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Elston Insights

8th April 2022

Nowhere to hide: bonds provide no protection

- All type of bond exposure showed negative returns in 1q22
- Rising rates and inflation means bond values remain under pressure
- Bonds are providing neither stability nor diversification

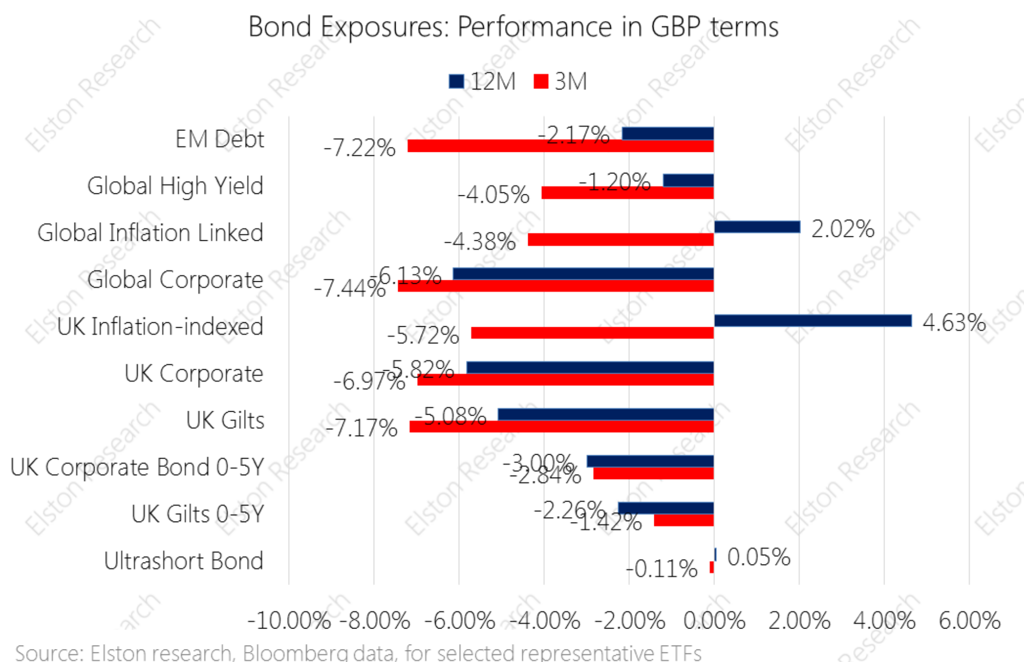
Equity markets endured a triple shock in the first quarter of 2022: a dramatic steepening of the likely path of interests, multi-year high inflation levels and a horrific war unleased in Ukraine.

The traditional rational for including nominal bonds was to provide steady income, lower but positive returns, and diversification – a place of safety in periods of market stress.

In face of rising inflation and rising interest rates, nominal bonds are providing none of these portfolio functions.

Indeed in 1q22 not a single bond exposure delivered positive returns, and over 12 months only inflation-linked exposures delivered positive returns.

Fig.1. Bond exposures: nowhere to hide



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

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Real Assets, including property and infrastructure, provide, one alternative

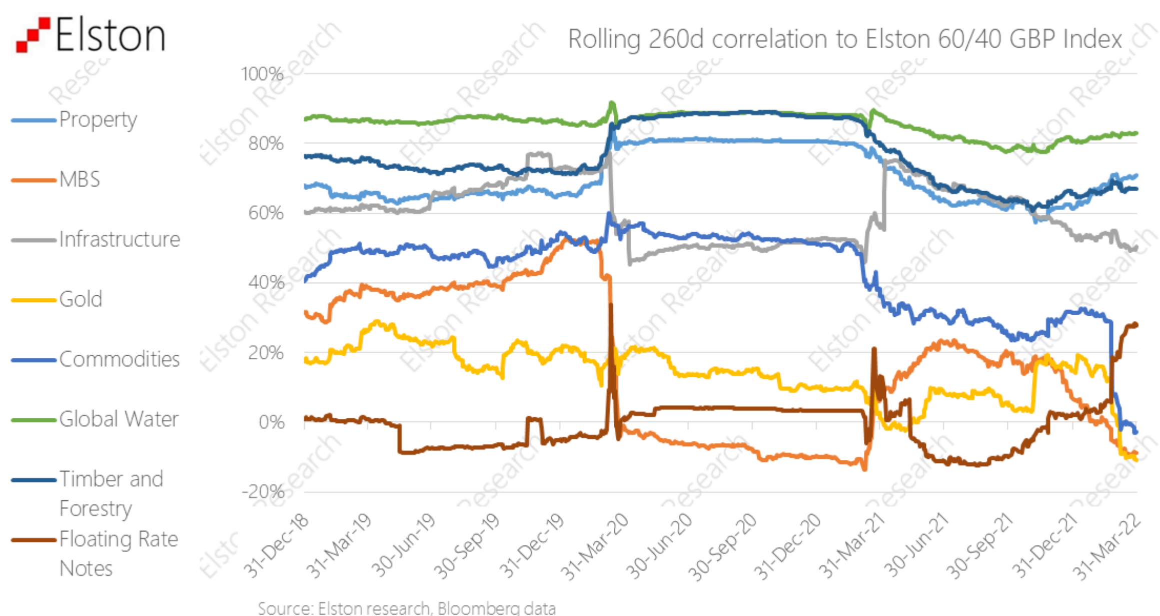
With inflation reaching multi-year highs, there is no remaining part of the fixed income market that could be expected to keep pace with inflation.

