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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.

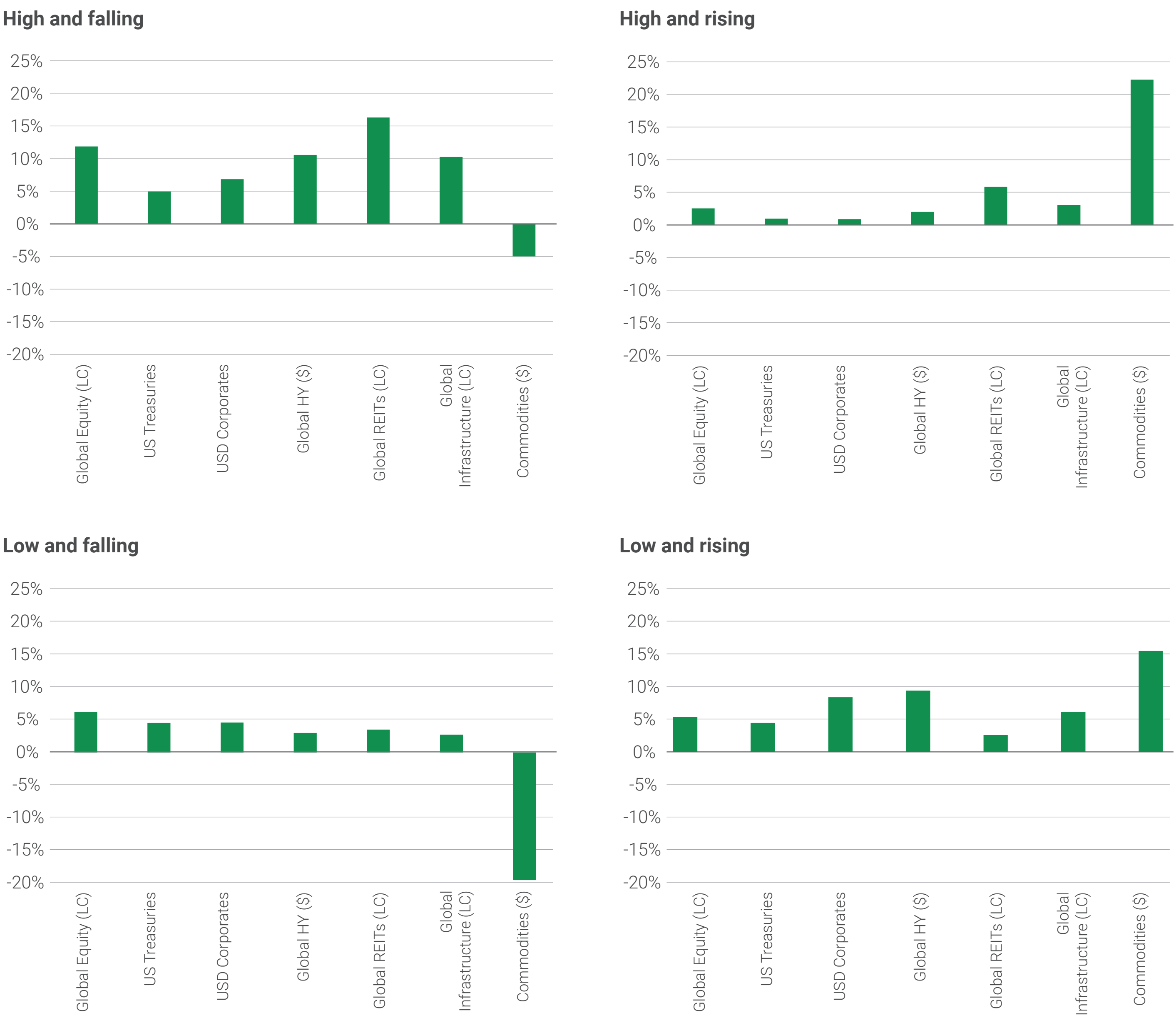
The problems begin when inflation is persistently above central bank targets. With most central banks' primary goal being to keep inflation within a range, a persistent overshoot is typically countered with tighter monetary policy through raising interest rates. The goal of central banks in this is to 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

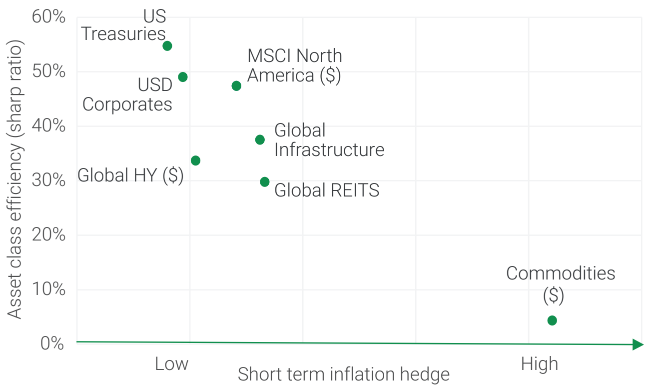
Figure 1: Historical performance of asset classes in differing inflation regimes



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 axis[1]. 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 again 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

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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.