28th February 2023

Elston Insights

Liquid Real Assets: for inflation diversification

- Our Liquid Real Assets Index strategy delivered on objectives
- Provides access to assets positively correlated with inflation
- For a risk-constrained liquid approach to real asset diversification

For more on the underlying March 2021 research on real asset inflation correlation in higher inflation regimes, watch our CISI-endorsed CPD webinar Focus on Inflation.

Find out more about this index strategy

Liquid Real Assets: design concept

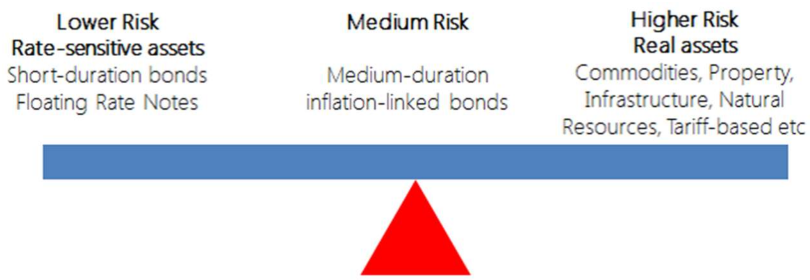
In March 2021 we launched our Elston Liquid Real Assets index. The idea for a risk-constrained real asset strategy was developed in October 2020 when inflation risks began to emerge and the risk to Bonds came in focus.

The strategy comprises a broad range of highly liquid "real asset" exposures (e.g. gold, commodities, infrastructure and property securities) which are positively correlated with inflation. These are typically as high risk as equities.

To create a risk-constrained approach, these are balanced with lower-risk Floating Rate Notes and ultrashort duration bonds, which are positively correlated with interest rates.

This way, the strategy is intended to deliver a return pattern consistent with real asset class behaviour, but overall volatility is intended to be commensurate to bonds.

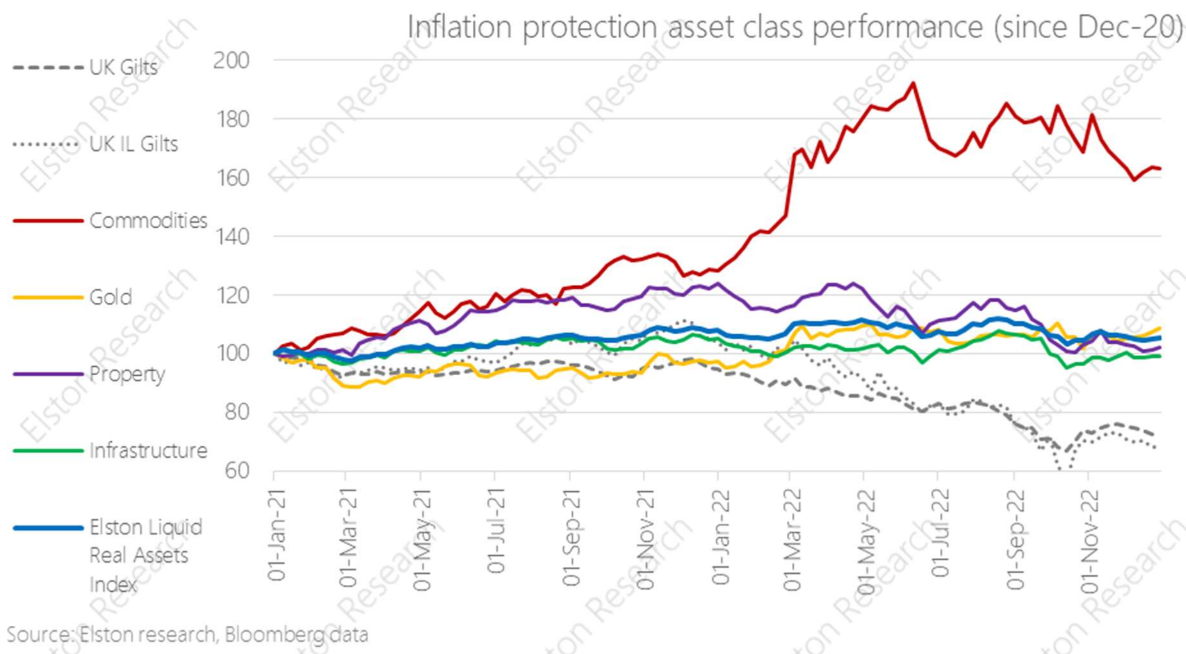
Fig.1. Combining higher risk real assets with lower risk rate-sensitive assets



