Best Strategies For Inflationary Times

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Summary

- Episodes of a high and rising inflation rate are mostly due to unexpected inflation shocks, and assets may reprice materially during such regimes.

- Unexpected inflation is bad news for traditional assets, the 60-40 equity-bond portfolio performed poorly during inflationary regimes, with a -6% real annualized return.

- Neither investment-grade nor high-yield corporate bonds came close to protecting purchasing power, with both having a -7% real annualized return during inflationary regimes.

- Futures trend (time-series momentum) performance is strong during inflationary periods.

- Treasury inflation-protected securities (TIPS) are robust when inflation rises, giving them the benefit of generating similar real returns in inflationary and noninflationary regimes.

Developed market investors have not had to deal with any sustained surge in inflation for 40 years. However, many economists, such as former Treasury Secretary Larry Summers, are now worried about the heightened risk of rising inflation caused by the massive fiscal stimulus provided by the governments of developed nations and the massive monetary stimulus provided by their central banks, especially given that we are already seeing signs of strong economic recoveries. Yet few investors have any experience addressing inflation concerns.
To provide some guidance to investors, Henry Neville, Teun Draisma, Ben Funnell, Campbell Harvey and Otto van Hemert, authors of the April 2021 study "The Best Strategies for Inflationary Times," analyzed both passive and active strategies across a variety of asset classes for the U.S., the U.K. and Japan over the past 95 years. They defined "inflationary regimes" as the times when headline year-over-year (YoY) inflation is accelerating, and when the level moves to 5 percent or more. Based on this definition, they identified 34 episodes from 1926 across the U.S., the U.K. and Japan and eight inflationary regimes. The eight regimes and the total price level changes were:


Following is a summary of their findings. As you consider them, keep in mind that their study is not about forecasting inflation. Instead, it is about providing evidence as to what might happen to the performance of a wide range of asset classes, as well as active strategies, if inflation does surge. Their long sample period is particularly important because inflation surges in developed economies have been rare in the past 40 years.
Episodes of a high and rising inflation rate are mostly due to unexpected inflation shocks, and assets may reprice materially during such regimes. Local inflation plays the most important role. For example, U.S. equities achieved 6 percent and 9 percent real annualized return in the U.K. and Japan inflationary periods compared to -7 percent in U.S. regimes - suggesting a diversification benefit.

Unexpected inflation is bad news for traditional assets, both nominal bonds (real returns were -5 percent) and equities (the nominal returns during inflationary periods were zero on average, with negative returns in 50 percent of the inflationary regimes), and the real return averaged -7 percent during inflationary times, with negative returns in 75 percent of the regimes. The 60-40 equity-bond portfolio performed poorly during inflationary regimes, with a -6 percent real annualized return.

Neither investment-grade nor high-yield corporate bonds came close to protecting purchasing power, with both having a -7 percent real annualized return during inflationary regimes.

During inflationary periods, equities suffer from the less stable economic climate - unexpected inflation could serve to increase risk premiums (increase discount rates), reducing equity prices - and costs tend to rise with inflation more than output prices.

No individual equity sector offers significant protection against high and rising inflation; even the energy sector was only slightly better than flat in real terms. Weak sectors included those with a high exposure to the individual consumer, such as durables (-15 percent), retail (-9 percent) and technology (-9 percent). Financials were also weak as default risk dominated the benefits of possible rising rates and because there can be a lag between an inflationary regime and central bank tightening.

Treasury inflation-protected securities (OTCPK:TIPS) are robust when inflation rises, giving them the benefit of generating similar real returns in inflationary and noninflationary regimes.

The best historical performance in inflationary periods was observed for commodities - commodities show much higher real returns during rising inflation environments than at other times, and they had a perfect track record of generating positive real returns during the eight regimes, averaging an annualized 14 percent real return - contrasting with normal periods when the commodity aggregate returns were low single digits.

Residential real estate holds its value during inflationary times (real returns were negative, but not of significant magnitude).

Futures trend (time-series momentum) performance is strong during inflationary periods, with U.S. regimes particularly relevant and the most pronounced effect when the U.S., the U.K. and Japan...
• Among the dynamic strategies, we find that trend following provides the most reliable protection during inflation shocks - inflation shocks tend to be prolonged episodes that play to the strength of trend strategies.

• Collectibles such as art, wine and stamps produced strong real returns during inflationary periods (although still weaker than commodities). Real annual returns were positive during inflationary episodes for art (7 percent), wine (5 percent) and stamps (9 percent). However, the extent to which these can form a sizeable part of institutional mandates is limited given liquidity constraints, and trading costs are high.

• Cross-sectional stock momentum was the best equity factor during the eight inflationary regimes, realizing an 8 percent annual real return versus 4 percent in normal times. However, skepticism is warranted due to a low t-statistic. Performance of the equity value factor has been mixed (real return of -1 percent), contrary to the belief held by some that it is robust during high and rising inflation. However, this was much better than the return of the market beta factor.

• The performance of the profitability factor was also mixed (real return of -1 percent).

• Smaller companies perform poorly in inflationary regimes. In real terms, the premium for being long small size and short large size was -4 percent a year in inflationary periods.

• The quality factor performed well in the inflation regimes (3 percent).

• The low beta factor performed poorly, with a real annual average return of -3 percent.

