Elston

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Elston Insights

Liquid Real Assets: 1q22 performance udpate

- Gilts are not providing capital protection in real terms
- The top 5 contributors to performance were Energy, Gold, Industrial Metals, Agriculture & Precious Metals
- Liquid Real Assets – with risk constraints - provide an alternative to Bonds

The pressure on nominal bonds from rising inflation continues. Real assets provide potential for inflation protection.

Our Liquid Real Assets Index represents a combination of higher-risk, inflation-sensitive assets (such as listed property, infrastructure, commodities and natural resources) and lower-risk, rate-sensitive assets (such as Floating Rate Notes).

This mix is intended to provide exposure to a real asset return pattern, with bond-like volatility.

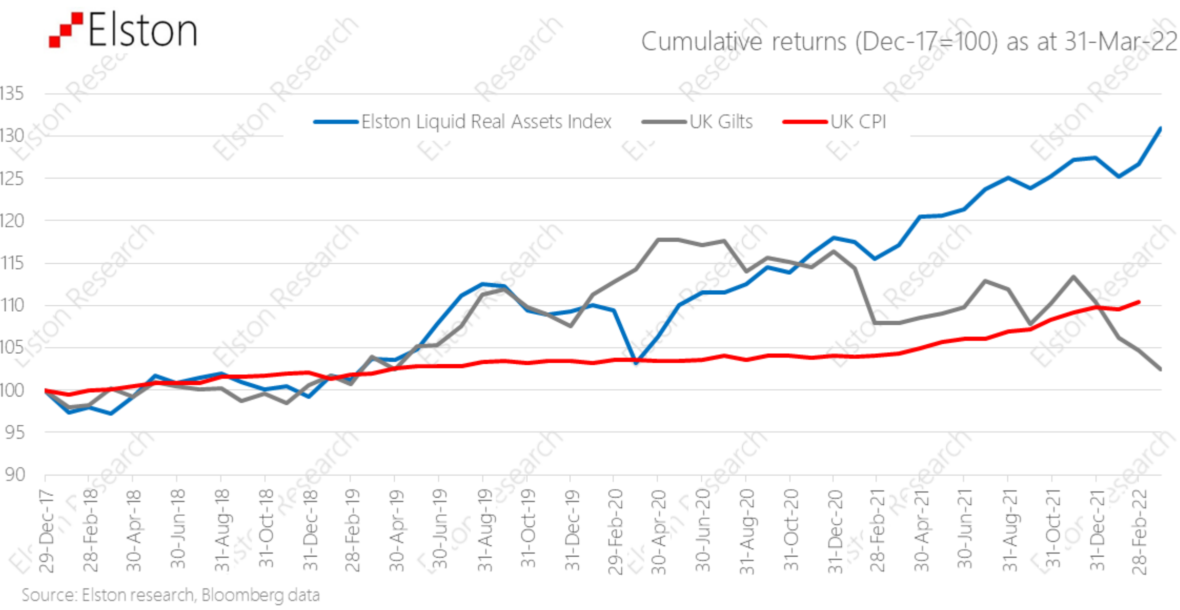
Bonds are not providing capital protection in real terms

Looking at cumulative performance since index inception, the total return on UK Government Bonds ("Gilts"), now lags behind cumulative inflation, meaning that bonds are failing to protect capital in real terms.

By contrast, the cumulative return of the Liquid Real Asset Index is outpacing inflation. In cumulative terms, since inception (Dec-17) the Liquid Real Assets Index has returned +30.87% in GBP terms, compared to +2.49% for Gilts.

In annualised terms, that translates to +6.53% and +0.58% per year respectively.

