Weatherizing Portfolios Against Inflation Risk

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BNY Mellon Investment Strategist Steve Kolano on why investors need a dynamic multi-asset solution to a multi-dimensional problem like inflation.

Takeaways

- Regardless of when inflation might hit, inflation protection for portfolios is like flood insurance: you need it before it starts raining.
- Inflation comes in different forms and affects asset prices differently, so consider a multi-asset solution of real assets that will protect purchasing power across different growth and inflation conditions.
- Inflation protection isn't a set-it-and-forget-it defense; we believe in an active, dynamic approach to weighting inflation-hedging components as macroeconomic conditions and valuations change.
- Incorporating a multi-asset approach can complement or replace existing allocations.

Since the financial crisis there have been different views around whether inflation or deflation is the bigger threat for investors. Where do you think we are in the cycle and should investors be concerned about inflation?

We're certainly seeing signs that the US economy is accelerating across a number of indicators. Unemployment has come down to around 6% and the participation rate is ticking up. We see reports of skilled labor shortages. Real wages are beginning to rise and voluntary separations from companies are starting to increase. Leading economic indicators are also improving. We're approaching a break-even rate for the economy's potential output from the very negative output gap following the financial crisis. With all these signs of a pick-up, everyone is waiting to see when the Fed might

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begin to raise interest rates. The concern is whether the Fed puts its foot on the brake too soon and chokes off growth, or too late and we see inflation accelerate.

Like everyone else, we don't have a crystal ball. But we do believe that incorporating inflation protection into portfolios is like buying flood insurance for your property: you want to have it before it starts to rain.

How did the Investment Strategy & Solutions Group's research on inflation drive the development of a dynamic, multi-asset class inflation-hedging solution?

Like all of our work, our research into inflation stemmed directly from client discussions. After the financial crisis, many clients came to us and said: "My diversified portfolio didn't exactly behave the way I thought it would in a crisis." They wanted a new lens through which to look at their portfolios and understand the underlying risks. It was part of a broader shift to think of asset allocation not only as a capital allocation process but as a risk management process as well.

That's what led us to look at the risks in portfolios across different macroeconomic environments to develop the regime-based asset allocation (RBAA) framework we use as part of all of our investment discussions.[1] We essentially looked at how different asset classes had behaved over the last 40 years under different growth and inflation conditions.

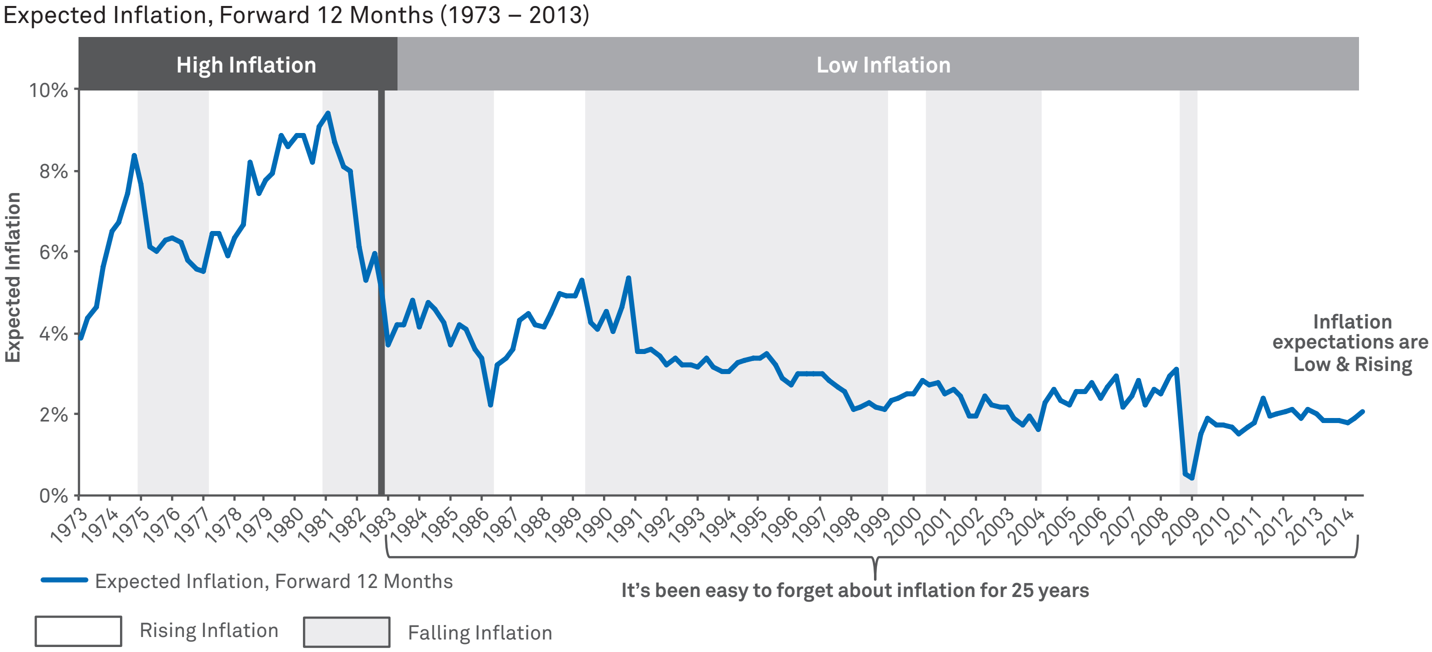
One of our most important insights was that asset class prices have historically reflected expectations about the future. It's less about actual levels of growth and inflation. Rather it's when expectations around growth and inflation start to change that asset prices have moved.

