



Richard Lubbock
Charities Client Director



Jonathan Joiner
Solutions Manager



Chris Teschmacher
Fund Manager Asset Allocation

Inflation: the unseen robber of investment returns?

Much has been documented about the sharp rise in inflation over the past year, with debate ongoing on whether it is transitory or not.

This has been exacerbated in recent weeks by the terrible developments in Ukraine and the resulting spike in energy costs. Central bank rhetoric has become increasingly hawkish and monetary policy has been tightening. The spending of charities and endowments is real in nature, with higher inflation putting pressure on expenditure. With investors being accustomed to the low-inflation environment of the past 20 years, this raises the question of how charities and endowments could now think about their strategic asset allocations?

What are the risks associated with higher inflation?

After years of the spectre of deflation weighing on the minds of many economists, one might wonder why an increase in inflation is making markets nervous. Indeed, some inflation can be beneficial, reducing the real value of debt burdens on both household and company balance sheets.

The problems begin when inflation is persistently above central bank targets. With most central banks' primary goal being to keep inflation within a range, a persistent overshoot is typically countered with tighter monetary policy through raising interest rates. The goal of central banks in this is to cool demand and 'soft land' the economy back to a steady state. Achieving this is very difficult in practice and likely to increase the risk of



recession.

Against this backdrop, investors' natural reaction is to look to reduce or hedge this risk. It is important, however, to define what risk one is actually trying to hedge. Discussion often revolves around hedging against short-term volatility caused by a spike in inflation. However, charities and endowments are long-term investors, with the central concern more typically the erosion of real asset values over the long term. The distinction is important as we will go on to see that it can have markedly different implications for portfolios.

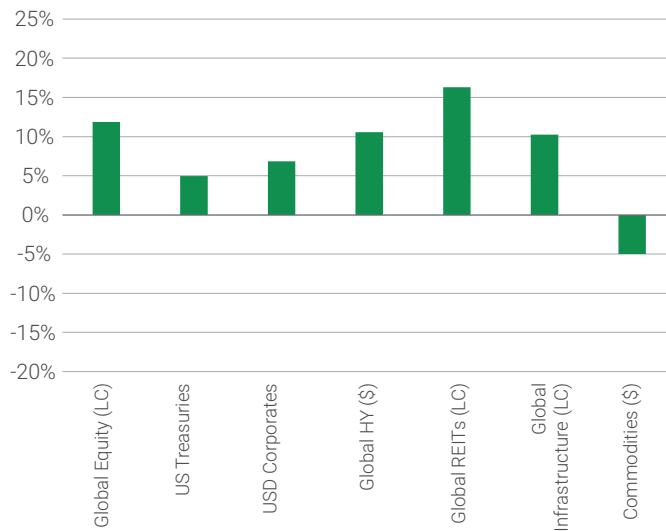
How have assets performed in differing inflationary environments

Looking at history can offer insights into how asset classes could react to changes in inflation expectations. Inflationary environments can be broadly split into four categories, namely whether inflation is currently high or low, cross sectioned with whether it is rising or falling. For the high-inflation data it is important to not take the output purely at face value, given the

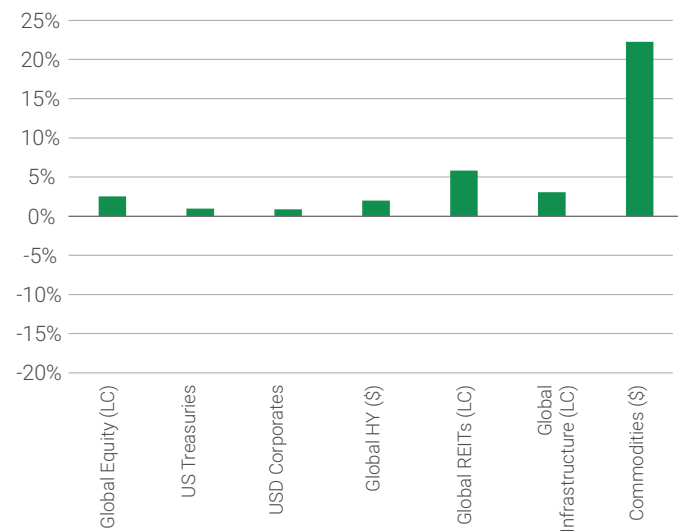
dearth of high-inflation periods in the recent past, but the experience from the 1970s and 80s still provide useful observations. Figure 1 details the historic performance in each of those regimes. It can be seen that in periods when inflation is rising, commodities have been the outperforming asset class, as one might expect. Other assets that have tended to perform strongly in high-inflation environments have been real assets, such as infrastructure and real estate (REITs) as well as equities. The laggard has tended to be fixed income assets, with rising

