Insights
Multi-Asset Solutions

Liquid Real Assets: Cost-Effective Inflation Protection

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Despite inflation moderating around the globe, we see a structural shift to a new norm of higher inflation. In this note, we discuss what liquid real assets are and how their characteristics can help protect capital in this new inflation environment. Understanding the drivers of real asset returns can help intelligently combine exposures to generate attractive portfolio characteristics, such as reduced drawdowns, risk-adjusted returns and diversification.

What Are Liquid Real Assets? How Can They Protect From Inflation?

Real assets are valued based on their utility or physical properties. Many also require a large capital investment and long periods of illiquidity to gain exposure and pick up premiums. Liquid real assets are at the more accessible end of the real asset spectrum.

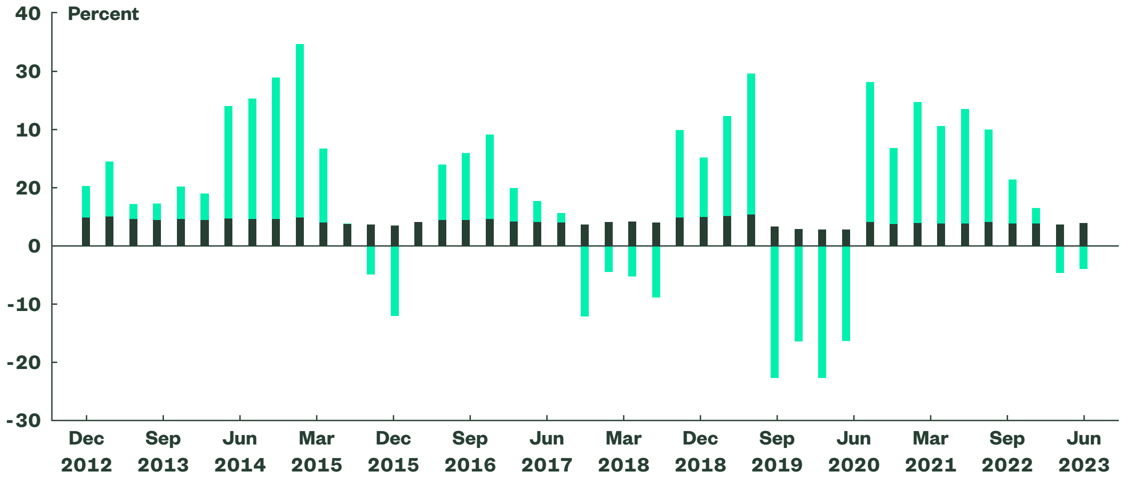
Many real assets share common characteristics, with either direct linkages to inflation (for example, in legal contracts) or second-order links to inflation through supply/demand dynamics, or even how the assets are financed.

Contractual arrangements in some real estate sectors such as hotels and self-storage have short-term leases, with owners being able to mark to market rents more often. So during periods of high inflation, being able to increase rents regularly benefits the investor. Longer-term real estate contracts, in sectors like offices, may require tenants to pay for the office space as well as the expenses that go along with maintenance, etc., irrespective of whether they use it or not. This helps protect the real value of cash flows.

Infrastructure assets tend to be long-term leases and their income streams often have rate escalators in their contracts tied to inflation. This means that they can charge customers price increases in line with inflation. A toll road is a good example. The large proportion of income in the total return of infrastructure helps generate attractive returns, even when inflation is stable or declining.

Figure 1
Global Infrastructure Returns
%, Rolling 4-quarter returns from income and capital appreciation

