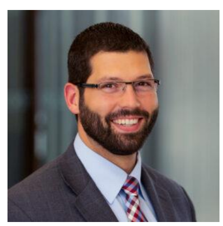
March 2022 Virtual Event-AICA Spring Closed-End Fund Roundtable Day 1 Panel #2; "Real Asset Funds as Inflation Hedges"

Tuesday, March 15, 2022

Mike Taggart of Taggart Fund Intelligence and also Executive Director of AICA moderates the second panel of Day 1 of the March 15th & 16th, 2022 virtual event; "Real Asset Funds as Inflation Hedges". Read the transcript below to hear the discussion among Mr. Taggart and panelists Larry Antonatos from Brookfield and Scott Carson from Principal Real Estate Investors.


Mike Taggart


Larry Antonatos


Scott Carson

To view the rest of the conference events and panels go to:
https://aicalliance.org/aica-event/cefroundtablespring2022/

John Cole Scott: All right, working on the next session, if you want to join me on stage. Rob Watson is scheduled to moderate this panel, currently is not in the room, so Mike Taggart our executive director, I told you you'd meet at some point, we now get to meet as the moderator for the panel. So thank you guys so much for this session, it's one of the topics we're really interested in and I'll let you guys get to it.

Mike Taggart: All right, Larry and Scott, apologies, but at least we spoke earlier. I think at this point for the audience's sake, just maybe we'll start with Larry and go to Scott. Larry, if you could maybe introduce yourself, your firm, and your strategy, especially how it relates to within your closed-end fund.

Larry Antonatos: All right, thanks. Hey, I'm Larry Antonatos, I'm a portfolio manager with Brookfield Asset Management. Brookfield is a global asset manager focused on real assets, principally real estate and infrastructure. We're relatively narrow in those spaces but we're very deep. We invest in real estate and infrastructure but also private equity and credit in public formats, private formats, equity and debt. What I'm doing with the Brookfield Real Assets Income Fund is a public-only strategy, it's a levered closed-end. It's roughly equally divided one third in high-yield credit, one third in residential and commercial mortgage-backed securities, and one third in real-asset equities, principally infrastructure and real estate. What we liked about this product is we have the flexibility to adjust the portfolio opportunistically as the market environment changes. So we can adjust the equity to credit ratio, we can adjust the mix of real estate and infrastructure, residential mortgage backed, commercial mortgage backed. We can be very dynamic and try to generate good returns in multiple market environments.

Mike Taggart: Thanks. Scott, your turn. Please, if you will.

Scott Carson: Yeah, good to be here today. My name is Scott Carson, I'm a portfolio manager for Principal Real Estate Investors. We, similar to what Larry said, we are a real estate manager that we cover all what we would call the four quadrants of commercial real estate, so both public and private debt and equity. The world that I live in and focus in would be the public debt, primarily commercial mortgage-backed securities. The fund we manage, the Principal Real Estate Income Fund is allocated about 35% to global real estate securities and 65% to US-based commercial mortgage-backed securities. So overweight to debt versus equity in that strategy which does make it more of a unique offering as we look across the closed-end fund landscape.

Our primary objective is to really offer an attractive risk-adjusted yield through this strategy. Also we do provide an alternative risk-return profile given the high allocation to debt rather than equity within the real estate space. Principal Real Estate Investors, we have a long-term history in real estate underwriting, fundamental analysis is at our core. And being where I sit in the public debt space, we do have the benefit of being able to utilize all of our commercial mortgage underwriters as well as our equity asset managers as resources as we look to select the best bonds for the strategy. Similar story over on the listed securities side, and that team spans not only the US but also has a very successful global strategy with an income focus for this product.

Mike Taggart: Excellent. All right, thank you both for the quick summary there. Now I want to thank Rob too because I'm basically, just so the audience knows, Rob unfortunately isn't here to moderate. He did prepare the questions, so they're not my questions. If you do have a question as an audience participant or audience member, please feel free to type that into the Q&A at any time.

So obviously the real asset space has been doing well lately to put it mildly. We don't really want to spend too much time I guess on the macro issues, but they're just so dominant and they're really I think driving the price return recently in closed-end funds, including your closed-end funds. So maybe if you could each spend a couple minutes giving us your view of the geopolitical macroeconomic dynamics today, and maybe how that's affected your [inaudible] over the last say, three to six months. And I think we'll bounce back to you, Larry, to kick us off.

