1290 FUNDS®

Ken Kozlowski Podcast – April 2023
Hard Assets Markets with Invesco

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Transcript

Intro – Sean Nicholason

Hello. I'm Sean Nicholason, head of sales and distribution for 1290 Funds and Equitable Investment Management LLC, the Funds' investment advisor. Welcome to another edition of our podcast series. Our podcasts seek to offer insights into investing and markets—with a long-term strategic view. In this podcast, Chief Investment Officer Ken Kozlowski spends about 15 minutes with Invesco evaluating the market for hard assets. You'll learn about how hard assets—for example real estate, infrastructure, and even commodities like oil—may offer a path to diversification in today's economy. The interview closes out with a perspective on how China's economic reopening may impact the global markets. I'm certain you'll find this information useful. Now, let's listen in.

Ken

Hello, everyone. Ken Kozlowski here. Today we're turning our attention towards sectors that some individuals may find intimidating, to spend time with Invesco's head of listed real assets Darin Turner. Darin's bio is all about the Lone Star State with multiple degrees from Texas schools in business and real estate. Today's rising interest rate environment, with recessionary rumbles in the background, seems to be a good time to talk about hard assets like real estate, metals, agriculture, and energy. The listed real assets team draws on a deep bench with more than 25 investment professionals dedicated to this space. They average about 25 years of experience in business as well. Welcome Darin. And, let's dive right in.

Darin

Great. Thank you.

Ken

So your team recently reported to us that the economic data releases continued to offer a picture of very weak leading indicators, but relatively resilient actual data. As you put it so succinctly, key government bond yield curves remain inverted, which would point to economic weakness. However, high yield credit spreads have tightened and equity markets were showing some positive trends as investors appear to have a more risk on appetite. So tell us how the environment in the latter part of 2022 benefited from hard asset companies and investors. Why don't you start with real estate.

Darin

Sure. Thank you, Ken. And I really appreciate the time today. So as you just outlined, the second-half of 2022 and then actually even the beginning of 2023 was really characterized by relatively robust economic growth and an inflation profile that was generally accelerating and for the U.S. specifically a very strong U.S. consumer as related to spending trends, but then also excess savings. Now for hard assets specifically, what that has meant was as inflation was accelerating those areas of the market that have the most direct ties to inflation did reasonably well in that environment, and as we go through this conversation, I'll probably provide more details by underlying sector. Now for real estate specifically, we would characterize real estate as having an indirect hedge to inflation. And by that what I mean is my direct input costs on building new buildings, which includes lumber, concrete, obviously labor - as inflation is increasing my cost to build that new building are also rising. Now what that means as an existing property holder is that market rents should be moving higher as well, to compensate those new developers and so in those types of periods, real estate is generally viewed as a store of value. Now for the second-half of 2022, real estate was relatively volatile as an asset class and so even though you had some of those positive trends as relates to inflation, store value, as interest rates moved higher, real estate is one of the more sensitive real asset sectors to interest rates. And so that's been a constant battle for real estate investors. It's still positive fundamentals, but from a valuation standpoint, just the concern of what the Fed is going to have to continue to do and what that can eventually mean for rates and then also valuations for real estate.

Ken

As a follow up, you invest in a number of sectors that our shareholders may not know much about. So, why is fertilizer, for instance, along with other agricultural sectors, finding favor now?

Darin

Yeah, that's an interesting question. So as you highlighted, some of the areas that we look to invest in is not just something that you would generally think about - fertilizer companies being a great example. And so when you look at fertilizer supply, Russia produces about 25% of world fertilization. And so even though fertilizers were not part of the sanctions put on Russia, they dramatically reduced their supply to try to increase the amount of price in the market. And so if you're a fertilizer company that had access to that supply had already pre-booked that, you saw your cash flows continue to rise as the prices of fertilizers were rising. Now additionally, what you've seen is that with the reopening of China, which has taken quite some time versus the rest of the of the world. China is one of the largest buyers of almost everything related to energy and also agricultural products, and so they are very much a key aspect, whether it be fertilizer companies but also soy and corn companies as well. And so that market reopening, and that demand increasing, has really provided a very positive backdrop for those types of companies focused in that area.

Ken

And can you say a few words about natural resources which added a ton of value last year? Can you tell us about energy as an investment right now?

Darin

Sure. So as you just highlighted, when you look at 2022, energy was one of the best performing asset classes in the world now mostly driven by two things; one, continuing positive economic growth and so as economic growth was higher, your demand for energy products generally coincides with that. Additionally, just because of some of the sanctions that were put on Russia overall supply was relatively limited last year as well. And so you saw that translate into much more robust and positive cash flows at the energy related companies. Now on a go forward basis, what we still believe in is you've had a severe lack of capital investment in energy related assets almost for the past decade. And so the U.S. is a prime example of this. We went through periods really going up until 2014 where we spent significant capital building out not only our shale drilling aspect, but also the associated pipelines. We've now again gone a decade without spending capital to increase that level of production. And so, even though our current view is that the later half of 2023 could be mired with some level of economic deterioration, the amount of supply in the market is likely to continue to be somewhat limited. And so, we continue to believe in much more of a supply demand balance type of market and historically when you're dealing with those areas, that is a relative positive for energy related companies.

Ken

Infrastructure is a sector that can cover a lot of different industries. Can you give us a sense where investors might be finding value in these areas?

