Flash update: JPMorgan Global Core Real Assets

JARA's diversification should bring resilience in troubled markets...

Update
10 May 2023

JPMorgan Global Core Real Assets (JARA) is a real asset fund that offers exposure to a highly diversified portfolio of real assets spread across sector and geography and accessed via a structure with a number of advantages over many open- and closed-ended funds.

Rising interest rates have seen many areas of the market re-price, including trusts investing in private assets. JARA has fallen onto a discount of 9%. While the NAV has not been immune from the same pricing pressures, JARA's diversification has given it some resilience, the balance sheet looks strong and there are a number of advantages to the structure which we think should support portfolio values and could mean the discount is short-lived.

JARA invests mostly in perpetual life private institutional funds run by JPMorgan's Global Alternatives Group. The strategies range from US and Asian real estate to diverse transportation and infrastructure assets operating around the globe. This offers flexibility during volatile environments like today's, as the underlying strategy managers are able to shift their allocations within each strategy as well as JARA also changing its high-level allocation. As the underlying funds are mostly very large, they are both diversified in themselves and turning over assets to adapt to market conditions. This means, on a look-through basis JARA's portfolio is currently exposed to 335 private investments, or 1,230 individual assets, plus an allocation to listed real assets, all of which supports an attractive yield of 4.7% (based on the latest price of 90pps). Importantly there is also long-term income growth potential. While some investors have been attracted by yields on offer in fixed income in 2023, these yields are 'fixed', while JARA's portfolio offers the potential for growth year-on-year, with the latest estimate of this growth being c.4%.

The latest asset allocation is shown below, with real estate debt now making up c.10% of the portfolio. Importantly the real estate equity exposure is globally diversified, with a significant allocation to Asia as well as the holdings in the US. (We note this provides diversification to the typical property exposure the UK investor is likely to have in the UK or Europe.) The Asian property allocation has displayed resilience in recent quarters, helped by lower inflation across the region meaning interest rate hikes have been more modest, and helped by stronger underlying economic growth as various countries, including China and Japan, drop their last COVID restrictions.

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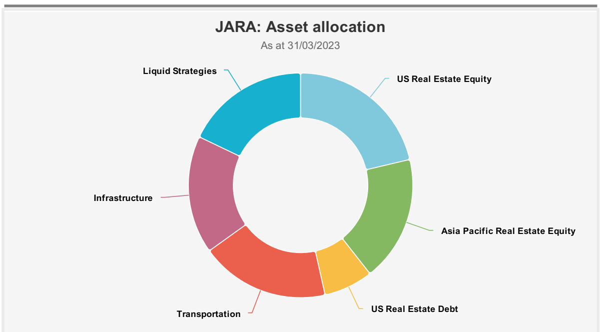
Fig.1:Asset Allocation



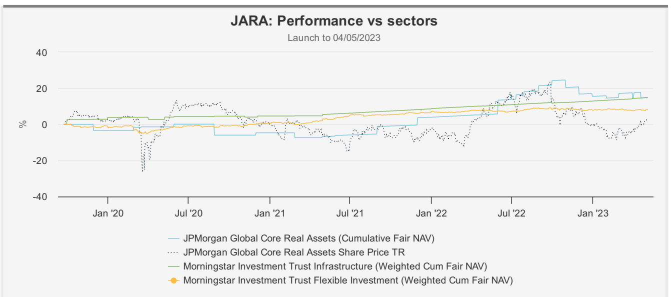
Source:JPMorgan, as at 28/02/2022

JARA's focus on core assets means it is invested in more defensive and higher-quality assets across its allocations. That said, the managers have been tilting the portfolio defensively, with a real estate debt allocation taking capital from real estate equity, and less economically sensitive additions being made to the underlying transportation and infrastructure allocations prior to the recent interest rate rise. Real estate debt is more defensive than equity as it is higher up the capital structure, which has helped the trust as US property has come under pressure. Additionally, most loans are at a floating rate which means the strategy has benefitted as rates have risen, acting, to some extent, as an interest rate hedge within the portfolio.

