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Keeping it "Real"—The Case for Natural Resource Equities

INSIGHTS

Natural resource equities can provide inflation protection and portfolio diversification, making them a potentially compelling investment option in environments characterized by elevated inflation, heightened geopolitical risk, and increasing energy demand.

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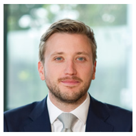

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Executive Summary

Natural resource equities have historically provided an effective inflation hedge, while also offering diversification benefits within a broader equity portfolio. Over the last 20+ years, natural resource equities have protected against inflation better than many other fixed income and equity asset classes. Further, as a 'real asset', commodities can continue to provide inflation protection even when global government debt levels are elevated, and hedge against the specter of rising fiscal deficits. Currently, short-term inflation expectations remain elevated, evident from the recent moves in U.S. Treasury yields and amplified by President Donald Trump's expansionary fiscal policy, U.S. import tariffs, and immigration policies. Longer term, the next phase of global growth will likely be energy intensive, driven by rising power demand from artificial intelligence and data centers. This increase will lead to a structural demand for key materials including copper and aluminum, at time when investment in new supply is insufficient.

When assessing the most effective way to allocate to this asset class, it is worth noting that natural resource equities have provided a much higher return than commodity futures over time, benefiting from the underlying cash flows of the companies and avoiding the significant costs of holding the underlying commodities. Natural resource equities can also serve as an effective diversifier for global equity portfolios given the high concentration risk of the broader global equity market and the dominance of a few mega-cap technology stocks—which has led to pools of capital globally exhibiting high exposure to sector and company risks.

In this world of higher market concentration, persistent inflation and rising geopolitical risks, the structural case for investing in natural resource equities is both compelling and vastly underappreciated. This is best framed in the following three key pillars:

Inflation Protection

Natural resource equities have a strong historical record in outperforming the broader equity market and providing real returns during inflationary periods.

Diversification & Low Correlation

Natural resource equities can be an effective diversifier for portfolios, especially given highly concentrated global equity indices.

The Investment Approach is Key

Historically, natural resource equities have significantly outperformed commodity futures, also offering structural advantages.

Inflation Protection

Inflation in the U.S. has remained elevated, with the U.S. Consumer Price Index (CPI) and the personal consumption expenditures (PCE) index—the U.S. Federal Reserve's (Fed) preferred measure—, persistently above the Fed's 2.0% target. Market expectations for future inflation have been rising too, with the 2-Year Treasury's implied inflation rate seeing steady rises, even as the Fed has cut short-term rates.

Figure 1: U.S. Inflation Expectations[1]

Source: Bloomberg; Barings. As of December 31, 2024.

Longer term, these inflationary pressures have the potential to persist. Energy demand continues to rise, driven by population growth and improving living standards in the developing world. Electrification of transport, power, and the build out of data centers, along with the continued expansion of artificial intelligence, will drive structural demand for mined commodities at a time when investment in new supply is insufficient to sustain demand over the medium and long-term. For example, copper is a key metal for electrification given its physical properties, and its annual consumption, accordingly, is projected to grow more than 70% to over 50 million tons by 2050[2]. What is less well recognized is that these trends also impact every day construction materials like steel and cement, as well as other forms of energy including renewables, natural gas and oil, that will be needed to drive this growth.