The Elston Liquid Real Assets Index is constructed with a broad range of large, liquid ETFs (and ETCs[1]) reflecting the various real asset classes. As well as creating asset-based diversification, this creates risk-based diversification owing to the uncorrelated nature of these asset classes to each other given their different return drivers.

This enables funds tracking the index to have an "all-in-one" approach to owning a diverse bunch of ETFs representing property and infrastructure securities, natural resources (such as water and timber companies), as well as ETCs for Gold & Precious Metals, Energy, Industrial Metals and Agriculture. The performance of some of the components is presented in this chart below.

Fig.2. Component performance Dec-20 to Dec-22



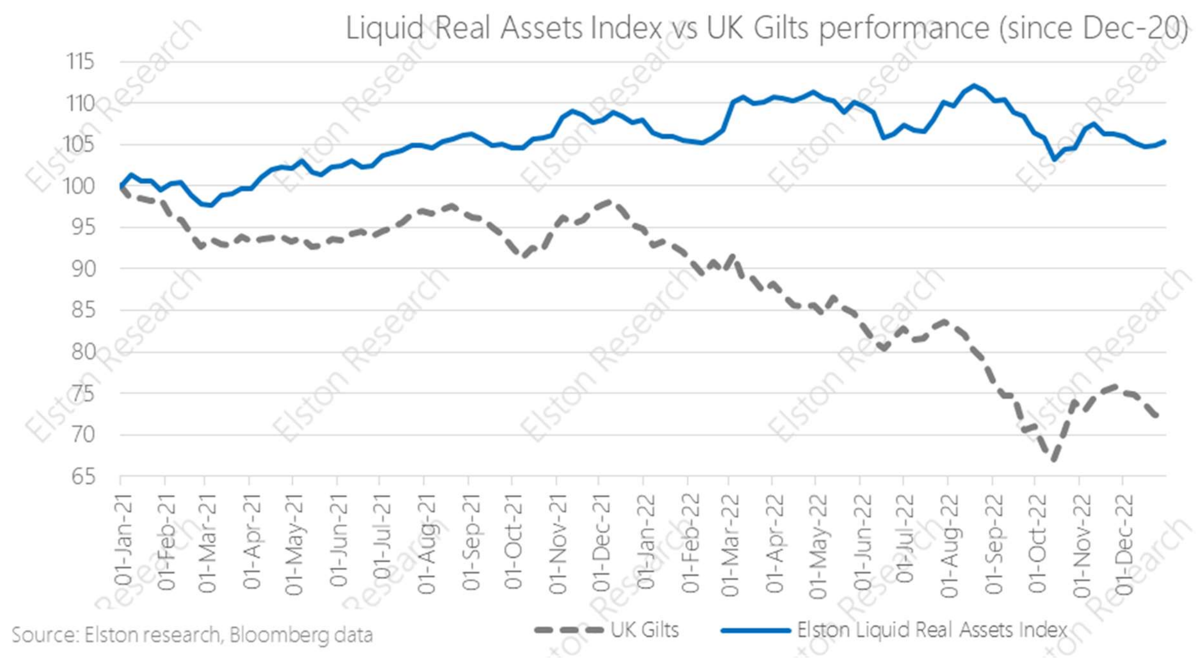
The objective of the Elston Liquid Real Assets Index is to deliver a real-asset return pattern with bond-like volatility characteristics while ensuring full underlying liquidity. Our focus on liquidity is to ensure that there are no capacity constraints on the fund for subscriptions and no gating risks for redemptions.