Income
Capital Appreciation

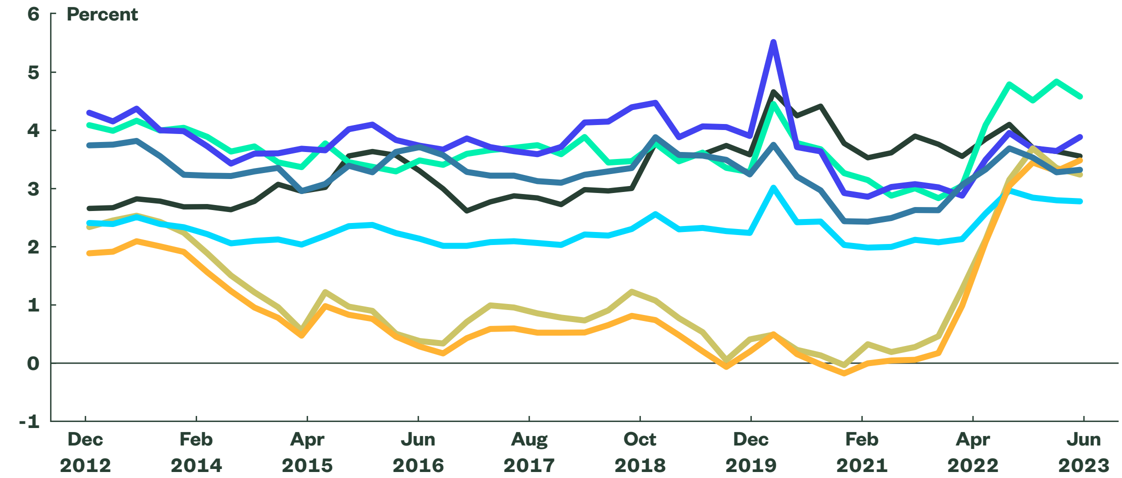


Source: State Street Global Advisors and S&P Dow Jones Indexes, as of 30 June 2023.
Infrastructure returns represented by the S&P Global Infrastructure Index and is calcualted in EUR. Data shows rolling one-year returns from income and capital appreciation. **Past performance is not a reliable indicator of future performance. Diversification does not guarantee investment returns or eliminate the risk of loss. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.**

It is not just infrastructure. As we can see in Figure 2, many real assets provide a healthy yield compared to the equity market. Supply and demand dynamics (e.g., commodities), or even the hurdles to entering a market (e.g., infrastructure assets), can all benefit real assets in times of high growth and inflationary environments. Many real assets are also leveraged with long-term fixed rate debt, which tends to do well in inflationary environments as debt gets paid down with inflated currency, supercharging their returns.

Figure 2
Historical Yields (%) of Real Asset Components and Benchmark

S&P Global Natural Resources Index
Real-Estate Investment Trusts (REITs)
Infrastructure
Inflation-Linked
Real Asset Composite Avg. Yield
Euro-Aggregate Bonds Yeild-to-Maturity (YTM)
MSCI EMU Div. Yld. (Last Twelve Months)



Source: FactSet, S&P Dow Jones Indexes, Barclays Live and State Street Global Advisors, as of 30 June 2023.
Past performance is not a reliable indicator of future performance. The average yield of the "Real Asset Composite" is produced by taking the weighted average of the yields of the 20% S&P Global Infrastructure Index, 15% Bloomberg Euro Inflation Linked Bond Index, 25% Bloomberg Commodity Total Return Index, 30% Natural Resources Index (12% MSCI Energy Sector and 18% Material Sector), 10% Global REITs (5% DJ Global Select Real Estate Securities Index + 5% FTSE EPRA Europe ex UK Real Estate). Proxy indexes used for asset classes: Infrastructure = S&P Global Infrastructure Index, Global Natural Resource = 40% MSCI Energy Sector and 60% Material Sector, REITs = 50% DJ Global Select Real Estate Securities Index and 50%% FTSE EPRA Europe ex UK Real Estate. Euro Inflation Linked = Bloomberg Euro Inflation Linked Bond Index, EMU Equities = MSCI EMU. Euro Agg. Bonds = Bloomberg Euro Aggregate Bond Index.

Long-Run Inflation Likely to be Higher

We believe there is a structural shift toward a higher-inflation environment. Inflation is often modelled as having a permanent component and a transitory component. The permanent component is driven by forces such as wage costs, productivity gains and demographics, whereas the transitory component can be driven by surges in energy costs, weather-related shortages or one-time effects resulting from fiscal measures such as tax holidays.

