Elston

29th April 2022

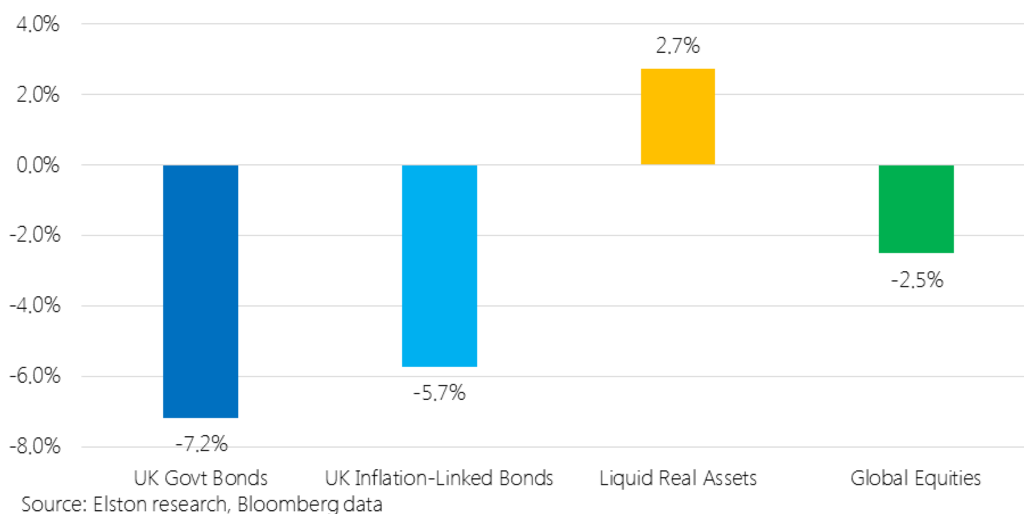
Elston Insights

# Blending liquid real assets with an equity/bond core

- Bonds fail to provide diversification or protection in inflationary regime
- Liquid real assets can improve inflationary resilience
- For advisers using equity/bond funds, a blended approach can help

In theory, through 2021 we have argued that bonds would remain under pressure against the twin pressures of rising interest rates and rising inflation. In practice, market dislocations of 1q22 evidenced this as bonds provide no place to hide in a time of market stress, and lost both their diversification and their protection characteristics. Indeed, the losses sustained on the bond side of a traditional multi-asset equity/bond portfolio were more extreme than the losses sustained on the equity side. The pressure on bonds will continue so long as we are in an inflationary regime. And that may be for the medium-term (e.g. 5 or more years based on market implied inflation rates). This is forcing a rethink for advisers reliant on equity/bond multi-asset funds to deliver a core investment strategy for their clients. The performance summary for key index exposures in 1q22 is summarised below.

*Fig.1. 1q22 Performance Summary (GBP, by asset class index exposure)*




Source: Elston research, Bloomberg data, as at 31st March 2022. Total returns in GBP terms.

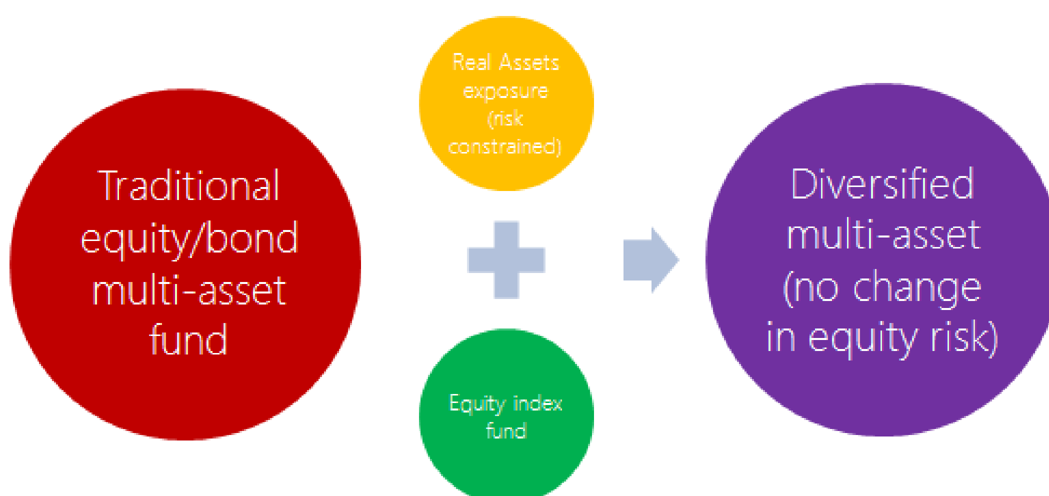
By contrast in 1q22 our Liquid Real Assets index strategy delivered positive returns in the first quarter owing to its inclusion of assets that are positively correlated with inflation. The degree of positive returns was less dramatic than a direct allocation to Commodities, for example, because

the strategy is risk-constrained and designed to have similar volatility to UK Gilts to enable substitutions without impacting portfolio risk profile.

