12th October 2020

Liquid Real Assets: using ETFs for a simpler, more transparent approach

- As Real Asset funds AUM increased, so too has their usage of ETFs and index-tracking funds to ensure good underlying liquidity
- Combining liquid real asset ETFs into a model portfolio enables access to similar performance characteristics, greater liquidity & transparency, at lower overall cost
- We contrast the performance of the Elston Liquid Real Asset index portfolio of ETFs to the largest Real Assets funds

What are "Real Assets"?

Real Assets can be defined as "physical assets that have an intrinsic worth due to their substance and property"[1]. Real assets can be taken to include precious metals, commodities, real estate, infrastructure, land, equipment and natural resources. Because of the "inflation-protection" objective of investing in real assets (the rent increases in property, the tariff increases in infrastructure), real asset funds also include exposure to inflation-linked government bonds as a financial proxy for a real asset.

Why own Real Assets?

There are a number of rationales for investing in Real Assets. The primary ones are to:

- Diversify a portfolio away from just equities and bonds
- Generate an income stream supported by the underlying asset's cashflows
- Protect against expected and unexpected inflation

For these reasons there has been substantial allocation to real asset by both institutional and retail investors.

Accessing Real Assets

Institutional investors can access Real Assets directly and indirectly. They can acquired direct property and participate in the equity or debt financing of infrastructure projects. Directly. For example, the Pensions Infrastructure Platform, established in 2021 has enabled direct investment by pension schemes into UK ferry operators, motorways and hospital construction projects. This provides funding for government-backed project and real asset income and returns for institutional

[1] Source: https://www.investopedia.com/terms/r/realasset.asp

investors. Institutional investors can also access Real Assets indirectly using specialist funds as well as mainstream listed funds such as property securities funds and commodities funds.

Retail investors can access Real Assets mostly indirectly through funds. There is a wide range of property funds, infrastructure funds, commodity funds and natural resources funds to choose from. But investors have to decide on an appropriate fund structure.

- OEICs have the advantage of convenience and pooled scale, but have the risk of a liquidity mismatch (the daily liquidity of the funds is not reflected by the liquidity of the underlying assets
- Investment Trusts have the advantage of being able to borrow to invest, but have the disadvantage of a volatile premium or discount to NAV based on demand/supply for the shares
- ETFs have the advantage of transparency, liquidity and cost, but the disadvantage of being restricted to owning only listed or tradable securities.

For this reason, there has been a risk in the use of Real Asset funds to outsource these decisions to professional managers.

The rise of real asset funds

The first UK diversified real asset fund was launched in 2014, with competitor launches in 2018. There is now approximately £750m invested across the three largest real asset funds available to financial advisers and their clients, with fund OCFs ranging from 0.97% to 1.46%.

Following the gating of an Equity fund (Woodford), a bond fund (GAM) and several property funds for liquidity reasons, there has – rightly – been increased focus by the regulator and fund providers (Authorised Corporate Directors or "ACDs") on the liquidity profile of underlying assets.

As a result, given their increased scale, real asset fund managers are increasingly turning to mainstream funds and indeed liquid ETFs to gain access to specific asset classes.

Indeed, on our analysis, one real assets funds has the bulk of its assets invested in mainstream funds and ETFs that are available to advisers directly. Now there's no shame in that – part of the rationale for using a Real Assets fund is to select and combine funds and manage the overall risk of the fund. But what it does mean is that discretionary managers and advisers have the option of creating diversified real asset exposure, using the same or similar underlying holdings, for a fraction of the cost to clients.

Creating a liquid real asset index portfolio

We have created the Elston Liquid Real Asset index portfolio of ETFs in order to:

- Gain exposure to real asset classes using the same or similar exposures to a real assets fund
- Have full transparency as regards underlying holdings and assured ETF liquidity
- Deliver a systematic, diversified exposure at a lower cost to clients

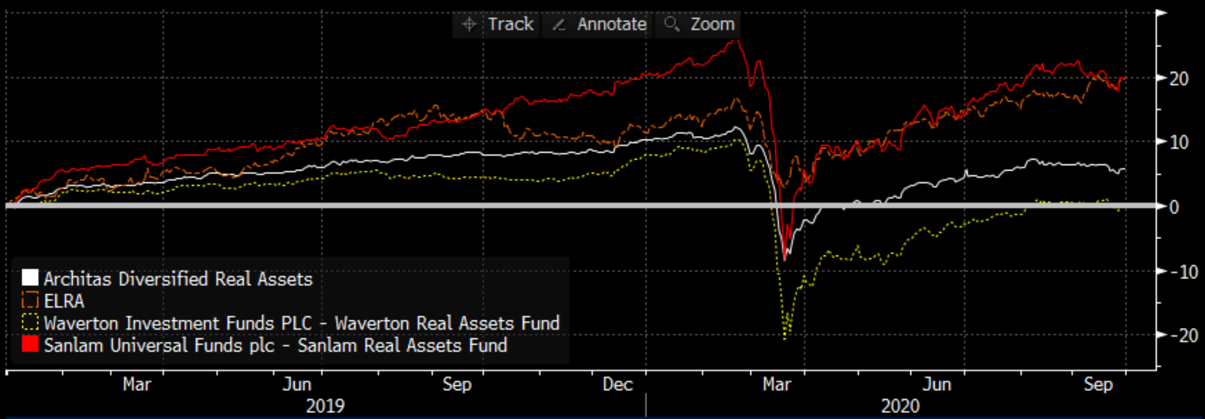
We have built the index portfolio using the following building blocks

