How to defend against inflation?

Man Group analysis shows it pays to own oil, gold and wine, and possibly also a bitcoin if and when inflation bites.

Guest writer YESTERDAY

This is a guest post by Ben Funnell, a portfolio manager at Man Group and Campbell R. Harvey, a professor at Duke University and an investment strategy advisor to Man Group. It is based on their recent research, “The Best Strategies for Inflationary Times”, which was co-authored with Man Group’s Teun Draaisma, Henry Neville and Otto Van Hemert.

Can you remember the last time the US inflation rate exceeded 5 per cent? The answer, remarkably, is 1990 – long before most investors operating today even got into the game. But with April CPI hitting 4.2 per cent and most large asset owners currently long equities and bonds -- asset classes which have historically suffered in inflations -- it's a good time to start evaluating alternative inflation hedging strategies.

In a newly published research paper on SSRN, the authors attempt to offer some insights into the best strategies.
Our research, it should be stressed, is not designed to forecast the level of inflation but rather draws on 34 inflation episodes in the US, UK and Japan (using nearly a century of data) to understand the impact of inflation on asset prices.

To understand the risks, the piece also analyses eight US price-level surges over the past 95 years where inflation started from a moderate level and shot past 5 per cent -- a situation we the authors feel could easily play out in coming quarters. We then focus on inflation's impact on various passive and active strategies, and on which mitigate risk and which potentially contribute to more pain.

A key finding is that it pays to act sooner rather than later. Traditional 60-40 equity-bond portfolios without an inflation hedge are likely to suffer if history were to repeat itself. Past experience indicates that the S&P equity market index is likely to get hammered during inflation surges, losing on average 7 per cent in annualised real terms (after adjusting for inflation). But fixed income offers no respite either, because rising rates have historically caused bond prices to fall. An unprotected 60-40 portfolio is thus a nexus of risk.

So what was it really like to invest in previous periods of unexpectedly high inflation? For a clue we looked back at Warren Buffett’s celebrated shareholder letters from the late 1970s and early 1980s, a time when inflation in the US peaked at almost 15 per cent and mortgage rates hit over 20 per cent. Buffett doesn’t pull any punches as can be seen from this passage in a 1980 letter:

Inflation rates not far from those recently experienced can turn the level of positive returns achieved by a majority of corporations into negative returns for all owners. At present inflation rates, we believe individual owners should expect no real long-term return from the average American corporation.

In a 1977 article for Fortune Magazine, Buffett set out his thoughts in even starker terms:

The inflation tax has a fantastic ability to simply consume capital . . . If you feel you can dance in and out of securities in a way that defeats the inflation tax, I would like to be your broker — but not your partner.
But let’s apply that logic to today. The US ran a deficit worth 15 per cent of GDP in 2020. The Congressional Budget Office also expects a multi-trillion-dollar deficit in 2021. This would be the first instance of consecutive double-digit deficit years since World War II. Covid-fuelled quantitative easing has also led the Federal Reserve’s balance sheet to nearly double in size. And this time around, the money stock is growing – US M2 has grown at a 26 per cent annualised rate since February last year, when the policy response started in earnest. Even to the cool-headed this all screams risk.

So if equities and bonds fail the inflation test, where should investors flee to? As clichéd as it might sound, our research shows commodities have proved a solid historical hedge due to the role commodity prices play in driving inflation in the first place. During inflation episodes, the energy complex has on average returned 41 per cent while industrial commodities have returned 19 per cent - both on a real basis. Gold and silver have also offered low double-digit returns.

Treasury inflation-protected securities (TIPS) are also by design created to hedge against inflation risk. However, there is a cost for this sort of hedge. The current price of the hedge is high given negative starting yields: investors would need to bear negative real returns in non-inflationary periods – unlike some other assets.

Active strategies are another option. For example, time-series momentum, a strategy that is designed to profit in sustained down-markets or up-markets, delivered a 25 per cent annualised real return during the last eight inflation episodes.

But there is a problem. While commodities, trend following strategies and TIPS have offered impressive inflation track records, they offer limited capacity for participation. Therefore high capacity active equity strategies must thus also be considered.

In that context the two best performing equity sectors (not surprisingly) are those linked to the energy complex, which have tended to return 1 per cent in real terms. The health sector is the next best performer at -1 per cent. Consumer durables, however, have tended to get walloped with a -15 per cent real return.

More generally, active strategies that focus on “quality” deliver a 3 per cent return while “value” produces -1 per cent (after transactions costs). And while this might appear modest, such returns are far greater than the -7 per cent for equity in general. Furthermore, these strategies are highly scalable, an important consideration for many big players in the market.

**Getting collectible and alternative**
Our research, however, looked beyond traditional financial assets. It discovered alternatives such as real estate as well as three collectibles (specifically art, stamps, and wine) should also be considered in inflation resilient strategies. Collectibles, even if much harder to access for average retail and institutional investors, provided impressive returns during inflation with wine rising by as much as 7 per cent during inflation surges.

The below chart shows the average real annualised total return of asset classes during the eight US inflationary episodes studied*:

![Chart: Inflation winners and losers](chart.png)

But what about new asset classes like cryptocurrencies? Theoretically, cryptocurrencies have no direct link to any central bank’s monetary policy. For example, bitcoin’s money supply is algorithmically based and the last fraction of a bitcoin will be produced in 2140.

So, will cryptocurrencies provide a hedge? Empirically, we obviously have no data. Cryptocurrencies are yet to experience an inflation spike to be tested against. Quality data only exists from 2013 – well after the last inflation surge afflicted western markets. Second, many cryptocurrencies appear to behave like risk assets. For example, in Q1 2020, equities markets shed 34 per cent and bitcoin plummeted an even greater 51 per cent. As investors began returning to risky assets, the stock market moved sharply higher and so did bitcoin.
This analysis suggests that cryptocurrencies like bitcoin do not necessarily behave independently of the equity market. As such, the limited history suggests the volatile cryptos will be, at best, an unreliable inflation hedge.

Nonetheless, overall, the research is reassuring. We find that an upswing in inflation need not necessarily be catastrophic for a properly positioned portfolio. Of course, a likely rotation into defensive strategies could be impactful in its own right. As it stands the world’s top 20 asset owners, accounting for some $11tn in assets, have an aggregate allocation of 49 per cent to equity and 34 per cent to bonds. Their combined commodity weighting is less than 1 per cent.

That means if you are a 60-40 investor without a defence against inflation, you could potentially be caught out if you don’t move fast enough.

*Commodity price performance is derived from front-end futures contracts taken from the Man AHL database, while trend following performance is constructed from an in-house time-series momentum strategy applied to liquid futures and forwards (or proxies) across assets. For wine, we use the index constructed in Dimson, Rousseau and Spaenjers 2013 paper. For TIPS we use a back-cast constructed by Goldman Sachs. Equity is from Standard and Poor’s, while treasuries are from global financial database. All sector and style portfolios are from the Kenneth R. French database. All data is from 1926 to the present. US residential real-estate data is taken from the Case-Shiller US house price index.*