With inflation and interest rates on the rise, nominal bonds are likely to remain under pressure for the medium-term. For advisers using equity/bond multi-asset funds to deliver client solutions, it would be prudent to incorporate some liquid real asset exposure for diversification purposes and to increase inflation resilience.

This can be done by 1) maintaining core equity/bond fund exposure; 2) adding on risk-constrained liquid real assets exposure and 3) using an equity index fund to ensure overall equity risk unchanged.

*Fig.2. Blending in real asset exposure to a multi-asset equity/bond fund: concept*




Source: Elston research, for illustration only

A blended approach means 1) no change in equity allocation, 2) no change in risk profile, but 3) an increased level of inflation resilience within the portfolio.

(For advisers currently using multi-asset funds, but looking to remove bond exposure entirely, a more complex overhaul is required, which is outside the scope of this article.)

Example: Illustration of a blended approach

By way of illustration, we modelled the blended approach using a theoretical allocation to two additional funds, using the following allocation assumptions:

1) 80% allocation to existing core equity/bond multi-asset fund; and

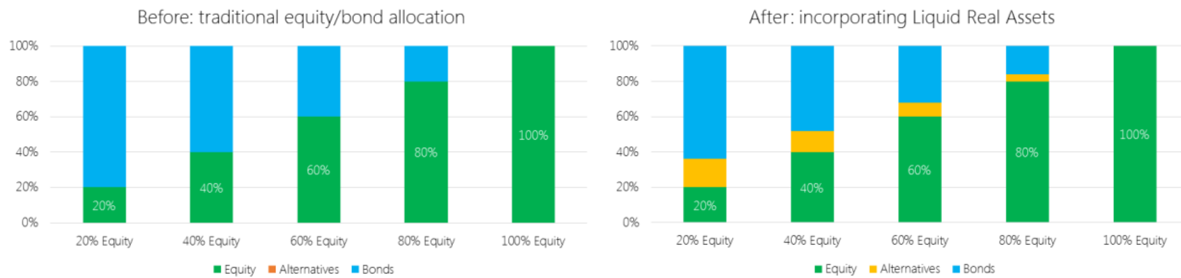
2) 20% allocation to a blend of:

   a) a 20/40/60/80% allocation to an equity index fund; and

   b) a 80%/60/40/20% allocation to a real assets index fund

Looking at the before and after asset allocation charts below, we can see that on a look through basis, the overall equity allocation does not change, and an alternatives allocation is introduced.

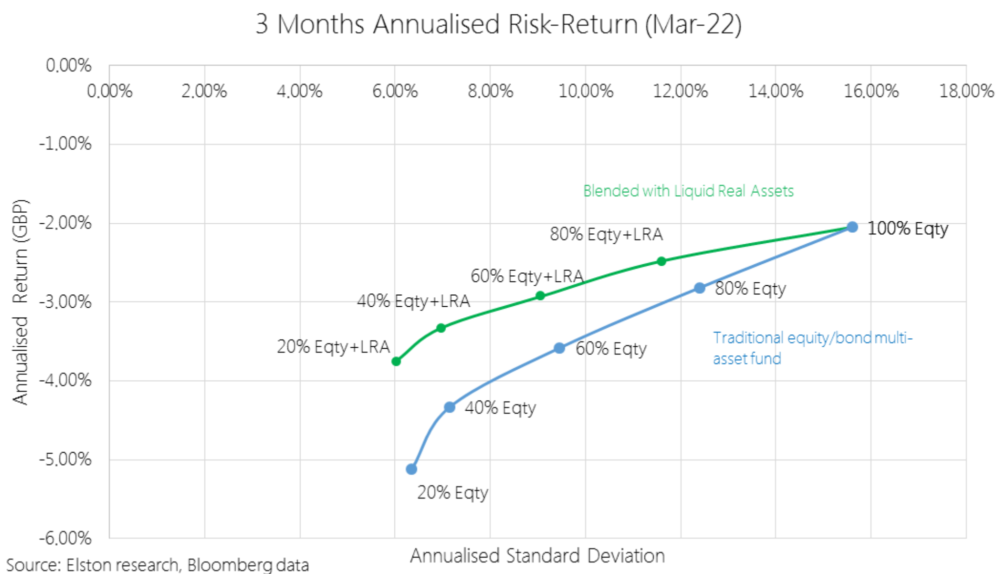
*Fig.3. Asset allocation: no change to equity allocation*




Source: Elston research, for illustration only

Looking at 1q22 performance, where bond losses were more severe than equity losses, the incorporation of Liquid Real Assets would have delivered a higher level of downside protection for all risk profiles.

