



Real Asset Funds

What Are They and Should I Use Them?

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Agenda

- What Are Real Assets?
- Why The Current Interest in Real Assets?
- Asset Class Overview
- Product Overview
- Investment Manager Due Diligence

What Are Real Assets?

Definition

Physical or tangible assets that have value, due to their substance and properties. Real assets include precious metals, commodities, real estate, agricultural land and oil. They are appropriate for inclusion in most diversified portfolios - with their proportion dependent on the investor's risk tolerance and preferences - because of their relatively low correlation with financial assets, such as stocks and bonds. They are particularly well-suited for inflationary times, because of their tendency to outperform financial assets during such periods.

Other Meanings

- “Real” in an investing context means “inflation-adjusted”
- “Real Asset” funds are designed to invest in financial assets (i.e. stocks/bonds, etc.) that are backed by real assets and/or provide positive inflation-adjusted returns

Why The Current Interest in Real Assets

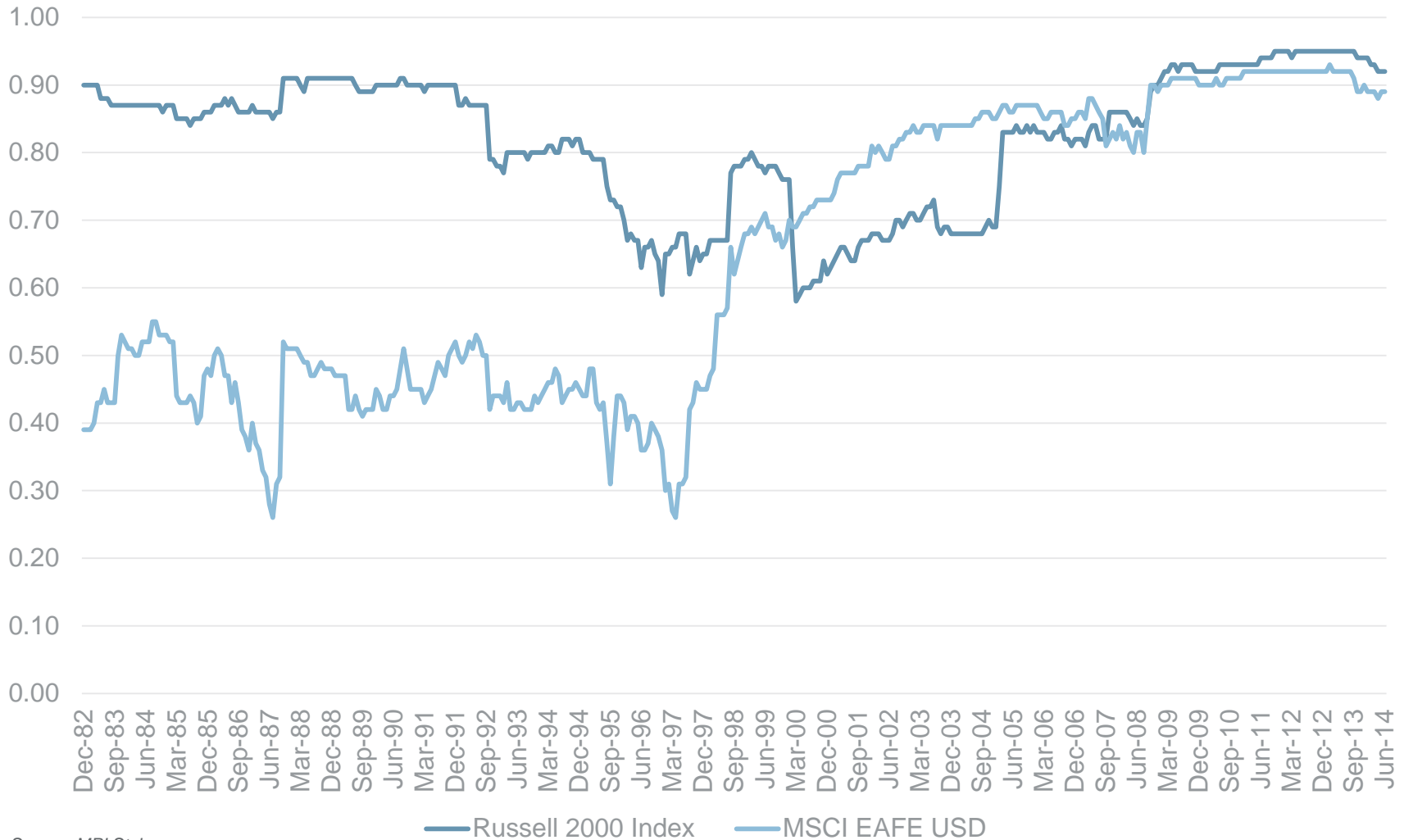
1. Changing Focus of Retirement Plan Objectives
2. Recognition That Financial Asset Correlations Have Increased
3. Concerns About the Impact of Fiscal and Monetary Policy