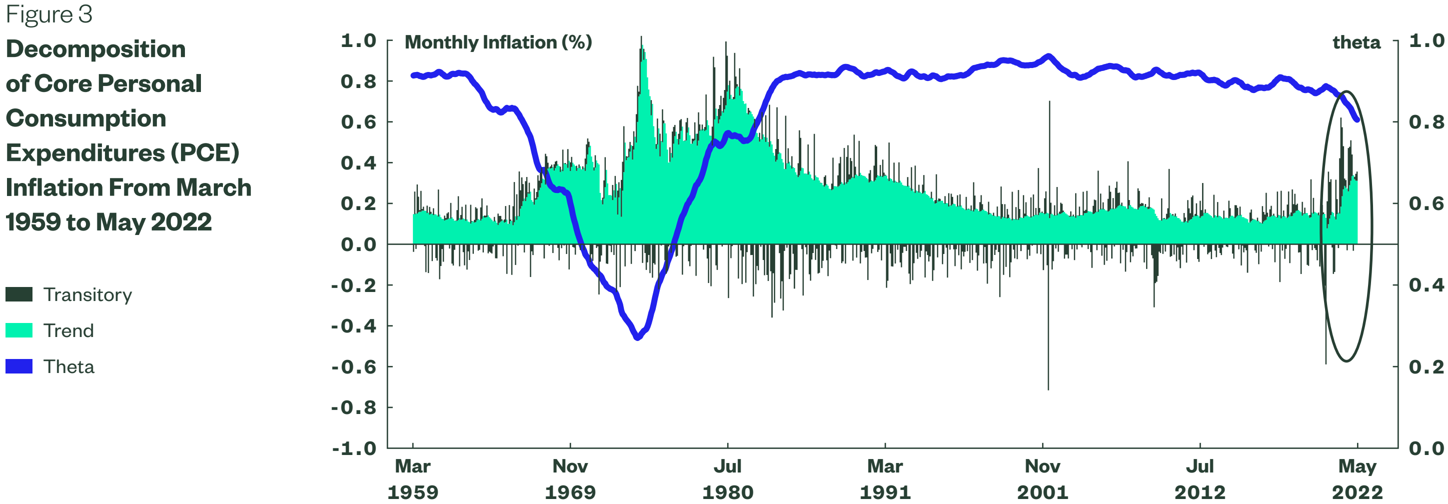
In their latest research paper "Are We Entering a New Era of Higher Inflation?" State Street's Ramu Thiagarajan, Senior Investment Advisor, and Hanbin Im, Global Macro Researcher, conclude that the recent rise in inflation has not been driven by transitory shocks, but by a steady rise in the spillover of these transitory shocks into the permanent component of inflation, meaning that long-run inflation is likely to be higher.

It is an important shift as it counters the view that transitory shocks dissipate, and certainly differs from the behavior of prior transitory shocks. The 1970s were a period with low theta values. Low theta values indicate that transitory shocks impact the long-run level of inflation and, as a result, have attained a certain "permanence." As such, inflationary shocks became more permanent and needed strong monetary action. It took several quarters for inflation to abate, and several years before the permanent component receded to levels of prior years.

> Theta is a measure of persistence. A higher theta indicates transitory shocks remain transitory and have no effect on the long-run level (permanent component) of inflation. A lower theta indicates that the transitory shocks impact the long-run level of inflation and, as a result, have attained "permanence".

Inflation eats away at nominal asset returns over time. As such, investors need to protect and factor this into their strategic asset allocation decisions. A liquid real assets strategy provides an effective solution that not only protects against inflation with a solid income, but provides diversification and downside protection compared to pure equity risk.

Figure 3
Decomposition of Core Personal Consumption Expenditures (PCE) Inflation From March 1959 to May 2022



Source: US Federal Reserve, State Street Global Advisors, as of May 2022.

Real Assets — Inflation-Hedging Efficacy

Understanding how asset classes perform across different inflation regimes can help investors to build appropriate protection into their strategic asset allocation.

Figure 4 shows the quarterly real asset returns over the last 22 years for three discrete inflation regimes: rising, stable and declining. It is important to note that this is a directional measure, rather than indicating the level of inflation. For example, a declining inflationary regime can still be experiencing high inflation.