- Liquidity: exposure to ultrashort duration bonds to provide ballast and stability
- Inflation protection: exposure to UK and government inflation-linked bonds
- Property & Asset backed securities: exposure to the capital value and income stream of property using property securities ETF, as well as being on the receiving end of mortgage payments using a mortgage backed securities ETF.
- Clean Energy & Infrastructure: clean energy means owning within an ETF the listed securities in providers of clean energy such as wind farms and solar farms. Infrastructure means owning within an ETF the listed equity and bond securities of infrastructure providers.
- Gold & Commodities: direct exposure to Gold using a physical ETC, and indirect exposure to a broad commodities basket using a synthetic ETC.
- Natural Resources: owning ETFs with exposure to listed global water companies as well as listed global timber and forestry companies.

As regards asset allocation, we are targeting a look-through ~50/50 balance between equity-like securities and bond-like securities to ensure that the strategy provides beta reduction as well as diversification when included in a portfolio.

For the index portfolio simulation, we have used an equal weighted approach.

Fig.1. Performance of the Liquid Real Asset Index Portfolio (.ELRA)



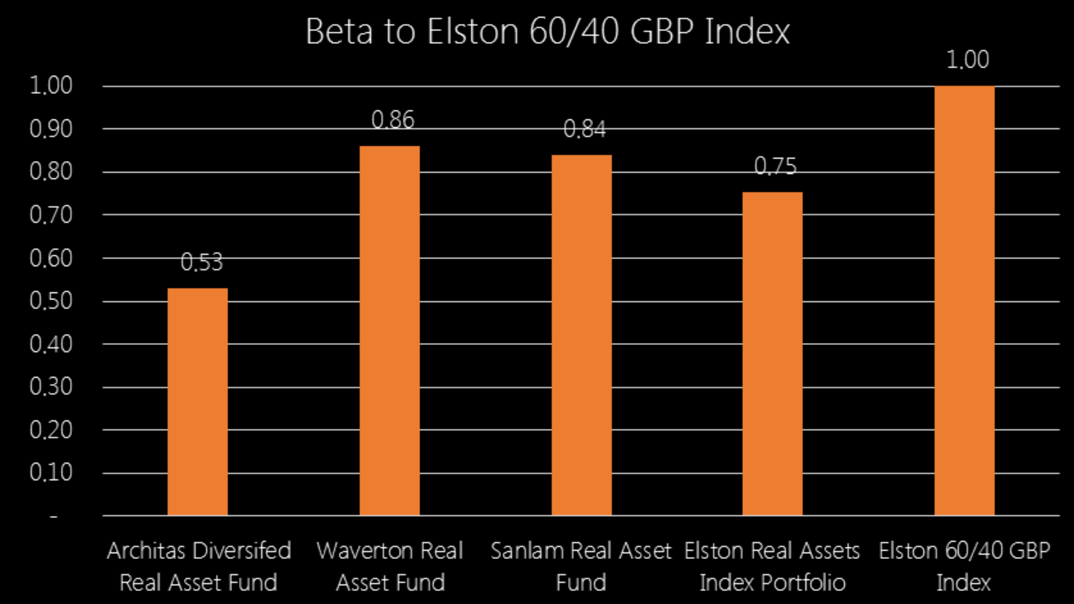
Source: Elston research, Bloomberg data. Total returns from end December 2018 to end September 2020 for selected real asset funds.

Since December 2018, the Sanlam Real Assets fund has returned 19.99%, the Elston Real Asset Index Portfolio has returned +19.76%. This compares to +5.86% for the Architas Diversified Real Asset fund and +0.16% for the Waverton Real Assets Fund.

What about Beta

Our Real Asset Index Portfolio has a Beta of 0.75 to the Elston 60/40 GBP index so represents a greater risk reduction than Waverton (0.86) and Sanlam (0.84), which are all higher beta than Architas (0.53).

