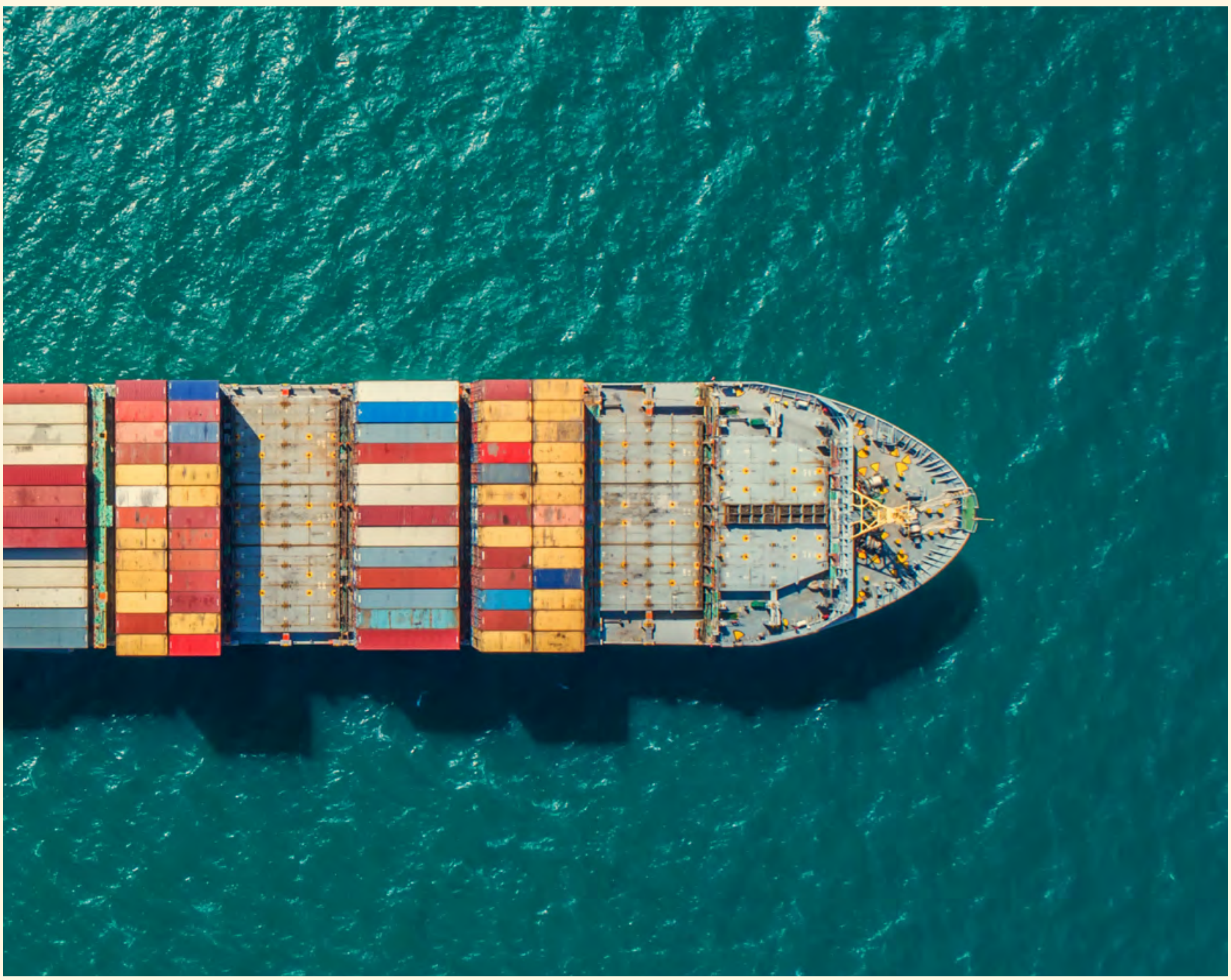
Group Retirement Services

Sun Life

The Real Deal: How Real Assets can improve member outcomes in CAPs



You know the story - inflation recently spiked to its highest levels in 40 years. Inflation erodes the spending power and wealth of your employees. It can also take a psychological toll – increasing an employee's stress and anxiety. One way to help your employees fight back against inflation is to offer them access to real assets. Now might be a good time to look under the hood and consider how your Capital Accumulation Plan (CAP) uses real assets.