Larry Antonatos: Sure. So from a macro perspective, we tend to think about interest rates, inflation as the two most important drivers along with economic growth. So from an interest rate perspective, we've had a big move in rates that has started. We expect rates to move modestly higher and we think that the pace of the move in rates is important to the generation of returns. We are not as concerned about rising rates as we were a year ago when rates were significantly lower, so a lot of that move is behind us but we do expect rates to continue to move modestly higher.

From a growth perspective, obviously we had a tremendous falloff in growth in 2020 with Covid. A tremendous rebound in 2021. We do expect growth to decelerate or probably back to where we were pre-Covid. So we think the economy's going to continue to be strong, we're not looking for a recession, we're not looking for massive growth either, we're just looking for a deceleration back to our long-term pre-Covid track.

And from an inflation perspective, we actually think that we are probably at peak inflation right now and we expect inflation to trend down. But different from growth, which we expected to trend down to pre-Covid levels, we're expecting inflation to trend down to something that's probably 100, maybe 200 basis points higher than pre-Covid level. So let's say if it was 2% in the past, we're looking probably at 3-4% over the next few years. And a lot of that is driven by the fact there's just been so much disruption with Covid slowdown, people not working in the mines or the in fields or on the ships, supply chain breakages. And all of that has been really exacerbated by the Russia-Ukraine tensions, which is a terrible situation, but we do think that we are pretty much at peak inflation right now. But inflation will be something to worry about for many years unlike pre-Covid when most of us simply didn't worry about it.

Mike Taggart: Right. And how about you, Scott, at Principal? What's your view on the current situation?

Scott Carson: Yeah, I don't need to repeat a lot of what Larry said. Obviously inflation is at the forefront. We're certainly trying to look through to growth. I would say starting in November when the Fed started to make their pretty substantial pivot going from this transitory rhetoric towards being more concerned about inflation and the stickiness if you will of some of the different drivers of inflation, we've been looking for volatility. Obviously the tragedy in Ukraine has added fuel to the fire in terms of there being a market-risk premium for volatility in geopolitical stress and uncertainty.

That said, I think the Federal Reserve removing accommodation is a big story that we'll see play out this year. In addition to that, the waning effects of the massive amount of fiscal stimulus that we've seen over the past couple of years, those are things that we had anticipated would create some volatility. As we've discuss internally, one thing we are optimistic about is that the real economy, at least in the US, seemed to be pretty well positioned for the type of volatility that we're stepping into now. When you look at the health of corporate balance sheets, corporate profits, consumer spending, the health of the consumer overall, and then the robust jobs landscape, we're in a pretty good position in terms of what I would call the real economy as we head into this stressed environment.

Also we're happy to be in real estate. The real estate capital markets continue to be extremely supportive of valuations. We do think that we're looking forward to a different regime in terms of the pace of total return in commercial real estate if I speak to equity return potential. That's going to be based on obviously the shift in Federal Reserve policy. Also we've seen just a very, very strong past couple of years in terms of equity appreciation, and that's due to temper as some of these tailwinds that we've been enjoying are starting to abate.

Mike Taggart: I'm going to stick with you this time, Scott, as we go through this bit. Given that and both of your expectations, can you give us some bigger picture things like in terms of tilts or emphases within those? I mean, both of you have a significant way in terms of shifting between equity and debt [inaudible] what your outlooks and how that's being reflected in the [inaudible].

Scott Carson: Yeah. Yeah, it's a great point. So our portfolio, it's pretty narrow in focus in terms of what we're trying to accomplish. It's very much about attractive income generation, and we're trying to capture some equity upside potential via the 35% or so allocation to global real estate securities. But over time since we launched this in 2013, we've been pretty focused on higher yielding commercial mortgage-backed securities, and that's been good in times of stability. When you've seen very strong equity bull markets, we've underperformed just a general equity-only strategy as you would expect. And so our fund profile tends to carry a lower standard deviation, a different risk-return profile versus just say a household name REIT-only type strategy.