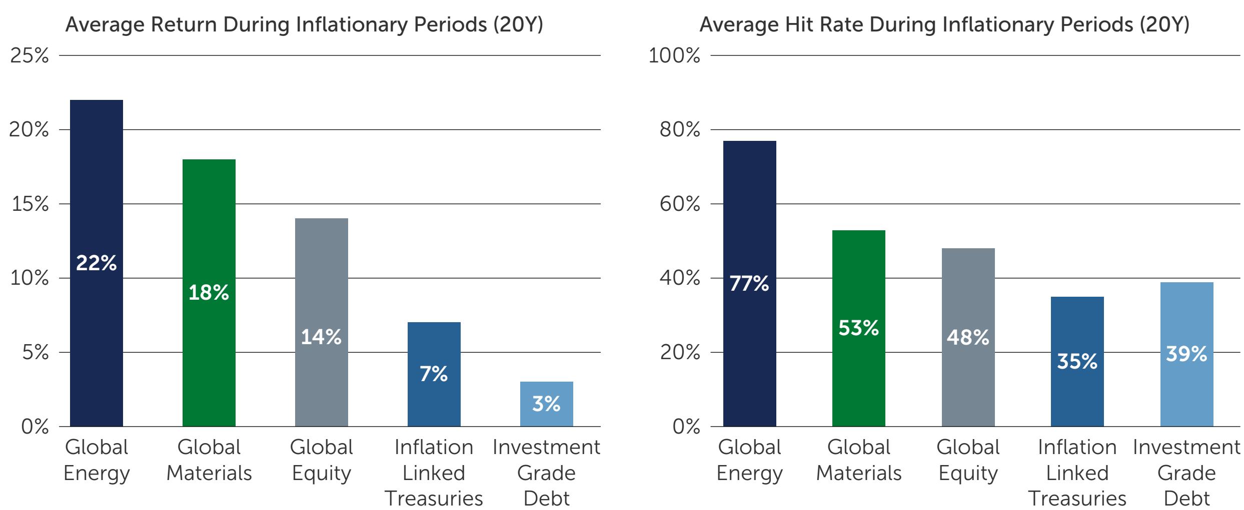
1. Source: Bloomberg; Barings. As of May 2025. The market's implied inflation rate is calculated by taking the nominal Treasury maturity curve and subtracting the 'real' yield of the inflation protected Treasury curve.
2. BHP Estimates 2025.

The impact of inflation, and its impact on 'real' returns, is one of the greatest risks investors face. Inflationary shocks can occur in commodities for several reasons, including government policy changes, strong demand or more restrictive supply. To gauge the impact of these shocks over time, we looked at both the average returns and the "hit rate" of different asset classes during periods of elevated inflation since 2003 (the 'hit rate' is defined as how often an asset class delivered a 'real' above-inflation return during these periods). What we found is that natural resource equities, which comprise both 'global energy' and 'global materials' shares, have historically produced compelling average returns, offering better protection against inflation compared to many key asset classes **(Figure 2)**. Moreover, the high 'hit rate' of natural resource equities indicates there may be a higher probability of delivering 'real' returns above inflation. We believe a combination of energy and materials equities can provide additional risk-return benefits to investors as well.

Commodities directly impact the prices of many products and services in the economy. Occasionally, raw material inflationary pressures can be acute enough that, indirectly, they can feed into wage demands, prompting more persistent inflation. As an example, the oil supply embargo of 1973 caused oil prices to quadruple, setting the scene for persistent and widespread inflation during the 1970s. Similarly, Russia's invasion of Ukraine saw a significant supply shock, prompting energy prices to rise and directly contributed to increasing broader inflation. Other materials offer similar examples. Food, for instance, is a key consideration given that it represents a significant proportion of household spending, particularly in emerging markets. Elevated grain prices can have widespread impacts across the food supply chain, pushing up the prices of goods from bread to, more indirectly, meat. Grain is also a key ingredient in animal feed as well as biofuel, specifically corn-based ethanol.