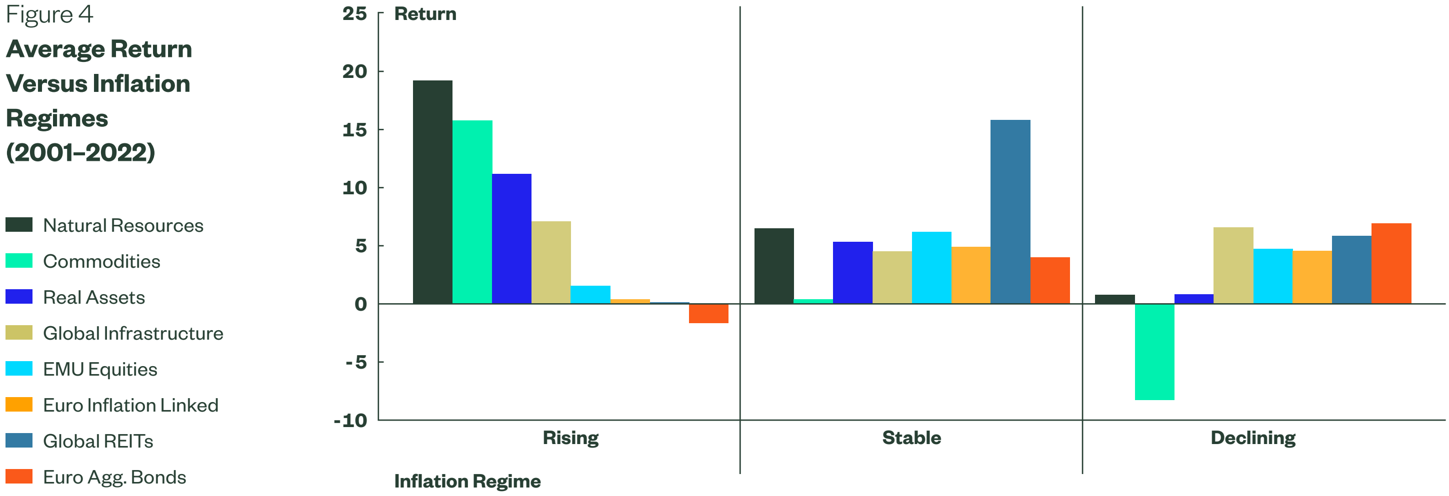
Figure 4 shows us that real assets provided attractive returns not only in rising inflationary regimes, but also during stable regimes. Even in declining regimes, many real assets may generate attractive returns compared to equities.

Understanding these nuances can help us construct a portfolio. Commodities and natural resources are very efficient protections against unexpected and rising inflation. Real estate investment trusts (REITs) and infrastructure also performed well in stable regimes, and even in declining inflationary environments.

Combing the exposures carefully, being aware of drivers and risks, resulted in a strategy that not only helped protection from inflation (driven by commodities and natural resources), but also reduced the opportunity cost, or premium for providing an inflation protection (REITs and infrastructure), when inflation is declining.

When we couple these real assets with exposures like inflation-linked debt and potentially floating rate notes, this could help provide an element of capital protection.

Figure 4
Average Return Versus Inflation Regimes (2001–2022)



Source: State Street Global Advisors, Bloomberg and FactSet, as of 31 December 2022. All average returns are calculated in euro based on annual calendar-year returns with quarterly data. **Past performance is not a reliable indicator of future performance.**
Regime Definition Declining regime is an annual decrease in headline Consumer Price Index (CPI) of greater than 50 bp. Rising regime is an annual increase in headline CPI of greater than 50 bp. Stable regime is everything else in between.
The "Real Assets Composite" consists of 20% Morningstar Multi-Asset Global Infrastructure Total Return Index, 15% Bloomberg Euro Inflation-Linked Bond Total Return Index, 25% Bloomberg Commodity Total Return Index, 30% Natural Resources Index (12% MSCI Energy Sector Net Return Index and 18% Material Sector Net Return Index) , 10% Global REITs (5% DJ Global Select Real Estate Securities Total Return Index + 5% FTSE EPRA Europe ex UK Real Estate Total Return Index).
Proxy indexes used for asset classes: Commodities = Bloomberg Commodity Index Total Return. Infrastructure = Morningstar Multi-Asset Global Infrastructure Total Return Index (S&P Global Infrastructure Total Return Index was used from 1 January 2001 to 31 December 2003). Global Natural Resource = 40% MSCI Energy Sector Net Return Index and 60% Material Sector Net Return Index. REITs = 50% DJ Global Select Real Estate Securities Total Return Index and 50%% FTSE EPRA Europe ex UK Real Estate Total Return. Euro Inflation Linked = Bloomberg Euro Inflation Linked Bond Total Return Index. EMU Equities = MSCI EMU Net Return Index. Euro Agg. Bonds = Bloomberg Euro Aggregate Bond Total Return Index. Benchmark returns are unmanaged and do not reflect the deduction of any fees or expenses. Benchmark returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Real Asset Strategies — Bringing It Together

An inflation-resilient portfolio has to be built with a diversified allocation to assets that exhibit high inflation beta, our preferred measure of inflation-hedging efficacy, on a leading basis. Clear inflation linkages to return outcomes is also key, in our view. We use our proprietary long-term asset class forecasts, while paying particular attention to tail risk.