Takeaways

While many investors are worried about the risks of rising inflation, the markets are not predicting a sharp increase. For example, as of April 29, 2021, the spread between the yield on 10-year nominal Treasuries (1.66 percent) and the yield on 10-year TIPS (-0.78) was less than 2.5 percentage points. And the first quarter 2021 forecast from the Philadelphia Federal Reserve Survey of Professional Economists is for inflation for the next 10 years to average just 2.2 percent. However, sophisticated investors know that the right way to think about forecasts is to treat them only as the mean of a potentially wide dispersion of outcomes. Thus, investment strategies should incorporate the risks on either side of that mean. The study by Neville, Draaisma, Funnell, Harvey and van Hemert provided...
One way is to increase their allocation to some of the alternatives to traditional stocks and bonds. For example, there are two fixed-income interval funds for consideration as alternatives to equities: Cliffwater Corporate Lending Fund (CCLFX) and Stone Ridge Trust V Alternative Lending Risk Premium Fund (LENDX).

The focus of CCLFX is investments in privately placed senior secured middle market corporate debt with low loan-to-value (about 50 percent). All loans have floating rates, and most have floors for the base LIBOR (London Interbank Offered Rate). Currently, the fund has an expected return of about 7 percent - a 7 percent premium over T-bills - and has no inflation risk. That 7 percent return is similar to the expected returns on equities, though the fund has much less risk, about one quarter of the volatility of equities. And while there is economic cycle risk compared to safe bonds (such as Treasuries), that risk is a tradeoff for eliminating inflation risk and a large risk premium.

Similar to CCLFX, LENDX makes short to intermediate-term loans to consumers, small businesses and students who are considered to have prime credit. The current expected return is also about 7 percent. While the loans are fixed rate, they are also fully amortizing. And given the high yields, borrowers tend to prepay quickly. Thus, the fund typically has a duration of only about one year. As is the case with CCLFX, investors in LENDX take on increased economic cycle risk (relative to safe bonds) in return for a large premium and minimal inflation risk. For investors concerned about inflation, these seem to be prudent tradeoffs.

Other examples of funds that should be considered because they are not subject to inflation risk and their returns are also expected to be uncorrelated with those of traditional stocks and bonds are reinsurance funds, such as the Stone Ridge Trust II Reinsurance Risk Premium Interval Fund (SRRIX) and the Pioneer ILS Interval Fund (XILSX). These funds have equity-like expected returns that are uncorrelated with the returns to traditional stocks and bonds and are not exposed to the risk of rising inflation. In fact, recent losses have led to increased premiums, raising the expected returns to about 10 percent. Note that I personally have investments in each of these alternatives.
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Las Vegas Investor

Today, 1:26 PM

CCLFX, LENDX not available in Chase and Merrill Edge, and min. Purchase 1 M and 15M in Fidelity. Where can these funds be bought reasonably?

Drfr

Today, 11:41 AM

Larry,

Did you gain any insight in which period(s) were most profitable? I would assume most gains come during the period where rates are picking up speed (and so do extreme expectations and valuations). And when the novelty factor is gone returns cool off rapidly. Would be interesting if you found any trends in this.

Tnx...

Drfr

md10

Today, 10:15 AM

Quality factor should be good to go- high returns on invested capital imply pricing power which becomes more important during inflations, and there is lower default risk. Quality stocks do at least tolerably well in less inflationary scenarios, so they’re also not the kind of hedge that costs you heavily if the anticipated risk fails to materialize. Right now i don’t think they’re any more overvalued than the general equity market.

md10

Today, 10:05 AM

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https://seekingalpha.com/article/4432245-best-strategies-for-inflationary-times
adjustments to ensure profitability (adjust inventory strategies, get eventually an initially delayed capacity to raise prices, or whatever). so i think it might be best to lighten up when there are rising odds of an inflationary breakout (like now), while raising allocation to equities when there is more resolution, whether inflationary or not.

md10

gone with the winds are the eternal allocations to value and smallcap investing!

sumoman

Checked all the mutual funds that the author mentioned. None of them is available to an individual investor/nonprofessional DIY person. Yes, rising inflation- we like commodities and hold some COM. Also, PRTNX in the mutual funds space.

md10

@sumoman The bank loan funds may work- the credit quality is poor but the loans are supposedly inserted at the top of the line, so recovery rates are supposed to be good. The loans tend to be short term. Although i think there's a triggering level before they reset, they are floating rate. I'm not sure how impacted they are by the current penchant for watering down covenants. Gundlach has recommended them. They're available via etfs, available to the little guy. BKLN is one of the etfs. If a 10k investment makes a difference to you, I-bonds offer an attractive floating rate option. I buy them every year, so eventually you can build up a more sizable position if you are patient. I also have a pretty good slug of TIP. I exited the rest of the bond market as sound credits no longer preserved purchasing power, which is one thing other small investors can also do. I mean selling assets that do not do well in inflationary periods is something of a hedge. I don't always carry gold, but bought a gold etf, and XME, as well. The hyper regulated major bank stocks are probably safer than banks of yore, and have more back up from the fed than in the past, so default risk is not as high as in the past, allowing for their capacity to gain on spreads to shine (may not mimic poor past performances)...

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https://seekingalpha.com/article/4432245-best-strategies-for-inflationary-times
Your link to TIPS appears to be wrong, should it be TIP?

Dale Roberts

Good post, but many portfolio managers and research firms offer that resource stocks are some of the best inflation hedges ...

"No individual equity sector offers significant protection against high and rising inflation; even the energy sector was only slightly better than flat in real terms."

I'm surprised the author does not know this.

But ya, commodities. And commodities stocks.

Dale

md10

@Dale Roberts yeah and it occurred to me that if reinsurance centric funds are good, buying stock in reinsurance stocks should also be good.