RETURNS DURING INFLATIONARY PERIODS[3]

Figure 2: Strategic Benefit: Natural Resources Benefit From Inflationary Environments



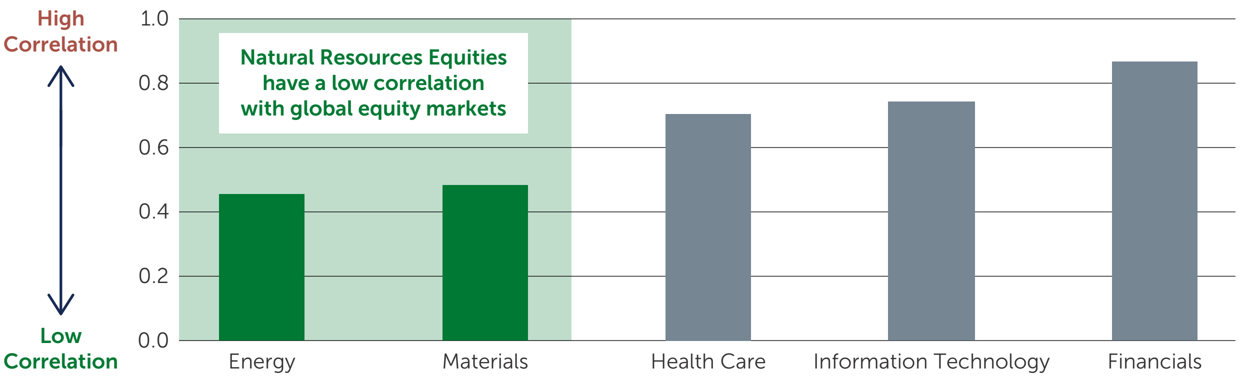
Source: Barings; MSCI. As of August 2024. Data from 31 December 2000 to 31 August 2024. Global Energy is represented by MSCI ACWI Energy, Global Material by MSCI ACWI Materials, Global Equity by MSCI ACWI World, Inflation Linked Treasuries by ICE BofA U.S. Inflation-Linked Treasury Index, and Investment Grade Debt by the Bloomberg U.S. Global Aggregate Index.

3. Source: Bloomberg; Barings. As of August 2024.

Diversification & Low Correlation

Growing market concentration has raised concerns that returns are focused on too few stocks, drawing comparison with periods such as the dot.com bubble, which ultimately collapsed in the early 2000s. Stock concentration has also served to syphon capital into narrow areas of the market, pushing multiples higher while leaving sectors such as energy and materials accounting for less than 10% of global equity[4]. This decline in representation and ownership has resulted in the asset class having increasingly lower correlations to world indices, making it an effective potential diversifier in broader equity portfolios.

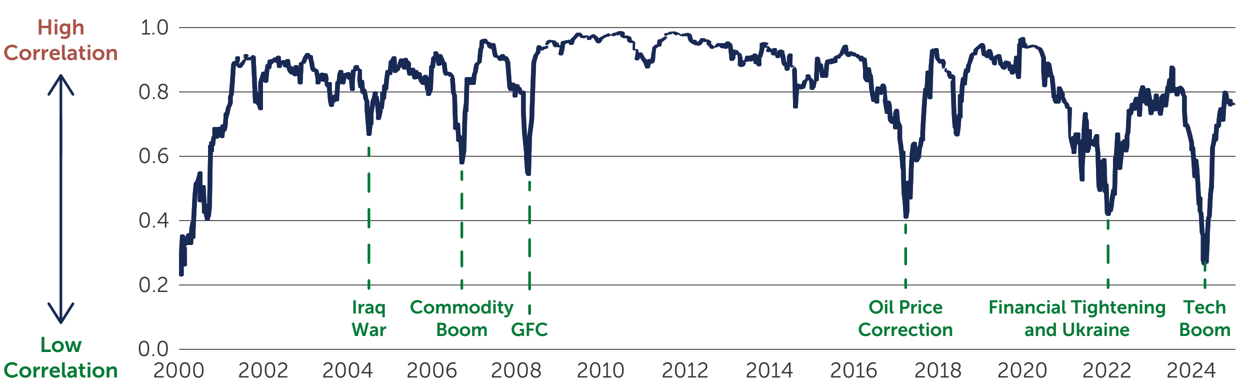
Figure 3: Strategic Benefit: Natural Resources is a Diversifier



Source: Barings; MSCI. As of August 2024. 5 Year Annualized Average Returns Correlation to MSCI AC World December 31, 1999 to August 31, 2024. Global Energy is represented by MSCI ACWI Energy, Global Material by MSCI ACWI Materials, Global Equity by MSCI ACWI World, Inflation Linked Treasuries by ICE BofA U.S. Inflation-Linked Treasury Index, and Investment Grade Debt by the Bloomberg U.S. Global Aggregate Index.