Figure 5
Eurozone Real Asset Model Portfolio

Eurozone Real Asset Model Portfolio	Ticker	Total Expense Ratio (TER; bp)	Strategic Weight (%)
Commodities	—	—	**25**
L&G Longer Dated All Commodities UCITS ETF EUR	COMF	30	25
Natural Resources	—	—	**30**
SPDR® MSCI World Energy UCITS ETF	WNRG NA	30	12
SPDR MSCI World Materials UCITS ETF	WMAT NA	30	18
REITs	—	—	**10**
SPDR® Dow Jones Global Real Estate UCITS ETF (Dist)	SPYJ GY	40	5
SPDR® FTSE EPRA Europe ex UK Real Estate UCITS ETF (Acc)	ZPRP GY	30	5
Global Infrastructure	—	—	**20**
SPDR® Morningstar Multi-Asset Global Infrastructure UCITS ETF (Dist)	ZPRI GY	40	20
Inflation Linked	—	—	**15**
iShares € Inflation Linked Govt Bond UCITS ETF	IBCI	25	15
Cash	—	—	**0**
Weighted TER (bp)	—	**31.8**	—

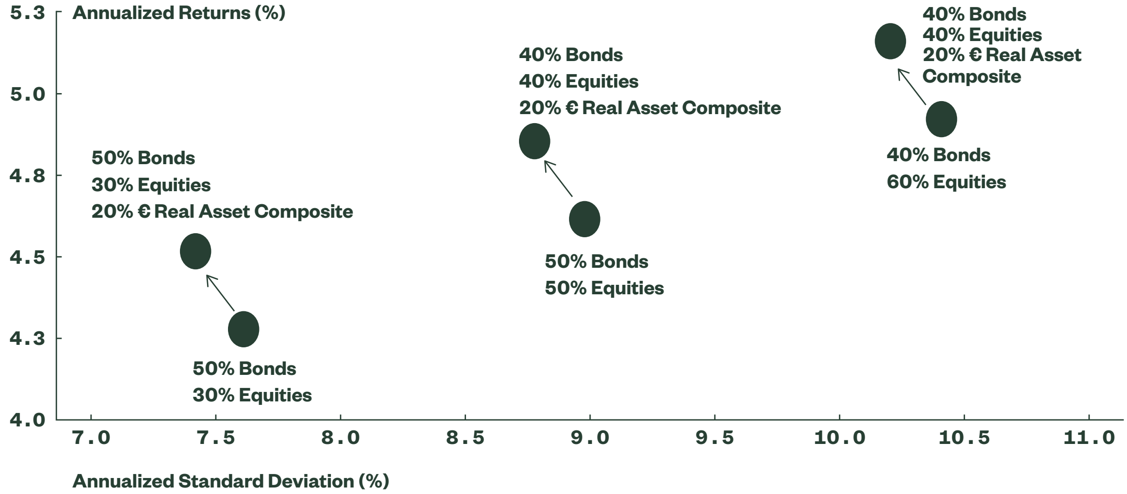
Source: State Street Global Advisors Investment Solutions Group, as of 30 June 2023.
Portfolio allocations are as of the date indicated, are subject to change, and should not be relied upon as current thereafter. **Model Portfolio Allocations presented above are hypothetical and have been provided for illustrative purposes only. They do not reflect the results of the actual trading of any account or group of accounts and actual results could differ substantially.** A model portfolio is an allocation to a list of funds that are grouped together. Where a model portfolio is offered on an investment platform, investors who select it effectively instruct the platform operator to acquire units in the exchange-traded funds (ETFs) that comprise the model portfolio. The model portfolio described above has not yet been implemented by State Street, so the results are hypothetical. The actual results of accounts managed by the Platform or Managed Accounts provider ("Provider") that receives access to the models may differ substantially from the hypothetical results for a variety of reasons, including, but not limited to, the Provider's decision to exercise its discretion to implement a model in a way that differs from the information provided by State Street. State Street cannot guarantee any payment of dividends, which is subject to the dividend payment policy of the individual issuers of the underlying ETFs and the Provider.