*Fig.4. Change to risk-return characteristics (1q22): traditional vs blended approach*

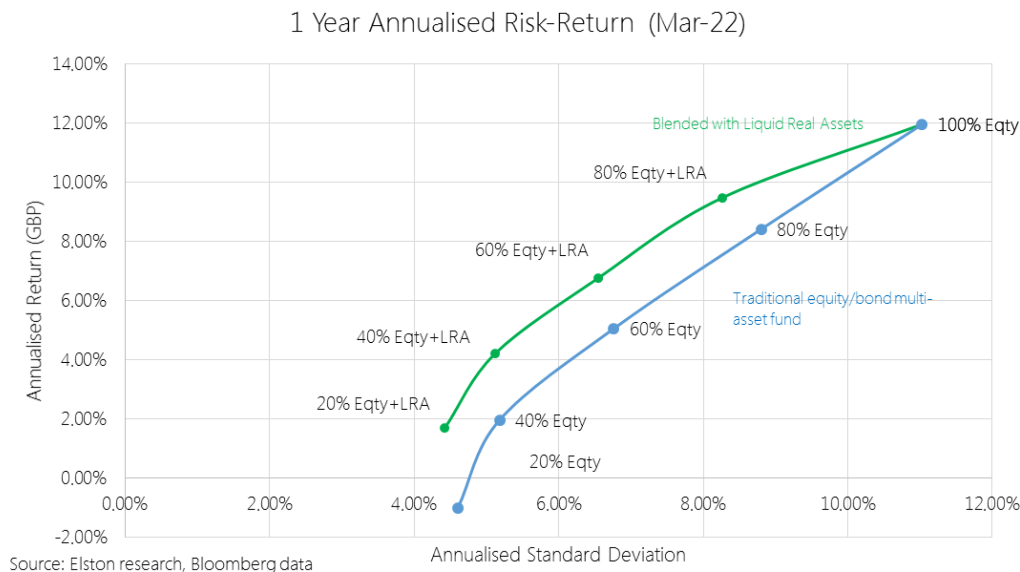



Source: Elston research, Bloomberg data, for illustration only. See Assumptions. "LRA" means Liquid Real Assets

Looking at 1 year performance, the incorporation of Liquid Real Assets would have delivered a higher level of diversification and risk-adjusted returns for all risk profiles.

Elston

*Fig.5. Change to risk-return characteristics (1 year data): traditional vs blended approach*




Source: Elston research, Bloomberg data, for illustration only. See Assumptions. "LRA" means Liquid Real Assets

### What about longer-term?

Looking at longer term performance would be interesting, and we could create comparison charts incorporating data from index inception (December 2017). But this would be less relevant as in the 20 years prior to 2020, markets were not in an inflationary regime. The most relevant period of historical performance would be during an inflationary regime (e.g. from 1973 to 1990). For that analysis, we refer back to our analysis of the academic research on asset class behaviour and correlation to inflation that inspired the strategy (Briere & Signori (2011)).

### Summary

We expect bonds to remain under pressure for the medium-term in the context of rising rates, inflation and quantitative tightening. For traditional multi-asset portfolios and equity/bond funds with high bond allocations, this may continue to deliver a structural drag on performance, and fail to provide the diversification or capital protection that can be expected in normal market regimes.

Incorporating real assets improves inflation resilience based on evidence of prior inflationary regimes and recent performance.

By incorporating individual real asset exposure directly, such as property, infrastructure or commodities may increase overall portfolio risk beyond agreed risk budgets. Furthermore, particular attention is required to the liquidity profile of actively managed property and infrastructure funds.

By contrast, by incorporating an allocation to liquid real assets in a way that is both liquid and risk-constrained, means that inflation resilience is improved, but risk budgets are unaltered.

Elston

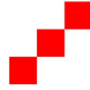
Henry Cobbe, Elston Consulting

Find out more about our Liquid Real Assets Index

CPD webinar: Adapting Portfolios for Inflation

See all our Research Insights

Elston



## 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" is a Regulated Benchmark. 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: 1 King William Street, London EC4N 7AF.

© Elston Consulting Limited. All rights reserved No unauthorised reproduction.