What I like about where we're at today is we do have what I would consider a fair amount of hidden beta in our debt portion of the portfolio. We invest in a lot of more seasoned, lower rated or high-yield type CMBS type investments. These investments aren't as exposed to the large day-to-day moves and market sentiment or even broad market volatility. The further you invest down the capital stack with any commercial mortgage-backed securities, the more it is about the fundamental performance of the real estate that is really securing the loans that are the collateral for our bonds. And so based on that I like how we're positioned today being more debt than equity given the yield advantage. And then also we're in an environment where the equity upside potential isn't as attractive as it was maybe a year ago when you look back at those very strong equity returns that we've recently experienced.

Mike Taggart: Okay, thanks. Now Larry, if you could do the same. How's your view on equity [inaudible] just said? Is that something you would agree with?

Larry Antonatos: So I do agree with everything Scott said. My portfolio has a few different levers to pull, in particular we have significant exposure to infrastructure. And as I think particularly to your question about equities, we think there does remain meaningful equity upside in real estate equities, but in infrastructure equities perhaps more. So within our equity portfolio we actually have a two to one ratio of infrastructure equity to real estate equity. One simple thing to consider is if you look back at the pre-Covid market peak which was roughly Valentine's Day 2020, real estate equities, public markets, and infrastructure public equities are both trading roughly in line with their pre-Covid valuations. The broad market, MSCI World, S&P 500 is probably 10-20% above its pre-Covid highs.

Now part of that is because real estate and infrastructure and anything that is mobility related was very significantly impacted by Covid. Some of us are still working from home, the economy is still not back where it was pre-Covid, but once everything goes back a little more towards normal, maybe we never get back to normal but we're going towards normal, I do think there's going to be significant interest in real estate and infrastructure of the sorts that were most impacted by Covid. So in real estate it's hospitality, retail, and office were all the worst performing sectors during the Covid drawdown, and we think those are the ones that are poised for the most rebound when things go back to normal. If I think about infrastructure, anything transportation related is obviously suffering and is really poised for a strong rebound when things get back to normal.

So within the equities that's how we're positioned. We actually think both of them have significant upside, but infrastructure perhaps a little bit more. But also because the picture isn't crystal clear, because we've got a war going on, a lot of uncertainty in geopolitics, infrastructure tends to be a somewhat more defensive equity class relative to real estate, and that contributes to our two to one ratio of infrastructure to real estate equities. I'm going to try to be brief and just talk about the debt side of our portfolio.

Mike Taggart: We have plenty of time.

Larry Antonatos: We have two thirds debt. The high yield has performed well, as has the mortgage-backed security portfolio. There's overlap with what Scott does in commercial mortgage backs that we have. We really like the single asset, single borrower profile within commercial mortgage-backed securities. We can get to understand the individual security, the individual building better than in a diversified pool, and maybe pick our spots and earn some excess returns that way.

In residential, where we have roughly one sixth of our portfolio, one thing we love there is that the residential market has been very strong, creating very good collateral protection, good asset value, good loan to value in our portfolio, but also the bulk of our residential book is floating rate. So in a rising rate environment, it's a great type of asset to have in the portfolio. And as interest rates move up, the coupon on our loans will move up and our income generation will move up. So that's a great thing to have in the portfolio.

Mike Taggart: Are any of your loans in your-- I'm sure some of them are probably floating rate, right Scott? Do you know percentage or how that might--

Scott Carson: Yeah. Yeah, so definitely not speaking to my portfolio but I would agree with Larry that we do find the single asset, single borrower part of the market attractive. We do not have any floating rate in the portfolio currently. Where we are managing duration is through shorter duration, more seasoned investments. So these would be bonds that were issued maybe in 2012, 2013, 2014. Originally they were 10-year bonds and now they've amortized down over time or shortened such that the duration of the overall debt portfolio is around three years right now. So that has helped in terms of the way we look at rising rates.

Additionally a lot of the securities that we purchase, back to that theme of really being able to look at a few select properties that are really driving the credit. For example, and this may be something that people may be surprised to hear, there are some bonds that we're holding that are exposed to some malls. And I know malls have been kind of a property type that have been under a lot of pressure. But what we do is we underwrite the malls, we look at the risk, we look at the position within the capital structure, and we can see what the market is kind of inferring in terms of the level of stress on these malls. And we've been able to be contrarian on some of the holdings that we have in this portfolio.