While some investors allocate to gold, the lack of income and direct inflation linkages driving returns deter us from taking large positions, preferring to allocate capital to other areas, although it can be a good diversifier to consider. We also avoid cryptocurrencies for the same reason, compounded by a lack of history. While crypto's limited and predictable supply gives it the semblance of being a real asset, showing promise, when looking at realized and surprise inflation, it does, however, experience huge volatility driven by regulatory, security and political risk. Inversely, weighting crypto exposure to its volatility can be a solution; however, we steer clear, for the time being.

Diversification Benefits

Real assets can be a valuable source of diversification when combined with broad equities and nominal bonds, shifting the efficient frontier up and to the left.

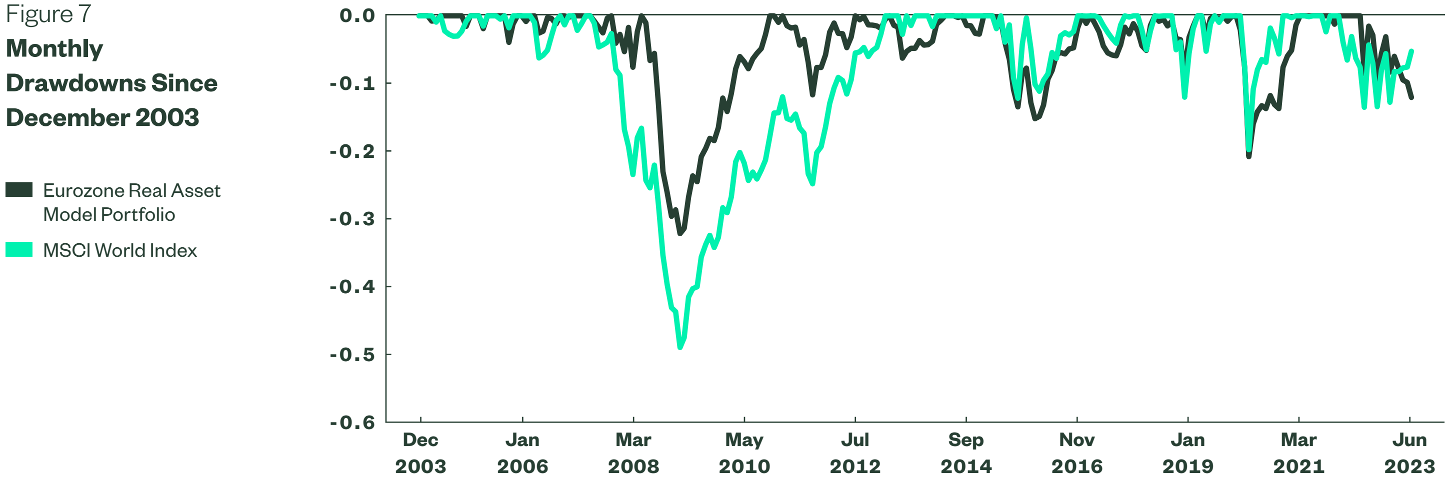
Figure 6
Annualized Volatility and Returns Since December 2003



Source: State Street Global Advisors, FactSet, as of 30 June 2023. **Past performance is not a reliable indicator of future performance. Benchmark returns are unmanaged and do not reflect the deduction of any fees or expenses. Benchmark returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Returns are calculated in EUR.**
*The "Real Asset Composite" consists of 20% Morningstar Multi-Asset Global Infrastructure Total Return Index, 15% Bloomberg Euro Inflation Linked Bond Total Return Index, 25% Bloomberg Commodity Total Return Index, 30% Natural Resources Index (12% MSCI Energy Sector Net Return Index and 18% Material Sector Net Return Index) , 10% Global REITS (5% DJ Global Select Real Estate Securities Total Return Index + 5% FTSE EPRA Europe ex UK Real Estate Total Return Index).
Proxy indexes used for asset classes: **Equities** = MSCI EMU Net Return Index. **Bonds** = Bloomberg Euro Aggregate Total Return Index — 50% Government + 50% Corporate.

A real assets strategy can also have drawdown benefits compared to market cap equity exposure, as we show below.

