

RISING STARS

If inflation makes a comeback, who will make it to the top?

BY MICHAEL KEENAN

INFLATION, like politics or religion, seems to be one of those subjects where your age influences your opinion. I have no studies to back it up, but my casual observation is that older investment professionals get a lot more worried about inflation than younger investors. Inflation bears talk about things like commodity markets stretched tight as a drum, the turning of the deflation tide out of Asia, and central banks that focus on the price of everything except the stuff that is going up. Younger investors tend to get a bit bored about the whole thing. All they have ever known is Wal-Mart, “made in China,” and falling interest rates—not exactly the sort of experience that will breed the next generation of bond vigilantes. *Canadian Investment Review* is not an economic forecasting effort, so the intention here is not to side with one camp or the other. Our interests lie more in thinking out loud about the potential effects of inflation on investment portfolios.

STOCKS DON'T GET THE PART

On the asset side, the generalization is that you hold stocks for growth, bonds for stability and everything else for diversification. Stocks are typically held out as a reasonable inflation hedge in theory because the underlying net income of the corporate sector should rise with the general price level. Unfortunately, in practice, stocks failed their big audition during the 1970s as the combination of high starting valuations and underperforming economic fundamentals (perhaps brought about by the very same high inflation) produced negative real returns in most developed equity markets.

The picture is clearer with bonds—they are a bad inflation hedge both in theory and in practice. Inflation erodes the purchasing power of fixed coupon payments and rising interest rates negatively impact capital values. One implication of this is that a prolonged bout of

inflation would likely test the conviction of those funds that have implemented liability-driven investment (LDI)-based strategies recently.

At the heart of most LDI strategies is the notion of buying more bonds, either directly in the cash market or indirectly through the swap market. These strategies will underperform during inflationary periods, at least from an asset-only perspective. Funds will rightly be able to point to a similar underperformance of liabilities, but there will nonetheless be a nagging sense that the fund would have been better off with a little less matching.

NO LOVE FOR REAL RETURN

As far as the “everything else” part of the portfolio, many funds have carved out an explicit inflation bucket which would typically comprise assets like real estate, infrastructure, real return bonds and perhaps commodities. Of the lot, real return bonds are the truest hedge. They were explicitly designed to compensate the holder for inflation and only a default on the part of the issuer would compromise performance. Interestingly, they are also among the least loved instruments in the market.

They are a tough sell these days because the real yields have been hovering in the vicinity of 2% for most of this decade. While that is a somewhat uninspiring return, it does seem that there is a bit of “money illusion” out there—one regularly meets investors who wouldn't touch a real return bond with a bargepole but who nonetheless sit on pretty healthy allocations to nominal bonds.

Unless you think that the market systematically misprices break-even rates, then the problem of low real yields is a problem for all bonds, not just real return bonds. Rather, real return bonds put the bad news right in your face. It's the assessment of the reasonableness of the break-even rate that is the true “over-under” in the real-nominal decision and one can readily conjure up scenarios where current break-evens of 2% to 3% might seem pretty cheap.

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The development of inflation-linked bond markets has also enabled the market to put a few new tools in the investment tool-kit in the form of inflation-based derivatives. So, for instance, an investor can overlay a corporate bond portfolio with an inflation derivative, thereby continuing to capture the yield premium from the credit exposure while reducing the fund's exposure to unexpected inflation.

INFRASTRUCTURE: NO EASY HEDGE

Real estate and infrastructure are similar to stocks in that they should provide a good inflation hedge in theory but you cannot be sure what performance you will get in practice. The intuition is again that the net income of the assets will tend to adjust upwards with price increases in the general economy. Certain infrastructure assets get this bump automatically through a regulated process while real estate typically relies on a gradual market-driven catchup.

Like stocks, however, the process is uncertain and exposed to a variety of risk factors related to the business cycle, idiosyncratic market risks, as well as valuation. So, if the economy is in recession or a market is overbuilt such that your tenants can walk across the street to get the same space for a lower price, then the net income from your property is going down, whichever direction inflation happens to be moving.

Valuation risk seems particularly relevant in both markets today as both have enjoyed a very long bull run. So even if earnings growth at the asset level keeps up with inflation, you cannot rule out a stalemate from a total return perspective if valuations were to decline.

The appeal of commodities as an inflation hedge derives less from theory and more from practice. Real commodity prices have tended to decline over long stretches of history as technological advances push out supply curves and create alternative products (non-renewable is not the same thing as non-replaceable). However, unlike stocks, commodities did pass their one big audition in the 1970s. In fact, it may be that rising commodity prices are a powerful enough force that you are more likely to have

inflation problems when commodity markets are tight than when they are slack.

FACT OR FICTION?

Just how to position a fund for inflation comes down to opinion to some extent. And when faced with conflicting opinions, it's usually a good idea to confuse the issue with the facts—start doing some research. It's probably time to brush off and update work on the inflation hedging properties of traditional asset classes, and testing what data has developed on the newer alternative asset classes. Funds should start to think about how to measure and quantify their inflation exposure and become familiar with the potential use of new instruments to manage that exposure.

Canadian Investment Review is always interested in testing opinions and we are actively looking for research on these topics. In my view, it's probably time to start the discussion—if the spectre of inflation is indeed upon us, then it's time to map out some serious strategies to help us get through what could be our biggest inflation audition yet. ■