Figure 1: Historical performance of asset classes in differing inflation regimes

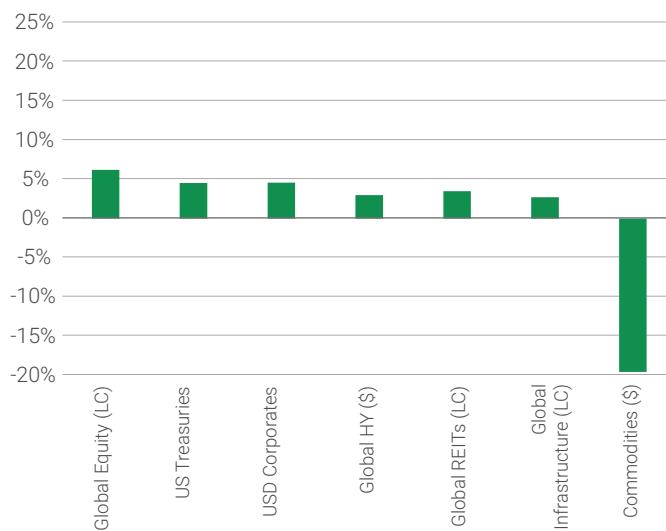
High and falling



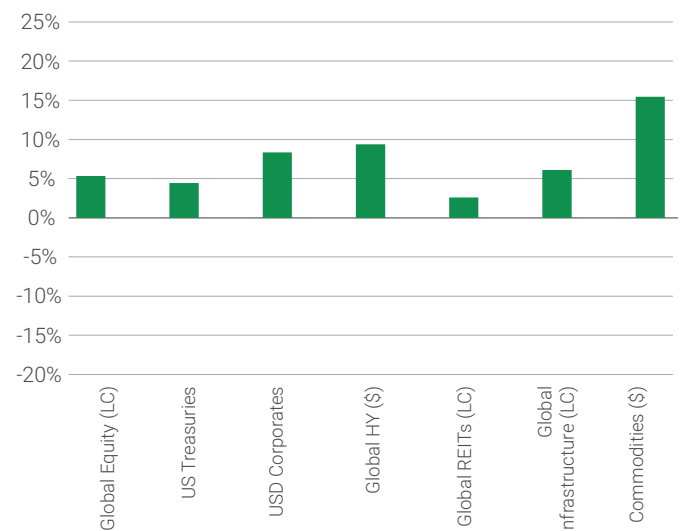
High and rising



Low and falling



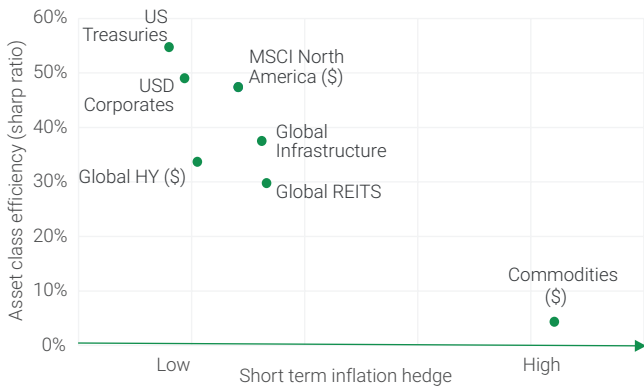
Low and rising



Source for all: LGIM and Bloomberg, data from 31 December 1973 to 28 February 2022. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Does this mean that equities and real assets are a direct hedge to inflation shocks? One can make a strong economic rationale for this as company earnings, rents and asset prices should all be broadly linked to inflation over the long term. However, one has to be careful to not be overly reliant on the economic rationale – (markets can stay irrational longer than you can stay solvent). In figure 2, we have delved into the data in more detail and show inflation hedge effectiveness on the horizontal axis¹. It can be seen that commodities are the outperformer on this metric. In essence, real assets and equities have tended to outperform in inflationary scenarios because they earn a risk premium over other asset classes, not necessarily because they are a direct inflation hedge.