Fig.1. Cumulative returns since inception

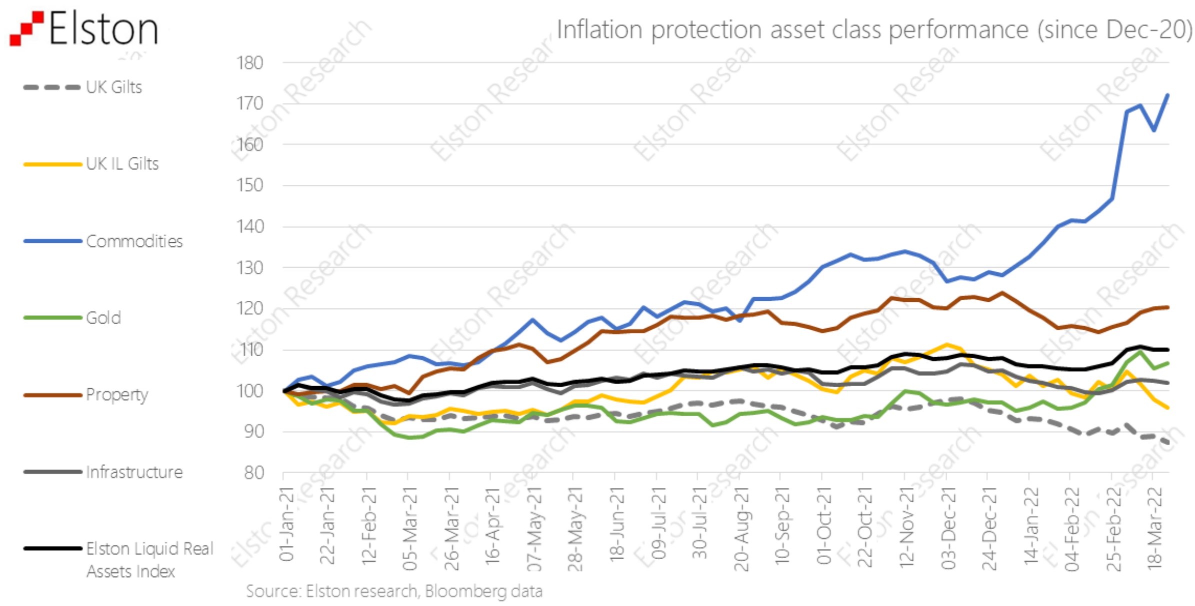


Source: Elston research, Bloomberg data, as at 31st March 2022

Looking at performance since Dec-20 – when we recommended an overweight on Liquid Real Assets relative to Gilts – the performance gap between the Liquid Real Assets index and Gilts has become more acute as inflation pressure has mounted.

Having exposure to liquid real assets means "owning the problem" when it comes to inflation risk.

Fig.2. YTD Performance (real asset components)



Source: Elston research, Bloomberg data, as at 31st March 2022

Top 5 contributors to performance

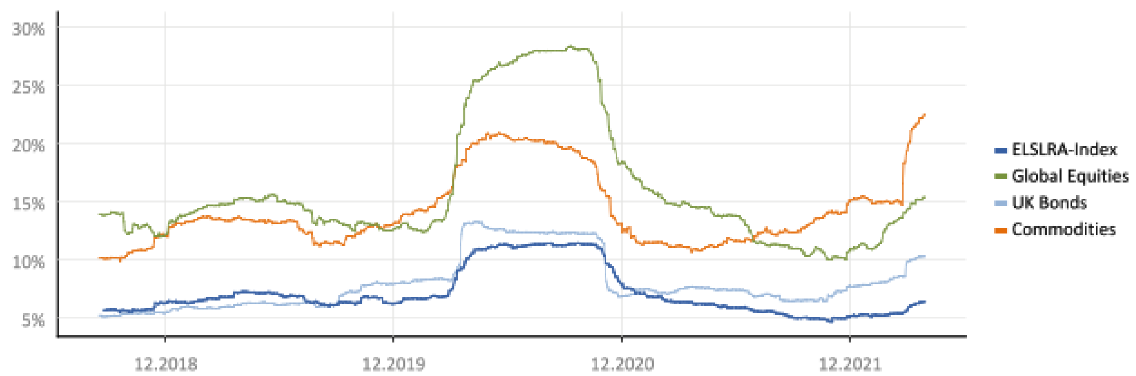
The contributors to returns in 1q22 have been Energy, Gold, Industrial Metals, Agriculture & Precious Metals. The detractors were Water, Index-Linked Gilts and Mortgage-Backed Securities. The attribution analysis for Liquid Real Asset components is summarised below.