From the beginning, we looked at multiple dimensions of inflation based on historical data. For example, there were expected levels of inflation and revisions to expectations. We looked at what happened with unexpected inflation. For example, if expected levels and revisions settled into a consensus expectation of 3% inflation but the actual CPI print turned out to be 4%, we saw a dramatic acceleration of positive inflation revisions and, as a result of that, expected levels started to go up and asset classes began to behave as you would expect: bond prices started to fall; while commodities, for example, started to move up as they tend to react very positively to unexpected inflation.

We also looked at the drivers of inflation, as those will affect asset classes differently. You can have demand-led inflation that stems from solid economic growth, along the lines of what we saw from 2003 to 2005, where inflation expectations were driven by expected labor shortages and wage growth. There's also inflation that results from a supply shock such as the spike in oil prices in 2008 or the oil embargo of the 1970s, which ended up in a period of high inflation and low growth, or stagflation.

Inflation Expectations Evolve Over Long Regimes

Expected Inflation, Forward 12 Months (1973 – 2013)



Source: Survey of Professional Forecasters, Philadelphia Federal Reserve Bank, ISSG, as of 11/30/13.

1 *"Great Expectations: Regime-Based Asset Allocation Seeks Higher Return, Lower Drawdowns,"* BNY Mellon Investment Strategy & Solutions Group.

Our research showed that the asset classes you would use to defend against each one of those types of inflation are very different. Demand-led inflation tends to be compensated or protected through the equity risk premium, because that kind of inflation is flowing through to the company's underlying earnings.

On the other hand, supply shocks tend to be very sudden and unexpected, so equities are hurt almost as badly as nominal bonds, because their current value represents discounted cash flows into the future. Commodities and commodity-like exposures, on the other hand, tend to perform better in these kinds of environments.

So we very quickly realized that investors needed a multi-asset approach to inflation hedging, one that could dynamically and actively re-weight allocations to different kinds of assets as macroeconomic conditions and valuations changed.

What do you say to investors who have 5% of their portfolio in TIPS and think they have adequate inflation protection?

That was often the initial reaction we encountered. But when we showed them the research into how various asset classes behaved across different macroeconomic conditions, or regimes as we call them, it was an eye-opener for them. They could quickly see that TIPS wouldn't really protect their portfolios against unexpected inflation or demand-led inflation as well as equities. Both equities and TIPS have historically taken a hit with supply shock inflation.

That opens up the conversation about taking a more multi-dimensional approach that includes equities and inflation-linked bonds but also real asset-type components like real estate and commodities or commodity-like assets that have done well in different kinds of inflation environments. When it comes to real assets, we also need to be aware of liquidity and valuations as well as the volatility concerns investors have around commodities.

Mindful of what clients told us they were trying to achieve around inflation protection, liquidity and volatility, we realized that a multi-asset solution based on liquid real assets and with a high degree of volatility control was likely to be more effective than a set-it-and-forget allocation to TIPS.

We believe that you can combine inflation-hedging assets in a solution that allows investors to protect against inflation while targeting equity-like returns with less volatility than stand-alone equities or commodities. In addition to TIPS, we look to combine assets like natural resource equities; risk-controlled commodities with annualized volatility targeted at 10%; global REITs; and emerging market value equities.

Why do you focus on value stocks within emerging markets?

That's based on our fairly detailed research into how emerging market equities have performed over time. Over the last 15 years since China became such a dominant driver of demand for commodities, we've seen a tighter correlation to emerging markets broadly in the commodities cycle. We also know that emerging market value equities have tended to be an effective inflation hedge and have a higher correlation to the threat of a supply shock. If you look at inflation-sensitive sectors within emerging markets, those are materials, energy as well as some of the metals and mining companies within the industrials sector. Those also tend to be very asset-intensive and cyclical industries and therefore trade at lower price-to-earning ratios. The idea is to take advantage of attractive valuations before inflation hits and then rotate out of that allocation into a higher weight for pure commodity exposure as inflation picks up.

That highlights the dynamic approach you seem to favor for inflation-hedging strategies. Why is that?

We think there should be both a strategic and tactical component. The tactical component has the potential to help enhance return over a full market cycle by seeking to take advantage of valuation shifts to achieve the kinds of targets clients want, such as inflation plus 5%, and as a result defray the cost of inflation protection during periods of low inflation. That's an important aspect for clients who want inflation insurance but don't want to pay a high premium for it.

Another important aspect of tactical weightings is to provide flexibility to enhance risk control and stay within a set volatility range.

How can investors incorporate this kind of multi-pronged real asset strategy into portfolios that might already have allocations to some of these asset classes?

For investors that have allocations to illiquid real assets like private equity, a liquid strategy could be incorporated as a complement. In other cases where investors have existing allocations to TIPS or commodities, they could consider reducing those holdings and allocate the capital to a multi-asset solution. It all depends on what current allocations are and what the investor is trying to solve for at the total portfolio level.

How might this type of approach fit into a target date strategy?

I think many target date strategies are a good example of limited approaches to inflation protection. We believe the dynamic nature of a multi-strat real asset strategy lends itself particularly well to the changing needs of target date investors as they approach their retirement date. Younger participants who have many years to save for retirement will need less inflation protection than older participants who are closer to retirement and need to protect the purchasing power of their portfolios. A dynamic strategy will allow for rotating in and out of the appropriate components as **1)** participants' investment needs change and **2)** macroeconomic conditions and valuations change.

So overall, we think a robust inflation solution needs to be **1)** forward-looking: closely monitoring the evolution of inflation risk in each and every market cycle; **2)** dynamic: in order to take advantage of valuation discrepancies and changing conditions; and **3)** active: in order to target alpha and help defray the cost of inflation insurance over a full market cycle.

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