Where, yep, we're going to acquiesce. Yes, these malls are in trouble, but based on the basis of the loans, based on the value of the dirt itself and the likely outcomes, we've been able to build a diversified exposure to these shorter duration securities that are generating very high yields. So yields in the 6-8% on some of these securities, and like I mentioned before, shorter durations and what I would consider more hidden beta, it's a different type of beta. The performance of a mall in Florida for example is not going to be swayed day-to-day by the prospect for peace talks in Ukraine for example. So that's just an example of somewhere where we're trying to manage duration shorter but also trying to find where there could be excess spread based on the way that we look at real estate and risk within a particular holding.

Mike Taggart: You know, gentlemen, I have to apologize, we jumped right in at the very beginning and here we are 15-20 minutes into it. I don't think either of you have identified your closed-end fund, nor have I, and I should have done that as the moderator. And there's plenty of people who watch this on the replay, Larry, you're with the Brookfield Real Assets Fund, RA, in addition to other portfolios. And Scott in addition to other portfolios, you're portfolio manager on the Principal Real Estate Income Fund, PGZ. So just for our viewers so they can go to CEF Data or CEF Connect or our website.

It always strikes me, and I've been in this industry for longer than I care to admit, and it's been especially in closed-end funds, I'll say the marginal investor who sets the price gets anxious. "Oh no, rates are rising. I have duration risk." If they even understand that, but express it as duration. Meanwhile they're paying professional managers to manage their funds, they act like the professional managers aren't aware that interest rates are going up. So I appreciate that both of you just spent some time explaining how you're positioning the portfolio in the face of rising rates. I think that's important to hear and to consistently let clients know.

So yes, the news is bleak [inaudible] the silver lining. So what would you tell investors? Is it the real asset story? What would be encouraging to the investment community about investing in either of these strategies right now? Larry, if you want to-- I don't know, maybe you don't want to tackle that.

Larry Antonatos: I'm happy to tackle it.

Mike Taggart: [inaudible] if that's the case.

Larry Antonatos: I'm happy to tackle it. Maybe I'll just speak about the infrastructure part of our portfolio, and Scott can speak about real estate with great knowledge. We'll split that question up in two parts. What I think is particular attractive now about infrastructure is the inflation protection that you get, the growing cashflows that you have in an inflationary environment. Within infrastructure, it's important to think about the drivers of the economics, the business model. I think we all understand how you make money in real estate. You have a building and you charge rent, and over time hopefully market rents go up so your cashflow goes up and your building's worth more.

Infrastructure, to US investors many people don't really think about infrastructure the way global investors do. Let's take airports. In the US almost every airport is owned by the local airport authority. In the rest of the world, many airports are owned by private equity funds or publicly traded companies. And infrastructure is widely available as an investment beyond simply utilities, which US investors know very well, and oil and gas pipelines, which US investors know very well. So I think to consider how you make money in infrastructure, think about supply, demand, and pricing.

The supply of most infrastructure assets is relatively constrained. For example, airports. Most cities have exactly one commercial airport. Limited competition. Maybe you have one utility. One electric utility, one water utility, etcetera. So limited competition. From a demand perspective, most infrastructure is relatively steady from demand. I've already mentioned that anything that's transport related like airports, seaports, and toll roads was impacted by Covid. But hey, electricity was still needed, water was still needed, and in fact cell phone communication and any kind of internet, which is part of infrastructure, that was dramatically rising during coronavirus. So pretty steady demand.

And then as you think about pricing, infrastructure's not a free-market business. Infrastructure is heavily regulated. If the government gives you a monopoly by allowing you to have the only utility or the only airport, the government will control your pricing. And the traditional regulation allows for pricing to increase in relation to inflation. So as inflation accelerates, you can raise your toll on your toll road or the landing fee at your airport. If you have a utility that is allowed to earn a real return on its invested asset base, as inflation moves up you can increase your charges to earn your same real return on your invested asset base. So infrastructure's particularly attractive in an inflationary environment. I'm sorry, go ahead.

Mike Taggart: I have two questions. One comes from the audience and one from me. What's typical lag in those pricing increases, Larry? I'm sure it varies, but just between the utilities and an airport, but just in general?