Figure 2: Short-term inflation hedge versus asset class efficiency



Source: LGIM and Bloomberg, data from 31 December 1973 to 28 February 2022. **Investments dominated in a currency other than [Sterling] may cause the returns to increase or decrease as a result of currency fluctuation. Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

This could lead to the conclusion that to protect against a sharp rise in inflation one could consider increasing the allocation to commodities. However, the qualification of what risk one is looking to hedge is very important. While commodities may protect against an inflation shock over the short term, for long-term investors, such as charities and endowments, the focus is often more on protecting the real value of their assets over the long term. In figure 2, the vertical axis plots the efficiency of the assets defined as the amount of return one can expect relative to the volatility (known as the sharp ratio). Under this lens commodities perform very poorly, with low long-term returns when allowing for the associated volatility. As such, a large strategic allocation to commodities is likely to lead to a significantly less efficient strategic portfolio over the long term, in our view.



1. This is calculated by deriving the 'Beta' of each asset to inflation. The Beta is derived by calculating how and asset moves with changes in inflation

Prepare, don't predict!

This can leave investors in a quandary: do I protect against short-term risks or focus on a long-term efficient portfolio? At LGIM we believe in the mantra of 'prepare, don't predict', particularly when it comes to inflation. While the current inflationary environment is a step change from the disinflationary/low inflation environment investors have become accustomed to over the past 20 years, the key principles behind setting a strategic asset allocation have not. For majority of long-term investors, we believe this means prioritising preserving real asset value over the long term. In line with that view, we have detailed three steps below that we believe investors could consider taking to help them navigate the current economic climate.

Ensuring your portfolio is diversified

We believe portfolio diversification is a key pillar to strategic asset allocation and is particularly important in the current environment. Within growth assets, real assets such as infrastructure and property may not have as strong a short-term correlation with inflation as commodities, but they can offer diversification benefits from equities and clear inflation drivers over the long term. Similarly, diversifying bond exposure globally can reduce the risk of being exposed to the inflation regimes in one currency.

Bonds may not be a safe hiding place

Exposure to long-term interest rates through allocations to government bonds and long-dated corporate bonds has long been thought of as a way to protect multi-asset investors from market downturns. The investment thesis behind this is that in market downturns, bonds are negatively correlated to equities and rally as investors anticipate interest rate cuts. This

relationship had already been under scrutiny over recent years as interest rates fell to all-time lows, and questions were raised about how much they could protect on the downside. With high inflation putting pressure on central banks to raise interest rates, it may be that bond prices and equities become increasingly positively correlated. Against this backdrop we would hold less bond exposure than usual, but not necessarily remove exposure entirely. While government bond yields are under pressure, in all of the past 12 recessions they have performed, and therefore still offer some protection, even if it is less than in previous cycles.

...but currency exposure may help

Domestic inflation shocks tend to coincide with currency weakness. This was particularly notable in 2016 following the Brexit vote, with the perceived inflation shock translating into Sterling weakness. Gains in sterling terms from overseas currency exposure could be used to offset the real losses in investors' portfolios. The current inflation story is truly global in nature, but the UK has a long history of high inflation compared with the rest of the developed world. We believe foreign currency exposure, particularly for Sterling-based investors, could provide useful protection.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative



Key risks

Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass. It should be noted that diversification is no guarantee against a loss in a declining market.* Investments dominated in a currency other than [Sterling] may cause the returns to increase or decrease as a result of currency fluctuation.