Many advisers are rightly exploring real asset exposures such as infrastructure funds and property funds – both of which can be income generative and have the "bond-like" characteristics of a regular income that should keep pace with inflation. However these can be more "equity-like" in their risk characteristics, so risk budgeting is key.

We agree with the rationale to include real assets such as property and infrastructure, but why limit the opportunity set to just-property and infrastructure. Real assets funds can include far broader exposures including asset-backed securities, timber, water, commodities and gold?

A broader real asset exposure can provide additional asset-based and risk-based diversification owing to the different correlations between these real asset classes. The challenge from a portfolio construction perspective, is to control overall risk levels. Our Liquid Real Assets index creates a benchmark for a combination of higher risk inflation-sensitive assets and lower risk interest rate-sensitive assets, to benchmark real asset returns with bond-like volatility characteristics.

Fig.2. Rolling correlation of real asset exposures vs 60/40 index



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

Our preference for liquidity (particularly in uncertain times), means that we would propose that advisers seeking exposure to property and infrastructure – or broader real assets – also consider index funds of related securities to gain access to those exposures whilst assuring liquidity, diversification and cost efficiency.

Going active? Three things to consider

If considering actively managed property and infrastructure funds, we would note the following:

1. **Consider both fund risk and contribution to portfolio risk:** infrastructure and property funds are typically higher risk, relative to bonds, and in some instances have similar risk characteristics to equities. Therefore a substantial switch from bonds to infrastructure and property is necessarily a material up-risking of overall portfolio risk. This is something to consider if risk budgets have been defined and agreed with clients.
2. **Consider liquidity:** when markets and therefore asset values are volatile, liquidity risk is key. Property funds have a tradition of gating investors' funds (in 2008, 2016 and 2020, for example) when the going gets tough. Whilst justifiable from the fund provider's perspective (protecting interests of all unitholders), it creates a real investment and operational problem as regards those investors' broader portfolio: namely the inability to resize or exit positions, and the difficulty of holding a gated funds within a model portfolio. The same risk applies to actively managed infrastructure funds, hence an understanding of the concentration and liquidity profile of underlying assets within each fund is key.
3. **Be selective:** actively managed property and infrastructure funds require an understanding of the investment manager's strategy, target and actual holdings. Performance should be considered relative to a property securities or infrastructure securities index.

Selectivity is key when considering property, infrastructure or real assets funds. We can help advisers with fund research on holdings in their portfolio and their portfolio as a whole.

Targeted Absolute Return funds provide another alternative

Targeted Absolute Return (TAR) funds have a mixed history. Some have failed to deliver on their objectives, others are unnecessarily complex and opaque. A few are both. But that does not mean dismissing the sector entirely.

Whisper it, but TAR funds could have a role to play in providing the diversifier and risk-reduction function that bonds used to offer, but providing a return premium to bonds by dynamically investing across other asset classes.

Classic "all-weather" strategies still hold some bonds, but by holding other asset classes too, aim to deliver a return premium to bonds, with bond-like volatility.

Again, selectivity is key. Fund providers may argue their objectives are unique and the sole comparator. However to assist advisers, we have developed a broader evaluation framework: firstly we contrast TAR funds against key metrics such as a standardised hurdle rate; secondly we explore risk-adjusted return and downside risk metrics relative to straight forward Equal Risk and Equal Weight multi-asset indices; and finally we look at the more traditional peer group comparison.

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Summary

With inflation running at multi-year highs, no part of the bond market offers a place to hide for investors seeking to protect capital in real terms or to diversify portfolios.

Property and Infrastructure funds offer an alternative, but these drives overall portfolio risk higher. Furthermore concentration risk and liquidity risk are key when using actively-managed versions of these exposures.

We believe a broader approach to real assets and a selective approach to Targeted Absolute Return funds, offer potential alternatives. These strategies aim to provide (in very different ways) a return premium to bonds, whilst maintaining bond-like volatility.

Henry Cobbe, Elston Consulting

Find out more about our Liquid Real Assets Index

CPD webinar: Adapting Portfolios for Inflation

CPD webinar: Comparing Absolute Return Funds

See all our Research Insights

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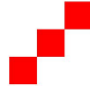

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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