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Elston Insights

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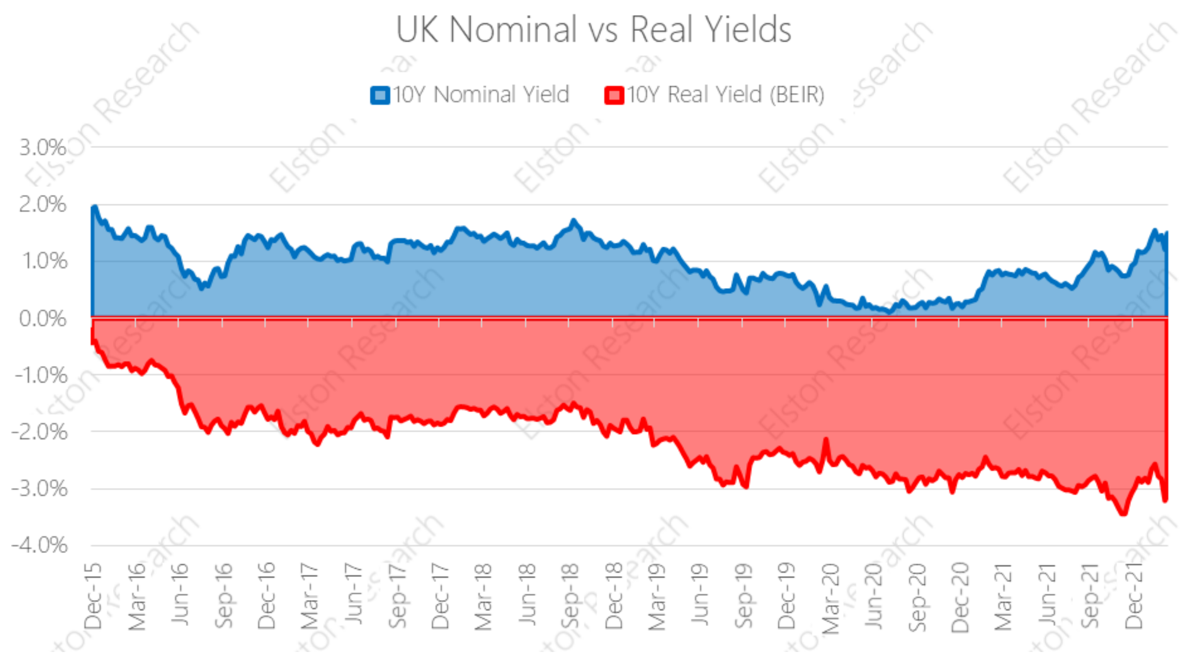
Alternatives to Bonds within a portfolio

- Nominal bonds will remain under pressure
- Explore the more resilient alternatives within the Bonds universe
- Property, Infrastructure, Liquid Real Assets and Targeted Absolute Return funds provide alternatives outside of Bonds

Rising inflation and rising interest rates, means nominal bonds (such as corporate bonds, UK gilts, and global government bonds) are under pressure, and will remain so for the medium-term.

For so long as real yields remain negative, bonds are "guaranteed" to lose capital value in real terms over time.

Fig.1 Real UK gilt yields remain negative



Source: Elston research, Bloomberg data, as at 9th March 2022

So what are the Alternatives to Bonds in a portfolio for UK investors?

Exploring alternatives within the Bonds sector

Within the bonds sector, there are of course alternatives to nominal bonds.

- Higher-risk alternatives include high yield bonds and emerging markets bonds. The higher yields available, for the higher credit and/or sovereign risk taken, means there is greater potential to keep pace with inflation in normal times. But with inflation potentially running up materially to 8-10%, even those higher yields don't help. Longer duration inflation-linked bonds offer long-term inflation protection, and but are negatively impact during an interest rate tightening cycle, because of their high, inverse sensitivity to changes in interest rates..
- Moderate-risk alternatives within the Bonds sector includes Mortgage-Backed Securities. These should re-rate as interest rates rise and have the advantage of being asset-backed by the mortgaged properties that are their collateral. Also intermediate inflation-linked bonds offer medium-term inflation protection, and moderate interest rate sensitivity.
- Lower-risk alternatives include Floating Rate Notes and Ultrashort Bonds. These are useful to dial-down the interest rate sensitive (duration) of a bond portfolio, and therefore offer a degree of indirect protection from rising interest rates, however they do not offer direct protection from rising inflation.
- Strategic bond funds provide a way of "delegating" investment management decisions around inflation estimates, interest rate estimates and duration targets. Whilst this has the advantage of leaving the decision-making to an external party, the disadvantage is that it's hard to monitor what those decisions are, what the underlying duration and liquidity profile is, and whether the decision-making proves effective.

So whilst it may make sense to reposition or tilt the bond part of a portfolio away from nominal bonds, some managers and advisers are looking to go further and eliminate bonds from a portfolio together to adapt portfolios to an inflationary regime. In this instance, managers and advisers need to consider asset classes outside of Bonds as potential alternatives.

Alternatives outside of bonds

Traditionally, popular alternatives to Bond funds have included Property and Infrastructure funds. We explore some other options too.

- Property: as an asset class property has bond-like income that has potential to pass through changes in inflation. But its capital value, and the use of leverage, means that is has equity-like property too. Open-ended funds with daily dealing investing in less liquid or illiquid property holdings can cause a liquidity mismatch. Property funds typically have a higher volatility level than bond funds. For a liquid version of the exposure, property securities (shares in property companies and real estate investment trusts) make sense, but these have equity-like volatility characteristics.
- Infrastructure: similar to property, infrastructure receives a steady income that can be inflation-linked. Infrastructure funds require careful examination of both volatility and liquidity profile. Infrastructure securities funds provide a more liquid format, but again

have equity-like volatility characteristics. Multi-asset infrastructure securities (listed infrastructure debt and equity) provide a lower risk version of this exposure.

- **Liquid Real Assets:** by combining a portfolio of lower risk rate-sensitive assets (such as Floating Rate Notes and Ultrashort Bonds) and higher risk inflation-sensitive assets (such as property, infrastructure, mortgage-backed securities, utilities, commodities, natural resources and gold), our approach to Liquid Real Assets investing, benchmarked by our Liquid Real Assets index, provides real asset return exposure, with bond-like volatility.
- **Targeted Absolute Return (TAR) funds:** TAR funds aim to provide positive rolling returns, at a premium to Bank Rates in all market regimes (including rising interest rates and rising inflation), with constrained risk. By aiming to provide a total return premium over bonds, with bond-like volatility, all-weather style TAR funds can be used as an alternative to bonds within a portfolio. However, performance outcomes vary both from a return, risk and value for money perspective, so selecting the right TAR fund requires careful consideration.

Summary

In face of rising rates and inflation, it makes sense to reduce or remove the allocation to bonds, and dial down the duration risk within a bond portfolio.

For alternatives to bonds, careful risk budgeting is required to make sure that asset classes with "bond-like" income, don't introduce "equity-like" risk.

View the Webinar on Alternatives to Bonds in a portfolio

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