What are real assets?

A **real asset** is a tangible investment that has worth due to its inherent properties. At first blush, in an era of cryptocurrencies and Non-Fungible Tokens (NFTs), real assets might seem downright stodgy. Unlike NFTs, real assets are things you can reach out and touch (if you had a mind to). Real assets can include a broad range of categories, but we'll focus on the main ones: **Real Estate, Infrastructure**, and **Commodities**.

Real Estate

What is it?

Everyone is familiar with real estate. You may own a home or cottage. **Commercial** real estate refers to land with a business purpose such as office buildings, industrial lots, business parks, and malls. Multi-residential properties (i.e. condos, apartments) are often also part of commercial real estate portfolios.

What are its properties?

Real estate is a “hybrid” asset class because it demonstrates both equity-like and bond-like characteristics. It tends to have return volatility that is higher than bonds but lower than equities. Due to its significant **income** component, real estate values, like bond values, will fluctuate inversely with interest rate movements. As interest rates rise, leverage (i.e. borrowing) becomes more expensive and the required rate of return (capitalization rate) on a property will increase. Both will have a negative impact upon real estate fund values. The reverse is true when interest rates decline.

The equity component of real estate stems from the changes in the prices of the properties. Real estate prices and equity market values do not move in lockstep since they can often have different drivers. This leads to **diversification** benefits within an investment portfolio that has a significant allocation to equities. Real estate prices also tend to be positively correlated with inflation leading to **inflation-protection**.

Real estate can also provide **downside protection** in comparison to global equity markets. This is due to the income component, which tends to be stable, as well as the more defensive properties intrinsic to real estate. The defensive nature of a real estate fund will vary with the amount of leverage employed. More leverage equates to more return volatility and downside risk.

Infrastructure

What is it?

Infrastructure is the physical structures and facilities needed for the operation of a society and an economy. Examples of infrastructure include roads, railways, airports, shipping terminals, water and gas supply. Infrastructure categories have broadened over time to include social (health-care centres, schools etc.) and communication (broadcast and wireless towers, satellite networks etc.) assets.

Other types of infrastructure, such as communication assets, can have returns that vary more widely with the business cycle and major global events. Similar to real estate, leverage can also increase risk and reduce downside protection.

The overall attraction of infrastructure is predictable long-term income, downside protection, diversification, and inflation protection. However, the overall return potential may be lower than the broad equity markets.

What are its properties?

Infrastructure investments are valued for their long-term and relatively **stable cash flows**. Traditional "core" infrastructure investments have inelastic demand (i.e. they are still needed in tough economic times), which helps them preserve their value during downturns. They are often regulated and may have near monopolistic status, with revenues based upon long-term government contracts. These contracted revenues are often linked to the CPI and provide inherent **inflation protection**.

Commodities/Natural Resources

What is it?

Commodities/Natural Resources are economic resources that are generally fungible. Examples include oil, natural gas, gold, silver, corn and wheat.

What are its properties?

Commodities can add **diversification** and **inflation** protection to a portfolio. The asset class is typically accessed through investment in either commodity futures or listed companies that focus on a particular commodity like gold or oil. Commodity prices can be unpredictable and commodity investments can have significant return volatility. For this reason, allocations to commodities are usually a small part of a larger real asset portfolio. Canadian investors, in particular, should limit commodity exposure since they comprise approximately 30% of the S&P/TSX Composite Index.

Who's investing in real assets?

There are many different types of investors investing in real assets:

- Many **large Canadian Defined Benefit (DB)** plans sponsors invest in real assets to help manage risk. For instance, Canada's largest plan, the Canadian Pension Plan (CPP) broadly invests in office buildings, shopping malls, toll roads, farmland, power transmission and many other real assets.
- Some of Sun Life's **larger CAP clients** create their own **custom target date or target risk funds**. An informal review of their asset mixes indicates that many include listed or direct real estate and infrastructure within these custom funds. Commodities are utilized far more rarely. Typical allocations range from 5% to 20%.
- **You** and **your employees?** Did you know that most plans offer a target date series and almost all of Sun Life's target date funds have dedicated allocations to real assets?