Changing Dynamics in Retirement Plans

Traditional Model		New Model
To maximize the accumulation of assets by retirement	Retirement Plan Objective	To replace current income in retirement
Asset class coverage with an emphasis on stocks to generate highest expected return	Investment Menu Design	Objective driven with a greater diversity of asset class exposure
Nominal investment returns relative to benchmarks and peer groups	Success Measures	Income replacement rates
Volatility of returns	Risk Management	Income replacement shortfall

Increased Correlations Among Financial Assets

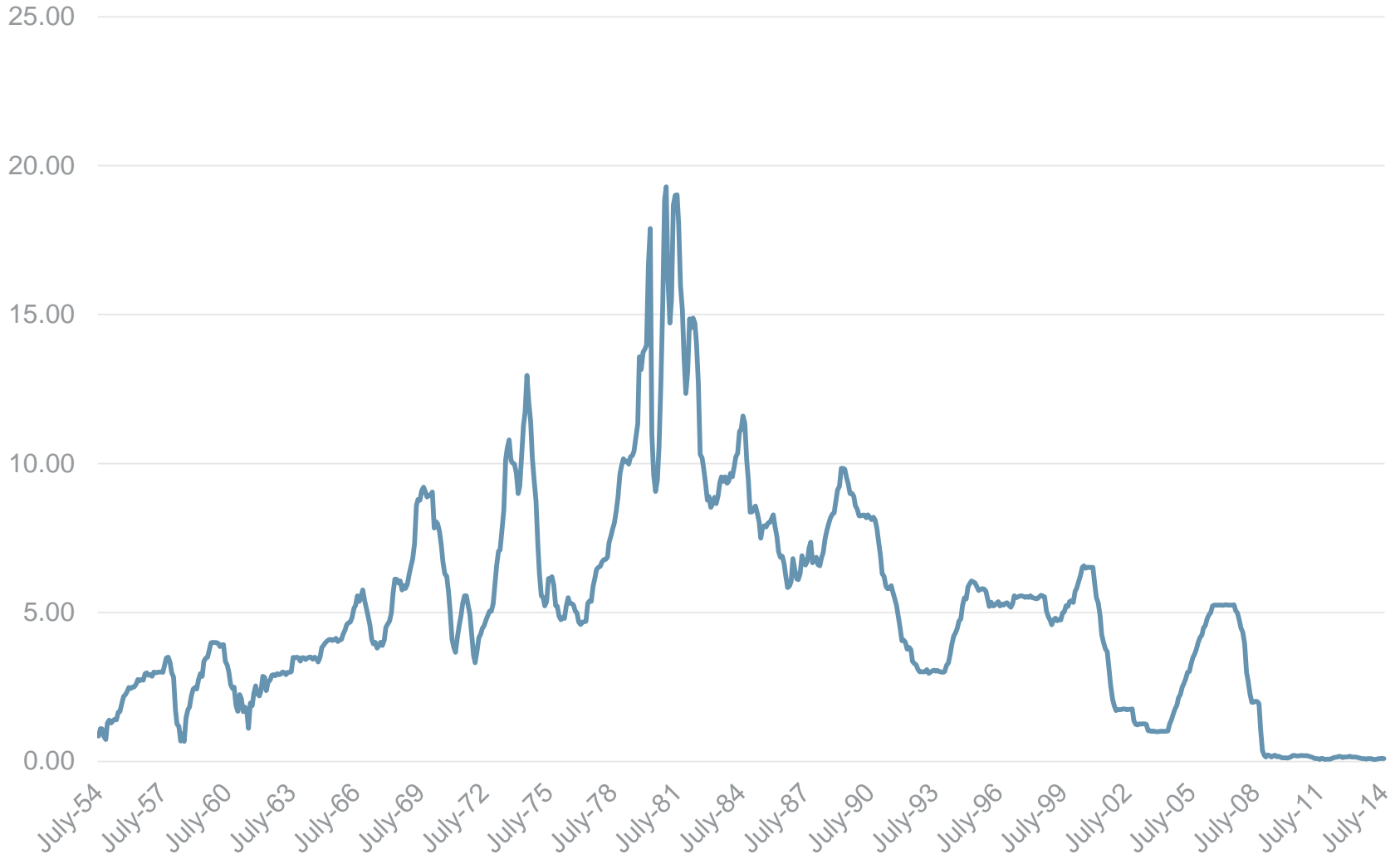
Rolling 60 Month Correlations to the S&P 500 Index