Fig.3. Attribution analysis

Source: Elston research, Bloomberg data, as at 31st March 2022

The volatility profile of the index is consistent with the volatility profile of UK gilts.

Fig.4. Rolling Volatility

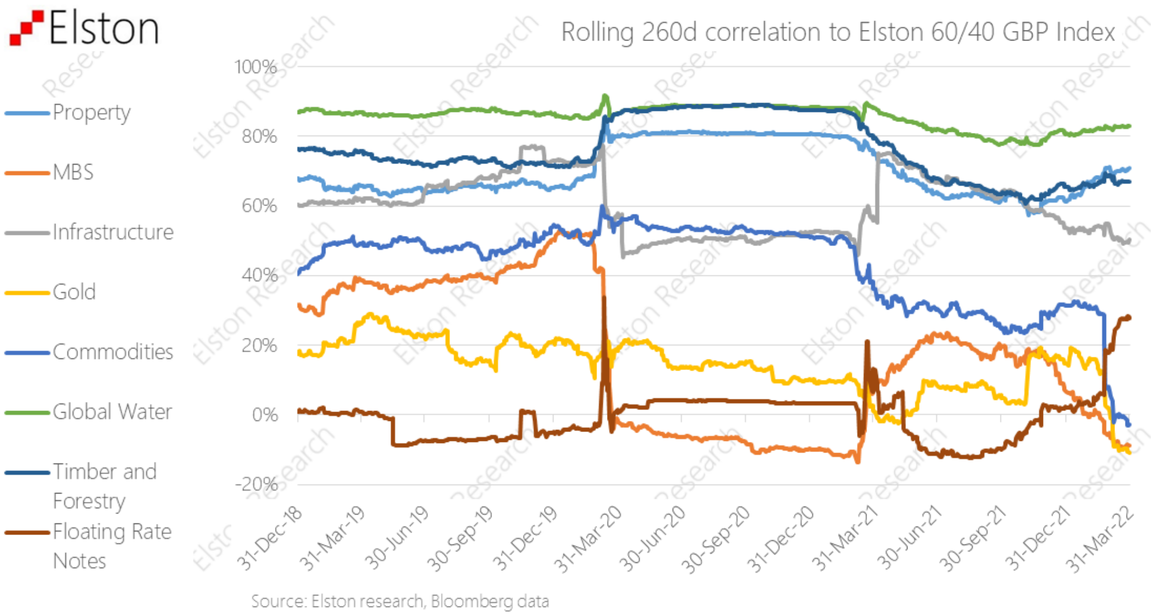


Source: Elston research, as at 31st March 2022

In addition to asset-based diversification of incorporating real assets into a multi-asset portfolio, the correlation structure of real assets, relative to an equity/bond portfolio introduces "risk-based" diversification.

Whilst long-run correlations are useful for strategic asset allocation, short-run correlations indicate realised potential for diversification benefits in the near-term. Relative to the previous quarter ending December 2021, the correlation of Gold, Commodities and Mortgage-Backed Securities were low and decreased relative to a 60/40 equity/bond portfolio. The rolling 260 day correlation of various Liquid Real Asset classes, relative to our 60/40 index is presented below.

Fig.5. Rolling correlation



Source: Elston research, Bloomberg data, as at 31st March 2022

Liquid Real Assets – with risk constraints - provide an alternative to Bonds

For so long as we are living with inflation, nominal bonds will remain under pressure. When it comes to adapting portfolios for inflation, it makes sense to substitute all or part of a traditional bond allocation with reduced duration, liquid real assets (subject to risk constraints) and alternative strategies (e.g. Targeted Absolute Return funds)

Summary

Liquid Real Assets provide asset-based diversification beyond property and infrastructure, and risk-based diversification owing to the varied and changing correlation structure of liquid real asset components with a traditional equity/bond portfolio.

In this way, the strategy's exposure to liquid real assets enables a return premium to nominal bonds during an inflationary regime, but is paired with lower risk rate-sensitive assets to give an overall level of risk commensurate with bonds.

Find out more about our Liquid Real Assets Index

Find out more Adapting Portfolios for Inflation

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

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

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