Larry Antonatos: It's going to vary asset to asset, and regulatory regime from country to country, from county to county sometimes or state to state. But what I would typically say, it's a very good question, there is a lag. I would say the most frequent regulation is typically annually, but there may be a crisis. For example right now in Europe a lot of the European utilities, particularly the gas utilities that are having troubles sourcing gas, electric utilities are also having trouble sourcing gas to generate electricity, the governments are looking at the impact of the commodity price on their consumers and trying to adjust certain things about the regulatory pricing. Maybe those are temporary adjustments, maybe they're more forward-looking. But other than that immediate crisis intervention, you should think about infrastructure regulation being generally an annual review or sometimes every two or three years allows you to increase your price.

Mike Taggart: So kind of like a floating rate.

Larry Antonatos: Yeah, exactly.

Mike Taggart: It's manual instead of the resets annually.

Larry Antonatos: Yeah, and one finer point on that and then I'll cede the floor. In the example I gave about European utilities, keep in mind that most infrastructure does not have commodity price risk. Sometimes you do, but most of the time a lot of the electric utility infrastructure is earning a return on the wires, the distribution network. And the cost of the gas that's used to generate the electricity is passed through to the ultimate customer, so the utility doesn't really have a lot of commodity priced risk. That's not always the case but that is generally the case. So think about much of the infrastructure universe as earning a return on your asset base, and for utilities that asset base can grow over time as you expand your network, add more households, improve the efficiency of your network, things like that.

Mike Taggart: We have a question from the floor that goes right into what you've been talking about, Larry. What are the valuation level differentials between US and international infrastructure investments right now?

Larry Antonatos: So it's going to vary by asset class, and it's actually somewhat tough to make those generalizations. So for example, an airport in Sydney and the regulation that governs Sydney may be very different from the regulation that governs an airport in London. And in the US there are very few airports that are in public hands. So it really is more of an asset specific question, and it can be the nature of the regulation, the nature of the customer base. So I can't give you any broad generalizations between onshore and offshore infrastructure.

Mike Taggart: I'm sure in addition [inaudible] some differentials in terms of accounting, in terms of financial reporting and that sort of thing as well.

Larry Antonatos: Right. And I will say though that in the public infrastructure equity universe, roughly 60% of the market cap is in the US. And in our debt portfolio, roughly 80% of the market cap is in the US.

Mike Taggart: Okay. And then Scott, if you could kind of go through a detailed thing there with [inaudible] and global real estate.

Scott Carson: Yeah, sure. So Larry set the floor well, or the stage well. So what we've really seen is just an improvement in fundamentals post-Covid. Real estate exists [inaudible], Covid made it so that we shouldn't be together. So it was very much a shock to the system, especially with respect to hotel and retail. We've sensed that that time as the reopening has occurred, we've seen a dramatic improvement in retail fundamentals, hotel as well. Office is kind of a wildcard, that might be a Pandora's box to open that discussion. But we have seen people start to come together again and delinquency rates in the CMBS world have really improved quite dramatically since the heights of the pandemic.

So now we're in a position where the asset class overall appears to be pretty stable from a fundamental perspective. And when we think about inflation now, we have to get into a discussion of the different property types. So obviously with respect to inflation, the shorter the lease terms are, the more ability a landlord or an owner of property has the ability to reindex the property to whatever is happening with respect to inflation. So a hotel's going to be the best example of that. And they benefit from that on the way up as rates are going up, inflation rates, as room rates are going up they can reset, think of it essentially as a nightly lease, you think of that resetting every day. Apartments might be next in line there. Usually annual leases there, so they can reset relatively quickly. I forgot about self-storage, those are very short lease terms.

So those property types are pretty well positioned to be able to increase their net operating income or their revenue at least as we enter a more inflationary environment. Property types like office that tend to have longer leases, or some retail centers that have longer leases, they aren't as able to keep up with the trends in inflation. However, one benefit that some leases have is that the tenants do passthrough expenses back to the landlord in the form of reimbursement. So as utility expenses go up, as the cost of insurance goes up, as other expenses that tenants are potentially on the hook for, as those rise, the landlord isn't just bearing the brunt of that. So that does help to maintain those levels of operating income at those properties.

