Four Strategies for Fighting Inflation

The transition to the later stages of the business cycle calls for creative portfolio solutions to hedge against increased inflation risk. Here are four ideas.

<table>
<thead>
<tr>
<th>Shifting Macro Trends</th>
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<tbody>
<tr>
<td>Cyclical</td>
<td>Secular</td>
<td></td>
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<tr>
<td>• Broad-based global growth</td>
<td>• Increased government investment</td>
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<tr>
<td>• Falling unemployment</td>
<td>• U.S. tax cuts</td>
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<tr>
<td>• Early signs of wage growth</td>
<td>• Central banks allowing prices to run higher</td>
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<tr>
<td>• Shrinking spare capacity</td>
<td>• Protectionism / tariffs</td>
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After one of the slowest expansions in history, the global economy is heating up and long-dormant inflation pressures are beginning to build. This cyclical shift—combined with unusual late-cycle tax cuts, rising protectionism and the unprecedented unwinding of quantitative easing—is thrusting investors into uncharted territory.

We believe investors can benefit from small but important changes to asset allocations, moving a portion of core stock and bond investments into reflation-oriented asset classes that have the potential to enhance real returns.

<table>
<thead>
<tr>
<th>Potential Implications</th>
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<td>Higher inflation</td>
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</tbody>
</table>

Global REITs
Rent growth has historically outpaced inflation, while correlations with equities are at a 16-year low.

Multi-Strategy Real Assets
A history of positive inflation sensitivity and equity-like returns, with lower potential volatility than standalone investments in real assets.

Low-Duration Preferred Securities
Combines the potential for high tax-advantaged income with low sensitivity to rising interest rates.

Midstream Energy
Contracted cash flows often have rate escalators tied to inflation, while the industry is benefiting from a turnaround in fundamentals.
Global REITs

Higher inflation → higher rents → higher dividends. Real estate investment trusts (REITs) have a long history of helping investors defend against inflation, with property values that tend to rise with the overall price environment, plus the potential for growing cash flows as landlords raise rents. Increased construction costs can also deter new property supply, easing competitive pressures. The net effect has been that REIT dividends have grown faster than inflation. In the U.S., for example, REITs have increased dividends at nearly double the rate of inflation over the past 25 years (Exhibit 1).

These attractive values come at a time when REITs’ correlation to equities is at a multi-decade low, underscoring the diversifying potential of real estate (Exhibit 2). Based on our view of generally solid real estate fundamentals and a record $266 billion of private equity dry powder waiting to invest in commercial property, we see this as a good opportunity to increase allocations to REITs.(3)


Data represents past performance, which is no guarantee of future results. See page 7 for index associations, definitions and additional disclosures.

Attractive value amid rate concerns. Despite healthy real estate fundamentals and rising dividend payments, global REITs have widely trailed global equities in recent years, hindered by concerns that rising interest rates could increase financing costs and reduce the relative appeal of REIT income. As a result of negative investor sentiment, earnings multiples have contracted and global REITs are now trading at an overall discount to the value of their underlying property holdings, with some REITs featuring discounts of 20% or more.(2)

These attractive values come at a time when REITs’ correlation to equities is at a multi-decade low, underscoring the diversifying potential of real estate (Exhibit 2). Based on our view of generally solid real estate fundamentals and a record $266 billion of private equity dry powder waiting to invest in commercial property, we see this as a good opportunity to increase allocations to REITs.(3)

(1) In the 5 years ended April 30, 2018, global REITs and global equities had annualized returns of 3.9% and 9.9%, respectively; over the long run (since 1991), global REITs have outperformed global equities, 8.7% to 8.1%. Source: FTSE, MSCI, Cohen & Steers.

(2) At April 30, 2018, global real estate securities traded at a 0.9% average discount to net asset value (company assets less liabilities), based on Cohen & Steers estimates.

(3) Private equity dry powder as of March 2018, representing total capital commitments in private real estate funds waiting to be called for investment. Source: Preqin.

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Low-Duration Preferred Securities

High current income with a focus on capital preservation.
When faced with the prospect of rising inflation and higher interest rates, many investors will rotate into shorter-term fixed income securities that are less vulnerable to rising rates, often sacrificing yield in the process. Low-duration preferred securities could offer a way to regain some of this lost income while keeping a defensive position relative to interest rates.