Uniquely, natural resource equities tend to offer the strongest diversification benefits in periods of heightened uncertainty, benefiting from the fact that commodities can move in different ways to the broader economic cycle. This is particularly prevalent in periods when conflict is present, which can physically tighten commodity markets, such as the Iraq or Russia-Ukraine war.

Figure 4: Natural Resource Equities' Correlation to Global Equity Over Time[5]



Source: Barings; MSCI. As of August 2024. 5 Year Annualized Average Returns Correlation to MSCI AC World December 31, 1999 to August 31, 2024.

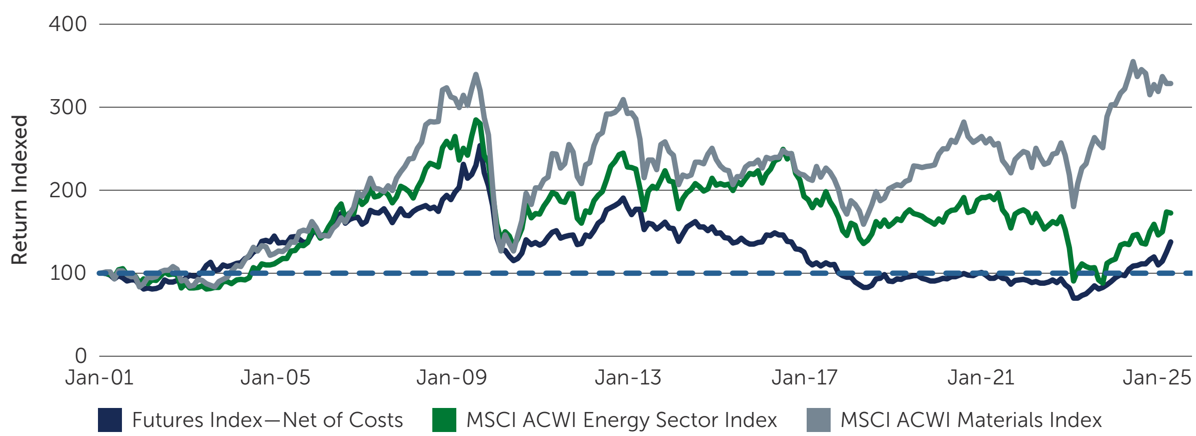
4. As represented within the MSCI AC World Index. As of May 2025.
5. Natural resource equities comprises 50% MSCI AC World Energy and 50% MSCI AC World Materials from July 7, 2000 to August 31, 2024, 6 month rolling returns correlated to MSCI AC World.

The Investment Approach is Key—Public Equity

While the benefits to owning natural resources are unique, we believe the best way to gain exposure is through listed equities rather than investing in the underlying commodities themselves.

First, the underlying companies within natural resource equities generate cash flows to invest and grow, while also returning capital to shareholders in the form of dividends and share buybacks. Investors often refer to an 'equity risk premium', or the rate of return equity investors require above the risk-free interest rate. Returns are variable, but studies from London Business School and Credit Suisse (now UBS), have shown an average global equity return of c.5 % per year above inflation over the last 120 years, ahead of other key asset classes. Second, there are underlying financial costs of owning physical commodities, such as storage and transportation, as well as the inconvenience cost of receiving a large shipment of oil or copper.