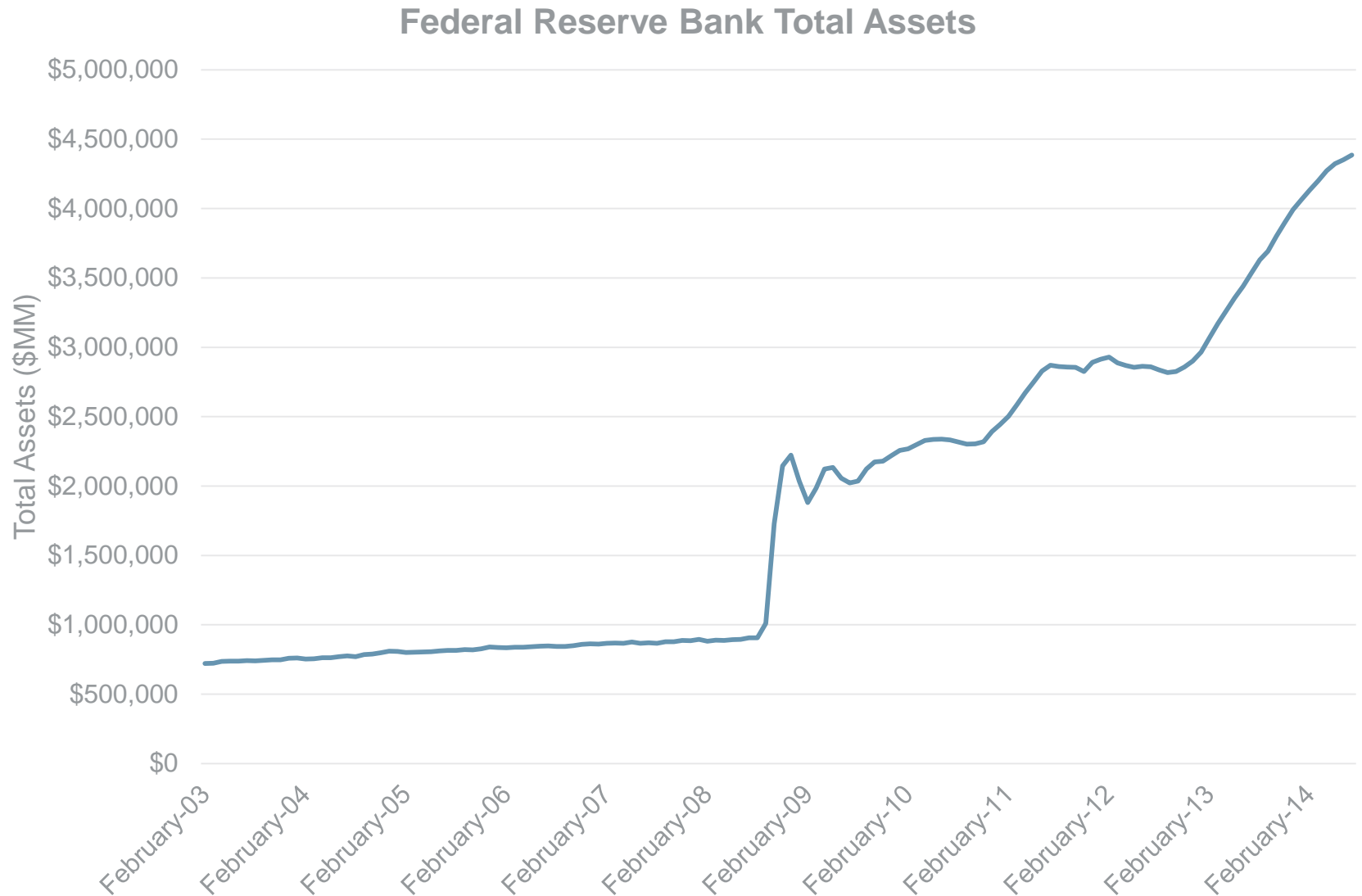
Source: MPI Stylus

Expansionary Monetary Policy (Low Rates)

