Which Asset Classes Protect Against Inflation?
by Larry Swedroe, 4/25/22

After a multi-decade pause, the winds of inflation have picked up. Only Treasury Inflation-Protected Securities (TIPS) have been an effective hedge against inflation. Other asset classes have failed to varying degrees.

The unprecedented increase in money creation and extraordinary, expansionary fiscal spending around the globe, combined with the supply constraints from both COVID and the invasion of Ukraine, have led to heightened inflation risk. With this in mind, Eugene Podkaminer, Wylie Tollette and Laurence Siegel, authors of the study, “Protecting Portfolios Against Inflation,” published in the April 2022 issue of The Journal of Investing, examined the historical performance of various assets and liabilities in response to unexpected inflation. Following is a summary of their findings:

- Anticipated inflation (the inflation rate that is embedded in the yield of the bond when issued) should have no effect on nominal bonds. However, negative shocks (unexpected inflation) are bad for nominal-return bonds.

- The best hedge against inflation has been provided by TIPS. Their risk is from unanticipated fluctuations in the real rate. Unfortunately, their current real yields are negative, at least out to 10 years (as of April 11, 2022), and even out to 30 years, they are only about 0.25%. Thus, there is significant risk of real rates rising – for example, before the great financial crisis, at the start of 2007, the yield on five- to 20-year TIPS was about 2.5%.
• Cash has not been a reliable inflation hedge.

• Equity indexes, sometimes thought to be an inflation hedge, only “work” over a very long-term horizon – they are a negative hedge in shorter time frames, tending to fall when inflation rates rise.

• Although the relationship is not perfect, real estate has been a good hedge against inflation. In particular, residential real estate values tended to rise with incomes.

• Commodities are another traditional inflation hedge and were negatively correlated to growth assets (equities) but were extremely volatile. However, in the long run, commodity prices have risen much less than consumer prices – the very long-term trend of real commodity prices was down due to greater efficiency in both obtaining resources and using them. Thus, commodity allocations were a “dish best served sparingly.”

• The best hedge against inflation – admittedly imperfect – has been a diversified portfolio of real assets including TIPS, real estate, commodities used sparingly, and certain equities selected for their ability to pass through cost increases to consumers. International equities and debt may also be a hedge against domestic inflation due to the currency effect.

• Nominal liabilities, such as the obligation to pay off a fixed-rate bond or mortgage, or a pension with no cost-of-living adjustment, benefit from inflation – they cost less to pay off in real terms.

Regarding real estate as an inflation hedge, while commercial real estate replacement costs rise with inflation (impacting the valuation of the property), commercial real estate’s ability to provide a hedge against inflation is related to the length of leases. For example, hotels can raise prices daily; apartments typically have one-year leases; other commercial properties, such as office rentals, can have leases of 10 years or longer. The longer the lease, the less of an inflation hedge real estate provides.
Podkaminer, Tollette and Siegel’s findings are broadly consistent with those of Henry Neville, Teun Draaisma, Ben Funnel, Campbell Harvey and Otto Van Hemert, authors of the study, “The Best Strategies for Inflationary Times,” published in the August 2021 issue of *The Journal of Portfolio Management*. They analyzed the performance of a variety of asset classes for the United States, the United Kingdom and Japan since 1926 to determine which have historically tended to do well (or poorly) in environments when year-over-year (YoY) inflation was accelerating and when the level moved to 5% or more. Following is a summary of their findings for the U.S.:

- Both nominal bonds (the 10-year Treasury lost 5% per annum in real terms) and equities (which lost 7% per annum in real return and was negative in 75% of the periods) tended to do poorly. Consequently, the 60/40 equity/bond portfolio performed poorly during high inflationary regimes, with a -6% real annualized return.

- No individual equity sector offered 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%) and retail (-9%). Technology was also weak, at -9%. Financials were weak (-9%) because default risk dominated the benefits of possibly rising rates and because there can be a lag between an inflationary regime and central bank tightening.

- Both high yield (HY) and investment grade (IG) bonds lost an annualized 7% in real terms during high inflationary regimes – hedging HY and IG long positions with short government bond positions of similar duration did not provide inflation protection.

- Treasury inflation-protected securities (TIPS) returns have been robust when inflation rises – they provided similar positive real returns in inflationary and noninflationary regimes (today, TIPS (real) yields are negative up to approximately 10 years in maturity).
• Commodities provided the best historical performance, showing much higher real returns during rising inflationary environments – averaging an annualized 14% real return. In all other periods, the real return averaged 1% annually. Energy provided the highest real return (41% annualized), while gold and silver returned 13% and 12% annualized, respectively.

• Residential real estate underperformed during high inflationary regimes, losing 2% annually in real terms. It gained 2% annually during all other periods.

• Collectibles, such as art (7%), wine (5%) and stamps (9%), provided strong real returns during inflationary periods (although weaker than commodities). In all other periods, the real annualized returns were 2%, 6% and 3%, respectively.

• Among equity factors, cross-sectional stock momentum was the best performer during inflationary regimes, realizing an 8% annualized real return versus 4% in normal times. However, the difference was not statistically significant for this volatile, high-turnover strategy. The quality and investment factors also performed well during inflationary regimes, returning 3% and 2% annualized, respectively, in all regimes.

• Equity factors with negative real annualized returns during high inflationary regimes included profitability (-1%), value (-1%), low volatility (-3%) and size (-4%). Low beta stocks tend to be more bond-like, and thus their poor performance is not surprising.

• The time-series momentum (trend-following) strategy performed well during inflationary regimes, with the bond and commodity trend doing particularly well, as inflation shocks do not tend to be overnight affairs but rather prolonged episodes that play to the strength of trend strategies.

**Investor takeaways**

While many investors believe equities provide protection from inflation (a firm’s debt obligations are inflated away, and product prices may be adjusted to inflation), equities
have tended to suffer from a less stable economic climate (the rate at which future earnings are discounted rises, lowering valuations), and costs tended to rise with inflation more than output prices. In addition, despite the poor performance of equities in high and rising inflationary regimes, equities benefited from rising inflation when the starting level was below the median (when there was risk of deflation) but were hurt by rising inflation if the starting level was above the median (when there was increased risk of escalating inflation). However, today, we are certainly well above the historical median rate of inflation (about 3% since 1926).

Even if you are optimistic that the Federal Reserve can manage to lower inflation back to its target of 2% without having to drive up real interest rates to levels that would dampen demand sufficiently to cause a recession, the dispersion of possible outcomes you should consider should be wider than it was over the past two decades when inflation was very stable. Thus, it is time to review your asset allocation in the face of the heightened inflation risk. Forewarned is forearmed.

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