Prefereds generally pay higher income rates than bonds due to their subordinate position in the capital structure, making them an appealing option for yield-seeking investors. These securities come in a variety of structures, which can significantly impact their interest-rate sensitivity. Fixed-rate prefereds may have high durations, whereas those with coupon resets—including fixed-to-float and floating-rate securities—can have relatively short durations. Most of these shorter-duration securities are found in the institutionally focused over-the-counter market. In fact, of the nearly $1 trillion in preferred securities issued globally, two-thirds have a duration of five years or less.

As shown in Exhibit 3, low-duration preferred securities offer an attractive mix of high current income and low interest-rate sensitivity. As a result, this strategy may defend better than other fixed income investments in periods of rising interest rates. In the recent period of rising Treasury yields from September 2017 to February 2018, low-duration prefereds outperformed many other types of fixed income (Exhibit 4).

Tax-advantaged income. Many prefereds are forms of equity and pay qualified dividend income (QDI), which is taxed at a lower rate than the interest payments from bonds. This means that prefereds may offer an income advantage—both before and after taxes—relative to many other fixed income categories, including those with much higher durations.

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Midstream Energy

Higher energy prices ➔ increased production ➔ higher pipeline volumes. Midstream energy companies can serve as natural inflation hedges, generating fee-based cash flows to gather, process and transport energy commodities. In many cases, service contracts include rate escalators tied to the Producer Price Index. (1) Perhaps more important is what rising global energy prices could mean for North American energy production—and, by extension, the potential for higher volumes of energy molecules flowing through the pipes.

Furthermore, we would expect global reflation to benefit developing economies, which account for the vast majority of global energy demand growth. U.S. shale’s production-cost advantage and speed to market has made it one of the world’s key resources for new supply, with a significant portion of crude oil exports going to developing countries (Exhibit 5).

The midstream fundamental cycle is turning. Midstream companies have widely underperformed the broad market since late 2014, with the Alerian MLP Index still 56% below its high as of March of 2018. However, for the first time since the energy down-cycle began, the three primary drivers for midstream asset demand are all seeing strong growth (Exhibit 6):

1. U.S. energy production is expected to hit record levels in 2018–2019, with crude oil output expected to exceed Saudi Arabia.
2. U.S. energy consumption is finally growing after several years of stagnation.
3. U.S. energy exports have grown exponentially since the crude oil export ban was lifted in 2015—and should continue to do so in a reflationary environment, in our view.

These trends continue to push more energy production through pipelines and pull it into demand centers, which should help tighten capacity for midstream assets and drive cash flow growth.

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(1) The Producer Price Index measures the average change over time in the selling price received by domestic producers for their output.
**Multi-Strategy Real Assets**

**Inflation sensitivity—the unifying attribute of real assets.**
Real assets are commonly known for their potential value as inflation hedges. However, we have found that it is not so much the level of inflation that’s important, but whether inflation exceeds expectations—the “inflation-surprise” factor. Historically, all real assets have tended to benefit from periods of unexpected inflation, contrasting with below-average returns for stocks and bonds (Exhibit 7).

Years of successive downward inflation revisions since the financial crisis have worked against real assets, contributing to their significant underperformance recently—particularly in commodities. However, we believe increased inflation risk and improving fundamentals have created a more favorable backdrop for real assets. With many listed real asset categories currently trading significantly below their highs, we see this as an attractive value opportunity for establishing a real assets allocation.

**Bullish outlook for commodities.** Among real assets, commodities have generally been the most sensitive to unexpected inflation—indeed, one of the main reasons investors own commodities is to hedge inflation risk. This is because the factors that cause inflation (strong economic growth and/or capacity constraints late in the business cycle) also tend to drive commodity prices. Also, rising food and energy costs are key contributors to official inflation measures: in the U.S., these components represented 21% of the 2017 CPI increase. It should not be surprising, therefore, that commodity returns have been closely tied to inflation surprise (Exhibit 8). It follows that commodities and commodity-related businesses should be among the primary beneficiaries of today’s heightened inflation risk. From a

![Exhibit 8: Commodities Linked to Inflation Surprise](chart)