On the inflation front, focus on shorter term leases and then think about a lot of these leases also have CPI rent resets built in, so that does help from that perspective. But beyond that, it's not just an inflation story, it's a structural growth story. And this is something that our REIT team is very focused on, so looking at the property sectors that are in the best position to actually grow organically. So the best example of that recently has been industrial, we've just seen a boom in industrial over the past 18 months or so. Covid really accelerated the ecommerce trends that we saw beginning prior to the pandemic. And so now you have the Amazon's of the world that are building out a vast distribution network, last-mile distribution around all these major metros across the country and that has really helped to drive industrial rents. Not to be hyperbolic, but it's been almost staggering to see how quickly risen.

Scott Carson: But so industrial is one of those, life science would be another property sector that within that structural growth. And then as an organization, we're pretty interested in more of the niche property types. If you think about towers or datacenters as well, again within that structural growth trend.

So the last thing I'll say is, since I'm a debt guy, NOI growth, revenue growth, operating and income growth, that's great and that's really good for the valuation of properties and something we should focus on. But as a debt investor, I don't need NOI to go up, I don't need these properties to generate 25% more income in 10 years than they do today. I just need the capital markets to be open so these borrowers can refinance and pay off my bonds. So that's really a difference when we look at the debt side of the world versus the equity side of the world that leads to that diversification. We're really focused on that current income, at times there will be total return potential. But overall, long-winded way of saying that fundamentals are supportive of debt, especially alongside the equity in commercial real estate right now.

Mike Taggart: We have a question from the floor so to speak. What do you think the five to 10 year future is for US malls? What will they look like? Then somebody else just wrote in too.

Scott Carson: Yeah. Yeah, a lot of them will look like parking lots with nothing in the middle. A lot of them will look like something else, it won't be a mall anymore. And so we really need to think about is the mall located somewhere where there's another highest and best use for that real estate? Now certainly there are going to be malls like Ala Moana Mall, there are a lot of good malls across the country that will continue to be good malls. Good malls are not going away, they're not dying. What we have to be concerned about are some of the B malls, some of the C malls.

So those tweener malls, it's pretty easy to look around. If you've been to a mall and you walk around and you see that 50% of the inline space is closed, it's dark, it doesn't feel inviting, those malls are going away. They are. Those are pretty easy to identify. What I think is more interesting is there's a very large subset in the middle where these malls, yep, they're not the shiniest mall in the country but they're still generating productive sales, and they need to evolve to make sense in the next five to 10 years. Pre-Covid, the trends we were seeing is more experience, more experiential malls. So you're seeing activities, arcades, or that sort of experiential rather than just an old Sears where you go in to buy your Wrangler blue jeans. It was let's take the family there and it's kind of a common meeting ground. Covid threw a wrench in that but I think we'll start getting back to that as people are more comfortable getting out again.

I also think that one trend to watch will be with the shift in ecommerce. There are what we would call – can't think of the right word I want to use right now – basically using your brick-and-mortar space not only as a retail storefront but also as a distribution center on the backend. Fulfilling retail transactions online at a brick-and-mortar store. Omnichannel is the word I was reaching for there. So I think you'll start to see a lot more of that out of malls as well, especially in some of the big boxes where landlords are trying to figure out what to do. And oftentimes, some people don't know this, but oftentimes it's the tenant, the former Sears or the JC Penny's that actually owned that box, and now landlords are able to acquire those boxes when the Sears blows at very reasonable prices on a per-foot basis and they can repurpose that for more productive use. So good malls will remain good malls, okay malls will have to adapt and evolve to this new world.

Mike Taggart: Larry, you've been quiet for a few minutes. Anything that you would like to add or any different color or anything about malls?

Larry Antonatos: I agree 100% on the malls. And the way I say it is that the best malls will keep getting better, and other malls have to adapt. And at the very bottom end, the lowest performing malls will probably be, as Scott said, in the long term they'll be something else. And we have to acknowledge that sometimes these malls are in great locations, it could be great for apartment, it could be great for single family, there's a lot of land value there.

Mike Taggart: Okay. I just got a question that came up from the floor. Question is, and this is for mortgage-backed securities but I guess we could probably go into CMBS. How should investors think about the one to three year outlook for MBS, is what it says.