Effective Federal Funds Rate

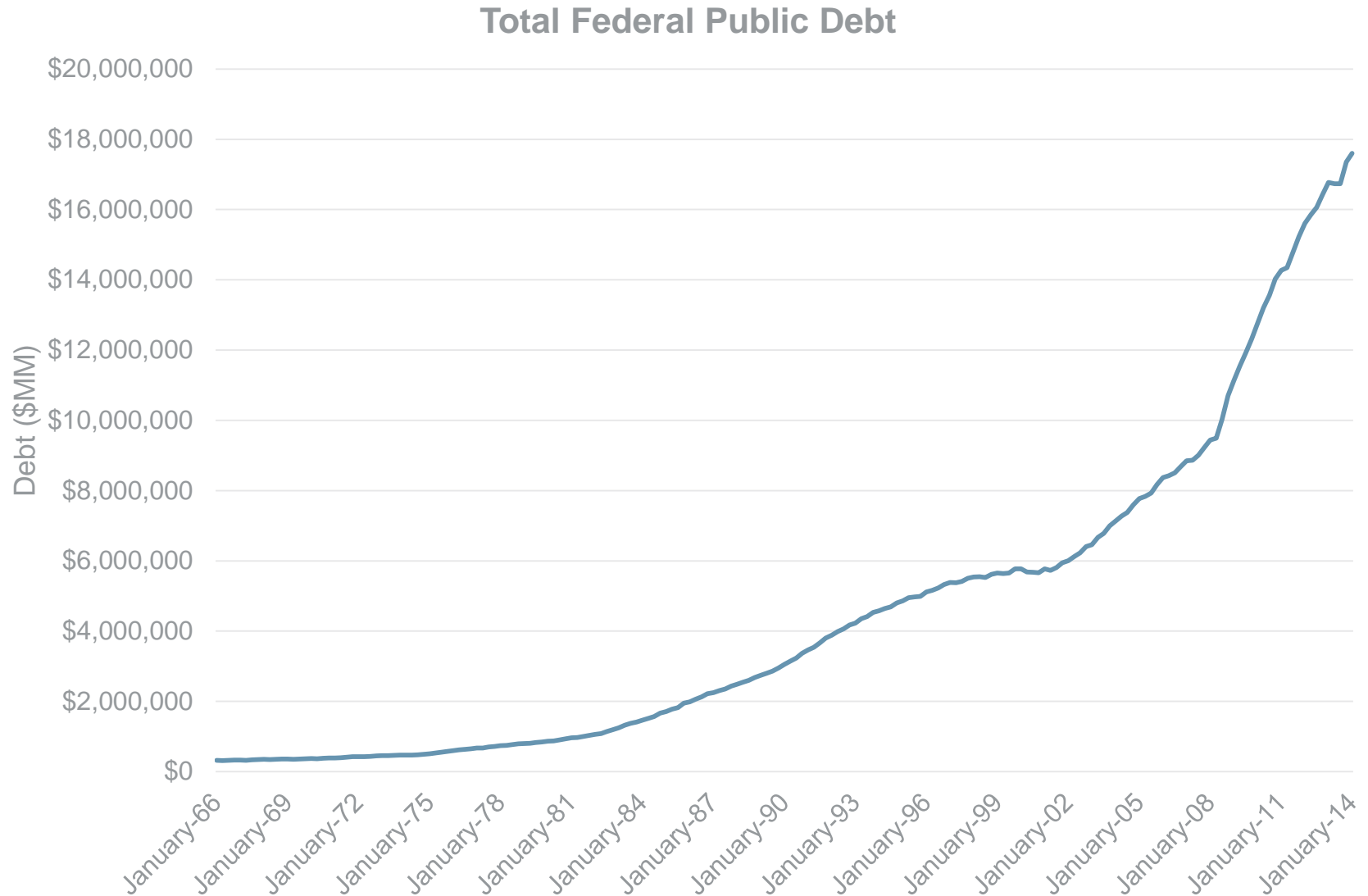


Expansionary Monetary Policy (Quantitative Easing)



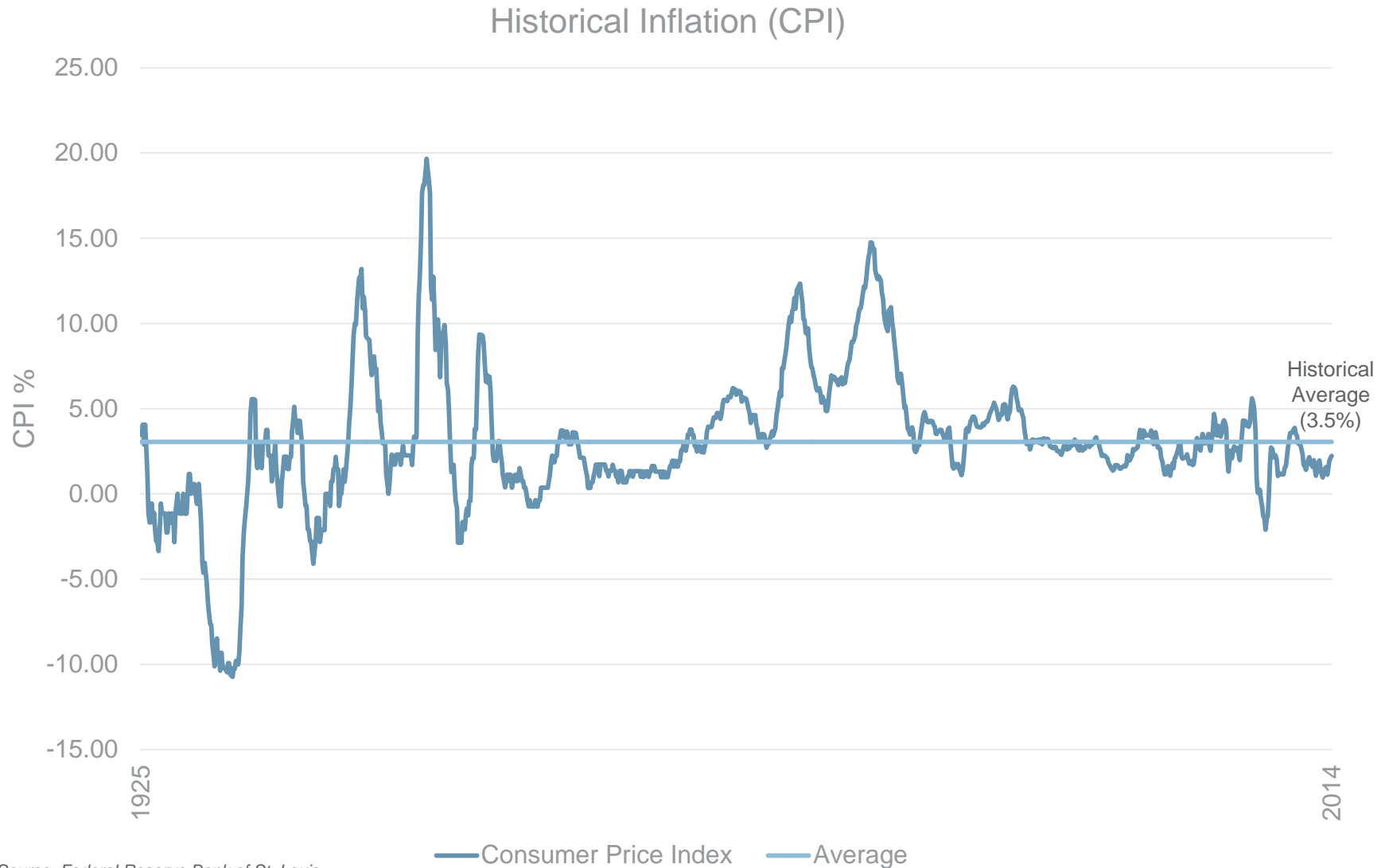
Source: Federal Reserve Bank of St. Louis

