

# Managing Inflation Risk

**Inflation. Wage demands. Strikes. Elections. They've all been with us for a very long time, as this cartoon from 1959 reminds us. And inflation, very low for a long time now, has suddenly started to cast its ugly shadow again.**

As capital markets have improved, more investors have shifted their concern from weathering the financial crisis to anticipating the inflationary effects of rising government spending and debt. Many people are asking how they can prepare for potentially higher inflation. This article explores two basic ways to address inflation uncertainty and highlights asset groups that may prove useful.

As we consider strategies, remember the difference between expected and unexpected inflation. Asset prices already reflect the market's expectations about future inflation, given all available information. Inflation may turn out to be worse than expected, and this risk of unexpected inflation is what some investors may want to manage.



fixed income investors, and others who would experience a diminished living standard during an inflationary period. Such investors may be willing to forfeit long-term growth potential in the hope of immediate inflation protection.

In a total return strategy, an investor attempts to outpace inflation by holding assets that are expected to earn higher real (inflation-adjusted) returns. Such investors are willing to give up short-term inflation protection for an opportunity to grow real wealth. Younger investors are typically well suited for this strategy because they have many years until retirement and expect their earnings to advance faster than the inflation rate. As they save and invest for the future, they should be able to accept more risk through greater exposure to higher-return assets, such as shares.

## Hedging vs. Total Return Strategies

Investors can prepare for unexpected inflation by following one of two basic strategies—

**Hedging** the immediate effects of inflation – this involves trying to ensure that at all times, including in the short term, the value of one's investments (and maybe the income from them) keep pace with inflation;

**Total return** – taking a longer term view, that may see inflation beating returns in the short term, but that aims to outpace inflation over time.

Hedging involves choosing assets with values that tend to rise with inflation. Although holding these assets may reduce the total return of a portfolio, the positive correlation with inflation can help an investor keep up with rising consumer prices, at least over the short term. (Correlation refers to the co-movement of asset returns. When two assets are positively correlated, their returns tend to move together; when negatively correlated, their returns are dissimilar.)

Investors who may find hedging suitable include retirees,

To insulate a portfolio from unexpected inflation risk, both strategies may employ some combination of shares, short-term fixed income, and index-linked gilts. Let's consider each of these:

## Shares

Equity securities have, in general, provided a positive inflation-adjusted return over the long term. From 1956 through 2009, the total UK stock market return, as measured by the FTSE All-Share Index, outpaced inflation by an average of 6.44% per year<sup>1</sup>. But to achieve this higher real return in stocks an investor had to accept more risk, measured by greater volatility in returns, and endure periods when stocks did not outpace inflation. As a result, stocks may be less effective for hedging short-term inflation and more suitable for investors who want to beat long-term inflation by earning a higher total return. Some investors assume that high inflation leads to lower stock market performance, while low inflation fuels higher stock returns. In reality, inflation is just one of many factors driving stock performance. Market history shows that nominal annual stock returns are not normally related to inflation.

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### Fixed Income (Bonds)

Higher inflation can hurt bondholders in two ways—through falling bond market values triggered by rising interest rates, and through erosion in the real value of interest payments and principal at maturity. This inflation exposure tends to impact the prices of long-term bonds more than those of short-term bonds, and investors can usually mitigate the effects of rising interest rates by holding shorter-term instruments.

Many types of investors may benefit from holding short-term bonds. When interest rates are climbing, a portfolio with shorter-term maturities enables an investor to more frequently roll over principal at a higher interest rate. This can help inflation-sensitive investors keep up with short-term inflation and enable total return investors to reduce portfolio volatility, which can lead to higher compounded returns and growth of real wealth.

### Index Linked Gilts

Issued by the UK government, index-linked gilts are fixed income securities whose principal is adjusted to reflect changes in the General Index of Retail Prices in the UK (RPI). When the RPI rises, the principal increases, which results in higher interest payments. At maturity, an investor receives the greater of the inflation-adjusted or original principal. The inflation provision enables Index-Linked Gilts to preserve real purchasing power and hedge against unexpected inflation.

Index-linked gilts are generally a good short-term inflation hedge since principal is adjusted for changes in the RPI. They can also be a good portfolio diversifier for some long-

term investors due to their negative correlation with equities and relatively low correlation with most types of fixed income assets. Index-linked gilts were introduced in 1981, so these correlations are based on a relatively short sample period.

However, keep in mind that index-linked gilts prices have also been affected by changes in real interest rates, so Index-linked gilts may not track inflation one-to-one in the short term or even over longer periods of time. In fact, index-linked gilts can lose market value if real interest rates increase.

### Commodities

Commodity futures, as well as gold and oil, are perceived as effective inflation hedges because their returns are positively correlated with inflation. But commodities are often more volatile than shares, and their returns do not always rise with inflation because of this significant volatility. So adding these assets to a portfolio may increase real return volatility, which could offset the benefits of hedging.

Investors should also consider the economic argument against holding commodities. Unlike stocks, commodity futures do not generate earnings or create business value. They are essentially a speculative bet in which there is a winner and loser at the end of each trade. Moreover, a broad-based stock portfolio already has significant commodity exposure through ownership of companies involved in energy, mining, agriculture, natural resources, and refined products.

### Summary

While the media have featured divergent opinions and theories about the effects of recent government actions on inflation, no one really knows how consumer prices will respond to the complex forces at work in the economy and markets. Investors should carefully review their financial circumstances and investment goals before making changes to their portfolio. As you assess your exposure to a high-inflation scenario and form a strategy that reflects your financial goals and risk tolerance, you should consider the following main points.

- *Expected inflation is built into asset prices.* In our view, markets efficiently integrate all known information into prices. Thus, current prices already reflect expectations of future inflation. Only unexpected news will affect the inflation outlook.
- *Hedging unexpected inflation has a cost.* Investments traditionally regarded as effective short-term inflation hedges have lower historical returns than stocks—and some have much higher volatility.
- *Volatility matters.* Evaluating assets solely on their ability to track inflation disregards the effect of volatility on returns and risk. Some assets that are positively correlated with inflation have large return variances, and adding these to a stock and bond portfolio may increase overall volatility.

**Even with the prospect for higher inflation, investors who take a total return approach may be better served than those who choose assets based on correlation with the RPI. By choosing assets with higher expected long-term returns and maintaining broad diversification, investors can seek to grow real wealth and preserve the purchasing power of their wealth.**

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## Endnotes

<sup>i</sup> Real return calculation: Annualised total return (net-dividends re-invested) of FTSE All-Share Index, minus the annualised rate of change in the Retail Price Index (RPI) between January 1956 and December 2009.

## Disclosures

Inflation is typically defined as the RPI which measures the average change from month to month in the prices of goods and services purchased by most households in the United Kingdom, using a large and representative selection of goods and services for which price movements are regularly measured around the United Kingdom. RPI data is available from the Office for National Statistics (ONS).

Equity, also known as shares, is the capital raised by a corporation through the issue of shares entitling holders to an ownership interest of the corporation. Gilt-Edged Securities or 'Gilts' are negotiable debt issued by the United Kingdom Treasury; they are backed by the government's full faith and credit and are exempt from Capital Gains Taxes (CGT).

The indices quoted are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results, and there is always the risk that an investor may lose money.

Diversification neither assures a profit nor guarantees against loss in a declining market.

Thanks to the British Cartoon Archive at the University of Kent for the Cummings cartoon.

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