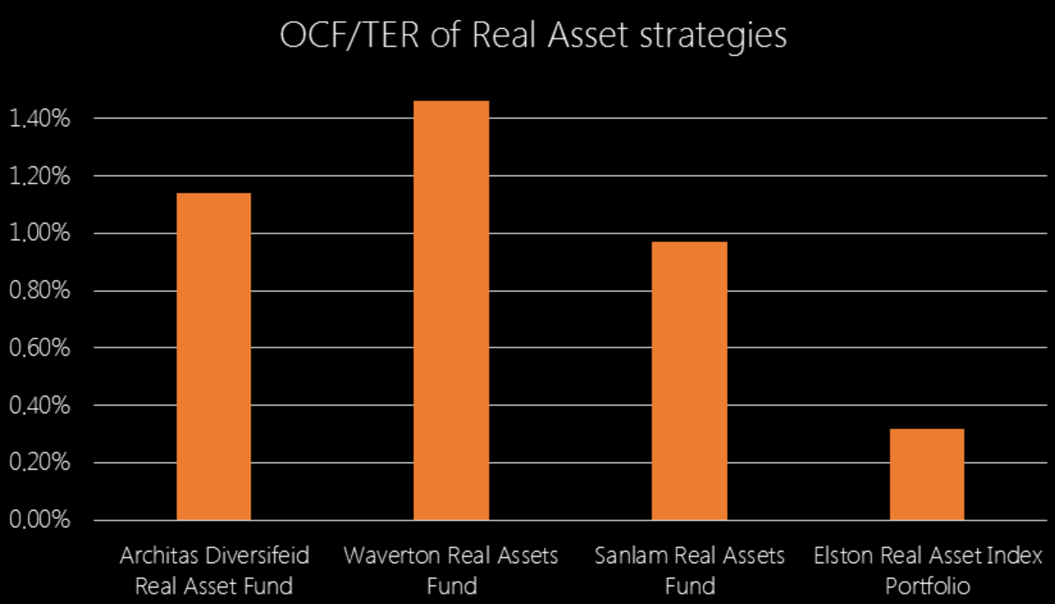
Fig.2. Real Asset strategies' beta to a 60/40 GBP Index



Source: Elston research, Bloomberg data. Weekly data relative to Elston 60/40 GBP Index, GBP terms Dec-18 to Sep-20.

Finally, by accessing the real asset ETFs directly, there is no cost for the overall fund structure, hence the implementation cost for an index portfolio of ETFs is substantially lower.

Fig.3. Cost comparison of Real Asset funds vs index portfolio of ETFs



Source: Elston research, Trustnet & Bloomberg data

Fund or ETF Portfolio?

The advantage of a funds-based approach is convenience (single-line holding), as well as having a a manager allocate dynamically between the different real asset exposures within the fund.

The advantage of an index portfolio is simplicity, transparency and cost. Creating a managed ETF portfolio strategy that dynamically allocates to the different real asset classes over the market cycle is achievable and can be implemented on demand.

Summary

The purpose of this analysis was to note that:

1. Real Asset Funds available to retail investors do not have any special access to an opportunity set of funds that cannot be accessed directly
2. The liquidity requirements on real asset funds is driving them more to the use of index funds and ETFs
3. It is possible to create a diversified, liquid real assets portfolios using ETFs and index funds.
4. There is a trade off between cost and convenience between having an index portfolio of ETFs and a unitised fund.
5. An equal-weight strategy can prove effective given the overall allocation to real assets within a portfolio. A managed dynamic-weight strategy would be an interesting enhancement.

Find out more

For more insights and information on research, portfolios and indices, visit:

www.elstonsolutions.co.uk or NH ETF<Go>

www.elstonsolutions.co.uk

ABOUT ELSTON

We research, design and build investment solutions with and for asset owners, managers and advisers.

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

NOTICES

With reference to the European Union Directive 2014/65/EU on markets in financial instruments ("MiFID II"): this Report does not provide a recommendation for an action, provides information freely available for public consumption and does not therefore constitute "Research" as defined by MiFID II. This is because this report contains purely factual information on one or several financial instruments or issuers and does not explicitly or implicitly recommend or suggest an investment strategy. It does not therefore constitute an investment recommendation as defined within the meaning of Article 3(1)(35) of EU Markets Abuse Regulation ("MAR"), in conjunction with Article 3(1)(34) of MAR. For further information, please refer to ESMA guidance ESMA70-145-111 Version 12.

With reference to the European Union's Market Abuse Regulation (Regulation (EU) 596/2014): we warrant that the information in this report is presented objectively, and the following commercial interests are hereby disclosed: Elston Consulting Limited creates research portfolios and administers indices that may or may not be referenced in this report. If referenced, this is clearly designated and is to raise awareness and provide purely factual information as regards these portfolios and/or indices.

An "Index Portfolio" is not a regulated benchmark but a research portfolio of index-tracking investments with a periodic rebalancing scheme.

All company, product and service names and trademarks used in this article are for identification purposes only and are the property of their respective owners, and their usage does not imply endorsement.

This document is not an advertisement or financial promotion. It is provided for informational purposes only and is not intended to be an offer or solicitation, or the basis for any contract to purchase or sell any security or other instrument, or for Elston Consulting Limited to enter into or arrange any type of transaction as a consequence of any information contained herein.

This document is issued by Elston Consulting Limited registered in England & Wales, registration number 07125478, registered office: 42 Brook Street, London W1K 5DB.