### Exhibit 7: Sensitivity to Inflation Surprise

<table>
<thead>
<tr>
<th>1991–Q1 2018</th>
<th>0%</th>
<th>2%</th>
<th>4%</th>
<th>6%</th>
<th>8%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversified Real Assets</td>
<td>5.7</td>
<td>1.9</td>
<td>4.9</td>
<td>6.7</td>
<td>9.1</td>
</tr>
<tr>
<td>Real Estate</td>
<td>6.7</td>
<td>4.9</td>
<td>12.8</td>
<td>7.9</td>
<td>3.4</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>9.1</td>
<td>6.7</td>
<td>12.1</td>
<td>7.9</td>
<td>3.4</td>
</tr>
<tr>
<td>Natural Resource Equities</td>
<td>5.4</td>
<td>1.9</td>
<td>4.9</td>
<td>6.7</td>
<td>9.1</td>
</tr>
<tr>
<td>Commodities</td>
<td>-1.2</td>
<td>3.9</td>
<td>7.3</td>
<td>-0.5</td>
<td>-0.4</td>
</tr>
<tr>
<td>U.S. Bonds</td>
<td>-0.4</td>
<td>-0.5</td>
<td>-0.4</td>
<td>-0.5</td>
<td>-0.4</td>
</tr>
<tr>
<td>U.S. Stocks</td>
<td>-0.4</td>
<td>-0.5</td>
<td>-0.4</td>
<td>-0.5</td>
<td>-0.4</td>
</tr>
</tbody>
</table>


Data represents past performance, which is no guarantee of future results. (a) Sensitivity to inflation surprise is a proprietary calculation that measures the typical response of real (inflation-adjusted) returns to the year-over-year inflation surprise, defined as the difference between the realized inflation rate and the lagged 1-year-ahead median inflation estimate from the University of Michigan Inflation Survey. Diversified Real Assets represented by an equal-weighted blend of global real estate securities, commodities, natural resource equities and global listed infrastructure. See page 7 for index associations, definitions and additional disclosures.
fundamental perspective, the rebalancing of commodity supply and demand has been underway for several years now, and many commodity markets are now balanced or in deficit. With the improvement in global growth, commodity consumption has also picked up, creating tighter conditions.

- Energy: Producers have shown greater discipline in capital spending, and we expect global consumption to exceed aggregate output, likely resulting in further inventory declines.
- Metals: Generally the furthest along in rebalancing, drastic spending cuts on new mines in recent years should allow deficit conditions to persist, since new mines can take years to bring on line.
- Agriculture: Grains have taken longer to rebalance, but should enter deficits in 2018 due to stabilization in global acreage expansion and recent weather-related production disruptions.

We believe the combination of favorable supply trends, improving consumption and increased inflation prospects creates a compelling argument for commodities.

**Benefits of the blend.** We believe that an effective way to gain broad exposure to real assets is through a mutual fund that invests across multiple real asset categories such as real estate, infrastructure, commodities and natural resource equities. This approach offers a one-stop real assets solution, appearing on portfolio statements as a single line item, potentially dampening the swings in returns that investors may experience with separate allocations to individual asset classes.

In addition, due to the low historical correlations among different types of real assets, a blended real assets portfolio has the potential to deliver inflation-hedging characteristics with a better balance of risk and return (Exhibit 9).

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### Exhibit 9: Risk-Return Comparison
1991–Q1 2018

<table>
<thead>
<tr>
<th>Annualized Return</th>
<th>Diversified Real Assets</th>
<th>Real Estate</th>
<th>Infrastructure</th>
<th>Natural Resource Equities</th>
<th>Commodities</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>6%</td>
<td>9%</td>
<td>12%</td>
<td>15%</td>
<td>18%</td>
</tr>
<tr>
<td>3%</td>
<td>U.S. Bonds</td>
<td>6%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9%</td>
<td>U.S. Bonds</td>
<td>9%</td>
<td>12%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12%</td>
<td>U.S. Bonds</td>
<td>12%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15%</td>
<td>U.S. Bonds</td>
<td>15%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18%</td>
<td>U.S. Bonds</td>
<td>18%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Annualized Nominal Return**
- 7.7%
- 5.4%
- 12.9%
- Sharpe Ratio: 0.44

**Annualized Return**
- 6.2%
- 7.3%
- 9.6%

**Risk (Standard Deviation)**
- 12.9%
- 15.4%
- 14.3%

**Sharpe Ratio**
- 0.38
- 0.54
- 0.61


Data quoted represents past performance, which is no guarantee of future results. Real return is the nominal return adjusted for inflation. Standard deviation is a measure of the dispersion of a set of data from its mean, also known as historical volatility and is used by investors as a gauge for the amount of expected volatility. Sharpe Ratio is a measure of risk-adjusted return, calculated by subtracting the risk-free rate from a return and dividing that result by the standard deviation. The higher the Sharpe Ratio, the higher the risk-adjusted return. Diversified Real Assets represented by an equal-weighted blend of global real estate securities, commodities, natural resource equities and global listed infrastructure. See page 7 for index associations, definitions and additional disclosures.
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