Important information

The information contained in this document (the 'Information') has been prepared by Legal & General Investment Management Limited, Legal and General Assurance (Pensions Management) Limited, LGIM Real Assets (Operator) Limited, Legal & General (Unit Trust Managers) Limited and/or their affiliates ('Legal & General', 'we' or 'us'). Such Information is the property and/or confidential information of Legal & General and may not be disclosed by you to any other person without the prior written consent of Legal & General.

No party shall have any right of action against Legal & General in relation to the accuracy or completeness of the Information, or any other written or oral information made available in connection with this publication. Any investment advice that we provide to you is based solely on the limited initial information which you have provided to us. No part of this or any other document or presentation provided by us shall be deemed to constitute 'proper advice' for the purposes of the Pensions Act 1995 (as amended). Any limited initial advice given relating to professional services will be further discussed and negotiated in order to agree formal investment guidelines which will form part of written contractual terms between the parties.

The Information has been produced for use by a professional investor and their advisors only. It should not be distributed without our permission.

The risks associated with each fund or investment strategy are set out in this publication, the relevant prospectus or investment management agreement (as applicable) and these should be read and understood before making any investment decisions. A copy of the relevant documentation can be obtained from your Client Relationship Manager.

Confidentiality and Limitations:

Unless otherwise agreed by Legal & General in writing, the Information in this document (a) is for information purposes only and we are not soliciting any action based on it, and (b) is not a recommendation to buy or sell securities or pursue a particular investment strategy; and (c) is not investment, legal, regulatory or tax advice. Any trading or investment decisions taken by you should be based on your own analysis and judgment (and/or that of your professional advisors) and not in reliance on us or the Information. To the fullest extent permitted by law, we exclude all representations, warranties, conditions, undertakings and all other terms of any kind, implied by statute or common law, with respect to the Information including (without limitation) any representations as to the quality, suitability, accuracy or completeness of the Information.

Any projections, estimates or forecasts included in the Information (a) shall not constitute a guarantee of future events, (b) may not consider or reflect all possible future events or conditions relevant to you (for example, market disruption events); and (c) may be based on assumptions or simplifications that may not be relevant to you.

The Information is provided 'as is' and 'as available'. To the fullest extent permitted by law, Legal & General accepts no liability to you or any other recipient of the Information for any loss, damage or cost arising from, or in connection with, any use or reliance on the Information. Without limiting the generality of the foregoing, Legal & General does not accept any liability for any indirect, special or consequential loss howsoever caused and on any theory or liability, whether in contract or tort (including negligence) or otherwise, even if Legal & General has been advised of the possibility of such loss.

Third Party Data:

Where this document contains third party data ('Third Party Data'), we cannot guarantee the accuracy, completeness or reliability of such Third Party Data and accept no responsibility or liability whatsoever in respect of such Third Party Data.

Publication, Amendments and Updates:

We are under no obligation to update or amend the Information or correct any errors in the Information following the date it was delivered to you. Legal & General reserves the right to update this document and/or the Information at any time and without notice.

Although the Information contained in this document is believed to be correct as at the time of printing or publication, no assurance can be given to you that this document is complete or accurate in the light of information that may become available after its publication. The Information may not take into account any relevant events, facts or conditions that have occurred after the publication or printing of this document.

Telephone Recording:

As required under applicable laws Legal & General will record all telephone and electronic communications and conversations with you that result or may result in the undertaking of transactions in financial instruments on your behalf. Such records will be kept for a period of five years (or up to seven years upon request from the Financial Conduct Authority (or such successor from time to time)) and will be provided to you upon request.

Legal & General Investment Management Limited. Registered in England and Wales No. 02091894. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 119272.

Legal and General Assurance (Pensions Management) Limited. Registered in England and Wales No. 01006112. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, No. 202202.

LGIM Real Assets (Operator) Limited. Registered in England and Wales, No. 05522016. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 447041. Please note that while LGIM Real Assets (Operator) Limited is regulated by the Financial Conduct Authority, we may conduct certain activities that are unregulated.

Legal & General (Unit Trust Managers) Limited. Registered in England and Wales No. 01009418. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 119273.