Target Date Series	Real Asset Type(s)	Min Target Allocation	Max Target Allocation
BlackRock LifePath	Listed Real Estate, Listed Infrastructure, Commodities	4.9%	10.5%
Fidelity ClearPath	None	n/a	n/a
MFS LifePlan	Listed Real Estate	1%	10%
Sun Life Granite (incl. multi-risk)[1]	Direct & Listed Real Estate, Direct and Listed Infrastructure, Listed Natural Resources	7.3%	9.5%
TD Greystone Plus	Direct Real Estate, Direct Infrastructure	20%	20%

[1] *Based upon enhancements to the Granite Target Date funds to be phased in by the end of 2024.*

Should my plan offer a real asset fund?

Real assets can offer multiple **benefits** to investors:

- High income;
- Inflation-hedging protection (i.e. returns that are positively correlated with inflation);
- Reduced return volatility relative to equities; and
- Diversification, due to their low correlation to traditional asset classes

Your CAP plan can go beyond the allocations to real assets in target date (and target risk) funds to offer a "stand alone" real asset fund. A small but growing percentage of Sun Life clients are choosing to do this. More than 11% of plans offer a stand alone real asset fund.[2]

[2] *Based upon Sun Life clients with assets greater than $25 million.*

If you decide to go this route, there are a few other questions you need to ask:

1. Listed or Direct?

There are two different ways of structuring a real asset fund:

a. A fund that invests directly in property and infrastructure. This is called a "**direct**" fund.

b. A fund that invests in the publicly-traded stock of companies that focus their activities upon real estate, infrastructure and/or commodities. This is called a "**listed**" fund.

Direct funds may provide lower return volatility and better diversification than listed funds. This is primarily because direct assets are valued less frequently (appraised quarterly or annually, for example). They are, therefore, largely isolated from the day-to-day volatility of the global equity markets.

However, direct funds will typically have higher management fees and operating expenses than a listed fund. Some direct funds may also have performance-based fees. Because they are private, direct investments have less publicly available information than listed investments. Investors are more reliant on the fund manager for information. Liquidity is also a consideration. A sudden surge in investor redemptions might cause a direct real asset fund to freeze redemptions for a period of time, as they work out a way to liquidate assets in an orderly fashion.

In contrast, the advantage of listed funds is their simplicity and lower costs compared to direct funds (listed real asset fund fees are often higher than other equity funds, however). Listed funds may be more "defensive" (i.e. lower down-side risk) than the equity market as a whole. But they will experience short-term sentiment-driven price volatility and returns will, therefore, have a higher correlation to equity markets than direct assets. This results in lower diversification.

[3] *Morningstar Real Estate Equity Universe relative to the FTSE/EPRA NAREIT Developed Real Estate Index as of December 31, 2022.*