Darin

Yeah, infrastructure is an incredibly interesting asset class. And so again, as you highlighted, it can cover multiple areas within a specific country. We view infrastructure as the backbone of economic growth, where we're generally looking for value, or other investors are today, are on those aspects of infrastructure that can have the most direct linkage to increases in inflation. So within infrastructure companies underlying contracts, they normally have a CPI rider that can adjust every single year. So you're actually able to capture that uplift or that increase in what inflation has been. So what are some of those areas that we're looking at? So they'd be places like European towers. So the cell phone tower companies where your cell phone actually connects to to provide you service, those leases are generally structured with inflation riders on them, and so you have very much long term demand as relates to overall data usage. And again I get to, as a cell phone tower company, capture that uplift and what CPI has been. Additionally, you've seen investors look to areas in Asia. As we highlighted earlier, with the China reopening and so areas like Asian toll roads, and specifically in whether it be Hong Kong or China, where you've seen a level of increased demand or just increased drivers on the road as you've had an overall reopening and that in most investors view is still a two year window of increasing traffic patterns there. The last area I would actually say can be in places like water utilities in the U.S. Now again, this is somewhat based upon a view of the potential for an economic decline, but water utilities are really the most basic service that you can be providing your underlying customer or most basic service in an economy. Independent upon economic growth, your water usage basically stays the same, and so what people have been looking for within these types of companies is that stability of cash flow and how is that currently valued if we were to eventually see interest rates decline because of economic deterioration.

Ken

You've recently made a case for a more defensive posture in coming months. What does defensive mean in terms of real assets?

Darin

In and so very similar to what I was just discussing with water utilities, defensive in real assets means stability of cash flow. And so I want a stable cash flow profile that has very little economic sensitivity and so water utilities as I just mentioned previously is a perfect example. Even in a recession, the amount of water that you use in your home is generally pretty static. And so that's a very defensive cash flow street. Now outside of that, even in areas like real estate, you have segments of real estate such as manufactured housing, medical office, which also provide very durable long term stable cash flows independent of the economic environment. And so as we've looked at history, your sensitivity to movement in GDP for every hundred basis points in GDP, manufactured homes cash flows move only 1%. Same with medical office. It's because your underlying demand drivers can be outside of what the economic environment is. And so we're always looking at those aspects; what provides me that long term stable view of cash flows within real assets versus what our underlying economic outlook might be.

Ken

Another big picture question, from real estate to supply chains to agriculture to airports, China has played a big role in recent years in many sectors you follow. What are the broader implications of a Chinese economic recovery for global real asset investors?

Darin

Yes, China is absolutely important as we think about overall global demand drivers within real assets. So within our asset class, as I highlighted natural resources, agriculture type companies, metals and mining, all of those companies you've seen historically been driven by the increased demand coming out of China as they've continued to have a long path of positive economic growth and more importantly, as the citizens in that country move from below, what I'd say median income to moving into a higher range of where they're buying more goods. And so a reopening of that economy really continues this multi-decade long trend that we've seen an increasing demand for most of those natural resources. Now, what we'd say it's interesting this time as well is that with some of the view of reshoring or onshoring due to some of the logistic issues that happened during COVID, you've seen certain countries, the U.S. is a great example of this, wanting to bring back some manufacturing from China to the U.S.. Now what that can mean as China reopening as reopens, is that your global trade routes can be impacted depending upon where am I manufacturing versus where the goods need to go. And so we've seen impacts on the port side within real assets as well. Historically certain areas, again out of China, we're just looking at exporting goods to the U.S. you've now seen some of those assets actually look to switch and actually the importing goods because of the underlying Chinese consumer demand. And so we continue to believe that China, yes, is going to play an important role as you think about investing in hard assets, really for the coming decade.

Ken

And finally, let's take a step back and answer one question important to individual investors. Hard assets used to be considered an important hedge against economic decline in a portfolio. In 2023, how do you believe hard assets fit into a traditional asset allocation?

Darin

Yeah, and so what we would say is hard assets have a unique position in their portfolio and I'll hit on a couple of different characteristics. So one is generally a level of recurring income or yield; they can provide a cash flow supplement versus other areas like fixed income. Now in the current environment, one of the most important characteristics has been the inflation sensitivity. Obviously, before the past 24 months, inflation hadn't been a major concern for investors. But what you've seen is that you normally need to be worried about unexpected inflation, and that's normally when real assets really provides you that benefit in your portfolio like we've seen over the past 12 months. Now lastly, as you outlined, Ken, it's just the defensive nature of what real assets can provide. I hit on the stability of cash flow that you can see within real assets, especially versus general equities, but maybe even just importantly is the stability of dividend that comes with the lot of these companies. Infrastructure, as an example, on an index basis has not seen a dividend decline in over 25 years. So even during the global financial crisis, infrastructure companies as a whole, actually we're still increasing dividends. And so that can play a very important role as people think about planning long term in their portfolios. And so as we think about our outlook for 2023, we think real asset companies that provide you that stability of cash flow and the ability to still increase that cash flow, if inflation remains a concern, as a very unique type of asset to have in your portfolio today. And so we think it's something that investors historically haven't spent as much time thinking about, but we would say this is the current environment where investors really need to relook at what the allocation can be and what real assets can provide in your portfolio.

Ken

Darin, thanks for your insights and time with us today. This has been incredibly helpful. Thanks again.

Darin

Thank you very much everyone.

Close – Sean Nicholason

Hello again everyone. Sean Nicholason here. We hope you enjoyed the discussion and are armed with a better understanding of how hard assets may fit into an overall investment allocation. Invesco’s global hard asset strategy is available in various Equitable variable insurance and variable annuity products. Interested? We encourage you to log on to equitable-funds.com to take a look at the prospectus. For now, have a great day and plan to keep these discussions going throughout the coming months.

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