Figure 7
Monthly Drawdowns Since December 2003



Source: State Street Global Advisors, MSCI, as of 30 June 2023. **Past performance is not a reliable indicator of future performance.** Returns are calculated in EUR. *The "Real Asset Composite" consists of 20% Morningstar Multi-Asset Global Infrastructure Total Return Index, 15% Bloomberg Euro Inflation Linked Bond Total Return Index, 25% Bloomberg Commodity Total Return Index, 30% Natural Resources Index (12% MSCI Energy Sector Net Return Index and 18% Material Sector Net Return Index), 10% Global REITs (5% DJ Global Select Real Estate Securities Total Return Index + 5% FTSE EPRA Europe ex UK Real Estate Total Return Index). **Benchmark returns are unmanaged and do not reflect the deduction of any fees or expenses. Benchmark returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.**

Real Asset Strategies at State Street

State Street's Investment Solutions Group manages real assets through both strategic and tactical asset allocation strategies, utilizing passive liquid building blocks. Figure 8 below shows details of the Eurozone Real Asset Model Portfolio.

Figure 8
Historical Annualized Model Portfolio Returns/ Standard Deviation Through June 2023

Eurozone Real Asset Model Portfolio	3 Years (%)	5 Years (%)	10 Years (%)	Entire Period* (%)	Standard Deviation (5-Year Weekly) (%)	Sharpe Ratio	Inflation Beta	Max Drawdown (%)	European Securities and Market Authority (ESMA) Risk Category
Real Assets									
Real Asset Portfolio	**11.81**	**5.35**	**4.92**	**5.43**	**13.71**	**0.42**	**2.92**	**-32.17**	**5**
Global Natural Resource Stocks	20.33	7.56	7.72	7.70	24.22	—	—	—	—
Commodities	18.96	6.15	0.75	0.61	17.27	—	—	—	—
Global REITs	-2.46	-2.89	3.73	5.99	21.28	—	—	—	—
Global Multi-Asset Infrastructure	3.87	5.26	6.58	7.10	9.89	—	—	—	—
Euro Inflation Linked Bonds	1.46	1.41	1.89	2.77	7.59	—	—	—	—
Developed Equities	13.27	10.56	11.44	8.39	17.10	0.56	0.65	-49.01	—
All World Equities	12.07	9.58	10.68	8.16	16.63	0.55	0.59	-48.80	—
Inflation									
Euro Area Inflation	5.32	3.47	2.16	2.12	—	—	—	—	—

Source: State Street Global Advisors, Investment Solutions Group (ISG), and FactSet. **Past performance is not a reliable indicator of future performance.**
Returns greater than one year are annualized. *Inception Date: 31/12/2003.
The blended performance of Real Assets Model Portfolio figures contained herein are provided on a gross of fees basis. Gross of fees do not reflect the deduction of advisory or other fees which could reduce the return. The performance includes the reinvestment of dividends and other corporate earnings and is calculated in EUR. Returns do not represent those of the strategy/a fund but were achieved by mathematically combining the actual performance data of 20% Morningstar Multi-Asset Global Infrastructure Total Return Index, 15% Bloomberg Euro Inflation Linked Bond Total Return Index, 25% Bloomberg Commodity Total Return Index, 30% Natural Resources Index (12% MSCI Energy Sector Net Return Index and 18% Material Sector Net Return Index) , 10% Global REITs (5% DJ Global Select Real Estate Securities Total Return Index + 5% FTSE EPRA Europe ex UK Real Estate Total Return).
The performance assumes no transaction and rebalancing costs, so actual results will differ. Proxy indexes used for asset classes: **Commodities** = Bloomberg Commodity Index Total Return, **Infrastructure** = Morningstar Multi-Asset Global Infrastructure Total Return Index. **Global Natural Resource** = 40% MSCI Energy Sector Net Return Index and 60% Material Sector Net Return Index, **REITs** = 50% DJ Global Select Real Estate Securities Total Return Index and 50%% FTSE EPRA Europe ex UK Real Estate Total Return Index. **Euro Inflation Linked** = Bloomberg Euro Inflation Linked Bond Total Return Index. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Conclusion

We believe:

- There is a structural shift toward higher inflation
- Real assets share common characteristics that help protect against inflation
- Understanding these drivers and intelligently combining exposures in a portfolio can protect capital from inflation
- The efficient frontier shift demonstrates good diversification potential
- Addition of real assets to a portfolio could lead to reduced drawdowns compared to market cap equity
- Addition of real assets could generate attractive risk-adjusted returns

State Street Global Advisors' Investment Solutions Group works closely with a broad array of clients to find both strategic and tactical asset allocation solutions in the liquid real asset space. Currently, State Street manages in excess of USD 8 bn in liquid real asset strategies.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 29 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $3.8 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2022.
† This figure is presented as of June 30, 2023 and includes approximately $63 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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