Figure 5: Natural Resources Equities Outperform Commodity Futures Over Time



Source: Barings, Bloomberg. As of February 2025. Spot Index = Bloomberg Commodity Spot Index. Futures Index—Net of Costs = Bloomberg Commodity Total Return Index. Bloomberg Commodity Total Return Index is composed of futures contracts and reflects the returns on a fully collateralized investment in the Bloomberg Commodity Index. This combines the returns of this index with the returns on cash collateral in 3 Month Treasury Bills.

Investing in Commodities is Expensive

In practice, many investors choose to invest in commodity 'futures'— a commitment to buy a commodity at a future date—or products underpinned by these 'futures', such as some commodity Exchange Traded Funds (ETFs). As part of this approach, investors need to contend with the 'roll yield' of futures, where they sell out of an expiring 'futures' contract before physical delivery and buy a longer dated 'futures' contract. As there are extra costs for holding commodities, such as storage and transportation, it is more common for the new 'futures' prices to be bought at a higher level than the expiring contract. What is effectively "selling low and buying high" can ultimately erode the realized return.

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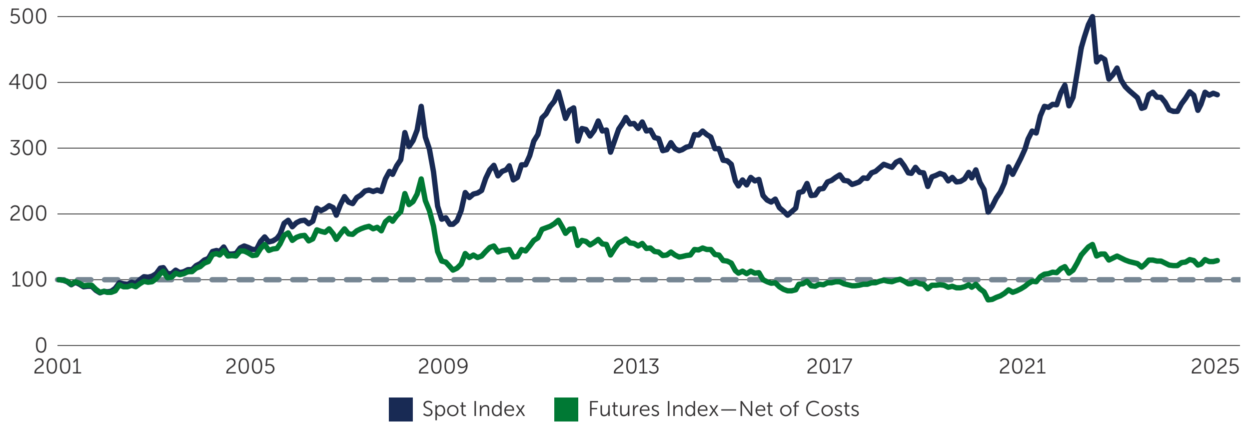
To further illustrate the costs of owning commodity futures, we have compared the commodity Spot Index return to a futures index, which is net of the roll yield and other associated costs. The spot return is the theoretical return you would have received if you could have bought the physical commodities today, but without the associated costs. Based on this analysis, the actual result is a far inferior return to the theoretical 'spot' market performance.

Figure 6: Investors in Commodities Have Not Benefitted from the Returns of 'Spot' Commodity Markets