Expanding Government Debt Levels



Source: Federal Reserve Bank of St. Louis

Low Current Inflation Relative to History



Source: Federal Reserve Bank of St. Louis

Asset Classes

Treasury Inflation Protected Securities (TIPS)

Commodities

Natural Resource Stocks

Utilities/Infrastructure

Real Estate

Gold

Floating Rate Debt

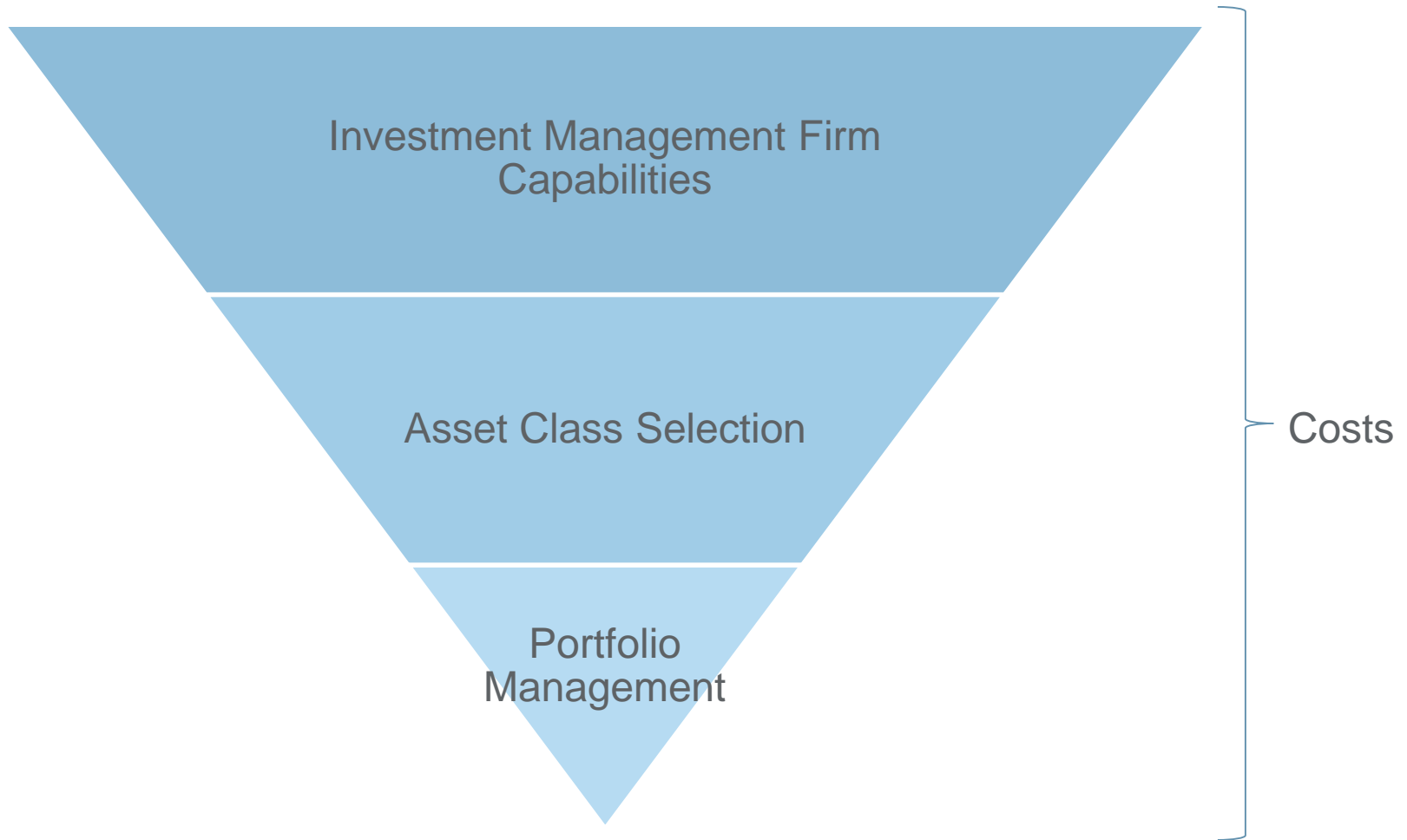
Currencies

Master Limited Partnerships

Product Overview

- At least 10 different investment management firms have launched “real asset” funds since 2010
- The funds generally include some, but not all of the asset classes discussed previously
- There is no consensus on what asset classes should be included in the products
 - Decisions generally align with the existing capabilities of the investment manager
- Lack of consensus on peer group
 - Morningstar categorizes the funds as Moderate Allocation, World Allocation, Conservative Allocation and Tactical Allocation
- Lack of consensus on benchmark indices
 - Either use a custom blended index or a single index that doesn’t really match the portfolio

Investment Manager Due Diligence



Investment Manager Firm Capabilities

- Real asset funds shift responsibilities to the fund manager from the participant
 - Asset allocation is the responsibility of the fund manager
 - Security selection is the responsibility of the fund manager
- Transitioning responsibility to the fund manager requires plan sponsor to gain deeper understanding of the investment management firm
 - Firm stability
 - Experience
 - Commitment
 - People
 - Process
 - Resources

Firm Evaluation Criteria

- How stable is the organization?
- What experience does the firm have in managing real asset portfolios?
- Commitment
 - Does the firm have a dedicated staff for managing the real asset funds?
 - Is this a core asset class of the firm?
 - Have the products shown sufficient traction in the market to ensure long-term viability?
 - Does the fund manager demonstrate thought leadership within the real asset universe?
- People
 - What experience do the portfolio managers have with real asset funds?
 - How long have they been managing these products?
 - Do they have any other responsibilities within the firm?
- Process
 - Do they have a process for evaluating changes to the portfolios?
 - Have they managed investment products before?
 - Do they have a defined process for managing cash flows?
 - How do they handle rebalancing?

Asset Class Considerations