2. Active or Passive?

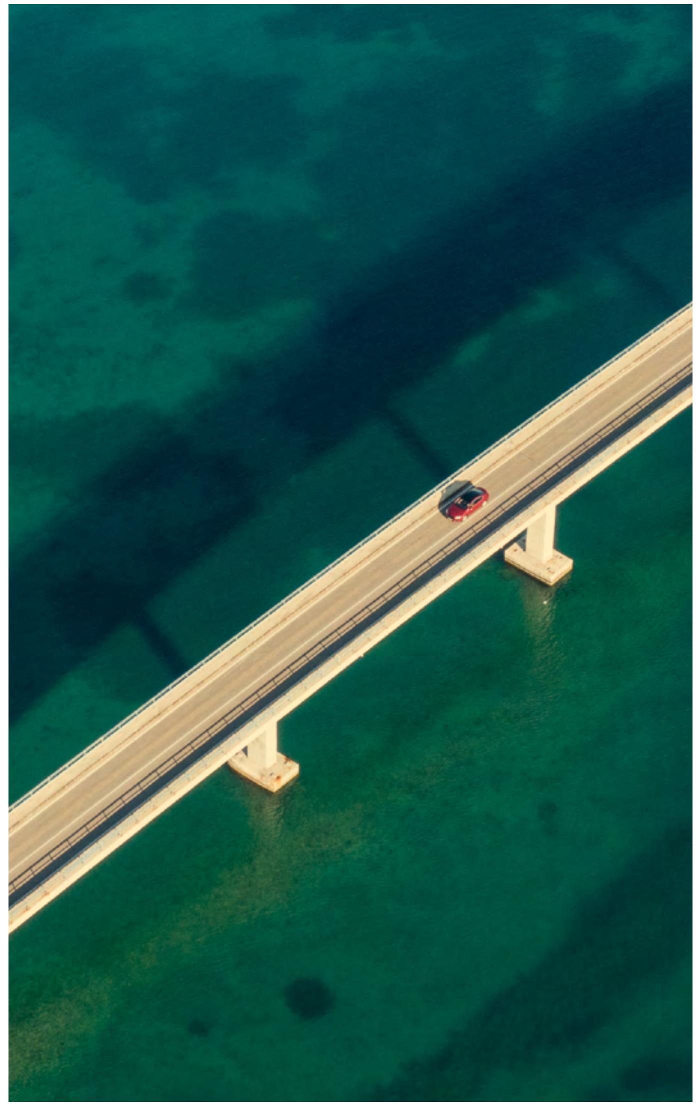
Direct real assets can be accessed only through active management. Listed real asset funds can be actively or passively managed. The evidence for active management is mixed, with the median active return in listed real estate outperforming the index over five years but underperforming over ten years.[3]

3. Canadian or Global?

The pros and cons are similar to a discussion of Canadian vs. foreign equities. Canadian real asset funds have the advantages of higher plan member comfort levels, no foreign currency risk, and usually slightly lower fees. The main disadvantages are less diversification and a much smaller opportunity set. Canada has only a few major urban centres and limited geographical diversification for real estate. Canada also offers a small proportion of global infrastructure investment opportunities.

Adding a stand-alone real asset fund offers plan members choice. They can take it or leave it. Real asset funds, like other single asset class funds, are not intended to be a plan member's only investment. They aren't fully-diversified and should serve as only a portion of a total investment portfolio. Most plan members are not sophisticated investors. They may not have the confidence or the awareness to invest in the real asset fund. In general, we have found that new funds added to a mature plan only very slowly gain assets.

We currently offer the following real asset funds to CAP plans on our core platform:



Fund	Real Asset Type	Listed or Direct?
BGO Canadian Real Estate Plus	Real Estate (Canadian)	Primarily Direct
BlackRock Global Infrastructure Equity Index	Infrastructure (Global), Passive	Listed
Franklin Global Real Assets	Real Estate, Infrastructure, Commodities (Global)	Primarily Direct
Invesco Global Real Estate	Real Estate (Global)	Listed
Lazard Global Infrastructure	Infrastructure (Global)	Listed
Sun Life KBI Global Sustainable Infrastructure	Infrastructure (Global)	Listed
Sun Life Multi-Strategy Real Assets	Real Estate, Infrastructure, Commodities (Global)	Listed

What you can do next

Real asset funds aren't just useful in periods of higher inflation. Did you know that some real asset funds were among a small number of funds on our core platform to generate positive returns in 2022? Stodgy or not, they can be a useful part of a long-term investment strategy.

Core platform investment manager TD Asset Management research indicates that members who include alternatives such as direct real assets in savings and retirement portfolios witness benefits comparable to: 1) investing an additional 5-10 years or more; or 2) increasing the contribution rate by 2%-3%.[4]

[4] *Source: DC Decisions – What Matters Most for Your Plan Members, TD Asset Management, August 2019.*

Sun Life offers access to real assets as part of diversified portfolios (Target Date/Target Risk) or as stand alone fund options. Best-in-class CAP governance includes regular reviews of the investment options offered to members to ensure they continue to meet your evolving needs. We recommend that plan sponsors:

- Review what real assets are in your current line-up; and
- Assess whether the current approach is right for you and your plan members.

The GRS Investment Solutions team is here to help you. Contact your client representative to leverage the expertise of an Investment Solutions Executive.