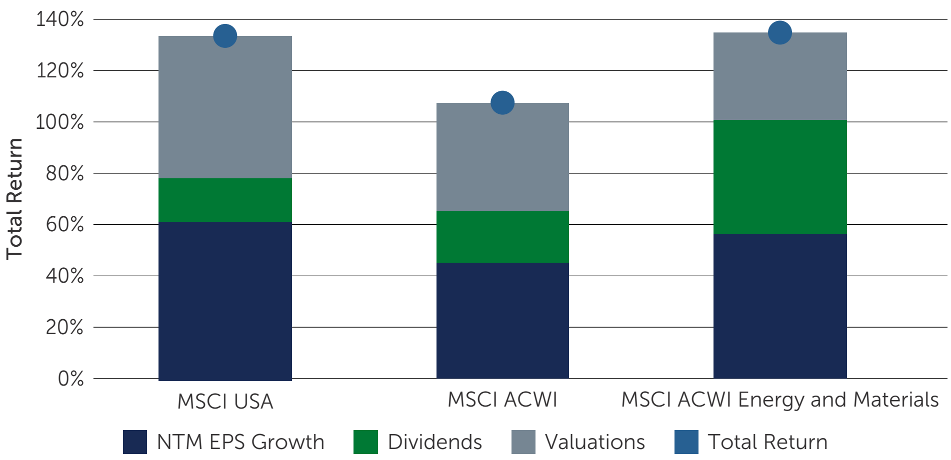
Source: Barings; Bloomberg. As of February 2025. Spot Index = Bloomberg Commodity Spot Index. Futures Index—Net of Costs = Bloomberg Commodity Total Return Index. Bloomberg Commodity Total Return Index is composed of futures contracts and reflects the returns on a fully collateralized investment in the Bloomberg Commodity Index. This combines the returns of this index with the returns on cash collateral in 3 Month Treasury Bills.

What Drives the Return of Natural Resource Equities?

Interestingly, when disaggregating the returns of natural resource equities over the past five years,[6] the largest contribution to total returns (over 130%) came from earnings growth and dividends, with only a small proportion of the overall return driven by a valuation re-rating. This stands in stark contrast to U.S. and global equities more broadly, where a significantly higher proportion of total returns was driven by a valuation re-rating, or the change in how much investors are willing to pay for each dollar of earnings. We believe this reduces the risk of the sector significantly de-rating in a broader market correction, while providing a compelling entry point into the asset class.

6. Source: Barings; Refinitiv; MSCI. As of March 31 2025, Data in USD, *50/50 split of MSCI ACWI Energy & Materials.

Figure 7: What Has Driven Returns?[7]



Source: Barings; Bloomberg. As of February 2025. Spot Index = Bloomberg Commodity Spot Index. Futures Index—Net of Costs = Bloomberg Commodity Total Return Index. Bloomberg Commodity Total Return Index is composed of futures contracts and reflects the returns on a fully collateralized investment in the Bloomberg Commodity Index. This combines the returns of this index with the returns on cash collateral in 3 Month Treasury Bills.

Why Barings Global Resources?

At Barings, we invest across the entire resources universe including energy, mining, chemicals and agriculture. Our broad capabilities allow us to uncover opportunities ranging from pure-play upstream commodity producers in mining or oil, to consumer-facing companies in the flavors and fragrances industry that provide ingredients into fast moving commodity goods companies. This ability to invest in upstream companies that benefit from stronger commodity prices, and in the downstream processing industries that may gain from lower raw materials prices, supports our ability to identify investment opportunities across a wide range of industries and economic environments. Ultimately, this drives diverse portfolio returns, and helps create greater stability than traditional single-sector strategies, with a lower drawdown across the cycle.

To identify investment opportunities, we conduct in-depth commodity analysis, which considers supply and demand dynamics, cost curves, and industry structures alongside bottom-up fundamentals. We integrate these commodity insights into our company specific analysis to generate company earnings forecasts and identify stocks with compelling upside and asymmetrical risk-return opportunities. Our process involves regular engagement with company management teams to deepen our assessment of business risks and opportunities. This approach is enriched by our depth of experience, supporting our ability to understand what drives resources equities across the cycle.

7. Source: Barings; Refinitiv; MSCI. As of March 31 2025, Data in USD, *50/50 split of MSCI ACWI Energy & Materials.

Barings is a $442+ billion global asset management firm that partners with institutional, insurance, and intermediary clients, and supports leading businesses with flexible financing solutions. The firm, a subsidiary of MassMutual, seeks to deliver excess returns by leveraging its global scale and capabilities across public and private markets in fixed income, real assets and capital solutions.*

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