- Which asset classes are included in the funds?
- How did the fund manager determine which asset classes would be suitable for inclusion within the funds?
 - What modeling was done to determine the appropriate mix of asset classes?
 - Did the fund manager utilize capital market assumptions in their modeling?
 - Historical data?
 - Forecasted data?
 - What impact do the fund manager's investment products play in determining asset classes?
 - Were asset classes excluded because the manager lacked a product?
 - Were asset classes included solely because a manager has a product in that class?
- How frequently does the fund manager review the asset class structure of the funds?
 - Have there been any recent changes in the asset classes utilized by the funds?
 - Are they evaluating any future changes to the asset class lineup?

Proprietary vs Open Architecture

Proprietary Investment Management

- All of the underlying portfolios are managed by the fund manager
- May create perceived conflicts between the fund investors and the fund manager
- May expose investors to highly correlated alphas

Open-Architecture Investment Management

- Fund manager utilizes outside portfolio managers to handle the security level portfolio management responsibilities
- Not very common
- Adds an additional level of fees to the funds
- Open-architecture is not a guarantee of higher performance

Hybrid Strategies

- Sub-advised portfolios
 - Fund manager utilizes sub-advisers for a portion of the portfolio

Ongoing Monitoring Methodology

- Has anything in our initial analysis changed?
- Is the fund behaving consistent with expectations given the market environment?
- Are the portfolio managers adding value?
- How do these products compare to alternatives in the market?

Conclusion

- Real asset funds are designed to provide attractive “real” returns by investing in a combination of real assets and financial assets that are positively correlated to inflation
- The use of these types of funds may be attractive within a defined contribution context because of the objective-based approach is simpler for participants to use
- There is no consistency in the design or construction of these funds with different investment managers
- A lack of a homogenous peer group or generally-accepted benchmark index makes selection and evaluation more complex
- Plan sponsors wishing to utilize these funds need to commit to greater oversight of these products

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