Scott Carson: I'll let Larry take that.

Larry Antonatos: Sure. So I think that from a residential perspective I'll answer it, and also I'll touch on commercial. I think it's really sort of the same story. What we like to see is that the value of the collateral is increasing over time, making the bond less risky in one way or more liquidity to be refinanced by the next lender. As Scott said earlier, we don't need the cashflows to increase on commercial property, we just need the capital markets to be open to the next lender is present to refinance that loan.

And from a residential perspective, the consumer being strong is very helpful, but what's also very helpful is that property values go up. So that whether the consumer is employed, the homeowner's employed or not employed or has to sell their house, there's somebody who can get an attractive loan to buy the home and refinance our loan. So we feel actually very good about both residential and commercial property.

From a commercial perspective, I think we all know that Covid has impacted commercial property. It's also really important to think about what happens to supply growth of real estate over time. Long term, 50-year average, new construction of commercial property as a percent of the existing commercial property is about 2%. So maybe that reflects obsolescence. Properties get old, they get torn down, we replace them with new property and there's a little bit of growth.

What set the commercial market up for a really strong recovery after the Global Financial Crisis, number one, people took a lot of pain on the way down. But for several years, roughly five to seven years after the peak of the Financial Crisis, commercial construction in the US approached it's all-time lows of roughly 50 basis points per year instead of 200 basis points or two percentage points per year. The same thing happened during Covid. Obviously there were certain types of properties where there was a lot of construction; datacenters, multi-family, industrial. But office, retail, hotels, not much was built over the last two years, and that just sets you up for a better environment in the next two years.

Mike Taggart: [inaudible] office, but like Scott said, let's not go there. Both of you manage your funds, to a certain level, investment objective would be income oriented securities, which I think we've talked about here quite extensively. Somebody wrote in, "Should investors fear leverage cost increases as a dividend reduction factor?" I think there are some funds where that can become an issue. But specifically for your funds as much as you're able to discuss that, we're not going to be forecasting [inaudible] with distributions, right? But as portfolio managers, how do you think about leverage and leverage costs when you're constructing your portfolio? Or do you not think about leverage and leverage cost and you just look at the entire pool of capital?

Scott Carson: Yeah, clearly the cost of leverage has to be accretive. We can take our leverage up within the constraints of the regulatory landscape, and we can also take it down. So we're never going to have leverage employed that doesn't make sense from a levered carry perspective.

Mike Taggart: Could you explain that? Because a lot of people, even [inaudible] are familiar with closed-end funds like people in our audience, a lot of people just don't get that carry cost. Can you just explain that?

Scott Carson: Sure. Sure, so just to make up some numbers using round numbers, let's say that it's going to cost me 2% to get some form of financing. If I know I'm paying 2% for this capital that I can then deploy and buy securities, or buy equity or debt, the securities I'm buying, they need to generate more than 2% by a healthy margin otherwise I'm paying more on my debt than I'm receiving on the deployment of that debt capital for the fund.

So traditionally that spread has been pretty attractive in our space given that we are focused on the higher yielding portions of both the equity and debt real estate. But if that changes, if the Fed is able to raise interest rates according to their dot plot, that can change over time. However I would also say that we've seen recently with the macro environment, we've seen credit spreads widen to such a degree that for the current mark to market of the portfolio, the current market yields of the securities that we're investing in have increased such that it's maintaining that situation where the yield generated by the assets is greater, much greater than the cost of that financing.

Mike Taggart: So let's go to your example though just real quick. You're borrowing at 2% and you're redeploying it at 10%. I'm making up numbers. The theoretical investor is doing that, so they're getting a spread of 8%, right? They take out their fee and they're sending back 5%. No, they're sending back 7.5% to the investors. But as that frontend comes up, are you redeploying into securities that are keeping that at 8%? Because that really gets to what people like about with distribution reductions, outside of a managed distribution policy and all that sort of thing. It goes up. If the cost leverage goes from 2% to 3%, your investable universe is probably going from 10% to 11%, right?

