy Outlook 2011.

Realty Reality. To us, the real assets landscape looks most promising in the various resources sectors, and we'll drill down into that topic further. But we don't want to imply that realty – or agricultural land and water resources, for that matter -- are off our radar. The realty sector remains challenging and fragile, and finding truly skilled managers that we think can navigate these

[1] *Guess Who's Fueling the Fracking Boom?*; Forbes; Oct. 22, 2012.

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treacherous waters is not easy. We remain focused on turnaround situations. The key is to install an appropriate capital structure based on reasonable underwriting, then roll up sleeves and work the devil out of the real estate. Currently, generating alpha in realty is all about adding value at the property level.

Drilling Down. While we see the resources segment of real assets as holding meatier opportunities than realty, we still favor a targeted approach within the resources area. The debate over the contours of a commodity "supercycle" continues to rage. Five years ago, it was a given that commodities were entering a boom period; today, it is not so clear where the market is headed. China's growth is slowing; growth in Europe and the US is hovering within range of mild recession to anemic expansion; global economic stagnation seems to lurk around every corner. Even so, global demand for natural resources like hydrocarbons, petrochemicals, metals, minerals, land, agricultural products, and of course water will increase in the decades ahead, in the view of many experts. Moreover, it will take years, massive capital investment, and deep expertise to supply that demand. As more and more countries strive to resemble the West, their use of resources will intensify. Thus, we like raw materials in the ground, and we seek to own them via managers in the upstream sector that have demonstrated an ability to add value through the drill bit. We will continue to seek out exposure to skilled management teams that are able to identify promising reserves and bring technical skill and operating expertise to bear in order to generate production at the low end of the cost curve. Similarly, the mining sector is beginning to appreciate the value that private investment can bring to junior mining companies and their early-stage development projects.

Selling Picks and Shovels. Cliché or not, there's nothing foolish about selling picks and shovels to the miner, and TIFF wants to sell the modern day equivalents by investing in the oilfield services sector. This means drill bits, steel pipe, technology, logistics, sub-sea equipment, and the myriad of services necessary to keep the oil patch humming. Unlike upstream production, which is highly localized, the equipment and services sector is truly global. While most of the world's known reserves are out of reach of private oil producers because they are controlled by National Oil Companies (NOCs), the services and equipment industry can get exposure to those opportunities because most NOCs are deficient when it comes to modern technology, equipment, and services. Moreover, the sector's returns are less dependent on commodity prices than on sales growth, operating leverage, and management.

Closer to Home. TIFF has always avoided large generalist/opportunity funds in the real assets space. Instead, we prefer smaller niche strategies where the general partner's focus is on management skill and execution rather than transaction size. That continues to be our guiding discipline as we seek new opportunities in an ever-crowded space. The combination of increasingly scarce resources and the advances in technology that allow them to be identified make real assets something to evaluate carefully. And the characteristics of those assets and the cash flows they can generate suggest they deserve a place in any portfolio. What always excites us, however, is finding the right GP to pursue these strategies. We gain conviction when we locate management teams with the finance, operating, and technical skill needed to pursue the real asset strategies deployed within TIFF's private investments portfolio. Understanding Grantham is necessary but insufficient in real assets investing. Our prize – and we hope our members' as well – is allocating capital to the smartest, most focused, and most disciplined teams. ■

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