The strategy was intended to enable partial/full substitution for Bonds in a rising interest rate/rising inflation regime. In this respect, the strategy has done and is doing "what is says on the tin", in our view (see chart).

Where next? We believe it makes sense to hold a ready-made diversification basket for liquid real asset exposures as part of a broader portfolio, and particularly while inflation remains stickier, for diversification purposes and as an inflation hedge.

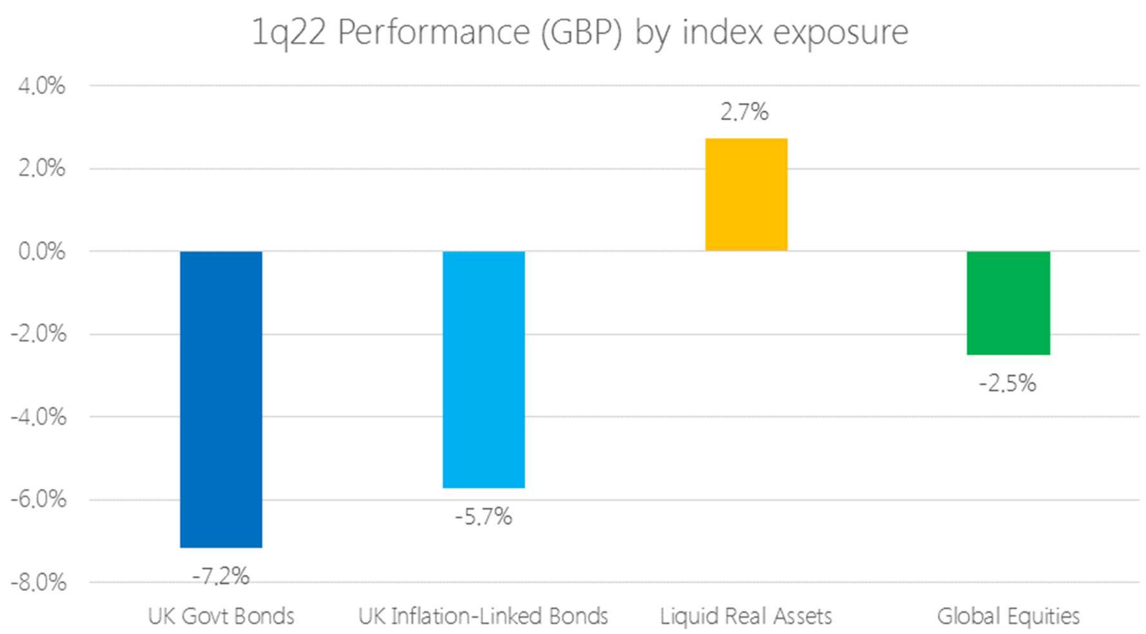
[1] Exchange Traded Products (ETPs) is a generic term that includes both Exchange Traded Funds (ETFs), Exchange Traded Commodities (ETCs) and Exchange Traded Notes (ETNs)

Fig.3. Liquid Real Assets Index vs UK Gilts (Dec-20 to Dec-22)



Importantly, the strategy also acted as a shock absorber in 1q22 on the war/energy shock, relative to bonds (and obviously to a lesser extent than its underlying commodities owing to lower overall risk posture). This reflects and confirms its differentiated return pattern. In this respect the strategy also delivered on its intended design parameters.

Fig.4. Shock absorber



Adapting portfolios for inflation

So what were the options to protect capital? We outlined our inflation playbook in late 2021/early 2022 on how best to adapt portfolios for inflation: 1) tilt equities towards value/income, 2) dial down bond duration and 3) reduce overall bond exposure in favour of liquid real assets and absolute return strategies.

These changes helped the adviser firms we work with avoid the foreseeable harm arising from rising interest rates and higher inflation. We were just not expecting the reality to be as extreme as it was, owing to the savage Russia/Ukraine war.

Incorporating a risk-constrained real asset diversification strategy provides a useful alternative to bonds. Construction using cost-efficient ETFs ensures liquidity, transparency and diversification.

Henry Cobbe, CFA

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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