Scott Carson: Yes, but we have to consider the book yield of the securities in the portfolio at the point that we purchased them. So as the frontend rises, that does make the levered carry equation less attractive. What we are benefitting from is our fund currently carries about – I'm just making sure that I'm looking at our most recent fact sheet – around a 30% leverage ratio. So 30%, we're not talking a 3x, we're talking 0.3, 30%. So leverage is not a very predominant driving force of our distribution. It's something that it's a nice to have, but *like I said, it's not by any means generating the majority of our income stream.

Mike Taggart: Right, right. No, I like leverage, the use of leverage in [inaudible] and this carry [inaudible]. That aspect of it is great. Larry, how about you? How do you look at the portfolio in terms of leverage, leverage cost, and just the entire pool of assets?

Larry Antonatos: Exactly the same way, it's a spread investing. And let me just elaborate on what Scott said. I agree with everything Scott said, that's how we think about it. Just to put a finer point on the yield curve and the shape of yield curve. Scott did mention in his example we're going to borrow at X and we're going to invest at Y, and Y needs to be a lot higher than X to make it work. We are typically borrowing at the short end of the yield curve, three month, six month financing, and we're typically investing in a portfolio bond with a duration of maybe four years. So the steepness of the yield curve is what drives that spread between our cost of borrowing and our return on investment. That's the base rate, the steepness of the base rate, the 10-year treasury let's say, and then the credit spread on top of that. So as you hear people talking about the yield curve is getting steeper, a steeper yield curve is better for us.

Mike Taggart: Excellent. Yeah, thanks [inaudible] I think that helps. I think we're coming up on time and I've exhausted the Q&A from the floor. Are there any final points that either of you would like to make as we wrap up here?

Larry Antonatos: Hey, I think the thing to watch for both of these funds is how real estate performs as we move back to normal. Real estate has underperformed in the broad equity market for the last two years, the same is true for infrastructure. I don't say we have to catch up, but the more people are back in the office, the more people are traveling, all of these mobility-based real estate and infrastructure assets have tremendous potential to grow their cashflow over the next few years and drive really strong performance both in the equity side of our business. And frankly to the extent in either of our portfolios are invested in property types that people may view as risky, like retail or hotel, as those cashflows come screaming back, if they do, the credit spread is going to narrow and the bond prices will move up. So there's actual capital appreciation potential in both sides of the portfolio.

Mike Taggart: Excellent. Scott, any final thoughts?

Scott Carson: Well said, Larry. I'd also say watch real economic growth. We have some mines to navigate here as we change this monetary policy framework that we're living in, but watch growth, watch jobs.

Mike Taggart: [inaudible]

Scott Carson: Yeah, yeah. And that'd be my suggestion right now.

John Cole Scott: Good. Again, thank you both for your insightful comments. Thank you, Mike, for stepping in. Turned out to be a Central versus Eastern Time Zone issue, but Rob Watson sends his apologies, but thankfully we had a wonderful Mike Taggart to help out.

And I was asked to remind people that those attending tomorrow, it's the same link for both days to go to the same session even though on LinkedIn it's two separate events. So hopefully that doesn't confuse tomorrow's attendees. With that, you guys are welcome to go off stage and we're going to enter another 10 minute break. Feel free to mingle at your tables if you like, and again we'll start promptly at 3:30 PM with the last panel of today's sessions. So thank you guys.

Mike Taggart: Scott and Larry, thank you very much.

Scott Carson: Thanks for your time, everyone.

Recorded on March 15, 2022.

Click the link below to go to the home page of Active Investment Company Alliance to learn more:

https://AICalliance.org/

Disclosure: *Views and opinions expressed are for informational and educational purposes only as of the date of production/writing/speaking and may change without notice at any time based on a multitude of factors. Speaker's/presenter's/author's opinions are their own and may not necessarily represent the opinions of AICA, its Board, or its staff. Materials may contain "forward-looking" information that is not purely historical in nature, such as projections, forecasts, market return estimates, proposed or expected portfolio composition, and other items. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor will be able to sell shares at a price greater than or equal to the purchase price or that a closed-end fund's discount will narrow. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather offer liquidity on a monthly, quarterly or semi-annual basis, often on a small percentage of shares. Closed-end funds often use leverage, which can increase the fund's volatility (i.e., risk). Actual distribution amounts may vary with fund performance and other conditions. Past performance is no guarantee of future results. This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).*