JARA has no gearing at the company level and leverage is therefore only currently at the underlying fund level. Private assets make up 82% of the portfolio, as of the latest quarterly report and have a look-through loan-to-value of 36.6%. This equates to 30% of the whole portfolio (42.9% on a NAV basis). While 22.6% of the trust's gearing is floating rate, the real estate debt allocation of 10% provides exposure to floating-rate loans on high-quality assets, which act as a form of interest hedge to this. As of the end of February, the blended average cost of debt was 3.7%. While this could rise modestly as interest rates do, the real estate debt allocation helps offset return drag. This puts JARA in a better position than many alternative asset trusts which require the use of floating rate revolving credit facilities to make further investments, build out existing assets, or fund their activities. JARA's debt has a weighted average maturity of 5.2 years, another strong characteristic. In our view, this takes the time horizon for refinancing out to when interest rates are likely to be substantially lower.

JARA has delivered solid returns since it launched just before the pandemic struck, a highly volatile period to say the least. The NAV per share was 99.85p as of the end of March 2023 compared to 99p at launch. Investing in core assets has helped dampen volatility in asset prices. The significant exposure to dollar assets has been a major factor, particularly in the strong returns in 2022 and the decline in the portfolio seen since Q3 2022 (see chart below).

Fig.2: Performance Since Launch



Source: Morningstar

Past performance is not a reliable indicator of future results.

Along with the decline in the dollar (exposure was 65% at the end of February), pressures on US real estate pricing have been felt in NAV valuations of recent quarters. So far the US market has proven more resilient than European and UK commercial property. That said, the managers note there has been some pricing pressure from rising interest rates felt across the market. In their view, rising rates have largely been incorporated into prices, and fundamentals will likely drive prices in the future. With debate still raging as to whether the US will see a recession, and whether that will be technical or substantial, there is some uncertainty. However, in the managers' views, fundamentals remain strong in the industrial and residential sectors, where they are focused. Bricks-and-mortar retail has been under pressure for many years and whilst it has had a better time recently the teams have been highly selective in any involvement here. Similar to what happened several years ago in retail they are seeing a bifurcation in the office market too. Higher-quality offices remain well positioned as older offices are increasingly unattractive, especially in a flexible working world and when the environmental footprint is an increasing consideration. However, the picture is different in Asia, where the working-from-home culture is not making headway. Offices in the region are seeing more resilient performance, and we note that by virtue of investing in very different geographies, JARA is able to maintain sectoral diversification rather than becoming focused purely on industrials.

Another interesting feature of the portfolio's diversification is its holdings in both renewables and energy transition investments, benefiting from the wider J.P. Morgan platform. One such example is a range of institutional investors advised by J.P. Morgan, including JARA, funded the construction of a fleet of modern LNG tankers which benefit from the shift from coal to less-polluting gas. In our view over the past two years, there has been a recognition that investing in cleaner fossil fuels is an essential step in the energy transition, and we note these have been lucrative investments. The managers think prices have moved substantially, and are therefore currently more interested in transport-orientated sectors such as aviation leasing and railcar leasing, whilst they are finding opportunities in renewables too.

Kepler View

We think JARA is an attractive way to get long-term exposure to real assets. These have a number of benefits: they are less economically sensitive as a whole, although of course, this varies across the asset in question, they offer a diverse source of income with growth potential, and they should be uncorrelated with equity markets over the long run. JARA's structure allows it to offer a highly diversified portfolio of assets otherwise restricted to institutional investors.

In recent quarters real asset trusts have come under pressure, with discounts widening. We think this reflects issues around gearing, discount rates, and income in the light of rising interest rates. In our view, JARA's gearing position is solid, with most of the debt fixed, and the average maturity being long. Whilst there is a small portion of floating rate debt, the trust also has exposure to floating rate loans on high-quality assets, which act as a form of inflation hedge.

As regards the discount rate, the managers tell us they were conservative when interest rates were cut. Their discount rates reflect an average expected rate over 20 years or more, so while there have been some increases in the light of rate hikes, they are likely to remain modest.

While it is true higher yields are available on some short-term debt now, we think the lack of growth potential in fixed income has to be borne in mind. For long-term investors, short-term debt can only be a stop-gap. With interest rates widely expected to fall towards the end of this year, short-term bond yields may too.

Overall we think JARA looks attractive on a significant discount. There could be further pressure to come on the US real estate portfolio in particular, particularly if a recession hits or if rates are hiked further. But the discount already compensates for this risk in our view. We think a yield of 4.7% with the prospect for growth is attractive, with the potential for the discount to close as rates peak and decline.

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